2014 MEDIUM TERM BUDGET POLICY STATEMENT

Presenter: Nhlanhla Nene | **Minister of Finance** | **23** October 2014

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Summary

- The budget policy framework for the next three years is designed to ensure fiscal sustainability while shifting spending towards government's priorities as set out in the NDP and MTSF
- South Africa's weaker-than-expected economic performance and outlook pose new fiscal challenges; the favourable conditions that supported high expenditure growth rates are no longer present
- Gross domestic product (GDP) growth of 1.4% is expected in 2014, rising to 3.0% in 2017. The forecast has been revised downwards due to structural constraints
- Government proposes a fiscal package that reduces growth in spending by lowering the 2014 Budget expenditure ceiling by R25 billion over the next two years and adjusting tax policy to generate additional revenue of at least R27 billion over two years
- The fiscal package results in net debt stabilising at 45.9 % of GDP by 2017/18
- Overall, public spending will rise by 7.6% a year over the medium term, with post school education and training, housing development, social infrastructure and employment, and labour affairs and social security funds receiving the largest increases
- Over the medium to long term, a combination of these fiscal measures and the microeconomic interventions in the Medium Term Strategic Framework will place the economy on a more sustainable development path

The macroeconomic forecast has been revised downwards

- Growth expected to be 1.4% this year from 3.6% 2011 due to stoppages, labour disputes, electricity constraints and other supply side bottlenecks
- It is expected to pick up to 3.0% in 2017 as the global outlook improves, confidence returns to the economy as constraints are relieved

Calendar year	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
		Actual		**Estimate**		**Forecast**	
Percentage change unless otherwise indicated							
Final household consumption	4.9	3.5	2.6	1.9	2.3	2.8	3.0
Final government consumption	4.3	4.0	2.4	1.8	1.5	1.5	1.5
Gross fixed capital formation	4.2	4.4	4.7	2.7	3.6	4.7	5.1
Gross domestic expenditure	4.6	4.0	2.2	0.9	2.6	3.0	3.3
Exports	6.8	0.4	4.2	3.1	4.2	4.7	5.2
Imports	10.0	6.0	4.7	1.0	4.1	5.0	5.6
Real GDP growth	**3.6**	**2.5**	**1.9**	**1.4**	**2.5**	**2.8**	**3.0**
GDP inflation	5.9	4.5	5.8	6.1	5.8	5.7	5.6
GDP at current prices (R billion)	**2 932.7**	**3 139.0**	**3 385.4**	**3 642.6**	**3 952.6**	**4 295.8**	**4 675.6**
Nominal GDP growth	**9.7**	**7.0**	**7.8**	**7.6**	**8.5**	**8.7**	**8.8**
Headline CPI inflation (Dec 2012 = 100)	5.0	5.7	5.8	6.3	5.9	5.6	5.4
Current account balance (% of GDP)	-2.3	-5.2	-5.8	-5.6	-5.4	-5.2	-5.0

Source: Reserve Bank and National Treasury

Global outlook remains uneven

IMF Growth Projections

Region / country	2013	2014	2015	2016
Percentage		GDP projections[1]		
World	**3.3**	**3.3**	**3.8**	**4.0**
Advanced economies	**1.4**	**1.8**	**2.3**	**2.4**
US	2.2	2.2	3.1	3.0
Euro area	-0.4	0.8	1.3	1.7
UK	1.7	3.2	2.7	2.4
Japan	1.5	0.9	0.8	0.8
Emerging markets and developing countries	**4.7**	**4.4**	**5.0**	**5.2**
Brazil	2.5	0.3	1.4	2.2
Russia	1.3	0.2	0.5	1.5
India	5.0	5.6	6.4	6.5
China	7.7	7.4	7.1	6.8
Sub-Saharan Africa	**5.1**	**5.1**	**5.8**	**6.0**
South Africa[2]	1.9	1.4	2.5	2.8

1. IMF World Economic Outlook, October 2014
2. National Treasury forecasts

Source: Bloomberg

- Moderately improving economic growth rates in developed markets are expected to contribute to stronger global demand and international trade – but the economic outlook is fragile and uneven

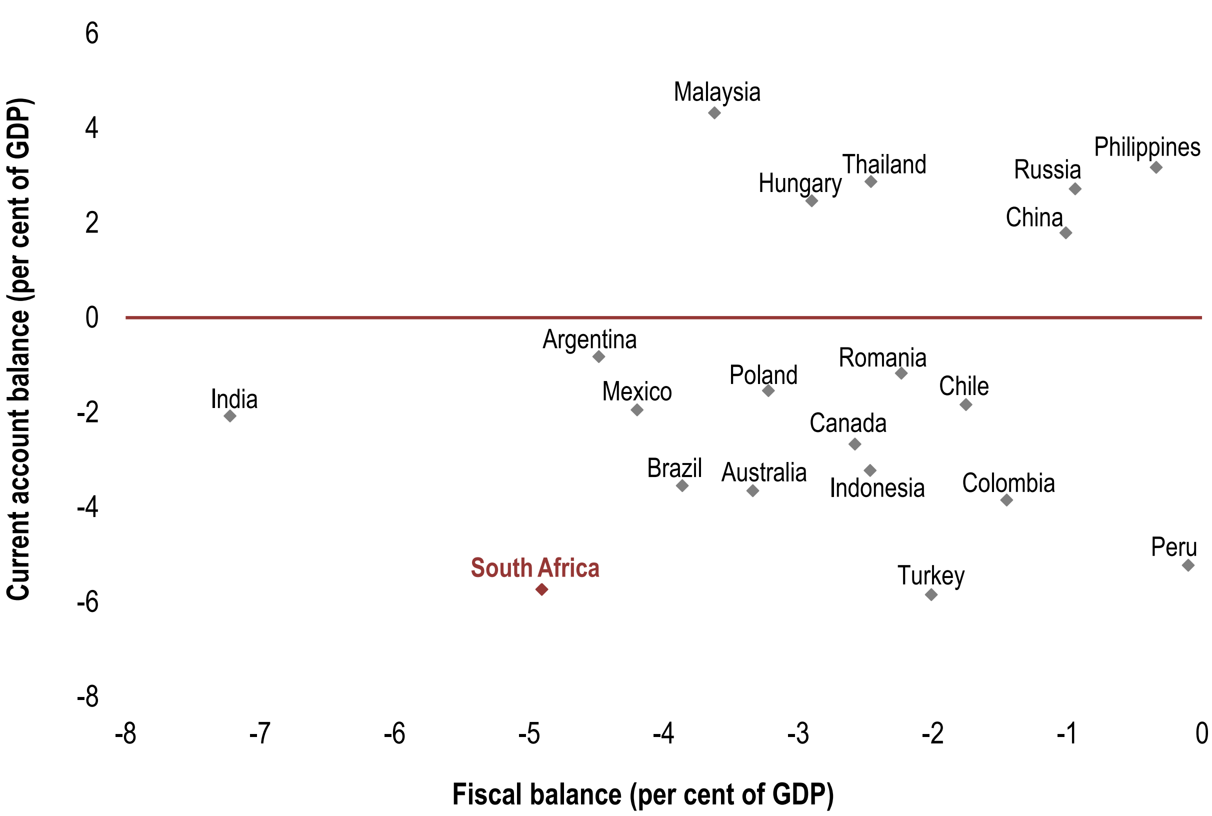
- **Developed economies:** US recovering, but EU and Japan remain weak. There is growing monetary policy divergence.

- **Emerging economies:** Growth has been revised downwards due to:
  - rebalancing of growth
  - supply side constraints and reliance on commodity exports

- ***Risks***:
  - Potential financial volatility given different monetary policy responses
  - shifting trade patterns
  - Vulnerability of Ems to fluctuations in capital inflows

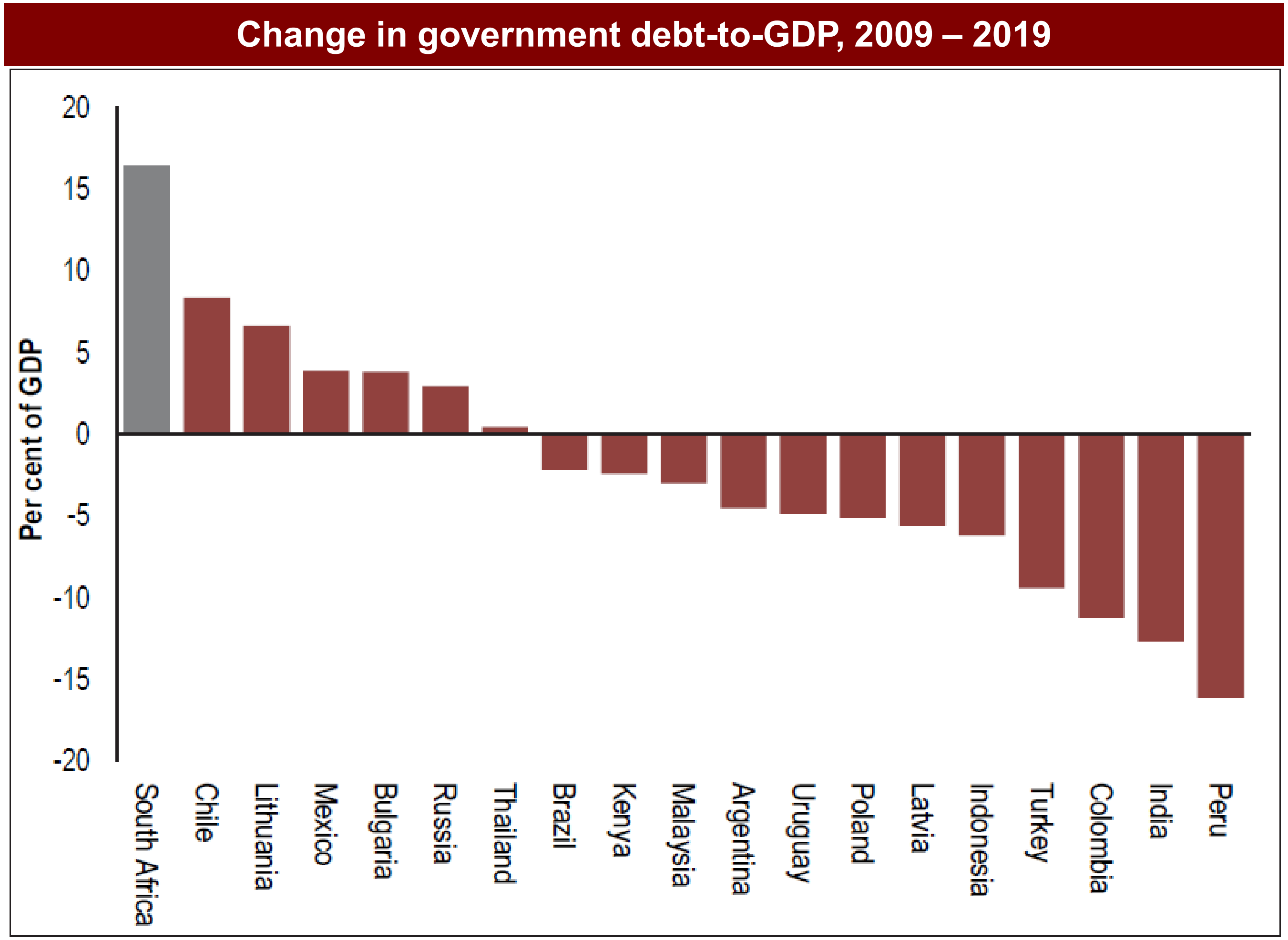
The "twin deficits" pose a risk to South Africa's investment perception

Current account and fiscal balances among "peers"



- The current account and the fiscal deficits remain high in comparison to "peer" countries
- The "twin" deficits, combined with electricity shortages and low growth prospects are seen as key risks by investors
- Other countries are signalling fiscal consolidation or a reduced current account deficit to strengthen investor perception

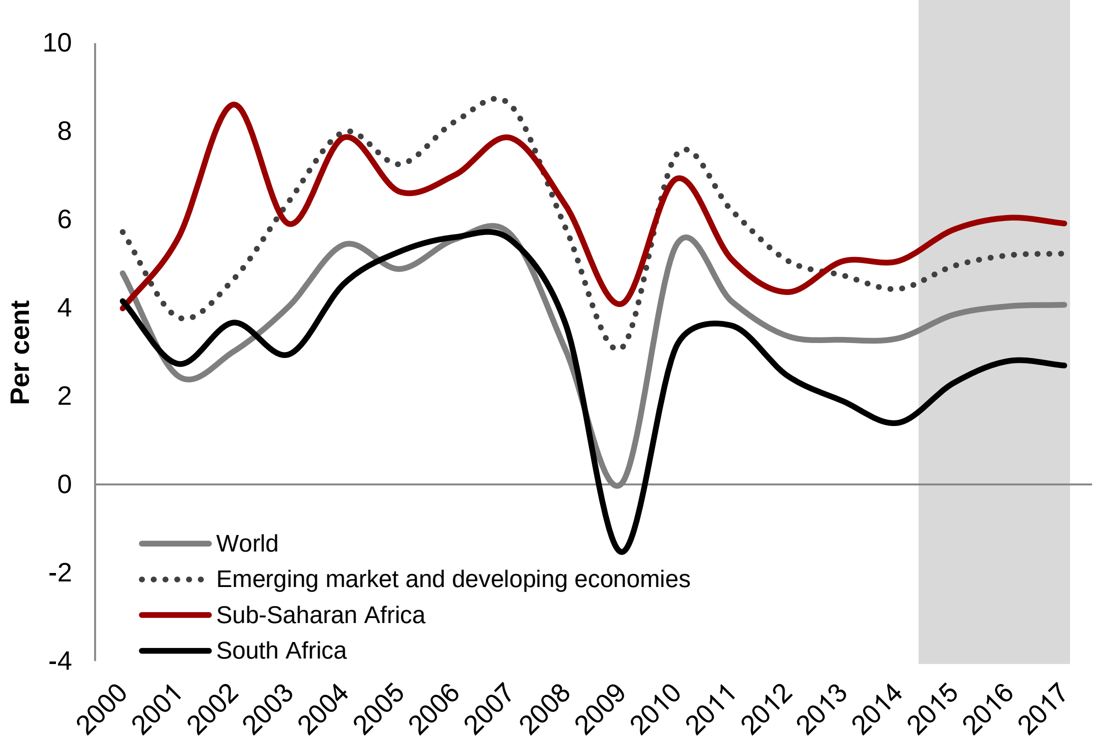
South Africa's debt is growing faster than emerging market peers



Source: South African data from National Treasury; all other data from IMF

Structural imbalances and constraints have lowered domestic GDP

World, Regional and South African Growth



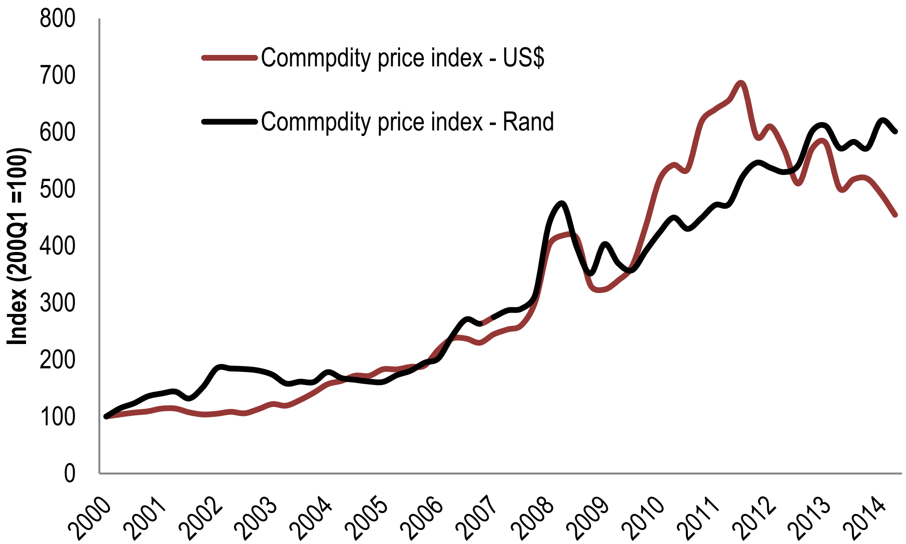
Source: Statistics South Africa

- South African growth has been weaker than peer countries, and has diverged from tracking the global average.
- A number of domestic constraints percieved as temporary have become embedded in expectations
- Mining & manufacturing have been volatile – due to stoppages (labour relations and infrastructure)
- Manufacturing sector has also been affected by stoppages, linkages to mining and infrastructure constraints
- GDP excluding mining and manufacturing is also slowing and only grew by 1.8% in 2014Q2.

Growth requires the supply side of the economy to grow

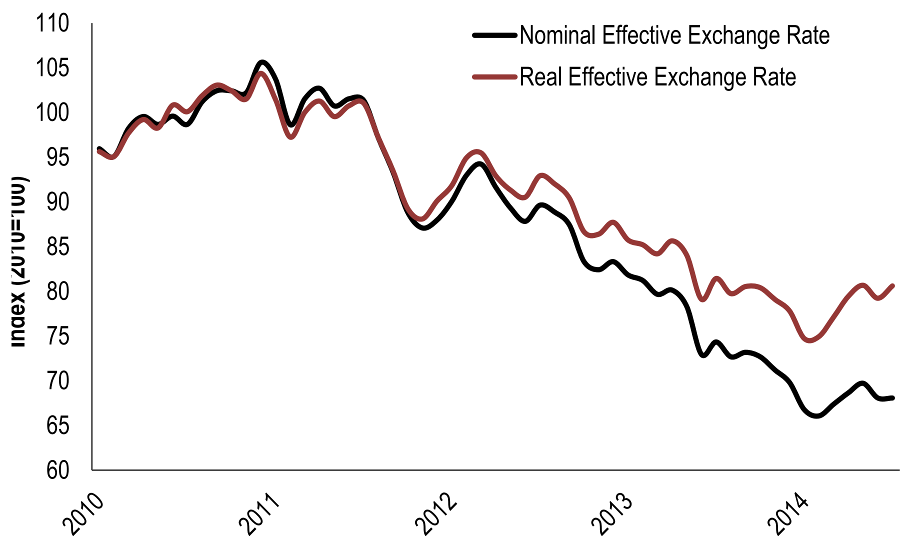
Commodity prices are lower, but weaker rand is providing some support

Commodity Price Growth



Source: Bloomberg, National Treasury

Exchange rate movements



Source: South African Reserve Bank

- Slower EM growth has led to softer commodity prices BUT weaker rand has provided support
- Weaker EM growth could lead to further weakness in commodity prices which will weigh on growth and the current account
- Wages rising faster than productivity and inflation have eroded some of the gains from a weaker exchange rate

Traditional exports are under pressure, but new opportunities are emerging

Major export destinations for South African products

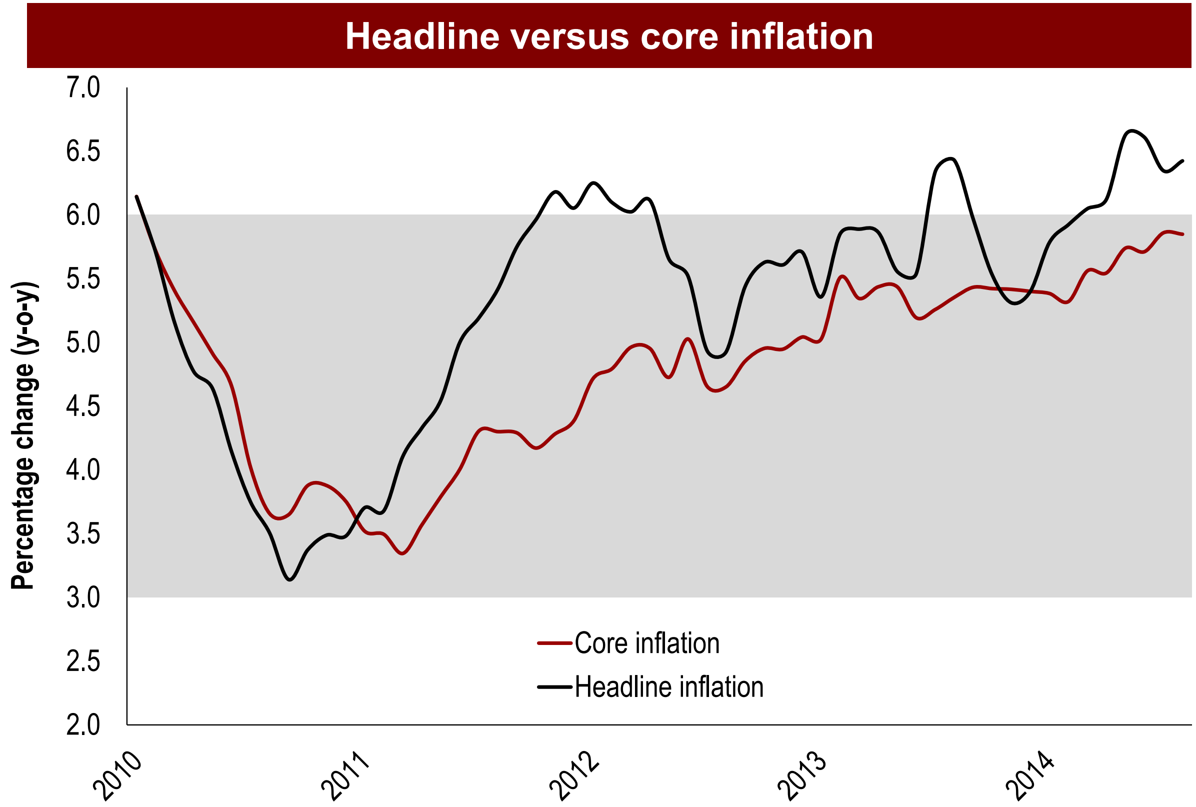
	2013 Contribution to export growth	2014[1] Contribution to export growth	2000 % Share	2012 % Share	2013 % Share	2014[1] % Share
EU	3.0	4.3	31.3	20.6	21.0	23.5
Germany	*0.6*	*0.9*	*7.8*	*5.4*	*5.3*	*5.9*
UK	*0.6*	*0.9*	*8.9*	*3.9*	*4.0*	*4.4*
Netherlands	*0.8*	*0.7*	*3.3*	*3.5*	*3.8*	*4.5*
India	-0.3	1.2	1.4	4.3	3.6	4.8
Brazil	-0.0	-0.0	0.7	0.9	0.8	0.8
China	4.0	-0.0	2.0	11.6	13.9	12.6
SADC	2.5	1.3	9.8	12.9	13.7	13.6
Mozambique	*1.1*	*0.5*	*2.3*	*2.7*	*3.4*	*3.7*
Zimbabwe	*0.5*	*0.3*	*2.2*	*2.7*	*2.8*	*2.8*
Zambia	*0.6*	*0.4*	*2.0*	*2.9*	*3.1*	*3.2*
US	0.5	-0.2	12.0	8.8	8.3	8.1
Japan	1.2	-0.7	8.1	6.3	6.7	5.7
Unallocated[2]	-1.4	-1.6	15.2	11.0	8.5	7.1
Other[3]	2.8	2.1	19.6	23.7	23.5	23.8
Total	**12.4**	**6.5**	**100.0**	**100.0**	**100.0**	**100.0**

1. First seven months of 2014
2. Commodities, such as gold, sold through exchanges
3. Includes Hong Kong, Korea, Singapore, Malaysia, Australia, Nigeria, Ghana, Angola, Egypt and United Arab Emirates
Source: Quantec

- Growth of exports to EU expected to be muted
- Commodity exports to China expected to be weak
- But SADC exports are diversified and grow strongly, with SADC forecast to grow above 5% over MTEF
- Other export opportunities emerging, with rising share of non-traditional markets (other)

SADC becoming increasingly important export destination, especially for manufactured goods

Inflation pressures are increasing as weak rand feeds through to core inflation

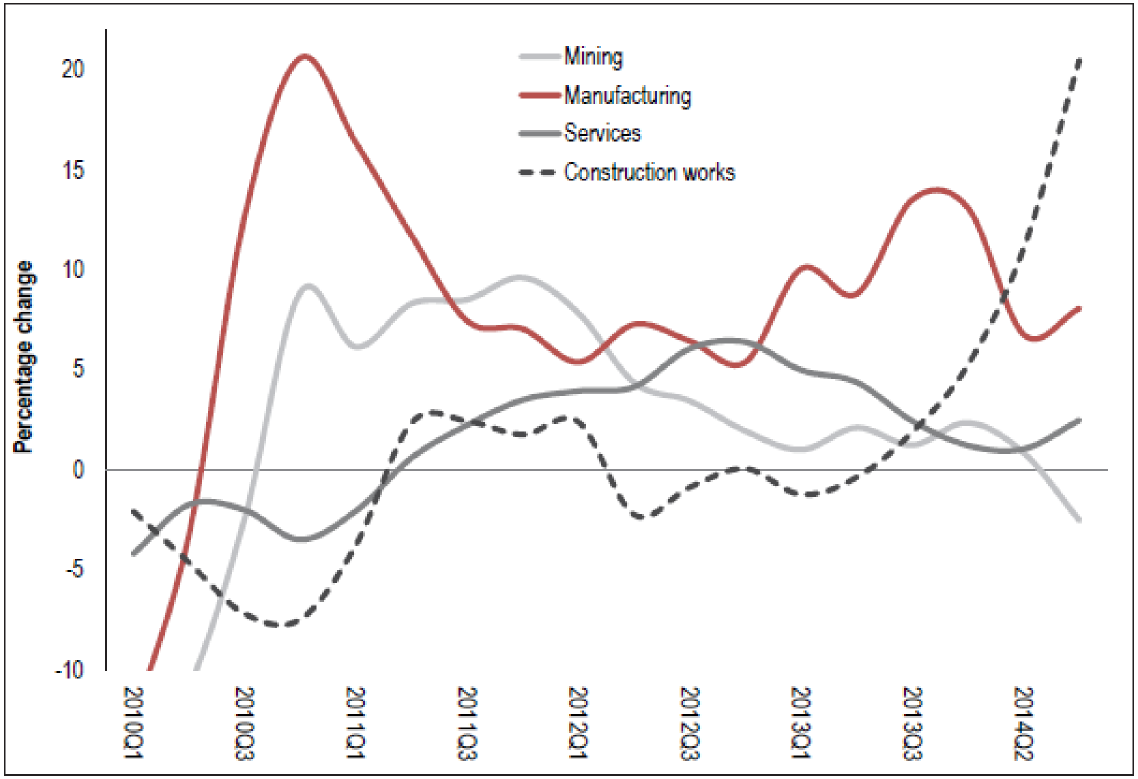


- Inflation breached the upper end of target in March 2014
- Expected to fall back in range in 2015Q1
  - Supported by lower oil prices and food inflation
- ***Risks:***
  - Further rand depreciation will increase headline inflation and feed through to core inflation
  - higher electricity prices

Inflation is forecast to stay in the 3%-6% range over MTEF

Private investment & structural transformation should support MTSF interventions & growth

Investment growth by sector



1. Real 2005 prices, year-on-year percentage change

Source: Reserve Bank

- Private investment expected to rise as key infrastructure projects, as detailed in MTSF, come online unblocking constraints.
- Some structural transformations are already occurring – manufacturing investment has averaged 9.2% since 1H2010, investing in machinery & equipment & improving productivity. Agriculture has shifted away from traditional crops, become more commercial and export focussed.
- Economic growth has become less energy intensive (7.5%), and sources of power have diversified
- Labour intensity has, however, declined

Risks to growth remain to the downside, but there are factors to support growth

Downside risks

- Volatility and risk of EM financial outflows
- Weaker Chinese growth and lower commodity prices
- Lack of EM Structural forms and reduced growth outlook
- Domestic supply side bottlenecks

Factors to support growth

- MTSF provides policy certainty and clear implementation plan for NDP
- New emerging export destinations, especially SADC.
- Continued investment in infrastructure will reduce supply constraints, improve competitiveness
- The rand's weaker real effective exchange rate, if not eroded by above productivity wage settlements is expected to support competitiveness in tradable goods sectors
- Various electricity supply options could release bottlenecks and support investments (including private procurement, increased energy efficiency, cogeneration, imports)

Fiscal objectives

- Over the MTEF, government's fiscal objectives are to:
  - Reduce the budget deficit in line with the targets announced in the 2014 Budget
  - Stabilise debt to ensure fiscal sustainability and shift resources away from interest payments to investment and service delivery
  - Continue to shift spending towards government's priorities as set out in the NDP and MTSF
  - Contain expenditure on goods and services, and compensation of employees, in order to raise government savings and reduce pressure on the current account
- Government remains committed to the fiscal principles of countercyclicality, debt sustainability and intergenerational equity
- Over the medium term, the focus will shift to debt sustainability, allocative efficiency and obtaining value-for-money in public spending

Weaker economic and fiscal outlook warrants a turning point for the fiscus

- South Africa's weaker-than-expected economic performance and outlook pose new fiscal challenges
- The favourable conditions that supported high expenditure growth rates are no longer present:
  - Commodity prices are declining and the rand's depreciation has pushed up inflation
  - After falling sharply during the 2000s, interest rates on newly issued government debt have stabilised and are projected to rise over the medium term
- Weak economic growth has entrenched a structural imbalance, with the date of debt stabilisation pushed further into the future
- Without action to narrow the deficit, public debt will continue to grow beyond the medium term resulting in a possible downgrade of South Africa's sovereign debt to "sub-investment grade"
- The 2012 MTBPS (and 2014 Budget) pointed out that if the economic and fiscal outlook were to deteriorate, a reconsideration of expenditure and revenue plans would be warranted

Proposed fiscal package to reinforce sustainability

- In order to narrow the deficit and stabilise debt over the medium term, government proposes a fiscal package with the following five elements:
  - Reduce growth in spending by lowering the 2014 Budget expenditure ceiling by R25 billion over the next two years
  - Adjust tax policy and administration. Proposals will be introduced in the 2015 Budget to generate additional revenue of at least R27 billion over the next two years
  - Place greater emphasis on longer-term planning and efficient resource allocation, within a framework that links expenditure and economic growth beyond the medium term
  - Freeze government personnel headcounts. Government will also review funded vacancies
  - Adopt a deficit-neutral approach to the financing requirements of state-owned companies over the next two years

Fiscal package elements: lowering the expenditure ceiling

Main budget non-interest expenditure, 2011/12 – 2017/18

R million	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
2012 Budget Review	814,554	879,977	953,024	1,030,539			
2013 Budget Review		878,642	955,333	1,029,262	1,107,564		
2013 MTBPS			949,109	1,027,762	1,106,064	1,185,110	
2014 Budget Review			947,853	1,027,662	1,105,943	1,184,424	
2014 MTBPS				1,021,855	1,095,761	1,168,940	1,267,025

- Government proposes to reduce the 2014 Budget ceiling by R10 billion in 2015/16 and R15 billion in 2016/17
- To effect the lower ceiling, national government will:
  - Freeze budgets of non-essential goods and services at 2014/15 levels
  - Withdraw funding for posts that have been vacant for some time
  - Reduce the rate of growth of transfers to public entities, particularly those with cash reserves

Fiscal package elements: changes to tax policy and administration

- Government proposes a structural increase in revenue over the medium term

- Policy and administrative reforms are expected to raise at least R12 billion in 2015/16, R15 billion in 2016/17 and R17 billion in 2017/18

- Consideration will be given to the recommendations of the Davis Tax Committee

- Details will be announced in the 2015 Budget

Fiscal package elements: reforms to medium-term budgeting

- Government needs to rebuild fiscal space to re-establish a sustainable foundation for public finances by:
  - Ensuring that once debt has stabilised, spending growth will match long-term economic growth trends
- A new approach to budget preparation will extend the scope and quality of long-term expenditure planning
- A comprehensive assessment will examine baseline estimates for the outer year, emphasising value for money and alignment with longer-term policy priorities
- Indicative allocations in 2017/18 have also been restrained, and there are substantial unallocated resources
  - These resources will be available to build a buffer against economic and fiscal shocks in the years ahead
  - A significant amount can also be considered for allocation to high-impact programmes

Fiscal package elements: freeze on personnel expansion and review of vacancies

- To contain compensation budget pressures, government will freeze national government personnel headcounts for the next two years
- Any increase in personnel will be funded from existing allocations
- NT, the DPME, the DPSA, and other officials will conduct a review over the next year to consider the permanent withdrawal of funded vacancies
- Natural attrition will create space for new appointments
- Exceptions will be considered for critical positions, with the onus on departments to justify exceptions
- Provincial governments will be strongly encouraged to follow the same approach

Fiscal package elements: deficit-neutral financing of state-owned companies

- Over the next two years, capital injections for Eskom and funding for other state-owned companies will be raised in a way that has no effect on the budget deficit

- In some instances, government will dispose of non-strategic assets to raise resources for financial support

- Private investment to strengthen the balance sheets of state-owned entities will also be explored

- Funding allocations will not be automatic, but will depend on entities demonstrating sound business plans and greater efficiencies

- Any capitalisation will only take place once the proceeds of asset sales are deposited with the National Revenue Fund, and will require a special appropriation bill tabled by the Minister of Finance

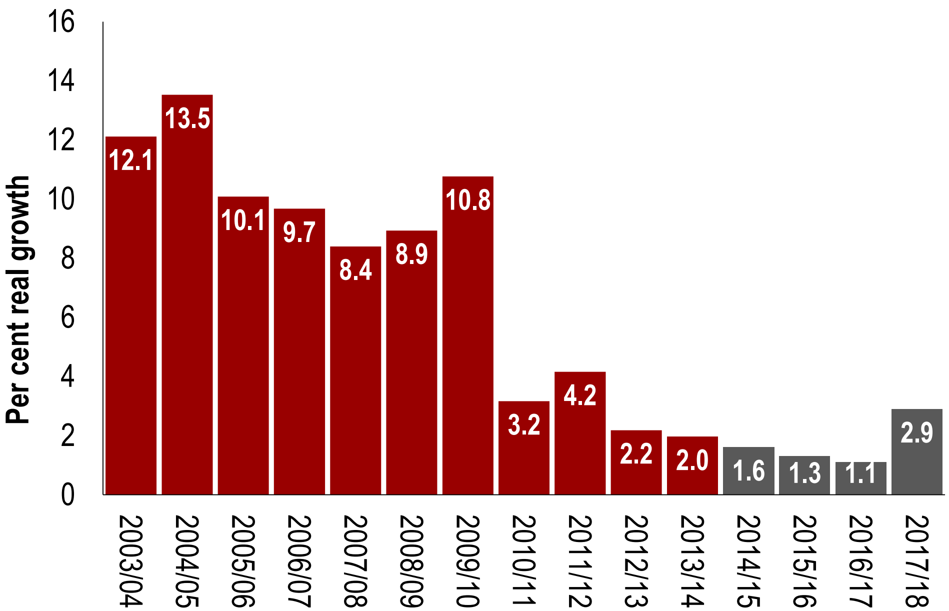
Fiscal framework including the proposed fiscal package

Consolidated fiscal framework, 2011/12 – 2017/18

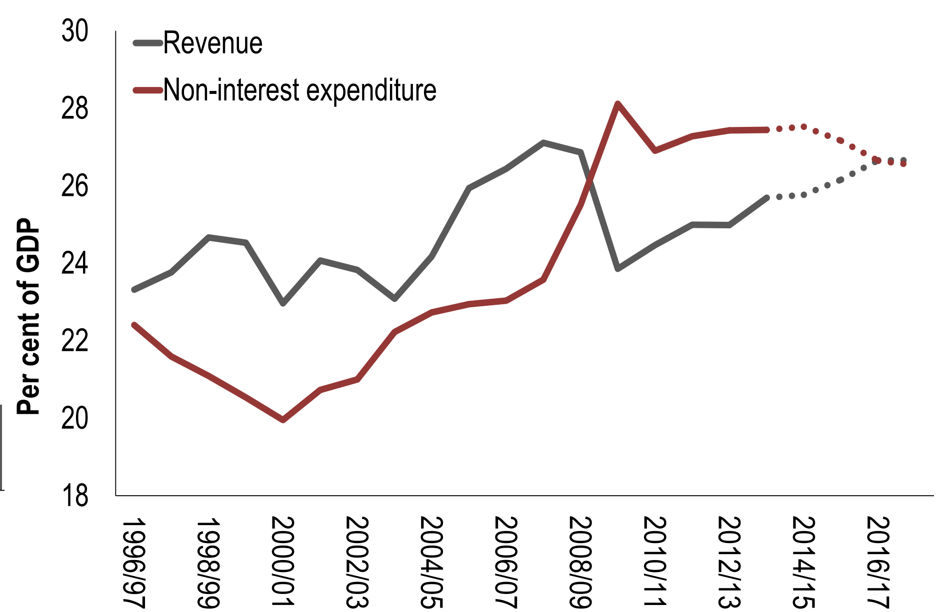
R billion/Percentage of GDP	2011/12	2012/13	2013/14	2014/15		2015/16	2016/17	2017/18
	Outcome			Budget	Revised	Medium-term estimates		
Main budget								
Revenue	**745.3**	**799.2**	**886.1**	**962.8**	**956.6**	**1,055.1**	**1,169.4**	**1,272.9**
Expenditure	**889.9**	**965.5**	**1,047.8**	**1,142.6**	**1,136.3**	**1,222.3**	**1,308.4**	**1,416.7**
of which								
Non-interest allocations	*813.5*	*877.4*	*946.6*	*1,024.7*	*1,021.9*	*1,090.8*	*1,153.9*	*1,222.0*
Debt-service costs	*76.5*	*88.1*	*101.2*	*114.9*	*114.5*	*126.5*	*139.4*	*149.7*
Unallocated reserves	–	–	–	*3.0*	–	*5.0*	*15.0*	*45.0*
Main budget balance	**-144.6**	**-166.3**	**-161.7**	**-179.8**	**-179.7**	**-167.2**	**-139.0**	**-143.8**
	-4.9%	*-5.2%*	*-4.7%*	*-4.7%*	*-4.8%*	*-4.1%*	*-3.2%*	*-3.0%*
Cash balances of social security funds, public entities and	33.8	30.1	27.0	26.7	26.5	22.7	25.0	25.0
Consolidated budget balance	**-110.8**	**-136.2**	**-134.7**	**-153.1**	**-153.2**	**-144.5**	**-114.1**	**-118.7**
	-3.7%	*-4.3%*	*-3.9%*	*-4.0%*	*-4.1%*	*-3.6%*	*-2.6%*	*-2.5%*

Spending continues to grow in real term, while reaching a primary balance within the current MTEF

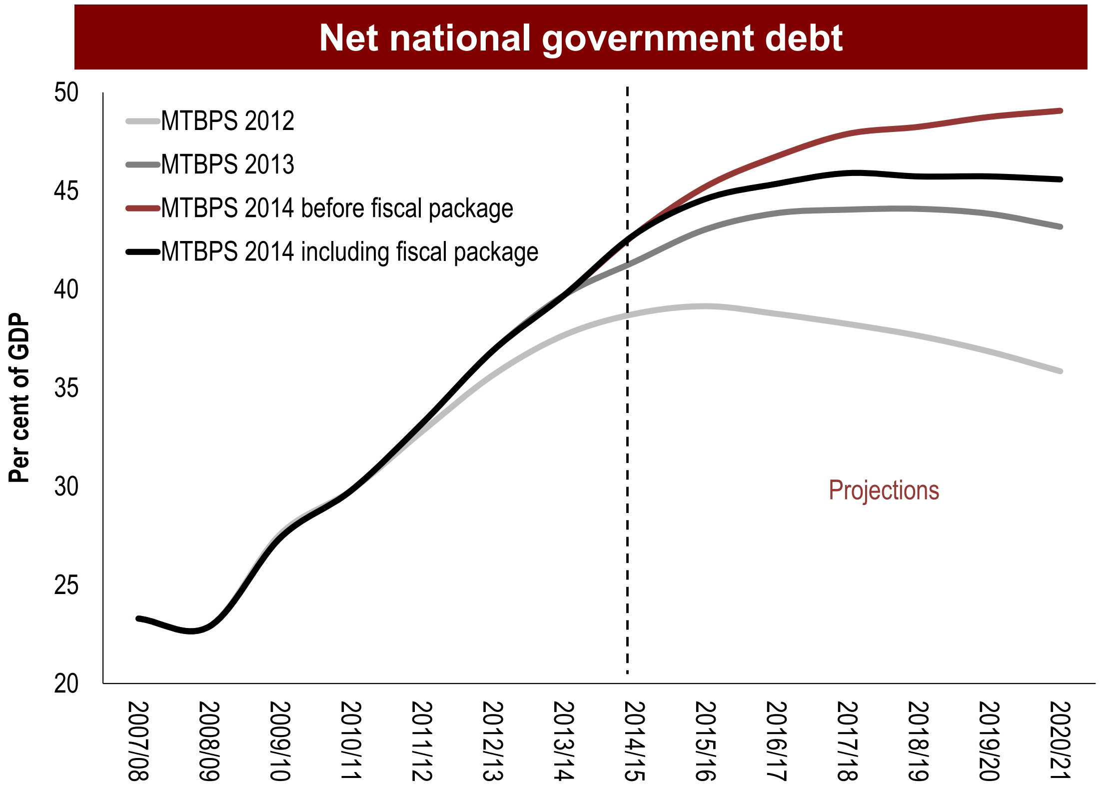
Main budget non-interest spending



Main budget primary balance



Net national government debt



- Before the proposed changes, national government's net debt was projected to continue growing as a share of GDP beyond 2021
- The fiscal package results in net debt stabilising at 45.9 per cent of GDP in 2017/18, while gross debt remains below 50 per cent

Risks to the proposed fiscal framework

- Economic outlook:
  - Rising global interest-rate cycle likely to place pressure on domestic interest rates, increasing the costs of issuing debt
  - The current account deficit remains persistently high, making SA more vulnerable to shifts in investment flows and market sentiment
  - A further deterioration in the GDP would require consideration of additional measures

- Government's wage bill:
  - Budgets assume CPI cost-of-living adjustments and headcount numbers at current levels
  - Current constraints suggest limited scope for additional resources
  - Deviations from CPI-linked cost-of-living adjustments will require either a reallocation of resources or a reduction in government employment

- A new framework for funding of SOCs and public entities will focus on:
  - Distinguishing purely commercial activities from the costs of exercising their developmental mandates
  - Close monitoring to ensure efficient delivery on government priorities, while simultaneously promoting improved commercial performance
  - Introducing more stringent financial reporting requirements for public entities
  - Capitalisation will be funded from sale of non-strategic state assets, and will not be drawn from tax revenue

In-year appropriation adjustments (national sphere)

Revised national allocations

- R1 billion has been declared as unspent funds by departments
- R705.1 million refunded to departments for monies paid directly into the NRF from department-specific activities
- R620 million for digital broadcast migration
- R350 million to cover rand depreciation on foreign-currency denominated expenditure
- R67.4 million for the funeral of former President Nelson Mandela
- R66.3 million in funds rolled over from2013/14
- R65.7 million for the 2014 national macro organisation of the state
- R63.1 million for contractual penalties incurred in relation to A400M aircraft contracts
- R34.6 million for water infrastructure interventions
- R32.6 million for the introduction of Ebola control and prevention measures

In-year appropriation adjustments (provincial and local spheres)

Revised provincial allocations

- R397.7 million shifted from *school infrastructure backlogs grant* to *education infrastructure grant*
- R262 million shifted from *national health grant* (health facility revitalisation component) to the *health facility revitalisation grant*

Revised local government allocations

- R157 million for the repair of infrastructure damaged by natural disasters
- R81.7 million is rolled over from unspent balances in 2013/14

Medium-term spending plans

- Government proposes to moderate expenditure growth over the medium term, so that it grows by 7.6 per cent a year, reaching R1.55 trillion in 2017/18

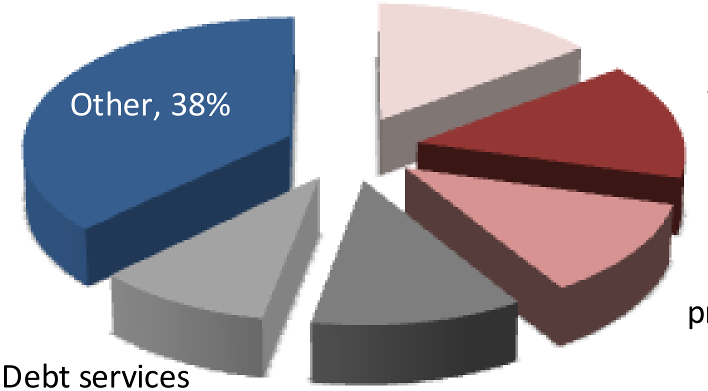
- The spending ceilings for 2015/16 and 2016/17 have been lowered by R10 billion and R15 billion, respectively
  - Government will ensure that these changes do not impact on service delivery, especially for the poor by focusing cuts on non-essential spending

- An unallocated reserve, amounting to R45 billion in 2017/18, can be used as a buffer against adverse economic or fiscal shocks

- Within the available resource envelope, the 2014-2019 MTSF outcomes frame the allocations over the medium term, with particular focus on:
  - Increasing investment in making SA's cities more dynamic
  - Continued focus on increasing competitiveness and expanding employment
  - Investing in education and skills

Functional composition of spending over MTEF

- 58% of spending over the medium term will go on:
  - Basic and post-school education
  - Housing and municipal infrastructure
  - Health
  - Social protection
- Industrial development, employment affairs and economic infrastructure account for 15% of spending
- Debt service costs consume 10% of spending over the medium term, up from less than 8% in 2008/09

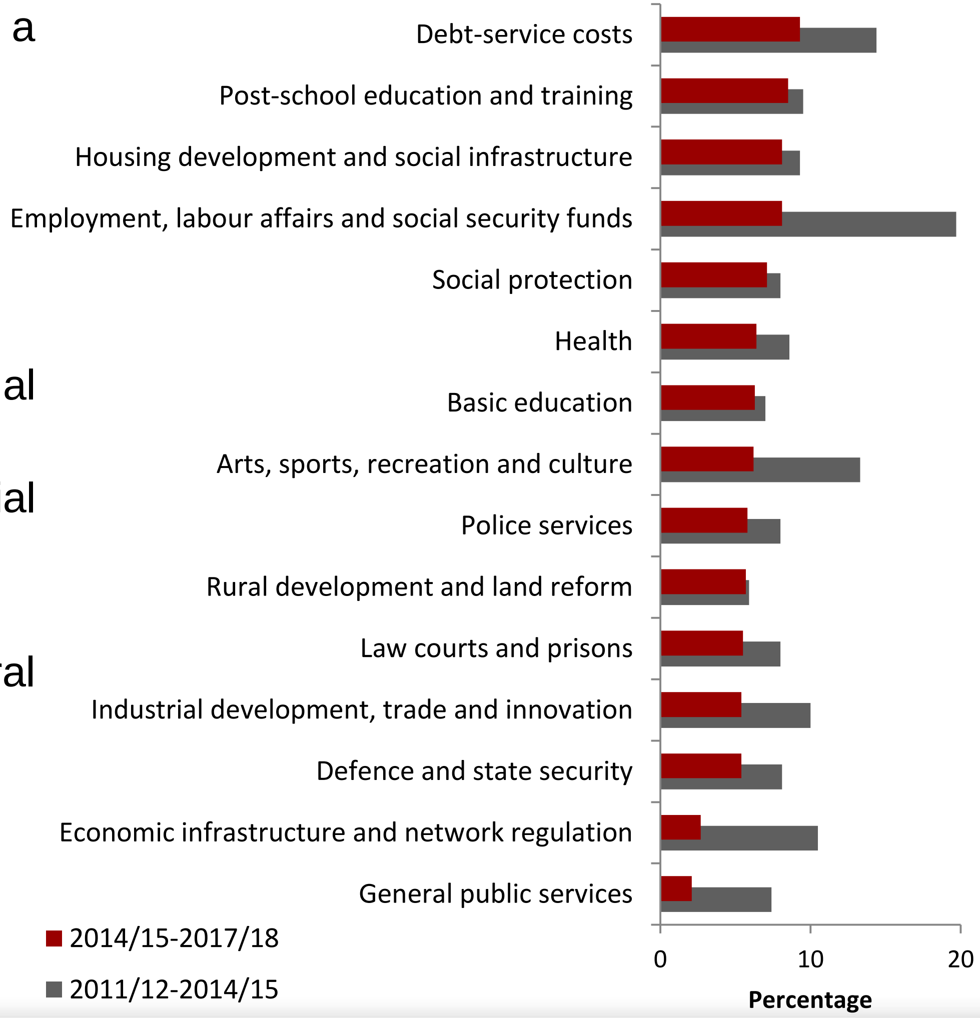


Other

Police	6%	Employment, labour affairs and SSFs	5%
Economic infrastructure and network regulation	5%	Post school education and training	4%
Industrial development, trade and innovation	5%	Defence	4%
General public services	5%	Courts and prisons	3%

Growth of spending by function group

- Overall, public spending will rise by 7.6% a year over the medium term
- Spending grows fastest for:
  - Debt-service costs – 9.3%
  - Post-school education – 8.5%
  - Housing development and social infrastructure – 8.1%
  - Employment, labour affairs and social security funds – 8.1%
- Slowest growth is concentrated in General public services - 2.1%

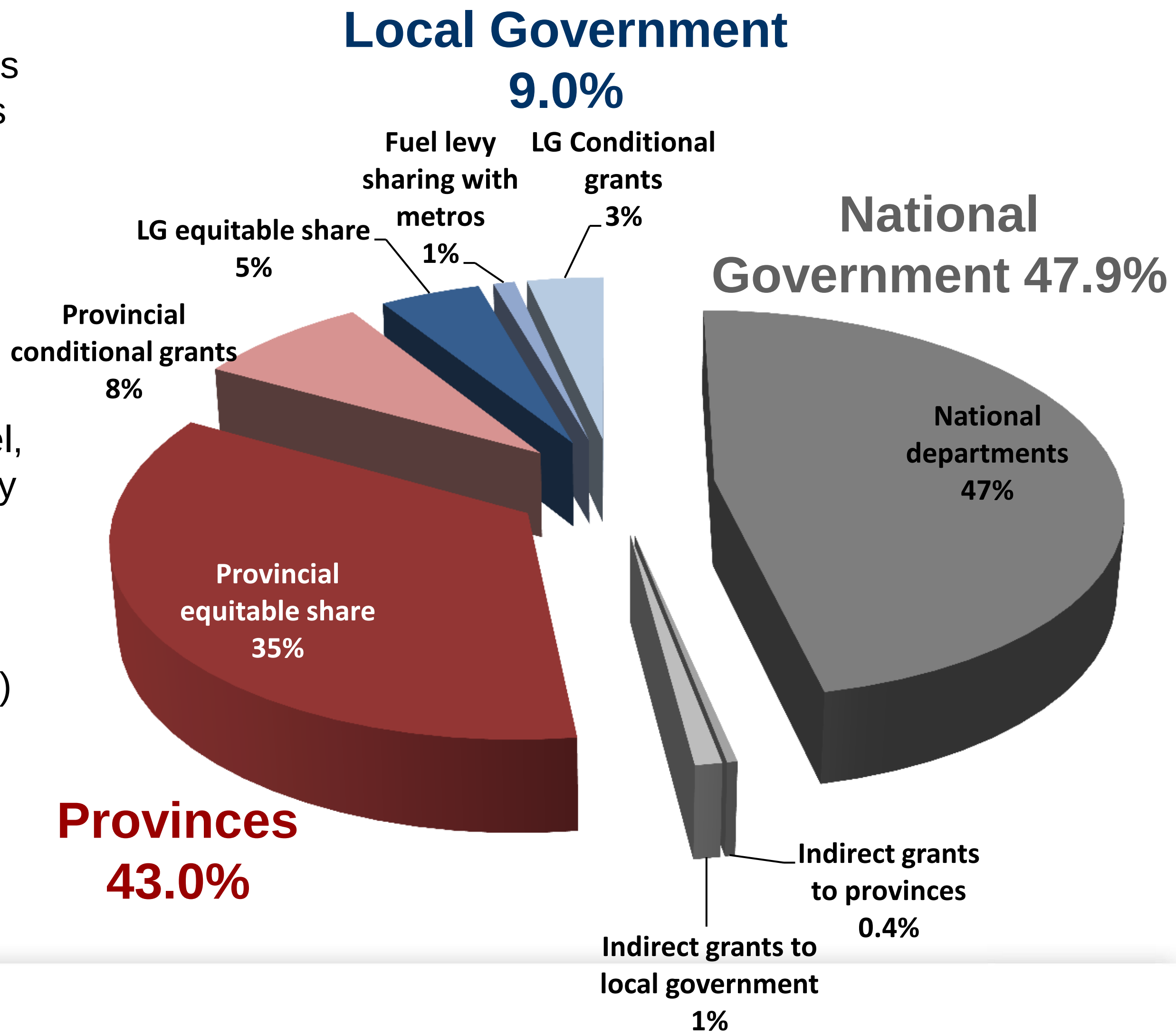


Division of revenue for the 2015 MTEF

Main changes to allocations:
- Baseline reductions to both spheres
- Reprioritised and ring-fenced funds for disaster recovery

Provinces:
- FET colleges, adult education and port health functions shifted to national
- Provinces to ensure that all non-discretionary obligations (personnel, goods and services) are adequately provided for

Local government:
- LG equitable share not reduced (free basic services cost pressures)
- Additions to water infrastructure grants
- Additions for cost of municipal mergers



Changes to conditional grants in the MTEF

Provinces

- *Maths Science and Technology Grant* will be created from merger of *Dinaledi Schools Grant* and *Technical Secondary Schools Grant*
- Provinces will begin to receive performance-based allocations for health and education infrastructure, incentivising improved performance

Local government

- New grant for 3 years to fund administrative costs related to municipal mergers due to take effect in 2016
- Review of infrastructure conditional grants (included SALGA, FFC, DCOG and DPME) will result in changes to:
  - rationalise the number of grants to each municipality, while increasing differentiation in the system (allowing better response to urban and rural issues)
  - Improve sustainability by focusing on life-cycle management of infrastructure
  - improve grant management, monitoring and support
- Review will continue in 2015, but the following changes will be implemented in 2015/16:
  - Consolidation of water and sanitation grants
  - Consolidation of public transport grants to cities

THANK YOU