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BER comment: 2011/12 Budget

FISCAL POLICY SET TO REMAIN COUNTERCYCLICAL, ALBEIT WITH HIGHER DEFICITS

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Introduction

In light of a fluid domestic policy environment, Finance Minister Pravin Gordhan's second Budget provides something for most of the key stakeholders in the SA economy. In line with President Zuma's state of the nation address that highlighted job creation as government's number one priority, the budget contained proposals to improve the skill base of the economy and assist in improving the high youth unemployment rate. While measures are being put in place to improve job growth, the poor will continue to benefit from social assistance spending, while consumers received personal income tax relief that exceeded expectations. Big business can look forward to improved infrastructure going forward, while Mr. Gordhan again pledged that both fiscal and monetary policy will continue to provide a stable macroeconomic environment conducive to private sector activity.

The implication of increased spending demands, unforeseen expenditure such as flood relief and lower than expected revenue growth is that the key fiscal ratios now look somewhat worse over the next three fiscal years (the so-called medium-term expenditure framework, or MTEF) than was the case in October 2010 when Gordhan delivered the Medium-Term Budget Policy Statement (or MTBPS). The revised estimates for the 2010/11 budget deficit indicate that somewhat lower government revenue (-R6bn) is expected to be counteracted by lower expenditure, resulting in the forecast for the deficit in the current fiscal year to remain at 5.3% of GDP. However, the budget shortfall is now expected to average 0.7% pts higher over the MTEF than was forecast in October 2010 with the 2011/12 deficit now projected to remain at 5.3% of GDP (against an October expectation of 4.6%). The shortfall is expected to narrow to 3.8% of GDP in the 2013/14 fiscal year compared to the October forecast of 3.2%

Table 1: Treasury expects higher inflation and an improved current account position

	Oct '10 MTBPS				Feb '11 Budget			
	2010	2011	2012	2013	2010	2011	2012	2013
Real GDP growth	3.0	3.5	4.1	4.4	2.8	3.4	4.1	4.4
CPI inflation	4.4	4.7	5.0	5.2	4.3	4.9	5.2	5.5
Current account (% of GDP)	-4.2	-4.9	-5.3	-5.8	-3.2	-4.2	-4.9	-5.0

Source: Budget Review, 2011 / MTBPS, 2010

In terms of Treasury's macroeconomic outlook, table 1 indicates that the view on real GDP growth for the period 2011-13 is (excluding a 0.1% pt difference for 2011) identical to the MTBPS numbers. The growth forecast is somewhat more optimistic than the latest Reuters consensus that sees growth averaging 3.9% and 4.2% in 2012 and 2013 respectively. Consumer inflation is forecast to be slightly

higher, which could explain why the Treasury now has higher nominal GDP figures. The current account deficit is expected to be lower over the MTEF than previously forecast.

Regarding the fiscal ratios, the nominal budget deficit is now expected to average R147bn over the next three fiscal years, R22bn higher than forecast in the MTBPS. Importantly, the deterioration is almost exclusively the result of lower projected government revenue. The outlook for consolidated government expenditure is largely unchanged.

The higher nominal budget deficits have resulted in an upward revision to the national government borrowing requirement, which is now expected to amount to R467bn (previously R407.8bn) over the next three fiscal years. Despite a projected reduced borrowing requirement from state owned enterprises such as Eskom and Transnet, the overall **public sector borrowing requirement** is now expected to average almost 8% of GDP over the MTEF against 7.7% expected in the MTBPS. This has implications for the capital market as government now expects to issue more debt. Between 75% and 80% of the financing is expected to come from domestic long-term loans, i.e. government bonds. Issuance is expected to average marginally higher at R123.8bn over the MTEF versus R117bn previously expected. The yields on key government bonds have already increased sharply so far in 2011 as concerns grow about SA's inflation outlook and the likelihood of an increase in the repo rate later in 2011. The yield on the R207 government bond closed marginally higher at 8.57% yesterday.

Table 2: Medium-term budget framework

R billion	2010/11		Medium-term estimates		
	MTBPS	Budget '11	2011/12	2012/13	2013/14
Revenue	761.0	755.0	824.5	908.7	1017.2
% of GDP	28.4	28.3	28.3	28.4	28.8
Expenditure	904.1	897.4	979.3	1061.6	1151.8
% of GDP	33.7	33.6	33.6	33.2	32.6
Debt service	67.6	66.6	76.6	90.8	104.0
% of GDP	7.5	7.4	7.8	8.6	9.0
Expenditure (excl interest payments)	-	830.8	902.7	970.8	1047.8
% of GDP	-	31.2	31.0	30.3	29.6
Budget balance	-143.1	-142.4	-154.8	-152.9	-134.6
% of GDP	-5.3	-5.3	-5.3	-4.8	-3.8

Source: Budget Review, 2011

Overall net government debt is expected to climb from 30.8% of GDP in 2010/11 to 39.3% during 2013/14.

Expenditure proposals – composition of spending concerning; job growth initiatives welcome

One of the unfortunate consequences of the higher debt levels is that the interest on the debt (debt service costs) is by far projected to be the fastest growing expenditure item, i.e. averaging 16% over the MTEF. This is in stark contrast to **non-interest expenditure**, which is set to grow by an average

of 7.2% (2.8% in real terms). During the period 2005/06 – 2008/09, real non-interest spending rose by a much faster 7.2%. The expected reduction in the budget deficit over time is thus expected to be as a result of both expenditure constraint and improved revenue.

However, we remain concerned about whether government will be able to keep spending in check. The concern is mainly as a result of the composition of government spending. According to the Budget review, 53% of consolidated government expenditure went to the compensation of employees and household transfers (social grants etc) during 2010/11. The figure is projected to rise to close to 60% in 2013/14 – the recent experience has shown that it is difficult to contain the public wage bill.

A further worrying aspect of the spending composition is that government is essentially borrowing to finance unproductive current expenditure whereas ideally most of the borrowing should be done to access finance for capital expenditure.

Table 3 provides a breakdown of the additional allocations to key spending areas when compared with the 2010 Budget. The concern raised above is again highlighted by the fact that more than 40% (R39.4bn) of the R94.1bn rise in allocations was for adjustments to the compensation of employees. This reflects the carry-through costs of the 2010 public-sector wage agreement (7.5% cost of living adjustment and R800 monthly housing allowance).

Table 3: Additional MTEF allocations (2011/12 – 2013/14)

R billions	
Job creation	10.0
Economic affairs & infrastructure	16.6
Housing	7.3
Education	18.8
Health care	7.9
Social assistance (incl social grants)	8.9
Public order & safety	1.8
General public services (incl flood relief)	5.2
Compensation of employees adjustments	39.4
Other (savings)	-21.9
Total	94.1

Source: Budget Review, 2011

On a more positive note, some of the increased expenditure allocations should be welcomed. This includes a **youth employment subsidy**, expected to increase demand for young workers that are hardest hit by unemployment. The projected cost of the subsidy is R5bn over the three-year spending period and it is set to result in new job creation of 178,000. However, at this stage the subsidy remains a Treasury proposal, set for discussion in Nedlac and other forums. Employment creation will also be supported by an R18.8bn increase in the education allocation. The positive factor is that the money seems to be well targeted, i.e. R14bn has been earmarked for **further education** and **training colleges**. Although the youth employment subsidy is not a new idea, the increase in job creation and education allocations could be seen as the first expenditure proposals linked to the economic development minister Ebrahim Patel's **New Growth Path** (NGP). Other proposals that could be tracked to the NGP include R800 million set aside over the next three years for "green economy" initiatives.

The 2011/12 Budget also made the first expenditure provision for the implementation of the **National Health Insurance** (NHI) plan with R8bn added to specific health service interventions, "laying the foundations for National Health Insurance". The amount includes R2.9bn to improve the quality of health facilities, medical equipment and hospital systems. Compared with the MTBPS, the outlook for spending on **public infrastructure** has been further (marginally) reduced to R808.6bn (in nominal

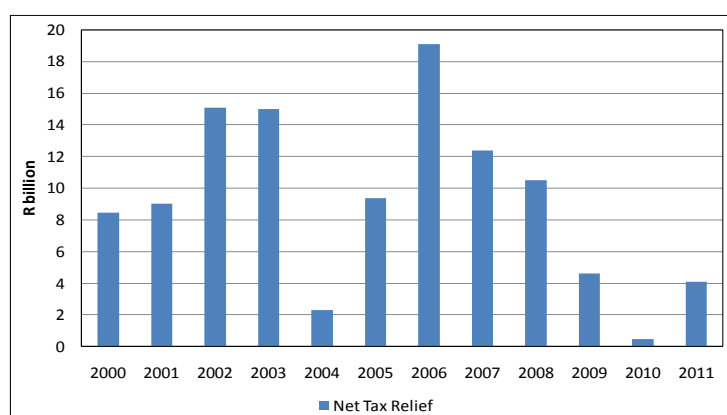
terms) over the next three fiscal years versus R811bn projected in the MTBPS. In terms of the growth rates, the pattern differs significantly from the MTBPS. The MTBPS saw the growth rate of public sector infrastructure slowing down from 7.5% in 2011/12 to 1.8% during 2012/13, before picking up to 4.7% in 2013/14. Currently, public infrastructure outlays are expected to decline by 2.8% (nominal, i.e. a large real decline) in 2010/11 and then set to increase by more than 6% in nominal terms during the next two fiscal years. The Budget Review highlights the well-known fact that capital expenditure continues to underperform budgeted amounts. Since 2006/07, provincial capital budgets have averaged around 85% of allocated capital budgets. Although government is aware of the problems, for example the lack of project management skills at provincial government level, a short-term fix to the problem is unlikely. As a % of GDP, infrastructure spending is forecast to decline from 9.8% of GDP in 2010/11 to 8.1% during 2013/14.

Tax proposals – consumers again receive the bulk of the relief

With government revenue recovering - albeit somewhat less than expected - the Budget provided net tax relief of R4.1bn versus only R450 million in 2010. This measure includes the impact of higher indirect taxes. As has become the norm, consumers received the bulk of the tax relief in the form of personal income tax adjustments (compensation for bracket creep / impact of higher inflation) amounting to R8.8bn. Lower income consumers benefit the most with 50% of the relief granted to taxpayers with a taxable income of R270,000 or less. Consumers with a taxable income above R1 million received only 5% of the relief.

According to Mr. Gordhan, the personal income tax relief not only took away the impact of bracket creep, but also compensates consumers for the fact that income tax brackets were not fully adjusted for the impact of inflation in the 2010 Budget. This relief was more than we expected and should be positive for consumer spending. *However, it may be that the Treasury made use of the opportunity to give something extra to consumers before the likely tax hikes from 2012 to fund the National Health Insurance. The Budget review mentions that the phasing in of a payroll tax (payable by employers), a higher VAT rate and a surcharge on individuals' taxable income could be considered as funding options. Announcements about specific funding instruments will be made in the 2012 Budget.* The projections in the 2011/12 Budget are already that tax revenue will rise from 25.2% of GDP in 2010/11 to 26.2% during 2013/14 – the funding of the NHI is set to push the ratio up even further.

Figure 1: 2011/12 Budget provides substantial more tax relief than in 2010



Source: Budget Reviews

Given the increased employment push from government, it was disappointing that no **corporate tax** relief was granted. However, the fact that corporate tax revenue has been slow to recover following the recession may explain Treasury's reasoning. Furthermore, the **youth employment subsidy** of R5bn over three years mentioned earlier will be in the form of a tax credit to business. In order to support the NGP, businesses embarking on new investments will also qualify for tax relief with additional relief for Greenfield investments in industrial development zones. No further details were provided.

Indirect tax proposals are set to boost government revenue by R4.9bn in 2010/11 and include a 4.5% to 10% rise in excise duties on **alcoholic beverages**, while the tax on **tobacco products** will increase by 9% to 10%. Combined, the **fuel** and **road accident fund (RAF)** levy will increase by 18c/litre from 6 April, somewhat lower than the 25.5c/litre rise in 2010. If the Brent crude oil price remains at current highs or rises further, it means that (combined with the fuel levies) the petrol price is set for another strong rise in April. At this stage, it looks like fuel costs could surge by 40c/litre in March. While less than last year, given the upward inflation pressure from the high oil price, a smaller rise in the fuel and RAF levy would have been appropriate.

Other issues – no capital controls; SARB inflation fighting mandate confirmed

Leading up to the Budget, there was some concern that government would announce capital controls in order to limit foreign purchases of SA bonds and equities. This is meant to result in a more competitive currency, although the international evidence on the success rate of controls is inconclusive. We always thought such a move was unlikely, especially in an environment where foreign investors have moved from being net buyers of SA assets in 2010 to net sellers so far in 2011. As a result, the rand weakened from R6.60/\$ at the end of 2010 to as high as R7.30/\$ in recent times.

It was clear from the Budget speech that the Treasury remains cautious in announcing measures that may result in a further weakening of the currency when the outlook for domestic and global inflationary pressures have deteriorated. Having said that, of interest is that government is not completely closing the door on the matter – the Budget Review mentions that Treasury will continue to monitor how other countries deal with competitiveness issues

In terms of **macroeconomic policy**, it was heartening that Minister Gordhan said in his speech that monetary policy "will continue to be focused on controlling inflation". The NGP mentions that tighter fiscal policy should be complemented by looser monetary policy – following that line of reasoning, the fact that the budget deficits are now projected to be higher than forecast in the MTBPS, suggests less room for accommodative monetary policy.

Conclusion

As has been the case over the past decade, the annual Budget should help to allay fears about the future of SA macro policy. While we do have some concerns that the higher budget deficits and borrowing is driven by current rather than capital expenditure, there remains a commitment to reduce the deficits over time.

Going forward, major policy initiatives such as the NHI mean that the longer-term fiscal outlook is more clouded with higher taxes to finance increased expenditure on the cards. It is worth remembering that the fiscal consolidation enacted through the 1990s provided the space for



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government to stimulate the economy during the 2008/9 recession without debt levels rising excessively. It also means that SA has the leeway to - unlike many developed and periphery European countries - gradually reduce the budget shortfall instead of enacting growth damaging austerity measures.

Hopefully, this message will continue to be relayed to those demanding an ever rising role of the state in the SA economy.

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