MEDIUM TERM BUDGET POLICY STATEMENT 97 - FISCAL POLICY & THE BUDGET FRAMEWORK

Introduction

Government's tax and spending policies are set out below, together with an account of recent developments in fiscal policy and budget reform. This chapter outlines the fiscal projections for the period 1998/99 to 2000/01, on which the Medium Term Expenditure Framework is based.

The fiscal policy framework

Objectives

Government's fiscal policy aims are to:

- ensure sound public finances and that government debt does not grow faster than its ability to repay it;
- ensure that debt service costs decline as a share of expenditure, so that these resources can be reallocated to the delivery of public services;
- improve domestic savings, to support a higher level of investment and reduce the need to borrow from abroad;
- ensure that excess consumption does not push up inflation or lead to a deterioration of the trade deficit;
- support an export-friendly trade and industrial strategy to improve South Africa's competitiveness; and
- counter inflationary pressures, to prevent interest rates from having to rise.

Deficit target

Government is therefore committed to reducing the budget deficit to 3 per cent of national income by the end of the decade and reaffirms its adherence to the deficit targets set out in its macroeconomic strategy.

By reducing the deficit, Government will reverse the upward trend in government debt, and the corresponding interest bill. Debt interest costs currently absorb 21 per cent of national budget expenditure.

The tax burden

Government plans to limit the share of national income taken by tax to around 25 per cent. The overall tax burden, including mandatory collections by social security and other statutory funds, is presently somewhat higher than this level.

Public expenditure

Public spending must be financed either from revenues or from borrowing. Government's commitment to reducing the deficit and the limits on the overall tax burden together determine the level of public expenditure over the next three years.

Composition of spending

Within the spending totals, Government is committed to reprioritising spending to meet reconstruction and development objectives, to deliver services more equitably, and to address infrastructure backlogs.

Government therefore plans to:

- ensure that eventually borrowing is not used to finance current expenditure, but only for investment;
- reduce government consumption spending as a share of national income;
- limit pay increases to within fiscally responsible limits; and
- increase public sector investment in social and economic infrastructure.

Sound public finances

This is a responsible fiscal policy, aimed at ensuring the sustainability of South Africa's economic transformation, promoting jobs and investment, and ensuring that public services reflect the Government's priorities.

Public finance

Progress in the main elements of fiscal policy over the period 1990/91 to 1996/97 is summarised below. These estimates refer to the general government as a whole (including national and provincial government, extra-budgetary accounts and agencies, social security funds and local government).

Dissaving

Government dissaving (that is, borrowing in excess of investment) has fallen steadily from a peak of 6,4 per cent of GDP in 1993 to 3 per cent in 1997, and is expected to fall to below 2 per cent in 1998.

Public sector borrowing requirement

Since 1993/94 the public sector borrowing requirement has been reduced from 10,4 per cent of GDP to 5,9 per cent in 1996/97. Since the national budget accounts for most public sector borrowing, the public sector borrowing requirement is projected to decline in line with the trend for the main budget.

Consolidated general government revenue

Tax revenue, including social security contributions and local rates and taxes, is estimated at 27,7 per cent of GDP in 1996/97, having risen from 25,6 per cent in 1992/93. Non-tax revenue has remained roughly constant at around 4 per cent of GDP over the same period.

Consumption expenditure by general government grew in real terms by just over 5 per cent in 1996. The 1997/98 budget provided for a constant real level of consumption expenditure.

Remuneration

Remuneration of general government employees comprises 75 per cent of consumption expenditure. The three-year wage agreement signed in the Central Bargaining Chamber in 1996 increased the national and provincial wage bill by R6,5 billion in 1997/98 and in 1998/99, or an average increase of 10,0 per cent per year. In addition, the wage bill will increase because of promotions and notch increments.

Investment

Because of lags in delivery, capital expenditure by the general government has not increased in recent years, despite increased budgetary provision. However, total public sector capital spending (which includes public sector enterprises and corporations) increased by about 8 per cent in 1996 in real terms. This trend will accelerate as telecommunications, municipal infrastructure, roads construction and other projects gather momentum.

Government recognises the importance of improving the quality of capital expenditure, within the available resource constraints, to contribute both to strengthening growth prospects and enhancing social infrastructure capacity.

Functional composition of government spending

Changes in the functional composition of consolidated national and provincial government spending are illustrated below.

- expenditure on *interest payments* has risen from 4,3 per cent of GDP in 1990/1 to a projected 6,2 per cent in 1997/98;
- expenditure on *defence* has fallen dramatically, from 4 per cent to 1,7 per cent of GDP, while spending on public order and safety has increased from 2,4 per cent to 3 per cent of GDP;
- spending on *social services*, including health, education, welfare, housing and land reform has increased as a share of the total, from 12,1 per cent of total expenditure in 1990/91 to 14,4 per cent in 1997/98;
- spending on *education* has risen slightly from 6,1 per cent to 6,5 per cent of GDP;
- spending on *social security and welfare* has risen from 2 per cent to 3 per cent of GDP; and
- the share of spending on *economic services* has declined, mainly because of the phasing-out of regional industrial incentives and the general export incentive scheme.

Table 4.1: Functional classification of consolidated national and provincial budget expenditure

% of GDP	**1990/91**	**1994/95**	**1997/98**
General public services	2,4	3,0	2,1
Defence	4,0	2,9	1,7
Public order and safety	2,4	3,2	3,0
Education	6,1	7,1	6,5
Social security and welfare	2,0	3,1	3,0
Other Social Services	4,0	4,5	4,9
Economic Services	4,0	4,0	3,0
Interest payments	4,3	5,6	6,2
Total expenditure (as % of GDP)	29,2	33,3	30,4

Source: Budget Review 1997

Budget reform

Challenges

Budgetary planning and procedures have a crucial role to play in ensuring that Government's social and developmental goals are translated into implementation strategies.

South Africa faces a critical tension in its budget reform programme, associated with the substantial role of provinces in the provision of services. On the one hand, there is a strong emphasis on decentralised management in Government's approach to transforming public service delivery. On the other hand, recent reviews have indicated serious deficiencies in financial and management capacity in several provincial governments or particular departments, leading to pressures for greater centralisation of control.

Personnel management issues have also been identified as a major area of budgetary concern. Personnel costs have absorbed a rising share of expenditure, and inflexibilities make it difficult to control costs and reprioritise expenditure.

New legislation

The evolution of new intergovernmental financing arrangements is not yet complete. Legislation currently before Parliament deals with some aspects, including the formal establishment of the Budget Council and the establishment and functions of the Financial and Fiscal Commission.

Medium term expenditure plans

The adoption of a three-year expenditure framework is a major reform initiative undertaken jointly by the Departments of Finance and State Expenditure and provincial treasuries.
The publication of three-year expenditure plans will have a number of important advantages. It will:

- encourage agencies to evaluate their policy proposals within realistic budget projections;
- create a framework within which the Government can assess the financial implications of policy proposals;
- foster medium term planning by spending agencies, which will improve their efficiency;
- facilitate the management of rollovers, since with three year plans, agencies will be able to enter into contracts that will involve future payments; and
- improve the credibility of fiscal policy targets, and hence reduce the cost of government borrowing.

Improved analysis

The analysis underlying the Medium Term Expenditure Framework provides a tool which links expenditure inputs to service outputs. It will take a number of years to develop the analytical framework more fully. In the short term, the analysis has concentrated on some key services: health, education and welfare at the provincial level; defence, criminal justice at the national level; and personnel management. As capacity develops the analysis will be broadened and deepened.

Financial management

The success of the medium term expenditure framework is in part dependent on other dimensions of fiscal planning. Medium term planning, improved reporting, careful expenditure evaluation and appropriate flexibility of line agencies are important elements in achieving expenditure restructuring.

White Paper

The Government expects to publish a White Paper on budget reform early next year. This White Paper will set out the principles of budget reform more fully, and make proposals for their implementation.

Fiscal projections 1998/99 to 2000/01

Assumptions

The Medium Term Expenditure Framework is based on the projected acceleration in the growth of real GDP from 2 per cent in 1997/98 to 3 per cent, 4 per cent and 5 per cent in the following years. Inflation is projected to decline from 9 per cent in 1997/98 to 7½ per cent, 6,½ per cent and 6 per cent in the following years.

These assumptions will be revisited in future years in the light of actual economic performance.

Table 4.2: Economic assumptions for medium term expenditure planning

	1997/98	1998/99	1999/00	2000/01
GDP growth		3,0%	4,0%	5,0%
GDP inflation		7,5%	6,5%	6,0%
GDP (R million)	618 570	684 920	758 610	844 340
National Budget Revenue (Rm)	161 980	178 080	195 720	216 150
National Budget Expenditure (Rm)	186 750	202 050	218 480	241 480
Deficit (Rm)	24 770	23 970	22 760	25 330
per cent of GDP				
Revenue	26,2%	26,0%	25,8%	25,6%
Expenditure	30,2%	29,5%	28,8%	28,6%
Deficit	4,0%	3,5%	3,0%	3,0%

The expenditure level

Projections for GDP, the Government's deficit reduction and tax targets and the total available expenditure over the MTEF period are set out in table 4.2 above.

This expenditure level refers to the total nationally-collected revenue to be shared between the national, provincial and local spheres of government, as described in more detail in chapter five of this Budget Policy Statement.

Amounts set aside

Before expenditure is equitably divided among the three spheres of government, three items are set aside from the total. These are:

- debt service costs – the nation's obligations to pay debt service costs represent a first charge against expenditure;
- standing appropriations – legally binding contributions to international institutions; and
- the Reserve – a proportion of the total available resources is not allocated at this stage (explained in more detail below).

Debt service costs

Provision is made for debt service costs on the following assumptions:

- a budget deficit of 3,5 per cent of GDP in 1998/99, falling to 3,0 per cent in the subsequent two years;
- refinancing of all domestic and foreign loans as they mature;
- continued borrowing mainly in long-dated domestic securities, supplemented by limited foreign bond issues and domestic short-term securities; and
- gradual declines in capital market rates, as inflation falls, to an average of 12 per cent in 2000/01.

It is expected that state debt costs will fall from 21,2 per cent of spending in 1997/98 to 20 per cent in 2000/01. This will reduce debt interest from 6,4 per cent of GDP to 5,7 per cent over the same period, and will bring the debt to GDP ratio down from 55 per cent in 1997/98 to 50 per cent in 2000/01.

Table 4.3: Projected funds available

R million	1997/98	1998/99	1999/00	2000/01
National Budget Expenditure (Rm)	186 750	202 050	218 480	241 480
Less amounts set aside				
Debt service costs	39 640	42 320	45 000	48 400
Standing appropriations	300	330	350	380
Reserve	2 150	5 000	7 000	10 000
Total expenditure to be shared	144 660	154 400	166 130	182 700

Expenditure growth rates

Total budget expenditure, excluding debt interest and standing appropriations, and excluding provincial and local government own revenues will grow by 9½ per cent a year, on average, over the next three years. In real terms, this amounts to 2¾ per cent a year.

As the table below shows, national budget expenditure grows in real terms in each year of the MTEF, by 1 per cent next year, accelerating to over 5 per cent by the end of the MTEF period.

The acceleration of expenditure in the outer years of the projections is dependent on the performance of the economy. If the economy does not grow as fast as the projections set out in Chapter 3 of this Statement, then expenditure growth will have to be contained below these levels.

Table 4.4: Growth of non-interest budget expenditure[1]

	1998/99	1999/00	2000/01	Average over MTEF
Non-interest spending (Rm)	159 400	173 130	192 700	
Nominal growth	8,6%	8,6%	11,3%	9,5%
Real growth	1,0%	2,0%	5,0%	2,7%

[1] National and Provincial budgeted expenditure, excluding interest, standing appropriations and expenditure financed by provincial own revenues, but including the reserve.

The Reserve

Uncertainty

Public expenditure projections over three years are inherently more uncertain than those that extend only a year ahead. Over the course of the next three years there are likely to be changes to macroeconomic conditions and price trends, the Government's policy priorities, and unforeseen emergencies and expenditure pressures.

In order that the public finances should not be thrown off track by such developments, and to increase the certainty surrounding the proposed allocations, a Reserve has been allocated within the expenditure totals.

The Reserve comprises two parts: a "policy reserve", and a "contingency reserve". These are explained below.

Policy reserve

A policy reserve has been set aside from the total available spending to enable Government to meet specific policy priorities without compromising the proposed budgets of other services. This policy reserve will be allocated to programmes between now and Budget Day.

Contingency reserve

Another part of the Reserve will remain unallocated in this year's budget, in order to deal with any costs arising from unforeseen natural or other disasters. This ensures that Government can make funds available for unforeseen circumstances in the year in question without breaching its overall expenditure ceiling.

A component of the contingency reserve in the second and third years of the projections will be allocated as part of the 1999 and 2000 MTEF processes. This part of the Reserve may be used to address emerging policy priorities or changes in economic circumstances. It enables Government to address its priorities in future budgets without having to disrupt the expenditure plans of other services.

Credibility of plans

This allocation of a substantial Reserve within the expenditure ceiling ensures that Government's expenditure plans are prudent and credible:

- it makes room in future years for emerging new priorities, without these having to be funded from reductions in other programmes;
- it ensures that funds are available to deal with contingencies as they arise in year without exceeding the expenditure ceiling;
- it increases the stability of the expenditure plans, which provides greater stability and certainty within which public services can plan; and
- it means that the three-year budgets can adapt to possible divergences of macroeconomic performance from the projections made at this stage.

Growth and spending

There is a correlation between the amount available for spending on public services and the performance of the economy. Slower growth or lower inflation in future years would require adjustments to expenditure projections and the size of the available Reserve.

Table 4.5 below sets out the size of the Reserve over the MTEF period.

Table 4.5: The Reserve

R million	**1998/99**	**1999/00**	**2000/01**
Policy reserve (to be allocated now)	3 000	3 000	3 000
Contingency reserve (to be partly allocated in future MTEFs)	2 000	4 000	7 000
Total	5 000	7 000	10 000