Investec

MTBPS Review: Retreat from planned fiscal consolidation; deficit estimated to remain at 3.9% of GDP over the medium term framework

25th October 2016

Figure 1: Macroeconomic projections, 2015-2019

R billion/percentage change	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Actual		Estimate		Forecast	
Real GDP growth	1.9%	0.5%	0.7%	0.9%	1.1%	1.6%	2.0%
Nominal GDP growth	7.0%	6.6%	6.8%	6.1%	6.3%	7.0%	7.5%
CPI inflation	5.6%	5.2%	6.3%	5.0%	5.4%	5.5%	5.5%
GDP at current prices	**3 867.9**	**4 122.6**	**4 404.5**	**4 672.2**	**4 968.1**	**5 315.5**	**5 716.7**

Source: National Treasury

The 2017 Budget identified the main risks to the fiscal position over the medium term to be “the macroeconomic outlook, budget execution, policy uncertainty and financially distressed state-owned companies.” Since the Budget was tabled in February 2017, some of these risks have materialised. Namely, the economy is underperforming, partly as a function of heightened perceived policy and political uncertainty, and several state-owned companies are financially distressed. Key risks that remain relate to budget execution which in turn is linked to this year’s civil service wage negations.

With the economy having entered a technical recession in Q1.17 and more recent high frequency indicators suggesting only modest levels of activity, National Treasury in its Medium Term Budget Policy Statement (MTBPS), lowered its real and nominal GDP growth projections (see figures 1 and 2). The Treasury noted that the forecasts are based on the “status quo” prevailing. Specifically, real GDP growth was revised down to 0.7% in 2017 from 1.3%, and over the medium term is envisaged to rise to just 1.9%. These forecasts are aligned closer to those of the SARB and of the major international authorities (see figure 2).

The downward revisions to the growth forecasts was ascribed mainly to domestic factors relating to the effects of a “significant deterioration in business and consumer confidence over the past year” (see figure 3). According to National Treasury, factors affecting confidence levels include “(d)elays in finalising key regulatory processes, as well as a pattern of poor governance in several large state-owned companies”. Prolonged policy uncertainty raises the risk of entrenching confidence levels, and therefore economic growth, at low levels.

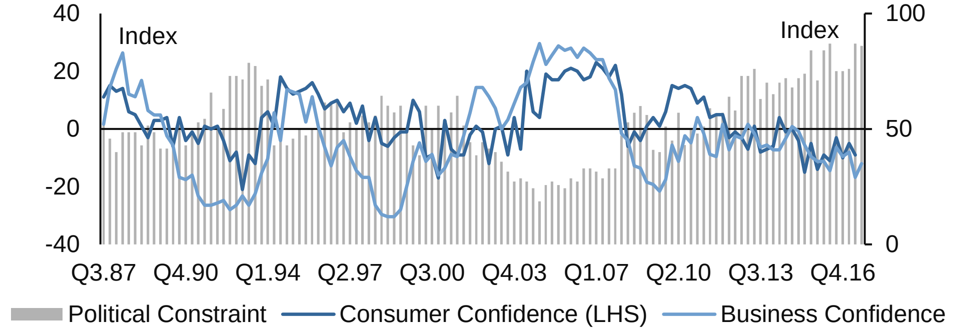
The MTBPS highlights that faster and sustained economic growth is vital to improving the fiscal outlook and recommends the “(r)apid implementation” of measures aligned with the National Development Plan (NDP). Additionally, the MTBPS outlined that confidence boosting measures would include restoring fiscal policy sustainability; managing risks associated with state-owned enterprises (SOEs) and finalising key legislative and policy processes. However, Finance Minister Gigaba admitted that the “greatest challenge remains effective implementation and slow pace in many instances.”

Figure 2: Real GDP growth, annual forecasts % change

	National Treasury		National Treasury	SARB	IMF	World Bank
(Date of forecast)	*(February 2017)*		*(October 2017)*	*(September 2017)*	*(October 2017)*	*(October 2017)*
2017	1.3	→	0.7	0.6	0.7	0.6
2018	2.0	→	1.1	1.2	1.1	1.1
2019	2.2	→	1.5	1.5	1.6	1.7

Source: National Treasury, SARB, IMF, World Bank

Figure 3: Confidence and policy uncertainty



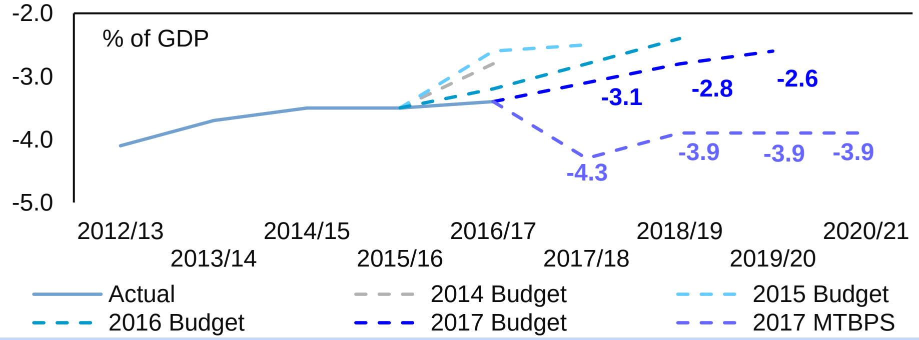
Source: BER

Lower real and nominal growth has rendered it more challenging to adhere to the fiscal consolidation path set out in the 2017 Budget (see figure 4). Specifically, the consolidated budget deficit was projected to decline from 3.4% of GDP in 2016/17, to 3.1% in 2017/18, 2.8% in 2018/19 and to 2.6% by 2019/20. However, the weaker than expected GDP growth trajectory, coupled with an absence of meaningful revenue and expenditure side adjustments, has seen the consolidated budget deficit estimates rise to 4.3% of GDP in 2017/18 and remain at 3.9% over the medium term framework period of 2018/19 to 2020/21.

The main contributing factor to the wider deficit forecasts is a substantial revenue shortfall, of an estimated R50.8bn in 2017/18 and an additional shortfall of a combined R158.7bn in 2018/19 and 2019/20 (see figure 5). The MTBPS confirmed that in the first six months of the 2017/18 fiscal year tax revenue rose by 5.9% y/y versus estimated growth for the full year of 10.7% y/y. The R50.8bn shortfall exceeds the shortfall of R30bn in 2016/17 and is the largest shortfall relative to estimates since 2009/10.

The revenue under-collection in the fiscal year so far, is apparent across all of the major tax categories. In particular, growth in personal and corporate taxes is falling short of targets. Personal income tax collections will have been affected by the technical recession, higher unemployment and slower growth in employee compensation. These factors, along with depressed consumer confidence and weak rates of credit extension have also restrained household consumption expenditure which is the tax base for VAT receipts. Another contributing factor to the lower collections relates to "(c)ompliance concerns [that] are mounting in the context of tax administration challenges and weakening tax morality."

Figure 4: Consolidated budget deficit actuals and National Treasury forecasts



Source: National Treasury

Figure 5: Gross tax revenue

	2016/17			2017/18		
R billion	**Budget[1]**	**Outcome**	**Deviations**	**Budget[1]**	**Revised**	**Deviations**
Persons and individuals	425.8	424.5	-1.3	482.1	461.3	-20.8
Companies	205.1	204.4	-0.7	218.7	213.9	-4.8
Value-added tax	290.0	289.2	-0.8	312.8	301.3	-11.4
Dividend withholding tax[2]	25.7	31.1	5.4	34.2	31.6	-2.6
Specific excise duties	35.7	35.8	0.1	39.9	37.4	-2.5
Fuel levy	63.0	62.8	-0.2	70.9	70.1	-0.8
Customs duties	47.5	45.6	-1.9	52.6	47.2	-5.4
Ad-valorem excise duties	3.4	3.4	0.0	3.6	3.6	-0.0
Other	48.2	47.3	-0.9	50.7	48.4	-2.3
Gross tax revenue	**1 144.4**	**1 144.1**	**-0.3**	**1 265.5**	**1 214.7**	**-50.8**

Source: National Treasury

[1] 2017 Budget figures

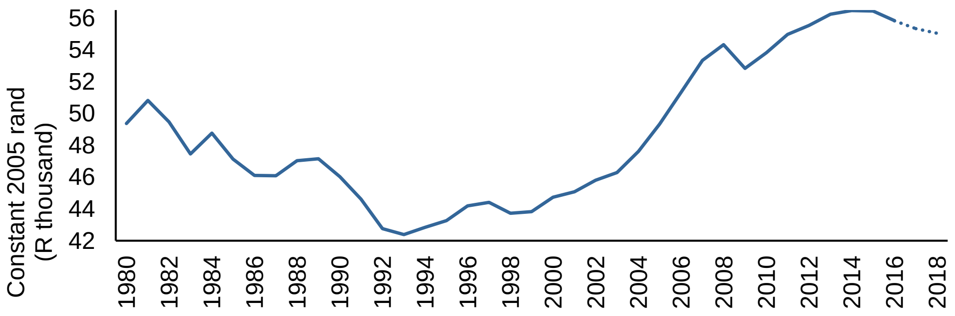
[2] Includes secondary tax on companies

The muted economic growth prospects are reflected in tax revenue collections remaining under pressure over the medium term framework period. However, the MTBPS reflected an absence of meaningful revenue side policy measures to be implemented. Specifically, the MTBPS did not hint at any further tax hikes in 2018/19, aside from the R15bn adjustment already announced in the 2016 Budget. In particular, the MTBPS cautioned that "(g)iven that per capita income is falling, the economic impact of further expenditure cuts or tax hikes could be counter-productive" (see figure 6).

With the MTBPS clearly not indicating a potential increase in personal or corporate tax rates it can be inferred that the R15bn is likely to be raised via the bracket creep adjustment and indirect taxes, namely sin taxes and the fuel levy.

On the expenditure side, there is a risk of the 2017/18 expenditure ceiling being breached by R3.9bn owing to the government bailouts of South African Airways (SAA) and the South African Post Office (SAPO) in this fiscal year (see figure 7). The combined allocation to SAA and SAPO totaled R13.7bn. However, this amount is partially offset by a projected underspending in the current fiscal year and a drawdown of the contingency reserve which adjusts the effect of the bailouts on expenditure to R3.9bn.

Figure 6: South Africa's per capita income



Source: Reserve Bank, National Treasury

Figure 7: Revisions to the 2017/18 expenditure ceiling

	R million
Expenditure ceiling: 2017 Budget Review	**1 229 823**
Upward expenditure adjustments	**16 167**
Roll-over of funds from 2016/17	217
Unforeseeable and unavoidable expenditure	586
Section 16 of the PFMA (SAA recapitalisation)	5 208
Announced in the 2017 Budget[1]	8 609
Self-financing[2]	1 547
Downward expenditure adjustments	**(12 268)**
Declared unspent funds	(1 668)
Direct charges against the National Revenue Fund: Magistrates' salaries	(100)
Contingency reserve	(6 000)
National government projected underspending	(3 000)
Local government repayment to the National Revenue Fund	(1 500)
Revised expenditure ceiling	**1 233 722**

Source: National Treasury

1. Includes the recapitalisation of the SAPO (R3.7 billion) and SAA (R4.8 billion) and the finalisation of the establishment of the Tirisano Construction Fund Trust (R117 million) *2. Spending financed from revenue derived from a vote's specific activities*

The previous National Treasury leadership had maintained the policy stance that "any intervention to support state- owned companies must be deficit neutral". It would appear that this remains the case with the MTBPS noting that "the disposal of assets to offset these appropriation" is being considered. The Minister's speech concretely made reference to the decision to dispose of a portion of government's Telkom shares. The 2018 Budget will confirm whether the asset sales transpired and the breach was reversed to maintain the expenditure ceiling.

The MTBPS acknowledges that the nominal expenditure ceiling, which places a limit on main budget non-interest spending, may need to be reduced further over the medium term framework period "to stabilise public finances" (see figure 8). In this regard, the MTBPS refers to the establishment of a Presidential Task Team that are to report on "a range of proposals to bring the public finances back onto a sustainable path". On the expenditure front, the task team "will identify savings and programme closures to improve the efficiency and impact of expenditure." Details will be outlined in the 2018 Budget.

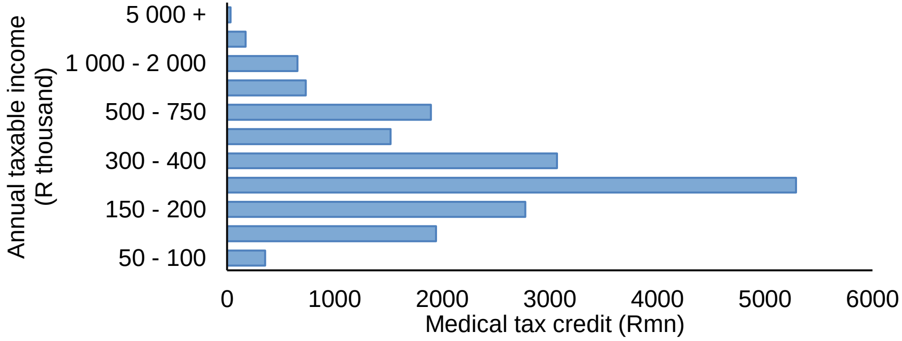
Figure 8: Main budget expenditure ceiling[1]

R billion/percentage change	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
2015 Budget Review	1 006 905	1 081 214	1 152 833	1 250 086			
2016 Budget Review	1 001 874	1 076 705	1 152 833	1 240 086	1 339 422		
2016 MTBPS		1 074 992	1 144 353	1 229 742	1 323 465	1 435 314	
2017 Budget Review[2]		1 074 970	1 144 225	1 229 823	1 323 553	1 435 408	
2017 MTBPS		**1 074 970**	**1 141 978**	**1 233 722**	**1 316 553**	**1 420 408**	**1 524 222**

Source: National Treasury

1. The expenditure ceiling differs from main budget non-interest expenditure. The precise definition and calculation of the expenditure ceiling is contained in Annexure C
2. Adjusted for the full amount for New Development Bank in 2015/16 and for the International Oil Pollution Compensation Fund.

Figure 9: Medical tax credit per income group



Source: National Treasury

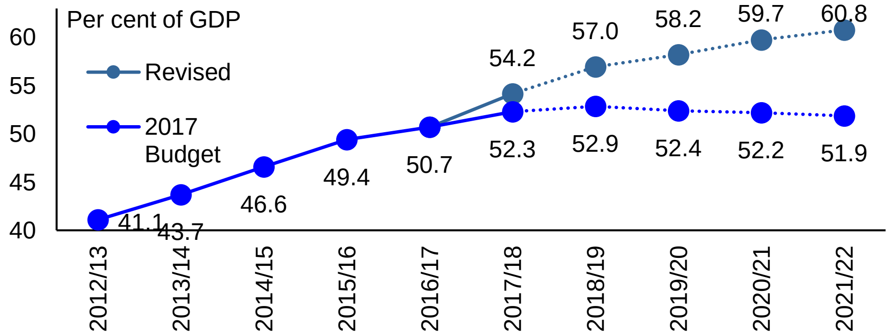
In the meantime, to partially offset the effect of revenue shortfalls the contingency reserve is estimated to be drawn down to R3bn in 2018/19 and R5bn in 2019/20 from R10bn and R20bn respectively as per the 2017 Budget. In total, over the medium term, the contingency reserve will amount to R16bn which is much lower than in previous budgeting cycles. Historically, SA's contingency reserve was used for natural disasters and global economic shocks.

In terms of additional spending priorities such as the funding of the national health insurance (NHI), the MTBPS maintains that these structural increases in expenditure must be matched by a permanent source of revenue. The medical tax credit is being considered as a funding source for the NHI and policy adjustments in this regard are to be announced in the 2018 Budget (see figure 9).

In the absence of meaningful revenue and expenditure side measures to achieve fiscal consolidation government debt to GDP ratios have also lifted over the medium term (see figure 10). Previously, gross debt was estimated to stabilise at 53% of GDP in 2018/19 and recede thereafter with net debt peaking at 48.2% in 2020/21. Gross and net loan debt are now seen rising throughout the medium-term framework period to 59.7% and 55.6% respectively in 2020/21.

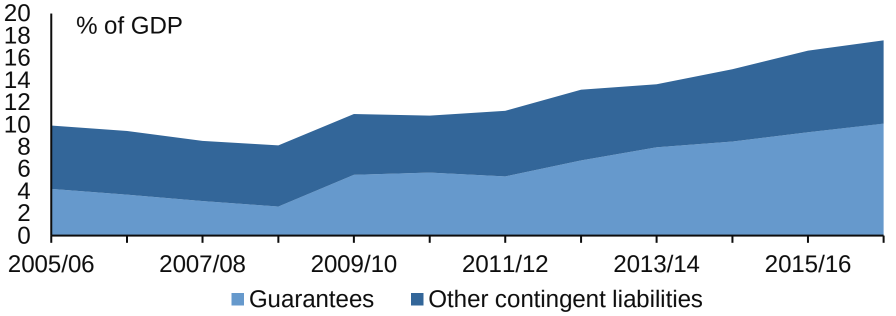
Achieving an eventual stabilisation of debt ratios will rely on addressing the sizeable fiscal risks associated with the realisation of contingent liabilities and/or recapitalisation of state-owned enterprises (SOEs). Government's major contingent liabilities relate to its guarantees. In the event of default by an SOE, the government may be called upon to fund the portion of the guarantees it has exposure to.

Figure 10: Gross-debt-to-GDP outlook without fiscal measures



Source: National Treasury

Figure 11: Contingent liabilities



Source: National Treasury

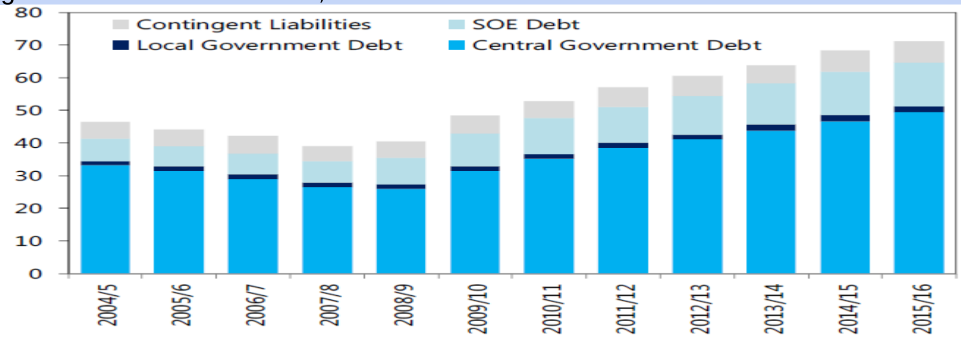
Government contingent liabilities have risen since 2008/09, reflecting the deterioration in the balance sheet position of several SOEs and the absence of structural reform in governance and management of SOEs (see figures 11). Specifically, guarantees to public institutions have risen from R298.4bn in 2009/10 to R477.7bn in 2016/17 (see figure 13). Over the same period, exposure (the amount that SOEs have borrowed against the guarantees) increased from R129.1bn to R308.3bn. The IMF has estimated that rising contingent liabilities in SOEs could push government debt levels from 51% of GDP presently to above the high-risk benchmark of 70% of GDP (see figure 12).

Encouragingly, the MTBPS states that government is developing a "new framework for the management of guarantees" rendering it more stringent. An overall reduction in guarantees, and therefore in contingent liabilities, would be positive from a fiscal perspective. In terms of governance issues, the urgency of establishing qualified Boards of Directors and returning SOEs to profitability was noted.

In this regard, a new board and CEO have been appointed at SAA. The Minister confirmed that government is not considering privatising SAA but noted the possibility of bringing in "a strategic equity partner." The recapitalisation of SAA in 2017/18 will total R10bn but the government's exposure to SAA will remain significant at R15bn.

The largest guarantee of R350bn is provided to Eskom. According to Eskom's 2017 integrated report, by March 2017 Eskom utilised R254bn of the guarantees with a further R84bn awaiting approval. With

Figure 12: Public sector debt, % of GDP



Source: IMF

Figure 13: Government guarantee exposure

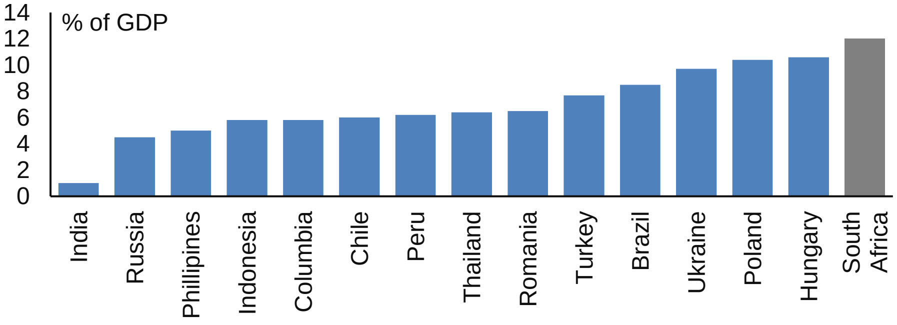
	2009/10		2016/17	
R billion	Guarantee	Exposure	Guarantee	Exposure
State-owned companies	**298.4**	**129.1**	**477.7**	**308.3**
of which:				
Eskom	*176.0*	*46.7*	*350.0*	*218.2*
SANRAL	*38.9*	*12.3*	*38.9*	*30.1*
Trans-Caledon Tunnel Authority	*25.6*	*20.7*	*25.7*	*20.7*
South African Airways	*1.6*	*1.4*	*19.1*	*17.9*
Land Bank	*3.8*	*2.6*	*11.1*	*5.4*
Development Bank	*29.3*	*26.6*	*12.7*	*4.2*
South African Post Office	-	-	*4.4*	*3.9*
Transnet	*11.4*	*11.6*	*3.5*	*3.8*
Denel	*1.9*	*1.9*	*1.9*	*1.9*
South African Express	-	-	*1.1*	*1.0*
Industrial Development Corporation	*1.6*	*0.9*	*1.9*	*0.2*
South African Reserve Bank	*7.0*	-	*3.0*	–
Independent power producers	**-**	**-**	**200.2**	**125.8**
Public-private partnerships[3]	**-**	**-**	**10.9**	**10.9**

Source: National Treasury

over two-thirds of the guarantees used up and with the utility under financial pressure following, amongst others, only a 2.2% tariff increase granted by NERSA this year, National Treasury did not elaborate on the “soft support” to Eskom outlined in the Minister’s 14-point inclusive growth action plan announced in July. It would appear from the MTBPS that an improvement in Eskom’s financial position will rely on NERSA granting Eskom the 19.9% plus tariff adjustment sought in 2018 combined with cost containment measures. In addition, The Minister confirmed that a new board will be appointed by the end of November 2017.

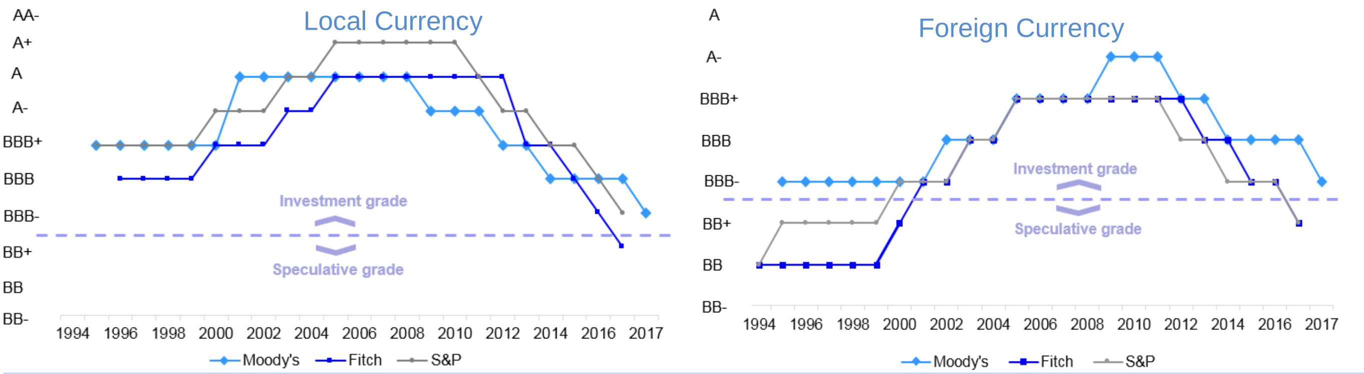
Government guarantee exposure to SOEs is already a key sovereign credit rating weakness, owing to the weak performance of the SOEs, and broader SOE reform cannot be delayed. On SOE reform, the IMF advises “(a) strong governance framework, including transparency surrounding board appointments and remuneration of board members and management, and stronger accountability are essential to improve efficiency and ensure incentives are aligned with those of the country.” Greater private participation has also been recommended to “help improve efficiency and service delivery, and free up resources for SOEs’ investments.”

Figure 14: Emerging market public sector wage bill



Source: IMF

Figure 15: South African local and foreign currency long-term sovereign credit ratings



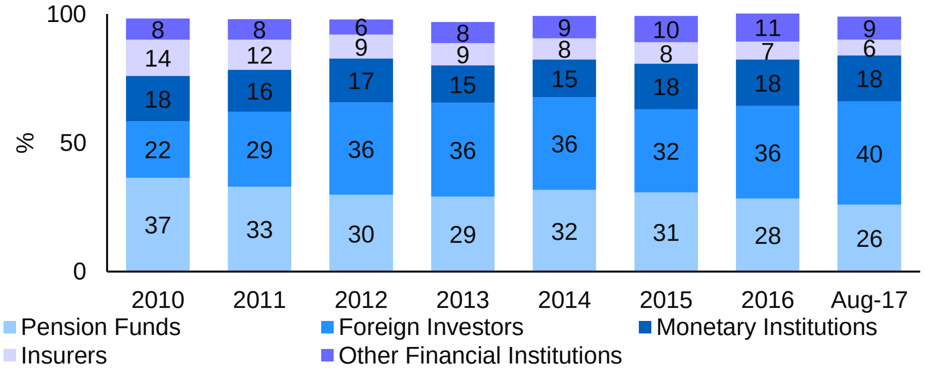
Source: Rating agencies

In terms of budget execution risk the MTBPS refers to the uncertainty surrounding the "outcome of public-service wage negotiations." Since 2008/09, compensation of employees has increased at an average rate of 10.3% per year, outpacing average nominal GDP growth of 7.9%. The Budget allows for compensation expenditure growth of 7.2% over the medium term. Compensation expenditure absorbs a sizeable share of total current expenditure, of 35%, "without a commensurate increase in productivity" according to the 2016 Budget. The outcome of the 2017/18 wage negotiations poses a potential risk if the settlement occurs in excess of the Budget estimate. Presently public sector wage demands are for a 10 – 12% increase. Wage bill pressures could threaten the expenditure ceiling and/or the composition of government spending (see figure 14).

The postponement of fiscal consolidation and the absence of a stabilisation of debt ratios substantially heightens the risk of further credit rating downgrades. South Africa's local currency credit rating with Moody's and S&P is one notch above non-investment grade and the outlooks are negative. SA's rating with Fitch is one notch below investment grade but with a stable outlook (see figure 15).

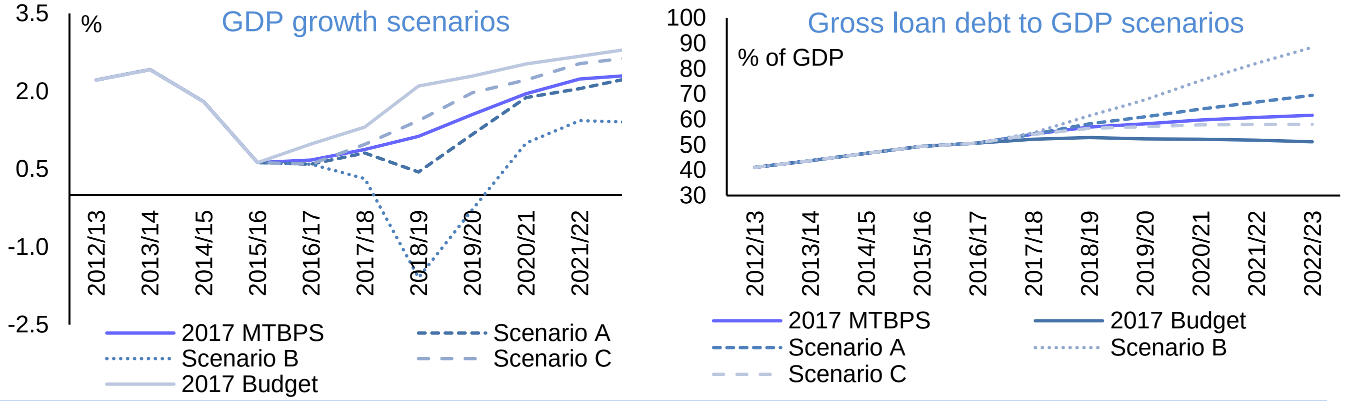
As the MTBPS did not deliver on fiscal consolidtion it is less likely that downgrades will be avoided in the end November 2017 scheduled country reviews. However, it may be the case that that before further downwards ratings actions, the rating agencies will look to the outcome of the ANC elective conference in December which will undoubtedly inform economic and fiscal policy and therefore the 2018 Budget.

Figure 16: Ownership of domestic government bonds



Source: National Treasury

Figure 17: GDP growth scenarios and Gross loan debt to GDP scenarios



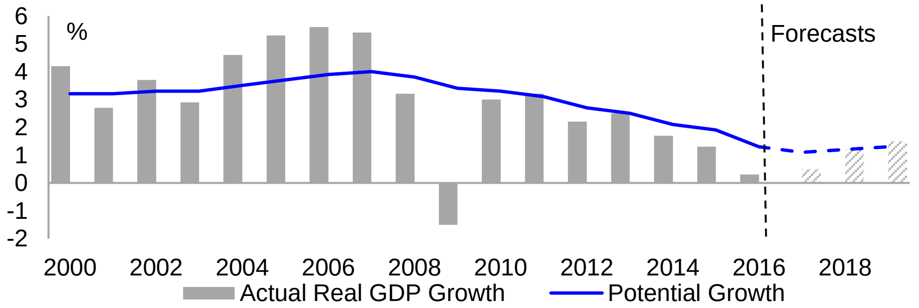
Source: National Treasury

A credit rating downgrade by both S&P and Moody's of the local debt rating would see SA exit key global bond indices, with forced selling by foreigners estimated at around US$10bn. Although only 10% of government debt is denominated in foreign currency, non-residents hold 40% of government's rand denominated debt which heightens SA's external vulnerability (see figures 16).

A critical concern of the ratings agencies pertains to economic growth prospects given the implications for fiscal consolidation. The MTBPS includes a scenario analysis of a situation where economic growth deteriorates further. Three scenarios are developed around the baseline as presented in the MTBPS. Scenario A assesses a local currency downgrade with limited effects. Scenario B assess a local currency downgrade with pronounced effects. Scenario C assesses the impact of higher global growth and commodity prices. As depicted in figure 17, a local currency downgrade will have adverse impacts on GDP growth and on gross loan debt ratios whilst a favourable external environment will be insufficient to offset the effects of weak domestic activity.

In the absence a sustained economic growth recovery to 3.0% and beyond, accomplishing fiscal consolidation will be difficult. As the IMF has previously assessed "implementation of pro-growth structural reforms would be the best sustainable way to ensure an improved fiscal outlook over the medium term." However, Moody's recently cautioned that "in the run up to the elections the commitment to difficult (and hence less popular) reforms aimed at promoting growth and consolidating government finances has been weakening." Effective policy implementation and the enhancement of policy certainty are required to restore business confidence and enhance the investment climate which would ultimately lift potential GDP growth (see figure 18).

Figure 18: Evolution of potential output growth



Source: SA Reserve Bank, Stats SA

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