PART II

FISCAL CHALLENGES

6

Role of Fiscal Policy in Stabilization and Poverty Alleviation

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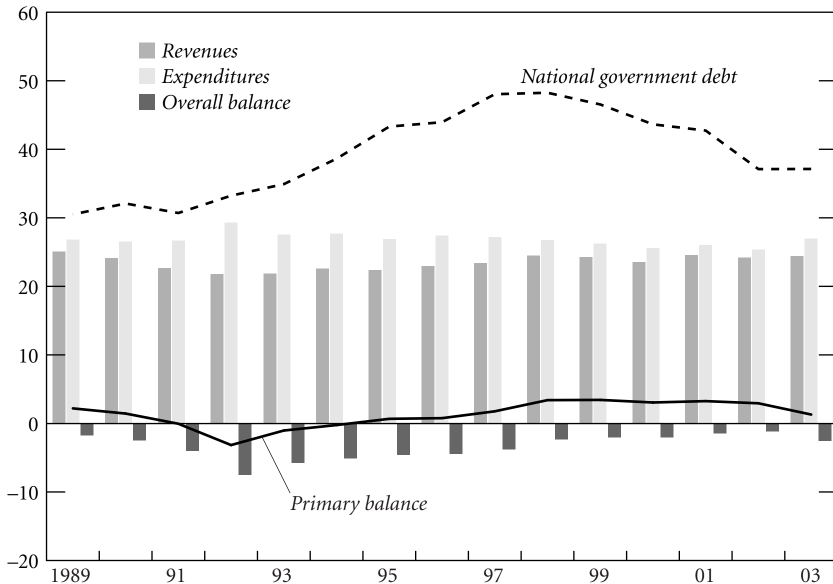
During the post-apartheid period, the South African government has undertaken a significant and sustained fiscal adjustment that has been a major force in helping stabilize the economy and make it more competitive internationally. The headline national-provincial budget deficit was reduced from 7.5 percent of GDP in 1992/93 to 1.1 percent of GDP in 2002/03 (April–March) (Figure 6.1).[1] The deficit subsequently increased in 2003/04 to 2.4 percent of GDP, because of additional social and investment spending. The decade-long adjustment has comprised both spending cuts and revenue gains, particularly from income taxes, and has been supported by a comprehensive reform of tax policy and administration. The primary balance has also improved, leading to a more sustainable debt position. A decline in debt-service payments in recent years has helped free significant resources for increases in social and investment spending (Table 6.1). Finally, fiscal consolidation has contributed to improved economic performance over the past ten years. Output growth was substantially higher, on average, than during the previous decade, while inflation was lower, the external current account position stronger, and foreign exchange reserves higher.

The decade-long fiscal adjustment may be divided into three phases: an initial consolidation during 1993–96 in support of the political transition;

[1]National accounts data were revised in 1999, and periodic payments have been made to defray central bank losses and to strengthen pension fund reserves. For 1992/93, the deficit of 7.5 percent of GDP excludes these payments and reflects the new GDP series; on the old GDP series, the deficit was 8.2 percent of GDP.

Figure 6.1. Fiscal Indicators
(In percent of GDP)



Source: National Treasury.

a period of policy reinforcement in 1997–98, with adoption of the Growth, Employment and Redistribution (GEAR) program and a series of institutional reforms; and a decisive breakthrough during 1999–2003, when the deficit was reduced to well below 3 percent of GDP and the public debt ratio was placed on a declining path. Adjustment during the first two phases focused on building policy credibility; during the last phase, the government targeted a modest stimulus through tax relief and increased social spending. These efforts have continued with the 2004/05 budget and medium-term expenditure framework.

Fiscal Adjustment

The substantial fiscal consolidation and improved economic performance in South Africa over the past decade can be usefully viewed in the context of studies of large fiscal adjustment. These have assessed the influence that the size and composition of adjustment have on sustainability and macroeconomic outcomes. Fiscal adjustment may affect macroeconomic (and social) developments through a variety of channels. According

Table 6.1. Main Budget Indicators
(In percent of GDP)

	1992/93	1998/99	2002/03	2003/04	Change		
					1992/93–1998/99	1998/99–2003/04	1992/93–2003/04
Revenues	21.8	24.5	24.2	24.5	2.7	0.0	2.7
Personal income taxes	8.9	10.3	8.2	8.1	1.4	–2.2	–0.8
Corporate income taxes (including dividends)	3.4	3.0	5.4	5.5	–0.5	2.5	2.0
Indirect taxes	7.7	8.8	8.5	9.0	1.1	0.2	1.3
Other	1.8	2.4	2.1	1.9	0.7	–0.5	0.2
Expenditures	29.3	26.8	25.3	26.9	–2.5	0.1	–2.4
Wage bill	11.1	10.9	9.5	9.9	–0.2	–1.0	–1.3
Transfers and subsidies[1]	8.6	6.4	8.7	9.9	–2.1	3.4	1.3
Capital expenditures[1]	2.0	1.8	1.2	1.3	–0.2	–0.5	–0.8
Interest	4.3	5.7	4.1	3.9	1.3	–1.8	–0.5
Balance	–7.5	–2.3	–1.1	–2.4	5.2	–0.1	5.1
Primary balance	–3.2	3.4	2.9	1.4	6.6	–2.0	4.6
Memorandum items[2]:							
Social security and welfare expenditures	3.0	3.4	3.7	4.2	0.4	0.8	1.2
Crime prevention (police, prisons, courts)	2.7	3.0	2.9	2.9	0.3	0.0	0.3
Health	3.1	3.3	3.0	3.2	0.2	–0.1	0.1
Education	6.0	6.1	5.4	5.7	0.1	–0.4	–0.2
Housing and community development	1.1	1.0	1.1	1.3	–0.1	0.3	0.2
Total social expenditures	15.8	16.8	16.1	17.4	0.9	0.7	1.6
Defense and intelligence	2.6	1.6	1.8	1.8	–1.0	0.2	–0.7
General administration	2.2	1.6	1.7	1.9	–0.6	0.3	–0.3
Economic services	4.3	2.5	3.3	3.7	–1.8	1.1	–0.6

Sources: National Treasury and IMF staff estimates.

[1]Beginning with the 2004 budget, transfers formerly considered part of capital expenditures were reclassified as transfers. A full data series is not available. These transfers amounted to approximately 0.9 percent of GDP in 2002/03.

[2]Nonfinancial public sector (including extrabudgetary funds).

to Keynesian theory, a reduction of the deficit will reduce aggregate demand and growth, depending on the size of fiscal multipliers and the extent of crowding out.[2]

Consolidation may, however, have a number of positive effects that could outweigh the negative impact of lower government spending or higher taxes, particularly over the medium term. Fiscal adjustment may, for example, contribute directly to higher national savings and to lower real interest rates. This may, in turn, foster increased private demand for consumer durables and investment goods. In cases of particularly large adjustment or adjustment taken under conditions of depressed confidence and high risk premiums, there may be favorable wealth and credibility effects, if the consolidation contributes to expectations of a lower future tax burden, a more sustainable external position, or reduced risk of default or inflation.[3] The result may be lower interest spreads, or a lesser degree of policy uncertainty and lower precautionary savings.

Fiscal adjustment may have other positive effects. Consolidation may help reduce inflationary pressures and, together with lower interest rates, help maintain a competitive real exchange rate. Competitiveness gains may also be fostered by cuts in the public sector wage bill and in transfers, if these ease pressures on private sector wages. The debt stock and debt-service burden may also be reduced, freeing resources for social programs or capital expenditures. Finally, adjustment may create an impetus to eliminate unproductive expenditures, better target other spending, and streamline the tax system by removing distortions and reducing rates.

Interest in the prospect of an "expansionary fiscal adjustment" was heightened by favorable experiences in Denmark and Ireland in the 1980s. Giavazzi and Pagano (1990) reviewed these cases and concluded that they were sufficiently large and persistent to alter expectations about future taxation and contribute to a pickup of consumption, investment and growth. Favorable conditions faded in Denmark, but in Ireland accelerated growth proved durable. Alesina and Perotti (1996) traced these different outcomes to policy choices, suggesting that increases in direct taxes and public sector wages in Denmark led to demands for higher pay in the private sector and, eventually, recession. In Ireland, personal income taxes were lowered, transfers cut, and civil service wages and employment reduced, so that wage pressures were muted while investment and output grew sharply.

[2]For a full review of the literature, see Hemming, Kell, and Mahfouz (2002).

[3]See Perotti (1999) and Giavazzi, Jappelli, and Pagano (2000).

Expenditure-based consolidation has been consistently found to have more favorable macroeconomic effects and to be more durable than revenue-based adjustments. The composition of spending cuts has also been found to be important.[4] Cuts in the wage bill and in transfer payments address budget categories viewed as politically sensitive and enhance the credibility of adjustment efforts. By contrast, cuts in investment or nonwage goods and services may have a direct, negative impact on growth and carry little credibility, if they are perceived as merely postponing needed outlays. Fiscal adjustment in South Africa initially targeted cuts in sectoral subsidies, and subsequently, a reduction of the wage bill.

Revenue-based adjustments have been found to be associated with less-favorable macroeconomic outcomes, particularly in industrial countries, and the risk of reversal is higher. In particular, increased taxes on labor income may lead to wage demands, weaker competitiveness, or higher unemployment. Alesina and Ardagna (1998) suggest that adjustment policies that combine wage moderation in the public sector with lower taxes on households may have beneficial effects on both unit labor costs and consumer spending. This formula has been employed in recent years in South Africa (see Table 6.1).

Revenue gains have been found to contribute to greater durability of adjustment in emerging market and low-income countries, although revenue improvements may be constrained initially by narrow tax bases, high tax rates, volatile revenue sources, and weak tax administration. Under such conditions, expenditure restraint will be needed at the outset, while comprehensive tax reforms are initiated.[5] Once again, this approach was taken in South Africa during the initial post-apartheid period. The government appointed an independent commission in 1994 to recommend a sweeping modernization of tax policy and administration, and reforms were progressively introduced in subsequent years. In the interim, cuts were made in subsidies and transfers, administrative outlays, and defense spending (see Table 6.1).

Finally, improved policy transparency has been found to boost confidence and contribute to positive outcomes.[6] Fragmented budgetary institutions, as reflected in an excessive number of ministries and agencies or in ambiguous and unstable relations with subnational authorities, have been

[4]See, for example, Alesina and Ardagna (1998); McDermott and Wescott (1996); von Hagen, Hallet, and Strauch (2001); and Gupta and others (2002).

[5]See, for example, Goldsbrough and others (1996); Mackenzie, Orsmond, and Gerson (1997); Abed and others (1998); and Hemming, Kell, and Schimmelpfennig (2003).

[6]See Hemming, Kell, and Schimmelpfennig (2003).

associated with spending pressures and larger deficits. Institutional reforms may, therefore, provide important support to fiscal consolidation. Key measures include improved expenditure planning and management, including through multiyear budgeting, and more predictable and transparent intergovernmental fiscal relations.[7] Institutional improvements in these areas have been at the heart of structural fiscal reforms in South Africa over the past decade.

Consolidation and Institution-Building in South Africa During 1993–2003

Context for Adjustment

With the impending political transition and concerns with the future course of policies, the budget deficit in South Africa widened from 2.4 percent of GDP in 1990 to 7.5 percent in 1992. Spending increased by 2½ percentage points of GDP, while revenues declined, due partly to recession and drought. A multiparty Transitional Executive Council (TEC) was formed to guide policies in the run-up to elections in April 1994.

A consensus emerged on the need to initiate fiscal adjustment in order to restore confidence and provide policy guidance through the transition. A credit arrangement was agreed with the IMF in December 1993 to help mitigate the adverse effects of lower mining exports and a surge of grain imports. The IMF arrangement, which was signed by the incumbent Finance Minister and the co-chairmen of the TEC, called for a reduction in the deficit of 2 percentage points of GDP over two years. Measures included an increase of the value-added tax (VAT) rate from 10 percent to 14 percent, postponement of bracket adjustments under the personal income tax (PIT), wage restraint, and cuts in defense spending. In January 1994, the African National Congress (ANC) launched the Reconstruction and Development Program (RDP), an ambitious, multisector reform initiative that warned of risks of higher inflation, balance of payments pressures, and slow growth in the absence of further fiscal adjustment. The RDP stressed tax simplification, reorientation rather than increases in spending, greater budget transparency, and the development of a five-year fiscal framework.

[7]See von Hagen, Hallet, and Strauch (2001).

Initial Phase of Adjustment: 1993–96

Following the ANC's landslide victory and the formation of a government of national unity, the authorities moved quickly to provide greater policy certainty by announcing a further reduction in the fiscal deficit by 2½ percent of GDP over five years. Revenues were to be kept constant as a share of GDP, capital spending increased by 1 percentage point, and noninterest expenditures cut, with a focus on rationalizing the complex, apartheid-era administrative system and reducing transfers and subsidies. Privatization receipts would be directed to reducing public debt, with interest savings to support additional social spending.

To provide a road map for revenue neutral tax policy and administration reforms, an independent commission chaired by Professor Michael Katz was appointed in June 1994. The first of nine commission reports, issued in November 1994, set out a broad strategy of rationalizing income tax brackets and exemptions, maintaining a single, nonzero VAT rate and strictly limiting zero-rated goods, and strengthening tax administration through autonomy in budgeting and wage setting and improved assessment and audit procedures. The commission recommended that poverty alleviation be targeted through spending measures rather than through tax breaks.

With this fiscal policy framework in place, the government announced and met its deficit targets during the initial post-apartheid adjustment phase, thus helping establish credibility. Expenditure cuts focused on subsidies and capital spending in agriculture, transport, communications, and energy. The wage bill was reduced by 2½ percentage points of GDP during 1994/95–1995/96, prior to introduction of a civil service reform program in 1996/97. With the elimination of exemptions, the corporate income tax rate was cut to 35 percent in 1995, and the dividend tax halved. The tax and customs administrations were unified in a new, independent South African Revenue Services (SARS). Capacity constraints, however, led to a buildup of unspent funds under the RDP, while weaknesses in provincial expenditure management contributed to overspending.

In spite of these initial gains, the policy environment remained fragile. Developments in 1996 were characterized by changes in investor sentiment and pressures on the rand, ostensibly triggered by rumors about the health of President Mandela in February and by the departure of the National Party from the national unity government in May. Although the approach of setting and achieving feasible adjustment targets had signaled moderation and gained credibility, there were growing concerns that the reform process was moving too slowly.

Further Fiscal Adjustment Under GEAR: 1997–98

The Growth, Employment and Redistribution (GEAR) strategy was launched in June 1996 to strengthen the adjustment and accelerate structural reforms. GEAR emphasized promotion of growth and job creation through labor market and trade reforms and privatization. Under GEAR, the fiscal deficit was to be cut by a further 1½ percent of GDP to 3.0 percent by 2000/01. Revenues would be kept below 25 percent of GDP, with continuing tax policy and administration improvements. GEAR aimed to cut the wage bill by 3 percentage points of GDP and reorient spending to health, education, welfare, and land reform. A formal medium-term expenditure framework would guide budget planning and execution.

The first budget under GEAR, for 1997/98, advanced the expenditure-based fiscal adjustment, broadened the tax base, and put in place improved provisions for expenditure management. Spending cuts targeted the wage bill, goods and services, transfers, and capital investment. Taxation of fringe benefits was introduced, as were fees on state guarantees. A formula for revenue sharing with the provinces was instituted. Public accounts were consolidated at the Treasury, and improved cash control and accounting standards were introduced. However, substantial provincial overruns reoccurred, and provincial borrowing was suspended.

A decisive breakthrough came in 1998/99. The national government moved with determination to address lingering wage pressures and provincial and municipal expenditure management weaknesses. The government unilaterally limited civil service wage increases to below contractual provisions and sent teams to work in provincial and municipal finance departments. Provincial fiscal balances improved by 1½ percentage points of GDP to record a surplus. With administrative improvements taking hold at SARS, revenues increased by 1 percentage point of GDP.[8] The deficit was cut to 2.3 percent of GDP, compared with a target of 3.5 percent. Building on this good performance, a medium-term expenditure framework was instituted in 1998/99.

Consolidating the Gains: 1999–2003

With improved capacity for expenditure management and tax administration, successful fiscal consolidation continued during 1999–2003, and

[8]Key measures included a focus on large taxpayers, better oversight and accountability, improved taxpayer service, strengthened information gathering and cross-checking, stepped up business inspections by dedicated sector teams, and reduction of the number of customs entry points.

the deficit was lowered further to 1.1 percent of GDP in 2002/03. Reflecting lower interest rates, improved debt management, and a declining debt stock, interest payments were sharply reduced, and part of the savings was channeled to capital spending and social transfers. Civil service employment, which had remained steady since 1994 as the provincial and municipal administrations were being restructured, was reduced by 13 percent, or nearly 200,000 positions, from 1998 to 2002. The wage bill was cut by over 1 percent of GDP.

Fiscal policy continued to target a tax burden of less than 25 percent of GDP through steps to lower tax rates and broaden bases. The corporate income tax rate was cut from 35 percent to 30 percent (and a lower rate was introduced for small businesses), a capital gains tax was introduced, and the personal income tax was switched to a worldwide income basis. Sizable personal income tax relief was provided through reduction of tax rates and adjustment of brackets and thresholds. Further improvements in expenditure management came with implementation of the Public Finance Management Act (1999), which provided for more timely financial information, improved internal control, and introduction of independent audit. An annual expenditure survey was initiated to develop performance indicators for strategic planning.

Additional resources were directed to social needs and capital investment in 2003/04, and the deficit increased from 1.1 percent to 2.4 percent of GDP. A further easing was planned in 2004/05 to 3.1 percent of GDP. Major expenditure initiatives include the public provision of anti-retroviral HIV/AIDS drugs, a further extension of targeted child support grants, and additional outlays on the Black Economic Empowerment program, land reform, policing, and provision of free basic utilities to poor households. The further fiscal easing was expected to lead to a modest increase in the public debt ratio, which has been on the decline since 1998. The revised fiscal stance was well received by financial markets and the business community, reflecting the widely accepted need to step up efforts to address South Africa's critical social problems and the strength and credibility of the country's fiscal policy institutions.

Assessing Fiscal Adjustment in South Africa

Cyclically Adjusted Estimates

The estimation of trend output growth, described in Chapter 2, provides a basis for distinguishing how much of the fiscal adjustment evident over the past ten years reflected business cycle and growth developments as opposed

Box 6.1. Fiscal Indicators

The *fiscal stance* provides an indication of how the fiscal position in any year relates to that of a base year, when the economy was considered to be operating at its potential level. Deviations from the base year position provide an indication of the extent of cyclical developments as opposed to discretionary fiscal policies. The *fiscal impulse* is calculated as the annual change in the fiscal stance and gives a sense of whether policies are expansionary or contractionary (see Heller, Hass, and Mansur (1986) and Chand (1993) for further discussion). "Neutral" revenues and noninterest expenditures were calculated as the annual amounts needed to maintain revenues and expenditures at their 1998 base year levels, relative to trend GDP. Neutral revenues were estimated by assuming that revenues grow at the same rate as actual GDP, while neutral noninterest expenditures were assumed to grow at the same rate as trend output. The fiscal stance is the difference between the neutral primary balance and the actual primary balance. When the actual primary balance in a given year is greater than the neutral primary balance, the fiscal stance is negative, indicating a discretionary tightening. A tightening (or loosening) of policies may be ascribed to revenue or expenditure measures by comparing actual revenues and expenditures with the neutral figures.

An alternative approach to distinguishing cyclical from discretionary fiscal developments is through estimation of the *structural balance*. The structural balance provides an indication of where the fiscal position would be in a given year, if the economy had been operating at trend output, and does not depend on the designation of a base year. Revenues and expenditures are assumed to have a structural component, reflecting economic performance at trend levels, and a cyclical component, reflecting the actual position relative to trend (see Chalk (2002), for more details). For the calculations presented here, two simplifying assumptions were made. First, as the size of government in South Africa is relatively small, and income-related expenditures, such as unemployment benefits are limited, the structural balance estimates assume that expenditures are largely independent of cyclical developments. Expenditures on unemployment insurance have amounted to approximately 0.3 percent of GDP a year in recent years, and the unemployment insurance fund has consistently run a surplus, in spite of variations of trend output and employment. Social transfers have increased in recent years, but serve as a long-term intervention, rather than as a form of short-term income support. Second, all revenues are assumed to have the same cyclical component and elasticity with respect to output. Three sets of structural balance indicators were calculated, based on revenue elasticities of 1.0, 1.35, and 1.7.

to discretionary policy changes. As described in Box 6.1 and Table 6.3, trend output is used to calculate fiscal stance and fiscal impulse indicators, based on a year when the South African economy was operating near its potential.

A plausible base year, arguably, is 1998, as real GDP was close to its estimated trend level in that year, while inflation was moderate and capacity utilization near its long-run average. Moreover, by 1998, a number of key structural fiscal reforms had been implemented, most notably the establishment of SARS and the strengthening of provincial expenditure management.

The fiscal stance and fiscal impulse indicators confirm that a progressive, discretionary tightening in policy occurred during 1992/93–1999/2000 (Table 6.2).[9] The fiscal stance was strongly positive in 1992/93, but was progressively reduced through 1999/00. The fiscal impulse, which is the change in the fiscal stance, was strongly negative in 1993/94, reflecting expenditure cuts and again in 1998/99, reflecting a balance of revenue gains and spending cuts. As noted earlier, improvements in the operations of SARS and a decisive strengthening of provincial expenditure management were key policy initiatives undertaken that year.

The results also confirm that there was a discretionary increase in expenditures in 2001/02–2003/04, as the government stepped up social and investment spending. A sizable increase of revenues, mainly from the mining sector, limited the fiscal impulse from this additional spending in 2001/02 (Figure 6.2). A comparison of the fiscal impulse and the output gap—the difference between actual and potential output—indicates that policies have become more calibrated to cyclical developments since 1999/2000 (Figure 6.3). In the initial years of the post-apartheid period, both the fiscal impulse and output gap were negative, indicating pro-cyclical fiscal contraction. Estimates of the structural balance confirm the pattern of discretionary tightening in 1992/93–1999/2000 and the increasingly pronounced loosening in recent years (Figure 6.4). A comparison of the estimated extent of discretionary fiscal policy changes with the output gap indicates that fiscal policy aimed mainly at consolidation, rather than aggregate demand management, over most of the decade (Figure 6.5).[10] During 2000–03, however, fiscal policy provided a stimulus in three out of four years.

Deviations from Budget Targets

A further consideration for assessing the effectiveness of fiscal policy is the extent to which budgetary outcomes differ from intended objectives. In the initial post-apartheid period, successive annual budgets targeted deficit

[9]A possible exception was 1996/97, when actual growth was well above trend, and expenditures provided a boost.

[10]The observations in the lower left quadrant of Figure 6.5 indicate discretionary fiscal tightening in the presence of below-trend economic performance.

Table 6.2. Fiscal Stance and Impulse Measures
(In percent of GDP, unless otherwise specified)

	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
I. Macroeconomic inputs												
Nominal GDP (in billions of rand)	381	443	497	564	636	700	753	820	915	1,012	1,150	1,223
Real GDP growth (percent change)	–2.3	2.5	3.5	2.7	4.7	1.9	0.7	2.6	3.5	2.6	3.7	1.4
Output gap (in percent of potential output)	–3.5	–3.4	–1.6	–0.1	2.0	2.2	0.0	–0.9	–0.3	–0.5	0.1	–0.9
Potential/actual GDP	1.04	1.04	1.02	1.00	0.98	0.98	1.00	1.01	1.00	1.00	1.00	1.01
II. Fiscal inputs												
Revenues	21.8	21.9	22.6	22.3	23.0	23.4	24.5	24.2	23.6	24.5	24.2	24.5
Expenditures	29.3	27.6	27.7	26.9	27.4	27.1	26.8	26.2	25.6	26.0	25.3	26.9
Noninterest	25.0	22.9	22.8	21.7	22.2	21.6	21.1	20.8	20.5	21.3	21.3	23.0
Interest	4.3	4.7	4.9	5.2	5.2	5.5	5.7	5.4	5.1	4.7	4.1	3.9
Balance	–7.5	–5.7	–5.1	–4.5	–4.4	–3.8	–2.3	–2.0	–2.0	–1.4	–1.1	–2.4
Primary balance	–3.2	–1.0	–0.2	0.7	0.8	1.8	3.4	3.4	3.1	3.3	2.9	1.4
Change in primary balance		2.1	0.8	0.9	0.1	1.0	1.6	0.0	–0.4	0.2	–0.3	–1.5
III. Neutral primary balance, fiscal stance, and fiscal impulse												
Neutral revenue	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
Neutral noninterest expenditure	21.8	21.8	21.4	21.1	20.7	20.6	21.1	21.3	21.1	21.2	21.1	21.4
Neutral primary balance	2.6	2.7	3.0	3.4	3.8	3.9	3.4	3.2	3.3	3.3	3.4	3.1
Fiscal stance	5.8	3.7	3.3	2.7	3.1	2.1	0.0	–0.2	0.3	0.0	0.5	1.6
Revenue stance	2.7	2.6	1.9	2.2	1.5	1.1	0.0	0.3	0.9	0.0	0.3	0.0
Noninterest expenditure stance	3.1	1.0	1.4	0.5	1.5	1.0	0.0	–0.5	–0.7	0.1	0.2	1.6
Fiscal impulse		–2.1	–0.4	–0.6	0.4	–1.0	–2.1	–0.2	0.5	–0.2	0.4	1.1
Revenue related		0.0	–0.7	0.2	–0.6	–0.4	–1.1	0.3	0.7	–1.0	0.3	–0.3
Expenditure related		–2.1	0.3	–0.8	1.0	–0.6	–1.0	–0.5	–0.2	0.7	0.1	1.4

Sources: National Treasury and IMF staff estimates.

Table 6.3. Structural Balances and Discretionary Fiscal Policy
(In percent of GDP, unless otherwise specified)

	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
I. Macroeconomic inputs												
Nominal GDP (in billions of rand)	381	443	497	564	636	700	753	820	915	1,012	1,150	1,223
Real GDP (percent change)	–2.3	2.5	3.5	2.7	4.7	1.9	0.7	2.6	3.5	2.6	3.7	1.4
Output gap (in percent of potential output)	–3.5	–3.4	–1.6	–0.1	2.0	2.2	0.0	–0.9	–0.3	–0.5	0.1	–0.9
Potential/actual GDP	1.04	1.04	1.02	1.00	0.98	0.98	1.00	1.01	1.00	1.00	1.00	1.01
II. Fiscal inputs (actual data)												
Revenues	21.8	21.9	22.6	22.3	23.0	23.4	24.5	24.2	23.6	24.5	24.2	24.5
Expenditures	29.3	27.6	27.7	26.9	27.4	27.1	26.8	26.2	25.6	26.0	25.3	26.9
Noninterest	25.0	22.9	22.8	21.7	22.2	21.6	21.1	20.8	20.5	21.3	21.3	23.0
Interest	4.3	4.7	4.9	5.2	5.2	5.5	5.7	5.4	5.1	4.7	4.1	3.9
Balance	–7.5	–5.7	–5.1	–4.5	–4.4	–3.8	–2.3	–2.0	–2.0	–1.4	–1.1	–2.4
Primary balance	–3.2	–1.0	–0.2	0.7	0.8	1.8	3.4	3.4	3.1	3.3	2.9	1.4
Change in primary balance		2.1	0.8	0.9	0.1	1.0	1.6	0.0	–0.4	0.2	–0.3	–1.5
III. Structural balances												
A. Elasticity = 1												
Estimated revenues	22.6	22.6	22.9	22.4	22.5	22.9	24.5	24.4	23.6	24.6	24.2	24.7
Noninterest expenditures	25.0	22.9	22.8	21.7	22.2	21.6	21.1	20.8	20.5	21.3	21.3	23.0
Primary balance	–2.4	–0.3	0.1	0.7	0.3	1.3	3.4	3.6	3.1	3.4	2.9	1.7
B. Elasticity = 1.35												
Estimated revenues	22.9	22.9	23.1	22.4	22.4	22.7	24.5	24.5	23.6	24.7	24.2	24.8
Noninterest expenditures	25.0	22.9	22.8	21.7	22.2	21.6	21.1	20.8	20.5	21.3	21.3	23.0
Primary balance	–2.1	0.0	0.3	0.7	0.2	1.1	3.4	3.7	3.1	3.4	2.9	1.7
C. Elasticity = 1.7												
Estimated revenues	23.2	23.2	23.2	22.4	22.2	22.5	24.5	24.6	23.7	24.7	24.2	24.9
Noninterest expenditures	25.0	22.9	22.8	21.7	22.2	21.6	21.1	20.8	20.5	21.3	21.3	23.0
Primary balance	–1.8	0.3	0.4	0.7	0.0	0.9	3.4	3.8	3.2	3.5	2.9	1.8

Table 6.3 (concluded)

	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
IV. Automatic stabilizers and discretionary fiscal policy												
Change in primary balance (actual)		2.1	0.8	0.9	0.1	1.0	1.6	0.0	–0.4	0.2	–0.3	–1.5
Automatic revenue stabilizers[1, 2]												
Elasticity = 1		–0.8	–0.4	0.0	0.5	0.5	0.0	–0.2	–0.1	–0.1	0.0	–0.2
Elasticity = 1.35		–1.1	–0.5	0.0	0.6	0.7	0.0	–0.3	–0.1	–0.2	0.0	–0.3
Elasticity = 1.7		–1.3	–0.6	–0.1	0.8	0.8	0.0	–0.4	–0.1	–0.2	0.1	–0.4
Discretionary fiscal policy[1, 3]												
Elasticity = 1		2.9	1.2	0.9	–0.4	0.5	1.6	0.2	–0.3	0.3	–0.3	–1.3
Elasticity = 1.35		3.2	1.3	1.0	–0.5	0.3	1.6	0.3	–0.3	0.4	–0.4	–1.2
Elasticity = 1.7		3.5	1.4	1.0	–0.7	0.1	1.6	0.4	–0.3	0.4	–0.4	–1.1

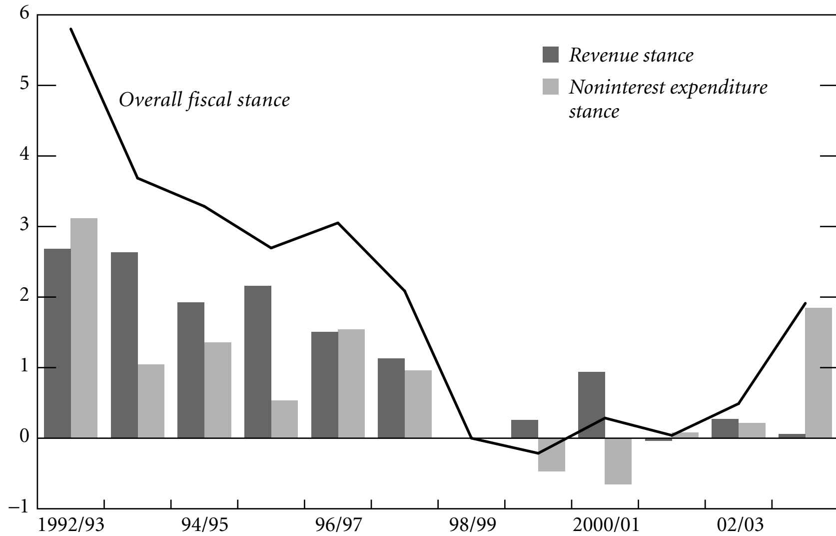
Sources: National Treasury and IMF staff estimates.

[1]Negative indicates loosening, positive indicates tightening.

[2]Calculated as actual revenues (Section II) less estimated revenues (Section III).

[3]Calculated as the change in the primary balance less the estimated impact of the automatic revenue stabilizer.

Figure 6.2. Fiscal Stance[1]
(In percent of GDP)



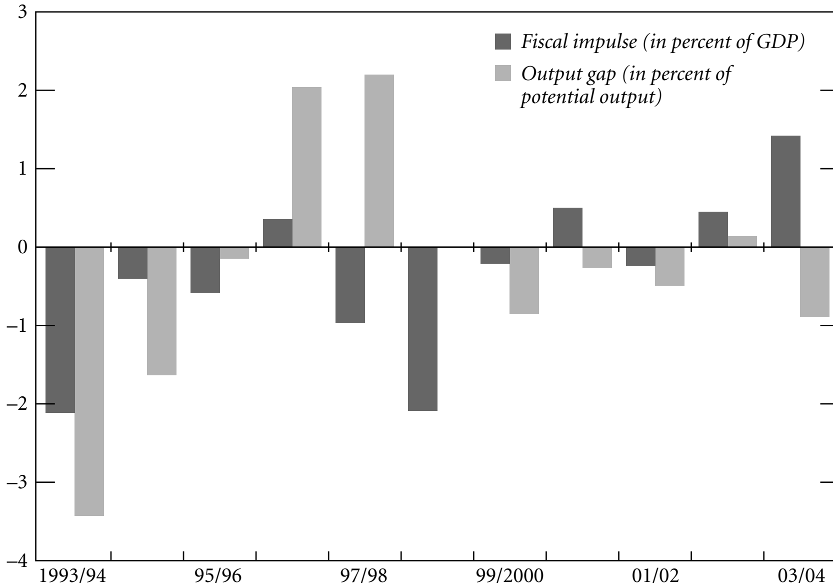
Source: IMF staff estimates.
[1]Positive/negative stance indicates discretionary loosening/tightening.

reduction, and these objectives were largely met, although there was a period of underspending at the provincial level, followed by subsequent overspending by some provincial administrations. During 1999/2000–2002/03, however, successive annual budgets targeted an easing of 0.5 percent to 1.0 percent of GDP, but outturns deviated significantly from plans (Table 6.4). In each year, the primary balance was consistently stronger than projected, by between 0.5 percent and 1 percent of GDP.[11]

The deviations appear to have reflected consistently higher-than-projected nominal GDP. Output growth was generally overstated in the budget, while inflation was underestimated. When inflation exceeded expectations, nominal expenditures were not fully adjusted in midyear revisions, likely reflecting concerns with absorptive capacity. Gains from improved tax administration also proved difficult to forecast, as SARS strengthened coverage and compliance in key sectors, particularly mining and financial services. Corporate tax revenues increased significantly in 1999–2002, outstripping budget projections.

[11]For the period as a whole, the primary surplus was reduced by 0.4 percent of GDP.

Figure 6.3. Output Gap and Fiscal Impulse



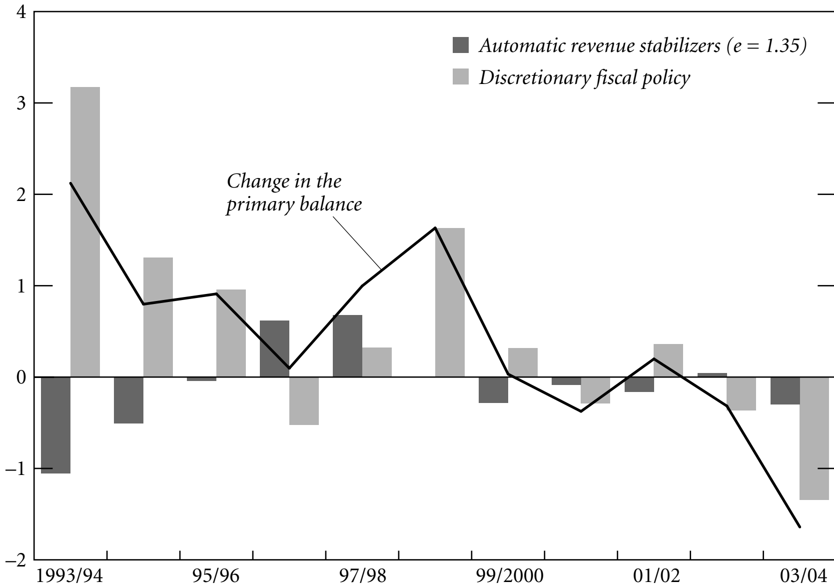
Source: IMF staff estimates.

Macroeconomic Performance

The post-apartheid fiscal consolidation was associated with improved macroeconomic performance in South Africa. As discussed in Chapter 2, growth performance strengthened substantially over the decade, with the average annual growth rate rising from 0.6 percent during 1985–93 to 2.8 percent during 1994–2003. Higher growth rates reflected gains in total factor productivity, owing in turn to greater trade openness and private sector participation. These improvements were supported by fiscal policy, which emphasized a competitive and efficient tax burden, tight control over the wage bill, the elimination of subsidies and transfers to industry, well-targeted infrastructure investments, and privatization.[12] As described in

[12]The National Treasury's *Budget Review 2003* has estimated fiscal multipliers, in order to measure the impact of policy changes on output. Increased civil service employment was found to have a positive multiplier of 1.2 in the short run, but a negative impact in the long run (–0.02). Increases in civil service wages have a short term multiplier of 0.4, but a long term multiplier of –0.15. For public investment, a multiplier of 0.9 was estimated for the short term, while capital spending was found to have a very strong impact in the long term, with a multiplier of 1.6.

Figure 6.4. Sources of Change in the Primary Balance[1]
(In percent of GDP)



Source: IMF staff estimates.
[1]Positive implies tightening, negative implies loosening.

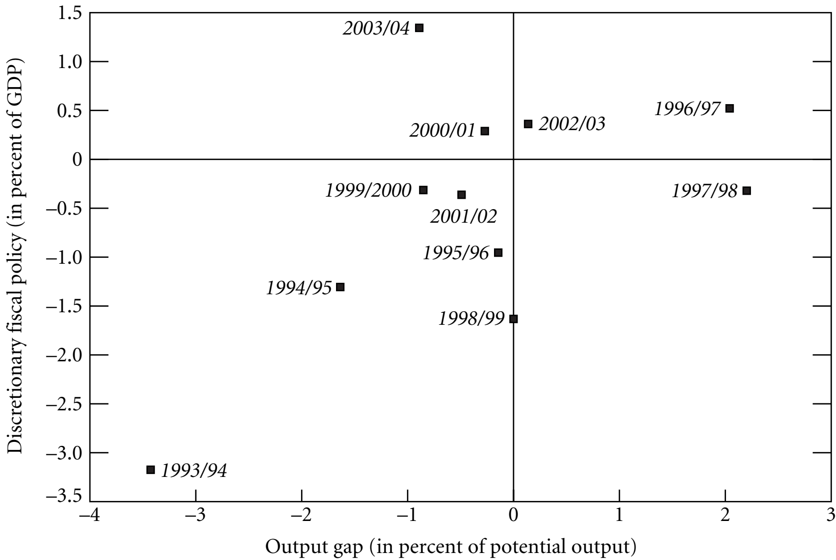
Chapter 13, fiscal adjustment also contributed to a decline in interest spreads.

Fiscal consolidation appears to have also been associated with lower inflation in South Africa over the past decade, although as discussed in Chapter 12, no stable, long-run relationship between the fiscal balance and inflation (or money growth) has been observed. As discussed in Chapter 9, however, a correlation of the fiscal balance and the real effective exchange rate (REER) has been established, with the REER depreciating by 2 percent for each improvement of the fiscal balance by 1 percentage point of GDP, probably through the subsequent reduction in the price of nontradables. Finally, the strengthening of the fiscal balance appears to have prevented a more pronounced decline in national savings over the decade (Chapter 3).

Fiscal Policy and Social Indicators

The post-apartheid government inherited a legacy of bias and fragmentation in the provision of health, education, and infrastructure services and deep inequality in wealth and income among population groups. Over the

Figure 6.5. Output Gap and Discretionary Fiscal Policy, 1993/94–2003/04[1]



Source: IMF staff estimates.

[1]Negative discretionary policy indicator implies tightening, positive implies loosening. Negative gap implies GDP growth below trend.

past decade, deficit reduction has been accompanied by a reorientation of spending from defense, administration, and industry subsidies toward poverty reduction and other social priorities, including crime prevention (see Table 6.1). A key initiative was the introduction of means-tested child support grants in 1998, and more recently, the extension of eligibility for the grants to older children. As of 2003, 2.5 million children were receiving the grants, compared with 400,000 who received the previous state maintenance grant.[13] Expenditures in such areas as health and education have also increasingly targeted nonwage inputs, including textbooks, laboratory materials, and maintenance, in order to improve the overall quality of spending. In response to a sizable outflow of skilled medical personnel, particularly from rural areas, the government has introduced special allowances for skilled staff, while continuing efforts to limit the overall

[13]Two million elderly South Africans received targeted old age grants in 2003, 300,000 more than in 1998, and 900,000 people received disability grants, 35 percent more than in 1998.

Table 6.4. Budget and Outturn
(In percent of GDP, unless otherwise specified)

	1998/99		1999/2000		2000/01		2001/02		2002/03		2003/04	
	Budget	Outturn	Budget	Outturn	Budget	Outturn	Budget	Outturn	Budget	Outturn	Budget	Outturn
National budget revenue	22.9	24.5	23.6	24.2	23.8	23.6	23.6	24.6	24.5	24.2	24.7	24.5
Corporate income tax (including secondary tax on corporations)	3.1	3.0	2.9	2.9	3.0	3.7	3.5	4.9	5.3	5.4	6.0	5.5
Personal income tax	9.3	10.3	10.2	10.5	9.9	9.4	9.1	8.9	8.3	8.2	7.8	8.1
Indirect taxes	8.7	8.8	8.7	8.8	9.0	8.6	8.8	8.6	8.6	8.5	8.9	9.0
Of which: value-added tax	5.6	5.8	5.8	5.9	6.0	5.9	6.1	6.0	6.1	6.1	6.6	6.6
Expenditure	26.0	26.8	26.7	26.2	26.4	25.6	26.2	26.0	26.6	25.4	27.1	26.9
Of which:												
Interest	5.5	5.7	6.0	5.4	5.3	5.1	4.9	4.7	4.4	4.1	4.1	3.9
Wages and salaries	10.8	10.9	10.6	10.5	11.0	10.0	10.0	10.0	9.9	9.5	9.9	9.9
Other goods and services	3.1	3.3	3.1	3.3	2.7	3.5	3.7	3.4	3.6	3.5	3.6	3.6
Capital expenditures[1]	1.9	1.8	1.7	1.5	1.8	1.4	1.9	2.1	2.1	1.2	1.3	1.3
Balance	–3.1	–2.3	–3.1	–2.0	–2.6	–2.0	–2.5	–1.4	–2.1	–1.1	–2.4	–2.4
Primary balance	2.4	3.4	2.9	3.4	2.6	3.1	2.4	3.3	2.3	2.9	1.7	1.4
Change in primary balance												
Intended	0.7		–0.5		–0.8		–0.7		–1.0		–1.2	
Actual		1.6		0.0		–0.4		0.2		–0.3		–1.5
Deviation		1.0		0.6		0.4		0.9		0.6		–0.3
Revenues		1.5		0.7		–0.2		0.9		–0.3		–0.2
Noninterest expenditures		0.6		0.1		–0.6		0.0		–0.9		0.1
Memorandum items:												
Nominal GDP (in billions of rand)	770	753	813	820	885	915	987	1,011	1,083	1,149	1,235	1,223
Real GDP (percent change)	3.0	0.7	1.8	2.6	3.6	3.5	3.7	2.6	2.7	3.4	3.4	1.6
GDP deflator	6.0	6.8	6.4	6.1	5.5	7.9	6.0	7.8	6.5	10.0	6.6	4.7
CPI inflation	5.5	7.5	5.5	7.4	6.6	7.8	6.2	6.6	6.7	9.8	6.1	5.4
Output gap (in percent of potential output)		0.0		–0.9		–0.3		–0.5		0.1		–0.9

Sources: National Treasury and IMF staff estimates.

[1]Beginning with the 2004 budget, transfers formerly considered part of capital expenditures were reclassified as transfers. A full data series is not available. These transfers amounted to approximately 0.9 percent of GDP in 2002/03.

wage bill.[14] Capital spending has focused on improving the provision of basic utility services to schools and clinics, and 56,000 new classrooms and 700 new clinics were built during 1994–2003.[15] In addition, since the end of apartheid, 1.6 million housing units have been constructed for low-income families, over 3.5 million houses were electrified, and potable water supply and basic sanitation services were provided to 9 million and 6.4 million people, respectively.[16] Still, as much as one-third of the population continues to live in substandard, informal dwellings, due to the large initial backlog, population growth, and migration to urban areas.[17]

The reorientation of spending has contributed to improved social development indicators in a range of areas, particularly relating to access to services and education (Table 6.5). Progress has also been made toward meeting some of the Millennium Development Goals (MDGs) that were agreed by world leaders in September 2000 (Table 6.6). The MDGs, which are intended to be attained by 2015, include (1) eradication of extreme poverty and hunger; (2) achievement of universal primary education; (3) promotion of gender equality and empowerment of women; (4) reduction of child mortality; (5) improvement of maternal health; (6) combating HIV/AIDS, malaria, and other diseases; (7) ensuring environmental sustainability; and (8) development of a global partnership for development.

While progress has been achieved in some areas, HIV/AIDS has severely strained the health system and contributed to a decline in a range of health indicators, notably maternal mortality and life expectancy.[18] The decline in life expectancy has contributed to a decline since 1995 in the Human Development Index (HDI), as calculated by the United Nations Development Program (UNDP). This has occurred in spite of improvements in two other components of the HDI, educational attainment and PPP estimates of GDP per capita. According to United Nations Development Program (2003b), the HDI for the black population has increased since 1995, although it remains significantly lower than the HDI for other population groups. The government has published alternative estimates for life expectancy, which indicate a lower figure at the end of the apartheid era

[14]A similar initiative is directed at skilled staff in criminal justice.

[15]According to South Africa Democratic Teachers Union (2000), 55 percent of schools lacked sanitation facilities in 1996; by 2000, the ratio was 17 percent. Sixty percent of schools lacked telephones in 1996 compared with 36 percent in 2000. The percentage of schools lacking electricity service declined from 58 percent in 1996 to 43 percent in 2000.

[16]See National Treasury's *Budget Review 2004* for more details.

[17]See United Nations Development Program (2003b) for additional discussion.

[18]See Chapter 7 for additional discussion of the impact of HIV/AIDS in South Africa.

Table 6.5. Selected Social Indicators

Indicator	Year		Year	
Access to services				
Households with access to piped water	1996	81.2 percent	2001	84.5 percent
Households with a telephone (or cellular service)	1996	28.8 percent	2001	42.4 percent
Households without sanitation service	1996	12.4 percent	2001	13.6 percent
Households with trash removal (once a week)	1996	52.2 percent	2001	55.4 percent
Households with electricity connections	1996	32 percent	2001	70 percent
Index of access to utility services (housing, water and sanitation, electricity and telephones)	1995	0.46	2002	0.60
Index of access to basic health and education services, environmental quality	1995	0.52	2002	0.67
Index of safety and security (crime, prosecution)	1995	0.53	2002	0.49
Index of economic participation (employment, earnings, poor)	1995	0.63	2002	0.60
Health and education				
Infant mortality (per 1,000 live births)	1990	45	2001	56
Under-five mortality (per 1,000 live births)	1990	60	2001	71
Measles immunization (one-year old)	1990	79 percent	2001	72 percent
HIV/AIDS prevalence (adult population)	1990	0.7 percent	2002	26.5 percent
Life expectancy at birth (years)[1]	1995	65	2001	50.9
Life expectancy at birth (years)[2]	1995	57	2001	55
UNDP human development index	1990	0.734	2001	0.684
Human development index (using South Africa Medical Research Council estimate of life expectancy)	1995	0.63	2000	0.71
Children reaching grade 5	1990	75 percent	1999	65 percent
Youth literacy rate	1990	88.5 percent	2001	91.5 percent
Adult literacy (percent of population age 15 and above)	1990	81.2	2001	85.6
Income and poverty				
Households living below the poverty line	1995	28 percent	1999	33 percent
Gini coefficient, excluding social transfers	1997	0.68	2000	0.59
Gini coefficient, including social transfers	1997	0.44	2000	0.35
Gini coefficient, nationwide	1995	0.565	2000	0.578

Sources: United Nations Development Program (2003a); Statistics South Africa (1998 and 2004); and Office of the Presidency (2003).

[1]United Nations Development Program.

[2]South Africa Medical Research Council.

and, consequently, a less dramatic decline in life expectancy with the advent of HIV/AIDS. Correspondingly, the government's estimates for the HDI show a significant improvement over the post-apartheid period.[19]

[19]Office of the Presidency (2003).

Table 6.6. Millennium Development Goals

	1990	1995	2001	2002
Goal 1. Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates			
Population below $1 a day (percent)	. . .	7.1	. . .	. . .
Poverty gap at $1 a day (percent)	. . .	1.1	. . .	. . .
Percentage share of income or consumption held by poorest 20 percent	. . .	2.0	. . .	. . .
Prevalence of child malnutrition (percent of children under five)	. . .	9.2	. . .	. . .
Population below minimum level of dietary energy consumption (percent)	. . .	. . .	. . .	. . .
Goal 2. Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	102.6	102.5	88.9	. . .
Percentage of cohort reaching grade 5 (percent)	75.3	. . .	64.5	. . .
Youth literacy rate (percent ages 15–24)	88.5	90.0	91.5	91.8
Goal 3. Promote gender equality	2005 target = reduce education ratio to 100			
Ratio of girls to boys in primary and secondary education (percent)	103.2	101.6	99.6	. . .
Ratio of young literate females to males (percent ages 15–24)	99.7	99.8	99.0	100.0
Share of women employed in the nonagricultural sector (percent)	. . .	. . .	. . .	. . .
Proportion of seats held by women in national parliament (percent)	3.0	25.0	30.0	30.0
Goal 4. Reduce child mortality	2015 target = reduce 1990 under five mortality by two-thirds			
Under five mortality rate (per 1,000)	93	65.0	71.0	85.0
Infant mortality rate (per 1,000 live births)	55	50.0	56.0	65.3
Immunization, measles (percent of children under 12 months)	71	76.0	82	. . .
Goal 5. Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	250	230	. . .	. . .
Births attended by skilled health staff (percent of total)	. . .	82.0	. . .	. . .
Goal 6. Combat HIV/AIDS, malaria, and other diseases	2015 target = halt, and begin to reverse, AIDS and other diseases			
Prevalence of HIV, female (percent ages 15–24)	. . .	. . .	25.6	. . .
Contraceptive prevalence rate (percent of women ages 15–49)	57.0	. . .	. . .	. . .
Number of children orphaned by HIV/AIDS	. . .	. . .	660,000	. . .
Incidence of tuberculosis (per 100,000 people)	221	185	346	. . .
Tuberculosis cases detected under Directly Observed Therapy Short-Course (DOTS) (percent)	. . .	6.0	67.0	. . .

Goal 7. Ensure environmental sustainability		2015 target = various (see notes)		
Forest area (percent of total land area)	7.4	. . .	7.3	. . .
Nationally protected areas (percent of total land area)	. . .	5.4	5.4	5.5
GDP per unit of energy use (PPP $ per kg oil equivalent)	3.2	3.2	3.8	. . .
CO2 emissions (metric tons per capita)	8.3	8.6	7.9	. . .
Access to an improved water source (percent of population)	. . .	78.5	84.3	. . .
Access to improved sanitation (percent of population)	86.0	. . .	87.0	. . .
Access to secure tenure (percent of population)	. . .	. . .		
Goal 8. Develop a Global Partnership for Development		2015 target = various (see notes)		
Youth unemployment rate (percent of total labor force ages 15–24)	. . .	. . .	55.8	. . .
Fixed line and mobile telephones (per 1,000 people)	93.6	114.9	364.3	. . .
Personal computers (per 1,000 people)	7.0	27.9	68.5	. . .
General indicators				
Adult literacy rate (percent of people ages 15 and over)	81.2	83.3	85.6	86.0
Total fertility rate (births per woman)	3.3	3.1	2.8	2.8
Life expectancy at birth (years)	61.9	58.0	47.1	46.5
Aid (percent of GNI)	. . .	0.3	0.4	. . .

Sources: World Bank, World Development Indicators database, April 2002; and United Nations Development Program. In some cases the data are for earlier or later years than those stated.

Notes:

Goal 1 targets: Halve, between 1990 and 2015, the proportion of people whose income is less than $1 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

Goal 2 target: Ensure that, by 2015, children (boys and girls) will be able to complete a full course of primary schooling.

Goal 3 target: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

Goal 4 target: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

Goal 6 targets: Halt by 2015 and begin to reverse the spread of HIV/AIDS. Halt by 2015 and begin to reverse the incidence of malaria and other major diseases.

Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, achieve a significant improvement in the lives of at least 100 million slum dwellers.

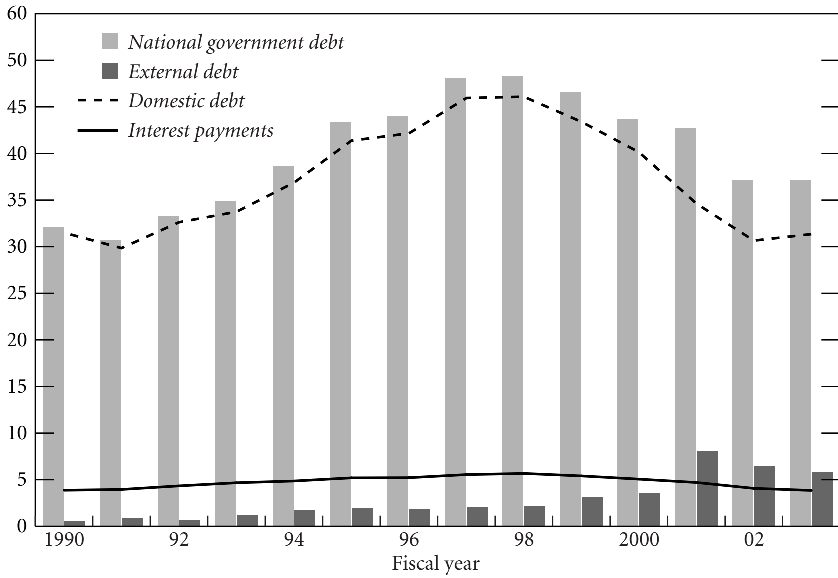
Goal 8 targets: Develop further an open, rule-based, predictable, nondiscriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Together with rising unemployment, the impact of HIV/AIDS appears to have contributed to mixed progress in improving poverty and income distribution indicators over the past decade. United Nations Development Program (2003b) reported that the percentage of South Africans living below the national poverty line decreased from 51.1 percent in 1995 to 48.5 percent in 2002. However, with population growth over the period, the total number of poor South Africans increased from 20.2 million in 1995 to 21.5 million in 2002. As for international poverty indicators, the UNDP reported that the percentage of South Africans living on $1 a day or less increased from 9.4 percent in 1995 to 10.5 percent in 2002, with a higher incidence of extreme poverty for virtually all population groups, family types, and provinces. There was a slight improvement, however, in the poverty ratio based on an indicator of $2 a day. In 1995, 24.2 percent of South Africans lived on $2 a day or less; by 2002, the figure was 23.8 percent. An improvement was registered among the black population, with the share of black South Africans living on $2 a day or less decreasing from 30.4 percent in 1995 to 28.7 percent in 2002. Poverty indicators worsened for three provinces that experienced significant inward migration and urbanization, Gauteng, Western Cape, and KwaZulu-Natal. The UNDP also reported that income distribution has worsened in South Africa in recent years, as the Gini coefficient increased during 1995–2001. The UNDP findings on income inequality contrast with those of the government, which suggest that income distribution has improved, particularly when social transfers are taken into account.[20]

In order to target a sustained improvement in social conditions, the government has announced an increase in expenditures on social security and welfare from 4.2 percent of GDP in 2003/04 to 4.7 percent in 2006/07. Continuing efforts to upgrade water and sanitation services should contribute to improved health indicators, particularly for infant mortality, while the universal provision of anti-retroviral drugs may help mitigate the worst impact of AIDS. The government has also initiated a five-year, R 20 billion (0.4 percent of GDP a year) public works program to provide job training and employment opportunities for one million unemployed people in labor-intensive projects, involving rural and municipal road maintenance, water and sewer projects, rehabilitation of schools and clinics, and social and environmental conservation programs. Further efforts are needed to strengthen health and education agencies at the provincial level and to address regional variations in per

[20]See Office of the Presidency (2003).

Figure 6.6. Public Debt Indicators
(In percent of GDP)



Sources: National Treasury and IMF staff estimates.

capita social expenditures and service provision. More generally, sustained progress in attaining the MDGs will require improved economic performance, as discussed in the other chapters of this book.

Looking Forward: Debt Sustainability

The government's success in consolidating the fiscal position contributed to a reduction of the ratio of public debt to GDP from 48 percent in 1999 to 37 percent in early 2004.[21] External debt has increased moderately in recent years, from less than 2 percent of GDP in 1997 to 6 percent of GDP at present, reflecting increased international borrowing and a real depreciation of the rand.[22] Debt service expenditures were reduced from 6 percent of GDP in 1998/99 to 4 percent in 2003/04 (Figure 6.6). This

[21]Contingent liabilities amount to approximately 11 percent of GDP, including guarantees and actuarial liabilities for pension and insurance funds.

[22]The recent appreciation of the rand reduced external public debt from 8 percent of GDP in 2002.

released resources for more productive purposes. Efforts to strengthen debt management targeted consolidation of debt instruments, a lengthening of maturities, the introduction of inflation-linked bonds across the yield curve, improved management of interest rate, currency, and credit risks, and the elimination of the net open forward position (NOFP) of the Reserve Bank.[23]

Looking ahead, fiscal adjustment and institution building have established a strong basis to address policy challenges over the next decade, including providing an enhanced response to HIV/AIDS and furthering the Black Economic Empowerment program and land reform, while maintaining a competitive tax burden. The policies contained in the 2004 budget and medium-term expenditure framework provided for an increase of the average annual national-provincial budget deficit to 3 percent of GDP during 2004/05–2006/07, ½ percentage point higher than the expected outturn in 2003/04 and 1½ percentage points higher than the average during 2000/01–2002/03. Additional spending will be directed to targeted social grants, health and education, criminal justice, and infrastructure, while the revenue to GDP ratio will be kept at just under 25 percent of GDP.

Under the government's present budgetary framework, together with additional assumptions described in Box 6.2, South Africa's public debt should remain moderate and sustainable over the coming decade, albeit with some increase in the debt-to-GDP ratio. In particular, the ratio of public debt to GDP is projected to reverse its declining trend and increase from 37 percent of GDP in 2002/03 to 41 percent in 2014/15 (Table 6.7). Stabilizing the public debt ratio at the level projected for the end of 2004/05, 37.8 percent of GDP, would require revenue or expenditure measures of 0.2–0.3 percent of GDP a year.

Public debt dynamics appear to be manageable under a variety of short-term shocks. These include lower GDP growth, a temporary weakening of the primary balance, a 30 percent real depreciation of the exchange rate, and a one-time, 10 percent increase of the debt stock, analogous to the assumption of outstanding contingent liabilities (Table 6.8). However, under each of these shocks, the public debt ratio increases over the projection period, again highlighting the need for policy flexibility and possible adjustment (Figure 6.7).

[23]The NOFP describes the Reserve Bank's net exposure in foreign exchange, taking into account off-balance-sheet positions, such as forward sales and purchases of foreign exchange. From 1985 to May 2003, the NOFP was negative, at times by very large amounts. The NOFP peaked at negative $23 billion in October 1998. For further details, see Chapter 11.

Box 6.2. Assumptions for Debt Projections

Debt projections over the next decade are based on a continuation of policies outlined in the 2004 budget. In particular, total revenues are projected to remain at just below 25 percent of GDP, in line with the government's long-standing policy objective, while expenditures incorporate an increase in allocations for HIV/AIDS drugs after 2006/07. In line with the government's November 2003 plan for enhanced HIV/AIDS treatment, this spending is projected to add 0.1–0.2 percent of GDP to spending annually in 2007/08–2010/11, before leveling off as the program is fully implemented. Other noninterest expenditures are expected to remain constant in percent of GDP at 2006/07 levels. This assumption provides scope for rationalization of spending, for example through lower defense spending once planned procurements are complete. Privatization revenues are assumed to be in line with projections in the 2004 budget through 2006/07 and zero thereafter.

Macroeconomic assumptions are cautious, with a recovery of GDP growth to 3.2 percent in 2004/05–2005/06 and 3.0 percent thereafter, in line with estimates of potential output. The GDP deflator is assumed to decline gradually to 3½ percent a year. Interest rates are also assumed to decline over the medium term, but to remain at approximately 2½ percentage points above the nominal GDP growth rate through 2008/09, with a margin of 2 percent thereafter. This assumption is cautious, as the interest rate-nominal GDP growth differential over the post-apartheid period has been close to 1 percent. The real effective exchange rate is projected to remain constant.

Conclusions

South Africa's successful fiscal adjustment over the past decade has reflected a number of key elements. Although faced at the beginning of the process with a recession, worsening fiscal conditions, and transition-related concerns, the public debt stock was low and the financial system relatively stable. Moreover, the adjustment effort was supported by a consensus approach to policymaking and the strong political position of the ruling ANC. The government effectively used medium-term policy frameworks to guide expectations and gained credibility by setting and achieving ambitious, but feasible, targets often by very comfortable margins. It reacted quickly to make necessary policy adjustments, such as imposing restraint on the growth of civil service wages and establishing greater financial discipline at the provincial level. Independent expert commissions and external advice were used effectively to build capable institutions in revenue administration and expenditure planning and management. Finally, expenditure restraint and reorientation and improved efficiency of the tax

Table 6.7. Debt Sustainability Scenarios
(In percent of GDP)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
I. Baseline scenario													
Revenue	24.2	24.5	24.5	24.8	24.7	24.7	24.7	24.7	24.7	24.7	24.7	24.7	24.7
Expenditure	25.3	26.9	27.7	27.8	27.6	27.7	27.8	27.5	27.6	27.6	27.7	27.7	27.7
Noninterest	21.3	23.0	23.9	24.1	23.9	24.0	24.2	24.3	24.3	24.3	24.3	24.3	24.3
Interest	4.1	3.9	3.8	3.7	3.6	3.7	3.6	3.3	3.3	3.3	3.3	3.4	3.4
Overall balance	–1.1	–2.4	–3.1	–3.0	–2.8	–2.9	–3.0	–2.8	–2.9	–2.9	–2.9	–2.9	–3.0
Primary balance	2.9	1.4	0.6	0.7	0.8	0.8	0.6	0.5	0.4	0.4	0.4	0.4	0.4
Gross loan debt	37.1	37.3	37.8	38.2	38.5	39.0	39.7	40.1	40.6	41.1	41.5	42.0	42.5
Domestic	30.6	31.5	32.1	32.3	32.7	33.1	33.6	33.9	34.2	34.6	34.9	35.3	35.6
Foreign	6.5	5.8	5.7	5.9	5.8	5.9	6.1	6.2	6.4	6.5	6.6	6.7	6.8
Memorandum items:													
Assumption: real GDP growth	3.4	1.4	3.1	3.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
GDP deflator	10.0	5.6	6.2	5.7	4.8	3.9	3.5	3.5	3.5	3.5	3.5	3.5	3.5
II. Constant debt ratio from 2004/05													
Revenue	24.2	24.5	24.5	24.8	24.7	24.7	24.7	24.7	24.7	24.7	24.7	24.7	24.7
Expenditure	25.3	26.9	27.7	27.5	27.4	27.1	27.0	27.0	27.0	27.0	27.0	27.0	27.0
Noninterest	21.3	23.0	23.9	23.8	23.7	23.5	23.5	23.9	23.9	23.9	23.9	23.9	23.9
Interest	4.1	3.9	3.8	3.7	3.6	3.6	3.5	3.1	3.1	3.1	3.1	3.1	3.1
Overall balance	–1.1	–2.4	–3.1	–2.8	–2.6	–2.4	–2.2	–2.3	–2.3	–2.3	–2.3	–2.3	–2.3
Primary balance	2.9	1.4	0.6	0.9	1.0	1.2	1.3	0.9	0.8	0.8	0.8	0.8	0.8
Adjustment needed	0.0	0.0	0.0	0.3	0.2	0.5	0.7	0.4	0.4	0.4	0.4	0.4	0.4
Gross loan debt	37.1	37.3	37.8	37.8	37.8	37.8	37.8	37.8	37.8	37.8	37.8	37.8	37.8
Domestic	30.6	31.5	32.1	31.9	31.9	31.8	31.7	31.7	31.7	31.6	31.6	31.6	31.5
Foreign	6.5	5.8	5.7	6.0	5.9	6.0	6.1	6.1	6.2	6.2	6.2	6.3	6.3

III. Low growth (lower revenues, higher interest rates)													
Revenue	24.2	24.5	24.5	24.7	24.7	24.5	24.5	24.4	24.2	24.2	24.0	24.0	23.7
Expenditure	25.3	26.9	27.7	27.8	27.8	27.9	28.0	27.8	28.0	28.2	28.3	28.5	28.7
Noninterest	21.3	23.0	23.9	24.1	23.9	24.0	24.2	24.3	24.3	24.3	24.3	24.3	24.3
Interest	4.1	3.9	3.8	3.7	3.8	3.9	3.9	3.6	3.7	3.8	4.0	4.1	4.4
Overall balance	–1.1	–2.4	–3.1	–3.1	–3.1	–3.4	–3.5	–3.5	–3.8	–3.9	–4.3	–4.5	–4.9
Primary balance	2.9	1.4	0.6	0.6	0.7	0.5	0.3	0.1	–0.1	–0.1	–0.3	–0.3	–0.6
Gross loan debt	37.1	37.3	37.8	38.3	38.7	39.8	41.1	42.4	44.0	45.7	47.9	50.2	53.0
Domestic	30.6	31.5	32.1	32.4	32.9	33.7	34.8	35.8	37.2	38.5	40.3	42.2	44.5
Foreign	6.5	5.8	5.7	5.9	5.8	6.1	6.3	6.6	6.9	7.2	7.6	8.0	8.5
Memorandum items:													
GDP growth differential (percentage points)				–0.3	–0.3	–0.5	–0.5	–0.8	–1.0	–1.0	–1.5	–1.5	–2.0
Risk premium versus baseline (percentage points)					0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5

Sources: National Treasury and IMF staff estimates.

Table 6.8. Public Sector Debt Under Short-Term Shocks
(In percent of GDP, unless otherwise indicated, calendar-year basis)

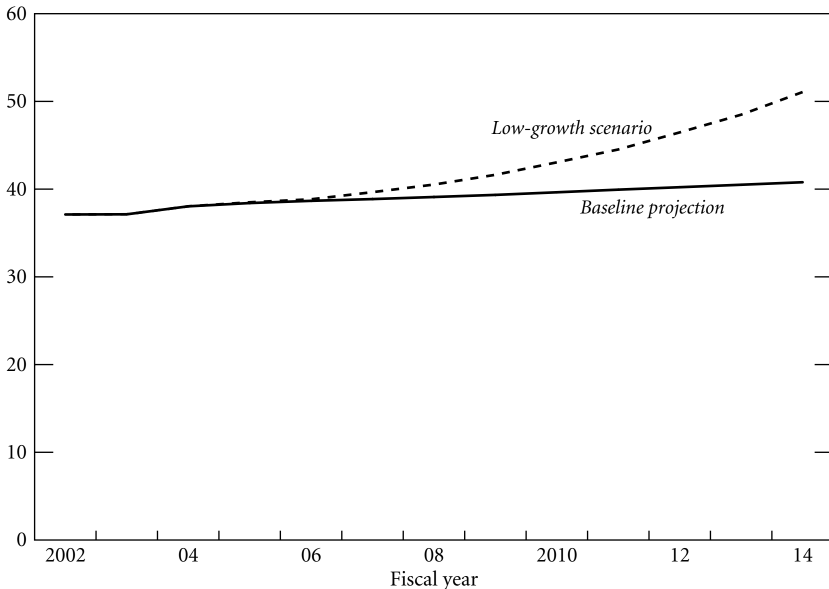
	Projections											
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	I. Baseline medium-term projections											
Public sector debt	37.2	38.1	38.7	39.0	39.2	39.4	39.7	40.0	40.3	40.6	40.9	41.2
Of which foreign currency denominated	6.6	6.1	5.9	6.0	5.9	6.0	6.1	6.2	6.3	6.4	6.5	6.6
Change in public sector debt	–1.3	0.9	0.5	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Primary deficit	–1.7	–0.8	–0.7	–0.8	–0.8	–0.6	–0.5	–0.4	–0.4	–0.4	–0.4	–0.4
Automatic debt dynamics	1.2	0.4	0.6	0.8	0.9	0.9	0.8	0.7	0.7	0.7	0.7	0.7
Contribution from interest rate/growth differential	1.2	1.2	0.5	0.7	0.8	0.8	0.7	0.6	0.6	0.6	0.6	0.6
Contribution from exchange rate depreciation	0.0	–0.9	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other identified debt-creating flows	–0.2	–0.2	–0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	1.9	2.6	3.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Average nominal interest rate on public debt (in percent)	11.0	11.0	10.7	10.2	9.6	8.8	8.4	8.3	8.3	8.2	8.2	8.2
Inflation rate (GDP deflator, in percent)	5.6	4.8	5.9	5.1	4.1	3.5	3.4	3.5	3.5	3.5	3.5	3.5
	II. Stress tests for public debt ratio											
Baseline	37.2	38.1	38.7	39.0	39.2	39.4	39.7	40.0	40.3	40.6	40.9	41.2
1. Real GDP growth, real interest rate, and primary balance at historical averages from 2004	37.2	36.4	35.8	34.8	33.6	32.3	31.0	29.6	28.2	26.8	25.4	23.9
2. Real interest rate at historical average plus two standard deviations in 2004 and 2005	37.2	38.8	40.6	40.9	41.2	41.5	41.7	42.1	42.4	42.8	43.1	43.4

3. Real GDP growth at historical average minus two standard deviations in 2004 and 2005	37.2	38.8	40.2	40.5	40.7	41.0	41.3	41.6	41.9	42.2	42.5	42.8
4. Primary balance at historical average minus two standard deviations in 2004 and 2005	37.2	39.8	42.0	42.3	42.6	43.0	43.3	43.6	44.0	44.4	44.7	45.1
5. Combination of 2–4 with one standard deviation shock	37.2	38.8	40.7	40.5	40.2	39.9	39.7	39.5	39.2	39.0	38.7	38.5
6. One-time 30 percent real depreciation in 2004	37.2	42.2	42.8	43.2	43.5	43.8	44.2	44.5	44.9	45.3	45.7	46.1
7. 10 percent of GDP increase in other debt-creating flows in 2004	37.2	48.1	48.8	49.3	49.8	50.3	50.7	51.2	51.8	52.3	52.7	53.2

Historical statistics for key variables (1994–2002)	Historical average	Standard deviation	Average 2003–08
Primary deficit	–2.0	1.5	–0.7
Real GDP growth (in percent)	2.9	1.0	2.9
Nominal interest rate (in percent)	13.3	1.5	9.2
Real interest rate (in percent)	5.0	1.6	5.1
Inflation rate (GDP deflator, in percent)	8.2	1.4	4.2
Revenue to GDP ratio	23.5	0.8	24.7

Sources: National Treasury and IMF staff estimates.

Figure 6.7. Public Debt Dynamics
(Gross public debt, in percent of GDP)



Source: IMF staff estimates.

system helped foster better overall economic performance, which in turn helped sustain the difficult process of adjustment.

The government budget is a primary vehicle for addressing South Africa's pressing social problems. This has been reflected in additional expenditures on social grants, health and education, the Black Economic Empowerment program, and social infrastructure. At the same time, the government recognizes that a modern and well-maintained economic infrastructure is vital to raising growth and living standards. While these spending pressures have led to a recent increase of the budget deficit, the overall fiscal stance remains consistent with a viable and sustainable debt position. The challenge facing the government looking forward is to ensure that spending on social needs remains compatible with macroeconomic stability and growth.

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