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Overview

The budget, transformation and inclusive growth

South Africa's budget makes a substantial contribution to transformation and inclusive growth. It finances the construction of houses and schools, the operation of hospitals and clinics, the education of youth, care of the elderly and social grants for the most vulnerable. A large number of programmes encourage the growth of new businesses, empower small farmers, develop human capabilities, and provide incentives for job creation and economic transformation.

Budget makes a large contribution to transformation and inclusive growth

The budget is strongly aligned with constitutional imperatives and is highly progressive. Two-thirds of spending goes to functions responsible for realising constitutionally mandated social rights. Among developing countries, South Africa's fiscal system is notable for its capacity to redistribute resources from the wealthy to the poor and working families. The allocation of funds to provinces and municipalities is governed by transparent rules that ensure redistribution of resources from cities to the countryside.

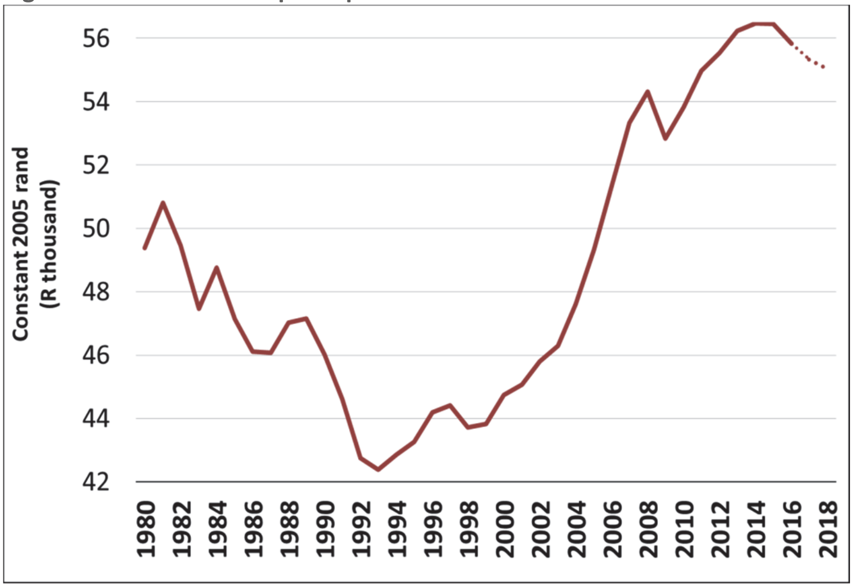
The budget establishes a solid foundation for national development. But government's ability to sustain improvements in the quality of life of citizens depends on investment and economic growth.

Government's ability to improve citizens' quality of life depends on investment and economic growth

Over the last several years, South Africa's per capita income has begun to stagnate. Unemployment is rising and, at 27.7 per cent, has reached the highest level recorded since 2003. Poverty, which had been in decline, has risen since 2011, and more than 30 million South Africans live on less than R1 000 per month.

To expand job creation, build an inclusive and transformed economy, and reduce inequality, South Africa needs a strong, sustained economic expansion. Growth is also the essential prerequisite for restoring the health of the nation's public finances.

Figure 1.1 South Africa's per capita income



Source: Reserve Bank

Economic outlook

Economic growth revised down to 0.7 per cent in 2017, reaching 1.9 per cent by 2020

The 2017 Budget projected GDP growth of 1.3 per cent in 2017. That projection has been revised down to 0.7 per cent, following a recession in the fourth quarter of 2016 and the first quarter of this year. Economic growth is expected to recover slowly, reaching 1.9 per cent in 2020.

The weaker growth outlook reflects a continued deterioration in business and consumer confidence that has gathered pace since 2014. It also flows from perceptions of heightened risk as indicated in lower credit ratings, higher bond yields and sluggish investment. In 2016, gross fixed capital investment declined by 3.9 per cent, with large decreases in mining and manufacturing. Capital investment is expected to decline by 0.6 per cent in the current year.

Conditions in the global economy continue to improve, but the risks of financial turbulence remain high, and the longer-term outlook for growth and commodity prices is muted.

Table 1.1 Macroeconomic projections

Calendar year	2016 Actual	2017 Estimate	2018	2019 Forecast	2020
Percentage change unless otherwise indicated					
Household consumption	0.8	1.0	1.2	1.6	1.9
Gross fixed capital formation	-3.9	-0.6	0.5	3.0	3.5
Real GDP growth	**0.3**	**0.7**	**1.1**	**1.5**	**1.9**
GDP at current prices (R billion)	**4 338.9**	**4 601.8**	**4 888.8**	**5 222.3**	**5 611.9**
CPI inflation	6.3	5.4	5.2	5.5	5.5
Current account balance (% of GDP)	-3.3	-2.3	-2.6	-2.9	-3.1

Source: Reserve Bank and National Treasury

These factors are important in the context of South Africa's external vulnerabilities. The country consumes more than it produces, and relies on foreign savings to finance the gap between low levels of domestic savings and the capital required for its investments. This relationship is expressed in the form of a persistent current account deficit, which is expected to widen over the medium term. Government debt held by non-residents has risen from 4.4 per cent of GDP in 2007 to 17.6 per cent of GDP in 2017. A sharply negative shift in global investor sentiment towards South Africa could result in large capital outflows, with highly destabilising consequences for the economy.

Decisive action needed for a new growth trajectory

South Africa confronts a low-growth trap

Last year's *Medium Term Budget Policy Statement* warned that further deterioration of the economy could see South Africa entering a low-growth trap. In such a scenario, weak gross domestic product (GDP) growth produces less tax revenue. Aggressive fiscal consolidation to stabilise the growth of national debt and narrow the budget deficit might reduce perceived financial risks, but could also weaken demand, curbing investment and job creation. Yet taking no action could well result in credit-rating downgrades, rapid exchange-rate depreciation and capital flight.

This cycle feeds on itself. Falling incomes and shrinking resources for public services raise social tensions, deepening political polarisation and creating doubts about future development. Declining confidence and economic uncertainty curb investment, entrenching low growth.

Much depends on policy choices and their effective implementation

The National Treasury's macroeconomic projections imply that per capita income will continue to stagnate in the years ahead. Unless decisive action is taken to chart a new course, the country could remain caught in a cycle of weak growth, mounting government debt, shrinking budgets and rising unemployment. Much depends on the policy choices made and the effectiveness of their implementation. Hard choices are required to return the public finances to a sustainable position. A failure to make such decisions, or to effectively implement them, will reinforce economic and fiscal deterioration.

Government recognises these risks and opportunities, and is acting to break out of the low-growth trap. A new cycle of inclusive development requires clear intervention to stimulate economic activity, ensure effective regulation, improve the competitiveness of manufactured exports, promote localisation and reindustrialise the economy. This in turn requires renewed attention to strengthen the capacity of the state to develop the country's economic potential.

Progress registered on 14 actions agreed by Cabinet to revive investment

In July, the Minister of Finance announced a set of 14 actions agreed to by Cabinet to revive investment. Progress has been made on several fronts:

- A new board and CEO have been appointed to lead a turnaround at South African Airways (SAA).
- The Budget Facility for Infrastructure, which is intended to overcome shortcomings in the planning and execution of large infrastructure projects, has begun considering proposals.
- New procurement regulations have been implemented.
- The Financial Sector Regulation Act has been signed into law.

Work is under way to license broadband spectrum and optimise the state asset portfolio

Work is under way to license broadband spectrum, optimise government's asset portfolio, reform the governance of state-owned companies and encourage private-sector participation in public investment programmes. A stronger package of measures to stimulate economic growth is being developed.

Government continues to prioritise the expansion of network infrastructure to support the economy, alongside social infrastructure that serves community needs. The public sector will spend more than R300 billion each year on infrastructure, with about half of this funded directly from the budget.

Reforms needed to transform markets, improve national competitiveness and reconfigure urban landscape

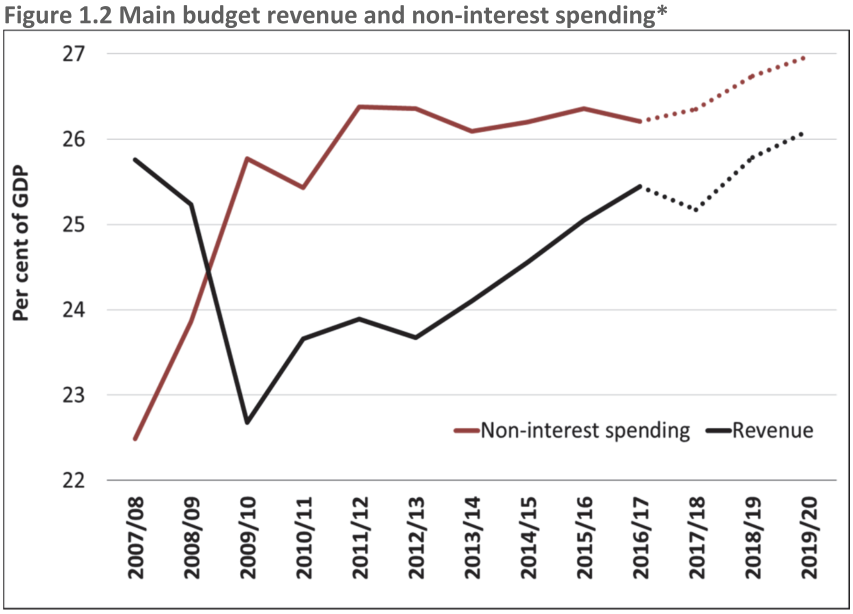
To sustain economic growth, these measures need to be accompanied by microeconomic reforms that raise productivity and labour absorption. These include taking strong steps to transform markets, improve national competitiveness through innovation, break down structural barriers to new economic participants, promote manufacturing development and deconcentrate industries dominated by a few producers. Such reforms need to be complemented by plans to reconfigure the urban landscape, which remains dominated by inefficient and inequitable patterns of settlement.

Fiscal outlook

Strong tax revenues, which sustained fiscal consolidation efforts, are now under threat

Over the past five years, government's efforts to achieve a measured and balanced fiscal consolidation met with some success. While the stabilisation of debt proved elusive, expenditure remained well contained, and the primary balance – the gap between revenue and non-interest spending – narrowed. This progress was sustained by tax revenues that outperformed economic growth.

Figure 1.2 Main budget revenue and non-interest spending*



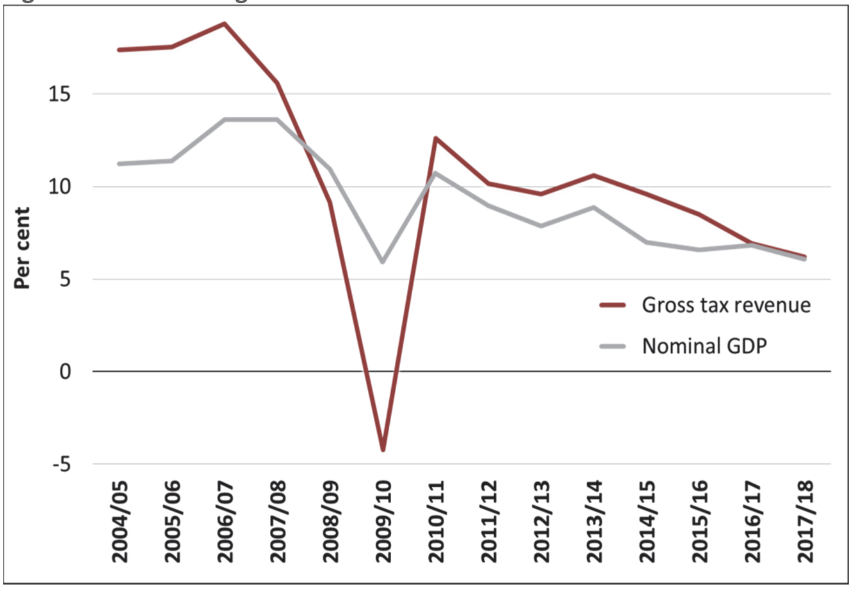
**Excluding transactions in financial assets and liabilities*
Source: National Treasury

Strong revenue collection was partly the result of policy changes that raised the rate of taxation. Growth in key sectors of the economy bolstered revenues. Personal income taxes benefited from robust public- and private-sector wage settlements. The expanding middle class contributed to resilient household demand. The sustained depreciation of the exchange rate in an environment of contained inflation lifted profits in tradable sectors, adding to company tax receipts. Growth in capital investment continued to draw in imports, attracting value-added tax and customs duties.

Revenue shortfall of R50.8 billion projected in 2017/18

This period of revenue buoyancy appears to have run its course. The National Treasury projects a revenue shortfall of R50.8 billion in 2017/18. Lower revenue this year carries forward, and gross tax revenue is projected to fall short of the 2017 Budget estimates by R69.3 billion in 2018/19 and R89.4 billion in 2019/20. This reflects slowing economic growth, but may also suggest a profound shift in the relationship between economic growth and tax collection in the years ahead.

Figure 1.3 Growth in gross tax revenue and nominal GDP



Source: National Treasury

Fiscal framework

As a result of revenue shortfalls, the consolidated budget deficit for 2017/18 is expected to be 4.3 per cent of GDP, compared with a 2017 Budget estimate of 3.1 per cent. The main budget deficit, which determines government's net borrowing requirement, will be 4.7 per cent of GDP this year.

Consolidated budget deficit is 4.3 per cent of GDP in current year against projection of 3.1 per cent

In contrast to projections set out in the last budget, the revised projection is for the deficit to remain at this elevated level over the medium term. On this estimate, gross national debt is projected to continue rising, reaching over 60 per cent of GDP by 2022.

Table 1.2 Consolidated government fiscal framework

R billion/Percentage of GDP	2016/17 Outcome	2017/18 Revised	2018/19	2019/20 Medium-term estimates	2020/21
Revenue	**1 298.2**	**1 363.6**	**1 477.5**	**1 594.2**	**1 709.3**
	29.5%	*29.2%*	*29.7%*	*30.0%*	*29.9%*
Expenditure	**1 445.7**	**1 566.6**	**1 670.6**	**1 802.3**	**1 935.1**
	32.8%	*33.5%*	*33.6%*	*33.9%*	*33.9%*
Budget balance	**-147.5**	**-203.0**	**-193.1**	**-208.1**	**-225.8**
	-3.3%	*-4.3%*	*-3.9%*	*-3.9%*	*-3.9%*
Total gross loan debt	**2 232.9**	**2 530.5**	**2 829.6**	**3 094.2**	**3 415.6**
	50.7%	*54.2%*	*57.0%*	*58.2%*	*59.7%*

Source: National Treasury

In this context, government faces difficult choices. To offset revenue shortfalls and reduce borrowing, the contingency reserve has been pared down to R16 billion over the next three years. This leaves government little room to manoeuvre if risks to the expenditure ceiling materialise. Beyond this, it is likely that some programmes will need to be eliminated, or their funding reduced.

South Africa's stated policy aspirations and its social needs far exceed available public resources. Moreover, there is little space for tax increases in the current environment. Any new policy proposals, or expansion of existing programmes, should address only the most effective and necessary interventions.

Government remains committed to operating within the expenditure ceiling over the medium term. In the current year, however, the recapitalisation of SAA and the South African Post Office put the ceiling at risk of a R3.9 billion breach.

Risks to fiscus include rising debt-service costs and public-sector wage bill

In addition, there are several risks to the fiscus over the period ahead:

- The economy and revenue could underperform projections. The GDP growth outlook may be improving, but the relationship between growth and revenue collection could deteriorate further.
- Strains and imbalances within the public finances may become more pronounced. The public-sector wage bill has increasingly crowded out other spending and limited government's ability to increase public employment.
- Debt-service costs are set to absorb a rising share of revenue.
- Several years of fiscal restraint have left funding gaps in both infrastructure and social services, reflected in the build-up of unpaid accounts and financial imbalances.
- Continued financial deterioration of major state-owned companies is a clear and substantial danger to the public finances.

Changing course to mitigate risks

Over the next three years, government will adhere strictly to the spending limits it has set for itself. But more is clearly required. A combination of fiscal measures and economic interventions is needed to grow the economy, address immediate challenges facing the public finances and reduce long-term risks.

Presidential task team to develop proposals to stabilise debt over medium term

A team of Cabinet ministers reporting directly to the President has been established to develop proposals to stabilise the national debt over the medium term. These will include proposals to narrow the deficit, stimulate economic growth and build investor confidence. The team will work to ensure that the spending ceiling remains intact in the current year. A broader set of asset disposals is also under consideration, along with a restructuring of the portfolio of public assets to reduce risks posed by contingent liabilities. A new framework for the management of guarantees is being developed.

Additional measures to reduce expenditure, raise revenue and improve the impact of public resources on economic growth will be announced in the 2018 Budget.

Spending priorities

Mandate Paper intended to strengthen alignment of budget, medium-term strategic framework and NDP

In August 2017, Cabinet approved a Mandate Paper to guide the spending choices of national government. Its purpose is to strengthen alignment of the national budget, the medium-term strategic framework and the National Development Plan (NDP) during the remaining term of the current administration.

The paper observes that on current trends, South Africa is unlikely to achieve its NDP goals. It also notes that there will be no additional funds available to increase baseline expenditure over the 2018 Budget, and some programmes may have to be cut to meet unanticipated spending pressures. It proposes seven expenditure priorities for the MTEF period:

- Job creation and small business development
- Youth development
- Infrastructure expansion and maintenance
- Land reform, smallholder farmer and agriculture development
- Comprehensive social security, education and skills
- An integrated plan to fight crime
- Advancing the national interest in the Southern African Development Community, throughout Africa, and through participation in the BRICS (Brazil, Russia, India, China and South Africa) bloc and the Indian Ocean Rim Association.

Government spending priorities continue to align with the NDP, as elaborated in the medium-term strategic framework and the Mandate Paper for 2018.

Table 1.3 Consolidated government expenditure

R billion	2017/18 Revised	2018/19	2019/20	2020/21	Average annual growth 2017/18 – 2020/21
		Medium-term estimates			
Learning and culture	317.8	340.7	367.3	395.7	7.6%
Health	189.6	204.5	220.0	235.5	7.5%
Social development	234.2	251.2	269.0	286.9	7.0%
Community development	193.5	210.1	226.5	243.1	7.9%
Economic development	190.9	202.2	217.7	229.9	6.4%
Peace and security	195.5	206.2	220.7	235.5	6.4%
General public services	62.3	64.7	67.5	71.6	4.8%
Payments for financial assets	19.5	5.0	5.2	5.5	–
Total expenditure by function	**1 403.3**	**1 484.5**	**1 594.0**	**1 703.8**	**6.7%**
Debt-service costs	163.3	183.1	203.3	223.4	11.0%
Contingency reserve	–	3.0	5.0	8.0	–
Total expenditure	**1 566.6**	**1 670.6**	**1 802.3**	**1 935.1**	**7.3%**

Source: National Treasury

Over the medium term, expenditure will grow by an annual average of 7.3 per cent, from R1.6 trillion in 2017/18 to R1.9 trillion in 2020/21. The fastest-growing category of expenditure is debt-service costs, which reach nearly 15 per cent of revenue in the outer year and increasingly crowd out spending on services. The fastest-growing elements of spending are Learning and Culture (which includes post-school education and training), Health and Community Development, with growth rates of 7.6 per cent, 7.5 per cent and 7.9 per cent respectively.

Spending that aims to deliver services to low-income households is protected

Despite a highly constrained fiscal environment, government is protecting expenditure that delivers services to low-income households. However, additional resources to support spending priorities are severely limited.

As in recent years, additional allocations will be funded mainly through reprioritisation of existing budget baselines. Structural increases in expenditure to accommodate new policy initiatives, and resulting adjustments to the spending ceiling, will need to be matched by parallel tax increases.

Conclusion

Improved confidence and microeconomic reforms will return the economy to a higher growth rate over time

Stronger economic growth is required to return the public finances to a sustainable position, and put South Africa back on a path of rising employment and increasing prosperity. Government is committed to transformation and confidence-boosting measures to promote investment. Combined with microeconomic reforms, higher levels of business and consumer confidence will return the economy to a higher growth path over time.