3

Fiscal policy

In brief

- Government proposes a comprehensive package of measures to narrow the budget deficit, stabilise debt and begin to rebuild fiscal space.
- Moderating expenditure growth, combined with tax measures to increase revenue, will improve the fiscal position by R22 billion in 2015/16 and R30 billion in 2016/17.
- Expenditure on core social and economic programmes will be maintained, with reductions focused on non-essential goods and services.
- Personnel budgets of national government will be frozen and funding for vacancies will be reviewed.
- Despite weak economic growth, the fiscal proposals will enable government to remain broadly in line with the deficit path announced in the 2014 Budget, stabilising national debt at 46 per cent of GDP in 2017/18.

A sustainable foundation for the public finances

Fiscal course adjustment responds to weaker-than-expected economic growth and moderate outlook

Government proposes a medium-term fiscal policy package to re-establish a sustainable foundation for the public finances in the decade ahead. The proposals represent a course adjustment in line with weak economic growth over the past several years and the moderate outlook for GDP. Over the medium-term expenditure framework (MTEF) period, government's fiscal objectives are to:

- Reduce the budget deficit in line with the targets announced in the 2014 Budget. This will require slower expenditure growth and tax reforms to increase revenue collection.
- Stabilise debt to ensure fiscal sustainability, and shift resources away from interest payments to service delivery.
- Continue to shift spending towards government's priorities as set out in the National Development Plan and the medium-term strategic framework (MTSF).
- Contain growth in budgets for goods and services, and compensation of employees.

Government remains committed to the fiscal principles of countercyclicality, debt sustainability and intergenerational equity. Over the period ahead, the focus will shift to debt sustainability, allocative efficiency and obtaining value for money in public spending.

Fiscal course adjustment

Favourable conditions that supported high expenditure growth rates are no longer present

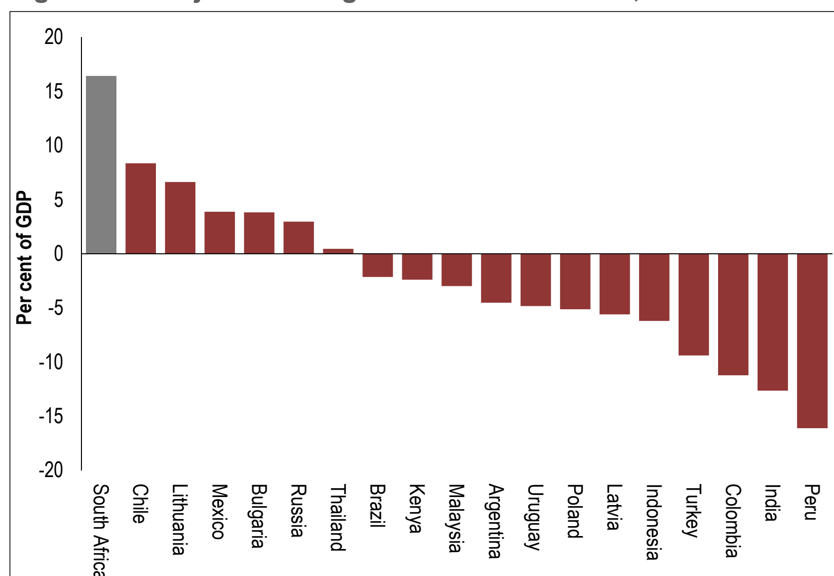
South Africa's weaker-than-expected economic performance and outlook pose new fiscal challenges. When the economy was in recession in 2009, fiscal space built up during preceding years enabled government to respond with a large spending package on the assumption that revenue would rebound in line with an improving economy. Low international interest rates helped government to finance its borrowing requirement, inflation was moderate and high commodity prices buoyed tax revenues.

The favourable conditions that supported high expenditure growth rates are no longer present. Commodity prices are declining and the rand's depreciation has pushed up inflation. After falling sharply during the 2000s, interest rates on newly issued government debt have stabilised and are projected to rise over the medium term.

South Africa's debt-to-GDP ratio increase is comparatively high among emerging markets

Despite government's success in maintaining the expenditure ceiling over the past three years, the main budget deficit remains at about 5 per cent of GDP. Weak economic growth has entrenched a structural imbalance between revenue and expenditure. Even after taking the fiscal package into account, the increase in South Africa's debt-to-GDP ratio between 2009 and 2019 is the highest among its emerging-market peers.

Figure 3.1 Projected change in debt-to-GDP ratio, 2009 – 2019



Source: South African data from National Treasury; all other data from IMF

Gross national debt is expected to reach R2.4 trillion in 2017/18

Over the next three years, government's gross debt stock is projected to increase by R590 billion, bringing total debt to R2.4 trillion. At the same time, redemptions on debt issued over the past decade will add R194 billion to the medium-term borrowing requirement. Government's gross financing requirement will escalate sharply from 2017, as bonds issued in the wake of the global financial crisis fall due.

Without action to narrow the deficit, public debt will continue to grow beyond the medium term. While prudent levels of government borrowing play an important role in supporting the economy and protecting spending priorities, continued borrowing at the current level is unsustainable. Without an adjustment, it is likely that South Africa's sovereign debt would be downgraded to "sub-investment grade", risking impaired access to credit markets as gross financing requirements escalate.

Fiscal consolidation can no longer be postponed

The 2012 *Medium Term Budget Policy Statement* pointed out that if the economic and fiscal outlook were to deteriorate, a reconsideration of expenditure and revenue plans would be warranted. In the 2013 Budget, government trimmed its spending plans and reduced the unallocated contingency reserve. Eight months ago, the 2014 Budget stated that additional measures to ensure fiscal sustainability would be required if the economic outlook were to worsen.

That turning point has been reached.

Fiscal package to reinforce sustainability

Proposals to narrow deficit and stabilise debt include spending and tax measures

Government proposes a series of measures to narrow the deficit and stabilise debt over the medium term. The five elements of the fiscal package are as follows:

- Reduce growth in spending. Government will lower its 2014 Budget expenditure ceiling by R25 billion over the next two years.
- Adjust tax policy and administration. Proposals will be introduced in the 2015 Budget to generate additional revenue of at least R27 billion over the next two years.
- Strengthen budget preparation. Government will place greater emphasis on longer-term planning and efficient resource allocation, within a fiscal framework that links aggregate expenditure and economic growth beyond the medium term.
- Freeze government personnel headcounts. Government will also review funded vacancies.
- Adopt a deficit-neutral approach to financing state-owned companies. Over the next two years, government will ensure that any capitalisation required does not widen the budget deficit.

Lowering the expenditure ceiling

The expenditure ceiling has been in place since 2012/13 and, since then, government has stayed within its spending targets.

Table 3.1 Main budget non-interest expenditure, 2011/12 – 2017/18

R million	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
2012 Budget Review	814 554	879 977	953 024	1 030 539			
2013 Budget Review		878 642	955 333	1 029 262	1 107 564		
2013 MTBPS			949 109	1 027 762	1 106 064	1 185 110	
2014 Budget Review			947 853	1 027 662	1 105 943	1 184 424	
2014 MTBPS				1 021 855	1 095 761	1 168 940	1 267 025

Source: National Treasury

In aggregate, expenditure will continue to grow in real terms by 1.8 per cent a year

The 2014 Budget limited non-interest expenditure to R1.028 trillion in 2014/15, R1.106 trillion in 2015/16 and R1.184 trillion in 2016/17. Government proposes to reduce this ceiling by R10 billion in 2015/16 and R15 billion in 2016/17. Decreases in indicative baselines will be allocated proportionately across national, provincial and local government, according to their share of national revenue. In aggregate, expenditure will continue to grow in real terms by 1.8 per cent a year. All government departments and agencies will need to reduce inefficiency and waste, and minimise the impact on front-line service delivery, by targeting non-essential items and uncommitted resources. Spending on core social obligations will be protected.

To effect the lower ceiling, national government will:

- Freeze budgets of non-essential goods and services at 2014/15 levels.
- Withdraw funding for posts that have been vacant for some time.
- Reduce the rate of growth of transfers to public entities, particularly those with cash reserves.

The provincial equitable share will also be reduced. Reductions in provincial and local conditional grants will target patterns of underexpenditure. The local government equitable share will be protected to ensure the provision of free basic services.

Changes to tax policy and administration

Structural revenue increase is proposed

Government proposes a structural increase in revenues over the medium term. Policy and administrative reforms will raise at least R12 billion in 2015/16, R15 billion in 2016/17 and R17 billion in 2017/18. The details of proposed changes will be announced by the Minister of Finance in February when he tables the 2015 Budget in Parliament.

The proposals will enhance the progressive character of the fiscal system, improve tax efficiency and realise a structural improvement in revenue. The short- and long-term implications for economic growth and job creation will be a key consideration.

Reforms to medium-term budgeting

Acting now to reduce deficit will allow government to rebuild fiscal space in future

Acting now to re-establish a sustainable foundation for the public finances will enable government to rebuild fiscal space in the years ahead. Once debt has stabilised, spending growth will match long-term economic growth trends.

Over the next two years, during which there is little scope to augment resources, the budget process will be refocused. A new approach to budget preparation will extend the scope and quality of long-term expenditure planning. A comprehensive assessment will examine baseline estimates for the outer year, emphasising value for money and alignment with longer-term policy priorities. Indicative allocations in the third year of the budget framework have been restrained, and there are substantial unallocated resources. These resources will be available to build a buffer against economic and fiscal shocks in the years ahead. A significant amount may also be considered for allocation to high-impact programmes.

Freeze on personnel expansion and review of vacancies

To contain compensation budget pressures, government personnel headcounts will be frozen for the next two years. Any increase in personnel will be funded from existing allocations. The National Treasury, the Department of Performance Monitoring and Evaluation, the Department of Public Service Administration and officials from other departments will conduct a review over the next year to consider the permanent withdrawal of funded vacancies. Natural attrition will create space for new appointments. Exceptions will be considered for critical positions, with the onus on departments to justify exceptions. Provincial governments will be strongly encouraged to follow the same approach.

Increases in departmental personnel will be funded from existing allocations

Deficit-neutral financing of state-owned companies

Over the next two years, capital injections for Eskom and funding for other state-owned companies will be raised in a way that has no effect on the budget deficit. In some instances, government will dispose of non-strategic assets to raise resources for financial support. Such assets could include property, direct and indirect shareholdings in listed firms, non-strategic government shareholdings in state-owned companies and surplus cash balances in public entities.

Capitalisation will not be automatic, but will depend on demonstration of sound business plans

Private investment to strengthen the balance sheets of state-owned entities will also be explored. Funding allocations will not be automatic, but will depend on entities demonstrating sound business plans and greater efficiencies. Any capitalisation will only take place once the proceeds of asset sales are deposited into the National Revenue Fund, and will require a special appropriation bill tabled by the Minister of Finance.

The fiscal framework

Table 3.2 summarises the fiscal framework.

Table 3.2 Consolidated fiscal framework,[1] 2011/12 – 2017/18

	2011/12	2012/13	2013/14	2014/15		2015/16	2016/17	2017/18
R billion/Percentage of GDP		Outcome		Budget	Revised		Medium-term estimates	
Main budget								
Revenue	**745.3**	**799.2**	**886.1**	**962.8**	**956.6**	**1 055.1**	**1 169.4**	**1 272.9**
Expenditure	**889.9**	**965.5**	**1 047.8**	**1 142.6**	**1 136.3**	**1 222.3**	**1 308.4**	**1 416.7**
of which								
Non-interest allocations	*813.5*	*877.4*	*946.6*	*1 024.7*	*1 021.9*	*1 090.8*	*1 153.9*	*1 222.0*
Debt-service costs	*76.5*	*88.1*	*101.2*	*114.9*	*114.5*	*126.5*	*139.4*	*149.7*
Unallocated reserves	*–*	*–*	*–*	*3.0*	*–*	*5.0*	*15.0*	*45.0*
Main budget balance	**-144.6**	**-166.3**	**-161.7**	**-179.8**	**-179.7**	**-167.2**	**-139.0**	**-143.8**
	-4.9%	*-5.2%*	*-4.7%*	*-4.7%*	*-4.8%*	*-4.1%*	*-3.2%*	*-3.0%*
Cash balances of social security funds, public entities and provinces	33.8	30.1	27.0	26.7	26.5	22.7	25.0	25.0
Consolidated budget balance	**-110.8**	**-136.2**	**-134.7**	**-153.1**	**-153.2**	**-144.5**	**-114.1**	**-118.7**
	-3.7%	*-4.3%*	*-3.9%*	*-4.0%*	*-4.1%*	*-3.6%*	*-2.6%*	*-2.5%*

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

The framework, which takes into account government's fiscal policy package, allows for moderate real growth in spending over the next three

Fiscal framework allows for moderate real growth in spending over medium term

years, enabling government to maintain its core social and economic programmes. A comprehensive presentation of the fiscal framework appears in Table A.3 of the technical annexure.

2014/15 budget deficit projected at 4.1 per cent of GDP

The 2014/15 budget deficit is projected at 4.1 per cent of GDP. Gross tax revenue has been revised downwards by R10 billion in the current year, owing to underperformance on corporate income tax, customs duties, value added tax and the fuel levy – and downside risks remain.

Lower tax revenue estimates have been partly offset by higher-than-anticipated receipts from financial transactions, reflecting premiums on inflation-linked bonds and higher revaluation profits on foreign-currency transactions. The borrowing requirement is also eased by projected underspending of R6.2 billion in the current year.

Figure 3.2 Main budget non-interest spending

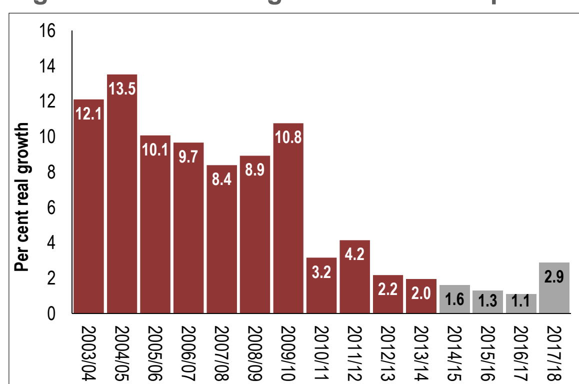
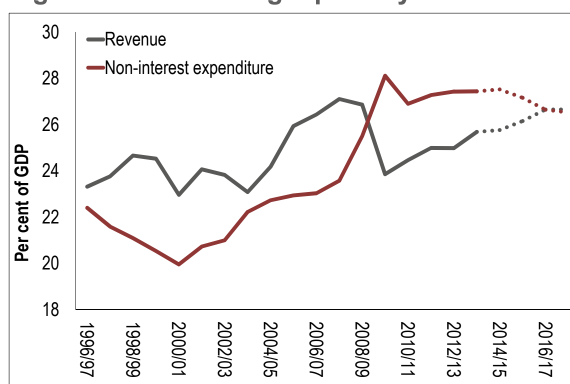


Figure 3.3 Main budget primary balance



Source: National Treasury

The slower rate of spending growth allows the main budget deficit to narrow to 3 per cent by 2017/18, helping to stabilise the debt-to-GDP ratio. The expenditure ceiling in the outer year of the framework includes R45 billion in unallocated reserves. These funds will serve as a fiscal buffer, though a portion could also be used to fund high-impact programmes.

The current balance, which shows how much government must borrow to finance non-capital spending, is an indicator of how public finances affect national savings. As Table 3.3 shows, government is projected to close the current deficit in 2015/16. By taking these steps, government will finance part of its capital budget from savings, rather than borrowing.

Table 3.3 Consolidated current and capital balances, 2013/14 – 2017/18

	2013/14	2014/15	2015/16	2016/17	2017/18
R billion/Percentage of GDP		**Estimate**	**Medium-term estimates**		
Current balance	**-8.9**	**-9.3**	**24.1**	**68.7**	**107.0**
	-0.3%	*-0.3%*	*0.6%*	*1.6%*	*2.2%*
Capital borrowing requirement	**-136.6**	**-149.8**	**-163.8**	**-174.5**	**-184.2**
	-4.0%	*-4.0%*	*-4.1%*	*-4.0%*	*-3.9%*

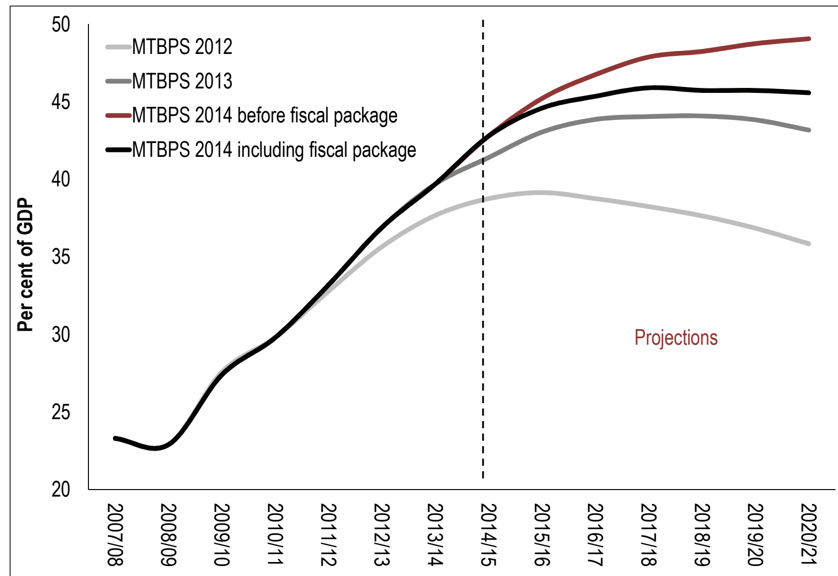
Source: National Treasury

Managing government's debt portfolio

Together with government's prudent debt management strategy, the fiscal package will ensure the sustainability of South Africa's debt stock. Before the proposed changes, national government's net debt – gross debt less surplus cash – was projected to continue growing as a share of GDP beyond 2021. The fiscal package results in debt stabilising at 45.9 per cent of GDP in 2017/18 and declining thereafter. More details on the financing of national government borrowing appear in Tables A4 and A5 of the technical annexure.

Net debt projected to peak at 45.9 per cent of GDP in 2017/18

Figure 3.4 Net national government debt, 2007/08 – 2020/21



Source: National Treasury

Risks to the fiscal outlook

The main risks to the fiscal outlook are economic performance, the public-sector wage bill and the balance sheets of state-owned companies.

Economic outlook

Over the past three years, fiscal consolidation has been hampered by lower-than-expected economic growth and revenue collections. Rand depreciation and higher inflation have pushed up the level of debt and debt-service costs on foreign-currency denominated and inflation-linked bonds, but have also helped to offset the weaker revenue outlook. Concerns about a rising global interest-rate cycle have put upward pressure on domestic interest rates, increasing the costs of issuing debt. The current account deficit remains persistently high, making South Africa more vulnerable to shifts in investment flows and market sentiment.

High current account deficit makes South Africa more vulnerable to shifts in investment flows

The fiscal package will mitigate some of these risks, including helping to reduce the current account deficit. Deterioration in the economic outlook, however, would require consideration of additional measures. More rapid economic growth in the context of stable prices would enable government to attain its fiscal objectives earlier.

Wage bill

Budgets planned on neutral assumption that cost of living adjustments will track consumer price index

Negotiations for a new public-sector wage agreement are under way. Budgets have been planned on the neutral assumption that cost-of-living adjustments will track consumer price index (CPI) projections. The budget also assumes that overall headcount numbers will stabilise at current levels. In previous budget cycles resources were available to accommodate unanticipated wage pressures, but given current constraints, there is little scope to provide more resources over the MTEF period. Any departure from the path of CPI-linked cost-of-living adjustments will require either a reallocation of resources from other spending areas (capital, goods and services, transfers), or prompt a need to reduce government employment.

State-owned companies and public entities

Financially sound state-owned companies are needed to broaden social and economic development

State-owned companies and public entities play important roles in realising government's economic and social mandate. They need to be financially sound and operationally effective, contributing to development without draining the fiscus.

Government is proposing a new framework for funding state-owned companies that will distinguish purely commercial activities from the costs of exercising their developmental mandates. It will include closer monitoring to ensure efficient delivery on government priorities, while simultaneously promoting improved commercial performance. Government has also introduced more stringent financial reporting requirements for public entities.

Capitalisation will be funded from sale of non-strategic state assets, and will not be drawn from tax revenue

Over the medium term, any funding of state-owned companies will be contingent on the implementation of sound restructuring plans with strong government oversight. Given fiscal constraints over the next two years, capitalisation will only be funded by the sale of non-strategic state assets, and will not be drawn from tax revenue or added to the debt of national government. Government policy remains that state-owned companies should operate on the strength of their balance sheets.

In line with the successful restructuring of the Development Bank of Southern Africa, reforms are being undertaken at South African Airways, South African Express, the South African Post Office and the Land Bank.