3

Fiscal policy

In brief

- The consolidated budget deficit for 2016/17 is projected at 3.4 per cent of GDP, marginally higher than the 2016 Budget estimate of 3.2 per cent.
- A combination of the declining GDP growth rate and lower tax buoyancy has reduced the in-year tax estimate by R23 billion. The shortfall is offset by drawdowns on the contingency reserve, declared savings and projected underspending. As a result, the shortfall declines to about R11.5 billion, limiting its impact on the budget balance.
- Without policy adjustments, gross tax revenue is projected to fall short of February estimates by R36 billion in 2017/18 and R52 billion in 2018/19.
- The *Medium Term Budget Policy Statement* proposes R26 billion in reductions to the expenditure ceiling over the next two years. Proposed tax measures amount to R13 billion in 2017/18. Combined with higher taxes signalled in the 2016 Budget, total revenue increases amount to R43 billion over the next two years.
- These adjustments result in net national debt stabilising at 47.9 per cent of GDP in 2019/20.

Creating conditions for faster growth

Government proposes additional measures to contain budget deficit and reduce debt accumulation

To create the conditions for more rapid growth, fiscal policy aims to deliver a measured consolidation that avoids a sharp contraction in expenditure, continues to prioritise capital investment and stabilises national debt as a share of GDP. Government's efforts to reduce borrowing have been frustrated by consistent downward adjustments to growth and tax revenue. Slowing household consumption and falling private-sector investment reflect profound uncertainty about the global and domestic economic outlook. In the current environment, building confidence and ensuring a sustainable outlook for the public finances require additional fiscal consolidation – in other words, steps to contain the budget deficit and slow the pace of debt accumulation.

The consolidation measures proposed in this MTBPS are likely to have some dampening effect on economic activity. But over the medium term, a further loss of confidence and a ratings downgrade – which could prompt higher interest rates and large capital outflows – remain greater risks to the economy than the likely effects of fiscal consolidation.

Accordingly, government proposes:

- Reductions to the expenditure ceiling of R10 billion in 2017/18 and R16 billion in 2018/19.
- Tax measures to raise an additional R13 billion in 2017/18. Combined with the proposals announced in the 2016 Budget, this brings the total increase next year to R28 billion. Government will also propose measures to raise additional revenue of R15 billion in 2018/19.

Consolidated budget deficit expected to narrow from 3.4 per cent to 2.5 per cent of GDP in outer year

These measures are expected to reduce the consolidated budget deficit from 3.4 per cent of GDP in the current year to 2.5 per cent in 2019/20. Net national debt is expected to stabilise at 47.9 per cent of GDP in 2019/20, against a February projection of 46.2 per cent of GDP in 2017/18. Government will mitigate fiscal risk by protecting the expenditure ceiling, and limiting the likelihood that contingent liabilities will materialise. A detailed fiscal risk statement is published as an annexure to this MTBPS.

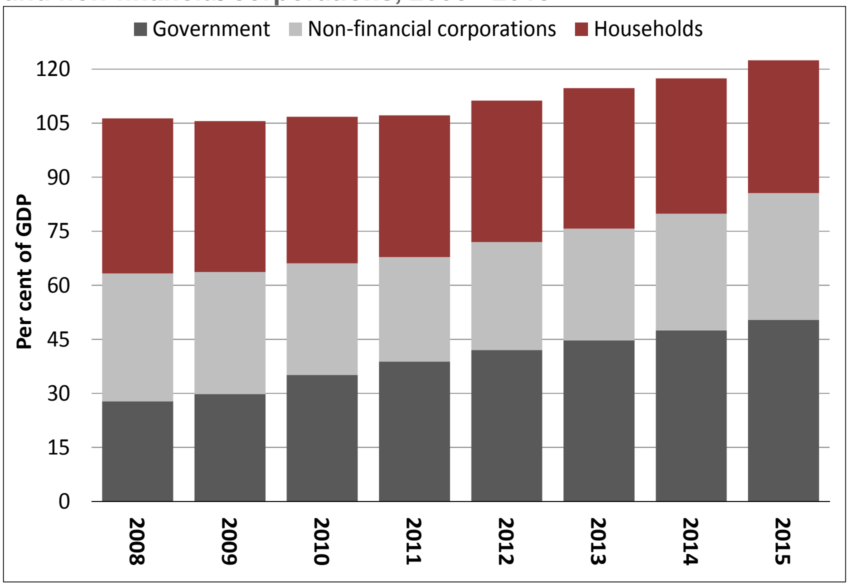
Fiscal policy, however, cannot act in isolation. Persistently low GDP growth reflects both global economic weakness and structural constraints in the domestic economy, as outlined in Chapter 2. Achieving faster, broad-based economic growth requires action to build confidence and encourage private-sector investment, alongside rapid implementation of structural reforms identified in the National Development Plan. Over time, faster economic growth will generate the revenue necessary for future expansion of public services. Improving GDP growth will also allow government to rebuild fiscal space.

Stabilising debt and encouraging investment

Reducing global debt overhang in a low-growth world is a major challenge

The October 2016 *IMF Fiscal Monitor* notes that global debt of governments, households and non-financial firms is at an all-time high. In many developed economies, banks are highly leveraged, while rising public debt has limited space for fiscal stimulus. Reducing the debt overhang in a world of lower growth is a major challenge.

Figure 3.1 Gross debt of South African government, households and non-financial corporations, 2008 - 2015



Source: Bank for International Settlements

In South Africa, government has borrowed to maintain core economic and social programmes, and respond to new spending pressures. State-owned companies have borrowed to fund capital investment. Corporate debt is relatively low, while cash balances are high by historical standards. The fiscal challenge is to stabilise government's debt-to-GDP ratio and create an environment that encourages private investment. Because government debt is the reference price for the rest of the economy, lower government bond yields will reduce borrowing costs across the economy.

Corporate debt is low, while cash balances are high

South Africa's current circumstances raise the possibility of a low-growth trap. In this scenario, government, facing the need to stabilise national debt, introduces consolidation measures that ultimately prove self-defeating. A tighter fiscal position reduces GDP growth, leading to lower revenue and higher deficits. This creates a dilemma. Aggressive fiscal consolidation may bolster investor and business confidence, but will likely add to the difficulties facing the economy. Taking no remedial action, however, may result in a ratings downgrade, higher interest rates and capital outflows, which could precipitate a recession. In either scenario, a slowing economy makes it more difficult to stabilise the debt-to-GDP ratio.

Slowing growth makes it difficult to stabilise debt-to-GDP ratio

A measured consolidation

Fiscal policy aims to deliver a measured consolidation that avoids a sharp contraction in expenditure, continues to prioritise capital investment, and stabilises national debt as a share of GDP. This will lay the foundation for more rapid economic growth in years ahead.

The MTBPS proposals are designed to narrow the deficit over the medium term, while allowing for real expenditure growth. As a share of GDP, spending remains unchanged, while tax revenue increases by 1.8 percentage points. The consolidation will stabilise the wage bill as a share of government spending. The current balance – the difference between current revenue and spending on compensation, goods and services, interest, and transfers and subsidies – moves further into surplus over the medium term. Over the same period, the capital financing requirement will remain broadly unchanged at about 3.7 per cent of GDP, financed in part by the current surplus.

MTBPS proposals designed to narrow deficit over medium term while allowing for real spending growth

Table 3.1 Announced consolidation measures, 2015/16 – 2018/19

R billion	2015/16	2016/17	2017/18	2018/19
2015 Budget Review				
Expenditure reductions	10	15	–	–
Revenue increases	17	–	–	–
2016 Budget Review				
Expenditure reductions	–	–	10	15
Revenue increases	–	18	15	15
2016 MTBPS				
Expenditure reductions	–	–	10	16
Revenue increases	–	–	13	–
Total				
Expenditure reductions	10	15	20	31
Revenue increases	17	18	28	15
Total	**27**	**33**	**48**	**46**

Source: National Treasury

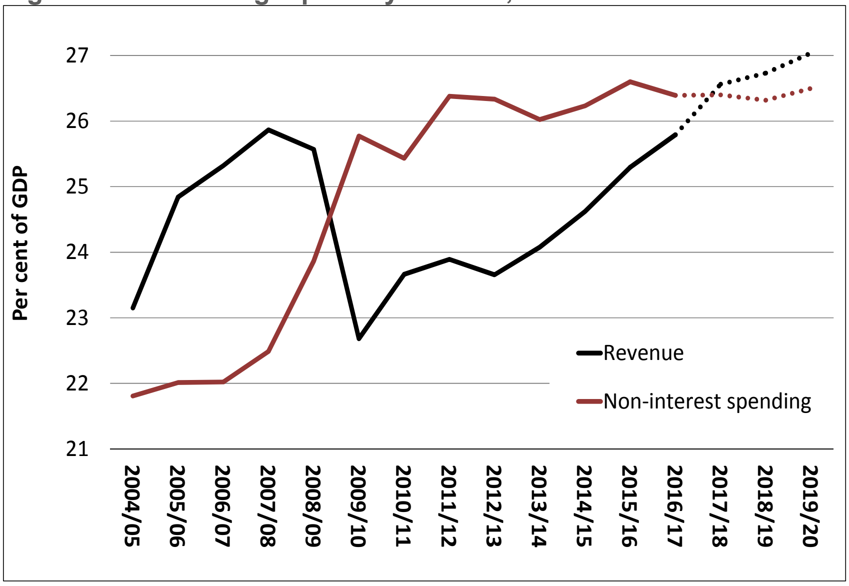
Table 3.2 Consolidated current and capital balances, 2015/16 – 2019/20

R billion/Percentage of GDP	2015/16 Outcome	2016/17 Estimate	2017/18	2018/19 Medium-term estimates	2019/20
Current balance	**0.3**	**7.9**	**23.7**	**49.5**	**73.5**
	0.0%	*0.2%*	*0.5%*	*1.0%*	*1.3%*
Capital borrowing requirement	**-164.3**	**-168.6**	**-176.0**	**-186.5**	**-199.5**
	-4.0%	*-3.8%*	*-3.7%*	*-3.7%*	*-3.6%*
Financial transactions	**11.7**	**10.3**	**11.2**	**8.8**	**7.0**
Contingency reserve	**–**	**–**	**6.0**	**10.0**	**20.0**
Budget balance	**-152.2**	**-150.5**	**-147.1**	**-138.2**	**-139.0**
	-3.7%	*-3.4%*	*-3.1%*	*-2.7%*	*-2.5%*

Source: National Treasury

The main budget deficit, which is equivalent to government's borrowing requirement, is set to stabilise at 3.2 per cent of GDP over the next three years. The deficit excluding interest payments – known as the primary balance – continues to narrow. Next year a primary surplus will be achieved, ensuring that government can meet its non-interest spending commitments without additional borrowing. Real main budget spending growth will increase from a low of 0.1 per cent in the current year to 2.6 per cent in 2019/20. Further details on the main budget are contained in the technical annexure.

Figure 3.2 Main budget primary balance,* 2004/05 – 2019/20



Excludes financial transactions

Source: National Treasury

Medium-term considerations

Low economic growth rates have delayed fiscal consolidation

Over the past four years, fiscal policy has adjusted to contain the budget deficit and limit debt accumulation. In 2012, government introduced expenditure ceilings. The 2015 and 2016 budgets set out a combination of spending reductions and tax increases. The ceilings have been effective: spending has remained stable as a share of GDP. At the same time, tax revenue has grown as a percentage of GDP, reflecting both policy measures and high tax buoyancy. Nevertheless, low economic growth rates have led to revenue shortfalls, delaying the consolidation.

Growth and revenue performance

The National Treasury's GDP growth projections have been revised down repeatedly, as shown in Table 3.3. Outer-year forecasts – on which fiscal consolidation depends – have proven overly optimistic.

Outer-year GDP forecasts have been overly optimistic

Table 3.3 Real GDP growth projections, 2015/16 – 2019/20

	2015/16	2016/17	2017/18	2018/19	2019/20
2014 Budget	3.3%	3.5%	–	–	–
2014 MTBPS	2.6%	2.9%	3.1%	–	–
2015 Budget	2.0%	2.6%	3.0%	–	–
2015 MTBPS	1.2%	2.1%	2.7%	2.8%	–
2016 Budget	0.9%	1.2%	1.9%	2.5%	–
Revised	**0.6%**	**1.0%**	**1.3%**	**2.1%**	**2.3%**

Source: National Treasury

In-year forecasts have also proven optimistic, but downward adjustments to growth have not translated into significant revenue shortfalls because tax buoyancy has remained high. In the current year, tax buoyancy has declined.

High revenue buoyancy under low-growth conditions

Revenue buoyancy describes the relationship between tax collection and economic growth.

Despite low GDP growth rates, tax buoyancy has averaged about 1.2 over the past five years. In other words, for every 1 per cent increase in nominal GDP, tax has grown by 1.2 per cent. Such high buoyancy levels are typically associated with periods of strong economic growth. Revenue collection will top 26 per cent of GDP in the current year – a level last observed during the mid-2000s.

The relatively strong growth in taxes is partly explained by economic factors: high wage settlements (particularly in the public sector), robust household consumption, asset price inflation, exchange rate depreciation, and resilient demand for imports. There have also been significant tax policy changes: less generous relief for the effects of inflation (fiscal drag), hikes in personal income tax rates, and strong growth in excise and fuel levies.

Gross tax revenue is projected to fall short of 2016 Budget projections by R23 billion in the current year, R36 billion in 2017/18, and R52 billion in 2018/19. This shortfall reflects:

- A sharp decline in year-on-year revenue growth in 2016/17. For the first half of the year, revenue grew by 7.4 per cent against an initial projection of 10.1 per cent. The forecast assumes a recovery in revenue growth in the second half, but the 2016/17 shortfall will feed through to the outer years of the framework.
- Downward revisions to economic growth and the tax bases. Relatively small revisions to nominal GDP obscure significant changes in its composition. As a result of these changes, the latest forecast shows significant reductions in major tax bases, including wages, household consumption and imports.

The additional tax measures proposed reduce the shortfall to R23 billion next year, and R38 billion in 2018/19. Compared with the past five years, the medium-term revenue outlook assumes lower buoyancies.

Tax measures reduce shortfall to R23 billion in 2017/18 and R38 billion in 2018/19

Changes to the management of government's foreign-currency investments will generate revenue that reduces the budget balance by R36 billion over the medium term. These changes are explained in the technical annexure.

Expenditure

Government has successfully maintained the expenditure ceiling for four consecutive years

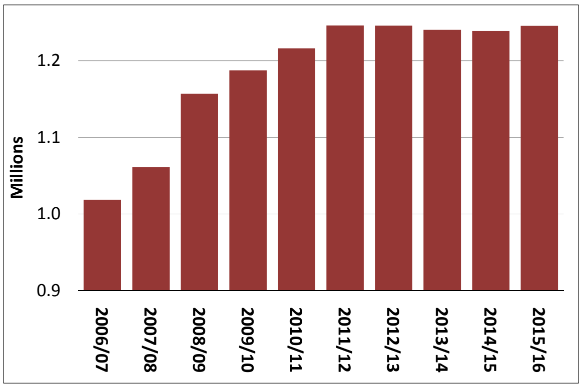
Government has successfully maintained the expenditure ceiling over the past four years. Spending pressures, including the carry-through effect of increased subsidies for university students, have been accommodated through the contingency reserve and reallocations from within baselines. Indicative allocations in the third year of the framework grow at 2.3 per cent above inflation, reflecting the intention to align spending with long-term economic growth.

Shifting the composition of spending towards capital investment would benefit the economy. Doing so, however, requires greater restraint in compensation spending. Constrained budgets have stabilised headcounts across the public sector. In functions such as health, education and policing, however, wages have grown at more than 2 per cent per year in real terms.

Aligning new wage agreement to inflation will ease pressure on headcounts

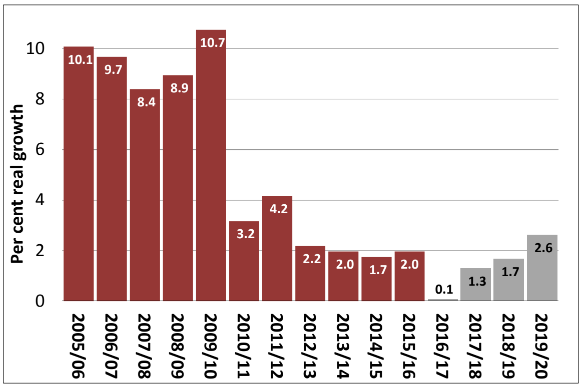
Medium-term projections show that to stay within budgets over the next three years, all national departments will have to moderate headcounts. This will be achieved through attrition, as staff who retire or leave employment will not be replaced. If the wage agreement to be negotiated in 2017/18 is aligned with inflation, however, a greater share of expenditure can be allocated to other spending priorities, and pressure on national headcounts will be reduced.

Figure 3.3 National and provincial employee headcount



Source: National Treasury (PERSAL)

Figure 3.4 Real growth of main budget non-interest spending*



** Excluding payments for financial assets. Deflated using CPI*
Source: National Treasury

Financing social infrastructure

Sustaining high levels of investment requires the state to tackle some evident problems in public infrastructure management, including lack of coordination, and weak planning and implementation capacity.

Government is considering the introduction of a financing facility for social infrastructure. It would fund large infrastructure projects, such as hospitals, that require national budget allocations. The facility would focus on projects with good social or economic returns, backed by independent project appraisal. It would include:

- A technical support unit, with expertise to appraise, recommend and monitor large projects.
- A financing facility that allocates resources to projects on development finance principles. This would be on government's balance sheet and fully integrated into the national budget system.
- The involvement of concessional lenders to provide funds and technical assistance.

This process will also clarify the requirements for public-private and public-public partnerships.

The fiscal framework

Table 3.4 summarises the consolidated fiscal framework. The consolidated deficit, which takes into account the budget balances of social security funds, public entities and provinces, is projected to narrow to 2.5 per cent over the medium term.

Consolidated deficit projected to narrow to 2.5 per cent of GDP over medium term

Revenue estimates are below 2016 Budget projections. Lower receipts in the current year will be partially offset by higher-than-anticipated income from financial transactions, reflecting premiums on inflation-linked bonds and government's bond-switch programme.

The social security funds and public entities have a combined cash surplus for the current year, which offsets the national budget deficit. Compared with the 2016 Budget estimates, the combined surplus of social security funds has been revised down in 2016/17 and over the two following years. This mainly reflects lower interest earnings on the investments of the Unemployment Insurance Fund. Despite this, the social security funds continue to generate large cash surpluses, increasing from R19.3 billion in the current year to R26.5 billion in 2019/20.

Public entities have combined deficits of R3.2 billion for 2016/17 and R6.1 billion for 2017/18. This is largely the result of operating deficits on the long-distance passenger services of the Passenger Rail Agency of South Africa, and lower toll revenues collected by the South African National Roads Agency Limited (SANRAL). Public entities move to a cash surplus of R3.9 billion by 2019/20, largely on the strength of higher revenues generated by the Water Services Trading Entity.

Public entities move from a combined deficit in 2016/17 to a cash surplus in 2019/20

Table 3.4 Consolidated fiscal framework,[1] 2013/14 – 2019/20

	2013/14	2014/15	2015/16	2016/17		2017/18	2018/19	2019/20
R billion/Percentage of GDP		Outcome		Budget	Revised		Medium-term estimates	
Main budget								
Revenue	**887.4**	**965.5**	**1 075.2**	**1 162.0**	**1 143.7**	**1 249.1**	**1 359.9**	**1 482.4**
Expenditure	**1 047.8**	**1 131.9**	**1 244.6**	**1 318.3**	**1 308.7**	**1 410.0**	**1 522.2**	**1 651.9**
of which								
Non-interest allocations [2]	*946.6*	*1 017.1*	*1 115.8*	*1 164.6*	*1 161.0*	*1 240.4*	*1 331.4*	*1 434.8*
Debt-service costs	*101.2*	*114.8*	*128.8*	*147.7*	*147.7*	*163.6*	*180.8*	*197.2*
Contingency reserve	–	–	–	*6.0*	–	*6.0*	*10.0*	*20.0*
Main budget balance	**-160.4**	**-166.4**	**-169.4**	**-156.3**	**-165.0**	**-161.0**	**-162.3**	**-169.6**
	-4.4%	*-4.3%*	*-4.1%*	*-3.6%*	*-3.8%*	*-3.4%*	*-3.2%*	*-3.1%*
Primary balance	**-59.2**	**-51.6**	**-40.6**	**-8.6**	**-17.3**	**2.7**	**18.5**	**27.6**
	-1.6%	*-1.3%*	*-1.0%*	*-0.2%*	*-0.4%*	*0.1%*	*0.4%*	*0.5%*
Budget balances of social security funds, public entities and provinces	24.7	28.9	17.2	17.4	14.5	13.9	24.1	30.6
Consolidated budget balance	**-135.7**	**-137.5**	**-152.2**	**-139.0**	**-150.5**	**-147.1**	**-138.2**	**-139.0**
	-3.7%	*-3.6%*	*-3.7%*	*-3.2%*	*-3.4%*	*-3.1%*	*-2.7%*	*-2.5%*

1. Further details of the fiscal framework can be found in the technical annexure
2. Including special appropriations
Source: National Treasury

The contingency reserves have been reduced to accommodate the carry-through effect of increased university subsidies, and to narrow the deficit. Projected reserves of R10 billion and R15 billion in the next two years have been cut to R6 billion and R10 billion respectively. The 2019/20 contingency reserve stands at R20 billion.

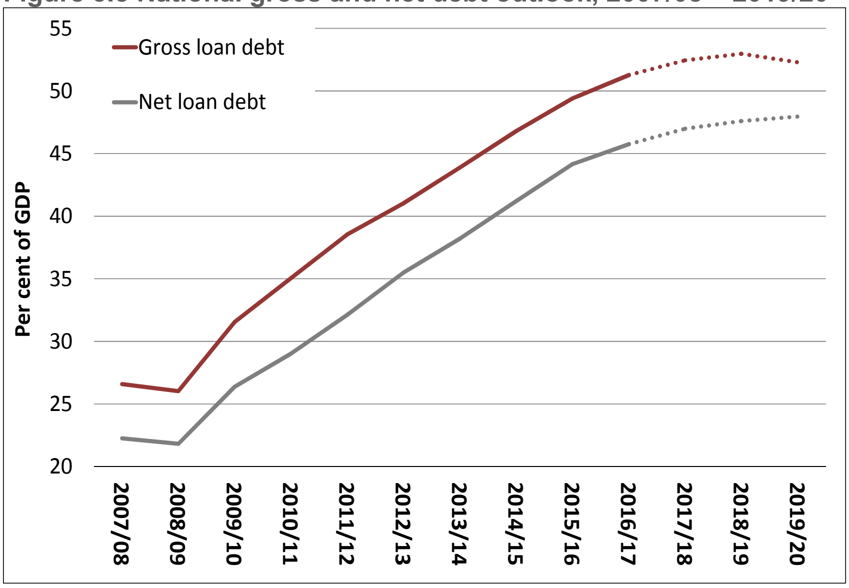
Southern African Customs Union (SACU) transfer projections have increased over the medium term, largely due to upward revisions in customs and excise duties. Adjustments to estimates of GDP, population and intra-SACU trade also contribute to an overall increase in South Africa's payments to its SACU partners.

National debt outlook

Net loan debt expected to stabilise at 47.9 per cent of GDP in 2019/20

The fiscal policy proposals are expected to stabilise net loan debt – the difference between gross debt and government's cash balances – at 47.9 per cent of GDP in 2019/20. The 2016 *Budget Review* projected that net debt would stabilise in 2017/18 at 46.2 per cent. The upward revision of the debt-to-GDP ratio reflects lower nominal GDP, higher borrowing and currency depreciation.

Figure 3.5 National gross and net debt outlook, 2007/08 – 2019/20



Source: National Treasury

Managing risks to the fiscal strategy

Macroeconomic, budget execution and policy risks

Main risk to debt stabilisation is slower GDP growth and associated decline in tax revenue

The main risk to debt stabilisation is slower economic growth and an associated decline in tax revenue. The fiscal risk statement published in the MTBPS considers three long-term risk scenarios. The first envisages a recession in 2017/18, followed by a period of protracted lower growth. In the second, growth is marginally lower than the baseline forecast. Either case would require higher taxes and reduced spending to stabilise debt. In the third scenario, exports respond strongly to the weaker exchange rate, and electricity supply continues to improve, resulting in a faster recovery. In this case, debt stabilisation would be accelerated.

Lower inflation outlook relieves pressure on inflation-linked expenditure

There are macroeconomic, budget execution and policy risks to the expenditure ceiling. The inflation outlook has been revised down since the February budget, relieving pressure on inflation-linked expenditures such as the wage bill. The depreciation in the exchange value of the rand, however, is likely to raise the costs of foreign currency-denominated purchases, including fuel, medicines, and the operating costs of South Africa's foreign missions. Government has responded to these developments by reallocating some funds and absorbing the remaining costs within existing budgets. Details are provided in Chapter 4.

Budget execution risks relate primarily to the wage bill. Most departments are on track to remain within the compensation ceilings set out in the 2016 Budget. Discussions are under way with some departments that face significant wage pressures to ensure that the compensation ceilings remain in place. While these pressures will not affect the overall expenditure ceiling, they may shift the composition of expenditure.

Looking ahead, the National Treasury is of the view that the current level of spending is sustainable if economic growth returns to its historic average of 3 per cent. However, if growth remains below 2 per cent over the long term, a stable debt path will be difficult to sustain at the current levels of expenditure, even if no new policy initiatives are taken.

State-owned companies

SAA, SANRAL, Eskom and the Post Office are being closely monitored to mitigate risks that may arise

Several state-owned companies could pose risks to the public finances. In particular, government is closely monitoring South African Airways (SAA), the South African Post Office (SAPO), SANRAL and Eskom, with the aim of stabilising these entities and mitigating any risks that may materialise. Key actions that have been taken include the following:

- In September 2016, a new, full-strength board was appointed at SAA. The Board has been tasked with returning the airline to financial sustainability, and is required to fill vacant executive management positions.
- With a new board and chief executive, SAPO has raised funding to repay creditors and launch its turnaround strategy, which includes an agreement with labour to reduce the likelihood of strikes.
- The new tolling dispensation has been implemented at SANRAL and legal action is being taken against users with overdue accounts. The agency's e-toll collections and auctions are closely monitored against projections.
- The recapitalisation of Eskom in 2015/16 has significantly improved its liquidity and profitability.

Steps being taken to rationalise state-owned housing and telecommunications entities

In addition to stabilisation measures, progress is being made on several reforms. Government is taking steps to rationalise several housing development finance institutions, as well as entities in the telecommunications sector. Advisors will be appointed to provide technical assistance as government considers the possible realignment of its airline shareholdings. The inter-ministerial committee responsible for overseeing the implementation of the reforms has approved the principles that will guide collaboration between state-owned companies and the private sector to accelerate the delivery of new infrastructure projects.

Responsibilities of state-owned company boards and executive authorities remain unchanged

Following its July 2016 lekgotla, Cabinet announced the decision to establish a Presidential State-Owned Companies Coordinating Council. The council will play a monitoring and coordinating role. The statutory responsibilities of company boards and executive authorities as set out in the Companies Act (2008) and Public Finance Management Act (1999) remain unchanged.

Over the medium term, any requests for fiscal support will be informed by the principles set out in the 2015 *Budget Review*:

- Intervention to support state-owned companies must be consistent with sustainable public finances.
- Capitalisation cannot have an impact on the budget deficit.
- Entities receiving support are required to demonstrate sound business plans, improve governance and address operational efficiencies.

Conclusion

Fiscal policy framework will help to reduce interest rates and create conditions for investment

South Africa's major challenge remains low economic growth. The fiscal policy framework will help to reduce interest rates and improve conditions for investment. Fiscal policy, however, cannot act in isolation. Achieving faster, broad-based economic growth requires government to rapidly implement structural reforms identified in the National Development Plan, and remove constraints to growth. Over time, faster economic growth will generate the revenue necessary for future expansion of public services.