momentum
investments

SA 2019 medium-term budget policy statement (MTBPS)

(FLASH NOTE)

Sharp fiscal deterioration as Eskom bailout drains dwindling revenue amidst weak growth

Overall impressions

- Much weaker fiscal picture than previously expected over the medium-term expenditure framework (MTEF) between FY19/20 and FY21/22 ➔ relative to February 2019 budget projections, budget-deficit-to-gross domestic product (GDP) is on average 2% wider and R99 billion higher in each year ➔ deficit staying above 6% of GDP up to FY22/23 ➔ primary budget balance (excluding interest payments) remains in deficit in MTEF period.
- Fiscal slippage is driven by weaker revenue projections (down R77 billion on average each year versus February 2019) linked to a smaller and weaker economy and poor SARS collections, coupled with higher spending (up R22 billion each year on average versus February 2019) due to a R161 billion Eskom bailout in the period.

Immediate market effect

- Budget cannot be regarded as fiscally prudent ➔ high deficits, expenditure growth outpacing revenue growth by 3½% on average initially and a rising debt ratio should be negative for bonds and the currency.

The FTSE/JSE ALSI rallied as rand-hedge shares rose in response to a rand sell-off	While the FTSE/JSE Resource Index rose sharply on the rand fall, the FTSE/JSE Financial Index suffered	Government bonds sold off sharply on the fiscal slippage and rand decline	The US dollar/rand weakened by nearly 3%

Fiscal and debt targets missed by far

- Main budget deficit to swell to 6.2% of GDP in FY19/20 (previously 4.7%), 6.8% in FY20/21 (previously 4.5%) before narrowing slightly to 6.5% in FY21/22 (previously 4.3%) and to 6.2% by FY22/23.
- Slower deficit reduction relative to Treasury's February 2019 projection is largely related to a materialisation in downside risks to growth and revenue forecasts and an upward revision to expenditure due to financial support for Eskom.
- Acute fiscal deterioration has torpedoed the possibility of debt stabilisation ➔ debt ratios rise throughout the MTEF period ➔ gross debt-to-GDP expected to rise from 56.7% in FY18/19 to 71.3% in FY22/23 and 81% by FY27/28 .

Both spending cuts and higher taxes needed in future to address huge fiscal slippage

- Government's economic assumptions on growth (1.4% on average for FY19-22) and inflation (4.7% on average) that drive their revenue projections in coming years are similar to ours, while its downwardly-revised tax buoyancy (revenue per unit of GDP) forecasts also look realistic.
- Tax burden (tax-to-GDP ratio) set to remain close to 26% throughout the MTEF period (FY19-22).
- The flat tax-to GDP ratio, the large tax shortfalls despite additional taxes and the poor tax buoyancy in recent and coming years could indicate that SA is close to the inflection point on its Laffer curve so that higher tax rates in future are unlikely to generate much higher tax revenues.
- Although there seems to be acknowledgement from government that future fiscal improvement will have to be driven by spending restraint, particularly on the public sector wage bill, the difficulty of discussions with labour on the latter and the magnitude of the fiscal problem mean that future tax increases are contemplated.

Revenue collection in MTEF continues to disappoint on implosion of growth and SARS

- During the last five years there has been an exponential rise in tax shortfalls every year as the economy and SARS imploded ➔ this trend is expected to continue in the MTEF ➔ the tax shortfall is estimated at R53 billion for FY19/20 (previously R15.4 billion) and R84 billion and R115 billion in the following two years.
- Lagging tax collections is widespread across every single revenue grouping ➔ most worrying is the underperformance in the big revenue categories of personal income tax, VAT and corporate tax.

Cuts to expenditure, but Eskom refinancing causes strong spending growth

- Although spending reductions of R50 billion over the next two years is budgeted for, financial support for Eskom overrides this, causing overall spending to still rise by 11.7% and 7% in the period, respectively ➔ it also needs to be carefully monitored that the mooted spending cuts will be on current spending and not on capital spending that could hurt growth down the line.
- Civil servants by far continue to consume the largest part of the expenditure cake ➔ 34% of total ➔ rising by 1.6% in real terms in the MTEF ➔ options considered to rein in the public sector wage bill are salary increases at or below inflation, halting pay progression and reviewing occupation-specific dispensation for wages ➔ but ominously government mentioned that they will first have to discuss these options with labour for buy-in, which may be unfeasible.
- Debt service costs remains the fastest-growing expenditure areas ➔ up 13.7% per annum in the MTEF.

Proposed initiatives to drive economic growth

- Growth-enhancing reforms mentioned in the MTBPS include supporting tourism by reducing the cost of travelling to SA and cutting red tape for tourism businesses, diversifying power generation, expanding telecommunications services by expanding fibre infrastructure, lowering the cost of doing business by automating processes, modernising road, rail and telecommunications to increase business competitiveness, export reforms to boost exports and employment and raising competition in the economy to make it easier for small firms to compete.
- Government remains committed to set aside R100 billion for the Infrastructure Fund in the next decade ➔ this will be a collaborative effort with the private sector ➔ pilot projects will receive R530 million in the current year ➔ these include the Student Housing and Small Harbours programmes.

State-owned companies remain a hefty drain on the budget

- Government realises that a sustainable restructuring of state firms are required to reduce the risk of future transfers ➔ plans should include the disposal of state assets and private sector participation.
- Apart from the R161 billion bailout for Eskom in the MTEF, funding for South African Airways, the South African Broadcasting Corporation, Denel and South African Express amounts to R10.8 billion in the current year ➔ almost the entire contingency reserve for FY19/20.
- Reduction of Eskom's debt burden will only be considered after it cuts costs and starts unbundling.

Moody's could downgrade SA's credit rating outlook on hefty fiscal slippage

- The rapid fiscal deterioration projected in the MTEF that causes SA's debt ratio to continually drift higher in the medium term could entice Moody's rating agency to seriously consider moving the country's credit rating outlook from stable to negative, followed by a rating downgrade to junk later in 2020 or in 2021 if no fiscal recourse is evident by then.
- A rating downgrade could be averted if the February 2020 budget provides clear evidence that government is credibly pursuing its newly-announced fiscal target of attaining a primary budget balance (excluding Eskom financing and interest expenditure) by FY22/23 ➔ this will necessitate cutting the public wage bill and instituting additional tax measures to generate the forecasted R150 billion required improvement in the fiscal balance in the period.
- Moody's already includes Eskom's government-guaranteed debt under the country's debt ➔ hence there should not be a negative impact on the rating from any future government move to take Eskom's debt onto its balance sheet.