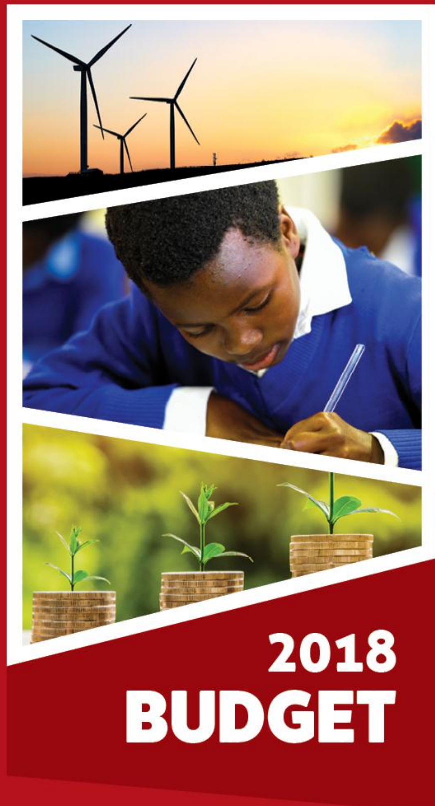


RESTORING ECONOMIC CONFIDENCE AND STABILISING THE PUBLIC FINANCES

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

2030 NDP

Main messages

- Following a difficult year for the economy and fiscus, a renewed sense of optimism has taken hold. The 2018 Budget outlines a series of measures to rebuild economic confidence and return the public finances to a sustainable path.
- The budget responds to revenue shortfalls presented in the 2017 Medium Term Budget Policy Statement (MTBPS), and the announcement of fee-free higher education and training. Budget 2018 also accelerates government's efforts to narrow the budget deficit and stabilise debt.
- New tax measures raise an additional R36 billion in 2018/19, mainly through a higher VAT rate and below-inflation adjustments to personal income tax brackets.
- The expenditure ceiling is revised down marginally over the next three years compared to the MTBPS. Underlying this change are major reductions and reallocations including: spending cuts amounting to R85 billion, an allocation of R57 billion for fee-free higher education, and additions to the contingency reserve of R10 billion.
- Together with an improved growth outlook, the revenue and spending measures reduce the consolidated deficit from 4.3 per cent of GDP in the current year, to 3.5 per cent by 2020/21. The main budget primary deficit closes, helping to stabilise debt at 56.2 per cent of GDP in 2022/23.
- Risks to the public finances include an uncertain growth outlook, wage pressures, and the weak finances of state-owned companies.

Global recovery provides a supportive environment for South Africa

- The world economy continues to strengthen supported by tax reforms in the US, strong domestic demand and trade in Europe, and accommodative monetary policy in developed economies
- Growth in developing economies is supported by external demand and a recovery in commodity prices
- As the world economy recovers, tighter financial conditions could reduce capital flows to developing economies

IMF growth projections

Region/country Percentage	2000-2008 Pre-crisis	2010-2016 Post-crisis	2017	2018	2019
			Average GDP forecast		
World	**4.3**	**3.8**	**3.7**	**3.9**	**3.9**
Advanced economies	**2.4**	**1.9**	**2.3**	**2.3**	**2.2**
United States	2.3	2.1	2.3	2.7	2.5
Euro area	2.0	1.1	2.4	2.2	2.0
United Kingdom	2.5	2.0	1.7	1.5	1.5
Japan	1.2	1.4	1.8	1.2	0.9
Developing countries	**6.5**	**5.4**	**4.7**	**4.9**	**5.0**
Brazil	3.8	1.4	1.1	1.9	2.1
Russia	7.0	1.8	1.8	1.7	1.5
India	6.8	7.3	6.7	7.4	7.8
China	10.4	8.1	6.8	6.6	6.4
Sub-Saharan Africa	**5.9**	**4.5**	**2.7**	**3.3**	**3.5**
South Africa[1]	4.2	2.0	1.0	1.5	1.8

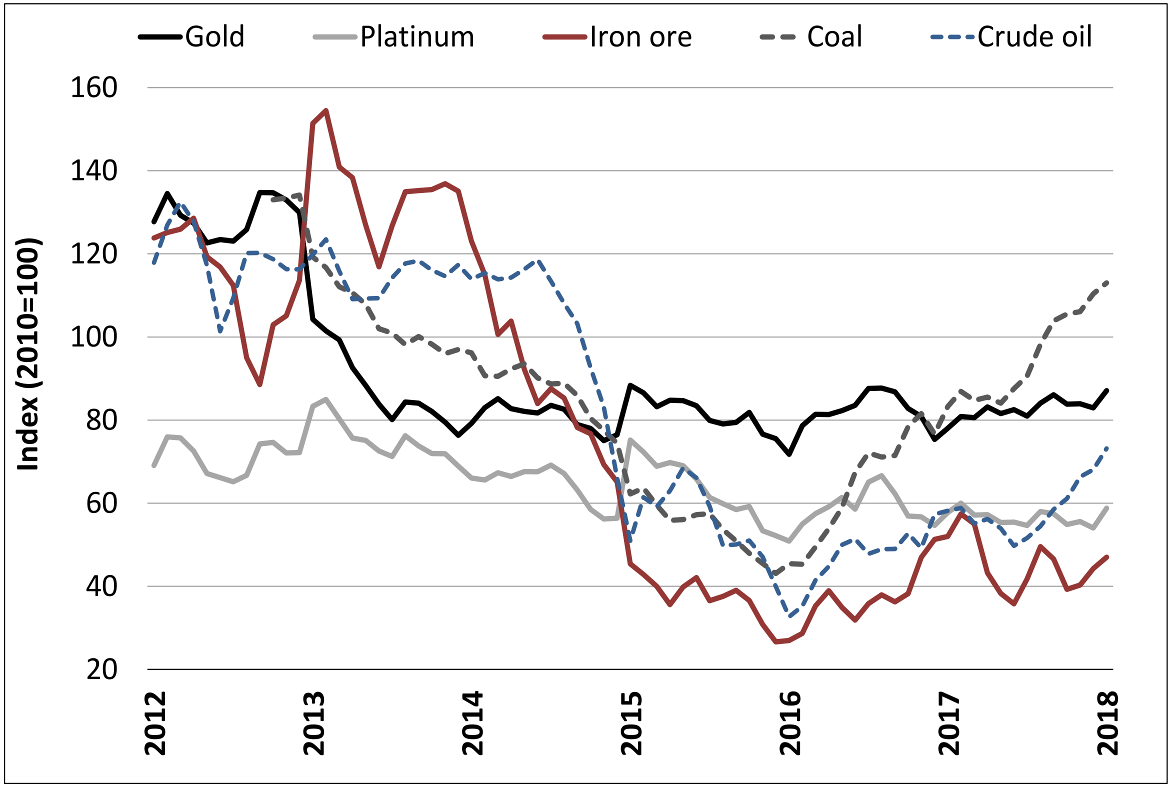
1. National Treasury forecast

Source: IMF WEO October 2017, January 2018

Commodity prices have begun to recover

- Commodity prices have rebounded over the past year resulting in an improved near-term outlook for commodity exporters like South Africa
- Oil prices have risen on the back of improved global demand and declining inventories
- Non-oil commodity prices have recovered from the low reached at the end of 2015, responding to higher demand from China and India

Commodity prices*



**The coal index is only available from 2012*
Source: Bloomberg and National Treasury calculations

The domestic economic outlook has improved since the 2017 MTBPS

Macroeconomic outlook				
Real percentage growth	**2017 Estimate**	**2018**	**2019 Forecast**	**2020**
Household consumption	1.3	1.7	1.9	2.3
Gross fixed-capital formation	0.3	1.9	3.3	3.7
Exports	1.5	3.8	3.4	3.5
Imports	2.7	4.4	4.6	4.5
Real GDP growth	**1.0**	**1.5**	**1.8**	**2.1**
Consumer price index (CPI)	5.3	5.3	5.4	5.5
Current account balance (% of GDP)	-2.2	-2.3	-2.7	-3.2

Source: National Treasury

- The economy has benefited from strong growth in agriculture, higher commodity prices and, in recent months, improving investor sentiment
- The medium-term growth outlook has improved since the 2017 MTBPS, mainly due to an expected increase in private investment as a result of improved confidence
- The SACCI business confidence index reached its highest level since October 2015, while the Absa PMI is at its highest level since January 2010

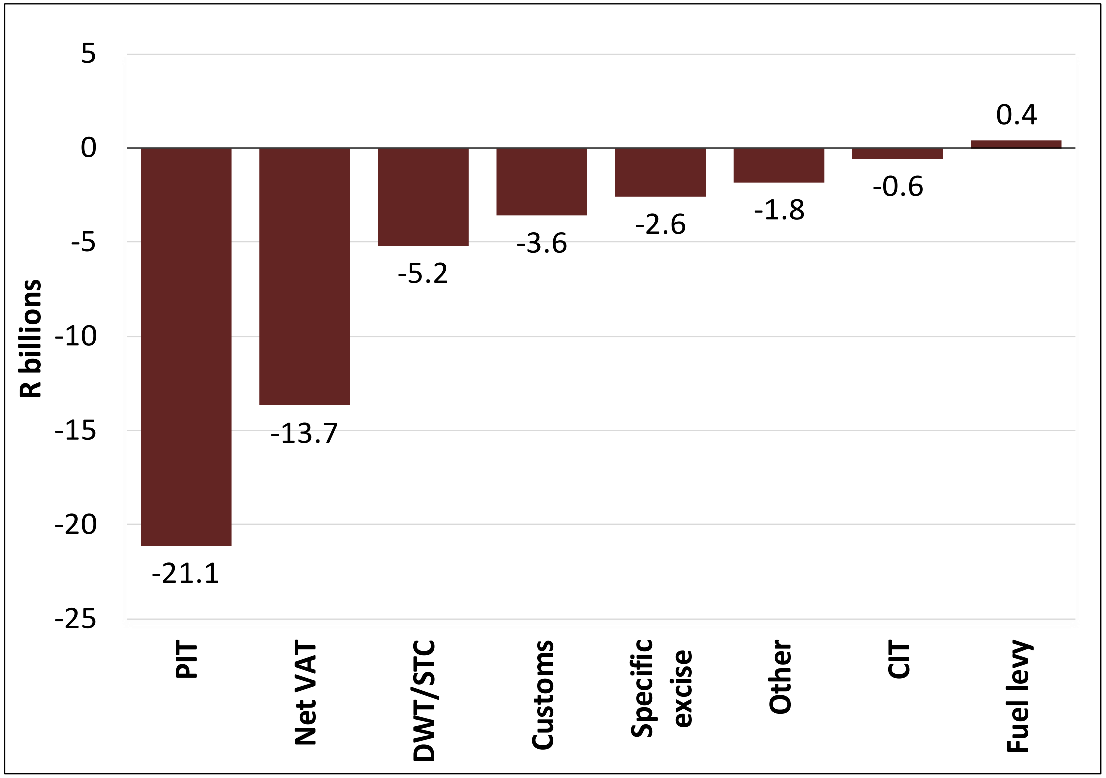
Towards faster economic growth

- Government has made progress in implementing short-term confidence boosting measures, including the appointment of new boards at Eskom and SAA
- Translating the cyclical upturn and improved investor sentiment into more rapid economic growth requires government to finalise many outstanding policy and administrative reforms, particularly in sectors with high growth potential.
- These include:
  - Mining sector policies that support investment and transformation
  - Telecommunications reforms, including the release of additional broadband spectrum
  - Lowering barriers to entry by addressing anticompetitive practices
  - Supporting labour-intensive sectors, such as agriculture and tourism, and increasing skills levels across the economy.
- The National Treasury estimates that, if the international environment remains supportive, effective implementation of these reforms could add two to three percentage points to real GDP growth over the coming decade.

Revenue shortfalls remain significant

- Revenue collection has improved since the 2017 MTBPS in line with stronger economic performance
- Nevertheless, gross tax revenue shortfall estimated at R48.2 billion compared with 2017 Budget
- Personal income taxes, net VAT, and dividend withholding tax are expected to show large shortfalls
- Risks include weaker-than-expected economic growth, and concerns about tax morality, compliance and administration

Tax performance in 2017/18 relative to Budget 2017 targets



Fee-free higher education requires additional allocation of R57 billion

- Over the medium term, the 2018 Budget allocates new funding of R57 billion to phase in fee-free higher education
- Together with provisional allocations announced in the 2017 Budget, the total additions amount to R67 billion

Additional medium-term education allocations				
R million	**2018/19**	**2019/20**	**2020/21**	**MTEF**
Universities: zero per cent fee increase for 2018 and subsidy funding	2 445	4 050	4 814	**11 309**
Universities: NSFAS student funding	4 581	13 124	15 315	**33 020**
TVET colleges: subsidy funding	1 414	2 222	3 014	**6 650**
TVET colleges: NSFAS student funding	2 585	3 735	3 996	**10 316**
TVET colleges: infrastructure	1 300	1 484	1 647	**4 431**
NSFAS: administration	30	35	40	**105**
Allocations to Department of Higher Education and Training[1]	–	675	712	**1 387**
Total	**12 355**	**25 325**	**29 538**	**67 218**

1. Operationalisation of 3 new TVET colleges, examination services and pension payments

Source: Interministerial Committee on Higher Education

Summary of 2018/19 budget proposals

Revenue adjustments:

- Raise an additional R36 billion in tax revenue through an increase in the VAT rate, limited personal income tax bracket adjustments and other measures

Expenditure adjustments:

- 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.

Tax proposals are expected to generate an additional R36 billion in tax revenue for 2018/19

Impact of tax proposals on 2018/19 revenue[1]		
R million		
Gross tax revenue (before tax proposals)		**1 308 965**
Budget 2018/19 proposals		**36 000**
Direct taxes		**7 310**
Revenue from not fully adjusting for	6 810	
Medical tax credit adjustment	700	
Special economic zones	-350	
Estate duty increase	*150*	
Indirect taxes		**28 690**
Increase in value-added tax	22 900	
Increase in general fuel levy	1 220	
Increase in excise duties	4 290	
Increase in environmental taxes	280	
Gross tax revenue (after tax proposals)		**1 344 965**

1. Revenue changes are in relation to thresholds that have been fully adjusted for inflation

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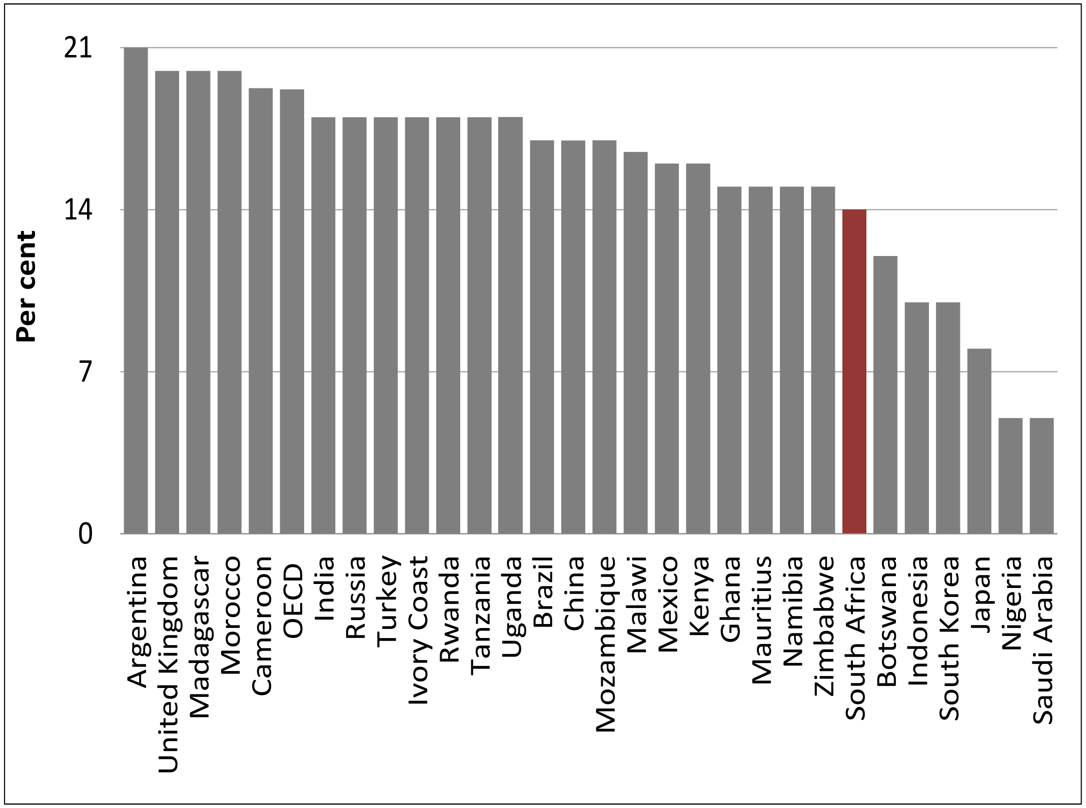
2018 BUDGET

2030 NDP

VAT will have the least harmful impact on growth

- VAT is an efficient tax provided that its design is kept simple, and will have the least detrimental effects on growth and employment
- At 14 per cent, the current VAT rate is lower than the global and African average.

Comparative standard VAT rates by country*



**Rates are for 2017 & 2018. The OECD rate refers to an unweighted average*
Source: International Bureau of Fiscal Documentation

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2018 BUDGET

Additional measures to enhance progressivity

- The VAT proposal increases the cost of living for all households. The wealthiest 30 per cent of households contribute 85 per cent of VAT revenue
- The impact on the poor will be partially mitigated through:
  - Zero rating of basic food items and paraffin
  - Above-inflation increases in social grants
- To strengthen the progressivity of the tax proposals, government is proposing:
  - No adjustment to the top four personal income tax brackets
  - Increases in *ad valorem* excise duties, including a higher cap on cars, ensuring that households spending more on luxury goods contribute proportionately more
  - A higher estate duty rate for estates worth R30 million and more

Baseline reductions by sphere of government before reallocations

- Spending cuts, and other small adjustments, reduce budget baselines by R85.7 billion over the medium term. The reductions fall on large programmes, transfers to government entities, and conditional grants to subnational government

Baseline reductions by sphere of government before reallocations

R million	2018/19	2019/20	2020/21	MTEF total	% of baseline
National government	**-18 048**	**-17 221**	**-18 177**	**-53 446**	**-2.1%**
Goods and services	-5 165	-5 525	-5 834	-16 523	-7.6%
Transfers to public entities	-10 402	-9 393	-9 917	-29 712	-7.7%
Other national spending items[1]	-2 481	-2 304	-2 427	-7 211	-1.1%
Provincial government	**-5 182**	**-6 387**	**-6 797**	**-18 366**	**-1.0%**
Provincial equitable share	-1 437	-1 584	-1 684	-4 705	-0.3%
Provincial conditional grants	-3 745	-4 803	-5 113	-13 661	-0.9%
Local government	**-3 152**	**-5 212**	**-5 499**	**-13 863**	**-3.5%**
Local government conditional grants	-3 152	-5 212	-5 499	-13 863	-9.3%
Total baseline reductions	**-26 382**	**-28 820**	**-30 473**	**-85 676**	**-1.8%**

1. Transfers to private enterprises and households, as well as capital items

Source: National Treasury

Marginal downward revisions to the expenditure ceiling

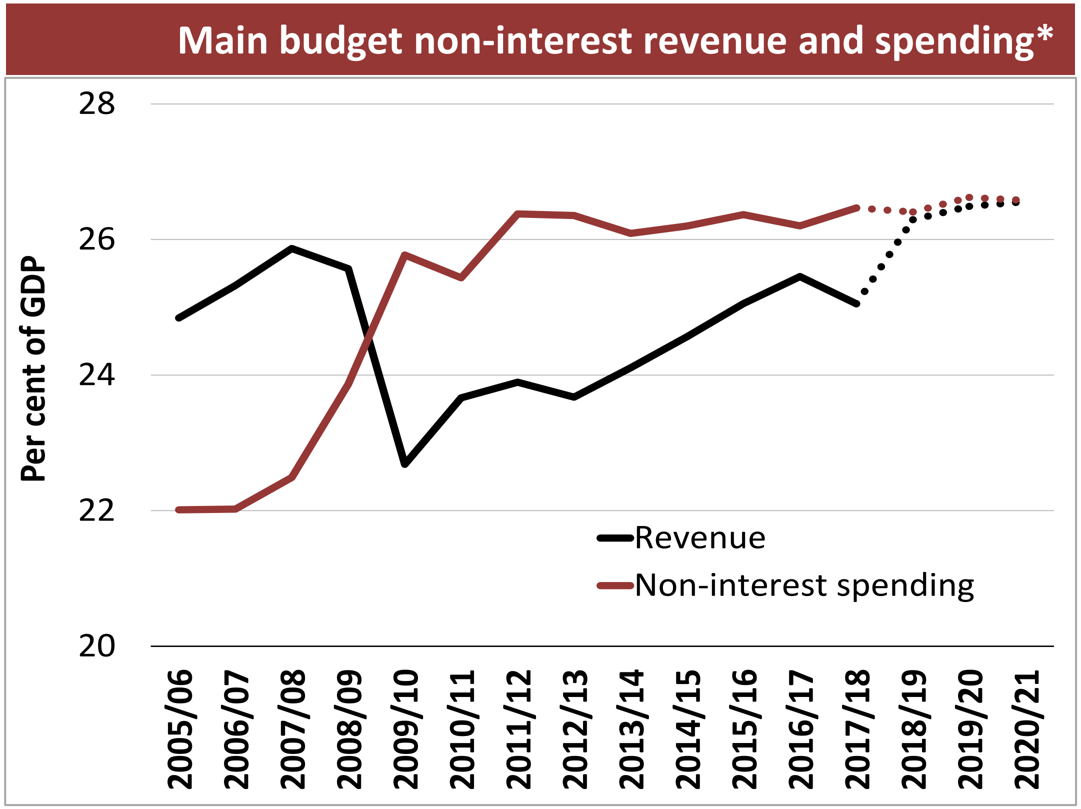
- After taking account of the spending reductions and reallocations, the expenditure ceiling has been revised down marginally over the medium term.

- 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.

Main budget expenditure ceiling

R million	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
2016 Budget Review	1 076 705	1 152 833	1 240 086	1 339 422		
2016 MTBPS	1 074 992	1 144 353	1 229 742	1 323 465	1 435 314	
2017 Budget Review	1 074 970	1 144 225	1 229 823	1 323 553	1 435 408	
2017 MTBPS	1 074 970	1 141 978	1 233 722	1 316 553	1 420 408	1 524 222
2018 Budget Review	1 074 970	1 141 978	1 232 678	1 315 002	1 416 597	1 523 762

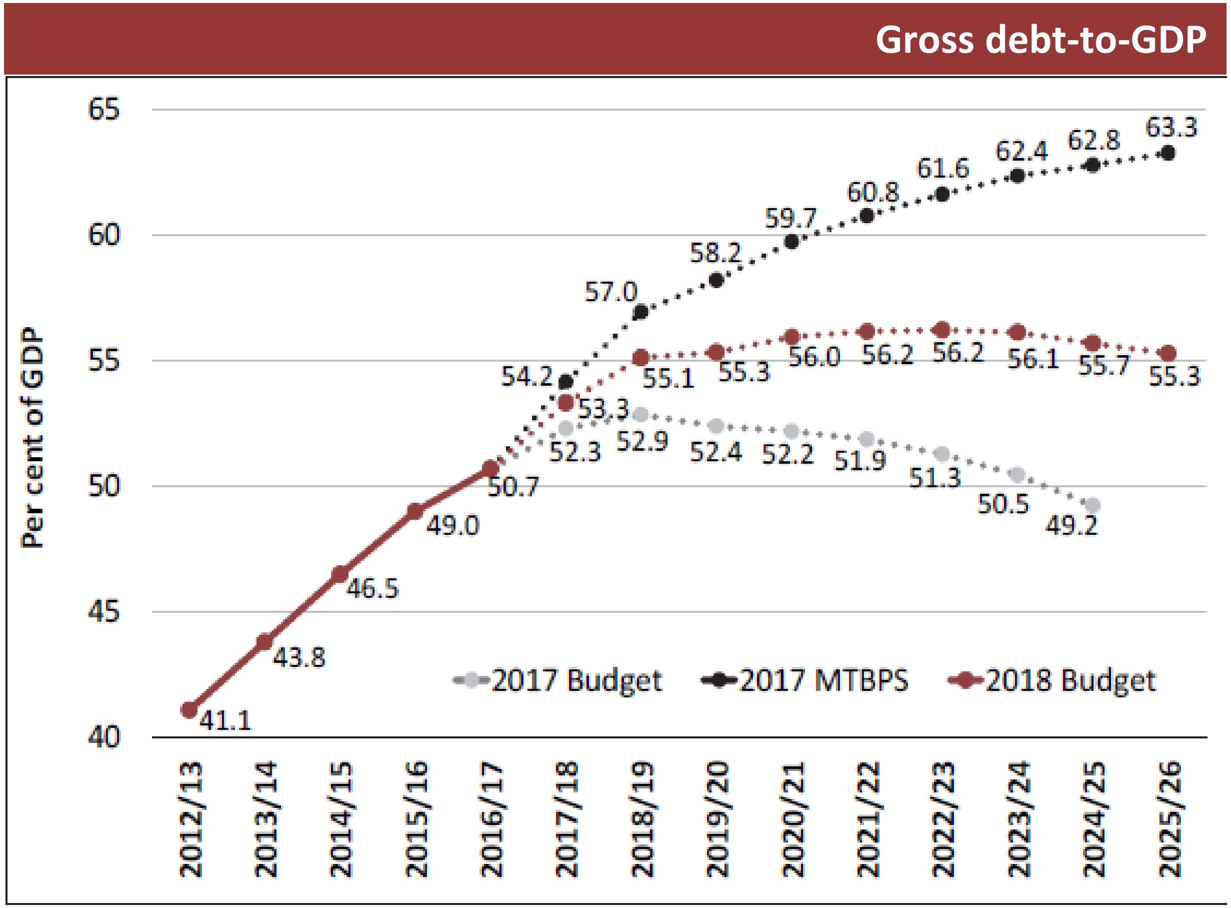
Main budget primary deficit closes over the medium term



**Excluding financial transactions*

- 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
- Main budget non-interest expenditure remains stable at 26.6 per cent of GDP

Debt-to-GDP ratio stabilises over the coming decade



Source: National Treasury

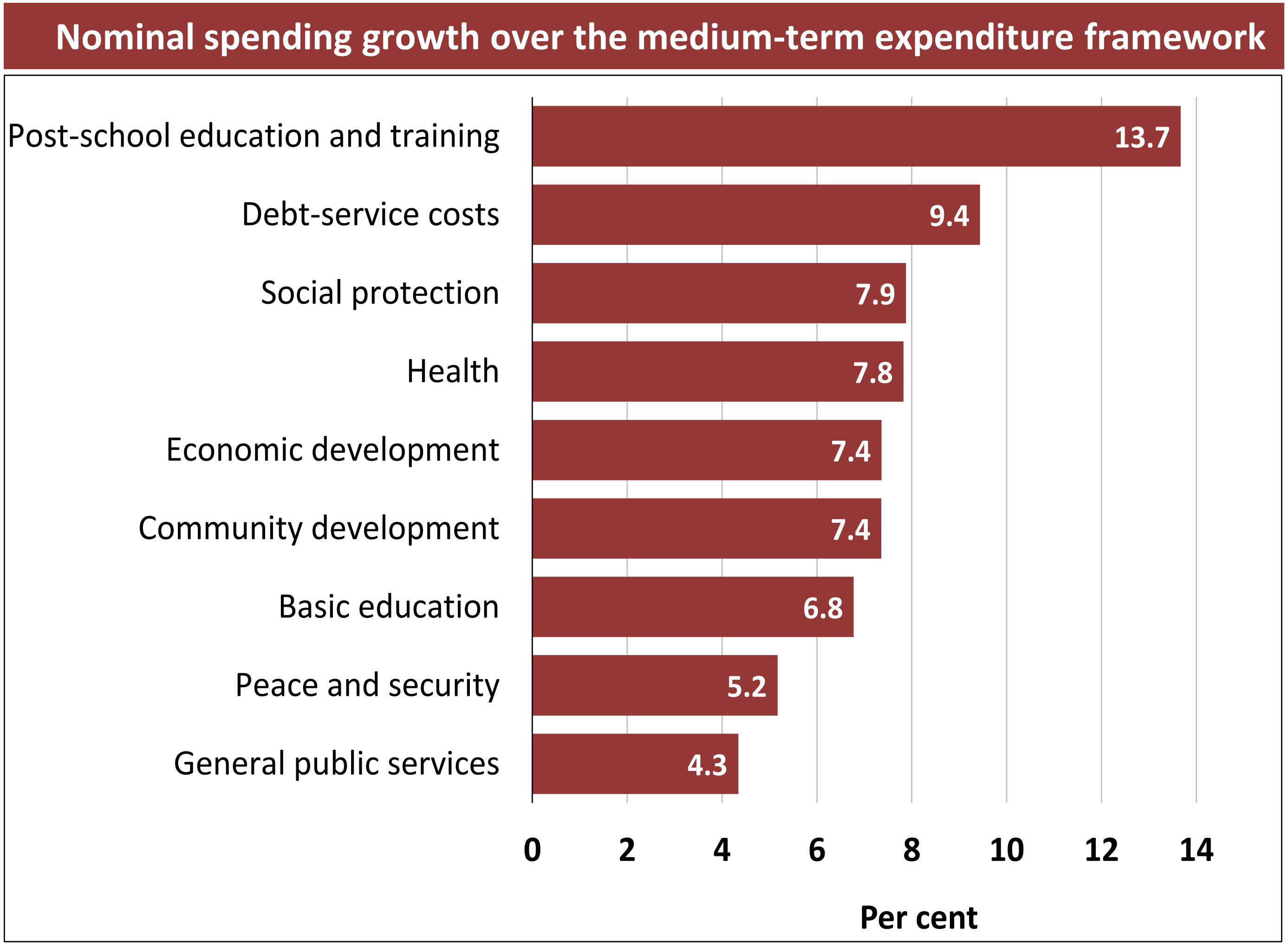
Consolidated fiscal framework

Consolidated fiscal framework							
	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Outcome		Revised		Medium-term estimates	
R billion/percentage of GDP				estimate			
Revenue	**1 095.3**	**1 215.3**	**1 285.7**	**1 353.6**	**1 490.7**	**1 609.7**	**1 736.9**
	28.3%	*29.5%*	*29.2%*	*28.8%*	*29.7%*	*29.9%*	*29.9%*
Expenditure	**1 235.0**	**1 366.2**	**1 441.8**	**1 558.0**	**1 671.2**	**1 803.0**	**1 941.9**
	31.9%	*33.1%*	*32.7%*	*33.2%*	*33.3%*	*33.4%*	*33.4%*
Non-interest expenditure	*1 113.6*	*1 227.8*	*1 285.0*	*1 387.6*	*1 483.4*	*1 596.9*	*1 718.0*
	28.8%	*29.8%*	*29.2%*	*29.5%*	*29.5%*	*29.6%*	*29.6%*
Budget balance	**-139.7**	**-151.0**	**-156.1**	**-204.3**	**-180.5**	**-193.3**	**-205.0**
	-3.6%	*-3.7%*	*-3.5%*	*-4.3%*	*-3.6%*	*-3.6%*	*-3.5%*

Source: National Treasury

- The consolidated budget includes the main budget as well as spending by provinces, public entities and social security funds financed from their own revenue

Post-school education and training is the fastest growing expenditure category over the medium term



Division of revenue

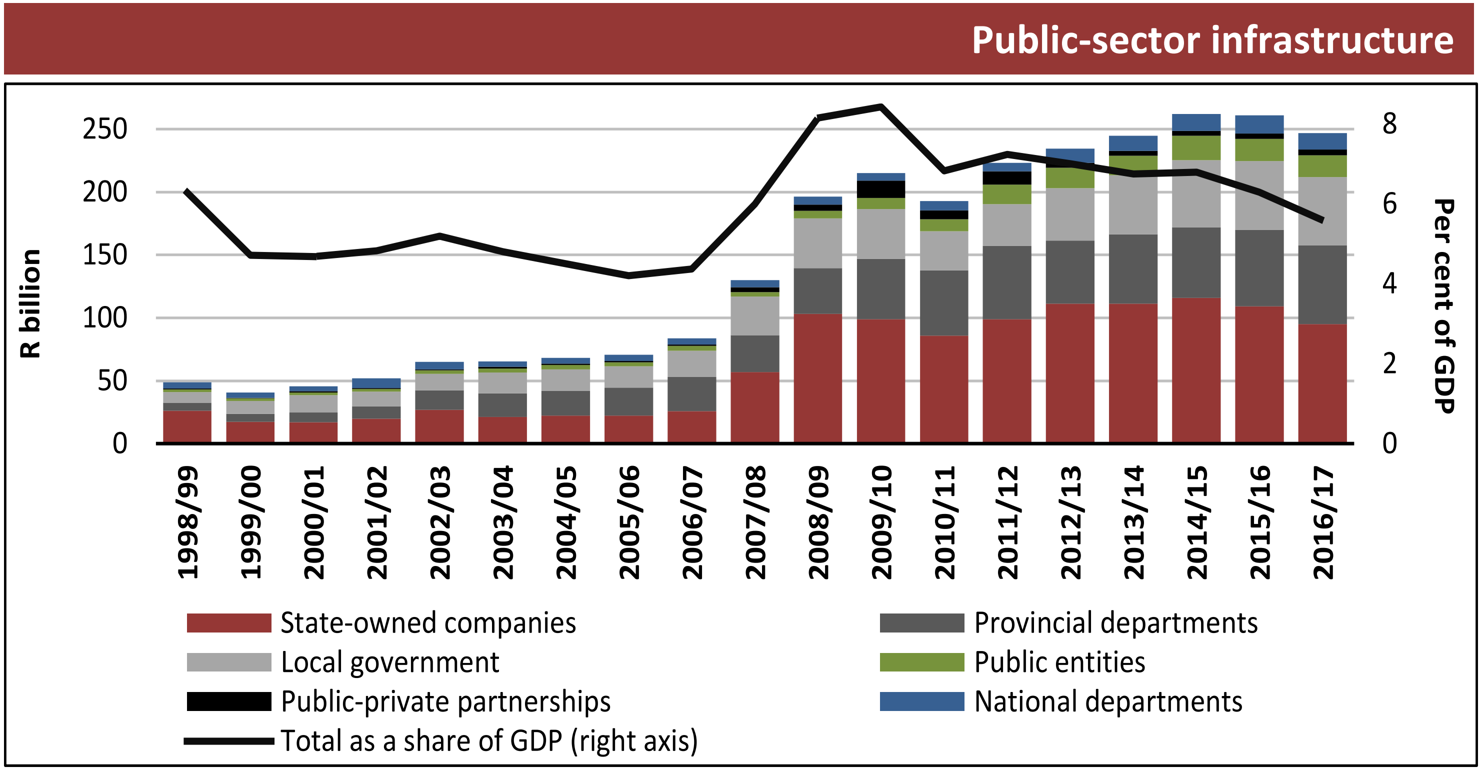
- Reductions to provincial and local government transfers focus primarily on infrastructure grants, which will result in some delays in infrastructure rollout
- Services have been protected, including grants funding school meals, bus subsidies and medicines
- Local and provincial government equitable share grows at over 10 per cent and 7 per cent a year, respectively
- Over the MTEF, total provincial allocations are reduced by 1 per cent and local government by 3.5 per cent

Division of revenue

R billion	**2017/18**	**2018/19**	**2019/20**	**2020/21**
National allocations	599.9	628.6	685.9	736.6
Provincial allocation	538.2	571.0	611.8	657.5
of which				
Equitable share	*441.3*	*470.3*	*505.0*	*542.4*
of which				
Conditional grants	*96.8*	*100.7*	*106.7*	*115.0*
Local government allocations	110.7	118.5	126.9	137.5
Provisional allocation not	–	6.0	2.3	2.1
Total allocations	**1 248.8**	**1 324.1**	**1 426.9**	**1 533.6**
Percentage shares				
National	*48.0%*	*47.7%*	*48.1%*	*48.1%*
Provincial	*43.1%*	*43.3%*	*42.9%*	*42.9%*
Local government	*8.9%*	*9.0%*	*8.9%*	*9.0%*

Source: National Treasury

Public-sector infrastructure investment



- Total public-sector infrastructure spending estimated at R834.1 billion over the MTEF
- The majority of these investments are in energy, transport and logistics, and water and sanitation
- SOCs remain the largest contributors, accounting for R368.2 billion of the MTEF total

Efficiency and composition of expenditure

- Over the past decade, the public sector has invested R2.2 trillion in economic and social infrastructure. Yet weaknesses in project preparation, execution and delivery have resulted in lengthy delays and cost overruns
- The Budget Facility for Infrastructure aims to build a pipeline of projects that have undergone rigorous technical analysis, and ensure that fiscal resources are committed in a transparent manner
- The facility has completed its review of 38 large infrastructure proposals. Additional work is being done to ensure that proposals can be considered for funding in the October Adjustments Budget. Options to engage development finance institutions and the private sector through the facility will also be explored
- To support higher levels of capital investment, the state needs to contain the public-service wage bill, which has crowded out spending in other areas
- Government is working to ensure that the current wage negotiations process results in a fair and sustainable agreement.

Financial position of state-owned companies

- The already weak financial position of SOCs deteriorated in 2016/17. Declining profitability is partly a reflection of mismanagement, operational inefficiencies and rising financing costs
- SOCs rely mainly on debt to fund infrastructure and operational requirements. Lenders have taken a more active stance in reaction to the governance failures
- Government has undertaken steps to improve governance and reduce liquidity constraints
- Over the medium term, the SOC sector will require far-reaching governance and operational interventions – including, where appropriate, private-sector participation

Financial position and performance of state-owned companies

R billion/per cent growth	2012/13	2013/14	2014/15	2015/16	2016/17
Total assets	800.3	910.7	1 042.2	1 183.7	1 225.2
	12.7%	*13.8%*	*14.4%*	*13.6%*	*3.5%*
Total liabilities	543.7	633.6	738.9	821.9	868.9
	15.5%	*16.5%*	*16.6%*	*11.2%*	*5.7%*
Net asset value	256.6	277.1	303.2	361.8	356.3
	7.2%	*8.0%*	*9.4%*	*19.3%*	*-1.5%*
Return on equity (average)	4.8%	3.3%	-2.9%	0.8%	0.3%

1. State-owned companies listed in schedule 2 of the PFMA, excluding development finance institutions
Source: National Treasury

Risks to the economy and fiscus

- 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
- The deteriorating financial position of the social security funds is a serious risk, owing to growing liabilities at the Road Accident Fund

Conclusion

- The 2018 Budget accelerates government's efforts to narrow the budget deficit and stabilise debt, laying the foundation for faster growth in the years ahead.
- It sets out a series of proposals to bolster the public finances by raising taxes and adjusting expenditure – decisions that involve difficult trade-offs.
- Major steps include a one percentage point increase in the value-added tax (VAT) rate in 2018/19 and large-scale spending reallocations over the medium term.
- In combination with the improved growth outlook, the 2018 Budget proposals will result in a considerably narrower budget deficit than was presented in October, and a clear path to debtstabilisation.
- Despite these positive signs, significant risks remain to economic and fiscal projections. Government is working to boost economic growth, promote more rapid investment to create employment, and stabilise the precarious finances of state-owned companies.