PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

Analysis of the 2015 Budget

Parliamentary Budget Office

The Parliamentary Budget Office (PBO) has been established in terms of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009). The PBO provides independent, objective and professional advice and analysis to Parliament on matters related to the budget and other money Bills. The PBO supports the implementation of the Act by undertaking research and analysis for the Finance and Appropriations Committees.

The PBO was requested to analyse the 2015 Budget. On the 3rd of March 2015 the PBO presented its analysis to a joint-sitting of the Standing and Select Committees on Finance and Appropriations.

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Introduction

The 2015 Budget was presented in a challenging context of slow growth and rising debt. The need to address rising debt is the imperative that shapes the budget.

Government responded to the effects of the global financial crisis by increasing spending to grow the economy. In 2009/10 government increased non-interest spending by R161bn. This began the expansionary phase of the "counter-cyclical" fiscal policy. Government had to increase borrowing as spending increased while revenue growth slowed. Debt has subsequently grown significantly. The country's debt-to-GDP level increased from 22 per cent in 2008/09 to 38 per cent by 2013/14.

The economy has however not returned to its pre-financial crisis growth level, despite the support from higher government spending. Since 2009 the economy grew by an average of 1.5 per cent annually compared to 4.9 per cent between 2004 and 2009. Increasing spending has increased the interest payments share of expenditure. Debt is expected to increase to 43.8 per cent by 2017/18.

In response to rising debt, in the 2014 Medium Term Budget Policy Statement National Treasury said "fiscal consolidation can no longer be postponed". It proposed a "fiscal package" including a R27 billion increase in revenue and a reduction in non-interest expenditure of R25bn over 2 years (2015/16 – 2016/17). In the 2015 Budget, National Treasury stressed "the counter-cyclical approach has reached its limits". The detailed proposals of the fiscal package are presented in the 2015 Budget, and include:

- An increase in Personal Income Tax
- A 30.5 c/L increase in the general fuel levy
- A 50 c/L increase in the Road Accident Fund levy
- A UIF contribution holiday for one year
- Average nominal expenditure growth of 7.9 per cent a year over the 2015 MTEF period (consolidated non-interest)

With the proposals contained in the 2015 Budget, National Treasury expects the budget deficit to improve from 3.9 per cent in 2014/15 to 2.5 per cent in 2017/18.

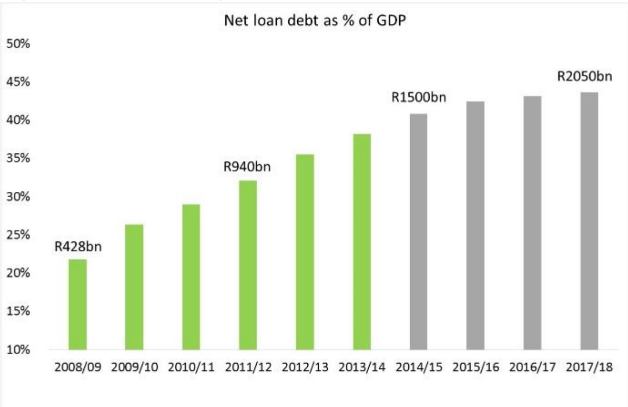
Considerations

In the 2014 MTBPS the Minister of Finance said that the budget "will not be balanced on the backs of the poor". It is important to assess how the poor are affected by the specific proposals of the fiscal package.

Naturally, the budget tabled is a ministry of finance or treasury approach to budgeting. It is primarily concerned with ensuring the financial health of the country, while meeting its expenditure priorities. If all needs were to be budgeted for, total expenditure would be considerably higher. This would therefore require additional revenue and/or borrowing.

In October 2014 South Africa updated its calculation of GDP in-line with international standards. The country's output was found to be higher than previously estimated. The result is that for a given target budget deficit (as a share of GDP), Treasury could increase expenditure.

Figure 1: Evolution of debt



Source: PBO using NT and SARB data

Debt

The current push for fiscal consolidation that drives many important components of the Budget derives primarily from concerns relating to public debt.

There are two ratios in particular that National Treasury appear to be concerned with, and which are also considered by relevant external institutions such as the IMF and credit ratings agencies. These are: net loan debt as a per cent of GDP, and net liabilities as a per cent of GDP. Net liabilities includes provisions and contingent liabilities in addition to net loan debt. A contingent liability is expenditure that government may incur in the future, but depends on the occurrence of events that are uncertain.

National Treasury have previously indicated that they believe it would be prudent to keep net loan debt as a per cent of GDP below 40 per cent, and net liabilities as a per cent of GDP below 50 per cent.

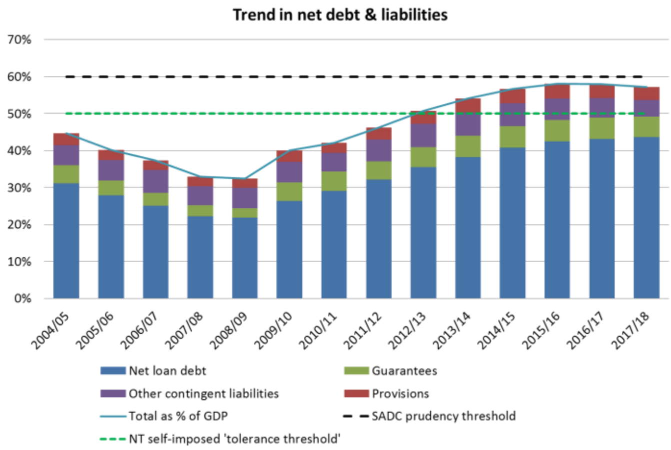
Such prudency levels are typically based on various forms of 'debt sustainability analyses'. Two questions for such analysis are:

1. Can a country service its debt (interest) payments?
2. Will a country be able to repay its loan debt, or 'refinance' it when it falls due?

Answers to these questions depend on the existing level of debt and interest costs, but also forecasts and expectations of economic growth and revenue collection, as well as investor confidence. Investor confidence is controversial because it can be highly subjective. It nevertheless may affect credit ratings, and consequently debt costs and the ability to obtain new loans.

Under the proposed fiscal framework, the growth of net loan debt will decline to 43.8 per cent by 2017/18 based on current plans and projections. Net liabilities will grow to a maximum of 58.1 per cent over the MTEF period. Both of these are above the thresholds discussed above, though the SADC guidelines and IMF analysis suggest a threshold of 60 per cent for net liabilities.

Figure 2: Net debt and liabilities



Source: PBO using NT and SARB data

Figure 2 shows the change in net debt and contingent liabilities, and its composition (as % of GDP), over the last decade, and the forecast for the MTEF period. Net loan debt has grown rapidly since 2008 due to slower economic growth and government's counter-cyclical policy. Provisions, guarantees and other contingent liabilities have also grown in absolute terms, but have decreased in relative terms. In other words, net debt is a higher proportion of the total net liabilities than it has been in the past.

However, it is important to note that these figures do not include guarantees to state owned entities that have not yet been used as a basis for borrowing. For example, Eskom has debt guarantees of R350 billion but has only borrowed against R224.9 billion.

It is critical to determine whether the thresholds used are appropriate, because maintaining a particular threshold implies lower borrowing and therefore either lower expenditure, higher revenue or (as in 2015 Budget) both. Their appropriateness depends on at least three main considerations:

1. Debt sustainability.
2. The expected relationship between government spending, economic growth and revenue collection. If lower government spending results in lower growth and revenue it could compound fiscal challenges. As a result this relationship is at the centre of the debate relating to austerity in OECD countries.
3. Policymakers' preferences relating to the balance of risk and benefits in relation to debt financing and reducing planned government expenditure.

On the one hand, reductions in government expenditure could slow growth and job creation, while increases in taxation could discourage economic activity. On the other hand, high debt levels could expose the country to shocks or credit downgrades and require more drastic reductions in future.

National Treasury has not provided any assessment of debt sustainability with the Budget documents. The IMF recently conducted a debt sustainability analysis as part of its Article IV consultation. In relation to contingent liabilities it modelled the outcomes of a 'shock' in which 75 per cent of government's guarantees were called upon. The IMF found that the effects on debt would place the country in a 'high risk' zone. However, this is an 'extreme' scenario and may not be a good guide as to what is an appropriate level.

Most contingent liabilities are debt guarantees provided by the Treasury to state-owned enterprises. In times where the fiscus is under pressure it may be desirable to shift more of the funding burden to future periods, through borrowing, debt guarantees or increased tariffs. However, this needs to be done with adequate consideration for debt sustainability (risk), intergenerational equity and consequences for the broader economy and citizens. Furthermore, utilising debt guarantees to shift the burden has implications for the risk levels of total public sector debt.

The PBO has been requested by the Standing Committee on Finance to produce a report on various aspects of SOE financing, which will be presented to the Committee in April. The report builds on the report and recommendations of the Presidential Review Committee on State-owned Entities. An important point from the PBO report is that the financial status of an enterprise is a function of a complex, and sometimes ill-defined, governance and regulatory framework interacting with the political, social and economic environment. Short-term and long-term measures to address SOE funding, as discussed in the 2014 MTBPS and 2015 Budget Review, need to take this into account.

Revenue

In the 2014 Medium Term Budget Policy Statement National Treasury proposed a R25 billion increase in revenue over the next two years as part of the fiscal package. The 2015 Budget presents the details.

Considerations

Countries have a wide range of options to raise revenue. In determining the optimal tax structure there are several important considerations.

A basic consideration is the incentives facing individual taxpayers and firms. While it seems that increasing the company or personal income tax rate may increase government revenue, the relationship is not obvious. Companies may choose to relocate or reduce taxable income to avoid higher tax, which may reduce national revenue. Higher tax rates also reduce income available for investment and spending. In the case of South Africa, where household consumption is a key driver of growth, lower after tax income will decrease consumption. It is therefore important to consider the effect of taxation on the economy.

Maintaining the progressivity of the tax regime is particularly important in South Africa. A tax is considered progressive if the tax rate increases as the income or wealth increases.

The burden on different categories of taxpayers is also an important consideration. At present individual taxpayers contribute over 30 per cent to national tax revenue.

National Treasury emphasised that tax proposals contained in the 2015 Budget maintain the progressivity of the tax system. However, this point was not substantiated. For Parliament's oversight role it would be useful if National Treasury provided any estimates of the impact on progressivity.

Key tax proposals

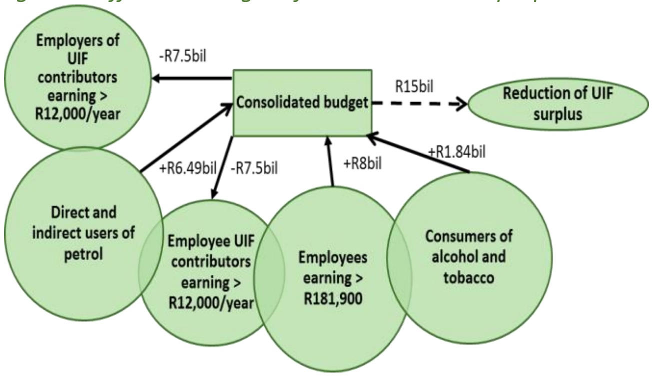
The effectiveness of the proposed changes to the tax regime is best assessed through actual revenue collected.

Figure 3 shows the main revenue proposals from the 2015 Budget with the expected effect on the consolidated budget. The circles overlap where taxpayers are affected by more than one of the proposed revenue changes.

The key tax proposals include:

1. A one percent increase in personal income marginal tax rates for those earning more than R 189 000 per year. This will add an additional R8 billion to the fiscus for the 2015/16 financial year. Below the R15 billion required according to the 2014 MTBPS and 2015 Budget.
2. A one-year UIF "holiday" for employees and employers for 2015/16. This is in response to the large surplus accumulated by the UIF. This will reduce consolidated budget revenue by R15 billion. This amount will be shared by employers and employees.
3. Proposed increases of 30.5 cents per litre to general fuel levy and 50 cents per litre to the Road Accident Fund levy. These increases are expected generate revenue from direct and indirect users of petrol totalling of R6.49 billion for the 2015/16 financial year.
4. Consumption taxes, also known as "sin taxes", on alcohol and tobacco will increase to maintain momentum from previous years. These increases are expected to generate an additional R1.8 billion.
5. Medical credit changes are expected to decrease consolidated budget revenue by R 92 million.
6. Property transfer duties have become more progressive. The threshold for exemption from transfer duties has been increased to R750 000, while duties on higher value property have increased. These changes are expected to raise an additional R100 million in 2015/16.
7. The energy-efficiency tax incentive is expected to reduce revenue by R150 million for 2015/16.

Figure 3. Effect on budget of selected revenue proposals



Source: PBO

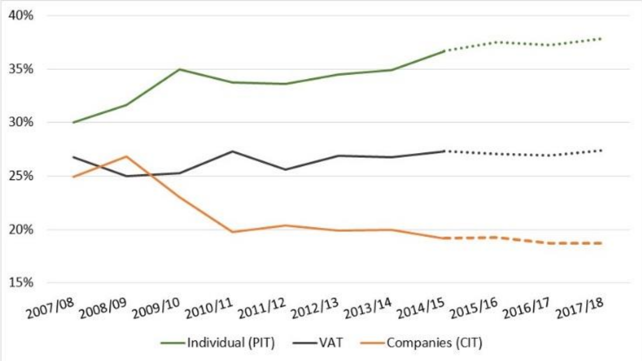
The net effect of current tax proposals cannot be reliably and accurately estimated prior to implementation. However it does appear that that individual taxpayers may bear a significantly higher burden than businesses.

Revenue instruments

South Africa raises tax revenue through several instruments. Personal Income Tax (PIT), Corporate Income Tax (CIT) and Value-added Tax (VAT) are the three main sources, and generate over 80 per cent of tax revenue. Figure 5 shows PIT's contribution to tax revenue increasing overtime while CIT's share decreases. The trend should be noted in considering changes to the tax regime.

Individual tax payers are affected by several of the revenue proposals. This includes the increase in PIT, the general fuel levy, the Road Accident Fund levy, and sin taxes. Combined with rising fuel prices due to a weakening rand, and a likely increase in electricity prices, individual tax-payers may experience a decline in disposable income. This is a concern for growth as the South African economy depends on household consumption.

Figure 5: South Africa's main revenue Instruments



Source: PBO using NT data

No changes were proposed to CIT. CIT has remained at 28 per cent since 2006 when it was reduced from 29 per cent. It is not clear if the reduction has attracted greater investment. While there may be valid reasons for leaving CIT unchanged, the 2015 Budget did not provide any reasons.

The Minister announced amendments to the current legislation to combat the practice of Base Erosion and Profit Shifting (BEPS) in South Africa. South Africa has had legislation to combat the BEPS since 1995, with many countries looking to South Africa for best practice. The Minister did not provide an estimate of the revenue that could be raised, and the associated costs in combatting BEPS.

South Africa's VAT rate has remained unchanged at 14 per cent since 1994 when it was increased from 10 per cent. Compared to other developed and developing countries, South Africa's VAT rate is relatively low. It is therefore argued that VAT could have been increased to raise the revenue required. The recent experience of the UK shows how VAT can respond to economic conditions. In 2008 the UK lowered its VAT rate by 1.5 per cent for a single year to stimulate the economy. However there are negative consequences associated with increasing VAT. The Davis Tax Committee's reports on tax systems, including VAT, are expected in 2016. Government may have to consider increasing VAT in the short term.

South Africa's contribution to the Southern African Customs Union (SACU) is a concern for government. South Africa's payment to fellow member states Botswana, Lesotho, Namibia and Swaziland has increased substantially since 2011/12 and is expected to stabilise by 2017/18. Without undermining the country's commitment to the customs union and regional development, it may be appropriate to review the revenue sharing formula.

Incentives for economic growth

Government has in recent years provided several incentives to promote growth. The goal has been to attract domestic and foreign investment. It is expected that the cost of providing incentives, in terms of revenue foregone and expenditure incurred, would be outweighed by the benefits. Expected benefits include higher growth, increased employment and lower inequality. The 2015 Budget introduced additional incentives for business. While it is not possible to attribute direct causality to incentives and observed outcomes, it is critical to evaluate the effectiveness of past incentives in relation to the associated costs.

Unemployment Insurance Fund

One of the major proposals in the Budget concerns the Unemployment Insurance Fund (UIF) contributions. The proposal is a once-off reduction, for 2015/16, in the contributions by employers and employees. This is because the Fund has been running annual surpluses and has accumulated net assets of R110.1 billion by 2014/15 – despite increased payments following job losses from the financial crisis.

This UIF proposal has a significant impact on the incidence and progressivity of the revenue proposals. It reduces the per cent of income paid in income tax and UIF for middle- and lower-income taxpayers, even with the increase in marginal income tax rates. But it does not entirely offset marginal income tax increases for those earning higher incomes.

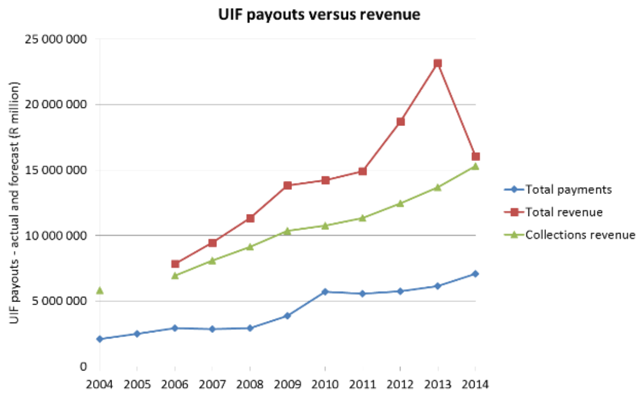
From a policy point of view it is important to consider why the UIF has accumulated such a large surplus, whether the proposal is an appropriate way of reducing the surplus, and what longer-term measures may be appropriate to remedy the situation.

There are three main reasons why the surplus might have accumulated to such an extent:

1. Mandated contributions in excess of what is required
2. Under-claiming of benefits
3. Collection/accumulation of surplus in expectation of future shock(s)

If the contribution is excessive then this unnecessarily increases the cost of labour at a time when unemployment is high and job creation a major priority.

Figure 6: UIF payouts and revenue



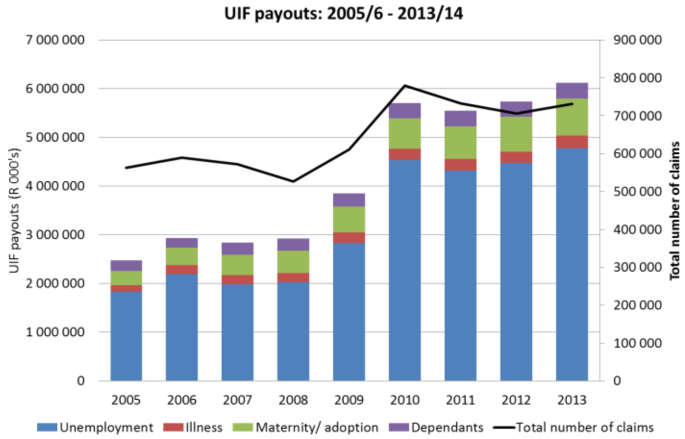
Source: PBO using UIF and NT data

The evidence shown in Figure 6 suggests that the required contributions are excessive relative to the benefits available. However, a definitive conclusion would require more information on potential UIF recipients instead of actual claimant numbers.

Nevertheless, one concern is that returning the UIF surplus in the manner proposed is a relatively crude remedy since it may 'compensate' employers and employees different to those who made the original contributions.

Figure 7 shows the change in UIF payments over time (from 2004/05 to 2012/13), by claim type. The black line shows the total number of claims in a given year. This shows that the UIF did 'respond' to the economic downturn, with a large increase in claims from 2007/8 to 2009/10.

Figure 7: Composition of UIF payouts



Source: PBO using UIF and NT data

However, the preceding graph showed that total revenue has nevertheless consistently exceeded payments and in recent times the extent of the gap has actually increased – contrary to what one might expect for a social security scheme.

Expenditure

In-line with the fiscal package contained in the 2014 MTBPS, revisions to the 2015 MTEF includes a decline in the non-interest expenditure. Other key components include revisions to the macro structure of government, and the identification of strategic priorities for the 2015/16 financial year.

Over the 2015 MTEF non-interest expenditure declines by R25 billion. This decline will be phased-in over the 2015/16 and 2016/17 financial years. Consolidated expenditure is however estimated to grow by an annual average of 7.9 per cent over the 2015 MTEF period. Real expenditure growth over the next three-years will be slower than the previous period. The slowdown in expenditure growth is uneven across functions. For example, spending growth for social services (including social protection, health, basic education and local economic development) is expected to grow at an annual average of 7.2 per cent over the medium term, while spending growth in general public services grows at 2.6 per cent.

In May 2014 the President announced a new Cabinet. The appointment of new ministers and deputy ministers required the reorganisation of national departments as well as the establishment of new departments. Table 1 shows the newly created departments and the departments from which the function and funds have been shifted.

Table 1: New departments and function shifts

Newly created Departments	Departments from which all or some functions and funding have been shifted
Planning, Monitoring and Evaluation	The Presidency: Performance Monitoring and Evaluation
Water and Sanitation	Human Settlements and Water Affairs
Women	Women, Children and People with Disabilities
Small Business Development	Trade and Industry
Telecommunications and Postal Services	Public Enterprises and Communications
Communications	Government Communication and Information Systems, The Presidency and Home Affairs
Office of the Chief Justice and Judicial Administration	Justice and Constitutional Development

Note: The Office of the Chief Justice and Judicial Administration has been included in the Department of Justice and Constitutional Development for the 2015 budget

Strategic priorities for growth

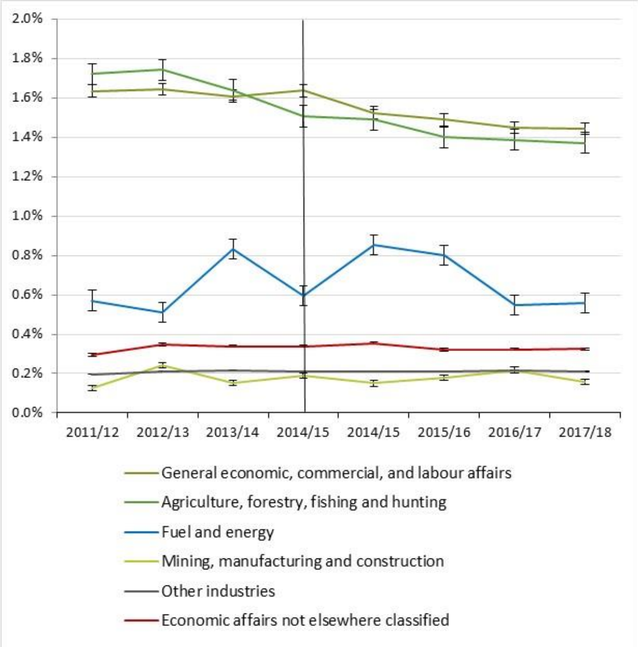
In the State of the Nation Address, the President said that the economy needs a major "push forward". The President outlined the country's nine point plan to boost growth and create jobs. The nine strategic priorities were further emphasised by the Minister of Finance with the tabling of the 2015 Budget. The nine for 2015/16 are:

1. Resolving the energy challenge
2. Revitalising agriculture
3. Adding value to our mineral wealth
4. Enhancing the Industrial Policy Action Plan (IPAP)
5. Encouraging private investment
6. Unlocking the potential of small enterprises
7. Infrastructure investment, and
8. Reducing workplace conflict
9. Support for implementation of the National Development Plan through in-depth, results-driven processes, known as *phakisa laboratories*.
10. To demonstrate the alignment of funding priorities with stated strategic priorities, the proportion of total spending of selected categories within the economic affairs functional classification is shown in Figure 8.

The vertical line in the Figure 8 shows the original budget allocation for 2014/15. The subsequent data points show the revised expenditure for 2014/15 and the estimated expenditure over the 2015 MTEF. The proportion of total spending on most categories decreases from the revised estimated expenditure and over the 2015 MTEF. The proportion received by mining, manufacturing and construction spending is the only category that increased from the original 2014/15 budget allocation.

The downward trend can be attributed to the slowdown in growth within this function group, and the R25bn expenditure reduction from the 2015 MTEF.

Figure 8: Funding and priority alignment: economic affairs



Source: National Treasury

It is, however, expected that funds allocated towards priority areas should not be reduced. It is further acknowledged that the realisation of a particular priority may result in fewer resources being available for other priorities.

The budget and the poor

The Minister of Finance stated during the 2014 MTBPS that "the national budget will not be balanced on the backs of the poor". While this is an important commitment, for the claim to be assessed a definition of the "poor" is required.

Poverty in a narrow sense is measured using income. Development economists, however, increasingly use multi-dimensional definitions of poverty. These include access to housing, health care, education, services, resources and measures of social dynamics. However, South Africa does not have an official definition of the poor or poverty, and the country has not committed to an official poverty line.

Government departments use the term "the poorest of the poor" to refer to beneficiaries of state policies and interventions. As in the case of poverty, this term has no official definition but it is used loosely to refer to the vulnerable groups within the country such as poor children, pensioners, women-headed-households and, citizens in rural areas.

To protect poor households and provide coverage for a large number of beneficiaries, the 2015/16 budget for social protection grows by 7.9 per cent. Social protection is an important safety net that helps alleviate poverty and some of the hardships of unemployment. The social transfer system of South Africa has a considerable impact on poverty.

A pro-poor budget?

The 2015/16 budget contains elements that are pro-poor and others that aren't.

Pro-poor elements:

- The increase in the value of social grants is a pro-poor change. National Treasury have indicated that the level would be reviewed at the 2015 MTBPS, this may allow for protection of the grant against inflation.
- Proposed changes to Personal Income Tax are pro-poor as low income earners are exempt from increases to the marginal tax rate.
- National Treasury also left VAT rate unchanged, leaving the VAT burden on the poor unchanged.

Non pro-poor elements:

- While the increase in social grants is greater than the estimated headline inflation, the poor may still be worse off. A large share of the consumption basket of low-income households is comprised of food, fuel and electricity. These items have experienced price increases in excess of headline CPI, this implies that inflation for the poor is higher than headline CPI.
- Increase in electricity tariffs, fuel and Road Accident Fund (RAF) levies will affect the poor disproportionately as a greater share of income is spent on fuel and electricity.
- The single year UIF contribution "holiday" is positive, but only benefits employers and those who are employed.

Sustainability of grants

Social grant expenditure remains stable at 3 per cent of GDP. The performance of the economy, particularly in terms of employment, is a risk to the sustainability of social grant expenditure. If growth continues to slow and unemployment increases, government may face increasing debt and higher number of social grant beneficiaries.

An additional consideration regarding the sustainability of grants is the burden on tax payers. At present, over a quarter of the country's population depend on social grants.

The public service wage bill

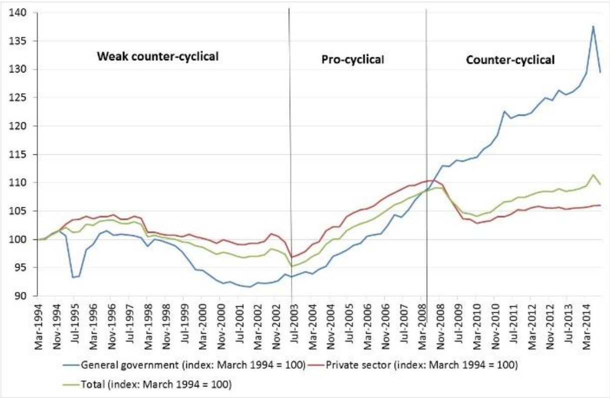
National Treasury flagged the growing public wage bill as a concern in the 2014 MTBPS, and instituted a moratorium on filling of non-funded vacant positions. It identified the public wage bill as a key risk to the fiscal framework in the 2015 Budget. This section draws from the PBO's work on the public wage requested by the Standing Committee on Finance, which will be presented in April 2015.

The major cost drivers of the public wage bill are:

1. Growth in the employment level of the public service
2. Cost of living adjustments in excess of inflation
3. Policy initiatives including the Occupational Specific Dispensation (OSD)

The South African government appears to have adopted different strategies with respect to the size of the public service since 1994. In some cases these strategies have been deliberate while in other cases the trends may be the outcome of circumstances.

Figure 9: Employment growth, 1994-2014



Source: South African Reserve Bank

Between 1994 and 2003, government gradually decreased the size of the public service at a time when the economy was growing between two to four per cent. After 2003 up until 2008, government's employment pattern reverted to a typical pro-cyclical public service response as is typical of the policy employed by the Organisation for Economic Co-operation and Development (OECD) countries. During this period, the size of the public service grew in-line with the private sector and global economic growth.

After the global financial crisis in 2008, growth decreased substantially leading government to adopt a counter-cyclical response. This resulted in a substantial increase in the size of the public service relative to the shrinking private sector. This growth was also likely the outcome of the implementation of the OSDs in 2007.

Growth in the public service appears to have reached a turning point as of late 2014. The announcement of a freeze in non-essential vacant posts in the 2014 Medium Term Budget Policy Statement may deter further growth over the medium-term. Private sector employment growth in recent years has been negligible partly because of a decrease in labour intensity and investment. This means that in the future, overall job growth may stagnate which could increase unemployment.

Public sector wage settlements

It should be noted that National Treasury has limited powers to contain the wage bill. National Treasury can only limit the compensation budgets for government departments and entities. In doing so, it can reduce the transfer of funds to departments and entities with previously funded vacant positions no longer considered essential. "Non-essential" is likely to mean managerial and administrative positions. However, assessments will be made on a case-by-case basis. National Treasury has little direct control over the cost-of-living wage adjustments agreed upon with public sector unions.

Typically, government budgets for a CPI plus one per cent adjustment in wages for public servants each year. The credibility of these estimates is questioned when persistently unrealised. Unreliable budget estimates lead to investors and credit ratings agencies re-evaluating the sustainability of government's finances. This can limit investment by inhibiting effective planning and/or result in credit ratings downgrades.

Government's cost of living adjustment estimates are often exceeded (particularly when single-year wage adjustment agreements have been concluded). This suggests that public sector labour unions have been successful in persuading government to deviate from their planned budgets. Government may be less likely to meet future budget estimates for the public wage bill should the existing bargaining dynamics continue.

The evolution of the public wage bill

While the public service wage bill has increased in real terms from 1994/95 to 2014/15 (by approximately 122 per cent), the growth in the overall budget has been higher (approximately 151 per cent). The share of the public wage bill has therefore decreased as a percentage of total expenditure and GDP from 1994 to 2008.

However, after 2008 the substantial increase in the size of the public service (partially the outcome of the implementation of OSD) accompanied by persistent cost of living adjustments, in excess of the CPI plus one per cent, has led to a marked increase in the size of the public wage bill. Over the past decade, the average remuneration per public-sector worker has increased by more than 80 per cent in real terms, with an average annual growth rate of more than 6 per cent above inflation.

Studies suggest that upward adjustments in the public wage bill are difficult to reverse. In South Africa's case, this has had the effect of worsening the budget balance and reducing the fiscal responsiveness of the state to future downturns in economic activity. Research by the Department of Public Service and Administration finds that the increases in the average pay per worker in the public service have not been met by increases in productivity, which poses a threat to the fiscus.

Data from the World Bank shows that South Africa's public wage bill prior to 2008 was higher (as a percentage of total expenditure, revenue and GDP) than the averages of low, middle and high income countries.

Sustainability analysis

In exploring the sustainability of the public sector wage bill, it is necessary to observe how the wage bill is affected by different key drivers. The PBO analysed scenarios to illustrate the effect of changes to the following components on the wage bill: 1) average wage settlement level 2) employment growth due to creation of new funded posts 3) vacancy rate.

Three scenarios were considered.

1. The first scenario, referred to as "*compliance*", assumes government adheres closely to its commitments, and budget estimates are realised.

2. Scenario two, “partial compliance”, entails government partially complying to its commitments, with budget estimates marginally exceeded due to a cost of living adjustment greater than CPI plus one per cent.
3. Scenario three, “recent trends continue”, entails the public wage bill continuing to grow as it has in recent years.

Under the *compliance*, South Africa’s budget deficit will be closely in line with what has been estimated by National Treasury. *Partial compliance* would result in the wage bill growing to 36.4 per cent of total expenditure. *Recent trends continue* would result in the wage bill growing to 37.4 per cent of total expenditure. Should scenario two or three materialise, government has the choice of funding the increase in the wage bill by borrowing more and increasing government debt or maintaining its debt levels by cutting spending in other areas.

Additional financing is required when employment levels increase and average wage settlements are at levels above “inflation plus one per cent”. The additional finance requirement can be acquired from reallocating funds from other expenditure items, increasing borrowing, drawing on the unallocated reserves, or a combination of the above. Employing each of these options has its own set of likely consequences and risks. Reallocating funds from goods and services is likely to negatively affect service delivery, while drawing on the unallocated reserves increases the country’s vulnerability in the event of fiscal and economic shocks. Increasing borrowing will increase interest expenditure, crowding-out other expenditure and increasing the likelihood of the country missing its budget deficit targets.

It is important to ensure that the containment of the public wage bill is done responsibly. It will therefore be important to monitor the personnel headcounts and compensation budgets of departments and entities to ensure that the slower budget growth does not compromise on their capacity to deliver on their mandates. This is particularly the case for departments performing functions that serve the most vulnerable populations, such as health and education services.

Private sector investment

Encouraging private investment is a central theme of the 2015 Budget. This is part of government’s nine point action plan to boost growth and create jobs.

Growth in private sector capital investment contracted over the last two quarters, the first time since the second quarter of 2010. The reasons behind the recent contraction are unclear. National Treasury suggests that this is the result of a loss in business confidence, and that a recovery in investment growth by general government will lead private sector investment higher (also known as the crowding-in effect).

Data on investment suggest that the private sector is currently undertaking only investment required to maintain current operations. This is reflected in the rate of increase in the cash held by corporates and close corporations. The rate of increase of these bank deposits in the last few years has been in excess of inflation, reflecting the accumulation of cash. The most recent figure (Jan 2015) from the South African Reserve Banks shows that the balance sheets of private businesses currently reflect a cumulative cash balance of R653.1 billion or 17.2 per cent of GDP.

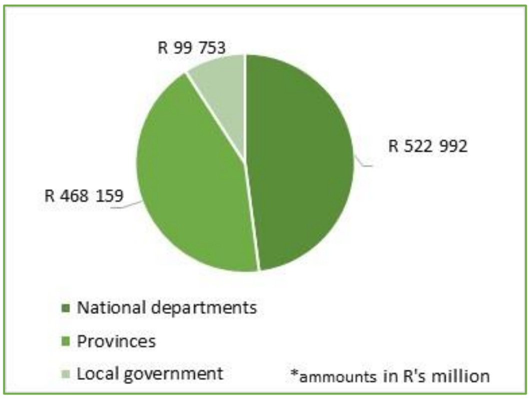
A contraction in investment by the private sector is a problem for several reasons. Firstly, government’s infrastructure build programme may require additional public-private partnerships. Secondly, it appears that public sector employment creation is slowing, requiring the private sector to create more employment. Finally, an increase in private sector investment is assumed in National Treasury’s growth and revenue estimates.

Despite a range of incentives targeted at business, private sector investment has not recovered to pre-2008 levels. If impediments to private sector investment are not addressed, economic growth and revenue growth are likely to underperform. Furthermore, unemployment is likely to rise due to slower growth in government employment. Given the constraints to growth, it is difficult to determine the basis for National Treasury’s assumption of an increase in private sector investment over the medium-term.

Division of revenue

In 2015/16, after providing for debt-service costs and the contingency reserve, 47.9 per cent of nationally raised funds are allocated to national government, 43.1 per cent to provincial government and 9.1 per cent to local government. In this division, the national share includes all conditional grants to the other two spheres of government, while the provincial and local government allocations reflect their equitable shares only.

Figure 10: Division of nationally raised funds in 2015/16



Source: National Treasury

The reduction in non-interest expenditure over the 2015 MTEF, including a R10 billion reduction for 2015/16, necessitated revised allocations to the three spheres of government. The result of the fiscal adjustments and other changes since the 2014 Budget, such as function shifts between the spheres of government and the consolidation of grants, are shown in Table 2.

Table 2: Changes between the 2014 and 2015 Budget to the division of revenue

R million	2014/15 Revised estimate	2015/16 Original budget	2015/16 Estimated budget	% change from original budget
Division of available funds				
National departments	**491 368**	**522 257**	**522 992**	**0.14%**
Provinces	**439 661**	**477 639**	**468 159**	**-1.98%**
Equitable share	359 922	387 967	382 673	**-1.36%**
Conditional grants	79 739	89 672	85 485	**-4.67%**
Local government	**89 076**	**100 047**	**99 753**	**-0.29%**
Equitable share	43 290	50 208	50 208	**0.00%**
Conditional grants	35 595	39 181	38 887	**-0.75%**
General fuel levy sharing with metropolitan municipalities	10 190	10 659	10 659	**0.00%**
Non-interest allocations	**1 020 105**	**1 099 943**	**1 090 904**	**-0.82%**
Percentage increase	*7.8%*	*7.8%*	*6.9%*	

Source: National Treasury

Allocations to provinces decrease by 1.98 per cent. To accommodate the slower growth in estimated expenditure, provinces will have to find efficiencies and cost savings in goods and services, personnel costs, and allocations to provincial entities. To protect the funding for free and subsidised basic services to poor households, the equitable share to local government remained unchanged. The 0.75 per cent reduction in the local government conditional grant allocation is mainly as a result of the revisions to slow spending and non-infrastructure grants.

Conclusion

The 2015 Budget was presented in a challenging context of slow growth and rising debt. Growth has not recovered to its pre-financial crisis levels despite support from increased government spending. This has resulted in a widening budget deficit and increasing debt. In the 2014 MTBPS National Treasury noted "fiscal consolidation could no longer be postponed", and proposed R27 billion increase in revenue and R25 billion reduction in non-interest expenditure over 2 years as part of its "fiscal package".

The 2015 Budget presents the details of the fiscal package. National Treasury indicated that the country's deficit is structural – even if growth were to increase the country would still experience a budget deficit. For this reason expenditure is reduced and revenue increased. Based on these proposals, National Treasury expects the budget deficit to improve from 3.9 per cent in 2014/15 to 2.5 per cent in 2017/18.

Net loan debt is expected to reach 43.8 per cent of GDP by 2017/18, while net liabilities will grow to a maximum of 58.1 per cent. Although National Treasury does not indicate a target for debt and net liabilities in the 2015 Budget, these estimates are higher than what it previously stated as prudent.

Revenue proposals including the increases to PIT and the fuel levies, as well increases to the "sin taxes" will reduce disposable income. This is a concern as growth has been consumption-driven in recent years. While VAT remains unchanged, the country's VAT rate is relatively low compared to other countries. Therefore Increasing VAT in the future exists as an option to increase revenue.

This UIF proposal has a significant impact on the incidence and progressivity of the revenue proposals. It reduces the per cent of income paid in income tax and UIF for middle- and lower-income taxpayers even with the increase in marginal income tax rates, but does not entirely offset marginal income tax increases for those earning higher incomes.

Over the 2015 MTEF non-interest expenditure declines by R25 billion. Consolidated expenditure is estimated to grow by an annual average of 7.9 per cent over the 2015 MTEF period (nominal), with real growth slower than previous years. In 2015/16 after providing for debt-service costs and the contingency reserve, 47.9 per cent of nationally raised funds are allocated to national government, 43.1 per cent to provincial government and 9.1 per cent to local government.

National Treasury has identified the public wage bill as risk to the fiscal framework. PBO's scenario analysis shows that additional financing will be required if government employment levels increase, and wage settlements are at levels above "inflation plus one per cent". This would require reducing allocations to other expenditure areas, increasing revenue, borrowing more or a combination of these.

The 2015 budget has proposals that are pro-poor and others that are not. Pro-poor proposals include the increase in the value of social grants, exemption of low income earners from increase in PIT and no change in VAT. Proposals that do not appear to favour the poor include social grants increases that may not reflect prices increases experienced by the poor, and increased burden on the poor from higher fuel and electricity costs.