

# Comment

## A ratings-positive 2014 Budget

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### Introduction

Against the backdrop of a challenging macroeconomic environment, Finance Minister Pravin Gordhan presented a budget that should be relatively well received by SA consumers and the international ratings community. Starting with the consumer, there was no increase in the top marginal personal income tax rate as speculated in some quarters. However, the tax bracket adjustments did not fully compensate taxpayers for the impact of higher inflation. From a ratings agency perspective, the Budget presented accelerated fiscal consolidation over the next three fiscal years (the MTEF period) compared to October's medium-term budget policy statement (MTBPS). The lower budget deficits are a function of a somewhat higher nominal GDP growth forecast (table 1) that improved the revenue outlook. Importantly, the Treasury also made a further downward revision to the growth in non-interest government expenditure (see below).

Table 1: Faster nominal GDP growth amid higher inflation

|                            | Oct '13 MTBPS |      |      | Feb '14 Budget |      |      |
|----------------------------|---------------|------|------|----------------|------|------|
|                            | 2014          | 2015 | 2016 | 2014           | 2015 | 2016 |
| Real GDP growth            | 3.0           | 3.2  | 3.5  | 2.7            | 3.2  | 3.5  |
| CPI inflation              | 5.6           | 5.4  | 5.4  | 6.2            | 5.9  | 5.5  |
| Nominal GDP growth         | 9.1           | 9.3  | 9.4  | 9.4            | 9.5  | 9.7  |
| Current account (% of GDP) | -6.4          | -6.2 | -6.1 | -5.9           | -5.8 | -5.5 |

Source: Budget Review 2014

The Treasury's updated macroeconomic assumptions are presented in table 1. Real GDP growth is now forecast to average 3.1% over the MTEF period. This is only marginally down from the 3.2% expected in October and is exclusively a function of a weaker forecast for 2014 (2.7%). For government revenue, the important figure is the **nominal GDP** growth outlook. This was revised higher to 9.5% on average from 9.3% in October amid a significant upward revision to the Treasury's **CPI inflation** forecast. The adjusted inflation figures are very much in line with the numbers presented by the SA Reserve Bank (SARB) at the January 2014 MPC meeting. Another notable feature of Treasury's macro numbers is a narrower **current account deficit** (5.7% on average versus 6.2%) than previously expected. This reflects the impact of the weaker rand exchange rate and most likely the expectation that the currency will remain at weaker levels (but not necessarily decline further) than previously envisaged.

Overall, Treasury's macro numbers are realistic, albeit that risks to the GDP growth outlook are on the downside.

## Accelerated fiscal consolidation

The revised forecast for the 2013/14 budget deficit is 4% of GDP, slightly down from the 4.2% projected in October 2013. The improvement reflects stronger than expected revenue collection, under spending by national departments, provinces and public utilities, as well as government sticking to its expenditure ceiling. Over the MTEF, the budget deficit is expected to average 3.5% of GDP, marginally down from the 3.6% forecast in October. Of more significance is that the fiscal consolidation process has been brought forward somewhat so that the budget deficit declines below 3% of GDP by 2016/17. Excluding the impact of interest payments, the primary budget deficit is forecast to stabilise at 0.4% of GDP in 2015/16 and 2016/17. Because government continues to run budget shortfalls, overall net government debt is forecast to rise through the MTEF period, before stabilising around 44% of GDP by 2016/17.

Table 2: Medium-term consolidated budget projections

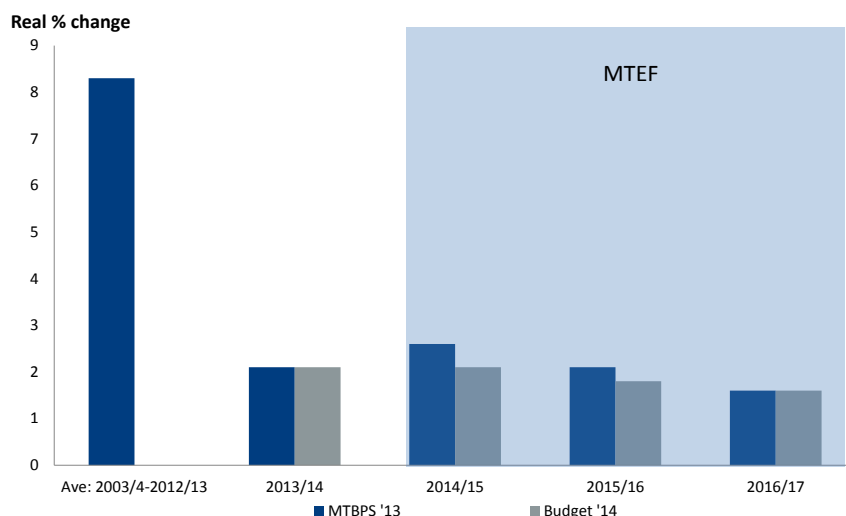
| R billion                       | 2013/14        |                | Medium-term estimates |                |                |
|---------------------------------|----------------|----------------|-----------------------|----------------|----------------|
|                                 | MTBPS '13      | Budget '14     | 2014/15               | 2015/16        | 2016/17        |
| <b>Revenue</b>                  | <b>999.1</b>   | <b>1,010.5</b> | <b>1,099.2</b>        | <b>1,201.3</b> | <b>1,324.7</b> |
| % of GDP                        | 28.7           | 29.2           | 29.0                  | 28.9           | 29.1           |
| <b>Expenditure</b>              | <b>1,143.7</b> | <b>1,149.3</b> | <b>1,252.3</b>        | <b>1,351.8</b> | <b>1,451.6</b> |
| % of GDP                        | 32.8           | 33.2           | 33.0                  | 32.6           | 31.9           |
| <b>Interest payments</b>        | <b>106.6</b>   | <b>107.7</b>   | <b>121.2</b>          | <b>133.5</b>   | <b>145.1</b>   |
| % of expenditure                | 9.3            | 9.4            | 9.7                   | 9.9            | 10.0           |
| <b>Non-interest expenditure</b> | <b>1,037.0</b> | <b>1,041.6</b> | <b>1,131.1</b>        | <b>1,218.1</b> | <b>1,306.5</b> |
| % of GDP                        | 29.8           | 30.2           | 30.0                  | 29.5           | 28.8           |
| <b>Budget balance</b>           | <b>-144.6</b>  | <b>-138.8</b>  | <b>-153.1</b>         | <b>-150.3</b>  | <b>-126.9</b>  |
| % of GDP                        | -4.2           | -4.0           | -4.0                  | -3.6           | -2.8           |

Source: Budget Review 2014

The combination of a somewhat higher nominal GDP growth forecast and slower spending growth resulted in the lower budget deficits over the MTEF. Treasury introduced an expenditure ceiling in 2012 which targets a nominal limit on main budget non-interest expenditure. This is the major spending over which government has direct legislative authority. Figure 1 on the next page highlights the sharp projected easing in real non-interest spending<sup>1</sup>. Indeed, the forecast has been reduced further compared to the MTBPS to 1.8% over the MTEF. Treasury also remains committed to shift the composition of spending from current to capital expenditure. Given the size of the public sector wage bill, this is naturally a slow process. In 2010/11, the compensation of public employees was responsible for 35.2% of consolidated government expenditure. By 2016/17, this is forecast to only decline to 34.8%. Over the same period, capital spending is expected to increase from 6.4% to 7.4% of expenditure.

<sup>1</sup> This excludes the impact of higher state debt servicing costs.

Figure 1: Non-interest spending growth expected to slow meaningfully



Source: Budget Review 2014

The lower deficits imply a smaller national government **borrowing requirement** that has to be financed. The financing is done mainly through the issuance of government bonds. Compared to October, Treasury now expects to issue roughly, R6bn, R13bn and R10bn less bonds than expected in the October MTBPS. This should be a mild positive for the local capital market. Of interest is the Budget comment that: “We must ensure that our fiscal and monetary choices keep inflation low and maintain the recent gains in competitiveness”. This refers to the potential competitiveness gains from the weaker currency. This was also noted in the January MPC statement, i.e. policymakers are concerned that the currency gains will be eroded through higher prices. These comments align with financial market (and our own) expectations that further interest rate hikes are likely.

## The budget and the consumer

Household finances are impacted by the **tax proposals** and **social expenditure** outlined in the budget. Treasury estimates that taxpayers will save R9.25bn in 2014/15 through the normal income tax bracket adjustments. This is done to prevent taxpayers from moving into higher brackets because of inflation. The saving is the extra amount in personal income tax that consumers would have paid if not for the bracket adjustments. CPI inflation is expected to average 5.8% between April 2013 and March 2014. Over the next 12 months, consumer inflation may well average above 6%. However, the tax brackets were “only” adjusted by 5.4% across the board. Households were not fully compensated for the effect that inflation had in pushing them into a higher tax bracket.

The Treasury also adjusted the tax rates for **lump sum retirement payments**. Previously, the first R315,000 was tax free. This has been increased to R500,000.

Regarding **indirect** taxes, the rise in the fuel and road accident fund levy combined will add 20c/litre to the petrol price in April. The sin tax on fortified wine and cigarettes was increased by 7.5 and 6.2% respectively.

For very poor households, the value of the monthly **child support** and **old age grants** will increase by around 6.5% in 2014/15. The number of total grant recipients is expected to increase by a modest 1.5% to 16 million in 2014/15. Combined with higher food and fuel costs, as well as anaemic employment prospects, the slowdown in the rollout of social grants suggests that the growth in non-durable goods consumption will moderate in 2014. *Indeed, we project the growth in non-durable goods sales to ease to 2.1% in 2014 from a projected 2.4% in 2013.*

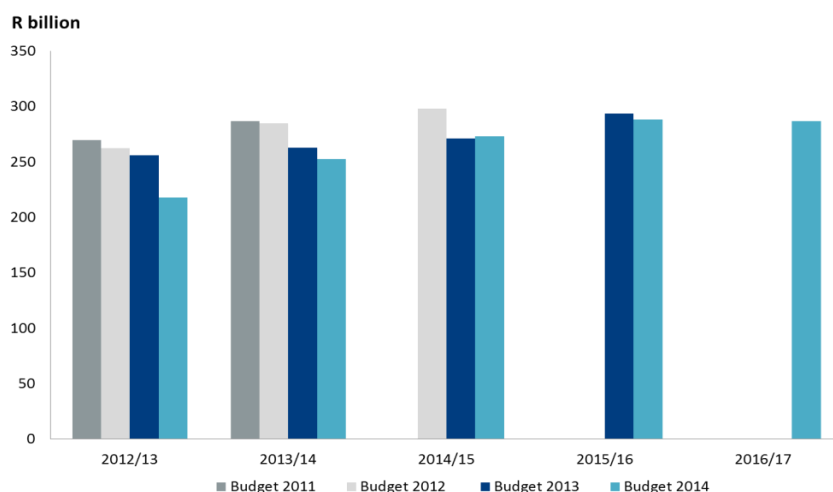
While the budget did also not provide significant support for more affluent households, this was never expected. The situation would clearly have been worse if the top marginal tax rate was raised.

## The budget and fixed investment

Treasury has budgeted a nominal R847bn in public infrastructure spending over the MTEF period. The fastest growth is expected in 2014/15 (8%), slowing to 5.5% in 2015/16 and followed by a small decline (-0.4%) the next year. Of interest is the key role that **Transnet** is set to play in driving the public infrastructure programme over the MTEF. After contributing an expected 31% to overall public infrastructure spend in 2013/14, the transport and logistics component (mainly Transnet) is forecast to contribute almost 45% by 2016/17. The sharp increase in the transport and logistics category may also reflect the construction of bus rapid transport systems in nine cities. This stems from the NDP proposal to improve public transport.

From a bulk commodity export point of view, it is crucial that Transnet delivers on their capital budget. The last number of years has seen persistent downward adjustments to the total amount spent on public infrastructure. This has partly been the result of strikes at Eskom's power station construction sites and municipal under spending. Figure 2 plots the expected public infrastructure spending over fiscal years since the 2011 Budget. For example, at the time of the 2011 Budget, R286bn was expected to be spent on public infrastructure in the 2013/14 financial year. The 2014 budget puts the estimated outlay for 2013/14 at R253bn, 12% lower than initially projected.

Figure 2: Public infrastructure spending estimates routinely revised lower



Source: Budget Reviews

Given the Budget comment that fixed investment is central to the national development plan, improved project delivery should be non-negotiable.

We expect real public sector fixed investment growth of 4 to 4.5% in 2014 and 2015. It is not always straight forward to reconcile the Treasury figures with the SARB fixed investment data that flows into the GDP numbers. However, the Budget numbers seem to be more or less consistent with the BER's latest fixed investment outlook. We are assuming improved delivery on infrastructure budgets.

## The general business environment – small supports

The first report of the Tax Review Committee appointed in July 2013 was handed to minister Gordhan in January. It examined how the tax system affects small and medium-sized enterprises. Subject to public consultation, the Treasury has accepted some of the recommendations. These concern businesses with an annual turnover of R1 million. It is proposed that:

- Turnover up to R350,000 be tax exempt,
- The maximum tax rate be reduced from 6 to 5%
- Companies only have to submit an annual tax return instead of bi-annual returns.

At present, the Tax committee is looking at the VAT, mining and estate duty tax regimes.

As widely expected, there was no change to other corporate tax rates. However, heavy industry should welcome the delay in the introduction of the **carbon tax** by a year to 2016.

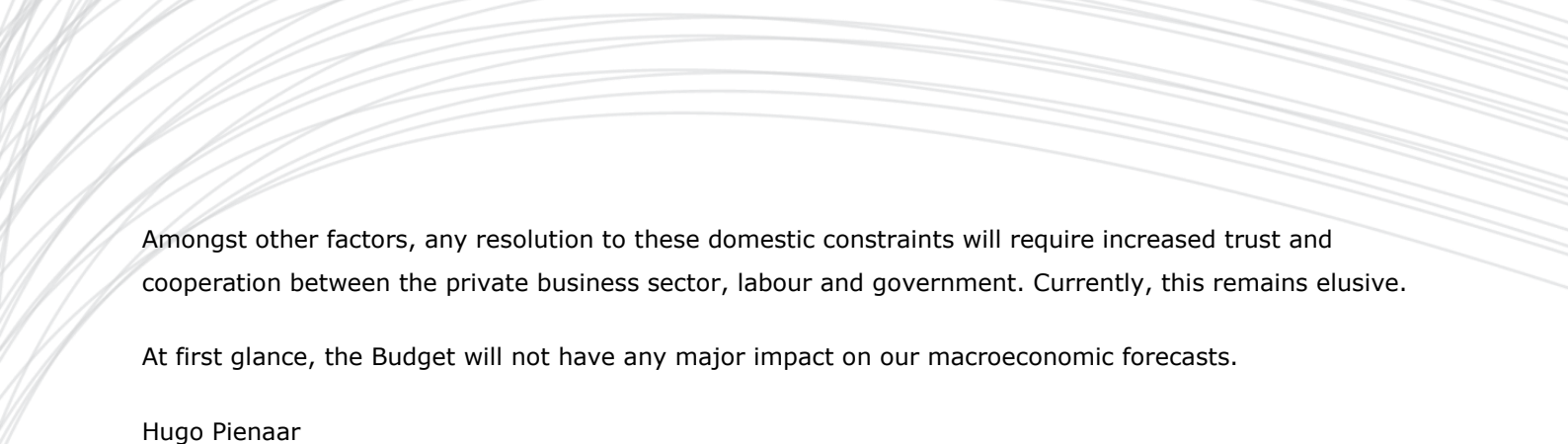
In terms of encouraging job creation, the **employment tax incentive** was introduced on 1 January. The budget speech mentioned that the scheme recorded 50,000 beneficiaries in the first month.

## Conclusion

Whereas the Budget contained no major surprises and made some positive noises on (slightly) accelerated fiscal consolidation, a number of issues were left out in the open. There was no indication on whether Minister Gordhan will continue in his current role after the May elections.

The Budget also lacked detail on the implementation of the NDP. The minister's speech mentioned that the next government will set out the details of plans to deliver on the NDP after it takes office in May. The key question remains whether SA will deliver on the Treasury's GDP growth projections. Failure to achieve these will mean the budget targets are unattainable.

Besides providing a temporary confidence boost and putting in place measures for enhanced public infrastructure delivery, to a large extent the GDP growth performance is out of the Treasury's hands. This is because 1.) Strained finances mean Treasury is in no position to stimulate the economy and 2.) Some of the factors that have weighed most heavily on growth in the recent past, including labour instability, public corporation inefficiencies, regulatory uncertainties and a soft global economic recovery, are largely independent of any Treasury actions.



Amongst other factors, any resolution to these domestic constraints will require increased trust and cooperation between the private business sector, labour and government. Currently, this remains elusive.

At first glance, the Budget will not have any major impact on our macroeconomic forecasts.

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