

■ TRANSFORMATION FOR INCLUSIVE GROWTH

To realise the vision of the Constitution, South Africa needs transformation that opens a path to inclusive economic growth and development. Growth without transformation would only reinforce the inequitable patterns of wealth inherited from the past. Transformation without economic growth would be narrow and unsustainable.

Government's objective is not merely to transfer ownership of assets or opportunities to contract with the state: it is to change the structure of the economy. Broad-based transformation should promote growth, mobilise investment, create jobs and empower citizens. It must create new resources to support social change, including assets and livelihoods for the majority, and strengthen South Africa's constitutional foundations.

The budget plays a central role in transformation by promoting redistribution and directing scarce resources towards catalytic investments in human and physical capital. But the budget depends on the economy to generate the resources to finance these investments, and South Africa has had several years of very low growth.

The 2017 Budget proposes several difficult trade-offs to safeguard citizens' quality of life, improve the efficiency of spending and ensure that the public finances are sustainable.

Transformation is not a zero-sum game

Since 1994, South Africa has been guided by the Constitution's call to heal the divisions of the past and establish a society based on democratic values, social justice and fundamental human rights. The country has made much progress in these areas. But too little has changed in the structure of the economy and patterns of wealth accumulation.

Too little has changed in structure of economy and patterns of wealth accumulation

Inclusive growth requires broad-based transformation to break down structural impediments to new economic activities, deconcentrate industries dominated by few participants, accelerate the inclusion of millions of black South Africans into jobs and businesses, and return to a path of rising per capita incomes for all.

The changes needed to achieve this are set out in the NDP. They include:

- Improving education and skills development, starting with a more effective basic education and early childhood development sector.
- Strengthening competition laws to address skewed ownership and control, which is a barrier to business entry and the expansion of key markets that are essential for job creation.
- Increasing private-sector participation in sectors dominated by public enterprises, and ensuring that effective regulatory authorities curb the power of monopolies.
- Providing support and incentives for labour-intensive sectors, including agriculture, agro-processing and tourism.
- Overcoming the spatial fragmentation of South Africa's cities, so that people have easier access to jobs and infrastructure.

Benefits of empowerment should be accessible to all

Transformation is not a zero-sum game. The benefits of empowerment should be accessible to all citizens, not limited to connected insiders. This will require action to transform the structure of production and patterns of asset ownership. Government is committed to promoting inclusive economic transformation through fair, transparent and predictable means. Public and private investment needs to be mobilised in tandem to help modernise and diversify the economy.

Redistribution through the budget

South Africa’s fiscal system makes a substantial contribution to transformation and inclusive growth. It finances the construction of houses and schools, the education of youth, care for the elderly and incomes of the most vulnerable. A large number of programmes aim to build new businesses, empower small farmers, develop human capabilities and incentivise job creation and economic transformation.

Good budget execution is a tool for transformation

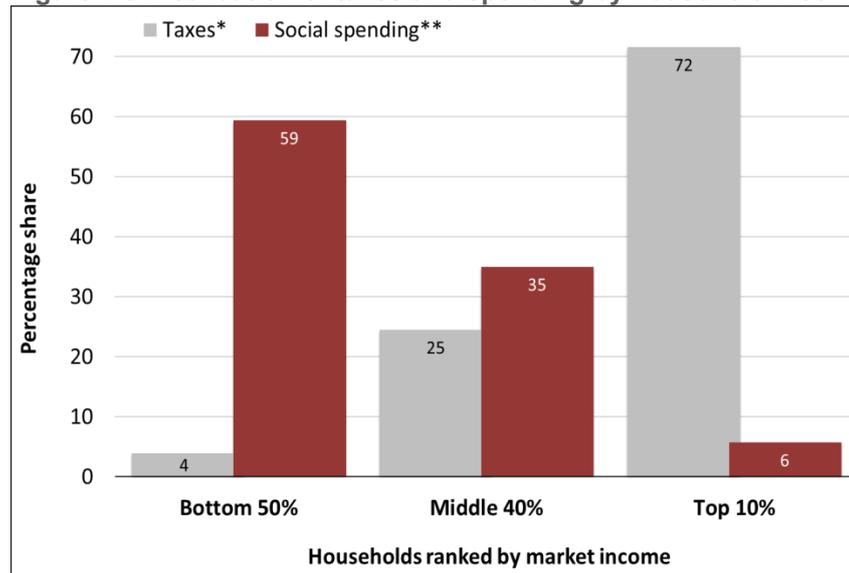
Ultimately, effective budget execution is a highly transformative tool for national development. Its success depends on a large range of implementing agencies in national, provincial and local government. And it can be strengthened by citizens demanding accountability to ensure public funds are used for their intended purposes.

The national budget is strongly aligned with constitutional imperatives: about two-thirds of the 2017 Budget is allocated to functions dedicated to realising constitutionally mandated social rights – including education, healthcare, social security and housing.

Budget is highly redistributive in favour of poor and working families

The budget is highly redistributive in favour of poor and working families. It also redistributes substantial resources from the urban economy to fund services in rural areas. The formulas used to distribute resources to provinces and municipalities are governed by a transparent, rules-based arrangement.

Figure 1.3 Distribution of taxes and spending by household income¹



¹Based on Statistics South Africa’s income and expenditure survey, 2010/11
 *Includes personal income tax, value-added tax, fuel levies and excise
 **Includes social grants, free basic electricity and water, health and education budgets,
 Source: Inchauste et al. (2015), *Distributional Impact of Fiscal Policy in South Africa*, World Bank

The division of revenue redistributes substantial resources from the urban economy to fund services in rural areas. It also subsidises services to millions of poor households in towns and cities through considerable allocations to urban municipalities and provinces. Metropolitan municipalities account for 70 per cent of personal income tax revenue, but receive only 31 per cent of local government transfers. Similarly, the 61 mostly rural local municipalities also receive 31 per cent of transfers to local government, but account for only 5 per cent of personal income tax revenues.

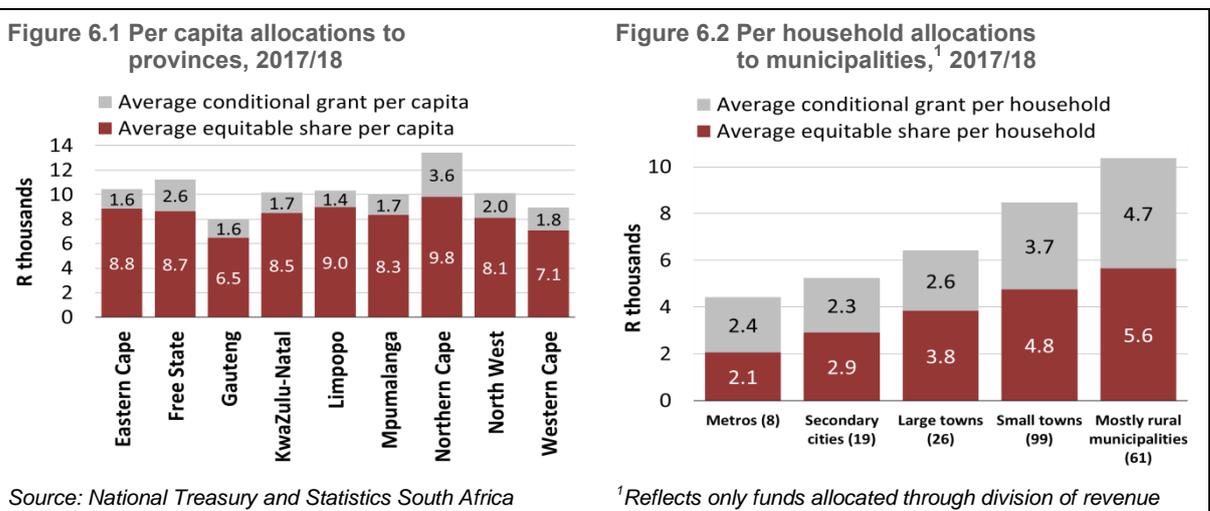
Allocations to provinces are based primarily on demand for services, established with data provided by Statistics South Africa (Stats SA). As Figure 6.1 shows, this results in higher per person allocations to more rural provinces, which tend to have high demand for public healthcare and schooling. Allocations in the provincial equitable share formula respond to high poverty rates and provide institutional support that benefits provinces with smaller populations. The allocation formulas are detailed in Annexure W1 to the *Budget Review*.

More than 80 per cent of transfers to provinces are allocated through the equitable share. The National Treasury, in consultation with provincial treasuries, national departments, the Financial and Fiscal Commission and Stats SA, is reviewing the formula used to allocate each province’s share. At the technical level, updates will involve assessing the reliability of data and how frequently it can be updated. At the policy level, the review will consider issues such as the funding burden of poorer schools and the cost of service provision.

Allocations to local government take into account the ability of municipalities to raise their own revenue to fund municipal services (through property rates and service charges). They also factor in the need to provide free basic services to poor residents and build infrastructure to extend services to those who do not have access. As a result, transfers per household to the most rural municipalities are more than twice as large as those to metropolitan municipalities (see Figure 6.2).

Government redistributes substantial resources from urban areas to fund services in rural areas

Per household transfers to rural municipalities are double the size of those to metros



Economic transformation

Government working to create new opportunities for inclusive growth

Stronger and more inclusive growth is required to address unemployment, poverty and inequality. Government continues to work with business and labour to improve confidence and boost investment. Over the medium term, these efforts will be focused on rapidly changing the structure of the economy and creating new opportunities for more inclusive growth.

Despite progress, transformation has been slow and its benefits distributed unequally

Government has made progress in transforming the economy since 1994. Black economic empowerment legislation, affirmative action policies and redistributive spending through the budget have aimed to expand employment and business opportunities for black South Africans, and address high levels of poverty and inequality. This is reflected in significant growth in the black middle class, the provision of housing to millions of South Africans and a vast expansion of access to services for all citizens. The pace of transformation, however, has been too slow and the benefits have been distributed unequally.

Government committed to mass-based transformation that raises per capita incomes across the board

Transformation that creates more jobs, increases wealth for all citizens and reduces inequality requires faster growth and more equitable distribution of resources and benefits. Government is committed to mass-based transformation that generates more meaningful black participation in the economy and raises per capita incomes across the board, rather than a narrow change that merely transfers ownership, benefits an elite and perpetuates inequality.

The NDP points out that transforming the economy will require reforms that lead to more competitive product markets and stronger growth in labour-absorbing sectors such as agriculture and tourism.

South Africa's redistributive budget lifts more than 3.5 million out of poverty

Macroeconomic stability supports transformation. South Africa's flexible exchange rate policy, inflation-targeting regime and prudent fiscal policies encourage investment and provide a buffer against fiscal, financial and balance of payment crises that could reverse transformational gains. A 2014 report by the World Bank shows that redistribution of income through the budget lifts more than 3.5 million South Africans out of poverty and reduces the Gini coefficient, a measure of inequality, from 0.77 to 0.59.

The measures outlined below have the potential to accelerate transformation and to lift GDP growth by more than 1.5 percentage points.

Increasing employment

Increasing employment requires greater business confidence to attract investment, attention to education and skills development, and support for employment-intensive sectors.

Legislative amendments to provide policy certainty and support growth in mining and agriculture

Technological innovation across a range of industries means that most new jobs are for skilled and semi-skilled workers. As South Africa builds its skills base, there is also scope to increase employment in sectors that have historically absorbed large numbers of less skilled workers, such as mining and agriculture. Policy certainty is required to support growth and employment in these sectors.

Tax and industrial incentives are designed to boost investment and employment. Government is reviewing such incentives for their efficiency

and contribution to inclusive growth, including whether they benefit capital-intensive rather than labour-intensive production.

Partnerships with the private sector can help boost employment. The National Treasury, working with other departments, plans to explore how private-sector training can be encouraged through incentives such as the learnership allowance. Government, business and labour are negotiating a three-year programme called the “YES Initiative” to enable 1 million young people to gain work experience in the private sector.

Tourism is an important contributor to inclusive growth and transformation, accounting for 4.5 per cent of total employment. An additional R230 million has been allocated to the Tourism Destination Development and Marketing Programme over the medium term.

Expanding tourism sector can continue to create a large number of jobs

Research and development to boost economic growth

Innovation, supported by research and development, can play a catalytic role in the economy. The Department of Science and Technology administers several research and development programmes:

- The Research and Development Tax Incentive Programme catalysed R30 billion of private investment in research and development in the decade to 2016.
- The Council for Scientific and Industrial Research is allocated R9.3 billion over the medium term for health, energy, advanced manufacturing and mining research and development.
- The Technology Innovation Agency funds innovative products with the aim of commercialising them. Of its R1.3 billion allocation over the medium term, R719 million will be for small and medium enterprises.
- The MeerKAT radio telescope project has a 75 per cent local content requirement and will receive R2.2 billion over the medium term.

Government is also reviewing research and development incentives, and assessing whether these can be increased. In addition to a budgeted baseline of R13.6 billion over the medium term, an additional R1 billion has been set aside to support innovation in 2018/19.

Cheap and accessible information and communications technology

Cheap, accessible and reliable information and communications technology (ICT) can provide a major boost to economic growth and employment. South Africa needs to rapidly conclude the transition from analogue to digital television signals (digital migration), and allocate new spectrum to expand wireless broadband services. This will reduce ICT costs and create business opportunities for new entrants.

Several studies highlight the link between improved ICT access and reduced poverty. Cheaper, more widely available ICT services can also improve access to educational and health resources, and enhance outcomes. Research by the National Treasury shows that a 50 per cent reduction in ICT costs can increase GDP growth by 0.3 percentage points per year and create over 200 000 additional jobs over the next decade.

50 per cent reduction in ICT costs could create 200 000 jobs over next decade

Transforming the energy sector

Transforming the energy sector, with growing opportunities to generate electricity from renewable sources, can open the market to new, innovative businesses and boost employment creation.

Black South Africans hold 31 per cent of IPP shares

The independent power producer programme has boosted power generation, attracted R194.1 billion in private investment and created thousands of jobs. IPPs have helped to reduce South Africa's carbon emissions and fostered the development of new renewable energy firms, some of which have become exporters. On average, black South Africans hold 31 per cent of shares across the IPP supply chain. Local communities own 11 per cent of the projects and are expected to receive R29.2 billion in income over 20 years. Contracts under negotiation have the potential to generate over R500 billion in investment and create more jobs.

Expanding IPP programme to other sectors requires clear, consistent and reliable policy application

Government plans to continue the IPP programme and extend the successful model to other sectors. Lack of clarity on Eskom's plans to connect new IPPs to the electricity grid, however, has prompted concerns that some renewable energy equipment manufacturers could go out of business. The 2017 State of the Nation speech addressed an important aspect of this policy uncertainty, noting that Eskom will sign outstanding power-purchase agreements for renewable energy in line with procured rounds.

The Department of Energy released the Integrated Energy Plan and the Integrated Resource Plan for public comment until the end of March 2017. Fiscal sustainability and consumer affordability will inform government's choices on the preferred generation mix.

Accessible, affordable financial services

Implementation of Financial Sector Code will expand accessible, affordable financial services

Government is increasing access to financial services for poor households and providing a supportive regulatory environment for the ongoing implementation of the Financial Sector Code.

- The Insurance Bill aims to establish a clear regulatory framework that will encourage the provision of quality, low-cost insurance products for low-income consumers.
- The Cooperative Banks Development Agency is working to create new opportunities in the financial sector, particularly new banks.
- Postbank's transition to a bank (see Chapter 8) will enable it to provide increased access to financial services for poor South Africans.

Annexure F of the *Budget Review* contains more detail on financial-sector reforms.

Economic transformation through lowering barriers to entry

South African industries tend to be highly concentrated. New firms face barriers to entry, including lack of access to long-term capital, integrated value chains that impede access to inputs and limited market access. Research by the National Treasury and the Centre for Competition, Regulation and Economic Development found examples of existing interventions that help to lower entry barriers:

- Well-channelled competition penalties and supplier development funds can provide long-term capital and market access. For example, the Soweto Gold brewery accessed finance through an Industrial Development Corporation fund established through the penalties imposed on Pioneer Foods for anti-competitive behaviour in the bread market. Lethabo Milling benefited from a fund established as part of the Walmart/Massmart merger to develop new black-owned suppliers in their supply chain.
- Partnerships with established firms can be effective. Pick 'n Pay, working with the Gauteng Department of Economic Development, opened its distribution centres to township spaza shops.
- Introducing effective competition can lead to a wide range of benefits. Capitec's entry into the banking sector has helped to lower costs and extended services to the previously unbanked.
- Improved regulation can drive down consumer and business costs. The reduction of mobile call termination rates enabled Cell C to compete, and encouraged MTN and Vodacom to reduce rates.

Expanding agriculture and accelerating land reform

Comprehensive land reform that promotes extensive cultivation of every hectare while resolving land rights issues under all tenure systems can transform agriculture. Such initiatives can open broad new markets and employ millions of South Africans living in rural areas. The National Treasury is considering the feasibility of agricultural insurance for poor farmers to protect them against economic shocks and natural disasters. It is envisaged that a pilot project will begin in the third quarter of 2017.

Comprehensive land reform that promotes extensive cultivation can transform agriculture

Developing regional growth opportunities

Promoting growth and economic transformation in the region requires South Africa and its neighbours to abolish tariff and non-tariff barriers to trade, cut red tape and enact other reforms. Stronger regional growth will increase demand for services and provide new opportunities for South African firms.

Expanding trade in the Southern African Development Community

The Southern African Development Community (SADC) is the largest market for South Africa's manufactured exports. Research by the National Treasury and the World Institute for Development Economic Research highlights additional opportunities to expand mutually beneficial intra-SADC trade.

- Regional supermarket chains are dominated by South African companies. Yet many products are sourced from outside the region. A regional framework to upskill suppliers can boost production and trade.
- SADC poultry production has increased significantly, but nearly all countries in the region remain net importers of poultry and animal feed. Given the favourable climate for maize and soya, Mozambique, Zambia and Zimbabwe can boost production of feed and poultry.
- Transport costs are high due to border delays and regulations that restrict competition. Joint action on border controls, standards, storage facilities and infrastructure investment can reduce costs.
- Many mineral resources in the region remain largely untapped. A regional system of mining innovation could expand opportunities for all participating countries.
- The SADC is home to an impressive array of potential energy sources, including gas. Wind power systems in promising locations can complement hydropower systems on the Zambezi. A regional perspective on power can generate substantial benefits.

Improving housing and city development

Housing ownership is the largest and most enduring vehicle for family wealth accumulation. Government supports housing schemes and the upgrading of informal settlements. Greater emphasis needs to be given to private investment in housing stock as part of urban densification initiatives and to contribute to affordable, improved residential neighbourhoods. Work with the private sector to redevelop South Africa's urban spatial form is discussed in Chapter 6.

Support for township economies

About 31 per cent of working-age South Africans, and almost half of the unemployed, live in townships. Developing township economies that create jobs and greater scope for entrepreneurship is a policy objective.

Townships have an in-built geographic disadvantage. They were established as dormitory suburbs for black workers, making it difficult for township businesses to compete in anything that requires high-quality infrastructure, a wide range of inputs, a broad customer base and a diverse skills set.

Government is working on reforms to promote township economies. This includes encouraging the property sector to develop infrastructure such as shops, offices, housing, schools and hospitals. Government is also considering ways to accelerate targeted investment, strengthen municipal borrowing and establish partnerships with local businesses.

A supportive environment for business development

Government helps small businesses by providing funding and targeted support for firms with high growth potential. The private sector has invested R1.5 billion in a small-business mentorship fund. Government's procurement reforms, which aim to strengthen financial management and save costs, are also focused on expanding access for small businesses. Chapter 5 details current reforms led by the Office of the Chief Procurement Officer. New procurement rules will increase opportunities for black women, youth, people with disabilities, cooperatives, military veterans and suppliers from rural communities.

Local content thresholds have the potential to boost South African manufacturing

In recent years, government has also established thresholds for local content in public procurement. Table 2.5 provides a list of some of the products and the required local content amounts.

Table 2.5 Local content requirements for selected designated products¹

	Product
Textile, clothing, leather and footwear	100%
Power pylons, substations, related hardware	100%
School furniture	100%
Working vessels/boats and components	10% -100%
Conveyance pipes	80% - 100%
Components and conversion activities	50% - 100%
Two-way radio terminals components	20% - 100%
Wheelie bins	100%
Fire trucks (crew cabin, super structure & assembly)	100%
Steel construction materials	100%

1. Excludes products below 100 per cent local content requirements

Source: Department of Trade and Industry

To increase market access and competition, the National Treasury will give private companies access to its supplier database and allow them to publish their own tenders on the eTender portal.

Economic transformation through preferential procurement

Revised preferential procurement policy regulations take effect on 1 April 2017. The following changes aim to enhance transformation:

- Tenders can be targeted to empower specific groups, such as black women.
- Bids up to R50 million will be evaluated in terms of the 80/20 preference point system (the previous threshold was R1 million), which will help smaller, black-owned firms to compete.
- Public entities will be allowed to negotiate prices and value for money with preferred service providers.
- Procurement of locally manufactured goods will be supported.
- Preference points will be allocated in line with broad-based black economic empowerment status.
- Compulsory subcontracting of at least 30 per cent for tenders above R30 million will be implemented, where feasible, to advance designated groups.

The Budget Review

The *Budget Review* describes the economic outlook and policies to promote growth; the fiscal policy choices of government; the revenue proposals for 2017/18; national spending proposals; the division of revenue; the financing strategy; and the financial position of public-sector institutions.

Annexures present the Minister of Finance's report to Parliament; tax expenditures and tax amendments; data on public sector infrastructure and public-private partnerships; and an update on financial-sector regulation and reform.

The full Budget Review, budget data and further information are available at www.treasury.gov.za