On balance, a mildly positive budget

Earlier today Finance Minister Tito Mboweni delivered South Africa’s 2020 Budget for the next Medium Term Expenditure Framework (MTEF) period. Since the 2019 Medium Term Budget Policy Statement (MTBPS), the National Treasury (NT) has made some significant downward adjustments to its growth and inflation outlook, which sets a more challenging environment for the formulation of the budget.

We are concerned that even though they have moved lower, NT’s forecasts remain significantly higher than ours (see Table 1). To this end, we are concerned about fiscal slippage in the event that NT’s forecasts do not materialise.

In sum, today’s annual budget statement highlighted that the underlying weakness in the economy continued to undermine tax revenue collection. In fact, the outlook for revenue has deteriorated meaningfully. Meanwhile, expenditure pressures persist as government continues to offer additional allocations to struggling (both operationally and financially) state-owned entities (SOEs) – primarily Eskom.

Encouragingly, significant reductions were made to the wage bill over the MTEF. It should be noted that delivery on these targets hinges on successful wage negotiations between government and the labour unions. However, the latter have already indicated that they will push back on any cuts or freezes to the wage bill.

When comparing the impact on the budget deficits over the MTEF, the 2020 Budget Review remains largely similar to what was tabled in the 2019 MTBPS. The main budget deficit is expected to average -6.4% over the MTEF. Even so, sovereign debt is expected to continue rising to such an extent that the debt-to-GDP trajectory is not projected to stabilise over the medium term. In fact, this ratio is projected to rise to 71.6% of GDP in fiscal year (FY) 2022/23.

Finally, it is important for NT to deliver on its proposals as failure to do so will result in a fiscus that is on an unsustainable path. This will ultimately lead to further sovereign ratings downgrades by global credit ratings agencies.

Expenditure

Over the medium term, NT managed to show meaningful spending consolidation amounting to R1.95 trillion in 2020/21 (−R24.3 billion), R2.04 trillion in 2021/22 (−R57.2 billion) and R2.14 trillion in 2022/23 (−R73.9 billion) – a cumulative R155.4 billion lower compared to the 2019 MTBPS projections.

In comparison to the 2019 Budget Review, the main budget non-interest expenditure was lowered by a notable...
R156.1 billion over the MTEF. A significant part of this was due to a R160.2 billion reduction of the public sector wage bill, but the final outcome of the reduction will be heavily contingent on a successful wage negotiation process between government and the labour unions. Proposals were also made for reductions in compensation ceilings and government programmes. Other funding of expenditure will take place through reallocations and reprioritisations over the MTEF. In total, this equates to a baseline reduction of R261 billion. However, this is partially offset by additional allocations of R111 billion to SOEs, with Eskom claiming the lion’s share of R60 billion.

In sum, the 2020 Budget Review continues to highlight the ever-deteriorating trend of government spending composition. Indeed, public sector infrastructure spending remains proportionately low, while the share of consumption spending (particularly the public sector wage bill) remains relatively high – accounting for 32.7% of total spending over the medium term. Moreover, debt-service costs are forecast to rise at an unsustainable 12.3% over the MTEF (see Figure 1) – much higher than the pace of total expenditure growth of roughly 5%. This is a disconcerting trend, which shows that interest payments have begun crowding out spending in other areas of priority.

Revenue

On the revenue side, poor economic growth, as well as tax revenue collection inefficiencies, adversely affected collections. Indeed, there was severe under-collection among almost all the major tax categories.

In the 2019 MTBPS, the projected revenue shortfall (compared to the 2019 Budget Review) was estimated at R52.5 billion for the current fiscal year 2019/20. Discouragingly, this shortfall is expected to widen by an additional R10.7 billion as estimated in the 2020 Budget Review. Over the MTEF projections show tax revenue shortfalls of R36 billion in 2020/21, R44 billion in 2021/22 and R49 billion in 2022/23 – a total of R129 billion.

Even against this backdrop of revenue shortfalls, government decided not to raise additional revenue from increased tax proposals over FY2020/21. For FY2020/21, the main tax proposals include:

- personal income tax relief through an above-inflation increase in the brackets and rebates;
- limiting corporate interest deductions to combat base erosion and profit shifting; and
- restricting the ability of companies to fully offset assessed losses from previous years against taxable income.

To some extent these will be offset by:

- increasing the fuel levy by 25 cents per litre (c/l) to adjust for inflation, consisting of a 16c/l increase in the general fuel levy and a 9c/l increase in the Road Accident Fund levy;
- increasing the annual contribution limit to tax-free savings accounts by R3 000 from 1 March 2020; and
- increasing excise duties on alcohol and tobacco by between 4.4% and 7.5%.

A total of R10 billion in revenue will be forgone for the next year from the choice to not apply additional revenue raising measures. These revenues were previously projected in the 2019 Budget Review. In assessing the main tax proposals tabled by Mr Mboweni it is clear that there was significant effort toward curtailing the tax base erosion. Against the backdrop of lower wage growth, dwindling consumption and fragile business profitability, NT assessed that substantial increases in taxes were likely to be ineffective and potentially harmful to the already fragile economy.

Tax revenue is expected to grow by 4.9% in FY2020/21, resulting in a decrease in gross tax buoyancy (the ratio of tax revenue to nominal GDP growth) to 0.93. The deterioration in revenue collection is associated with lower personal and corporate income tax receipts, as well as weaker value-added tax collections.

It is encouraging that there is an ongoing commitment towards institutional strengthening at the South African Revenue Service, with the goal being revenue
recovery and increased tax collection. Government will continue to work with the re-established Davis Tax Committee, which is currently addressing issues such as tax leakages, customs fraud, trade mispricing and harmful tax practices, among others. This bodes well for future revenue collection efficiencies if implemented effectively.

Table 2 below compares the 2020 Budget Review outlook for tax buoyancy relative to previous budget updates. From this, it is evident that revenue collection weakness has simply been moved forward to the upcoming FY2020/21.

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Table 2: Tax buoyancy

Source: National Treasury

Budget framework

At best, the combination of the current tax proposals and expenditure reduction has left the course of the budget deficit largely unchanged. The estimate for the main budget balance is expected to widen to -6.8% of GDP in FY2020/21, before narrowing marginally to -5.9% in 2022/23 (Figure 2). The key fiscal challenge that government is faced with is that, while revenue has remained broadly stable (at about 26%) as a percentage of GDP, expenditure has been growing. Figure 3 demonstrates the widening of the gap between revenue and expenditure, both as a percentage of GDP.

Although the proposed measures to rein in expenditure will go some distance in containing the budget deficit, the outlook for revenue performance remains fragile – preventing debt from stabilising. Indeed, the debt-to-GDP trajectory is projected to continue rising with no stabilisation in sight over the MTEF. Debt is projected to rise to 71.6% of GDP in FY2022/23, from 65.6% in FY2020/21 (Figure 4).

Risks to fiscal outlook and conclusion

The ultimate indication of a fiscus that is suffering is a debt-to-GDP trajectory that fails to stabilise over the medium term. At this stage, the rate of growth in gross debt is fuelling rapid growth in debt-service costs. Even with the current budget in place, there are several risks to the outcomes, including chronically weak economic growth, which is the central factor restricting public finances; the high demand that SOEs (mainly Eskom) continue to place on public finances; as well as uncertainty surrounding the outcomes from the upcoming negotiations of the multi-year public sector wage agreement.

In conclusion, while government managed to make significant reductions on the expenditure side, a significantly poorer outlook on revenue collection led to a net effect that is virtually unchanged. Although we saw no material deterioration in the budget balance, the gross debt picture continues to look worrying. To this end, higher debt is expected to push the debt-service cost higher to the extent that it continues to crowd out other more beneficial expenditure items.

Against this backdrop, we still expect Moody’s to lower South Africa’s sovereign credit rating only in November this year, as opposed to at its next review for the country, which is on 27 March. Although the 2020 budget looks very similar to the 2019 MTBPS on a net basis, we assess that the ratings agencies could view it favourably given the concerted effort to cut expenditure.
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