3

Fiscal policy

- The 2008 budget framework reinforces government's commitment to sustainable growth and development, providing strong real growth in expenditure while steadily reducing the debt burden on future generations.
- Tax revenue remains buoyant and is expected to exceed expenditure over the next three years. Improved budget balances provide for increased government savings in response to greater risk to the economic outlook over the medium term. The budget position enables government to contribute to containing inflation and current account pressures, and creates the fiscal space required to continue to invest in infrastructure and better public service delivery. The main budget surplus of 0.6 per cent of GDP – or 0.9 per cent including the social security funds – also creates room for anticipated growth in borrowing for capital projects by state-owned enterprises, municipalities and the private sector.
- The improved sustainability of the fiscus is reflected in the structural budget balance. As an estimate of what the budget balance would be if temporary tax revenues were removed, the structural budget balance averages a deficit of 0.6 per cent of GDP over the period ahead.

Overview of medium-term fiscal policy

Fiscal policy has enabled the public sector to make a major contribution to improved welfare

Robust economic growth over the past five years has provided greater fiscal resources to support growth in government expenditure. Average annual real growth in central government non-interest spending of more than 9 per cent a year since 2003/04 has allowed the public sector to make a substantial contribution to the welfare of all South Africans by expanding the social wage, increasing transfers to households, and accelerating infrastructure investment and service provision.

South Africa's economic outlook is positive. GDP growth is expected to remain healthy, averaging about 5 per cent over the medium term. However, the global economic environment is marked by greater uncertainty today than in recent years. In the event of sharply slower world growth or a reversal of capital inflows to emerging markets, South Africa's high current account deficit and inflationary pressures could expose the domestic economy to heightened risk, putting pressure on the fiscus and government's development programme.

Framework takes account of risks by improving government savings

The 2007 *Medium Term Budget Policy Statement* (MTBPS) takes account of these risks by setting out a fiscal framework that provides for a moderation in government expenditure growth, while further improving government savings and investment.

Table 3.1 Fiscal trends and projections

Calendar year	2002 – 2006		2006 – 2010
Average annual real growth			
Gross fixed capital formation			
General government[1]	7.0%		12.2%
Public corporations	14.8%		19.4%
Government consumption expenditure			
Compensation of employees	1.8%		4.5%
Non-wage	9.3%		7.0%
Government transfers to households	21.7%		9.4%
Fiscal year	**2002/03**	**2006/07**	**2010/11**
Percentage of GDP			
Interest on public debt	4.4%	3.4%	3.2%
General government savings	-1.0%	0.6%	1.0%
Public sector borrowing requirement	1.4%	-0.2%	1.2%
General government tax revenue	25.3%	29.5%	29.4%

1. General government refers to the accounts of national government, provincial government and local government, the social security funds, extra-budgetary institutions, adjusted to net out flows between government institutions.

Expenditure and revenue

Government expenditure continues to grow strongly

In line with government's commitment to poverty reduction and development, expenditure continues to grow in real terms over the medium term.

Higher spending over the medium-term expenditure framework (MTEF) will continue to be financed mainly by tax revenue. Despite a steady reduction in personal and corporate income tax rates over the past 10 years, tax revenue has grown from 25.2 per cent of GDP in 2000/01 to an estimated 29.5 per cent of GDP in 2006/07. The buoyancy in revenue has been supported by sustained economic growth, high commodity prices and relatively low interest rates. Growth in tax revenue is expected to moderate over the medium term as a result of higher business investment allowances and a slower rate of consumption growth.

Compensation of public sector employees accounts for the greatest share of government consumption expenditure and is expected to grow by about 4.5 per cent a year in real terms.

Three elements account for growth in the government wage bill. Firstly, higher-than-expected inflation for 2007/08 has been taken into account in the recently negotiated salary agreement. Secondly, in support of improved career progression and to retain high-quality personnel, occupation-specific remuneration dispensations have been developed. Finally, government employment is expected to continue to grow in support of broader access to and quality of public services.

Cost-of-living adjustments driven by higher inflation push up wage bill

Improvements in conditions of service for public-sector employees

The 2007 wage agreement takes account of higher-than-expected inflation by providing for salary adjustments of 7.5 per cent in 2007/08 and inflation plus 1 per cent for 2008/09. Employees at the lower end of the wage scale with long periods of service receive a larger once-off increase.

The payment of the non-pensionable housing allowance for permanent employees is fast-tracked, and the medical aid subsidy for employees on the Government Employees Medical Scheme has been adjusted. Outstanding issues related to overtime pay and Sunday work have also been resolved.

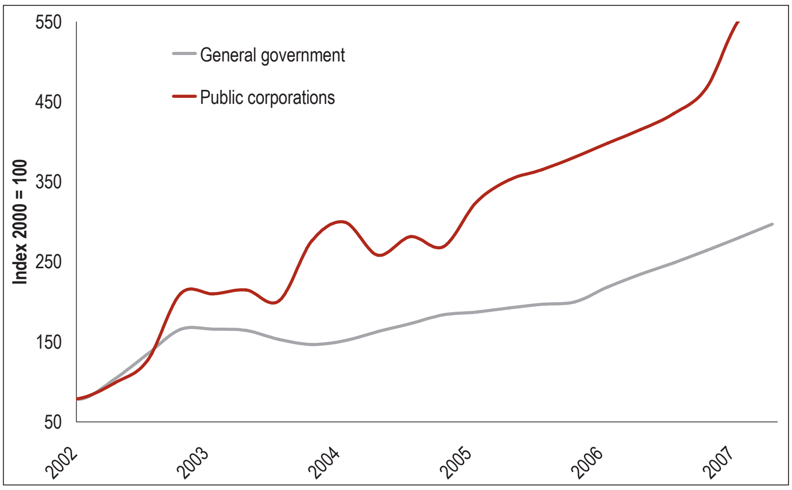
Occupation-specific dispensations

Occupation-specific dispensations aim to improve government's ability to attract and retain skilled employees, in part by allowing for diversified remuneration and career progression for a range of occupational categories previously grouped under a single salary structure.

Occupational groupings to be phased in over the next two years include health professionals (specifically nurses), educators, correctional services employees and legally qualified personnel in the justice system. The new dispensations will be implemented over the next three years, with priorities to be determined by agreement within sector bargaining councils. Career-pathing opportunities based on competencies, experience and performance are taken into account. Government seeks to attract and retain professional staff through improved recognition of career progression in the salary structure. A similar dispensation was put in place for police in 2005.

Fixed investment expenditure has grown strongly across all sectors of the economy. Government capital investment has increased at an average annual real rate of 7 per cent over the past five years. The pace of capital outlays by public corporations has also grown, with average annual real growth of 14 per cent for the past two years.

Figure 3.1 Real gross fixed capital formation by sector, 2002 - 2007



Source: SARB data

Investment in economic and social infrastructure remains a core government priority, with the goal of enhancing economic efficiency and broadening development. Continued growth in expenditure baselines reflects additional allocations to public transport, education, health, social development, justice and protection services, housing and land reform.

Public sector borrowing to increase to fund infrastructure investment

The public sector borrowing requirement is forecast to increase significantly over the next three years to about 1.2 per cent of GDP. This increase is driven by the accelerating capital investment programmes at all levels of the public sector, in particular the non-financial enterprises. The improved fiscal position of national government creates the space for the state-owned enterprises, municipalities and the private sector to increase their borrowing for capital purposes, without placing undue pressure on capital markets and interest rates.

Table 3.2 shows that over the medium term, public sector infrastructure expenditure plans total R482.4 billion. Public sector infrastructure plans account for about 6.5 per cent of GDP over the period ahead, up from 5.4 per cent in 2006/07. After several years in which actual spending has lagged behind budget allocations, infrastructure programmes are now well under way.

Support for school buildings, public transport, housing water and sanitation

Major funding proposals over the next three years include additions to the school building programme, public transport, housing, water and sanitation. In addition, non-financial public enterprises continue to invest in power generation, transmission, distribution, airports, ports, freight rail and pipelines.

Table 3.2 Infrastructure expenditure estimates, 2006/07 – 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
R million		**Estimate**		**Medium-term estimate**	
National departments [1, 2]	4 626	4 810	5 601	6 367	8 899
Provincial departments [2]	26 731	32 709	34 432	42 481	44 502
Municipalities	21 441	28 768	30 663	33 871	36 773
Public private partnerships [3]	2 443	4 050	7 886	9 288	11 367
Extra-budgetary public entities	3 999	4 747	4 950	5 323	7 814
Non-financial public enterprises	37 176	53 165	64 570	63 956	63 687
Total	**96 416**	**128 249**	**148 102**	**161 286**	**173 042**
percentage of GDP	*5.4%*	*6.4%*	*6.6%*	*6.6%*	*6.4%*
GDP	1 787 311	2 019 148	2 230 281	2 458 882	2 723 837

1. Transfers between spheres have been netted out.

2. Includes maintenance of infrastructure assets.

3. Infrastructure expenditure on PPPs overseen by the Treasury PPP Unit, South African National Roads Agency, Department of Public Works and at municipal level.

Fiscal sustainability

Economy is receiving a cyclical boost

The South African economy, is subject to temporary global and domestic cyclical factors. In recent years, high commodity prices and relatively low real interest rates have had a large impact on the pattern of growth. High investment and low savings have resulted in a large increase in the current account deficit and higher inflation.

Fiscal policy plays a role in supporting an orderly correction of these economic and financial imbalances, and smoothing volatility in expenditure over the cycle. In the context of current macroeconomic pressures and extraordinary buoyancy in revenue, it is recognised that government should contribute positively to national savings. By not spending the full value of buoyant tax revenues, government helps to limit current account and inflationary pressures, and takes some pressure off domestic interest rates, contributing to the sustainability of economic growth.

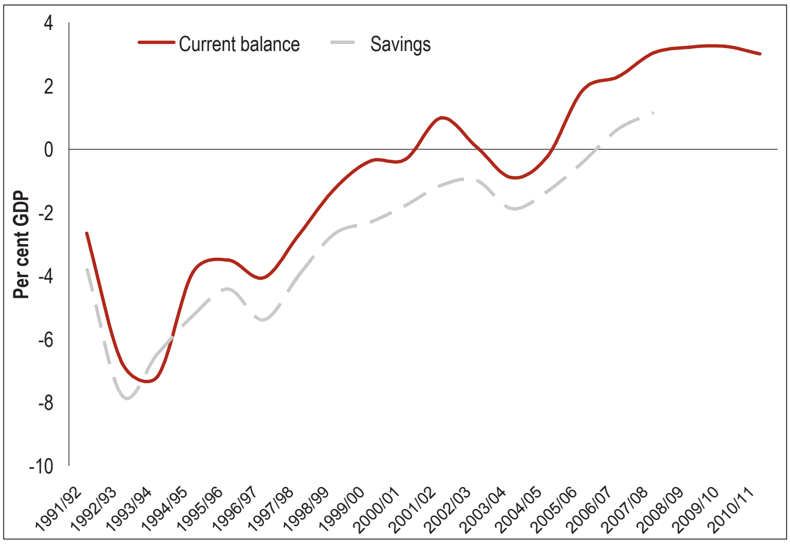
Government saves a share of tax revenue to offset economic risk

Figure 3.2 shows the current balance (measured on the consolidated government level as current income less current expenditure) and general government savings. The current balance is a useful proxy for government savings, with consumption of capital stock and local government savings accounting for the difference between the two.

In 2006, for the first time since 1981, government savings moved into a positive position. Given their relationship to investment levels and the current account balance, savings are an important indicator of economic stability. As household and corporate savings continue to indicate a decline, improved government savings are an important contribution to strengthening the macroeconomic outlook. In combination with lower debt levels, these savings also provide a buffer against future cyclical revenue reductions. This allows government to continue to meet its expenditure priorities without negatively affecting welfare by cutting other expenditure, raising taxes or borrowing excessively.

Improved government savings provide a buffer against a decline in cyclical revenue

Figure 3.2 General government savings and current balance, 1991/92 – 2010/11



The budget framework

The budget framework presented in the 2007 MTBPS takes into account the consolidated revenue and expenditure of the social security funds in addition to the main budget. This provides for a more

Social security funds' revenue and expenditure shown in main budget complete view of the revenue and expenditure activities of government and their effects on the economy.

Tax revenue as percentage of GDP moderates over the medium term

Growth in gross tax revenue is expected to continue to increase as a percentage of GDP next year, before moderating over the medium term in response to higher business investment and the lagged effects of lower consumption expenditure. The movement in gross tax revenue is the main factor driving consolidated national revenue from 28.5 per cent in 2007/08 to 28.8 per cent in 2009/10, before declining to 28.3 per cent in 2010/11.

Table 3.3 Consolidated national government, 2006/07 – 2010/11

R billion / *per cent*	2006/07	2007/08 Estimate	2008/09	2009/10 Projections	2010/11
Main budget revenue					
Gross tax revenue	495.5	566.1	632.4	699.3	764.0
percentage of GDP	*27.7%*	*28.0%*	*28.4%*	*28.4%*	*28.0%*
plus: other non-tax receipts and payments	10.9	11.8	11.9	12.5	13.3
less: SACU transfers	-25.2	-24.7	-28.4	-32.1	-36.8
Total Revenue	**481.2**	**553.1**	**616.0**	**679.6**	**740.5**
Main budget expenditure					
State debt cost	52.2	52.9	51.2	51.0	50.4
percentage of GDP	*2.9%*	*2.6%*	*2.3%*	*2.1%*	*1.9%*
Non-interest expenditure[1]	418.0	489.4	548.7	614.6	675.8
percentage of GDP	*23.4%*	*24.2%*	*24.6%*	*25.0%*	*24.8%*
per cent real growth	*9.0%*	*9.8%*	*6.9%*	*7.2%*	*5.2%*
Of which:					
Increases over 2007 Budget		11.5	14.4	21.2	45.8
Unallocated		–	4.0	8.0	16.0
Total Expenditure	**470.2**	**542.4**	**599.9**	**665.6**	**726.2**
Main budget balance[2]	**11.0**	**10.8**	**16.2**	**14.0**	**14.3**
percentage of GDP	*0.6%*	*0.5%*	*0.7%*	*0.6%*	*0.5%*
Social security funds					
Revenue	20.6	22.9	25.6	28.5	30.3
Expenditure	14.0	17.4	19.1	21.2	23.3
Of which:					
Unemployment Insurance Fund	3.6	5.5	6.1	6.7	8.0
Compensation funds	2.9	3.2	3.5	3.7	3.9
Road Accident Fund	7.5	8.7	9.6	10.9	11.4
Consolidated national budget[3]					
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%*
Consolidated national budget balance[2]	**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. Includes transfers to provinces and local government, the National Skills Fund and sectoral skills development funds.

2. A positive number reflects a surplus.

3. Flows between funds are netted out.

Main budget expenditure allows for 6.4 per cent real growth in non-interest expenditure over the 2008 MTEF, with R81.4 billion being added to the main budget framework. Of this, R20 billion is made available to compensate social grant recipients and government employees for higher-than-anticipated inflation, leaving R61.4 billion for allocation to new projects and enhanced service delivery. Because new policy initiatives often have long lead times, and given already strong expenditure growth in 2008/09 and 2009/10, the additional resources are mainly allocated in the final year of the MTEF. Including inflation adjustments, total new allocations are R14.4 billion in 2008/09, R21.2 billion in 2009/10, and R45.8 billion in 2010/11.

6.4 per cent real growth in non-interest expenditure over the 2008 MTEF

Including the expenditure of the social security funds, total consolidated national expenditure grows from 27.7 per cent of GDP in 2007/08 to 27.9 per cent of GDP in 2009/10, before declining marginally to 27.5 per cent of GDP in 2010/11.

Since peaking at 5.6 per cent of GDP in 1998/99, debt service costs have shown a steadily declining trend, and move further down from 2.9 per cent of GDP in 2006/07 to 1.9 per cent of GDP by 2010/11. The decline in debt service costs underscores the sustainability of the framework by providing fiscal space to accommodate cyclical volatility or to finance new priorities in the years ahead.

Debt service costs continue to fall as percentage of GDP

Table 3.4 Total government debt, 2004/05 – 2010/11

As at 31 March	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
R billion		**Outcome**		**Estimate**		**Medium-term estimates**	
Domestic debt	432.4	461.8	469.5	474.5	488.3	488.6	492.2
Foreign debt[1]	69.4	66.8	82.6	78.8	80.7	77.1	79.1
Gross loan debt	**501.8**	**528.6**	**552.1**	**553.2**	**568.9**	**565.7**	**571.3**
Less: National Revenue Fund bank balances	-30.9	-58.2	-75.3	-89.4	-116.8	-125.1	-141.9
Net loan debt[2]	**470.9**	**470.4**	**476.8**	**463.8**	**452.1**	**440.6**	**429.5**
As percentage of GDP :							
Net loan debt	*32.9*	*29.8*	*26.7*	*23.0*	*20.3*	*17.9*	*15.8*
Foreign debt	*4.9*	*4.2*	*4.6*	*3.9*	*3.6*	*3.1*	*2.9*
As percentage of gross loan debt:							
Foreign debt	*13.8*	*12.6*	*15.0*	*14.2*	*14.2*	*13.6*	*13.8*

1. Forward estimates are based on National Treasury's projections of exchange rates.
2. Net loan debt is calculated with due account of the bank balances of the National Revenue Fund (balances of government's accounts with the Reserve Bank and the tax and loans accounts with commercial banks).

Table 3.4 reflects the net and gross debt of national government. As a consequence of budget surpluses the debt burden on future generations continues to fall, with net loan debt reaching a low of 15.8 per cent of GDP by 2010/11. Over the forecast period cash balances of the National Revenue Fund are estimated to increase by R53 billion to R142 billion. The higher cash balances will be used to build reserves and manage the foreign debt.

Debt burden on future generations continues to fall

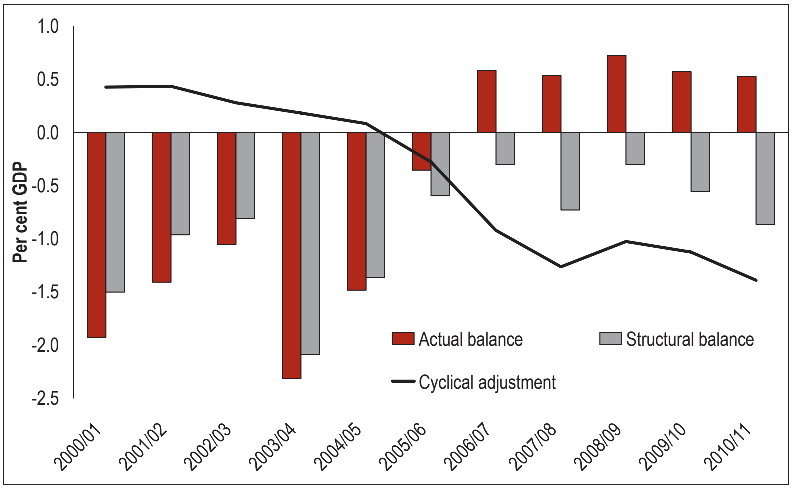
Budget balances

Structural budget balance estimates the budget balance excluding cyclical factors

The structural budget balance (also known as the cyclically adjusted budget balance) is an estimate of the budget balance after adjustment for cyclical revenue and spending. In arriving at the structural budget balance, the main budget balance is adjusted to take into account the cyclical under- or overperformance of revenue and cyclical deviations in spending trends. The resulting structural budget balance provides a useful indicator of the sustainability of the fiscal stance.

South Africa's economic cycle responds to the performance of its major trading partners, commodity prices, domestic and foreign interest rates, inflation trends and business profitability. Over the past five years, many of these factors have favoured domestic economic growth, resulting in generally positive cyclical factors, including commodity price strength and high levels of global liquidity. While commodity prices are expected to remain firm over the medium term, emerging weaknesses related to US economic growth and increased global inflation pressures may threaten this forecast.

Figure 3.3 Main budget and structural budget balances, 2000/01 – 2010/11



High commodity prices, low interest rates have fuelled strong revenue growth

The strong revenue performance of recent years has a cyclical component. High commodity prices have boosted mining profits, while low interest rates have spurred profitability in the retail, banking and construction sectors. High consumption spending has also contributed to higher VAT receipts. Where companies have used cyclical profitability to employ workers, the positive effects of the economic cycle will have also boosted personal income tax receipts.

Cyclical value of revenue must be factored into framework

To the extent that part of the present tax revenue trend can be attributed to the economic cycle, the main budget and consolidated budget surpluses of about 0.6 per cent over the medium term overstate the fiscal position. By running a moderate budget surplus, government has the fiscal space to increase borrowing to finance expenditure priorities when the cycle turns without placing an excessive financing burden on the economy.

Preliminary National Treasury calculations estimate that the value of revenue derived from cyclical activity will remain in excess of the main budget surplus over the MTEF. As a result, a share of the cyclical revenue is not saved and is allocated to expenditure. To maintain fiscal sustainability and avoid excessive volatility in the financing of government expenditure over the economic cycle, it is necessary that these amounts not saved be invested in physical and human capital development that serves to lift the potential growth rate of the economy.

Cyclical revenue not saved should be invested to lift potential growth rate of the economy

The structural budget balance

An economy has a "potential" or 'trend' level of GDP growth determined by its state of development and utilisation of capital and labour. Economies may perform better or worse than their potential level for a period of time. These periods of over- or underperformance are cyclical, because the economy tends to return to its potential level. Sustainable growth is about expanding this output potential over time. Determining the extent of the cycle is extremely complex; however, rising inflation and a burgeoning current account deficit are signals that an economy is performing above potential.

Generally, when an economy is in the positive phase of the business cycle, tax revenue will over-perform. The resulting improvement in the budget balance is temporary, and an economy seems "richer" than it really is. The structural budget balance adjusts by subtracting this revenue in the positive phase of the business cycle, and making the opposite adjustment in a downturn. These calculations provide a more accurate picture of the real budget balance, allowing for informed policy decisions that avoid permanent expenditure or tax decisions based on temporary revenue events.

The structural budget balance (also known as the cyclically adjusted balance) is calculated by estimating the cyclical components of revenue and expenditure. This is done by considering differences between potential and actual GDP growth, shifts in the composition of tax revenue, and cyclical estimates of key commodity export prices. The actual budget balance is adjusted by this amount to arrive at a structural budget balance. A more detailed discussion of the cyclical revenue estimate is available on the National Treasury website at *www.treasury.gov.za*.

Public sector borrowing requirement

Table 3.5 shows the anticipated public sector borrowing requirement for the period ahead, taking into account the current capital spending plans of state-owned enterprises, municipalities and other public entities.

Borrowing requirement widens over medium term

Table 3.5 Public sector borrowing requirement, 2006/07 – 2010/11

	2006/07	2007/08		2008/09	2009/10	2010/11
R billion	Outcome	Budget	Revised	Medium-term estimates		
Main budget balance[1]	**-11.0**	**-10.7**	**-10.8**	**-16.2**	**-14.0**	**-14.3**
Extraordinary payments	4.2	0.4	0.8	–	–	–
Extraordinary receipts	-3.4	-1.3	-2.6	-1.3	-1.3	-1.0
Financing requirement	**-10.2**	**-11.6**	**-12.6**	**-17.4**	**-15.3**	**-15.3**
Other government borrowing[2]	-2.3	3.1	-1.8	3.8	5.6	5.7
General government borrowing	**-12.5**	**-8.5**	**-14.4**	**-13.6**	**-9.7**	**-9.6**
Percentage of GDP	*-0.7%*	*-0.4%*	*-0.7%*	*-0.6%*	*-0.4%*	*-0.4%*
Plus: Non-financial public enterprises	8.1	13.6	19.9	32.1	36.4	41.5
Public sector borrowing requirement	**-4.4**	**5.1**	**5.5**	**18.5**	**26.8**	**31.9**
Percentage of GDP	*-0.2%*	*0.3%*	*0.3%*	*0.8%*	*1.1%*	*1.2%*
Gross domestic product	*1 787.3*	*1 938.9*	*2 019.1*	*2 230.3*	*2 458.9*	*2 723.8*

1. A negative number reflects a surplus and a positive number a deficit.

2. Includes social security funds, provinces, extra-budgetary institutions and local government.

Since 2002, buoyant economic conditions have boosted revenue receipts for all levels of the public sector. While capital expenditure plans have grown significantly, the implementation of these plans tends to lag behind revenue growth, resulting in significant public sector cash surpluses between 2002/03 and 2005/06.

The marked reduction of the public sector cash surplus over the past two years is largely the result of increased capital expenditure by local government and the public enterprises. Strong growth in capital expenditure plans by all levels of government is expected to lead to an increasing public sector borrowing requirement over the longer term.

Over the past three years, capital spending by non-financial public enterprises has been financed through operational revenue. As their infrastructure programmes have accelerated, the public enterprises have gone from a cash surplus of R10 billion in 2005/06 to a borrowing requirement of R8.1 billion in 2006/07. In raising finances from capital markets, public enterprises will generally be expected to borrow based on their own balance sheets. Both Eskom and Transnet have taken steps in this direction.