Macroeconomic outlook

In line with our expectations, National Treasury (NT) downwardly revised its macroeconomic outlook to reflect the weaker growth and inflation outcome. NT’s growth forecasts over the next three years are slightly above our estimate, the key difference between our forecasts is NT’s slightly higher assumption for gross fixed capital formation (GFCF). NT expects improved confidence, the replacement of old machinery and greater execution of capital projects to contribute to improved fixed investment expenditure. Contrary to our view of below 5% inflation in 2019, NT expects inflation to rise to 5.2% led by higher food, fuel and utility prices.

Fiscal framework

The budget review sees a R15.4bn shortfall in revenue in the current financial year, and by a further R16.3bn over the following three financial years relative to the 2018 MTBPS. Measures to improve tax collection include muted inflation adjustments on personal income tax.

The amendments on the expenditure side were the biggest surprise. An additional R75.3bn in expenditure was introduced – R69bn of which was directed at supporting Eskom’s income statement. Of the remaining R6.3bn, R5bn will be allocated to the investment fund and the rest will go towards the 2021 census. R50.3bn in savings were recorded; over half of this was due to a reduction in compensation, the rest was from savings from goods and services and programmes that have accumulated surpluses. The contingency reserve will be increased by R6bn in FY19/20 and reduced by R8bn over the two subsequent financial years.

In all the expenditure ceiling will be increased by R14bn in FY19/20, R1.3bn in 20/21 and R732m in FY21/22.

On Eskom

As far as Eskom’s financial position is concerned, government has steered clear from providing balance sheet support to the ailing entity, instead opting to allocate funds to Eskom’s income statement (mainly for debt service costs and operational spending). Although this support will amount to a significant R69bn over the next three years, not taking Eskom’s debt on balance sheet will prevent an even further deterioration of government’s debt metrics.

As already announced, Eskom will be broken into three entities (Generation, Transmission and Distribution). A portion of Eskom’s assets will be transferred to a new transmission company, which will be opened for strategic equity.
partnerships.

According to the Budget Review (BR), Eskom has managed to contain costs over the past few months through many measures; and the utility has committed to reducing costs by more than R20bn a year by 2022. While the details of Eskom’s turnaround and restructuring are yet to be finalised, part of the turnaround plan includes:

- optimising primary energy costs;
- reprioritising capital expenditure and optimising contract management;
- driving operational and cost efficiency in procurement;
- growing revenue with price incentives; and
- improving workforce efficiency.

**Revenue**

Since the 2018 MTBPS, revenue shortfalls intensified against the backdrop of weaker economic growth and residual problems in tax administration mainly in the form of further unexpected increases in VAT refunds. The adverse impacts of these factors were evident in poorer-than-anticipated company income tax (CIT) and personal income tax (PIT) revenue receipts.

In fact, the 2019 BR estimates that deviations in the three key tax levers deteriorated significantly relative to the MTBPS. The expected undercollection for PIT worsened on account of lower production in the mining industry and the financial services sector. The widening in CIT revenue undercollection is expected to reach R12.8bn, compared to the previous estimation of R697m. VAT revenue undercollection is expected to disappoint by a significantly worse R22.2bn in FY18/19, compared to the estimated R1bn as per the 2018 MTBPS.

After taking the above into consideration, tax revenue estimates for FY18/19 were revised down by a substantial R15.4bn, compared to the 2018 MTBPS. The projected shortfall for FY18/19 currently stands at R42.8bn (2018 MTBPS: R27.4bn).

Over the Medium Term Expenditure Framework (MTEF), government’s proposed tax measures are expected to add R15bn in 2019/20 and R10bn in 2020/21.

Key tax proposals were evident for PIT, the fuel levy and sin taxes. PIT’s tax threshold increased from R78 150 to R79 000; the inflation adjustment to PIT was marginal. The overall impact on the consumer will be that those individuals who receive an inflation increase on their taxable income will face a relatively larger tax burden. Adjustments to indirect taxes include the below-inflation adjustment to fuel taxes.

Regarding adjustments to sin taxes, above-inflation increases were instituted to excise duties on tobacco products and alcoholic beverages. This is consistent with above-inflation increases in retail prices for these goods to maintain taxes at the target level.

**Expenditure**

Over the MTEF compensation is expected to be reduced by about R27bn as a means to limit expenditure growth.

The overall unfavourable shift in the expenditure framework since the 2018 MTBPS was largely a function of adverse economic developments, as well as the materialisation of risks from Eskom.

While the 2018 MTBPS proposed a reprioritisation of R33.4bn over three years with an unchanged expenditure ceiling, the 2019 BR proposes a reprioritisation of R50.3bn with a R16bn rise in the expenditure ceiling over the MTEF, mainly to finance the reconfiguration of Eskom.

The R50.3bn reduction in baselines will mainly be a function of savings from reduced compensation of employees through a combination of natural attrition and active measures to freeze wage and salary increases. This partly explains the slight moderation in compensation of employees as a percentage
of overall spending. At the moment it averages 34.4% over the MTEF (35.4% in 2018 MTBPS).

**Fiscal ratios**

The main budget deficit (the difference between tax and expenditure as a percentage of GDP) is expected to widen to 4.7% in FY19/20 versus 4.4% projected in the MTBPS.

Government’s gross borrowing, which consists of the budget deficit and maturing debt, will increase to 6.2% in FY19/20 before declining to 5.3% of GDP in 2021/22. To finance the deficit gross loan, debt will rise to R2.8 trillion (56.2% of GDP) in FY19/20 and stabilise at R3.5 trillion in FY21/22 (58.9% of GDP).

**Sovereign rating implications**

The budget presented today does not change our expectation that Moody’s will change the government’s sovereign rating to a negative outlook. We can list two key reasons to support this assessment:

1) all the key fiscal ratios presented are worse, and in some cases much worse, than Moody’s had anticipated in October; and

2) the spending ceiling, which until recently was almost considered sacrosanct by Treasury, has been breached.

What also doesn’t help is the unprecedented scale of Eskom’s required restructuring and the uncertainty that still surrounds the depth of its operational challenges.

**Conclusion**

The damage inflicted by years of persistent weak economic growth has left the government in the following unenviable position:

- Its debt load has swollen so much that the interest bill now consumes a projected R210bn of tax revenue in FY19/20. This is already R35bn more than the state’s planned capex budget over the same period. Put differently, what the government plans to borrow this fiscal year will only marginally exceed the interest cost of serving its R3 trillion stock of debt (expected to climb to R3.5 trillion in two years’ time).

- Spending reduction and revenue increases will continue to weigh on economic activity in the foreseeable future.

These are realities the country can’t escape from. The way out is to implement structural reforms including the successful implementation of Eskom’s proposed turnaround strategy.

**Main budget framework**

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<td>1 076.2</td>
<td>1 137.9</td>
<td>1 196.4</td>
<td>1 298.3</td>
<td>1 400.3</td>
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<td>Main budget expenditure</td>
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<td>1 405.0</td>
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<td>1 637.9</td>
<td>1 766.0</td>
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<td>Non-interest expenditure</td>
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<td>1 159.0</td>
<td>1 242.3</td>
<td>1 332.3</td>
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<td>Debt-service costs</td>
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<td>202.5</td>
<td>221.7</td>
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<td>3.4%</td>
<td>3.6%</td>
<td>3.7%</td>
<td>3.8%</td>
<td>3.9%</td>
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<tr>
<td>Main budget balance</td>
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<td>-4.4%</td>
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<td>Primary balance</td>
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Source: National Treasury
Disclaimer

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