

Comment

MTBPS delays fiscal consolidation amid revenue squeeze

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Introduction

In presenting his second Medium-Term Budget Policy Statement (MTBPS), Finance Minister Nhlanhla Nene had to incorporate the adverse revenue impact of a weaker GDP growth outlook. Furthermore, the Treasury was faced with the budgetary implications of the higher than expected public sector wage deal for the next three years. Against this backdrop, it was almost inevitable that the fiscal outlook would deteriorate. Indeed, while the figures for the current (2015/16) fiscal year are largely similar to those presented in February, the key fiscal parameters have worsened over the medium term. This is reflected in higher budget deficits, more elevated government debt levels and (relative to the February outlook) an increased borrowing requirement.

At first glance, this may raise some eyebrows at the credit rating agencies. However, despite having to fork out R64bn more for the public sector wage bill over the next three fiscal years, the Treasury stuck to its **expenditure ceiling** on the main budget. No increase in government spending was announced. Unfortunately, one of the key negative implications of the wage deal is that the aim of rebalancing government expenditure from current to capital outlays has been postponed. Spending priorities needed to be re-allocated to finance the wage bill. *Current payments are now expected to increase at an annual average of 8.2% over the medium-term expenditure framework (MTEF). Previously, this was forecast to rise by an average of 6.7%. At the other end of the scale, capital payments (i.e. government investment) are set to rise by only 4.3% on average, less than half the 8.9% projected in February.* Except for a R200 million allocation to facilitate the Department of Energy with preparatory work, there was no major expenditure set aside to finance the proposed **nuclear procurement** programme.

The higher budget deficits and delayed fiscal consolidation is a function of **weaker revenue projections** as the Treasury downgraded the outlook for nominal GDP growth (see table 1). Albeit at a somewhat higher level than previously thought, the aim is still to stabilise the growth in overall government debt by 2018/19. This is achieved by projected small surpluses on the **primary** (which excludes debt service costs) **budget balance** from 2016/17 onwards.

After the tax hikes in the February budget, the Treasury gave the strong impression that they are averse to additional revenue raising measures in next year's budget. A rise in value added tax, for example,

seems off the table for now. Given the poor domestic growth outlook and growing strain on the consumer, this seems prudent. Time will tell how this is viewed by the rating agencies.

A more constrained macroeconomic backdrop

The deterioration in the global and domestic GDP growth outlook since February has predictably resulted in downgrades to the Treasury's macroeconomic assumptions. Table 1 compares the revised MTBPS forecast with the 2015 Budget projections. On average, for the period 2015-2017, expected real GDP growth is now 0.6 percentage points (% pts) lower. The largest downward revision (-0.9% pts) was for 2016. At 1.7%, the adjusted number for 2016 is still somewhat above our revised current forecast of 1.4%.

Table 1: More subdued macro outlook compared to February

	Feb '15 Budget				Oct '15 MTBPS				
	2015	2016	2017	Ave '15-'17	2015	2016	2017	Ave '15-'17	2018
Real GDP growth	2.0	2.6	3.0	2.5	1.5	1.7	2.6	1.9	2.8
CPI inflation	4.3	5.9	5.7	5.3	4.8	6.2	5.9	5.6	5.8
Nominal GDP growth	8.2	8.0	8.7	8.3	6.2	7.9	8.7	7.6	8.8
Current account (% of GDP)	-4.5	-4.9	-5.2	-4.8	-4.1	-4.4	-4.6	-4.4	-4.8

Source: Budget Review, MTBPS 2015

The Treasury's 2017 and 2018 real GDP forecasts are 0.4% pts above our latest outlook, but not unreasonable. On **inflation**, the Treasury's forecast for CPI inflation is somewhat higher than the February numbers, but very much in line with how the consensus has moved since February. Crucial from the point of view of the government's tax revenue projections is the **nominal GDP** outlook. Here the latest forecast is 0.7% pts (on average) lower than that of the 2015 Budget.

Of interest is that when confronted with similar downgrades to the growth outlook in October 2014, the Treasury opted to focus on fiscal sustainability. The October 2014 MTBPS noted that: "Fiscal consolidation can no longer be postponed. Ensuring continued progress towards a better life obliges government to safeguard the public finances by acting within fiscal limits that can be sustained over the long term." The result was a budget policy statement that indicated tax increases in the February 2015 main Budget and proposed substantial spending cuts. Although the government spending limits have remained in place, this time the tone of the MTBPS seems to suggest a deeper concern about the growth fundamentals. On potential future tax hikes, the document notes: "Given the weak economic outlook, proposals for additional taxes – which are essential to fund government's ambitious policy agenda – will be approached with caution."

Budget consolidation pushed back as revenue outlook downscaled

The Treasury's revised forecast sees the budget deficit averaging 3.4% of GDP between 2015/16 and 2017/18. This compares with the average of 3% expected in February. The deterioration is focused on the outer MTEF years. Indeed, at a projected 3.8% of GDP, the 2015/16 shortfall is marginally lower than expected in February. This is despite the forecast for gross tax revenue being reduced by R7.6bn. The

withdrawal of the February proposal of a one-year reduction in Unemployment Insurance Fund (UIF) contributions boosted the revenue projection for 2015/16. The revised budget deficit projections for 2016/17 and 2017/18 are 0.7% pts higher than expected in February. Again, this is a function of a weaker tax revenue outlook, which has been reduced by a cumulative R27.4bn in the outer years.

Table 2: Medium-term consolidated budget projections

R billion	2015/16		MTBPS		Ave: 2015/16 to 2017/18		MTBPS
	Budget '15	MTBPS '15	2016/17	2017/18	Budget '15	MTBPS '15	2018/19
Revenue	1 188.9	1220.8	1306.4	1416.0			1540.9
% of GDP	28.4	29.8	29.4	29.3	29.0	29.5	29.3
Expenditure	1 351.0	1378.7	1451.7	1568.8			1699.1
% of GDP	32.2	33.6	32.7	32.5	31.9	32.9	32.4
Interest payments	132.4	133.9	148.4	162.0			179.0
% of expenditure	9.8	9.7	10.2	10.3	10.0	10.1	10.6
Non-interest expenditure	1 218.6	1244.7	1303.3	1406.7			1519.3
% of GDP	29.1	30.3	29.4	29.1	28.7	29.6	28.9
Budget balance	-162.2	-157.9	-145.3	-152.8			-158.2
% of GDP	-3.9	-3.8	-3.3	-3.2	-3.0	-3.4	-3.0

Source: Budget Review, MTBPS 2015

The higher deficits have resulted in an upward revision to the government debt-to-GDP ratio. Gross debt is now expected to rise to 49% (net debt 44.7%) versus 47.6% (net debt 43.7%) expected in February. The implication of this is that government will need to borrow more on the domestic and international capital markets. This is done largely through the issuance of long-term government bonds. At a projected R122.7bn and R126.6bn during 2016/17 and 2017/18, domestic long-term **bond issuance** is set to be R7.4bn and R28.9bn more than foreseen in February. This is likely to be a mild negative for the bond market. Foreign bond issuance is also expected to increase, from an estimated R9.5bn in 2015/16 to R17bn by 2018/19.

On the expenditure side, the ceiling has been maintained, i.e. overall spending is not higher as a result of the higher public sector wage bill. This is proposed to be achieved as follows:

- The **contingency reserve** will be drawn down by R5bn in 2015/16, R10bn in 2016/17 and R26bn in 2017/18. *Unless other spending is reduced, this means that any unforeseen expenditures over the MTEF will add to the budget deficit.*
- The MTEF provides no funds to increase public-sector employment over the next three years. Treasury officials commented that while this does not amount to an explicit directive to departments to freeze positions, employment will only be allowed to rise if budgets allow. *Our forecast already incorporates weak government employment, but this suggests that the risks are on the downside.*
- Government departments will shift funds from other budget lines to meet their compensation commitments. These resources will be drawn from spending on goods and services, as well as

capital budgets. *As mentioned earlier, the revised numbers suggest that capital expenditure will take most of the knock. This delays the much-needed shift in the composition of government spending.*

Other notable initiatives on the expenditure front include a new long-term fiscal guideline that aims to align the spending ceiling explicitly with the path of long-term GDP growth. This is to ensure that fiscal policy remains countercyclical.

Summary and macroeconomic implications

The macroeconomic and public sector wage developments since the February Budget were always going to make the Treasury's fiscal consolidation job exceedingly difficult. In order to stick to the previous deficit targets, the Treasury would have had to cut overall expenditure and / or signal tax increases in the February 2016 Budget. This would have arguably depressed the growth outlook even further and (unlike in October 2014) the Treasury seems to have rather opted for pushing out the fiscal consolidation path.

The MTBPS is a mixed bag for the **consumer**. On a positive note, major tax hikes are unlikely next year, while the MTEF allocations for social grant expenditure were increased. Less positive from a consumer spending point of view is the tougher line taken on future public sector employment. From a fixed investment perspective, the sharply lower growth pencilled in for general government capex expenditure over the MTEF suggests that the risk to our already subdued outlook for government fixed investment (averaging just over 2% in 2016 and 2017) lies on the downside.

The **rand exchange rate** was sharply weaker on Wednesday afternoon, trading around R13.50/\$. Rather than an expression of foreign investor concern about the budget numbers, this may rather be related to the violence that erupted outside Parliament during and after the Minister's speech.

Hugo Pienaar



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