

GOVERNMENT ANNOUNCES A WELCOME COMMITMENT TO SHIFT THE COMPOSITION OF SPENDING

- Introduction
- Budget deficit now set to remain above 5% of GDP through 2012
- Other issues
- Macroeconomic implications

Introduction

Against the backdrop of much weaker global economic prospects than during early 2011, Finance Minister Pravin Gordhan's third Medium-Term Budget Policy Statement (MTBPS) provided a more downbeat outlook for the SA economy and the fiscal position than was the case in the February Budget. Besides announcing a package worth R25bn over six years to boost the competitiveness of SA Inc and moves to attract more foreign companies to the JSE, the MTBPS contained no apparent headline grabbing announcements. However, in our view the most significant thread running through the document and the Minister's speech was a welcome confirmation that, in order to contribute to a higher GDP growth rate and employment in future, the composition of government outlays has to shift from consumption to investment.

Table 1: Macroeconomic forecasts: GDP growth outlook revised down

	Feb '11 Budget			Oct '11 MTBPS			
	2011	2012	2013	2011	2012	2013	2014
Real GDP growth	3.4	4.1	4.4	3.1	3.4	4.1	4.3
CPI inflation	4.9	5.2	5.5	5.0	5.4	5.6	5.4
Current account (% of GDP)	-4.2	-4.9	-5.0	-3.4	-3.8	-4.0	-4.2

Source: Budget Review / MTBPS

In an update of its macroeconomic projections (table 1), the Treasury said that it now expected GDP growth between 2011 and 2013 to average almost 0.5 percentage points (% pts) lower than previously estimated, while at an average of 5.3%, the outlook for CPI inflation remained largely unchanged. The Treasury's 5.4% CPI forecast for 2012 is certainly on the low side compared with most private sector forecasters that expect consumer inflation to average closer to 6% during 2012. Of interest is that the current account deficit is now forecast to average 1% pt lower at 3.7% of GDP during 2011-13 than expected in February.

The Treasury's revised GDP growth forecasts is more or less in line with the latest (September) Reuters Ecometer consensus views, but both the 2012 and 2013 figures of 3.4% and 4.1% respectively are quite a bit higher than the BER's latest views of 2.8% and 3.6%. In terms of the GDP components, the most significant divergence between the Treasury's and our forecast for 2012 concerns exports (6.9% versus the BER's view of 3.9%).

Budget deficit now set to remain above 5% through 2012

In terms of the key fiscal ratios, the revised MTBPS numbers indicate that the budget deficit is expected to average 5.06% of GDP between 2011/12 and 2013/14, around 0.5% pts higher than the 4.6% projected in February (table 2). The budget shortfall is set to narrow to 3.3% of GDP during 2014/15, helping to stabilize overall government debt from 2015.

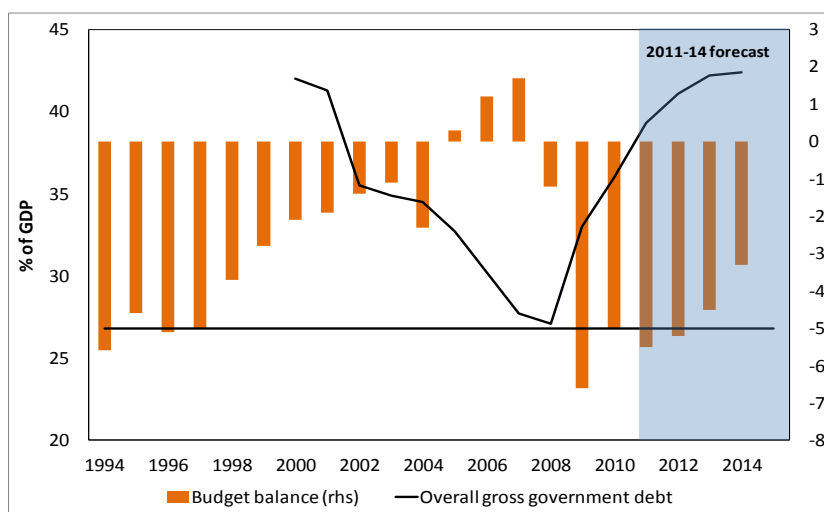
The updated forecast means that for the first time since 1994, SA will run a budget deficit in excess of 5% of GDP for four consecutive fiscal years, i.e. 2009/10 through 2012/13 (graph 1). The impact of the sustained deficits is to push overall gross government debt from a low of 27.1% of GDP in 2008/9 to 42.4% by 2014/15. Whereas a figure around 40% of GDP still compares very favourably with most advanced countries, IMF forecasts suggest that the projected rise of around 15% pts in SA's overall debt between 2008 and 2014 is large compared with our emerging market peers.

Table 2: Medium-term expenditure framework (MTEF)

R billion	2011/12		MTEF estimates		
	Budget (Feb '11)	MTBPS	2012/13	2013/14	2014/15
Revenue	824.5	814.2	890.0	994.5	1,113.0
% of GDP	28.3	27.3	27.0	27.3	27.7
Expenditure	979.3	978.8	1,062.3	1,157.4	1,247.0
% of GDP	33.6	32.9	32.2	31.8	31.0
Debt service	76.6	76.9	89.1	104.1	115.1
% of expenditure	7.8	7.9	8.4	9.0	9.2
Budget balance	-154.8	-164.6	-172.3	-162.9	-134.1
% of GDP	-5.3	-5.5	-5.2	-4.5	-3.3

Source: MTBPS

Figure 1: SA fiscal dynamics since 1994



Source: MTBPS

Downwardly revised revenue estimates are responsible for the slightly higher projected budget shortfall (-5.5% vs. -5.3%) in 2011/12. Estimates for gross tax revenue have been revised down by R13bn, largely as a result of **VAT receipts** that are now set to come in R13.4bn below the February projection. Of interest is that the reduced VAT forecast is not because of weaker than thought consumer spending, but rather an underestimation of VAT refunds for 2011/12.

The MTBPS provides for a small downward adjustment to the government spending forecast for 2011/12 to the tune of R900 million. Higher than expected outlays on public sector wages and salaries are offset by underspending on investment and maintenance of infrastructure – Minister Gordhan said that “this is a pattern that needs to be reversed in the period ahead”.

Looking forward, weaker economic conditions have also resulted in an R18.8bn downward revision to overall budget revenue for 2012/13. If anything, the Treasury’s 2012 GDP growth forecast may turn out to be on the optimistic side, which raises the risk that revenue could turn out to be even softer than the downward revision.

Regarding **government expenditure**, the MTBPS highlights that real government spending is at a record level and higher than any time since 1994 in relation to GDP (above 30%) - non-interest government spending rose by 8.2% of GDP from 2002/3 to 2009/10.

The MTBPS makes the point that in order to return the budget to a sustainable position over the medium term, spending needs to be limited in line with the capacity of the economy to generate revenue. Real spending growth is forecast to slow to 2.3% per annum over the medium-term expenditure period (MTEF), down from expected growth of 2.8% mentioned in the February budget. In nominal terms, consolidated government expenditure (national and provincial government as well as social security funds and selected public entities) is set to increase by an average of 8.4% over the MTEF. As a result of the higher budget deficits since 2008, at 14.4% **interest payments** on overall government debt is set to be the fastest growing spending item.

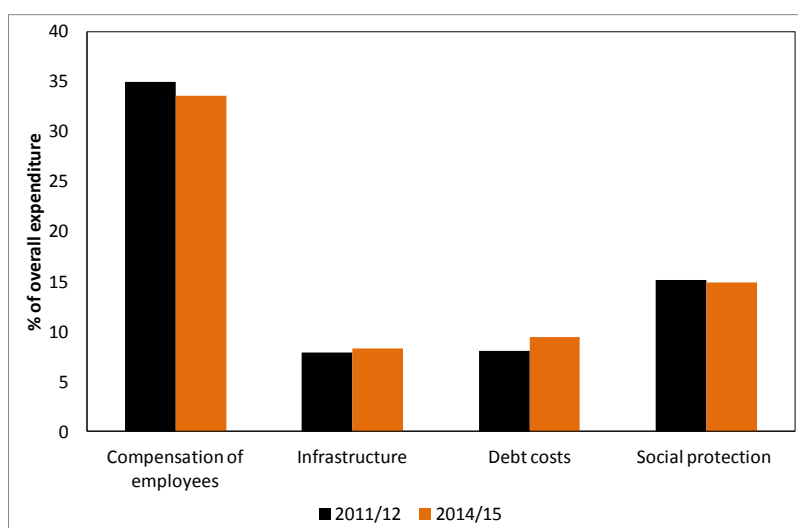
Not once or twice, but on several occasions throughout the MTBPS, the importance of changing the composition of government spending away from current spending on public salaries and wages to capital expenditure is emphasized. Indeed, after state debt costs, spending on **transport infrastructure** (average of 10.7% in nominal terms) is forecast to be the fastest growing spending category between 2011/12 and 2014/15. Compensation of employees is forecast to rise at a slower pace of 6.2% over the same period - wage increases of 5% for public sector workers have been budgeted for. In light of government’s projection that CPI inflation will average 5.4% over the MTEF, in real terms government employees are set to face declining wages. Already yesterday the challenge of sticking to the budget was highlighted. Manie de Cleque, deputy manager of the association of government employees, said there is no way that they will accept wage increases that are below the inflation rate. The expected moderation in public sector wage increases may be part of the reason why the Treasury’s 2012 CPI inflation forecast is so much lower than the current market consensus.

While we welcome the commitment to allocate more resources to expenditure items that will in future hopefully provide a return in terms of higher GDP growth, figure 2 highlights that when expressed as a percentage of overall spending, capital outlays are set to “only” rise from 7.9% in 2011/12 to 8.3% during 2014/15. Over the MTEF period, infrastructure plans amount to R802bn. Minister Gordhan mentioned in his speech that a greater effort is necessary to strengthen the capacity to manage

capital budgets and construction contracts, especially at local government level. The Development Bank of Southern Africa is providing support in this regard.

The combination of employee compensation, state debt costs and social protection (social grant payments etc) moves from 58.2% of overall spending in 2011/12 to 57.9%. Although the trend is in the right direction, the Treasury's forecasts still imply that a worryingly large proportion of SA's expenditure will go to fairly unproductive spending by 2014/15.

Figure 2: Changing the composition of spending, really?



Source: MTBPS

Despite the projected higher budget deficits that are forecast to see the main budget borrowing requirement peak at R181.2bn in 2012/13, the government is not planning to issue additional government bonds to provide financing. This should be welcomed by the bond market. The additional financing requirement will be covered by drawing on **government's cash balances** and exchanging debt maturing in the next several years for longer-dated debt.

Other issues

The MTBPS contained fairly scant information on detailed spending plans tied to the planned implementation of **National Health Insurance (NHI)**. Nominal health spending is set to increase by 7.4% over the MTEF, from R113bn in 2011/12 to R140bn by 2014/15. The spending rise includes NHI pilot projects in 10 districts that will be focused on comprehensive primary health care.

After discussing potential financing options for the NHI in the February budget, including the possibility that taxes may have to already be raised in the 2012 Budget, no mention of NHI financing was made in the MTBPS. This may suggest that the uncertainty regarding government revenue in light of the fluid global environment has resulted in a slower than previously envisaged implementation of the NHI.

- Government will provide about **R25bn over the next six years** for a range of interventions aimed at supporting industrial development zones, enterprise investment, supporting the transition to a green economy and to leverage private sector infrastructure investment. The package will include temporary mechanisms to bolster productivity and innovation in industries that have long-term competitive potential.
- In an effort to improve SA's position as a **financial gateway to Africa**, all inward-listed shares (foreign owned companies) on the JSE will henceforth be classified as domestic assets and be included on the JSE indices. In the past, the JSE could not include foreign companies in its indices as local investors were not able to buy the shares freely. The measures are set to take effect by January 2012.
- Of interest was that on more than one occasion the MTBPS mentions that the current global and SA growth outlook should result in monetary policy remaining accommodative for the next 12 months. While this is in line with the BER's forecast, the Treasury does not normally send such a clear signal of its preference for the stance of monetary policy.

Macroeconomic implications

Despite a downward revision to government revenue for 2011/12 and 2012/13, the Treasury kept the outlook for expenditure largely unchanged, providing a moderate countercyclical impulse to the economy.

The fiscal stimulus may reduce some of the pressure on the SA Reserve Bank to reduce the repo rate further. However, the likelihood of another 50bps cut remains high if more concrete signs emerge that the European and / or US economies have entered a second downturn. Although the MTBPS is normally not the time to talk about any potential tax adjustments in the main February budget, the uncertain growth environment reduces the possibility of major tax increases during February.

The release of the MTBPS has not altered the BER's recently updated forecast for the SA economy, but we will closely monitor government's progress on accelerating infrastructure investment. Positive developments on this front may necessitate an upward revision to our outlook for real growth in government fixed investment (average of 5.2% between 2012 and 2015) over the MTEF period.

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