

## Comment

# Budget 2015: The start of fiscal consolidation

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## Introduction

In his first main Budget address, Finance Minister Nhlanhla Nene followed through on earlier warnings of the need for fiscal consolidation. He announced a rise in the country's net tax burden. This includes a 1% hike in the **marginal tax rates** of all taxpayers earning more than R180,000 per annum, as well as a hefty increase in the **fuel** and **road accident fund** (RAF) levies. On the expenditure side, the minister reiterated government's commitment to limit the real growth in government expenditure to low single digits.

The tightening in fiscal policy was necessitated by a further downgrade of the Treasury's macroeconomic outlook (table 1). Softer expected **nominal GDP** growth required even more additional revenue for the 2015/16 fiscal year than outlined in the October 2014 Medium-Term Budget Policy Statement (MTBPS). The revenue raising and expenditure control measures ensured that, relative to the MTBPS figures, the Treasury could present largely unchanged **budget deficit** figures (see table 2 below) over the medium-term expenditure framework (MTEF, or the next three fiscal years). However, at 3.9% of GDP, the 2015/16 budget deficit is now expected to be 0.3 percentage points (% pts) higher than expected in the MTBPS as the major expenditure tightening is only set for the outer years. A higher nominal GDP level (because of the earlier Stats SA GDP rebasing) and a change in government's debt issuance strategy are expected to result in overall **net government debt** stabilising at 43.7% of GDP in 2017/18. This is 2.6 % pts lower than estimated in the October MTBPS and should be welcomed by the credit rating agencies.

Table 1: Weaker medium-term GDP growth outlook

|                            | Oct '14 MTBPS |      |      | Feb '15 Budget |      |      |
|----------------------------|---------------|------|------|----------------|------|------|
|                            | 2015          | 2016 | 2017 | 2015           | 2016 | 2017 |
| Real GDP growth            | 2.5           | 2.8  | 3.0  | 2.0            | 2.4  | 3.0  |
| CPI inflation              | 5.9           | 5.6  | 5.4  | 4.3            | 5.9  | 5.7  |
| Nominal GDP growth         | 8.5           | 8.7  | 8.8  | 8.2            | 8.0  | 8.7  |
| Current account (% of GDP) | -5.4          | -5.2 | -5.0 | -4.5           | -4.9 | -5.2 |

Source: Budget Review 2015

Also positive was mild support for the business sector, including marginal tax relief for small businesses with a turnover below R1 million and increased company tax deductions for efficient energy use.

The Treasury's updated macroeconomic assumptions are presented in table 1. Real GDP growth is now forecast to average 2.5% over the MTEF period. This is 0.3 % pts lower than the 2.8% expected in October. In particular, the forecast for 2015 was reduced to 2% from 2.5%, i.e. in line with our latest forecast of 1.9%. For government revenue, the important figure is the **nominal GDP** growth outlook. This was revised to an average of 8.3% over the next three years, down from an average of 8.7% expected in October. A sharp downward adjustment to the 2015 **CPI inflation** figure (to 4.3% from 5.9%) helps to account for the lower nominal GDP figure. In line with our view, the Treasury expects consumer inflation to accelerate again in 2016 towards the 6% upper band of the SA Reserve Bank's (SARB) inflation target. In line with most private sector forecasts, the Treasury now forecasts a lower **current account deficit**. This is driven by the much lower oil price, which reduces SA's oil import bill.

## Following through on fiscal consolidation

The revised forecast for the 2014/15 budget deficit is 3.9% of GDP, slightly down from the 4.1% projected in October 2014. Over the next three fiscal years, the deficit is forecast to average 3% of GDP, largely unchanged from the 2.9% expected in the October 2014 MTBPS. Looking back to what was expected in last year's main February Budget, the latest projections for the 2015/16 and 2016/17 deficit numbers also compare relatively favourably. Back then, deficits of 3.6% and 2.8% of GDP were expected. Against this backdrop, the **public sector borrowing requirement** (PSBR) is expected to measure 6.1 and 4.2% of GDP during 2015/16 and 2016/17. Again, this is largely unchanged from the expectation in the 2014 Budget. The PSBR requirement is largely financed through the issuance of domestic long-term government bonds. Net issuance is expected to total R145bn in 2015/16, declining to R116bn during 2016/17. The figure for 2015/16 is about R10bn higher than expected in last year's Budget, but should not have an overly negative impact on the domestic capital market.

Table 2: Medium-term consolidated budget projections

| R billion                       | 2014/15        |                | Medium-term estimates |                |                |
|---------------------------------|----------------|----------------|-----------------------|----------------|----------------|
|                                 | MTBPS '14      | Budget '15     | 2015/16               | 2016/17        | 2017/18        |
| <b>Revenue</b>                  | <b>1 093.9</b> | <b>1 090.0</b> | <b>1 188.9</b>        | <b>1 331.5</b> | <b>1 439.5</b> |
| % of GDP                        | 29.5           | 28.1           | 28.4                  | 29.3           | 29.2           |
| <b>Expenditure</b>              | <b>1 247.1</b> | <b>1 243.4</b> | <b>1351.0</b>         | <b>1 448.8</b> | <b>1 561.7</b> |
| % of GDP                        | 33.6           | 32.0           | 32.2                  | 31.9           | 31.7           |
| <b>Interest payments</b>        | <b>120.8</b>   | <b>120.8</b>   | <b>132.4</b>          | <b>146.8</b>   | <b>158.3</b>   |
| % of expenditure                | 9.7            | 3.1            | 3.2                   | 3.2            | 3.2            |
| <b>Non-interest expenditure</b> | <b>1 126.3</b> | <b>1 122.6</b> | <b>1 218.6</b>        | <b>1 302.0</b> | <b>1 403.5</b> |
| % of GDP                        | 30.3           | 28.9           | 29.1                  | 28.7           | 28.5           |
| <b>Budget balance</b>           | <b>-153.2</b>  | <b>-152.4</b>  | <b>-162.2</b>         | <b>-117.3</b>  | <b>-122.2</b>  |
| % of GDP                        | -4.1           | -3.9           | -3.9                  | -2.6           | -2.5           |

Source: Budget Review 2015

Importantly, because of a weaker GDP growth outlook, the only way for government to achieve similar deficit outcomes than previously expected is through some form of fiscal consolidation. Given the subdued GDP growth outlook, the Budget Review emphasises that the deficit cannot be reduced through a cyclical upturn in revenue. As a result, specific measures were taken.

- Compared to the 2014 Budget, government's expenditure ceiling was reduced by R25bn over the next two years. This implies real spending growth of 2.5% in 2015/16, slowing to 0.7% in 2016/17. A key underpin to the expenditure slowdown is a freeze on personnel headcounts for 2015/16 and 2016/17, as well as inflation-linked salary adjustments. The nominal consolidated government wage bill is expected to increase by 6.6% over the MTEF period. *Higher than expected wage bill growth remains a key risk to the fiscal consolidation path.*
- The rise in personal income tax rates and the fuel levy will raise an additional R16.8bn in gross revenue (see details below).
- The financing of state-owned enterprises such as Eskom will not raise general government debt levels.

Given the weak state of the real economy, it could be argued that these consolidation measures are inappropriate. Treasury officials emphasised that, at this stage, ensuring the credibility of SA's fiscal policy is more important for long-term sustainable growth than measures to support the economy over the short term. At the same time, the *Budget Review* highlights that the consolidation measures were designed to limit the dampening effect on short-term growth. For example, the most significant slowdown in spending growth is in 2016/17. Furthermore, in an effort to offset the rise in the personal income tax burden, Treasury proposes a temporary (for the 2015/16 fiscal year) reduction in unemployment insurance contributions to both employees and employers. This is made possible by a R90bn accumulated surplus for the Unemployed Insurance Fund.

## Tax proposals - burden to increase

The Treasury's updated estimate is that tax revenue for the 2014/15 fiscal year will be R14.7bn below the 2014 Budget forecast and R4.6bn lower than the revised estimate in the October 2014 MTBPS. This is as a result of weak GDP growth in 2014 and its particularly negative impact on corporate tax revenues.

In order to raise additional tax revenue in 2015/16, the marginal personal income tax (PIT) rates for all income tax brackets (excluding the lowest) will be increased by 1%. This implies that the top marginal PIT rate will increase from 40 to 41%. These measures will provide R9.4bn in extra revenue, but the impact will be limited by the normal inflation-related adjustment of the income tax brackets. All brackets will be adjusted by 4.2%. Furthermore, the tax credit for medical contributions increases slightly. The net impact of these tax changes is that the Treasury will receive no additional income from the personal income tax proposals. Those consumers earning less than R450,000 will receive tax relief, whereas income earners above that will pay more tax. However, the numbers are so marginal that in effect it is only consumers who earn more than R1.5 million per annum that will pay significantly more PIT. This was done to make the PIT structure even more progressive.

Given that the net impact of the PIT measures are revenue neutral, it does raise the question of why go to the trouble? One explanation may be that, while Treasury is trying to limit net tax hikes this year while the economy is still weak, the higher marginal tax rates may contribute more to revenue in future years if, for example, the Treasury decided not to adjust the tax brackets for inflation going forward. This is especially relevant given the comment in the Review that there remains little room to broaden the tax base further as this approach has largely been exhausted. While on net the PIT burden will not increase in 2015/16, this in itself is a change from at least the past decade where consumers received “tax relief” through the adjustment of the tax brackets and stable marginal rates.

**Indirect tax hikes** were substantial. Going into the Budget, we expected that government would make use of the lower domestic petrol price to hike the fuel levy substantially. Indeed, the levy will rise by 30.5c/litre on 1 April, but the surprise was the sharp hike in the RAF levy of 50c/litre. This will add 80.5c to the petrol price from April 1. Combined, the rise in the fuel and RAF levy is double the amount we expected. Along with the expected sharp petrol price hike in March and significant recent increase in maize futures prices, it puts upside risks to our 2015 inflation forecast. Staying with the cost of travel, of interest was Minister Nene’s comments in the budget speech that suggested the **e-toll tariffs** in Gauteng may be reduced. **Sin tax hikes** on tobacco products (5 to 7%) and alcoholic beverages (4.8% for fortified wine to 8.5% for spirits) were above the expected CPI inflation rate for 2015/16.

Other notable tax proposals include:

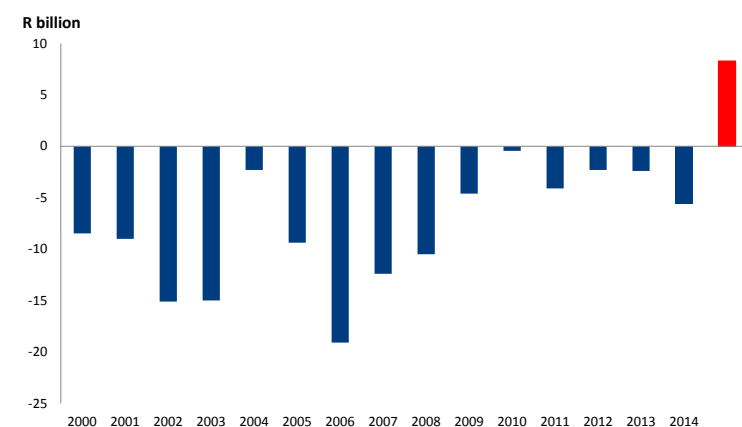
- The threshold for paying **transfer duties** on the sale of property will increase from R600,001 to R750, 001. However, a new category for homes above R2.25 million was introduced. Sales of these properties will carry a transfer duty of 11%. In effect, this can be described as the introduction of a new “wealth tax”.
- The government is considering an increase in the **electricity levy** from 3.5c/kWh to 5.5c/kWh. As this is still up for discussion, the impact of the rise was not included in Treasury’s revenue proposals.
- The energy-efficiency savings tax incentive will be increased from 45c/kWh to 95c/kWh.
- Support to the small business sector. The threshold for the payment of turnover tax was raised from R150 000 to R335 000, while the thresholds and tax rates for companies with a turnover up to R1 million were also adjusted to be more attractive for smaller firms.

Combined, the net impact of all these tax changes is to raise the tax burden by R8.3bn. Figure 1 on the next page suggests that this is a significant change from the situation since 2000 when Treasury provided for net tax relief.

The tax measures are expected to raise the tax/GDP ratio to 25.8% in 2015/16 from 25.2% in 2014/15 and 23.5% back in 2009/10. A further rise in the tax burden is likely in coming years. Treasury is still awaiting the Davis tax commission’s recommendations on the overall tax system, VAT, estate duty, wealth and mining taxes. These reports will inform policy considerations in the 2016 Budget and may be one reason (besides the political sensitivity) why the VAT rate was not increased at this stage. The tax hikes in the 2015 Budget may be followed by more in future budgets. This will be the case once we move closer to

the implementation of significant new government programmes, including **National Health Insurance** (NHI). A discussion paper on NHI financing options will be released shortly.

Figure 1: Net tax hikes total R8.3bn in 2015/16



Budget Reviews

## Public infrastructure and financing Eskom

The Budget confirmed that government will provide Eskom with additional funding of R23bn, but again failed to provide any specific details on how government plans to finance this. As already mentioned, the funding will be deficit neutral through the sale of non-core assets. Because some of these assets are listed entities, Treasury officials mentioned that the details will only be provided at a later stage so as not to unduly influence share price movements. The limited details are likely to be a disappointment for potential buyers of Eskom debt.

Regarding the broader **public infrastructure** drive, the latest estimate puts the nominal projected capital investment programme at R813bn over the MTEF period. However, even in nominal terms, the projected growth rates slow down substantially and turn negative through the MTEF period (table 3). The growth decline is driven by SOEs as general government fixed investment is set to post positive growth. Indeed, capital outlays are projected to be the fastest growing non-interest government expenditure item. Based on these projections, public infrastructure spending is unlikely to add to GDP growth through 2017/18.

Table 3: Public-sector infrastructure expenditure and estimates

| R billion                                                  | MTEF estimates |              |              |              |              |
|------------------------------------------------------------|----------------|--------------|--------------|--------------|--------------|
|                                                            | 2013/14        | 2014/15      | 2015/16      | 2016/17      | 2017/18      |
| Eskom                                                      | 57.8           | 59.5         | 61.8         | 46.2         | 30.0         |
| Transnet                                                   | 32.5           | 41.3         | 36.3         | 44.7         | 46.8         |
| SANRAL                                                     | 11.6           | 15.6         | 15.6         | 13.8         | 14.3         |
| <b>Total (including other SOEs and general government)</b> | <b>226.9</b>   | <b>262.4</b> | <b>274.0</b> | <b>273.3</b> | <b>265.8</b> |
| % change (nominal)                                         |                | 15.7         | 4.4          | -0.3         | -2.7         |

Source: Budget Review 2015

## Conclusion and macro impacts

The 2015 Budget introduced the first instalment of a potential multi-year process of measures aimed at reducing, or at the minimum, stabilising government debt levels against the backdrop of an economy that is unable to generate the required revenue to fund existing and proposed new government policy programmes (NHI and social security reform).

Perhaps the key message from Minister Nene's speech is that the perceived easy routes of stimulating growth, i.e. accommodative fiscal and monetary policy, are now effectively blocked. Monetary policy already started tightening in 2014 and although currently on hold, is set to resume in early 2016. This means that other avenues need to be unblocked in order to foster higher medium and longer-term growth. The Minister touched on this when he said: "...our primary challenge is to deal with the structural and competitiveness challenges that hold back production and investment in our economy." These include the problems in the labour and education systems.

Regarding the Budget's impact on our macro forecasts, the sharp fuel and RAF levy hike add to emerging inflation risks. Relative to previous years, the Budget provided less stimuli to the consumer. While our 2.8% forecast for the real growth in consumer spending during 2015 already assumed a less supportive household tax environment, the Budget went further than expected. In isolation, this provides a specific downside risk to our consumer spending outlook. Of particular interest will be whether the tax measures negatively impact consumer confidence levels to high-income consumers. This group has to date remained fairly confident about their own household finances.

However, the temporary reduction in UIF contributions for 2015/16 means that the real fiscal tightening is delayed to 2016/17 when this measure falls away. This is also reflected in the budget deficit that is forecast to stabilise at 3.9% of GDP in 2015/16, before narrowing more forcefully to 2.6% in 2016/17. From that perspective, the Budget proposals may in the end have little negative impact on growth in 2015. The larger impacts are set to be felt from 2016/17 onwards.

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