Medium Term
Budget Policy Statement
1999

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Minister of Finance

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FOREWORD

The Medium Term Budget Policy Statement outlines emerging spending plans in advance of the Budget in February. Although Government retains responsibility and accountability for budget decisions, all stakeholders have a right to be heard in the budget process. I hope this statement will encourage public discussion and debate in advance of the Budget.

We presented last year's Statement against the background of a world economy in crisis. South Africa has weathered the storm remarkably well because of, amongst other things, our open and transparent public finances and our sound, coherent and sustainable macroeconomic and fiscal policies. This Statement confirms that positive outlook, while announcing steps for a continued strengthening of public finances.

The economy's ability to cope with adverse external shocks will be further enhanced by the new fiscal framework this Statement sets out. It incorporates the finances – particularly, the borrowing – of the wider public sector into the budget-planning process. This framework projects that the public sector borrowing requirement will decline to 3,0 per cent of GDP over the next three years, with the national budget deficit falling to 2,4 per cent of GDP.

More widely, the economy is benefiting from declining interest rates and a renewal of capital inflows. The recent improvement in the gold price is also encouraging. But structural difficulties in the economy still remain. A number of the programmes described in this Statement will contribute to job creation. And, to increase certainty in support of lowered inflation, the Government has decided to introduce an explicit inflation target during 2000.

The spending plans which the Statement outlines reflect falling debt interest costs and rising revenue, allowing substantial increases in national, provincial and local allocations for services. The spending proposals outlined in this Statement pursue objectives the President set out in his opening address to Parliament on 25 June.

Security and peace-keeping in Africa require a carefully planned and managed strategic defence procurement and this is reflected in a sustainable increase in the defence budget. But, reflecting the government's reprioritisation towards social and civil protection services, the proportion of government spending on defence remains lower than in 1995/96.

The integrated justice sector – justice, police and prisons – is a priority, with new money for the Scorpions investigative directorate and other important measures. The social services receive continued priority, with spending now projected to grow faster than at the time of the 1999 Budget.

The division of revenue between provinces increases the pace of redistribution from richer to poorer provinces. There is also a greater emphasis on social services in the distributive formula, taking into account the spending trend reflected in our recent *Intergovernmental Fiscal Review 1999*. These changes have been agreed in the Budget Council, which is one of a number of bodies that promote co-operative budgeting between national and provincial spheres.

Budget reform began with the Medium Term Expenditure Framework, which is the three-year basis for all the national budget plans set out in this Statement. We are taking reform further. The new fiscal framework heralds increased scrutiny of the wider public sector, to ensure sound public finances, to protect the corporate assets owned by government, and to ensure that public sector activities provide optimal support for reconstruction and development. In order to support a renewed emphasis on better service delivery, the budget will increasingly focus on this key Government goal. This will see selected national and provincial departments piloting service delivery objectives, indicators and targets that will help assess service outputs when budgeting.

The policies we outline here promote a sounder economy and stronger public finances, together with increased, and more effective, expenditure on services.

Trevor Manuel
Minister of Finance

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INTRODUCTION AND OVERVIEW

Role of the MTBPS

The *Medium Term Budget Policy Statement* (MTBPS) outlines the Government's fiscal framework and expenditure plans. It is a preliminary statement in advance of the 2000 Budget which makes Government's budget plans more transparent. By setting out policy considerations, it helps to promote public discussion of the spending proposals.

Proposed division of revenue

The MTBPS includes the proposed division of revenue between national, provincial and local government. Provinces, in particular, benefit from a clear statement of the proposed division of revenue in advance of the new financial year. This helps them to plan their spending and to table their budgets shortly after national Budget Day.

Alongside the Statement, the Government is also publishing an MTBPS summary. This will make information more accessible to those who do not have the time to read this document, or who do not need its technical detail.

Overview of the MTBPS

The MTBPS outlines the Government's fiscal and expenditure policies, in advance of more final and detailed announcements in February's Budget. These policies contribute to realising the vision which the President set out in his opening address to Parliament.

Economic recovery

The context is set by the overall state of the economy, described in chapter 2. Following the international crisis which began in Asia, the months since the 1999 Budget have seen stabilisation and improved world economic prospects. South Africa has benefited from this through falling interest rates and renewed capital inflows.

Revised statistics, announced in June, have also shown the economy to have been healthier than supposed over the last five years.

Chapter 2 includes new forecasts for a number of economic indicators, including growth in gross domestic product (GDP), inflation, and investment and consumption expenditure.

Structural change in the economy

Although the present picture is more favourable than it seemed eight months ago, structural problems in the economy will still take time to address. Government is working towards further structural change in the economy through measures such as inflation targeting, steps to promote public and private sector investment, restructuring of the public sector, enhancing the propensity to save and a review of elements in the labour market that may impact on employment creation. Over the longer term, exports should also benefit from the European Union and Southern African Development Community trade agreements.

Fiscal policy

The President's opening address to Parliament on 25 June 1999 emphasised the importance of a growing economy capable of extending sustainable and equitable benefits to all South Africans. Management of the public finances is a key element supporting this.

The recent financial crisis of emerging economies has brought into focus the importance of a sound financial environment. It underscored the vulnerability of emerging economies to adverse international developments. It highlighted particularly the problems that can be caused by off-budget public sector debt.

Chapter 3 therefore sets out a more comprehensive fiscal policy which will help ensure lower interest rates and a reduced tax burden. This will stimulate economic growth, lower inflation and job creation.

New budget deficit targets are set, taking into account borrowing outside the budget but within the public sector. These targets will contribute to lowering the Government's claim on available savings, strengthening prospects for future growth.

Government spending

Chapter 4 sets out the overall spending picture and summarises trends in national and provincial expenditure. Strong revenues, and a reduction in debt interest payments as a consequence of lowered interest rates, allow an increase in planned non-interest spending. Together with up-dating of the contingency reserve allocation, compared to the last Budget, this provides R4 billion additional spending on services in 1999/00, R7,5 billion extra in 2000/01 and some R10,5 billion extra in 2001/02.

Defence procurement

For Africa to prosper it will have to ensure that it is a safer and stable continent. The SANDF will have to play a role. This requires that it replace outdated equipment. The strategic defence procurement package will rectify this deficiency and support the South African National Defence Force's contribution to the Government's aims. It is the single biggest new item of expenditure, but, nonetheless, defence's share of government expenditure will remain below that for 1995/96.

Key spending priorities

A number of other spending initiatives are also outlined. They reflect themes in the President's speech to Parliament:

- strengthening of a more integrated criminal justice system, including the new Scorpions unit and improved information systems;
- provision for the South African Revenue Service (SARS) to improve its collection systems in order to maintain and improve revenue without increasing tax levels, and to help combat economic crime;
- reducing government dissaving through prudent fiscal policies and expenditure management;
- the skills development programme to promote higher employment through a more skilled workforce;
- relief of poverty, and support for job creation;
- extra funding to tackle HIV/AIDS;
- more money for provinces, which will mainly support improvement of social services; and
- focusing on the rural poor, extending infrastructure provision and other service delivery to rural areas.

Provinces and local government

Chapter 5 looks at provinces' and local government's spending. It sets out the vertical division of revenue, and the proposed division between the nine provinces. It highlights co-operative governance in the budget context.

Conditional grants and agency payments to provinces are outlined, noting that over time national departments will be encouraged to convert agency payments to conditional grants. This will enable provincial and local government to be held accountable for delivery of services and the management of funds.

Chapter 5 also reviews allocations to local government. These include revision of funding for R293 towns and the piloting of the Consolidated Municipal Infrastructure Programme in rural areas.

Improving public services

Spending alone cannot solve problems

A common theme in chapters 4 and 5 is the role of budgeting in improving public services. The budget should not just be about numbers, because expenditure alone will not solve problems. The Government is also putting increased emphasis on the quality and efficiency of service delivery. This was a key theme in the President's speech to Parliament.

Budgeting for service delivery

Budget reforms in the last few years have changed budgeting from a technocratic exercise focusing on financial data, to a tool for reprioritising provision of services to promote reconstruction and development.

The Medium Term Expenditure Framework (MTEF) has placed expenditure planning on a three-year basis in contrast with the previous system's yearly incremental changes. It provides a framework in which to align spending plans and policy-making.

The MTEF also enables legislatures and the public to see what government plans for the future. It allows government to set spending changes in the context of policy developments, and show how they fit with the drive to improve service delivery.

More service information in budgeting

The budget process therefore already plays a part in improving services, for example by ensuring that public funds are directed to where they are most needed and where they can add the most value. The aim now is to improve the information on service delivery that will enable budget decision-making to take yet more account of what money will buy.

The *National Expenditure Survey* was introduced this year, for the first time publishing service delivery information with the Budget. Government will build on this to increase the breadth and the rigour of service information considered in the budget process and published in budget documentation.

Piloting service delivery indicators

In addition to increasing the amount of informal service delivery information available for budgeting, the Departments of Finance and State Expenditure will work with selected pilot departments in national and provincial government to develop more formal service delivery objectives, indicators and targets to assist with budgeting and other management tasks.

Public finance management

Public services can only be as effective as the management of the money that funds them. Parliament's recent passage of the Public Finance Management Act hails a transformation in the way in which public money is managed. No longer will processes simply be administered for their own sake. Such an out-dated approach can never meet the challenges of reforming public services for the new South Africa. Instead, managers are to be given greater freedom to manage, with a much stronger framework of accountability to ensure that such management delivers the outcomes which are needed.

Personnel policy and spending

Personnel spending forms almost half of total government spending, excluding interest on the debt. Part of improving service delivery therefore relates to spending money more wisely on personnel. The Government is developing a remuneration policy that, while allowing appropriate pay increases, will see total personnel spending grow in line with inflation. The new remuneration policy will also enable departments to attract and retain appropriate skilled personnel, supporting development of a public service that is geared to better service delivery.

Budget reform

The Government will shortly announce its future budget reform programme, which will particularly reflect the theme of improving service delivery and will support the new fiscal framework outlined in chapter 3.

Conclusion

The MTBPS sets out the Government's intended plans for the next three years. As well as the numbers, these plans include key policy developments. But, above all, they look to improve the economy's health and the quality of public services provided to South Africans.

Public comment on the proposals and spending plans set out in the MTBPS may be sent to the Department of Finance before 31 December 1999. Comments may be emailed to mtbps@Finance.pwv.gov.za or posted to:

MTBPS
Room 1709
Department of Finance
Private Bag X115
Pretoria 0001.

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MACROECONOMIC RECOVERY AND IMPROVING GROWTH PROSPECTS

Introduction

Changes since the Budget

Since the Budget was announced in February, the global economy has stabilised and the pace of growth has improved in Europe and Japan. The South African economy has weathered the crisis well. Interest rates have fallen. New projections show an earlier recovery than the February Budget forecasts, with growth averaging some 3,4 per cent over the next three years.

New growth and inflation forecasts

The forecast of domestic growth remains 0,9 per cent for 1999. For 2000, it increases to 3,5 per cent, in effect bringing forward growth formerly projected for 2001, for which 3,4 per cent growth is now forecast. Growth of 3,2 per cent is projected for 2002.

Since mid-1998, consumer price index (CPI) inflation has steadily declined to 1,9 per cent for the year to September 1999. CPI inflation is expected to average 5,5 per cent in 1999, and to decline gradually in subsequent years. Core inflation, which excludes certain food products and mortgage rates from the index, is projected to remain above CPI inflation, with the gap narrowing over time.

Improved manufacturing prospects

A broad recovery of growth in manufacturing is expected over the next three years, as is a continuation of the strong financial and retail growth seen through most of the 1990s. Rising commodity prices will also benefit the economy. However, the low level of employment continues to be a concern – only the retail and wholesale trade sector has shown increases in employment.

Growth in trade

A moderate reversal in recent balance of payments improvements is expected as growth takes hold and imports expand. But this should readily be financed by strong capital inflows. Over time, exports will benefit from the recently signed trade agreement with the European

Union and further expansion of trade within the Southern African Development Community (SADC) region.

Strong increases in capital investment are forecast.

The rand is expected to remain steady in real terms over the period to 2003. Rising commodity prices will provide it with support, benefiting the local economy and boosting investor confidence.

Interest rates and inflation

Long term interest rates have declined less than short term rates, kept up by higher borrowing by public corporations and uncertainty over inflation and exchange rates.

The Government will introduce inflation targeting in 2000, to reduce uncertainty over the future level of inflation.

Recovery from the financial crisis

The capacity of well-managed economies to recover from severe international shocks has been amply demonstrated over the last six months by the performance of several emerging markets, including South Africa.

Effects of the crisis

The world financial crisis brought large reductions in global capital flows. During the second half of 1998, South Africa experienced a net outflow of portfolio funds of R10 billion, after net inflows of R31 billion in 1997 and over R30 billion in the first half of 1998.

This required an abrupt adjustment. Short term interest rates rose sharply and the exchange rate depreciated by almost 20 per cent against the dollar. These adjustments were largely successful in reducing domestic demand and the demand for imports. As a result, growth for 1998 was substantially below trend. Higher interest rates also constrained the increase in inflation following the depreciation of the rand.

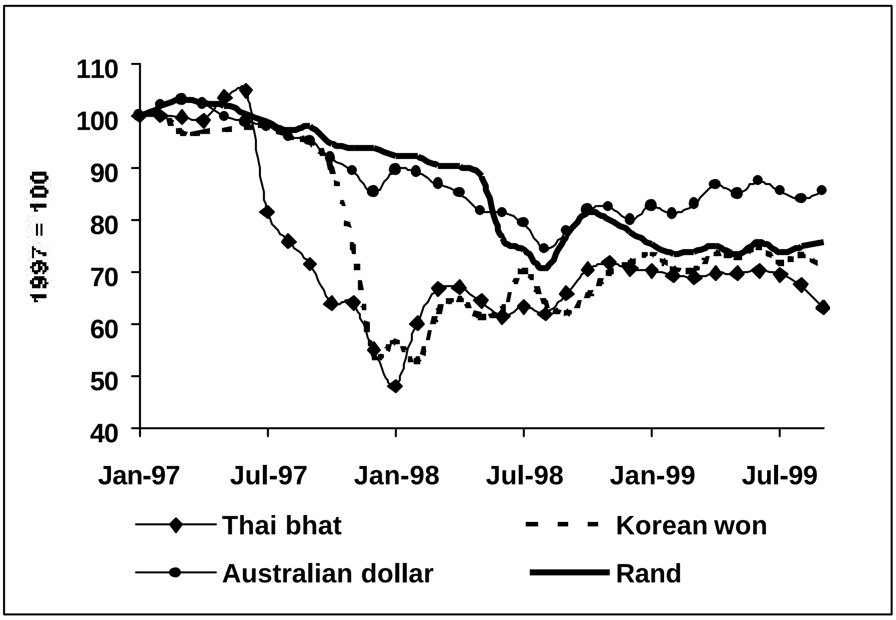
Recovery of capital flows

The impact of last year's financial crisis on capital flows appears to have been short-lived. Net inward portfolio investments during the first half of 1999 reached R22 billion, which compares to R20 billion received over 1998 as a whole. These increases reflect a significant improvement in investor sentiment towards South Africa, which should be reflected by further inflows in the second half of the year.

World outlook and its implications

Outside South Africa, while output and employment in East Asian economies have been damaged by the international financial crisis, some strong positive signs are emerging as currencies have recovered or stabilised (figure 2.1). Investor confidence in these economies is increasing, and domestic financial and asset prices have recovered from the lows of last year.

Figure 2.1: Comparative currency adjustments



The growth of capital inflows and a broadly favourable international economic outlook have supported a substantial decline in South Africa's interest rates, and contributed strongly to the prospects for recovery in the year ahead.

Improved growth prospects

The prospects for the world economy continue to improve. Recovery in the crisis economies was helped by the continued strength of American consumer spending, which despite almost full employment was not associated with rising inflationary pressures.

The revival of the Japanese economy during the first half of 1999 and concerns over the sustainability of the United States current account deficit have prompted a decline in demand for US dollar assets and contributed to the appreciation of the Yen and the Euro against the dollar.

Risk of slowdown in USA economy

The possibility of an unduly rapid slowdown in United States demand is now the main risk to the world economic outlook. However, the revival of growth prospects in Europe and Japan offsets the potential threat to international trade.

Growth in the main industrial economies for 1999 and 2000 is expected to average 2,8 per cent and 2,7 per cent, respectively.

Implications for SA growth

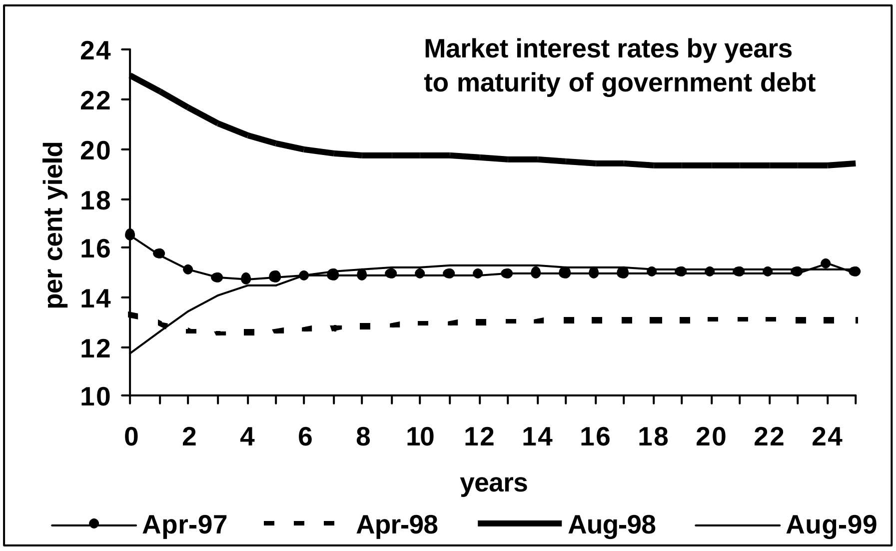
With a cyclical rise in commodity prices presently underway, prospects for sustained growth in South Africa remain healthy, even allowing for the possibility of a slowdown in the United States economy. Rising commodity prices will benefit the local economy and improve investors' perception of the underlying strength of the rand. The recent recovery in the gold price is also a considerable boost to the economy.

Falling interest rates

Short term rates

Increasing liquidity in the economy caused by a renewal of capital inflows has enabled the Reserve Bank to lower the repo rate. The consequent rapid decline in short term interest rates has now brought relief to households and improved investment prospects.

Figure 2.2: SA yield curves



Long term rates

However, figure 2.2 shows that interest rates on longer term government debt have not declined as quickly as short term rates. Compared to US rates, South African long term rates include a risk premium, explained in the text box below. The level of the premium is associated with an increase in the demand for funds in the local capital markets, uncertainty over the future exchange rate, and uncertainty over the future inflation trend.

Demand for capital market funds

Although the demand for funds to meet the national budget deficit has declined, there has recently been an increase in borrowing by public corporations and other public bodies (see chapter 3). Given the low level of domestic savings, this has contributed to comparatively high long-term interest rates. Government aims to bring the overall public sector borrowing requirement down as a share of GDP over the next three years.

Determinants of long term interest rates

Foreign investors are increasingly important holders of South African long term debt. As a consequence, long term interest rates largely reflect international capital market rates adjusted for the perceived risks associated with the rand market.

Long term interest rates on SA domestic debt can accordingly be decomposed into three elements: the interest on US debt (the best approximation to a "risk free" rate); the premium SA has to pay on its foreign currency denominated debt compared to US debt (credit risk); and the difference in the rate of inflation between the US and SA which approximates the anticipated decline in the value of the local currency relative to the dollar.

A decomposition of long term interest rates

	%
Yield on US long bonds	**5,5**
Premium on SA foreign bonds over US bonds of equivalent maturity	3,0
Yield on SA Yankee Bond	**8,5**
Inflation differential between expected SA and US inflation	3,0
Residual premium	3,0
Yield on SA domestic long bonds	**14,5**

The premium over US interest rates that SA has to pay on its foreign currency denominated debt (about 3 percentage points) is a measure of the country risk premium, or the perceived risk of SA defaulting on its debt, after taking account of limited liquidity of SA bonds and other factors. This is significantly below the peak in September 1998, at the height of last year's financial crisis (when the SA Yankee bond traded at a yield of some 7 percentage points above the US bond rate), signalling a rapid recovery in confidence in the South African economy.

The difference between the yield on SA domestic debt (14,5 per cent) and foreign currency debt (8,5 per cent) is currently about 6 percentage points. This can in part be explained by the difference in expected inflation between SA and the US, as the inflation differential underlies expected depreciation of the rand. The residual premium can be attributed to uncertainty over the exchange rate, uncertainty related to future inflation and other currency risk factors.

Exchange rate uncertainty

Uncertainty over the exchange rate also contributes to the premium paid on long term borrowing. In the context of considerable pressure on the rand in 1998, the Reserve Bank intervened in forward currency markets to protect the rand. The resulting net open position on the Reserve Bank's forward book and South Africa's low level of foreign reserves contribute to the prevailing uncertainty regarding the future value of the rand.

The Reserve Bank is in the process of reducing the size of the forward book and has made significant progress in recent months. Further progress is anticipated given the current strength of inflows and the impact of a higher gold price on the balance of payments, all of which should contribute to greater exchange rate stability.

Inflation expectations

Uncertainty in inflation increases the risk premium faced by long term borrowers. Over the course of the 1970s and 1980s, many governments found that lowering inflation was best accomplished by reducing the expectations of inflation held by the public. Any mismatch between inflation expectations and actual inflation interferes with investment, pricing and wage-setting decisions, which all contribute to rising inflation, or declining capacity utilisation.

To address these factors, Government has decided to introduce an explicit inflation target during 2000, which is intended to reduce inflation uncertainty. This should contribute over time to lower long term interest rates.

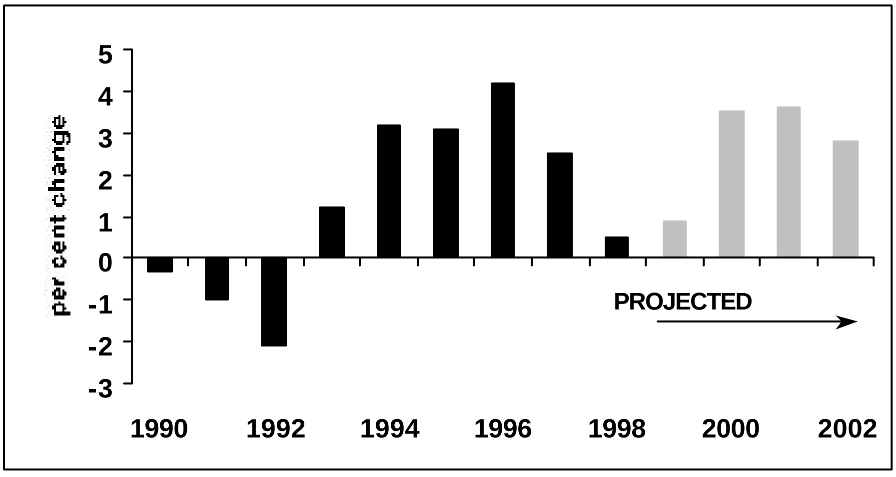
The domestic economy

Gross domestic product

Growth in GDP in 1999 has been weak, but represents a substantial improvement over the fourth quarter of 1998. The economy grew at annualised rates of 0,6 and 1,7 per cent in the first and second quarters of 1999, respectively, after declining at a rate of 2,3 per cent in the third quarter of 1998.

The recovery of economic activity is expected to continue during 1999, and to gather momentum in 2000 and 2001, as shown in figure 2.3.

Figure 2.3: GDP growth 1990 to 2002 (projections for 1999 to 2002)



Revised national accounts estimates

In June 1999, Statistics SA and the Reserve Bank re-based the National Accounts in line with the System of National Accounts 1993 (SNA93) standards. The base year was changed from 1990 to 1995.

New areas of economic activity have also been included and new data sources utilised. The revisions incorporated newly available data from the 1993 and 1996 Censuses of Mining, and the 1996 Population Census and Census of Manufacturing, together with new estimates from the taxi industry, cellular network firms, micro lenders and the security industry. Figures relating to the internet industry were also included for the first time.

Improvements in the methodology were introduced, including the calculation of annual GDP estimates from annual surveys. Previously, GDP estimates were derived from the sum of the GDP estimates for the four quarters of the relevant year, which were short term and incomplete.

The new GDP level at current prices is approximately 14 per cent higher than the previous GDP estimates, increasing from R484,6 billion to R548,1 billion in 1995. From 1994 to 1998, the economy grew on average by 2,7 per cent a year, compared to the pre-revision average of 2,2 per cent. The primary sector's share of GDP (agriculture plus mining) declined from 15 per cent to 10,9 per cent in the new data. Manufacturing's share of GDP also declined, from 25,5 to 21,2 per cent. The financial services share increased from 14,5 to 16,4 per cent. The share of government services increased from 13,8 to 16,2 per cent. The transport, storage and communications share increased from 7,4 to 8,9 per cent. The contribution of financial services and communications to GDP was also revised upwards, to 4,3 and 6,8 per cent, respectively.

Government's share of GDP increased largely because the treatment in the accounts of the depreciation of fixed capital assets was changed, infrastructural assets were included in capital formation, and some expenditure was reallocated between compensation of employees and intermediate consumption. (The new SNA distinguishes between final consumption by general government and intermediate government expenditures that contribute to the final consumption of households).

Agriculture and mining variable

The primary sector (agriculture and mining) has continued to be a variable contributor to growth in the economy. While agriculture fell in 1998, its growth in the second quarter of 1999 (an annualised 19,5 per cent), brought primary sector growth to 7,0 per cent on an annualised basis. The mining sector has remained weak, partly as a result of the depressed gold price in the first half of 1999.

As noted above, the present cyclical rise in commodity prices will benefit the mining industry and the wider economy.

Manufacturing expected to grow

Manufacturing output remains flat. The overall year-on-year decline in secondary sector output of 0,5 per cent in the second quarter of 1999 is attributed to decreases in the output of the electricity, gas and water and construction sectors.

However, there are early signs of increased activity from the motor vehicle industry. The longer term trend in manufacturing suggests that as economic growth picks up momentum over the second half of 1999 and through 2000, sectoral output should increase strongly.

Financial services and retail trade

The tertiary sector, composed of financial and community services, and wholesale and retail trade, catering and accommodation, continued to grow moderately through the first half of 1999 (by 1,5 and 2,0 per cent year a year in the first two quarters of 1999, respectively). As household consumption increases with faster growth, and consumers reach more sustainable debt levels, it is expected that the strong growth that these sectors experienced for most of the 1990s will again emerge.

Private consumption expenditure decline in 1999

Consumption spending by households grew strongly from 1994 to 1997, increasing by an annual average of 4,2 per cent. In 1998, growth in household consumption fell to 1,3 per cent. The full brunt of the economic slowdown, however, became evident in 1999, when spending fell for the first time since 1992 – by annualised rates of 1,0 and 0,1 per cent in the first two quarters.

Private consumption expenditure is expected to grow in the second half of 1999, contributing to the economic recovery.

General government consumption spending

Real consumption expenditure by general government, comprising personnel remuneration and purchases of goods and services, has grown moderately, by an annual average of 1per cent from 1994 to 1998, despite an apparent decline in 1996. In the first half of 1999, consumption spending fell by an annualised 1,1 per cent. The decline reflected improved controls over spending by Government departments, and is in line with Government's policy to reduce dissaving.

Investment growth

Gross fixed capital formation (GFCF) grew by an annual average of 7,3 per cent from 1994 to 1998. In 1998, investment growth slowed to 4,8 per cent, followed by a substantial reduction in investment spending in the first half of 1999 (falls of 24,4 and 9,3 per cent in the first two quarters, respectively).

Most of the increase in investment in 1998 resulted from large-scale public infrastructure investment in the energy, transport and telecommunications sectors. A pause in the rollout of infrastructure contributed to the sharp drop in investment in the first half of 1999. It is expected that as the economy recovers, private investment will increase strongly, complementing further increases in capital formation by public enterprises.

As a percentage of GDP, gross fixed capital formation increased to 16,5 per cent in 1998 from 16,4 per cent 1997. In the first two quarters of 1999, GFCF was 15,5 per cent and 15,0 per cent of GDP, its lowest level since 1993.

Saving

In the first half of 1999, saving as a percentage of GDP increased, albeit marginally, from the poor levels seen in 1997 and 1998. Saving grew to 14,4 per cent and 15,1 per cent in the first two quarters of 1999, after reaching a low of 12,9 per cent in the fourth quarter of 1998. This remains far lower than required to finance a rate of investment consistent with rapid economic growth.

The main contributions to the marginally improved saving performance in 1999 came from a decline in government dissaving, and an increase in the financial surpluses of corporations. Household saving continued to weaken, falling to 1,4 per cent of households' disposable income.

Change in inventories

In the first half of 1999, industrial and commercial inventories continued their long term decline, falling to 12,5 per cent of GDP. There was some increase in the second quarter of 1999, and further inventory re-stocking is expected as the economic recovery continues through 1999 and 2000.

Balance of payments

The slowdown in economic activity in 1998 resulted in an improved balance of payments, particularly in the first half of 1999. As growth increases through the second half of 1999 and 2000, it is expected that the current account balance will deteriorate moderately, but will be financed by strong capital inflows.

Current account deficit

The underlying performance of the current account of the balance of payments has been distorted by large imports associated with the investment programmes of public corporations. Despite the sharp increase in interest rates and the depreciation of the currency during the second half of 1998, imports continued to increase and the current account deficit reached R19,6 billion (2,6 per cent of GDP) in the last two quarters of 1998. After recording a modest surplus of R3,9 billion in the first quarter of 1999, the current account fell into a deficit of R4,9 billion in the second quarter of 1999. The initial improvement reflected a slowdown in public corporation investment spending and a modest increase in export activity, while the subsequent deficit was caused by a deterioration in the trade balance.

As economic growth and private consumption expenditure recover, it is expected that imports will rise during the second half of 1999. Overall, the current account deficit is anticipated to average a relatively modest 0,5 per cent of GDP over the calendar year.

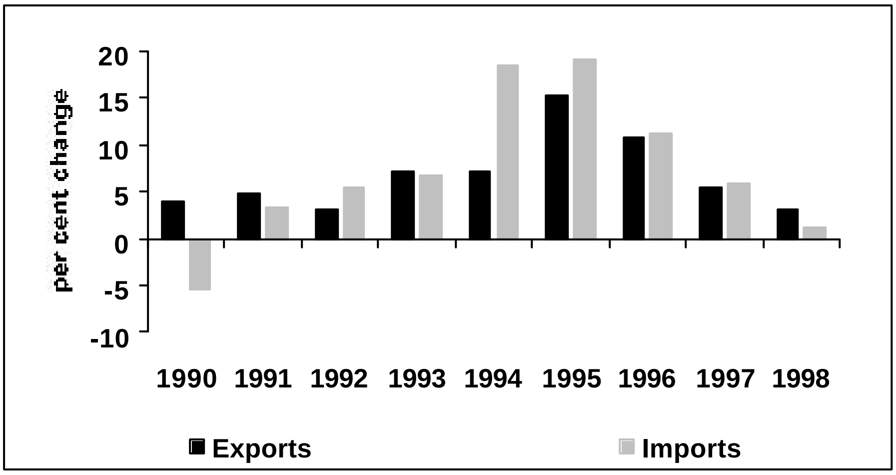
Trade with the EU

On 11 October, South Africa signed a Trade, Development and Co-operation Agreement with the European Union (EU), which aims to consolidate strategic links with South Africa's largest trade and investment partner. The agreement provides for the establishment of a free trade area between South Africa and the European Union over a period of twelve years, liberalising 95 per cent of SA exports into the EU over a ten-year period and 86 per cent of EU imports into SA over a twelve-year period.

SADC trade protocol

The SADC Protocol on Trade is expected to enter into force on 1 January 2000. This will lead to the creation of a duty-free area in SADC over a period of 8 years.

Figure 2.4: Real merchandise imports and exports



As shown in figure 2.5, growth in real merchandise exports has slowed since 1995 to 5,4 and 3,1 per cent in 1997 and 1998, respectively. In the first two quarters of 1999, the annualised rate of growth in exports swung from 7,7 per cent in the first quarter to negative 4,5 per cent in the second quarter. These trends include the impact of the lower gold price on gold exports. The recent recovery in the gold price should contribute to stronger export performance in the second half of 1999 and beyond.

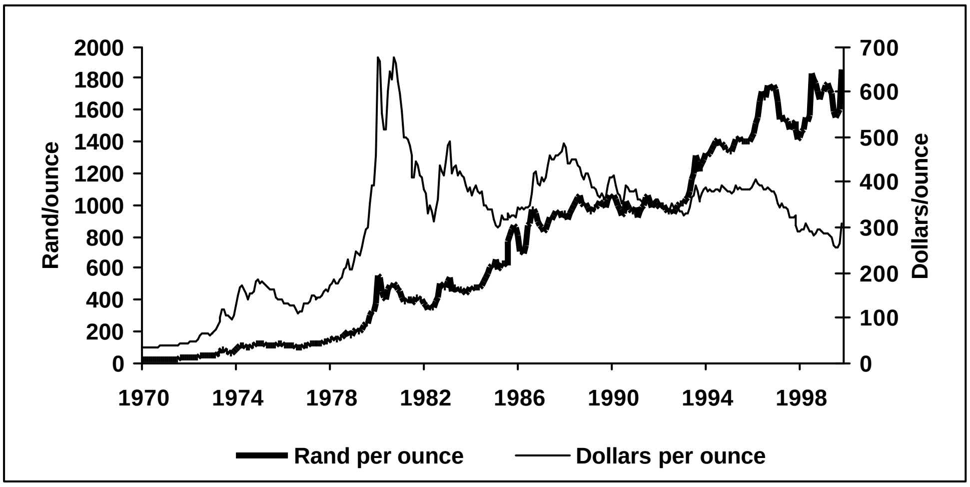
The gold price and exports

When Government announced its macroeconomic strategy in June 1996, gold was trading at approximately $400 per ounce. At the time, it was generally expected that gold would continue to trade in the $380 to $400 range. The sharp fall in the US dollar gold price over the last four years, from $388 in 1996 to a low of $256 in mid-1999, had a serious impact on the country’s export earnings and employment, although this has been somewhat offset by the depreciation of the rand and the resulting increase in the rand gold price.

Although the importance of gold has declined over the last few decades, it still contributes about 16 per cent of South Africa’s merchandise exports. The recent sharp increase in the gold price, if sustained, will provide a significant boost to the South African economy.

South Africa currently produces just over one million ounces of gold per month. Assuming the gold price remains at $300, or approximately $30/oz above the average price for the year to date, an additional $30 million (approximately R200 million) in export earnings would be achieved every month.

US $ and rand price of gold: 1970 to 1999



The current account deficit is expected to remain between 1 and 2 per cent of GDP over the next three years. Recent financial flows indicate that this can be readily financed, and the rising gold price helps to offset the impact of the substantially higher oil price on the balance of payments.

Foreign reserves

Total gross international reserves fell sharply in the second half of 1998, to end the year at R42,2 billion. The overall surplus on South Africa’s balance of payments in the first half of 1999 generated a net increase in gross reserves, which rose to R47,2 billion by the end of June.

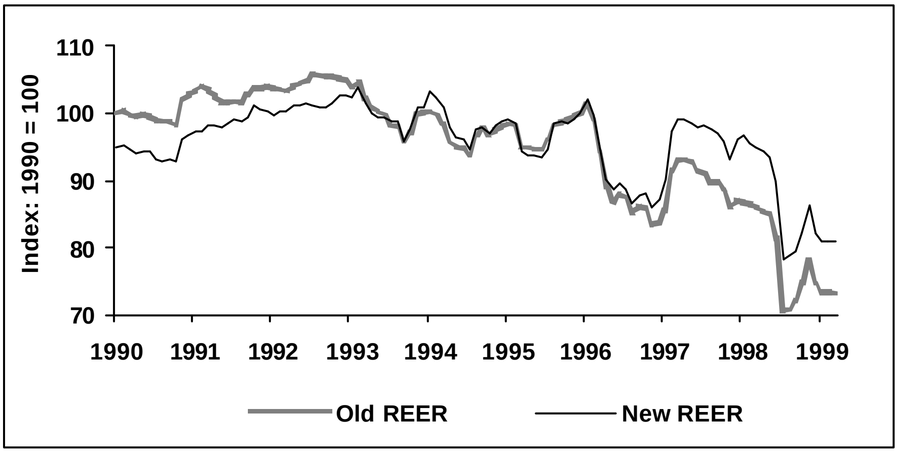
The real effective exchange rate

The real effective exchange rate takes account of the difference between price trends in South Africa and major trading partners, to provide an estimate of the relative price competitiveness of South African goods in international markets.

In September 1999, the South African Reserve Bank increased the number of currencies used in the compilation of the real effective exchange rate, from four to fourteen. The graph shows the competitive gains to exporters implied by the depreciation of the real effective exchange rate over the last few years using the new and old indices.

The new estimates show that the Rand is about 15 per cent below its 1990 real value, whereas the former index implied a real depreciation of more than 20 per cent.

Real effective exchange rates (REER): 1990 to 1999



Import cover, which measures the number of weeks' worth of imports of goods and services accounted for by the country's gross international reserves, has increased from 10 to 12 weeks over this period.

Exchange rate trends

The real effective exchange rate of the rand declined by 14,6 per cent from December 1997 to December 1998. The currency has since stabilised and even strengthened in the first 9 months of 1999. South African exporters are nonetheless expected to benefit from the overall depreciation of the rand during the past year and a half.

Labour market developments

Employment

Labour absorption in the economy has been weak since 1990, and the trend in formal employment since 1994 has not improved, despite the resumption of economic growth.

While the available data on employment do not cover all economic sectors, the Survey of Total Employment and Earnings does include activity in most of the formal, non-agricultural economy. These series indicate persistent declines in employment. The June 1999 release shows employment falling by 1,5 per cent year-on-year, and by 1,1 per cent from March to June 1999. Quarterly employment reductions were largest in the public sector, construction and manufacturing, while increases occurred in financial services. From June 1998 to June 1999, only the wholesale and retail trade sector showed an increase in employment. The average decline for the year to June was 4,0 per cent for all other sectors combined.

Wage trends

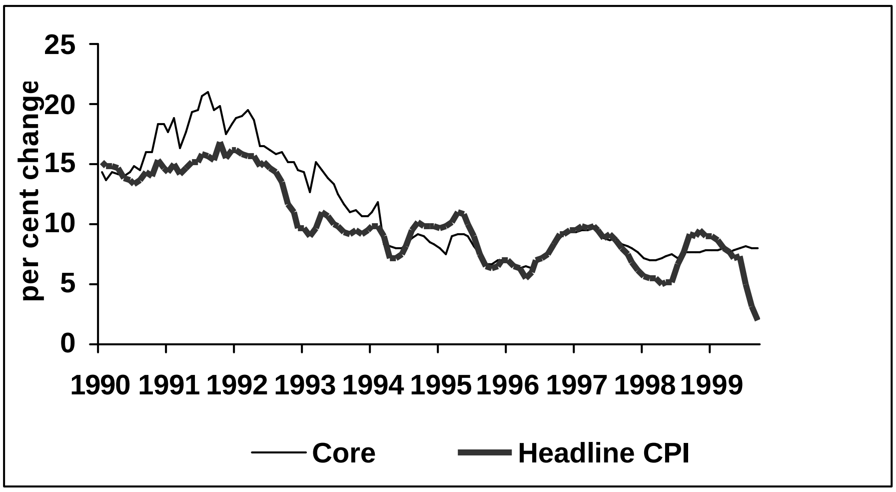
Nominal unit labour costs rose by 9,9 per cent in 1998. Largely reflecting the economy’s weakness over 1998, nominal unit labour costs subsided in the first half of 1999, increasing by 6,0 per cent from a year earlier.

Inflation and money supply

Inflation trends

Although consumer price inflation rose sharply with the increase in nominal interest rates in mid-1998, it has subsequently declined to 1,9 per cent for the year to September 1999.

Figure 2.5: Core and headline consumer price inflation (year on year increase in the indices)

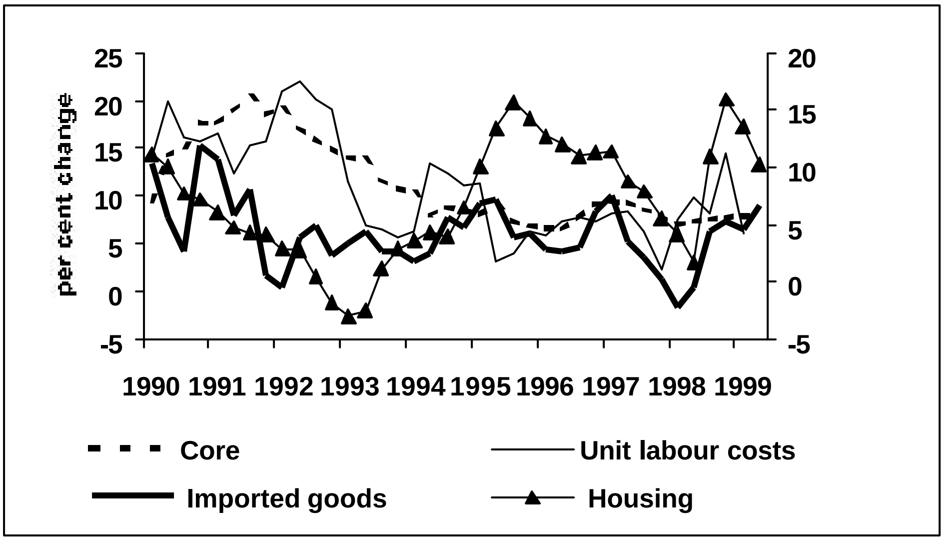


Determinants of core and headline CPI inflation

The consumer price index (CPI) is composed of a weighted basket of prices of commodities and services, including the cost of housing, transport, and other items. As several components of the "headline" CPI are affected by changes in policies (such as taxes or interest rates) or by extraneous factors (such as the weather), the underlying inflation trend is better measured by "core" CPI. Core inflation is similar to headline CPI inflation, except that certain items in the basket of commodities and services have been stripped out. These include mortgage costs, indirect taxes and certain food products.

In 1999, headline and core CPI inflation have diverged. The decline in mortgage interest costs (about 10 percentage points) since the fourth quarter of 1998 has pulled CPI down through 1999. Core, however, has remained high, at around 8,0 per cent. Mortgage interest costs are excluded from the core inflation measure. As a result, oil and other imported goods prices have a larger impact in core than in CPI inflation. In 1998, unit labour costs kept core high, while in 1999, oil price increases as reflected in the rising cost of imported goods prevented a decline in core.

Core inflation, unit labour costs and imported goods prices (quarterly data)



Consumer price inflation is expected to average 5,5 per cent in 1999. However, core CPI inflation has remained above 7,5 per cent since 1996. In 1999, CPI and core inflation have diverged. The decline in mortgage interest costs (about 10 percentage points) since the fourth quarter of 1998 has been the main contributor to the decline in headline inflation.

Money supply and credit

Declining GDP growth in the third quarter of 1998 and lower demand for credit from the private sector contributed to a sharp deceleration in the M3 measure of money supply over the past year.

Inflation prospects for the coming year will be influenced by developments in the oil price, wage settlements, and price-setting by parastatals. OPEC supply restraints have given a firm upward momentum to crude oil prices, which have doubled in recent months and remain the single most important threat to stability in all measures of inflation.

Challenges

Structural changes

Since 1994 the South African economy has undergone a process of structural transformation. The economy is now considerably more open. Exchange controls have been substantively removed, and trade barriers have been reduced through the EU trade agreement, a more open environment in the SADC region, and other measures. Fiscal policy has been reformed and the level of borrowing significantly reduced. These policies contribute to falling inflation, higher investment of improved quality, and stronger growth.

Inflation prospects

Macroeconomic forecasts cannot take account of all the benefits these changes bring for the economy's long term growth path. The current outlook for the economy reflects a significantly improved long run outlook by comparison with economic performance in the early 1990s. Further structural reforms will in due course improve growth prospects further.

Economic reform

In his opening of Parliament address, the President indicated that steps would be taken to accelerate the restructuring of state assets and revisit labour market regulation. Restructuring could significantly strengthen the financial account of the balance of payments, reduce the level of government borrowing, support a lower level of interest rates, and contribute to faster economic growth.

Inflation

The successful implementation of inflation targeting should also reduce wage inflation, and contribute to a further reduction of interest rates. However, rising oil prices and continued wage pressures remain significant factors underlying inflation expectations.

Global markets more steady

Although global financial markets are more stable than they were at this time last year, considerable volatility remains and there is a relatively low level of demand for emerging markets assets. While the net open forward position and the low level of external reserves still leave South Africa vulnerable to a general loss of confidence in global financial markets, there has been a substantial improvement in the external position over the last nine months.

The current forecasts assume that long term interest rates decline steadily. A more rapid inflow of foreign funds, or other developments that improved the foreign reserve position, would reduce the risk premium on South African assets and contribute further to an improved financial environment.

Outlook

The economic outlook for the next three years is summarised in table 2.1.

Table 2.1: Macroeconomic projections: 1999 to 2002

Calendar year:	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Gross domestic product (R billion)	**548,1**	**614,9**	**680,2**	**737,8**	**793,2**	**862,6**	**940,0**	**1 014,1**
Real GDP growth	3,1%	4,2%	2,5%	0,5%	0,9%	3,5%	3,4%	3,2%
GDP inflation	10,3%	7,7%	7,9%	7,9%	6,4%	5,3%	5,0%	4,8%
Real growth in demand:								
Final consumption growth	**2,6%**	**5,3%**	**2,9%**	**1,1%**	**0,8%**	**2,7%**	**2,8%**	**2,8%**
Gross fixed capital formation growth	10,7%	7,5%	5,2%	4,8%	-5,7%	6,3%	7,7%	4,9%
Gross domestic expenditure	**4,3%**	**4,0%**	**2,4%**	**0,5%**	**-0,4%**	**4,3%**	**4,2%**	**2,8%**
Exports	10,4%	9,3%	5,5%	2,3%	0,0%	5,0%	6,6%	5,3%
Imports	16,9%	8,7%	5,4%	2,1%	-5,9%	9,6%	8,5%	5,0%
CPI inflation:								
Headline	8,7%	7,4%	8,6%	6,9%	5,5%	5,2%	5,1%	4,8%
Core	7,9%	7,2%	8,8%	7,5%	7,9%	6,9%	5,5%	5,0%
Balance of payments:								
Current account balance (% of GDP)	1,5%	1,3%	1,5%	1,6%	-0,5%	-1,3%	-2,1%	-1,9%

Growth recovers

A modest recovery in economic growth is expected during 1999, which will gather momentum in 2000 and 2001. Investment and consumption expenditure are projected to recover strongly in 2000 to 2001, before stabilising during the subsequent two years.

Exports recover, but gold price effect only felt in 2000

Export prospects have improved as a result of the recovery of the global economy, a more competitive rand, and the recent improvement in the gold price. The current account of the balance of payments is expected to deteriorate somewhat as economic growth increases, but this will be moderated by increased exports.

Inflation and currency stable

Consumer price inflation is projected to decline steadily from about 5,5 per cent in 1999. The rand is expected to remain at current levels in real terms, depreciating by between 3 and 4per cent per year in nominal terms.

Fiscal year projections

Table 2.2 summarises revised GDP growth and inflation projections for the fiscal years 1998/99 to 2002/03, shown alongside the February 1999 Budget estimates.

Table 2.2: Macroeconomic projections: 1999/00 to 2002/03

Fiscal year:	**1998/99**	**1999/00**		**2000/01**		**2001/02**		**2002/03**
	Outcome	1999 Budget	Revised	1999 Budget	Revised	1999 Budget	Revised	
Gross domestic product (R bill)[1]	**751,4**	**813,9**	**809,2**	**881,1**	**881,9**	**952,1**	**957,5**	**1 034,6**
Real GDP growth	0,2	1,8	1,7	3,2	3,6	3,8	3,4	3,2
GDP inflation	7,7	6,4	5,9	4,9	5,2	4,1	5,0	4,7
CPI inflation:								
Headline	7,7	5,5	4,4	4,5	5,3	4,0	5,0	4,7
Core	7,6	-	7,7	-	6,6	-	5,3	4,8

1. The 1999 Budget projections of GDP growth and inflation are applied to the new estimate of 1998/99 GDP, to obtain the adjusted 1999 Budget GDP projections shown here for comparative purposes.

3

FISCAL POLICY AND THE BUDGET FRAMEWORK

Revised budget framework

Stronger growth in the South African economy – described in chapter 2 – rests in part on continued strengthening of the public finances. Government's fiscal policy objectives are discussed below, together with a review of key fiscal indicators and a summary of the proposed framework for the 2000 Budget.

Robust spending growth

The revised budget framework provides for an increase in spending on public services of over R7,5 billion a year over the new MTEF period. Total expenditure is budgeted to grow at 7,3 per cent a year over the next three years.

Lower interest on debt

Increased spending is based on the revised macroeconomic projections described in chapter 2, which include somewhat higher nominal GDP growth than anticipated at the time of the 1999 Budget. Lower interest on state debt – partly as a result of reduced debt through state asset restructuring receipts – contributes R2,2 billion to the increase in available resources in 2000/01.

Healthy revenue trends

National revenue exceeded the revised budget estimate by R4,5 billion in 1998/99, contributing both to increased revenue projections and further scope for lowering the burden of tax on citizens and the economy. The budget framework allows for a moderate reduction in the tax-GDP ratio over the next three years, while also providing for the phasing in of the new skills development levy.

General government tax revenue, which includes social security and local government taxes, is expected to decline steadily from 26 per cent of GDP in 1998 to about 25 per cent of GDP in 2002 and beyond.

Budget deficit 2,8 per cent of GDP

The national budget deficit is projected to fall from 2,8 per cent of GDP in 1999/00 to 2,4 per cent in 2002/03. This reflects strong revenue trends, improved expenditure management and the recovery of GDP growth projected for the next three years.

Declining public sector borrowing requirement

Taking into account a moderate rise in borrowing by government enterprises and by provincial and local government, the public sector borrowing requirement is projected to decline to 3,0 per cent of GDP over the next three years.

Fiscal policy considerations

Balance between conflicting objectives

The budget framework must achieve a balance between three broad objectives:

- reducing the overall burden of tax, so as to reduce the costs of investment and job creation and release household spending power;
- lowering the budget deficit, to improve the sustainability of the public finances and contribute to lower interest rates; and
- providing for the social, developmental and infrastructural expenditure responsibilities of the State.

Improved long run growth, employment creation and an equitable distribution of income are the underlying goals of fiscal policy. Government seeks to contribute to accelerated investment and strengthen public service delivery within the context of an affordable and sustainable budget framework.

Fiscal policy goals

Increased investment and sustainable growth are supported through the following fiscal policy objectives:

- moderating the level of government consumption spending relative to GDP, including public service personnel expenditure;
- enhancing capital formation by general government and public corporations;
- reducing the level of government dissaving, in part through steady reductions in the budget deficit;
- stabilising the level of debt and reducing debt service costs;
- lowering the burden of tax on the economy, both through broadening the tax base and reducing the distorting effects of tax; and
- reprioritising government expenditure to support growth, employment, income redistribution and extending economic opportunities.

Key fiscal indicators

Changed GDP ratios

Upward revisions in South Africa's main national accounts aggregates result in changed key measures of fiscal performance. The budget deficit was 2,6 per cent of GDP in 1998/99, compared to 3,0 per cent measured against the previous GDP index. Total tax revenue is now around 26 per cent of GDP, whereas it reached nearly 30 per cent of the former aggregate. Government consumption expenditure is 20,2 per cent of the new GDP, compared to 23 per cent of the previous estimate.

Trends in several key fiscal indicators since 1994 are summarised in table 3.1.

Table 3.1: Key fiscal trends (national accounts estimates)

	1994	1995	1996	1997	1998
Government consumption expenditure (% of GDP)	20,0%	18,3%	19,4%	19,8%	20,2%
Gross fixed capital formation (real growth):					
General government		6,0%	5,3%	4,4%	2,5%
Public corporations		15,8%	10,6%	9,7%	51,4%
General government saving (% of GDP)	-5,9%	-4,2%	-4,9%	-4,9%	-3,9%
Interest on public debt (% of GDP)	5,5%	5,9%	6,4%	6,1%	6,3%
Average yield on long-term government stock	16,8%	14,6%	16,2%	14,1%	16,4%
General government tax revenue (% of GDP)	24,4%	24,1%	24,7%	24,9%	26,0%
Distribution of general government expenditure (% of current expenditure):					
Interest on public debt	17,5%	20,0%	20,5%	19,7%	20,3%
Subsidies and transfers	19,0%	18,2%	17,2%	16,3%	14,9%
Final consumption expenditure					
Individual services	28,3%	27,9%	26,5%	30,0%	30,1%
Collective services	35,1%	33,8%	35,9%	34,0%	34,7%

Several conclusions emerge from this.

Rise in government consumption expenditure

Final consumption expenditure by government has increased relative to GDP since 1995, partly reflecting the impact of public service remuneration trends since 1996.

Strong growth in capital spending

The contribution of the public sector to capital formation has been strong, reflected both in real (though declining) growth in general government investment spending and a particularly sharp increase in investment by public corporations in 1998. Estimated gross fixed capital formation by public corporations grew by 51,4 per cent in 1998, as Telkom and South African Airways, amongst others, substantially raised their investment spending.

Declining government dissaving

As mentioned in chapter 2, general government dissaving, which is now calculated after taking into account government consumption of fixed capital (depreciation), has fallen from 5,9 per cent of GDP in 1994 to 3,9 per cent in 1998, brought about largely by the reduction in the national budget deficit.

Interest on debt affected by higher interest rates

Interest on public debt peaked at 6,4 per cent of GDP in 1996, but recorded an increase again in 1998 in the context of financial uncertainty and high interest rates. After falling to 14,1 per cent in 1997, interest rates on long-term government debt averaged 16,4 per cent in 1998.

Rising tax-GDP ratio

General government tax revenue has increased from 24,4 per cent of GDP in 1994 to 26,0 per cent in 1998. This includes taxes collected by the SA Revenue Service as part of the national budget, provincial and local government taxes, unemployment insurance contributions and South African tax revenue diverted to other countries in terms of the SA Customs Union agreement.

Distribution of government spending

The distribution of general government current expenditure shows several broad features:

- interest on debt has been about 20 per cent of current expenditure since 1995;
- subsidies on products or production and current transfers to households (mainly social grants) and the rest of the world have fallen from 20 per cent to 15 per cent of the total – partly as a result of the phasing out of the general export incentive scheme and early retirement and voluntary severance offers;
- final consumption expenditure on individual (household) services, such as education and health care, has increased from 28,3 per cent to 30,1 per cent of current spending;
- final consumption expenditure on collective services, such as defence, police and administrative functions, has ranged between 33,8 per cent and 35,9 per cent of current expenditure.

Fiscal policy aims

Contribution of fiscal policy to growth

The trends outlined above suggest a mixed contribution of fiscal policy to growth and investment – positive capital spending trends; uneven progress in reducing debt service costs and interest rates; a rising tax burden; increasing government consumption expenditure and a downward trend in subsidies and transfers.

Fiscal policy aims

Taking into account the fiscal policy goals set out above, Government has adopted the following aims for the three years covered in the 2000 Budget estimates:

- to lower government consumption expenditure to 19 per cent of GDP by 2002;
- to maintain real growth in general government capital formation of 5 per cent a year;
- to reduce general government dissaving by 1 per cent of GDP a year;
- to reduce interest on public debt to 5,5 per cent of GDP by 2002; and
- to lower general government tax revenue to 25 per cent of GDP by 2002.

Wider scope of fiscal planning

These indicators relate to the wider general government and public sector accounts – of which the national budget is the main part. Consistent with these aims, fiscal planning and budget documentation will in future cover the full range of government agencies and public sector entities.

Revenue, expenditure and the budget deficit

Revenue growth exceeds spending growth

National budget revenue has increased by an average of 13,5 per cent since 1995/96, while total expenditure has grown by 10,3 per cent a year. As shown in table 3.2, the budget deficit has fallen from 4,6 per cent of GDP in 1995/96 to an estimated 2,6 per cent in 1998/99.

Preliminary outcome of 1998/99 budget

The preliminary budget outcome for the 1998/99 year includes total revenue of R184,5 billion – R4,5 billion more than the revised estimate published in the February 1999 *Budget Review* and 12,8 per cent more than 1997/98 revenue. Expenditure exceeded the February estimate by R0,4 billion, and was 7,4 per cent more than in 1997/98. These estimates include several technical changes that should be noted when comparing revenue and expenditure with previous estimates:

- Revenue includes the charge on the proceeds of demutualisation received from Sanlam in 1998/99 (and the Old Mutual in 1999/00), and the transfer of these proceeds to the Umsobomvu Trust will be recorded as expenditure;

Table 3.2: National budget outcome: 1995/96 – 1998/99

R billion	1995/96	1996/97	1997/98	1998/99 1999 Budget estimate	1998/99 Preliminary outcome
Total revenue	**126,1**	**146,5**	**163,5**	**180,0**	**184,5**
per cent of GDP	*22,3%*	*23,2%*	*23,5%*	*24,0%*	*24,6%*
per cent increase		*16,2%*	*11,6%*	*10,1%*	*12,8%*
Total expenditure[1]	**151,8**	**175,3**	**189,9**	**203,6**	**204,0**
per cent increase		*15,5%*	*8,3%*	*7,2%*	*7,4%*
Budget deficit	**25,7**	**28,8**	**26,5**	**23,6**	**19,5**
per cent of GDP	*4,6%*	*4,6%*	*3,8%*	*3,1%*	*2,6%*

1 Excluding revaluation of maturing foreign loans of R30 million in 1995/96, R942 million in 1996/97, R659 million in 1997/98 and R682 million in 1998/99.

- Revenue includes receipts from the RDP Fund of foreign grants in terms of international cooperation agreements, and the corresponding project spending is included in expenditure; and
- Expenditure excludes the revaluation of maturing foreign loans, previously reflected as a "management cost" in state debt costs and now shown on an accrual basis in foreign loan financing, in keeping with international practice.

Inclusion of skills development levies

With effect from 2000/01, the budget estimates will also include provision for the national skills development levy-grant programme.

Revised estimates for 1999/00 and the 2000/01 to 2002/03 period are set out in table 3.3.

Revaluation of maturing foreign loans

The Budget estimates provided for R2,1 billion in state debt costs for the revaluation of a US$750 million bond due to be repaid in December 1999. Based on recent exchange rate trends, a revaluation of R2,0 billion is now expected. Taking this into account, total estimated expenditure in 1999/00 will amount to R218,6 billion, and the budget deficit will be R24,6 billion, or 3,0 per cent of GDP. In the 2000 Budget estimates, the revaluation of foreign loans will be excluded from expenditure, as announced in the 1999 *Budget Review*.

These projections show the national budget deficit falling to 2,4 per cent of GDP in 2002/03.

Table 3.3: Revised medium term budget framework

R billion	1999/00 1999 Budget	1999/00 Revised	2000/01 1999 Budget	2000/01 Revised	2001/02 1999 Budget	2001/02 Revised	2002/03
Revenue	**191,7**	**194,0**	**207,4**	**210,7**	**222,3**	**227,3**	**243,0**
Per cent of GDP	*23,5%*	*24,0%*	*23,5%*	*23,9%*	*23,3%*	*23,7%*	*23,5%*
Expenditure	**214,7**	**216,6**	**230,7**	**234,2**	**247,2**	**251,6**	**267,9**
Per cent increase	*5,4%*	*6,2%*	*7,4%*	*8,1%*	*7,2%*	*7,5%*	*6,5%*
Interest on debt	46,1	44,7	49,8	47,6	52,6	50,8	53,0
Contingency reserve	1,1	-	3,5	2,0	8,0	4,0	8,0
Non-interest spending	**167,5**	**171,9**	**177,4**	**184,6**	**186,6**	**196,9**	**206,9**
Deficit	**23,0**	**22,6**	**23,3**	**23,4**	**25,0**	**24,4**	**24,9**
Per cent of GDP	*2,8%*	*2,8%*	*2,6%*	*2,7%*	*2,6%*	*2,5%*	*2,4%*
Gross domestic product[1]	813,9	809,2	881,1	881,9	952,1	957,5	1034,6

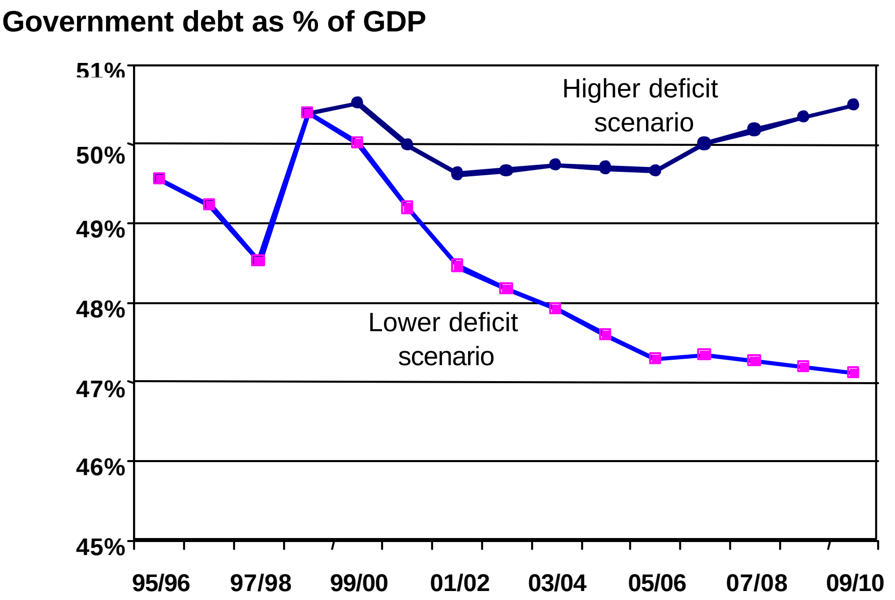
[1] The 1999 Budget projections of GDP growth and inflation are applied to the new estimate of 1998/99 GDP, to obtain the adjusted 1999 Budget GDP projections used here for comparative purposes.

Debt sustainability

Increase in debt as % of GDP

Of particular importance is the ongoing sustainability of the consolidated debt of national government and the wider public sector. The slowdown in economic growth since 1997 together with persistent high interest rates have contributed to the increase in the level of government debt relative to GDP to 50,3 per cent at the end of March 1999, up from 48,3 per cent at the end of 1997/98. Debt service costs remain over 20 per cent of national budget expenditure.

Figure 3.1: Debt sustainability projections



Assumptions	1999/00	2000/01	2001/02	Subsequent years
Higher deficit (% GDP)	3,0	3,0	3,0	3,0
Lower deficit (% GDP)	2,8	2,7	2,5	2,4
Real GDP growth (%)	1,7	3,6	3,4	3,2

Impact of the budget deficit on the debt-GDP ratio

Figure 3.1 illustrates the sensitivity of the debt–GDP ratio to the national budget borrowing requirement. Assuming that the financing requirement is fully met through borrowing, these projections suggest that a phased lowering of the budget deficit to 2,4 per cent of GDP leads to a steady decline in government debt relative to GDP. In contrast, a deficit of 3 per cent of GDP leaves the debt–GDP ratio more or less unchanged. So, assuming that debt continues at 2,4 per cent of GDP in later years, the new budget framework contributes a reduction of over 3 percentage points in the ratio of debt to GDP over a ten year period.

Benefits of reduced debt

Lower government debt over time contributes to lower debt service costs. It also reduces the vulnerability of the economy to adverse economic shocks, which typically lead to both slower growth and higher real interest rates. In contrast, a rising debt–GDP ratio heightens the severity of the adjustment forced on the economy by adverse balance of payments developments or international financial shocks.

Revenue projections

Growth in revenue

National budget revenue is projected to grow at an annual average rate of 7,8 per cent over the next three years, illustrated in figure 3.2.

Figure 3.2: Total revenue – medium term projections

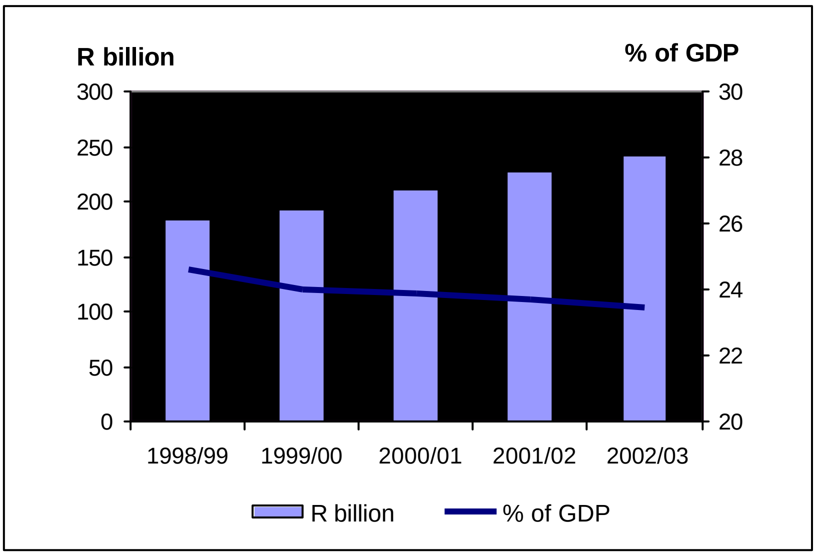


Table 3.4 shows the envisaged changes to the 1999 Budget estimates, and the projected trend in revenue as a per cent of GDP.

Table 3.4: Medium term revenue projections

	1998/99	1999/00		2000/01	2001/02	2002/03
R billion	Outcome	Budget	Revised	Medium term estimates		
National budget revenue	**183,7**	**190,9**	**193,0**	**209,3**	**224,8**	**240,3**
Grants (RDP Fund)	0,5	0,8	0,4	0,4	0,4	0,4
Demutualisation & other levies	0,3	-	0,6	0,1	0,1	0,1
Skills development levies	-	-	-	1,0	2,0	2,2
Total revenue	**184,5**	**191,7**	**194,0**	**210,7**	**227,3**	**243,0**
Per cent of GDP	*24,6%*	*23,5%*	*24,0%*	*23,9%*	*23,7%*	*23,5%*
Per cent increase	*12,8%*	*3,9%*	*5,2%*	*8,6%*	*7,8%*	*6,9%*
Real growth	*4,8%*	*-2,3%*	*-0,7%*	*3,3%*	*2,7%*	*2,1%*
Change from 1999 Budget	**4,5**		**2,3**	**3,4**	**5,0**	

Upward adjustment in revenue estimates

The additional R4,5 billion in revenue in 1998/99 derived mainly from higher taxes on income (R3,4 billion above the revised estimate). Revenue collections have remained buoyant in 1999/00, increasing by 8,2 per cent for the first six months of the year over the corresponding period in 1998/99. An additional R2,1 billion in national budget revenue is projected for the 1999/00 year.

Charge on demutualisation proceeds

Additional revenue in 1998/99 also included the R279 million charge on the demutualisation of Sanlam. Projected 1999/00 revenue includes R577 million received as a charge on the Old Mutual demutualisation proceeds, bringing total proceeds to be transferred to the Umsobomvu Trust to R855 million.

Donor funded expenditure

The preliminary budget outcome for 1998/99 includes foreign grant receipts of the RDP Fund of R522 million. The revised estimate for 1999/00 is R350 million, and the budget estimates for subsequent years include foreign grants amounting to R400 million a year. These receipts and the associated expenditure are no longer voted by Parliament in the departmental appropriations, but will continue to be reported in the budget documentation.

Increase in revenue in 2000 Budget

The strengthening of economic growth results in higher revenue projections for the 2000 budget. The revised budget framework provides for R3,4 billion more revenue in 2000/01 and R5,0 billion more in 2001/02 than anticipated in the 1999 Budget projections. At the same time, the revised framework permits steady reductions in the tax-GDP ratio and further progress towards a more competitive tax environment.

Introduction of skills development levies

Total revenue projections include provision for the phasing in of skills development levies, imposed on private sector employers at a rate of 0,5 per cent of payroll in 2000/01, increasing to 1,0 per cent in 2001/02.

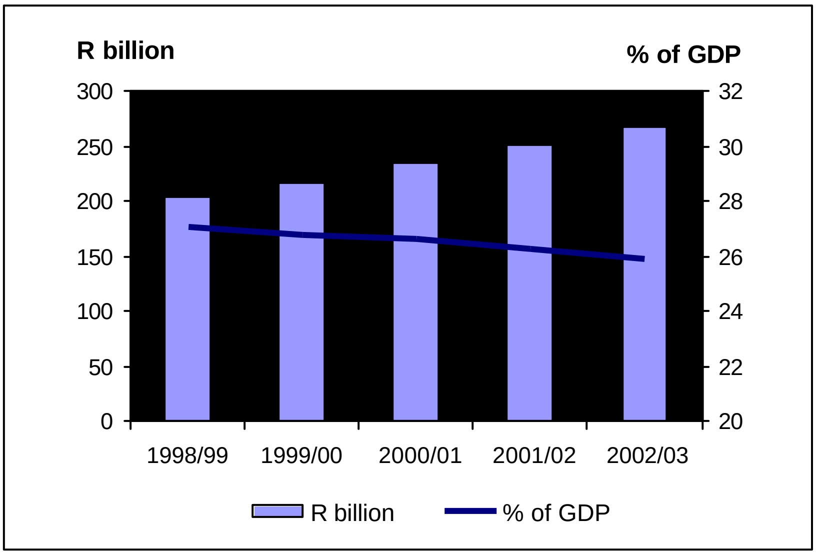
National budget expenditure

Robust expenditure growth

The revised estimates provide for an average annual expenditure growth of 7,4 per cent over the next three years. In real terms, this is an average annual growth of 2,3 per cent.

Table 3.5 shows the changes in expenditure estimates by comparison with the February 1999 Budget estimates, and expenditure growth is illustrated in figure 3.3.

Figure 3.3: Total expenditure – medium term projections



Adjustments to the 1999/00 Budget

The Adjustments Estimate for 1999/00 adds R2,2 billion to projected national budget expenditure, including the committed transfer of R855 million to the Umsobomvu Trust. The Adjustments Estimate provides for:

- a reduction of R1,4 billion in projected interest on state debt;
- additional allocations of R1,5 billion to national departments;
- additional transfers of R1,4 billion to provinces;

- a further R203 million for local government, in support of Y2K-related expenses;
- R250 million for additional improvements in conditions of service; and
- approved rollovers of R2,6 billion out of unspent 1998/99 appropriations, partially offset by projected under-spending and savings of R2,1 billion in the current year.

Table 3.5: Medium term expenditure projections

	1998/99	1999/00		2000/01	2001/02	2002/03
R billion	Outcome	Budget	Revised	Medium term estimates		
National budget expenditure	**203,5**	**213,9**	**215,3**	**232,7**	**249,2**	**265,2**
Debt service costs	42,6	46,1	44,7	47,6	50,8	53,0
Contingency reserve		1,1	-	2,0	4,0	8,0
Available non-interest expenditure	**160,8**	**166,7**	**170,7**	**183,2**	**194,4**	**204,2**
per cent increase	*6,6%*	*4,0%*	*6,1%*	*7,3%*	*6,1%*	*5,1%*
Committed funds:						
RDP donor-funded spending	0,5	0,8	0,4	0,4	0,4	0,4
Umsobomvu & other funds		-	0,9	0,1	0,1	0,1
Skills development funds				1,0	2,0	2,2
Total expenditure	**204,0**	**214,7**	**216,6**	**234,2**	**251,6**	**267,9**
per cent of GDP	*27,1%*	*26,4%*	*26,8%*	*26,6%*	*26,3%*	*25,9%*
per cent increase	*7,4%*	*5,4%*	*6,2%*	*8,1%*	*7,5%*	*6,5%*
real growth	*-0,3%*	*-1,1%*	*0,3%*	*2,8%*	*2,3%*	*1,7%*
Changes from 1999 Budget						
Debt service costs	-0,1		-1,4	-2,2	-1,8	
Contingency reserve			-1,1	-1,5	-4,0	
Available non-interest expenditure	0,6		4,0	7,5	10,5	
Committed funds	-0,2		0,4	-0,3	-0,3	
Total expenditure	**0,4**		**1,9**	**3,5**	**4,4**	

Increase in non-interest spending

In sum, the revised 1999/00 budget provides for R4 billion more in non-interest expenditure allocations.

Projected available expenditure

The available non-interest expenditure level in the MTEF refers to the total nationally-financed spending to be shared between the national, provincial and local spheres of government.

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

- debt service costs – the nation's obligations to pay debt service costs are a statutory claim against expenditure; and
- the contingency reserve – a proportion of the total available resources is not allocated at this stage.

Lower debt service costs

The revised budget framework provides for lower debt service costs over the MTEF period than the 1999 Budget estimates, mainly resulting from:

- the lower deficit in 1998/99, which in turn reduced the net borrowing requirement in that year; and
- debt reduction and lower borrowing associated with state asset restructuring, including the conversion of SASRIA to a state-owned public company in 1999 and anticipated proceeds of further privatisation transactions.

Together with the continued reduction in the annual budget deficit, these factors permit debt service costs to be reduced from 5,7 per cent of GDP in 1998/99 to a projected 5,1 per cent in 2002/03.

Provision for contingencies

A contingency reserve is set aside within the expenditure envelope to deal with unforeseen circumstances. This ensures that Government can adjust to adverse macroeconomic developments, or make funds available for natural or other disasters, within the agreed overall expenditure programme.

A drawdown of R1,5 billion in 2000/01 and R4,0 billion in 2001/02 in the contingency reserve set aside in the 1999 Budget is made in the revised Budget framework, contributing to the increase in available expenditure. A reserve of R2,0 billion in 2000/01 will be retained in the 2000 Budget, increasing to R4,0 billion in 2001/02 and R8,0 billion in 2002/03.

Increase in available expenditure

The revised estimates provide for increases in non-interest expenditure allocations of R7,5 billion in 2000/01 and R10,5 billion in 2001/02, bringing the available non-interest expenditure level to R183,2 billion in 2000/01, increasing to R204,2 billion in 2002/03. The projected functional and economic breakdown of expenditure is set out in chapter 4, and the division of available resources between national, provincial and local government is discussed in chapter 5.

Social and economic priorities

In revising the overall expenditure level, Government is mindful of both fiscal policy considerations and the wide range of social, economic and developmental responsibilities of the State. Spending pressures over the current MTEF period include:

- strengthening and modernising the justice system;
- upgrading the quality and effectiveness of education;
- maintaining public infrastructure and reinforcing safety and health standards on roads, public transport and public buildings;
- provision for training and strengthening management capacity in the public sector;
- transformation of social services in response to HIV/AIDS; and
- provision of basic services, especially to the rural poor, by maintaining and re-inforcing existing programmes as well as through implementation of poverty relief and Jobs Summit programmes.

Defence arms procurement

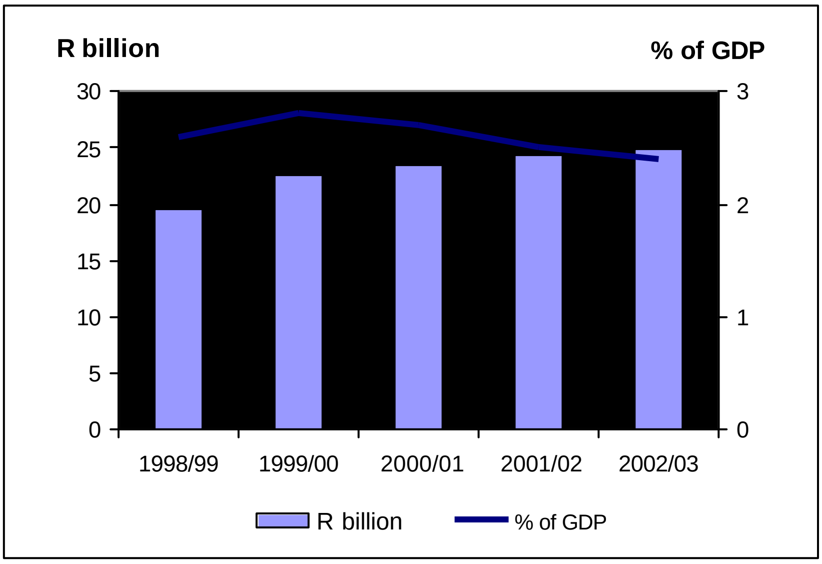
The available expenditure projections include supplementary allocations to the Defence vote of R2,8 billion, R3,8 billion and R4,5 billion over the next three years to meet the projected additional expenditure associated with new arms procurement contracts.

The budget deficit and the public sector borrowing requirement

Budget deficit declines as % of GDP

The projected trend in the national budget deficit over the MTEF period is illustrated in figure 3.4.

Figure 3.4: Budget deficit – medium term projections



Composition of the public sector borrowing requirement

For fiscal policy purposes, it is the overall public sector borrowing requirement (PSBR) that represents the broader claim of government on available savings. This includes the national budget deficit, after taking into account extraordinary payments and receipts and some adjustments for differences in timing between recorded exchequer account transactions and cash flows. It also includes the surplus or deficit of provinces, local government, extra-budgetary agencies and non-financial public enterprises.

PSBR of 3,7% of GDP in 1998/99

Table 3.6 shows the borrowing requirements of the various components of the public sector since 1995/96. The public sector borrowing requirement has declined from R35,6 billion, or 5,6 per cent of GDP, in 1996/97 to an estimated R27,6 billion in 1998/99, which is 3,7 per cent of GDP.

Table 3.6 Public sector borrowing requirement: 1995/96-1998/99

	1995/96	1996/97	1997/98	1998/99	
R billion *deficit (+) / surplus (-)*				1999 Budget estimate	Preliminary outcome
National budget deficit	**25,7**	**28,8**	**26,5**	**23,6**	**19,5**
Cash-flow & other adjustments	1,6	3,3	-2,4	0,7	1,7
Extraordinary payments[1]	3,1				0,9
Proceeds of state asset restructuring, oil sales & other extraordinary receipts	-1,3	-1,6	-2,9	-2,7	-3,0
Main budget borrowing requirement	**29,1**	**30,5**	**21,2**	**21,6**	**19,1**
Plus:					
Provincial governments	-1,3	2,5	6,2	-2,1	-3,2
Social security funds	0,2	0,2	0,3	0,8	0,3
Extra-budgetary institutions	0,4	1,1	1,4	1,8	1,8
Local authorities	0,5	0,8	0,8	0,5	1,0
General government borrowing requirement	**28,9**	**35,1**	**29,9**	**24,1**	**19,0**
per cent of GDP	*5,1%*	*5,6%*	*4,3%*	*3,2%*	*2,5%*
Plus:					
Non-financial public enterprises	1,1	0,5	2,3	1,6	8,6
Total borrowing requirement	**30,0**	**35,6**	**32,2**	**25,7**	**27,6**
per cent of GDP	*5,3%*	*5,6%*	*4,6%*	*3,4%*	*3,7%*

Source: SA Reserve Bank

1 Transfer of R3,1 billion to the Gold and Foreign Exchange Reserve Account in 1995/96 and assumption of debt of former regional authorities of R0,9 million in 1998/99.

Significant trends include:

- a marked reduction in the main budget borrowing requirement since 1996/97;
- a consolidated provincial deficit of R6,2 billion in 1997/98, followed by a cash-flow surplus of R3,2 billion in 1998/99;
- steady increases in the consolidated shortfalls of extra-budgetary agencies and local government (including local government enterprises); and
- a steep increase in the borrowing requirement of public enterprises in 1998/99.

Increased borrowing by public corporations

In 1998/99 public corporations and central government enterprises recorded a deficit to cover both operating losses and investment requirements of R8,5 billion, or 1,2 per cent of GDP – more than double the total borrowing of public enterprises over the previous three years. This includes the borrowing of Eskom, Telkom and the Transnet group of companies, to finance the purchase of new aircraft and telecommunications equipment, amongst other significant investment initiatives.

Forward cover losses

These estimates do not include provision for the losses incurred by the Reserve Bank as a result of foreign exchange forward market operations since 1997. In the context of considerable international financial instability, losses amounting to some R14,4 billion – 1,9 per cent of GDP – were recorded on the Gold and Foreign Exchange Contingency Reserve Account in 1998/99. These are liabilities of government, although not yet incorporated into government loan debt.

Table 3.7: Public sector borrowing requirement - medium term projections

	1998/99	1999/00		2000/01	2001/02	2002/03
R billion	Outcome	Budget	Revised	Medium term estimates		
National budget deficit	**19,5**	**23,0**	**22,6**	**23,4**	**24,4**	**24,9**
per cent of GDP	*2,6%*	*2,8%*	*2,8%*	*2,7%*	*2,5%*	*2,4%*
General government borrowing requirement	**19,0**	**27,4**	**24,4**	**25,6**	**25,8**	**26,9**
per cent of GDP	*2,5%*	*3,4%*	*3,0%*	*2,9%*	*2,7%*	*2,6%*
Public sector borrowing requirement	**27,6**	**29,1**	**28,1**	**29,1**	**29,7**	**31,0**
per cent of GDP	*3,7%*	*3,6%*	*3,5%*	*3,3%*	*3,1%*	*3,0%*
Change from 1999 Budget	**-0,6**		**-1,0**	**2,4**	**2,0**	

Public sector borrowing targets

Projections of the public sector borrowing requirement over the 2000/01 to 2002/03 period must accordingly take account of the national budget deficit, prospective state enterprise restructuring proceeds, possible conversion of the Gold and Foreign Exchange Contingency Reserve Account liability into loan debt, debt obligations of other public sector entities to be taken on by the fiscus, and the financing requirements of provinces, social security funds, local authorities and the non-financial public enterprises. Government aims to lower the overall public sector borrowing requirement to 3,0 per cent of GDP by 2002/03.

Conclusion

Budget projections have been revised to reflect the improved growth projections for the South African economy and to take account of social, economic and developmental spending responsibilities of government.

Lower interest on debt, higher spending on services

The lowering of the budget deficit to below 3,0 per cent of GDP, and debt reduction associated with state asset restructuring, have contributed to substantial downward adjustments in projected debt service costs. Together with improved revenue trends, this enables Government to plan for a R7,5 billion increase in spending on public services in 2000/01 and beyond, while continuing to reduce both the tax burden and the budget deficit relative to GDP.

Strengthened fiscal policy framework

This is a budget framework that provides for further progress in Government's reconstruction and development spending programmes, while continuing to strengthen the role of fiscal policy in promoting investment, growth and financial stability.

4

THE MEDIUM TERM EXPENDITURE FRAMEWORK

Social and development policies and the budget

Spending reflects Government priorities

This chapter reviews the medium term spending plans of national and provincial government. It outlines the spending of national and provincial government, and the budget allocations to local government. It highlights the impact of key national policy priorities on trends in spending on the main functions of Government, and the trends in investment and personnel spending.

Policy priorities

The President's opening address to Parliament on 25 June 1999 committed Government to building a people-centred society that is sustained by a growing economy capable of providing services to all South Africans.

Social and economic policies in place

Government has made significant strides in developing a comprehensive social and economic policy and legislative framework. The hard work lies ahead – speeding up service delivery and implementing programmes that will improve the quality of life of all people in our country.

Over the past three years there has been a major shift towards social service provision. This has created an environment in which Government is able to focus on improving the efficiency and effectiveness of social spending as it grows moderately in the medium term.

Some of the key medium term policy and development priorities highlighted by the President are:

- strengthening and modernising the integrated justice system;

- accelerating investment and further public sector restructuring;
- implementing poverty relief and Jobs Summit programmes that focus on the rural poor;
- transforming social services in response to HIV/AIDS and development needs;
- improving the quality and effectiveness of education and training; and
- contributing to regional conflict-resolution and promoting the African Renaissance.

Improved safety and security

Government proposes to allocate additional funds to the integrated justice sector to improve the efficiency and effectiveness of the sector in the fight against crime.

Public enterprise restructuring

Restructuring of state assets has focused on core functions of public enterprises, improved management and more effective services. The current restructuring of the Government's forestry operations and the South African Post Office has released resources to be spent on other Government priorities.

Public enterprise restructuring over the next three years will contribute further to reducing government debt and improving the transparency and effectiveness of government entities.

Focus on the rural poor

Rural areas are specifically targeted in several poverty relief and Jobs Summit programmes, the extension of the municipal infrastructure programme, and water supply projects.

HIV/AIDS strategy

Government is committing more funds to developing an intersectoral strategy and transforming social services to combat the spread of HIV/AIDS in South Africa.

Quality education

The efficiency and effectiveness of spending in the formal education system is a key priority. Improved financial management and quality in the classroom are the key elements of reform in provincial education spending. This is supported by an ongoing conditional grant to provinces.

Skills development and further education

A skills development levy-grant programme will be introduced in 2000/01 to strengthen industrial training and create learning opportunities for the unemployed. A skills development levy on payroll will finance implementation of the strategy.

Conflict-resolution

The Government is committed to contributing to conflict-resolution on our continent through concerted diplomatic engagement and defence force peace-keeping activities. A strategic arms procurement programme will commence in 2000/01 to strengthen South Africa's defence and peace-keeping capacity.

Budgeting for service delivery

Budgets reflect policy priorities

Budgets are more than just numbers. They reflect the Government's policy priorities, and ultimately, are about delivering better services to people. Improving the quality of government spending and strengthening service delivery are central commitments of the democratic Government's second term.

The Medium Term Expenditure Framework (MTEF) provides Government with a tool to manage the tension between competing policy priorities and budget realities. This helps to reprioritise expenditure and make informed policy choices that are affordable in the medium term.

Service delivery information

But spending alone cannot deliver services. Government is placing greater emphasis on the delivery of quality and efficient services to people. Budget decision-making must take account of what money will buy, and direct spending in a way that has the greatest impact on people's quality of life.

Informed budget decision-making

Informed decisions are made on the basis of information on service delivery. Improved service delivery information will indicate how money is being spent, enabling budgeting to direct funds to where they are most needed, and to where they best contribute to meeting Government's priorities.

The *National Expenditure Survey* was introduced this year, for the first time publishing service delivery information with the Budget. Provinces have similarly improved th equality of budget documentation. The 1999 *Intergovernmental Fiscal Review* expanded this information base, outlining key social service delivery information at the provincial level.

Government aims to improve service delivery information that is used to inform budget decisions. Better service delivery information published in budget documentation also enables Parliament and provincial legislatures, as well as the public, to understand what government does, what programmes and activities are funded, and what outputs the budget buys.

Projected expenditure trends and the division of revenue

Projected expenditure trends set out in tables 4.1 to 4.3 include consolidated national and provincial expenditure, and reflect the share of the national budget going to local government.

Preliminary spending projections

Spending projections reflected in this chapter are based on preliminary proposals for national and provincial spending. More detailed *Estimates of Expenditure* will be tabled before Parliament and provincial legislatures in February 2000.

Spending by sphere of government

Table 4.1 shows projected spending by national and provincial government, and the national budget allocation to local government, comparing projections to the 1999 Budget.

Table 4.1: Consolidated expenditure by sphere of government

	1998/99	1999/00	2000/01	2001/02	2002/03	1999/00	2000/01	2001/02
R billion	Outcome	Revised	Medium term estimates			Changes from 1999 Budget		
National spending (excluding conditional grants)	68,2	71,7	77,4	82,7	87,2	1,7	4,7	6,5
Provincial spending	92,7	97,3	104,5	110,3	117,0	1,9	2,3	3,3
Total national and provincial spending	**160,9**	**169,0**	**181,9**	**193,1**	**204,2**	**3,7**	**7,0**	**9,8**
Local government equitable share plus conditional grants	2,2	2,5	2,8	3,0	3,2	0,2	0,4	0,5
Debt service costs	42,6	44,7	47,6	50,8	53,0	- 1,4	- 2,2	- 1,8
Unallocated reserves	0,0	2,5	3,7	5,7	8,3	- 1,0	- 1,4	- 3,8
Committed funds	0,5	1,3	1,5	2,5	2,7	0,5	-0,3	-0,3
Total	**206,2**	**219,9**	**237,5**	**255,0**	**271,4**	**1,9**	**3,5**	**4,4**

Compared to projections at the time of the 1999 Budget, non-interest expenditure has increased and debt service costs fallen.

Shares of spending

Table 4.2 shows the shares of spending for national and provincial government, and the local government equitable share, and their projected growth over the MTEF period.

Table 4.2: Consolidated expenditure shares and growth

	1998/99	1999/00	2000/01	2001/02	2002/03	1999/00 to 2002/03
per cent	Outcome	Revised	Medium term estimates			Average annual growth
National spending (excluding conditional grants)	41,8%	41,8%	41,9%	42,2%	42,0%	6,7%
Provincial spending	56,9%	56,7%	56,6%	56,3%	56,4%	6,4%
Local government equitable share plus conditional grants	1,3%	1,5%	1,5%	1,5%	1,6%	8,7%
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**6,6%**

Unallocated reserves

Excluding debt service costs, total expenditure shown in table 4.1 above rises on average by 7,6 per cent a year from 1999/00 to 2002/03. After setting aside the contingency reserve and committed funds, available expenditure grows by 6,6 per cent a year. Table 4.2 excludes the unallocated provincial finance reserves and the contingency reserve of the national budget. The proportion of the reserve that will ultimately be allocated to expenditure, and the division of that between spheres, cannot be projected.

Spending shares

The increase in the proportion of spending in the national share mainly reflects provision to the Defence budget required for the new arms procurement programme.

Expenditure by economic type

Table 4.3 below shows projected estimates of consolidated national and provincial spending on personnel, and other current and capital spending, compared to the 1999 Budget.

Table 4.4 below draws out the national component from the consolidated picture, showing projected national spending (excluding conditional grants and interest payments on government debt) on personnel, and other current and capital spending.

Table 4.3: Consolidated national and provincial spending by economic type

R billion	1998/99 Outcome	1999/00 Revised	2000/01	2001/02	2002/03	1999/00	2000/01	2001/02
			Medium term estimates			Changes from 1999 Budget		
Current expenditure								
Personnel	82,2	85,6	90,4	95,4	100,2	1,4	1,4	3,0
Transfer payments	43,0	39,7	43,7	46,1	49,0	0,9	4,1	5,1
Goods and supplies	23,1	32,0	34,7	37,5	40,0	1,1	0,8	0,9
Capital expenditure								
Acquisition of assets	7,5	8,0	9,2	9,8	10,6	0,2	0,5	0,6
Transfer payments	5,2	3,7	3,9	4,3	4,4	0,2	0,1	0,4
Total	**160,9**	**169,0**	**181,9**	**193,1**	**204,2**	**3,7**	**7,0**	**9,8**

Table 4.4: National spending (excluding conditional grants) by economic type

R billion	1998/99 Outcome	1999/00 Revised	2000/01	2001/02	2002/03	1999/00	2000/01	2001/02
			Medium term estimates			Changes from 1999 Budget		
Current expenditure								
Personnel	25,3	26,5	27,4	28,6	29,5	0,8	0,5	1,0
Transfer payments	23,0	17,9	20,9	22,4	23,8	0,1	3,4	4,4
Goods and supplies	11,1	19,8	21,2	22,8	24,3	0,6	0,3	0,4
Capital expenditure								
Acquisition of assets	4,0	4,1	4,4	4,8	5,4	0,1	0,5	0,6
Transfer payments	4,7	3,4	3,6	4,1	4,2	0,1	0,0	0,1
Total	**68,2**	**71,7**	**77,4**	**82,7**	**87,2**	**1,7**	**4,7**	**6,5**

The increase in current transfer payments over the medium term is largely due to the envisaged transfer to the Special Defence Account for purchase of strategic military equipment.

Personnel expenditure

Personnel expenditure forms about half of consolidated national and provincial spending, excluding payment of interest on government debt.

Total employment in the public service has declined slightly since 1997, while average remuneration has increased by about 2 per cent a year in real terms.

A new remuneration policy will be tabled in due course for discussion in the Public Sector Co-ordinating Bargaining Chamber. The policy will benefit from the certainty brought by Government's targeting of inflation over the medium term. Government spending proposals envisage average personnel spending growth of about 5,4 per cent a year.

Under the new remuneration policy, Government aims to:

- Provide greater clarity for employers and employees on remuneration issues;
- Support development of a public service geared towards better service delivery;
- Attract and retain appropriate skilled personnel; and
- Improve the consistency between available resources, Government spending priorities and human resource development in the public service.

Infrastructure

Government spending on infrastructure includes spending on housing, municipal infrastructure development, and investment in water infrastructure and services. Public sector investment on infrastructure development such as telecommunications and electrification is largely the responsibility of public enterprises and municipalities, which are not reflected in these tables.

Public Private Partnerships

Government is focusing increasingly on public-private partnerships (PPPs) for infrastructure and service delivery. Public-private partnership investment projects include national road concessions, Build-Operate-Transfer (BOT) and management contracts for prisons, and municipal services.

Major new projects include two maximum-security facilities, located in Bloemfontein and Louis Trichardt. Both facilities, each to hold approximately three thousand prisoners, are expected to be operational in April 2001.

While public-private partnerships are not a new concept in South Africa, they are not yet widely accepted or applied. And, while some public-private partnerships have improved efficiency of service delivery, others have generated mixed results.

An enabling environment for PPPs

Taking these concerns into account, and the potential of public-private partnerships to improve service delivery, an interdepartmental task team has explored ways of increasing their use. This will be followed by a process of legislative, regulatory and institutional reforms to strengthen the enabling environment in support of public-private partnerships.

Expenditure by type of service

Table 4.5 presents a projected breakdown of consolidated national and provincial expenditure classified by type of service. These medium term projections, based on preliminary budget proposals, are subject to possible changes as budgets are finalised by national and provincial governments.

Table 4.5: Consolidated national and provincial expenditure by type of service

	1998/99	1999/00	2000/01	2001/02	2002/03	1999/00	2000/01	2001/02
R billion	Outcome	Revised	Medium term estimates			Changes from 1999 Budget		
Social services								
Education	44,9	47,2	50,8	53,7	56,8	0,3	0,8	1,1
Health	23,3	25,3	26,8	28,4	30,3	0,9	0,5	0,9
Welfare	18,3	19,7	20,9	22,1	23,3	0,6	0,5	0,7
Protection Services								
Defence and intelligence	11,4	11,4	14,6	16,1	17,3	- 0,1	2,8	3,9
Integrated justice system	20,9	22,2	24,4	25,7	26,9	0,0	0,5	0,8
Economic services	**11,3**	**11,4**	**12,0**	**13,0**	**14,0**	**0,6**	**0,2**	**0,4**
Infrastructure	**23,8**	**21,0**	**20,3**	**21,5**	**22,6**	**1,8**	**0,4**	**0,4**
Administration	**7,1**	**10,7**	**12,0**	**12,5**	**13,1**	**- 0,3**	**1,3**	**1,7**
Total	**160,9**	**169,0**	**181,9**	**193,1**	**204,2**	**3,7**	**7,0**	**9,8**

This classification does not fully correspond with the more detailed functional breakdown that is published in the *Budget Review* and in the official general government statistics.

Provincial finance reserves and the contingency reserve on the national budget, which are likely in part to be allocated to services, are not included in the breakdown.

Service shares

The table below shows the proportions of expenditure attributed to each service, together with projected growth rates for each service.

Table 4.6: Service shares and growth

per cent	1998/99 Outcome	1999/00 Revised	2000/01 Medium term estimates	2001/02	2002/03	1999/00 to 2002/03 Average annual growth
Social services						
Education	27,9%	27,5%	27,7%	27,6%	27,8%	6,4%
Health	14,5%	14,8%	14,6%	14,6%	14,8%	6,2%
Welfare	11,4%	11,5%	11,4%	11,4%	11,4%	5,8%
Protection Services						
Defence and intelligence	7,1%	6,6%	8,0%	8,3%	8,5%	14,9%
Integrated Justice System	13,0%	13,0%	13,3%	13,2%	13,2%	6,6%
Economic services	**7,0%**	**6,6%**	**6,5%**	**6,7%**	**6,8%**	**7,1%**
Infrastructure	**14,8%**	**12,3%**	**11,1%**	**11,1%**	**11,0%**	**2,4%**
Administration	**4,4%**	**6,3%**	**6,6%**	**6,4%**	**6,4%**	**6,7%**
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**6,5%**

The main changes to the 1999 Budget medium term estimates are:

Social services

- Additional spending on social services over the period allows average annual growth of 6,4 per cent in education, 6,2 per cent in health, and 5,8 per cent in welfare over the medium term.

Protection services

- Strong growth in protection services over the medium term largely reflects additional defence spending of R2,8 billion in 2000/01 and R3,8 billion in 2001/02 on the strategic procurement package.
- Proposed additional spending of R0,5 billion in 2000/01 and R0,8 billion in 2001/02 for the integrated justice system reflects Government's commitment to improving the productivity of this function.

Economic services

- Economic services – such as trade, industrial and agricultural services – are projected to grow by 7,1 per cent a year over the period. These functions are complemented by the activities of various public sector corporations and extra-budgetary government agencies, such as Eskom and Telkom.

Infrastructure

- Changes from medium term estimates in the 1999 Budget indicate that Government spending on infrastructure increases by an additional R2,6 billion between 1999/00 and 2001/02.

Administration

- Additional spending of R1,3 billion in 2000/01 and R1,7 billion in 2001/02 on administration includes proposed additional allocations to administrative services such as the South African Revenue Services to strengthen their capacity to broaden the tax base and combat tax evasion and economic crime.

Also included in the administration function are activities to ensure Y2K readiness of all Government departments and systems.

Government has identified several further spending priorities over the next three years. These include:

Action against HIV/AIDS

HIV/AIDS is one of the biggest challenges facing South Africa over the medium term. South Africa has one of the highest HIV infection rates in the world. The pandemic poses a serious risk to our country's economic development prospects and threatens the social fabric of families and communities. Government proposes to allocate significant resources to fund an aggressive intersectoral strategy aimed at combating the spread of the disease.

Poverty relief

As part of Government's commitment to relieving poverty and creating jobs, funds have been set aside for special poverty relief and infrastructure investment projects. The rural poor, particularly, have fewer economic opportunities and access to social services than other South Africans. These projects will therefore focus especially on the needs of the rural poor, as well as on employment creation projects identified for the Presidential Job Summit last year.

Poverty relief projects were allocated R800 million for programmes in 1998/99 and R1,0 billion in 1999/00. This allocation increases to R1 billion in 1999/00, R1,2 billion in 2000/01, and R1,5 billion in 2001/02.

Programmes funded within the 1999/00 allocation are summarised in table 4.7.

Job Summit projects

Following the Presidential Job Summit agreement last year, the poverty relief allocations are focused on projects that have a specific potential for job creation. These include the land care programme, the local tourism infrastructure programme, the community based public works programme, rehabilitation of rural roads, and the Working for Water programme.

Table 4.7: Poverty relief and Jobs Summit allocations 1999/00

Department	Programme	Allocation R million
Agriculture	Land care programme	20
Environmental Affairs and Tourism	Clean cities campaign Local tourism infrastructure and national arts campaign	70
Health	Health related issues affecting the poor, such as malnutrition	23
Housing	Introduction of rental housing stock as part of the main housing delivery programme	75
Labour	Social plan projects in response to job losses, in co-operation with the department of Provincial Affairs and Local Government	50
Provincial Affairs and Local Government	Social plan projects in response to job losses, in co-operation with the Department of Labour	45
Public Works	Community based public works and projects to make public buildings friendly to disabled persons	377
Transport	Rehabilitation of rural roads	100
Water Affairs and Forestry	Working for Water programme, and rural and water and sanitation programme	200
Welfare	Income generating projects for the most vulnerable groups	40
Total		**1 000**

Umsobomvu fund

As announced in the 1998 Budget, the newly created Umsobomvu job creation fund will receive funds from the demutualisation of Sanlam and Old Mutual. The process of setting up a legal trust, which will be a section 21 company, is underway, and is nearing completion. The company will be responsible for the management and disbursement of funds aimed at assisting and stimulating employment creation and the development and upgrading of skills among young people.

The skills development levy

The skills development levy, to be introduced next year, is aimed at increasing the development of skills in the formal and informal sectors of the economy. Starting at 0,5 per cent of payroll, the levy is expected to raise R1 billion in 2000/01. For subsequent years, the rate will rise to one per cent of payroll, which is projected to yield R2 billion in 2001/02 and R2,2 billion in 2002/03.

One-fifth of all levies collected will go to the National Skills Fund, which provides training for people not employed in the formal sector and other disadvantaged groups. Government may also contribute directly to this fund from the fiscus.

Government has made a commitment to devote at least 0,5 per cent of its own payroll, rising to one per cent, to training, through normal budgetary allocations.

Forestry restructuring

The Department of Water Affairs and Forestry is currently restructuring forestry operations under its management. As a result of the restructuring, Government expects to make significant savings on the projected medium term estimates of the commercial forestry budget.

SA Rail Commuter Corporation

The 2000 Budget will include an increased allocation to the transport function to supplement subsidisation of the South African Rail Commuter Corporation.

Eskom's electrification programme

Eskom spends about R1,4 billion per year on its electrification programme, drawing on revenue generated through existing grid electricity consumers. About 90 per cent of urban areas and 40 per cent of rural areas have already been electrified. Government is considering alternatives to grid electrification for more cost-effective energy provision to remote areas of the country.

In due course Eskom will also become liable for income tax and will pay dividends to Government as sole shareholder, while the funding of electrification will shift to the budget.

Strategic arms procurement package

Government is committed to the resolution of conflict on our continent, to make Africa safer and more prosperous. The strategic defence procurement package allows the SANDF to upgrade obsolete defence equipment to help contribute towards Government's objectives in this regard. The total price for the military equipment is R21,3 billion (in 1999 rands), or R29,9 billion if all aircraft options are taken.

Defence and intelligence spending will increase from 7 per cent of non-interest expenditure in 1998/99 to 8,5 per cent in 2002/03, roughly the level of spending on this function in 1995/96. The cost of most of the equipment will be spread over an eight-year period. Extensive industrial participation commitments incorporated into the procurement contracts will in due course benefit both the South African economy and the fiscus.

Integrated justice system

Government is striving to improve the efficiency and productivity of the integrated justice system in the fight against crime. Tables 4.5 and 4.6 show that proposed collective allocations to the Departments of Safety and Security, Justice and Correctional Services on average grow by 6,6 per cent over the medium term.

Government intends allocating additional funds to the sector for direct law enforcement initiatives, including the Directorate of Special Operations, the Office of Public Prosecution, and increased spending on the lower courts. Government will also spend more on modernisation and integration programmes designed to improve the performance of the justice system, including an electronic docket management system to improve the management of cases and acquisition of an automated fingerprint identification system (AFIS) which will reduce the average length of criminal trials.

Directorate of Special Operations

The newly established Directorate of Special Operations (the 'Scorpions') is a high-profile unit charged with investigating and prosecuting high priority crimes. It links the work of dedicated prosecutors, investigators and intelligence workers and focuses primarily on organised crime, serious economic offences, corruption (especially in the criminal justice system), individual high profile crimes, and violent crime.

Increased spending on lower courts

Increased spending on the lower court system is also important in order to improve the impact of spending on law enforcement. Government intends increasing spending on lower courts in an effort to increase the number of cases they process. Improved productivity of the lower court system will contribute to improved productivity of the overall justice system.

Conclusion

The MTEF provides a framework that enables Government's social and development policy priorities to be reflected in the medium term spending plans of national and provincial government.

5

DIVISION OF REVENUE

Introduction

Three spheres of government

The Constitution lays the foundation for a unitary but decentralised system of intergovernmental relations by providing for three “distinctive, interdependent and interrelated” spheres of government. The Constitution provides for expenditure and tax assignment and intergovernmental transfers. Section 214 of the Constitution stipulates that all revenue raised nationally be divided equitably between the three spheres. In addition to their equitable share, provincial and local governments also receive conditional or unconditional allocations from the national share. Conditional grants were first introduced in the 1998 Budget.

The Constitution also has some unique features pertinent to intergovernmental fiscal relations. This is underpinned by a commitment to basic human rights, set out in the Bill of Rights in Chapter 2, and to co-operative governance, spelled out in Chapter 3. The Bill of Rights sets the tone for the emphasis on the delivery of basic services to all South Africans, which impacts on the budgets of all three spheres of government. The commitment to co-operative governance has created an environment in which the intergovernmental system has evolved and responded to emerging needs. It has allowed a more collegial approach to problem solving and sharing of resources, encouraging consensus rather than conflict between the spheres.

Financial management

Financial management continues to improve in the nine provinces. Expenditure has been brought in line with available resources and budgetary processes are now more robust and transparent. The strong emphasis on co-operative governance and on laying sound foundations for intergovernmental relations is showing positive results, as evidenced by the improving fiscal position of the provinces and the increased number of beneficiaries of social services. Some progress has been made in improving local government finances, but the demarcation process and the transformation of local government continue to pose significant challenges.

The intergovernmental budget process

Guided by the Intergovernmental Fiscal Relations Act

The Intergovernmental Fiscal Relations Act of 1997 came into effect on 1 January 1998 and was first fully implemented for the 1999 Budget. The Act formalises an intergovernmental budget process. In terms of the Act, the Financial and Fiscal Commission (FFC) proposes a division of revenue ten months before the new financial year. This is submitted to the Minister of Finance, Parliament and the nine provincial legislatures. The Minister then consults the provinces, local government and the FFC before proposing a division of revenue for consideration by Cabinet.

Division of revenue bill

At the time of the Budget, the Minister tables a Division of Revenue Bill, setting out the final allocations to the three spheres and each of the provinces, as well as any conditions that apply. The Bill is accompanied by a memorandum explaining any assumptions and formulae used in determining the allocations, and how those allocations comply with constitutional requirements and take into account the recommendations of the FFC.

The division of revenue between the spheres

An evaluation of priorities

The equitable division of national revenue between the three spheres of government is not determined by a formula because it is a political judgement based on the relative priorities of the functions performed by each sphere. The 1999/00 division of revenue sought to protect the social services and basic service delivery despite the unanticipated slowdown in economic activity. In 2000/01, the revised economic projections afford Government an opportunity to give attention to national functions while still allowing increased growth in social services expenditure.

Own revenues

In accordance with the Constitution, provincial and local government own revenues are not included in the calculation of the equitable shares. Provincial own revenue has been steadily decreasing, falling from R4,3 billion in 1995/96 to an estimated R3,4 billion in 1998/99. Provincial own revenue sources are limited, mainly comprising fees for motor vehicle licences, gambling licences and hospital services. Local government collects revenues primarily from electricity and water charges, levies and property taxes.

Projected allocations

Revised economic projections, fiscal policy considerations and adjustments to the calculation of GDP have been discussed in earlier chapters. The revised budget framework provides for additional non-defence spending of R4,6 billion, and R6,5 billion above the MTEF 1999 Budget estimates over the next two years. Over half of this has been allocated to provincial government, underscoring Government's commitment to social service delivery. The adjustments provide a significant growth in the share of resources allocated to local government.

Funding provincial priorities

Expenditure decisions made by provincial governments impact directly on the lives of citizens because provinces are responsible for more than 60 per cent of non-interest spending. More than 80 per cent of provincial budgets are spent on delivering social services. The increased allocation to the provincial sphere recognises the increasing demand for these services. Extending health services, broadening the social security net and improving the quality of education services are central goals of Government. In addition, the increased provincial allocation provides for other provincial priorities, including:

- the maintenance of social and economic infrastructure;
- improved financial systems to support implementation of the Public Finance Management Act;
- personnel management reforms and restructuring of the public service; and
- agricultural and rural development.

Funding local government

The small proportion of nationally collected revenue flowing to local government reflects the ability of local government to raise the bulk of its own revenue. Local government is the sphere of government closest to the people, and is responsible for delivering basic services and infrastructure to households. Local government is undergoing considerable transformation and restructuring through the demarcation process and other initiatives. The current system of local government has been transitional, governed by interim legislation. Policy work has been completed and will be presented to Cabinet shortly. The allocations to local government need to accommodate the powers and responsibilities of new local government structures and take into account the extension of municipal infrastructure and the provision of basic services to low-income households.

Improvements in conditions of service

Improvements in conditions of service are negotiated annually in the Public Sector Central Bargaining Chamber. When the negotiations are concluded funds are distributed to departments and provinces from the ICS vote on the national budget. These funds, however, only cover increases in basic salary and directly linked benefits. Increases in other benefits or arising from promotions must be met from departmental or provincial budgets. In addition, the transfer through the ICS vote only covers the initial increase – the future costs implied by these increases must also be funded from departmental and provincial budgets. These additional costs have exerted enormous pressure on provincial budgets.

Table 5.1: The vertical division

R million	1999/00 Revised	2000/01	2001/02	2002/03
		Medium term estimates		
National allocation[1]	71 715	77 429	82 739	87 207
Provincial allocation	96 357	102 770	108 403	113 507
Conditional grants[2]	*8 363*	*8 361*	*8 236*	*8 349*
Local government allocation[3]	2 519	2 830	3 030	3 233
Total to be shared	**170 591**	**183 029**	**194 172**	**203 948**
Changes from 1999 Budget				
National allocation	*1 722*	*4 669*	*6 485*	
Provincial allocation	*1 959*	*2 359*	*3 346*	
Local government allocation	*203*	*350*	*450*	

1. The national allocation excludes conditional grants to provinces and local government as these are spent at the provincial and local levels.
2. The conditional grants exclude R1 420 million allocated to provinces in 1999/00 as part of the Adjustments Estimate.
3. Excludes conditional grants, such as the municipal infrastructure programme and bus subsidies allocated from national departments.

Impact on provincial budgets

The Budget provided R3 billion for improvements in conditions of service for 1999/00 of which R2,1 billion was estimated to accrue to provinces. Based on the final wage settlement, provinces will receive R2,4 billion from the ICS vote this year out of a revised total of R3,3 billion. As part of the budget reform process and the development of a remuneration policy, the continued treatment of ICS as a conditional grant is being reviewed.

The provincial equitable shares

Division by formula

The distribution of the equitable share between provinces is done on the basis of a redistributive formula that takes into account the demographic and economic profiles of the provinces. The elements of the formula are not indicative budgets or guidelines as to how much should be spent on those functions. Rather, the components are weighted broadly in line with expenditure patterns to provide an indication of relative need.

Improved stability in allocations

An advantage of the MTEF process is that it increases the predictability of revenue flows to provinces to facilitate budget planning. Last year, the allocations to provinces had to be adjusted to incorporate the results of the census and to reflect changes to the structure such as the introduction of the backlog component. This year, no changes have been made to the structure and fewer data adjustments were necessary. The largest adjustment will flow from the higher than anticipated equitable share for the provincial sphere.

Table 5.2: Provincial equitable shares

	1999/00	2000/01	2001/02	2002/03
R million	Revised	Medium term estimates		
Eastern Cape	15 238	16 452	17 280	17 956
Free State	5 918	6 408	6 750	7 036
Gauteng	12 932	14 235	15 244	16 152
KwaZulu-Natal	17 166	18 894	20 233	21 435
Mpumalanga	5 790	6 423	6 931	7 398
Northern Cape	2 117	2 302	2 436	2 551
Northern Province	11 509	12 626	13 476	14 231
North West	7 405	8 009	8 427	8 773
Western Cape	8 499	9 059	9 390	9 625
Total	**86 573**	**94 408**	**100 167**	**105 158**

Note: The equitable share allocations exclude conditional grants but include estimated improvements in conditions of service.

Components of the formula

The provincial revenue-sharing formula is based on the demographic and economic profiles of the provinces. It comprises six components:

- an education share (41 per cent) based on the average size of the school-age population (ages 6–17) and the number of learners enrolled in public ordinary schools;
- a health share (19 per cent) based on the proportion of the population without access to medical aid funding;
- a social security component (17 per cent) based on the estimated number of people entitled to social security grants – the elderly, disabled and children – weighted using a poverty index derived from the 1995 Income and Expenditure Survey;
- a basic share (7 per cent) derived from each province’s share of the total population of the country;
- a backlog component (3 per cent) based on the distribution of capital needs as captured in the schools register of needs, the audit of hospital facilities and the share of the rural population;
- an economic output share (8 per cent) based on the distribution of total remuneration in the country; and

- an institutional component (5 per cent) divided equally among the provinces.

Updating the formula

Data in the formula were adjusted to reflect new information in two instances. Updated remuneration data have been incorporated into the economic activity component. Second, the weighting of the social services components reflect expenditure on these services over a three year period. Based on the expenditure data reported in the *Intergovernmental Fiscal Review 1999*, the weights of the education and health components have been increased by one percentage point, with a balancing reduction in the weight of the basic share.

Table 5.3: Components of the formula

	Education	Health	Social security	Basic share	Backlog	Economic output	Institu-tional	Weighted average
Weights	**41%**	**19%**	**17%**	**7%**	**3%**	**8%**	**5%**	
Eastern Cape	18,5%	17,0%	19,6%	15,5%	20,7%	5,9%	11,1%	16,8%
Free State	6,3%	6,5%	7,1%	6,5%	5,6%	5,1%	11,1%	6,6%
Gauteng	12,3%	14,7%	13,9%	18,1%	5,0%	43,2%	11,1%	15,7%
KwaZulu-Natal	22,1%	21,7%	19,6%	20,7%	23,0%	18,9%	11,1%	20,7%
Mpumalanga	7,3%	7,2%	6,5%	6,9%	8,5%	4,7%	11,1%	7,1%
Northern Cape	1,9%	2,0%	2,2%	2,1%	1,3%	1,6%	11,1%	2,4%
Northern Province	15,7%	13,3%	13,7%	12,1%	22,9%	1,7%	11,1%	13,5%
North West	8,0%	8,6%	8,7%	8,3%	9,5%	5,1%	11,1%	8,2%
Western Cape	7,9%	8,9%	8,8%	9,7%	3,6%	13,7%	11,1%	8,9%
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**

Phasing

The equitable share formula has been phased in to avoid disruptions in provinces where the target shares differ substantially from the current allocation of resources. Last year, taking into account the impact of the final census data on the allocations, a five-year phasing period was employed beginning in 1998/99. The target date of 2003/04 will be retained, with the effect of reducing the phase-in period to four years, from 1999/00 to 2003/04.

Moving towards equity

The equitable share formula recognises that the provinces have different demographic and economic profiles, markedly different levels of economic development and significant variations in socio-economic circumstances. The levels of wealth or income within a province are important determinants of demand for social services, particularly primary health care, education and income support. The equitable share formula is accordingly redistributive, to assist provinces in providing a basic level of services for all South Africans.

Conditional grants to provinces

Purposes of grants

The primary purposes of conditional grants are to support compliance with national norms and standards, to compensate provinces for providing services that may extend beyond provincial boundaries and to enable national priorities to be adequately provided for in sub-national budgets. The conditional grants proposed over the MTEF period are summarised in table 5.4.

Table 5.4: Conditional grants to provinces

	1999/00	2000/01	2001/02	2002/03
R million	Revised	Medium term estimates		
Health				
Central hospitals	*3 075*	*3 112*	*3 221*	*3 350*
Training and research	*1 118*	*1 174*	*1 215*	*1 264*
Redistribution of specialised services	*165*	*176*	*182*	*189*
Hospital rehabilitation	*200*	*400*	*500*	*520*
Durban and Umtata Hospitals.	*400*	*273*	*103*	
Provincial Nutrition Programme	*796*	*582*	*582*	*582*
Finance supplementary	2 500	2 212	2 000	2000
Education				
Financial management and quality enhancement	*111*	*272*	*283*	*294*
Classroom backlogs	*13*			
Housing: Capacity building	10	10	10	10
State Expenditure	59	100	140	140
Welfare and population development	137	50	0	0
Labour	56	0	0	0
Sub-total	**8 639**	**8 361**	**8 236**	**8 349**
Projected underspending	-276	0	0	0
Total[1]	**8 363**	**8 361**	**8 236**	**8 349**

1. This table excludes the R1 420 million to be transferred to provinces in 1999/00 as part of the Adjustments Estimate.

Existing conditional grants are continually reviewed to assess whether the type of grant, and the conditions applied, support attainment of their objectives.

Principal grant programmes

A conditional grant is voted as expenditure in the national budget and is recorded as revenue in the provincial or local government accounts. The national department is responsible for monitoring compliance with the conditions of the grant, whereas the province is accountable for the actual expenditure of the funds. The incentive, therefore, lies with the provincial department to meet the conditions of the grant as efficiently as possible. The largest grants are:

- several health grants, including provision for specialised health services, hospital rehabilitation and construction, and provincial nutrition programmes. These grants totalled R5,7 billion for 1999/00;
- a supplementary allocation to augment provincial funding of social services and assist in improved financial management, managed by the Department of Finance; and
- a number of grants, totalling R191 million in 1999/00, spread across departments to improve financial management systems.

Converting agency payments

Agency payments are grants made to provinces and municipalities to re-imburse them for services provided on behalf of national government. Agency payments are not reflected on provincial or local budgets, and accountability rests with the national department. In the past, there has been some confusion surrounding the use and treatment of agency payments as opposed to conditional grants. Over time, national departments will be encouraged to convert agency payments into conditional grants with provincial and local governments being held accountable for both delivery of the service and management of the funds.

National–provincial fiscal relations

An evolving system

Intergovernmental fiscal relations have evolved rapidly over the past four years and will continue to do so, within the broad parameters of the Constitution and drawing on the advice of the Financial and Fiscal Commission.

Learning from international experience

International experience, particularly in developing countries, has shown that while fiscal decentralisation can offer significant gains under the right conditions it also carries the risk of accentuating inequities and compromising macroeconomic stability. Thus, establishing strong foundations and correctly sequencing the devolution of responsibilities is critical to attaining good governance. In developing a framework for intergovernmental fiscal relations, Government has been mindful of these considerations.

Commitment to co-operative governance

The principle of co-operative governance is articulated in Chapter 3 of the Constitution. A primary role of the institutions of co-operative governance is to align national policy goals and provincial budgets and planning.

Establishing intergovernmental institutions

Each of the relevant major departments has a MinMEC where national and provincial departments discuss policy issues. A MinMEC is a political forum consisting of the national Minister and the nine provincial MECs, supported by key departmental officials. For treasuries, the MinMEC – known as the Budget Council – was established in terms of the Intergovernmental Fiscal Relations Act. Joint MinMECs, where the Budget Council meets with other sectoral MinMECs, provide opportunities to review both budget and policy issues.

Extending sectoral co-ordination

Several technical committees (known as "4X4's") were established in 1998 to support the policy co-ordination process in the social services and provide inputs into the Budget Council and the Joint MinMECs. These deal with issues such as managing transformation, developing coherent policy within sectors and norms and standards for service delivery. They have met regularly and include representation from national and provincial treasuries and the line departments responsible for education, health and welfare. A transport technical committee was introduced this year, and similar processes are planned for public works and personnel. In addition to enhancing understanding of the impact of policy choices on budget decisions, these technical committees identify cost pressures within the key sectors and pursue innovative methods of improving service delivery without compromising the need for government to live within its means.

Allocations to local government

Equitable shares

The local government equitable share is the primary source of funding for poor and rural local governments. For the 2000/01 financial year, the local government allocation amounts to R2,8 billion. This represents an increase of R350 million over the original baseline allocation (see table 5.1). Several transitional arrangements impact on the actual allocation by formula. This includes historical factors, such as the phasing out of provincial management of former R293 towns and restructuring considerations. The Budget Forum is in the process of finalising an approach to guide the use of this allocation.

Distributing the equitable share

The formula for distributing the equitable share between municipalities comprises a municipal basic services transfer and a municipal institutional transfer. The basic services component enables poor municipalities to deliver basic municipal services to households while the institutional component provides support to those municipalities that lack administrative capacity and basic infrastructure. The current equitable formula is being reviewed to assess its impact on different sized municipalities and the extent to which it does benefit poorer households.

Other allocations

In addition to the equitable share, local government will receive a set of conditional grants aimed at providing infrastructure and subsidising commuter transport. The baseline allocations for these grants are reflected in table 5.5. These and other grants to local government will be finalised as part of the budgets of national departments. The table excludes grants for water infrastructure, estimated at R610 million for 1999/00.

Table 5.5: Baseline allocations to local government

R million	1999/00	2000/01	2001/02	2002/03
Municipal infrastructure programme	695	793	780	811
Bus subsidies	1 294	1 429	1 475	1 534
Land development objectives	38	44	46	47
Total	**2 027**	**2 266**	**2 301**	**2 392**

Conclusion

The division of revenue continues to support social services and provide for redistribution from richer to poorer areas of the country. Co-operative governance underpins intergovernmental fiscal relations, and is a cornerstone of improved financial management and budgeting in provincial and local government.

GLOSSARY

Adjustments estimate	Presentation to Parliament of the amendments to be made to the appropriations voted in the main budget for the year.
Agency payments	Payments made by one government department to another department or sphere of government to pay for services administered by the body receiving the payments. Agency payments do not form part of the budget of the receiving body. (See also *conditional grants*.)
Appropriation	The approval by Parliament of spending from the National Revenue Fund, or by the provincial legislature from the Provincial Revenue Fund.
Available expenditure	That part of the national budget which can be divided between the national, provincial and local spheres of government, after debt interest and the contingency reserve have been taken into account.
Balance of payments	A summary statement of all the international transactions of the residents of the nation with the rest of the world during a particular period of time.
Baseline	The initial allocations used during the budget process, derived from the previous year's forward estimates.
Budget Council	A body established to co-ordinate financial relations between national and provincial government, comprising the Minister and Deputy Minister of Finance and the nine provincial MECs for finance.
Budget deficit	The difference between budgeted expenditure and budgeted revenues.
Capital inflow	An increase of foreign assets in the country or a reduction in the country's assets abroad.
Conditional grants	Allocations of money from one sphere of government to another, conditional on certain services being delivered or on compliance with specified requirements. Conditional grants appear as expenditure in the budget of the department making the grant and as revenue of the province or municipality

receiving the grant. (See also a*gency payments)*

Consolidated expenditure — Total expenditure by national and provincial government, excluding allocations to local government other than *agency payments.* Consolidated expenditure includes spending by provinces financed from their own revenues. It is therefore the sum of national and provincial spending, excluding the double counting of transfers from national to provincial government.

Consumer price inflation — Price increases as measured by the consumer price index (CPI), which reflects the prices of a representative basket of consumer goods and services. (See also *inflation; core inflation; GDP inflation*.)

Contingency reserve — The portion of the spending total which is set aside and not allocated in advance, in order to accommodate changes to the economic environment and to meet unforeseen spending pressures.

Core inflation — Consumer price inflation, excluding certain items such as mortgage costs, indirect taxes and the costs of certain foods.

Current account deficit — The difference between total imports and total exports, also taking into account service payments and receipts, interest, dividends and transfers. A current account deficit means that South African residents consume and invest more than they produce, which must be financed by capital inflows from abroad.

Debt interest — The cost of interest on government debt.

Depreciation (capital) — A reduction in the value of fixed capital as a result of wear and tear as well as redundancy.

Depreciation (exchange rates) — A reduction in the external value of the rand. A depreciation makes South African goods cheaper to foreign purchasers, and imported goods more expensive to South African buyers.

Direct investment — Investment from abroad in physical assets such as factories. (See also *portfolio investment*.)

Direct taxes — The term *current taxes on income and wealth* replaces *direct taxes*, and refers to taxes payable on incomes, profits and capital gains. In addition, the terms *current taxes on capital* and *miscellaneous current taxes* are introduced. The former refers to periodic taxes on the property or net wealth of institutions, with the latter applicable to poll taxes and license payments by households.

Dissaving — The difference between current income and current

	expenditure, including depreciation of fixed capital.
Division of revenue	The allocation of funds between the spheres of government as required by the Constitution.
Domestic demand	The total level of spending in an economy, including imports but excluding exports.
Emerging markets	A name given by international investors to middle income economies.
Equitable shares	The allocation of revenue to the national, provincial and local spheres of government as required by the Constitution.
Financial and Fiscal Commission (FFC)	An independent body established by the Constitution to make recommendations to Parliament and provincial legislatures about financial issues affecting the three spheres of government.
Fiscal policy	Policy on tax, spending and borrowing by government.
GDP inflation	A measure of the total increase in prices in the whole economy. Unlike CPI inflation, GDP inflation includes price increases in goods that are exported, excludes imported goods, and includes intermediate goods such as machines. (See also *consumer price inflation; core inflation; inflation*.)
Government debt	The total amount of money owed by government.
Gross domestic product (GDP)	A measure of the total national output, income and expenditure in the economy. GDP per head is the simplest overall measure of welfare, although it does not take account of the distribution of income, nor of goods and services that are produced outside the market economy, such as work within the household.
Growth	An increase in the total amount of output, income and spending in the economy.
Improvements in conditions of service (ICS)	The sum set aside to meet the costs of pay increases for public servants. The distribution of improvements in conditions of service depends on the agreements between the government as employer and the public service unions.
Inflation	The rate of increase of prices. (See also *consumer price inflation; core inflation; GDP inflation*.)
Inventories	Stocks of goods held by firms. An increase in inventories reflects an excess of output relative to spending over a period.
Investment	The flow of expenditure on new capital goods.

Macroeconomic	To do with the branch of economics dealing with the whole economy – for example, growth, inflation, unemployment and the balance of payments.
Medium term expenditure framework (MTEF)	The three-year spending plans of national and provincial governments published at the time of the budget.
Merchandise exports	Exports of goods, but not services. In the South African accounts this usually excludes exports of gold.
MinMEC	A MinMEC is a political forum where national and provincial departments in the same sector discuss policy issues. It consists of the national Minister and the nine provincial MECs, supported by key departmental officials.
Monetary policy	Policy in relation to interest rates, the exchange rate and the supply of money in the economy. Monetary policy is usually focused mainly on keeping control of inflation.
National budget	The projected revenue and expenditures which flow through the national revenue fund. Does not include spending by provinces or local government from their own revenues.
Net open forward position	The difference between aggregate future commitments of purchases and sales of foreign exchange by the South African Reserve Bank, net of holdings of gold and foreign reserves.
Nominal exchange rates	The current rate of exchange between the rand and foreign currencies.
Outcomes	The effect on individuals and communities as a result of the activities of government.
Outputs	Goods and services delivered by government.
Portfolio investment	Investment in financial assets such as stocks and shares or government bonds.
Public sector borrowing requirement (PSBR)	The consolidated cash borrowing requirement of general government and public enterprises.
Real effective exchange rate	A measure of the rate of exchange of the rand relative to a trade-weighted average of South Africa's trading partners' currencies, adjusted for price trends in South Africa and the countries included.
Real expenditure	The level of expenditure after taking account of inflation.
Recession	A period in which national output and income declines. A recession is usually defined as two consecutive quarters of

	negative growth.
Remuneration	The costs of personnel including salaries, housing allowances, car allowances, and other benefits received by personnel.
Repo rate	The rate of interest that the Reserve Bank pays on repurchase agreements with money market participants.
Reserves (expenditure)	See *contingency reserve; unallocated reserves*.
Reserves (foreign exchange)	Holdings of foreign exchange, either of the Reserve Bank only, or of the Reserve Bank and domestic banking institutions.
Rolling budgets	A budget system in which three year forward projections are revised each year.
Saving	The difference between income and spending.
Service delivery indicators	Quantitative measures of how well expenditure is achieving its purpose. Indicators could, for example, measure a service's outputs, its effectiveness in terms of outcomes and its unit cost. They could also bring out how well a department was addressing issues of transformation, or show how well it reached those most in need.
Technical committees	Committees of national and provincial officials which provide support to MinMECs and the Budget Council.
Unallocated reserves	Potential expenditure provision not allocated to a particular use. Mainly consists of the *contingency reserve* and amounts of money left unallocated by provinces.
Vertical division	The division of revenue between spheres of government.