3

Fiscal policy

In brief

- Government's central fiscal objective over the medium term is to stabilise the growth of debt as a share of GDP. Continued revenue growth and strict adherence to the planned expenditure ceiling are projected to result in gross debt stabilising at 49.4 per cent of GDP in 2018/19. Net debt stabilises at 45.7 per cent of GDP in 2019/20.
- The projected budget deficit of 3.8 per cent for the current year is broadly unchanged from 2015 Budget expectations, and narrows to 3 per cent over the medium term.
- A proposed long-term fiscal policy guideline links expenditure and GDP growth. The spending ceiling in the outer year of the medium-term expenditure framework grows by 2.5 per cent in real terms.
- Expenditure on core social and economic programmes will be maintained, while spending on non-essential goods and services continues to decline in real terms.
- Government continues to support the capital expenditure programmes of state-owned companies, while working to improve their governance and financial sustainability.

Introduction

In the 2015 Budget, government announced a medium-term fiscal policy package to ensure a sustainable foundation for the public finances. Government is meeting these commitments. Main budget expenditure remained within the 2014/15 limits and is on track to stay within the spending ceiling in the current year. Debt is stabilising as a share of GDP. Despite some slippage in medium-term budget deficit projections, the deficit will continue to narrow.

Spending remains well contained and budget deficit narrows over medium term

In recent months, two risks identified in the 2015 Budget materialised: a public-sector wage agreement significantly above inflation and a deterioration in economic performance. The fiscal framework accommodates these developments and the fiscal trajectory remains on course to achieve government's objectives.

Long-term fiscal guideline

Countercyclicality, debt sustainability and intergenerational fairness underpin fiscal policy

Fiscal policy works to ensure the long-term health of the public finances by applying the principles of countercyclicality, debt sustainability and intergenerational fairness. This enables government to act within its available resources to progressively realise fundamental social and economic rights, as required by the Constitution.

The 2014 *Medium Term Budget Policy Statement* (MTBPS) marked a turning point for the public finances. Several measures were announced to bolster fiscal sustainability, including a reduced spending ceiling, moderate tax increases and a commitment to finance equity injections into state-owned companies without expanding the budget deficit. Government remains committed to this course.

Central medium-term fiscal objective is to stabilise growth of debt as share of GDP

The central fiscal objective over the medium term is to stabilise the growth of debt as a share of GDP. Rising debt-service payments are already crowding out spending on social and economic priorities. Failure to stabilise the growth of public debt would further erode the composition of spending and increase the risk of a shock to the economy. A ratings downgrade, for example, could induce a sudden outflow of foreign capital and sharply higher interest rates. Given South Africa's reliance on foreign lending to finance investment, such a development would compromise the country's ability to sustain growth and social progress.

Expenditure ceiling

The expenditure ceiling remains the primary tool to stabilise debt. No resources will be added to the spending ceiling over the next two years. Beginning with the 2016 Budget, government will align spending limits in the outer year of the medium-term expenditure framework (MTEF) with the long-term path of GDP growth, building on government's countercyclical and sustainable approach to fiscal management.

A guideline for debt sustainability

The National Treasury proposes a fiscal guideline to set the expenditure ceiling in the outer year of every fiscal framework.

This fiscal rule of thumb will link the spending ceiling to South Africa's long-term economic growth projections. Estimates of real long-term growth vary. Over the past 20 years, real GDP growth has averaged 3 per cent per year. The International Monetary Fund estimates real GDP growth of 2.6 per cent in 2020, while the Reserve Bank estimates potential output growth at 2.1 per cent in 2017. The expenditure ceiling has been set to grow by 2.5 per cent in real terms in 2018/19.

The long-term guideline gives expression to the fiscal principles of countercyclicality and debt sustainability. It will ensure that spending grows at a stable rate over the business cycle. In good times, spending will grow more slowly than the economy, and in bad times, spending will outpace GDP growth. All South Africans will be able to share in the benefits of economic expansion on a sustainable basis.

Over the long term, the guideline maintains spending as a stable share of national income. However, where structural improvements in revenue are apparent, through tax policy changes, improved administration or economic shifts, a corresponding increase in the spending ceiling will be considered. Over time, government's ability to properly appraise capital projects, as discussed on the next page, may also be a factor in the application of the guideline.

The expenditure ceiling should be sufficiently flexible to accommodate large shocks and structural changes to the economy. The ceiling could be adjusted in two scenarios:

- Structural improvements in revenue – Several policy proposals set out in the National Development Plan imply significant spending increases. Sustainable financing of these initiatives would require a permanent increase in revenues before adjustments to the ceiling are considered.
- Large inflation shocks – The advantage of setting the fiscal limit in nominal terms is that it can be easily understood, but unanticipated inflation could erode the real value of planned spending. Government would consider adjusting the ceiling if annual inflation were to depart significantly from the 3-6 per cent target band. There is little risk of such an outcome given the robust inflation-targeting framework.

This policy statement makes a technical modification to the spending ceiling. Payments that are directly and fully financed by dedicated revenue flows authorised by specific legislation, such as the skills development levy, will be excluded, as will payments that arise from technical adjustments to the value of assets and liabilities. As a result, the spending ceiling will differ slightly from non-interest expenditure. Details are provided in the technical annexure.

Steps to make fiscal reporting more transparent

The National Treasury is also taking several steps to make fiscal reporting more transparent in the years ahead. In this MTBPS, several assumptions underlying economic and revenue projections are disclosed for the first time. A stronger reporting framework on government guarantees and other contingent liabilities will be included in the 2016 Budget. During 2016 the National Treasury will publish a fiscal risks report.

Capital project appraisal

By entrenching the principle of intergenerational equity, government ensures that current social programmes can be sustained over several decades without a large build-up of debt and the higher tax burden this would impose on future generations.

Government will improve its capacity to appraise, select, plan and build capital projects

In principle, borrowing to fund investments that generate high returns for national development should not be unduly constrained by the fiscal framework. However, government’s capacity to appraise, select, plan and build capital projects can be strengthened. While coordination and oversight has improved, further work is required to develop institutions that can deliver technically sound cost-benefit analyses, enabling government to choose projects and assess their returns.

A capital budgeting framework that addresses the planning, skills and capacity shortfalls across the public sector is being developed. Over the medium term, the emphasis will be on improving spending efficiency within existing budgets, with a greater share of funds directed to improving asset management and maintenance. The development of a strong capital project planning and appraisal system will also enable government to adjust expenditure plans where financially viable projects with clear social or economic benefits have been identified.

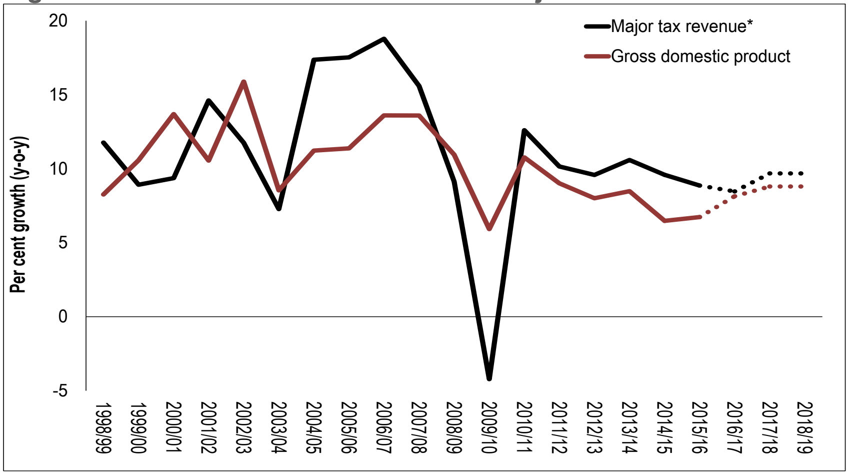
Medium-term fiscal considerations

Revenue performance and outlook

Gross tax revenue revised down by R35 billion between 2015/16 and 2017/18

In 2015/16, gross tax revenue has been revised downwards by R7.6 billion. This is attributable to weak performance of corporate income tax collection in the year to date due to the steep decline in commodity prices and the slowdown in economic activity. In total, lower growth has resulted in a downward revision of R35 billion to gross tax revenue between 2015/16 and 2017/18.

Figure 3.1 Growth in nominal GDP and major tax revenues



**Personal income tax, corporate income tax and value-added tax*

Source: National Treasury

Gross tax revenue for 2014/15 came in R7.3 billion above projections in the 2015 Budget, led by strong growth in personal income tax. Factors contributing to the increase included moderate relief for the effects of inflation, high growth in public-sector compensation and fairly high private-sector wage settlements.

Tax issues under consideration

Since 2014, the Davis Tax Committee has published reports on small business taxation, value-added tax (VAT), base erosion and profit shifting, estate duty and mining taxation. The committee also published a report on the role of the tax system in supporting inclusive growth, employment, equity and fiscal sustainability. The reports are intended to stimulate debate on tax issues, which can sometimes be contentious. Two topics of current interest are:

- Corporate income tax – Concerns about base erosion and profit shifting, in particular the misuse of transfer pricing, remain topical globally and in South Africa. Initiatives are underway to comprehensively deal with leakages in corporate income tax.
- VAT – While VAT might be perceived as regressive, comparative studies show that South Africa's overall fiscal system (tax and public expenditure) is strongly redistributive. Receipts generated from VAT – the second-largest source of tax revenue – are an important part of the resources that fund progressive public expenditure programmes in education, health and social protection. The committee's analysis of the efficacy of the VAT system, and the scenarios it presented on the likely impact of an increase in the VAT rate, have generated welcome debate. To date, no decisions have been made. But an increase in the VAT rate remains one of the options available over the medium term to finance key elements of the National Development Plan.

Carbon tax

The need to take action to address the causes and consequences of climate change is increasingly important. The National Treasury will soon publish a draft carbon-tax bill for public comment. It will provide further opportunity for debate on the detailed design and impact of the proposed tax.

Despite weak economic growth over the past five years, revenue collection has consistently outpaced economic expansion. While nominal GDP growth has averaged 8.6 per cent over the past five years, tax revenue has averaged 10.5 per cent growth during this period. It is not clear whether this is due to temporary or permanent factors. Over the medium term, gross tax revenue collection is projected to continue growing faster than nominal GDP, but by a narrower margin than in the recent past.

Increases in tax rates and fuel levy announced earlier this year help sustain revenue collection

The increases in income tax rates and the fuel levy announced in the 2015 Budget will help sustain revenue collection over the medium term. Growth in corporate income tax receipts, however, is expected to remain subdued through 2016/17. The technical annexure includes key assumptions underpinning the medium-term revenue forecast.

Public-sector wage bill

The 2015 Budget assumed that the public-sector wage agreement would not depart significantly from inflation. The final settlement increases the salaries and benefits of public servants by 10.1 per cent in the current year, followed by improvements that will be at least two percentage points higher than consumer inflation in the next two years. Without corresponding improvements in the quality of public services, increases of this kind are not sustainable over the long term.

Shortfall in compensation budgets has significant consequences for fiscus

The shortfall in compensation budgets has significant consequences for the public finances, absorbing resources that had been set aside for other priorities. A moderating factor is that the number of personnel employed on government's payroll has declined since 2012. Nonetheless, departments will need to reallocate spending away from existing priorities. Budgets that would have been available to fund vacant positions will now be required to compensate existing employees. It is expected that national and provincial employment will remain stable in the years ahead.

The National Treasury will work with national and provincial departments to avoid any compromises on service delivery, or the diversion of resources from capital budgets to pay for compensation. Nevertheless, it is likely that the agreement will have adverse consequences for the quality and composition of the public finances.

The fiscal framework

Medium-term revenue estimates underperform 2015 Budget projections

Table 3.1 summarises the consolidated fiscal framework. Medium-term revenue estimates are below 2015 Budget projections. The lower receipts will be partially offset by higher-than-anticipated income from financial transactions, reflecting premiums on inflation-linked bonds and the bond-switch programme, as well as higher revaluation profits on foreign-currency transactions.

Southern African Customs Union (SACU) transfer projections have increased over the medium term, largely due to upward revisions in customs and excise duties, and a lower-than-expected reconciliation payment in 2016/17. Adjustments to estimates of GDP, population and intra-SACU trade also contribute to an overall increase in SACU payments. The volatility of transfers remains a concern for Botswana, Lesotho, Namibia and Swaziland. South Africa continues to work with its fellow SACU member states on a new revenue-sharing agreement that would reduce the volatility of transfers and encourage regional development.

Spending growth will slow during 2016/17 as government implements the reduced ceilings announced in the last budget. From 2017/18, the fiscal framework allows for moderate real growth in spending aligned with the longer-term trend of economic growth.

Table 3.1 Consolidated fiscal framework,[1] 2012/13 – 2018/19

	2012/13	2013/14	2014/15	2015/16		2016/17	2017/18	2018/19
R billion/Percentage of GDP		**Outcome**		**Budget**	**Revised**		**Medium-term estimates**	
Main budget								
Revenue	**800.1**	**887.3**	**963.6**	**1 049.3**	**1 070.7**	**1 147.7**	**1 249.1**	**1 365.0**
of which: Asset disposals	–	–	–	–	*25.4*	–	–	–
Expenditure	**965.5**	**1 047.8**	**1 132.0**	**1 222.3**	**1 246.9**	**1 313.1**	**1 426.9**	**1 551.1**
of which								
Non-interest allocations [2]	*877.4*	*946.6*	*1 017.2*	*1 095.9*	*1 093.8*	*1 168.0*	*1 260.8*	*1 361.5*
Special appropriations [3]	–	–	–	–	*25.2*	–	–	–
Debt-service costs	*88.1*	*101.2*	*114.8*	*126.4*	*127.9*	*142.6*	*157.2*	*174.6*
Contingency reserve	–	–	–	–	–	*2.5*	*9.0*	*15.0*
Main budget balance	**-165.4**	**-160.5**	**-168.4**	**-173.1**	**-176.3**	**-165.4**	**-177.8**	**-186.1**
	-5.0%	*-4.4%*	*-4.4%*	*-4.1%*	*-4.3%*	*-3.7%*	*-3.7%*	*-3.5%*
Primary balance	**-77.2**	**-59.3**	**-53.6**	**-46.6**	**-48.4**	**-22.8**	**-20.7**	**-11.5**
	-2.3%	*-1.6%*	*-1.4%*	*-1.1%*	*-1.2%*	*-0.5%*	*-0.4%*	*-0.2%*
Budget balances of social security funds, public entities and provinces	29.5	24.3	31.5	10.9	18.4	20.1	25.1	28.0
Consolidated budget balance	**-135.8**	**-136.2**	**-136.9**	**-162.2**	**-157.9**	**-145.3**	**-152.8**	**-158.2**
	-4.1%	*-3.8%*	*-3.6%*	*-3.9%*	*-3.8%*	*-3.3%*	*-3.2%*	*-3.0%*

1. Further details of the fiscal framework can be found in the technical annexure

2. Excluding special appropriations

3. Special appropriations for Eskom and New Development Bank

Source: National Treasury

Contingency reserves sharply reduced to accommodate increase in compensation budgets

The contingency reserves have been sharply reduced to accommodate the increase in compensation budgets and to fund critical social priorities. The R5 billion contingency reserve for 2015/16 was fully absorbed by the wage bill shortfall. Projected reserves of R15 billion and R45 billion in the two outer years have been cut to R2.5 billion and R9 billion respectively.

The main budget deficit, which defines government's borrowing requirement, stabilises at 3.5 per cent of GDP over the medium term. The deficit excluding interest payments – known as the primary balance – continues to narrow in nominal terms, stabilising the growth of debt and ensuring that government can meet its spending commitments without additional borrowing.

Consolidated deficit declines towards 3 per cent over medium term

The consolidated deficit, which takes into account the budget balances of social security funds, public entities and provinces, declines to 3 per cent over the medium term. Compared with the 2015 Budget forecast, the consolidated deficit is roughly unchanged in the current year, and wider by about 0.7 per cent of GDP in 2016/17 and 2017/18.

Following consultation on the 2015 Budget's proposed once-off relief for contributors to the Unemployment Insurance Fund, the proposal was withdrawn, resulting in an improvement in consolidated revenue this year. However, this is offset by substantial reductions in revenue projections at the Compensation Fund, reflecting lower debt collection estimates. In the outer years, the wider deficit reflects a combination of lower Compensation Fund revenues and a wider main budget deficit.

Figure 3.2 Real main budget non-interest spending

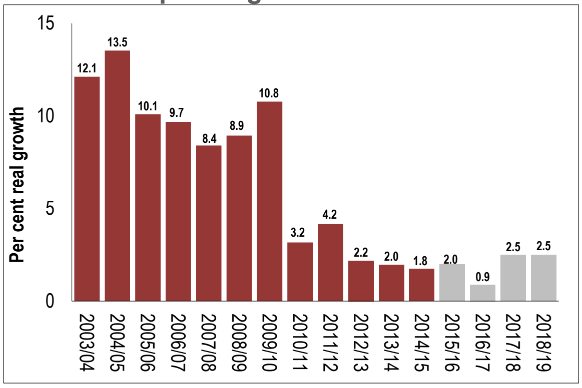
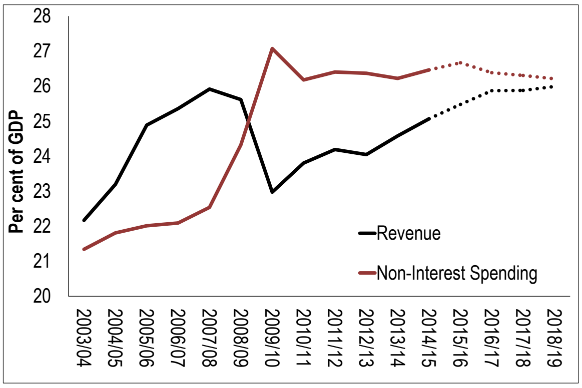


Figure 3.3 Main budget primary balance



Source: National Treasury

Despite higher wage bill projections, government's current balance – the difference between current revenue and spending on compensation, goods and services, interest, and current transfers and subsidies – will move into surplus over the medium term. Over the same period the capital financing requirement will remain broadly unchanged at about 3.8 per cent of GDP, financed in part by the current surplus.

Table 3.2 Consolidated current and capital balances, 2014/15 – 2018/19

R billion/Percentage of GDP	2014/15 Outcome	2015/16 Estimate	2016/17 Medium-term estimates	2017/18	2018/19
Current balance	**-1.0**	**-3.1**	**17.7**	**31.2**	**45.4**
	-0.0%	*-0.1%*	*0.4%*	*0.6%*	*0.9%*
Capital borrowing requirement	**-145.3**	**-158.3**	**-168.4**	**-179.3**	**-193.0**
	-3.8%	*-3.9%*	*-3.8%*	*-3.7%*	*-3.7%*
Financial transactions	**9.4**	**3.4**	**7.9**	**4.3**	**4.4**
Contingency reserve	**–**	**–**	**2.5**	**9.0**	**15.0**
Budget balance	**-136.9**	**-157.9**	**-145.3**	**-152.8**	**-158.2**

Source: National Treasury

The expenditure ceiling set in the 2015 Budget remains in place. Indicative allocations in the third year of the budget framework have been restrained, growing at 2.5 per cent above inflation. Spending pressures, including the higher wage bill, have been accommodated within the contingency reserve and departmental baselines.

R23 billion special appropriation for Eskom funded from sale of Vodacom shares

The special appropriation of R23 billion announced in the 2015 Budget is not regarded as part of the spending ceiling because it is funded directly from the sale of government's shareholding in Vodacom, and has no effect on the budget balance. Future payments from sales of non-strategic state assets to finance capital payments will also be excluded from the expenditure ceiling.

Table 3.3 Main budget expenditure ceiling, 2012/13 – 2018/19

R million	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
2013 Budget Review	864 658	942 000	1 015 718	1 092 747			
2014 Budget Review		935 071	1 014 222	1 091 253	1 168 284		
2014 MTBPS			1 008 344	1 081 242	1 152 800	1 250 078	
2015 Budget Review			1 006 905	1 081 214	1 152 833	1 250 086	
2015 MTBPS[1]			1 001 789	1 077 527	1 152 833	1 250 086	1 354 422

1. Excludes skills development levy and special appropriations for Eskom and the New Development Bank. See technical annexure for further details

Source: National Treasury

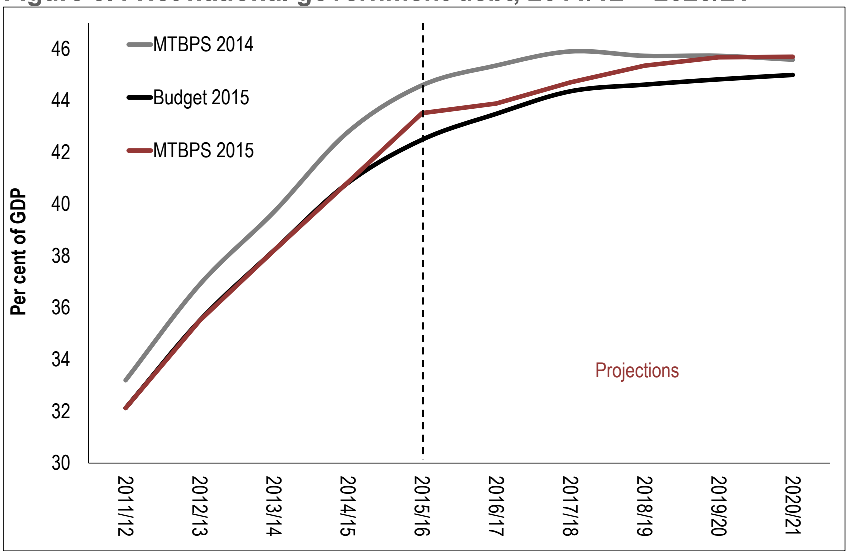
Stabilising the growth of debt

Debt ratio stabilises over medium term as result of restrained spending growth and improved budget balance

The downward revision to GDP, shortfalls in revenue and the weaker exchange rate have led to an upward revision of the debt-to-GDP ratio. However, as Figure 3.4 shows, the debt-ratio trend stabilises in the years ahead as a result of continued restraint in expenditure growth and improvements in the budget balance. Gross debt stabilises at 49.4 per cent of GDP in 2018/19. Net debt stabilises at 45.7 per cent of GDP in 2019/20.

Government's gross debt stock is projected to increase by about R600 billion over the next three years, reaching R2.4 trillion in 2018/19. The domestic capital market remains the main source of financing. Debt management is focused on mitigating the risks presented by the sharp increase in loan payments over the medium term and beyond. To meet these repayments, government will continue its bond-switch programme, through which short-dated bonds are exchanged for longer-dated paper. More details on the financing of national government borrowing appear in Tables A7 and A8 of the technical annexure.

Figure 3.4 Net national government debt, 2011/12 – 2020/21



Source: National Treasury

Risks to the fiscal outlook

Main risks are lower GDP growth, inflation and financial weakness of some state-owned companies

The main risks to the medium-term fiscal outlook are a further deterioration in economic growth, inflationary pressures and the weak financial positions of several major public entities.

The economic outlook

Weaker economic growth remains the main risk to government achieving its fiscal objectives. Any decline in growth typically results in falling revenue growth, increasing the deficit and debt as a share of GDP. As discussed in Chapter 2, the primary risks to the economic outlook are the binding electricity constraint, slowing global growth and declining commodity prices.

Decline in growth would typically result in a rising deficit and debt as a share of GDP

Continued global uncertainty, particularly concerning the path of US monetary policy, could put upward pressure on domestic interest rates, increasing the cost of issuing debt. Further rand depreciation and higher inflation would push up the level of debt and debt-service costs on bonds denominated in foreign currency and those linked to inflation.

Expenditure pressures

Rising inflation would increase the likelihood of unplanned expenditure. Inflation is expected to peak at about 6 per cent next year and then decline, but risks to this outlook include further rand depreciation, faster food inflation due to drought, and a strong rebound in the oil price. In addition, higher-than-expected increases in electricity and water tariffs would increase the cost of providing free basic services.

Risks to inflation outlook include exchange rate, oil price, and water and electricity tariff escalations

A deterioration in the outlook would also result in faster compensation expenditure growth, because the wage agreement is linked to inflation. Maintaining expenditure priorities under these circumstances would require further reductions in headcount or spending reallocations. Higher inflation would also require government to revise social protection budgets to ensure that the real value of the social wage is protected.

State-owned companies and public entities

Reform of state-owned companies

The 2014 MTBPS announced changes to the financial management framework for state-owned companies. Government expressed its intention to cost the developmental mandates undertaken by companies separately from their commercial activities, with the financial implications being more clearly set out in shareholder compacts. This process is being piloted at a number of entities. Work has also begun to develop a uniform legislative framework to regulate state-owned companies.

Work on a uniform legislative framework to regulate state-owned companies is under way

While these reforms gather pace, government has acted to stabilise several state-owned enterprises.

Financial stabilisation of public entities

In June 2015, approved government guarantees to state-owned companies amounted to R470 billion, with Eskom, the South African National Roads Agency Limited (Sanral) and South African Airways (SAA) constituting some of the largest exposures. Of this total, R245 billion has been utilised. Government's focus has been on stabilising these entities with the aim of ensuring that potential risks do not materialise, which would lead to calls on government guarantees and requests for additional funding. Government remains committed to deficit-neutral capital financing of state-owned companies in the years ahead.

Government has focused on stabilising entities to ensure that potential risks do not materialise

Minister of Finance has attached strict conditions to Eskom's R23 billion capitalisation

Eskom constitutes the largest share of government's guarantee portfolio. The utility benefits from a R350 billion guarantee facility, of which R162 billion has been utilised. During 2015/16, R23 billion of equity will be injected into the company. The Minister of Finance has attached stringent conditions to the R23 billion recapitalisation to drive delivery of planned maintenance, capital expenditure and cost savings. In addition, government's R60 billion subordinated loan has been fully converted to equity, adding to Eskom's equity and reducing the company's debt burden.

The National Treasury, Department of Public Enterprises, Department of Cooperative Governance and Traditional Affairs, and South African Local Government Association have provided support to Eskom by ensuring that 59 defaulting municipalities enter into agreements to repay the utility R4.9 billion in outstanding debt over time. These efforts are beginning to yield results, with an immediate reduction in the debt observed. Eskom recorded a profit of R3.5 billion in 2014/15.

Sanral maintains its investment-grade rating and remains well funded over medium term

Sanral, which holds the second-largest share of guaranteed debt, has maintained its investment-grade rating and remains well-funded over the MTEF period. Total guarantee support to the agency stands at R39 billion, including R32 billion in committed guarantees. In addition, national government provided a one-time allocation of R5.75 billion for the Gauteng Freeway Improvement Project in 2011/12.

The new tolling dispensation has created greater certainty about Sanral's finances and restored confidence in its investment programme. Sanral's most recent bond issuance was oversubscribed. The reduction in toll fees has created a long-term revenue shortfall that will be shared between national government and the provincial government. In the first year of the new dispensation, an allocation of R301 million will be made to Sanral.

Even with diligent efforts, SAA is only expected to generate sustainable profits in five years' time.

Government guarantees to SAA amount to R14.4 billion, of which R11.4 billion has been used. With support from the National Treasury, SAA executed a 90-day action plan, which included closing unprofitable routes, reducing the cost of its fleet, and reviewing onerous agreements and procurement contracts.

However, a successful turnaround will require continued diligent implementation of a long-term strategy to boost revenues, contain costs, strengthen governance, improve accountability and manage performance. Even if these measures are well executed, the airline is only expected to generate sustainable profits in five years' time. Continued government support will be required over this period to allow SAA to operate.

Conclusion

Government's central fiscal objective over the medium term is to stabilise the growth of debt as a share of GDP. The fiscal framework sets a path to achieve this objective. A new fiscal guideline links spending in the outer year with the long-term path of economic growth. Government will continue efforts to improve the governance and financial sustainability of state-owned enterprises.