3

Fiscal policy: stability and growth

Government has steadily strengthened the overall fiscal position in recent years, mindful of the risks associated with growing global economic and trade imbalances. The public finances are therefore capable of withstanding the strains of the present crisis, while continuing to address South Africa's development challenges. In the context of a sharp slowdown in the world economy and domestic supply constraints, the fiscal stance supports sustainable economic growth by increasing public spending on government's social and economic priorities, and boosting capital investment to increase long-term productive capacity.

Strong growth in capital spending relative to current expenditure ensures that government savings remain positive. The budget posts a modest deficit over the medium term due to growth in government expenditure and lower projected revenue.

Medium-term allocations protect the value of public spending on core programmes in the face of higher inflation. A loan of R60 billion is provided to Eskom for its capital investment programme. Funding for infrastructure expansion, which will contribute to accelerated economic growth in the future, is increased. Rising employment and targeted salary increases in certain categories of the public service aim to strengthen service delivery.

Overview

Fiscal policy ensures that public spending is sustainable

The sound fiscal stance adopted over the past decade enables government to address risks to the economy associated with a volatile global environment. Fiscal policy provides a necessary balance between reducing external vulnerability by supporting domestic savings, and investing in infrastructure and public services that will contribute to higher growth and a broadening of opportunities in the future.

The fiscal stance outlined in this policy statement reaffirms government's commitment to increase spending on infrastructure, public services and job creation, while making the necessary adjustments in a tougher global and domestic environment.

In the period ahead, the fiscal stance is shaped by three goals:

- Bolstering the ability of the economy to grow sustainably through efficient investment and improved service delivery
- Contributing to economic stability by limiting the inflationary and current account effects of government spending in a supply-constrained environment
- Minimising short-term risks to continued investment financing.

Over the past six years the fiscus benefited from rising commodity prices in the form of higher tax revenues. Over the medium term, revenue growth – in particular corporate tax collection – is expected to decline as a share of GDP.

Increase in spending and weaker revenue projections result in a moderate deficit

The 2008 *Medium Term Budget Policy Statement* makes provision for additional allocations totalling R170.8 billion. Of this amount, R50 billion forms part of the R60 billion loan to Eskom and R59 billion consists of adjustments to spending programmes to accommodate higher inflation. This increase in spending, in combination with a weaker revenue projection, results in a moderate budget deficit.

Low debt position helps cushion fiscus from effects of global volatility

Government's moderate debt position and low foreign debt level help to cushion the fiscus from the effects of global financial volatility. Continued positive savings ensure that government is able to finance its current expenditure without placing an excessive burden on the economy or future generations, while the fiscal space created over the past 10 years ensures that the deficit is sustainable.

The structural budget balance introduced last year gives an indication of the fiscal position adjusted for cyclical variables, which have played a strong role in South Africa's growth over the past five years. There is some weakening in the structural budget balance next year, mainly due to higher expenditure, though the balance remains broadly stable over the medium term.

Fiscal trends in the broader public sector

Fiscal policy involves spending by the entire public sector, including national government, state-owned enterprises, local government and extra-budgetary public institutions. Table 3.1 summarises the fiscal indicators of general government using national accounts data, which differ from government financial statistics data used in the budget.

Spending on social welfare grants has increased rapidly, but will show a slower growth trend

Transfers to households consist mainly of social welfare grants and payments by the social security funds. Transfers grew rapidly in the past four years due to the significant increase in recipient numbers. This trend is expected to moderate over the medium term.

Government consumption expenditure has grown relatively rapidly in the past four years, driven primarily by increases in personnel spending for additional employment – especially in health and policing – and higher spending on complementary inputs such as medicines and school books. Over the next three years general government consumption expenditure will continue to grow, but at a more moderate pace.

New and upgraded public infrastructure – including power generation and transmission, rail, ports, roads and pipelines – is needed to boost growth potential and expand private investment. Some of this capital spending has a high import intensity, which will put upward pressure on the current account. Over the long term, however, these investments will help to unwind economic imbalances by lifting the growth potential of the economy.

General government investment spending accelerates

Real growth in general government investment gathers pace over the medium term, averaging 7.3 per cent a year. Increased capital budget allocations reflect government's priorities, with more funds flowing to public transport, education, health, social development, justice and protection services and housing. In addition, a number of new prisons are being constructed through public-private partnerships.

State-owned enterprises are playing a bigger role in driving investment

Public enterprises are shouldering a large share of the capital investment programme. Having grown by an average of 15.9 per cent in real terms over the past four years, investment by public enterprises will accelerate and is expected to average about 20 per cent a year over the medium term. Eskom's infrastructure programme (R340 billion over five years) accounts for the largest share of this expansion, followed by Transnet (R80 billion), the Central Energy Fund (R30 billion) and the Airports Company of South Africa (R17 billion). Investment spending by the large water boards also contributes to rising public-sector capital spending.

Table 3.1 Fiscal trends and projections

Calendar year	**2003 – 2007**		**2007 – 2011**
Average annual real growth			
Gross fixed capital formation			
General government[1]	3.8%		7.3%
Public corporations	15.9%		19.7%
Government consumption expenditure			
Compensation of employees	2.5%		2.5%
Non-wage	9.2%		5.6%
Government transfers to households	15.8%		5.6%
Fiscal year	**2003/04**	**2007/08**	**2011/12**
Percentage of GDP			
Interest on public debt	4.0%	2.8%	2.0%
General government savings	-2.0%	0.8%	1.0%
Public sector borrowing requirement	2.0%	-0.3%	2.6%
General government tax revenue	25.6%	28.8%	28.0%

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

Appropriate price-setting for electricity and water services is a pre-condition for sustainable financing of infrastructure investment. In addition, government will support the role of its development finance institutions in infrastructure finance and provide selective support to state-owned enterprises by guaranteeing some of their debt.

Table 3.2 Infrastructure expenditure estimates, 2007/08 – 2011/12

	2007/08	2008/09	2009/10	2010/11	2011/12
R million		Estimate	Medium-term estimate		
National departments [1, 2]	6 833	7 954	8 125	8 868	13 454
Provincial departments [2]	31 048	33 103	36 074	41 387	48 168
Municipalities	30 736	31 816	32 501	35 871	38 132
Public private partnerships [3]	3 857	9 911	12 511	10 767	11 259
Extra-budgetary public entities	3 076	5 273	6 765	7 144	7 252
Non-financial public enterprises	56 765	78 393	110 139	125 582	138 527
Total	**132 315**	**166 450**	**206 115**	**229 619**	**256 792**
percentage of GDP	*6.4%*	*7.0%*	*7.9%*	*8.0%*	*8.1%*
GDP	2 061 942	2 366 728	2 598 620	2 870 228	3 170 273

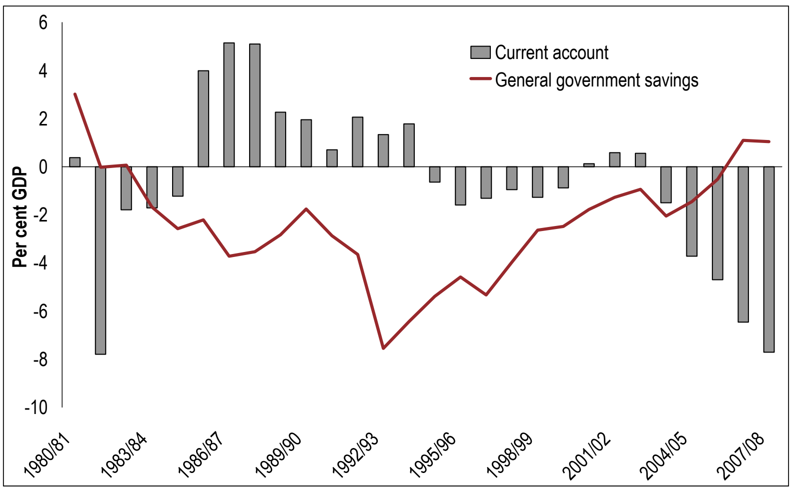
1. Transfers between spheres have been netted out.
2. Includes maintenance of infrastructure assets.
3. Infrastructure expenditure on PPPs overseen by the Treasury PPP Unit, South African National Roads Agency, Department of Public Works and at municipal level.

Revenue growth moderates in line with slower economic activity

As a result of weaker economic activity, tax revenue growth is expected to moderate. Following the buoyancy of recent years, a reduction of gross tax revenue as a percentage of GDP is projected. Much of this decline represents a natural reduction in the cyclical component of revenue, as economic growth and commodity prices retreat from relatively high previous levels. As the economy begins to pick up pace in 2010, the revenue performance should stabilise.

The slowdown in cyclical revenue will put pressure on government savings. This will be partly offset by continued adjustment in the composition of spending, with capital spending growing as a share of total expenditure. The net effect is that government savings are expected to decline marginally, but remain positive.

Figure 3.1 The current account and general government savings, 1980/81 – 2007/08



Improved government savings contribute to economic stability

Investment growth depends on the ability of the economy to finance such expansion, either through domestic or foreign savings. Sound fiscal policy has led to a considerable improvement in government savings. This has helped to offset the widening current account deficit over the past seven years and contributed significantly to the country's economic stability and ability to finance investment.

The public sector borrowing requirement increases, mainly due to the significant increase in borrowings by state-owned enterprises to finance their capital programmes.

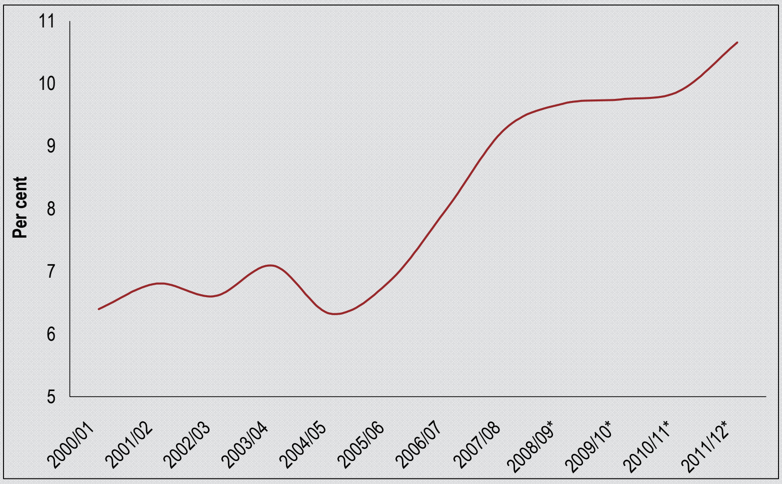
Capital spending: towards higher growth and improved service delivery

Between 1994/95 and 2003/04, consolidated general government capital spending as a percentage of total expenditure was broadly stable. Since 2003/04, fiscal policy has sought to reprioritise government spending towards capital investment in support of public service delivery and higher economic growth. As a result, government's share of capital spending has been rising since 2004/05. Capital spending as a per cent of total government spending increased from 6.3 per cent in 2004/05 to 9.3 per cent by 2007/08. This rising trend is expected to continue over the medium term, with capital expenditure reaching almost 11 per cent of spending by 2011/12.

There have been four major areas of general government capital spending:

- Built environment infrastructure such as housing, water, sanitation, electrification, roads and public transport, including bulk infrastructure and distribution networks for water and electricity
- Social service infrastructure including schools, further education and training colleges, health facilities and welfare services facilities
- Network infrastructure in the economic services sector, including broadband internet connectivity and signal distribution, and investment in research and development infrastructure
- Improving the capacity of the public service through investing (mainly in telecommunication and IT networks) in Home Affairs, the South African Revenue Service and the criminal justice sector.

Capital spending as a percentage of consolidated government expenditure, 2000/01 – 20011/12



**2008/09 – 2011/12 are based on MTEF estimates.*

The budget framework

The proposed budget framework takes into account the consolidated revenue and expenditure of the social security funds in addition to the main budget.

R170.8 billion added to spending plans over next three years

The main budget allows for additional allocations of R170.8 billion over the next three years. Eskom receives support from government in the form of a R60 billion loan, of which R10 billion flows this year and R50 billion over the next two years. Of the remaining R120 billion in additional allocations, the largest share (R59 billion) is allocated to offset the effects of higher inflation, especially on salaries, social grants, fuel and capital projects.

The expanded public works programme, the school feeding programme and municipal infrastructure also receive significant allocations. Spending priorities financed over the next three years are discussed in Chapter 5.

Table 3.3 Consolidated national government, 2007/08 – 2011/12

R billion / *per cent*	2007/08	2008/09	2009/10	2010/11	2011/12
		Estimate		Projections	
Main budget revenue					
Gross tax revenue	572.9	642.3	699.0	769.2	852.8
percentage of GDP	27.8%	27.1%	26.9%	26.8%	26.9%
plus: other non-tax receipts and payments	11.6	11.3	11.1	10.6	11.0
less: SACU transfers	-24.7	-27.1	-27.3	-28.7	-30.4
Total revenue	**559.8**	**626.5**	**682.9**	**751.1**	**833.4**
Main budget expenditure					
State debt cost	52.9	53.9	52.7	55.1	56.7
percentage of GDP	*2.6%*	*2.3%*	*2.0%*	*1.9%*	*1.8%*
Non-interest expenditure[1]	488.6	581.5	682.2	737.4	787.9
percentage of GDP	*23.7%*	*24.6%*	*26.3%*	*25.7%*	*24.9%*
per cent real growth	*8.1%*	*6.7%*	*11.5%*	*2.7%*	*2.1%*
Of which:					
Increases over 2008 Budget		27.7	60.6	52.5	57.7
Contingency reserve		–	4.0	12.0	20.0
Total expenditure	**541.5**	**635.5**	**735.0**	**792.5**	**844.6**
percentage of GDP	*26.3%*	*26.8%*	*28.3%*	*27.6%*	*26.6%*
Social security funds					
Revenue	24.8	29.5	30.0	32.4	35.7
Expenditure	16.5	17.4	19.4	22.0	24.0
Consolidated national budget[2]					
Revenue	**584.6**	**653.5**	**712.8**	**783.5**	**869.2**
percentage of GDP	*28.4%*	*27.6%*	*27.4%*	*27.3%*	*27.4%*
Expenditure	**558.0**	**650.3**	**754.3**	**814.5**	**868.6**
percentage of GDP	*27.1%*	*27.5%*	*29.0%*	*28.4%*	*27.4%*
Budget balance	**26.6**	**3.2**	**-41.5**	**-31.0**	**0.6**
percentage of GDP	*1.3%*	*0.1%*	*-1.6%*	*-1.1%*	*0.0%*
Gross domestic product	2 061.9	2 366.7	2 598.6	2 870.2	3 170.3

1. Includes transfers to provinces and local government, the National Skills Fund and sectoral skills development funds.

2. Flows between funds are netted out.

Following the exceptional revenue performance of the past six years, tax buoyancy has declined in 2008/09 in response to cyclical factors. Over the medium term, tax revenue growth will begin to correlate more closely with the rate of GDP growth, and is expected to stabilise at just below 27 per cent of GDP.

Excluding the Eskom loan, additional main budget resources of R120 billion over the medium-term expenditure framework (MTEF) period result in real growth in expenditure of about 6 per cent a year.

Social security funds continue to run a surplus

The budget framework makes provision for a contingency reserve totalling R36 billion over the next three years. The contingency reserve allows the fiscus to respond within the agreed resource envelope to unforeseen and unavoidable events. The reserve is also available for partial drawdown to fund new priorities in the outer two years. The social security funds continue to run significant surpluses in aggregate, despite a projected deficit on the Road Accident Fund. The budget framework excludes expenditure of about R1.6 billion a year financed by foreign development assistance.

Debt service costs continue to fall as a share of GDP

Debt service costs have fallen from nearly 6 per cent of GDP in 1998/99 to 2.3 per cent in 2008/09. Declining deficits and fiscal surpluses in recent years have resulted in a particularly pronounced drop in debt service costs. This has created significant fiscal space, enabling government to preserve the real value of previous allocations and make available additional resources to improve the availability and delivery of public services without having to increase taxes. The decline in debt service costs as a percentage of GDP is expected to continue over the MTEF, although at a slower rate.

Budget deficit of 1.6 per cent of GDP in 2009/10

The budget balance of the consolidated national budget for 2008/09 is revised to a surplus of 0.1 per cent of GDP. As the economy slows further next year, the budget balance moves to a deficit of 1.6 per cent of GDP.

Debt management

Given the current volatility in global markets and a high current account deficit, debt management policy is focused on managing external vulnerability. In keeping with this position, government will continue to assist the Reserve Bank to increase the level of foreign exchange reserves and actively manage its portfolio to reduce short-term debt, taking into account market considerations.

Table 3.4 reflects the net and gross debt of national government. Including forward estimates of the impact of exchange and inflation rates on foreign and inflation-linked debt, net loan debt will continue to decline as a share of GDP to 19.9 per cent by 2011/12. Foreign debt is projected to fall to 2.8 per cent of GDP.

Table 3.4 Total government debt, 2005/06 – 2011/12

As at 31 March R billion	2005/06	2006/07 Outcome	2007/08	2008/09 Estimate	2009/10	2010/11 Medium-term estimates	2011/12
Domestic debt[1]	461.5	471.1	479.6	518.7	572.9	626.2	660.9
Foreign debt[1]	66.8	82.6	96.2	87.7	85.2	86.3	88.8
Gross loan debt	**528.3**	**553.7**	**575.8**	**606.4**	**658.1**	**712.5**	**749.7**
Less: National Revenue Fund bank balances	-58.2	-75.3	-94.5	-113.7	-101.3	-104.6	-119.8
Net loan debt[2]	**470.1**	**478.4**	**481.3**	**492.7**	**556.8**	**607.9**	**629.9**
As percentage of GDP :							
Net loan debt	*29.7*	*26.5*	*23.3*	*20.8*	*21.4*	*21.2*	*19.9*
Foreign debt	*4.2*	*4.6*	*4.7*	*3.7*	*3.3*	*3.0*	*2.8*
As percentage of gross loan debt:							
Foreign debt	*12.6*	*14.9*	*16.7*	*14.5*	*12.9*	*12.1*	*11.8*

1. Forward estimates are based on National Treasury's projections of exchange and inflation 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 commercial banks).

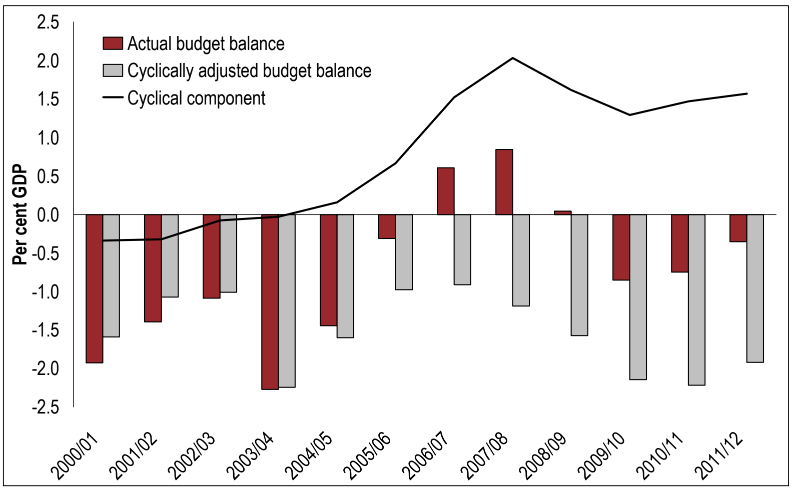
Structural main budget balance

Structural budget balance adjusts fiscal policy for cyclical effects

In 2007, government introduced the concept of a structural budget balance, also called the cyclically adjusted budget balance, to help guide fiscal policy. The aim of this shift is to take account of temporary fiscal developments that do not represent structural changes in expenditure or revenue.

In arriving at the structural budget balance, the main budget is adjusted to take account of cyclical spending and revenue collection, including abnormally high tax on profits when commodity prices are at elevated levels. In the 2009 MTEF, spending is adjusted by removing the Eskom loan – a once-off item that supports investment in infrastructure that will raise potential growth.

Figure 3.2 Main budget and structural budget balances, 2000/01 – 2011/12



Both the actual and cyclically adjusted budget balances have been adjusted for the loan transfer to Eskom.

South Africa's economic cycle is influenced by a range of factors, the most important elements of which are the prices of major exports relative to our imports (often referred to as the terms of trade). Over the period ahead the cyclical adjustment to the budget balance remains positive, signalling that revenue trends are likely to continue to be supported by cyclical factors.

Commodity prices have significant impact on economic cycle

The positive cyclical adjustment is mainly the result of continued favourable terms of trade. Because the prices of imports have fallen by more than the prices of exports, the economy has experienced a positive wealth effect, meaning that South Africa can afford more imports for a given quantity of exports. This feeds through into tax revenue. Such revenue is considered to be cyclical because it does not result from a structural change in the economy and can be expected to unwind as the relative prices adjust.

The structural budget deficit declines from about 1.6 per cent of GDP in 2008/09 to average about 2.0 per cent over the medium term, but remains within an acceptable margin. Over the longer-term, government spending in support of higher GDP growth is expected to contribute to the reduction of the structural budget balance by structurally raising the growth potential of the economy.

Structural budget balance deteriorates slightly, but still within an acceptable margin

Public sector borrowing requirement

The public sector borrowing requirement provides the aggregate cash position of the entire public sector, including state-owned enterprises.

The accelerating capital investment programmes at all levels of the public sector, combined with the more challenging operating environment, result in the cash position of the public sector moving from a surplus in 2007/08 to a borrowing requirement averaging about 3 per cent over the medium term.

Capital spending plans of public enterprises raise public sector borrowing requirement

Table 3.5 Public sector borrowing requirement, 2007/08 – 2011/12

	2007/08	2008/09		2009/10	2010/11	2011/12
R billion	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Main budget balance[1]	**-18.3**	**-14.3**	**8.9**	**52.1**	**41.5**	**11.2**
Extraordinary payments	0.8	–	4.9	–	–	–
Extraordinary receipts	-1.8	-0.9	-7.2	-1.4	-0.6	-0.6
Financing requirement	**-19.3**	**-15.2**	**6.6**	**50.7**	**40.9**	**10.6**
Other government borrowing[2]	2.2	4.5	-4.1	-3.8	-2.1	-3.0
General government borrowing	**-17.0**	**-10.7**	**2.6**	**46.9**	**38.7**	**7.5**
Percentage of GDP	*-0.8%*	*-0.5%*	*0.1%*	*1.8%*	*1.3%*	*0.2%*
Plus: Non-financial public enterprises	11.1	37.7	27.9	30.3	53.0	74.9
Public sector borrowing requirement	**-5.9**	**27.0**	**30.4**	**77.2**	**91.7**	**82.4**
Percentage of GDP	*-0.3%*	*1.2%*	*1.3%*	*3.0%*	*3.2%*	*2.6%*
Gross domestic product	*2 061.9*	*2 286.9*	*2 366.7*	*2 598.6*	*2 870.2*	*3 170.3*

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.

The main factors driving the increase in the public sector borrowing requirement are the budget deficit and borrowing by non-financial public enterprises to finance their capital investments. A significant portion of the short-term increase in the main budget borrowing requirement is to support Eskom.