2016 Budget Review Analysis

Parliamentary Budget Office

PARLIAMENT

Presentation Outline

- Purpose
- Fiscal policy and Fiscal Framework
- Debt outlook
- Revenue outlook
- Expenditure outlook
- Additional analysis of risk
- Appendixes

Purpose

- The Money Bills Amendment Procedure and Related Matters Act enables Parliamentary Committees to make amendments to Money Bills
- The PBO supports Parliament in its oversight role by providing advice, analysis and research
- This presentation aims to analyse the revised MTEF and to identify challenges within the revised medium term expenditure framework

Fiscal Policy and Fiscal Framework

Fiscal Policy over the years

- Between the late 1990's and 2007: Fiscal policy supported economic growth and less countercyclical:
  - This created fiscal space
  - GDP growth averaged 3.3%
- Between 2008 and 2014: Fiscal policy stance was a countercyclical:
  - Fiscal space eroded and led to structural deficit-
  - GDP growth averaged < 2.5%
- Post 2014: Fiscal consolidation to reduce deficit, stabilise debt levels and create fiscal space:
  - GDP growth estimated to grow on average < 1.5%

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Fiscal Policy

This section provides a background of the South African fiscal policy since the late 1990 until the recent budget review. The fiscal framework is guided by the fiscal policy, hence it is considered important to understand the policy before looking at the framework. Having this background would provide insights into the build-up to the current public finance status in South Africa.

Late 1990's → 2007- Fiscal policy support economic growth- Fiscus space created- GDP averaged 3.3%

South African fiscal objectives has evolved over the years, the late 1990s until 2007 has seen fiscal policy that supported growth with intention to reduce inequality and poverty.

Government used growth in capital expenditure and broadly consumption (expenditure on goods and services) as measure to ensure South African economy growth. It is during those years where fiscal space was created within the public finance, as GDP averaged around 3.3% between late 1990s and 2007.

Recession period- 2008 → 2014- Fiscal policy in a countercyclical approach- Fiscus space eroded and led to structural deficit- GDP averaged < 2.5%

During and after recession period the fiscal objective was to support economic activity to counter low business activities created by the recession. It is during this period where fiscal space was eroded and government debt to GDP ratio grew

drastically. Global and domestic economy is still recover from growth levels experienced before recession, this has led to continuous budget deficit in South Africa's public finance. During and post recession there was low economic growth and that meant lower government revenue, however government borrowed more to keep economic activities buoyant. Contingency reserves were also eroded during this period of countercyclical, but higher than inflation public sector wages increases were the main reason for poor reserves.

It could be argued that due to recession adverse effects by private sector investment involvement in economy, the involvement of government countercyclicality may have been crowded out private sector.
The recession effect were severe, in that the countercyclical approach adopted led to the government situation of *entrenched deficit* or '*structural deficit',* that is proving difficult to deal with than normal deficit.

Fiscal consolidation- post 2014 -Fiscal policy to reduce deficit, stabilise debt levels and create fiscal space- GDP averaged < 1.5%
Global and domestic economic conditions continue to disappoint, as a result government could not attain its objective to reduce deficit, stabilise debt and create fiscal space. Government in 2016 signalled intention to support economic growth initiatives, but to also create a more private sector participation friendly environment in growing economy.

The 2016 Budget Review indicates that government intend to support economic growth initiatives, by listing specific measures within government control to foster growth including: provide strong platform for growth, supporting private investment, addressing infrastructure bottlenecks, improve policy coordination certainty and implementation, rebuilding trust between business and labour, and improving the ease of doing business. It is arguable on how much any government can directly influence economic growth sustainably, yet such attempt could in long run lead to high than affordable

The 2016 Budget Review cited monetary policy —inflation targeting-- as part of platform to enhance economic growth. The SARB make use of the interest rate to keep the inflation in check. Further concerns are that hiking interest rate have potential to dampen economic growth. Concerns to support economic growth and hiking of interest rate feeds into long standing argument of how ensure the complementary role of South African Monetary and Fiscal Policy. Both policy strategy have different objectives, however they are expected to play a complementary role rather contradicting roles.

Fiscal framework- Fiscal consolidation

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**

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Fiscal Framework

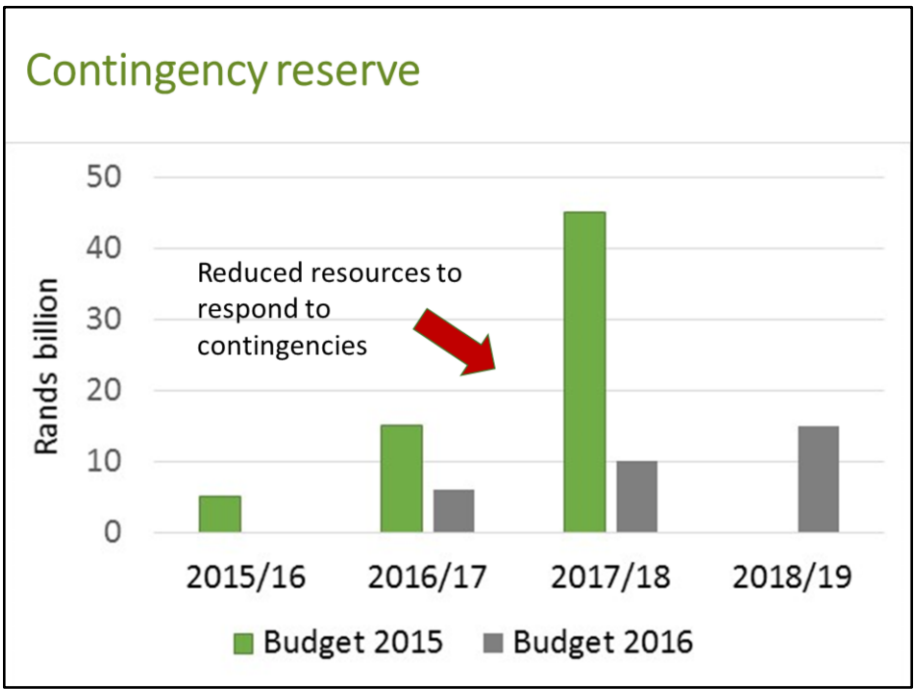
The 2016 Budget Review presented an updated Fiscal Framework from the 2015 MTBPS to deal with the effects of deteriorating global and domestic economy and mainly to continue the Fiscal Path of reducing budget deficit and stabilise debt. To achieve the fiscal objective of the Budget Review propose to:

- Reducing expenditure ceiling 25 billion over the MTEF period, and reprioritise 31.8 billion over the next three years,
- Propose tax adjustments intended to raise revenue by 48.1 Billion over the medium term,
- National debt is projected to stabilise at 46.2 per cent of GDP in 2017/18,

Government expect fiscal space to allow contingency reserves within medium term. Contingency reserves is a buffer that also allows government to respond to fiscal shocks like Drought effects or Freeze of high education fees increase and so on,

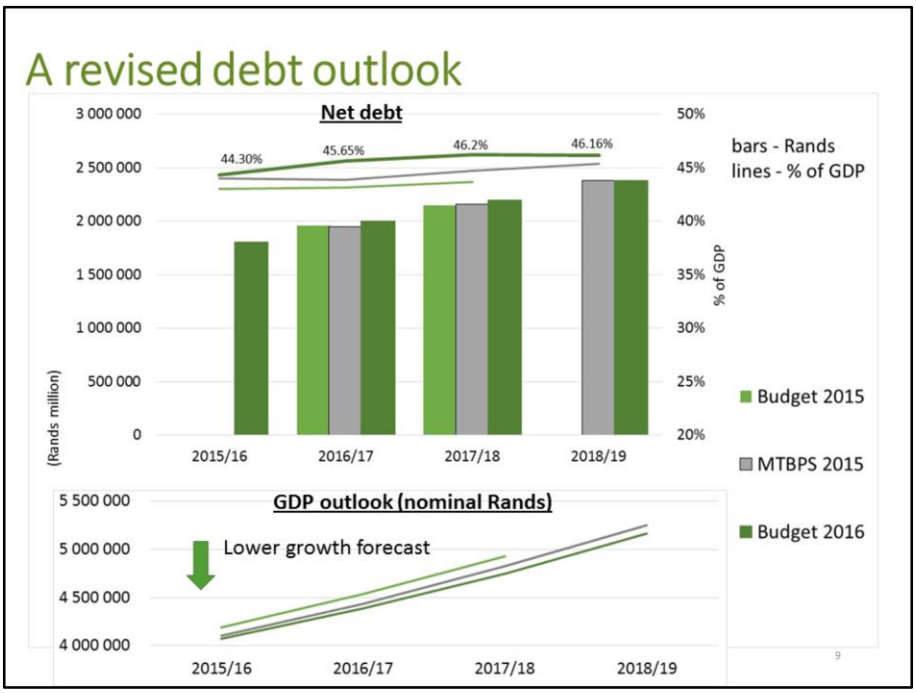
Government continue to meets its expenditure ceiling since its introduction, however the challenge to maintain this is that expenditure continues to grow beyond inflation, if this persist the fiscal objectives may take longer to be realised and further challenges the credibility of the fiscal framework,

Government intends increasing revenue by adjusting tax policy and other measures, it is important to ensure revenue expenditure are effective as more tax incentives are announced in the 2016 Budget Review,

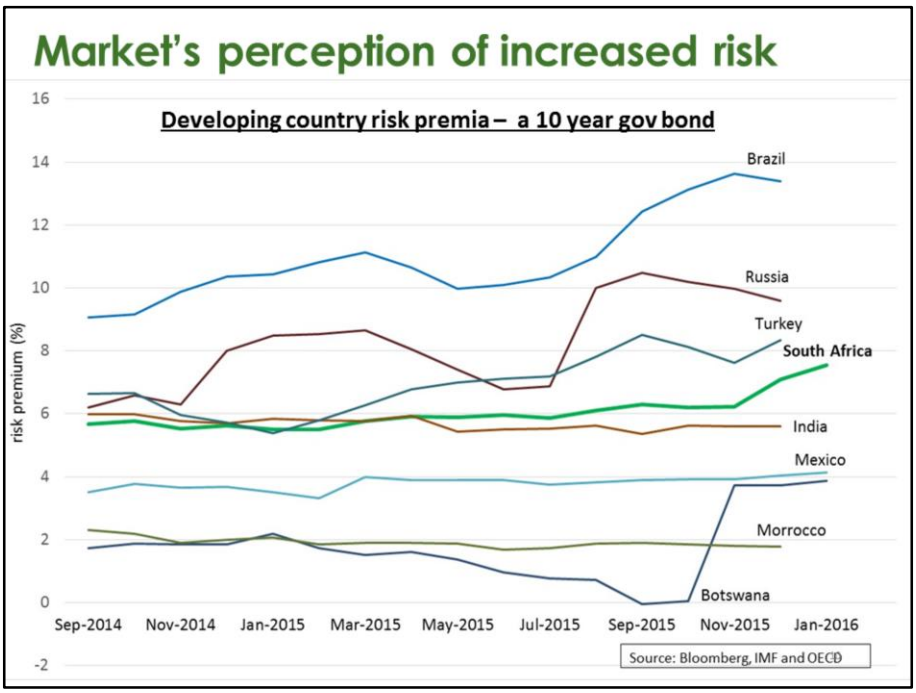


Compared to the 2015 Budget, South Africa's ability to respond to contingencies has been reduced
The country now has less fiscal room to respond to contingencies such as the effects of the drought, higher education pressures etc.

Debt outlook



1. The central focus of the 2016 Budget is the country's high level of debt
2. This continues government's efforts over the past few years to stabilise and reduce debt
3. The country's debt outlook has changed since the 2015 Budget and MTBPS
4. Net debt is expected to be higher over the MTEF compared to the projections made in the 2015 MTBPS and Budget
5. Net debt is now expected to increase from 44.3% of GDP in 2015/6 to 46.16%.
6. The key drivers for the worsened debt outlook include a weakened exchange rate. The depreciation of the Rand has increased the Rand value of foreign currency denominated debt.
7. A downwardly revised growth forecast from what was presented at the 2015 MTBPS and Budget has increased the ratio of the same value of debt to a lower GDP value.
8. High levels of debt increase interest share of total spending, squeezing out non-interest expenditure



1. South African government bonds are considered to be quite risky relative to peer developing countries
2. This is due to the country's poor economic performance and outlook
3. This increases the countries cost of borrowing

Risk of downgrade and implications

Sovereign 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

Red indicates foreign currency | ◯ indicates local currency

Reasons for SA rating change
Poor growth outlook
Effect of electricity shortage on growth
Insufficient fiscal tightening
Limited room for fiscal response
Pressure on B/S from contingent liabilities

R/US$ ↓ **GDP ↓** **Debt costs ↑**

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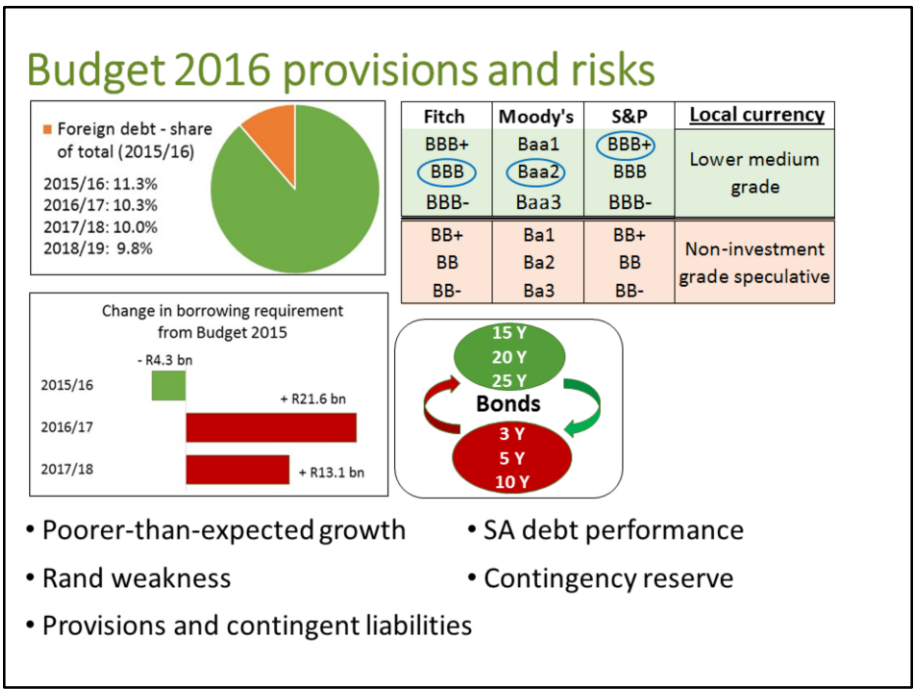
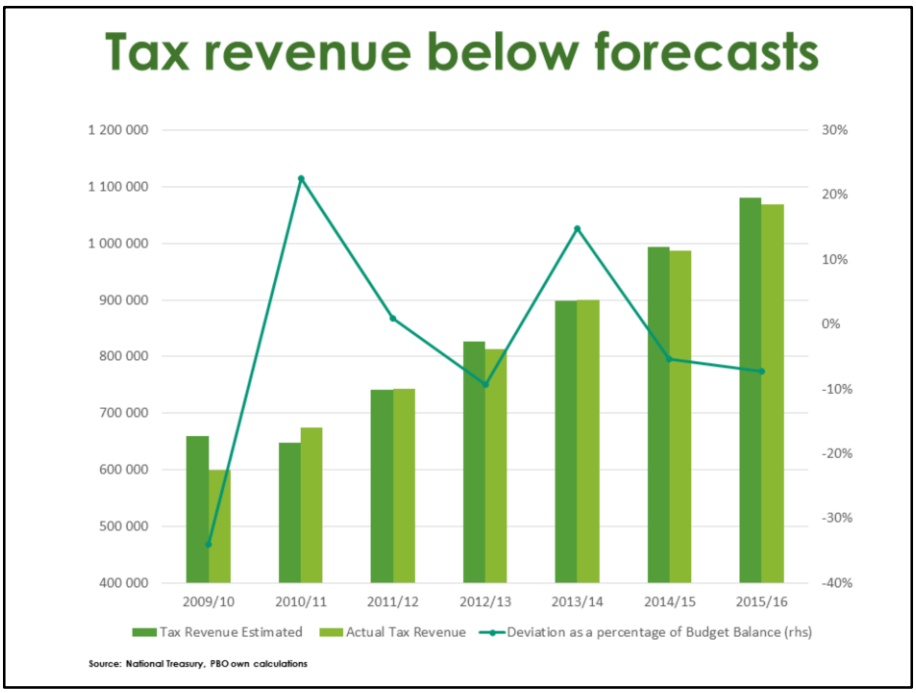
1. Ratings agencies provides a rating on the risk of a country defaulting on its debt obligations
2. All three agencies voiced their concern regarding the on country's economic and debt outlook
3. Since the tabling of the 2015 MTBPS, South Africa's overall credit rating has worsened with its foreign denominated credit rating teetering above non-investment grade status.
4. n December 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 African foreign denominated debt from stable to negative – indicating their growing concern over the risk of South African debt and their preparedness to move to country's rating to non-investment grade status.
5. The three ratings agencies cited poor growth prospects, the risk of fiscal slippage, and limited room for fiscal responsiveness as key in their decisions.
6. A downgrade of the country's credit rating will increase the cost of borrowing and squeeze out non-interest spending.

7. A downgrade will place upward pressure on the exchange rate as investors sell-off South African bonds. In addition, international experience has shown that it takes a country a few years to return to investment grade status following a ratings downgrade.



1. The 2016 Budget makes several provisions to improve the country's credit metrics and reduce the risk associated with the high levels of debt
2. A relatively small share of total debt is foreign currency denominated.
3. This reduces the risk associated with currency depreciation.
4. South Africa's credit rating on local currency debt still has about a 2-level buffer above non-investment grade.
5. The Budget presents a reduction in overall borrowing requirements, but only for the first year of the MTEF
6. Treasury have been changing the maturity profile of its debt. Replacing shorter maturity debt with longer maturing debt.
7. **However other risks are still present:**
8. Ratings agencies may respond to continued weak growth performance
9. Further Rand weakness will increase the total value of debt and debt service costs for dollar denominated debt
10. When provisions and contingent liabilities are added to net debt, the countries balance sheet position deteriorate from about 46% to about 70% over the MTEF.
11. If demand decreases for South African debt, South Africa will face additional borrowing costs.

Revenue outlook



This section considers state revenue and its instruments. Specifically, it will provide an overview of the recent trend in gross tax revenue collection, highlight the most substantive revenue policy proposals in response to this trend and highlight their potential impact.

Following the global recession in 2008/9, South Africa's gross tax revenue collections have mostly disappointed. This has made it more difficult to reduce the budget deficit prompting the state to adjust revenue policy.

Notwithstanding the over-collection in 2010 and 2013, the state tax revenue collected was below the same-year budget review estimate in 2009, 2012 and 2014, with the same trend set to continue in 2015 according to the latest SARS data.

In all but one of these years, the under-collection was responsible for at least 10 per cent of the resultant budget deficit for that financial year. This means that had the state collected tax revenue projected at the beginning of the financial year, the amount of money borrowed would have been at least 10 per cent lower.

The under-collection is largely a consequence of the slower than expected economic growth as highlighted National Treasury. National Treasury have estimated the relationship between economic growth and revenue collection – known as a multiplier – to be 1.04. This means that in general, an additional 1 per cent in economic growth will result in an additional 1.04% in gross tax revenue collected.

Persistent under-collection is not sustainable as it results in faster than anticipated growth in national debt. Further, economic growth projections over the medium-term have been revised downward, and revenue have also been revised downward.

Revenue proposals to address structural deficit

	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, Increase in transfer duty rate

Source: National Treasury

This has added to the creation of a fiscal environment considered unsustainable by National Treasury in which budget deficits have become entrenched – known as a structural deficit -- as opposed to 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.

To maintain the integrity of the fiscus and avert further credit rating downgrades, the state has, in the last two years, proposed adjustments to the existing revenue policies.

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 proposals are captured in this table and in some cases, represent the first changes to these tax instrument for several years.

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

Revenue collection from fiscal drag adjustments

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)	2015/16 - 2016/17 Adjustment (real)
1st (bottom)	R 33 000	R 188 000	10.78%	4.67%	-3.05%
2nd	R 50 000	R 293 600	10.97%	4.85%	-3.05%
3rd	R 60 000	R 406 400	11.91%	5.74%	-3.04%
4th	R 70 000	R 550 100	12.89%	6.67%	-6.19%
5th (top)	R 120 000	R 701 300	10.94%	4.82%	-6.19%
Primary rebate	R 3 710	R 13 500	7.89%	1.94%	-4.47%

Source: South African Revenue Service , PBO own calculations

Given the substantive revenue proposals in the two most recent budget reviews, the following sub-section will focus on providing clarity on these proposals as well as highlighting their potential impact.

The 2015/16 budget review 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 4 million registered individuals.

This 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 and persistent real increases in the tax free threshold between 2005 and 2014.

National Treasury highlight, in their 2015 budget review, that this has resulted in the effective personal income tax rate remaining below its 1999/2000 peak of 20.6 per cent.

The table considers how the thresholds of income tax brackets have been adjusted since the 1999/2000 financial year. Annual increases to the

thresholds has averaged around 11 per cent across the brackets resulting in real income tax relief of about 5 per cent per year. This, along with the reduction in marginal tax rates and the real increases in the primary rebate over the same period, explains the reduction in the effective personal income tax rate. Holding other factors constant, registered taxpayers at present, pay less income tax as a percentage of income than they did in 1999/2000. National Treasury 2015 Budget Review.

The distribution of the average adjustments has arguably favoured middle to higher income earners, with the bottom two brackets experiencing the slowest average growth. This has been amplified by the slower growth in the primary rebate. While all taxpayers have benefitted from real increases in tax thresholds, the lower income earners have arguably benefitted the least.

The 2016 budget review did not propose an increase in marginal tax rates, but offered limited relief for fiscal drag. Fiscal drag is the process in which inflation adjustments to income are not matched by inflation adjustments to the income tax thresholds. This 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 not enough to compensate for inflation. In real terms, the three lower brackets have been decreased by approximately 3.05 per cent. This means that 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. This is because 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.

Further, some low income registered taxpayers currently paying no tax because of the primary rebate, may be liable for income tax in the 2016/17 financial year. This is as a result of the reduction in the primary rebate by 4.47 per cent in real terms.

Registered taxpayers earning above R701 301 are mostly unaffected by the proposals in the 2016/17 budget review. They will, however, pay a slightly higher proportion of their income at the highest marginal tax rate of 41 per cent as a result of the freeze in the R701 301 threshold.

Implications of fuel levy hike

- Fuel levy versus VAT – both similar characteristics
- Poorer commuters more exposed to fuel levy hikes
- An increase in the USD oil price and/or further depreciation in the rand amplifies effects on poorer households

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

The recent trend of increases in the fuel levy is likely to disproportionately impact negatively on poorer households. Further rand weakness and/or an increase in the price of oil above 41USD per barrel will amplify these effects.

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, it shares characteristics with VAT.

While VAT does have a mechanism – such as the zero-VAT ratings on staple foodstuffs – aimed at providing relief to poorer households, the fuel levy offers no such mechanism.

In addition, both instruments tax items which form a comparatively larger share of poorer household's income. In the case of transport, the spatial legacy of apartheid has led to poorer workers residences being located far from their places of work. This has both time and cost implications for these households. Many South Africa workers now spend an average of 102 minutes per day, commuting to and from work. This is longer than the

commuter times experienced in the US and 23 EU countries. With extended travel times comes larger costs. The impact of increases to these costs through higher levies, therefore, tends to have a disproportionately larger impact on poorer households.

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

Research conducted in 2015 using the 1993 PSLSD survey conducted by SALDRU and the 2003 and 2013 National Travel Surveys (NTS) conducted by Statistics South Africa, show that commuters are increasingly making use of minibus taxis while train and bus transport has stagnated. Kerr, A. (2015).
Stutzer and Fray (2008).

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.

This is significant because public train and bus transport are subsidised by government, providing some protection against cost hikes such as the fuel levy. Minibus taxi commuters are, however, fully exposed to a fuel levy increase. These increases are likely to be passed on to consumers with poorer consumers 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.

Notwithstanding the weaker rand – which makes fuel more expensive for South Africans – the fall in the price of oil has resulted in a lower fuel price. This had allowed government the space to impose further fuel levies as a means to raise revenue.

The price South African's pay for fuel is a function of the value of rand and the international USD price of oil. Future increases in fuel taxes would depend on government's forecast of these two variables. National Treasury adopt an assumption of 41USD per barrel of oil in their economic model, while providing no explicit forecast for the value of the rand. Should the oil price rise to levels above their estimate and should the rand depreciate further against the USD, the price of fuel domestically will increase. This will amplify the effects highlighted of the recent fuel levy hikes and remain a substantial risk to the

economy and to the fiscus.

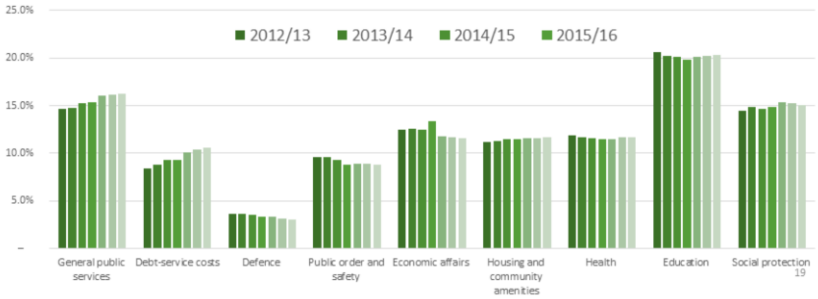
Expenditure outlook

Alignment of expenditure with the NDP

The NDP supports government's intention to gradually shift resources towards investment that grows the economy, broadens opportunities and enhances capabilities.

- Priority functions in 2016/17:
  - Education receives the highest proportion of 20.1 %
  - General public service (includes debt service cost) is second with 16.1 %
  - Social protection is at 15.4 %
  - Economic affairs is at 11.8 %
  - Housing and community amenities and Heath are at 11.6 % and 11.5 % respectively

Changes between 2012/13 and 2018/19



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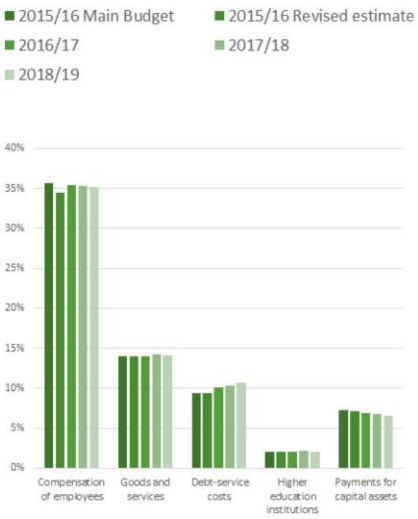
The NDP supports government's intention to gradually shift resources towards investment that grows the economy, broadens opportunities and enhances capabilities.

Priority functions in 2016/17 and estimated changes in the outer years:

- Education receives the highest proportion of 20.1 per cent of the 2016/17 budget
- General public service is second with 16.1 per cent of which debt-service cost is on 10.1 per cent and increasing to 10.6 per cent in 2018/19.
- Social protection is at 15.4 per cent from a revised estimate proportion of 14.9 per cent for 2015/16. This budget is estimated to decrease to 15.3 and 15.1 per cent of the total budget in 2017/18 and 2018/19 respectively. The latter 2 proportions do not include the expansion and improvement of the Early Childhood Development funding.
- Economic affairs is at 11.8 per cent and is estimated to decrease to 11.6 per cent in 2018/19.
- Housing and community amenities and Heath are at 11.6 per cent and 11.5 per cent respectively. Both functions are estimated to increase to 11.7 per cent in the outer year of the MTEF.

Proportion spend per Economic Classification

- Compensation of Employees
  - Based on the 2015/16 main budget
  - Different annual average growth rates per function group: (average CPI inflation: 6.2%)
    - Health: 7.4%
    - Provincial Basic Education: 7.9%
    - Economic Affairs: 7.6%
    - Human Settlements and Municipal Infrastructure: 8.2%
    - Defence, Public Order and Safety: 6.4%
- Debt-service cost
  - Proportion of budget increase from 9.4% in 2015/16 to 10.6% in 2018/19
- Payment for capital assets
  - Proportion of budget decrease from 7.2% in 2015/16 to 6.6% in 2018/19



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- Compensation of Employees

The outcome for 2015/16 is estimated to be 34.5 per cent of the total expenditure. It is estimated that the proportion allocated for compensation of employees will decrease from 35.6 per cent estimated in the 2015/16 main budget to 35.2 per cent in 2018/19. This proportion is, however, higher than the estimated proportion for 2015/16.

The annual average growth rates per function group are based on different assumptions. It does, however raises some questions if the increases are below the wage negotiation agreement (average CPI inflation: 6.2%) or in some instances in line with the negotiations, but not allowing for increasing front line services.

- 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.

- Debt-service cost

Proportion of budget increase from 9.4 per cent in 2015/16 to 10.6 per

cent in 2018/19.

- Payment for capital assets

Proportion of budget decrease from 7.2 per cent in 2015/16 to 6.6 per cent in 2018/19.

The shift in the proportion of the budget allocated to the previous 2 functional groups creates the perception of a trade-off between these 2 functional groups.

- Higher education:

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.

Reprioritisation to fund new requirements over the 2016 MTEF

From

- National Government: 0.8%
  - Compensation of employees: 1.5%
  - Goods and services: 2.5%
  - Transfers to public entities: 1.7%
- Provincial Government: 0.4%
- Local Government: 2.2%

Based on

- Recommendations from expenditure reviews (30)
- Modelling of remuneration trends (preliminary results)
- Programmes with a history of underspending

To

- Higher education
- New Development Bank
- Contingency Reserve
- Small business development
- Planning, monitoring and Evaluation
- Social protection

Reasons

- The freeze in university fees
- Binding international agreement
- Job creation (Department revised estimates downward from adjusted budget)
- Capacity for monitoring and evaluation (Department revised estimates downward from adjusted budget)
- Social protection: Grant increases and ECD grant

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- National Government reduces by 0.8 per cent of which:
- Compensation of employees reduce by 1.5 per cent.
- Goods and services by 2.5 per cent.
- Transfers to public entities by 1.7 per cent.
- Provincial Government reduces by 0.4 per cent over the MTEF.
- Local Government reduces by 2.2 per cent over the MTEF.

These reductions are estimates over the MTEF. It is, however, important to monitor these revisions in specific during 2016/17. Experience has shown that the budget reflects efficiency measures, but changes during the adjustments process might reverse these measures.

- Higher education receives R16 269 million over the 2016 MTEF
- The New Development Bank receives R11 750 million over the 2016 MTEF
- The Contingency Reserve increased by R3 000 million in 2016/17
- Small business development receives R475 million over the 2016 MTEF
- Planning, monitoring and Evaluation receives R300 million over the 2016 MTEF, despite the fact that the revised estimate for 2015/16 has

been revised downwards.

- Social protection will receive additional funding for expanding and improving Early Childhood Development in 2017/18 and 2018/19. It is important to ensure the preparedness of provincial departments to implement this new grant from 2017/18 onwards

The revisions are based on:

- Recommendations from expenditure reviews (30). This might be followed-up to also monitor implementation
- Modelling of remuneration trends (preliminary results). An exercise in progress between National Treasury and Department of Public Service and Administration
- Programmes with a history of underspending. This is not necessarily a good thing. These might be the programmes with job creation potential.

Some of the reasons for the revisions include:

- The freeze in university fees
- Binding international agreement (Contributing to the New Development Bank)
- Job creation (Department revised estimates downward from adjusted budget)
- Capacity for monitoring and evaluation (Department revised estimates downward from adjusted budget)
- Social protection: A new grant for the expansion and improving of ECD

Provincial and Local government spending

Provincial government

Receives 43.2% over the MTEF

- New Early Childhood Development Grant from 2017/18
- Compensation of Employee budgets ranges from 53% in the WC to 72% in Limpopo
- Spending on capital assets as a share of total spending is expected to decline

Local government

Receives 9.1% over the MTEF

- Number of municipalities reduce from 278 to 257
- Direct transfers for infrastructure are reduced by 3.5% over the MTEF
- A subsidy of R335 in 2016/17 per household per month to provide for free basic services
- Revisions to infrastructure grants to improve infrastructure investment
- Improving of municipal efficiency

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Provincial government: Receives 43.2 per cent on average of the budget over the MTEF
Revisions to take note of include:
New Early Childhood Development Grant from 2017/18
Compensation of Employee budgets ranges from 53 per cent in the WC to 72 per cent in Limpopo
Spending on capital assets as a share of total spending is expected to decline

Local government: Receives 9.1 per cent of the budget on average over the 2016 MTEF
Revisions to take note of include:
Number of municipalities are reduced from 278 to 257
Direct transfers for infrastructure are reduced by 3.5 per cent over the MTEF
A subsidy of R335 in 2016/17 per household per month to provide for free basic services
Revisions to infrastructure grants to improve infrastructure investment
Improving of municipal efficiency

Unauthorised, Irregular and Fruitless spending

Municipalities						
Expenditure Item R' million	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	Total
Unauthorised Expenditure	6 005	4 851	9 788	9 195	11 402	41 241
Irregular Expenditure	4 455	6 950	9 824	11 600	11 473	44 302
Fruitless and Wasteful Expenditure	209	248	568	815	687	2 527
Total Expenditure	**10 669**	**12 049**	**20 180**	**21 610**	**23 562**	

Provincial and National Government						
Expenditure Item R' million	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015
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
Total Expenditure	**18 051**	**27 477**	**33 149**	**32 079**	**66 540**	**28 259**

In response to pre-budget analysis concerns raised by Members about the lack reference to corruption as a risk to public finance, PBO conducted a study and summarise work done by AGSA with regard to Unauthorised Expenditure, Irregular Expenditure and Fruitless and Wasteful Expenditure popularly known UIFs.

It is important for Members to firstly must understand the meaning and context of these expenditures:

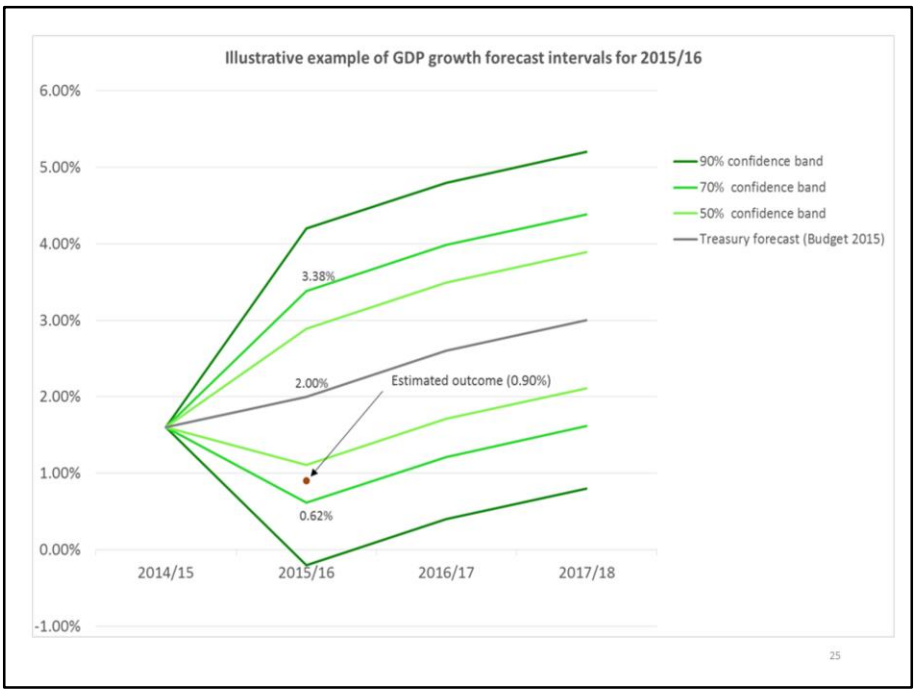
Unauthorised Expenditure (U)

Unauthorised expenditure is expenditure by departments that was not spent in accordance with the approved budget (overspending). The PFMA and MFMA requires accounting officers to take all reasonable steps to prevent unauthorised expenditure. The departments should have processes in place to identify any unauthorised expenditure that was incurred and disclose the amounts in the financial statements. The PFMA and MFMA also includes the steps that accounting officers and oversight bodies should take to investigate unauthorised expenditure to determine whether any officials are liable for the expenditure and to recover the money if liability is proven

Irregular Expenditure (I)
Irregular expenditure is 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. It is also an indicator of a significant breakdown in controls at some auditees.

Fruitless and Wasteful Expenditure (F)
Fruitless and wasteful expenditure is expenditure that was made in vain and that would have been avoided had reasonable care been taken. The PFMA and MFMA requires accounting officers to take all reasonable steps to prevent fruitless and wasteful expenditure. The auditee should have processes in place to detect fruitless and wasteful expenditure and, if incurred, to disclose the amounts in the financial statements. Fruitless and wasteful expenditure is required to be reported when it is identified – even if the expenditure was from a previous financial year.

Additional analysis on risks



- Forecasts of GDP growth and revenue collection play fundamental role in the Budget
- E.g. lower GDP growth means higher debt:GDP ratio, and lower revenue implies larger deficit
- The PBO is currently completing an assessment of the historical performance of National Treasury's forecasts
    - Internationally, independent advice on forecasts is a core component of PBOs' role
- Using findings from the project, we use historical forecast errors to construct 'confidence intervals' for the forecasts in the 2016 Budget
    - The results provide a crude indication of risk

▪As shown in the graphs in the appendix slides, it is possible to use historical performance of Treasury's forecasts to construct 'uncertainty intervals' around current forecasts

▪This provides some indication of the inherent risk in the assumptions underlying the Budget, and that should be taken into account in processing the fiscal framework

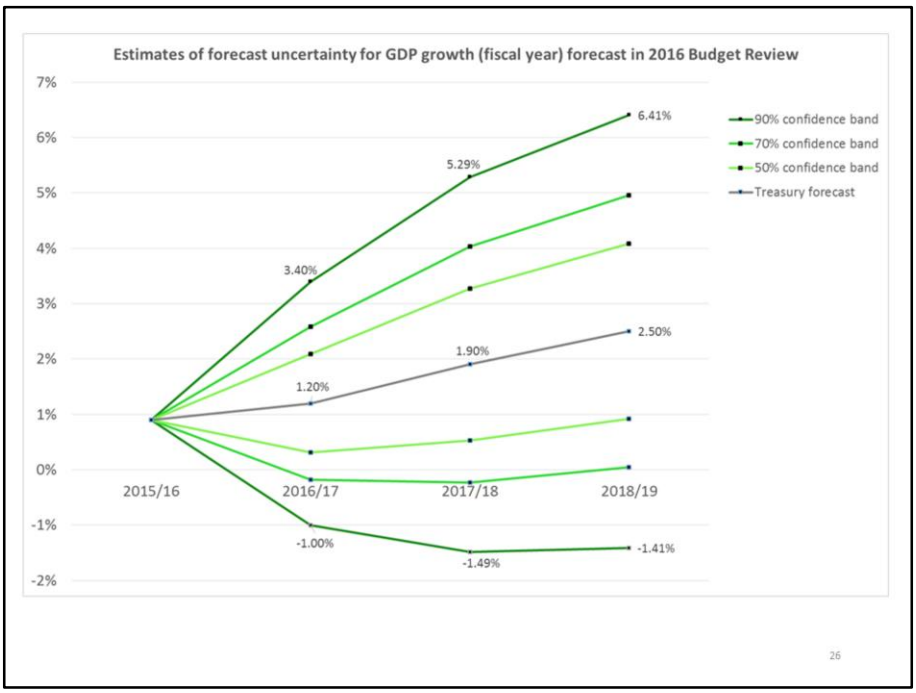
- The graph illustrates how applying this approach to Treasury's forecasts can assist committees in appreciating the uncertainty in the economic

outlook

- The real GDP growth forecast for 2015/16 in the 2015 Budget Review was 2%
- Based on *historical* forecast errors we could say that there is a 70% chance that actual growth would be between 0.62% and 3.38%
- The expected outcome for 2015/16 at the time of preparing this presentation was 0.9%, which is within the '70% confidence band'
- 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

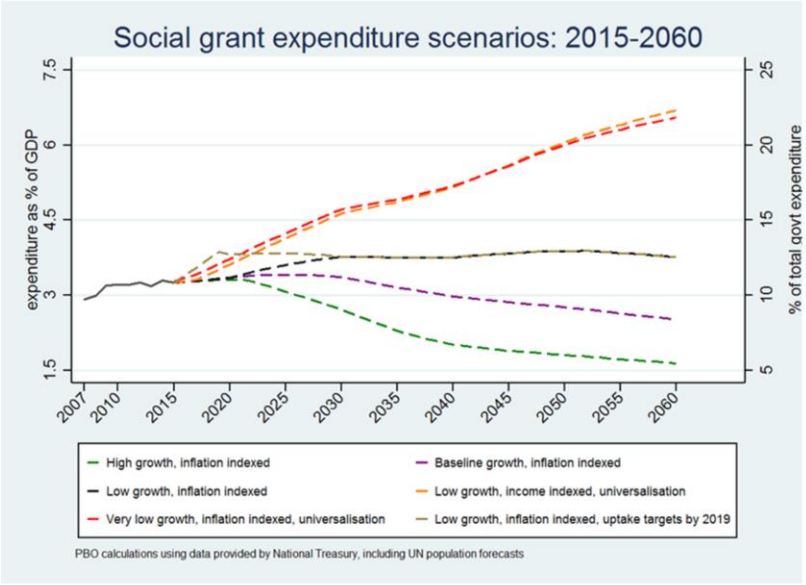
Note 1: The phrase 'we can be 70% confident' should be interpreted to mean that statistically the probability of growth being in this range is 70%.

Note 2: 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



- The graph shows the results of applying the previously-described approach to the forecasts in the 2016 Budget Review
- The interpretation of the results, for the numbers shown, is as follows:
  - Treasury's real GDP growth forecast for 2016/17 is 1.2%. Based on historical errors we can be 90% confident that growth will be between 3.4% and -1%.
  - Treasury's real GDP growth forecast for the outer year (2018/19) is 2.5%. Historical errors for 3 year forecasts suggest that we can be 90% confident that growth will be between 6.41% and -1.41%.
- These figures should be seen as a rough guide to uncertainty in the economic outlook. Their most important limitation is that they require the assumption that the past is a good guide to the future. Nevertheless, they arguably give Members a more accurate picture of what to expect than a single forecast number.

Sustainability of social grants



- The PBO has completed a report on the sustainability of social grant expenditure, which was requested by the Standing Committee on Finance
    - This will be presented at a convenient time for the relevant committees
- Examined National Treasury's models, reproduced Treasury's findings on this subject and came to similar conclusions re sustainability: grant expenditure is sustainable based on current policies, demographic projections and *long-term* growth forecasts. Claims by other authors regarding a 'fiscal cliff' are not based on a credible methodology.
- However, an important caveat is that the growth rate assumed in Treasury's 'low growth' scenario is higher than recent low growth rates
    - The PBO examined an additional, pessimistic scenario in which current low growth rates persist indefinitely
    - In that case, sustainability could be compromised, particularly given expected increases in beneficiary numbers due to higher uptake rates by eligible citizens and population growth
- This raises the question of what the government's approach is in the current Budget to this challenge. The two primary options are:
    - Continue with existing plans in regard to uptake and grant value

increases
    - Reduce planned increases in grant values and/or beneficiary numbers

The merits of these different approaches are among the issues that Members need to consider in adopting the Fiscal Framework and, later, the Appropriation Bill

- An examination of the 2016 Budget indicates that:
    - grant increases are below CPI and therefore constitute a cut to the real value of grants (the PBO report discusses the issue of appropriate inflation measures in more detail)
    - the planned increase in grant beneficiaries are broadly the same as the 2015 Budget (see Table 17.1 of the ENE), except that Disability Grant recipients are 100,000 less and Child Support Grant recipients increase by 300,000 in 2016/17 and 500,000 in 2017/18. The change in CSG numbers probably reflects changes in demographic projections. And Disability Grant projections appear to be the most error-prone.
    - Notable increases in allocation to Grant-in-Aid and Social Relief of Distress (+/- R500mil for 2016/17) over MTEF

Update on SOE financing risks

- **Equity injections**
- Only R15bn of R23bn appropriated for Eskom has been transferred
  - Budget states that R5bn transfer delayed for compliance reasons
  - Unclear when remaining R3bn will be paid
- Planned support to the Post Bank (R650mil in 2016/17) appears to suggest greater emphasis on deficit-neutrality rather than asset sales
- **Debt guarantees and other contingent liabilities**
- Large increase due to recognition of previously implicit risks: IPP tariff guarantees (R200.2bn) and PPP agreements (R8.9bn)
  - Addresses some of the concerns raised in PBO's report on SOE financing
  - Improved basis for responsible 'off-budget' infrastructure funding
- Rationale for including IPPs is that they hold tariff guarantees from Eskom, and Eskom holds debt guarantees from the Treasury

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- There are two main forms of fiscal risk posed by SOEs:
  1. Financial deterioration that necessitates an equity injection (colloquially referred to as a 'bailout')
  2. Financial deterioration that requires government to meet SOE interest payments or/and debt repayments due to debt guarantees

Equity injections

- The 2014 MTBPS committed to only providing 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 R25.4bn. Of this, R23bn was to be transferred to Eskom – as per the Eskom Special Appropriation Bill – and the remaining amount would be used for the first contribution to the New Development Bank.
- According to the Budget, R15bn has been paid to Eskom, but R5bn was not transferred in December. It is expected to be transferred in March when certain (unstated) conditions are met. The contribution to the NDB was made in December. It is unclear when the remaining R3bn will be transferred to Eskom.
- The only equity injection currently planned for 2016/17 is the R650mil 'recapitalisation' for the Post Bank. The Budget Review states that this was

financed through reprioritisation. The absence of a corresponding announcement regarding an asset sale suggests a possible shift in policy toward maintaining deficit neutrality but without necessarily requiring assets sales for all equity injections.

Debt guarantees and other contingent liabilities

- Government had R753bn in contingent liabilities at the end of 2015/16, the single major contributors to which are guarantees to Eskom (R168bn), liabilities of the Road Accident Fund (R132bn) and – a recent addition – tariff guarantees to Independent Power Producers (R200bn)
- The inclusion of the IPP guarantees and also Public Private Partnership contracts addresses some of the concerns raised in the PBO's report on SOE financing in relation to 'off-balance sheet' measures
- The rationale for including IPPs is as follows:
    - Government (including SOEs) reduces its infrastructure expenditure costs by contracting with IPPs to build and operate renewable energy production
    - Private capital is encouraged to do this because Eskom provides guarantees of future tariffs, which provides these producers with some certainty of their return on investment
    - However, there is a risk if these tariffs turn out to be more than is granted by the regulator for electricity sales, or if demand turns out to be lower than predicted and the power is not actually needed
    - In that instance, Eskom would still have to pay for the power even though it is not receiving enough revenue to compensate for that
    - The negative effects on Eskom's balance sheet could force government to step in and pay Eskom's debt when it becomes due (because of debt guarantees)
- The broader point is that while encouraging the involvement of private capital may be particularly desirable during periods of low growth, this does come with corresponding risks and those should be recognised as part of prudent management of public finances. This now provides a more solid basis for such endeavours in future years.

Selected points for consideration

- What is the expected impact of a higher fuel levy?
- What is NT's basis for determining an appropriate contingency reserve?
- To what extent are the proposed measures to reduce the compensation of employees (as a share of total spending) feasible and desirable?
- What are the contingency plans, including protection of the social safety net, for lower growth scenarios?
- Given the upward revision of contingent liability estimates, what is being done to ensure that the risks of future off-budget financing is properly recognised and managed?

Thank you

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Appendices slides

No increase in rates, but limited relief for fiscal drag

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, PBO own calculations

The distribution of the average adjustments has arguably favoured middle to higher income earners, with the bottom two brackets experiencing the slowest average growth. This has been amplified by the slower growth in the primary rebate. While all taxpayers have benefitted from real increases in tax thresholds, the lower income earners have arguably benefitted the least.

The 2016 budget review did not propose an increase in marginal tax rates, but offered limited relief for fiscal drag. Fiscal drag is the process in which inflation adjustments to income are not matched by inflation adjustments to the income tax thresholds. This 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 not enough to compensate for inflation. In real terms, the three lower brackets have been decreased by approximately 3.05 per cent. This means that 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. This is because 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.

Further, some low income registered taxpayers currently paying no tax because of the primary rebate, may be liable for income tax in the 2016/17 financial year. This is as a result of the reduction in the primary rebate by 4.47 per cent in real terms.

Registered taxpayers earning above R701 301 are mostly unaffected by the proposals in the 2016/17 budget review. They will, however, pay a slightly higher proportion of their income at the highest marginal tax rate of 41 per cent as a result of the freeze in the R701 301 threshold.

Ratings agencies are concerned

	Fitch	Moody's	Standard & Poor's
Current rating	BBB-	Baa2	BBB-
Outlook	stable	negative	negative
Reasons for revision/ affirmation and risks	Government's "decision" not to tighten fiscal policy in response to weaker revenue growth Government is having difficulting to reduce the budget deficit and stabilise the debt/gdp ratio Pressure on government balance sheets from contingent liabilities SA has limited room to respond to fiscal shocks as public wage agreement reduced the contingency reserve	Poor growth outlook for the medium-term Risk of fiscal slippage due to low growth and political pressures	Low growth outlook due to electricity constraints and labour disruptions Impact of electricty shortage on growth Reduced fiscal space due to contingent liabilities
Growth forecast*			
2015	1.4%	1.4%	1.4%
2016	1.7%	1.4%	1.6%
2017	2.4%	-	2.0%

*From December 2015

Change in SOE guarantees

SOE (R billion)	Guarantees held (2015/16)	Change	Exposure (2015/16)	Change
Eskom	350	-	168.5	+18.6
SAA	14.4	-	14.4	+6
SA Express	1.1	-	1.1	+0.6
SANRAL	38.9	-	35	+2.6
SAPO	4.4	2.5	1.3	+1
Land Bank	6.6	-	5.3	+3.2

- Marginal changes for other SOCs and DFIs
- Guarantee exposure increases over MTEF primarily due to gradual increase in Eskom borrowing
  - Significant in as much as it implies that current intention is not to extend guarantees much further