

Medium-Term Budget Policy Statement

Fiscal slippage for three consecutive years

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- Compared to the 2018 Budget, the Medium-Term Budget Policy Statement (MTBPS) shows lower economic growth for FY2018/2019, while keeping the growth forecast for FY2019/2020-FY2022 largely unchanged.
- Tax revenue under collection of R27.4bn in FY2018/2019 is expected, mainly due to the underestimation of VAT refunds (R20bn) and lower corporate income tax (R5.9bn).
- Over the Medium-Term Expenditure Framework (MTEF), tax revenue is R75bn lower than budgeted, which reflects lower tax buoyancy and higher Southern African Customs Union (SACU) payments.
- The main budget fiscal deficit for FY2018/2019 is revised up to 4.3% of GDP, from 3.8% forecast in the 2018 Budget, and rising to 4.4% in FY2019/2020, before gradually declining to 4.2% in FY2021/2022.
- The gross government debt increases by R862bn over the MTEF, which pushes the debt-to-GDP ratio to 58.5% in FY2021/2022, with stabilisation at 60% of GDP in FY2023/2024. Net debt is forecast to stabilise at 56.5% in FY2025/2026, seven years from now.
- There are no adjustments in the main tax revenue sources, given the constraints of weak corporate earnings and job losses.
- Growth-boosting reforms pivot on the investment drive. However, the details of investible infrastructure projects are still in the planning phase.
- We expect Moody's to change the outlook of our Baa3 sovereign credit rating, from stable to negative, at the very least, with a potential downgrade after the 2019 Budget, if significant measures are not taken.
- Within our Living* Investing™ framework, this budget presents significant risks.
 - A weaker growth environment implies weaker corporate sector profitability, which translates to potential job losses, putting our asset accumulation targets at risk.
 - A potential change in the credit rating outlook, from stable to negative, by Moody's implies that bond yields will rise, which reduces the value of portfolios with higher weightings to bonds, especially at the short end of the curve.
 - Although the MTBPS is negative for financial well-being over the medium term, the focus on infrastructure investment will create opportunities to diversify source of return, over the longer term.

Economic growth realities put fiscal path at risk

The MTBPS, published today, takes us back to 2017's MTBPS, a bleak future, with few options to craft a new and sustainable path. The economic growth forecast for 2018 has halved to 0.7%, from an earlier estimate of 1.5%. In later years, growth is forecast at 1.7%, 2.1% and 2.3%, for each of the next three years. This, in an environment of above-trend global growth, which should have lifted South Africa's growth, along with other emerging markets. Once a distant thought, the downside scenario of a global downturn over the MTEF is increasingly plausible, and if it plays out, these economic growth forecasts will again be revised downwards, before they are revised upwards.

The growth forecasts are as realistic as the announced economic reforms, which are not entirely new. The 2018 Budget listed reforms in network industries – transport, energy, telecommunications and water, which would lift potential economic growth to 3.8%. However, the 2018 MTBPS projections

remain far too low, primarily reflecting the hard choices that need to be taken, including the reduction of the wage bill at state-owned enterprises (SOEs) and the government, reforming the education sector to increase skills production, reducing the cost of regulation on businesses, and providing certainty to investors.

What this means is that job losses will likely increase over the short term, before employment growth resumes. The combination of potential job losses and an increased cost of living through higher fuel and electricity costs – Eskom has applied for a 15% increase in electricity tariffs for 2019 – will decrease the financial well-being of many working South Africans, while worsening the chances of those still looking to enter the job market.

Tax revenues under-collection due to the underestimation of VAT returns

While tax revenue collections seem to have held up to the budget, the technical recession in the first half of 2018, is expected to feed through to poor revenue collections. Consequently, Treasury has now forecast a revenue shortfall of R75bn over the MTEF: -R27.4bn, -R24.7bn and -R33bn, in FY2018/2019, FY2019/2020 and FY2020/2021, respectively. This reflects four key aspects: a decrease in tax buoyancy – the amount of tax revenue collected for a level of economic growth – an increase in VAT returns relative to the budget, an increase in the SACU common revenue pool transfers, and the zero-rating of white bread flour, cake flour and sanitary pads.

R billion	2017/2018			2018/2019		
	Budget1	Outcome	Deviations	Budget1	Revised	Deviations
Persons and individuals	461.0	461.0	-0.0	505.8	504.2	-1.6
Companies	218.1	217.4	-0.7	231.2	225.3	-5.9
Value-added tax	299.1	298.0	-1.1	348.1	328.1	-20.0
Dividend withholding tax ²	29.0	27.9	-1.1	30.8	29.3	-1.5
Specific excise duties	37.3	37.4	0.1	40.7	40.0	-0.6
Fuel levy	71.3	70.9	-0.4	77.5	77.4	-0.1
Customs duties	49.0	49.2	0.1	52.6	54.0	1.4
Ad-valorem excise duties	3.8	3.8	-0.0	4.2	4.3	0.1
Other	48.7	51.0	2.3	54.0	54.9	0.9
Gross tax revenue	1 217.3	1 216.5	-0.8	1 345.0	1 317.6	-27.4

1. 2018 Budget figures; 2. Includes secondary tax on companies
Source: National Treasury

Expenditure overruns controlled by dipping into contingency reserves

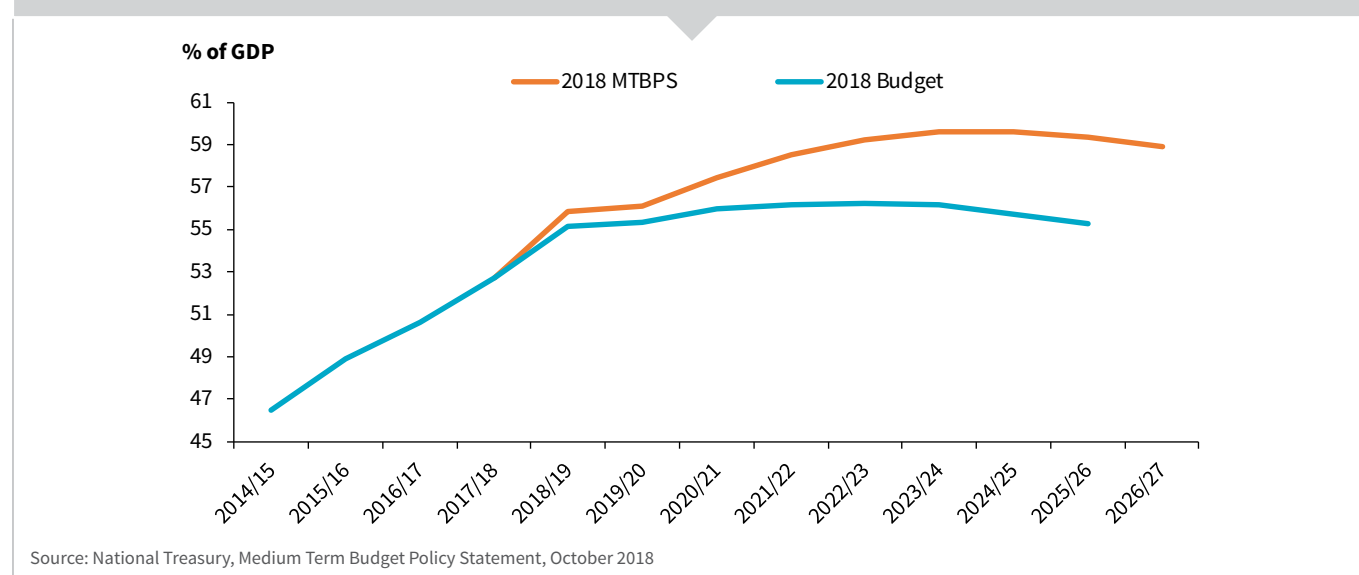
Government's expenditure ceiling remains unchanged compared to the 2018 Budget, and is forecast to grow by 7.8% per year, from R1.8tn to R2.1tn in FY2021/2022, with a greater focus on education, health, safety, and social development. Upward expenditure adjustments of R17.4bn, including a budget facility for infrastructure projects and project preparations (0.9bn), a school's infrastructure grant (0.8bn), drought relief (R3.4bn), and support for SOEs (R9.2bn), were completely offset by dipping into the contingency reserves (R8bn), provincial contingency reserves not allocated to any vote (R6bn), and projected underspending by national government (R2.7bn). To increase efficiency, there is a reprioritisation of R32bn from non-performing and underperforming areas.

Fiscal deficit and debt targets to overshoot over the MTEF

The combination of lower tax revenue without a decrease in spending implies that the fiscal deficit will need to widen. The MTBPS forecasts the main budget deficit will widen to 4.3% of GDP in FY2018/2019, from a budgeted 3.8%. The revenue shortfall extends beyond the current fiscal year, so too does the budget deficit, which increases to 4.4%, before gradually moderating to 4.2% in FY2021/2022.

Worryingly, total government debt will increase by R862bn, from R2.8tn to R3.7tn, over the next three years, with the increase financing the deficit.

Figure 1: Gross government debt to GDP ratio



Impact on credit ratings and markets

Treasury essentially reproduced Moody's expected fiscal deficit, which it forecast not to exceed 4.3% of GDP. However, the deficit and the debt ratio in the outer years of the MTEF, do not decline as initially projected by Treasury and in line with Moody's expectations. We believe that the fiscal slippage, combined with slow progress in structural reforms that will boost growth, means there is a more than 50% probability that Moody's will change its outlook from stable to negative.

Implications for our Living* Investing framework

The weaker economic growth, and high debt levels, imply low job creation and increasing bond yields, respectively. This implies that our asset accumulation targets will be hard to achieve, and portfolios that have a higher weighting to bonds, especially at the short end of the curve, will likely reduce in value. As we have

highlighted before, this ultimately means that portfolio return expectations will likely be lower than our initial expectations. Over the longer term, we believe that the focus on infrastructure investment will provide more opportunities to diversify into private markets, thus enhancing return expectations, or providing protection against a downturn in future returns from traditional asset classes.

Disclaimer

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