1

Accelerated and shared growth

The economic recovery that began in September 1999 – already the longest business cycle upswing on record – gathered further momentum in 2004 and the first half of 2005. Total employment increased briskly during the year to March 2005, and investment continues to grow strongly. The pace of economic growth will moderate somewhat during 2006, before accelerating to between 4,4 and 5 per cent a year in 2007 and 2008. South Africa's growth strategy aims to reinforce modernisation and deepen the competitiveness of the economy, while also broadening participation and addressing structural constraints that inhibit the development of small businesses and cohesive communities. It is a strategy for both accelerated and shared growth, recognising that economic prosperity must be built on a broad-based foundation of social solidarity. On the strength of robust revenue performance and a favourable financial environment, Government is again able to table an expansive medium term budget framework. The 2006 Budget will:

- *Add R78,3 billion to national, provincial and local spending plans over the next MTEF period, enhancing public services, accelerating infrastructure investment and strengthening the fight against crime*
- *Promote development partnerships between the public and private sector, focused on housing, investment in the built environment and industrial infrastructure*
- *Shift social service expenditure towards quality improvements in education, health care and support for poverty-focused welfare services*
- *Contribute targeted support to municipalities for capacity building, basic services and local economic development.*

A medium term strategic framework

The 2004 *Medium Term Budget Policy Statement* summarised Government's medium term strategic framework as follows:

- Accelerating the pace of economic growth, and the rate of investment in productive capacity

- Promoting opportunities for participation of marginalised communities in economic activity, and improving the quality of livelihoods of the poor
- Maintaining a progressive social security net, alongside investment in community services and human development
- Improving the capacity and effectiveness of the state, including combating crime and promoting service-oriented public administration
- Building regional and international partnerships for growth and development.

Progress on these fronts is outlined below, followed by an overview of the subsequent chapters of the 2005 *Medium Term Budget Policy Statement*.

Growth and investment

Policy aims to accelerate and broaden economic growth

Under the leadership of the Deputy President, work is in progress on an *accelerated and shared growth initiative* – addressing the constraints to more rapid expansion of output and income, and reinforcing measures aimed at broadening employment and economic participation.

GDP growth expected to average about 4,5 per cent a year

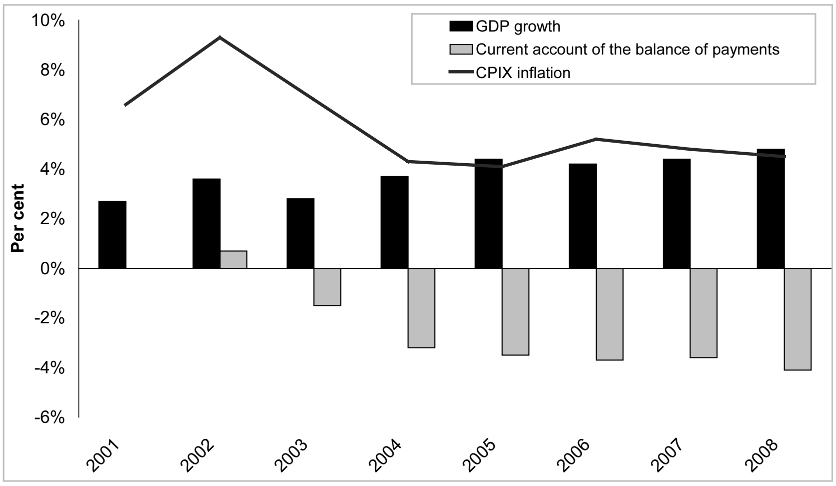
Economic growth in 2004 and 2005 has been buoyed by robust consumer demand and rising business investment, on the strength of benign inflation, moderate interest rates, rapidly rising property values and a generally improved economic outlook. Domestic expansion and continued strength in commodity prices have contributed to a surge in both turnover and valuations on the Johannesburg Securities Exchange. Gross domestic product (GDP) growth is expected to moderate to just above 4 per cent in 2006, and to increase to between 4,4 and 5 per cent in 2007 and 2008.

Figure 1.1 illustrates that South Africa's improved growth performance is accompanied by a stable moderate inflation rate and a deficit on the current account of the balance of payments of between 3 and 4 per cent of GDP. Growth over the longer term needs to be supported by continued macroeconomic stability, a favourable investment environment, improved trade performance and enhanced education and skills development.

Strong growth in capital spending underway

As was anticipated a year ago, capital formation by both the public and private sectors has continued to grow strongly during the first half of this year, and will be boosted by several major construction projects and industrial investments over the period ahead. Government investment spending on key transport networks – road, rail and ports infrastructure – will increase markedly in 2006 and beyond. Stepped up investment in the residential and local built environment – housing, community services, water and electricity – has also been prioritised.

Figure 1.1 GDP growth, inflation and the current account of the balance of payments, 2001 – 2008



Government's growth initiative recognises that several infrastructure sectors are critical for long-term growth prospects and lowering the costs of doing business. In addition to expanded capacity in power generation and improved freight logistics networks, the economy needs greater competition and modernisation in the communications sector, and strengthened research and technology capabilities. South Africa's mineral wealth and diversified metals and chemicals capacity are strengths on which to build, but aspects of the structure, competitiveness and pricing behaviour in several industries warrant review.

Government recognises that infrastructure investment is critical for growth

Accelerated growth also requires attention to the legacy of a fragmented spatial economy, and the particular constraints that inhibit job creation and restrain the growth and prospects of small enterprises, informal traders and emerging farmers. Small business support programmes will be revitalised, spending on skills development is increasing rapidly and agricultural support for land reform beneficiaries will be stepped up over the period ahead.

Constraints on small business and job creation to be addressed

The economic growth strategy rests on a sound and sustainable macroeconomic platform. Government has set a 3-6 per cent target range for consumer price inflation, which remains the central monetary policy objective of the Reserve Bank. Financial sector development, trade promotion and sound labour market policies remain key elements in maintaining and enhancing a favourable investment environment.

Inflation target remains in place

Economic participation and the informal economy

The available data suggest that the pace of job creation has quickened since 2000, contributing to a steady lowering of the unemployment rate to an estimated 26,5 per cent in March 2005.

Job creation has accelerated

Improved links between formal and informal businesses promote development

The increase in employment is partly accounted for by the growth of informal and small-scale enterprises, but there is evidence also of growing linkages between formal businesses and emerging entrepreneurs. In sectors such as the handcrafts industry, fresh produce supply, timber production, waste collection and clothing and textiles, partnership initiatives are contributing to the growth in job creation and more secure forms of small business participation.

Several policies and programmes contribute to broadening economic participation:

- Procurement policies of both the public sector and larger private businesses, focused on small enterprise support and black economic empowerment
- The expanded public works programme, which promotes labour-intensive methods in many areas of infrastructure maintenance and public service delivery
- Skills development programmes for employees and the unemployed, expansion of learnership and intern training schemes, and improvements in further education programmes
- Land restitution, land reform and complementary agricultural support programmes
- Consolidation of small enterprise support in the new Small Enterprise Development Agency, and enhanced access to credit, business advice and market opportunities
- New directions in housing policy and community investment, aimed at accelerating delivery and consolidating local development initiatives.

Regulatory reform to ease burden on small business is under review

Regulatory and administrative reforms aimed at easing the compliance burden on small businesses and facilitating integration into the formal economy are under review. Preliminary work has been undertaken on the possible role of regulatory impact assessments in improving the environment for small businesses. Tax reforms and a more proactive, client-oriented approach to tax administration are focused on assisting small enterprises. These and other public service reforms complement Government's rising investment in community infrastructure, and key initiatives aimed at strengthening municipal governance and local economic development.

Financial sector contributes to broad-based empowerment

Transformation of the financial sector plays an enabling role in broadening economic participation. More than 1,7 million South Africans have gained access to banking services through the Mzansi initiative, a framework has been developed for extending R42 billion in housing finance on affordable terms to households largely excluded from the mortgage market until now, and new initiatives to improve the micro-credit and small business lending environment are underway. Within the framework of the Financial Sector Charter, greater impetus will be given to the mobilisation of private sector resources in support of housing, small businesses, emerging farmers, community development and public infrastructure investment.

Social security, health care and human development

Income support for the vulnerable has grown strongly

Income support to the most vulnerable has grown rapidly over the past five years. Social assistance grants to the elderly, the disabled and to support vulnerable children now reach more than 10 million beneficiaries. Social security and welfare spending will exceed R72 billion in 2005/06, nearly one-fifth of consolidated non-interest expenditure.

Progressive extension of welfare services for children and the elderly

Social assistance grants will in future be administered by a consolidated Social Security Agency, incorporating the present provincial social security administration components. Welfare services will remain a provincial function, and will see considerable reform over the years ahead as part of Government's progressive extension of improved protection and care to older persons, families affected by HIV and Aids, and children in conflict with the law.

Education and health to be prioritised over the MTEF period

Following a period of considerable growth in income support to the poor, the priority for the decade ahead shifts to strengthening and improving public health care and education.

Key initiatives include:

- Upgrading and revitalisation of hospitals, and additional funding for medical equipment and information systems
- Consolidation of primary health care services under provincial administration
- Increased funding for school buildings, facilities and curriculum materials, together with phasing out of fees at schools serving low-income communities
- Progressive expansion of early childhood education opportunities
- Introduction of a new national subsidy programme for community libraries
- Investment in facilities and equipment at further education colleges, modernisation of curricula and improved linkages with skills development programmes
- Increased funding for school sport and community sport participation.

Retirement funding and health insurance reform in progress

Several reforms relating to the wider social insurance environment are under way. With effect from 2006, medical scheme contributions by lower-income families will be more favourably treated for tax purposes. Progress has been made in evaluating options for sharing risk burdens between medical schemes through a statutory equalisation fund. A discussion paper on retirement fund reform was published in December 2004 and responses are being reviewed. A series of rulings by the Pensions Fund Adjudicator has given impetus to a rethink by the industry and the regulatory authorities on the structure and disclosure of costs associated with retirement products. Further steps in reform of the Road Accident Fund and arrangements for compensation for occupational injury and disease are under consideration.

Improving the capacity of the state

Wide range of initiatives focus on building capacity in public sector

In the absence of improvements in public administration, neither rapid economic growth nor social progress will be sustained. Government's medium term development strategy includes a strong focus on improving public sector institutions, with particular emphasis on technical and managerial capacity of municipalities and service delivery departments.

Current initiatives include:

- Developing managerial capacity through revitalisation of the South African Management Development Institute and the Public Service Education and Training Authority
- Investment over the next three years in a new Integrated Financial Management System to replace outmoded government information processing systems
- Continued improvements in the quality and content of planning, budgeting, project management and reporting systems, including quarterly monitoring of progress against the published targets of Government's Programme of Action for the 2004-2009 period
- Targeted support for municipalities under stress, and for critical infrastructure development capacity in identified provincial departments and local authorities
- Improved coordination of local public services through multi-purpose community centres and phased in employment of local community development workers.

Public administration reform is complemented by investment in information management systems

Progress with public administration reforms is evident in several major areas, such as the South African Revenue Service's *Siyakha* initiative; the focus on priority crimes and implementation of "sector policing" by the South African Police Service; mergers and reorganisation of universities and further education institutions; and anti-corruption and fraud investigations in several departments and agencies. Contractual public-private partnerships have contributed to improved management of services in a number of hospitals, toll roads, prisons, office accommodation, fleet management and eco-tourism projects. A new financial management system for the Master's Office will be implemented during the period ahead, management information networks will be strengthened in provincial health and education departments, and road traffic management will be overhauled.

State capacity rests on healthy partnerships with private sector

Progressive improvements in the capacity of the state lead, in due course, to more streamlined administration of justice, better schools and clinics, reduced crime and lower costs of doing business. The challenges are huge and Government's approach recognises many interconnected elements to be addressed. More rapid advances will rest in part on stronger partnerships between Government and the private sector, and between state institutions and non-governmental development agencies.

International relations

South Africa's international relations are focused on both the economic gains from expanded trade, tourism, investment and financial integration, and the global challenges of poverty reduction, human development and conflict resolution.

Revised SACU agreement marks step forward

Within the region, a significant step forward has been taken with the implementation of the revised Southern African Customs Union Agreement, signalling both a shared commitment to improved trade relations with the rest of the world and a development-oriented distribution of customs and excise revenue between South Africa and Botswana, Lesotho, Namibia and Swaziland.

Increased financial integration into global economy

South Africa's standing as a financial centre has been enhanced over the past year through several credit rating upgrades, active foreign participation in the RSA bond and equity markets, increased inward investment by foreign companies and rising investment abroad by South African firms. Good progress has again been made in modernising South Africa's financial regulatory environment, improving standards of corporate governance, and ensuring that fiscal and trade arrangements keep pace with the demands of the global economy.

Focus on Africa remains a Government priority

South Africa has taken responsibility for hosting the Pan-African Parliament, and will continue to support the coordinating secretariat of the New Partnership for Africa's Development (NEPAD) and the institutions of the African Union and the Southern African Development Community.

Overview of the Medium Term Budget Policy Statement

Macroeconomic outlook

Business cycle upswing is longest on record

Robust consumer demand over the past year has been reinforced by strong growth in investment and improving export conditions, fuelled by continued global growth and commodity price increases. The current business cycle upswing began in September 1999, is the longest on record, and shows no sign of abating. Economic growth is broad-based, with particularly strong increases recorded in mining, construction, transport and communications in the first half of 2005.

Productivity continues to improve and skills training expands

A marked acceleration in employment creation has been recorded since March 2003, supported by both strong economic growth and moderation in real wage increases. More than half of the increase in employment is in formal non-agricultural activities, signalling an encouraging new trend in the labour market. Skills shortages remain a cause for concern, but productivity continues to improve and there has been a marked increase in registered training and skills development activities.

CPIX inflation reached a low point of 3,1 per cent in February 2005, and has since increased to 4,8 per cent in August, mainly as a result of the marked rise in oil prices this year. Inflation expectations remain moderate.

Money supply and credit extension show strong growth

The Reserve Bank announced a 0,5 percentage point reduction in its benchmark repo rate in April 2005, leading to commensurate reductions in bank lending rates. Long-term capital market interest rates have remained moderate, creating a favourable environment for financing both corporate investment and household borrowing. Money supply and credit extension have grown strongly, consistent with high levels of both business and consumer confidence.

Table 1.1 Macroeconomic projections, 2004 – 2008

Calendar year	2004	2005 Estimate	2006	2007 Forecast	2008
Percentage change unless otherwise indicated					
Final household consumption	6,1	5,9	4,1	4,2	4,5
Final government consumption	7,2	4,6	4,3	4,4	4,7
Gross fixed capital formation	9,4	8,6	9,6	9,8	9,6
Gross domestic expenditure	6,3	4,3	5,1	4,7	5,6
Exports	2,9	6,8	5,3	5,0	6,0
Imports	12,9	6,4	8,6	6,1	8,3
Real GDP growth	**3,7**	**4,4**	**4,2**	**4,4**	**4,8**
GDP deflator	5,9	5,3	5,5	4,8	4,6
GDP at current prices (R billion)	**1 374,5**	**1 510,0**	**1 659,5**	**1 816,3**	**1 991,1**
CPIX	4,3	4,1	5,2	4,8	4,5
Current account balance (% of GDP)	-3,2	-3,5	-3,7	-3,6	-4,1

GDP to accelerate as public infrastructure investment picks up

The economic outlook for the next three years is summarised in table 1.1, and discussed in more detail in Chapter 2. GDP growth is expected to slow to just above 4 per cent in 2006 before accelerating in subsequent years, mainly on the strength of the upward momentum in capital formation associated with public infrastructure investment and industrial expansion. The current account of the balance of payments is expected to record a deficit of 3,5 to 4,1 per cent of GDP over the period ahead.

CPIX inflation is expected to rise to 5,6 per cent in the first quarter of 2006, declining thereafter as oil prices abate.

Fiscal policy and tax considerations

Chapters 3 and 4 review the fiscal policy framework for the period ahead and summarise developments in tax policy.

Economic vigour boosts tax receipts

The revised revenue estimate for 2005/06 is R400 billion, or R30 billion more than the February Budget estimate. Tax receipts have been boosted by the overall vigour of the economy, robust consumer expenditure, higher than anticipated company profits and rapid growth in imports.

Debt service costs down sharply

Debt service costs are expected to be R52 billion this year, or R1,3 billion less than anticipated in February. The revised estimate of total national budget expenditure of R416 billion results in an expected deficit of R15,7 billion, or 1 per cent of GDP. The outcome for 2004/05 and revised estimates for 2005/06, together with the budget framework for the MTEF period ahead, are shown in table 1.2.

Table 1.2 Main budget framework, 2004/05 – 2008/09

	2004/05	2005/06	2006/07	2007/08	2008/09
R billion	**Outcome**	**Estimate**	**Medium term estimates**		
Total revenue[1]	347,9	400,1	437,0	479,0	527,2
Percentage of GDP	*24,7%*	*25,9%*	*25,8%*	*25,8%*	*25,9%*
Total expenditure[1]	368,5	415,8	474,0	518,3	568,7
Percentage of GDP	*26,2%*	*27,0%*	*28,0%*	*27,9%*	*28,0%*
Debt service cost	48,9	51,8	53,9	54,8	56,6
Percentage of GDP	*3,5%*	*3,4%*	*3,2%*	*3,0%*	*2,8%*
Non-interest expenditure	319,6	363,9	420,0	463,5	512,1
Percentage of GDP	*22,7%*	*23,6%*	*24,8%*	*25,0%*	*25,2%*
real growth (non-interest expenditure)	*8,8%*	*8,8%*	*9,9%*	*5,3%*	*5,7%*
Contingency reserve	*–*	*–*	*2,0*	*4,0*	*7,0*
Deficit	-20,6	-15,7	-37,0	-39,3	-41,5
Percentage of GDP	*-1,5%*	*-1,0%*	*-2,2%*	*-2,1%*	*-2,0%*
Gross domestic product	*1 405,5*	*1 542,2*	*1 693,7*	*1 856,7*	*2 033,3*

1. Includes provision for RSC levies of R7 billion in 2006/07, R8 billion in 2007/08 and R9 billion in 2008/09.

Additional spending of R78,3 billion over baseline estimates

The revised growth outlook, robust revenue performance and a steadily declining burden of debt service costs as a percentage of GDP allow once again for a substantial upward adjustment in public expenditure plans over the MTEF period. The 2006 budget framework allows for additional spending of R78,3 billion over the baseline estimates, or average real growth in non-interest expenditure of 6,3 per cent a year.

A contingency reserve of R2 billion in 2006/07, R4 billion in 2007/08 and R7 billion in 2008/09 will remain unallocated in the 2006 Budget.

National budget framework includes compensation for RSC levies from 2006/07

As announced in the 2005 Budget, RSC levies[1] will fall away with effect from July 2006. The national budget framework includes R7 billion in 2006/07, rising to R9 billion in 2008/09, to compensate municipalities and district councils for this loss of revenue. Other tax policy measures given effect this year or in 2006 include:

- A revised treatment of medical scheme contributions and employer-provided health services to provide greater relief to lower-income taxpayers
- More stringent parameters for calculating tax benefits associated with travel allowances and company cars
- Relaxation of exemption criteria for offshore banking activities and tax treatment of the restructuring of companies
- Further extension of the tax depreciation benefit for urban development zones
- Substantial relief for individual taxpayers through revised rates and thresholds.

Budget deficit to average about 2,1 per cent over next three years

The budget deficit is expected to average about 2,1 per cent of GDP over the next three years. Borrowing for capital projects by provinces and municipalities and the financing requirements of investment spending by state-owned enterprises will raise the aggregate public sector borrowing requirement to between 3 and 3,5 per cent of GDP.

The medium term expenditure framework and division of revenue

Chapters 5 and 6 set out the proposed expenditure priorities for the 2006 Budget and the allocations of nationally collected revenue to provinces and municipalities. Annexure A provides details of the expenditure outcome for national departments and provinces in 2004/05, together with provisional mid-year spending outcomes for 2005/06.

Total national budget expenditure in 2004/05 was R368 billion

Total national budget expenditure in 2004/05 was R368 billion, or R1,7 billion less than the revised estimate of R370 billion published in February. For the current year, national departments had spent 49 per cent of the main budget estimate by midyear and provincial spending amounted to an estimated 38 per cent of their consolidated budget estimate by the end of August.

The 2006 medium term expenditure framework (MTEF) proposes the following changes to the division of revenue, summarised in table 1.3:

- R31 billion more over the next three years for the provincial equitable share

[1] Regional Services Council and Joint Services Board levies.

- R15 billion to supplement conditional grants to provinces
- R2 billion for local government, in addition to the replacement of RSC levies within the national budget framework
- R30 billion for national department functions.

Provincial equitable share allocation grows, taking into account education reforms

Increased allocations to the provincial equitable share take into account Government's commitment to phase out fees for schools in low-income communities and the implementation of curriculum reforms. The allocations allow for improved resources for schools, clinics and hospitals; augmentation of social development and welfare services, including appropriate care for children in conflict with the law; implementation of early childhood development and other social service programmes; and increased investment in roads, economic services and support for emerging farmers.

Table 1.3 Medium term expenditure framework and division of revenue, 2005/06 – 2008/09

R billion	2005/06 Revised	2006/07	2007/08	2008/09
		Medium term estimates		
National	136,7	152,9	166,8	181,5
Provincial	209,8	238,1	262,8	290,0
Local[1]	17,5	27,0	29,9	33,6
Total	**363,9**	**418,0**	**459,5**	**505,1**
Changes from baseline[2]	**1,2**	**22,2**	**32,0**	**48,0**
National	0,4	6,3	9,2	14,8
Provincial	0,5	8,6	14,4	23,1
Local	0,3	7,3	8,5	10,2

1. *Includes provision for RSC levies of R7 billion in 2006/07, R8 billion in 2007/08 and R9 billion in 2008/09.*
2. *Baseline allocations comprise the medium term estimates published in the 2005 Budget, together with an inflation projection and growth assumption in 2008/09 over the 2007/08 allocations.*

Additional national department allocations and conditional grants include:

- R20 billion for investment in the built environment – housing, municipal infrastructure grants, water schemes, public transport and community facilities
- R12 billion for social services – higher education, hospital revitalisation, community libraries, social grants, cultural and heritage institutions and sports participation
- R9 billion for economic services – support for science and technology development, industrial policy initiatives, communications infrastructure, the national road network, tourism development and small enterprise development
- R7 billion for improved courts administration, enhancement of policing capacity, modernisation of defence equipment and improving access to justice services

- R8 billion for investment in public administration – improved government accommodation, upgrading of ports of entry, capacity building in Home Affairs, modernisation of financial administration and further strengthening of revenue administration.

The anticipated growth and distribution of consolidated national and provincial expenditure over the MTEF period are summarised in table 1.4.

Table 1.4 Consolidated expenditure, 2006/07 – 2008/09

	2006/07	2007/08	2008/09
R billion	**Medium term estimates**		
Education	91,2	101,7	112,8
Health	53,5	58,5	64,6
Welfare and social security	82,2	90,0	97,2
Housing and community development	25,1	28,1	30,6
Police, prisons and courts	51,5	56,1	60,8
Defence and intelligence	25,7	26,7	29,1
Economic services	69,6	76,6	83,8
General administration[1]	39,0	42,6	48,2
Non-interest expenditure	**437,8**	**480,3**	**527,1**
State debt cost	53,9	54,8	56,6
Unallocated	2,0	4,0	7,0
Total expenditure	**493,7**	**539,1**	**590,7**

1. Includes provision for RSC levies of R7 billion in 2006/07, R8 billion in 2007/08 and R9 billion in 2008/09.

Conclusion

Accelerated and shared growth is about policies, administration, regulation and partnerships

Accelerated and shared growth is partly about better-focused policies and government programmes, partly about improved public administration and well-targeted regulation, and partly about stronger partnerships between Government, the business sector and civil society. The fiscal policy framework, tax measures, investment plans and spending proposals for the 2006 Budget will provide further impetus to growth and broadening participation in the economy, both in the MTEF period and in the years beyond.

The *Medium Term Budget Policy Statement* aims to encourage debate in Parliament and throughout the wider community on Government's policies, plans and spending proposals. Comment on the framework set out for the 2006 Budget can be emailed to tipsfortrevor@treasury.gov.za, or posted to:

"Tips for Trevor"

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