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Towards a higher growth path

- Strong economic growth has brought substantial benefits for South Africa, leading to sustained increases in employment, declining poverty, rising investment, rapid growth in public spending and household welfare gains. While the economic outlook remains positive, raising the momentum of growth requires structural reforms focused on trade and productive capacity.
- Transforming South Africa is a long-term project. Economic, fiscal and budget policy are about delivering sustainable economic growth, accompanied by rising welfare gains for present and future generations. Continued social progress requires a careful balance between managing the sustainability of growth, channelling spending to high-priority areas and raising the bar for government departments to deliver better value for money.
- This budget framework takes account of cyclical factors in determining government's macroeconomic and fiscal stance. We introduce the concept of a structural budget balance to help measure the impact of the fiscal stance on aggregate macroeconomic performance.
- Preparations for the 2010 FIFA World Cup provide a strong boost to growth and investment over the medium term. The 2008 budget framework sees public spending continuing to rise rapidly, by about 6.4 per cent a year. Key spending priorities include investing in human and physical capital, broadening access to household services, improving the quality of public services and targeted anti-poverty programmes, strengthening the criminal justice sector and raising economic performance.

The medium-term strategic framework

The 2007 *Medium Term Budget Policy Statement* (MTBPS) sets out the fiscal framework for the period 2008/09 to 2010/11. During this period, South Africa will see the transition to its fourth democratically elected government.

AsgiSA crystallises government's efforts to realise higher growth

The centrepiece of government's Programme of Action is to halve the rate of unemployment and the proportion of people living in poverty between 2004 and 2014[1]. To achieve these objectives, it is critical to raise the rate of economic growth and to make sound interventions in the interests of poor and marginalised communities. The introduction of the Accelerated and Shared Growth Initiative (AsgiSA) has crystallised government's efforts in this regard.

Government's priorities for 2004-2009

A framework to enhance the social, cultural and economic welfare of all South Africans

This MTBPS is informed by the priorities set out in the 2004 Programme of Action, and also takes account of strategic and policy changes announced by the President in the annual State of the Nation addresses. In summary, government's strategic framework seeks to enhance the social, cultural and economic welfare of all South Africans by:

- Accelerating the pace of growth and the rate of investment in productive capacity
- Facilitating decisive interventions to accelerate the pace of job creation
- Investing in community services and human development, and maintaining a progressive social security net
- 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.

Solid progress in meeting major development objectives

Progress in expanding economic opportunity, creating jobs, increasing investment, reducing poverty and broadening human development is summarised in the Presidency's recently released *Development Indicators Mid-term Review.* Since 2004 government has succeeded in raising the average annual rate of economic growth to 5 per cent compared with 3.3 per cent between 1999 and 2004. Employment has risen by about 2.7 per cent a year since 2001 – faster than at any point in the previous two decades. The proportion of people living below an indicative poverty line has fallen from 52.1 per cent in 1999 to 43.2 per cent in 2006. The proportion of national income spent on fixed investment, which contributes to future production, has risen from 15 per cent in 2002 to 20.7 per cent in the first half of 2007.

Needs and expectations are still a long way from being met

While these achievements deserve to be celebrated, they do not meet the needs and expectations of all of South Africa's people. In the period ahead, the pace of economic growth must be accelerated, the labour-absorption capacity of the economy must be increased, and the quality of government's social and household services must be stepped up.

[1] The unemployment rate was 28 per cent in 2004 and the poverty headcount index (based on a poverty line of about R3 000 per capita per year in 2000 prices) was 47 per cent. The estimated unemployment rate in March 2007 was 25.5 per cent and the poverty headcount index 43.2 per cent.

Economic policy takes account of increased uncertainty in the world economy

The 2007 MTBPS focuses on accelerating social progress through sustaining rapid economic growth and employment creation over the long term. This requires careful management of shorter-term risks on the macroeconomic front, such as crises in the financial markets of developed countries and volatile commodity prices. It also requires appropriate economic and social policy reforms to improve competitiveness, broaden participation and expand opportunities and capacity. While analysts' forecasts continue to suggest robust growth for the period ahead, there is probably greater uncertainty in the economic environment today than at any point in the past six years. More rapid and sustainable growth requires both structural reforms and improved policy implementation.

Economic risks, fiscal policy and real income growth

Sound economic management requires careful analysis of the risks, and the identification of economic and budgetary policies that will sustain high rates of growth and more rapid job creation. Concurrently, alongside South Africa's social security system, government must continue to broaden the social wage, which makes a tangible difference in poor and marginalised communities.

Rising investment and higher consumption have not been fully matched by rising savings and domestic production. The consequence of this imbalance is that the import bill has risen sharply and buoyant demand has contributed to inflationary pressures. The sustainable solution to this problem is to increase domestic productive capacity, earning export revenue to pay for rising capital imports. Although South Africa benefits from relatively high commodity prices and global growth, the size of the current account deficit signals the need to improve trade and industrial performance to compete on a broader front in the global economy.

Fiscal policy adjusts for cyclical factors

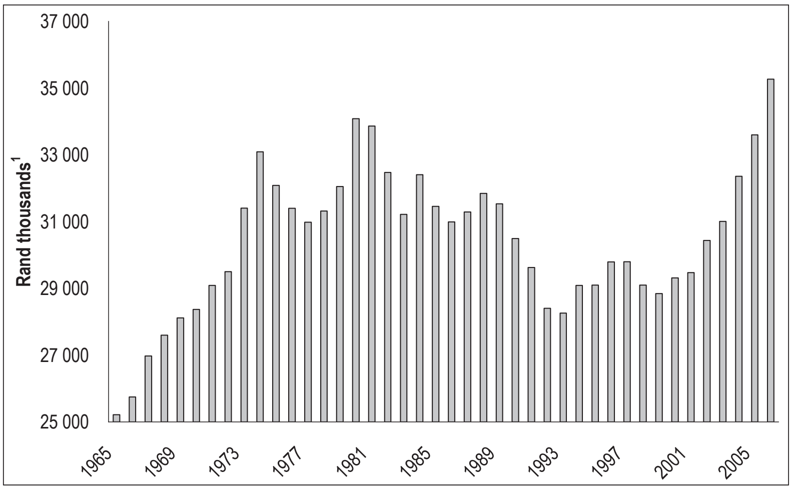
Fiscal policy over the past few years has increasingly taken account of the economic cycle. Government revenue performance fluctuates in response to economic fortunes, influenced in turn by the economic performance of our major trading partners, commodity prices, interest rate cycles, inflation trends and business profitability. These are complex factors that affect the economy and tax revenue in ways that cannot be fully modelled or predicted. In the face of potentially destabilising cyclical factors, it is important to adopt a policy stance oriented towards stable long-term growth.

Introducing the structural budget balance

In this MTBPS the National Treasury introduces the concept of a structural budget balance as a contribution to more systematic and consistent adaptation of the fiscal stance to cyclical factors. Simply put, when economic conditions are good, as they are now, we must invest and save in a manner that allows us to maintain public spending and societal welfare when economic conditions turn less favourable, as they inevitably will.

South Africans today have incomes that are, on average, about 22 per cent higher in real terms than they were in 1999. Household income at all levels has risen due to higher rates of employment, salary increases, lower real interest rates, tax relief, rising social spending, and rising house and asset prices. These gains follow improved economic performance and sound policy implementation since 1994. Yet millions of South Africans continue to live in poverty, so we must accelerate the pace of economic growth and social transformation.

Figure 1.1 Gross national income per capita, 1965 - 2006



1. Denominated in constant 2007 rand values.

Sustaining macroeconomic gains

In recognition of cyclical factors, a moderate budget surplus is proposed

To sustain these gains and make further progress in reducing poverty, a strong fiscal position needs to be carried forward over the medium term. The framework proposed for the 2008 Budget, taking into account current cyclical factors, reflects a moderate budget surplus continuing over the next three years. Government's approach is to use the windfall revenues from favourable economic conditions to invest in physical and human infrastructure – investments that will yield results for decades to come – and to increase the level of savings so that when these windfall revenues abate, resources will be available to spend on key priorities.

Public spending continues to grow strongly and in real terms is now double what it was in 1995

Public finances have benefited demonstrably from higher economic growth. Non-interest public spending has risen by an average of 9.4 per cent a year in real terms for five years and is now twice as large, in real terms, as in 1995. Per capita spending has risen from about R6 800 per person in 1995 to R10 560 per person in real 2007 prices. Higher public spending has allowed government to increase the number of police on the streets, introduce no-fee schools for the poorest 40 per cent of learners, expand the social grant system to benefit over 12 million people, scale-up the comprehensive HIV and Aids programme, build more than 2 million homes, electrify more than 3 million homes, provide water to 16 million people and deliver free basic municipal services to more than 70 per cent of the population.

South Africa experiencing an accelerated rate of urbanisation

The Community Survey released by Statistics South Africa in October 2007 reaffirms the steady progress made in extending services to the poor, and also discusses some complex features of social change. Gauteng, Western Cape and KwaZulu-Natal have all experienced strong population growth. The pace of urbanisation has accelerated over the past five years, consistent with improved economic opportunities in our major cities. Such demographic shifts have profound social and economic policy implications, and will be taken into account in the equitable share distribution between provinces.

As spending growth moderates, efficiency must improve

For several years, the rate of real growth in public spending has been substantially higher than the rate of real gross domestic product (GDP) growth. This cannot proceed indefinitely, although for the period ahead government expenditure will continue to benefit from sound fiscal policy, falling debt interest costs, efficiency gains in revenue collection and a broadening tax base as a result of the growing economy.

The fiscal framework anticipates a gradual slowdown in real growth in public spending from over 9 per cent a year to about 6.4 per cent a year, which is still somewhat higher than economic growth.

Allocating resources to ensure the greatest impact on poverty

As the rate of growth in public spending moderates, it becomes crucial to allocate money to those programmes with the highest rate of social return, or which have the greatest impact on reducing poverty and unemployment over the long term. Many social and economic investments only yield benefits well into the future. Building power plants, railway lines, ports, laboratories or further education and training centres will contribute to higher productivity in the long term. Nevertheless, these are crucial investments if our country is to raise growth and living standards for future generations.

Raising the standard for departments to be more efficient

Allocating resources correctly is only half the battle. We must also focus on using resources efficiently to deliver better value for money, and better-quality services for each rand spent. The 2008 Budget will place particular emphasis on improving the efficiency of public spending, partly by getting departments to report on their outputs in a transparent manner. In addition, national departments will be asked to find efficiency savings of about R2.3 billion over the next three years by limiting spending on unnecessary entertainment, travel and hotel accommodation; misplaced branding and communication initiatives; poorly managed consultancy services; and related frills. The intention is to shift more resources to the frontline of service delivery.

New format for the MTBPS this year

This MTBPS varies somewhat from the format of previous years. The document is more of a concise policy statement, reflecting both economic policy and budget priorities. The MTBPS is not intended to be a mini-budget; rather, it provides a perspective on government's view of the economy in the period ahead and sets out the proposed budget framework. Allocations to departments will be set out in the main budget in February and in separate budgets for each province.

Improved format for presentation of numbers

The 2007 MTBPS introduces an improvement in the format of numbers used in National Treasury documents. In line with international practice, a full stop is used to indicate a decimal point. Previously, a comma was used. A space is still used to delimit thousands (e.g. R12 345 or R12 345 678).

The remainder of Chapter 1 provides a synopsis of the subsequent chapters.

Overview

Economic policy and macroeconomic outlook

Chapter 2 discusses the macroeconomic outlook and provides a perspective on government's economic policy. It assesses the economy, presents the economic forecasts for the next three years, discusses risks to the outlook and closes with a discussion of key economic policy issues.

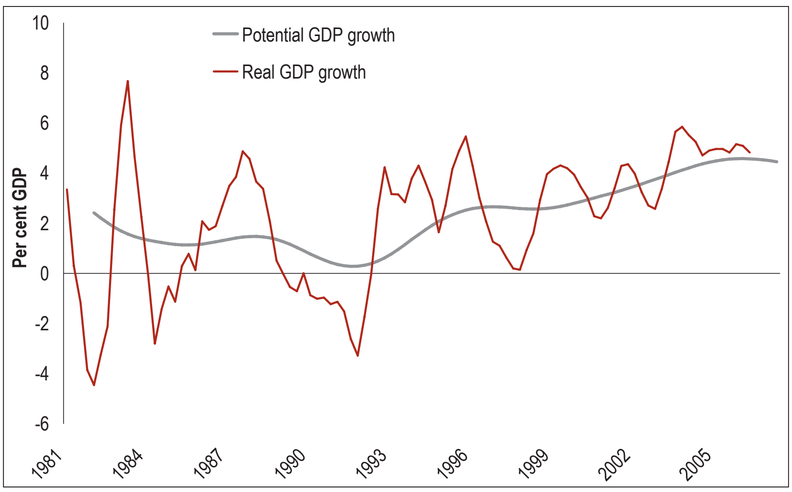
Economy must transform to absorb more labour and grow more rapidly

The core objectives of economic policy are to accelerate growth, raise employment levels and provide poor and marginalised communities with the human capital and physical infrastructure to participate in the formal economy. Recognising that deep structural flaws in the economy in place for much of the 20th century have trapped millions of people in poverty and left a significant gap in incomes, the economy needs to transform to absorb more labour and grow more rapidly to generate the resources to invest in higher production.

Structural reforms of 1990s put the country on a higher growth path

The structural reforms that were achieved during a difficult period in South Africa's economic transformation in the 1990s have placed the economy on a new growth path. Trend growth, or the rate at which the economy can grow sustainably without the occurrence of significant imbalances, has been increasing steadily since 1994. After averaging just below 3 per cent a year for the 1990s, it is now about 4.5 per cent.

Figure 1.2 Real and potential GDP, 1981 - 2007



Reforms needed to raise growth rate above 6 per cent

To raise the sustainable rate of growth above 6 per cent, a series of reforms are required. The 2007 Budget speech listed a number of requisites for more rapid growth, including:

- Exporting more goods and services, and accelerating investment in areas of competitive advantage
- Raising productivity levels and generating more jobs
- Cutting bureaucratic red tape that hobbles business
- Improving the performance of the public sector
- Enhancing infrastructure capacity, especially in relation to telecommunications, rail, roads, ports, electricity and water.

Economy likely to grow by 4.9 per cent this year

Economic growth remains strong and is projected at 4.9 per cent for the whole of 2007. The most robust activity is concentrated in construction, manufacturing and services. This is supported by strong domestic demand and rising fixed investment, which has grown by over 15 per cent in the first six months of this year, reaching 20.7 per cent of GDP. The AsgiSA target of raising the level of gross fixed capital formation to 25 per cent by 2014 is imminently achievable. The economic expansion has strengthened job creation and increased fiscal revenue, contributing to rising living standards.

High current account deficit due to import intensity of capital investment

Partly driven by capital imports, the current account deficit averaged 6.7 per cent over the first half of this year. A high current account deficit is a natural phenomenon when an economy increases investment rapidly. In the period ahead, supply-side reforms such as eliminating bureaucratic obstacles, investing in skills, and improving transport and communications will complement industrial policy initiatives to raise productivity and exports.

Global growth has slowed marginally since the February 2007 Budget. Demand in the United States, the world's largest economy, is subsiding and global financial markets are still assessing the full impact of the US subprime mortgage crisis. High oil prices and rising inflation, even in countries such as China and India, pose risks to the world outlook. Global growth is expected to slow to 4.8 per cent next year from over 5 per cent this year.

GDP growth to average about 5 per cent over next three years

Despite increased global risk and slowing international demand, the South African economy is still expected to grow by an average of about 5 per cent a year for the next three years. However, the pace of economic expansion is expected to cool somewhat in 2008, reflecting the impact of tighter monetary policy and slower growth in developed markets. Inflation has been above the target range since April 2007, driven both by higher food and fuel prices and evidence of second-round effects coming through from higher wage settlements. The price of oil is a significant obstacle to the task of bringing inflation down within the target by early next year.

Slower household consumption offset by higher fixed investment

The macroeconomic forecast for the next three years is summarised in Table 1.1 below. A central feature of this forecast is that slower household consumption growth will be offset by higher fixed investment. South Africa's investment needs and the capital imports required to support infrastructure expansion will likely exceed the economy's ability to raise export performance, resulting in a relatively large current account deficit.

Table 1.1 Macroeconomic projections, 2006 – 2010

Calendar year	2006	2007 Estimate	2008	2009 Forecast	2010
Percentage change unless otherwise indicated					
Final household consumption	7.3	6.6	4.2	4.5	5.3
Gross fixed capital formation	12.7	15.4	10.4	10.5	11.1
Real GDP growth	**5.0**	**4.9**	**4.5**	**4.8**	**5.3**
GDP at current prices (R billion)	**1 727**	**1 965**	**2 183**	**2 401**	**2 659**
CPIX	4.6	6.2	5.4	4.6	4.5
Current account balance (% of GDP)	-6.5	-6.7	-6.9	-7.7	-7.8

Fiscal policy and revenue trends

Government will balance investment with need for higher savings

Over the next three years, fiscal and tax policy will have to balance continued investment in public infrastructure and services with the need to raise government savings in response to the cyclical element of revenue collection.

During the late 1990s, government's fiscal policy aimed to reduce public borrowings to prevent a debt spiral and to take pressure off inflation and real interest rates, which curtailed both business investment and household consumption.

For a number of years government has made implicit use of cyclical factors to inform fiscal policy. This MTBPS introduces the concept of a structural budget balance to take account of these factors, mainly as they affect revenue collection. Put simply, high consumption expenditure and high commodity prices raise revenue temporarily, and these cyclical revenues need to be managed differently from structural growth in the revenue base. Otherwise, we risk living beyond our means.

Non-interest spending grows by 6.4 per cent a year over 2008 MTEF

Strong economic performance has allowed public spending to grow by more than 9 per cent a year in real terms for five years. In the period ahead, non-interest public spending continues to rise, at about 6.4 per cent a year in real terms, again focused on rising capital spending and broadening access to household services. Education, health and welfare spending increase strongly in real terms. The public sector wage bill also rises to accommodate higher salary increases for key professionals in the public service and to take account of rising employee numbers in health and criminal justice.

Government continues to budget for a surplus

The tax-to-GDP ratio has increased by nearly 5 per cent of GDP over the past six years as a result of improved revenue collections, base-broadening efforts and faster growth. This increase has mainly occurred in company taxes. Revenue has grown despite lower tax rates and substantial personal income tax relief. Higher tax revenue has allowed for an improvement in the fiscal balance, and part of this revenue has gone to fund higher public spending.

The fiscal framework for the next three years indicates a relative moderation in revenue buoyancy due mainly to higher capital investment by companies and slightly slower growth in household consumption. Debt service costs continue to decline in line with decreasing public debt. The consolidated national budget balance (including social security funds) remains in surplus over the period at just below 1 per cent of GDP. Taking into account cyclical factors in revenue growth, the structural budget balance reflects a deficit of about 0.6 per cent of GDP over the forecast period.

Fiscal framework projects a relative moderation in revenue buoyancy over medium term

Table 1.2 Consolidated national government, 2006/07 – 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
R billion	**Outcome**	**Estimate**	**Medium-term estimates**		
Revenue	**501.6**	**575.6**	**641.1**	**707.6**	**770.3**
Percentage of GDP	*28.1%*	*28.5%*	*28.7%*	*28.8%*	*28.3%*
Expenditure	**484.0**	**559.4**	**618.5**	**686.3**	**749.0**
Percentage of GDP	*27.1%*	*27.7%*	*27.7%*	*27.9%*	*27.5%*
Budget balance[1]	**17.6**	**16.2**	**22.6**	**21.3**	**21.3**
Percentage of GDP	*1.0%*	*0.8%*	*1.0%*	*0.9%*	*0.8%*
Gross domestic product	*1 787.3*	*2 019.1*	*2 230.3*	*2 458.9*	*2 723.8*

1. A positive number reflects a surplus.

Tax policy aims to broaden the tax base, improve administration and simplify the tax system to raise compliance. Revenue gains from broadening the tax base and improvements in compliance can be used to moderate rates in certain areas. However, it would not be prudent to use cyclical revenues to provide permanent tax relief.

The surplus on the main budget creates room for higher investment and borrowing by businesses and the wider public sector. Taking into account substantial investment plans over the next decade, borrowing by state-owned enterprises is expected to increase. Similarly, it is anticipated that municipalities will increase borrowings now that their financial health has improved.

State-owned enterprises likely to increase borrowings for infrastructure investment

Medium-term budget priorities and the division of revenue

The budget framework adds a further R81.4 billion to spending over the next three years. Together with strong real growth in the baseline, the additional spending allows for public expenditure to rise by about 6.4 per cent a year in real terms.

Additional R81.4 billion for public spending

Budget priorities include the following:

- Investing in human and physical capital to ensure long-term growth
- Improving the quality of education, health and other public services and targeted anti-poverty programmes
- Extending coverage of basic household services such as water, sanitation and electricity, and reducing the number of people living in informal settlements
- Improving the efficacy of the criminal justice sector

- Supporting targeted interventions in the economy that raise productivity and efficiency, and fostering international partnerships for development.

National departments will improve efficiency and increase accountability

The 2008 Budget will also signal a renewed focus on efficiency, cost-containment and value for money. The sequencing of government's plans needs to be well managed, and spending programmes need to complement one another. Programmes that are critical to the success of other initiatives, such as system improvements in the Department of Home Affairs, or expanding early learning opportunities as a foundation for improving school performance, will find favour in the 2008 Budget.

Provincial and local government receive most of nationally raised revenue

The division of revenue continues to reflect a strong flow of nationally raised resources to provincial and local government to fund key priorities. Local government continues to receive a disproportionately large share of additional resources in the proposed framework for the 2008 MTEF. Investing in household infrastructure and services and the provision of free basic services – the broadening of the social wage – remain high on government's agenda. Increased transfers for public transport infrastructure are also supported. Municipalities are set to receive R12.6 billion or 15.4 per cent of the additional revenue allocated in the next budget.

Higher allocations support school infrastructure improvements and learners with special needs

Provinces also gain relative to the national sphere due to higher allocations for school infrastructure, early learning opportunities, occupation-specific dispensations, expanding the school nutrition programme and for more places for learners with special educational needs. Programmes aimed at preventing and treating HIV and Aids and multidrug-resistant tuberculosis receive support. The hospital revitalisation programme and tertiary health services will benefit from supplementary funding. The housing programme receives additional resources. Total additions to provincial budgets amount to R36.1 billion or 44 per cent of further allocations.

National departments receive 40 per cent of additional amounts

Additional amounts for national departments, excluding conditional grants to provinces and municipalities, amount to 40 per cent of the available pool, including further financial support for several state-owned enterprises.

Conclusion

The *Medium Term Budget Policy Statement* seeks to encourage public debate on the economic challenges ahead and government's budget priorities. Comments on the MTBPS can be emailed to tipsfortrevor@treasury.gov.za, or posted to:

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