Financial and Fiscal Commission

Submission on the 2016 Medium Term Budget Policy Statement

For an Equitable Sharing of National Revenue

02 November 2016

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List of Acronyms

AIDS	Acquired Immunodeficiency Syndrome
CIT	Corporate Income Tax
FTE	Full Time Equivalent
GDP	Gross domestic product
HIV	Human Immunodeficiency Virus
HSDG	Human Settlements Development Grants
IMF	International Monetary Fund
INEP	Integrated National Electrification Programme
LGES	Local Government Equitable Share
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDP	National Development Plan
NHI	National Health Insurance
NSFAS	National Student Financial Aid Scheme
NSNP	National School Nutrition Programme
OECD	Organisation for Economic Co-operation and Development
PES	Provincial Equitable Share
PFMA	Public Finance Management Act
PEP	Public Employment Programme
PetroSA	Petrol South Africa
PIT	Personal Income Tax
PSET	Post School Education and Training
SAA	South African Airways
SARB	South African Reserve Bank
SAPO	South African Post Office
SANRAL	South African National Roads Agency Limited
SME	Small to Medium Enterprises
SOE	State Owned Enterprise
TB	Tuberculosis
TVET	Technical Vocational Education and Training
USDG	Urban Settlements Development Grant
U&U	Unforeseen and Unavoidable
WEO	World Economic Outlook
VAT	Value-Added Tax

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1. Background

1.1. This Submission on the 2016 Medium Term Budget Policy Statement (MTBPS) is made in terms of Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (2009), which requires committees of Parliament to consider recommendations by the Financial and Fiscal Commission (the Commission) when dealing with money bills and related matters. The Submission is also made in terms of Part 1 (3) {1} of the Financial and Fiscal Commission Act (2003) as amended, which provides for the Commission to act as a consultative body for, and to make recommendations to, organs of state in the national, provincial and local spheres of government on financial and fiscal matters.

1.2. The 2016 submission on the MTBPS is divided into following sections:

- Economic outlook and overview of public finances
- Fiscal framework and revenue proposals
- Review of actual spending by national departments and provincial government (1 April-30 September 2016)
- Local Government issues
- Revised division of revenue, 2016/17 and
- Conclusion

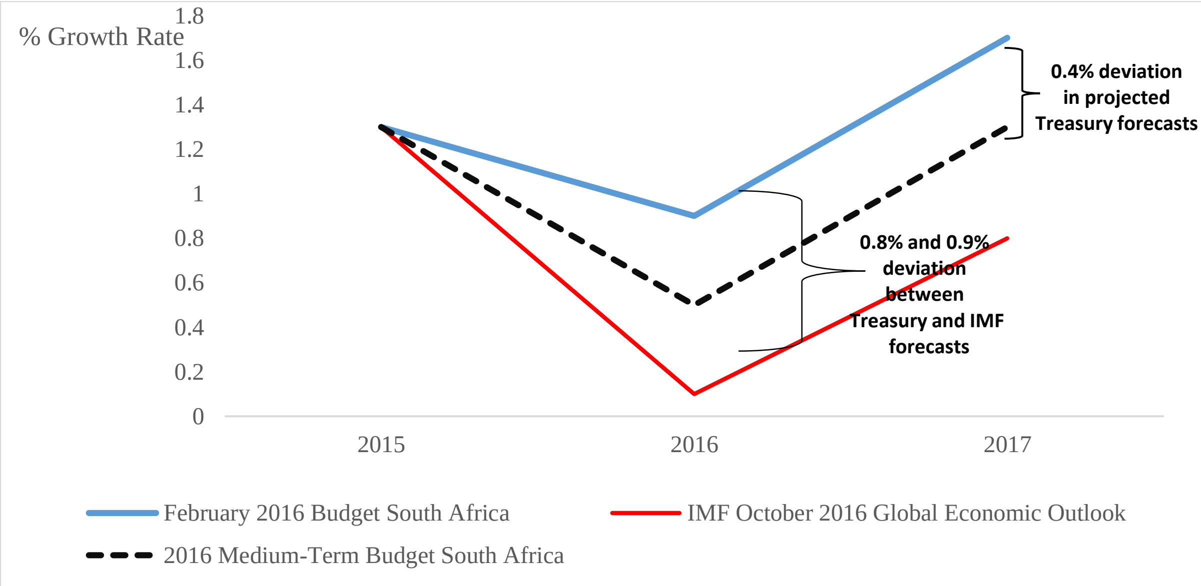
2. Economic Outlook and Public Finances Overview

Economic Growth and Employment

2.1. Based on expectations of an upturn in global trade and investment, reduced infrastructure constraints and recovering consumer and business confidence, the 2016 Budget presented in February projected that gross domestic product (GDP) will grow by 0.9 percent in 2016, eventually rising to 1.7 percent by the 2017/18 financial year. In line with recent assessments of the global economic outlook, South Africa's growth forecast has been revised downwards. Both National Treasury and the International Monetary Fund (IMF) project South Africa's growth to be less than 1.5 percent in both 2016 and 2017. As shown in Figure 1, this downward revision translates to growth in 2016 and 2017 that is

0.4 lower (or 0.8 percent and 0.9 percent lower as per IMF forecasts) than at the time of the 2016 Budget announcement.

Figure 1. Actual and projected growth in GDP, 2015-2017

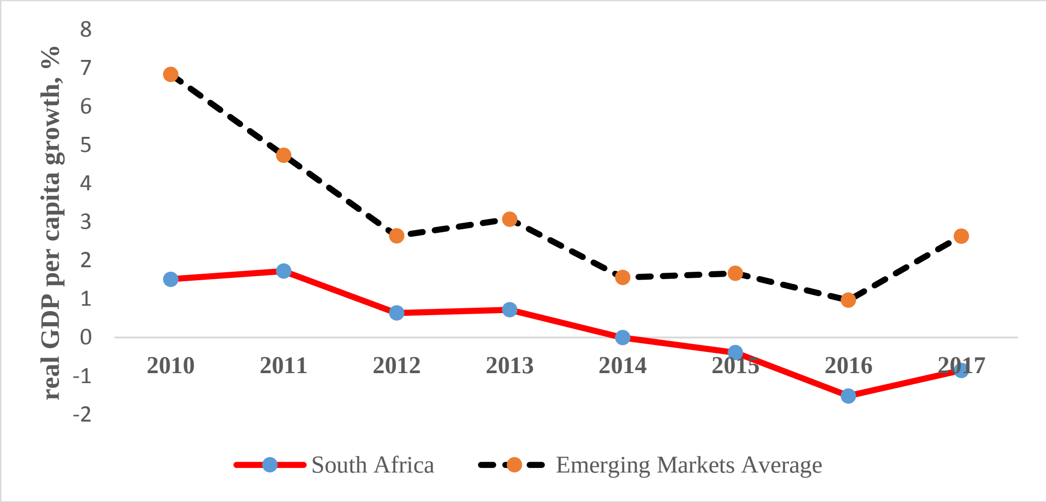


Sources: National Treasury 2016 Budget Review; 2016 World Economic Outlook (WEO).

2.2. In 2011, the Commission's GDP simulations predicated that under a severe scenario of protracted slow global growth that results in a sustained period of constrained public budgets, South Africa's GDP will not recover to its pre-2008 levels without shocks and deliberate interventions to counteract the negative impacts of the world economic crisis. The predicted slowdown mirrors the Commission's simulations then under the severe scenario and highlights subdued and fragile global economic growth stemming from ongoing realignments within economically advanced countries, as well as constraints imposed by domestic factors.

2.2.1. Figure 2 shows that South Africa's growth continues to underperform peer countries such as Brazil, Chile, Indonesia, India and Malaysia where strengthening private and public consumption, a scaling-up of public investment and increased focus on diversification to sectors such as tourism and knowledge economy, have ensured that effects of a weak global economy are largely offset by robust domestic demand.

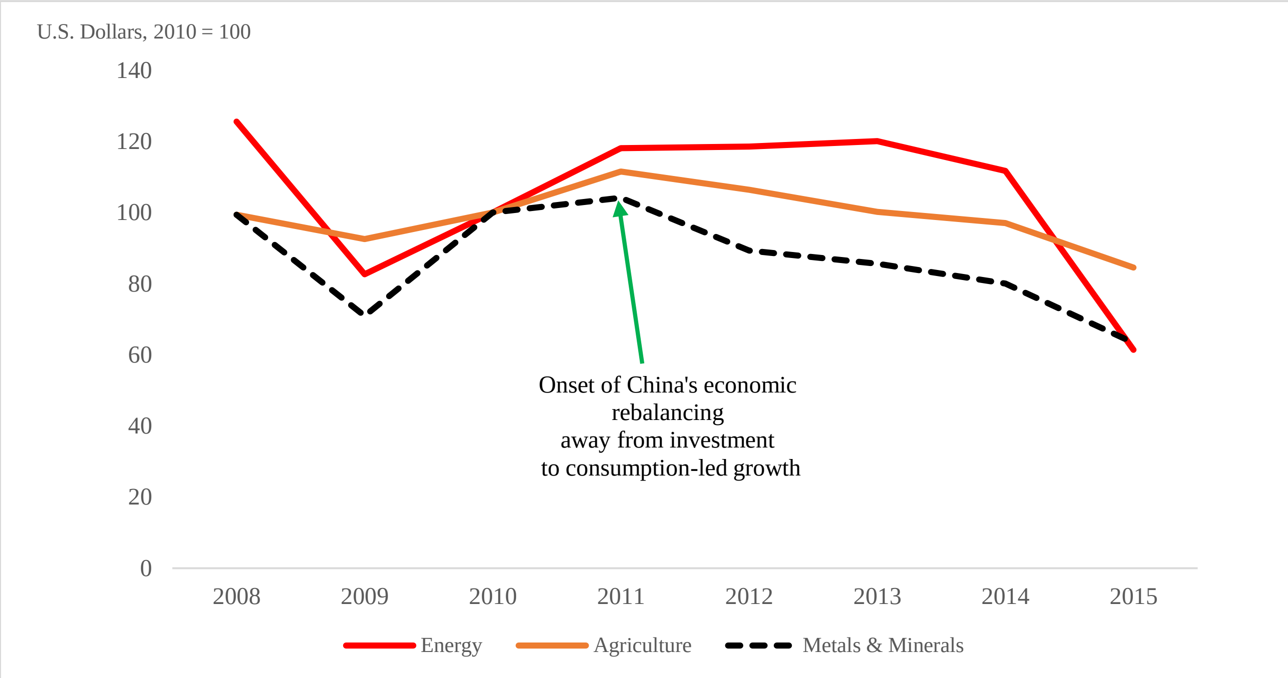
Figure 2. Real GDP per capita growth for South Africa and emerging markets, 2010-2017



Source: World Economic Outlook Database

2.2.2. The past decade has seen rising trade linkages and reliance on the Chinese market. China accounts for almost 13 percent of South Africa's exports, and more importantly, is a key driver of global demand for commodity exports. With commodity and manufactured goods accounting for over 50 percent of total exports to China, that country's current transition from investment to consumption-led growth has exerted a significant toll on South Africa's economy. With Chinese investment activity more import-intensive and commodity-reliant, the slowdown in investments have contributed to a deceleration in Chinese import growth which fell by 8 percentage points between 2013 and 2015. China's reduced demand for metals coupled with the urgent need to address problems of overcapacity stemming from excessive expansion in sectors such as steel and cement continue to depress global commodity prices (see Figure 3). This has created significant spillovers into the South African economy, with the impact of lower commodity prices amplified by sectoral interlinkages that have adversely impacted corporate profitability and employment within the country's non-mining sectors.

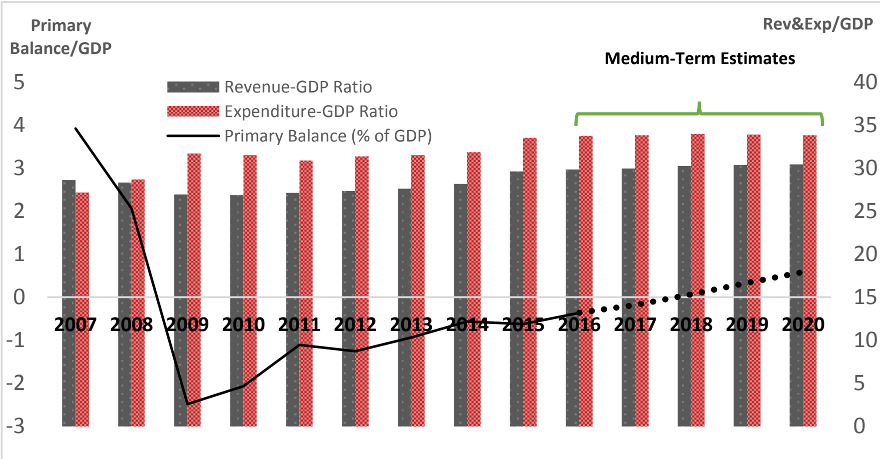
Figure 3. International commodity prices, 2008-2015



Source: World Bank Commodities Market Outlook (2016)

2.3. In line with expenditure ceilings introduced in 2012, the national budget framework implemented since 2015 has been anchored on attaining fiscal consolidation through a combination of spending reductions and tax increases. Measures aimed at slowing public sector hiring, improving spending efficiency and enhancing effectiveness of procurement processes in limiting wasteful expenditure have ensured that since 2014, the share of total government spending in GDP has stabilized to 34 percent. Figure 4 shows that over the medium term, further strengthening of consolidation efforts is expected to impact positively on the primary balance – the difference between current revenue and non-interest expenditure.

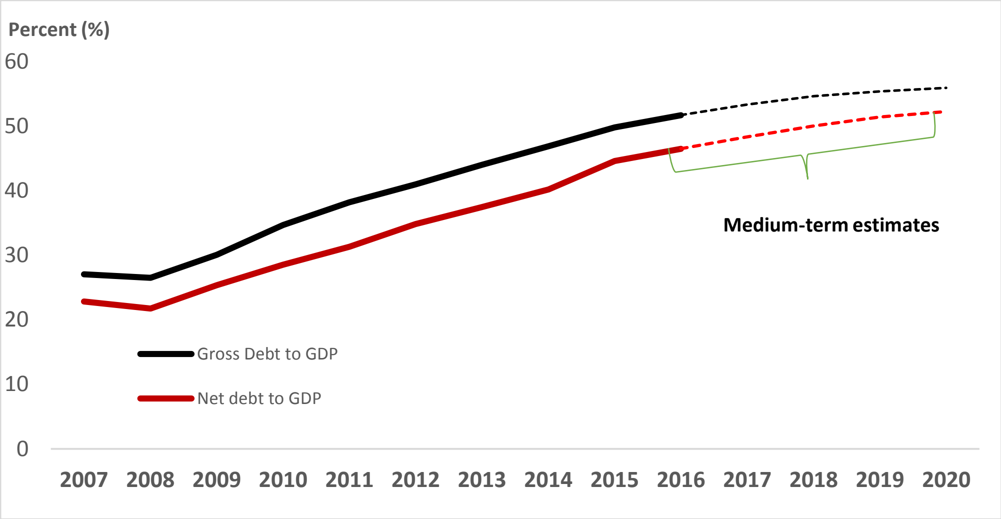
Figure 4. Shares of government budget and primary balance in GDP, 2007-2020



Source: SARB Database, National Treasury MTBPS (2016) and WEO Database

2.3.1. While ongoing fiscal consolidation efforts could boost investor and business confidence, a scenario in which South Africa's low-growth environment is sustained over the long-term would present significant risks to efforts to contain public debt and reduce budget deficits. Over the medium-term, tax revenues will be negatively affected by weak growth. South Africa's wage bill as a share of GDP remains one of the highest among its emerging market peers. With the burden of addressing most of the vulnerabilities and structural obstacles faced by the economy being heavily shouldered by the fiscal policy, the combined effects of continued realization of low economic growth may result in debt stabilising at higher than anticipated level. The medium-term budget already recognizes this risk with lower nominal GDP, higher borrowing costs and currency depreciation contributing to an upward revision in medium term estimates of the debt-to-GDP ratio (see Figure 5).

Figure 5. National debt outlook, 2007-2020



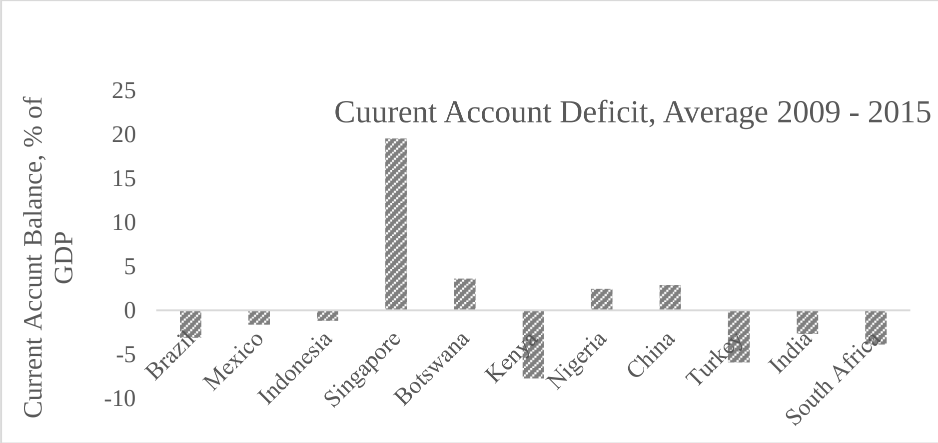
Source: *National Treasury MTBPS (2016) and WEO Database*

2.3.2. Despite South Africa's low-growth conditions, revenue buoyancy – the relationship between tax collection and economic growth, has remained relatively high and averaged 1.2 percent since 2011. The relatively strong performance of tax collection reflects gains from the 2015 wage settlement, impact of exchange rate depreciation on asset prices and higher import values feeding into increased excise tax revenues. Ongoing fiscal consolidation aimed at curbing the wage bill coupled with low-growth conditions that constrain productive spending could pose a significant risk to growth in tax collections relative to economic growth. Revenue buoyancy has also been assisted by the performance of the financial sector which accounts for around half of personal income tax and about a third of corporate income tax. Protracted slowdowns in both domestic and global economies coupled with external shocks that amplify financial market volatility, could adversely impact on overall revenues.

2.4. For the first time, the medium-term budget was tabled with a Risk Report that outlines an assessment of risks that can impact the achievement of Government's macroeconomic goals, as well as a framework for responding to identified risks. The Commission welcomes the introduction of this report as it resonates with previous recommendations on the need to establish a sound framework to enhance discussions around different fiscal options for addressing South Africa's economic challenges. While the report is detailed in its assessment, areas around policy risks would need to be strengthened through an assessment of *implementation risks.* Structural reforms included as part of the ongoing fiscal consolidation strategy have highlighted the need to free up resources through initiatives that aid consolidation efforts without adversely impacting service delivery. Uncertainty around the implementation of initiatives such as the proposed sale of non-core assets have an impact on how Government's commitment to its plans to reduce debt levels and contribute to growth is viewed by investors and markets. Inclusion of potential implementation risks and efforts to address such would contribute to enhancing the risk framework.

2.5. South Africa's current account deficit (at 4.3 percent of GDP) remains among the highest in emerging markets (see Figure 6). The country's high current account financing needs are thus vulnerable to the slow pace of adjustment imposed by structural bottlenecks and the low responsiveness of export volumes to a lower Rand exchange rate against major global currencies. Despite a strengthening job market, subdued wage growth and consumer price inflation along with concerns about the pace of global economic recovery, have prompted the U.S. Federal Reserve to adopt a policy of gradual, future hikes in interest rates. However, a more rapid-than-expected shift from current accommodative monetary policy or increased global risk aversion carry the risk of reduced capital inflows, Rand depreciation against the U.S. dollar and rising financial volatility. With American investors accounting for almost half of South Africa's portfolio liabilities, sharp global financial tightening stemming from a change in the gradual normalization of U.S. monetary policy would increase South Africa's debt-service burdens and debt-rollover risks over the short to medium term period.

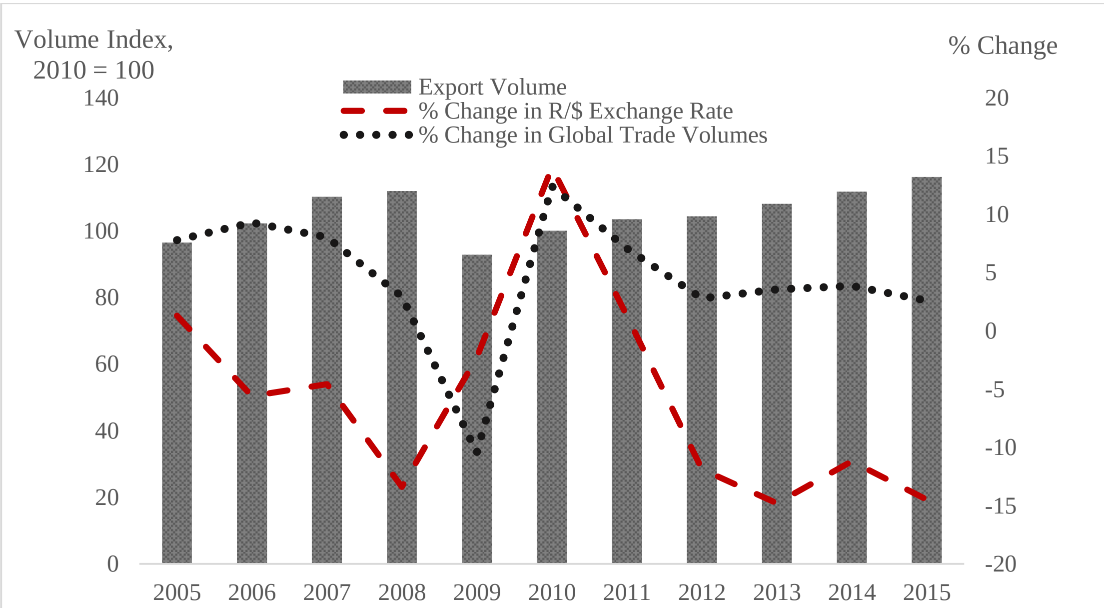
Figure 6. Current account deficit - SA and other emerging economies, 2010-2017



Source: WEO Database and SARB Statistical Database

2.5.1. A significant share of South Africa's exports serve the advanced economies of China, the United States and the European region. Despite a notable depreciation in the Rand/U.S. Dollar exchange rate, the responsiveness of exports has remained weaker amid subdued activity in global trade (see Figure 7).

Figure 7. Trade volume and Rand/US dollar exchange rate, 2005-2015



Source: South African Reserve Bank and World Bank

2.5.2. The large and persistent current account deficit has consequently increased external debt. According to the September-2016 South African Reserve Bank

Quarterly Bulletin, South Africa's external debt as a ratio of annualised GDP increased from 39.4 percent in December 2015 to a record high of 43.6 percent in March 2016, translating to an average of 40.4 percent between 2014 and 2015. The current account deficit has also contributed to relatively large annual gross external financing requirements, which stood at about 19 percent of GDP as of September 2015. The main concern is the financing of the current account deficit which has now shifted from portfolio and direct investment flows to other investment flows and unrecorded transactions. The shift is attributable to a rise in outward foreign direct investment by South African companies and a moderation in net portfolio flows amid a significant decline in portfolio debt flows. Other investment flows comprise primarily bank loans and deposit flows, with the remainder balance corresponding to financial derivatives, trade credit, and other net receivables.

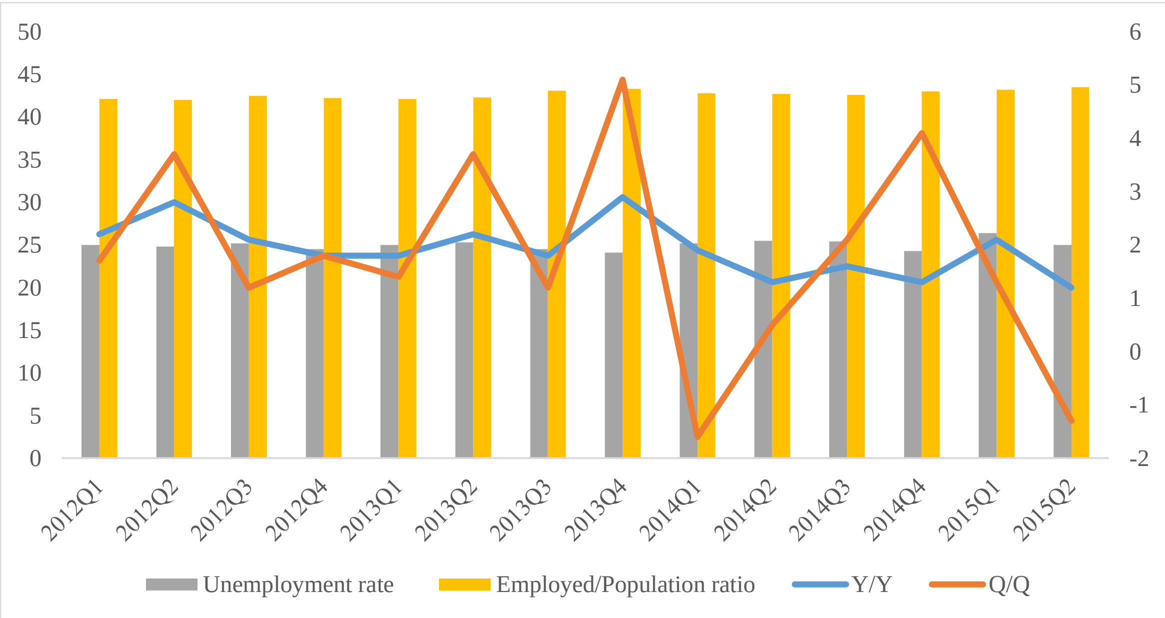
2.5.3. The outlook for net foreign direct investment flows is largely negative given that South African companies continue to pursue opportunities externally due to muted domestic growth as well as lower and more volatile portfolio flows as a result of the U.S. monetary policy normalisation. In this context, the cost of capital is likely to increase and other investment flows are more likely to be the main source of external financing in the coming years. Capital outflows would affect the economy through various channels such as depreciation of the Rand, an increase in the interest cost of debt, and a decline in local asset prices (bonds and equity) with negative wealth effects.

2.5.4. A large capital outflow shock is likely to diminish growth through severe import contraction and a sudden widening of the current account deficit. A larger than expected depreciation of the Rand, on the other hand, could ultimately raise inflation, triggering the tightening of monetary policy through interest rates hikes, which would in turn hurt growth. Eventually, higher interest rates and slower growth would likely increase non-performing loans and reduce banks' profitability. This would in turn have a significant negative impact on fiscal revenue because a large share of income tax revenue stems from the financial sector. The large size of South Africa's domestic financial sector would likely allow the Government to secure the necessary financing in the domestic market. However, the resultant portfolio rebalancing by domestic financial institutions may trigger a further decline in equity prices, an increase in interest rates, and crowding out of private sector lending, placing further downward pressure on growth.

2.5.5. The difficult external and global trade environment have interacted with difficult domestic political conditions which have heightened policy uncertainty and adjustments to declining terms of trade. This is reflected in weakening investor confidence and raised possibility of South Africa's sovereign credit rating being downgraded to speculative grade. Such a possibility poses considerable risks to an economy battling declining commodity prices, as well as ongoing efforts to improve growth prospects and manage fiscal risks.

2.6. Figure 8 shows a relatively flat employment/population ratio against a stubbornly high unemployment rate in the face of sluggish growth between 2012 and 2015.

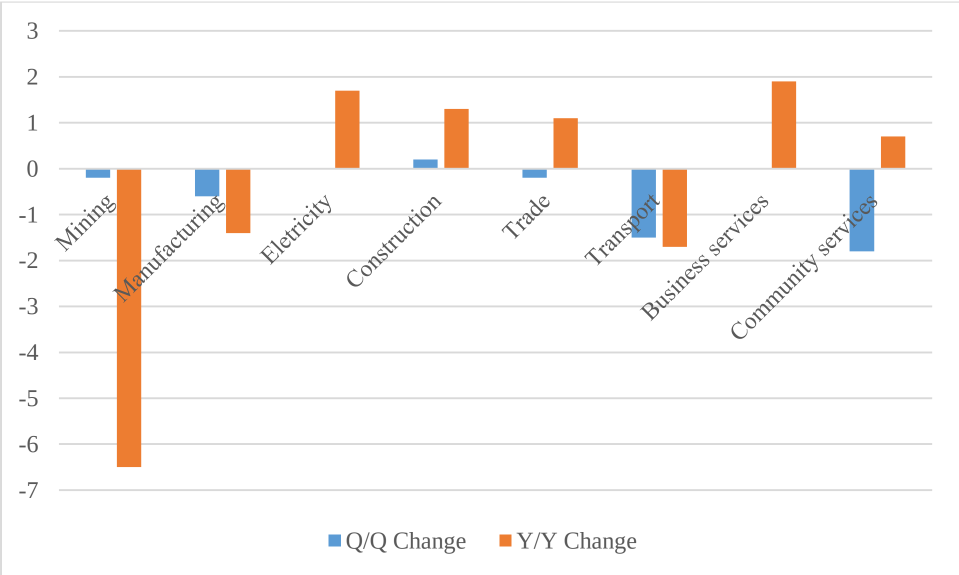
Figure 8. Unemployment and employment rate and GDP growth, 2012-2015



Source: Statistics South Africa.

2.7. While growth remains weak, 2016 could be the trough of the business cycle in South Africa, as a recovery is expected to commence from 2017 translating into some improvements in both the employment and unemployment figures[1]. Notwithstanding this optimistic outlook, labour market conditions remain very challenging. The sluggish employment growth since the global financial crisis has now turned into job losses in almost all sectors of the economy. Figure 9 below shows that almost all the sectors recorded negative employment growth quarter-on-quarter between June 2016 and March 2016: community services (-1.8 percent); manufacturing (-0.6 percent); transport (-1.5 percent); trade (-0.2 percent); mining and quarrying (-0.2 percent) and business services (-0.01 percent). The only positive employment growth was recorded by the construction sector (+0.2 percent). Employment declines were recorded both quarter-quarter and year-on year in manufacturing and transport sectors.

Figure 9. Changes in employment by sector, June 2015-March 2016



Source: Statistics South Africa Quarterly Employment Statistics (June 2016)

2.7.1. The unemployment rate has also remained high. According to the Labour Market Dynamics survey by Statistics South Africa, long-term trends of unemployment show that in 2015, the expanded unemployment rate was 5.1 percentage points higher than the 2008 rate. While the absorption rate increased above its lowest ever level (of 41.8 percent in 2010), this rate, at 43.7

[1] See World Bank Macro Poverty Outlook for South Africa, October 2016 available at http://documents.worldbank.org/curated/en/125721475867577104/pdf/108892-WP-PUBLIC-Macro-Poverty-Outlook-for-South-Africa.pdf

percent in 2015, is still below the rate for 2008 of 45.9 percent. The labour force participation rate was 58.5 percent in 2015 but still below its highest recorded for 2008 (which stood at 59.3 percent). These persistently high unemployment rates and the lack of job opportunities, has led to very long unemployment spells, for instance, in 2015, 57 percent of the unemployed in South Africa had been out of a job for a year or more.

2.7.2. Young people who are neither employed nor in education or training risk being left permanently behind in the labour market. This risk is especially high for the relatively large share of low-skilled young people. Effective policies are needed to reconnect members of this group with the labour market and improve their career prospects.

2.7.3. The stubbornly high unemployment rate reflects that the job creating capacity of the economy is not sufficient to absorb an expanding labour force, which is the result of population growth and partly immigration. Improved education and training remain critical to promote growth and employment in the private sector. Job creation, especially in small medium enterprises (SMEs), which are more labour intensive and hire a relatively high share of low-skilled workers, is the best way to ensure a sustainable reduction in inequality. These reforms will lower business costs, increase efficiency, boost employment and savings, and reduce the external gap, making the economy more resilient.

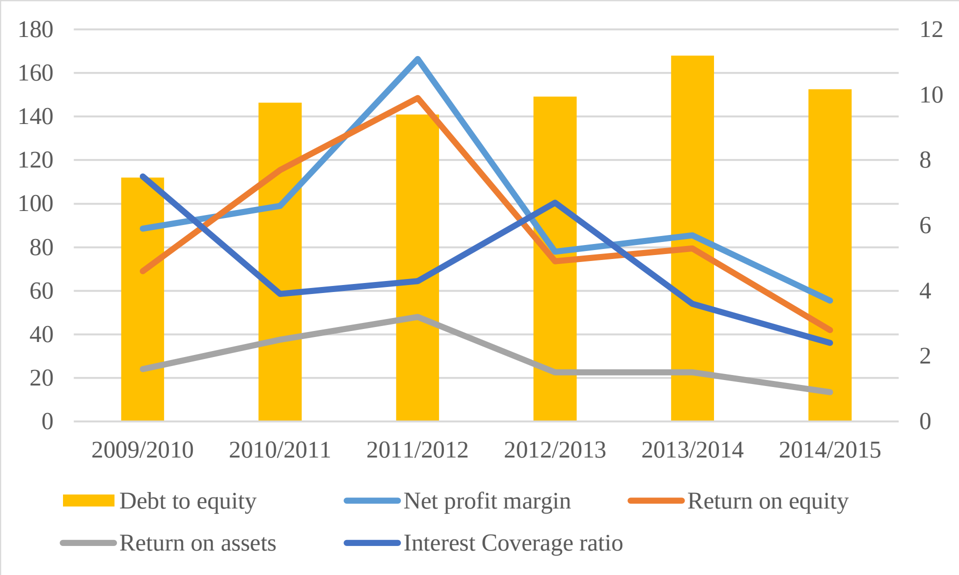
2.8. Strengthening governance and private participation in state-owned enterprises (SOEs) is vital in improving their performance, public service delivery, protecting the poor and reducing contingent liabilities. Substantial contingent liabilities emanating from financially-weak SOEs dependent on government guarantees increases vulnerabilities and fiscal risks.

2.9. Government is continuously monitoring the financial position of SOEs through a formal fiscal risk mechanism, and contingent liabilities are reported in the annual Budget. The 2016 Budget outlines four areas of reform that are intended to strengthen the ability of SOEs to support the National Development Plan (NDP): financial and operational stabilization, coordination and collaboration among different entities, rationalization and consolidation, and the enactment of a new governance framework. Government also monitors fiscal risks associated with SOEs on an on-going basis. Additional broad areas of reform encompass exploring ways to stabilize SOEs' financial performance, quantifying the cost of developmental activities, improving transparency and governance by benchmarking boards' and executives' performance and compensation where appropriate.

2.10. Notwithstanding these noble initiatives, PetroSA, South African Airways (SAA), the South African Post Office (SAPO), Eskom and The South African National Roads Agency Ltd (SANRAL) are hamstrung by inefficient operations, poor governance, and weak balance sheets, highlighting the need for more comprehensive and extensive reforms in order to ensure that they deliver essential economic and social services that will enhance growth and the fiscal outcomes. Given their strategic position in network industries and their role in carrying out the government's infrastructure build program, SOEs play an important role in the economy, particularly in enabling the environment for the private sector investment.

2.11. While some SOEs such as Transnet are performing well, the financial performance of most SOEs has deteriorated. In particular, their measures of profitability and leverage have worsened. This means any shocks to borrowing costs and earnings could undermine their ability to service debt and require government intervention. For instance, PetroSA, SAA and SAPO are recording losses and their dependence on government guarantees has increased to R553 billion or 14 percent of GDP in 2015/16 from R177 billion or 8 percent of GDP in 2007/08. Figure 10 shows SOE performance for the period between 2009 and 2015.

Figure 10. State owned enterprise performance, 2009/10-2014/15[2]



Source: National Treasury and own calculations

2.12. The tight fiscal position necessitates structural reforms that are firmly premised on political will and aimed at rollout of broad-band networks. The strengthening the governance of SOEs remains critical during the medium-term. The current challenges faced by most SOEs require comprehensive reforms. A robust governance framework, encompassing transparency in board appointments and remuneration policies, and stronger accountability are crucial in enhancing efficiencies and aligning incentives with national priorities. Fostering private competition in some sectors, partial stock market listings, establishing management contracts and effective regulation could greatly enhance efficiencies and service delivery. Clarifying mandates for SOE such that the cost of potential conflicts between commercial and developmental mandates are quantifiable, would enable benchmarking performance and increase accountability.

3. Fiscal Frameworks and Revenue Proposals

Overview of the Fiscal Framework

3.1. The medium-term estimates are presented under a depressed macroeconomic outlook with projected weaker revenue and higher debt service costs. This situation imposes

[2] Major state-owned enterprises listed in Schedule 2 of the PFMA, excluding development finance institutions

constraints on the broader fiscal framework. Table 1 outlines the proposed fiscal framework for the 2017 Medium-Term Expenditure Framework (MTEF) period. In total, Government is expected to spend R4.584 trillion over the three years relative to a revenue envelope of R4.091 trillion. Over the 2017 MTEF, expenditure is projected to increase by a real annual average of 2 percent per annum. Relatively stronger real annual average growth of 2.9 percent is projected in respect of revenue over the 2017 MTEF period. The bulk of resources are allocated in respect of non-interest allocations in the form of equitable share and conditional grant funding. The key components of the fiscal framework are discussed in greater detail below.

Table 1. Consolidated fiscal framework, 2013/14-2019/20

	2013/14	2014/15	2015/16	2016/17		2017/18	2018/19	2019/20
R billion/Percentage of GDP	**Outcome**			**Budget**	**Revised**	**Medium-term estimates**		
Main budget								
Revenue	**887**	**965**	**1 075**	**1 162**	**1 144**	**1 249**	**1 360**	**1 482**
Expenditure	**1 048**	**1 132**	**1 245**	**1 318**	**1 309**	**1 410**	**1 522**	**1 652**
of which								
Non-interest allocations	*947*	*1 017*	*1 116*	*1 165*	*1 161*	*1 240*	*1 331*	*1 435*
Debt-service costs	*101*	*115*	*129*	*148*	*148*	*164*	*181*	*197*
Contingency reserve	*0*	*0*	*0*	*6*	*0*	*6*	*10*	*20*
Main budget balance	**-160**	**-166**	**-169**	**-156**	**-165**	**-161**	**-162**	**-170**
	-4.4%	*-4.3%*	*-4.1%*	*-3.6%*	*-3.8%*	*-3.4%*	*-3.2%*	*-3.1%*
Primary balance	**-59.2**	**-51.6**	**-40.6**	**-8.6**	**-17.3**	**2.7**	**18.5**	**27.6**
	-1.6%	*-1.3%*	*-1.0%*	*-0.2%*	*-0.4%*	*0.1%*	*0.4%*	*0.5%*
Budget balances of social security funds, public entities and provinces	25	29	17	17	15	14	24	31
Consolidated budget balance	**-136**	**-137**	**-152**	**-139**	**-150**	**-147**	**-138**	**-139**
	-3.7%	*-3.6%*	*-3.7%*	*-3.2%*	*-3.4%*	*-3.1%*	*-2.7%*	*-2.5%*

Source: MTBPS, 2016.

3.2. Table 2 summarises the division of non-interest allocations amongst the three spheres of Government. After accounting for national debt, there are estimated receipts of R1.240 trillion to share amongst the three spheres in the 2017/18 financial year. The budget available for sharing is projected to increase to R1.331 trillion in the 2018/19 financial year and R1.435 trillion in the outer year.

3.3. Over the 2017 MTEF period, the division of revenue amongst the three spheres will generally be characterised by low growth increases with a total real annual average growth of 1.2 percent being projected. Over the medium term, the main driver of this growth will be allocations to the local government sphere (projected to grow by a real annual average of 2 percent) and, to a lesser extent, provincial allocations which are set to grow by 1.4 percent per annum in real terms. As noted in MTBPS 2016, allocations to these two spheres have been prioritised due to the importance attached to the provision of education, health and basic services such as electricity, water and sanitation and refuse removal.

3.4. In terms of the proportion of total revenue allocated to the three spheres, relative to 2016/17, the share allocated to the national sphere declines from 48.0 percent to 47.5 percent. The shares allocated to the provincial and local spheres increase from 43 percent and 9 percent to 43.4 percent and 9.1 percent respectively. There are no radical changes to this proportional allocation over the two outer years of the 2017 MTEF period. If one compares the proportional allocation to the three spheres to the allocation as at 2013/14, the proportion allocated to the local government sphere is the one that shows significant change – from 8.7 percent in 2013/14 to a projected 9.1 percent in 2017/18. Given the critical role the local government sphere plays in the delivery of basic services to poor households, the priority afforded to this sphere of government is welcomed.

3.5. Of the total allocation to provinces, 82 percent is in respect of the provincial equitable share (PES) and 18 percent is towards provincial conditional grants. Over the entire period reviewed this proportional allocation between these items remains constant. In terms of the real growth in the allocations to provinces, provincial conditional grants are projected to grow more rapidly (2.5 percent) relative to growth in the PES (1.2 percent) over the 2017 MTEF period. The Commission notes the growth in conditional grants and would caution Government against allowing growth in conditional grants to consistently outpace growth in the PES. As far back as 2000, the Commission noted that whilst conditional grants can be an effective avenue through which much needed funding can be channelled to subnational spheres, there are definite drawbacks to excessive growth in these types of grants. This includes the fact that in a decentralised system, excessive use of these fiscal levers can dilute the autonomy of subnational governments and that through utilising them, national departments can unduly influence the priorities of provincial and local governments.

3.5.1. Key changes to provincial conditional grants relate to baseline reductions to a number of the larger grants. Reductions to these grants are due to the need to free up resources to support new priorities whilst still remaining within the expenditure ceiling set by Government. In total the reductions amount to R6.4 billion over the 2017 MTEF period and will affect the Education Infrastructure grant, the Human Settlements grant and the Comprehensive Agriculture Support Programme grant.

3.5.2. According to the 2016 MTBPS, a three-stage review of the PES is underway. To date, the first phase which focusses on the appropriateness of and alternatives for the data underlying the components of the formula has been concluded. Based on the potential impacts that any changes to the formula will have, the next step in the review process will be to focus on the development of principles that should guide policy that is reflected in the components, and the structure of the formula. As per the 2016 MTBPS, the review process should be concluded by 2018.

3.6. Of the total allocation to the local government sphere, the bulk of the resources are channelled to the local government equitable share (LGES) allocation. As at 2013, the component consumed 47 percent of the total resources to municipalities. By 2019/20, it is projected that this component will be allocated over half (52 percent) of the total resources to the local government sphere. The increase in the proportion allocated in respect of the LGES is offset by reductions in the proportions allocated to local government conditional grants (proportion allocated will decline from 41 percent as at 2013/14 to a projected 38 percent by 2019/20) and the General Fuel Levy Sharing with Metropolitan Municipalities (proportion allocated will decline from 12 percent as at 2013/14 to a projected 10 percent by 2019/20). In principle, the Commission welcomes the projected growth in the proportion allocated in respect of the LGES. As the LGES is a non-conditional transfer, it is anticipated that municipalities, who are best placed to understand the priorities and needs within their respective communities, will be able to channel additional resources accordingly.

Table 2. Division of revenue amongst the three spheres, 2013/14-2019/20

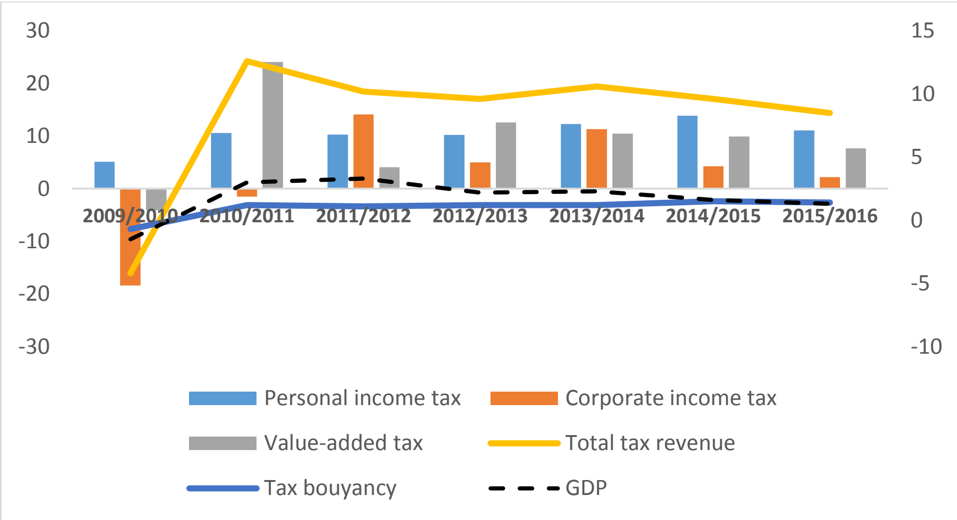
	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	Real Annual Average Growth 2017/18-2019/20
R billion	**Outcome**			**Revised**	**Medium-term estimates**			
Division of available funds								
National departments	**453**	**490**	**546**	**560**	**590**	**631**	**682**	**0.8%**
Provinces	**411**	**440**	**471**	**501**	**538**	**579**	**621**	**1.4%**
Equitable share	336	360	387	411	441	472	506	1.2%
Conditional grants	74	80	85	90	97	107	115	2.5%
Local government	**83**	**88**	**98**	**105**	**113**	**121**	**132**	**2.0%**
Equitable share	39	42	49	53	57	63	69	3.5%
General fuel levy sharing with metropolitan municipalities	10	10	11	11	12	12	13	-0.4%
Conditional grants	34	36	38	41	44	46	50	0.6%
Total	**947**	**1 017**	**1 116**	**1 165**	**1 240**	**1 331**	**1 435**	**1.2%**
Percentage shares								
National departments	47.9%	48.2%	48.9%	48.0%	47.5%	47.4%	47.5%	
Provinces	43.4%	43.2%	42.2%	43.0%	43.4%	43.5%	43.3%	
Local government	8.7%	8.6%	8.8%	9.0%	9.1%	9.1%	9.2%	

Source: 2016 MTBPS. Commission calculations

Revenue and Tax Proposals

3.7. The growth of gross tax revenue has decreased significantly from a peak of 12.2 percent in 2011/12 to 8.5 percent in 2015/16, the lowest growth rate recorded after the global financial crisis. The marked decline in gross tax revenue coincided with a sharp decline in corporate income tax (CIT) from a peak of 14.1 percent in 2011/12 to 2.2 percent in 2015/16, reflecting a devastating impact of the deteriorating economic performance. The poor economic outlook means that this trend is likely to continue in the medium term. The economic slowdown is also reflected in the trends in the growth of value-added tax (VAT). VAT growth declined significantly from a peak of 24.1 percent in 2010/11 to 7.7 percent in 2015/16. In contrast, the growth in personal income tax (PIT) has been relatively strong, averaging 10.5 percent over this period. However, there has been a notable decline from 13.8 percent in 2014/15 to 11.1 percent in 2015/16, reflecting the fact that the worsening economic performance is now filtering through to income tax. Figure 11 shows revenue performance and GDP growth over the seven-year period between 2009 and 2016. The figure also shows a close correlation between tax revenue and economic growth. In essence, tax revenues rise and fall in tandem with economic growth, highlighting the fact that the recent poor economic performance and outlook effectively represents a critical constraint to fiscal consolidation that is partially premised on tax revenue growth.

Figure 11. Revenue performance, 2009/10-2015/16



Source: National Treasury Budget Review (2016).

3.8. There was an overall over-collection of R0.3 billion more than the 2016 Budget estimate in gross tax revenue for 2015/16. VAT recorded an over-collection of R3.1 billion, CIT (R2.2 billion) while PIT recorded an under-collection of R3.9 billion. This over collection more than compensated the downward revision in nominal gross tax revenues of R11.6 billion in the 2016 Budget. A combination of marginal revisions to nominal GDP growth and a sharp revision of gross domestic expenditure has translated into significant net reductions to all major tax bases. The new gross tax revenue short falls projections for the medium term will now exceed the 2016 Budget targets by R22.8 billion in the current year, R36.2 billion in 2017/18, and R51.9 billion in 2018/19. However, the 2016 MTBPS proposes to raise an additional R28 billion in 2017/18 and R15 billion in 2018/19. The specific tax proposals will be elaborated upon in the 2017 Budget. Table 3 below shows the total tax consolidated budget revenue for the period 2015/16-2017/18

Table 3. Total tax and consolidated budget revenue, 2015/16-2017/18

	2015/16	**2016/17**			**2017/18**
R billion	**Outcome**	**Budget**	**Revised**	**Deviations**	**Estimates**
Persons and individuals	388.102	441.04	428.5	-12.54	471.73
Companies	191.152	198.293	200.78	2.487	211.949
Value-added tax	281.111	301.26	293.34	-7.92	315.206
Revenue measures in 2017 Budget	0	0	0	0	28
Gross tax revenue	1069.983	1174.788	1152.026	-22.762	1273.289
Consolidated budget revenue	1220.869	1324.339	1300.992	-23.347	1416.911

Source: National Treasury MTBPS (2016)

3.8.1. The tax structure has largely benefited from extensive reforms spanning the past two decades. Key reforms include the introduction of capital gains tax, a shift to using worldwide income as the base and harmonising the treatment of personal income from different sources. The 2015 and 2016 Budgets raised environmentally related taxes and modernised tax collection but future tax policy changes will largely be guided by the recommendations of the Davis Tax Committee. While the reforms have produced a well-balanced, modern tax system, substantial revenues will be required in the medium to long-term upgrade infrastructure and expand social spending order to enhance growth.

3.8.2. The major constraint in raising tax revenue is narrow tax bases. For instance, with regards to PIT, only 30 percent of the working-age population is employed in the formal sector. Company tax bases are limited by oligopolistic industrial structure that translates into few profitable companies. The large size of informal companies also compromises effective tax bases[3].

3.8.3. The second constraint in raising tax revenue is the concentrated industrial structure which translates into industries that are highly concentrated with large rents prominent in the financial services and mining sectors. This is further complicated by a narrow and underdeveloped SME sector. By way of

[3] See Davis Tax Committee (2015), "The Tax System and Inclusive Growth in South Africa: Towards an Analytical Framework for the Davis Tax Committee", Discussion Document, June, Pretoria.

demonstration, in 2012/13, approximately 60 percent of the CIT came from just 0.2 percent of the companies that reported positive taxable income. More shocking, 96 percent of corporate tax raised, came from only 16 percent of the companies that reported positive taxable income. Deductions and incentives are the main drivers in narrowing the tax base of corporate tax. The tax base is also compromised by (legal) tax avoidance and profit-shifting measures taken by multinational companies. The Davis Tax Committee assesses the magnitude of this problem to be sizeable, pointing to a 33 percent increase in legal and marketing consulting services[4].

3.8.4. VAT, the single largest source of indirect tax, is raising revenue comparable to that of Organisation for Economic Cooperation and Development (OECD) countries. However, reducing the number of items with preferential tax treatment or improving compliance could raise the VAT revenue ratio and consequently the VAT revenue. Comparing the National Treasury’s estimates of tax expenditures to the potential tax base suggests that exemptions (mostly food items and petrol) account for around one third of the lost revenue[5]. Given that consumption taxes are one of the more growth-friendly forms of taxation and that the current VAT rate is relatively low, there is scope to raise additional revenue using the VAT.

3.8.5. The broadening personal and corporate income tax bases by reducing deductions, credits and allowances will go a long way in enhancing tax revenue collection. Complimentary measures such as reviewing the effectiveness of tax incentives provided to firms and simplify the range of available incentives as well as broadening the VAT base and strengthen VAT compliance will also greatly aid tax revenue collection endeavours.

Unallocated Resources, Economic Classification And Expenditure Prioritisation

3.9. Unallocated reserves (see Table 4) are meant to serve as a fiscal buffer for Government in times of unplanned emergencies. In previous submissions, the Commission raised concern around the danger of excessive drawdowns on these resources, and in so doing,

[4] See Davis Tax Committee (2014), “First Interim Report on Base Erosion and Profit Shifting”, December 2014, Pretoria.

[5] See OECD (2014), “Measuring Performance of VAT”, in *Consumption Tax Trends 2014: VAT/GST and Excise Rates, Trends and Policy Issues*, OECD Publishing, Paris.

creating a risk of having low reserves should an emergency arise. The Standing Committee on Appropriations adopted the Commission's recommendation to avoid drawdowns on the contingency reserve in its submission on the 2015 MTBPS.

3.10. The contingency reserve over the 2016/17 MTEF has remained unchanged in the 2016 MTBPS when compared to the 2016 Budget. While the amounts being put aside for the contingency reserve is still far from adequate (R6 billion in 2016/17, increasing to R15 billion in 2018/19), the Commission welcomes the new policy approach of maintaining consistency in the contingency reserve as it provides the fiscus with at least some room to manage ongoing fiscal pressures.

Table 4. Adjustments to unallocated reserves, 2014/15-2019/20

R'billion	2014/15	2015/16	2016/17	2017/18	2018/19
Budget 2014	3	6	18		
MTBPS 2014		5	15	45	
Budget 2015		5	15	45	
MTBPS 2015			2.5	9	15
Budget 2016			6	10	15
MTBPS 2016			6	10	15

Source: Budget Review (2014, 2015, 2016); MTBPS (2013, 2014, 2015, 2016)

3.11. Table 5 provides details of the economic classification of consolidated government expenditure. Over the period reviewed (2015/16 to 2019/20), not surprisingly compensation of employees records the highest real average annual growth rate (1 percent). Disaggregating this average growth to real year on year growth, the following trends are notable

3.11.1. The compensation budget grows by 0.6 percent in 2017/18 and outpaces inflation by 1 percent on average over the MTEF period. The growth in compensation is marginally lower than forecasted at the time of Budget 2016 (equivalent to R8.5 billion savings for the period 2016/17 – 2018/19) and steps being taken are intended to reign in the unsustainable wage bill. The increase in the compensation budget is being offset by reducing headcounts in administrative and managerial posts and elimination of unnecessary positions. The Commission has noted previously that wage increases should be linked to productivity. In its efforts to strengthen the link between pay and performance, government should note a recommendation in the Commission's submission on the 2016/17 Division of Revenue, which called for a framework for measuring productivity as a first step to benchmark improvements in the public-sector over time. The Commission welcomes the decision by Government that critical positions such as teachers, nurses, doctors and police officers will not be affected by these headcount reductions.

3.11.2. In line with the push to contain spending on goods and services, especially in non-essential items, growth of this component amounts to 0.7 percent over the 2017/18 MTEF period. The growth rate on goods and services has remained unchanged compared to at the time of the 2016 Budget. Since its establishment, the Office of the Chief Procurement Officer has initiated a number of reforms aimed at delivering lower cost goods and service more efficiently and transparently. Some of these reforms include establishing a central supplier database as a way of reducing administrative and cost burden of procurement, eTender portal which gives government departments an opportunity to purchase routine supplies through transversal contracts and simplifying procurement documents. A further development in the pipeline is the tabling of the Public Procurement Bill, which will replace all other legal instruments governing public procurement. The Commission welcomes these initiatives and calls for appropriately formulated indicators that can track the impact of these reforms in achieving value for money and reducing graft in government operations.

3.11.3. Allocations in respect of capital assets declines by 3 percent on average over the 2017/18 MTEF period. The decline in capital is a result of a diversion of resources in underspending capital grants to offset the increase in allocations to other priority areas such as higher education and drought related initiatives. It appears the reduction of Government's capital budget is being offset by large investments in public infrastructure by SOEs, which will amount to R311 billion over the 2017/18 MTEF period, with borrowing reaching R257 billion. While funding infrastructure investment through SOEs may seem a viable fiscal strategy, weak management and the inability of Government to effectively intervene, has contributed to poor outcomes among SOEs and pose a significant risk to the fiscus. The Commission welcomes reforms announced in the 2016 MTBPS to strengthen financial management and governance at SOEs. Included among the reform measures announced: establishing a single governing law for public entities; rationalising the number of entities; and mobilising co-investment and technical support from the private sector to strengthen management and financial capacity

Table 5. Real growth of consolidated government expenditure by economic classification

R'billion	2015/16	2016/17	2017/18	2018/19	2019/20	Real Annual Average Growth Rate
Compensation of employees	472.8	515	549.4	587	629.7	1.0%
Goods and services	190.9	204.5	219.7	234.6	249.9	0.7%
Transfers and subsidies	441.4	402.5	436.5	464.3	499.2	-3.1%
Payments capital assets	102.6	101.1	104.4	109.2	117.9	-3.0%
Real Year on Year Growth (%)	**2014/15-2015/16**	**2015/16-2016/17**	**2016/17-2017/18**	**2017/18-2018/19**	**2018/19-2019/20**	
Compensation of employees		2.5%	0.6%	0.9%	1.5%	
Goods and services		0.7%	1.3%	0.9%	0.7%	
Transfers and subsidies		-15.2%	2.3%	0.5%	1.7%	
Payments capital assets		-7.9%	-2.8%	-1.3%	2.2%	

Source: MTBPS (2016)

3.12. Over the 2017 MTEF period, growth in total government consolidated expenditure will be subdued, expected only to grow by 7.9 percent and 1.6 percent in nominal and real terms, respectively. The projected budget for 2017 is identical to estimates made during the 2016 MTBPS, reflecting stability and predictability in the midst of a worsening economic climate. Low revenue growth expectations impose the need for further expenditure tightening and reprioritisation amidst the growing impasse on financing free higher education and plans for rolling out the infrastructure build programme.

3.13. Government has been on a long-term trajectory of fiscal consolidation, constantly instructing various government departments to either cut or reprioritise expenditure. The contracted emphasis on consolidation has evidently contributed to the maintenance of fiscal balance and a low debt requirement at an aggregate level. Requirements for further reprioritisation at a sectoral level should be accompanied by an objective assessment of policy priorities to ensure alignment between the set priorities in terms of expenditure shares and services supplied. Therefore, there must be a clear link between sectoral performance and budget reprioritisation if the national development goals are to be met under a constrained fiscal environment. The Commission is of the view that the current reprioritisation process is delinked from the long-term development goals as outlined in the NDP. Attaining some of the NDP targets would require government to drastically reconsider the package or pattern of its social expenditure composition from one that seeks to embed expenditure programmes to one that drives developmental impact in a meaningful way. Reprioritisation largely entails the shifting of unspent allocations from one embedded expenditure programme to the other without altering the trajectory for long-term socio-economic impact. All levels of government need to urgently adopt a system of reprioritisation that emphasises human and infrastructure-related development given that much of its committed expenditure is unlikely to decline and the macroeconomic climate is less likely to improve in the near to medium term.

3.14. For 2017/18, the total consolidated budget (national government, provinces and social security) is projected to reach R1.5 billion with basic and higher education taking a large chunk of the allocated funds. The analysis of expenditure priorities shows that basic education continues to account for 16 percent of total expenditure whilst health, social protection and defence takes 12 percent, 11 percent and 12 percent respectively. At 10 percent of the total, debt service costs constitute the same amount allocated in respect of social protection, but are however projected to slow down to 9.1 percent in the outer year of the 2017 MTEF period.

3.15. **Social services** continue to enjoy moderate expenditure growth in the 2016 MTBPS, reflecting Government's commitment to social upliftment and ensuring that fiscal consolidation does not occur at the expense of the effective delivery of much needed social services. The 2016 MTBPS projects a combined allocation of R568 billion to social services with a real annual average growth rate of 2 percent over the 2017 MTEF period. Health and social protection allocations grows the highest with a 2.2 percent real increase over the 2017 MTEF period, whilst basic education grows at 1.1 percent. In comparison to the 2015 MTPBS growth projections, social services allocations are slightly lower due to heightened fiscal constraint. The lower than expected rate of growth in the allocations to social services will continue to affect expansion of services to new eligible recipients as well as the amount and quality of services delivered to existing beneficiaries. Much of the increase will be absorbed by the operational expenditure inflationary adjustments leaving scant resources available for service delivery. For this reason, the Commission is of the view that expenditure reprioritisation processes should entail comprehensive sectoral expenditure and performance reviews to minimise operational and spending inefficiencies and eliminate non-performing programmes.

3.16. **Economic services** account for 14 percent of the total consolidated budget. Over the 2017 MTEF period, allocations to economic services will decelerate at a real annual average growth rate of 1.1 percent compared to a projected 1.2 percent increase in 2016.

A ‘large chunk’ of economic services allocations are, however, attributable to economic administration. By way of priority, industrial development receives the highest allocation. The Commission is concerned about Government’s ‘inadequate focus on, or allocations made to improve’ employment and economic infrastructure. In its annual submission for the 2017/18 division of revenue, the Commission noted that Public Employment Programs (PEPs) have poor labour market outcomes and further recommended a shift away from chasing numbers to focusing on skills transfer and employability. Prioritisation need not only take place at an expenditure level, but also within programme implementation processes.

3.17. **Protection services** has been undergoing significant strain caused by continuous service delivery protests, student unrest (free education protests) and court battles. Over the 2017 MTEF period, the allocation to protection services amounts to R197 billion or 13 percent of total consolidated government expenditure - with the police accounting for 47 percent of the total allocations. Protection services allocations grow at a negative real rate of 0.2 percent over the 2017 MTEF period amidst the growing pressure placed on the criminal justice system. The Commission supports the expenditure reprioritisation underlying the 2017 MTBPS, but further implores Government to adopt a proactive approach when addressing community concerns to avoid damage of social infrastructure and the subsequent long term deployment of police forces within protest hotspots.

Table 6. Real growth in expenditure by functional classification, 2016/17-2018/19

R billion	2016/17`	2017/18	2018/19	2019/20	2017/18	2018/19	2019/20	Real average annual growth 2016/17 - 2019/20
	Revised	Medium-term estimates			Nominal annual growth			
Basic education	**228.4**	**244.8**	**261.9**	**280.6**	**7.2%**	**7.0%**	**7.1%**	**1.1%**
Basic education	218.3	233.8	250.7	268.8	7.1%	7.2%	7.2%	**1.2%**
Arts, sport, recreation and culture	10.1	11.0	11.2	11.9	8.4%	2.7%	5.5%	**-0.5%**
Health	**169.3**	**184.4**	**198.9**	**214.2**	**8.9%**	**7.8%**	**7.7%**	**2.2%**
Social protection	**165.1**	**180.0**	**193.3**	**208.9**	**9.0%**	**7.4%**	**8.1%**	**2.2%**
Defence, public order and safety	**189.5**	**197.9**	**210.7**	**224.6**	**4.5%**	**6.4%**	**6.6%**	**-0.2%**
Defence and state security	52.2	53.7	56.0	59.8	2.8%	4.3%	6.9%	**-1.3%**
Police services	87.0	93.2	99.3	106.0	7.1%	6.6%	6.7%	**0.8%**
Law courts and prisons	41.5	43.8	46.6	49.8	5.6%	6.4%	6.8%	**0.2%**
Home affairs	8.8	7.3	8.8	9.1	-17.2%	20.6%	3.1%	**-5.0%**
Post-school education and training	**68.6**	**76.6**	**81.1**	**89.3**	**11.7%**	**5.9%**	**10.1%**	**3.2%**

Economic affairs	**207.6**	**216.4**	**225.8**	**239.6**	**4.2%**	**4.4%**	**6.1%**	**-1.1%**
Industrial development and trade	27.9	29.9	32.1	34.4	7.1%	7.5%	7.2%	**1.3%**
Employment, labour affairs and social security funds	73.7	76.2	78.0	79.0	3.3%	2.5%	1.2%	**-3.7%**
Economic infrastructure and network regulation	86.8	90.4	94.7	103.1	4.2%	4.7%	8.9%	**-0.1%**
Science, technology, innovation and the environment	19.2	19.9	20.9	23.1	3.3%	5.3%	10.2%	**0.2%**
Human settlements and municipal infrastructure	**181.1**	**197.6**	**212.1**	**228.3**	**9.1%**	**7.3%**	**7.6%**	**2.0%**
Agriculture, rural development and land reform	**26.3**	**26.9**	**28.4**	**30.3**	**2.4%**	**5.5%**	**6.5%**	**-1.2%**
General public services	**67.8**	**69.8**	**73.0**	**76.4**	**2.9%**	**4.7%**	**4.7%**	**-1.9%**
Executive and legislative organs	13.0	13.6	14.5	15.3	4.9%	6.3%	5.9%	**-0.3%**
General public administration and fiscal affairs	43.2	43.7	45.9	47.9	1.2%	4.9%	4.5%	**-2.5%**
External affairs and foreign aid	11.6	12.4	12.7	13.2	6.8%	2.1%	4.0%	**-1.7%**
Allocated by function	**1 303.8**	**1 394.3**	**1 485.2**	**1 592.2**	**6.9%**	**6.5%**	**7.2%**	**0.9%**
Debt-service costs	147.7	163.6	180.8	197.2	10.8%	10.5%	9.1%	4.1%
Contingency reserve	–	6.0	10.0	20.0	-	66.7%	100.0%	
Consolidated expenditure	**1 451.5**	**1 564.0**	**1 676.0**	**1 809.4**	**7.8%**	**7.2%**	**8.0%**	**1.6%**

Source: MTBPS 2016. Commission calculations.

3.18. **Post School Education and Training (PSET)**: The Commission welcomes the interim funding made available (and fee adjustment cap) to the PSET sector to address student demands for free tertiary education and cushion higher education institutions and technical, vocational education and training (TVET) colleges against rising cost pressures while a sustainable solution is being sought. The 2017 MTBPS proposes an additional funding of R5 billion in 2017/18 growing to R18 billion by the end of the 2017 MTEF period to cover fee increment exemptions and expansion of National Student Financial Aid Scheme (NSFAS) to new beneficiaries. The medium-term budget shows government expenditure on higher education and specifically universities, will be the fastest growing expenditure items on the budget driven by subsidies to universities and transfers to the NSFAS. All these are aimed at improving the access of poor students and students coming from 'missing middle' families. This is commendable and the MTBPS has done the best that could be expected, given the constraints within which the economy is operating as outlined above and given current Government policy. Admittedly, South Africa's post-secondary education, heightened by the ongoing university crisis, needs a change of policy if it is to address demands by students, not just more money. The fiscus faces immense pressure from students to spend more on higher education and to ensure fee-free education. This will require a change in government policy informed by discussion of the trade-offs Government must make when setting its expenditure priorities in future. The report from the Heher Commission will be useful in this regard. Once this step is complete, the Commission's view is that a costed norms approach should then be used in implementing changes in the funding formulae; changes that reflect the costed norms approach to measuring the expenditure needs is a central element in developing a system of accountability for post-secondary and higher education training. If the *costed norms* approach is used to define allocations, then one can no longer use the excuse that they lack adequate resources to meet set national targets.

3.19. **Housing Development and Municipal Infrastructure**: The funding and provision of human settlements has to be implemented in a coordinated manner. For the delivery of housing and social infrastructure amenities, which include education and health facilities as well as key basic services infrastructure (electricity, sanitation and water) to be effective and sustainable, a forward-looking vision is key since conditions do change from time to time. Therefore, issues relating to future growth (resulting from urbanization among other things) and the fact that some areas are likely to lose households, should be taken into account in the planning and delivery of social infrastructure. To achieve this forward-looking vision, a strong link, and coordination with respect to all relevant departments and programmes, is key and this is one of the Commission's recommendations in its 2016/17 year's submission on the MTBPS.

3.19.1. There has been uncertainty with respect to accreditation/housing function shift to local government recently. While the Commission in the past few years has raised concerns with respect to the slow pace of accreditation and the fact that the Municipal Human Settlements Capacity Grant (which was established to capacitate metros for level 3 accreditation/housing assignment) got discontinued, the Commission remains concerned as not even a single municipality has been accredited at any level in 2015/16. The Commission is aware that the Department of Human Settlements is in the process of developing and finalizing a new approach to accreditation and recommends that a revised approached be finalized without further delays as this creates uncertainty and affects housing delivery.

3.19.2. Under the current economic outlook and to ensure that key programmes are sustainable, reprioritization from the existing baseline has been necessary. While the Commission supports reprioritisation of funding to speed and scale up rental housing for lower income groups, downward revision of the baseline may negatively affect housing delivery. Therefore, even if the baseline is not revised downwards there is a strong need for government to promote and encourage self-build housing initiatives in order to scale-up housing delivery.

3.20. **Health**: In its 2016 Submission on the MTBPS, the Commission welcomed the decision to shift the Western Cape's indirect allocation of the National Health Grant into a direct allocation as that was consistent with the Commission's recommendation to reduce the growing prevalence of indirect conditional grants. Furthermore, such a shift further provides the province with flexibility to meet its National Health Insurance (NHI) contracting requirements and address the funding gaps experienced by the NHI pilot implementation. Last year, the Commission recommended that shifting of indirect grant to direct grant be extended to other provinces and sectors that demonstrated capacity. One of the developments in 2016 (during adjusted budget) includes the indication by the National Department of Health that in-year transfer to be redirected out of the indirect NHI to the NHI direct grant for Western Cape and KwaZulu-Natal. The Commission notes and welcomes this development and calls for a more systematic and transparent process with defined criteria to be used when shifting grants from indirect to direct form in line with previous recommendation that the National Treasury adds the necessary enabling clause in the Division of Revenue Bill to facilitate the choice of a province to opt out of indirect conditional grant if it has demonstrated such capacity to implement grants.

3.20.1. As part of fiscal consolidation, the comprehensive HIV, AIDS and TB grant will be reduced by 0.57 percent. The Commission understands the necessity of such reduction and welcomes the fact that the reduction is quite small so as not to drastically negatively impact on performance outcomes. Furthermore, this grant has been one of the fastest growing grants in the system.

3.21. **Basic Education**: The Commission notes and welcomes funding (R307.9 million) for rehabilitation of the Vuwani schools that were burnt earlier in 2016 as the funding will ensure that the schools are rebuilt in order for the learning and teaching to take place. The Commission would like to caution that destruction of property during community protest is putting a strain on the limited fiscal purse and replacements may result in perverse incentives and society at large must guard against this.

3.21.1. The Commission also welcomes additional funding of R390 million over the 2017 MTEF on basic education for the National School Nutrition Program

(NSNP) as it indicates that nutrition program remains a priority for the government. In its 2015 submission on the MTPBS, the Commission emphasised the importance of meeting the minimum requirements in respect of providing nutritious meals to all learners within the quintiles 1 to 3 at both primary and secondary schools as per the National Norms and Standards for funding. The Commission also recommended an alignment of provincial and national quintile classification as the current misalignment result in a number of schools not benefiting from the NSNP.

3.22. **Job Creation**: The 2016 MTBPS highlights a number of successful public and private initiatives to support and create jobs. These programs clearly indicate Government's commitment to reversing the trend of growing unemployment. The Commission welcomes the report regarding the number of jobs created and supported. For completeness, the reports on the outcome of job creation schemes must indicate the number of new and existing jobs, cost per job created or retained, duration and occupation type and productivity performance of supported businesses. By their very nature, incentives generate distortions and can be used to offset internal business operational inefficiencies without achieving the objectives for which they are intended for. The Department of Monitoring and Evaluation must complement the MTBPS by regularly reviewing existing job creation incentives and recommending the necessary reprioritisation aligned to performance.

3.22.1. The rate at which unemployment is rising, requires more than just public employment programs (PEPs) or private sector job creation incentives. South Africa's unemployment rate has remained stagnant for a long period, highlighting structural weaknesses within the economy. The majority of unemployed people are young and unskilled while the economy is becoming more skills intensive. Turning the tide against unemployment thus requires improvement in the quality of education offered, increment in attainment levels and concerted investment in higher education and training, particularly vocational and technical training. The latest Quarterly Labour Force Survey indicates that 92 percent of graduates (post-matric) or skilled people, are employed. Therefore, hard choices have to be made regarding whether to invest in incentives for job creation and retention or skills which can respond to the needs of a knowledge economy.

Table 7. Public supported job creation programmes

Programme	Investment amount R' billion	Number of Jobs created
Independent Power Producers	R197	27000
Automotive private investments	R15.4	4675
Oceans economy	R17	5000
Manufacturing Competitiveness Enhancement programme	R28	200 000
Small business support	R1.5 b	-
Jobs Fund	R3.7 b	-

Source: Compiled from 2016 MTBPS

3.22.2. Furthermore, there is an urgent need for the removal of investment constraints caused by the centralised or oligopolistic nature of the South African economy. The few large dominant firms control value chains and markets to the detriment of small players and competition in general which in turn generates economy wide market inefficiencies. These firms are gradually investing in high technology equipment and systems, so as to maximise operational efficiency, which not only displaces unskilled workers but also requires skilled workers. Moreover, some of these big players (Automobile Manufactures) are the beneficiaries of public investment incentives schemes through the Automotive Investment Schemes. Government needs to assess the cost and benefit of maintaining private investment incentives for job retention against investment in skilling the future workforce and reskilling those who are laid-off as industries mechanise. The Commission therefore is of the view that the short to medium term job creation initiatives should focus on reskilling laid-off workers in the mining and steel industries through the skill levy as well streamlining job creation schemes to focus on few selected strategic sectors. The long run efforts to create jobs should entail reduction or elimination of investment incentives to mature industries towards supporting vocational and technical training.

3.22.3. As regards the PEPs, the Commission reiterates the recommendation made during the 2015 MTBPS submission. The hallmark of PEPs success rest in the design and the subsequent labour market outcomes – not necessarily the headcount number of jobs or Full Time Equivalent (FTE) employment created. The focus of PEPs should be directed towards improving regular employment, medium skills development, wages and productivity of program participants, not the income earned during employment. More importantly, government must introduce innovative ways of improving the job quality of PEP participants through incorporating maintenance of community infrastructure into the work-stream and direct contracting of worker groups (i.e. Early Childhood Development Centres and public schools).

4. Review Of Actual Spending By National Departments And Provincial Government – 1 April To 30 September 2016/17

4.1 Expenditure smoothing implies government spending that is evenly distributed through the four quarters of the financial year. If such smoothing were to occur, it would be expected that total expenditure up to September would be at 50 percent of the main budget. This would of course differ depending on whether a government programme that the department is dealing with is recurrent or capital-expenditure driven. Expenditure smoothing would most likely lead to improved quality of spending and reduced level of unauthorised spending.

4.2 Table 8 shows aggregate spending and the percentage spent six months into 2015/16 financial year. Total government spending is approximately equal to the norm of 50 percent. Spending by all votes is approximately 49 percent (R354.2 billion of the main budget). With respect to the provincial equitable share, 50 percent of the total amount has been transferred.

4.3 Using selected national departments that are driving government priorities (education, health) and key built environment programmes for example, transport, energy and water and sanitation, government has spent R175.9 billion which is above the norm. An assessment of individual departmental performance shows somewhat uneven spending patterns. The Departments of Higher Education (68 percent) and Energy have spent significantly above the norm while Human Settlements (42 percent) and Land Reform and Rural Development (43 percent) have spent significantly below the norm. The above average spending by Higher Education could be a reflection of the funding crisis and the Department's role in addressing the funding shortfalls at universities. The Commission welcomes the increased allocations to Higher Education over the MTEF period as well as the establishment of the Presidential Commission of Inquiry into Higher Education to deal with the existing the fiscal pressures in the sector. The underspending by Human Settlements may be a result of poor spending on the Human Settlements Development Grants (HSDG) and the Urban Settlements Development Grant (USDG). Provinces have a history of underspending the HSDG, especially in the Eastern Cape and Limpopo provinces. Underspending by these provinces is a concern especially since the intent of the grant is to fund housing backlogs. Housing backlogs are significant is these two provinces.

4.4 Excessive deviations below or above the norm is undesirable from an expenditure smoothing perspective. Unless a department's in-year cash management plan explicitly identifies under or over spending as a chosen spending profile, departments should attempt to remain within the confines of spending performance guidelines

Table 8. Aggregate spending and deviation from the norm (April-September 2016)

R'million	**2016/17**		
	Main Budget	**Actual Spending April - September**	**% Spending**
Total	1 318 338	643 723	49%
Total Appropriation by vote	721 148	354 222	49%
Total direct charges against the National Revenue Fund	590 923	289 500	49%
General fuel levy	11 224	3 741	33%
Debt-service costs	147 720	71 684	49%
Provincial equitable share (National Treasury)	410 699	205 349	50%
Selected Key Budget Votes	**345740**	**175927**	51%
7 Public Works	6 529	3 256	50%
15 Basic Education	22 270	11 712	53%
16 Health	38 563	18 912	49%
17 Higher Education and Training	49 188	33 508	68%
21 Correctional Services	21 577	10 994	51%
25 Police	80 985	38 922	48%
26 Agriculture, Forestry and Fisheries	6 333	3 370	53%
28 Economic Development	675	341	51%
29 Energy	7 545	4 667	62%
31 Human Settlements	30 691	13 030	42%
33 Rural Development and Land Reform	10 124	4 310	43%
37 Transport	56 015	25 534	46%
42 Water and Sanitation	15 245	7 371	48%
Provincial Level			
Education	211 702	104 482	49%
Health	163 934	84 550	52%
Social Development	17 781	8 576	48%
Other	123 772	59 620	48%

Source: MTBPS (2016).

5. Local Government Issues

Total Allocations to the Local Government Sphere

5.1. The main transfer streams to the local government sphere are conditional grants and the LGES. As noted above, allocations to the local government sector continue to increase both in nominal and real terms. The real annual average growth rate for the transfers to local government over the 2017 MTEF is 2 percent and the LGES is expected to grow faster (at 3.5 percent) than local government conditional grants and the fuel levy allocations, which grow at 0.6 percent and -0.4 percent respectively.

Local Government Equitable Share

5.2. The Commission welcomes the redistribution of resources through the LGES which allocates more funds to lesser resourced municipalities. The allocation of resources through the LGES enables municipalities to fulfil their constitutional mandate of affording poor members of society with basic services. The real growth in the LGES is presented in Figure 12.

Figure 12. Real growth in LGES allocations

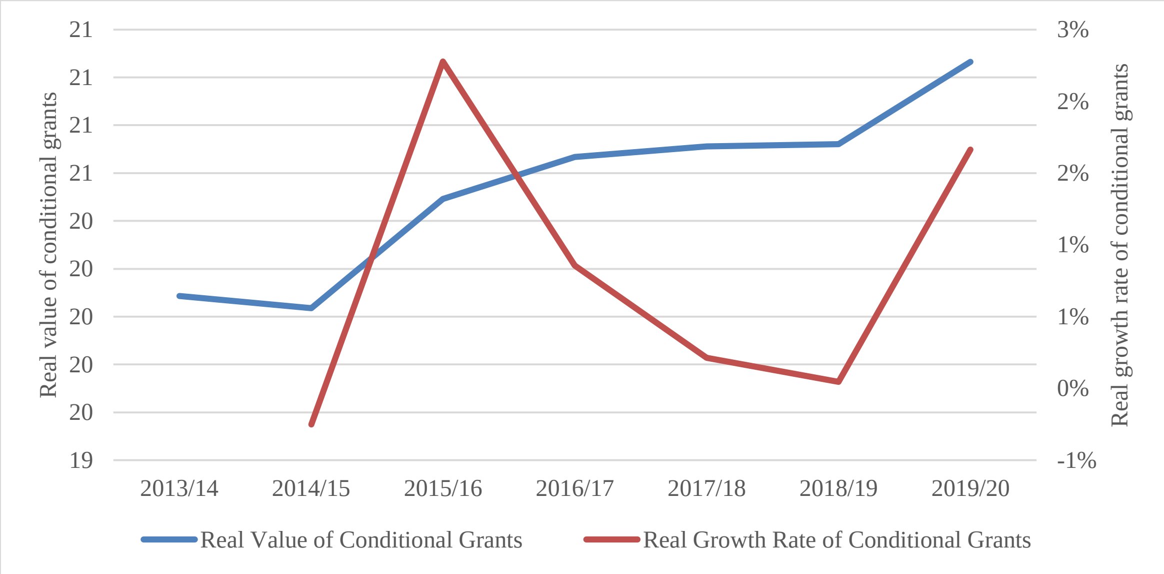
Source: Division of Revenue Bill, 2013, 2014, 2015. 2016, 2016 MTBPS. Commission's calculations.

5.3. Over the 2017 MTEF period, the local government sector is expected to receive an additional R16.7 billion through the LGES. In other words, the LGES will grow by 8.5 percent in 2017/18, 10 percent in 2018/19, and 10.4 percent in 2019/20 (in nominal terms). The Commission notes the expected increase in the LGES allocations for the 2017 MTEF although it remains concerned about the anticipated overall slow growth of 3.5% in the LGES allocations and the 0.4% decline in the fuel levy allocations when viewed in real terms. The low growth in the LGES and the decline in fuel levies will constrain the ability of many municipalities to provide basic services. This is because of increasing cost pressures, driven by the bulk electricity and water price increases, and the growth in the number of poor households. The Commission recognises that the fiscus is constrained due to the current economic state, therefore, it re-emphasises the recommendations made in its Submission for the 2017/18 Division of Revenue on the need to tighten the expenditure supervision methods in order to encourage efficient utilisation of resources and for municipalities to improve on revenue collection from existing sources.

Conditional Grants

5.4. Local government conditional grants are set to grow from R41. 1 billion in 2016/17 to R43.7 billion in 2017/18, and to 46.3 billion in 2018/19. In 2019/20, conditional grants are expected to increase to R49.8 billion. The real growth rates in grant allocations from 2014/15 up until 2019/20, is depicted in Figure 13. The Commission notes the subdued growth (0.6 percent average real growth rate) in conditional grants over the 2017 MTEF, which is understandably a part of the required fiscal consolidation process. The Commission notes the reductions in the public transport network grant, the water services infrastructure grant, the municipal infrastructure grant and the urban settlements development grant. The Commission reiterates its previous recommendation that the historical performance of individual grants should be taken into consideration, before a decision on the reductions of grants is made. In principle, the Commission would support reprioritisation of funds from underperforming grants, provided service and infrastructure delivery to the poor is not affected and plans to improve grant performance are put in place. In its 2017/18 submission, the Commission noted the worrisome levels of inefficiencies in the local government sector. Under conditions of low growth in transfers, it is vital that municipalities achieve maximum efficiencies.

Figure 13. Real values (in billions) and growth rates of conditional grant allocations



Source: MTBPS 2016. Commission's calculations.

5.5. The Commission supports the proposal to absorb the Integrated National Electrification Programme (INEP) municipal grant in metropolitan municipalities into the USDG as this will ensure a holistic approach to the delivery of electricity infrastructure and contain the proliferation of grants. This will also curb the current uneven and disintegrated manner in which electrification projects are funded in cities. The Commission also notes the reprioritization of the INEP Eskom grant to fund nuclear waste.

5.6. Figures 12 and 13 show some spikes in the growth of LGES and conditional grants. The spikes can be traced to a number of reasons. On the LGES, the rapid growth in 2015/16 can be traced to a number of municipalities being compensated for the previously withdrawn LGES funds. On conditional grants, the spike was due to the introduction of the demarcation transitional grant, as well as other grants that increased sharply, far beyond their historical growth pathways. For example, the Municipal Water Infrastructure Grant rose by 237% in nominal terms in 2015/16; the INEP (Direct) by 79%; and the Rural Household Infrastructure and Regional Infrastructure Grants by 18% and 23%, respectively. Among other things, cost pressures were responsible for the unprecedented increase in the allocations to these grants. As pointed out, the slow growth in the allocations in 2016 was due to the fiscal consolidation process pursued which affected all the three spheres of government.

6. Revised Division of Revenue 2016/17

6.1. Government annually makes adjustments to the budget that was approved in February. The aim of the adjustments is to cater for unforeseen and unavoidable expenditure. Declared unspent funds amount to R1.3 billion in 2016/17, which is a significant decline when compared to R3.18 billion declared in the 2015/16 revised division of revenue. With respect to underspending, R3 billion is projected in 2016/17.

6.2. Roll-overs amount to R412 million. This represents a substantial decrease when compared to 2015/16, when R1.6 billion worth of roll-overs was declared. The decline in rollovers suggests that government is exercising stricter controls with respect to monitoring expenditure and rollover requests. The Department of Transport has the largest roll-over, amounting to R275.6 million. The Department of Cooperative Governance and Traditional Affairs has drastically improved and reduced the extent of its roll-overs from R1.5 billion in 2015/16 to R27.8 million in 2016/17.

6.3. The Treasury Regulations Section 6.4, restricts roll-overs (as follows amongst others): unspent funds on payments for capital assets may only be rolled over to finalise projects or the acquisition of assets already in progress. In terms of roll-overs of provincial conditional grants, a rollover has been granted for a total of R275.7 million in respect of the provincial Roads Maintenance grant in KwaZulu-Natal. The Commission however, submits that grant funding rolled over for roads maintenance that is typically infrastructure-related projects, suggests possible implementation and project management weaknesses. Furthermore, the rollover of a grant for road maintenance means postponing road maintenance. This results in direct and indirect costs, as neglected roads or poorly maintained roads constrain mobility, significantly raises vehicle operating costs, increases accident rates etc. The Commission emphasises the importance of regular road maintenance as a well maintained road network makes a crucial contribution to economic development and growth.

6.4. Unforeseen and unavoidable (U&U) expenditure amounts to R1.2 billion. The departments that dominate the U&Us are: International Relations and Cooperation (R950 million) and Basic Education (R179.9 million).

7. Concluding Remarks

7.1. The 2016 MTBPS has been crafted in a severely constrained environment characterised by downward economic growth forecasts and government's debt-to-GDP ratio having doubled since the global economic crisis in 2009. The low economic growth places pressure on tax revenue growth and this has necessitated tighter spending to ensure that debt does not become unsustainable. Government has also had to contend with severe pressure from students to spend more on higher education and to ensure fee-free education. Given the constrained environment, Government has been compelled to raise budget deficits for the next three years.

7.2. Overall, the 2016 MTBPS re-affirms and still reflects the major thrust and spirit of the recommendations that the Commission has been making since the onset of the global economic crisis: that growth and employment in South Africa can only be achieved by combining gradual fiscal consolidation and investment into future growth given the prevailing economic climate coupled with undertaking requisite structural reforms.

7.2.1. Given the current negative economic outlook, the Commission fully supports the government's new position on 'gradual' fiscal consolidation which is in line with previous Commission recommendations and tightening measures to maintain expenditure sustainability.

7.2.2. Given the tight fiscal framework, the Commission commends efforts by Government to protect social expenditures, which are fundamental in maintaining and improving wellbeing of vulnerable communities.

7.2.3. Proposed improvements in running of SOEs are welcome as they increase prospects of improved service delivery and limit government's potential liability (from guarantees).

7.2.4. To enhance conditions for sustained economic growth and employment, Government should continue re-directing government spending towards activities that directly or indirectly create jobs through enhancing productivity performance. The emphasis on education as the number one priority is commendable in this effort towards productivity improvements.

7.3. In the Commission's 2010's submission, it proposed a "multi-pronged" strategy to take long-term fiscal concerns into account in the short to medium-term. The tenets of this were to include a budget process and framework more clearly recognizing long-term fiscal risks that builds on existing work, strengthened analytic approaches and a blend of aggregate fiscal rules. It is in this regard that the Commission welcomes that Government has for the first time tabled a Risk Report with the MTBPS which was the next step following guidelines for fiscal sustainability aimed at protecting fiscal gains for future generations.

7.3.1. The Commission is of the view that indeed fiscal risks identified including pressures on public sector wages, infrastructural underspending and the possibility of renewed depreciation in the exchange rate, increasing age profile of the country and the realigned low economic growth of under 2 percent over the longer term are indeed the pressing ones. These impact on public spending and the ability of the country to sustain a stable debt path.

7.3.2. The Commission is looking forward to contributing to the debates surrounding these topics.

7.4. The political economy challenge of dealing with long-term fiscal policy issues in relation to free higher education requires provocation of public debate on long-term fiscal challenges – implied intergenerational trade-offs, degree of risk aversion, etc. Policy pronouncement on free education by Government will be a big positive step in this direction. Pertaining to fairness, Government should be required to publish analysis of the distributional impact of such new policies. Requiring such analysis as a rule on all new policy would be welcome, as would a requirement to publish assessments of the inter-generational or long-term impact of policies whose effects vary over time and/or generations such as free education.

7.5. Given the tight fiscal framework, the Commission commends efforts by Government to protect various conditional grants, which are fundamental in maintaining and improving service delivery to communities. The Commission supports the proposed conditional grant changes, addressing identified weaknesses it has raised in the past and will continue engaging with government and other stakeholders in the exercise.

7.6. The proposed adjustments estimates are supported subject to matters raised by the Commission in this Submission.

7.7. Finally, what is very clear is that the economy remains far below the economic growth rates required to meet NDP goals. There is need for better economic growth requiring structural reforms. Rebuilding state capabilities should continue to be prioritised with efforts aimed at both economic and social capabilities for citizens and infrastructure and how these will be managed within the context of current consolidation measures. In this regard, much more needs to be done still to implement the NDP and the Medium Term Strategic Framework.

For and on behalf of the Financial and Fiscal Commission

Mr Velile Mbete

Acting Chief Executive Officer

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