31 October 2019

Medium Term Budget Policy Statement (MTBPS)

Treasury emphasises implementation and urgency

'Now is the time. We cannot wait any longer. If we want a successful harvest, we must act today.'

Finance Minister Tito Mboweni

- The country's finances have deteriorated dramatically since the February budget.
- The key problem, again, has been a lack of economic growth, following a stagnant first-half. The estimate for economic growth in 2019 has been revised down sharply, to 0,5% from 1,5% expected in the February budget. Medium-term estimates are now also more realistic, with growth reaching just 1,7% in 2022 from the 2,1% projected in February.
- The Treasury will present a revised version of its earlier economic strategy, with suggested quick implementation of certain policies such as prioritising small-scale power generation projects, reducing barriers to tourism, reducing the cost of doing business and expanding fibre access through regulation. Longer-term, more structural, measures will also be implemented over time to improve competitiveness.
- Expenditure rises over earlier budget estimates despite identified cuts in certain areas of R21 billion in 2020/21 and by R29 billion in 2021/22. There will be a concerted effort to regain control of personnel expenses and to improve the effectiveness of government spending in general. However, there will still be annualised non-interest spending growth of 1,4% over the period. Eskom bailouts and higher debt service costs push overall expenditure higher.
- Revenue collection has again been disappointing, with a likely R53 billion shortfall in 2019/20. This year's budget deficit estimate goes up to 5,9% of GDP from 4,5% at the time of the budget. The deficit then remains elevated at over 6,0% of GDP in marked contrast to hopes at the time of the budget of a fall to 4% of GDP over the medium term.
- Gross debt is now expected to continue rising significantly, to over 70% in 2023/24 excluding support for Eskom, but 73,7% including projected support. The escalation continues over the longer term.
- Government finances are clearly in an unsustainable state, with much better expenditure control and greatly improved economic growth the only solutions. It is difficult to imagine the sovereign ratings agencies taking an optimistic view of the country unless significant changes are made.

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Background and assumptions

With no sign of the hoped-for economic turnaround and escalating problems at Eskom, Finance Minister Tito Mboweni's task in this year's MTBPS was particularly difficult. The arithmetic was always bound to be bad, with a needed focus on stopping the bleeding to start containing expenditure and restoring more favourable business and economic conditions to try to improve tax collection.

Important disclosures can be found in the disclaimer

A repeat of poor conditions in the first half of 2019 forced Treasury to revise its assumptions made at the time of the Budget. Economic growth in 2019 is now expected to be just 0,5% from 1,5% expected in February, with more realistic assumptions over the medium term as well. Growth in capital formation is expected to remain very slow over the medium-term framework. Overall, the assumptions are much in line with the consensus view.

Table 1 : Economic assumptions: calendar years

	2016	2017	2018	2019	2020	2021	2022
		Actual		Estimate		Forecast	
Household spending	0.7	2.1	1.8	1.3	1.3	1.5	1.7
Government spending	1.9	2.0	1.9	1.8	1.8	1.1	0.6
Gross fixed capital formation	-4.1	1.0	-1.4	-0.8	0.8	1.3	1.8
Exports	1.0	-0.7	2.6	-1.7	2.5	2.8	3.1
Imports	-3.8	1.0	3.3	1.1	1.9	2.6	3.0
GDP growth	0.6	1.4	0.8	0.5	1.2	1.6	1.7
GDP inflation	6.8	5.3	3.9	4.8	4.9	4.9	4.8
Headline CPI inflation	6.3	5.3	4.7	4.3	4.9	4.8	4.8
Current account (% of GDP)	-2.8	-2.5	-3.5	-3.4	-3.5	-3.5	-3.5

Source: National Treasury

Fiscal stance and revised MTBPS

The overall fiscal position deteriorates significantly in this MTBPS. This is mainly because of a combination of weaker economic growth as well as lower tax revenue forecasts, combined with additional support for electricity utility Eskom. Treasury has reduced the main budget expenditure ceiling modestly from that in the 2019 Budget, excluding the Eskom bailouts. Even so, total expenditure rises significantly over the medium term given the higher debt burden and support for Eskom.

Deficits consequently are much higher over the period. This year's deficit is kept marginally under 6% of GDP, but this rises to 6,5% in 2020/21 and then stays over 6% during the whole period. There will therefore have to be further adjustments in next year's budget, hopefully to the spending estimates, but probably also on the taxation side.

Table 2: Consolidated government fiscal framework

	2018/19		2019/20		2020/21		2021/22		2022/23
	Budget Feb 2019	MTBPS Oct 2019	Budget Feb 2019	MTBPS Oct 2019	Budget Feb 2019	MTBPS Oct 2019	Budget Feb 2019	MTBPS Oct 2019	MTBPS Oct 2019
Revenue (Rbn)	1455.2	1445.4	1583.8	1537.9	1696.4	1618.5	1836.6	1729.6	1841.2
% gdp	28.8	29.4	29.3	29.5	29.2	29.3	29.4	29.4	29.3
Yoy%	7.5	6.8	8.8	6.4	7.1	5.2	8.3	6.9	6.4
Expenditure (Rbn)	1665.4	1652.8	1826.6	1844.1	1948.9	1978.7	2089.0	2097.5	2214.9
% gdp	32.9	33.6	33.7	35.4	33.5	35.8	33.4	35.6	35.3
Yoy%	7.9	7.1	9.7	11.6	6.7	7.3	7.2	6.0	5.6
Balance (Rbn)	-210.2	-207.5	-242.7	-306.2	-252.6	-360.2	-252.4	-367.9	-373.7
% gdp	-4.2	-4.2	-4.5	-5.9	-4.3	-6.5	-4.0	-6.2	-5.9
GDP (Rbn)	5059.1	4921.5	5413.8	5210.8	5812.4	5530.3	6249.1	5893.1	6283.0
Yoy%	7.2	4.7	7.0	5.9	7.4	6.1	7.5	6.6	6.6

Source: National Treasury

Revenue

Revenue is expected to increase by just 6,4% in 2018/19 versus an already modest 8,8% anticipated at the time of the budget. Large shortfalls in taxes on individuals (R25,3 billion), companies (R10,6 billion) and VAT (R12,1 billion) will be mainly to blame for the total R52,5 billion shortfall.

Revenue growth is expected to remain weak over the period, with the revenue to GDP ratio remaining just above 29%. There were no major hints at future tax measures that may be employed to try and reduce the deficit, but better tax administration could help address some of the gap.

Expenditure

Expenditure estimates rise over the 2019 Budget mainly because of planned transfers to Eskom over the period. Non-interest expenditure is projected to grow by 1,4% per annum in real terms over the 3-year period.

The fastest rising category of spending over the period remains debt service costs, which increase by an average of 13,7% per annum from 2019/20 to 2022/23. Health rises by 7% over the period. Treasury has indicated that NHI may require an additional R33 billion annually from 2025/26. However, the MTBPS talks of helping the department consider more limited policy reforms than those originally envisaged, stating that cost projected in the 2017 White Paper are no longer affordable. Compensation of employees is also set to rise by an unaffordable 6,3% per annum over the period. Other than this there is a concentration on community development (mainly improving water resources) and economic development (with some concentration on agricultural development and support for land reform), which get 7% and 6,9% annualised over the period.

Eskom remains the biggest thorn in government's and the country's flesh. It receives provisional support of R49 billion this year, R56 billion in 2020/21 and R33 billion in 2021/22. However, scrutiny of the utility will increase and government is finally starting to ask the right questions, such as whether expensive but ineffective capital expenditure can be stopped or deferred. Wastage on Medupi and Kusile already probably runs to over R300 billion if capitalised interest is considered. From once being a national asset, the utility is now a massive liability.

The deficit and financing

Main budget borrowing requirements will rise significantly over the medium term due to higher deficits compared with the numbers predicted at the time of the February Budget.

Total gross loan debt is budgeted to rise to a revised 60,8% of GDP in 2019/20, much higher than the 56,2% forecast in the February 2019 budget speech, and to continue rising to 71,3% in 2022/23. Even excluding Eskom bailouts, the figures are unflattering, with a move to 68% over the period. Financing will remain mainly longer-term and sourced in domestic markets.

Table 3: Main budget borrowing requirement and financing

	2018/19	2019/20	2020/21	2021/22	2022/23
R million	Outcome	Revised	Medium-term estimates		
Main budget balance	**-232.0**	**-324.3**	**-375.3**	**-383.9**	**-389.8**
Redemptions	**-15.5**	**-69.9**	**-65.2**	**-64.1**	**-128.2**
Domestic long-term loans	-13.5	-19.5	-52.5	-59.7	-112.7
Foreign loans	-2.0	-50.4	-12.7	-4.4	-15.5
Total	**-247.5**	**-394.2**	**-440.5**	**-448.0**	**-518.0**
Financing					
Domestic short-term loans (net)	14.1	46.0	37.0	50.0	58.0
Domestic long-term loans	183.0	284.1	343.0	353.9	407.4
Foreign loans	25.3	76.1	45.5	46.4	54.2
Change in cash and other balances	25.1	-12.0	15.0	-2.3	-1.6
Total	**247.5**	**394.2**	**440.5**	**448.0**	**518.0**

Source: National Treasury

Comment and implications

The fiscal arithmetic in this MTBPS is again shocking. Although this year's deficit is slightly below our expectation, future years show a continual deterioration that most analysts would not have expected. However, the figures are probably realistic. Most of the deterioration is on the taxation side of the budget and this in turn reflects very weak economic growth forecasts. The debt spiral will continue if proper structural reforms are not implemented quickly and effectively. It has become clear that the solution to the growth problem must come more from the supply side. This is obvious not only because the strategy so far has concentrated on the demand side by boosting public sector wages and through extravagant public sector spending practices that have inflated costs and acted as massive income and wealth transfers, but also because private sector investment has not been crowded in. Clearly, years of accumulating layers of regulatory burden and increased costs have made South Africa an unattractive investment and business destination. Without new activity jobs will not be created and inequalities will multiply.

Fortunately, this reality does seem to be sinking in, at least in parts of government. Treasury's economic strategy document hits the right notes, although version 2, to be released later today, may contain some fatal wounds inflicted by the unions and the ideologically captured. If the right urgency can be applied to removing key obstacles and if all legislation can be checked for its impact on jobs and growth, there is hope that the country can move onto a better path.

A key question again is how this MTBPS will be received by the rating agencies and Moody's in particular. Moody's still has South Africa on investment grade with a neutral outlook, but is due to make some pronouncements on Friday. It may wait to see if more corrective action is taken in the budget before deciding to change its positive stance. However, the severe deterioration in the country's finances and the likely negative reaction in markets will be challenges.

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