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The economy at a crossroads

In brief

South Africa finds itself at a crossroads. This *Medium Term Budget Policy Statement* (MTBPS) highlights the difficult economic and fiscal choices confronting government over the next several years.

During 2018, South Africa has faced lower-than-expected economic growth and exchange rate depreciation. The global outlook remains positive, but is characterised by greater risk, particularly for developing economies. State institutions are being repaired and renewed, but serious governance challenges exist across the public sector.

Government remains committed to fiscal sustainability, but there has been fiscal slippage since the 2018 Budget. Tax revenues have been revised down, partly due to higher value-added tax refunds. Despite spending pressures materialising, the expenditure ceiling remains intact as the anchor of fiscal policy. The consolidated budget deficit narrows from 4.2 per cent in 2019/20 to 4 per cent in 2021/22. Gross debt is expected to stabilise at 59.6 per cent of GDP in 2023/24.

The President's economic stimulus and recovery plan is intended to address the country's most pressing challenges: anaemic economic growth and high unemployment. The initiative includes an infrastructure fund to be developed in partnership with the private sector, reforms to enhance economic growth and improve governance, and support for urgent education and health needs.

Introduction

R5.9 trillion of spending commitments complemented by balanced effort to consolidate public finances

The medium-term expenditure framework (MTEF) commits public resources of R5.9 trillion over the next three years. Of this amount, R3.3 trillion or 56.2 per cent will be allocated to education, health, the provision of water and electricity services, and social grants. At the same time, government intends to consolidate the public finances in a balanced manner by maintaining the spending ceiling and ensuring that debt stabilises over the longer term.

In combination, these commitments support economic and social development, and ensure sustainable support to millions of South Africans who live in poverty. Yet the resources available cannot be substantially expanded without faster economic growth and job creation. Poor economic performance in the first half of the year has put additional strain on the public finances. Unemployment remains elevated, and many lowand middle-income households are contending with higher prices for water, electricity and transport. Governance failures and corruption have harmed public service delivery.

Economic recovery requires a substantial improvement in business investment. The President has taken the lead in rebuilding confidence by appointing a team of investment advisors. The October 2018 Investment Conference will help to restore policy certainty.

Focus on reforms that support economic growth, reduce inflationary pressures and improve service delivery

Over the period ahead, government is focusing on reforms that support economic growth, reduce inflationary pressures and improve service delivery. Fiscal options have become increasingly limited, and higher revenues need to flow from a broad-based economic expansion.

Accordingly, this MTBPS prioritises three interlinked policy areas:

- Implementing the President's economic stimulus and recovery plan, particularly by encouraging private-sector investment.
- Improving governance and financial management in national, provincial and local government departments to support service delivery.
- Reforming state-owned companies. Improving the financial health of the major state-owned companies will take time, but measures are being taken to strengthen governance.

Further steps are being taken to strengthen infrastructure planning and address shortcomings in public administration and finances. This includes the work of commissions investigating corruption and governance failures at several institutions, along with ongoing management training, financial strengthening and organisational renewal across the public sector.

Public-service wage agreement exceeds budgeted baselines by R30.2 billion

Government's compensation bill accounts for about 35 per cent of consolidated expenditure, and forms the major driver of spending pressures. The 2018 public-service wage agreement exceeds budgeted baselines by about R30.2 billion through 2020/21. National and provincial departments are expected to absorb these costs within their R1.8 trillion compensation baselines over the same period. Government is working on an approach to manage these pressures over the medium term.

Restoring confidence and strengthening investment

The 2018 Budget set out expectations of improved economic performance that proved premature. During the first half of this year, South Africa experienced a technical recession – that is, declining quarter-on-quarter GDP – driven primarily by contractions in agriculture and mining.

Inflation targeting, flexible exchange rate and prudent debt management reduced effects of external volatility

A strengthening US dollar and rising global interest rates have triggered fiscal crises in several major developing countries. South Africa's inflation targeting regime, flexible exchange rate and prudent debt management strategy have protected the economy from some of the global fallout. But these events have led to a sharp depreciation of the rand and large increases in government bond yields.

To promote a return to faster growth and job creation, the President announced an economic stimulus and recovery plan in September 2018. The initiative focuses on five interventions:

- Implementing growth-enhancing economic reforms
- Reprioritising public spending to support economic growth and job creation
- Establishing an infrastructure fund
- Addressing urgent matters in education and health
- Investing in municipal social infrastructure improvement.

Boosting infrastructure investment

Public-sector infrastructure plans estimated at R855.2 billion over medium term

Increased investment in social and economic infrastructure will be a focus of economic recovery over the medium term. This requires an increased role for the private sector and better implementation of government's existing plans. Over the next three years, public infrastructure expenditure is estimated to be R855.2 billion, of which state-owned companies account for R370.2 billion. General government accounts for the remaining R485 billion, mainly in the form of conditional infrastructure grants.

Growth in gross fixed-capital formation has declined significantly in recent years. A central policy objective is to promote an increase in capital investment by the private sector.

Figure 1.1 Growth in fixed-capital stock

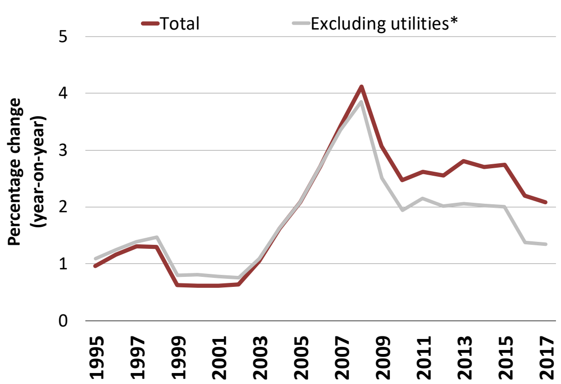
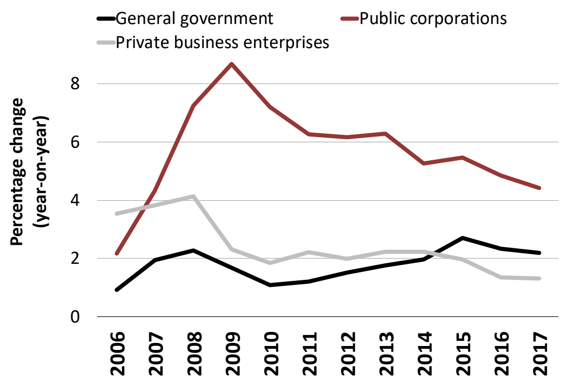


Figure 1.2 Growth in fixed-capital stock by sector



** Electricity, gas and water*
Source: Reserve Bank

Interventions to increase the efficiency of existing public infrastructure spending include the following:

- To address weaknesses in infrastructure planning, government, development finance institutions and private-sector partners have begun work on a project preparation facility (see Chapter 2).
- To strengthen accountability and transparency, government will publish online expenditure reports of current infrastructure projects. As a first step, Annexure C includes a breakdown of the general government project list.
- Over the medium term, the Development Bank of Southern Africa, the Government Technical Advisory Centre and the Presidential Infrastructure Coordinating Commission receive R625 million to prepare projects and support implementation.

- Government is negotiating access to infrastructure funding from development finance institutions, multilateral development banks and private banks. These institutions have committed technical resources to help plan, approve, manage and implement projects.
- Consideration is being given to scaling up selected urban investment programmes by switching their financing from national government's balance sheet to development finance institutions, which would facilitate additional technical support.

The infrastructure initiative announced by the President builds on efforts to transform public infrastructure provision. It will support projects with "blended" finance, combining capital from the public and private sectors, and development finance institutions. Work to design the fund is under way, with assistance from the private sector and multilateral development banks. Government will report on the progress of these deliberations in the 2019 Budget.

Fund design to include innovative financing and regulatory reforms

The fund is expected to identify innovative financing mechanisms and allow for accompanying regulatory reforms. An example of this approach is the Renewable Energy Independent Power Producer Programme, which involved very little public funding, but required offtake agreements guaranteeing future cash flow, and regulatory changes to allow private electricity production.

Improved oversight and implementation of the existing capital budget can sharply reduce underspending, which based on recent performance is estimated at R30 billion over the MTEF period.

A framework for financing infrastructure

Government will develop a framework for investors to assess potential long-term returns on public infrastructure projects. This will support funding from development finance institutions, commercial banks and pension funds. Innovative financing mechanisms (such as initial capital payments, current subsidies or guaranteed offtake agreements) may also be proposed alongside regulatory reforms. Government will publish a list of projects suitable for private-sector and development finance support.

Projects will initially be evaluated on the following basis:

- Can the project be fully privately funded? Many large infrastructure projects are commercially sustainable. Rather than commit scarce public resources, government will remove regulatory impediments that stand in the way of projects in sectors such as housing, telecommunications and transport (airports, for example).
- Is hybrid funding an option? If the project is borderline commercially viable, the fund could support a range of hybrid options, including public-private partnerships, concessional financing, government guarantees, loan subsidies and development finance.
- Are there clear social benefits? If the project is not commercially viable and has demonstrated benefits, direct fiscal support may be provided.

Reform, reprioritisation, and interventions in health and education

The structure of South Africa's economy is not conducive to high growth or job creation. Network industries – energy, water, transport and telecommunications – need to be modernised. Barriers to entry remain high, making it difficult for small businesses to compete.

During 2018, government has initiated reforms in several areas. These include creating policy certainty in the mining and energy sectors by finalising the Mining Charter and updating the Integrated Resource Plan. Growth-enhancing policy initiatives are also under way in the telecommunications, electricity and transport sectors (see Chapter 2).

To support these reforms within a constrained fiscal framework, government is proposing reprioritisation of R32.4 billion over the next three years. Of this amount, R15.9 billion goes towards faster-spending infrastructure programmes (including R3.4 billion for school infrastructure and eradicating pit latrines), clothing and textile incentives, and the Expanded Public Works Programme.

The remaining R16.5 billion will be allocated to various programmes, including recapitalising the South African Revenue Service (SARS), a minimum wage for community health workers, critical posts and goods and services in health, and streamlining the management of the justice system.

R14.7 billion for upgrading informal settlements in partnership with communities

In addition, changes to grant structures amounting to R14.7 billion will promote upgrading of informal settlements in partnership with communities. Housing subsidies amounting to R1 billion will be centralised to better support middle- and lower-income home buyers. In the current year, R1.7 billion is added to infrastructure spending (including funding for fast-spending school building programmes), and R3.4 billion is allocated to drought relief, mostly to upgrade water infrastructure.

Rebuilding state institutions

South Africa's budgets for social and economic services are substantial, but the quality of spending is in many areas unacceptably poor, undermining (and in some cases collapsing) service delivery. Poor governance – reflected in inefficiency, corruption and financial mismanagement – reduces the impact of spending and increases pressure on the budget.

Governance failures uncovered in state institutions are beginning to be addressed

Government has begun the process of rebuilding important state institutions. The Judicial Commission of Inquiry into Allegations of State Capture, chaired by Deputy Chief Justice Raymond Zondo, and the Commission of Inquiry into Tax Administration and Governance by the South African Revenue Service, chaired by retired Judge Robert Nugent, have both highlighted serious governance failures. These failures are beginning to be addressed. At SARS, for example, reforms under way include regularising VAT refund payments and rebuilding enforcement capacity. This process is supported through the budget, which reprioritises R1.4 billion to SARS over the medium term.

Yet serious challenges remain. Some national, provincial and municipal departments are in financial disarray. The Auditor-General's latest findings raise significant concerns about the level of irregular spending across government. The independent report on VBS Mutual Bank, including the reported large-scale theft of public funds, reinforces those concerns.

While deterioration is cause for concern, constitutional institutions have proven resilient

While the scale of deterioration in the public sector is serious, key institutions established by the Constitution have proven resilient. Parliament, the courts and the Reserve Bank have helped to uncover corruption, with the support of a robust media.

The National Treasury's efforts to strengthen financial management include:

- Working with the Auditor-General and law enforcement agencies to reduce irregular expenditure in government, and improving transparency in expenditure classification to reduce fraud and opportunities for corruption.

- Enhancing public finance capacity-building in local government by deploying skilled professionals to manage and recover revenue.
- Introducing a strategic framework to support more efficient, cost-effective and transparent procurement efforts, particularly in the health sector. Procurement policy also aims to support small and black-owned businesses.
- Developing a framework that will include financial recovery plans to address non-performing departments.

Reforming state-owned companies

Reforms under way at Eskom, Transnet, Denel, SA Express and PRASA

The finances of major state-owned companies remain weak. Government has initiated reforms in these entities to improve governance and strengthen financial management:

- Over the past year, new boards and executives have been appointed at Denel, Transnet, South African Express Airways and the Passenger Rail Agency of South Africa (PRASA).
- The Auditor-General is working alongside private firms on the audits of several state-owned companies. To date, previously unreported irregular expenditure amounting to R27 billion has come to light.
- The boards of state-owned companies have initiated forensic investigations into allegations of corruption and are taking action where evidence shows employee involvement in maladministration.
- The Eskom board is preparing a long-term turnaround strategy to be presented to government in November 2018, and several other entities have updated their turnaround strategies in recent months.

Restructuring of network industries is under consideration

Reforms to strengthen network industries, provide sustainable and affordable increases in water and electricity, and reduce the costs of doing business are likely to require major changes in the mandates and operations of state-owned companies. Such changes will build on successes such as the Renewable Energy Independent Power Producer Programme, which has substantially increased private participation in the energy sector, generating 46 000 jobs to date. Government has begun to study long-term reforms in electricity, telecommunications, transport and logistics. Without restructuring, there is a significant risk that the weak financial condition of state-owned companies will put major pressure on the public finances.

Government has published a draft Integrated Resource Plan for public comment. Once the plan is final, it will provide long-term certainty on the country's future energy plans.

Overview of the MTBPS

Economic outlook

Chapter 2 sets out the medium-term economic forecast, together with details of government's efforts to accelerate economic growth. The GDP growth forecast for 2018 has been revised down from 1.5 per cent in February to 0.7 per cent, rising to 2.3 per cent by 2021. Inflation is expected to remain within the 3-6 per cent target band over the medium term, despite pressure from a weaker exchange rate and higher oil prices.

Table 1.1 Macroeconomic projections

Calendar year	2017 Actual	2018 Estimate	2019	2020 Forecast	2021
Percentage change unless otherwise indicated					
Household consumption	2.2	1.6	1.9	2.3	2.6
Gross fixed-capital formation	0.4	0.9	1.5	2.1	2.9
Real GDP growth	**1.3**	**0.7**	**1.7**	**2.1**	**2.3**
GDP at current prices (R billion)	**4 651.8**	**4 949.1**	**5 317.2**	**5 724.1**	**6 167.2**
CPI inflation	5.3	4.9	5.6	5.4	5.4
Current account balance (% of GDP)	-2.4	-3.2	-3.2	-3.7	-3.9

Source: Reserve Bank and National Treasury

Fiscal policy

Chapter 3 provides an overview of fiscal policy. The expenditure ceiling remains intact, allowing for real non-interest spending growth of 1.9 per cent per year over the medium term. No additional tax increases are proposed at this time. The consolidated deficit, which includes national government, public entities and social security funds, is projected to narrow from 4.2 per cent of GDP in 2019/20 to 4 per cent of GDP in 2021/22.

Table 1.2 Consolidated government fiscal framework

R billion/percentage of GDP	2017/18 Outcome	2018/19 Revised	2019/20	2020/21 Medium-term estimates	2021/22
Revenue	**1 360.0**	**1 467.2**	**1 582.0**	**1 705.1**	**1 840.0**
	28.8%	*29.1%*	*29.2%*	*29.2%*	*29.3%*
Expenditure	**1 549.5**	**1 669.2**	**1 808.4**	**1 950.9**	**2 091.1**
	32.8%	*33.1%*	*33.4%*	*33.4%*	*33.2%*
Budget balance	**-189.6**	**-202.0**	**-226.4**	**-245.8**	**-251.1**
	-4.0%	*-4.0%*	*-4.2%*	*-4.2%*	*-4.0%*
Total gross loan debt	**2 489.7**	**2 817.7**	**3 038.4**	**3 349.6**	**3 679.9**
	52.7%	*55.8%*	*56.1%*	*57.4%*	*58.5%*

Source: National Treasury

Expenditure priorities

Chapter 4 sets out government's three-year spending priorities and explains how funding is divided between national, provincial and local government. The budget continues to prioritise social spending, including education, health and social grants. Of the R1.7 trillion allocated to consolidated expenditure in 2018/19, 15 per cent goes to basic education, 12 per cent goes to public health and 12 per cent goes to social protection. In addition, government funds basic services such as water and electricity, and job-creation initiatives. After debt-service costs, education is the fastest-growing area of expenditure.

Table 1.3 Consolidated government expenditure

R billion	2018/19 Revised	2019/20 Medium-term estimates	2020/21	2021/22	Average annual growth 2018/19 – 2021/22
Learning and culture	352.3	386.5	414.1	446.1	8.2%
Health	205.1	223.7	243.5	257.7	7.9%
Social development	258.7	281.1	304.9	324.9	7.9%
Community development	195.6	209.7	228.4	245.4	7.9%
Economic development	193.5	211.3	223.9	233.5	6.5%
Peace and security	203.6	213.1	227.0	242.0	5.9%
General public services	64.4	67.3	72.7	75.2	5.3%
Payments for financial assets	15.1	6.1	6.7	7.1	0.0%
Total expenditure by function	**1 488.1**	**1 598.9**	**1 721.1**	**1 831.9**	**7.2%**
Debt-service costs	181.1	202.5	221.7	247.2	10.9%
Contingency reserve	–	7.0	8.0	12.0	0.0%
Total expenditure	**1 669.2**	**1 808.4**	**1 950.9**	**2 091.1**	**7.8%**

Source: National Treasury

Additional information

The MTBPS includes annexures on fiscal risk, the compensation bill and technical data:

- The fiscal risk statement (Annexure A) outlines risks that would materially affect the baseline projections for growth, revenue and spending. These include lower economic growth, weak financial management in subnational government and contingent liabilities.
- Detailed compensation data is provided in Annexure B. The analysis shows that earnings growth, rather than headcount, has been the major driver of the public-service wage bill over the past decade.
- Annexure C provides additional technical information and data on the MTBPS figures, including a detailed breakdown of projected general government infrastructure expenditure.

Conclusion

Decisive action can support faster economic growth and sustainable public finances

Difficult decisions are required to raise productivity, increase competition, reduce the cost of doing business and develop a sustainable approach to public-service remuneration. Decisive action will support more rapid economic growth and sustainable public finances.