2017

MEDIUM TERM BUDGET POLICY STATEMENT

MTBPS

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Core message of the MTBPS

- Tough times require tough decisions. We are committed to making them. Working together, we can grow the economy for the benefit of all
- Radical economic transformation is required to change the economy to include all South Africans
- South Africa's budget is progressive and redistributive, and makes large contributions to transformation and growth
- Yet the pressures on the public finances are mounting, and there are a series of risks that must be managed. This will require difficult trade-offs and compromises
- Government remains committed to a path of fiscal consolidation. It will maintain the expenditure ceiling over the medium term, and a presidential task team will develop proposals to restore fiscal sustainability
- The only sustainable solution for our development and the health of our public finances is to grow the economy inclusively

Improving global outlook

A window of opportunity

- Global economic conditions continue to improve
- But the risks of financial turbulence remain high and the longer term outlook for growth and commodity prices is muted.
- Strong domestic demand should boost EU growth
- Japan to benefit from higher net exports
- The return to growth in Russia and Brazil on track

South Africa remains vulnerable to external conditions.

- *Foreign savings are required to finance investment*
- *Government debt held by non-residents has increased to 17.6 per cent of GDP*

Economic growth in selected countries

Percentage	2000-2008 Pre-crisis	2010-2015 Post-crisis	2016	2017	2018
			Average GDP[1]		
World	**4.3**	**3.9**	**3.2**	**3.6**	**3.7**
Advanced economies	**2.4**	**1.9**	**1.7**	**2.2**	**2.0**
US	2.3	2.2	1.5	2.2	2.3
Euro area	2.0	1.0	1.8	2.1	1.9
UK	2.5	2.0	1.8	1.7	1.5
Japan	1.2	1.5	1.0	1.5	0.7
Developing countries	**6.5**	**5.5**	**4.3**	**4.6**	**4.9**
Brazil	3.8	2.2	-3.6	0.7	1.5
Russia	7.0	2.2	-0.2	1.8	1.6
India	6.8	7.4	7.1	6.7	7.4
Chile	4.8	4.2	1.6	1.4	2.5
Mexico	2.6	3.2	2.3	2.1	1.9
Indonesia	5.3	5.7	5.0	5.2	5.3
China	10.4	8.3	6.7	6.8	6.5
Sub-Saharan Africa	**5.9**	**5.0**	**1.4**	**2.6**	**3.4**
South Africa[2]	4.2	2.3	0.3	0.7	1.1

1. IMF World Economic Outlook Update, October 2017

2. National Treasury Forecasts

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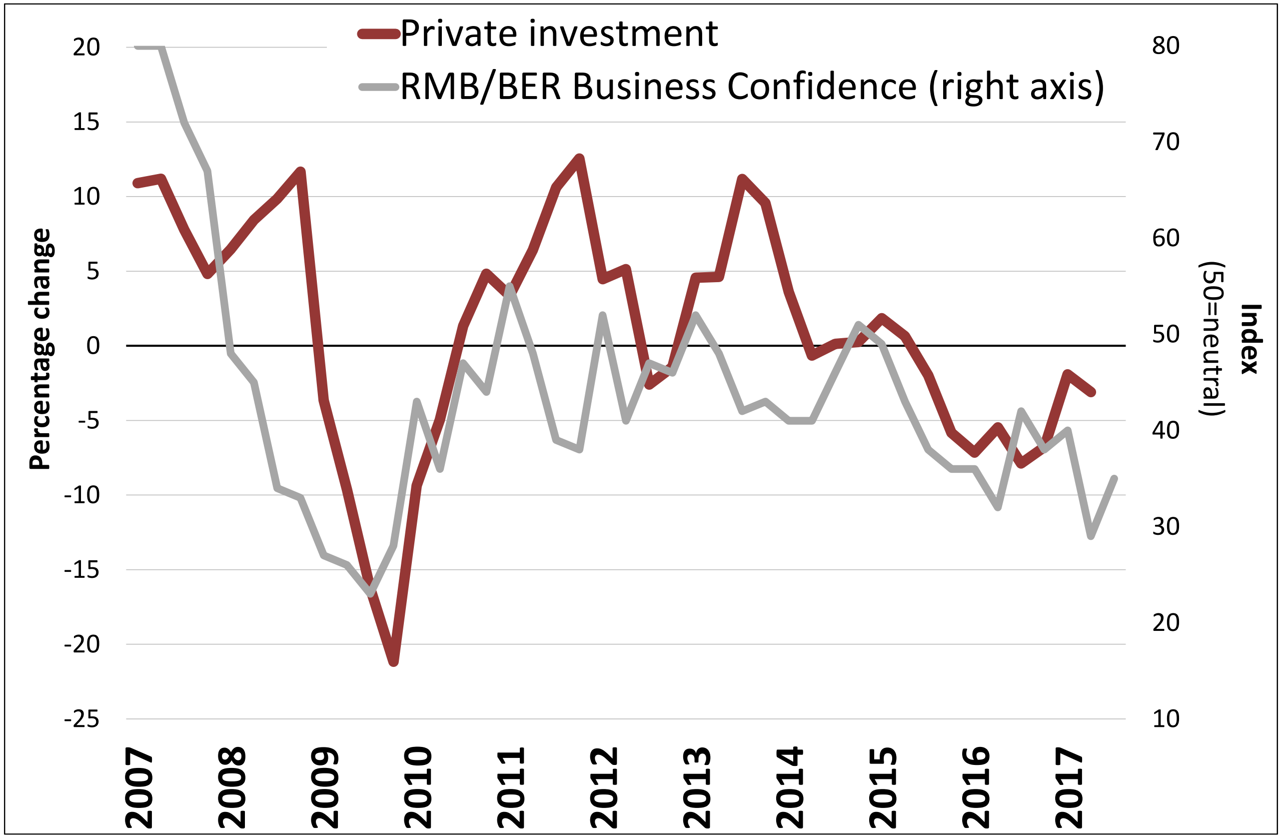
South Africa

Weaker confidence, falling investment

- South Africa's economic performance reflects low levels of business confidence, weak domestic demand and a heightened risk premium
- Investment declined by 3.9 per cent in 2016, with large falls in mining and manufacturing capital

South Africa: Investment growth and business confidence



Economic forecast

Moderate recovery insufficient to reduce unemployment

- Economic growth is expected to be 0.7 per cent this year, recovering slowly to reach 1.9 per cent by 2020.
- Inflation has been revised down.
- The recovery in growth depends on improved investment outlook and rising exports.

Macroeconomic performance and projections

Calendar year Percentage change	2014	2015 Actual	2016	2017 Estimate	2018	2019 Forecast	2020
Household consumption	0.7	1.7	0.8	1.0	1.2	1.6	1.9
Government consumption	1.1	0.5	2.0	0.9	1.7	1.0	1.0
Gross fixed capital formation	1.7	2.3	-3.9	-0.6	0.5	3.0	3.5
Gross domestic expenditure	0.6	1.8	-0.8	1.2	1.1	1.5	2.0
Exports	3.2	3.9	-0.1	2.5	3.2	3.4	3.5
Imports	-0.5	5.4	-3.7	4.0	3.1	3.5	3.8
Real GDP growth	**1.7**	**1.3**	**0.3**	**0.7**	**1.1**	**1.5**	**1.9**
GDP inflation	5.8	5.0	6.8	5.1	5.0	5.3	5.5
GDP at current prices (R billion)	**3 808**	**4 050**	**4 339**	**4 602**	**4 889**	**5 222**	**5 612**
CPI inflation	6.1	4.6	6.3	5.4	5.2	5.5	5.5
Current account balance (% of GDP)	-5.3	-4.4	-3.3	-2.3	-2.6	-2.9	-3.1

Source: National Treasury

Breaking out of the low-growth trap

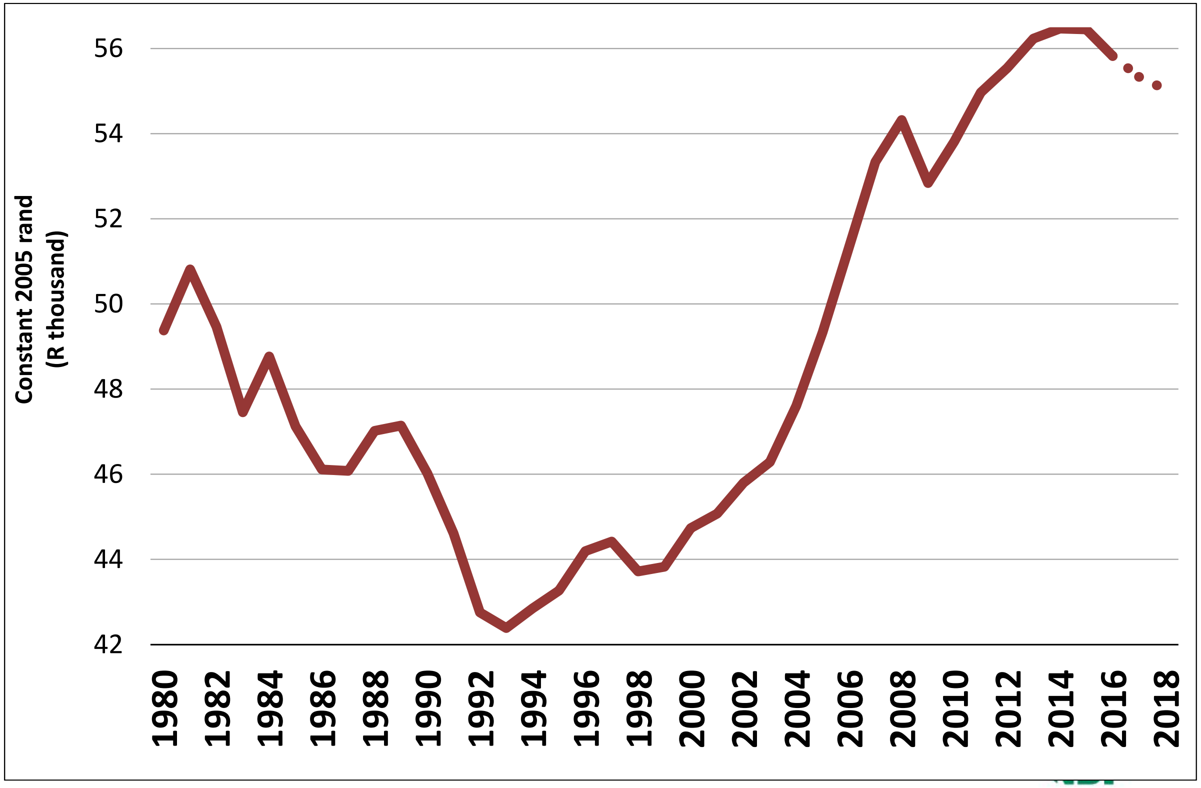
Government committed to decisive action

- South Africa's per capita income has begun to stagnate. National Treasury's projections imply that this will continue in the years ahead.
- Unless decisive action is taken to charge a new course, the country could remain caught in a cycle of weak growth, mounting government debt, shrinking budgets and rising unemployment.

Hard choices are required to break out of the low growth trap.

A new cycle of inclusive development requires intervention to stimulate activity, ensure effective regulation, improve competitiveness of manufactured exports, promote localisation and reindustrialise the economy, together with renewed attention to the capacity of the state.

South Africa: Per capita income



Source: Reserve Bank

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UPDATE: Actions to boost confidence

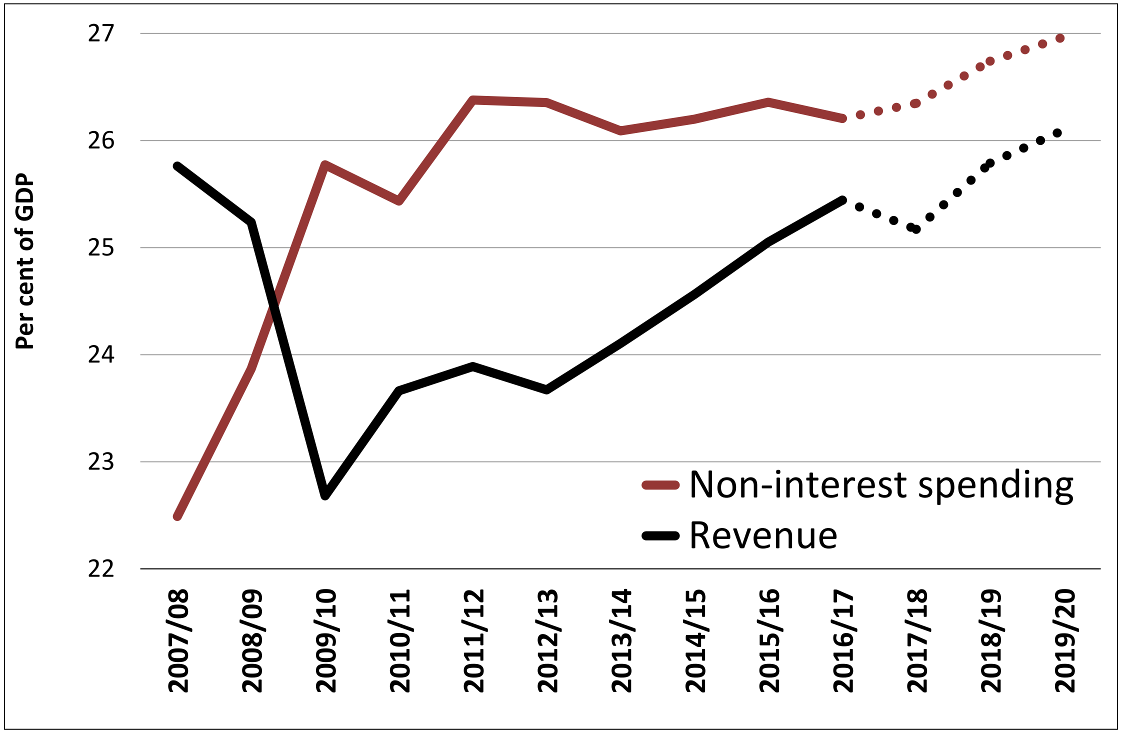
- **Restore the sustainability of fiscal policy**
  - Budget Facility on Infrastructure - 59 submissions received, project appraisals under way
  - Negotiations on the next public-service wage agreement have commenced
- **Promote transformation and competitive outcomes by implementing sector reforms**
  - Preferential Procurement Policy Framework Act Regulations took effect on 1 April 2017
  - Financial Sector Regulation Act signed into law on 21 August 2017
  - Small business fund for ideation and start-up being set up
- **Manage fiscal and economic risks associated with state-owned companies**
  - SAA recapitalised, with new board and permanent CEO
  - Frameworks for private sector participation and costed SOC mandates approved by Cabinet
  - Eskom governance interventions in motion. IPP agreements to be signed at 77c/kWh or below
- **Create policy certainty by finalising key legislative and policy processes**
  - CSIR study on spectrum availability and open access
  - Market inquiry launched into broadband data prices
  - Licensing of Postbank under way
  - Mining Charter engagements following postponed implementation
  - Stakeholder consultation on the Regulation of Agricultural Land Holdings Bill

Fiscal outlook

- Government has followed a path of measured fiscal consolidation over the last four years, reducing spending and increasing taxes, reflected in a narrowing primary deficit
- This year, a sharp deterioration in revenue collection and further downward revisions to economic growth projections have eroded government's fiscal position
- Revenue shortfalls are projected at R50.8 billion in 2017/18, R69.3 billion in 2018/19 and R89.4 billion in 2019/20.
- Additional appropriations to forestall calls against guaranteed debt by the creditors of SAA and SAPO, partially offset by contingency reserve

Government's options are limited. Given that per capita income is falling, the economic impact of further expenditure cuts or tax hikes could be counter-productive.

Revenue and non-interest spending
Main budget excluding financial transactions



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Fiscal framework

- The consolidated budget deficit to be 4.3 per cent of GDP, compared to a 2017 Budget estimate of 3.1 per cent.
- Without action, national debt will continue rising, reaching over 60 per cent of GDP by 2022.
- Key fiscal risks in the period ahead include:
  - Further revenue shortfalls
  - Compensation budgets
  - Debt-service costs are rising
  - Funding gaps in infrastructure and social services
  - Financial deterioration in major state-owned companies.

Consolidated government fiscal framework

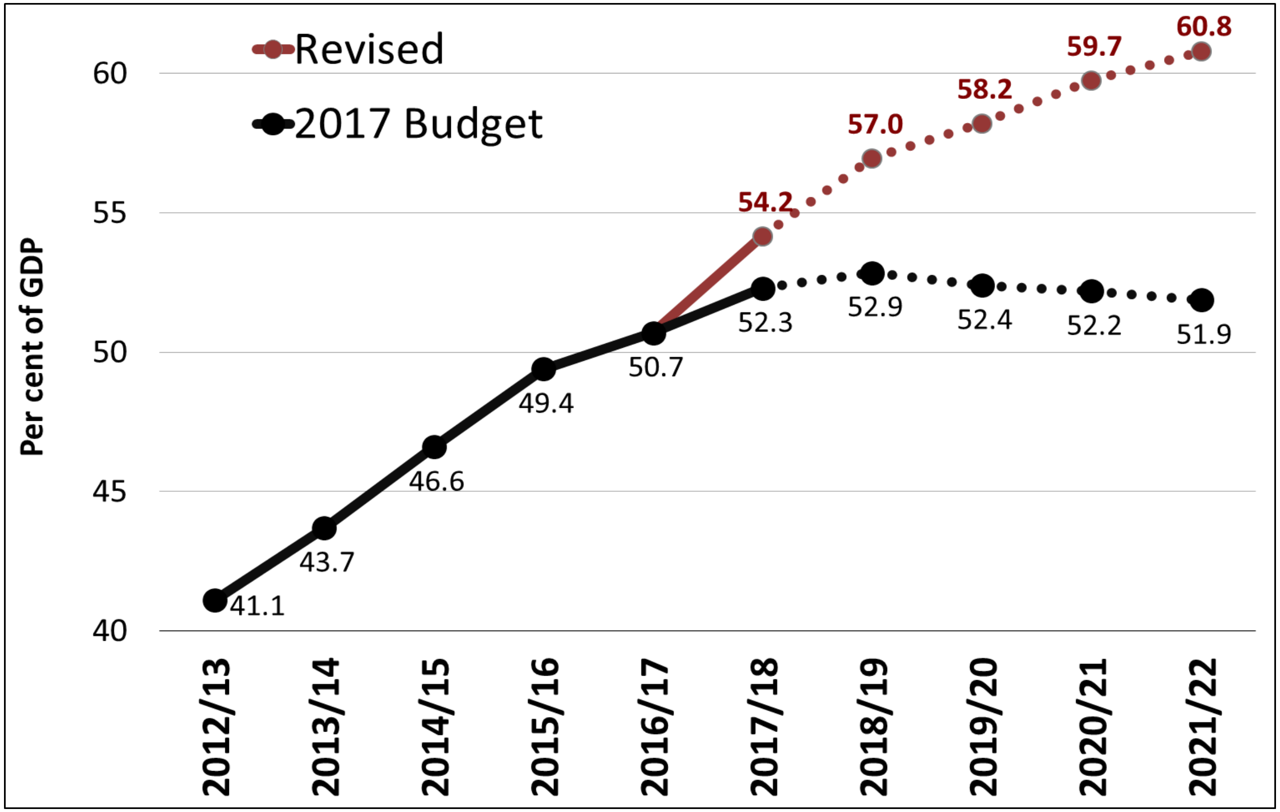
	2016/17	2017/18	2018/19	2019/20	2020/21
R billion/Percentage of GDP	**Outcome**	**Revised**	**Medium-term estimates**		
Revenue	**1 298**	**1 364**	**1 477**	**1 594**	**1 709**
	29.5%	*29.2%*	*29.7%*	*30.0%*	*29.9%*
Expenditure	**1 446**	**1 567**	**1 671**	**1 802**	**1 935**
	32.8%	*33.5%*	*33.6%*	*33.9%*	*33.9%*
Budget balance	**-147**	**-203**	**-193**	**-208**	**-226**
	-3.3%	*-4.3%*	*-3.9%*	*-3.9%*	*-3.9%*
Total gross loan debt	**2 233**	**2 531**	**2 830**	**3 094**	**3 416**
	50.7%	*54.2%*	*57.0%*	*58.2%*	*59.7%*

Source: National Treasury

National government debt outlook

- Gross national debt is projected to reach over 60 per cent of GDP by 2022
- The National Treasury estimates that stabilising gross debt below 60 per cent of GDP over the coming decade will require spending cuts or tax hikes amounting to 0.8 per cent of GDP.
- In 2018/19, 0.8 per cent of GDP would amount to R40 billion.

Gross debt-to-GDP outlook without additional fiscal measures



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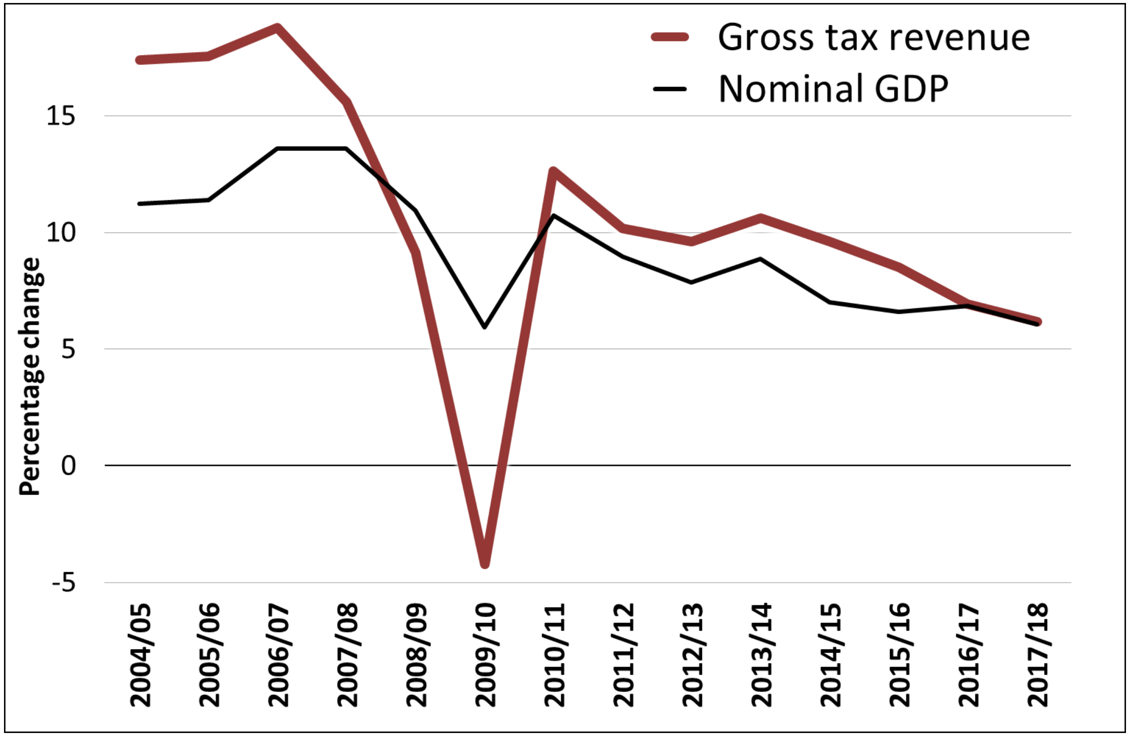
Revenue buoyancy has stalled

- This period of revenue buoyancy appears to have run its course.
- Revenue growth outpaced GDP between 2011 and 2015 - partly the result of tax policy, partly the result of underlying economic trends.
- Revenue weakness reflects a number of economic factors:
  - Growth in key sectors has slowed – finance, retail and telecoms
  - Low bonus payments, moderate wage settlements, job losses and a slower employment growth
  - Persistently weak growth and commodity price volatility in mining sector
  - Sharp contraction in imports
  - Stabilisation of the rand
- Other factors could include:
  - Behavioural responses to tax increases
  - Compliance concerns and weakening tax morality
  - Administrative challenges in SARS

Revenue under-collection reflects slowing economic growth, but may also suggest a profound shift in the relationship between economic growth and tax collection in the years ahead.

Growth in gross tax revenue and nominal GDP



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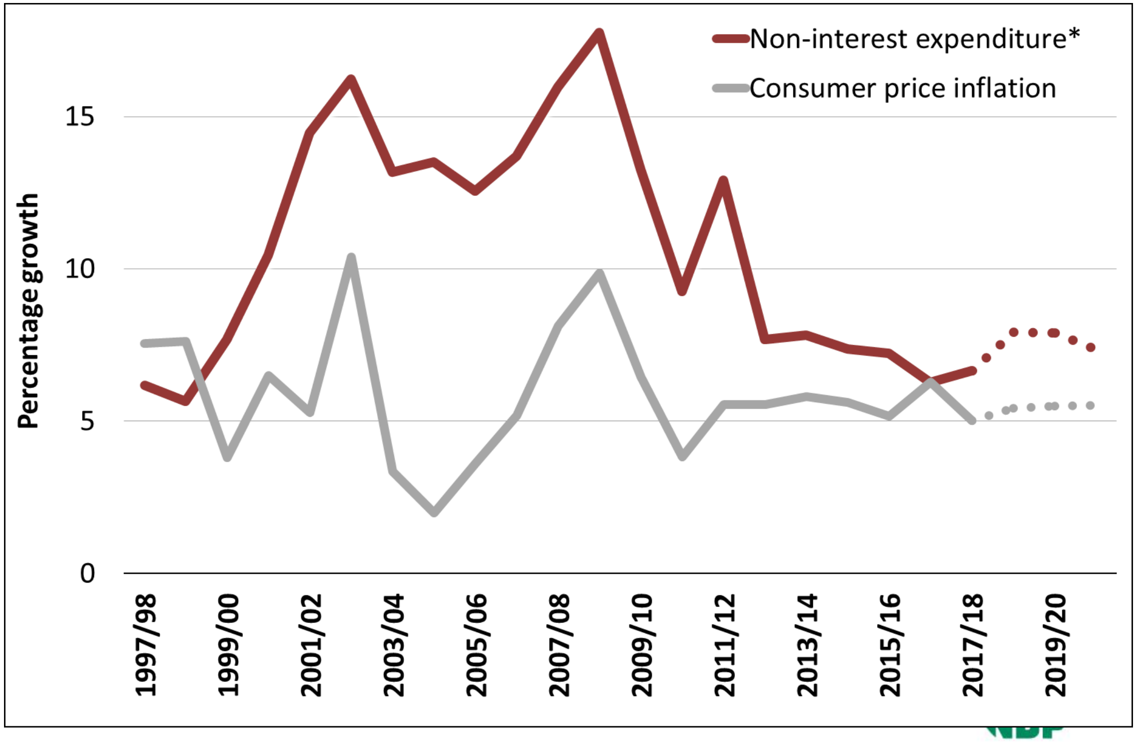
Expenditure is contained

But there are growing pressures and risks across the public finances

- The public-service wage bill has increasingly crowded out other areas of spending, including complementary inputs that public servants need to do their work
- Several years of fiscal restraints have left funding gaps in a number of programmes
- Unpaid accounts are building up, particularly in provincial health budgets
- Infrastructure projects that are poorly designed or not effectively delivered have resulted in high operating deficits, with insufficient allocations for maintenance

Without resolute action to cut wasteful and inefficient spending, there is a growing danger that the most vulnerable citizens will suffer the effects of fiscal consolidation.

Growth in main budget expenditure and consumer inflation



** Non-interest expenditure excluding payments for financial assets and other items.*

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Compensation budgets have grown

…and are crowding out space for employment and complementary inputs

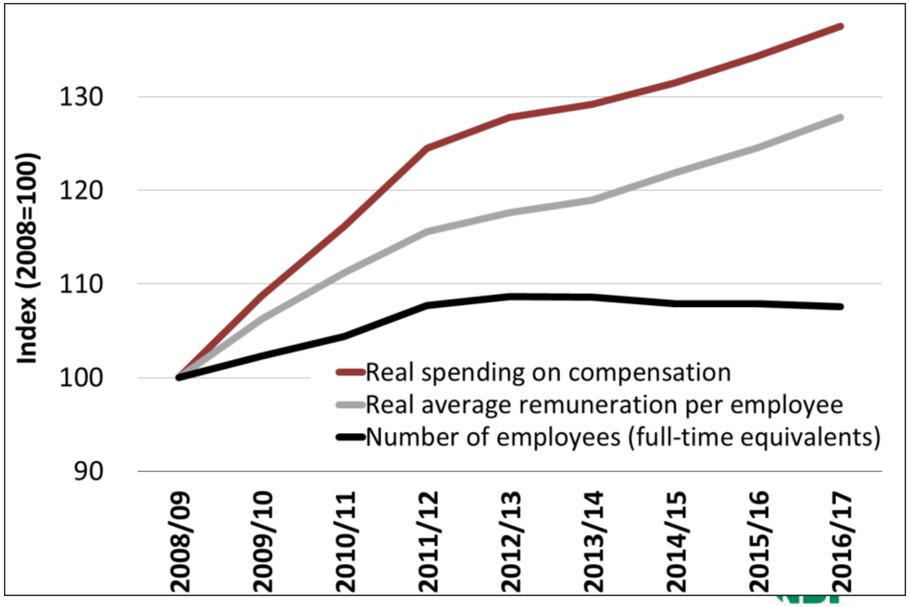
- Since 2011 government has been forced to restrict employee headcount growth to accommodate rising salaries
- Yet spending on compensation continues to grow more quickly than nominal GDP
- The MTEF provides for an overall increase of 7.3 per cent a year to accommodate improvements in conditions of service
- Many departments are already at risk of exceeding this limit, even assuming that personnel numbers do not increase.
- A fair and reasonable compromise between government and state employees is in the public interest

Compensation as % of total budget

	2008/09	2016/17
Selected national departments		
Correctional services	*63.0%*	*66.9%*
Defence	*38.2%*	*57.3%*
Justice	*54.1%*	*55.9%*
Police	*70.0%*	*76.6%*
Selected provincial health departments		
Eastern Cape	*58.0%*	*65.6%*
Gauteng	*52.0%*	*62.2%*
KwaZulu-Natal	*58.9%*	*63.1%*
Limpopo	*58.9%*	*71.0%*
Mpumalanga	*58.5%*	*63.2%*
North West	*56.6%*	*62.0%*

Source: National Treasury (budget data)

Spending, employment and remuneration

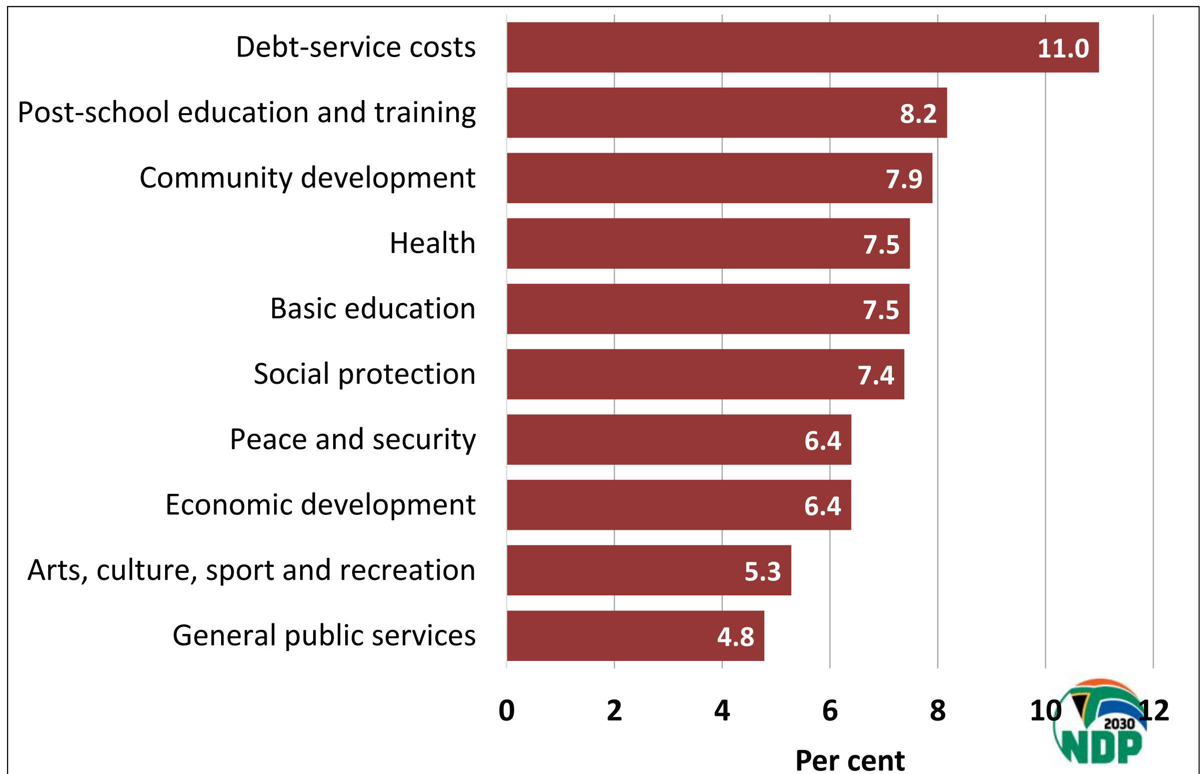


Spending priorities

- The Mandate Paper proposes seven expenditure priorities for the MTEF period:
  - Job creation and small business development
  - Youth development
  - Infrastructure expansion and maintenance
  - Land reform, smallholder farmer and agriculture development
  - Comprehensive social security, education and skills
  - An integrated plan to fight crime
  - Advancing the national interest in the region, Africa and the world

Consolidated government expenditure

Nominal average growth over MTEF (2017/18-2020/21)



Spending priorities

- To offset revenue shortfalls and reduce borrowing, the contingency reserve has been pared down to R16 billion over the next three years. This leaves government with little room to manoeuvre if risks to the expenditure ceiling materialise
- The fastest-growing elements of spending are Learning and Culture (which includes post-school education and training), Health and Community Development, with growth rates of 7.6 per cent, 7.5 per cent and 7.9 per cent respectively
- Government is protecting expenditure that delivers services to low-income households. However, additional resources to support spending priorities are severely limited

Consolidated government expenditure

R billion	2017/18 Revised	2018/19 Medium-term estimates	2019/20	2020/21	Average growth
Learning and culture	317.8	340.7	367.3	395.7	7.6%
Health	189.6	204.5	220.0	235.5	7.5%
Social development	234.2	251.2	269.0	286.9	7.0%
Community development	193.5	210.1	226.5	243.1	7.9%
Economic development	190.9	202.2	217.7	229.9	6.4%
Peace and security	195.5	206.2	220.7	235.5	6.4%
General public services	62.3	64.7	67.5	71.6	4.8%
Payments for financial assets	19.5	5.0	5.2	5.5	–
Total expenditure by function	**1 403.3**	**1 484.5**	**1 594.0**	**1 703.8**	**6.7%**
Debt-service costs	163.3	183.1	203.3	223.4	11.0%
Contingency reserve	–	3.0	5.0	8.0	–
Total expenditure	**1 566.6**	**1 670.6**	**1 802.3**	**1 935.1**	**7.3%**

Source: National Treasury

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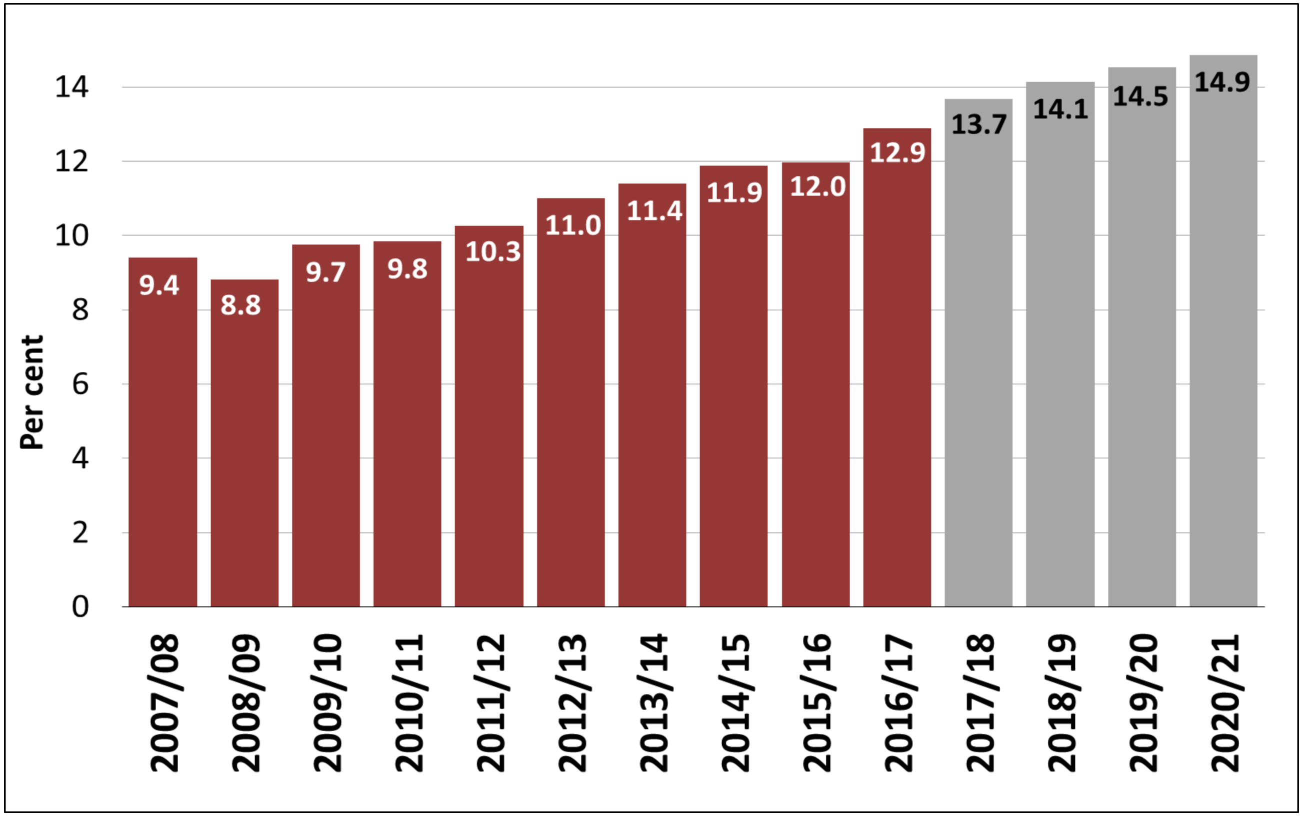
Rising debt-service costs

- The fastest-growing category of expenditure is debt-service costs, increasing at an annual average of 11 per cent each year for the next three years
- This year, debt service costs are R163.3 billion, rising to R223.4 billion by 2020/21
- Debt service costs will soon absorb 15c for every R1 collected in revenue

Interest payments as a share of main budget revenue



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Containing spending on non-essentials

- Since expenditure ceilings and cost-containment measures were introduced in 2012/13, spending on consultants, travel, lodging, catering, advertising and conferences has fallen sharply.
- There is now little room for departments to further curb such spending without negatively affecting service delivery.
- Transversal contracts negotiated by government have begun to yield positive results. Under these agreements, a supplier procures goods and services for more than one department, provided that the contracts are cost-effective.

Expenditure on cost-containment items (national and provincial)

R million	2013/14 Audited outcome	2016/17 Preliminary outcome	Change in value	Average annual growth (nominal)
Consultants	6 980	6 148	-832	-4.1%
Travel and subsistence	9 828	9 305	-523	-1.8%
Catering and events	908	815	-93	-3.6%
Entertainment	44	25	-19	-17.5%
Advertising	1 246	1 094	-152	-4.2%
Newspapers and publications	270	202	-68	-9.2%
Conferences (venues and facilities)	1 241	999	-242	-7.0%
Other expenditure (communication)	3 227	3 243	16	0.2%
Total	**23 744**	**21 831**	**-1 913**	**-2.8%**

Source: National Treasury

Risks to the expenditure outlook

- Several state-owned companies persistently demonstrate operational inefficiencies, poor procurement practices, weak corporate governance and failures to abide by fiduciary obligations
- A new civil service wage agreement in which salary increases exceed CPI inflation, and without headcount reductions, would render the current expenditure limits difficult to achieve
- Additional spending commitments may emerge from policy processes under way
  - Government is evaluating the implications of providing fee-free higher education and training to poor and middle-income students
  - Other policy commitments include NHI, proposals in the Defence Review, improved early childhood development, accelerated land reform and several large infrastructure project proposals
- To anchor a sustainable budget, structural increases in expenditure must be matched by structural increases in revenue
- The expenditure ceiling can be adjusted to accommodate new spending priorities when a permanent source of revenue is found to offset increased spending (As stated in the 2015 MTBPS). For example, government is considering proposals to finance NHI through adjustments to the medical tax credit

Division of revenue

- The proposed division of revenue continues to prioritise funding of services for poor communities.
  - Allocations to provinces focus on education, health and other social services.
  - Allocations to local government subsidise the delivery of free basic services to low-income households, and the infrastructure needed to deliver those services.
- Over the MTEF, government proposes to allocate national departments 47.6 per cent of available non-interest expenditure, provinces 43.2 per cent and local governments 9.2 per cent.
- Over this period, national government resources grow by 6.5 per cent, provincial resources by 7.2 per cent and local government resources by 8.3 per cent.

Division of revenue framework

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
R billion		**Outcome**		**Revised**		**Medium-term estimates**	
Division of available funds							
National departments	**490.0**	**546.1**	**555.7**	**603.5**	**633.1**	**683.5**	**729.2**
Provinces	**439.5**	**471.4**	**500.4**	**538.2**	**575.8**	**617.8**	**663.9**
Equitable share	359.9	386.5	410.7	441.3	471.7	506.6	543.7
Conditional grants	79.6	84.9	89.7	96.9	104.1	111.2	120.1
Local government	**87.6**	**98.3**	**102.9**	**112.6**	**121.6**	**132.4**	**143.0**
Equitable share	41.6	49.4	50.7	57.0	62.7	69.0	75.7
Fuel levy sharing with metros	10.2	10.7	11.2	11.8	12.5	13.2	14.0
Conditional grants	35.8	38.3	40.9	43.8	46.4	50.3	53.3
Total	**1 017.1**	**1 115.8**	**1 159.0**	**1 254.3**	**1 330.5**	**1 433.7**	**1 536.1**
Percentage shares							
National departments	48.2%	48.9%	48.0%	48.1%	47.6%	47.7%	47.5%
Provinces	43.2%	42.2%	43.2%	42.9%	43.3%	43.1%	43.2%
Local government	8.6%	8.8%	8.9%	9.0%	9.1%	9.2%	9.3%

Source: National Treasury

Changing course

- Decisive action is needed for a new growth trajectory
- Interventions need to improve the competitiveness of manufactured exports, promote localisation and reindustrialize the economy
- Work is underway to license broadband spectrum, optimise government's asset portfolio, reform the governance of state-owned companies and encourage private-sector participation
- A stronger package of measures to stimulate economic growth is being developed
- A team of ministers reporting directly to the President has been established to develop proposals to narrow the deficit, stimulate the economy and build investor confidence
- The team will work to ensure that the spending ceiling remains in tact this year, and consider a broader set of proposals to restructure to portfolio of public assets
- Additional measures to reduce expenditure, raise revenue and improve the impact of public resources on economic growth will be announced in the 2018 Budget

Website

Further information including documents and data, graphs and tables in excel format are available at:

www.treasury.gov.za/documents/MTBPS/