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# Consolidation, reform and growth

**In brief**

- The 2020 Budget proposes total consolidated spending of R1.95 trillion in 2020/21, with the largest allocations going to learning and culture (R396.4 billion), health (R229.7 billion) and social development (R309.5 billion).
- The economic outlook is weak. Real GDP is expected to grow at 0.9 per cent in 2020, 1.3 per cent in 2021 and 1.6 per cent in 2022. Achieving faster economic growth requires far-reaching structural reforms.
- The public finances continue to deteriorate. Low growth has led to a R63.3 billion downward revision to estimates of tax revenue in 2019/20 relative to the 2019 Budget. Debt is not projected to stabilise over the medium term, and debt-service costs now absorb 15.2 per cent of main budget revenue.
- Halting the fiscal deterioration requires a combination of continued spending restraint, faster economic growth, and measures to contain financial demands from distressed state-owned companies.
- As a first step, the 2020 Budget makes net non-interest spending reductions of R156.1 billion in total over the next three years compared with last year's budget projections. This includes large reductions to the public-service wage bill.

## Overview

In 2019, consolidated government spending reached a historic high of 36 per cent of GDP. This increase reflects downward revisions to the size of the economy, spending plans based on an assumption of economic growth that has not materialised, and increased demands from financially distressed state-owned companies. While government makes a significant contribution to development, this level of spending is unsustainable, and results in continued high deficits and debt accumulation.

*Government spending has reached a historic high of 36 per cent of GDP*

A year ago, the *Budget Review* projected real economic growth of 1.5 per cent in 2019 and 1.7 per cent in 2020. We now expect real growth of only 0.3 per cent in 2019 and 0.9 per cent in 2020.

The impact of low growth on revenue collection has been considerable. Government expects to collect R63.3 billion less revenue than projected at the time of the 2019 Budget. The state is borrowing at an increased rate to

*The state is borrowing at an increased rate – not to build infrastructure, but to fund operations* fund operations, with the deficit projected at 6.3 per cent of GDP this year. Debt-service costs now absorb 15 cents of every rand government collects. By 2022/23, interest payments will exceed health spending.

*Baseline expenditure reductions of R261 billion partially offset by R60 billion set aside for Eskom and SAA*

As a major step towards fiscal sustainability, government has reduced the main budget expenditure baseline by R156.1 billion over the next three years in comparison with 2019 Budget projections. This is approximately 1 per cent of GDP per year. The net reduction is mainly the result of the following changes over the medium term:

- Reductions to baselines of R261 billion, which includes a R160.2 billion reduction to the wage bill of national and provincial departments, and national public entities.
- Reallocations and additions totalling R111.1 billion, of which R60.1 billion is set aside for Eskom and South African Airways (SAA).

Non-interest expenditure is forecast to grow at 3.8 per cent over the next three years, down from an average of 8.4 per cent over the past three years. Despite slower growth in spending, the deficit is forecast to remain in excess of 6 per cent of GDP next year, as a result of lower economic growth and tax revenue projections. The scale of the challenge requires fundamental changes to support economic growth, continued restraint in spending growth and improved spending efficiency.

**Figure 1.1 Gross debt-to-GDP outlook**

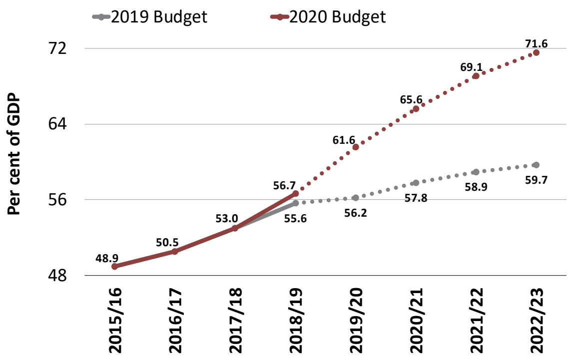



**Figure 1.2 Debt-service costs as proportion of main budget revenue**

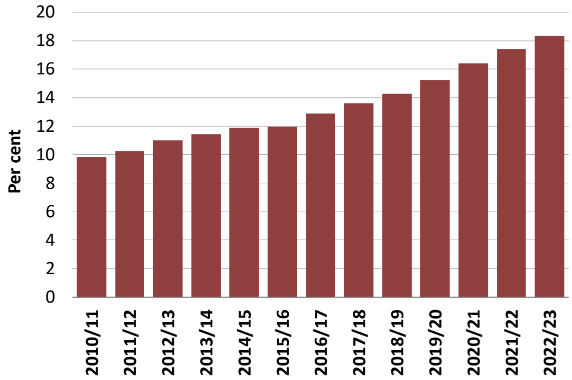



**Figure 1.3 Compensation of employees as share of consolidated expenditure**

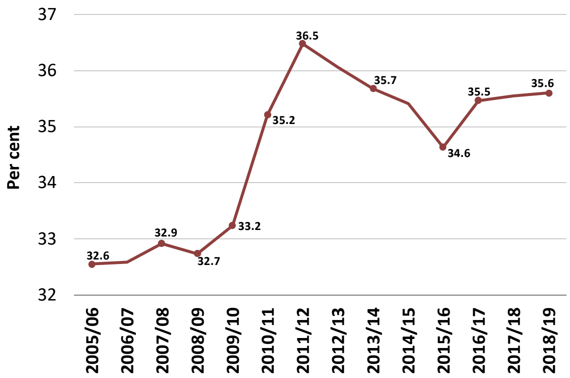
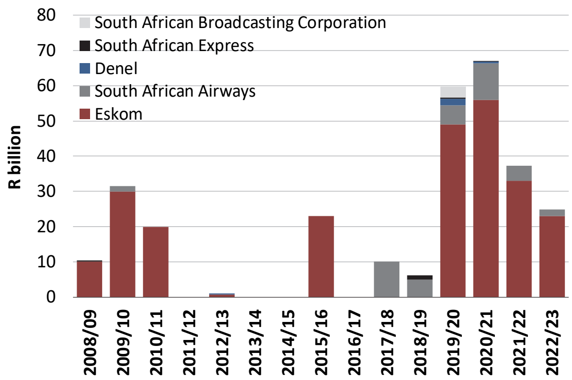



**Figure 1.4 Financial support provided for state-owned companies**




*Source: National Treasury*

To achieve faster economic growth, South Africa requires structural reforms in a number of areas. Most urgently, the regulatory path should be cleared to enable the private sector to generate electricity, contributing both financial and technical capacity to the country's energy needs. In other areas, cumbersome and unpredictable regulatory frameworks are undermining private investment. The President's State of the Nation Address made several announcements in this regard, and more decisive steps will be required in the months ahead.

*Most urgent structural reform is to clear path for private-sector electricity generation*

## Stabilising the public finances

Achieving fiscal sustainability requires a combination of continued spending restraint, faster economic growth and measures to contain extra-budgetary pressures – including reform of state-owned companies.

Since 2012/13, government has taken steps to reduce spending growth and raise tax revenue. As a result of lower nominal GDP and revenue growth, however, these interventions have not stabilised debt. Revenue and expenditure are near or at historic highs as a share of GDP. Over the same period, the composition of spending has deteriorated. Debt-service costs have been the fastest-growing area of spending, rising from 9.8 per cent of main budget revenue in 2010/11 to 15.2 per cent in 2019/20. The wage bill has grown strongly over this period, averaging 35.4 per cent of total consolidated expenditure.

*Debt-service costs have been fastest-growing category of expenditure*

Over the past five years, the majority of efforts to reduce the deficit have come through tax increases. The 2020 Budget centres the consolidation effort on expenditure, by reducing compensation growth. The aim is to reduce spending as a share of GDP, and improve the composition of spending. Government will not raise additional revenue from tax proposals for 2020/21.

### Towards a sustainable wage bill

Government recognises that public-service employees should be fairly remunerated, but is obligated to balance compensation demands with the broader needs of society as reflected in the budget. Civil servants' salaries have grown by about 40 per cent in real terms over the past 12 years, without equivalent increases in productivity. Growth in the wage bill has begun crowding out spending on capital projects for future growth and items that are critical for service delivery.

*Government is obligated to balance fair compensation with needs of broader society*

The 2020 *Budget Review* includes R160.2 billion in medium-term reductions to the wage bill. This will affect national and provincial departments, and national public entities that receive transfers from government. Government has tabled an agenda item on the management of the public-service wage bill at the Public Service Co-ordinating Bargaining Council, and will discuss with unions options for achieving the required reduction. This target can be achieved through a combination of modifications to cost-of-living adjustments, pay progression and other benefits.

The proposed wage reductions will see consolidated compensation spending contract by 1 per cent in real terms over the medium term. Goods and services and capital budgets will continue to grow in real terms.

### Revenue considerations

*No overall tax increase proposed for 2020/21*

In preparing the 2020 Budget, government considered but decided against proposing tax increases. The main factors in this decision were the weakness of the economy and, in the context of the muted growth outlook, the elevated tax-to-GDP ratio of 26.3 per cent. Government's short-term focus is to rebuild the capacity of the South African Revenue Service (SARS) and public trust in the institution.

### State-owned companies

Over the past 12 years, government has allocated R162 billion to financially distressed state-owned companies, of which Eskom accounts for 82 per cent. Fiscal support for Eskom, as outlined in Annexure C of the 2019 *Medium Term Budget Policy Statement* (MTBPS), remains unchanged. The roadmap on Eskom, published by the Minister of Public Enterprises, outlines the reform process. Eskom has begun the process of separating its three operating activities – generation, transmission and distribution – each of which will soon have its own board and management structure. These are the first steps in the necessary restructuring of South Africa's electricity sector for the 21st century.

*R16.4 billion set aside for SAA to repay guaranteed debt and cover debt-service costs*

SAA's board placed the airline into voluntary business rescue in December 2019 as a result of its inability to meet financial obligations. Since 2008/09, SAA has incurred net losses of over R32 billion. Government has set aside R16.4 billion for SAA over the medium term to repay the airline's guaranteed debt and to cover debt-service costs. The costs of this adjustment are still being finalised, and will be financed from existing provisional allocations for state-owned companies.

## Structural reforms for investment and growth

*Reforms needed to promote investment, create jobs and enable state to sustainably grow revenue*

South Africa needs much faster economic growth to promote investment, create jobs, and enable the state to sustainably grow the revenue that pays for social and developmental programmes. These objectives underpin *Economic Transformation, Inclusive Growth, and Competitiveness: Towards an Economic Strategy for South Africa* – a discussion document released by the National Treasury in August 2019.

The barriers to economic growth are complex and require structural reforms. In other words, the cost of doing business, the cost of finding or conducting work, and the cost of living must be meaningfully reduced. Such reforms will help to transform the economy by improving the profitability of existing businesses, encouraging the start-up of new enterprises, boosting private-sector investment, creating jobs and reducing unemployment, and improving the purchasing power of all households.

*Low and stable inflation, flexible exchange rate, rule of law and transparent public finances promote certainty*

South Africa's macroeconomic policy provides a sound platform for the success of structural reforms. Government is committed to low and stable inflation, a flexible exchange rate and a sustainable fiscal framework. These policy commitments in turn reduce uncertainty and risk in investment decisions, and support business and consumer confidence. The Constitution entrenches the rule of law, and commits South Africa to transparent public finances, accompanied by expenditure controls, and a central bank that executes its functions independently.

Government is committed to building partnerships with the private sector to provide infrastructure. The Infrastructure Fund has a project pipeline with potential investments of more than R700 billion over the next 10 years, including both government and non-government contributions.

*Government is committed to partnerships with private sector to provide infrastructure*

Urgent attention is required to implement structural reforms to South Africa's network industries. Alongside implementation of the reform agenda outlined in the discussion document, these efforts will help to lay the foundation for higher confidence and growth.

**Electricity**

The most pressing reform is to ensure that all businesses and households have sufficient and dependable electricity supply. Government can expand private-sector power generation by rapidly implementing the commitments made in the President's State of the Nation Address. These include acquiring additional electricity from existing independent power producers, opening bid window 5, procuring an additional 2 000 to 3 000 megawatts (MW) of emergency power for the national grid within three to 12 months from approval, and allowing municipalities to procure power from the private sector.

*All businesses and households must have sufficient and dependable electricity supply*

The speed with which the related procurement processes are undertaken is critical. Regulatory processes need to be simplified to meet deadlines for responses to licensing applications. Self-generation could reduce demand pressures and boost overall supply. Accordingly, government should implement previously announced commitments to make changes to schedule 2 of the Electricity Regulation Act (2006).

**Ports**

Urgent regulatory reforms are needed in the ports sector to reduce the cost of trading. The corporatisation of the National Ports Authority should be accelerated. The authority, which regulates port operators and undertakes infrastructure investment, currently operates as a division within Transnet. Corporatising the authority would allow for better independent regulation of South Africa's ports and increased competition in terminal operations. It would also support greater investment in ports from operating profits, free from Transnet group considerations.

*Corporatisation of National Ports Authority, provided for in law, should be accelerated*

**Telecommunications**

The issuance of rapid deployment guidelines would enable the private sector to invest more quickly in telecommunications infrastructure. Enforcement of existing open-access conditions would avoid duplication of infrastructure. Digital migration should be accelerated and work to release spectrum through the auction process should continue.

**Freight rail**

The Economic Regulation of Transport Bill, which was approved by Cabinet for submission to Parliament, will improve third-party access to freight rail. This, in turn, can generate efficiencies in the rail sector. Regulatory reforms that promote freight rail efficiency should be complemented by the removal of implicit subsidies in road freight transport, ensuring a level playing field for competition.

*Reforms needed to level the playing field for competition in land-based freight transport*

## Improving spending efficiency and reducing waste

*Reforms under way to improve procurement, strengthen provincial grants, reduce claims against the state*

Government's contribution to the economy is not matched by adequate spending efficiency. Reports by the Auditor-General have consistently highlighted patterns of wasteful expenditure. Reforms under way include:

- Procurement – The state maintains a complex and often ineffective procurement system. Some measures have had the unintended effect of severely hampering government's ability to efficiently contract for goods and services. Many of these regulations can be reformed to make legitimate procurement easier without undermining the necessary anti-corruption safeguards. As a first step, the draft Public Procurement Bill has been gazetted for public comment.
- Provincial grants – Government has made progress in reducing unfunded municipal budgets and is piloting initiatives to improve municipal revenue collection. Following a review, government is introducing several changes to the provincial grant system.
- Medico-legal claims – Medical malpractice claims and litigation against the state have increased rapidly in recent years. Although in many cases the quality of care is insufficient, the increase in claims is inconsistent with certain indicators of health outcomes in the public sector. Work has begun to limit unreasonable claims against the state.
- Public office bearers – There will be no increase in the salaries of public office bearers in 2020/21. This follows a reduction in benefits stemming from changes to the Ministerial Handbook.

*Tax incentives to be reviewed and expenditure to be assessed to improve efficiency*

Over the period ahead, the following interventions will be undertaken:

- South Africa's tax incentive system favours incumbents and those able to afford specialist tax advice. Over the medium term, government will conduct a review of such incentives, repealing or redesigning those that are redundant, inefficient or inequitable.
- The National Treasury and the Department of Planning, Monitoring and Evaluation will undertake a new round of expenditure reviews to identify cost savings and improve efficiency.
- Government will publish a new law this year introducing a remuneration framework for public entities and state-owned companies. One goal of this legislation is to eliminate excessive salaries and bonuses being awarded to executives and managers.

Over the next year, the National Treasury and the Department of Public Service and Administration will improve the wage-setting mechanism; report on the causes of unauthorised and wasteful expenditure; and examine ways to reduce state litigation, accommodation and information technology costs.

## Summary of the budget

### Economic outlook

The economic growth outlook has weakened since the 2019 MTBPS, following lower-than-expected growth in the second half of the year.

Electricity shortages are expected to constrain growth over the next few years. GDP is estimated to have grown by only 0.3 per cent in 2019. Over the medium term, economic growth projections have been revised down to 0.9 per cent in 2020, rising to 1.6 per cent in 2022. In 2020, the global economy is expected to recover moderately from its recent slowdown, supported by low interest rates and reduced trade tensions between the United States and China.

*Electricity shortages expected to constrain growth over medium term*

**Table 1.1 Macroeconomic outlook – summary**

| Real percentage growth | 2019 Estimate | 2020 | 2021 Forecast | 2022 |
|---|---|---|---|---|
| Household consumption | 1.1 | 1.1 | 1.3 | 1.6 |
| Gross fixed-capital formation | -0.4 | 0.2 | 1.3 | 1.9 |
| Exports | -2.1 | 2.3 | 2.6 | 2.8 |
| Imports | 0.2 | 1.8 | 2.5 | 2.8 |
| **Real GDP growth** | **0.3** | **0.9** | **1.3** | **1.6** |
| Consumer price index (CPI) inflation | 4.1 | 4.5 | 4.6 | 4.6 |
| Current account balance (% of GDP) | -3.4 | -3.4 | -3.5 | -3.7 |

*Across all tables in the Budget Review, the use of "0" refers to a value of small magnitude that is rounded up or down to zero. If a value is exactly zero, it will be denoted by "–". If data is not available, it is denoted by "N/A"*
*Source: National Treasury*

## Fiscal policy

The consolidated budget deficit is estimated at 6.3 per cent in 2019/20. A key driver of the widening deficit has been a sharp decline in nominal GDP since 2018/19 and associated tax revenues. Nominal GDP is projected to fall below the 2019 MTBPS estimates by an average of R131 billion per year over the medium term. As a result, tax revenue is expected to be significantly lower. Requests for support from financially distressed state-owned companies have continued to mount.

*Sharp decline in nominal GDP and associated tax revenues has widened consolidated budget deficit*

The 2020 Budget proposes measures to reduce public spending as a share of GDP and improve the composition of spending by reducing growth in the wage bill. Over the medium term, spending baselines will be reduced by R261 billion. The consolidated budget deficit is expected to narrow from 6.8 per cent in 2020/21 to 5.7 per cent of GDP in 2022/23.

**Table 1.2 Consolidated government fiscal framework**

| R billion/percentage of GDP | 2019/20 Revised estimate | 2020/21 | 2021/22 Medium-term estimates | 2022/23 |
|---|---|---|---|---|
| **Revenue** | **1 517.0** | **1 583.9** | **1 682.8** | **1 791.3** |
| | *29.4%* | *29.2%* | *29.2%* | *29.2%* |
| **Expenditure** | **1 843.5** | **1 954.4** | **2 040.3** | **2 141.0** |
| | *35.7%* | *36.0%* | *35.4%* | *34.9%* |
| **Budget balance** | **-326.6** | **-370.5** | **-357.5** | **-349.7** |
| | *-6.3%* | *-6.8%* | *-6.2%* | *-5.7%* |

*Source: National Treasury*

## Revenue trends and tax proposals

Government expects to collect tax revenue of R1.43 trillion (26.3 per cent of GDP) in 2020/21. Given the weak economic outlook, no overall tax increase is proposed for next year. Tax revenue is projected to grow by

*No overall tax increase is proposed for 2020/21*

4.9 per cent. Reflecting the weak economic environment and reductions in state compensation, gross tax buoyancy is expected to fall to 0.93.

*Personal income tax relief through inflation adjustments in all brackets, and increases in fuel and RAF levies*

The main tax proposals include personal income tax relief through inflation adjustments in all brackets, along with inflation-adjusted increases in the fuel and Road Accident Fund (RAF) levies. The revitalisation of SARS is expected to contribute to increased tax revenue over the medium term.

**Table 1.3 Impact of tax proposals on 2020/21 revenue[1]**

| R million | | |
|---|---|---|
| **Gross tax revenue (before tax proposals)** | | **1 425 418** |
| **Budget 2020/21 proposals** | | **–** |
| **Direct taxes** | | **-2 000** |
| **Taxes on individuals and companies** | | |
| **Personal income tax** | **-2 000** | |
| Increasing brackets by more than inflation | -2 000 | |
| *Revenue if no adjustment is made* | *12 000* | |
| *Higher-than-inflation increase in brackets and rebates* | *-14 000* | |
| **Indirect taxes** | | **2 000** |
| Carbon tax | 1 750 | |
| Plastic bag levy | 250 | |
| **Gross tax revenue (after tax proposals)** | | **1 425 418** |

*1. Revenue changes are in relation to thresholds that have been fully adjusted for inflation*
*Source: National Treasury*

## Medium-term spending plans

*Largest spending areas are learning and culture, health and social development*

Total consolidated spending amounts to R1.84 trillion in the current year, rising to R2.14 trillion by 2022/23.

**Table 1.4 Consolidated government expenditure by function**

| R billion | 2019/20 Revised estimate | 2020/21 Budget estimate | Average growth 2019/20 – 2022/23 |
|---|---|---|---|
| Learning and culture | 385.6 | 396.4 | 4.0% |
| Health | 222.0 | 229.7 | 5.1% |
| Social development | 284.5 | 309.5 | 6.2% |
| Community development | 201.7 | 212.3 | 6.3% |
| Economic development | 198.9 | 211.5 | 6.6% |
| Peace and security | 214.4 | 217.0 | 2.2% |
| General public services | 66.3 | 70.0 | 3.7% |
| Payments for financial assets | 65.2 | 73.6 | |
| **Allocated expenditure** | **1 638.5** | **1 720.2** | |
| Debt-service costs | 205.0 | 229.3 | 12.3% |
| Contingency reserve | – | 5.0 | |
| **Consolidated expenditure[1]** | **1 843.5** | **1 954.4** | **5.1%** |

*1. Consisting of national, provincial, social security funds and selected public entities See Annexure W2 on the National Treasury website for a full list of entities included*
*Source: National Treasury*

In 2020/21, the largest areas of spending by function are learning and culture (R396.4 billion), health (R229.7 billion) and social development (R309.5 billion). Over the medium term, aside from debt-service costs, the fastest-growing areas of expenditure are economic development and community development. Slow growth in learning and culture, health, and peace and security reflects the effect of proposed wage bill reductions on these labour-intensive functions.

### Division of revenue

*Effect of wage reductions on division of revenue to be set out in adjustments budget*

Over the medium-term expenditure framework period, after budgeting for debt-service costs, the contingency reserve and provisional allocations, 48.2 per cent of nationally raised funds are allocated to national government, 43 per cent to provinces and 8.8 per cent to local government. The share allocated to national government was somewhat larger than in 2019/20, mainly as a result of increased transfers to state-owned companies. These shares will change significantly as wage reductions are applied, although the exact distribution is yet to be determined. These changes will be considered during the course of the year and included in the October adjustments budget.

As outlined in the 2019 MTBPS, most conditional grants have been lowered as part of efforts to reduce growth in government expenditure and ensure public debt is sustainable. To manage the effect on services, these reductions take into account past performance and whether there has been significant real growth in allocations in recent years. Grants that have persistently underperformed have been reduced by larger amounts.

**Table 1.5 Division of revenue**

| R billion | 2019/20 | 2020/21 | 2021/22 | 2022/23 |
|---|---|---|---|---|
| National allocations | 739.5 | 757.7 | 768.9 | 797.8 |
| Provincial allocations | 612.8 | 649.3 | 692.0 | 730.7 |
| *Equitable share* | *505.6* | *538.5* | *574.0* | *607.6* |
| *Conditional grants* | *107.3* | *110.8* | *118.0* | *123.1* |
| Local government allocations | 125.0 | 132.5 | 142.4 | 151.4 |
| Provisional allocations not assigned to votes | – | -7.8 | -16.1 | -34.9 |
| **Total allocations** | **1 477.3** | **1 531.7** | **1 587.2** | **1 645.1** |
| Percentage shares | | | | |
| *National* | *50.1%* | *49.2%* | *48.0%* | *47.5%* |
| *Provincial* | *41.5%* | *42.2%* | *43.2%* | *43.5%* |
| *Local government* | *8.5%* | *8.6%* | *8.9%* | *9.0%* |

*Source: National Treasury*

### Government debt and contingent liabilities

*Gross borrowing requirement expected to reach R497.5 billion in 2022/23*

Over the past year, government's gross borrowing requirement has increased by 21.4 per cent to R407.3 billion. Borrowing is expected to reach R497.5 billion in 2022/23. The steep increase reflects the worsening fiscal position, and an increase in domestic bond redemptions.

Government's long record of prudent debt management has enabled the National Treasury to consistently match higher borrowing requirements without dramatically increasing the cost of debt. Nonetheless, prudent debt management cannot substitute for sustainable public finances and a growing economy. The risk to South Africa's remaining investment-grade credit ratings has become more pronounced.

**Table 1.6 Projected state debt and debt-service costs**

| R billion/percentage of GDP | 2019/20 | 2020/21 | 2021/22 | 2022/23 |
|---|---|---|---|---|
| **Gross loan debt** | **3 176.1** | **3 561.7** | **3 978.1** | **4 383.6** |
| | *61.6%* | *65.6%* | *69.1%* | *71.6%* |
| **Debt-service costs** | **205.0** | **229.3** | **258.5** | **290.1** |
| | *4.0%* | *4.2%* | *4.5%* | *4.7%* |

*Source: National Treasury*

### Financial position of public-sector institutions

*Net asset value of state-owned companies has declined sharply in recent years*

The financial performance of state-owned companies has deteriorated sharply. Liability growth has outpaced that of assets, with a consequent decline in net asset value. This erosion of financial value is largely a result of weak revenue growth, high compensation costs and rapidly growing debt-service costs.

The net asset value of the three largest development finance institutions – the Development Bank of Southern Africa, the Industrial Development Corporation and the Land Bank – increased by 4.7 per cent in 2018/19 to R139.4 billion. With the exception of the RAF, the financial positions of the social security funds and the Government Employees Pension Fund are strong. They are able to meet their long-term obligations.

**Table 1.7 Combined financial position of public institutions**

| R billion/net asset value | 2016/17 | 2017/18 | 2018/19 |
|---|---|---|---|
| State-owned companies | 354.0 | 362.1 | 342.0 |
| Development finance institutions[1] | 126.8 | 133.1 | 139.4 |
| Social security funds | 1.0 | -27.0 | -90.2 |
| Other public entities[2] | 674.9 | 719.0 | 751.7 |

*1. Institutions listed in schedule 2 of the PFMA*
*2. State-owned institutions without a commercial mandate and listed in either schedule 1 or 3 of the PFMA such as the National Library of South Africa*
*Source: National Treasury*

## Budget documentation

The 2020 *Budget Review* accompanies several other documents and submissions tabled in Parliament on Budget Day. These include:

- The Budget Speech
- The Division of Revenue Bill
- The Appropriation Bill
- The Estimates of National Expenditure.

These and other fiscal and financial publications, including the *People's Guide* to the Budget, are available at www.treasury.gov.za.