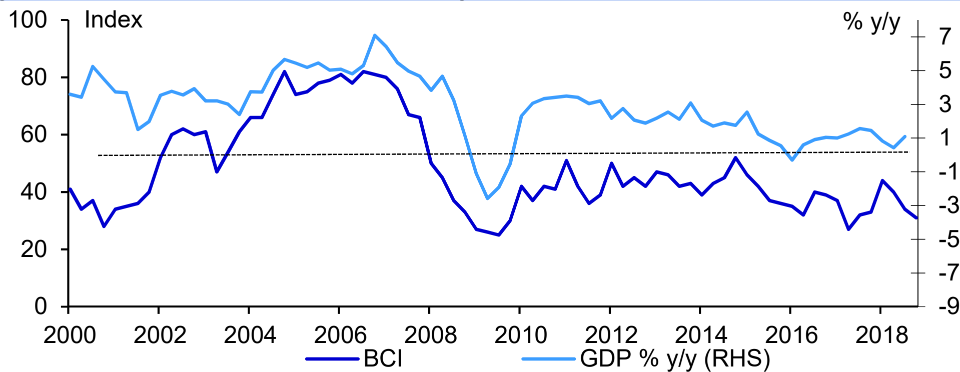
Investec

Budget Preview: 2019 Budget likely to reflect elevated deficit and debt levels with limited fiscal space

18th February 2019

Figure 1: Business confidence and GDP growth



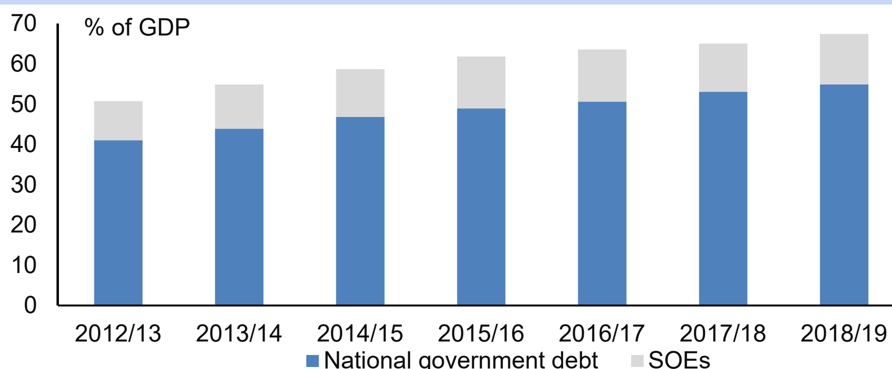
Source: BER, Stats SA

The most critical issue of the 2019 Budget will be the details of government's strategy to address the financing requirements and restore the longer-term sustainability of Eskom. This week, the Portfolio Committee on Public Enterprises was briefed that "Eskom […] is technically insolvent and will cease to exist at the current trajectory by April 2019. The high levels of debt currently are at R420 billion of the sovereign debt. Default risk is threatening the economy."

The materialisation of the associated Eskom contingent liability (government guarantees on Eskom loans) would push government debt towards the high risk benchmark of 70% of GDP over the medium term. The extent of insufficient and disrupted electricity supply damages economic growth prospects, and by extension government revenues, thereby heightening fiscal risks. Additionally, the recent implementation of rotational load-shedding and the prospect of another above inflation increase in electricity tariffs could further dampen already weak business and investor confidence levels.

Persistently depressed confidence undermines the prospects for an investment led recovery in economic growth. As outlined in the State of the Nation Address (SONA) (February 2019) and the 2018 Medium Term Budget Policy Statement (MTBPS) (October 2018), government's key economic objective to place the economy on a sustainable faster economic growth path and to ensure fiscal sustainability is premised on an increased rate of fixed investment associated with a lift in confidence.

Figure 2: Government and SOE debt



Source: National Treasury and SARB

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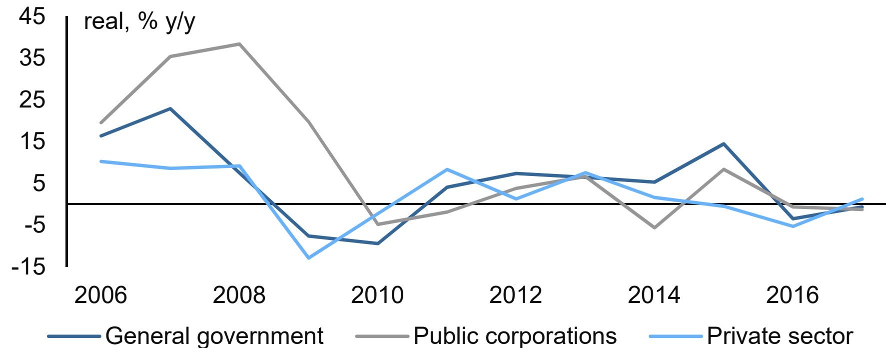
Figure 3: Fixed investment



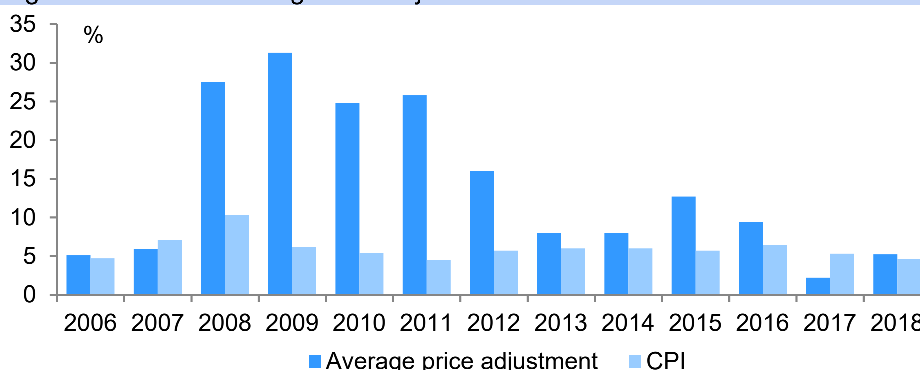
Source: Stats SA

Stabilising Eskom operationally is not the domain of National Treasury, and the nature of financial support provided in the Budget will be assessed in conjunction with government's turnaround strategy for the utility.

It was affirmed in the SONA that government will extend financial support to Eskom, although the quantum was not specified. Eskom has requested a R100bn debt transfer. It is unlikely that government will extend the full support in the Budget until the impacts on Eskom's financial position of the energy regulator Nersa's decision on electricity tariffs and the government's turnaround strategy are evident. Nersa is scheduled to announce its decision on Eskom's tariff application for the next three year period only in mid-March 2019. In terms of a turnaround strategy, steps have been taken to improve governance and the President announced that there will be an unbundling of the generation, transmission and distribution segments. However, these are longer-term and evolving solutions that do not address the more immediate financial strain at Eskom. In the near-term, the turnaround strategy will need to outline meaningful cost saving and revenue raising (such as the disposal of non-core assets) measures.

As such, the Budget is expected to specify the magnitude of the capital injection for Eskom and whether it will be deficit neutral. Specifically, to raise the necessary funding to extend financial support to Eskom, the government could dispose of non-strategic assets (e.g. property, direct and indirect shareholding in listed firms) and possibly rely on the contingency reserve, which would yield no increase in overall fiscal expenditure (deficit neutral).

Figure 4: Eskom's average tariff adjustment



Source: Eskom, Stats SA

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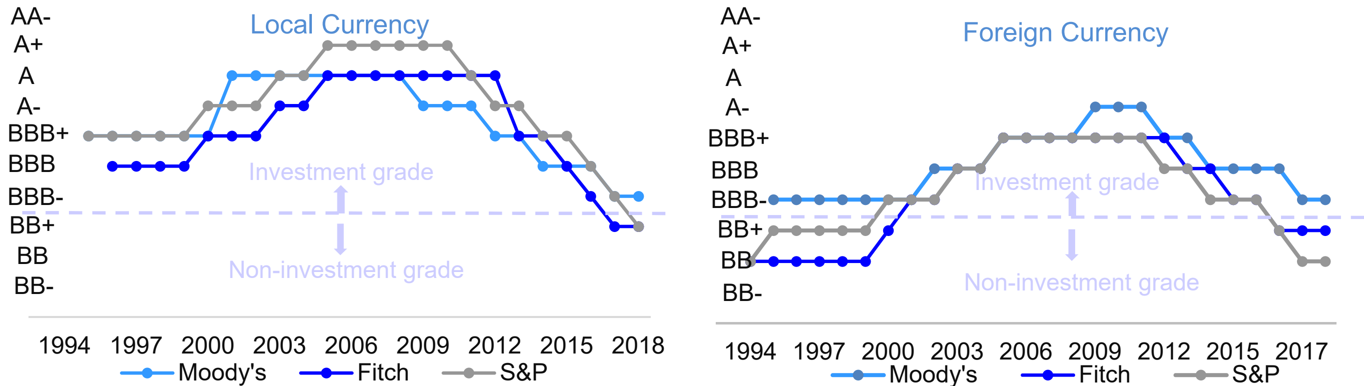
Figure 5: South African local and foreign currency long-term sovereign credit ratings



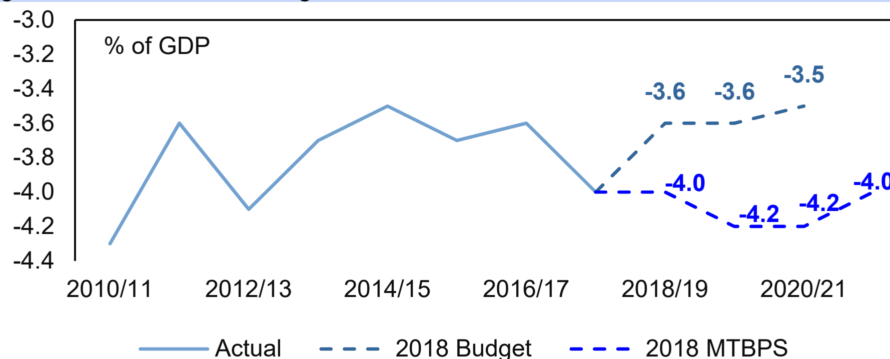
Sources: Rating Agencies

The manner in which the financial transfer is effected will have implications for the contingent liability risk and by extension for the sovereign credit rating. SA's local and foreign currency bonds are rated not investment grade by S&P and Fitch, with the rating by Moody's at one notch above non-investment grade. 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.

Aside from the approach to extending financial support to Eskom, the overall size and composition of the 2019 Budget will be a key input to Moody's review of SA's sovereign credit rating scheduled for the 29th March. The Budget is not expected to reflect further significant fiscal slippage and should the Eskom financial support be deficit neutral it is likely that Moody's will maintain its SA rating. The next key event will be the national election in May following which Moody's will be able to assess the policy agenda, the momentum of implementation of structural reforms and the strategy for dealing with other vulnerable state-owned enterprises. We expect Moody's to downgrade SA's outlook from stable to negative this year, with a possibility that the credit rating itself will be downgraded.

The MTBPS set a clear tone of a weaker fiscal outlook for the upcoming 2019 Budget. Specifically, the MTBPS outlined a deterioration of fiscal ratios versus the 2018 Budget expectations, projecting the

Figure 6: Consolidated budget deficit



Source: National Treasury

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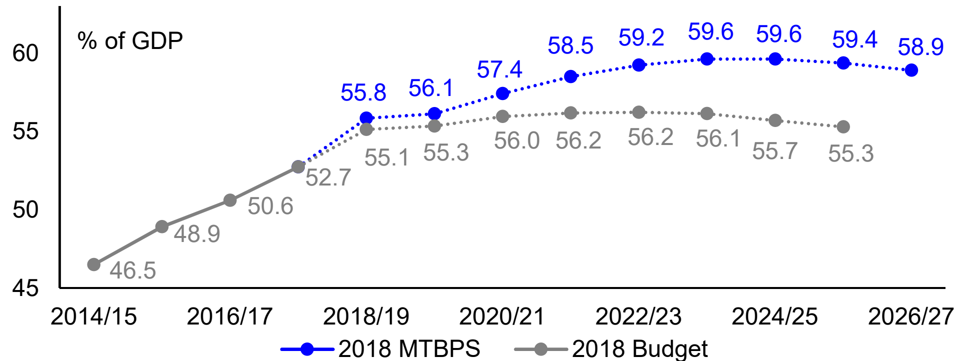
Figure 7: Gross-debt-to-GDP outlook



Source: National Treasury

main budget deficit at over 4.0% of GDP over the medium-term, with debt stabilising at an elevated 59.6% of GDP only in 2023/24 (see figures 6 and 7).

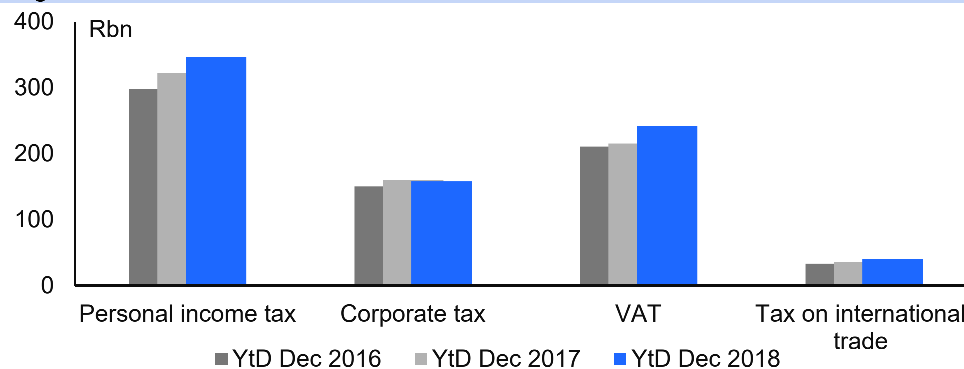
Inferring from the monthly government finance updates, for the 2018/19 fiscal year, the 2019 Budget could reflect a slightly lower *main budget* deficit of 4.1% of GDP compared to the 4.3% contained in the MTBPS, on slower than expected expenditure growth.

Specifically, in the first nine months (April 2018 to December 2018) of the 2018/19 fiscal year expenditures rose 4.6% y/y, well below the MTBPS estimate of 7.7% growth for the full fiscal year. Applying this year to date expenditure growth for the last quarter of the fiscal year (January 2019 – March 2019) yields underspending of approximately R43.0bn. Typically expenditure lifts in the last quarter but given the extent of underspending to date, it is still likely to come in below target.

The expenditure savings should counter some of the effects of weaker than expected tax receipt growth. In the April 2018 – December 2018 period, government tax revenue rose by 7.6% y/y versus the 2018 Budget estimate of 8.3% y/y growth for the full year.

The underperformance stems mainly from corporate income tax receipts which declined by 1.1% in the first nine months. December 2018 was particularly weak with corporate income tax receipts contracting by 6.6% y/y, despite the month of December typically registering an increase in corporate tax receipts on provisional payments from those companies with a December year–end. Personal income tax collections lifted by 7.6%

Figure 8: Main tax revenue items



Source: National Treasury, Investec

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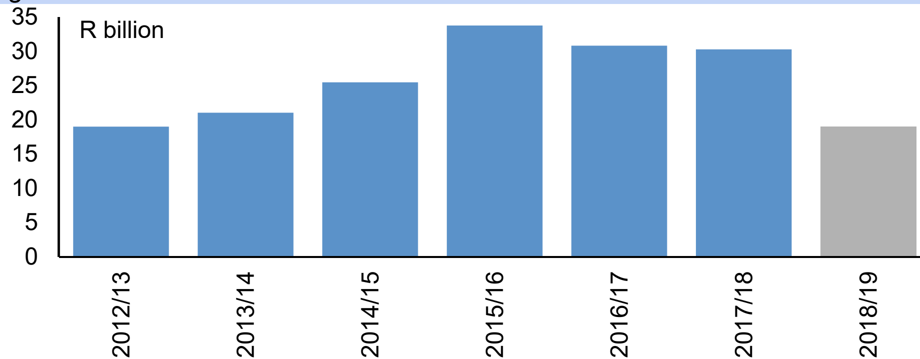
Figure 9: SARS VAT credit book



Source: National Treasury

y/y in April 2018 – December 2018 versus the target of 9.4% y/y. Comparatively, growth in VAT collections ran ahead of the target of 10.1% y/y, having increased by 12.4% in the year to date. VAT collections have performed strongly even though SARS has increased VAT refund payments in an effort to clear the backlog. Applying the year to date growth rate in gross tax revenues to the remainder of the fiscal year yields a gross tax revenue shortfall of R8.6bn. Employing the same method to overall main budget revenue reflects a shortfall of R9.8bn.

The consolidated budget comprises the main budget deficit which is typically partially offset by a combined cash surplus from social security funds and public entities financed from their own revenue. Factoring in these flows yields a *consolidated* budget deficit estimate of -3.9% of GDP, versus the MTBPS projection of -4.0%.

Although the 2019 Budget could reflect a slightly lower deficit ratio for the 2018/19 fiscal year, there is limited scope for meaningful consolidation over the medium-term (2019/20 – 2021/22) 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. GDP growth is expected to lift only modestly over the medium-term framework which will be associated with constrained growth in government revenues. Compared with the 2018 MTBPS, nominal GDP forecasts are likely to be revised lower on likely weaker household spending and fixed investment growth assumptions as well as a weaker than expected inflation outcome (see figure 10). Concurrently, expenditure cuts are unlikely to be forthcoming in an election year and amid ongoing social and economic spending pressures.

Figure 10: National Treasury macroeconomic projections

	2017	2018	2019	2020	2021
Calendar year	**Actual**	**Estimate**		**Forecast**	
Percentage change unless otherwise indicated					
Household consumption	2.2	1.6	1.9	2.3	2.6
Gross fixed-capital formation	0.4	0.9	1.5	2.1	2.9
Real GDP growth	**1.3**	**0.7**	**1.7**	**2.1**	**2.3**
GDP at current prices (R billion)	**4 651.8**	**4 949.1**	**5 317.2**	**5 724.1**	**6 167.2**
CPI inflation	5.3	4.9	5.6	5.4	5.4

Source: National Treasury

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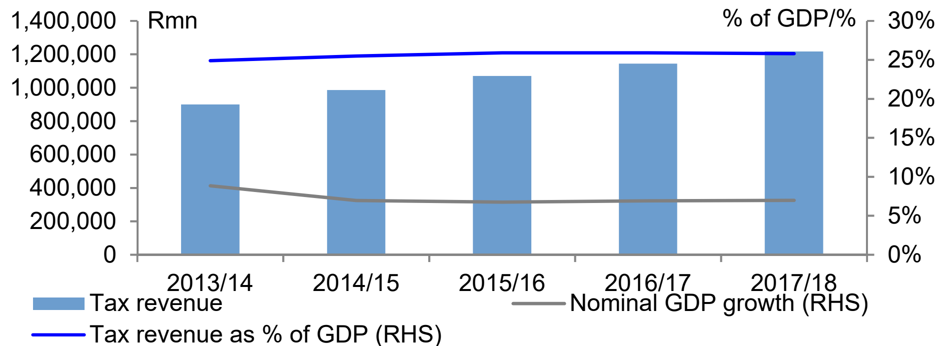
Figure 11: Tax revenue collections and GDP



Source: SARS

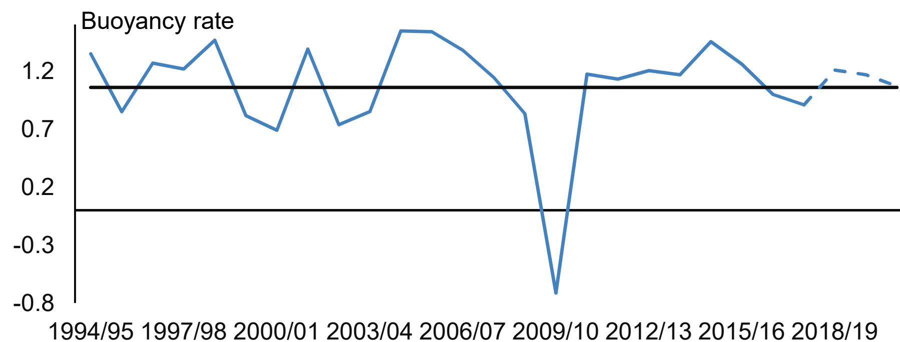
The MTBPS affirmed that "(f)ollowing years of slow spending growth and tax increases, there is little room for large fiscal adjustments." Consequently, the MTBPS noted that the deficit and debt ratios, of over 4.0% and close to 60% respectively, will reflect a modest recovery in economic growth, the maintenance of the expenditure and national departments' compensation ceilings and no increases in the main tax instruments.

Based on the guidance contained in the MTBPS, the 2019 Budget is not expected to announce any tax adjustments to the main tax instruments.

In terms of the main indicators of government revenue performance over the medium term framework the MTBPS forecasts a relatively stagnant tax-to-GDP-ratio at 25.9% (see figure 11) and a lower tax buoyancy ratio (measures the fluctuation in tax revenues relative to economic activity) (see figure 12). These indicators reflect the effects of weak economic growth as well as the effects of a deterioration in tax compliance and administration.

Personal income taxes comprise the largest share, 38.1%, of tax collections (see figure 13). According to the MTBPS revenue collection in this category has been "negatively affected by job losses, moderate wage settlements, lower bonus payments and a slower expansion of public sector employment." The personal income tax burden has risen over the last few years on increases in effective tax rates and below-inflation adjustments to the tax brackets. Moreover, the burden has shifted towards the higher income earners and so a narrower tax base. Specifically, 67% of the personal income tax is paid by 7.7% (just over 1 million individuals of the 14 million registered taxpayers) (see figure 14).

Figure 12: Tax buoyancy



Source: National Treasury

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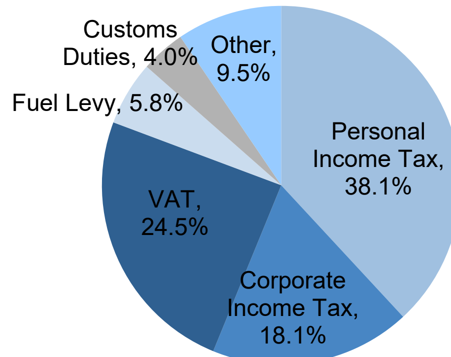
Figure 13: Tax revenue contributions, % of total tax revenue



Source: National Treasury, Investec

Shortfalls in personal income tax collections the last few years suggest that further increases in the effective tax rate will likely not lift revenues from this source. There is an outside possibility that the maximum marginal tax rate would be further increased but this is unlikely as "relatively few individuals face the top marginal tax and so increasing the top rate alone would yield relatively little revenue" according to the OECD. The OECD further cautioned that large increases in the top rate could have "detrimental effects on skill accumulation, entrepreneurial activity and immigration of high-skilled workers." As such, it can be expected that the 2019 Budget will propose that the higher marginal tax brackets and thresholds will be increased well below expected inflation. This will translate to limited, or no, fiscal drag relief. It is likely that continued tax relief will still be granted for low income earners.

Corporate income tax which comprises 18.1% of tax collections is also likely to see unchanged rates. Recent company earnings updates signal weak profitability which suggests that corporate tax collections will continue to underperform in the near term. Given the relatively modest economic growth climate, raising corporate taxes at this juncture would weaken the prospects for a recovery in private sector fixed investment rates and employment levels. Moreover, the corporate tax burden is relatively high by international standards and an increase in the tax rate would undermine competitiveness at a time where government is seeking to attract increased foreign investment.

Figure 14: Estimates of individual taxpayers and taxable income, 2018/19

Taxable bracket	Registered individuals		Taxable income		Income tax payable after 2018 Budget proposals	
R thousand	**Number**	**%**	**Rbn**	**%**	**Rbn**	**%**
R0 - R70[1]	6,557,245	–	170.2	–	–	–
R70 - R150	2,502,678	33.4	262.0	10.8	10.2	2.0
R150 - R250	1,790,280	23.9	351.8	14.5	33.2	6.6
R250 - R350	1,178,901	15.7	349.8	14.4	50.5	10.0
R350 - R500	934,615	12.5	386.8	15.9	72.7	14.4
R500 - R750	576,469	7.7	348.4	14.3	84.5	16.7
R750 - R1 000	233,652	3.1	200.7	8.3	58.0	11.5
R1 000 - R1 500	161,014	2.2	192.3	7.9	62.1	12.3
R1 500 +	109,783	1.5	339.4	14.0	134.6	26.6
Total	**7,487,392**	**100.0**	**2 431**	**100.0**	**505.8**	**100.0**
Grand total	**14,044,637**		**2 601**		**505.8**	

1. Registered individuals with taxable income below the income-tax threshold

Source: National Treasury

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Figure 15: Main budget expenditure ceiling[1]

R billion/percentage change	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
2015 Budget Review	1 081 214	1 152 833	1 250 086				
2016 MTBPS	1 074 992	1 144 353	1 229 742	1 323 465	1 435 314		
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**	**1 630 026**

Source: National Treasury

1. *The expenditure ceiling differs from main budget non-interest expenditure.*

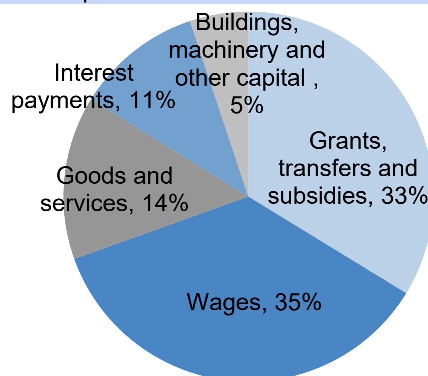
Following the 1% increase in the VAT rate last year to 15%, no further adjustments are expected but further items for zero-rating are likely to be added to mitigate the impact on poor households. It is expected that tax adjustments in the 2019 Budget will be limited to other indirect taxes. Excise taxes on alcohol and tobacco are likely to continue increasing at an above inflation rate, as has been the case since 2002. Further increases in fuel taxes are likely. The 2019 Budget will likely announce the implementation of the carbon tax however this new tax would likely bring little in revenue initially with tax free thresholds as the tax is phased in.

The Budget is likely to reinforce efforts undertaken to improve tax administration and tax compliance which would improve tax buoyancy. The MTBPS specifically noted that "(g)overnment is committed to tackling concerns related to SARS in an open manner. Ensuring transparency in tax administration will help rebuild taxpayer confidence and compliance."

On the expenditure side, the Budget is likely to preserve the expenditure ceiling, which places a limit on main budget non-interest spending, outlined in the MTBPS, unless the capital injection to Eskom transpires not the be deficit neutral. The main measures likely to be taken to contain spending (that includes allocations for the President's economic stimulus and recovery plan) within the expenditure ceiling will comprise the reprioritsation of expenditure; improvement of spending efficiency, increasing capacity and strengthening governance.

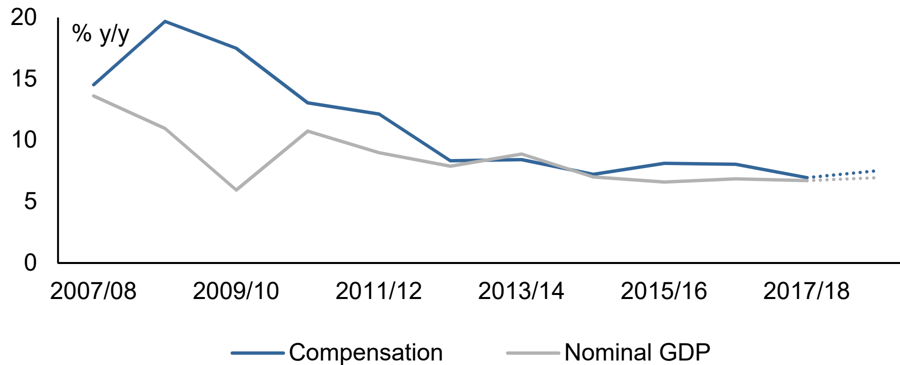
The government wage bill remains the single largest driver of expenditure, accounting for around 35% of the total (see figure 16). Growth in compensation of employees has outpaced average nominal GDP growth and wage settlements have typically exceeded budgeted levels (see figure 17). The 2018 public-service

Figure 16: Consolidated expenditure



Source: National Treasury

Figure 17: Annual growth of compensation spending and nominal GDP

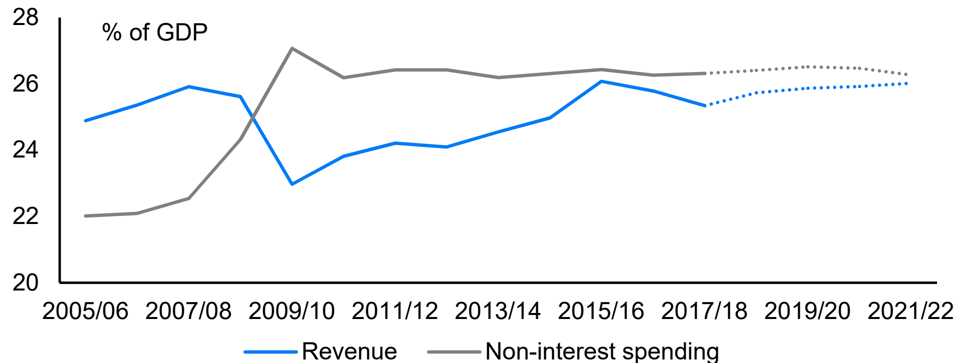


Source: National Treasury

wage agreement was to be funded through national and provincial departments by adjusting their compensation baselines. Should departments experience shortfalls this would pose a risk to the expenditure ceiling. Increased compensation expenditure has diverted spending away from investment allocations and other growth enhancing expenditures. The SONA made reference to “examining the size and structure of the state” which could imply restructuring and lower headcounts but this could be a longer term strategy and therefore compensation expenditure pressures are unlikely to be alleviated over the medium term.

Fiscal space for further policy stimulus has been eroded. As such, a meaningful and durable increase in economic growth relies on the implementation of structural reforms and enhancing policy certainty. Business and investor confidence would strengthen in response leading a private investment led increase in economic growth. The IMF has previously calculated that with the implementation of reforms “real GDP growth could rise to 4 percent by 2022. A meaningful reduction of unemployment and poverty would follow. Public debt would decline to close to 50 percent of GDP by 2023.” National Treasury has previously noted that to sustain current public spending commitments, economic growth of 2.5 – 3.0% is required.

Figure 18: Main budget primary balance



Source: National Treasury

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