2016 Budget Review Analysis Report

Parliamentary Budget Office

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Director: Prof M Jahed

Contributing authors[*]: Abigail Stiglingh Brandon Ellse, Dumisani Jantjies, Mmapula Sekatane, Nelia Orlandi, Rashaad Amra and Sean Muller

Enquiries: djantjies@parliament.gov.za

Ref.no. 31 March 2016

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List of Acronyms

COE	Compensation of Employees
CIT	Corporate Income Tax
CSG	Child Support Grant
DTC	Davies Tax Committee
GDP	Gross Domestic Product
ECD	Early Child Development
IMF	International Monetary Fund
MTEF	Medium Term Expenditure Framework
MTBPS	Medium Term Budget Policy Statement
MTSF	Medium Term– term Strategic Framework
NDP	National Development Plan
PBO	Parliamentary Budget Office
PIT	Personal Income Tax
SOE	State Owned Enterprises
VAT	Value Added Tax

Executive summary

South Africa's economy continues on a slow path of growth, with the 2016 Budget Review reflecting such conditions and providing further measures to address the consequences of lower economic growth. The PBO analysed the 2016 Budget Review and identified areas for the attention of the Members of the Committees of Finance and Appropriation in both Parliament Houses. This report provides details of some of the issues for consideration in the 2016 Budget Review.

The 2016 Budget Review presents a further downward revision of economic growth forecasts after the 2015 MTBPS, with implication for public finances. Slow economic growth means lower government tax revenue and lower revenue put pressure on government spending programmes and levels of debt. In response, the government has continued to pursue a policy of fiscal consolidation in order to stabilise the debt-to-GDP ratio by:

- Further reducing the spending ceiling by R 25 billion over the MTEF and reprioritising R 31. 8 billion over the next three years; and,
- Raising an additional R48.1 billion in revenue over the medium term by adjusting tax policy,

This report provides a brief history of South Africa's fiscal policy leading to the 2016 Budget Review, with the emphasis on support to economic growth over the years. The government is confident that it will achieve a 3.9 per cent budget deficit and stabilise debt within the MTEF. However, this PBO report highlights the importance of ensuring efficiencies of tax incentives and aligning government social expenditure growth with inflation.

While the government debt-to-GDP ratio continues to increase and is expected to continue increasing in the MTEF, the report highlights two risks associated with a high debt level for the MPs consideration. First, debt service costs are growing faster than any expenditure component and second, high debt requires government to have high levels of revenue to service the debt. The government intends to increase revenue by adjusting tax policies. This report noted that government continues to miss its revenue collection targets persistently. The government intends to use PIT and fuel levy among tax policy adjustments aimed at increasing revenue. However, this PBO report emphasises the importance of keeping the tax system progressive.

The government intends to reduce the expenditure ceiling further. However, in order to support economic growth, the PBO report emphasises the importance of ensuring that government expenditure programmes are aligned to the NDP, since this is currently not entirely the case. The COE budget shows a growing trend over the medium term. The report thus emphasises the importance of ensuring such an increase is in line with government commitment to allowing growth in critical areas, such as front line services.

The PBO report further emphasises the need for MPs to be aware of key fiscal risks. The three risks here highlighted in this report: the uncertainty of economic growth and other government forecasts; the effects of long-term lower economic growth on the sustainability of social grants; and update on contingent liability risks.

1. Purpose

This report aims to provide Parliament with an analysis of the proposed Fiscal Framework and Division of Revenue. It will hence provide more information for consideration during Parliament's adoption of the fiscal framework.

2. Introduction

The 2016 Budget Review, presented on the 24 February 2016, forecasted downward revised Gross Domestic Product (GDP) growth for South Africa in 2016/17 and over the medium term. The revised downward GDP growth outlook is in part due to lack of both domestic and international demand, a fragile recovery, and weak commodity prices.

The South Africa's (RSA) economic conditions have worsened since the presentation of the 2015 Medium Term Budget Policy Statement (MTBPS). In particular, the Rand has depreciated further, economic growth has been lower than anticipated and RSA sovereign status has been downgraded to one level above sub-investment by two of the three major international rating agencies, Fitch and S&P.

Lower than expected economic growth means lower government tax revenue and less funds to spend on government programmes. The government has responded by proposing further taxes to increase revenue –taking into account the need for a sustainable tax burden to taxpayers— and a reduced government spending ceiling. The government is committed to stabilising the debt-to-GDP ratio over the medium term, as failure to do so may lead to an erosion of confidence in public finance management. Moreover, this might lead to a higher cost of servicing the debt, which remains the fastest-growing expenditure in the budget.

The government is further committed to addressing any domestic factors that may drive economic growth. The need to address these issues has also been cited by the credit rating agencies and they include bottlenecks to infrastructure spending, and the subdue private sector participation in certain areas of the economy.

3. Fiscal Policy and Framework

Fiscal Policy

The South African fiscal policy has evolved somewhat from the late 1990s until the recent years, with explicit support for economic growth moving from being primary objectives to becoming secondary objectives. However, South Africa continues to pursue the countercyclical policy –approach used by various governments globally to support economic activities-over the years, but the lack of fiscal space poses a challenge to follow the approach further.

The fiscal framework is guided by fiscal policy; hence it is necessary to understand the policy in order to analyse the framework. The historic background to fiscal policy provides insight into the current state of public finance in South Africa.

Higher Growth Period – 1990s to 2007-

South Africa's fiscal objectives have evolved over the years. The period from the late 1990s to 2007 has seen objectives of fiscal policy that have explicitly indicated the government's position of supporting economic growth with the aim of reducing inequality, poverty and unemployment. The government has used growth in infrastructure expenditure and consumption of goods and services as a broad measure to enhance economic growth. It was during these years that a fiscal space was created within the public finance –this is consistent with countercyclical policy – since South Africa's GDP growth averaged more than 3.3 per cent between the late 1990s and 2007.

Global Financial Crisis Period- 2008 to 2014-

Both during and after the global financial crisis, the government's fiscal policy objective was to increase its involvement in supporting economic growth. This was intended to counter the low levels of business activities (countercyclical policy) created by the global financial crisis. It is during this period that fiscal space created before was eroded and the government's debt-to-GDP ratio grew significantly.

Global and domestic economies are still to return to growth levels experienced before the financial crisis. As South Africa's economic growth continued to be lower than expected, part of the government's expenditure programmes were financed by borrowing, resulting in a budget deficit. South Africa's contingency reserves were also eroded during this period of countercyclical fiscal policy. However, higher than inflation public sector wage is among reasons that led to the depletion of contingent reserves.

The slowdown in economy saw a reduction in private sector investment. While the involvement of government's countercyclical policy may have crowded out the private sector, other local factors

may have adversely affected private investment. The financial crisis effects were severe insofar as the countercyclical policy adopted by government led to a situation of entrenched deficit or 'structural deficit. During the financial crisis, GDP growth averaged less than 2.5 per cent.

Fiscal Consolidation Period - post 2014 -

Lower than expected economic growth continued globally and domestically more than five years after the financial crisis. As a result, the South African government has been unsuccessful in attaining its fiscal objectives to reduce the deficit, stabilise debt levels and create fiscal space. In the 2016 Budget Review, the government intended to support economic growth initiatives as secondary objectives. However, it also intended to improve environment for doing business in South Africa.

The government intends to support growth by providing a strong platform for growth, attracting private investment to the economy, while addressing infrastructure bottlenecks, improving policy coordination certainty and implementation, rebuilding trust between business and labour, and improving the ease of doing business and other measures. However, the government may now need to set indicators and targets –for initiatives to support growth— to ensure future success in supporting economic growth.

As part of supporting economic growth strategies, monetary policy — notably, inflation targeting — has been advanced as a measure to ensure competitiveness of businesses and protect purchasing power. The South African Reserve Bank (SARB) in an attempt to keep inflation within target band uses repo rate. However, there is a concern that higher repo rate may dampen economic growth prospects. In essence, high repo rate may contradict the fiscal objective of supporting economic growth.

3.1. Fiscal Framework

Figure 3.1: 2016 Revised fiscal framework

R billion/percentage of GDP	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
		Outcome		Revised estimate	Medium-term estimates		
Revenue	**907.6**	**1 008.1**	**1 100.0**	**1 223.1**	**1 324.3**	**1 436.7**	**1 571.6**
	27.3%	*27.9%*	*28.6%*	*30.0%*	*30.2%*	*30.2%*	*30.4%*
Non-interest expenditure	950.1	1 034.5	1 116.5	1 245.6	1 308.9	1 403.4	1 509.6
	28.6%	*28.7%*	*29.0%*	*30.6%*	*29.8%*	*29.5%*	*29.2%*
Interest payments	93.3	109.6	121.2	135.3	154.3	168.7	185.6
	2.8%	*3.0%*	*3.2%*	*3.3%*	*3.5%*	*3.6%*	*3.6%*
Expenditure	**1 043.4**	**1 144.1**	**1 237.7**	**1 380.9**	**1 463.3**	**1 572.1**	**1 695.2**
	31.4%	*31.7%*	*32.2%*	*33.9%*	*33.3%*	*33.1%*	*32.8%*
Budget balance	**-135.9**	**-136.0**	**-137.8**	**-157.9**	**-139.0**	**-135.3**	**-123.6**
	-4.1%	*-3.8%*	*-3.6%*	*-3.9%*	*-3.2%*	*-2.8%*	*-2.4%*
Primary balance	**-42.6**	**-26.4**	**-16.6**	**-22.6**	**15.4**	**33.4**	**62.0**

Source: National Treasury

The 2016 Budget Review has presented an updated fiscal framework following the 2015 MTBPS. The 2016 fiscal framework deals with the effects of further deteriorating global and domestic economic growth to avoid the failure of attaining a fiscal path of reducing the budget deficit and stabilising public debt. To achieve the fiscal objectives laid out for MTEF, the 2016 Budget Review proposes to:

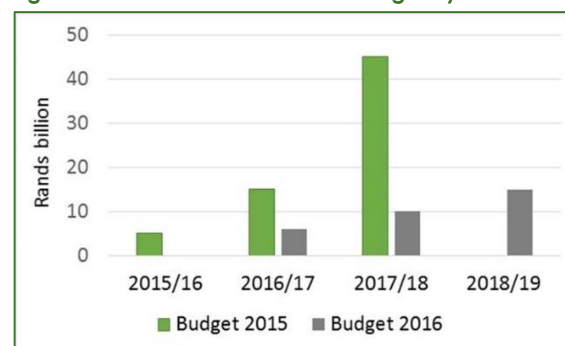
- Reduce expenditure ceiling further by R25 billion over the MTEF period and reprioritise R31.8 billion over the next three years,
- Raise revenue of R48.1 billion over the medium term by proposing tax adjustments; and,
- National debt is projected to stabilise at 46.2 per cent of the GDP by 2017/18,

The government continues to meet its expenditure ceiling since it was introduced in 2012. However, government expenditure continues to grow beyond inflation. If expenditure continues to grow beyond inflation, then government's fiscal objectives may take longer to be realised and this may further erode the credibility of the fiscal framework. The government proposes increasing revenue by adjusting tax policy and other measures. However, it is important to ensure that current revenue expenditures are effective, being that there are more tax incentives that are announced in the 2016 Budget Review.

3.2. Contingency Reserves

As part of the 2016 fiscal framework, the government expects fiscal space to be created to allow for contingency reserves within the medium term. Contingency reserves act as a buffer allowing the government to respond to fiscal shocks like drought effects or a freeze in higher education fees increase. Compared to the 2015 Budget Review; South Africa's ability to respond to contingencies is reduced. Figure 3.2 shows a comparison of contingency reserves between the 2015 and 2016 budget reviews.

Figure 3.2: Reduction in contingency reserves



Source: National Treasury

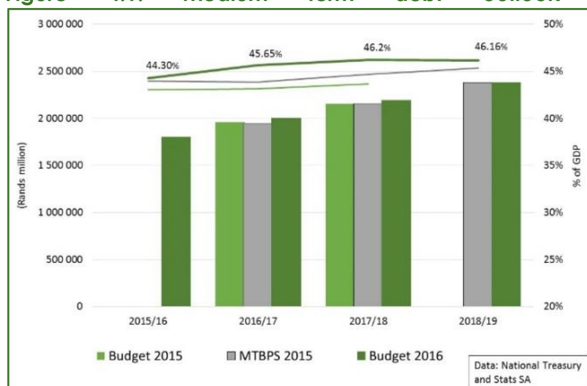
4. Debt Outlook

One of the key fiscal objectives in the 2016 Budget Review is stabilising the country's debt-to-GDP ratio.

Net debt[1] is expected to increase from 44.3 per cent of GDP in 2015/16 to 46.16 per cent in 2018/19. This is higher than the 2015 Budget Review and MTBPS debt outlook, and it is due to higher projected debt stock as well as downwardly revised economic growth forecasts (see Figure 4.1).

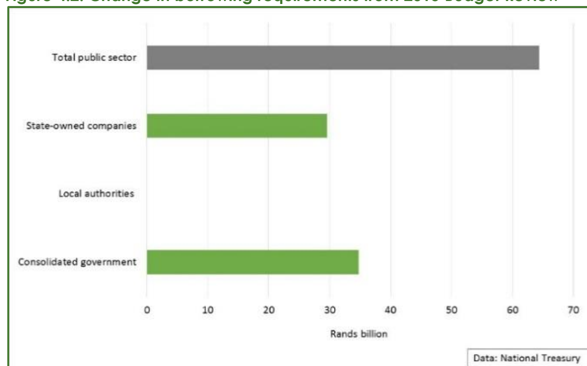
When provisions and contingent liabilities are added to net debt, the country's debt-to-GDP ratio increases to about 70 per cent over the MTEF from 46 per cent. Figure 4.1 and 4.2 show increases in the borrowing requirements and net-debt stock over the MTEF.

Figure 4.1: Medium term debt outlook



Source: National Treasury and Stats SA

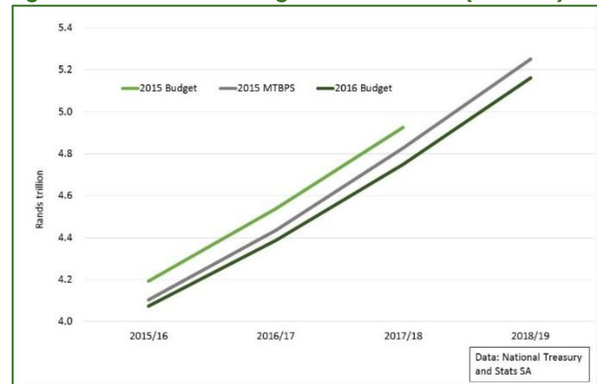
Figure 4.2: Change in borrowing requirements from 2015 Budget Review



Source: National Treasury

As debt is expressed as a share of GDP, the downwardly revised economic growth forecasts also require the debt stock to be reduced for the ratio to be constant. However, since debt forecasts reflect a prior commitment to fiscal priorities, it is impossible to reduce funding requirements suddenly when economic growth forecasts are adjusted. As a result, the debt outlook has been revised, with debt stabilising as a share of GDP, but at a higher level than projected in the 2015 MTBPS and 2015 Budget Review.

Figure 4.3: Revisions to growth forecasts (nominal)

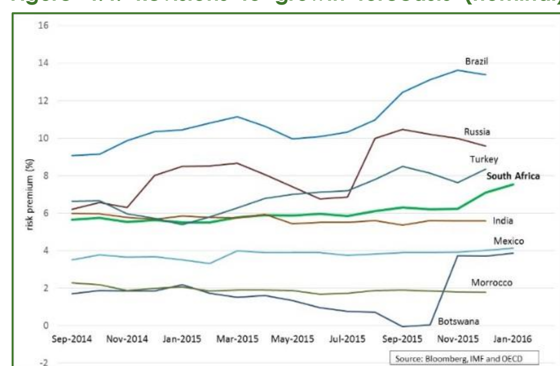


Source: National Treasury and Stats SA

High levels of debt-to-GDP ratio are of concern for the country for two main reasons. First, the higher the debt, the larger the portion of total expenditure dedicated to debt-service costs. This squeezes out non-interest expenditure, constraining the government's ability to meet other key priorities. In the 2016 Budget Review, 10.34 per cent of the total main budget expenditure is dedicated to servicing the national debt.

Second, a high level of debt may diminish South Africa's creditworthiness, more so in the context of slowing economic growth and lower revenue. As a result, lenders may refuse to lend to the government of the RSA, or may demand a higher interest rate.

Figure 4.4: Revisions to growth forecasts (nominal)



Source: Bloomberg, IMF and OECD

The recent performance of the South African government's 10-year bonds signals that lenders consider SA risky, relative to other emerging market economies. Figure 4.4 shows the risk premium on 10-year government bonds for the RSA and fellow emerging market economies. The risk premium is the return above a risk-free rate (proxied by the yield on equivalent US Treasury bonds) which lenders require before investing in a country's bonds. The higher the premium, the riskier the bond.

[1] Net Debt is calculated taking into account the National Revenue Fund (balance of government's accounts with the Reserve Bank and Commercial Banks)

The riskiness of RSA bonds has increased steadily over the past eight months, with its risk premium approaching that of riskier countries such as Brazil and Russia. Sustained higher bond yields will therefore increase the borrowing costs faced by the country for the new debt issued.

International credit ratings agencies are also concerned about the risk of South Africa's debt. In December 2015, the credit ratings agency Fitch downgraded South Africa's foreign currency debt to one level above non-investment grade status from BBB to BBB-. In the same month, fellow credit ratings agencies Standard and Poor's and Moody's both revised their outlook on South Africa's foreign denominated debt from stable to negative. These changes indicated that their growing concern over the risk of RSA debt and their preparedness to move the country's foreign currency debt rating to a non-investment grade status.

The three ratings agencies cited lower than expected economic growth prospects, the risk of fiscal slippage and limited room for fiscal responsiveness as key reasons in their decisions.

Table 4.1: South Africa's foreign-currency credit rating

Fitch	Moody's	S&P		Countries (selected)	
A+	A1	A+	Upper medium grade	Botswana	Malaysia
A	A2	A		Czech Rep.	Poland
A-	A3	A-		Japan	Slovakia
BBB+	Baa1	BBB+	Lower medium grade	India	Mexico
BBB	**Baa2**	BBB		Italy	Spain
BBB-	Baa3	**BBB-**		**South Africa**	Turkey
BB+	Ba1	BB+	Non-investment grade speculative	Bangladesh	Namibia
BB	Ba2	BB		Brazil	Portugal
BB-	Ba3	BB-		Indonesia	Russia

Source: PBO

In the 2016 Budget Review, the National Treasury (NT) acknowledged that while the exact impact of a downgrade to RSA's credit rating is unknown, the consequences will certainly be negative for the country. A downgrade in the country's ratings will increase both the cost of issuing new debt and the cost of servicing current debt. A downgrade will place upward pressure on the exchange rate as investors sell-off South African assets, thereby increasing inflation.

International experience has shown that it takes a country several years to return to investment grade status following a ratings downgrade. Given the negative consequences and significant costs associated with a downgrade to the country's credit rating, the 2016 Budget Review has proposed some measures to address the risk of a downgrade.

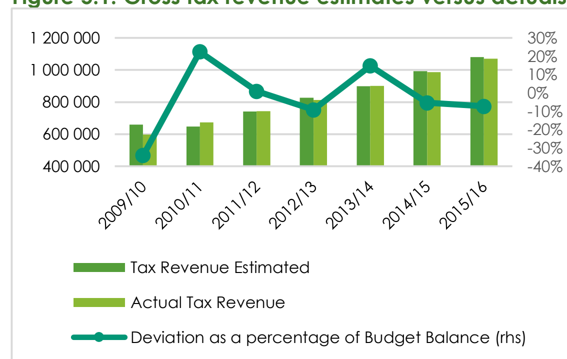
1. To reduce South Africa's debt denominated in foreign currency from 11,3 per cent to 9.8 per cent total debt stock over the MTEF. Lowering the percentage reduces the costs associated with a potential downgrade to the country's foreign-currency denominated debt.
2. To maintain the current --at two levels above non-investment grade status-- credit rating of South Africa's local currency debt – and, so providing the country with a buffer.

The National Treasury (NT) has been changing the maturity profile of its debt. It has been in the process of replacing shorter maturity debt – debt that needs to be repaid sooner – with longer maturity debt. Moreover, changing the maturity profile relieves the short-term pressure on the fiscus, deferring the need to repay the debt sooner.

5. Revenue outlook

Following the global financial crisis of 2008/9, South Africa's gross tax revenue collections have mostly been below target. Collecting lower than targeted revenue has made it more difficult to reduce the budget deficit, prompting the state to adjust its revenue policy. Notwithstanding the over-collection of tax revenue in 2009/10 and 2012/13, the state tax revenue collected was below estimates in 20008/9, 2011/12 and 2013/14. The same trend is set to continue in 2015/16 according to the latest SARS data.

Figure 5.1: Gross tax revenue estimates versus actuals



Source: National Treasury and PBO calculations

In all but one of the under-collection years, the under-collection was responsible for at least 10 per cent of the resultant budget deficit for that financial year. The implication is that had the state collected the entire tax revenue projected in those years, the amount of money borrowed would have been 10 per cent lower. The under-collection is largely a consequence of the slower than expected economic growth as highlighted earlier in the report.

The NT has estimated that the relationship between economic growth and revenue collection for 2016/17 – known as a multiplier – is 1.04 per cent. Therefore, in general, a 1 per cent reduction in economic growth will result in 1.04 per cent less in gross tax revenue

collected, compared to the 2015/16 tax multiplier of 1.4 per cent.

Persistent under-collection may thus result in faster than anticipated growth in national debt. The persistent under-collection of tax revenue has led to what is, arguably, an unsustainable fiscal environment in which budget deficits have become entrenched – known as a structural deficit - as opposed to being merely cyclical.

A cyclical budget deficit occurs when economic growth is in a temporary slowing phase. Assuming other variables remain constant, when economic growth enters the recovery phase in the cycle, the budget deficit reverts to a budget surplus. A structural deficit is when a persistent imbalance exists between state revenue and expenditure, regardless of the status of the growth cycle.

To maintain the integrity of the fiscus and avert further credit rating downgrades, the state has proposed adjustments to the existing revenue policies in the last two years. The adjustments follow several years of broadening the tax base in which government has been able to lower effective tax rates – the rate at which personal incomes are taxed after considering rebates. The most significant of the recent tax proposals are captured in Table 5.1 and, in some cases, represent the first changes to these tax instruments for several years.

Table 5.1: Key tax proposals, 2015/16 – 2016/17

	2015/16	2016/17
Tax proposals	Increase marginal tax rates by one per cent for all taxpayers earning more than R181 900	No adjustment to income tax brackets for taxpayers earning more than R406 401
	Increase the general fuel levy by 30c/litre and the RAF levy by 50c/litre	Increase the general fuel levy by 30c/litre
		Increase in Capital Gains Tax (CGT) for individuals and businesses

Source: National Treasury

The recommendations emerging from the ongoing work of the Davis Tax Committee (DTC) – commissioned in 2013 to revaluate South Africa's existing tax framework – will likely inform future proposals.

5.1. Key Tax Proposals

Personal Income Tax (PIT)

The 2015 Budget Review has introduced a 1 per cent increase in the marginal tax rates for all taxpayers earning more than R181 900. The adjustment was projected to raise an additional R9.42 billion from approximately four million registered individuals.[2]

The increase was the first in several years and followed a reduction in the top personal income marginal tax rate from 45 per cent in 1998 to 40 per cent in 2002, alongside persistent real increases in the tax-free threshold between 2005 and 2014. The NT highlights that, in their 2015 Budget Review, persistent real increase in the tax-free threshold resulted in the effective personal income tax rate remaining below its 1999/2000 peak of 20.6 per cent.

Another factor contributing to the lower effective personal income tax rate has been the adjustments to the personal income tax bracket thresholds taking place over the years. Table 5.2 shows how the thresholds of brackets have been adjusted since the 1999/2000 financial year. Annual increases to the thresholds have averaged around 11 per cent across the brackets, resulting in a real income tax relief of about 5 per cent per year. These increases, along with the reduction in marginal tax rates and the real increases in the primary rebate over the same period, explain the reduction in the effective personal income tax rate.

Holding other factors constant, at present registered taxpayers pay less income tax as a percentage of income than they did in 1999/2000.

Table 5.2: Compounded average fiscal drag

Personal Income Tax Bracket	1999/00	2016/17	Compounded Average Growth Rate, 1999/00 - 2016/17 (nominal)	Compounded Average Growth Rate, 1999/00 - 2016/17 (real)
1st (bottom)	R 33 000	R 188 000	10.78%	4.67%
2nd	R 50 000	R 293 600	10.97%	4.85%
3rd	R 60 000	R 406 400	11.91%	5.74%
4th	R 70 000	R 550 100	12.89%	6.67%
5th (top)	R 120 000	R 701 300	10.94%	4.82%
Primary Rebate	R 3 710	R13 500	7.89%	1.94%

Source: South African Revenue Service and PBO calculations

The distribution of average adjustments has arguably favoured middle to higher income earners, with the bottom two brackets experiencing the slowest average growth. The bias in average adjustments benefits has thus been amplified by the slower growth in the primary rebate. While all taxpayers have

[2] National Treasury 2015 Budget Review.

benefited from real increases in tax thresholds, the lower income earners have arguably benefited the least.

Table 5.3: Adjustments to taxable income brackets, 2015/16 vs 2016/17

Taxable Income		Adjustment (nominal)	Adjustment (real)
2015/16	**2016/17**		
R0 - R181 900	R0 - R188 000	3.35%	-3.05%
R181 901 - R284 100	R188 001 - R293 600	3.34%	-3.05%
R284 101 - R393 200	R293 601 - 406 400	3.36%	-3.04%
R393 201 - R550 100	R406 401 - R550 100	0.00%	-6.19%
R550 101 - 701 300	R550 101 - R701 300	0.00%	-6.19%
R701 301 and above	R701 301 and above	0.00%	-6.19%
Primary Rebate			
R 13 257	R 13 500	1.83%	-4.47%

Source: National Treasury and PBO calculations

The 2016 Budget Review has not proposed an increase in marginal tax rates, but offered limited relief for fiscal drag.[3] Fiscal drag leads to taxpayers moving into higher tax brackets, which effectively reduces their after-tax incomes. The taxable income thresholds for lower to middle-income earners have been increased marginally in nominal terms, but has not been enough to compensate for inflation.

In real terms, the three lower brackets have been decreased by approximately 3.05 per cent, as shown in Table 5.3. Therefore, lower to middle income earners are vulnerable to moving to higher tax brackets should their incomes be adjusted to compensate for inflation. While the nominal increases will provide temporary relief in the initial phases of the 2016/17 financial year, inflation-linked wage adjustments throughout the year are therefore likely to leave taxpayers worse off. One explanation is that registered taxpayers on the margins of brackets are likely to be paying a higher marginal tax rate by the end of the 2016/17 financial year.

Furthermore, some low-income registered taxpayers - those currently paying no tax because of the primary rebate - may be liable for income tax in the 2016/17 financial year as a result of the reduction in the primary rebate by 4.47 per cent in real terms, which is below 6 per cent inflation. Registered taxpayers earning above R701 301 are mostly unaffected by the proposals laid out in the 2016/17 Budget Review. They will, however, pay a slightly higher proportion of their income at the highest marginal tax rate of 41per cent as a result of the freeze in the R701 301 threshold.

Fuel Levy

The recent trend of increases in the fuel levy may have a disproportionate negative impact on poorer commuters. Depreciation of the local currency - the rand - or an increase in the price of oil above US$41 per barrel, or both, will amplify any negative effects in the short run despite the improved fuel efficiency of vehicles.

A fuel levy is a fixed amount charged to consumers for every litre of fuel purchased. The actual rate charged per litre is a function of the amount of the fuel levy and the price of fuel. All consumers pay the same rate regardless of their level of earnings. In this sense, a fuel levy shares many characteristics with VAT.

VAT versus Fuel Levy

Given their similar characteristics, it may be useful to draw comparisons between increases in the fuel levy and VAT. Table 5.4 provides analysis in this regard.

Table 5.4: Comparing of Vat increase and Fuel Levy increase

VAT	Fuel Levy
The Davis tax committee's first interim report on VAT released in December 2014, contained a modelling exercise on the impact of an increase in VAT. The model compared the economic impact of raising an additional R45 billion in revenue through an increase in either VAT and, personal income tax rates or the corporate income tax rate.	The fuel levy has been increased by 30c/litre in each of the last two financial years. The 2016 Budget Review estimates that this year's increase is likely to raise an additional R6.8 billion. For illustrative purposes, a simple calculation holding all other factors constant, suggests that a 0.5 per cent increase in VAT would raise a similar amount.
With the VAT increase, the report found there to be a clear trade-off between efficiency and equity. A 3 per cent VAT increase was found to result in a marginal increase in inequality – measured by the ratio of the richest decile relative to the poorest four deciles – while being the most efficient and having the least impact on long-run economic growth relative to comparable increases in PIT and CIT	If we assume that a fuel levy is at least as regressive as VAT, it will likely affect poorer commuters the most and, therefore, may increase inequality. In addition, like a VAT increase, a fuel levy hike will be inflationary and detrimental to economic growth in the short run. The effects of the latter may, however, not be as long-term as an increase in PIT or CIT

Sources: PBO and WB

The exact distributional nature of VAT in South Africa is contested, with most studies finding that it is mildly regressive. The World Bank (WB) has conducted two studies on the issue. The first found that VAT was mildly regressive and at least as regressive as South Africa's other indirect taxes such as the fuel levy.[4] However, a more recent study, showed VAT to be less regressive than before.[5] Furthermore, the modelling conducted last year by both the NT and the OECD showed that a higher VAT rate may increase inequality, suggesting

[3] National Treasury: Fiscal drag relief entails adjusting personal income tax brackets and rebates for inflation so that an individual's purchasing power remains the same from one year to the next

[4] World Bank (2005).
[5] World Bank (2015).

that the tax is probably mildly regressive.[6] While the exact distributional impact of VAT remains contested, zero-ratings have been found to make it less regressive.

However, the fuel levy offers no such mechanism and has been found to be regressive.[7] A study done by the University of Stellenbosch reports that while the fuel levy may be regressive, the advances in vehicle technology could minimise the negative impact of a levy hike for poorer commuters. Their research shows that the vehicle population and kilometres travelled have increased while fuel sales have remained relatively flat.[8] This means that commuters have gradually been getting more for their money. The gradual decrease in the productivity of a fuel levy has been experienced in several countries including the United States (USA), Germany, Singapore, Sweden, New Zealand and the United Kingdom (UK). This could potentially limit the negative economic effect of the recent fuel levy increases, but would not address its fundamental regressivity, as wealthier commuters are likely to benefit the most from more fuel efficient vehicles.

Another similarity between VAT and the fuel levy is that both instruments appear to tax items which form a comparatively larger share of poorer household's income. The Statistics South Africa (Stats SA) media release in December 2015 reported that more than two-thirds of households in the lowest income quintile spend more than 20 per cent of their monthly household income per capita on public transport. This is in contrast to 3 per cent of households from the highest income quintile spending more than 20 per cent in transport [9]

The spatial legacy - inequality, poverty and unemployment - of apartheid has led to poorer workers' residences being located far from their places of work, a reality which has both time and cost implications for these households. Many South African workers now spend an average of 102 minutes per day, commuting to and from work.[10] The South African workers' time spent commuting exceeds that of the USA and twenty three EU countries.[11] With extended travel times comes larger costs. The implications of increases to these costs through higher levies is therefore likely to have a disproportionately larger impact on poorer commuters.

Furthermore, the structure of RSA's public transport subsidies and the preferred mode of transport leaves poorer workers most vulnerable to fuel levy increases.

The research conducted in 2015 using the 1993 PSLSD survey (conducted by SALDRU) and the 2003 and 2013 National Travel Surveys (NTS) conducted by Stats SA, show that commuters are increasingly making use of minibus taxis while train and bus transport has stagnated

Table 5.5: Work travel mode by income quintile in 2013

Work travel mode (%)	NTS 2013					
Income quintile	**1**	**2**	**3**	**4**	**5**	**Total**
Walk	44.5	24.9	17.0	14.8	7.2	21.8
Car driver	5.6	8.0	18.8	34.7	61.6	25.5
Car passenger	6.4	7.3	8.2	8.9	5.6	7.3
Train	1.8	4.5	3.4	2.5	1.5	2.8
Bus	5.5	8.2	8.0	5.8	2.8	6.1
Minibus Taxi	19.6	30.0	28.5	20.3	11.3	22.0
Company transport	1.7	2.3	2.2	1.9	0.9	1.8
Other	0.4	0.5	0.5	0.4	0.3	0.4
Multiple modes	4.8	8.5	9.3	6.6	4.0	6.6
Works at home	8.3	4.3	3.4	3.0	4.2	4.6
Cycle	1.5	1.6	0.8	0.9	0.5	1.1
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Data First, University of Cape Town

As of 2013, 26.03 per cent of commuters in the lowest three income quintiles were making use of minibus taxis, compared with only 10.47 per cent train and bus users. These statistics are presented in Table 5.5.

It is significant that public train and bus transport are subsidised by government, providing some protection against cost hikes such as the fuel levy. However, minibus taxi commuters are fully exposed to a fuel levy increase. The fuel levy increases are therefore likely to be passed on to consumers with poorer commuters already incurring substantial transportation costs.

Estimates compiled using the NTS 2003 survey data show that the effective transport tax rate for a full-time worker earning R3 000 per month and making use of a minibus taxi is, on average, at least 26 per cent (R780 per month). This rises to 39 per cent (R1 170 per month) for commuters making use of multiple nodes – for example, a train and a minibus taxi.[12]

[6] Davis Tax Committee (2015), OECD (2015).
[7] Krygsman and Van Rensburg (2015).
[8] Krygsman and Van Rensburg (2015).
[9] Statistics South Africa (2015).
[10] Kerr (2015).
[11] Stutzer and Fray (2008).
[12] Kerr (2015).

The price that South Africa pays for fuel is a function of the value of rand and the international USD price of oil. Notwithstanding the weaker rand – which makes fuel more expensive for South African consumers – the fall in the commodity price of oil has resulted in a lower overall fuel price. Lower oil prices have allowed the government the space to impose further fuel levies as a means of raising revenue.

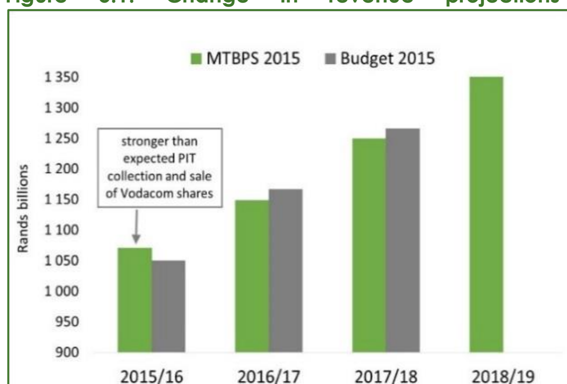
The scope for future increases in fuel taxes would depend on government's forecast of these two variables: the oil price and currency exchange rate. The NT adopts an assumption of US$41 per barrel of oil for 2016 in its economic model, while providing no explicit forecast for the value of the rand. Should the oil price rise to levels above US$41 and the rand depreciates further against the USD, then the price of fuel will domestically will increase. The depreciating local currency and higher oil price will amplify the effects of the recent fuel levy hikes on all commuters, but particularly on poorer commuters.

Growth Effect on Revenue

Slow economic growth and downwardly revised growth outlook has negatively affected actual and expected revenue collection. Gross tax revenue has been revised downward by R7.6 billion in 2015/16, R14.6 billion in 2016/17, and 12.4 billion in 2017/18. Corporate income tax (CIT) collection has been revised downwards by R13 billion for the current year from R202 billion to R189 billion. This is due to poor economic performance, particularly in mining and manufacturing. However, revenue collection for the current year has benefited from higher PIT.

Higher PIT receipts have been due to the effects of higher public and private wage settlements, as well as the increase in the marginal PIT brackets announced in the 2015 Budget Review. In the 2015/16 financial year, revenue is expected to benefit from the sale of government's Vodacom shares. The sale of Vodacom shares is expected to raise R25.4 billion to finance Eskom's requirements and the country's first instalment for the New Development Bank (NDB).

Figure 5.1: Change in revenue projections



Source: National Treasury

It is Important to note that these revenue estimates for 2015/16 do not reflect adjustments and changes to tax instruments.

6. Expenditure Outlook

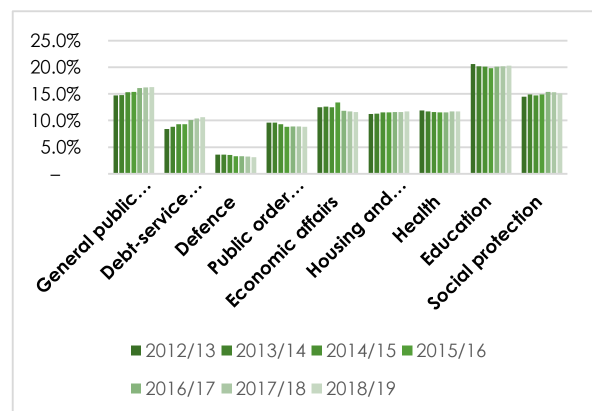
6.1. Policy Priorities

In order to fund priority areas identified by the National Development Plan (NDP) within the expenditure ceiling, a trade-off between functional groups as well as between expenditure items is required. The government intends to use NDP to support its economic growth strategy by gradually shifting expenditure towards investment, broadening opportunities and enhancing capabilities. As a result, certain parts of the budget will need to grow at a slower rate. It is for this reason that the NDP has also focused on how the government can improve efficiency.

The fourteen National Outcomes reflected in the 2014-2019 medium term strategic framework (MTSF), guides the allocation of public funds over the MTEF between functional groups. Figure 6.1 shows the percentage share allocated per functional group over the years 2012/13 and 2018/19. The changes in the percentage share of the total budget allocated towards these functional groups are marginally low over the period under consideration.

Expenditure priorities over the years 2012/13 and 2018/19, include education, social protection, economic affairs and general public services. The biggest share of 20.1 per cent of the 2016/17 total budget is allocated towards education followed by general public services at 16.1 per cent. The lowest share of the total budget is allocated towards defence at 3.3 per cent. The proportion of total spending on most categories, except for defence, public order and safety and economic affairs, has increased from the revised estimated expenditure and so it is over the 2016 MTEF.

Figure 6.1: Percentage shares per functional group



Source: National Treasury

Table 6.1 shows changes to the consolidated government expenditure within functional groups since the tabling of the 2015 Budget Review. Spending on public order and safety, economic affairs and education has increased from the revised estimated expenditure over the 2016 MTEF, while spending on general public services and health has decreased from the 2015 revised estimated expenditure and increases over the 2016 MTEF. On the other hand, spending on social protection has decreased from the 2015 revised estimates, but has increased over the 2016 MTEF.

Changes made from the 2015 Budget Review are based on expenditure reviews, new policy priorities and programmes with a history of underspending. The main reductions since the tabling of the 2015 Budget Review are within economic affairs and housing and community amenities.

Table 6.1: Consolidated expenditure changes: functional classification

	2015/16		2016/17		2017/18	
R million	Changes from the 2015 Budget	% Changes from the 2015 Budget	Changes from the 2015 Budget	% Changes from the 2015 Budget	Changes from the 2015 Budget	% Changes from the 2015 Budget
General public services 2)	-887.9	-0.42%	-853.0	-0.36%	1 845.9	0.74%
of which: debt-service costs	2 670.7	2.11%	6 749.1	4.79%	8 551.0	5.58%
Defence	409.3	0.91%	-163.0	-0.34%	-1 220.2	-2.41%
Public order and safety	1 059.3	0.88%	1 811.7	1.42%	2 810.7	2.07%
Police services	400.4	0.49%	953.7	1.10%	1 694.9	1.84%
Law courts	-62.7	-0.34%	305.2	1.52%	329.6	1.56%
Prisons	705.4	3.55%	478.4	2.27%	738.8	3.31%
Public order and safety not elsewhere classified	16.2	7.85%	74.5	37.98%	47.4	23.44%
Economic affairs	25 030.3	15.65%	8 870.2	5.43%	11 947.8	6.99%
General economic, commercial, and labour affairs	12 173.4	51.55%	9 858.6	39.49%	9 290.1	35.79%
Agriculture, forestry, fishing and hunting	9.7	0.05%	218.5	1.11%	369.2	1.80%
Fuel and energy	19 951.6	166.93%	44.0	0.47%	-53.3	-0.51%
Mining, manufacturing and construction	-734.1	-23.29%	-1 372.0	-35.33%	-614.8	-19.30%
Transport	-5 061.7	-5.52%	1 159.6	1.24%	5 207.0	5.29%
Communication	330.5	10.49%	1 249.2	33.70%	211.9	5.46%
Other industries	245.3	8.52%	164.1	5.23%	214.1	6.58%
Economic affairs not elsewhere classified	-1 884.4	-37.61%	-2 451.9	-47.47%	-2 676.3	-49.73%
Environmental protection	-440.2	-5.78%	-129.3	-1.62%	-432.4	-5.23%
Housing and community amenities	5 722.2	3.73%	3 663.0	2.21%	6 998.8	4.01%
Housing development	827.0	2.39%	-2 740.6	-7.34%	-1 391.0	-3.52%
Community development	1 782.3	2.03%	975.8	1.05%	2 463.7	2.50%
Water supply	3 112.9	10.13%	5 427.8	15.37%	5 926.1	16.17%
Health	-91.5	-0.06%	-1 494.7	-0.88%	3 031.3	1.69%
Recreation and culture	696.6	6.94%	1 336.4	13.32%	1 520.0	14.30%
Education	3 684.7	1.36%	7 189.9	2.51%	13 384.2	4.42%
Social protection	-263.1	-0.13%	3 255.7	1.47%	5 435.6	2.33%
Subtotal: functional classification	34 919.7	2.59%	23 486.9	1.64%	45 321.8	2.99%
Total consolidated expenditure	1 380 926.5		1 463 290.7		1 572 061.8	

Source: National Treasury

Table 6.1 shows the proportion of consolidated government expenditure by economic classification. The outcome for compensation of employees (COE) is estimated to be 34.5 per cent of the total expenditure in 2015/16. It is estimated that the proportion allocated for COE will decrease from 35.6 per cent estimated in the 2015/16 main budget to 35.2 per cent in 2018/19. However, this proportion is higher than the revised estimated proportion spent in 2015/16, which implies an increase in the estimated proportion of expenditure from the revised estimate for 2015/16.

The annual average growth rates of COE budgets over the 2016 MTEF for a selection of function groups are:

- Health: 7.4 per cent
- Provincial Basic Education: 7.9 per cent
- Economic Affairs: 7.6 per cent
- Human Settlements and Municipal Infrastructure: 8.2 per cent
- Defence, Public Order and Safety: 6.4 per cent

The inconsistency in growth rates of COE budgets among selected functional groups has raised concerns. In some instances, the increases are below the wage negotiation agreement of the Consumer Price Index (CPI) plus 1 per cent, (average CPI inflation: 6.2%). In other instances, the increases are in line with the negotiations, but do not allow for filling positions in essential services (Education and Health).

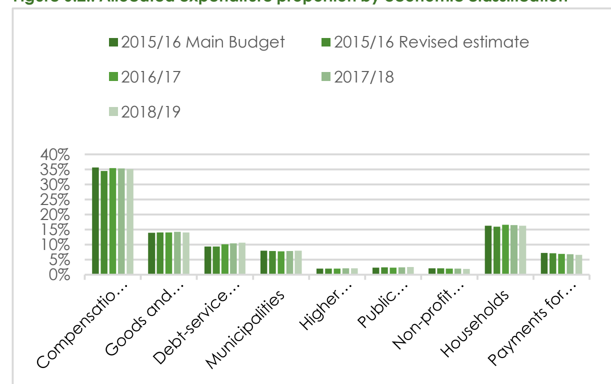
The proportion of debt-service cost budget increases from 9.4 per cent in 2015/16 to 10.6 per cent in 2018/19, while payment for capital assets decreases from 7.2 per cent in 2015/16 to 6.6 per cent in 2018/19. This shift in the proportion of the budget allocated for debt-service costs and payment for capital assets may imply a trade-off between these two functions. The proportion of the budget allocated to higher education increases from 2.01 per cent in the 2015/16 main budget to 2.09 per cent in 2018/19

Table 6.2.: Proportion of expenditure per economic classification

R million	2015/16 Main Budget	2015/16 Revised estimate	2016/17	2017/18	2018/19
			Medium-term expenditure framework		
Economic classification					
Current payments	**59.41%**	**58.35%**	**60.10%**	**60.31%**	**60.30%**
Compensation of employees	**35.62%**	34.53%	35.46%	35.30%	35.17%
Goods and services	**13.94%**	14.03%	14.05%	14.21%	14.08%
Debt-service costs	**9.39%**	9.35%	10.14%	10.37%	10.63%
Transfers and subsidies	**33.09%**	32.41%	32.65%	32.60%	32.83%
Municipalities	**7.97%**	7.87%	7.76%	7.81%	8.01%
Higher education institutions	**2.01%**	1.99%	2.01%	2.12%	2.09%
Public corporations and private enterprises	**2.34%**	2.42%	2.32%	2.37%	2.47%
Non-profit institutions	**2.07%**	2.06%	2.03%	1.95%	1.88%
Households	**16.31%**	16.01%	16.63%	16.47%	16.31%
Payments for capital assets	**7.24%**	7.09%	6.89%	6.76%	6.58%

Source: National Treasury

Figure 6.2.: Allocated expenditure proportion by economic classification



Source: National Treasury

6.2. National departments' expenditure

Table 6.2 shows the estimated expenditure per national department presented in the 2015 Budget Review, as well as adjusted estimates and revised 2015/16 estimates and the 2016 medium term expenditure estimates. The middle column shows the changes from the 2015 budget review to the revised estimate for 2015/16. The total net increase in estimated expenditure at national level is R22 million, taking into account the additional R23 million allocated to Public Enterprises for supporting Eskom.

Table 6.3: Expenditure by national vote

R million	2015 Budget	Adjusted appropriation 2015/16	Revised estimate 2015/16	Changes from the 2015 main	2016/17	2017/18	2018/19
1 The Presidency	510.3	475.9	448.3	-62.0	499.7	500.3	520.0
2 Parliament	1 566.9	1 594.2	1 594.2	27.3	1 659.6	1 731.2	1 802.3
3 Communications	1 280.9	1 290.9	1 288.6	7.7	1 345.4	1 431.0	1 526.9
4 Cooperative Governance and Traditional Affai	69 314.2	70 815.5	69 415.5	101.3	72 994.0	78 557.2	84 258.5
5 Home Affairs	6 450.8	7 348.7	7 348.7	897.9	7 167.1	7 060.4	7 173.7
6 International Relations and Cooperation	5 698.6	6 510.9	6 510.9	812.2	5 888.7	5 913.0	6 182.6
7 National Treasury	26 957.3	28 726.1	28 704.6	1 747.3	28 471.4	31 127.0	32 310.5
8 Planning, Monitoring and Evaluation	717.7	754.2	749.2	31.5	827.7	907.8	994.3
9 Public Enterprises	267.5	23 302.6	23 282.6	23 015.1	274.0	279.5	289.9
10 Public Service and Administration	930.9	847.6	830.3	-100.5	770.4	900.9	948.7
11 Public Works	6 411.1	6 312.2	6 252.2	-158.9	6 528.8	7 221.2	7 661.8
12 Statistics South Africa	2 245.2	2 323.3	2 260.1	14.9	2 489.1	2 168.3	2 200.4
13 Women	187.0	189.1	189.1	2.1	196.9	207.4	216.9
14 Basic Education	21 511.1	21 286.4	21 088.4	-422.7	22 269.6	23 471.0	24 829.6
15 Higher Education and Training	41 844.0	42 016.8	41 929.3	85.4	49 188.3	52 316.1	55 334.8
16 Health	36 468.0	36 211.1	35 753.8	-714.2	38 563.3	42 778.1	46 734.2
17 Social Development	138 168.6	137 893.6	136 943.6	-1 225.0	148 937.7	161 520.1	174 808.5
18 Correctional Services	20 617.6	20 588.6	20 588.6	-29.0	21 577.3	23 048.9	24 700.7
19 Defence and Military Veterans	44 579.4	45 088.2	45 088.2	508.8	47 169.7	48 744.6	50 725.7
20 Independent Police Investigative Directorate	234.8	234.8	234.8	–	246.1	255.5	267.0
21 Justice and Constitutional Development	14 984.0	15 010.8	14 850.8	-133.2	16 049.7	16 983.2	17 845.2
22 Office of the Chief Justice and Judicial Adminis	742.4	783.4	783.4	41.0	865.0	1 009.0	1 060.9
23 Police	76 377.1	76 720.8	76 220.8	-156.2	80 984.9	87 252.2	92 954.3
24 Agriculture, Forestry and Fisheries	6 383.0	6 408.8	6 398.8	15.7	6 333.0	6 706.3	6 999.0
25 Economic Development	885.8	885.8	885.8	–	674.7	714.3	751.0
26 Energy	7 482.1	7 267.6	7 257.9	-224.2	7 545.2	8 129.0	8 486.4
27 Environmental Affairs	5 948.0	5 943.3	5 943.3	-4.7	6 430.1	6 660.6	6 756.8
28 Labour	2 686.9	2 704.2	2 682.8	-4.1	2 847.9	3 032.0	3 224.2
29 Mineral Resources	1 618.5	1 638.5	1 638.5	20.0	1 669.1	1 847.2	1 824.6
30 Science and Technology	7 482.1	7 466.1	7 461.1	-21.0	7 429.0	7 562.5	7 756.4
31 Small Business Development	1 103.2	1 127.5	1 115.2	12.0	1 325.4	1 459.5	1 540.0
32 Telecommunications and Postal Services	1 413.3	1 405.3	1 205.3	-208.1	2 417.4	1 636.3	1 751.1
33 Tourism	1 800.2	1 794.2	1 769.2	-31.1	2 009.5	2 067.3	2 172.6
34 Trade and Industry	9 593.7	9 497.8	9 497.8	-95.9	10 327.5	9 290.5	8 631.4
35 Transport	53 357.3	53 615.1	53 615.1	257.8	56 015.2	61 100.7	65 453.3
36 Water and Sanitation	16 446.5	15 746.5	15 294.5	-1 152.0	15 245.3	16 038.3	17 159.7
37 Arts and Culture	3 919.9	3 826.0	3 761.0	-158.9	4 070.9	4 492.7	4 542.9
38 Human Settlements	30 943.4	30 543.4	30 543.4	-400.0	30 690.9	34 566.3	36 620.0
39 Rural Development and Land Reform	9 379.7	9 197.4	9 187.4	-192.3	10 124.3	10 549.5	11 078.8
40 Sport and Recreation South Africa	988.5	980.9	979.4	-9.2	1 028.6	1 075.0	1 135.0
Total appropriation by vote	**679 497.5**	**706 374.0**	**701 592.3**	**22 094.8**	**721 148.2**	**772 311.7**	**821 230.4**

Source: National Treasury

The Departments of Social Development and Water and Sanitation are the two departments showing the highest estimated underspending in 2015/16. Social Development estimates an underspending of R1, 225 million, while Water and Sanitation shows an estimated underspending of R1, 152 million.

6.3. Reprioritisation

Table 6.4 shows baseline reductions by spheres of government over the 2016 MTEF. The total reductions over the 2016 MTEF amount to R32 880 million, of which the biggest proportion of R19 235 million was taken from national government. R7 208 million has reduced the COE at a national level.

Table 6.4: Baseline reductions per government sphere

R million	2016/17	2017/18	2018/19	MTEF total	% of baseline
National government	**6 163**	**6 355**	**6 717**	**19 235**	**0.8%**
Compensation of employees	1 499	2 981	2 729	7 208	1.5%
Goods and services	1 412	1 504	2 090	5 007	2.5%
Transfers to public entities	2 683	1 539	1 548	5 770	1.7%
Other national spending items[1]	568	331	350	1 249	0.2%
Provincial government	**3 551**	**1 659**	**1 620**	**6 830**	**0.4%**
Provincial equitable share	1 500	1 000	800	3 300	0.2%
Provincial conditional grants	2 051	659	820	3 530	1.2%
Local government	**2 150**	**2 015**	**2 650**	**6 815**	**2.2%**
Local government equitable share	300	500	1 000	1 800	1.1%
Local government conditional grants	1 850	1 515	1 650	5 015	3.7%
Total baseline reductions	**11 864**	**10 029**	**10 987**	**32 880**	**0.8%**

Source: National Treasury

In terms of the NT, allocations to provincial and local government have been reduced by 0.4 and 2.2 percent respectively. The biggest proportion of the reductions have been taken from estimated conditional grant allocations over the 2016 MTEF.

Table 6.5 shows a total reduction of R14 900 million or 1.1 per cent over the 2016 MTEF on provincial equitable share, being that the preliminary estimates are in the 2015 MTBPS. The amounts allocated to fund priorities are R1 500 million in 2016/17, R100 million in 2017/18 and R800 million in 2018/19. In 2017/18, R4 800 million and in 2018/19 R6 800 million in 2018/19 million will be contributed to fiscal consolidation, while R5 800 million is unallocated for 2018/19.

Table 6.5.: Baseline reductions per province

R millions	2016/17	2017/18	2018/19
	Differences		
Eastern Cape	211	815	1 067
Free State	84	324	423
Gauteng	293	1 136	1 494
KwaZulu-Natal	319	1 232	1 611
Limpopo	177	683	894
Mpumalanga	123	476	624
Northern Cape	40	154	201
North West	103	399	524
Western Cape	150	581	761
Total	**1 500**	**5 800**	**7 600**

Source: National Treasury

The biggest change to provincial conditional grants were in the human settlements development grant and the consolidation of the provincial disaster grant with other grants. Reductions in local government grants include regional bulk infrastructure and municipal systems improvement.

Table 6.6 shows the funding of spending pressures over the MTEF. An additional funding of R31 794 million over the 2016 MTEF is allocated towards the following:

- Higher education receives R16 269 million due to the freezing of university fees in 2016
- The New Development Bank receives R11 750 million as a result of an international agreement to contribute to the New Development Bank
- The Contingency Reserve has increased by R300 million
- Small business development receives R475 million for job creation programmes
- Planning, monitoring and evaluation has received R300 million over the 2016 MTEF, despite the fact that the revised estimate for 2015/16 has been revised downwards. The additional fund will contribute towards capacity for monitoring and evaluation

Social protection will receive additional funding for expanding and improving Early Childhood Development (ECD) in 2017/18 and 2018/19. However, it is important to ensure that provincial departments

are prepared for implementing this new grant from 2017/18 onwards.

The reprioritisation of funds is based on:

- Recommendations from expenditure reviews (30).
- Modelling of remuneration trends (preliminary resulting from an exercise between the National Treasury and the Department of Public Service and Administration).
- Programmes with a history of underspending.

Table 6.6: Expenditure funded by reprioritised funds

R million	2016/17	2017/18	2018/19	MTEF total
Higher education	4 882	5 555	5 832	16 269
New Development Bank	3 750	3 500	4 500	11 750
Provision for contingency reserve	3 000	–	–	3 000
Small business development	150	158	167	475
Planning, monitoring and evaluation	50	100	150	300
Social protection ECD[1]		300	500	800
Total	**11 832**	**9 313**	**10 649**	**31 794**

Source: National Treasury, PBO

Table 6.7.Unauthorised, Irregular and Fruitless spending

Expenditure Item R' million	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015
Municipalities						
Unauthorised Expenditure	6 005	4 851	9 788	9 195	11 402	n/a
Irregular Expenditure	4 455	6 950	9 824	11 600	11 473	n/a
Fruitless and Wasteful Expenditure	209	248	568	815	687	n/a
Provincial and National Government						
Unauthorised Expenditure	6 605	3 809	2 978	2 279	2 644	1 641
Irregular Expenditure	11 009	22 124	28 378	27 414	62 730	25 682
Fruitless and Wasteful Expenditure	437	1 544	1 793	2 386	1 166	936

Source: PBO (using AGSA Reports)

In response to the PBO's pre-budget analysis, the concerns raised by Members of Parliament about the lack of analysis of government wastage of public finance, the PBO summarised the work done by the Office of the Auditor General of South Africa (AGSA) with regard to unauthorised[13], irregular[14] and fruitless and wasteful[15] expenditures commonly known as UIFs. It is important for MPs firstly to understand the meaning and context of the UIFs. Table 6.7 shows a trend of unauthorised, irregular and fruitless expenditure from 2009/10 until 2014/15 by national, provincial and local governments, with the national and provincial funds combined.

7. Risks to Fiscal Outlook

In a separate projects, the PBO has conducted a detailed analysis of three risk areas that are relevant to the 2016 Budget Review: uncertainty in relation to economic growth; the sustainability of social grant expenditure; and risks posed by the financial status of SOEs.

7.1. Uncertainty in the Economic Growth Forecast

The forecasts of real economic growth and revenue collection play a fundamental role in the budget review. However, there have always been uncertainties about what will actually transpire and what may be important for assessing the appropriateness of budget proposals. For example,

If economic growth is lower than forecast in the Budget (and everything else stays the same) that will mean a higher debt-to-GDP ratio than planned.

In practice, lower growth usually leads to lower revenue collection, implying a larger deficit and faster growth in the stock of debt than planned. The result is that if the government intends to keep to its debt-to-GDP ratio and deficit targets for the current fiscal year, growth lower than forecast will usually require reductions in planned expenditure.

It would therefore seem appropriate that MPs are given some indication of the risk that actual GDP growth will be different to the forecast when processing the fiscal framework. Providing independent advice on budget forecasts is, internationally, a core component of the role played by Parliamentary Budget Offices. The South African PBO is currently completing a detailed assessment of the historical performance of the NT's forecasts. Using findings from that project – which will be finalised at the end of March 2016 – we use historical forecast errors to construct uncertainty bands- also known as 'confidence intervals' - for the forecasts in the 2016 Budget Review. The results provide a crude indication of risk.

Figure 7.2 illustrates how applying this approach to NT's forecasts would have assisted Members in providing an accurate sense of uncertainty in the growth forecasts presented in the 2015 Budget Review. The graph shows 50 per cent, 70 per cent and

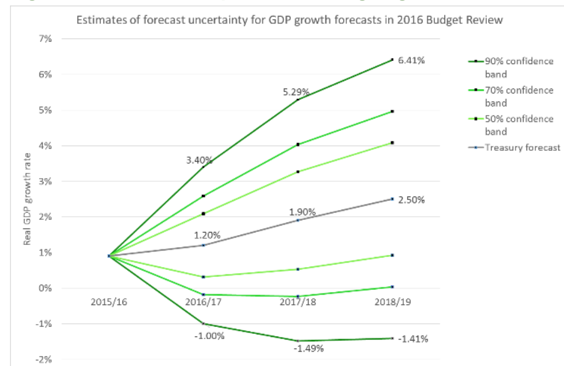
[13] Unauthorised Expenditure: expenditure by departments remaining unspent in accordance with the approved budget overspending

[14] Irregular Expenditure: expenditure that was not incurred in the manner prescribed by legislation. Such expenditure does not necessarily mean that money had been wasted or fraud committed, but is an indicator that legislation is not being adhered to, including legislation aimed at ensuring that procurement processes are competitive and fair.

[15] Fruitless and Wasteful Expenditure is expenditure that was made in vain and that would have been avoided had reasonable care been taken.

90 per cent uncertainty bands around the NT's forecasts for each year of the MTEF.[16] The higher the level of confidence, the wider the gap between the lowest and highest estimates. The gap then increases for longer forecast horizons and there is then much more uncertainty about growth three years from now than for one year.

Figure 7.1 Uncertainty in 2016 budget growth forecasts

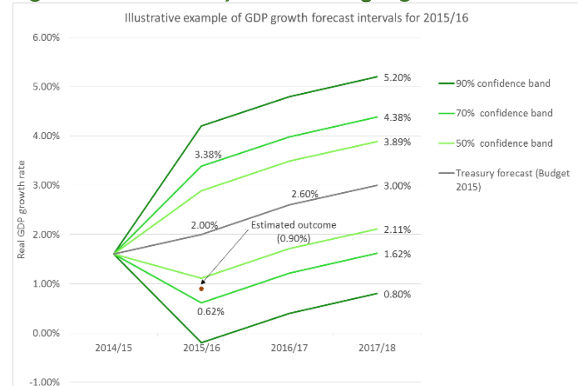


Source: PBO

To illustrate how the graph should be interpreted, consider the 70 per cent uncertainty band. The 2015 Budget Review forecast for 2015/16 real GDP growth was 2 per cent. *Historical* forecast errors suggest that there is a 70 per cent chance that actual growth would be between 0.62 per cent and 3.38 per cent. The current estimate of growth for the recently ended 2015/16 year is 0.9 per cent. This is much lower than originally forecast, but it lies within the 70 per cent confidence interval. In other words, using historical uncertainty would have provided a more accurate picture of likely economic growth than just the single forecast number used in the budget.

Figure 7.2 shows the results from performing the same exercise for the 2016 Budget Review growth forecasts. The NT's forecast for 2016/17 is 1.20 per cent, but historical errors suggest that we can be 90 per cent confident that growth will actually be between -1 per cent (a recession) and 3.4 per cent.

Figure 7.2 Uncertainty of 2015 budget growth forecasts



Source: PBO

7.2. Sustainability of Social Grants

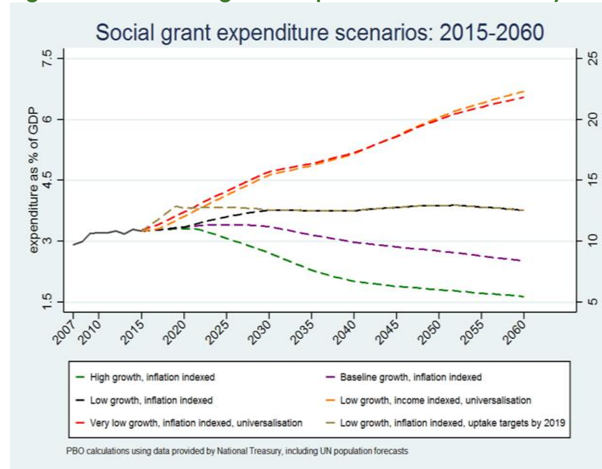
Some analysts have suggested that social grant expenditure is unsustainable. The PBO has completed a report on the sustainability of social grant expenditure, which was requested by the Standing Committee on Finance (SCOF) after the 2015 Budget review. The Report examined the NT's models, reproducing its findings on this subject and coming to similar conclusions regarding sustainability. It found that grant expenditure is sustainable based on current policies, demographic projections and *long-term* growth forecasts. Claims by other analysts regarding a 'fiscal cliff"' are not based on a credible methodology.

One important caveat is that the economic growth rate assumed in the NT's 'low growth" scenario is higher than recent low growth rates would suggest.[17] The PBO examined an additional, pessimistic scenario in which current low growth rates persist indefinitely. In that case, as shown by the red line in Figure 7.3, sustainability could be compromised – particularly given expected increases in beneficiary numbers due to higher uptake rates by eligible citizens and population growth.

[16] A detailed explanation of the basis for this approach will be provided in the Technical Report to be circulated by the end of March 2016.

[17] Other important caveats to the conclusion that grant expenditure is sustainable are discussed in greater detail in the full Report.

Figure 7.3 Social grant expenditure sustainability



Source: PBO

It is important to add that there are other major expenditure areas, such as health and education, which are also vulnerable if real GDP growth is lower than population growth. While the persistence of current economic growth rates beyond the medium-term seems unlikely at present, the analysis highlights the challenge faced by the government in the short-term from grant expenditure pressures. One way to address this would be to reprioritise expenditure from elsewhere. The other is to reduce planned grant expenditure. The two primary mechanisms for reducing planned grant expenditure are first, reduction in planned increases in grant values or, second, reduction of planned beneficiary numbers. In this regard, the 2016 Budget Review has proposed:

- Grant increases below forecast inflation, reducing the real value of grants
- Maintaining planned increases in grant beneficiaries at similar levels to the 2015 budget.

There are some changes at the level of individual grants, with Disability Grant recipients 100,000 less than planned in 2015 and Child Support Grant recipients higher by 300,000 in 2016/17 and 500,000 in 2017/18. In addition, there are notable increases in allocation to Grant-in-Aid and Social Relief of Distress (approximately R500 million for 2016/17) over the MTEF. In terms of Grant-in-Aid, this corresponds to large increases in projected beneficiaries (from 89,273 in 2015/16 to 164,756 in 2016/17), presumably due to the consequences of low economic growth and drought.

In other words, the NT intends to continue expanding the coverage of the safety net provided by the grants system in-line with population increases and improved uptake, while marginally reducing the real value of grants to individual recipients. Whether this is the appropriate trade-off depends in part on its expected distributional impact and is ultimately a policy decision rather than a public finance issue

7.3. Update on Contingent Liabilities Risks

In recent years, the NT and SCOF have raised a number of concerns regarding the implications of the financial status of state-owned enterprises (SOEs) for the fiscal framework. Deterioration in SOE financial status poses two main, direct risks to public finances. The state may be forced to provide an equity injection (colloquially referred to as a "bailout") in order to keep an enterprise solvent. Alternatively, it may have to meet an SOE's debt obligations (interest payments or debt repayments) because of government-issued debt guarantees. Debt guarantees for SOEs constitute the majority of the state's contingent liabilities, which stood at R753 billion at the end of 2015/16.

Although the NT has not committed itself to a particular target for net debt and contingent liabilities, financial problems at SOEs have raised the concern that the government's debt obligations could increase dramatically if it had to honour some its larger debt guarantees to SOEs. Similarly, the government's commitment to expenditure ceilings would be challenged if any large equity injections are required.

Equity Injections

The 2014 MTBPS committed to only provide equity injections to SOEs if these were matched by revenue from the sale of non-core assets. In 2015/16 the government sold its stake in Vodacom, reportedly realising revenue of R25.4 billion. Of this sum, R23 billion was to be transferred to Eskom – as per the Eskom Special Appropriation Bill – while the remaining amount was to be used for the first contribution to the NDB.

According to the 2016 Budget Review, R15 billion had been paid to Eskom, but the R5 billion of the R10 billion due to be paid in December 2015 was withheld and destined to be transferred in March 2016 when certain (unstated) conditions were met. A clarifying statement from the NT after the 2016 Budget speech then indicated that R3 billion of this sum would be transferred to Eskom in early March 2016. The remaining R5 billion will be transferred subject to approval after Eskom has submitted further information to the NT in March 2016. The contribution to the NDB was made in December 2015.

The only equity injection currently planned for 2016/17 is the R650 million "recapitalisation" of the Post Bank. The 2016 Budget Review states that this was financed through reprioritisation of funds rather than a sale of assets. This suggests a possible shift in policy towards maintaining a neutral effect of such support on the deficit, without necessarily requiring assets sales for all equity injections.

Debt Guarantees and Other Contingent Liabilities

The largest components of government's current contingent liabilities are debt guarantees to Eskom (R168 billion), liabilities of the Road Accident Fund (R132 billion) and – a recent addition – tariff guarantees to Independent Power Producers (IPPs – R200 billion). The inclusion of the IPPs guarantees and Public Private Partnership contracts (R8.9 billion) is reported to be part of an updated approach to accounting for contingent liabilities.

The inclusion of such contingent liabilities is particularly significant in light of the pressure on the current budget, along with the desire to involve private capital in SOE financing. Having been finalised and presented to SCOF in 2015, the PBO's report on SOE financing noted that while encouraging private capital in financing large investments may reduce direct pressure on the budget, such 'off-budget" financing comes with corresponding future risks that need to be acknowledged and managed.

The rationale for including IPPs tariff guarantees as contingent liabilities appear to be as follows. Eskom and government have reduced their infrastructure investment burden by contracting with IPPs to build and operate renewable energy production. This has been done by guaranteeing future tariffs that Eskom will pay for this electricity, which provides these producers with some certainty of their return on investment. However, this shifts a number of important risks on to Eskom.

First, if the tariffs Eskom is allowed to charge consumers are lower than if it has to pay the IPPs; then it will make a loss on those sales. Second, if demand turns out to be lower than predicted and the power produced is not required, then Eskom will still have to pay for it. In either event, this may compromise Eskom's financial situation to the extent that the state will need to step in to meet these contractual obligations. Eskom revenue formulas consider IPPs as pass through costs, which the regulator is obliged to approve, this partly mitigates risks noted.

Social Security funds continue to be a concern. Specifically, the net assets value (negative) of the Road Accident Fund (RAF) is projected to decrease further by 18 per cent per year, with an increase in the corresponding contingent liability at a rate of 11.6 per cent per year. It is not immediately clear what the basis is for the projected divergence between the RAF's net asset value and the state's contingent liabilities. The 2016 Budget Review notes that the Road Accident Fund Benefit Scheme Bill is expected to be tabled by the Department of Transport in Parliament in 2016/17. However, given the possible fiscal implications of any changes to the system, it may be appropriate for the finance committees to play some role in the processing of this Bill by Parliament.

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Parliamentary Budget Office,
Parliament of the Republic of South Africa

Tel: +27 021 403 2360
Fax: +27 086 718 2531

Email: pboinfo@parliament.gov.za