1

Sustaining investment and safeguarding the public finances

The Constitution requires government to act within its available resources to progressively realise fundamental social and economic rights. Over the past decade, government spending has doubled in real terms, funding a large expansion of the social wage and capital budgets. These investments, alongside political change, have transformed South Africa.

A decade of rapid expansion in public budgets was supported first by strong economic growth, and then by using the fiscal space that had been built up to stimulate the economy as the global crisis took hold.

Today, South Africa faces a difficult economic environment. The consumption-led, debt-financed economic growth of recent years has reached its limits, and growth has slowed. The growth rate is set to improve over the next several years as new energy and transport investments start to operate, exports increase and investment recovers. Yet weak economic performance has put a great deal of pressure on the fiscus, with revenue insufficient to cover expenditure. The budget deficit is high, debt levels have approached the limits of sustainability and the economy is vulnerable to global volatility.

Government therefore proposes a package of fiscal measures to re-establish a sustainable foundation for the public finances, and to build a platform for investment-led growth in the future. The proposals include a lower spending ceiling, reduced government consumption expenditure and increases in revenue. The most important public spending programmes – those that help poor South Africans – will remain in place and will be protected from inflation.

These proposals are necessary to sustain social progress and to improve the lives of all South Africans.

Introduction

The 2014 *Medium Term Budget Policy Statement* signals a shift in fiscal policy. Government proposes a series of measures to reduce the budget deficit and stabilise public debt. These steps are necessary to ensure the sustainability of South Africa's most important public spending programmes in a weaker economic environment. The proposals complement reforms under way to moderate consumption, boost savings and expand productive investment.

A sustainable foundation for the public finances can open the way for investment-led growth

In a mixed economy, the burden of development cannot be carried by the fiscus alone

In promoting these objectives, two challenges stand out over the next several years. The first is to encourage greater private-sector investment in the economy. Private investment has remained subdued since the opening of the global financial crisis in 2008, and this is reflected in economic performance. In a mixed economy, vibrant markets and private investment complement public action to improve people's lives and sustain progress. The burden of development cannot be carried by the fiscus alone. Removing obstacles to private investment must be a priority for government at all levels.

The second challenge is to improve the state's capacity to plan, manage and maintain its programmes and infrastructure. Recent supply failures in electricity, water and postal services, for example, hurt the economy and wear down public confidence. Greater state capacity and efficiency are prerequisites for more rapid development.

MTSF sets out five-year roadmap to tackle urgent challenges as part of long-term development plan

Government's medium-term strategic framework (MTSF) for the period 2014-2019 provides a roadmap to address these challenges. It is the first five-year policy framework designed in sync with the 2030 vision of the National Development Plan. The MTSF aims to improve policy coherence, alignment and coordination across government. It highlights the need for partnerships between a capable developmental state, a thriving business sector and a strong civil society. It identifies employment, education and enhancing the capacity of the state as core policy objectives.

MTSF priorities for structural reform over the period ahead include:

- Building the capacity of the public sector, particularly at local government level, through the "back-to-basics" approach, focused on improving service delivery, accountability and financial management.
- Reshaping South Africa's urban environment through integrated spatial planning and an expansion of the municipal debt market.
- Improving the quality of the education system, starting with greater attention to human resources management and annual assessment of learners to benchmark progress.
- Enhancing dispute-resolution mechanisms in industrial relations.
- Strengthening competition policy.
- Enacting immigration reform to enable people with skills to work in South Africa more easily.

As the MTSF points out, achieving a higher developmental trajectory and building a more equitable society will require a strong social compact. Government, business and labour need to work together to improve public services, revive investment and avoid lengthy production stoppages.

Towards faster economic growth

GDP growth forecast to improve as infrastructure constraints ease and private investment recovers

South Africa's economic performance has deteriorated over the past several years. Gross domestic product (GDP) growth of 1.4 per cent is estimated in 2014, down from 3.6 per cent in 2011. GDP growth is forecast to improve over the medium term as infrastructure constraints ease, private investment recovers and exports grow. However, recent trends have led to understandable concern about the country's growth prospects.

Table 1.1 Macroeconomic projections, 2013 – 2017

Calendar year	2013 Actual	2014 Estimate	2015	2016 Forecast	2017
Percentage change unless otherwise indicated					
Final household consumption	2.6	1.9	2.3	2.8	3.0
Gross fixed capital formation	4.7	2.7	3.6	4.7	5.1
Real GDP growth	**1.9**	**1.4**	**2.5**	**2.8**	**3.0**
CPI inflation	5.8	6.3	5.9	5.6	5.4
Current account balance (% of GDP)	-5.8	-5.6	-5.4	-5.2	-5.0

Source: Reserve Bank and National Treasury

Faster economic growth is both a key objective of the National Development Plan and a necessary condition to raise the resources needed to fund the country's social and economic transformation. The plan targets 5 per cent annual GDP growth as the minimum requirement to create employment, overcome poverty and reduce inequality. It seeks to achieve this through significant investment in South Africa's people and infrastructure over an extended period.

South Africa needs higher investment, reduced consumption and growing exports

The approach to macroeconomic policy outlined in the MTSF and the National Development Plan can be summed up as follows:

- Sustaining high levels of public investment and increasing private investment.
- Reducing consumption so that a greater share of investment can be financed from domestic savings.
- Supporting rapid growth in exports, and maintaining a competitive real exchange rate to boost economic output and job creation.

Sustaining public-sector infrastructure investment

Completion of energy, transport and logistics projects will boost growth potential

Investment has risen to nearly 20 per cent of GDP. This trend has been supported by the sustained expansion of public infrastructure spending. The completion of major energy, transport and logistics projects over the medium term will boost the growth potential of the economy.

But high levels of consumption and poor growth outcomes have seen domestic savings lag behind. Government consumption contributes to a persistent deficit on the current account, which reached 6.2 per cent of GDP in the second quarter of this year. This makes South Africa over-reliant on foreign savings and vulnerable to shifts in global sentiment.

Two things are required to sustain high levels of public-sector capital investment. First, government needs to moderate its consumption spending, which accounts for 56 per cent of consolidated non-interest expenditure in 2014/15. Moderating consumption will create fiscal space to sustain investment and reduce reliance on foreign savings. Second, greater space must be created for partnerships that draw private capital into public-sector infrastructure projects. Initiatives such as the independent power producer programme will grow in the years ahead, and will promote greater confidence in private investment in the broader economy.

Support for state-owned companies will depend on sound business plans

Most major economic infrastructure investments are financed on the balance sheets of state-owned companies. Over the next two years, financial support provided to these companies, including capital injections for Eskom, will be provided in a manner that does not affect the budget balance. Where government agrees that resources are required to firm up balance sheets, funds will be raised through the disposal of non-strategic assets held by the state, or from private investors. Support will depend on state-owned firms making a sound and sustainable business case, and strengthening internal governance.

Supporting Eskom to ensure electricity supply

A strong, sustainable electricity generation sector is necessary for the economy to grow more rapidly. Over the medium term, significant improvements to the reliability and performance of the distribution, transmission and generation system are being made, and additional power is being procured.

Government's financial support to Eskom will take several forms:

- A direct allocation to the utility of at least R20 billion, raised through the sale of non-strategic state assets. This will have no impact on the budget deficit; funds will be appropriated as they are realised.
- National government will work with municipalities to ensure that the equitable share is targeted to help poor households cope with increased electricity tariffs.
- Eskom's additional borrowing, expected to be about R50 billion over the medium term, will be accommodated within the existing guarantee facility. No new guarantees will be issued.

In the short term, greater priority will be given to cogeneration to relieve pressure on the grid. The successful execution of maintenance and refurbishment plans, timely completion of power stations under construction and the transition to a more efficient business backed by cost-reflective tariffs are needed to secure and sustain electricity supply. Government will closely monitor Eskom's financial position and, if necessary, could consider providing additional support to the utility by converting its existing subordinated loan to equity. Steps will also be taken to expand private investment in electricity.

The energy policy white paper sets a target of 30 per cent private-sector participation in electricity generation. Opportunities for independent power producers are being expanded to include other generation technologies, drawing private capital and expertise into meeting the country's energy needs.

Reviving investment in cities

Policy seeks to reshape urban landscape, renewing investment in affordable housing

Public policy seeks to reshape the urban landscape, and revive investment in affordable housing in partnership with the private sector. Improved spatial planning will help transform South Africa's urban spaces, encouraging greater integration of housing, employment and trade.

South Africa's large municipalities require massive investment to stimulate growth, maintain infrastructure and ensure that basic services are provided for growing populations. Over the next three years, government will roll out a new approach to local government infrastructure financing. Incentives will encourage large urban municipalities to promote more compact, efficient and equitable cities. Planning will focus on developing mixed-use precincts that can help to catalyse economic activity, and on upgrading informal settlements.

Reforms to grants will improve the uptake of available resources for social infrastructure. National government will work with municipalities to expand their direct contributions to investment, and the grant system will allow for more flexibility in the design of locally appropriate solutions. Greater integration between the capital investment plans of state-owned companies and city development strategies will be encouraged.

Lenders will be encouraged to expand debt-finance market for municipal infrastructure

Government will also work with private investors and development finance institutions to expand debt financing for municipal infrastructure. The Development Bank of Southern Africa is examining ways to encourage greater private investment in the municipal infrastructure market through infrastructure bonds, municipal bond underwriting, project finance and various contracting models. Any new initiatives will complement the Bank's own loan disbursements, which currently total R17.8 billion over the next three years. These initiatives will aim to improve liquidity and extend maturities in the municipal bond market – and to encourage, rather than crowd out, private investment.

Sustaining public expenditure

Fiscal consolidation can no longer be postponed. Ensuring continued progress towards a better life obliges government to safeguard the public finances by acting within fiscal limits that can be sustained over the long term. To do otherwise would risk exposing the country to a debt trap, with damaging consequences for development for many years to come.

Postponing fiscal consolidation could expose South Africa to a debt trap

Over the last five years, expansionary policies cushioned South Africa from the effect of the global crisis. Public debt is now approaching the limits of sustainability. Debt-service payments consume a growing share of the national budget, narrowing the space to expand public services and investment. Sustaining deficits while the economy is unresponsive can worsen the current account deficit, push up inflation and interest rates, and reduce the competitiveness of the currency. Over time, these conditions undermine growth and employment.

Table 1.2 Consolidated government fiscal framework, 2013/14 – 2017/18

	2013/14	2014/15	2015/16	2016/17	2017/18
R billion/Percentage of GDP	Outcome	Revised	Medium-term estimates		
Revenue	**1 012.7**	**1 093.9**	**1 199.5**	**1 323.0**	**1 434.6**
	29.4%	*29.5%*	*29.7%*	*30.2%*	*30.0%*
Expenditure	**1 147.4**	**1 247.1**	**1 344.0**	**1 437.1**	**1 553.4**
	33.3%	*33.6%*	*33.3%*	*32.8%*	*32.5%*
Budget balance	**-134.7**	**-153.2**	**-144.5**	**-114.1**	**-118.7**
	-3.9%	*-4.1%*	*-3.6%*	*-2.6%*	*-2.5%*
Total net loan debt	**1 379.5**	**1 588.8**	**1 799.1**	**1 989.7**	**2 192.1**
	40.0%	*42.8%*	*44.6%*	*45.4%*	*45.9%*

Source: National Treasury

Table 1.3 Division of revenue, 2014/15 – 2017/18

R billion	2014/15 Revised	2015/16	2016/17	2017/18	Average annual growth 2014/15 – 2017/18
		Medium-term estimates			
National allocations	494.7	523.1	553.2	585.0	5.7%
Provincial allocations	440.2	468.5	496.8	527.0	6.2%
Equitable share	*360.2*	*383.0*	*405.6*	*429.3*	*6.0%*
Conditional grants	*80.0*	*85.4*	*91.2*	*97.7*	*6.9%*
Local government allocations	91.1	99.2	103.9	110.0	6.5%
Total allocations	**1 026.0**	**1 090.8**	**1 153.9**	**1 222.0**	**6.0%**

Source: National Treasury

Spending and revenue measures

Proposals enable government to remain broadly in line with deficit path announced in 2014 Budget

Restoring sustainability to the fiscus while protecting core social and economic programmes requires a combination of spending and revenue adjustments over the next two years. Moderating expenditure growth, combined with tax measures to increase revenue, will improve the fiscal position by R22 billion in 2015/16 and R30 billion in 2016/17. This approach will enable government to remain broadly in line with the deficit path announced in the 2014 Budget, stabilising public debt despite weaker economic growth.

Proposed reductions to planned expenditure ceilings will be targeted to avoid cuts in front-line service delivery. Budgets for non-essential goods and services will be frozen, resulting in substantial savings over the next two years. For example, across national departments, planned expenditure on travel and subsistence has been cut by R555 million. Advertising and communications budgets have been reduced by R240 million. Lower spending on consultants will generate savings of R370 million, while spending on venues and catering will be R150 million lower than previously planned. Building on the cost-containment guidelines, government at all levels will need to identify opportunities to increase efficiency and reduce waste.

Restraint in growth of government's wage bill is needed to ensure fiscal rebalancing

Restraining the growth of government's wage bill is an important aspect of this rebalancing. Wage settlements should protect workers' purchasing power, with any upward adjustments matched by productivity improvements. If increases in public-sector wages significantly outpace inflation, government will be forced to curtail service delivery – either by reducing social spending or capital budgets, or by trimming staff numbers.

Over the period ahead, government will approach budgeting with a greater focus on the scope and quality of long-term expenditure planning. Indicative allocations in the third year of the framework have been restrained. A comprehensive assessment will examine baseline estimates for the outer year, emphasising value for money and alignment with longer-term policy priorities. Pending the outcome of this assessment, significant resources are left unallocated in the third year of the framework. These funds are intended to serve as a buffer against fiscal and economic shocks; a portion may also be held back to finance high-impact programmes aligned with core MTSF objectives.

Tax proposals will take into account implications for economic growth and job creation

The recommendations of the Davis Tax Committee will inform proposals that will be tabled with the 2015 Budget in February. Government's proposals will balance several policy objectives. These include enhancing the progressive character of the fiscal system, improving tax efficiency and realising a structural improvement in revenue. The short- and long-term implications for economic growth and job creation will be a key consideration.

By acting now to re-establish a sustainable foundation for the public finances, government can rebuild fiscal space in the years ahead. From this more stable base, the expansion of social budgets and public investment can proceed in line with long-term economic growth.

Government acknowledges that the proposed measures may have a dampening effect on economic growth in the short term, but they are essential to sustain investment and revive growth over the longer term. In combination with structural reforms already under way, restoring fiscal stability can open a new period of investment-led economic growth.

Improving government services and delivery

Massive expansion of national budget over past 10 years has funded large growth in social wage

The resources available in the national budget have increased from R378.2 billion in 2004/05 to R1.136 trillion in 2014/15. Increased public spending has funded a large expansion of the social wage, rising public-sector salaries and increased capital budgets. Government remains committed to maintaining the value of core social expenditure programmes while sustainably increasing capital investment.

Budgets for health, education and social grants will keep pace with inflation over the medium term. Allocations to employment programmes, technical training and skills development, as well as housing and social infrastructure, will continue to grow in real terms.

Most priorities of the five-year MTSF are financed within the three-year medium-term expenditure framework (MTEF). Where funds are needed to expand programmes or to introduce new ones, savings must be sourced from within baselines, or implementation will have to be phased in more gradually.

Better alignment and coordination can improve programme effectiveness

Better alignment and coordination across government has the potential to improve programme effectiveness without requiring additional funds. Accordingly, over the medium term, national budgets will emphasise:

- Improving the use of public resources and identifying savings to finance policy priorities without affecting service delivery.
- Restructuring the way departments and agencies work together to eliminate inefficient resource allocation and overlapping mandates.
- Reinforcing cost-containment. The 2015 Budget will pay particular attention to reducing line items that are not critical for service delivery or that do not support MTSF objectives.

In addition, government will encourage expanded partnerships between public agencies, or with the private sector, where such initiatives can bring about more efficient outcomes.

Combating corruption

Efforts to improve value for each rand spent will include strengthened measures to identify, prevent and combat corruption in both the public and private sectors. Government's anti-corruption task team has been investigating 169 criminal cases involving 945 individuals. By September of this year, these investigations had led to 54 convictions, with R1.8 million in assets frozen and R105 million in assets forfeited.

South Africa has the benefit of world-class audit and accounting institutions. Financial accounting and control systems are being strengthened, resulting in improved reporting of unauthorised, irregular or wasteful spending. Effective responses will distinguish between technical infractions and illegal activity.

Nationally negotiated contracts to be expanded over next three years

Establishing centralised oversight of public procurement will improve efforts to root out tender fraud. Over the next three years, the Office of the Chief Procurement Officer will build a foundation for more cost-effective operations in the public sector. The range and scope of nationally negotiated contracts will be expanded, a national price-referencing system will be introduced, and government will draw on private-sector expertise and best practice in procurement systems.

The fight against corruption also depends on an active citizenry, which the National Development Plan stresses is a precondition for South Africa to achieve its ambitious social and economic objectives.

Table 1.4 Consolidated government expenditure, 2014/15 – 2017/18

R billion	2014/15 Revised	2015/16 Medium-term estimates	2016/17	2017/18	Average annual growth 2014/15 – 2017/18
Basic education	188.0	201.5	212.8	226.1	6.3%
Health	145.5	154.6	163.8	175.1	6.4%
Defence, public order and safety	163.9	171.6	181.7	193.1	5.6%
Post-school education and training	53.3	59.5	64.7	68.1	8.5%
Economic affairs	195.0	202.4	217.7	227.2	5.2%
Local development and social infrastructure	176.4	199.6	208.8	221.5	7.9%
General public services	67.1	68.3	67.8	71.4	2.1%
Social protection	143.4	154.9	165.4	176.3	7.1%
Total expenditure by function	**1 132.6**	**1 212.4**	**1 282.6**	**1 358.7**	**6.3%**
Debt-service costs	114.5	126.5	139.4	149.7	9.3%
Unallocated reserves	–	5.0	15.0	45.0	
Total expenditure	**1 247.1**	**1 344.0**	**1 437.1**	**1 553.4**	**7.6%**

Source: National Treasury