

Comment

Budget takes aim at high earners

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Introduction

Against a backdrop of rising (mainly global) uncertainty and domestic calls for radical economic transformation (RET), the 2017 Budget contained few major surprises. The fiscal framework largely stuck to the consolidation targets outlined in the October 2016 Medium-Term Budget Policy Statement (MTBPS). As expected, the major Budget headlines concern the tax proposals as no significant new expenditure initiatives were outlined. In line with the comments in the MTBPS, tax hikes totalling R28bn were announced with the more affluent consumers shouldering the burden. In particular, a new top marginal personal income tax (PIT) bracket of 45% was introduced, while the dividend tax rate was also increased. As expected, the value-added tax (VAT) rate was kept at 14%.

A key theme of President Zuma's State of the Nation Address in early February was the need for RET. While mention of this is scattered through the budget speech, there was a clear shift in focus from the Treasury. Importantly, we struggle to find any additional expenditure that can be directly linked to RET. This is a positive development from a credit ratings perspective. Finance Minister Gordhan emphasised that "SA's growth challenge is intertwined with our transformation imperative. We need to transform in order to grow, we need to grow in order to transform". Furthermore, the minister came out strongly against the view expressed by some that the Treasury is a key stumbling block in the transformation imperative. He argued that: "...sound public finances, the health of our financial institutions, investment-grade credit ratings and our competitive public procurement processes are valued elements in the sustainability and integrity of our transformation path".

While the need for faster growth was emphasised, the Budget did not provide anything new in terms of progress with growth-enhancing structural reforms or announce any new measures to support SA's medium-term growth trajectory. Similar to the trend in the recent past, the Budget may therefore receive a mixed response from the major credit rating agencies.

Macro outlook: Growth outlook unchanged, slightly higher inflation

The Treasury's revised macroeconomic forecasts are set out in Table 1. Relative to the outlook detailed in the October MTBPS, Treasury's forecast for **real GDP growth** remained unchanged at an average of 1.8% for the 2017-2019 period. Treasury expects GDP growth to pick up from an estimated 0.5% in 2016 to 1.3% in 2017, with a sustained moderate improvement over the medium term. According to Treasury, factors supporting this view include marginally higher global growth, stabilising commodity prices, more

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favourable domestic weather conditions, and the expectation of a recovery in business and consumer sentiment. Despite the relatively subdued growth outlook, Treasury's forecast is still somewhat more optimistic than our own view for growth of 1% and 1.8% in 2017 and 2018 respectively.

Table 1: Largely unchanged macroeconomic outlook

	Oct '16 MTBPS				Feb '17 Budget			
	2017	2018	2019	Average	2017	2018	2019	Average
Real GDP growth	1.3	2.0	2.2	1.8	1.3	2.0	2.2	1.8
CPI inflation	6.1	5.9	5.8	5.9	6.4	5.7	5.6	5.9
Nominal GDP growth	7.4	7.9	8.1	7.8	7.8	8.0	8.2	8.0
Current account (% of GDP)	-3.9	-3.8	-3.8	-3.8	-3.9	-3.7	-3.8	-3.8

Source: Budget Review 2017, MTBPS 2016

Treasury's forecast for **nominal GDP growth**, which is more important from a government revenue perspective, was revised up by an average of 0.2 percentage points (% pts) over the medium-term expenditure period. The upward revision reflects the impact of higher inflation projections, with Treasury's forecast for the GDP price index (deflator) revised up from an average of 5.8% in the October MTBPS to 6% in the 2017 Budget.

Importantly, Treasury seems more concerned about the short-term **consumer inflation** (CPI) outlook than both the SA Reserve Bank (SARB) and the BER. At an average of 6.4% for 2017, the forecast for CPI inflation is even higher than the SARB's above-consensus 6.2% and substantially higher than our own view of 5.8%. This mainly reflects a more pessimistic outlook for 2017 food price inflation. Another key difference relative to our forecast concerns the expected narrowing of the **current account deficit**. While the BER expects the deficit to remain in the 4.5% to 5% range, Treasury's view is closer to 4%. This is due to a combination of a more optimistic view on export volume growth and a slightly more upbeat forecast for key export commodity prices (including gold and coal).

In all, while leaning toward the optimistic side, in our view the fiscal parameters in the Budget were based on relatively credible macroeconomic projections.

Higher taxes, reduced spending keep fiscal consolidation on track

Broadly speaking, the fiscal consolidation outlined in the Budget is at a similar pace to that envisaged in the October MTBPS. The estimate for the consolidated **budget deficit** in both the 2016/17 and 2017/18 fiscal years is unchanged relative to the projection in October (see Table 2), while the 2017 Budget proposes to bring down the budget deficit at a similar, albeit slightly slower, pace over the medium term. In all, the consolidated budget deficit is expected to decline from an estimated 3.4% of GDP in 2016/17 to 2.6% in 2019/20. This will be achieved through a combination of sticking to the (reduced) expenditure ceiling for non-interest expenditure proposed in the MTBPS and higher taxes. Similar to the October projections, the consolidated **primary budget balance** (i.e. excluding debt service costs) is set to be in surplus from 2016/17.

Table 2: Medium-term consolidated budget projections

R billion	2016/17		Medium-term estimates			Ave: 2017/18 to 2019/20	
	MTBPS '16	Budget '17	2017/18	2018/19	2019/20	MTBPS '16	Budget '17
Revenue	1301.0	1297.3	1414.1	1535.2	1668.5	1541.7	1539.3
% of GDP	29.7	29.4	29.8	29.9	30.1	30.3	29.9
Expenditure	1451.5	1445.2	1563.1	1677.1	1814.3	1683.1	1684.8
% of GDP	33.1	32.8	33.0	32.7	32.7	33.1	32.8
Interest payments	154.5	153.4	169.3	187.6	206.3	188.3	187.7
% of expenditure	10.6	10.6	10.8	11.2	11.4	11.2	11.1
Non-interest expenditure	1297.0	1291.8	1393.8	1489.5	1608.0	1494.9	1497.1
% of GDP	30.2	29.3	29.4	29.0	29.0	30.0	29.1
Budget balance	-150.5	-147.9	-149.0	-141.9	-145.8	-141.4	-145.6
% of GDP	-3.4	-3.4	-3.1	-2.8	-2.6	-2.8	-2.8

Source: Budget Review 2017, MTBPS 2016

As outlined in the MTBPS, relative to what was expected in February last year, the 2017 Budget proposes to reduce the **expenditure ceiling** by R10.2bn in 2017/18 and by a further R15.9bn in 2018/19 through a reduction in spending on non-core goods and services, as well as keeping the public sector wage bill in check. In addition to the cut in the expenditure ceiling, **tax policy measures** that will raise an extra R43bn over the next two fiscal years are proposed.

Despite the largely unchanged outlook for the pace of fiscal consolidation, overall **net government debt** is expected to stabilise at a higher level of 48.2% of GDP in 2019/20. In the 2016 budget, net debt was expected to stabilise at 46.2% of GDP in 2017/18. According to Treasury, the higher debt level reflects revenue shortfalls and the build-up of cash reserves for significant government debt repayments over the period ahead. While the GDP growth outlook remained largely unchanged relative to the October MTBPS, declining tax buoyancy is expected to result in lower tax revenue over the medium term. Underspending and higher non-tax revenue could partially offset the shortfall, but government will need to borrow more to bridge the gap.

As a result, the gross **public sector borrowing requirement** is projected to increase from R220.9bn in 2017/18 to R284.4bn in 2019/20. Most of this requirement will be met by domestic long-term bond issuance, which on net (taking account of redemptions) is expected to average R142.5bn over the medium term. This is an upward revision from the average of R130bn expected in the MTBPS and a negative for the domestic capital market.

Tax proposals: No VAT hike, high-income consumers bear the brunt

The revised estimate for **total tax revenue** in 2016/17 is R1.14 trillion, R30.4bn below that expected at the time of the 2016 Budget and R7.6bn lower than the estimate in the October MTBPS. This is the largest tax revenue shortfall relative to budgeted estimates since the economic downturn in 2009/10.

The shortfall was as a result of weaker than expected revenue collection in three of the four main tax categories, i.e. PIT, VAT and custom duties. Corporate income tax collections are expected to exceed the 2016 Budget expectation. In recent years, weaker than expected GDP growth has weighed on revenue outcomes, but in the current fiscal year the tax shortfall was largely a function of the decline in imports (dragging down revenue from custom duties) and slower wage growth (depressing PIT revenue).

As signalled in the October 2016 MTBPS, the need to fund existing government spending priorities in a revenue-constraining growth environment meant that tax hikes were unavoidable this year. As a result, and in line with Treasury's expectation in October, the Budget proposes to raise R28bn in additional revenue in the 2017/18 fiscal year. The impact of the revenue-raising measures will be to increase the **tax burden** to 26.7% of GDP in 2017/18 from 26% in 2016/17.

The main tax proposals are:

- A new **top marginal income tax bracket** with a tax rate of 45% (up from 41%) for taxpayers earning more than R1.5 million per year. The estimate is that this will result in additional tax revenue of R4.4bn. Treasury calculations show that someone with annual taxable income of R2 million in 2017, will now pay R19,000 more in tax per year. The rest of the personal income tax brackets were only adjusted by 1%. By not fully adjusting the tax brackets for the impact that inflation has in pushing taxpayers into higher brackets, the Treasury saves R12.1bn.
- The combination of limited tax bracket adjustments and the hike in the top marginal income tax rate is estimated to provide R16.5bn in additional tax revenue.
- The **tax rate on dividends** (dividend withholding tax) declared to shareholders will increase from 15 to 20%. Treasury estimates that this will boost tax revenue by R6.8bn. The reason for the increase is to reduce the difference between the top marginal PIT rate and the dividend tax. The rise is effective from 22 February. The increase in the top marginal PIT rate and withholding tax will further increase the progressiveness of SA's tax structure. *The broad-based nature of the effective PIT hike suggests that, although our consumer spending forecast has already factored in a sizeable rise in the PIT burden, there may be downside risk to the consumer outlook.*
- Effective from 1 March 2017, the tax-free threshold on purchases of **residential property** will be increased from R750 000 to R900 000.
- The **fuel levy** will increase by 30c/litre and the **Road Accident Fund Levy** by 9c/litre, effective 5 April 2017. *Our CPI inflation forecast already built in about a 30c/litre rise in the fuel levy so this will not have any meaningful impact on the inflation forecast. However, the levy hikes may well be less than what the SARB built into their January CPI forecast. Along with the recent rand strength, the further fall in maize futures prices and the stable oil price, the SARB is likely to downwardly revise their inflation forecast next month.*
- The Budget Review mentioned proposals to expand the **VAT base** by removing the zero-rating on fuel. To mitigate the impact on the fuel price, a freeze (or potentially a decline) in the fuel levy will be considered. The discussions surrounding these proposals will take place in the lead-up to the 2018 Budget.

- The sin tax on **cigarettes** will increase by a nominal 8%, 8.5% for alcoholic spirits, 9% for ciders and between 6 to 9% for different categories of wine. Combined, the rise in the fuel levy and sin taxes are expected to raise R5.1bn in indirect tax revenue.
- The proposed **tax on sugary beverages** will be implemented as soon as the necessary legislation is approved by Parliament. This is only likely to be later in the year with the Treasury making no provision for revenue from this source in 2017/18.
- A revised **Carbon Tax Bill** will be polished for public consultation and tabled to Parliament by mid-2017. The Budget noted that in the first phase of the tax (through 2020) there will be no impact on the price of electricity.

Besides these tax measures, the Budget noted that if GDP growth does not accelerate over the medium term and revenue subsequently continues to underperform, it may be necessary to adjust consumption taxes, i.e. the **VAT rate**, which is low by global standards.

Protecting core expenditure in the face of spending cuts

In addition to higher taxes, government has been forced to revise its spending plans in light of weak GDP growth and lower-than-expected revenue collection. Indeed, after increasing by an average of 2.3% between 2013/14 and 2016/17, real consolidated government expenditure is expected to slow to an average of 1.9% over the medium term. Apart from the R26.1bn reduction in the expenditure ceiling over the next three years, about R30bn has been reprioritised to ensure that core expenditure is protected in the face of baseline budget cuts. The largest share of the reprioritised funds (R16.1bn) is allocated to higher education, while strong additional support is provided for social protection and health.

Table 3 outlines the projected medium-term (nominal) growth rates for key government expenditure items. The fastest growing item is **debt service costs**, reflecting the increase in the public sector borrowing requirement over the medium term. Despite a downward revision relative to the MTBPS, growth in spending on **higher education** remains elevated. Subsidies to universities are budgeted to grow by 10.9% over the medium term and transfers to the National Student Financial Aid Scheme (NSFAS) by 16.1%. Of the additional R21.1bn allocated to the sector (which includes a further R5bn provisional allocation in 2019/20), R7.2bn is allocated to fund the shortfall caused by the zero % fee increase for students from household earning up to R600 000 per year in the 2017 academic year.

Spending on **transfers to households** has been revised upward, reflecting average growth of 8.2% in social protection expenditure (i.e. social grants). Growth in the **compensation of employees** also saw a marginal upward revision compared to the MTBPS. However, relative to the 2016 Budget, compensation budget limits for national departments have been reduced by R1.4bn over the medium term.

Table 3: Debt costs and tertiary education fastest growing spending items

% change (nominal)	Ave: 2017/18 to 2019/20	
	MTBPS '16	Budget '17
Current payments	7.5	7.7
Compensation of employees	6.9	7.2
Goods and services	6.9	6.8
Debt-service costs	10.1	10.5
Transfers and subsidies	7.3	7.7
Higher education institutions	14.1	10.4
Households	6.8	7.8
Capital payments	5.3	5.1
Buildings and other capital	4.3	5.8
Machinery and equipment	8.6	2.4
Consolidated expenditure	7.6	7.9

Source: Budget Review 2017, MTBPS 2016

After a significant upward revision in spending plans on **capital goods** in October, growth projections were revised down marginally on the back of a significant reduction in expected investment in machinery and equipment. In contrast, spending on buildings and other capital is projected to increase at a faster pace. However, government spending on capital goods is still expected to contract in real terms over the medium term, in line with the BER's latest forecast. Based on figures provided by the major state-owned companies, Table 4 outlines Treasury's outlook for overall **public-sector infrastructure expenditure**. After a sharp contraction in 2016/17, capital expenditure by Transnet is expected to pick up over the medium-term as previously deferred projects come online. A contraction in capital expenditure by Eskom is pencilled in for 2019/20 as several longer-term construction projects (including the Kusile power station and the Ingula pumped-storage scheme) wind down. Disconcertingly, overall public sector infrastructure investment is expected to contract in real terms throughout the entire budget period

Table 4: Public-sector infrastructure expenditure and estimates

R billion	MTEF estimates				
	2015/16	2016/17	2017/18	2018/19	2019/20
Eskom	57.0	63.1	67.2	71.4	65.1
Transnet	29.4	22.8	36.2	37.3	45.0
Total (including other SOEs and general government)	261.2	289.8	306.7	314.3	326.1
% change (nominal)	-0.4	10.9	5.8	2.5	3.8

Source: National Treasury

Conclusion

The initial domestic financial market reaction to the Budget was fairly muted. The rand was somewhat weaker on the day, but this should be seen against the backdrop of a stronger US dollar. At the time of writing, the JSE was under some selling pressure, which may be related to the increase in the dividend withholding tax.

More important for the short-term prospects of the economy is how the credit rating agencies are likely to react to the Budget. There may be some concern in the further upward adjustment to overall government debt levels, but this may be eased somewhat by the fact that the outlook for fiscal consolidation is largely on par with the numbers presented in the October MTBPS. Our main concern is that the current political backdrop simply does not allow for the underlying structural constraints in the economy to be adequately addressed. This limits our medium-term growth potential and should ensure that - although not our baseline view - the risk of a credit rating downgrade in 2017 remains elevated.

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