momentum
investments

24 October 2018

SA medium-term budget policy statement

(FLASH NOTE)

Tough balancing act between fiscal discipline and growth protection

Initial impressions

- Disappointing wider-than-expected budget deficit on poorer growth and revenue outcomes
- Expansionary budget ➔ (real) expenditure growth expected to outstrip revenue growth in the next two years
- Relative to February 2018 budget, expenditure was revised higher by R12.4 billion and revenue was adjusted R83 billion lower between FY2018/19 and FY2020/21
- Budget focused on growth-enhancing mechanisms to restore investor confidence and revive SA's longer term growth trajectory

Immediate market effect

- Perceived as expansionary budget ➔ wider deficit and higher debt ratio is negative for bonds and the currency ➔ growth-supportive budget underpins shares dependent on local economy

FTSE/ALSI initially rose 0.5%, supported by a rise in resource and industrial shares

FTSE/ALSI Resources gained 1.0% on rand weakness, while 0.4% rise in the FTSE/ALSI Industrials Index

R186 government bond sold off 7 basis points

USD/ZAR initially weakened by 1.6%, but retraced partially thereafter

Fiscal and debt targets missed

- Main budget deficit expected to remain steady at 4.3% of GDP between FY2018/19 and FY2020/21 ➔ previously expected to narrow marginally from 3.8 to 3.7%
- Slower deficit reduction relative to Treasury's February 2018 projection is largely related to lower growth and revenue forecasts and a marginal upward revision to expenditure
- Notable deterioration in government's (gross) debt ratio projection ➔ debt expected to peak at 59.6% of GDP in FY2022/23 (previously expected to peak at 56.2% in FY2021/22)

Little wiggle room to increase taxes further

- Tax burden (tax-to-GDP ratio) set to climb from 26.1% (previously 26.8%) in FY2018/19 to 26.6% (previously 27.2%) in FY2020/21
- Value-added tax (VAT) exempt items expanded to include white bread flour, cake flour and sanitary products from 1 April 2019
- Carbon tax implementation date pushed out from 1 January 2019 to 1 June 2019
- Likely tax increases to emerge in the February 2019 budget include sin taxes on alcohol and tobacco-related products and limited compensation for bracket creep
- No announcement on potential fuel price caps despite current investigation by task team ➔ budget indicated further large fuel levy increases would be required to manage the short-term liability of the Road Accident Fund

Downside risks to revenue collection

- Personal tax and VAT collections are surprising positively this year, but company and property taxes are disappointing ➔ tax buoyancy (tax growth relative to economic growth) has declined in the past four years ➔ lower growth environment may dent tax buoyancy further
- Main budget revenue shortfall for FY2018/19 estimated at R27.7 billion
- Few structural tax adjustments hinted at to boost revenue base

Overall positive consumer effect

- In February 2018, Treasury suggested the number of social grant recipients would grow from the current 17.5 million to 18.1 million by FY2020/21
- Real growth in social grants (between 2% and 3% in the medium term) to help cushion burden on low-income households
- No mass layoffs in the public sector and above-inflation civil servant wage increases ➔ more support for consumption spend
- Increase in list of VAT exempt items
- Jobs Summit aims to create 275 000 jobs every year for the next five years

Expenditure challenges remain

- An above-inflation wage settlement and a moratorium on public sector retrenchments prevent a significant reigning in of the public wage bill, which accounts for around 14% of GDP
- Civil servant wage increases expected to average 7.6% (2.1% real) in the medium term expenditure framework (MTEF)
- Interest bill expected to be the fastest-growing expenditure item ➔ average growth of 10.9% (5.4% real) in the MTEF

A renewed focus on infrastructure

- No net new funding set aside ➔ fiscus to contribute R400 billion within the next three years
- The formation of the new infrastructure fund is intended to reduce current fragmentation of infrastructure spend
- Dedicated execution team to reduce spending inefficiencies
- Fund will be used to leverage additional resources from development finance institutions, multilateral development banks, private lenders and investors

Long-term spending commitments

- Agriculture and rural development budget accounts for a miniscule 1.7% of spending in the MTEF
- Implementing the National Health Insurance (NHI) remains a policy priority ➔ health budget accounts for 12.4% (previously 13.9%) of total spending between FY2018/19 and FY2020/21 ➔ allocation to health expected to grow at an average rate of 7.9% (2.4% real) in the MTEF ➔ in Momentum Investments' view, unsuccessful pilot projects, a lack of resources, limited specialists and maladministration pose a risk to an effective rollout
- Social protection expected to account for 11.4% of expenditure in the MTEF

State firms are still a drain on the budget

- Treasury's guarantee portfolio totals R670 billion (R334.2 billion already utilised) ➔ Eskom, independent power producers and the Road Accident Fund account for the majority
- Government is allocating R5 billion to SA Airways, R1.2 billion to SA Express and R2.9 billion to the SA Post Office in FY2018/19
- In Momentum Investments' opinion, further financial support should come from a combination of disposing of non-core assets and underutilised government properties, introducing strategic equity partners or direct capital injections

Rising risk, but rating agencies likely to give SA benefit of the doubt

- No imminent economic recovery anticipated ➔ growth and debt trajectories only expected to stabilise in the medium term ➔ political and economic realities necessitate a slow implementation path for structural reform
- Political stability has improved ➔ rating agencies expected to take a 'wait-and-see' approach to issues which could be affected by populist political posturing in the run up to the elections
- A number of low-hanging fruit have been addressed ➔ overhaul of leadership and governance at key parastatals, forging a new social compact (labour market reforms and Mining Charter), increasing engagement, attempts to address elevated levels of unemployment (Jobs Summit), rebuilding investor confidence and attracting new investment (Investment Summit)
- Stimulus package involves a reprioritisation of funds targeted at agriculture, rural development, tourism and beneficiation ➔ but expected to leave the expenditure ceiling intact