

Comment

MTBPS stresses short-term pain for long-term fiscal sustainability

Constrained macro backdrop	Tax proposals and spending cuts	Fiscal risks	Summary and macro impacts
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Introduction

Newly appointed Finance Minister Nhlanhla Nene faced a really tough test in his first Medium-Term Budget Policy Statement (MTBPS) yesterday. For starters, he had to deal with a significantly weaker macroeconomic backdrop than was projected at the time of the February Budget. Furthermore, the credit rating agencies and financial markets were looking for credible proposals to contain government spending in the face of very high civil servant salary demands and sustained high unemployment. In the event the minister certainly rose to the occasion; not only did he base his fiscal analysis on reasonably conservative growth projections, but he was also prepared to lower the government's expenditure ceiling and to signal tax increases at the February 2015 main Budget. In the process, he largely stuck to the government deficit numbers projected by former Finance Minister Pravin Gordhan in the 2014 Budget speech. In the process Minister Nene also signalled a decidedly tougher line on Eskom and other parastatals that depend on government financing to bail them out.

A more constrained macroeconomic backdrop

The sharp deterioration in South Africa's economic growth performance from the time when the macro forecasts for the 2014 Budget were generated required a substantial cut in the government's **GDP growth** forecasts, particularly for 2014. Table 1 compares the revised MTBPS forecast with the 2014 Budget projections. On average, for the period 2014-2016, expected GDP growth is now 0.9 percentage points (% pts) lower. The largest downward revision (-1.3%) was for 2014. At 1.4%, the adjusted number is in line with our own forecast for 2014.

Table 1: More subdued macro outlook compared to February

	Feb '14 Budget			Oct '14 MTBPS			
	2014	2015	2016	2014	2015	2016	2017
Real GDP growth	2.7	3.2	3.5	1.4	2.5	2.8	3.0
CPI inflation	6.2	5.9	5.5	6.3	5.9	5.6	5.4
Nominal GDP growth	9.4	9.5	9.7	7.6	8.5	8.7	8.8
Current account (% of GDP)	-5.9	-5.8	-5.5	-5.6	-5.4	-5.2	-5.0

Source: Budget Review, MTBPS 2014

However, the Treasury's figure for 2015 (at 2.5%) is lower than our 2.9%, but in line with the latest Reuters market consensus. For 2016, the Treasury is also somewhat more conservative than us and the market. Whereas in the past the Treasury was frequently criticised for an overly optimistic growth outlook, this was not the case yesterday.

On **inflation** the Treasury's forecast for CPI inflation is largely unchanged from the February numbers. However, what is more important from the point of view of the government's tax revenue projections is **nominal GDP** and thus the GDP deflator measure of inflation. Here the latest forecast is more than a percentage point (on average) lower than that of the 2014 Budget, sharply lowering the tax base. These changes in the government's economic forecasts obviously considerably complicated the minister's task of presenting an economically and fiscally responsible budget policy statement. On the one hand, the very weak economy calls for continued fiscal stimulus. On the other hand, ensuring long-term fiscal sustainability called for fiscal restraint. In the end the minister decided that long-term fiscal sustainability demanded fiscal restraint, not only for the next year but well beyond that. Indeed, the MTBPS notes that: "Fiscal consolidation can no longer be postponed. Ensuring continued progress towards a better life obliges government to safeguard the public finances by acting within fiscal limits that can be sustained over the long term."

The result was a budget policy statement that indicated tax increases in the February 2015 main Budget and proposed substantial spending cuts.

Tax proposals and spending cuts result in largely unchanged deficit projections

As noted above, the implication of the sharply weaker growth performance in 2014 is reduced **tax revenues**. The Treasury estimates the shortfall at about R10bn in 2014/15, rising to R19.1bn in 2015/16 and R31.8bn in 2016/17. In response, the minister did indicate that taxes are likely to be increased in the foreseeable future.

As tax changes are formally presented only in the main Budget and not in the MTBPS, the minister signalled increases from next year. The details will be presented in the February main Budget. However, he did put some numbers to these increases, indicating that tax policy and other administrative reforms would raise revenue of R12bn in 2015/16, R15bn in 2016/17 and R17bn in 2017/18. He also suggested that the Davies tax commission report will inform these tax changes. Furthermore, the MTBPS mentioned that the tax proposals will enhance the "progressive character of the fiscal system." This is important given recent speculation that the value added tax (VAT) rate may be increased. VAT is a regressive tax as high and low income consumers pay the same rate, although certain items are zero-rated. The MTBPS comments may suggest that the VAT rate will not be tinkered with at this stage, implying that other tax increases will have to raise the additional revenue.

Arguably the most important "tests" the minister had to pass from the perspective of the markets and the credit rating agencies were those of restraint in government spending and to maintain both the levels and the declining trend in the budget deficits projected in the 2014 Budget. For two years running, the

projected fiscal consolidation was pushed out to the latter years of the three-year rolling budget cycle. Given the weak economy, there was a real risk that the consolidation would again be postponed. The minister responded to these challenges in the form of a **fiscal package** to reinforce sustainability. The five elements of the package are:

- Spending cuts by lowering the previously established expenditure ceilings (by R25bn over the next two years). The spending cuts involve reductions in non-essential goods and services such as on travel and subsistence, consultants and personnel vacancies.
- Tax proposals to generate additional revenue of at least R27bn over the next two years.
- Greater emphasis on longer-term planning and efficient resource allocation.
- A freeze on government personnel headcounts. Increases in the government wage bill are to be limited to increases at the rate of inflation. Should the looming public sector wage negotiations result in above inflation wage increases, the minister indicated that savings elsewhere in the Budget (eg in personnel numbers or reduced service delivery) would have to compensate.
- A deficit-neutral approach to financing state-owned enterprises (SOEs). This implies that any further SOE support will be financed through the sale of non-core state assets, i.e. it will not raise the budget shortfall.

Table 2: Medium-term consolidated budget projections

R billion	2014/15		MTBPS		Ave: 2014/15 to 2016/17		MTBPS
	Budget '14	MTBPS '14	2015/16	2016/17	Budget '14	MTBPS '14	2017/18
Revenue	1 099.2	1 093.9	1 199.5	1 323.0			1 434.6
% of GDP	29.0	29.5	29.7	30.2	29.0	29.8	30.0
Expenditure	1 252.3	1 247.1	1 344.0	1 437.1			1 553.4
% of GDP	33.0	33.6	33.3	32.8	32.5	33.2	32.5
Interest payments	121.2	120.8	133.3	145.3			155.9
% of expenditure	9.7	9.7	9.9	10.1	9.9	9.9	10.0
Non-interest expenditure	1 131.1	1 126.3	1 210.6	1 291.7			1 397.5
% of GDP	30.0	30.3	30.0	29.4	29.4	29.9	29.3
Budget balance	-153.1	-153.2	-144.5	-114.1			-118.7
% of GDP	-4.0	-4.1	-3.6	-2.6	-3.5	-3.4	-2.5

Source: Budget Review, MTBPS 2014

It is clear that maintaining the government deficit numbers presented in the February Budget and thus not allowing for the 'slippage' widely expected in the market was an important guiding principle of the 2014 MTBPS. Table 2 outlines the new projections. They are very close to the February Budget numbers: 4.1% of GDP (versus 4% in February) for 2014/15; 3.6% in 2015/16 (identical) and 2.6% (against 2.8% in February) for 2016/17. The Reuters consensus was for a revised Budget deficit figure of 4.4% of GDP in 2014/15. The implications for the overall government debt dynamics are similarly reassuring: total net loan debt is expected to increase to (and peak at) 45.9% in 2017/18 from the current 42.8%.

Fiscal risks

The MTBPS document identifies three possible risks to the numbers presented. Firstly, the risk that the economic performance over the next few years is even weaker than projected. Given the most recent adverse international developments and the domestic realities, this is certainly not to be discounted. Secondly, the outcome of the public sector wage negotiations may not fit in the proposed fiscal framework. If government remains steadfast in not budging from an inflation-linked rise in the wage bill, there is also the risk of a prolonged public-sector strike in early 2015. Thirdly, that the envisaged new framework for funding the state-owned corporations may not be as deficit neutral as planned.

Summary and macroeconomic implications

The MTBPS should go some way in alleviating short-term concerns about South-Africa's fiscal sustainability. In particular, the credit rating agencies should react reasonably favourably to the so-called mini-Budget. However, at least until the public sector wage negotiations have been concluded and the subsequent impact on the February main Budget is clear, lingering concerns about government's ability to deliver on the proposed fiscal consolidation will remain.

If implemented, the proposed fiscal restraint should be positive for the longer-term domestic growth performance. However, over the shorter term, it does put additional downside risks on our above-consensus 2015 GDP growth forecast of 2.9%. In particular, our forecast assumes that **real government consumption expenditure** increases by 2.3% next year. The Treasury is only projecting a rise of 1.5%, also for 2016 and 2017. On its own, the lower government spending in 2015 will shave 0.15% pts from our GDP growth forecast. Potential tax increases and a freeze on government employment also pose important downside risks to our **real consumer spending forecast** of 3% in 2015.

Combined with the September **consumer inflation figure** that came in below market expectations at 5.9% y-o-y yesterday, the more (short-term) growth-inhibiting fiscal policy may see the SA Reserve Bank hold off from raising the repo rate at their final rate meeting in November. However, we first want to gauge global and domestic financial market developments over the next week or so before (potentially) altering our rate call for a 25bps rate hike at the November meeting.

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