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Recovery and reform in the face of uncertainty

Introduction

The 2012 Budget is being prepared in an exceptionally challenging environment. Slowing world economic growth, an unresolved financial crisis in the euro area and a sluggish recovery in the United States all point to extended difficulties in the global outlook. Inflationary pressures have emerged in several countries, including China. Rising income inequality and high unemployment have fuelled widespread public indignation. Although South Africa has seen positive growth since emerging from the 2009 recession, job creation has been weak. The volatility of the rand has harmed economic activity. Revenue has slowed and the budget deficit has increased.

The world economy holds substantial risks for South Africa's growth

The risks that these trends pose to the South African economy and fiscus are significant. The 2011 *Medium Term Budget Policy Statement* sets out a fiscal framework that will narrow the gap between spending and revenue, while providing support to the economy and strengthening infrastructure investment for sustainable long-term growth.

Fiscal framework provides economic support and investment in infrastructure for long-term growth

A deficit of 5.5 per cent of gross domestic product (GDP) is expected this year, moderating to 3.3 per cent by 2014/15. Over the medium term, fiscal consolidation will be accompanied by shifts in the composition of public expenditure towards investment and economic development. Measures to promote industrial development and expand trade opportunities will be strengthened. Financial support for housing and urban infrastructure investment will be extended. Funding for employment programmes and training will be increased.

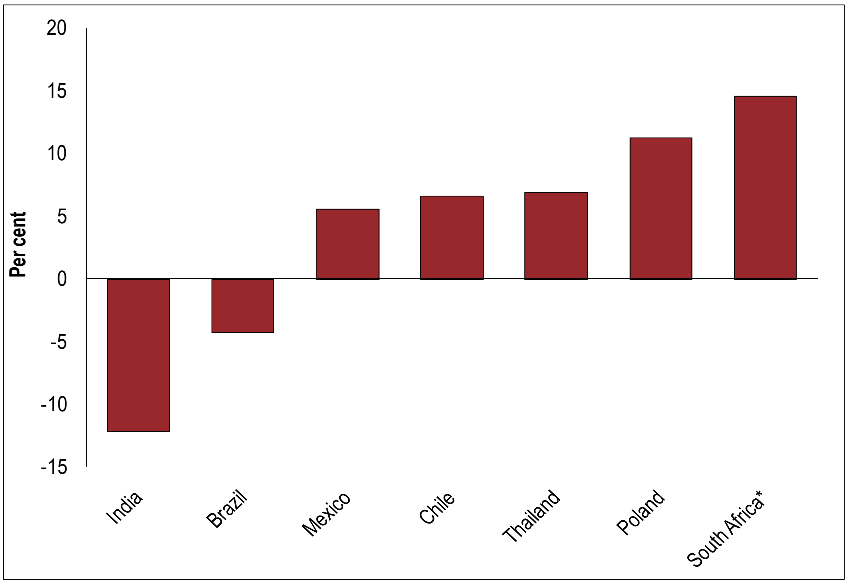
South Africa is not alone in facing challenging circumstances. Slower economic growth, falling tax revenue and uncertain financial conditions confront many of our trading partners and other developing economies.

South Africa's considerable strengths include moderate government debt and well-capitalised banks

However, South Africa's financial institutions are well capitalised and government debt is moderate. These are considerable strengths, and allow a countercyclical fiscal and monetary stance to be pursued into the year ahead, while helping enterprises to adjust to changing market conditions.

In response to the global financial crisis that began in 2008 and a sharp decline in revenue, government adopted an accommodative fiscal stance. Public spending has compensated in part for the deterioration in business activity, which has yet to regain momentum. Government debt is set to rise to about 40 per cent of GDP by 2015, after which it should stabilise and decline. In contrast, more restrictive fiscal policies have had to be adopted in several countries because of high initial debt levels, financial distress or rising inflation.

Figure 1.1 Change in government debt-to-GDP ratio, selected countries, 2007 – 2014



Source: International Monetary Fund WEO, September 2011 and National Treasury
**Gross national government debt in fiscal years*

Shifting the composition of government expenditure

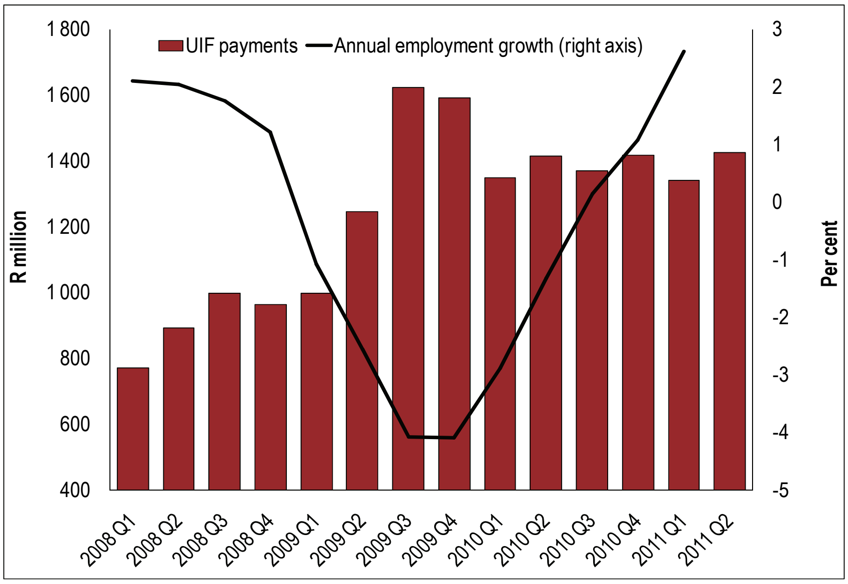
South Africa enjoyed strong economic growth in the five years leading up to 2008. This trend contributed to buoyant revenue, steadily improving public and private investment spending, and a declining public debt burden.

Despite lower economic growth over the past several years, public expenditure has continued to grow

Between 2002/03 and 2009/10, government spending as a share of GDP increased from 27.2 to 33.8 per cent. Despite lower economic and revenue growth since 2008, public expenditure has continued to expand, although at a more moderate pace since 2008/09.

In response to the steep deterioration in employment that began in 2009, the Unemployment Insurance Fund has provided income support to increased numbers of claimants. Workers and enterprises have also been assisted through a training lay-off scheme and financial support provided by the Industrial Development Corporation. Real increases in public-sector pay levels have been accompanied by increases in departmental personnel numbers, contributing positively to household earnings at a time of declining private-sector employment. Many households have received support through social assistance.

Figure 1.2 Unemployment benefits paid and formal sector non-agricultural employment growth, 2008 – 2011



Source: UIF and Statistics South Africa (QES-Quarter 2, 2011)

Investments in electricity, transport and water, alongside rural development and education initiatives, are crucial for the long term

Alongside assistance of a short-term nature, it is also necessary to invest in a longer-term recovery and economic adjustment to changing global conditions. Several important reforms are under way. Electricity generation capacity is being expanded, public transport is undergoing renewal and investment in water supply is in progress. Steps have been taken towards a more energy-efficient economy, integrated rural development programmes are being piloted, and new initiatives are under way in education and skills development.

Private sector and government investment, however, have declined since 2007. This trend must be reversed in the period ahead if more rapid growth and employment creation are to be achieved and sustained.

A shift of resources in favour of growth and job creation

The path for South Africa's public finances outlined in this statement of budget policy involves a shift of resources in favour of growth and job creation, and to support stronger private-sector investment in pursuit of new opportunities in a changing international environment. A fiscal framework grounded in countercyclicality, long-term sustainability and intergenerational fairness provides support to the economy in the medium term, while building strong foundations for faster growth, sustainable development and employment growth that benefits all South Africans.

Time to make difficult decisions

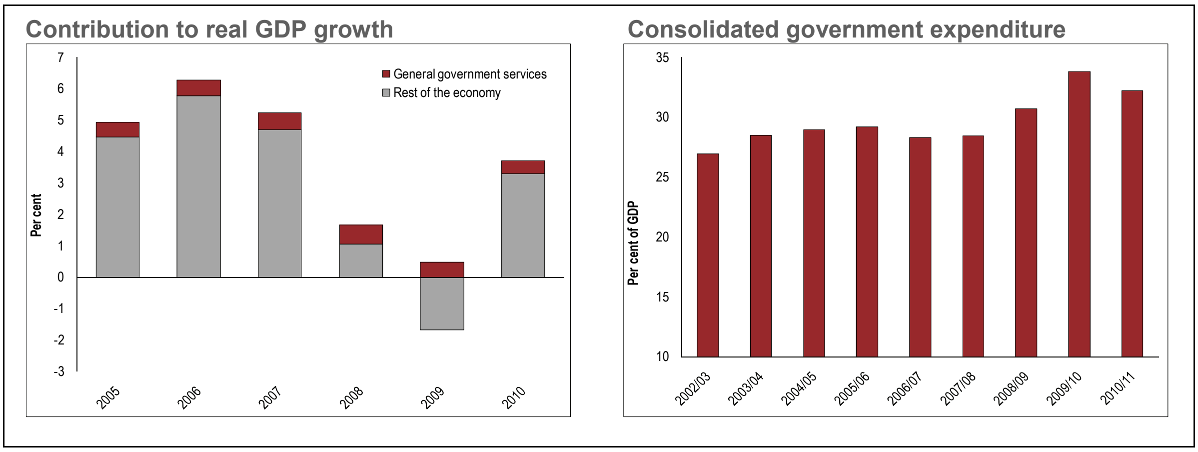
It is not the number of objectives in a strategy that matters, but the focus on the ones that count

The measure of a strategy is not in the breadth of objectives it seeks to address, but rather in its focus on those objectives that really matter. Fiscal constraints force government to choose carefully between competing objectives. Difficult decisions are required to ensure that scarce resources are directed towards economic development and more effective service delivery, while ensuring that debt levels are sustainable. As recent international experience has demonstrated, putting off tough decisions can have damaging consequences for public finances, economic growth and social stability.

Government's share of GDP will need to moderate to avoid an unwarranted future debt burden

Over the next three years, government's share of GDP will need to moderate to avoid an unwarranted future debt burden. Ensuring a sustainable level of debt is also necessary to create an environment in which the private sector can grow, invest and create jobs based on stable inflation, a low cost of capital and a competitive real exchange rate.

Figure 1.3 Government contribution to growth and share of GDP



Source: Reserve Bank and National Treasury estimates

Substantial improvements in public-service remuneration and increases in employment have raised the wage bill to about 42 per cent of government revenue, up from 31 per cent four years ago. Over the medium term, salary increases for all role players need to be given careful attention. The principle of moderation extends also to senior management and executive salaries, and remuneration of the employees of public entities. Within the corporate sector too, South Africa needs greater accountability, transparency and moderation in executive and financial sector remuneration.

Budget framework provides for a 5 per cent annual cost-of-living adjustment for public-sector employees

The proposed framework for the 2012 Budget provides for a 5 per cent cost-of-living adjustment for public-sector employees, implemented with effect from April each year. Similar adjustments to social grants are assumed in the expenditure estimates. Increased spending on municipal services and housing is proposed, alongside progressive improvements in education, health services and social protection, stronger spending on infrastructure maintenance and investment, and support for economic development.

Economic support for faster growth

South Africa's public finances are strongly redistributive. Progress towards a more equal economy also requires more inclusive private-sector growth, expanding levels of employment and a narrowing wage gap, thereby reducing inequality.

The 2012 Budget will include an economic support package aimed at strengthening the medium-term recovery and giving impetus to the longer-term structural shifts required for faster growth and development.

Economic support package to strengthen recovery and promote structural reforms

These initiatives, outlined in Chapter 2, will focus on enhancing the competitiveness of manufacturing, accessing new and emerging markets, continued investment in network infrastructure and identified industrial development zones, enhanced regional integration, environmental initiatives, and targeted support for low-wage sectors and enterprises.

Financing the economic support package will require significant additional resources. Realising these resources within the fiscal framework outlined in Chapter 3 requires government to be more efficient, and to achieve greater alignment between resources and priorities. In addition, consideration has to be given to the state's overall financial balance sheet, with a view to long-run strategic priorities, and sound management of financial and fiscal risks and liabilities.

Government needs to become more efficient in the way it spends money

Government has substantial investments in enterprises and public entities, which in many cases hold cash, excess financial reserves or assets that are not associated with public-service delivery. Where these resources could more productively be applied to finance future public-policy priorities, this can be effected through a return of surplus funds to the fiscus.

Better control of expenditure and a clear focus on core mandates by government departments also has potential to yield recurrent savings. In preparing the 2012 Budget, departments are expected to identify savings that will contribute to financing government's targeted outcomes.

Better control of spending and clear focus on mandates can yield recurrent savings

Social security and health care

Expenditure on health care and social protection has grown strongly over the past decade. About 27 per cent of the consolidated budget is devoted to these priorities, which form a large part of the social wage. Substantial reforms are currently under consideration for health financing and social security.

A discussion paper on the reform of South Africa's social security and retirement funding arrangements has been prepared and will be released before the end of the financial year. Its central focus is the inclusion of a retirement pension in the contributory social security system. Modernisation of the administrative arrangements for social assistance and social security is also proposed, as are changes to the regulatory framework governing retirement funds. These reforms complement measures to strengthen labour market institutions, including more effective employment services linked to training opportunities.

Social security reform discussion paper to be released before the end of the financial year

A green paper on national health insurance has been published. Steps will be taken over the medium-term expenditure framework (MTEF) period ahead to improve public health administration, accelerate the hospital revitalisation programme and pilot district-based primary health services as part of the preparation for national health insurance.

National health insurance and social security reform will have long-term implications for the fiscus

Over the longer term, the envisaged changes to social security and health systems will have implications for both the public finances and the structure of remuneration across the economy. These reforms, and appropriate transition arrangements, will be the subject of an in-depth consultation process during 2012.

Overview of the 2011 policy statement

Economic outlook

Chapter 2 provides an economic context to the public finances, and a discussion of broader developments in the domestic and international economy.

GDP growth is forecast to reach 4.3 per cent in 2014

The revised economic outlook shows growth slowing, mainly due to developments in the global economic environment. GDP growth is forecast to increase to 4.3 per cent in 2014 as global uncertainty subsides and confidence strengthens. The average annual increase in consumer prices is expected to remain at about 5.5 per cent a year.

Growth at the levels projected, however, remains insufficient for South Africa to meaningfully reduce unemployment and poverty in line with the objectives set out in the New Growth Path. Chapter 2 provides details on initiatives aimed at enhancing competitiveness and accelerating economic growth. Measures that broaden access to work opportunities, especially for young people, will enjoy special priority.

Table 1.1 Macroeconomic projections, 2010 – 2014

	2010	2011	2012	2013	2014
Calendar year	**Actual**	**Estimate**		**Forecast**	
Percentage change unless otherwise indicated					
Final household consumption	4.4	4.3	3.7	4.4	4.5
Gross fixed capital formation	-3.7	2.9	4.5	5.7	6.3
Real GDP growth	**2.8**	**3.1**	**3.4**	**4.1**	**4.3**
GDP at current prices (R billion)	**2 664.3**	**2 931.8**	**3 208.2**	**3 555.0**	**3 930.5**
CPI inflation	4.3	5.0	5.4	5.6	5.4
Current account balance (% of GDP)	-2.8	-3.4	-3.8	-4.0	-4.2

Fiscal policy and trends

Fiscal framework is supportive of growth

Chapter 3 presents a fiscal framework that is supportive of the economy over the medium term, while strengthening interventions aimed at boosting sustainable long-term growth. The budget deficit widens in the current year owing to lower-than-anticipated revenue. Moderation in spending, together with improving revenue performance, will reinforce the fiscal position over the next three years. It is expected that debt-service costs will stabilise as a percentage of GDP by 2014/15.

Table 1.2 Consolidated government fiscal framework, 2010/11 – 2014/15

R billion	2010/11 Outcome	2011/12 Estimate	2012/13	2013/14 Medium-term estimates	2014/15
Revenue	**758.4**	**814.2**	**890.0**	**994.5**	**1 113.0**
Percentage of GDP	*27.6%*	*27.3%*	*27.0%*	*27.3%*	*27.7%*
Expenditure	**885.8**	**978.8**	**1 062.3**	**1 157.4**	**1 247.0**
Percentage of GDP	*32.2%*	*32.9%*	*32.2%*	*31.8%*	*31.0%*
Budget balance	**-127.4**	**-164.6**	**-172.3**	**-162.9**	**-134.1**
Percentage of GDP	*-4.6%*	*-5.5%*	*-5.2%*	*-4.5%*	*-3.3%*

Medium-term expenditure priorities and the division of revenue

Chapter 4 outlines the proposed 2012 MTEF. The spending outcome for 2010/11 and adjusted estimates for 2011/12 are presented, along with indicative revisions to spending plans for the next three years. Spending trends and public-service priorities are reviewed, both by function and by level of government.

Real growth in non-interest spending will average just over 2 per cent a year over the medium term

Real growth in government non-interest spending will average just over 2 per cent a year for the MTEF period. Education remains the largest category of expenditure, followed by social protection, local government and housing, and health services. State debt cost, however, is the fastest-growing component of expenditure, followed by economic infrastructure (transport, communications and energy).

Table 1.3 Consolidated government expenditure, 2011/12 – 2014/15

R billion	2011/12 Revised estimate	2012/13	2013/14 Budget estimate	2014/15	Average annual growth 2011/12–2014/15
General public services	53.0	54.7	58.7	64.9	7.0%
Defence	38.3	41.8	44.4	47.0	7.1%
Public order and safety	90.6	98.8	105.9	112.1	7.4%
Economic infrastructure	77.4	85.5	91.9	101.5	9.5%
Economic services and environmental protection	52.4	56.3	60.2	62.6	6.1%
Local government, housing and community amenities	121.5	128.4	140.5	146.2	6.4%
Health	113.2	121.5	130.6	140.1	7.4%
Recreation and culture	9.6	9.6	9.2	9.7	0.2%
Education	190.8	202.6	218.2	231.7	6.7%
Social protection	147.8	159.8	172.6	182.3	7.2%
Science and technology	7.3	8.1	9.2	9.6	9.5%
Contingency reserve	–	6.0	12.0	24.0	
Non-interest expenditure	**901.9**	**973.2**	**1 053.3**	**1 131.9**	**7.9%**
State debt cost	76.9	89.1	104.1	115.1	14.4%
Total expenditure	**978.8**	**1 062.3**	**1 157.4**	**1 247.0**	**8.4%**

The proposed division of revenue between national, provincial and local government is set out in Table 1.4. National departments account for 47.1 per cent of expenditure in 2012/13, provinces 44.1 per cent and transfers to municipalities 8.8 per cent.

Table 1.4 Division of revenue, 2011/12 – 2014/15

R billion	2011/12	2012/13	2013/14	2014/15
National allocations	377.8	410.3	444.7	474.7
Provincial allocations	363.2	384.5	411.0	437.8
Equitable share	*291.7*	*308.5*	*328.4*	*348.8*
Conditional grants	*71.5*	*76.0*	*82.6*	*89.0*
Local government allocations	70.1	77.0	83.8	90.8
Total allocations	**811.2**	**871.9**	**939.5**	**1 003.3**
Changes to baseline				
National allocations	-2.3	1.9	5.8	15.1
Provincial allocations	5.3	4.1	6.7	9.4
Equitable share	*3.2*	*2.8*	*4.8*	*5.8*
Conditional grants	*2.0*	*1.3*	*2.0*	*3.6*
Local government allocations	–	–	1.5	3.5
Total	**2.9**	**6.0**	**14.0**	**28.0**

Conclusion

The *Medium Term Budget Policy Statement* contributes to South Africa's broader economic and development debate through improved understanding of public finances. Before the end of the year, work done by the National Planning Commission will provide a longer-term perspective on South Africa's growth and development challenges.

Policy statement summarises spending plans in preparation for the 2012 Budget

The budget policy statement provides a scan of the medium-term economic outlook, an overview of the fiscal framework and related issues, and a summary of government's spending plans, as background to the more detailed sectoral policies and departmental programmes that will accompany the 2012 Budget.