



FINANCIAL AND FISCAL COMMISSION BRIEFING ON THE 2015 FISCAL FRAMEWORK AND REVENUE PROPOSALS

“For an Equitable Sharing of National Revenue.”

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LIST OF ACRONYMS

CPI	Consumer Price Index
CPO	Chief Procurement Officer
CWP	Community Works Programme
EPWP	Expanded Public Works Programme
ETI	Employment Tax Incentive
FFC	Financial and Fiscal Commission
GTAC	Government Technical Advisory Centre
IGFR	Intergovernmental Fiscal Relations
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDP	National Development Plan
NHI	National Health Insurance
NPO	Nonprofit Organisation
OECD	Organisation for Economic Co-operation and Development
RAF	Road Accident Fund
SAA	South African Airways
SABC	South African Broadcasting Corporation
SALDRU	Southern African Labour and Development Research Unit
SANRAL	South African National Roads Agency Limited
SARB	South African Reserve Bank
SOC	State Owned Company
VAT	Value Added Tax

1. THE CONTEXT

- 1.1 This submission is made in terms of Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009) which requires Parliamentary Committees to consider any recommendations of the Financial and Fiscal Commission (hereafter FFC or the Commission) when considering Money Bills. It is also made in terms of the FFC Act (1997) as amended which requires the Commission to respond to any requests for recommendations by any organ of state on any financial and fiscal matter.
- 1.2 The submission consists of six sections. The second section gives a brief review of the 2015 fiscal framework. The third section provides an overview of the economy and public finances, with a particular focus on long-term fiscal risks confronting South Africa. Section 4 discusses the key components of the fiscal framework and revenue proposals for 2015. Section 6 gives options for improving the fiscal framework and the final section presents concluding remarks.

2. BRIEF REVIEW OF THE 2015 FISCAL FRAMEWORK

- 2.1 Table 1 outlines the fiscal framework for the 2015 medium term expenditure framework (MTEF) period. Over the next three years, Government is expected to spend R3.95 trillion relative to a revenue envelope of R3.48 trillion. Over the 2015 MTEF period, real annual average growth in expenditure is projected at 4.8 percent. A relatively stronger 6.8 percent growth is projected in respect of revenue. Reducing growth in expenditure is to be driven by a combination of cost containment measures and efforts to improve the efficiency of spending. Stronger growth in revenue will be achieved through adjustments to tax policy discussed below.
- 2.2 The bulk of resources are allocated in respect of non-interest allocations in the form of equitable share and conditional grant funding.

Table 1. Consolidated Fiscal Framework, 2012/13-2017/18

R billion/percentage of GDP	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
	Outcome		Revised estimate	Medium-term estimates		
Revenue						
Gross tax revenue after Proposals	813.8	900.0	979.0	1 081.3	1 179.2	1 289.7
Non-tax revenue	16.2	18.9	18.1	17.0	17.9	18.6
SACU	-42.2	-43.4	-51.7	-51.0	-36.5	-45.4
National Revenue Fund Receipts	12.3	11.7	8.9	2.0	5.4	2.5
Main budget revenue	800.1	887.3	954.3	1 049.3	1 166.0	1 265.4
Expenditure						
National departments	420.0	453.2	491.4	523.0	553.8	586.1
Provinces	380.9	410.6	439.7	468.2	496.3	526.4
Local government	76.4	82.8	89.1	99.8	103.9	110.0
Non-interest allocations	877.4	946.6	1 020.1	1 090.9	1 154.0	1 222.5
Debt-service costs	88.1	101.2	115.0	126.4	141.0	153.4
Unallocated reserves	–	–	–	5.0	15.0	45.0
Main budget expenditure	965.5	1 047.8	1 135.1	1 222.3	1 309.9	1 420.9
Main budget balance	-165.4	-160.5	-180.9	-173.1	-144.0	-155.5
	-5.0%	-4.4%	-4.7%	-4.1%	-3.2%	-3.2%
Primary balance	-2.3%	-1.6%	-1.7%	-1.1%	-0.1%	0.0%

Source: Medium Term Budget Policy Statement (MTBPS) (2014) and Budget Review (2015).

2.3 In rebalancing and aligning policy decisions with sustainable fiscal policy, Government is emphasising the principle of cost containment. The practical application of this principle has implications for tariffs charged in respect of basic infrastructure services, notably electricity, roads and water.

2.3.1 Budget 2015 has highlighted Government's commitment to provision of free basic services to indigent households alongside cost reflective tariffs for all other households. The downside of not aligning tariffs closely to costs is well illustrated in by the current electricity crisis. Due to highly subsidised tariffs, particularly over the period 1980-2007, Eskom has been since trying to shift towards more cost reflective tariffs. In the face of the current energy crisis and accompanying power outages, higher tariffs may face strong resistance and unwillingness to pay, yet increases are essential to fund maintenance and expansion of generation capacity.

2.3.2 Unwillingness to pay has posed a similarly serious challenge in the case of the Gauteng Freeway Improvement Project with resistance to payment of tolling tariffs.

Given Government's stated stance in applying a user pay principle, what is required now is putting in place measures to improve acceptability of the user charge principle for higher levels of infrastructure services and differentiated high value products, compared with the standard offering that is paid by and is affordable to the tax base.

- 2.4 Public investment in infrastructure will total R813 billion over the next three years. State owned companies (SOCs) are responsible for 45 percent of this spending over the 2015 MTEF period. Continuous cash injections to assist ailing SOCs not only places undue stress on the fiscal framework and redirects funding away from core service delivery areas, but it also brings into question the ability of SOCs to effectively drive South Africa's infrastructure-led growth.
- 2.5 Intentions to reform both health-care and social security pose significant areas of risk in relation to potential impacts of these reforms on the national and provincial fiscal frameworks. The provision of universal health-care through the proposed National Health Insurance (NHI) is a significant pending development. The implementation of the NHI will impact the fiscal framework. Pending social security reform as alluded to by the Minister of Finance in the 2015 Budget Speech will similarly, have an impact on the fiscal framework. The extent of the impact can only be assessed once specific proposals around the reform are known.
- 2.6 The usual concern around the eventual outcome of salary negotiations, which still have to be concluded, exists and poses a critical long-term risk. Indications from Government are that should the outcome of these negotiations be higher than expected, unallocated reserve funding will be utilised. The ability of labour and Government to reach a mutually beneficial agreement that closely aligns wage demands with inflation so as to guard against having to reallocate resources away from essential spending areas will be critical. To this end, Commission research and recommendations has focussed on strategies for managing the provincial wage bill so as to contain fiscal stress as part of the Submission for the 2014/015 Division of Revenue¹. The Commission welcomes Government efforts aimed at trying to find a long-term solution to the wage bill issue, especially the recent establishment of the Presidential Public Service Remuneration Review Commission which the Commission is a member of.
- 2.7 The main underlying message from the Commission's analysis is that Government has tabled a budget that generally maintains stability and ably balances contending priority

¹ Further details on this research can be accessed at: www.ffc.co.za

areas. There are however various aspects and areas of risk that can unsettle this delicate balancing act – these are elaborated on below.

3. MACROECONOMIC OUTLOOK AND LONG-TERM FISCAL RISKS CONFRONTING SOUTH AFRICA

ECONOMIC GROWTH

- 3.1 South Africa's economy remains vulnerable to slow global recovery but increasingly more to domestic factors such as the recent labour unrest. Consistent with similar downward revisions in growth projections from 2012 to 2014, the lacklustre forecast for 2015 is related to considerable risks posed by disruptions to production stemming from more labour unrest, electricity supply constraints², the slow recovery in the Euro Area and the gradual deceleration of growth in China. Compared with forecasts for 2015 and 2016 made at the tabling of the 2014 Medium Term Budget Policy Statement (MTBPS) of 2.5 percent and 2.8 percent respectively, the 2015 Budget incorporates growth forecasts for these years is just 2.0 percent and 2.4 percent. The downward revision of the economic growth figure is an indication of a further obstacle to the achievement of the targets set out in the National Development Plan (NDP), most notably a decrease in the unemployment rate by 14 percent by 2030 that require a 5.4 percent annual growth.
- 3.2 Looking at the contributions of each industry to the annualised percentage change in seasonally adjusted real gross domestic product (GDP), most volatile contributions to real GDP growth have come from the (i) mining and quarrying, and (iii) manufacturing sectors. Historically, these have been the sectors most affected by strikes and the recent strikes in the mining industry have had a negative impact in the mining sector's contribution to GDP growth although they rebounded in the fourth quarter of 2014. It should be noted that mining and quarrying as well as manufacturing sectors have been shrinking continuously and given that they constitute important contributions to South

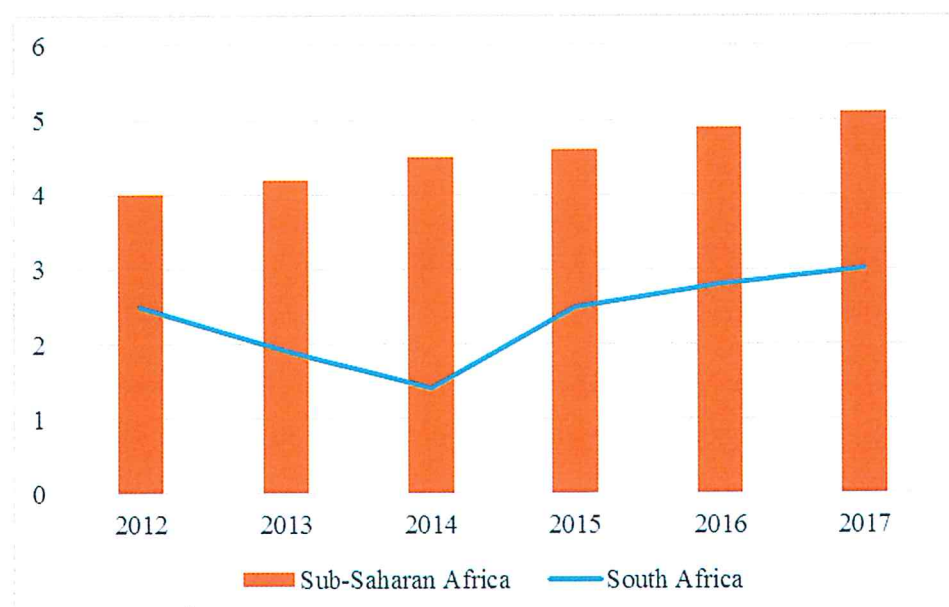
² There are three different types of electricity supply constraints:

- The installed capacity is insufficient to meet peak demands as a result of the gap between the installed generating capacity and peak demand.
- The consumption of electricity exceeds the capacity of the system to supply because of the gap between consumption levels and the ability to supply power.
- The margin between capacity and demand due to demand rising faster than operational capacity.

Africa's export sector, developments in these sectors should be closely monitored by South African government particularly over the medium term.

3.3 Figure 1 indicates that compared to the rest of sub-Saharan Africa, South Africa is expected to record only a marginal acceleration in economic growth of between 2.75 – 3 percent between 2016 and 2017. This projected moderate growth is premised on sustained public investment in infrastructure and a marginally better global outlook.

Figure 1. GDP Growth for South Africa and Sub-Sahara Africa, 2012-2017

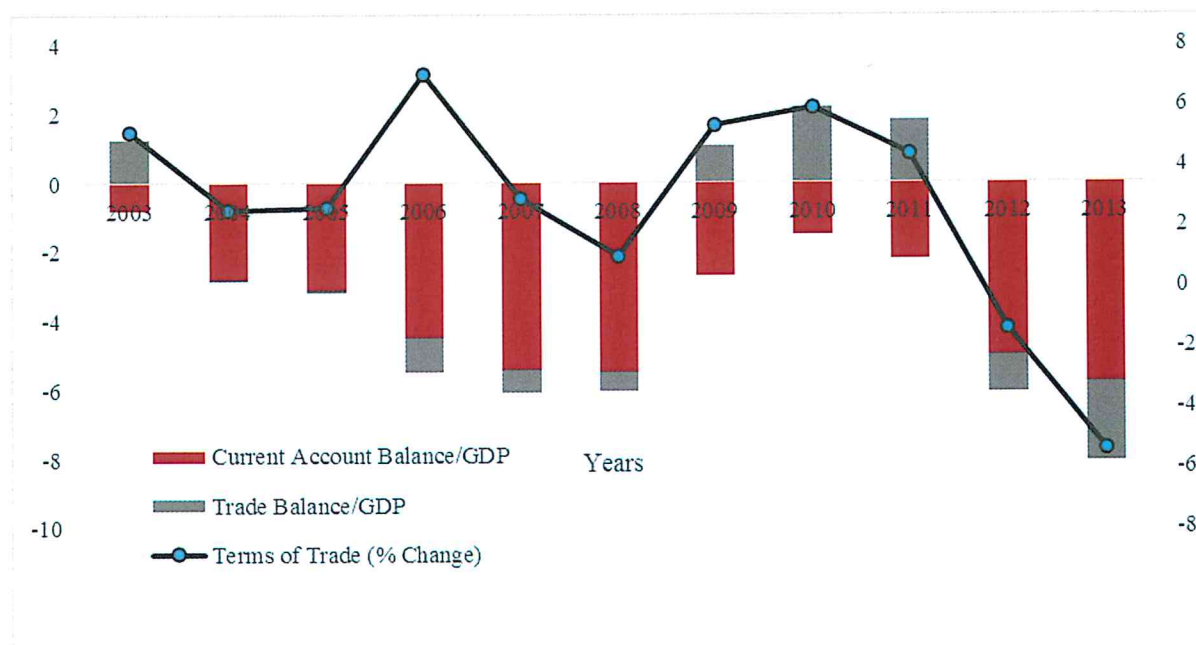


Source: National Treasury and the World Bank.

CURRENT ACCOUNT DEFICIT

3.4 The slow rate of recovery in the global economy has adversely impacted South Africa's export markets. Figure 2 shows that the country has experienced weaker terms of trade that have contributed to a wider trade deficit, an outcome that has increased the current account deficit.

Figure 2. Percentage Change in Terms of Trade, Current Account and Trade Balance as a Share of GDP, 2003-2013

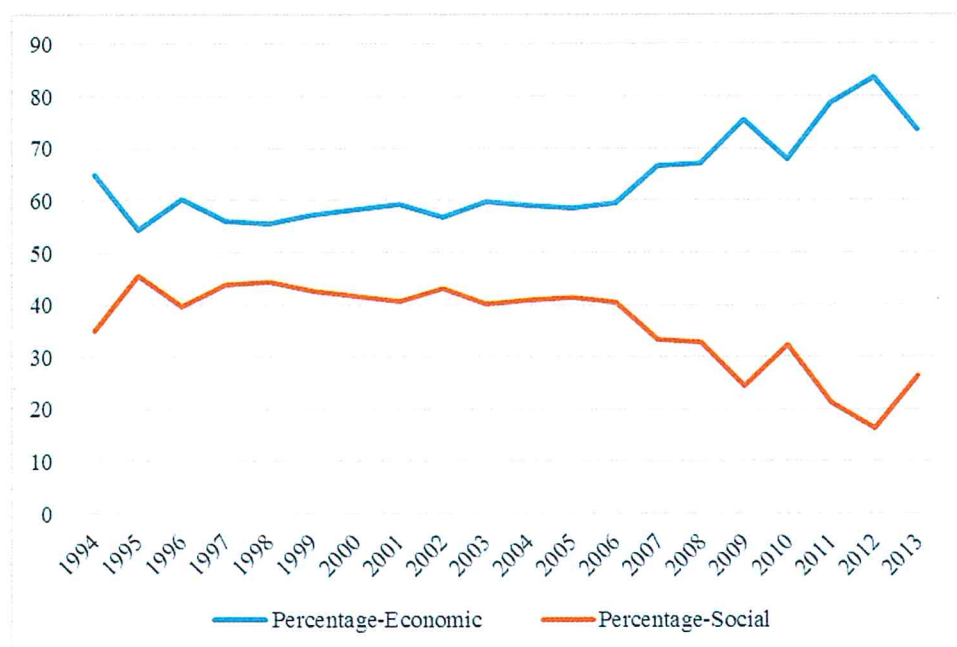


Source: South African Reserve Bank.

INFRASTRUCTURE INVESTMENT

3.5 Despite ongoing fiscal consolidation, Government remains committed to completing large infrastructure projects in line with objectives stated in the NDP. Figure 3 shows that investment in infrastructure by public sector institutions continues to increase. According to Statistics South Africa, public sector institutions investment in infrastructure has increased by 4.8 percent (or R9.7 billion), from R202.8 billion in 2012 to R212.5 billion in 2013. A disaggregation of capital expenditure by type reveals increases in plant, machinery and equipment (up R10 billion from 2012), 'other' fixed assets (R2 billion) and transport equipment (R1 billion). There were capital expenditure decreases on new construction works (R3 billion), leased assets and investment property (R0.7 billion) and on land and existing buildings (R0.1 billion). The percentage of gross fixed capital formation allocated to economic infrastructure has been substantially larger than that of social infrastructure between 2010 and 2013. The percentage of gross fixed capital formation by economic infrastructure generally increased from 68 percent in 2010 to 73 percent in 2013 while that of social infrastructure declined from 32 percent in 2010 to 27 percent in 2013.

Figure 3. Gross Fixed Capital Formation by Type of Infrastructure, 1994-2013



Source: National Treasury and World Bank.

GLOBAL AND DOMESTIC RISKS

3.6 Multiple risks stemming from external and domestic factors are likely to define the economic outlook for South Africa.

3.6.1 Three key issues underpin the likely effect of external factors on the domestic economy. Firstly, the likely commencement of monetary policy rate hikes in the United States, and the implementation of accommodative policies in the Euro Area and Japan, could result in modestly tighter global financing conditions in the medium term. The impact of tighter financial conditions could negatively affect highly indebted households' banks through credit channels, and aggregate demand via private consumption. Secondly, falling of commodity prices due to increased supply, modest growth in main export markets of China and the Euro zone and anxieties about global growth, are expected to persist. Lower commodity prices could negatively impact export earnings and contribute to the widening of South Africa's trade deficit. Thirdly, the weak recovery in the Euro Area and the possible Greece default and/or exit from the European Union implies relatively slow growth of markets for South Africa's exports and depressed investor confidence.

3.6.2 Outside of the external factors discussed above, another key exogenous issue that could likely affect the growth outlook is uncertainty over the price of oil. Oil prices fell sharply in the second half of 2014, ending a four-year period of stability around \$105 per barrel. The World Bank projections for oil prices show that they will

remain low in 2015 with a marginal increase only in 2016. Realization of these forecasts will have a positive impact on the South African economy. Given that oil is an important feedstock for many sectors in South Africa, a reduction in oil prices directly impacts a wide range of processed or semi-processed inputs. Therefore lower oil prices benefit a wide range of sectors encompassing transportation, petrochemicals, and agricultural sectors, and some manufacturing industries. A reduction in oil prices has had a significant and favourable impact on the medium-term inflation expectations. This could allow the South African Reserve Bank to sustain its accommodative stance on monetary policy. The combination of lower inflation and lower oil prices is likely to support an increase in domestic consumption and enhance the country's growth prospects.

3.6.3 On the domestic front, structural constraints remain an impediment to growth. South Africa's potential growth³ has declined to between 2–2.5 percent, reflecting a negative output gap⁴ of around 0.5 – 1.25 percent in 2014. This suggests that the cyclical factors previously perceived to be growth-constraining are increasingly becoming structural⁵. An exceptionally high unemployment rate that is widening differences in labour income and wealth is turning South Africa into one of the most unequal societies in the world. The poverty rate is also relatively high when compared with other emerging market economies⁶. South Africa's employment rate is very low by international standards. It is estimated at 40 percent of the working-age population against an Organisation for Economic Cooperation and Development (OECD) average of 65 percent and comparable rates amongst other middle-income non-OECD economies⁷. Figure 4 shows that trend in that the number of employed people in South Africa has remained relatively flat since the global financial crisis, with a post-crisis peak of 314 000 additional people employed in the third quarter of 2013. The low number of people employed can be explained by various factors. On the labour supply-side, inadequacies in education and training, have contributed to skill mismatches. On the demand side, sluggish economic growth has meant growth that is inadequate to absorb the growing labour supply.

³ Potential growth refers to the long-term potential growth rate given the productive capacity, technology, as well as factor inputs of the economy.

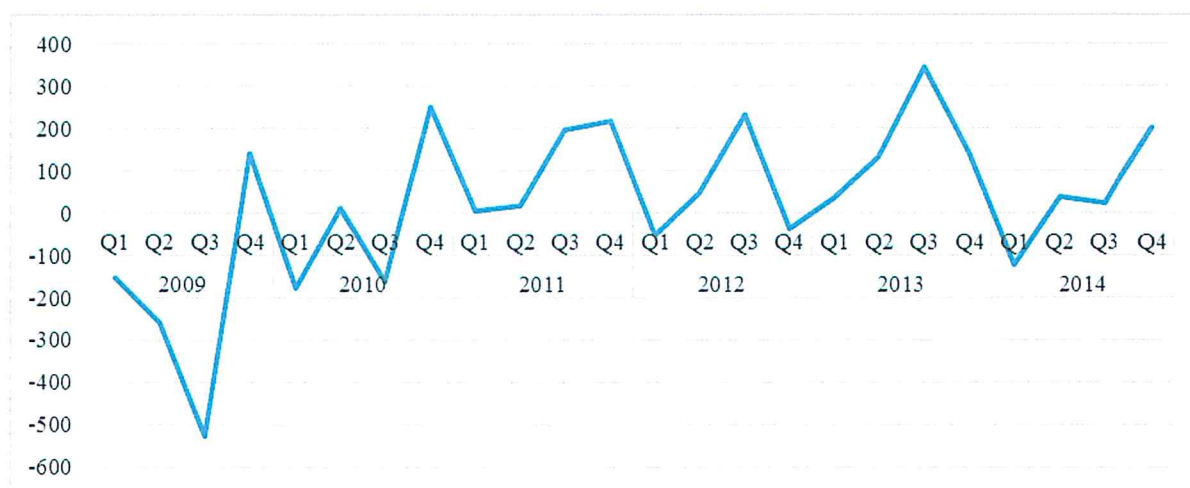
⁴ Potential output is the maximum amount of goods and services an economy can produce when it is most efficient.

⁵ See IMF 2014 Article IV Consultation Staff Report-South Africa

⁶ The percentage of the population that is poor in South Africa is 45,5% translating to 23 million people living below the upper-bound poverty line

⁷ See OECD Economic Surveys: South Africa 2013

Figure 4. Quarter-to-Quarter Change in Employment, Quarter 1: 2009 to Quarter 4: 2014



Source: Statistics South Africa.

3.6.4 The weakness of competition in factor and product markets in the economy potentially contributes to lower innovation. Moreover, the collective bargaining system results in bargains including the setting of sectoral minimum wages extended to the whole sector, translating to barriers to entry in product markets. This further exacerbates the country's unemployment problem⁸. The education system is also not producing the skills needed in the labour market resulting in skill mismatches. These factors combined with limited opportunities for entrepreneurship are also contributing to the high unemployment rate⁹ and are hindering the attainment of required growth rates needed to address the significant levels of poverty and inequality^{10,11}.

3.6.5 Constrained electricity supply is increasingly becoming a key factor slowing down growth and employment creation. South Africa started experiencing electricity shortages in 2007 as a result of a combination of underinvestment in new generating capacity and temporary supply disruptions. The electricity system appears to be constrained because the margin between peak demand and available electricity

⁸ Most industries are highly concentrated and there is lack of competition in network industries that produce intermediate goods such as iron and steel, paper and chemicals, telecommunications and energy sectors (see OECD (2007), OECD Reviews of Innovation Policy: South Africa 2007, OECD Publishing, Paris). The collective wage bargaining system which essentially results in sector-wide agreements extended to non-parties provide protection from potential entrants in the labour market. The collective wage bargaining system and lack of skilled labour protects the labour market from competition by pushing up entry level wages thus contributing to high unemployment (See Faulkner and Loewald, (2008), Policy Change and Economic Growth: A Case Study of South Africa, Policy Paper Number 14).

⁹ Unemployment rate is 25.5%

¹⁰ Gini coefficient for South Africa is 65.0

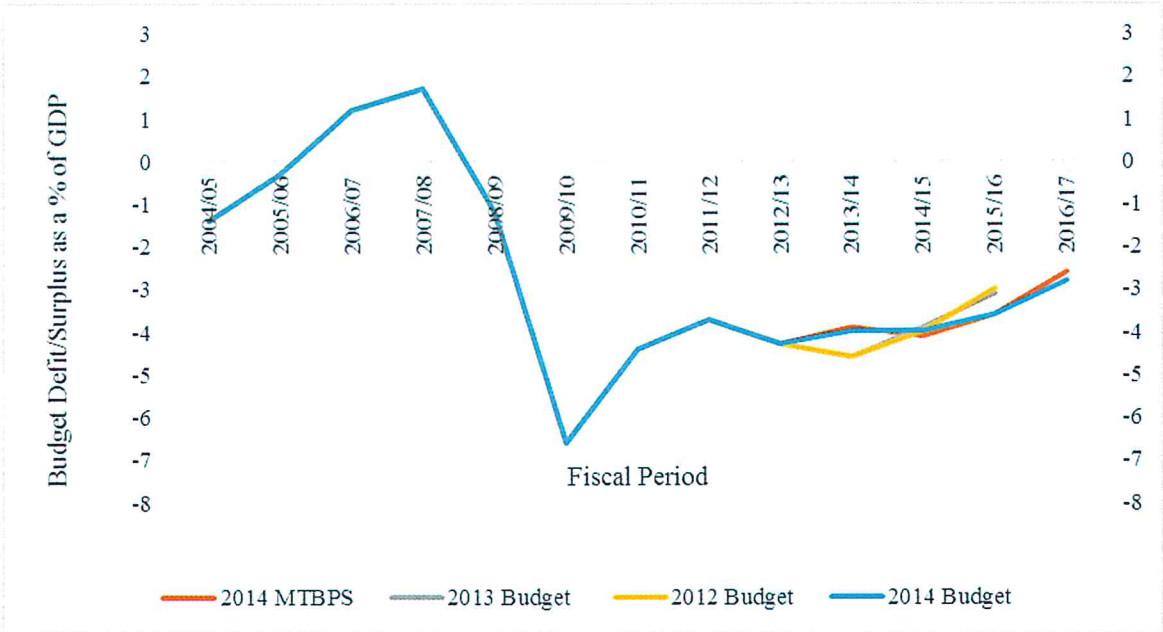
¹¹ See OECD Economic Surveys: South Africa 2013

supply has been precariously narrow for the past few years. Emergencies in electricity supply shortages were initially declared in 2008 and once again in early 2014. The most recent electricity shock highlights the need for funding to maintain existing infrastructure to keep the lights on and investment in new generation capacity. In the absence of this new capacity, the expansion of investment, particularly in energy-intensive activities such as mining and manufacturing will be severely compromised. The effects of this renewed electricity supply shock will be felt on export revenues. Since the electricity intensive sectors, mining and manufacturing, account for 85 percent of total exports, the export volume could decrease substantially. The electricity supply has coincided with low commodity prices, implying an acute impact on the export sector.

FISCAL CONSOLIDATION

3.7 Figure 5 shows that despite South Africa’s weak growth, plans to put the country’s public finances on a consolidation path is still maintained.

Figure 5. Consolidated Fiscal Deficit as a % of GDP, 2004/05-2016/17



Source: National Treasury Database.

3.8 As outlined during the Minister of Finance’s MTBPS in October 2014, efforts to achieve fiscal consolidation will require (a) generating additional revenues via broadening the tax base, increased tax compliance and possibly higher tax rates on consumption and income, especially of high income earners; (b) the reduction in planned growth in

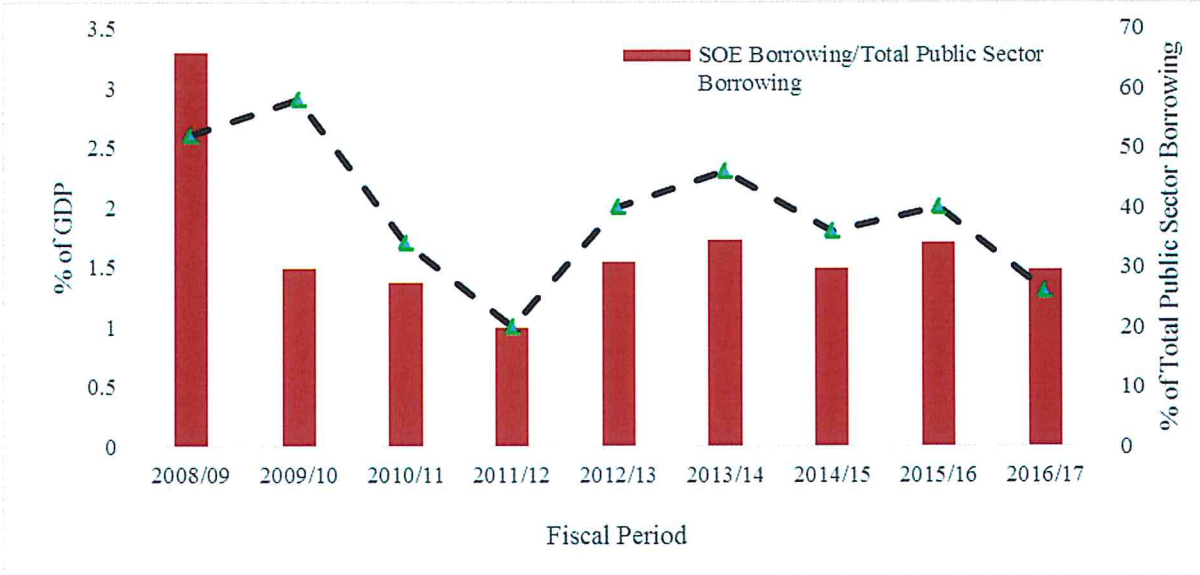
government expenditure; (c) more effective budgeting and efficient allocation as well as utilization of resources, and (d) a deficit-neutral approach to financing state-owned enterprises through the sale of non-strategic state assets. Multiple risks could adversely impact ongoing efforts to stabilize South Africa's public finances. These include

- a. Substantial wage demands in the public sector. In the MTBPS, the Minister of Finance highlighted the need for consumer price index (CPI)-linked cost of living adjustments to the public sector wages. By aligning wage demands with CPI, Government aims to mitigate against the reallocation of resources away from essential spending areas or a reduction in government employment. Falling oil prices coupled with the significant decline in inflation rate should afford government some room to ensure that final settlements are substantially more affordable when linked to reduced CPI.
- b. Persistent weakness in the balance sheets of several SOCs¹² could trigger calls for additional government support. Since 2008, borrowing by SOCs has constituted a significant part of South Africa's public sector borrowing requirement¹³ as well as GDP (see Figure 6).

¹² In South Africa, SOCs are of two types: commercial (or financial) SOCs and non-commercial (or non-financial) SOCs. Financial SOCs operate in sectors where there is either a natural monopoly, or where government has a strategic interest. Examples in South Africa include the electricity parastatal – ESKOM, and the defence conglomerate – Denel. On the other hand, non-financial SOCs denote state entities created for purposes of delivering of public goods and services and facilitating investments in line with stated welfare objectives of the government. Examples include the Development Bank of Southern Africa and the Industrial Development of South Africa.

¹³ The public sector borrowing requirement refers to funds needed by the public sector to cover any deficit incurred in the financing of its activities.

Figure 6. SOC Borrowing as a % of Total Public Sector Borrowing and GDP, 2008/09-2016/17

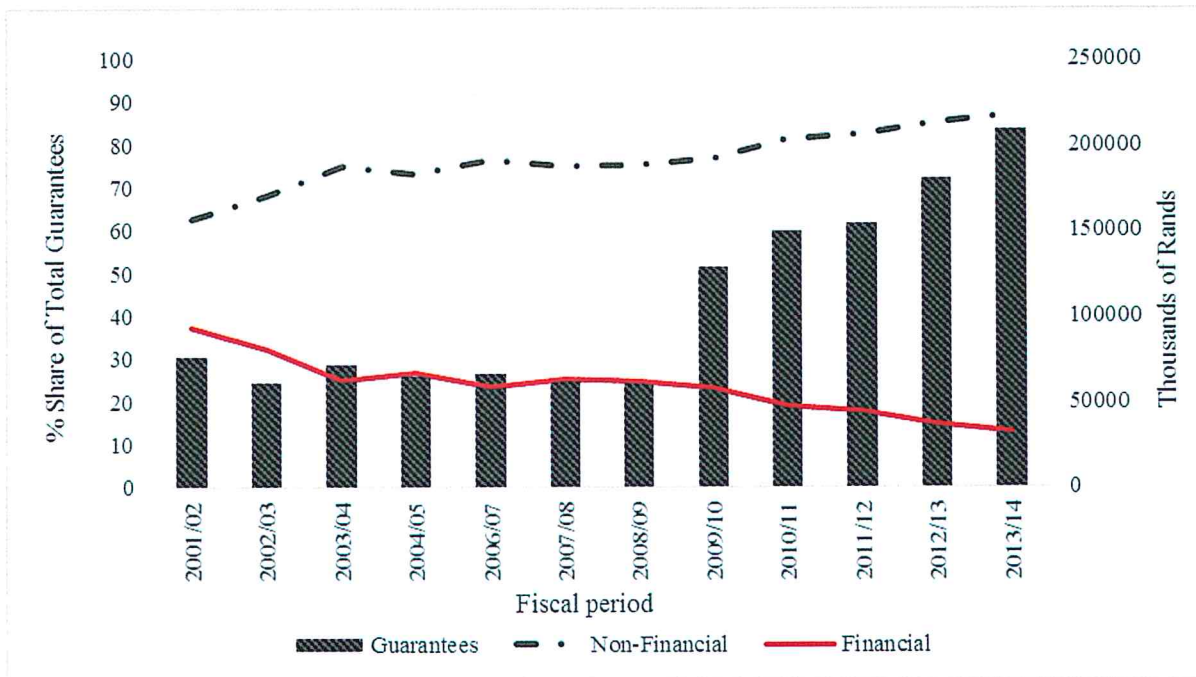


Source: National Treasury Database.

c. Around 45 percent of SOCs’ borrowing is covered by government guarantees¹⁴ which have risen significantly since 2001/02, with financial SOCs accounting for the bulk of these guarantees (See Figure 7). In an environment of weak economic growth and tightening global conditions, increases in liabilities of SOCs will lead to a commensurate increase in the stock of public debt financed in domestic and international markets. The effect of higher borrowing costs would adversely affect plans to reduce the budget deficit and stabilize debt, thus limiting government’s ability to expand fiscal space necessary to implement key social programs outlined in the NDP. The critical point is that even though guarantees do not appear as part of the budget, they still represent a contingent liability for the fiscus and as such, Government cannot continue indefinitely with no tangible result and improvements in the management and performance of SOCs.

¹⁴ See IMF Country Report No.14/338.

Figure 7. Total Government Guarantees to Non-Financial and Financial SOCs



Source: National Treasury Database

4. FISCAL FRAMEWORKS AND REVENUE PROPOSALS

The key components of the 2015 fiscal frameworks and revenue proposals are discussed in greater detail below¹⁵.

4.1 Non-Interest Allocations: Division of Revenue

4.1.1 Table 2 compares the MTEF estimates for non-interest expenditure at the time of the 2014 MTBPS with figures tabled in the 2015 Budget. At the time of the 2014 MTBPS, real annual average growth in total MTEF allocations was projected to be 2.9 percent. This level of growth is maintained in Budget 2015.

4.1.2 Government is expected to allocate a total of R3.5 trillion to non-interest expenditure over the 2015 MTEF period, with the national sphere responsible for 47.9 percent of total allocations, followed by provincial government at 42.9 percent. Local allocations are the lowest at R313.7 billion although the proportion of resources allocated to local government increases from 8.3 percent in 2014/15 to 9.1

¹⁵ The components of debt service and consolidated budget deficit have already been discussed as part of the economic outlook and that discussion is not repeated here.

percent in 2015/16. Contrary to previous years, the allocation to the local sphere will show the smallest real annual average growth (2.1 percent), compared to the national and provincial spheres, which are set to grow by a real annual average of 2.9 percent and 3.1 percent respectively.

4.1.3 The bulk of non-interest expenditure is allocated in respect of national departments. Relative to projections at the time of the 2014 MTBPS, the allocation to the national sphere has increased by R1.6 billion with real annual average growth increasing from an estimated 2.8 percent (2014 MTBPS projection) to 2.9 percent. This deviation is due to the shifting of further education and training colleges, adult education and port health from the provincial to national sphere.

4.1.4 A total of R1.5 trillion is allocated to provinces over the 2015 MTEF period. Taking inflation into account, a real annual average growth of 3.1 percent is projected for the provincial allocation over the 2015 MTEF period.

4.1.5 Funding to the local government sphere is aimed at supporting the roll-out of free basic services to indigent households. Local government receives an allocation of R313.7 billion over the 2015 MTEF period (R99.8 billion in 2015/16, R103.9 billion in 2016/17 and R110 billion in 2017/18).

Table 2. Medium Term Expenditure Framework Division of Revenue

Division of Revenue	Total 2015/16-2017/18 (R' Billion)		Real Annual Average Growth Rate	
	2014 MTBPS	2015 Budget	2014 MTBPS	2015 Budget
National Allocation	1661.3	1662.9	2.8%	2.9%
Provincial Allocation	1492.3	1490.8	3.1%	3.1%
Local Allocations	313.1	313.7	2.4%	2.1%
Total	3466.7	3467.4	2.9%	2.9%

Source: Commission's calculations based on MTBPS (2014) and Budget Review (2015).

4.1.6 Over the past few years the structure of the allocations and trends highlighted in Table 2 have been largely consistent, with the national sphere receiving the largest share of resources and the local government allocation illustrating the fastest growth. The key question for South Africa is whether the existing structure of the fiscal framework and the underlying distribution of revenue and expenditure competencies, facilitates economic growth. In its submission for the 2012/13 division of revenue, the Commission found that the current system of intergovernmental transfers, in particular in health and education sectors are strongly

redistributive and equity enhancing. However, the quantitative magnitude in terms of accelerating GDP growth was small leading the Commission to conclude that the transfer system is not the most effective instrument to support government's growth objectives, and that the transfer system should continue to be strengthened so that it plays a supportive role in this respect. Follow up Commission research conducted in 2012 that informed recommendations for the 2013/14 division of revenue¹⁶ found that existing revenue and expenditure assignments at the provincial level had a negative effect on economic growth while at the municipal level, revenue decentralisation had a positive effect on economic growth with expenditure decentralisation negatively affecting economic growth.

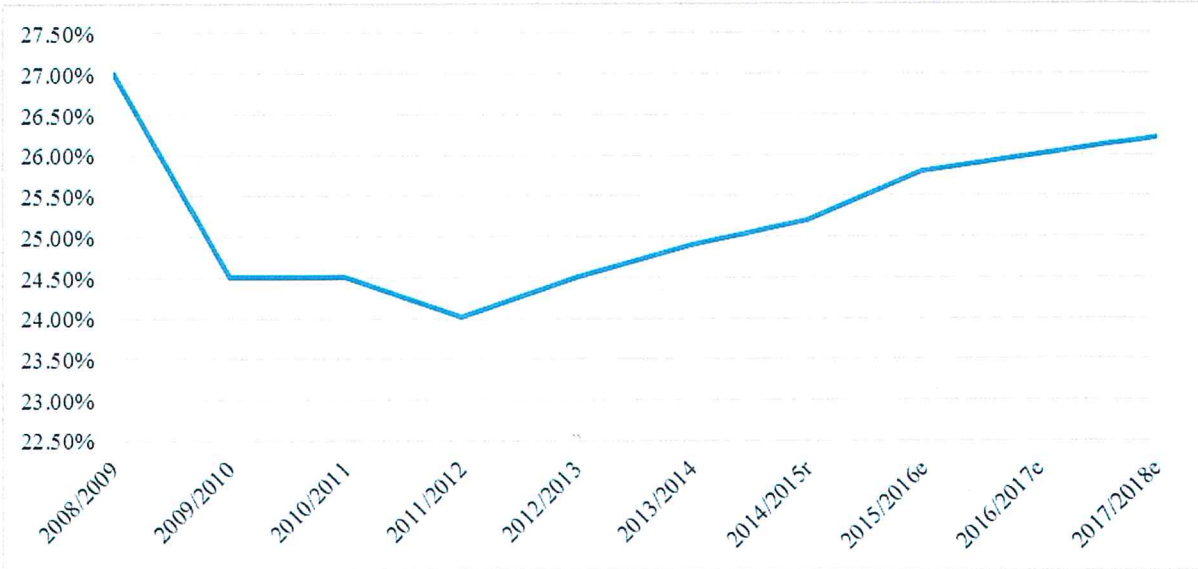
4.2 Revenue Estimates and Tax Proposals

4.2.1 Tax revenue projections for 2014/15 reflect shortfalls of R14.7 billion and R4.6 billion against the 2014 Budget Review and MTBPS forecasts respectively. These projected revenue shortfalls are largely attributable to the sluggish economic growth over the past year. Given the muted economic growth outlook for South Africa, lower medium term revenue estimates are forecasted.

4.2.2 Tax revenue trends show that from 1994/95 to 1999/2000, nominal gross tax revenues grew at an annual average of 12.1 percent, averaging 22.8 percent of GDP. Improvements in tax administration, the introduction of capital tax and higher corporate profits, as well as strong commodity prices resulted in the acceleration of tax revenue an average annual growth rate of more than 17 percent between 2000/01 and 2004/05. This drove the share of tax revenue as a percentage of GDP to 23.4 percent over the same period. This ratio peaked at 26.4 percent in 2007/08. The advent of the global financial crisis altered this positive picture drastically. Tax revenue growth declined by 4.2 percent and tax as a share of GDP fell to 23.5 percent in 2009/10. Tax revenues have stabilised since then, but weak economic performance has slowed down revenue growth as shown in Figure 8.

¹⁶ For further details on this research, consult the Submission for the Division of Revenue 2013/14. This document can be accessed at: www.ffc.co.za

Figure 8. Tax Revenue as a % of GDP, 2008/09-2017/18



Source: National Treasury. Note: r-revised e-estimate

4.2.3 Fiscal measures adopted by Government in the 2015 Budget, encompass adjustments to tax policy. Government increased the fuel levy by significantly more than inflation (by 30.5 cents per litre). There is also an additional 50 cents per litre added on to the Road Accident Fund (RAF) levy, equivalent to a hike of 40% in this levy. Government is also proposing a 1% hike in the average tax rate of individuals, which is fairly well spread across all income categories. The combination of these tax increases will erode disposable income but will contribute to much needed government revenue for successful fiscal consolidation as well as financing and maintaining the social wage as shown in in Table 3 and Figure 9.

4.2.4 Table 3 shows that the compensation for fiscal drag relief will be compensated by one percentage point increase in personal income tax, which is moderately distributive to the extent that higher income earners pay progressively more tax. The increases in indirect taxes and taxes on property together account for the net increase in tax revenues in 2015/16.

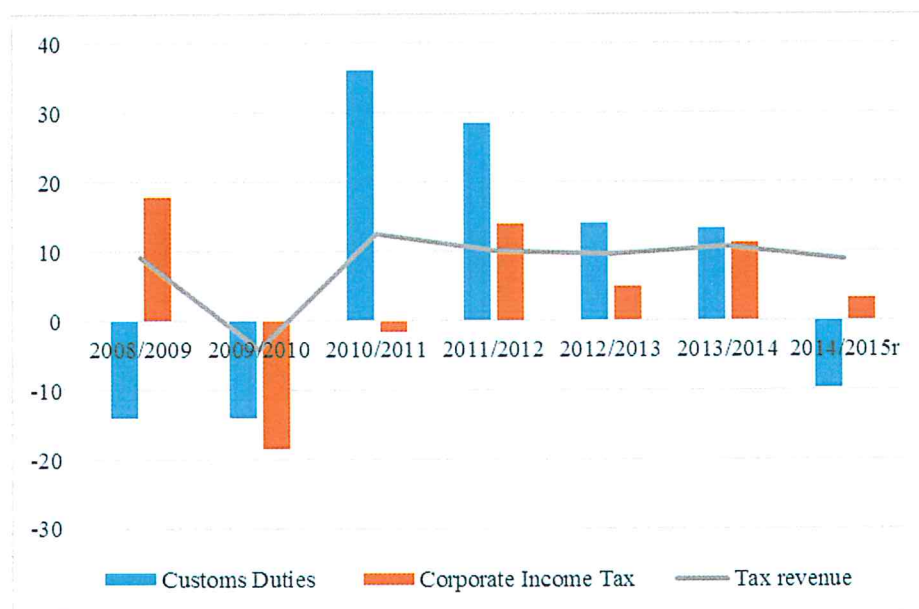
Table 3. Impact of Tax Proposals on 2015/16 Revenue

Item	Effect of tax proposal
Tax revenue (before tax proposals)	1 073 000
Consolidated revenue (before tax proposals)	1 180 579
Personal income tax	
Fiscal drag relief	-8 500
Rate increase in income tax	9 420
Medical credits	-920
Business income tax	
Energy-efficiency savings tax incentive	-150
Taxes on property	
Adjustment in transfer duty	100
Indirect taxes	
Increase in general fuel levy	6 490
Increase in excise duties on tobacco products	602
Increase in alcoholic beverages	1 234
Tax proposals before fiscal drag 2015/16 (gross)	16 775
Tax proposals after fiscal drag 2015/16 (net)	8 275
Tax revenue (after tax proposals)	1 081 275
Consolidated revenue (after tax proposals)	1 188 855

Source: National Treasury.

4.2.5 Nominal gross tax revenue for 2013/14 increased by 10.6 percent when compared with 2012/13. The 2014 Budget Review projected 10.5 percent growth in nominal gross tax revenues for 2014/15. This projection has been revised downwards to 8.8 percent as a result of sharp falls in estimates of corporate tax and customs duties as shown in the Figure 9.

Figure 9. Annual Change in Tax Revenue Performance, 2008/09-2014/15



Source: National Treasury and South African Reserve Bank. Note: r-revised.

4.2.6 Tax revenue as a percentage of GDP is expected to marginally accelerate from 25.2 percent in 2014/15 to 25.8 percent in 2015/16. The Budget tax proposals are expected to add R16.8 billion to revenue in 2015/16, before fiscal drag. These additional revenues and lower spending ceiling are envisaged to close the structural fiscal deficit over the medium term.

4.2.7 Overall, compared to the magnitude of revenue shortfall announced in 2014 MTBPS required for successful fiscal consolidation, it is the Commission's view that these tax proposals are more of a 'holding pattern' than a radical consolidation exercise. Our research and experience elsewhere suggests that the probability of a successful fiscal consolidation is increased if all taxes increase, and if the wage bill is decreased. With NHI and Social Security reforms both placed on the table again, there is a need to structurally look at revenue take to match these entitlements which would make reviewing all revenue options unavoidable. Politically it would perhaps be more palatable to reform value added tax (VAT) at the same time as say NHI and social security reforms.

4.3 Unallocated Resources and Expenditure Prioritisation

4.3.1 Unallocated reserves are meant to serve as a fiscal buffer for Government in times of unplanned emergencies. At the time of Budget 2014, the Commission raised concern around the danger of excessive drawdowns on these resources and in so doing, creating a risk of having low reserves should an emergency situation arise. The maintenance of the fiscal buffer that was provided for in the 2014 MTBPS and which is protected in Budget 2015 (see Table 4) is therefore welcomed, particularly in the current constrained economic environment.

Table 4. Adjustments to the Unallocated Reserves, 2013/14-2017/18

R billion	2013/14	2014/15	2015/16	2016/17	2017/18
				Medium-term estimates	
Budget 2013	4.0	6.5	10.0		
MTBPS 2013		3.0	6.0	18.0	
Budget 2014		3	6	18	
MTBPS 2014			5.0	15.0	45.0
Budget 2015			5.0	15.0	45.0

Source: MTBPS (2013, 2014) and Budget Review (2013, 2014 and 2015).

4.3.2 Table 5 reports on changes in allocation to key functional categories for the 2015/16 financial year by comparing MTBPS 2014 and Budget 2015. The following functions were revised upwards: basic education, health, police service, post-school education and training, economic affairs, arts, sport recreation, and culture and social protection. The Commission notes post-school education receives the largest upward revision of 4.57 percent. The increase is driven by the expanded revenues from the skills levy, increased transfers to the National Student Financial Aid Scheme, increased transfers to higher education and continued construction of two new universities. The focus on expanding access to post-schooling education is welcomed as this is in line with the NDP and the overall thrust of moving South Africa towards a more knowledge-based economy. Expenditure in respect of social protection provides an important buffer for the poor, making the upward revision a welcome development, especially at the time of downward fiscal pressure on most spending programmes. The Commission would like to reiterate its previous findings on social security which show the positive socio-economic impacts on poor households such as increased likelihood of job search, education provision and food

security among others and calls on government to maintain increased access provision.

Table 5. Expenditure Component Revisions (Functional Classification)

	2015/16 Figures		% Change from 2014 MTBPS to 2015 Budget
	2014 MTBPS	2015 Budget	
Basic education	201 464	203 468	0.99%
Health	154 607	157 294	1.74%
Defence, public order and safety	171 569	171 150	-0.24%
Defence and state security	50 012	49 364	-1.30%
Police services	82 423	82 724	0.36%
Law courts and prisons	39 134	39 063	-0.18%
Post-school education and training	59 520	62 238	4.57%
Economic affairs	202 445	206 164	1.84%
Industrial development, trade and innovation	67 843	69 688	2.72%
Employment, labour affairs and social security funds	64 139	64 138	0.00%
Economic infrastructure and network regulation	70 463	72 338	2.66%
Local development and social infrastructure	199 623	199 570	-0.03%
Housing development and social infrastructure	179 611	179 224	-0.22%
Rural development and land reform	10 731	10 709	-0.21%
Arts, sport, recreation and culture	9 280	9 638	3.86%
General public services	68 341	64 385	-5.79%
Social protection	154 852	155 297	0.29%
Consolidated expenditure	1 343 956.0	1 351 006.8	0.52%

Source: Commission's calculations based on MTBPS (2014) and Budget Review (2015).

4.3.3 The following areas were revised downwards: defence, public order and safety, local development and social infrastructure and general public services. The decline in housing development is a surprise, especially in the context of the NDP goal of upgrading all informal settlements by 2030. The Commission, however, welcomes reductions on general public services, especially since these cuts are in non-core areas such as goods and services, foreign mission and property management. Even though the downward revision of rural development and land reform is not significant, care should be taken in reprioritising away from a function where new priorities have been identified and where additional funding would be required (for example, re-opening of new land claims). Further, the Portfolio Committee of Land

Reform and Rural Development in its 2014 Budget Review and Recommendations report also called for more funding to the sector to support smallholder farmers in the main.

4.3.4 In terms of the 2015 budget, job creation initiatives remain a priority for Government. Government's strategy to create jobs is multi-pronged and revolves around: (a) public employment programmes (this includes the Expanded Public Works Programmes (EPWP) and Community Works Programme (CWP)); (b) Employment tax incentive and (c) Jobs Fund.

- a. The National Treasury has taken over the responsibility of managing the Jobs Fund from the Development Bank of South Africa. The Jobs Fund was launched in 2011 and provided once-off grant funding in the areas of enterprise development, infrastructure, support for work seekers and institutional capacity building. The Commission welcomes the new strategy, which intends to seek partnerships with larger intermediaries and ensure proper monitoring and evaluation processes are implemented. Thus far, the Fund has paid grants worth R1.48 billion and created 30 701 permanent jobs in the process.
- b. The Commission notes employers claimed the Employment Tax Incentive (ETI) for a total of 270 000 employees in the first year of implementation. Research conducted by the Southern Africa Labour and Development Research Unit (SALDRU) on the effect of the ETI show that collectively, firms would have employed most of the youth in the absence of the subsidy¹⁷. The Commission has reiterated in the past the need for the ETI to create 'new jobs' irrespective of whether the incentive grant was available or not. The Commission calls on Government to make incremental adjustments to the grant design as more data comes online rather than waiting until 2016 for a broader review of the grant and effectively forfeiting the benefits of any design improvements in the interim.
- c. While the economy is creating jobs, a large share of these jobs are seasonal in nature. The average level of job creation in the fourth quarter of each year over the past six years has amounted to 120 percent of annual job creation as a result of temporary employment opportunities in the retail and tourism sectors ahead of the holiday season and in the agricultural sector at the time of harvesting. For real

¹⁷ Ranchhod, V., Finn, A. (2014). Estimating the short run effects of South Africa's Employment Tax Incentive on youth employment probabilities using a difference-in-differences approach. A Southern Africa Labour and Development Research Unit Working Paper Number 134. Cape Town: SALDRU, University of Cape Town

disposable income of households to improve, the economy will need to create sustainable jobs at a pace that can absorb new entrants into the labour market. Existing structural impediments that have led to a decline in the labour intensity of production is partly a reflection of labour market challenges that government must address.

- 4.3.5 Table 6 provides real growth rates on the economic classification of consolidated government expenditure, projected revenue spending and compensation per capita over the period 2013/14 to 2017/18. Allocations in respect of capital show the strongest real average growth over the period compared to growth in current expenditure¹⁸. Over the 2015 MTEF period, real growth in capital-related allocations range from 8.2 percent in 2015/16, to 0.5 percent in 2016/17 before marginally increasing to 0.8 percent by 2017/18. Given government's adoption of infrastructure-led growth, these trends are welcomed.
- 4.3.6 While the intent to significantly drive up infrastructural investment is welcome, the Commission notes that the Budget Review outlines how the planned cumulative expenditure on infrastructure will amount to R803 billion over the next three years. This is against the backdrop that previous MTEF have projected three-year capital expenditure planning programme between R800 billion and R850 billion. The 2015 MTEF figure suggests therefore downward revision in budgeted infrastructural investment. This is of concern given that the country is still recovering from a fairly dramatic decline in the growth of fixed capital formation in part induced by the global financial crisis and hence could reduce the sustainable growth rate of the economy still further later on.
- 4.3.7 Disaggregating the data by year, the following trends are observable:
- a. In line with the push to contain spending on goods and services, real growth of this component declined markedly in 2014/15. Whereas the decline in real growth reached -4.2 percent in 2014/15, negative growth of this component is projected to continue in 2015/16, even though at a lower rate. Real annual average growth over the MTEF period is -1.5 percent.
 - b. Allocations in respect of transfers and subsidies will decline from 4.7 percent in 2015/16 to -1.4 percent towards the end of the MTEF period. The decline in transfers is largely in respect of a slowdown to subnational government, non-

¹⁸Current expenditure is comprised of compensation of employees, goods and services and interest and rent on land.

profit organisations (NPOs) and public corporations. NPOs play an important enabling role in delivering critical socio-economic services to the poor. Reducing real expenditure to NPOs places a further financial strain on a struggling sector and may even lead to possible closures and termination of vital services to the poor.

- c. Real growth of compensation of employees is projected to slow from 3.6 percent in 2014/15 to -0.7 percent in 2017/18. The Commission welcomes measures being taken to reign in the wage bill such as freezing of all national department posts and a review of funding for vacant posts. For the compensation projections to be realistic a wage bargaining agreement where salaries are pegged close to the inflation rate, will be required. Whether this will materialise may influence the credibility and likely sustainability of the fiscal framework. Despite the projected slowdown of compensation expenditure, compensation per capita still increases in real terms by close to 5 percent in 2015/16 and only marginally slows to 3.47 percent by 2017/18.
- d. Revenue is expected to grow in real terms by 1.55 percent on average per annum over the 2015/16 MTEF period. If the economy grows below expected in the 2015 budget or if the cost of employment increases at a faster pace than projected, then the growth in the cost of employment will outstrip revenue growth over the 2015/16 MTEF period. This implies that the proportion of revenue required to absorb the cost of employment will increase, thereby crowding-out expenditure on other priorities.

Table 6. Spending by Economic Classification, Revenue and Compensation per Capita 2013/14-2017/18

Real Year on Year Growth	2014/15	2015/16	2016/17	2017/18	Real Annual Average Growth 2014/15 - 2017/18
Compensation of employees	3.6%	2.9%	0.4%	-0.7%	1.55%
Goods and services	-4.2%	-0.7%	0.8%	-2.0%	-1.53%
Transfers and subsidies	4.3%	4.7%	0.3%	-1.4%	1.97%
Payments for capital assets	1.9%	8.2%	0.5%	0.8%	2.82%
Revenue	3.6%	2.9%	0.4%	-0.73%	1.55%
Compensation per capita	2.98%	4.85%	4.26%	3.47%	3.89%

Source: Commission's calculations based on Budget Review (2014 and 2015).

5. HOW SOUTH AFRICA'S FISCAL FRAMEWORK CAN BE IMPROVED

- 5.1 The fiscal framework has maintained a stable macroeconomic balance, improved intergovernmental and sectoral resource allocation, ensured predictability of the budget and more importantly strove for efficient utilisation of allocated resources on a continual basis. The credibility of this framework remains the glue that binds the economy together and maintains fiscal sustainability in the midst of heightened economic growth constraints. With the rising prospects of a weaker economic outlook, a reconsideration of expenditure and revenue plans will be necessary (fiscal consolidation).
- 5.2 The 2014 MTBPS outlined a package of fiscal measures to reinforce consolidation and fiscal sustainability. The fiscal package comprises of five interventions including the lowering of the expenditure ceiling, adjusting tax policy administration, strengthening budget planning and outcomes, freezing personnel headcounts and adopting a deficit neutral approach to bailing-out SOCs.
- 5.3 Improving the fiscal framework and maintaining its credibility would need more than just the lowering of the expenditure ceiling. Although government has evidently been meeting its target spending ceilings, it is also clear that spending has been increasing faster than inflation. Invariably, expenditure growth which outpaces inflation creates an artificial hard budget constraint and offsets the disincentive effect of the budget constraint imposed by the ceiling on budget claimants (spending agencies). Aggregate spending ceilings that are set abruptly and which are less tied to a specific long-term goal are not effective. More importantly, ceilings are likely to create incentive that bias

revenue projections, especially where revenue is unconstrained. Rather than aligning to the revenue projections, the ceiling should instead be linked to a medium to long-term goal such as the reduction of the debt/GDP ratio. The aggregate expenditure ceiling must also incorporate expenditure cuts that would have been determined through an elaborate expenditure review process. In order to maintain their credibility and effectiveness, ceilings must be set outside of the budget preparation phase, must have the time horizon, be enforceable and an explicit numerical definition. This will require fostering the numerical fiscal rules, determining the ceiling and monitoring adherence thereof.

- 5.4 Government further proposes to generate additional revenue amounting to R27 billion through adjustments of the tax policy and administration to deal with the burgeoning revenue gaps. With NHI and Social Security reforms on the cards, there is a need to structurally look at revenue to match these entitlements which would make reviewing all revenue options unavoidable.
- 5.5 A related aspect to improve fiscal frameworks relates to the scope that does exist for all spheres of government and their entities to expand their own financing of capital expenditures and economic development. Options previously discussed by the Commission include improvements in expenditure efficiencies informed by ongoing expenditure reviews, debt collections efficiencies and so forth. Private funding will need to be sourced for some of the required infrastructure investments, although this needs to be better managed to avoid the negative experiences of Gauteng e-Toll roads and electricity generation¹⁹. The long term problem to address is that the system of revenue-raising is highly centralized, especially with respect to the provincial level. This is a consequence of the top-down nature of the system. Part of the natural evolution of the intergovernmental fiscal relations (IGFR) system is the gradual decentralization of revenue-raising responsibilities to the provinces. It is natural that spending be decentralized prior to revenue-raising. However, it is now opportune to begin the process of revenue-raising decentralization. This can be done in a way that does not threaten the integrity of the tax system by allowing the provinces some say in setting their own tax rates on the same tax base used by the national government, using user charges like e-tolls as well, because user charges can be used at any sphere of government. Finally, the Commission agrees with Government that some scope does exist for municipalities to

¹⁹ Obviously there is an aspect of risk transfer involved here. This is the real essence of what Government wants to achieve in a PPP.

expand debt financing of capital expenditures. This will likely result in accelerated economic growth.

- 5.6 The fiscal framework can also be improved through government-wide commitment to long-term planning and efficient resource utilisation. Long-term planning however remains the purview of selected provincial infrastructure conditional grants and an elusive goal across the three spheres of government. There are no fiscal parameters to measure the extent to which resources are utilised efficiently or not. In its Submission on the 2014/15 Division of Revenue, the FFC recommended that the interface between planning, budgeting and outcomes be improved through the newly adopted outcomes-oriented delivery approach. To promote effective capital infrastructure spending, the Commission calls on scaling up institutionalisation of the Built Environment Performance Plans as a tool for changing the spatial development patterns of cities as well as the model for infrastructure conditional grants which couples incentives for performance with holistic capacity building. The Chief Procurement Office (CPO) should start developing spending efficiency indicators against which spending agencies can be measured. Moreover the CPO should lead the professionalization of public sector supply chain management practitioners.
- 5.7 Government efforts to maintain stability of the fiscal framework and overall fiscal sustainability are continuously undermined by the constant need to recapitalise SOCs. Previous Commission submissions on the fiscal framework alerted government to the potential contingent liabilities associated with SOC guarantees. Despite the standing guarantees and the subsequent private capital secured, SOCs continue to demand additional capital injections, diverting crucial funding away from core spending and putting pressure on the country's debt requirement. Although the current deficit-neutral financing stance is commendable, SOC's should be allowed to leverage financing through their balance sheet given the increase in their asset base.
- 5.8 The continuous cash injection into SOCs would be futile and continue to place financial duress on the fiscal framework if such interventions are not accompanied by stringent requirements for improvements in governance and performance. There are considerable weaknesses in the governance and performance of SOCs manifesting as follows: the inability of Eskom to meet construction delivery targets; failure of South African Airways (SAA) to submit its annual report timely; long drawn-out labour disputes within the Post Office; continuous functional challenges of the South African Broadcasting Corporation (SABC) board and the inability to meet the profit potential. With the

eminent reality of economic downturn, SOCs, need to find a balance between satisfying expectations to support government stimulus plans through increased spending and job retention and increasing pressure to become more efficient. Government should play a leading role in creating the right environment for SOCs to excel. This is particularly important because SOCs often traverse multiple, unclear, or conflicting financial and social objectives. Thus the long term strategies for turning around SOCs should involve clarifying their objectives, focusing scarce resources for high financial impact and improving accountability.

- 5.9 The Commission agrees with the thrust of the adopting the user pay principle as part of a menu of options for financing economic infrastructure. The Commission recommends that funding mechanisms such as user charges should work in tandem with other elements of the developmental strategies to raise efficiency. Examples include user charges which encourage people to reduce congestion or factoring social and environmental “externalities” into prices, especially where use of the facility or service is currently unpriced. Putting in place measures to improve acceptability of the user charge principle for higher levels of infrastructure services and differentiated high value products, compared with the standard offering that is paid by and is affordable to the tax base should also be considered. Examples of such measures include differentiation within the user charge principle and/or ensuring costs are aligned with willingness to pay. The incremental costs of improving service levels of infrastructure should be kept to within the amount that users and other beneficiaries and stakeholders indicate they are willing to pay. This should be based on *evidence* about people’s willingness to pay, obtained through a transparent and robust examination.
- 5.10 Finally, efforts to improve the fiscal framework and reduce the burgeoning fiscal constraints should ultimately be premised on re-igniting growth. The current economic growth estimates falls short of the required growth rate to fulfil NDP expectations and compares unfavourably with the rest of developing economies. South Africa needs to focus its strategy for reigniting growth on improving education expenditure outcomes, increasing the skills bases, maintaining strong growth on social safety-net spending and redirecting infrastructure spending towards underserved areas. On the micro front, South Africa needs to diversify its export away from raw mining commodities and de-concentrate the vertical market structure of its economy.

6. CONCLUDING REMARKS

- 6.1 The Commission commends Government for tabling a stable budget with plans to put the country's public finances on a consolidation path still being maintained. Within the constraints of further reduced overall economic growth compared with earlier forecasts and an associated reduction in budgeted revenue growth, the 2015 Budget should just help prevent economic growth from falling too far and the country from entering into a debt trap.
- 6.2 The Commission notes Government efforts to facilitate economic growth through infrastructure-led growth. To this end growth in the percentage of gross fixed capital formation allocated to economic infrastructure between 2010 and 2013 is welcomed. Government should continue sending a firm message regarding the application of cost reflective tariffs and general user pay principle to underpin the provision of infrastructure.
- 6.3 Structural constraints remain an impediment to growth. Declines in potential growth and a negative output gap indicate that the cyclical factors previously perceived to be growth-constraining are increasingly becoming structural.
- 6.4 Various risk areas that will affect the fiscal framework exist – these include pending reforms to health-care and social security. At this stage it is not possible to estimate the financial and fiscal impacts of these reforms. To ensure that the fiscal framework is protected, details on these reforms are required.
- 6.5 Borrowing by SOCs has constituted a significant part of South Africa's public sector borrowing requirement. The continuous cash injection into SOCs continues to place financial stress on the fiscal framework especially if such interventions are not accompanied by stringent requirements for improvements in governance and performance of SOCs. The long term strategies for turning around SOCs should involve clarifying their objectives, focusing scarce resources for high financial impact and improving accountability.
- 6.6 The Commission welcomes Government's focus on expanding access to post-school education as this is in line with the NDP and the overall thrust of moving South Africa towards a more knowledge-based economy.
- 6.7 Expenditure in respect of social protection provides an important buffer for the poor, making the upward revision a welcome development, especially at the time of downward fiscal pressure on most spending programmes. There are positive socio-economic

impacts on poor households such as increased likelihood of job search, education provision and food security among others from such expenditures and Government should continue to maintain increased access provision to the needy and deserving.

- 6.8 Allocations in respect of transfers and subsidies will decline over the MTEF period. The decline in transfers is largely in respect of a slowdown in transfers to subnational Government and notably NPOs. NPOs play an important enabling role in delivering critical socio-economic services to the poor. Reducing real expenditure to NPOs places a further financial strain on a struggling sector and may even lead to possible closures and termination of vital services to the poor.
- 6.9 Even though the downward revision of rural development and land reform is not significant, the Commission advises that care should be taken in reprioritising away from a function where new priorities have been identified and where additional funding would be required (for example, re-opening of new land claims).
- 6.10 Real growth of compensation of employees is projected to slow down over the MTEF period. The Commission welcomes measures being taken to reign in the wage bill but notes that for the compensation projections to be realistic a wage bargaining agreement where salaries are pegged close to the inflation rate will be required. This will enhance the credibility and likely sustainability of the fiscal framework.
- 6.11 The Commission has made various suggestions for strengthening the fiscal framework and ensuring that it re-ignites economic growth.

For and on behalf of the Financial and Fiscal Commission



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3 March 2015