

Comment

Budget starts to undo MTBPS damage

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Introduction

The Budget started to repair the fiscal credibility lost in October when the Medium-Term Budget Policy Statement (MTBPS) shocked domestic financial markets and resulted in further sovereign credit rating downgrades.

The wave of positive global sentiment towards South Africa and signs of improved domestic confidence so far in 2018 seem to have encouraged the Treasury to announce some bold steps. These include the first increase in the **value-added tax** (VAT) rate since 1993 and an unexpected further lifting in the **prudential limit** for offshore investing. Also positive was confirmation in the Budget that no allocations were made for the provision of **nuclear power** over the medium term.

On the other hand, the Budget numbers reveal the stark reality of former President Zuma's populist announcement of **free higher education** in December 2017. In all likelihood, this forced Treasury's hand on the tax front. All things being equal, the additional allocations for tertiary education announced in the Budget add 0.3 percentage points (% pts) to the budget deficit in 2018/19 and 0.4% pts for 2019/20 and 2020/21 (see Table 2 for details).

These contrasting signals from the Budget mean that it is no easy task to pass judgement. Financial markets should celebrate the higher VAT rate as it shows real commitment to get the fiscal house in order. However, a number of concerns remain, especially about government expenditure and the continued lack of concrete measures to lift SA's potential growth rate.

Growth outlook revised up on improved confidence, supportive global conditions

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** has been revised up by an average of 0.3% pts over the 2018-20 period. Treasury expects growth to measure 1% in 2017 (up from the 0.7% expected in the MTBPS), before gradually picking up to reach 2.1% in 2020. This is broadly in line with our views. According to Treasury, the improved growth outlook reflects an upward revision to global growth prospects, higher commodity prices, strong growth in domestic agriculture (for 2017 in particular), and an expected increase in **private fixed investment** as a result of improved business and consumer sentiment.

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Please refer to the [glossary on the BER's website](#) for explanations of technical terms.

The confidence gain reflects a renewed sense of optimism following the election of Cyril Ramaphosa as ANC president in December and his elevation to President of the Republic following the recall of Jacob Zuma.

Table 1: Improved macroeconomic outlook

	Oct '17 MTBPS				Feb '18 Budget			
	2018	2019	2020	Average	2018	2019	2020	Average
Real GDP growth	1.1	1.5	1.9	1.5	1.5	1.8	2.1	1.8
CPI inflation	5.2	5.5	5.5	5.4	5.3	5.4	5.5	5.4
Nominal GDP growth	6.2	6.8	7.5	6.8	7.3	7.2	7.7	7.4
Current account (% of GDP)	-2.6	-2.9	-3.1	-2.9	-2.3	-2.7	-3.2	-2.7

Source: Budget Review 2018, MTBPS 2017

Treasury's forecast for **nominal GDP growth**, which is more important from a government revenue perspective, was revised up by an average of 0.6% pts over the 2018-20 period. The upward revision reflects higher real growth and the impact of higher inflation projections. Treasury's forecast for the GDP price index (deflator) increased from an average of 5.3% in the October MTBPS to 5.6% in the 2018 Budget. This mainly reflects an upward revision to inflation expectations for 2018 due to the inflation implications of the tax proposals, most notably the increase in the VAT rate.

Similarly, Treasury's outlook for 2018 **consumer price inflation (CPI)** has also been revised up marginally. Treasury estimates that the tax proposals will add 0.6% pts to the CPI in 2018. However, over the medium term, this is countered by a much stronger rand exchange rate and contained increases in electricity tariffs. As a result, overall inflation is expected to average 5.4% over the 2018-20 period, unchanged from the October MTBPS. The main risks to the inflation outlook remain a weaker-than-expected rand exchange rate, higher global oil prices and higher average wage growth. Finally, an improved net export position, mainly due to stronger global demand and improved terms of trade on the back of higher commodity prices, is projected to result in a narrowing of the **current account deficit** from 3.3% of GDP in 2016 to just above 2.2% in 2017/18. The deficit is expected to deteriorate marginally over the MTEF, reaching 3.2% of GDP in 2020.

We think Treasury presented realistic macro numbers. As always, there are a number of downside risks to the outlook. However, as outlined in our recent **comment**, we judge the risks to be slightly tilted on the positive side. In all, both the BER and the Treasury project real GDP growth to average below 2% over the medium term.

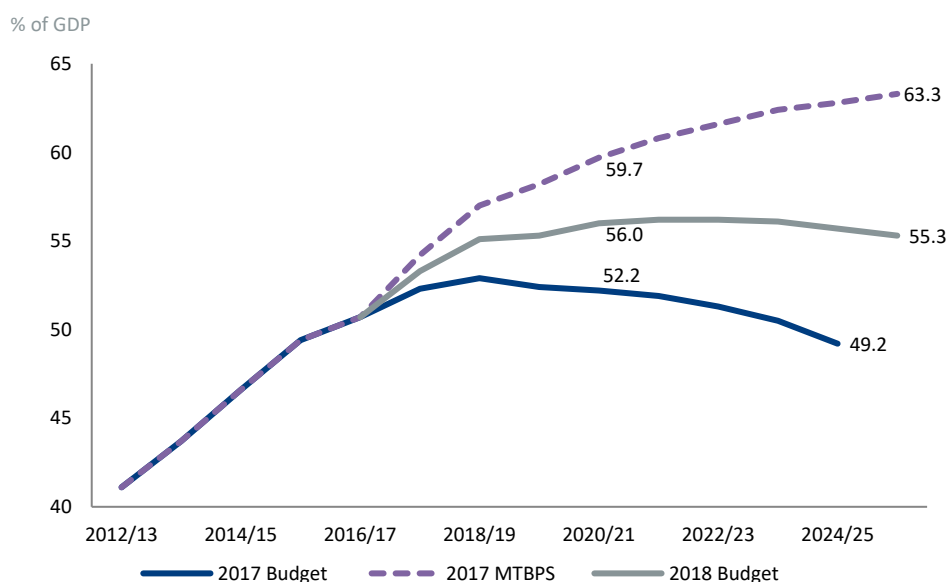
As was the case in the MTBPS, the Budget also includes a reference to several **macroeconomic scenarios**. Disconcertingly, even under a scenario in which the increase in business confidence evident in early-2018 is sustained, real economic growth comes in at an average of only 2.7% over the 2018-20 period. Although this would be a notable improvement from the recent past, it is still significantly below the rate required to meaningfully reduce poverty and alleviate unemployment.

Better growth, consolidation measures improve the debt trajectory

Table 2 outlines Treasury's revised outlook for the main fiscal ratios. On average, the consolidated **budget deficit** is expected to be 0.3% pts lower than outlined in the MTBPS. The marginal improvement is very much in line with our expectation.

While the smaller deficits are a positive development, some perspective is required. Relative to the 2017 Budget, the consolidated budget shortfalls for 2018/19 and 2019/20 are, on average, wider by 0.8% pts. It is a similar story for the overall **debt trajectory**, which is somewhere in the middle of the fairly optimistic view outlined in the 2017 Budget and the concerning trend (continuous rise in debt) presented in the 2017 MTBPS (see Figure 1).

Figure 1: Gross debt expected to stabilise below 60% of GDP



Source: Budget Review 2018

The comparisons are complicated because we were always of the opinion that the debt trajectory outlined in the MTBPS should not be taken at face value, i.e. that the numbers would be revised come the February Budget. Compared to the MTBPS, the improved fiscal dynamics are a function of the following:

- The improved Treasury **macro outlook** outlined above
- The proposed **tax hikes** and further expenditure constraint, i.e. another modest reduction in the **expenditure ceiling** over the medium term
- The stronger **rand exchange rate** and **lower borrowing costs**. The latter reflects the notable decline in domestic government bond yields from the highs reached in the wake of the October MTBPS

The **primary deficit** (which excludes the interest on government debt) closes over the medium term, stabilising the debt-to-GDP ratio around 56% of GDP by 2020/21. However, the government debt trajectory is worse than expected in February 2017. Combined with the rising debt burden of SOEs, the

public sector borrowing requirement is significantly higher than outlined in the February 2017 Budget. However, the domestic bond market should be buoyed by a reduction (relative to the MTBPs) in the expected issuance of long-term bonds to finance the debt. On average, over the next three fiscal years, government expects to issue R45bn less in long-term bonds. This implies roughly R800 million less long-term bonds issued per week. The initial capital market reaction to the budget was positive with the yield on the benchmark R186 government bond declining to below the key 8% mark.

Table 2: Medium-term consolidated budget projections

R billion	2017/18		Medium-term estimates			Ave: 2018/19 to 2020/21	
	MTBPS '17	Budget '18	2018/19	2019/20	2020/21	MTBPS '17	Budget '18
Revenue	1363.6	1353.6	1490.7	1609.7	1736.9	1593.7	1612.4
% of GDP	29.2	28.8	29.7	29.9	29.9	29.9	29.8
Expenditure	1566.6	1558.0	1671.2	1803.0	1941.9	1802.7	1805.4
% of GDP	33.5	33.2	33.3	33.4	33.4	33.8	33.4
Interest payments	163.6	170.4	187.8	206.1	223.9	203.3	205.9
% of expenditure	10.4	10.9	11.2	11.4	11.5	11.3	11.4
Non-interest expenditure	1403.0	1387.6	1483.4	1596.9	1718.0	1599.4	1599.4
% of GDP	30.0	29.5	29.5	29.6	29.6	30.0	29.6
Budget balance	-203.0	-204.3	-180.5	-193.3	-205.0	-209.0	-192.9
% of GDP	-4.3	-4.3	-3.6	-3.6	-3.5	-3.9	-3.6
% of GDP (excl FTE*)			-3.3	-3.2	-3.1		-3.2
Gross debt (% of GDP)	54.2	53.3	55.1	55.3	56.0	58.3	55.5
	Budget '17	Budget '18	2018/19	2019/20	2020/21	Budget '17	Budget '18
PSBR** (% of GDP)	5.3	7.0	5.9	5.8	5.8	4.5	5.8

*Free tertiary education

**Public sector borrowing requirement. This includes national government's borrowing needs, as well as those of SOEs and local government.

Source: Budget Review 2018, MTBPS 2017

Tax proposals: VAT hike accompanied by measures to enhance the progressiveness of the tax system

The focus of the 2018 Budget was always going to be on the revenue side, both in terms of the magnitude and the composition of the tax hikes announced. In the end, the tax proposals plan to raise R36bn in additional government revenue during the 2018/19 fiscal year. As highlighted in Figure 2, this is by far the largest tax increase in recent memory. Our latest (January 2018) forecast assumed tax hikes worth R30bn, so the proposals exceeded our expectations.

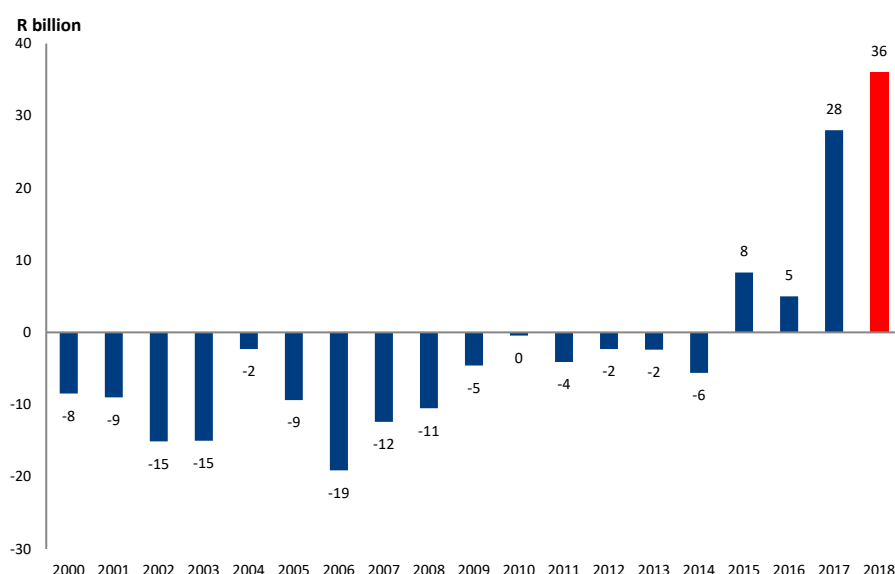
The headline announcement is that, for the first time since 1993, the **VAT rate** was increased. Treasury estimates that the 1% hike (from 14 to 15%) will bring in additional revenue of R22.9bn. Our January forecast did not include a general VAT hike. The Budget review mentions that above-inflation increases in **social grants** will help to cushion low-income households from the effects of the VAT rise. SA's VAT system also includes 19 basic food items that are zero rated for VAT, further softening the blow to the

poor. In a broader sense, the Treasury (correctly in our view) argues that a VAT hike will do the least damage to the economy and, at the same time, guarantees substantial revenue.

Other notable tax measures include:

- A rise in effective **personal income tax**. Only minimal (around 3%) adjustment to the tax brackets for the impact of inflation was made in the lowest three income tax brackets. No adjustment was made in the top four brackets. These measures, which are expected to raise R6.8bn in revenue, further increase the progressiveness of the SA tax system.
- Below-inflation adjustment in **medical tax credits** over the next three years. For the 2018/19 fiscal year, this is expected to boost government revenue by R700 million. This is intended to provide partial funding for the roll-out of **national health insurance** (NHI).
- Higher **ad valorem excise duties** for luxury goods. This will further increase the progressiveness of the tax system and, given that it is only expected to yield R1bn in extra revenue, is (in our view) more of a token to appease the alliance partners that the VAT hike will not make the overall SA tax system more regressive.
- An increase in the **estate duty**, to be levied at a rate of 25% for estates valued at more than R30 million.
- A relatively large increase in **fuel taxes** of 52c/litre. This consists of a 22c/litre increase in the general fuel levy and 30c/litre for the Road Accident Fund levy.
- Above-inflation increases in the excise duties on **tobacco products** (8.5%) and **alcohol** (6-10%).
- The introduction of a **tax on sugary beverages** (health promotion levy) from 1 April. This is expected to raise R1.9bn during 2018/19.
- Government proposes to implement a **carbon tax** from 1 January 2019.

Figure 2: Significant increase in the tax burden proposed for 2018/19



Source: Budget Review 2018

Expenditure constraint countered by new spending priorities

The Budget reflects the tension between the funding of major new expenditure commitments and the need for fiscal consolidation. This is highlighted by the two major spending changes contained in the Budget relative to the October MTBPS: spending cuts amounting to R85bn over the medium term, and an additional allocation of R57bn for **fee-free higher education** and training.

According to Treasury, the medium-term **spending reductions** are necessary to ensure a sustainable fiscal trajectory. However, these reductions will have a negative impact on the composition of spending. About 50% of the R85bn in spending cuts comprise cuts to transfers for **capital expenditure** to local government in particular. Spending on goods and services will be cut by R16.5bn, while current transfers will be reduced by R27.4bn (the latter is offset by allocations to the Department of Higher Education and Training for fee-free higher education). While these programmes continue to grow in real terms over the medium term, the reductions result in a further shift in the composition of spending away from capital and towards consumption expenditure. Following reductions in capital budgets, capital payments and transfers grow by an average of 4.1% in nominal terms over the budget period. Given the inflation outlook, this implies a contraction in real outlays, representing a drag on overall economic growth over the medium term.

The major **additions** to the spending framework include:

- Allocations to **fee-free higher education** for poor and working-class students amounting to R57bn over the medium term. This is in addition to the R10bn provisional allocation in the 2017 Budget. This implies a total allocation of R67bn over the MTEF period. Most of this (R43bn) will be allocated to the NSFAS student funding scheme.
- R4.2bn for **national health insurance**, funded through adjustments to the medical tax credit.
- A provisional allocation of R6bn set aside in 2018/19 for **drought relief**, assistance to the water sector, and public investment projects.
- An additional R10bn allocated to the **contingency reserve** over the medium term to cushion against fiscal risks materialising.

After taking these adjustments into account, the **expenditure ceiling** was revised down marginally by R5.8bn (relative to the October MTBPS) over the medium term. However, the ceiling is likely to be breached by R2.9bn in 2017/18 as a result of the recapitalisation of South African Airways and the SA Post Office.

In all, **total consolidated spending** is expected to post annual average (nominal) growth of 7.6% between 2018/19 and 2020/21 (see Table 3 below), or 2.1% in real terms. In keeping with the shift toward current spending, spending on staff and salaries remains one of the fastest growing categories. Expenditure on **compensation of employees** is expected to grow at an average of 7.3% per year over the medium term. However, should the current public-sector wage negotiations result in higher salary growth, additional funding will be required.

Table 3: Consolidated government expenditure

	Average MTEF growth (nominal %)	
	MTBPS 2017	Budget 2018
Current payments	7.9	7.5
Compensation of employees	7.3	7.3
Transfers	7.5	8.4
Payments for capital assets	3.6	7.6
Total	7.3	7.6

Source: Budget Review 2018, MTBPS 2017

Spending on **social grants** is projected to increase by an average of 7.9% per year over the medium term. All but one grant, the foster care grant, will increase faster than inflation to offset the impact of the increase in the VAT rate on the poor.

While **payments for capital assets** (this excludes transfers for capital expenditure) are projected to grow at a faster pace than previously expected, this mainly represents a positive base effect for 2018/19 as 2017/18 saw an underspend of around R20bn relative to the budgeted amount. In all, expected spending on capital assets over the next three fiscal years has been reduced by over R30bn relative to the MTBPS. In keeping with this trend, Table 4 outlines Treasury's outlook for overall **public-sector infrastructure expenditure**. Disconcertingly, with average nominal growth of only 3.2%, overall public sector infrastructure investment is expected to contract in real terms over the medium term. Given the current difficulties faced by public enterprises such as Eskom and Transnet, there is bound to be pressure on infrastructure budgets. This represents a drag on overall economic growth.

Table 4: Public-sector infrastructure expenditure and estimates

R billion	MTEF estimates				
	2016/17	2017/18	2018/19	2019/20	2020/21
Eskom	58.9	54.7	67.0	74.1	56.2
Transnet	21.4	23.1	27.2	32.0	42.2
Total (including other SOEs and general government)	249.9	260.1	266.0	282.3	285.8
% change (nominal)	-4.3	4.1	2.3	6.1	1.2

Source: National Treasury

Other issues: Relaxation in exchange control regulations

In an unexpected move, the first major exchange control relaxation since 2010 was announced in the Budget. The prudential limit for offshore investing by all categories of institutional investors (pension funds, investment managers, etc.) will increase by 5% pts to 30%, allowing domestic fund managers greater portfolio diversification. The prudential limit for investment in the rest of Africa will increase from 5 to 10%.

Conclusion: It's tight, but Moody's should provide a reprieve

While there were one or two major announcements in the Budget that were not in our baseline forecast (most notably the VAT hike), the outlook for the fiscal ratios largely met our expectation. The Budget is very much a middle ground between (arguably) a too positive outlook provided in the 2017 Budget and a worst-case scenario outlined in the MTBPS.

The question is whether this will be sufficient to prevent **Moody's** from downgrading SA's local currency credit rating in March. If the Budget is viewed in isolation, probably not. This is especially the case because, apart from paying lip-service to progress made on the confidence-boosting measures announced in mid-2017, the Budget does not include concrete references to any major structural reforms aimed at supporting long-term growth. Mention is made of the possible positive growth impacts of finalising outstanding policy and administrative reforms, but little substantive comments were forthcoming as to the status of these reforms and implementation timelines.

However, combined with the dramatic political events of recent weeks, as well as initiatives to stabilise SOEs and correct institutional decay (major issues flagged by rating agencies), we think the Budget may just have done enough to give SA a stay of execution on ratings. Importantly, to ensure no further downgrades in future, the GDP growth outlook will need to improve further. Without much-needed structural reforms, growth will remain subpar. After a much-anticipated cabinet reshuffle, the real test for President Ramaphosa will be whether his administration has the will and the ability to implement these essential structural reforms in a timely fashion.

In terms of our **macro outlook**, we will re-evaluate the numbers in the next few days and communicate any changes to clients. In particular, recent political events and confirmation of the Budget numbers are likely to result in some adjustment to our currency, inflation and potentially also the interest rate outlook. Inflation is interesting, as we will need to find a balance between a stronger-than-expected rand exchange rate and the impact of the VAT hike. On that note, our January forecast incorporated a larger fuel-tax induced hike in the petrol price than what was announced in the Budget. This should limit the upside potential for our inflation view.

Regarding the SA Reserve Bank's reaction to the VAT hike, they should treat it as an exogenous shock. As in our case, the SARB will have to balance the impact that the VAT hike will have on driving inflation higher against a stronger than expected currency.

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