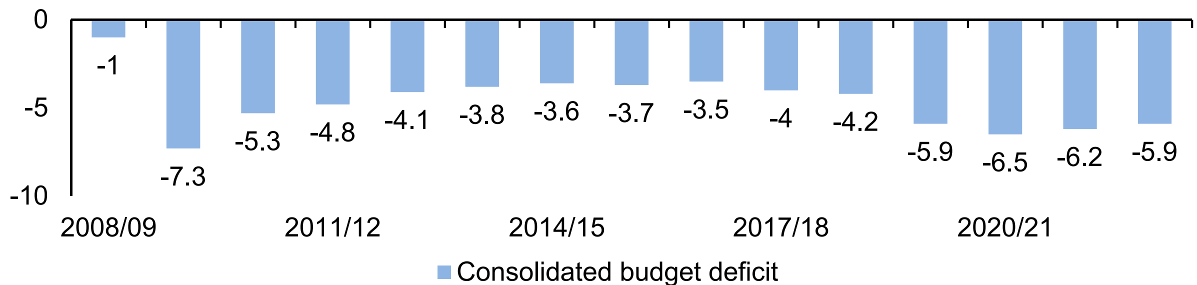
Investec

Budget Preview: A widening of the fiscal deficit is anticipated in the 2020 Budget, underpinned by weaker economic growth than previously projected

24th February 2020

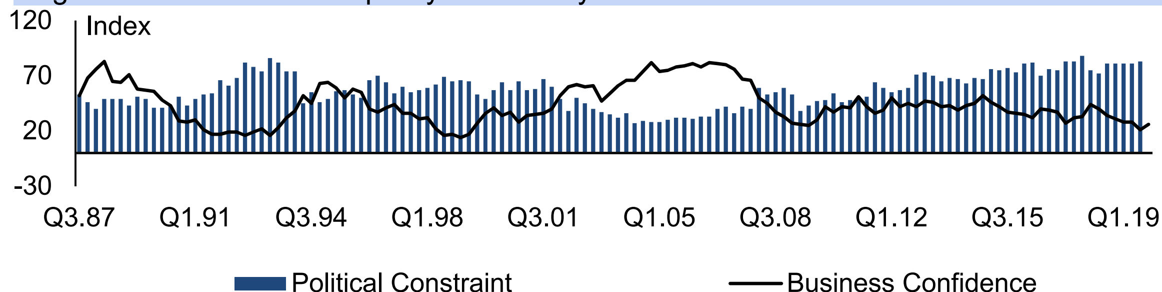
Figure 1: Budget deficit projections: (% GDP)



Source: MTBPS, National Treasury

- Since the tabling of the medium term budget policy statement (MTBPS) in October 2019, economic growth prospects have softened further, with recorded headline GDP for 2019 anticipated to be less than 0.5% y/y. Additionally, the World Bank and IMF have lowered their GDP growth forecasts for SA over the medium-term. Lower real and nominal growth continue to undermine efforts to adhere to fiscal consolidation.
- Specifically, the consolidated budget deficit (in February 2019's budget) was projected to reach 4.5% of GDP in 2019/20 and decline thereafter to 4.3% in 2020/21 and 4.0% by 2021/22. However, the weaker than anticipated GDP growth trajectory, coupled with expected, substantial revenue shortfalls and expenditure side overshoot, saw the consolidated budget deficit estimates (MTBPS) rise to a marked 5.9% of GDP in 2019/20 and average 6.2% over the medium term framework period.
- Stated reforms have been slow to implement, with confidence at historically low levels. Faced with a low-growth scenario, maintaining government's policy commitments continues to be challenging with repeated adjustments to either revenue or expenditure necessary. Considering the revenue and expenditure side measures already undertaken by Treasury, along with slower CPI inflation and nominal GDP growth, we anticipate the consolidated budget deficit to be slightly higher than forecast (MTBPS) at 6.1% of GDP in 2019/20. The tightening of fiscal levers (adjustments to revenue and expenditure projections) is key to rebuilding confidence and avoiding further credit rating downgrades.
- Eskom remains a key drag on the fiscus and government guarantees on its debt is a major concern for rating agencies, a workable, transparent solution to deal with the utility's spiraling debt, needs to be conveyed timeously, as ratings agencies deliberate SA's sovereign position.

Figure 2: Confidence and policy uncertainty



Source: BER

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Figure 3: Real GDP growth, annual forecasts % change

(Date of forecast)	National Treasury *(February 2019)*		National Treasury *(October 2019)*	SARB *(January 2020)*	IMF *(January 2020)*	Investec *(February 2020)*
2019	1.5	→	0.5	(0.4)	(0.4)	(0.3)
2020	1.7	→	1.2	(1.2)	(0.8)	(0.8)

Source: National Treasury, SARB, IMF, Investec

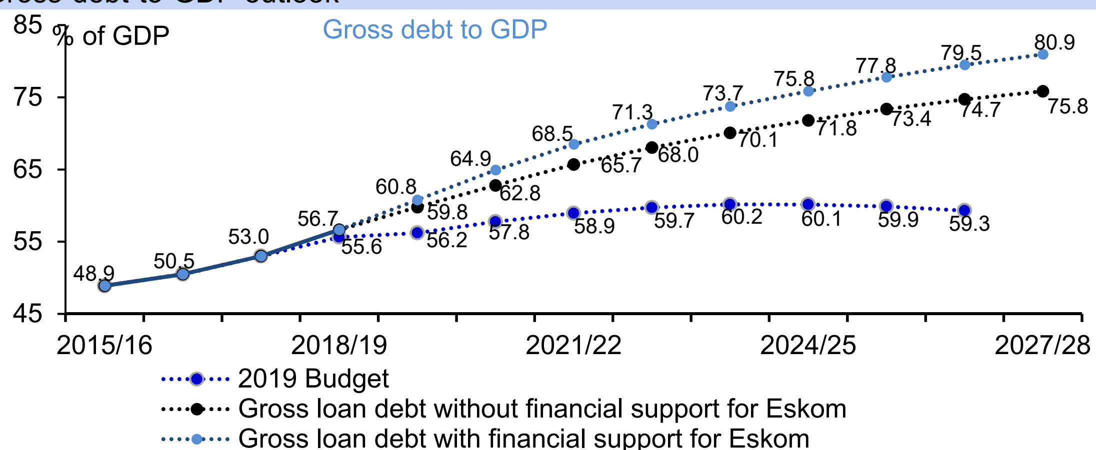
Globally, trade tensions did recede somewhat towards the beginning of the year, following the signing of a phase-1 trade agreement between China and the US. In its latest world economic outlook, published in January, the International Monetary Fund (IMF) projected global growth to lift to 3.3% y/y in 2020 and thereafter rise moderately to 3.4% y/y in 2021.

Subsequently, however the outbreak of novel coronavirus 2019, has reignited risk-off sentiment. Specifically slower economic activity in China would suppress the country's demand for commodities, with negative implications for global trade growth as well.

For the South African economy, the challenges arising from the global macroeconomic backdrop, have been compounded by multiple domestic factors. These pertain to the security of electricity supply in the country, with heightened rotational load shedding impeding the optimal functioning of the economy. Additionally, persistent policy uncertainty and the slow implementation of crucial reforms, continue to weigh on business and consumer confidence, inhibiting satisfactory growth.

The IMF recently cut its growth expectations for SA to 0.8% and 1.0% for 2020 and 2021 respectively, from 1.1% and 1.4% previously (October projections). Similarly, the SARB downgraded its domestic growth outlook to 1.2% y/y (from 1.4% y/y) and 1.6% y/y (from 1.7% y/y) for 2020 and 2021 respectively at its last monetary policy committee meeting in January.

Figure 4: Gross-debt-to-GDP outlook



Source: 2019 MTBPS National Treasury

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Figure 5: Revised Revenue Projections (MTBPS)

R billion	2019/20	2020/21	2021/22	2022/23
2019 Budget	**1,422.2**	**1,544.9**	**1,670.4**	
Buoyancy	1.31	1.17	1.08	
Revise estimates	**1,369.7**	**1,460.9**	**1,555.7**	**1,658.2**
Buoyancy	1.08	1.09	0.99	1.00
Change since 2019 Budget	**-52.5**	**-84.0**	**-114.7**	

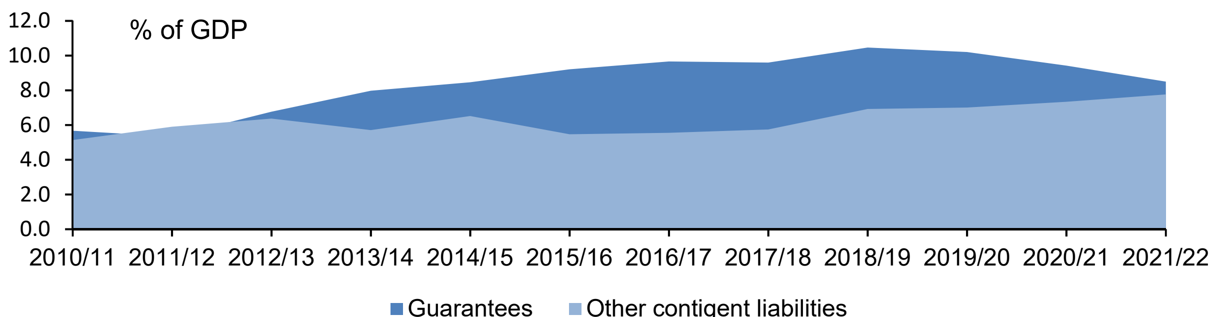
Source: National Treasury

Risks to the SARB's growth forecasts were furthermore evaluated to be to the downside. Specifically, an "(e)scalation in global trade tensions, geo-political risks, further domestic supply constraints and/or sustained higher oil prices," were cited as possible impediments to growth. Accordingly, the SARB emphasized the pressing need for "(i)mplementation of prudent macroeconomic policy and structural reforms," to bring down costs and lift "(i)nvestment, potential growth and job creation."

The hastened stabilisation of key, cash strapped state-owned enterprises (SOEs) is critical in view of sizeable fiscal risks associated with the realisation of contingent liabilities. Government's major contingent liabilities relate to its guarantees, which have risen markedly since 2008/09, reflecting the deterioration in the balance sheet position of several SOEs, largely as a result of governance failures and substandard operational performances. Specifically, Government's guarantee portfolio increased from R670 billion in March 2018 to R683.3 billion in March 2019, of which the largest facility was granted to Eskom.

Ballooning debt levels have been further undermined by marked revenue shortfalls, as weak economic activity and subdued sentiment levels suppress gross tax collections. Specifically a revised gross tax revenue shortfall, of R52.5bn was projected in the MTBPS for 2019/20, with an additional shortfall of a combined R198.7bn expected in 2020/21 and 2021/22.

Figure 6: Contingent liabilities



Source: National Treasury

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Figure 7: Gross tax revenue

R billion	2018/19 Budget[1]	2018/19 Outcome	2018/19 Deviations	2019/20 Budget[1]	2019/20 Revised	2019/20 Deviations
Persons and individuals	497.5	492.1	-5.4	552.9	527.6	-25.3
Companies	218.4	212.0	-6.4	229.6	219.0	-10.6
Value-added tax	325.9	324.8	-1.2	360.5	348.4	-12.1
Dividend withholding tax[2]	30.3	29.9	-0.4	31.9	32.0	0.1
Specific excise duties	40.3	40.8	0.6	42.4	46.5	4.2
Fuel levy	75.4	75.4	-0.0	83.0	78.4	-4.6
Customs duties	55.6	55.0	-0.7	60.0	58.4	-1.7
Ad-valorem excise duties	4.2	4.2	0.0	4.5	4.3	-0.1
Other	54.6	53.5	-1.1	57.6	55.1	-2.4
Gross tax revenue	**1 302.2**	**1 287.7**	**-14.5**	**1 422.2**	**1369.7**	**-52.2**

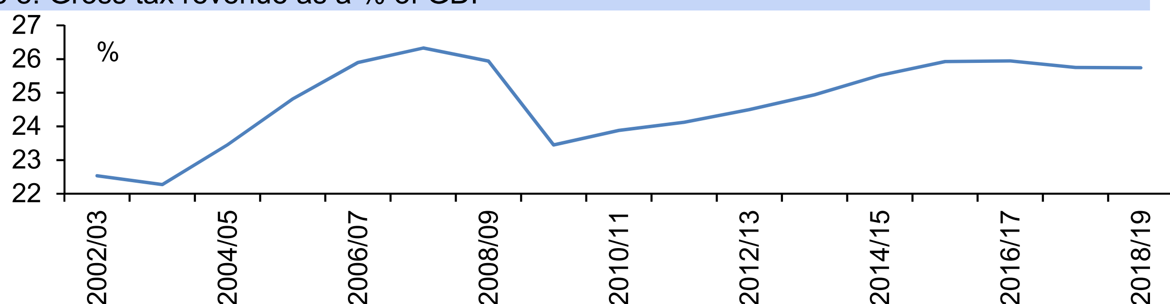
Source: National Treasury

1. 2019 Budget figures
2. Includes secondary tax on companies

While, government's economic reform agenda is expected to boost confidence and investment, "(t)hese reforms are only expected to begin yielding results over the next several years, implying continued weakness in revenue collection over the period ahead," according to Treasury.

Revenue under-collection has been apparent across all of the major tax classifications, but particularly in the VAT receipts category. Personal income tax growth has been restricted by job losses, with unemployment reaching 29.1%, the highest reading in over a decade. Additionally, low levels of confidence, high consumer indebtedness and slowing labour income growth have dampened household consumption expenditure. This has in turn weighed on domestic and import VAT collections as well as custom duties, on a lower demand for consumption goods. Similarly, corporate income tax collections have been particularly low, with corporate profit margins under pressure on stagnant economic activity, exacerbated by electricity load shedding, commodity price and exchange rate volatility and higher operating costs linked to administered price increases. According to Stats SA's latest liquidations and insolvencies release, "(l)iquidations increased by 10,7% in 2019 compared with 2018", with company specific liquidations up 11.0% y/y.

Figure 8: Gross tax revenue as a % of GDP



Source: National Treasury

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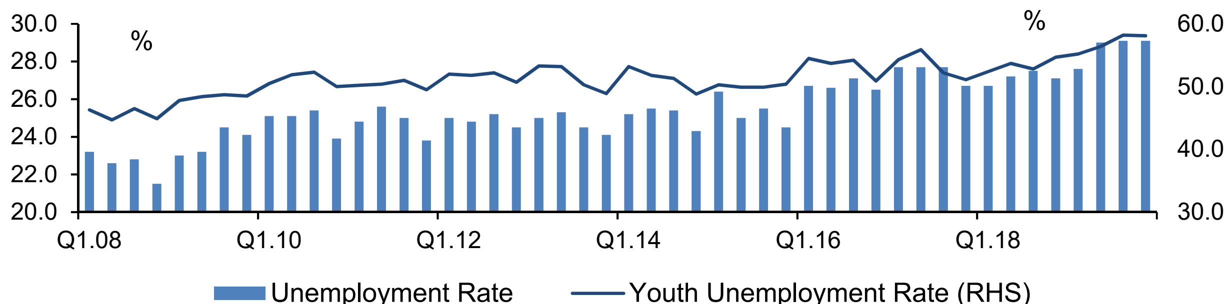
Figure 9: Unemployment Levels

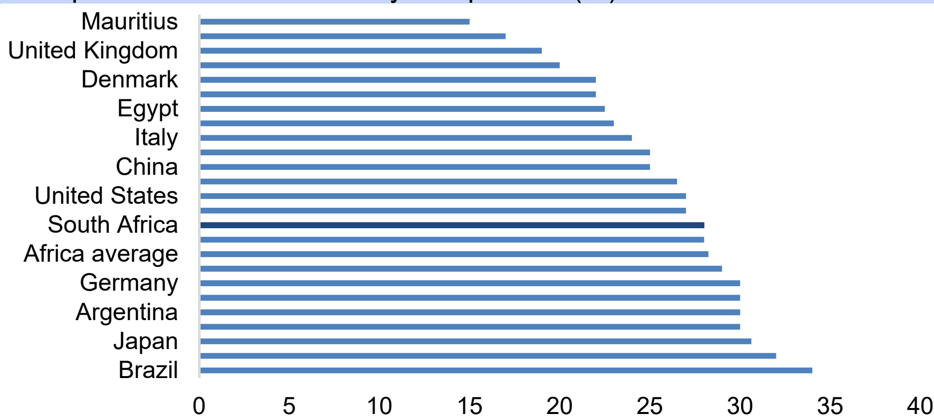


Source: Stats SA

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." Details surrounding the additional R10 billion in tax increases for 2020/21, specified in the 2019 budget are expected. However, the tax-to-GDP ratio is hovering close to its 2007/08 peak of 26.4 per cent, leaving only "(m)oderate scope to boost tax revenue", according to Treasury. Given the size of the required adjustment, however, additional tax measures are under consideration. "To reduce future transfers, a sustainable plan for state-owned companies is required."

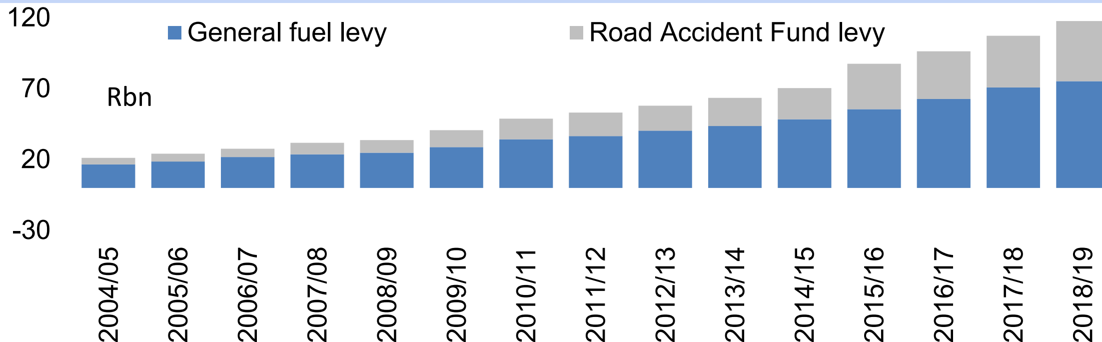
Fiscal drag may be used to raise around R12bn or more from taxation. Additionally, although it is not our central view, an increase in the VAT rate from 15% to 16% cannot be precluded. Indeed, although the VAT rise in 2018 was not well received by the already financially stretched consumer, according to Treasury in terms of longer term implications for the economy, an increase in the VAT rate would "(h)ave the least detrimental effects on economic growth and employment over the medium term." Specifically, the "(z)ero-rating of basic food items mitigates the effect of the increase on poor households. However, it could give rise to social discontent, where political tensions are already high, and are holding-up the implementation of key policy reforms in SA.

Figure 10: Corporate tax rates – country comparison (%)



Source: KPMG, National Treasury

Figure 11: Collections of combined fuel taxes



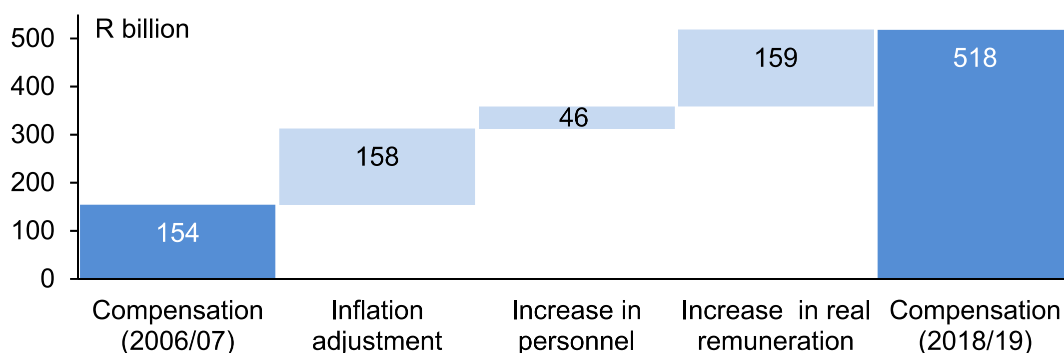
Source: National Treasury, Investec

Additional consumption taxes are likely to come from the general fuel levy, excise taxes on alcohol and tobacco, while an increase in taxes on sugar (health tax) is probable. Finally, the implementation of an expat tax is anticipated from the beginning of March. Specifically, SA residents working abroad will only be exempt from paying tax on the first R1 million they earn overseas, thereafter, they will be obliged to pay tax on their foreign earnings. Double taxation can thus occur "(i)f an individual earns employment income in excess of R1 million and the double tax agreement between South Africa and the foreign country, if any, does not provide a sole taxing right to one country, both countries will have a right to tax the income," according to SARS.

Measures implemented by Government to claw back some of the revenue shortfall, like reductions to departmental baselines have proved insufficient. Urgent additional actions to stabilise the debt outlook and improve the composition of spending are thus vital, with a reduction of the public wage bill a priority.

Indeed, "(s)alaries for civil servants have grown by about 40 per cent in real terms over the past decade", and remain a significant portion of the consolidated budget. Options put forward in the MTBPS to reduce the rate of growth in the wage bill, included "(p)egging cost-of-living adjustments at or below CPI inflation, halting automatic pay progression and reviewing occupation-specific dispensations for wages." The upcoming budget will likely highlight progress in this regard, following in-depth discussions with labour.

Figure 12: Drivers of higher compensation spending



Source: National Treasury

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Figure 13: Real main budget non-interest spending*

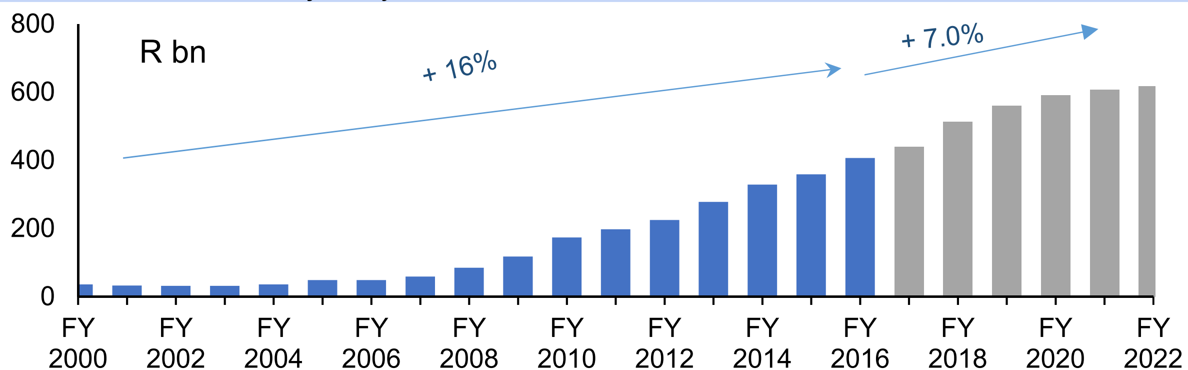
Source: National Treasury

*Excluding Eskom financial support and transactions in financial assets and liabilities

Main budget expenditure was revised up in the MTBPS, from initial projections outlined in the 2019 Budget Review, primarily as a result of additional support for Eskom. Specifically, main budget non-interest spending is projected to climb by R23 billion in 2020/21, relative to 2019 Budget projections and thereafter decline by R8.2 billion in 2021/22. “Spending additions include financial support for Eskom and the reversal of estimated savings from compensation measures and the reorganisation of government, which were announced in the 2019 Budget”.

Indeed, Eskom remains a significant drag on the fiscus and in its current state is a major concern for rating agencies. Its survival is however essential to the security of electricity supply and as such it remains vital for the optimal functioning of the economy. The MTBPS outlined the revised medium-term allocations for Eskom, specifically R49 billion for the current year, and an expected R112 billion over the medium-term expenditure framework (MTEF) period. Further resolution around Eskom’s financing requirements is highly anticipated, particularly by ratings agencies. In the meantime, government’s bailouts of Eskom, and other state owned organisations, have undermined fiscal consolidation and have tipped government debt levels toward the high-risk benchmark of 70% of GDP.

Figure 14: Eskom’s Debt Trajectory



Source: National Treasury

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Figure 15: Revised medium term allocations to Eskom

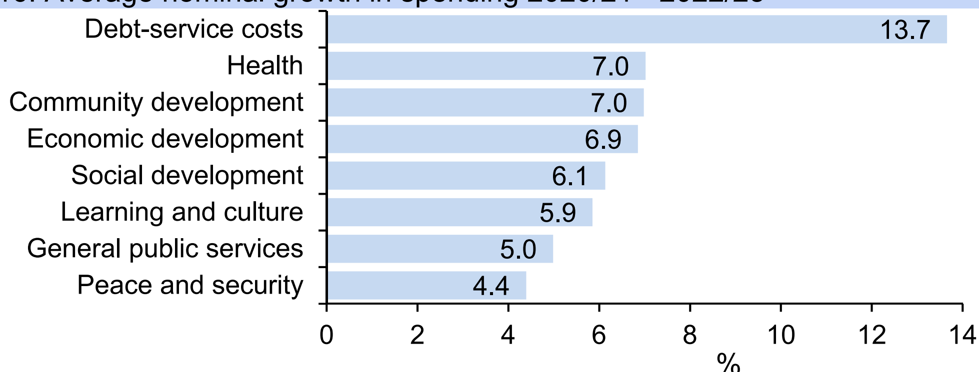
R million	2019/20	2020/21	2021/22	2022/23
2019 Budget baseline	23,000	23,000	23,000	23,000
Proposed changes	26,000	33,000	10,000	–
Revised 2019 MTBPS allocation	49,000	56,000	33,000	23,000

Source: National Treasury

The State of the nation address (SONA) however, did offer some guidance on what measures government intends to take "(t)o rapidly and significantly increase generation capacity outside of Eskom". This includes municipalities in good financial standing being permitted to procure power from independent power producers; increased reliance on existing wind and solar plants; the opening of bids for investment in renewable energy and faster processing of applications by industry for the generation of own use electricity. The President also reaffirmed the unbundling of Eskom into separate divisions of generation, transmission and distribution.

Spending has been directed towards consumption and debt-servicing rather than infrastructure and productive activities. The Minister of Finance will likely outline a series of measures to improve the composition of spending. Learning and culture is expected to garner a large share of funding as upskilling youth to enable them to enter the job market is a priority of government, this as the youth unemployment rate continues to climb to critically high levels (above 58% in Q4.19). Early learning initiatives are also being prioritized by government. Including, the introduction of coding and robotics into schools, essentially equipping children with the skills and knowledge required to function effectively in a changing world, with 4IR a reality. Additionally, a bill was recently been tabled by the department of education, to make it compulsory for children to do two schooling years before Grade 1.

Figure 16: Average nominal growth in spending 2020/21 - 2022/23



Source: MTBPS

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Figure 17: SA's credit ratings

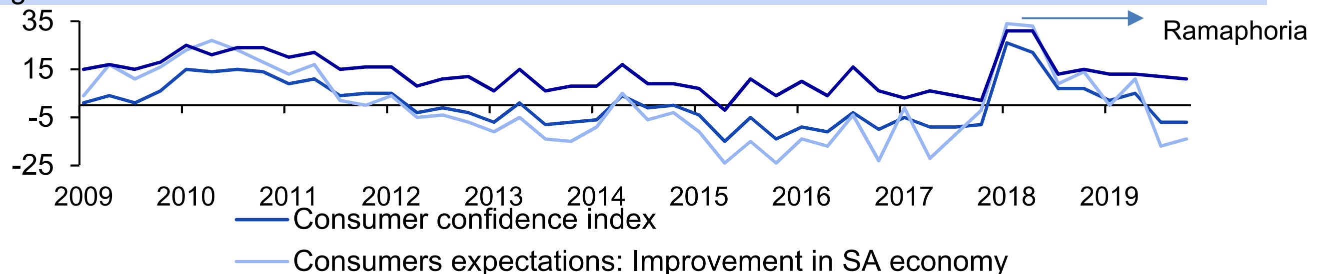
South Africa – S&P Ratings		South Africa – Fitch Rating		South Africa – Moody's	
03/10/1994	BB	22/09/1994	BB	14/10/2004	Baa2
20/11/1995	Upgraded to BB+	19/05/2000	Upgraded to BB+	11/01/2005	Upgraded to Baa1
25/2/2000	Upgraded to BBB-	27/06/2000	Upgraded to BBB-	16/07/2009	Upgraded to A3
07/05/2003	Upgraded to BBB	05/02/2003	Upgraded to BBB	27/09/2012	Downgraded to Baa1
01/08/2005	Upgraded to BBB+	25/08/2005	Upgraded to BBB+	06/11/2014	Downgraded to Baa2
12./10/2012	Downgraded to BBB	10/01/2013	Downgraded to BBB	09/06/2017	Downgraded to Baa3
13/06/2014	Downgraded to BBB-	04/12/2015	Downgraded to BBB-		
03/04/2017	Downgraded to BB+	07/04/2017	Downgraded to BB+		
24/11/2017	Downgraded to BB				

Source: Bloomberg

Fiscal space for further policy stimulus has been largely eroded. Inferring from the government finance statistics available for the fiscal year thus far, the revenue shortfall over and above the estimate in the 2019 MTBPS could be at least R5.0bn. Based on our revenue and expenditure estimates, we are anticipating a consolidated budget deficit of -6.1% of GDP, versus the -5.9% MTBPS projection. A deterioration in the fiscal metrics will likely weigh on Moody's decision, with markets anticipating a downgrade to sub-investment grade. Moody's is the only major ratings agency to rate South Africa's debt at investment grade, following downgrades to sub-investment grade by S&P Global Ratings and Fitch Ratings in 2017. A sub-investment grade rating would lead to an expulsion from the FTSE World Government Bond Index and a forced selling of SA bonds, weighing on the rand.

In the absence a sustained economic growth recovery to around 3.0% and beyond, accomplishing fiscal consolidation will be difficult. 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. In the President's State of the Nation address he highlighted the necessity of rectifying the fundamentals and "(p)ursuing critical areas of growth", to ultimately "(b)uild a capable state and place the economy on the path to recovery."

Figure 18: Consumer confidence index[1]



Source: BER

1. The consumer confidence index is expressed as a net balance between optimistic and pessimistic consumers. According to the Bureau for Economic Research, the index can vary between -100 for 'extreme pessimism' and 100 for 'extreme optimism', with 0 being 'neutral'

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