3

Fiscal policy and trends

In brief

- A narrow fiscal window is available to government over the next three years, given moderate economic growth prospects and elevated levels of public debt.
- During 2013/14 and 2014/15, spending will remain within the non-interest expenditure ceilings established in the 2012 Budget. Over the medium term, government will limit real expenditure growth to average 2.9 per cent per year. Spending on key social and economic programmes will be maintained.
- As economic growth gathers pace, the budget deficit is projected to narrow from an estimated 4.8 per cent of GDP in the current year to 3.1 per cent of GDP by 2015/16.
- With spending well contained, the primary risk to the fiscal outlook is lower-than-projected GDP growth that would result in poor revenue outcomes.
- To realise improved outcomes, government must shift the composition of expenditure away from consumption towards capital investment, and improve the quality of spending.
- South Africa's fiscal guidelines promote countercyclicality, sustainability and intergenerational equity. The National Treasury will publish a long-term fiscal report on the sustainability of spending options.

Securing South Africa's fiscal footing

South Africa's fiscal framework remains grounded in a sustainable, countercyclical approach to managing revenue and expenditure. Spending will be well contained over the medium-term expenditure framework (MTEF) period. Key social and economic programmes will be maintained, complemented by efforts to improve the quality of spending.

Spending growth will remain contained, while continuing to support social and economic priorities

Fiscal policy began adjusting to a new economic terrain with the onset of the global financial crisis. After nearly a decade of rapid expansion in non-interest expenditure, government began to reduce the rate of growth in the budget while continuing to support the economy. This approach was made possible by the fiscal space built up in previous years.

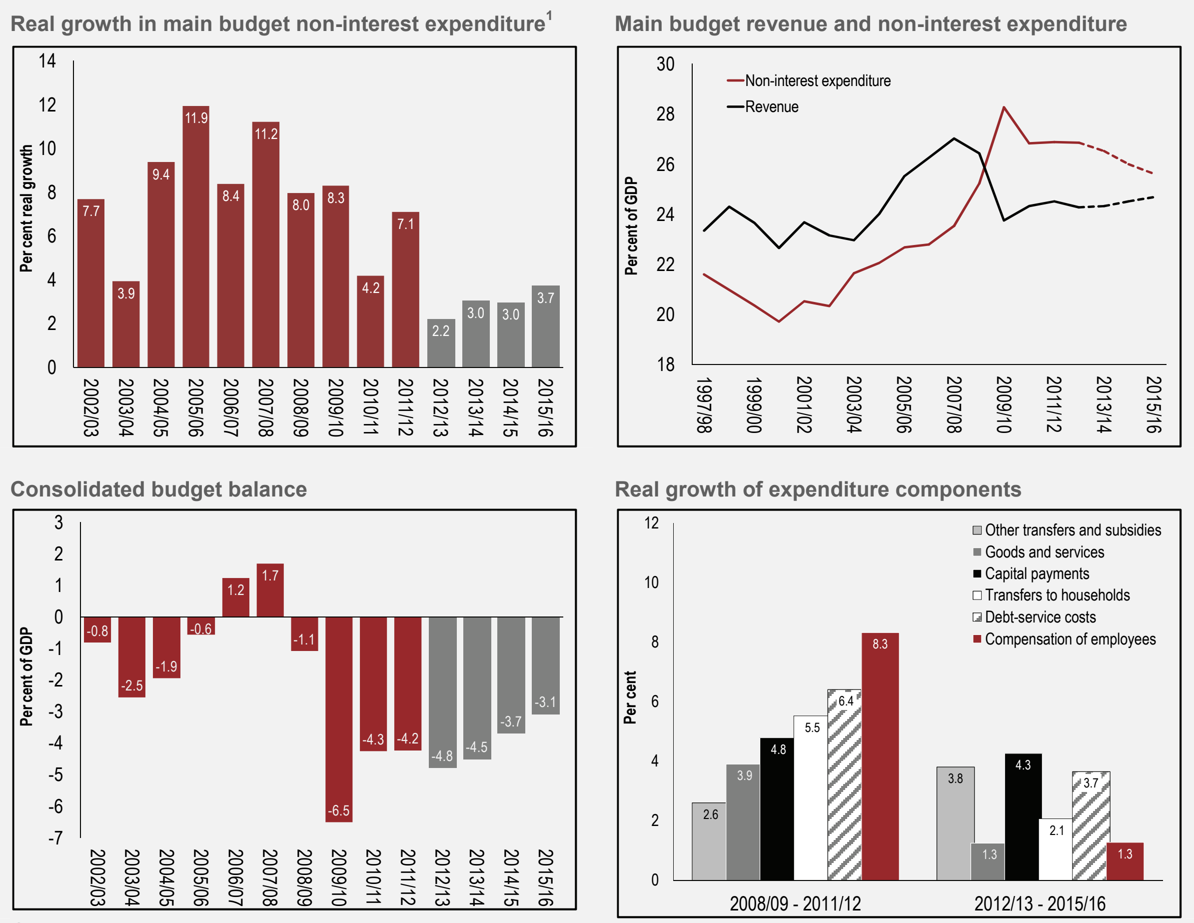
Today government does not have ample fiscal space. The economic environment and attendant risks outlined in Chapter 2 impose sharp limits on government spending. The challenge is to navigate a path between fiscal consolidation and an excessive, premature withdrawal of support for the economic recovery.

Fiscal policy over the past decade

Over the past 10 years real government spending has doubled

South Africa's national income, adjusted for inflation, is 50 per cent larger than it was a decade ago. Over the same period, government expenditure has doubled. As shown in Figure 3.1, real non-interest expenditure grew by an annual average of 8 per cent between 2002/03 to 2011/12.

Figure 3.1 Fiscal performance and projections



Source : National Treasury

Expenditure growth during this period resulted from a conscious decision to improve access to services and accelerate the pace of infrastructure investment. The expanding fiscal envelope has enabled a doubling of the social wage, rising capital budgets, growing social transfers, increased public employment and improved public-sector wages.

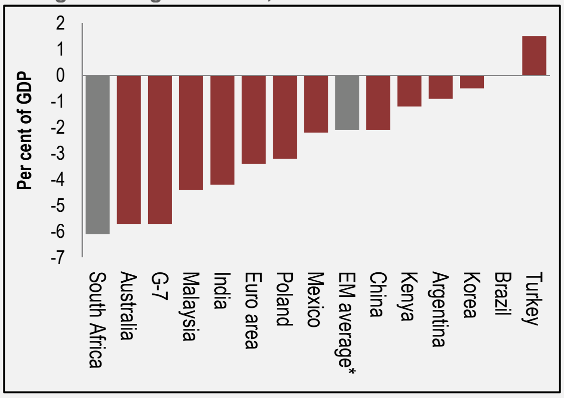
[1] The main budget includes expenditure financed from the National Revenue Fund at national, provincial and local government level, but excludes spending of social security funds, public entities and provinces financed from their own revenue. Since 2002/03 government has presented consolidated accounts in line with international standards. The budget deficit is generally reported in consolidated form and used by government as the core measure of fiscal sustainability. Unless indicated otherwise, budget data is presented in consolidated form. Two figures above use main budget data because it is available over a longer period of time.

Government's response to the 2009 recession has led to a dramatic widening of the deficit. By the time debt stabilises in 2015/16, more than R1 trillion will have been added to government debt (see Table 3.4). The cost of servicing this debt has grown rapidly, and the doubling of the debt-to-GDP ratio means that government has fewer countercyclical options at its disposal.

Fiscal policy and the global downturn

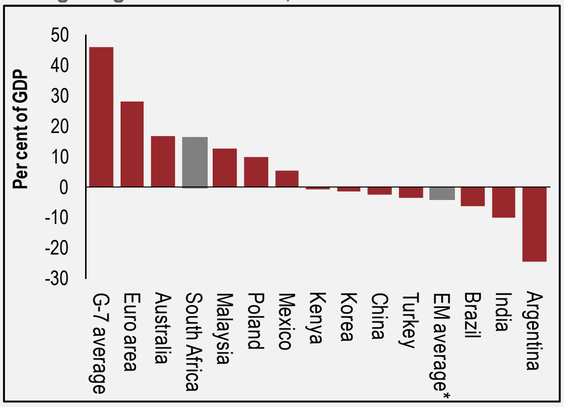
South Africa's fiscal response to the 2009 recession was strong by international comparison. This is reflected in the change in the budget balance. South Africa's balance fell by about 6 per cent of GDP, from a budget surplus of 1.7 per cent of GDP in 2007/08 to a deficit of 4.2 per cent of GDP in 2011/12, reflecting strong spending growth in the face of lower revenue collection. The corollary of this trend is shown in the growth of public debt, depicted in the figure on the right. The increase in South Africa's debt-to-GDP ratio, albeit from a low base, was far greater than that of other emerging markets.

Change in budget balance, 2007 – 2011



Source: IMF Fiscal Monitor, October 2012

Change in government debt, 2007 – 2014



* Emerging markets average

Stable, well-contained expenditure over medium term

South Africa's medium-term challenge is to improve the quality and composition of expenditure

Over the past decade, the redistributive and pro-poor character of public spending has significantly improved, alleviating poverty and advancing social development. But there is increasing concern within government that additional budget allocations do not result in commensurate improvements in service delivery. Government's ability to support accelerated growth, increase employment, and reduce poverty and inequality is limited by two factors: the *quality* of spending and the *composition* of spending, with a shift necessary from consumption towards capital investment.

The narrowing of fiscal space, in combination with the erosion of the link between budget inputs and social outputs, implies the need for additional measures to secure the country's fiscal footing and improve the quality of spending. While current levels of spending can be sustained over the medium term, expenditure cannot grow at the rate it did over the last decade. Nor is it possible to sustain budget deficits in excess of 4.5 per cent of GDP indefinitely.

Government will act to stabilise the growth of public debt and begin rebuilding fiscal space

Over the next three years spending growth will remain stable and well contained, while continuing to support social priorities and enhancing the contribution of the public finances to output growth. This will make it possible to restore the deficit to sustainable levels and begin rebuilding fiscal space.

If substantial risks materialise, it may be necessary to reconsider spending and revenue plans

If, however, the substantial risks to the outlook materialise and the economic environment deteriorates, realising these fiscal objectives will require a reconsideration of current spending and revenue plans. In a lower-growth scenario, an appropriate balance between spending restraint and new revenue initiatives would be necessary, taking into account the need to limit the potential impact on growth, employment and equity. In either case, the necessary adjustments will avoid an unwarranted early withdrawal of fiscal support for the recovery.

Fiscal policy objectives

Countercyclicality, debt sustainability and intergenerational equity anchor fiscal approach

Government's fiscal guidelines promote countercyclicality, debt sustainability and intergenerational equity. The fiscal stance targets medium-term consolidation, with moderate expenditure growth supporting economic recovery and sustaining the social wage.

The 2011 *Medium Term Budget Policy Statement* (MTBPS) projected that the budget deficit would narrow in line with moderate expenditure increases and automatic revenue growth. While expenditure has remained within budgeted targets, revenue has continued to underperform, reflecting the weakness of the economic environment. As the economy improves revenue is expected to recover, narrowing the budget deficit from 4.8 per cent of GDP in 2012/13 to 3.1 per cent of GDP in 2015/16.

South Africa continues to run a large structural deficit that reflects an underlying, longer-term imbalance in revenue and expenditure (rather than one based on short-term factors). The aim of fiscal policy over the next three years is to narrow this structural deficit towards 3 per cent of GDP and rebuild fiscal space. Three policy objectives will be targeted:

- Improving the impact of spending, including by shifting the balance of resource allocation towards investment in infrastructure.
- Ensuring that expenditure grows at a moderate pace.
- Stabilising public debt.

Moderating expenditure growth

By reducing waste and inefficiency government can achieve better outcomes

Expenditure growth must balance the need to sustain the current level of social commitments with support for improved competitiveness, investment and maintenance of productive infrastructure. The spending plans outlined in the 2012 Budget targeted these objectives and allocated sufficient resources to achieve them. By reducing waste and inefficiency government can achieve better outcomes within this resource envelope.

No upward adjustment of overall spending projection set out in 2012 Budget over next two years

Accordingly, government has decided that there will be no upward adjustment of the overall spending projection set out in the 2012 Budget during the first two years of the MTEF period. This marks a necessary shift from the pattern of additional spending allocations that had come to be taken for granted over the past decade. Through savings and reprioritisation, government has also ensured that despite the larger-than-budgeted public-sector wage agreement, the overall spending envelope for the current year has not increased. The outer year of the fiscal framework makes provision for moderate growth of non-interest expenditure, consistent with the objective of stabilising debt.

Table 3.1 Main budget non-interest expenditure plans, 2010/11 – 2015/16

R million	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Budget 2010	746 785	799 875	860 292			
Budget 2011	743 353	812 345	877 324	948 992		
Budget 2012		814 554	879 977	953 024	1 030 539	
MTBPS 2012			878 669	953 024	1 030 539	1 118 991

Stabilising government debt

Rebuilding fiscal space depends on stabilising the level of public debt. Although the stock of debt remains manageable, it is expected to increase from 35.7 per cent of GDP in the current fiscal year to 39.2 per cent of GDP in 2015/16, and then to decline in subsequent years.

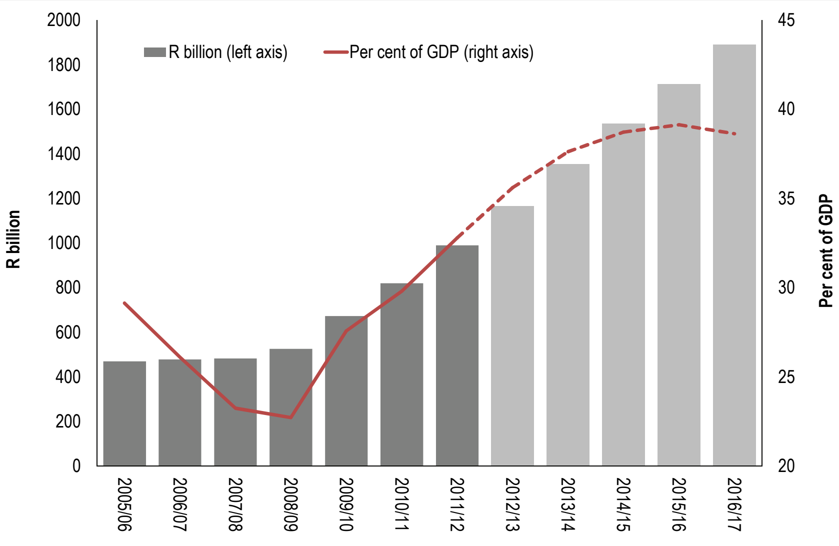
To rebuild fiscal space, government must stabilise debt

Arresting the growth in debt will require a significant reduction in the primary deficit – the amount by which non-interest spending exceeds revenue. In combination, slower spending growth and a recovery in revenue will narrow the primary deficit from 2.1 per cent of GDP in 2012/13 to 0.4 per cent in 2015/16, resulting in the stabilisation of debt. The reduction of the debt-to-GDP ratio thereafter will require government to maintain a small primary surplus.

Despite the expected moderation of the budget deficit over the next few years, debt-service costs are projected to grow at an annual average of 8.9 per cent in nominal terms over the MTEF period. In the outer year it will cost government R114.8 billion to service the debt, draining resources that could be spent on productive investment and social priorities.

Debt-service costs continue to grow over the medium term, draining resources that could be spent on productive investment

Figure 3.2 Stock of government debt, 2005/06 – 2016/17



Source: National Treasury

Government's debt management strategies will continue to support fiscal sustainability by meeting financing requirements at the lowest possible cost and within prudent levels of risk.

Improving outcomes and shifting the composition of spending

Government remains committed to improving the quality of spending – by eliminating waste, inefficiency and corruption – and ensuring that public resources are used to greater effect.

Efforts to shift the composition of expenditure have begun to yield results

Last year's MTBPS emphasised the need to shift the composition of spending in favour of the creation of social and economic assets. This process has begun. Over the MTEF period, real growth in compensation of employees will average 1.3 per cent, while capital payments will grow at 4.3 per cent.

The wage agreement reached this year between government and public-sector unions was higher than projected in the 2012 Budget. Over the medium term the cost of the agreement is R37.5 billion, absorbing a large share of additional allocations made available through reprioritisation. Over the period ahead, government will take a more deliberate approach to managing overall employment and wage trends across the public sector, including state-owned entities. In particular, government will curtail unwarranted growth in personnel numbers.

The pace of public infrastructure spending has picked up over the past 12 months and government remains committed to sustaining this improvement. While the bulk of infrastructure spending is financed from the balance sheets of state-owned companies, the fiscus funds the provision of social infrastructure, delivered primarily through provinces and municipalities. The main challenge is to ensure that budget allocations are spent – and spent efficiently.

Government will step up efforts to combat waste, inefficiency and corruption

In preparing their medium-term plans, departments have been required to reprioritise spending away from underperforming programmes and identify savings within existing budgets. Over the next several years government will also step up its efforts to combat waste, inefficiency and corruption. These measures will include:

- Reforms to procurement systems that prioritise value for money and introducing centralised procurement where warranted. These initiatives will be led by a chief procurement officer in the National Treasury.
- Introducing safeguards such as reviews by the Auditor-General and the Parliamentary Standing Committee on Public Accounts for tenders above a certain amount.
- Assigning authority and improving capacity within the National Treasury to investigate the value for money associated with tenders.
- Strengthening the anti-corruption system by providing additional resources to agencies such as the Office of the Public Protector, the Anti-Corruption Task Team and others.
- Instituting a series of detailed expenditure reviews to consider the outcomes that are achieved from the use of public finances.

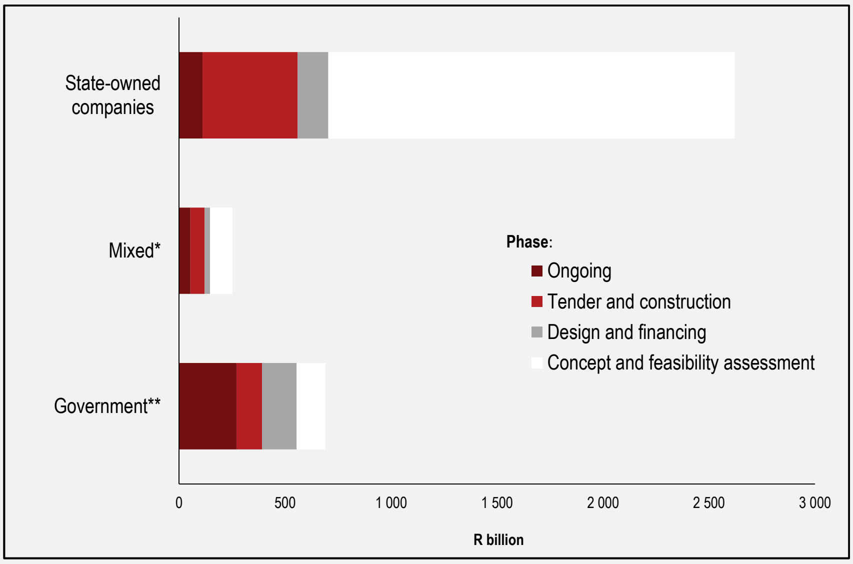
Public-sector infrastructure investment and the budget

During the State of the Nation Address the President announced an ambitious infrastructure programme. The 2012 *Budget Review* provided further details of the programme, which is initially costed at R3.2 trillion over 20 years. The bulk of this spending will be financed from the balance sheets of state-owned enterprises, either from retained earnings or through the issue of debt. The costs of this infrastructure, which supports profitable economic activity, will be recovered by charges levied on users.

The *Budget Review* identified R690 billion worth of projects at various stages of development to be financed from the fiscus over the next decade. These initiatives include the majority of the envisaged social and community infrastructure projects such as schools, health facilities and secondary roads. The bulk of this infrastructure will be provided to citizens without direct charge or at highly subsidised rates.

Over the next three years, budgeted capital allocations amounting to R250 billion will finance those projects that are "shovel ready". These funds need to be spent – and spent effectively. Other investments are under consideration and, following rigorous feasibility assessments, cost-effective projects that provide optimal long-term benefits will be eligible for support from the fiscus.

Major infrastructure projects by phase and implementing agent



Source: National Treasury

** Mixed means financed jointly by state-owned companies and government*
*** Government includes national, provincial and local government infrastructure projects financed from the budget*

Long-term fiscal objectives

Beyond the medium term, government intends to reduce the structural deficit, and restore and maintain a primary surplus. This will ensure that spending is financed mainly by revenue, and create the fiscal space to respond to future variations in the business cycle and external shocks.

Forthcoming fiscal report to assess sustainability of long-term spending options

The National Treasury is preparing a long-term fiscal report that assesses the sustainability of spending options in light of demographic and economic projections. This includes growth projections for different age cohorts and how this will affect public spending over time. Given the uncertainty of economic projections that stretch over several decades, the report will also consider the limits to expenditure in low, medium and high-economic growth scenarios.

Demographic trends may reduce pressure on fiscus

Unlike many developed economies, the effects of population ageing will not begin to fully exert pressure on the South African fiscus for several decades. Population growth is already slowing and the growth rates of key demographic cohorts, such as those eligible for *child support grants*, are moderating or declining. This implies reduced pressure on the fiscus from social grants over the next two decades. Similarly, the school-age population is beginning to fall, underscoring the need to improve the quality of education rather than increase the quantity of resources available.

Long-term fiscal report to model impact of various policy considerations

The long-term fiscal report will model the impact of a variety of policy changes, including the introduction of national health insurance and proposals contained in the National Development Plan. Increased structural spending will require significantly accelerated economic growth, unless it is financed by a concomitant increase in structural revenue. The report aims to inform policy debate and make explicit the implications of new initiatives. Preliminary observations will be published in November, and the full report will be issued early in 2013 to include data from the 2011 census.

Fiscal framework

The fiscal framework is presented in Table 3.2. Owing to weaker economic conditions, anticipated tax revenue for 2012/13 has been revised downwards, leading to a higher-than-projected consolidated budget deficit in the current fiscal year. The deficit narrows gradually towards 3.1 per cent of GDP in 2015/16.

Table 3.2 Consolidated fiscal framework, 2010/11 – 2015/16

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
R billion / percentage of GDP	Outcome		Estimate	Medium-term estimates		
Revenue	**757.4**	**837.0**	**900.6**	**986.1**	**1 092.1**	**1 205.0**
	27.5%	*27.7%*	*27.5%*	*27.5%*	*27.6%*	*27.6%*
Expenditure	**874.4**	**964.4**	**1 057.1**	**1 147.4**	**1 238.1**	**1 339.0**
	31.8%	*32.0%*	*32.3%*	*32.0%*	*31.3%*	*30.7%*
Non-interest expenditure	808.2	887.9	968.3	1 048.8	1 131.3	1 224.2
	29.4%	*29.4%*	*29.6%*	*29.2%*	*28.6%*	*28.0%*
State debt cost	66.2	76.5	88.8	98.6	106.8	114.8
	2.4%	*2.5%*	*2.7%*	*2.7%*	*2.7%*	*2.6%*
Budget balance	**-117.0**	**-127.4**	**-156.5**	**-161.3**	**-146.0**	**-134.0**
	-4.3%	*-4.2%*	*-4.8%*	*-4.5%*	*-3.7%*	*-3.1%*
Primary balance (percentage of GDP)	*-1.8%*	*-1.7%*	*-2.1%*	*-1.7%*	*-1.0%*	*-0.4%*

Revenue is expected to grow in line with the economic forecast presented in Chapter 2, remaining at about 27.5 per cent of GDP. Real growth of non-interest expenditure is projected to average 2.9 per cent per year over the MTEF period, below the pace of economic growth, which will enable a gradual reduction in the ratio of expenditure to GDP as the economy recovers. The primary balance is expected to narrow towards 0.4 per cent of GDP, stabilising the growth of debt. Nevertheless, debt-service costs will continue to outpace the overall growth of expenditure.

Revenue outlook

Tax revenue is revised downwards by R5 billion in current year

Given projected weakness in the economic environment, tax revenue is revised downwards by R5 billion in the current year. This still implies a robust nominal growth rate of 10.6 per cent over the previous year. If economic conditions deteriorate or mining sector output is disrupted over an extended period, further downward revision may be warranted.

Table 3.3 Total tax and budget revenue, 2011/12 – 2013/14

R million	2011/12 Outcome	2012/13 Budget	Revised Estimates	Difference	2013/14
Persons and individuals	250 389	285 970	282 000	-3 970	312 450
Companies	151 563	167 839	166 100	-1 739	185 322
Value-added tax	191 014	209 675	212 000	2 325	233 620
Secondary tax on companies/ dividend withholding tax	21 965	19 050	18 800	-250	20 980
Specific excise duties	25 450	28 772	28 500	-272	29 410
Fuel levy	36 589	42 776	41 000	-1 776	42 310
Custom duties	34 173	36 160	38 000	1 840	39 550
Other	31 508	36 160	35 001	-1 159	37 749
Total tax revenue	**742 651**	**826 401**	**821 401**	**-5 000**	**901 392**
Non tax revenue	19 193	15 091	15 183	92	16 597
of which mineral royalties	*5 612*	*6 510*	*5 900*	*-610*	*6 490*
Estimate of SACU payments[1]	-21 760	-42 151	-42 151	–	-43 700
Provinces, social security and selected public entities	96 922	105 489	106 204	714	113 284
Repayment of Gautrain loan[2]	–	–	–	–	-1 521
Total budget revenue	**837 007**	**904 830**	**900 637**	**-4 194**	**986 052**

1. *Estimates are based on National Treasury projections. Actual payments will be determined by outcomes of customs and excise revenue collections in line with the SACU agreement*
2. *Netting of repayment of Gautrain loan included in non tax revenue*

Personal and corporate income tax revenue for first half of 2012/13 adjusted downwards; VAT and customs duties revenue revised upwards

In line with performance during the first half of 2012/13, the estimated personal and corporate income tax revenue collections for the year have been adjusted downwards, and value-added tax (VAT) and customs duties collections have been revised upwards. Mineral and petroleum royalties have also been revised downwards due to lower commodity prices and mining strikes. Revenues from import-related taxes, such as customs duties and VAT on imports have performed strongly. Gross tax revenue collection is expected to remain subdued next year, but should improve during the outer years of the MTEF period as economic conditions strengthen.

Government debt and public-sector borrowing

The main budget borrowing requirement is projected to increase from R165.5 billion in 2012/13 to R173.7 billion in 2013/14, before declining to R151.5 billion in 2015/16. Government debt, as shown in Table 3.4, is expected to peak at 39.2 per cent of GDP in 2015/16.

Table 3.4 Total national government debt, 2009/10 – 2015/16

As at 31 March	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
R billion		Outcome		Estimate		Medium-term estimates	
Total gross loan debt	**805.0**	**990.6**	**1 187.8**	**1 351.9**	**1 522.1**	**1 690.5**	**1 864.4**
Total net loan debt	**673.1**	**820.4**	**989.7**	**1 166.0**	**1 352.8**	**1 535.6**	**1 709.9**
As percentage of GDP:							
Total gross loan debt	33.0%	36.0%	39.4%	41.3%	42.4%	42.7%	42.7%
Total net loan debt	27.6%	29.8%	32.8%	35.7%	37.7%	38.8%	39.2%
Foreign debt as percentage of:							
Gross loan debt	12.4%	9.9%	9.8%	8.5%	6.9%	6.4%	6.2%
Net loan debt	11.0%	4.8%	5.0%	3.5%	3.5%	3.3%	3.4%

See National Treasury website for further detail on government debt

Table 3.5 Main budget net borrowing requirement and financing, 2011/12 – 2015/16

	2011/12	2012/13		2013/14	2014/15	2015/16
R million	Outcome	Budget	Revised		Medium-term estimates	
Main budget balance	**-147 962**	**-170 025**	**-173 031**	**-177 292**	**-165 776**	**-154 747**
Extraordinary receipts and payments	3 821	1 176	7 498	3 550	3 300	3 200
Borrowing requirement (-)	**-144 141**	**-168 849**	**-165 533**	**-173 742**	**-162 476**	**-151 547**
Domestic short-term loans (net)	18 725	22 000	22 000	23 000	22 000	21 000
Domestic long-term loans (net)	138 501	119 998	126 319	135 923	118 275	117 115
Foreign loans (net)	9 135	-7 492	-7 114	-3 553	3 701	9 044
Change in cash and other balances[1]	-22 219	34 343	24 328	18 372	18 500	4 388
Financing	**144 141**	**168 849**	**165 533**	**173 742**	**162 476**	**151 547**

1. A positive change indicates a decrease in cash balances
See National Treasury website for further detail on net borrowing and financing

Domestic debt market will remain the main source of funding

The domestic market will remain the main source of funding. Debt issuance in the domestic market will be maintained at sustainable levels. This will be achieved by drawing on cash balances, exchanging debt maturing within the next several years for longer-dated debt and borrowing in global capital markets to finance part of South Africa's foreign currency commitments.

The public sector borrowing requirement remains at 7.1 per cent of GDP, as reported in the 2012 *Budget Review*, and is expected to moderate over the medium term.

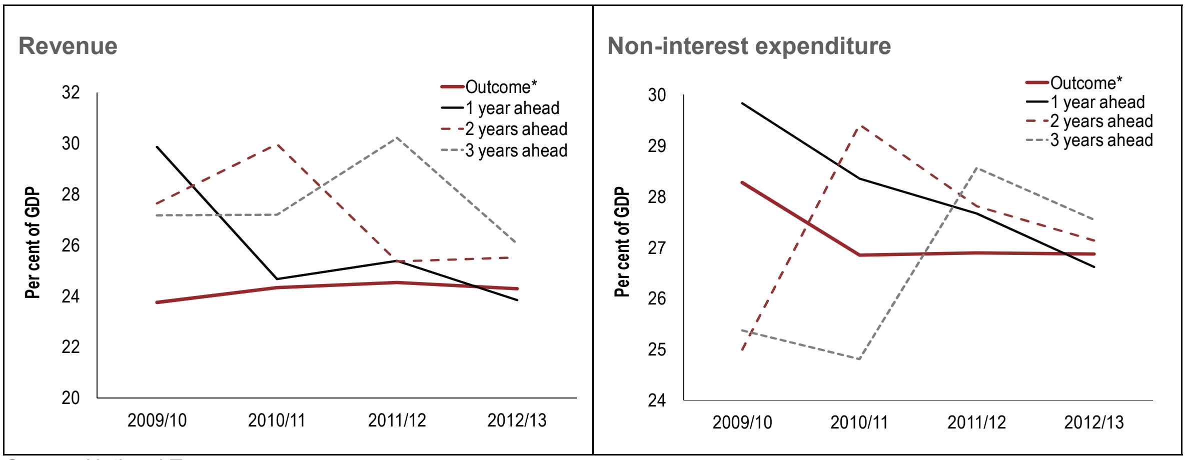
Fiscal performance and risks

Budgeting should be understood as part of a three-year framework

The MTEF requires the publication of detailed three-year spending plans that give substance to government's priorities. Containing expenditure growth over the next three years while improving the quality of the public finances implies renewed emphasis on medium-term planning.

Figure 3.3 contrasts the budget outcomes with the National Treasury's MTBPS estimates in the three years prior to those outcomes. Revenue forecasts have generally been optimistic, with outcomes falling short of expectations. The revenue outcome for 2009/10, for instance, was well below the estimate made in the 2008 MTBPS. Since then, forecasts have been closer to the mark, but revenue has continued to underperform as a result of the weakness of the economic recovery.

Figure 3.3 Forward estimates compared with budget outcomes, 2009/10 – 2012/13



Source: National Treasury
** For 2012/13 the outcome reflects the revised in-year estimate*

Alignment with budgeted expenditure estimates has improved over the past few years

Over the past two years spending has been below MTEF estimates. This is in contrast to the general pattern in the decade prior to the recession, where spending outcomes were often greater than MTEF estimates as a result of significant additions to planned spending in each successive budget. More recently, alignment with budgeted estimates has improved, and outcomes correspond more closely to the planned expenditure.

Main risk to fiscal framework is related to economic performance

In summary, higher-than-anticipated budget deficits have been the result of a weak recovery in tax revenue, rather than uncontrolled increases in non-interest spending. The main risk to the fiscal framework over the forecast period is related to economic performance. If GDP growth does not match expectations, revenue will fall short of current forecasts, implying the need for policy shifts to achieve the targets in the fiscal framework. An appropriate balance between spending restraint and new revenue initiatives would be necessary, taking into account the need to limit the potential impact on growth, employment and equity.

Government remains vigilant on contingent liabilities

Outstanding guarantees and other contingent liabilities remain within prudent levels, but do represent potential risks, especially in an environment of economic weakness. State-owned entities need to operate in a prudent, accountable manner and borrow on the strength of their balance sheets. Cost recovery from user charges is essential to ensure the sustainability of long-term financial commitments associated with capital investment in infrastructure. From time to time, additional support may be necessary and government may issue guarantees with strict conditions. The National Treasury continually monitors contingent liabilities to ensure the health of the fiscus.

The risk of further sovereign rating downgrades needs to be considered. Although the impact of recent rating actions on the yield on government debt has been very limited, further downgrades would raise the cost of borrowing.

The three-year wage settlement between government and public-sector trade unions provides a stable medium-term basis for planning. The contingency reserve, which enables government to absorb such risks, is somewhat lower in the first two years of the proposed fiscal framework.

Conclusion

Stabilisation of spending growth will continue as government works to rebuild fiscal space

South Africa's fiscal policy framework is based on the principles of countercyclicality, debt sustainability and intergenerational equity. The stabilisation in the growth of spending achieved over the last three years will continue over the medium term as fiscal space is rebuilt. While the prospects of achieving government's fiscal objectives remain good, there are risks to these projections. As the context changes over the medium term, government will realign its policy stance, firmly grounded in a sustainable budget structure that promotes growth, equity and employment.