

SUBMISSION ON THE 2017 MEDIUM-TERM BUDGET POLICY STATEMENT (MTBPS) AND REVISED FISCAL FRAMEWORK

1. Requirements under the Money Bills Act (2009)

The Money Bills Act requires the finance committees of Parliament to report on:

- the *revised fiscal framework* tabled as part of the Adjustments Budget (s12(7))
- the *proposed fiscal framework* for the medium-term, tabled as part of the Medium-Term Budget Policy Statement (s6(5)).

The timelines for these processes are, respectively:

- Submit a report on the *revised fiscal framework* to the relevant Houses within 9 days of the tabling of the Adjustments Budget
- Report to the National Assembly or National Council of Provinces (as appropriate) on the *proposed fiscal framework* within 30 days of the tabling of the MTBPS.

The now-established custom of dealing with both matters together has resulted in the shorter time period applying to both processes. Arguably this dramatically limits the depth of engagement with the MTBPS proposals. I suggest that this is problematic, given that the MTBPS is intended to lay the foundation for the national budgets of the subsequent three years. Furthermore, Treasury has indicated in the past that in-year amendments (such as might be proposed after tabling of the Budget) are more difficult to accommodate than changes proposed in relation to the MTBPS.

In the current fiscal and macroeconomic environment, the finance committees should consider whether they are able to adequately discharge their responsibilities – including public consultation – in relation to the MTBPS by processing the *proposed fiscal framework* it within 9 rather than 30 days.

2. The Revised Fiscal Framework (2017/18)

The revised fiscal framework is very concerning. The key ‘adjustments’ proposed are as follows:

1. Revenue is now forecast to be *R50.8bn less* for 2017/18 than was assumed in the 2017 Budget
2. Expenditure may breach the ceiling set in the 2017 Budget by R3.9bn due to allocation of funds to state-owned enterprises (SOEs) that had not been provided for
3. The *main budget deficit*, which is the gap between revenue and expenditure in the main (non-consolidated) budget, is now expected to be R248.3bn (5.3% of GDP) instead of R220.9bn (4.7% of GDP). As a result, government is expected to have to borrow approximately R28bn more than planned.¹
4. Due to this, and lower economic growth, net loan debt is expected to rise to R2294.2bn (49.1% of GDP) rather than the R2226.3bn (47% of GDP) proposed in the 2017 Budget.

This effectively signals the failure of efforts towards ‘fiscal consolidation’ and the stabilisation of debt levels that was committed to in previously-tabled Budget and MTBPS documents.

¹ And this number appears to have been offset by lower-than-expected redemptions of domestic long-term loans (see Table 3.8, p.30 of the MTBPS).

2.1. Revenue shortfall

Given the lower economic growth outlook, it would be expected that revenue would be less than forecast. However, the extent of the revenue shortfall suggests that other factors could also be involved. These are subsumed in the discussion of 'revenue buoyancy' in the MTBPS, but in simple terms what the figures show is that the positive relationship between tax collection and economic growth is weakening. Once again, as in the 2017 Budget, this raises questions about the role of, and failures in, tax administration.

2.2. State-owned enterprises

The second point above, relating to a possible breach of the expenditure ceiling, arguably understates that issue, given the questionable use of R5.2bn from the contingency reserve to fund South African Airways. In effect, the MTBPS indicates that by the end of the financial year weak SOE finances linked to poor governance will result in a direct cost to the state of R13.7bn that had not been budgeted for (and therefore not approved by Parliament). Besides the dubious use of the contingency reserve for this purpose, some of the funds for are being obtained from underspending. Neither is desirable. This simply substantiates concerns expressed over the last few years (at least) about the fiscal risks posed by poor SOE governance. The failure to implement the governance recommendations of the National Development Plan and Presidential Review Committee on State Owned Entities, along with the associated rampant abuse of SOEs for personal gain, are arguably the primary causes of this situation.

2.3. The failure/abandonment of fiscal consolidation

The abandonment of fiscal consolidation should be of serious concern to all citizens and the members of the finance committees. Such consolidation, whether or not explicitly phrased as such, has been the basis for fiscal policy for at least the last three years. It therefore has also formed the basis for investor and rating agency decisions about the country's debt instruments. In the absence of dramatic improvements in the economy and political outlook, abandonment of this policy is likely to lead to further sovereign rating downgrades. Indeed, these may now be unavoidable.

3. The Proposed Fiscal Framework (2018/19 – 2020/21)

3.1. Revenue trajectory

The revenue trajectory is grave. Over-and-above the shortfall for 2017/18 discussed above, the MTBPS projects a revenue shortfall of approximately R160bn for 2018/19 and 2019/20. It is important for Members to note that these calculations *already reflect R15bn in additional tax measures expected to be introduced with the 2018 Budget*.

Over the medium-term, the shortfall could increase by R130bn to R450bn in the event of a downgrade of the local currency-denominated debt: depending on the extent of negative indirect effects.

As noted above, one issue that has not yet been adequately resolved is the role of tax administration failures/shortcomings at the South African Revenue Service (SARS) in the expected revenue shortfalls. The 2017/18 tax legislation referred to the finance committees provides the Minister with powers to obtain information from the SARS Commissioner within a specified format and level of detail. The committees should ensure that such powers are used to obtain more information from SARS on relevant tax administration issues (such as the timing of assessment and refunds) that is placed in the public domain in order to facilitate proper oversight. Annexure

A contains a request previously sent to SARS for such information, to which no reply was ever provided, that illustrates one such level of information that could be useful.

3.2. The risk of further sovereign downgrades

There has been some confusion around South Africa's sovereign debt rating. After the ill-advised and dubiously-motivated replacement of the finance minister in March 2017, the country's foreign currency denominated debt was downgraded to sub-investment grade ('junk'). The consequences of this were relatively muted because only a small proportion of our debt is denominated in foreign currency. Nevertheless, partly as a result, the cost of servicing debt is expected to rise to 14.9% of the main government budget.

What now looms on the horizon is a downgrade of local currency-denominated debt to 'junk' status. The *direct* effect of that will be to increase borrowing costs further, which means either more rapidly growing debt (as we borrow to finance more expensive borrowing) or reduced expenditure on government's core mandates.

A sovereign downgrade is also likely to affect the debt ratings of state-owned enterprises and local financial institutions. Institutional investors will withdraw capital from South African government debt instruments. This is uncharted territory in the post-1994 era, but suffice to say that the *indirect* effects are unpredictable and could be far-reaching.

The further risk, now clearly evident in the proposed fiscal framework, is of entering a 'debt spiral': increases in national debt lead to rising debt servicing costs, requiring more borrowing, further increases in debt, higher servicing costs, etc. until eventually the country is forced to seek external assistance for debt servicing and/or repayments.

3.3. Public sector remuneration

Public sector remuneration is increasingly drawing focus because it is a large proportion of total government expenditure and with a new wage settlement to be negotiated in 2018 it could, therefore, pose a serious risk to the proposed fiscal framework.

At the same time, it is important to recognise that in some sectors (including, but not limited to, health, education, defense and policing) reductions in expenditure ceilings may have led to 'austerity by stealth' in which national and provincial departments reduced posts in important service delivery areas. Both the finance and appropriations committees need to be aware of the knock-on effects of such reductions in expenditure ceilings.

3.4. Austerity by stealth

Although annual GDP growth remains positive, it is lower than the rate of population growth: in other words, leaving aside the limitations of GDP as a measure, the country's wealth per person is decreasing. Similarly, main budget non-interest expenditure is forecast to grow by 6.7% from 2017/18 to 2018/19, but in some sectors this could be less than the combined effects of inflation and population growth: in those sectors, real government expenditure per person will fall. This relates to the issue of public sector remuneration.

The Treasury have argued in the past that it should be possible for departments to reprioritise expenditure in such a way as to protect service delivery. However, it is increasingly evident – from anecdotal but credible sources – that key posts and associated services are being compromised.

Similarly, while the commitment to protect social grant expenditure is welcome, it is unclear whether the assertion that social grants will increase in line with inflation reflects the higher-than-expected population growth rates.

3.5. The contingency reserve

The only measure currently proposed to reduce planned expenditure ceilings is through a cut in the contingency reserve. This year's experience shows why that is a 'false economy': with negative per capita GDP growth, political uncertainty and financially vulnerable state-owned enterprises, the fiscus is arguably at higher risk over the next three years than it has been in most years since the late 1990s. If the contingency reserve is expected to provide a buffer against such risks, cutting it merely serves to artificially reduce the (already sharp) projected increase in debt levels.

3.6. State-owned enterprises

The problems of state-owned enterprises are now well-known and well-established. One issue raised by the MTBPS is the extent to which National Treasury see the stability of Eskom's finances being (partly) dependent on assumptions that it will sign renewable energy contracts (REIPPs) at a rate lower than previously agreed (77c/kWh). Also the extent to which the assumption of 'electricity inflation' from 2018/19 of 8% is realistic, both for Eskom and for municipalities.

4. Recommendations

As always, in the time available it is extremely difficult to make recommendations based on detailed analysis. While Treasury gets months to compile the MTBPS, public submissions have to be made within 3 working days.

4.1. Address the origins of revenue shortfalls and weak economic growth

The proposed increase in national debt, given its origins and wholesale absence of any defensible basis, is highly undesirable. Unfortunately, it is driven by weak economic growth and faltering revenue collection, the root causes of which usually develop over a period of time. Both these failures have political origins that must be addressed in order to prevent the situation worsening even further.

4.2. Protect key expenditure areas and associated civil service posts

The perversity of the current situation, albeit not a unique one internationally, is that political failures affecting revenue and growth are most likely to be addressed through cuts to critical expenditure areas. This is because precisely the same dynamics that favour corruption, poor governance and policy uncertainty have little regard for service delivery or fulfilment of the government's core mandate. To the extent that expenditure must be reduced to stabilise debt, the cuts should first target the bloated cabinet, ministries and managerial bureaucracies.

Accompanying this, even greater efforts should be made to target corruption and wasteful expenditure. The Chief Procurement Officer's role should be protected and strengthened in order to save money through improved contracting and efficiency across government.

Only once all other measures have been exhausted should cuts to critical expenditure areas be entertained.

4.3. Interrogate the role of SARS in anticipated revenue shortfalls

The committees should ensure that Minister obtains the requisite information from SARS for oversight purposes and that this is placed in the public domain. (See Annexure A for a, non-exhaustive example).

4.4. A public sector wage agreement based on a fair social compact

The public sector wage negotiations in 2018 are both a risk and a possible source of hope. The MTBPS 'budgets' for a 7.3% across-the-board increase – partly via conditions of service improvements. In the current economic and fiscal environment, there is a strong argument to be made that even this is excessively generous. With an appropriate social compact, it could be possible to negotiate an inflationary increase only. However, in the current climate of abuse of public resources by senior politicians and bureaucrats, such an agreement appears impossible. Strong and credible leadership is required, which should include salary cuts for the highest paid within the state.

4.5. A fiscally responsible, socially progressive approach to higher education funding

Given the fiscal constraints – whatever their origins – a substantial increase in higher education funding seems neither feasible nor desirable. Yet the principle that no suitably talented student should be barred from higher education, or have their studies compromised by insufficient funding, is almost universally accepted. Given these two fundamental considerations, at this point in may be prudent to focus on: addressing underfunding for students who currently qualify for financial support; ensuring that the numbers of students admitted to higher education institutions do not exceed what the state can responsibly support. It should be noted that increasing direct funding for student (through greater allocations to NSFAS) while cutting funding to institutions (as appears to be proposed via the below-inflation increases in the MTBPS) may simply equate to giving with one hand while taking with the other. Once again, strong and credible leadership would go a long way to addressing the financial challenges in the tertiary sector that have been highlighted by student protests.

4.6. Enforcement of good governance at state-owned enterprises

Poor governance at SOEs has direct costs in the form of corruption, wasteful expenditure and policy uncertainty that harms service delivery, economic growth and investment. In the current environment, poor governance also exposes the fiscus because it substantially increases the risk that private lenders (local or international) will not roll-over loans to SOEs – leading either to the financial collapse of SOEs or treasury intervention that, as with SAA, has direct, negative consequences for the fiscus.

4.7. Clarifying the mechanisms of budget decision-making by the Executive

There is some uncertainty on the changing role of the Presidency in the budget process. This is generally undesirable and is particularly so in the current context. This has specifically related in recent times to the 'mandate paper' reportedly approved by cabinet. While it is obvious that cabinet always has a say over the budget, the process by which this happens – and the associated powers of the relevant government departments – should be clarified.

Relatedly, the MTBPS refers to a group of ministers advising the president on 2018 budget proposals. The identity of these ministers and their respective roles should be made public.

Once again, given the dire picture painted by the 2017 MTBPS, I would strongly encourage the finance committees to consider utilising the full 30 days for consultation and deliberation on the proposals therein.