Budget update: Persistent fiscal constraints, amid a subdued economic environment, dragged down by Eskom's financial position suggest a possible downgrade in March

22nd February 2019

Figure 1: Macroeconomic outlook - summary

	2018	2019	2020	2021
Real percentage growth	**Estimate**		**Forecast**	
Final household consumption	1.5	1.5	2.0	2.3
Final government consumption	0.9	0.2	0.9	0.7
Gross fixed-capital formation	0.2	1.5	2.1	3.0
Gross domestic expenditure	1.2	1.3	1.9	2.2
Exports	2.0	2.3	2.7	2.8
Imports	3.8	1.7	3.2	3.3
Real GDP growth	**0.7**	**1.5**	**1.7**	**2.1**
Consumer price index (CPI)	4.7	5.2	5.4	5.4
Current account balance (% of GDP)	-3.5	-3.4	-3.8	-4.0

Source: National Treasury

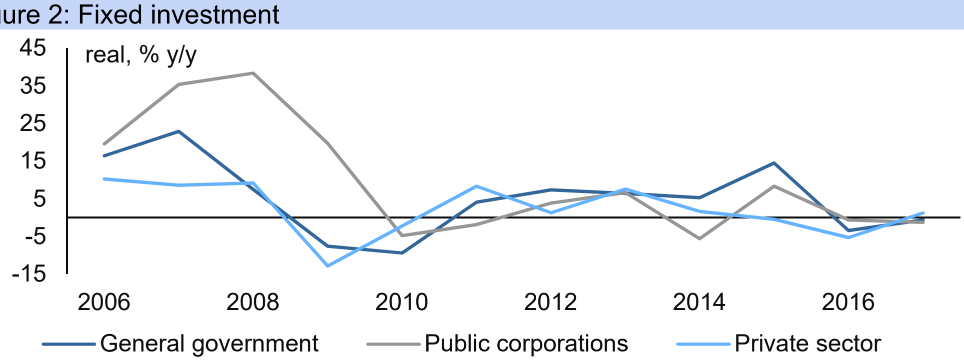
Finance Minister Tito Mboweni's maiden budget continued to reflect a tough fiscal environment, and was delivered against a backdrop of lackluster economic growth, characterized by elevated unemployment rates and suppressed consumer and business confidence levels. In addition, risks to global growth have increased, with lower commodity prices and waning international trade conditions further weighing on the domestic situation. However, despite these less than favourable circumstances "(g)overnment remains committed to managing the budget deficit and containing public debt at sustainable levels".

Severe operational and financial challenges at key state owned entities, especially Eskom pose the greatest risk to SA's public finances and the economy and while efforts have been made to contain spending, "(n)ew revenue and cost-cutting measures will not be sufficient to fully compensate for the revenue shortfall and support to Eskom," Moody's stated. As such a downgrade to SA's rating outlook is anticipated in March.

Central to the budget were immediate measures to address the crisis facing SA's electricity sector, including support in the form of R23 billion per year assigned over the medium term. "These amounts will allow Eskom to service its debts and meet redemption requirements, while making resources available for urgent operational improvements".

The division of Eskom into three independent units, was announced in the President's recent State of the Nation Address (SONA), reinforcing the necessity of a establishing a "(m)ore competitive electricity sector". This would ultimately "(i)mprove business and consumer confidence, encourage private investment and reduce upward pressure on prices", according to Treasury.

Figure 2: Fixed investment



Source: Stats SA

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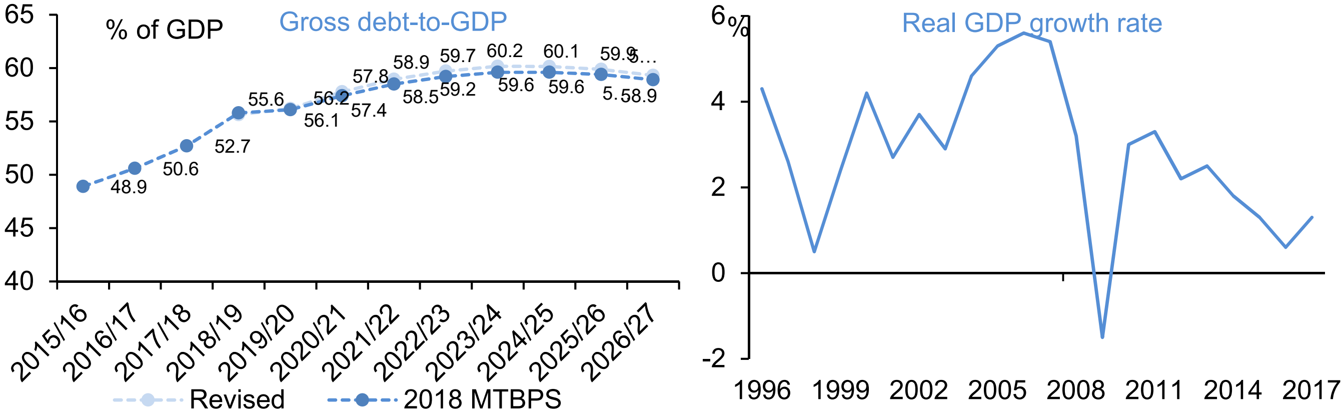
Figure 3: Gross debt-to-GDP outlook and Real GDP growth rate



Source: National Treasury

A weakening of the revenue and economic outlook since the MTBPS release, together with a surge in funding pressures from selected state owned entities has motivated "(l)arge-scale expenditure reprioritization" and tax measure proposals that see the budget deficit constrict from 4.2% of GDP in the 2018/19 fiscal year to 4.0% in 2021/2022.

Additionally, gross debt is expected to "(s)tabilise at 60.2 per cent of GDP in 2023/24, with net debt stabilising at 57.3 per cent of GDP a year later". These positive projections aside, there remains limited scope for meaningful consolidation that would gradually bring the deficit and debt levels, towards the international benchmarks of sustainable and prudent targets of 3.0% of GDP and 40 - 55% of GDP respectively.

Tax measures are projected to achieve an "(a)dditional R15 billion in 2019/20 and R10 billion in 2020/21", relative to the 2018 MTBPS estimates, with the extra revenue in 2019/20 "(r)aised primarily from limiting relief for the effects of inflation on personal income tax".

Expenditure additions are estimated to amount to R75.3 billion over the medium-term, "(o)f which R69 billion is a provisional allocation for reconfiguring Eskom, R5 billion is for the infrastructure fund and R1.3 billion is for the 2021 Census". These will however be "(p)artially offset by reductions to baselines and proposed savings from compensation adjustments totaling R50.3 billion".

"The contingency reserve is increased by R6 billion in 2019/20 (to respond to possible requests for financial support by SOCs), and is lowered by R8 billion in the two outer years of the framework − Any financial support agreed on will be raised from the sale of non-core assets and will be excluded from the expenditure ceiling".

Figure 4: Expenditure ceiling[1]

R million	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
2017 Budget Review	1 074 970	1 144 225	1 229 823	1 323 553	1 435 408	
2017 MTBPS		1 141 978	1 233 722	1 316 553	1 420 408	1 524 222
2018 Budget Review			1 232 678	1 315 002	1 416 597	1 523 762
2018 MTBPS			1 225 455	1 314 865	1 416 597	1 523 762
2019 Budget Review				1 310 156	1 430 595	1 525 052

Source: National Treasury

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Figure 5: Estimates of individual taxpayers and taxable income, 2019/20

Taxable bracket	**Registered individuals**		**Taxable income**		**Income tax payable before relief**		**Income tax relief**		**Income tax from medical tax credits**		**Income tax payable after proposals**	
R thousand	Number	%	R billion	%	R billion	%	R billion	%	R billion	%	R billion	%
R0 - R70[1]	6 369 806	–	183.4	–	–	–	–	–	–	–	–	–
R70 - R150	2 385 046	31.2	254.0	10.0	10.3	1.9	-0.34	28.5	0.05	5.0	10.1	1.8
R150 - R250	1 949 150	25.5	387.4	15.2	36.4	6.6	-0.32	26.9	0.20	23.1	36.2	6.5
R250 - R350	1 169 590	15.3	349.9	13.7	49.6	9.0	-0.19	15.8	0.21	22.1	49.7	9.0
R350 - R500	984 790	12.9	408.5	16.0	75.9	13.7	-0.16	13.3	0.23	21.9	76.0	13.7
R500 - R750	610 331	8.0	367.1	14.4	89.1	16.1	-0.10	8.2	0.15	14.3	89.2	16.1
R750 - R1 000	261 631	3.4	224.7	8.8	66.1	12.0	-0.04	3.5	0.07	6.1	66.2	12.0
R1 000 - R1 500	161 868	2.1	193.9	7.6	65.8	11.9	-0.03	2.2	0.05	4.4	65.8	11.9
R1 500 +	120 751	1.6	362.7	14.2	159.8	28.9	-0.02	1.6	0.04	3.2	159.8	28.9
Total	**7 643 157**	**100.0**	**2 548.1**	**100.0**	**553.0**	**100.0**	**-1.18**	**100.0**	**1.00**	**100.0**	**552.9**	**100.0**
Grand total	**14 012 963**		**2 731.5**		**553.0**		**-1.18**		**1.00**		**552.9**	

Source: National Treasury

The tax revenue shortfall has risen to R42.8 billion, notably "(h)igher than the revised estimate of R27.4 billion published in the 2018 MTBPS". This, as the effects of "(e)conomic weakness has fed through to lower personal income tax and corporate income tax receipts", coupled with inefficiencies in tax collection.

As such, tax collections for 2018/19 are projected at R1.3 trillion, with the marked "(t)ax revenue shortfall and new expenditure pressures" necessitating "(f)urther tax policy and spending interventions".

"The Commission of Inquiry into Tax Administration and Governance by the South African Revenue Service (the SARS Commission), has recommended steps to improve governance at the agency. SARS is strengthening its operations by re-establishing the Large Business Centre and setting up a dedicated unit to tackle syndicated tax evasion".

Figure 6: Impact of tax proposals on 2019/20 revenue [1]

R million		
Gross tax revenue (before tax proposals)		**1 407 208**
Budget 2019/20 proposals		**15 000**
Direct taxes		**13 800**
Taxes on individuals and companies		
Personal income tax	**13 800**	
Revenue from not fully adjusting for inflation	12 800	
Revenue if no adjustment is made	14 000	
Partial bracket creep for personal income tax	-1 200	
No adjustment to medical tax credit	1 000	
Indirect taxes		**1 200**
General fuel levy adjustment	-500	
Introduction of carbon tax on fuel	1 800	
Additional VAT zero-rated items	-1 100	
Increase in excise duties on tobacco products	400	
Increase in excise duties on alcoholic beverages	600	
Gross tax revenue (after tax proposals)		**1 422 208**

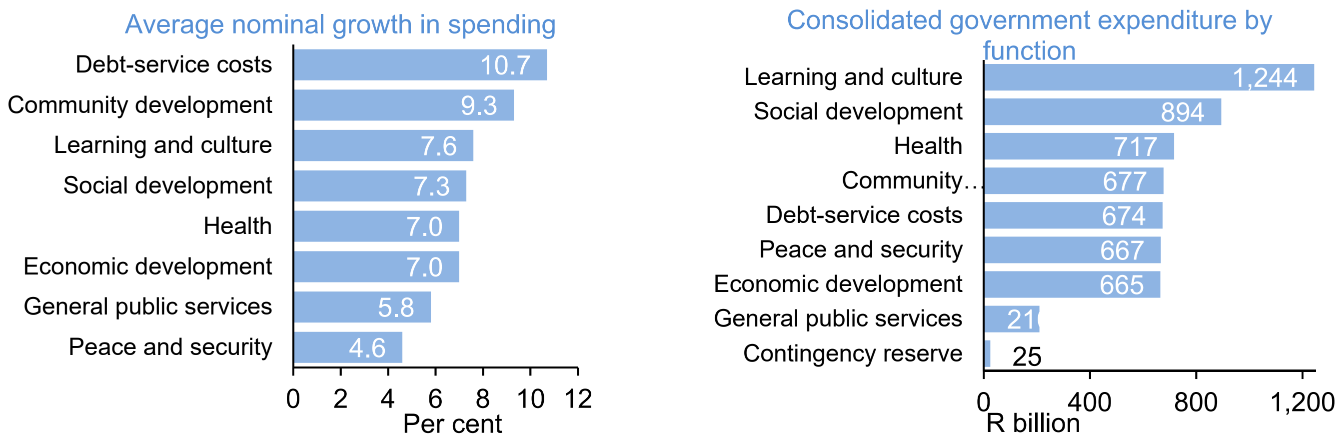
Source: National Treasury

The key tax proposals for 2019/2020 fiscal period include:

- Raising the tax-free threshold for personal income taxes from R78 150 to R79 000. "No changes will be made to personal income tax brackets" with no adjustment made for inflation. "This is expected to raise R12.8 billion in revenue, as individuals with an inflationary increase in their taxable income face a larger tax burden".
- "Increasing the fuel levy by 29c/litre, consisting of a 15c/litre increase in the general fuel levy, a 5c/litre increase in the Road Accident Fund (RAF) levy and the introduction of a carbon tax on fuel of 9c/litre".
- "Increasing excise duties on alcohol and tobacco products by between 7.4 per cent and 9 per cent", with the adjustments leading "(t)o an excise burden slightly above the targeted levels".
- "Increasing the eligible income bands for the employment tax incentive".

Additionally, from the 1st of April, as announced in the MTBPS, the list of zero-rated items, where VAT is charged at 0% will be expanded to include white bread flour, cake flour and sanitary pads.

Figure 7: Average nominal growth in spending, and Consolidated government expenditure by function 2019/20-2021/22



Source: National Treasury

Over the medium term, government remains committed to improving the efficiency and effectiveness of its spending, however the "(r)isks from Eskom and adverse economic conditions have required substantial spending adjustments". Government continues to prioritise key areas of social infrastructure, access to health services, education and social protection.

In order to contain growth in public debt and "(r)espond to poor revenue performance, baselines have been reduced by R50.3 billion over the next three years relative to the 2018 MTBPS", with projected spending increases totaling R75.3 billion, R69 billion of which has been allocated to Eskom. "As a result, non-interest expenditure has been increased by R21.6 billion in 2019/20, R1.9 billion in 2020/21 and R1.4 billion in 2021/22".

Government spending is set to rise "(o)n average by 7.8 per cent over the MTEF period, from R1.67 trillion in 2018/19 to R2.09 trillion in 2021/22". With a prioritization of funding towards enhancing service delivery, predominantly in the areas of "(h)ealth, roads, public transport and educational infrastructure".

Education remains a key priority of government, as highlighted in the president's recent State of the Nation Address and as such learning and culture was allocated the largest portion of government spending (see figure 9) in the budget, as it "(p)rovides access to basic and higher education, develops skills, provides training and contributes to social cohesion".

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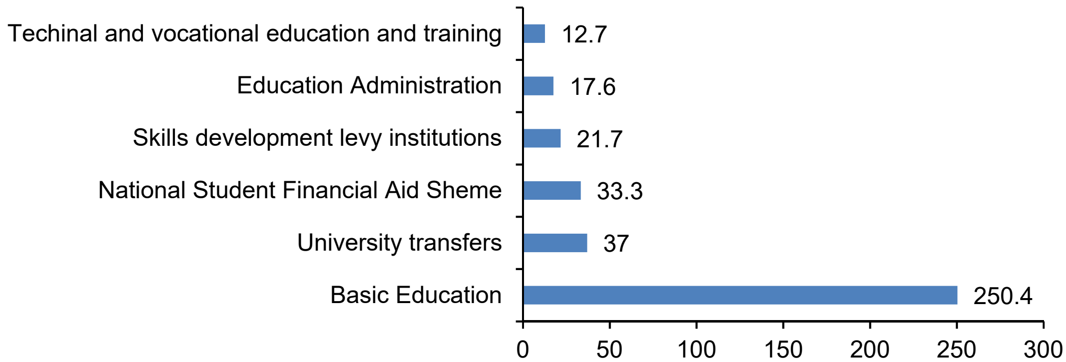
Figure 8: Breakdown of Learning and Culture (Rbn)



Source: Treasury

Furthermore, R5 billion has been reserved for the infrastructure fund, with interim provisions of R4.3 billion made, mostly for road maintenance and broadband.

"Compensation of employees remains the largest category of spending, accounting for an average 34.4 per cent of expenditure over the MTEF period". Government is executing procedures to "(c)ontain the public sector wage bill, which will produce some savings and assist in rebalancing the composition of expenditure". These measures are projected to decrease compensation by R27 billion over the medium term period.

Some of the key actions undertaken in this regard include:

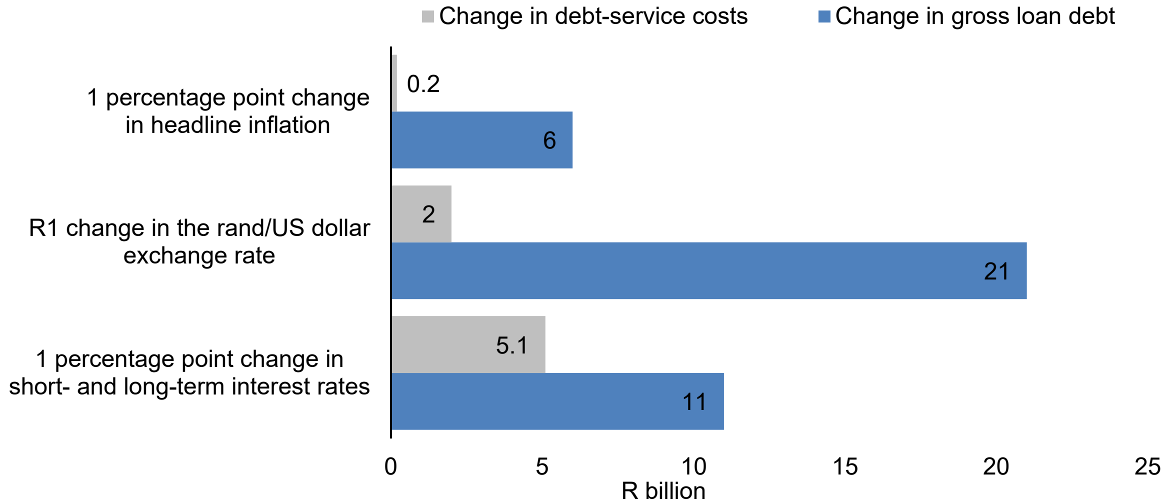
The scaling up of early retirement without penalties;

"A change to performance bonus payments"

The "active management of overtime and progression payments";

Additionally, public entities are persuaded to freeze the salaries of employees earning R1.5 million or above per annum in 2019/2020, "(w)hile those earning between R1 million and R1.5 million per annum should receive a below-inflation increase of 2.8 per cent".

Figure 9: Sensitivity of debt and debt-service costs, 2019/20*



Source: Treasury

*Assuming all other variables remain unchanged. An increase/decrease in inflation, the rand/US dollar rate or interest rates causes an increase/decrease in debt-service costs and debt

"Government's medium-term financing strategy reflects a prudent approach to managing debt in an environment of great uncertainty". Lower than expected revenue collections was the chief driver behind the rise in Government's gross borrowing requisite, which climbed R15.3 billion to R239.5 billion, over the past year, or 4.7% of GDP. This borrowing requirement is projected to lift further in 2019/2020 to R335.3 and will "(b)e financed primarily by domestic capital markets".

Domestic borrowing projections by treasury indicate that net Treasury bill issuance for 2019/2020 will total to R15 billion, while "(b)orrowing from the Corporation for Public Deposits will increase to R27.3 billion". Additionally, over the medium-term, "'(b)ond issuance will increase from R216 billion to R254 billion".

Net debt is anticipated to reach R2.52 trillion in 2018/19, or 49.9% of GDP, before climbing to a projected R3.47 trillion by 2021/22 (or 55.5% of GDP) and thereafter steadying at around 57.3% of GDP in 2024/25.

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Figure 10: Government guarantee exposure[1]

R billion	2016/17 Guarantee	2016/17 Exposure[2]	2017/18 Guarantee	2017/18 Exposure[2]	2018/19 Guarantee	2018/19 Exposure[2]
Public institutions	**475.7**	**290.4**	**469.8**	**321.3**	**483.1**	**372.4**
of which:						
Eskom	350.0	202.8	350.0	244.7	350.0	294.7
SANRAL	38.9	29.4	38.9	30.4	38.9	30.3
Trans-Caledon Tunnel Authority	25.6	20.9	25.7	18.9	43.0	14.9
South African Airways	19.1	17.8	19.1	11.1	19.1	17.3
Land and Agricultural Bank of South Africa	11.1	3.8	9.6	3.8	9.6	2.5
Development Bank of Southern Africa	12.5	4.1	12.2	4.1	11.4	4.4
South African Post Office	4.4	4.0	4.2	0.4	–	–
Transnet	3.5	3.8	3.5	3.8	3.5	3.8
Denel	1.9	1.9	2.4	2.4	3.4	3.4
South African Express	1.1	0.8	1.1	0.9	1.2	0.2
Industrial Development Corporation	0.4	0.2	0.4	0.1	0.5	0.2
South African Reserve Bank	3.0	–	–	–	0.3	–
Independent power producers	**200.2**	**125.8**	**200.2**	**122.2**	**200.2**	**146.9**
Public-private partnerships3	**10.0**	**10.0**	**10.0**	**9.6**	**10.1**	**10.1**

Source: National Treasury

1. A full list of guarantees is given in Table 11 of the statistical annexure in the Budget Review
2. Total amount of borrowing and accrued interest for the period made against the guarantee
3. These amount only include the national and provincial PPP agreements

"Government debt-service costs are determined by the debt stock, new borrowing and macroeconomic variables" and average 3.9% of GDP over the medium term. In "2018/2019 debt-service costs were revised up by R2.1 billion", underpinned by the greater borrowing obligation.

Contingent liabilities, which remain a significant risk to the country's fiscal position and "(i)nclude guarantees to state-owned companies, independent power producers and public-private partnerships" are estimated to reach R879.6 billion on 31 March 2019. State-owned companies are the largest beneficiaries, with guarantees totaling R529.4 billion, with operationally and financially challenged Eskom receiving 55.7% of the pie.

Economic growth prospects have softened since the MTBPS, as such National Treasury has lowered its GDP projections. That is, 1.5% y/y growth is now forecast for 2019 as opposed to 1.7% previously, rising to 2.1% in 2021. "The revisions take into account weaker investment outcomes in 2018, a more fragile recovery in household income and slower export demand than expected due to moderating global growth'.

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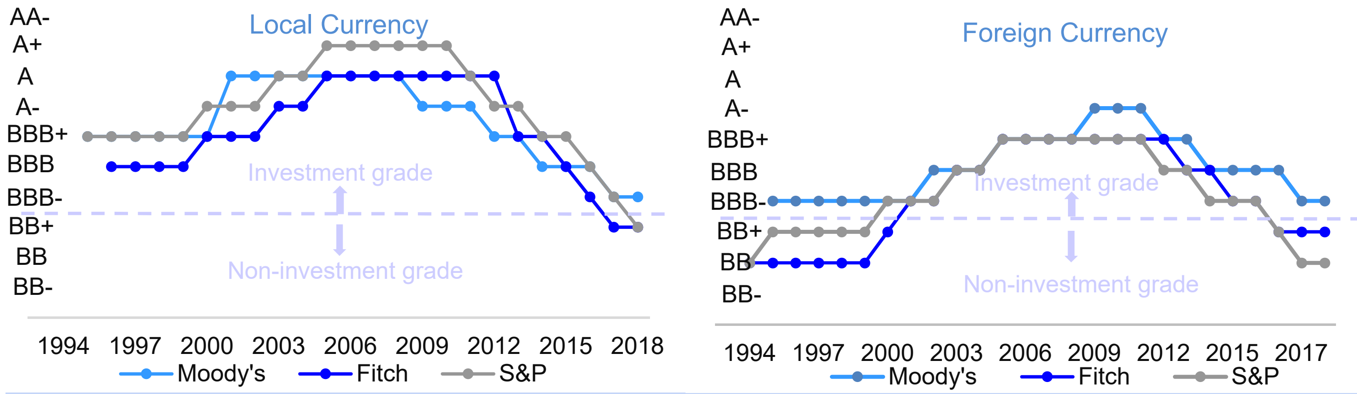
Figure 11: South African local and foreign currency long-term sovereign credit ratings



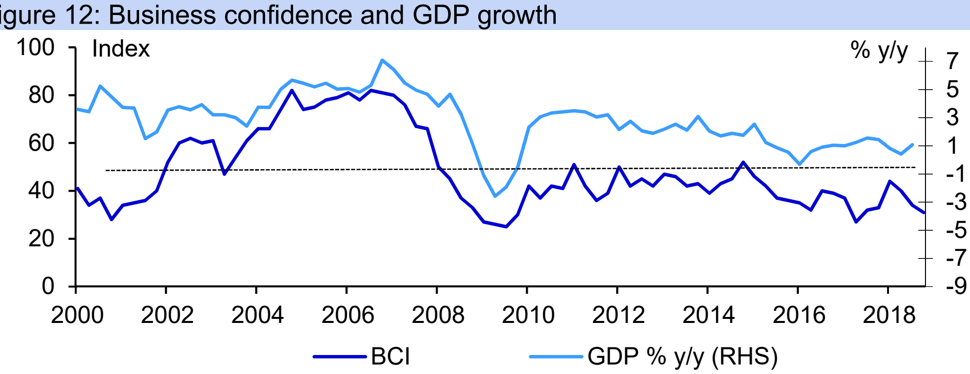
Sources: Rating Agencies

Moody's rating agency has previously indicated that "(f)or the sovereign, financial support to Eskom accompanied by measures that durably stabilizes its financial health would be credit neutral". However, while measures to assist the debt-strapped utility were addressed, they weren't viewed as sufficient and in the interim Moody's have called for additional information to be made available on their restructuring strategy. Additionally, the budget indicates "(f)urther erosion in fiscal strength" according to Moody's. This, after the MTBPS had already indicated "(w)ider deficits for longer". As such, we think that Moody's could downgrade South Africa's ratings outlook from stable to negative. However, averting a credit rating downgrade over the longer-term will require a sustained economic growth recovery to 3.0% and beyond.

A downgrade by Moody's would trigger exclusion of rand denominated bonds from the World Government Bond Index (WGBI), which would result in forced selling of these bonds of an estimated US$8-10bn. In the event, the cost of government debt would rise significantly and the rand exchange rate would come under pressure.

In a persistently subdued growth environment, accomplishing fiscal consolidation will continue to be challenging, therefore 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.

Figure 12: Business confidence and GDP growth



Source: BER, Stats SA

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