3

Fiscal policy

In brief

- The 2018 Budget proposes major spending adjustments and tax measures in response to the unsustainable debt outlook presented in the October 2017 Medium Term Budget Policy Statement (MTBPS). Together with faster economic growth, these measures serve to reduce the budget deficit and stabilise national debt as a share of GDP over the medium term.
- The fiscal framework reflects two major spending changes that followed the MTBPS: cuts identified by a Cabinet subcommittee amounting to R85 billion over the medium term, and an additional allocation of R57 billion for fee-free higher education and training. Contingency reserves have been increased to reflect uncertainty in the growth outlook, spending pressures and the precarious finances of several state-owned companies.
- Proposed tax measures will raise an additional R36 billion in 2018/19. These include an increase in the rate of value-added tax (VAT) and below-inflation adjustments for personal income tax brackets.
- The consolidated deficit is projected to narrow from 4.3 per cent of GDP in 2017/18 to 3.5 per cent in 2020/21. The main budget primary deficit will close over the medium term, helping to stabilise the gross debt-to-GDP ratio at 56.2 per cent of GDP in 2022/23.

Overview

The economic and fiscal outlook has improved since the October 2017 MTBPS. Investor confidence has grown on the promise of renewed policy coordination and effective implementation. Yet the challenges highlighted in October – rising national debt, significant revenue shortfalls and the precarious financial condition of several state-owned companies – remain central policy concerns.

Despite an improved outlook, government still faces a revenue gap of R48.2 billion in 2017/18, which feeds through to the outer years of the medium-term expenditure framework (MTEF). In addition, the December 2017 announcement of fee-free higher education and training entails an additional allocation of R57 billion over the medium term.

Accordingly, the 2018 Budget proposes measures to reduce the budget deficit while providing space for new spending commitments.
The central adjustments to the fiscal framework in 2018/19 are to:

- Raise an additional R36 billion in tax revenue through an increase in the VAT rate, limited personal income tax bracket adjustments and other measures.
- Reduce MTBPS baseline expenditure by R26 billion.
- Allocate R12.4 billion for fee-free higher education and training.
- Set aside an additional R5 billion for the contingency reserve.
- Provisionally allocate R6 billion for drought management and public infrastructure.

The baseline spending reductions and tax measures feed through to the outer years of the framework, while allocations to higher education increase sharply.

Together with an improved growth outlook, the proposals will reduce the consolidated budget deficit – the difference between total revenue and expenditure – from 4.3 per cent of GDP in 2017/18 to 3.5 per cent in 2020/21. A narrower deficit, stronger rand and lower borrowing costs result in gross government debt stabilising at 56.2 per cent of GDP by 2022/23. Net debt stabilises at 53.2 per cent of GDP in 2023/24.

The risks to the fiscal outlook remain elevated and include uncertainty in the pace of economic recovery, public-service wage pressures and the precarious finances of state-owned companies.

### Table 3.1 Consolidated fiscal framework

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<td>-3.5%</td>
<td>-4.3%</td>
<td>-3.6%</td>
<td>-3.6%</td>
<td>-3.5%</td>
</tr>
</tbody>
</table>

Source: National Treasury

### Stabilising the public finances

The present fiscal position is the cumulative result of trends at work since a structural budget deficit emerged following the 2009 global recession. The fiscal gap reflects both policy choices, including high public-sector wage settlements, and persistently low economic growth.

For several years, the *Budget Review* has noted that, in the absence of a significant upturn in GDP growth, government would face increasingly difficult budget decisions. Since 2012, successive budgets have reduced the rate of expenditure growth and raised taxes. While this measured path of fiscal consolidation achieved some success, debt continued to rise as a share of GDP as economic growth declined and new spending pressures emerged.
In combination with concerns over policy certainty, this led to credit-rating downgrades in 2017. South Africa is now rated sub-investment grade for both local- and foreign-currency debt by two of the three major rating agencies. At the time of the 2017 MTBPS, gross government debt was approaching R3 trillion over the medium term. If left unchecked, debt would continue to rise above 60 per cent of GDP over the coming decade.

Since then, the economy has shown signs of recovery. Projected real GDP growth in 2017/18 and 2018/19 has been revised up by 0.4 percentage points, and by an average of 0.3 percentage points over the subsequent two years. Nominal GDP projections have also been revised up, partly as a result of higher commodity prices.

Revenue collection for 2017/18 is projected to be R2.6 billion higher than the October 2017 estimate. Yet compared with the 2017 Budget estimates, this still leaves a shortfall of R48.2 billion in 2017/18.

Risks to the economic and fiscal outlook remain elevated:

- The recovery in economic growth is not yet broad-based. Much depends on continued improvements in political and policy certainty, and a supportive global environment. Tax buoyancy, which declined over the past two years, may not increase as quickly as projected.
- Talks on a new public-service wage agreement are in progress. An agreement locking in salary increases that exceed consumer price index inflation would make expenditure limits difficult to achieve.
- While decisive action by government to strengthen governance at Eskom has staved off the likelihood of near-term default, the financial positions of the power utility and several other large entities pose risks to the economy and the fiscus.
- The costs associated with fee-free higher education and training are uncertain. The Department of Higher Education and Training will need to ensure that its plans are aligned with allocations.
- A sub-investment downgrade for local- and foreign-currency debt by Moody’s would result in South Africa’s exclusion from the Citi World Government Bond Index, triggering a sell-off of South African debt. This would raise future borrowing and debt-service costs.

Prudent fiscal policy decisions and increases in the contingency reserve will help government to manage these risks. Improved policy certainty, alongside governance and economic reforms, will support fiscal consolidation.
Medium-term consolidation plans

Over the next three years, government will reduce the budget deficit through spending adjustments and revenue measures. Baseline reductions and reallocations for new spending commitments result in main budget non-interest expenditure remaining stable at 26.6 per cent of GDP. As a result of tax increases, main budget revenue grows from 25.4 per cent of GDP in the current year to 26.6 per cent of GDP in 2020/21. The primary deficit approaches zero by 2020/21.

Figure 3.1 Main budget revenue and non-interest spending*

*Excludes financial transactions
Source: National Treasury

Tax measures

In developing tax proposals, government reviewed the potential contributions from all major tax instruments. Policy measures in recent years have introduced successive increases in personal income tax. Over the same period, corporate income taxes have underperformed.

Figure 3.2 Tax revenue performance and projections

Source: National Treasury
Unlike other major taxes, the VAT rate has remained unchanged since 1993, and is lower than the average rate across peer countries. Raising VAT is less harmful to growth than raising other taxes. The zero-rating of basic foods and paraffin limits the regressivity of VAT, and additional adjustments are proposed to enhance the progressivity of the tax system. *Ad valorem* excise duties on luxury goods and estate duties for wealthy individuals are being increased. Above-inflation increases to social grants will also help cushion low-income households from the effects of the VAT increase.

**Expenditure adjustments**

In November 2017, a committee appointed by the President identified expenditure cuts totalling R85 billion over the MTEF period. About R53 billion of this amount has been cut at national government level, including large programmes and transfers to public entities. At sub-national level, conditional infrastructure grants of provincial and local government have been reduced by R28 billion. In addition, all national and provincial departments were required to reduce their spending on administration. The reductions exclude compensation of employees, which is already subject to a ceiling.

The major additions to the framework following the 2017 MTBPS are:

- Allocations to fee-free higher education and training for poor and working-class students amount to R12.4 billion in 2018/19, R20.3 billion in 2019/20 and R24.3 billion in 2020/21. This is in addition to a R10 billion provisional allocation made in the 2017 Budget.

- Allocations of R4.2 billion for national health insurance funded through adjustments to the medical tax credit, R490 million to establish the Tirisano Construction Fund Trust and R1 billion for the 2021 Census.

- An additional amount of R2.6 billion to enable an above-inflation increase to social grants to partially offset the impact of tax increases on the poor.

- A provisional allocation of R6 billion set aside in 2018/19 for drought relief in several provinces, assistance to the water sector, and public investment projects supported by improved infrastructure planning. These allocations will be considered in the Adjustments Budget process.

- Additions of R5 billion in 2018/19, R3 billion in 2019/20 and R2 billion in 2020/21 for fiscal risks and unforeseen developments, bringing the total contingency reserve to R26 billion over the medium term.

After taking account of the various adjustments to the framework, the expenditure ceiling has been revised down marginally over the medium term. In 2017/18, however, the expenditure ceiling is likely to be breached by R2.9 billion as a result of the recapitalisation of South African Airways (SAA) and the South African Post Office. These appropriations total R13.7 billion, partially offset by the use of the contingency reserve and projected underspending.
Efficiency and composition of spending

The medium-term spending reductions are necessary to ensure a sustainable fiscal trajectory, but they will have a negative impact on the composition of spending. About 47 per cent, or R39.7 billion, of the R85 billion in spending reductions consists of cuts to capital transfers. Goods and services, a category already reduced in previous budgets, will be cut by R16.5 billion. Current transfers will be reduced by R27.4 billion, offset by allocations to the Department of Higher Education and Training.

As far as possible, these reductions have been applied to programmes that underspent in previous financial years. Even after the baseline reductions, allocations to these programmes continue to grow in real terms over the medium term. Nevertheless, the reductions result in a shift in the composition of spending away from capital and towards consumption expenditure.

Reductions in baselines require departments to improve spending efficiency. A portion of the R6 billion amount provisionally set aside will support improved planning and implementation of large capital projects.

Rigorous assessment process begins building pipeline of large infrastructure projects

Government recognises that it needs to allocate money for infrastructure more efficiently. Weaknesses in project preparation, execution and delivery have resulted in project delays and cost overruns. In 2016, Cabinet mandated the National Treasury and the Presidential Infrastructure Coordinating Commission (PICC) to strengthen planning and implementation of large infrastructure projects. As a result, the Budget Facility for Infrastructure was launched by the National Treasury.

The facility is overseen by a technical committee. It is establishing processes to improve technical assessment and budgeting for the capital, operational and maintenance costs of large infrastructure projects and programmes that require public funds. Over time, this will lead to a pipeline of projects that have undergone rigorous technical analysis. The facility works to ensure that fiscal resources are committed in a transparent manner.

The National Treasury, the PICC and the Department of Planning, Monitoring and Evaluation participate in the facility, which develops project recommendations for the Medium Term Expenditure Committee (MTEC), the Ministers’ Committee on the Budget (MinComBud) and Cabinet. During the budget process, national departments submitted 64 potential projects with estimated funding requirements of R139 billion. Of these, 38 projects that met submission requirements were assessed for their value for money, socioeconomic rationale and readiness to implement. These projects were in the justice and protection services, and the water, health, telecommunications and transport sectors. The facility has completed its assessment and its recommendations have been considered by the MTEC and MinComBud.

Managing the public-service wage bill

Improving the composition of spending will require renewed efforts by government to manage the public-service wage bill. According to the Organisation for Economic Cooperation and Development (2017), South Africa’s government wage bill is one of the highest among its developing-
country peers. The consolidated wage bill increased rapidly from 32.9 per cent of spending in 2007/08 and remains at about 35 per cent of total expenditure in 2017/18.

Data published in the 2017 MTBPS showed that over the past decade, compensation has crowded out other areas of spending, particularly in labour-intensive departments. At the same time, cost-of-living adjustments have exceeded consumer price index inflation by an average of two percentage points. Public servants tend to be better paid than most taxpayers in general, as discussed in Annexure B of the 2017 MTBPS.

In the 2016 Budget, government reduced the compensation ceilings of national and provincial departments by R10 billion in 2017/18 and R15 billion in 2018/19. The compensation baselines in the 2018 Budget maintain this status quo. As a result of these adjustments, and a generally tighter fiscal environment, total national and provincial headcount growth has declined. Nevertheless, some national departments are at risk of breaching their compensation ceilings. Departments will need to continue paying careful attention to managing headcount levels. Government is working to ensure that the current wage negotiations process results in a fair and sustainable agreement.

Fiscal framework

Table 3.4 presents government’s consolidated operating and capital accounts. The consolidated deficit in 2017/18 (4.3 per cent) is larger than was estimated in the 2017 Budget (3.1 per cent). This is mainly due to lower tax revenue and higher main budget expenditure, partially offset by higher surpluses of public entities. A provincial deficit is projected for 2017/18 as some provinces draw on their accumulated reserves.

Compared with the 2017 Budget, deficit estimates for 2018/19 and 2019/20 are wider on average by about 0.8 percentage points. This is mainly because of lower tax revenue, despite additional revenue measures. Lower consolidated spending partially offsets the increased deficit. In addition, nominal GDP estimates in those two years are lower by an average of about R130 billion compared with the 2017 Budget. The deficit is projected to narrow significantly between 2017/18 and 2018/19, before reaching 3.5 per cent of GDP in 2020/21.

Consolidated non-interest expenditure will grow at an annual real average rate of 1.8 per cent over the next three years. Compensation as a share of total expenditure is projected to moderate from 35.4 per cent in 2016/17 to an average of 35.2 per cent in the current year and over the medium term. The consolidated wage bill is projected to grow at a nominal annual average of 7.3 per cent over the medium term.

The current deficit – the gap between revenue and current spending – is projected to narrow from -0.9 per cent of GDP in 2017/18 to an average of -0.2 per cent of GDP over the next three years. The capital financing requirement, which is the sum of capital payments, transfers and receipts, is expected to narrow from -3.4 per cent of GDP in the current year to -3.1 per cent of GDP in 2020/21. Following reductions in capital budgets, capital payments and transfers grow by a nominal annual average of 4.1 per cent over the medium term.
Elements of the consolidated budget

The consolidated budget includes the main budget and spending financed from the revenues raised directly by provinces, social security funds and public entities.

Main budget framework

The main budget framework, presented in Table 3.5, summarises spending financed from the National Revenue Fund. The main budget deficit, which is government’s net borrowing requirement, has widened to 4.6 per cent of GDP in 2017/18, compared with a 2017 Budget projection of 3.5 per cent. This mainly reflects tax revenue shortfalls and slightly higher projected spending. As a result, net borrowing increases by R50.5 billion in the current year.

The main budget deficit is projected at 3.8 per cent of GDP over the next two years, narrowing slightly to 3.7 per cent of GDP in 2020/21. As a result of fiscal measures, the primary deficit is projected to narrow towards a balance by 2020/21.

Since the 2017 MTBPS, the tax revenue outlook has improved marginally due to stronger performance in some major tax categories, and upward revisions to nominal GDP growth. National Revenue Fund receipt projections for the next three years have declined significantly compared with the 2017 MTBPS estimates due to lower revaluation profits on foreign-currency transactions.
CHAPTER 3: FISCAL POLICY

Payments to the Southern African Customs Union (SACU), projected at R48.3 billion in 2018/19, decline to R46.3 billion in 2019/20. As the economy recovers and imports rise, SACU payments are expected to increase to R60.1 billion in 2020/21.

In real terms, main budget non-interest expenditure is expected to increase by 2.7 per cent in the current fiscal year, then moderate to an average of 1.8 per cent over the next three years. Transfers to local government continue to grow faster than transfers to national departments and provinces, with the local government equitable share growing at an annual average of 11 per cent over the MTEF period. Compared with the 2017 Budget estimate, debt-service costs are R0.8 billion higher in the current year, mainly as a result of increased borrowing. On average, debt-service costs for 2018/19 and 2019/20 are largely in line with the 2017 Budget projections.

Social security funds, public entities and provincial balances

The social security funds, provinces and public entities have a combined cash surplus over the medium term, which partially offsets the main budget deficit. Estimates of the combined cash surplus generated by social security funds have declined significantly compared with the 2017 Budget. This is mainly driven by lower cash surpluses from the Unemployment Insurance Fund. The fund now anticipates higher expenditure than at the time of the 2017 Budget due to legislative changes that increased benefit payments.

Table 3.5 Main budget framework

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<td>-1.2%</td>
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<td>-0.1%</td>
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1. Southern African Customs Union. Amount made up of payments and other adjustments
Source: National Treasury
Public entities ran a combined cash surplus of R6.1 billion in 2016/17. This is largely a result of a surplus at the Passenger Rail Agency of South Africa (PRASA), which receives a significant share of its income in the form of transfers from government. PRASA’s R6.2 billion surplus arose because it underspent on its capital projects, including the rolling stock fleet renewal programme. This was partially offset by an operating deficit of about R1 billion. Over the next two years, the combined surplus of public entities averages R2.3 billion per year – R5.5 billion lower than projected in the 2017 Budget.

Chapter 8 provides more discussion on social security funds and other public-sector institutions.

| Table 3.7 Consolidated budget balance |
|-----------------------------|------|------|------|------|------|------|------|------|
| Main budget               | -166.4 | -168.4 | -167.6 | -217.3 | -191.1 | -204.8 | -214.8 |
| Social security funds     | 11.6   | 10.1   | 8.2    | 9.8    | 9.6    | 7.2    | 3.9    |
| Provinces                 | 6.2    | 0.6    | -2.6   | -1.6   | 0.3    | 1.1    | 1.6    |
| Public entities           | 8.6    | 7.7    | 6.1    | 4.9    | 1.0    | 3.5    | 4.5    |
| RDP Fund\(^1\)            | 0.4    | -1.0   | -0.2   | -0.1   | -0.3   | -0.3   | -0.3   |
| **Consolidated budget balance** | **-139.7** | **-151.0** | **-156.1** | **-204.3** | **-180.5** | **-193.3** | **-205.0** |

1. Reconstruction and Development Programme Fund
Source: National Treasury