



BUDGET PROVIDES CONFIDENCE AMID GATHERING STORMS

- Introduction
- Expenditure proposals – Eskom to receive a capital injection
- Tax proposals – a much needed shift in emphasis
- More budget highlights
- Macroeconomic implications
- BER growth forecast

Introduction

Although one could be forgiven for thinking otherwise in light of the rand's 20c fall against the US dollar, the 2008/9 budget once again highlighted that (in the wake of mounting economic challenges) SA's public finances are in safe hands.

For one thing, there was little (if any) indication of a move towards more populist fiscal policies, a concern that was raised in some quarters following the dramatic changing of the guard at the ANC's December conference in Polokwane. In the budget speech Finance Minister Trevor Manuel made a point of emphasising that *"It is precisely because of the [prudent] macroeconomic policies put in place since 1996 and the fiscal stance [budgeting for surpluses] in operation that we can be confident that we will weather the storm."* If that wasn't a clear enough signal, Manuel was even more specific with regards to the SA Reserve Bank's (SARB) mandate, saying that *"A policy stance that accommodates higher inflation cannot be consistent with a government that is intent on reducing poverty."* In this vein the inflation target was (as expected) kept unchanged. As is discussed in more detail below, the spending plans over the next three years also do not give the impression that the Treasury was under (or is bowing to) pressure from the left.

The budget stance is in line with comments made by President Thabo Mbeki in the State of the Nation Address when he, amongst other things, said that *"We speak of Business Unusual not referring to any changes in our established policies but with regard to the speedy, efficient and effective implementation of these policies and programmes, so that the lives of our people should change for the better, sooner rather than later."* Having said all this, the point has to be made that most

of the budget planning would have been completed before the Polokwane conference. Besides providing an indication of the direction for future economic policies in the lead up to the budget the big topic of interest was to get an indication of the Treasury's thoughts on how the weaker global economic outlook, higher domestic interest rates and the electricity crisis are likely to impact on SA's growth performance. Table 1 indicates that (as expected) the Treasury's GDP growth forecasts have indeed been revised down, albeit by less than the adjustment made by some private sector

Table 1: Macroeconomic outlook

		2007	2008	2009	2010
Real GDP growth*	MTBPS	4.9	4.5	4.8	5.3
	Budget '08	5.0	4.0	4.2	4.6
CPIX inflation (average)	MTBPS	6.2	5.4	4.6	4.5
	Budget '08	6.5	7.1	4.9	4.7
Current account (% of GDP)*	MTBPS	-6.7	-6.9	-7.7	-7.8
	Budget '08	-7.2	-7.3	-7.8	-8.0

*Estimated figure for 2007

MTBPS: Medium Term Budget Policy Statement, October 2007

Source: Budget Review, 2008

economists, including the BER's updated forecast (see below). It also comes as no surprise that inflation forecasts (especially in 2008) were revised higher, although the Treasury's 2009 CPIX forecast may prove to be on the optimistic side.

The main budget proposals (table 2) should be seen against this more challenging macroeconomic backdrop. In particular, in light of the projection for continued large current account deficits over the next three years, Manuel emphasised the need to increase the local savings rate. A sobering statistic is that SA requires R3bn in foreign capital inflows every week to finance the current account shortfall. Government's contribution to a higher national savings rate is to aim for a budget surplus for each of the following three fiscal years.

Table 2: Medium-term budget framework

	2007/8	2008/9	2009/10	2010/11
Total Revenue	557.9	625.3	692.8	758.9
% of GDP	27.3	27.3	27.6	27.5
Total Expenditure	542.1	611.0	681.6	744.6
% of GDP	26.5	26.7	27.2	27.0
Debt service	52.8	51.2	51.1	51.1
% of GDP	2.6	2.2	2.0	1.9
Fiscal balance	15.8	14.3	11.2	14.3
% of GDP	0.8	0.6	0.4	0.5

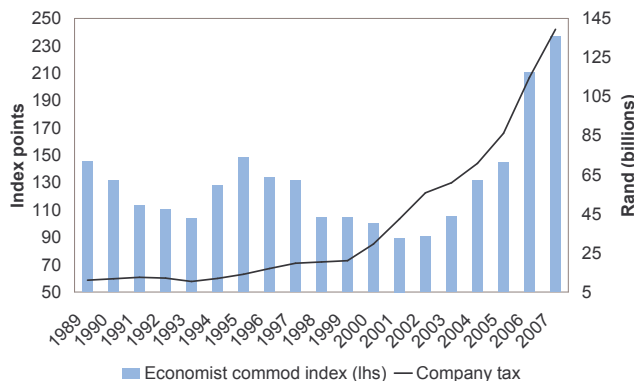
Source: Budget Review, 2008

The revised estimate for 2007/8 now sees a budget surplus of 0.8% of GDP against the 0.5% forecasted in the October 2007 MTBPS. The higher surplus is courtesy of an almost R15bn tax revenue overrun versus the projections in the 2007/8 budget, in large part due to higher inflation. With GDP growth expected to be around the 4% mark for the MTEF¹ period, the Treasury sees revenue remaining fairly robust. This is despite slower consumer demand in 2008. For 2008 at least, a part of the reasoning may be indications that precious metal prices could remain at (or close to) record highs for longer than previously thought. Graph 1 highlights the close correlation between the commodity price cycle and company tax revenues in SA. Furthermore, the Treasury seems confident that SARS will continue to be successful in widening the personal income tax net.

Expenditure proposals - Eskom to receive a capital injection

The 2008 budget adds R115.6bn to the spending plans set out in the 2007/8 budget. Over the next three years, public spending is projected to grow at a real rate of 6.1% per annum, down from the 10.4% recorded in 2007/8. The more "modest" rate of spending increase is proposed to take some of the demand pressures out of the economy. It could also be seen as an effort to provide financing leeway for the huge public corporation investment over the next number of years.

Graph 1: Commodity prices versus SA company tax receipts



Source: Budget Review, 2008

Table 3: Consolidated government spending

R billion	2008/9est	(2008/9 to 2010/11)*
Education	121.1	11.5%
Health	75.5	10.6%
Social security & welfare	105.3	10.8%
Housing & other social serv	52.6	14.4%
Police, prisons & courts	64.9	11.1%
Defence & intelligence	30.4	6.5%
Economic services	165.2	9.3%
General admin	40.3	10.4%
Interest on state debt	55.0	-0.1%
Total	716.2	10.6%

*Growth

Source: Budget Review, 2008

¹ Medium Term Expenditure Framework (the next three fiscal years)

Over the MTEF period, state-owned enterprises (dominated by Eskom and Transnet) are expected to borrow R133bn from the domestic debt market to finance R271bn in capital expenditure. Speaking of Eskom, a welcome announcement was that the Treasury will offer up to R60bn in financial support over the next five years to help the utility meet its (upwardly revised) capital expenditure programme of R343bn. While the final details must still be decided on, over the next three years R20bn is set to be funded from the Treasury's contingency reserve, which allocates funds for unexpected spending needs, and would therefore not result in new government debt. The exact financing details are, however, still sketchy. In light of Eskom's deteriorating balance sheet, it is correct for government (as the sole shareholder) to contribute to recapitalise the company in order to alleviate the severe electricity supply constraint facing the country. The massive public sector infrastructure is set to push the public sector borrowing requirement (PSBR) up to 1.4% of GDP in 2010/11 from -0.7% during 2005/6 (Figure 2). In all, revised projections show that government, the municipalities and the parastatals will together spend R568bn on infrastructure investment over the MTEF period.

As has become the norm, substantial resources were again allocated to assisting the poor. Additional social assistance costs amount to R12bn over the MTEF. The disability and old age grants will be increased by R70 per month (8%) to R940 in April 2008. The qualifying age for men for the old age pension will be reduced from 65 to 63 in 2008, to 61 next year and 60 in 2010. The child support grant will increase by R10 in both April and October 2008 to R220 per month. Furthermore, the grant will be extended to include children up to age 15 (currently the cut-off age is 14) from January 2009. Cosatu has recently pleaded that the grant should be extended to children up to the age of 18.

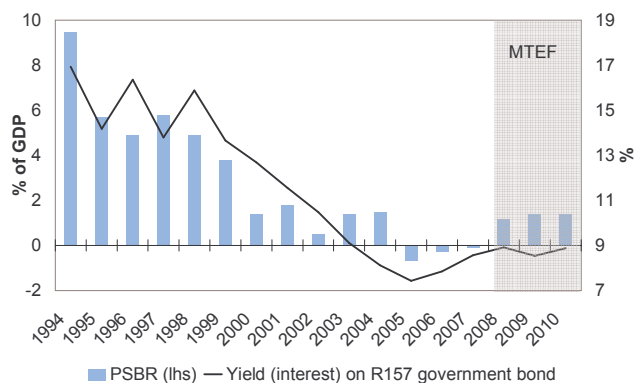
Tax proposals - a much needed shift in emphasis

The 2008/09 budget proposed net tax relief (this number includes the impact of higher indirect taxes) of R10.5bn, somewhat less than the R12.4bn in 2007/8. Of more importance is that companies received a larger share of the cuts this time around. Combined, the tax relief for individuals and companies amount to R15.1bn (R14.6bn in 2007/8). Of that amount, R7.4bn (or almost half) goes to companies. In 2007/08 only R2.78bn (19%) of the R14.6bn went to companies.

The bulk (R5bn) of the relief for companies comes from a reduction in the company tax rate to 28% from 29%. In light of the hardships (slower consumer demand growth, electricity woes etc) domestic companies will have to cope with in 2008, this move is welcomed. Other tax proposals include:

- Confirmation that the secondary tax on companies (STC) will be converted to a tax on shareholders at a rate of 10%. The change will be implemented in 2009 with pension funds being exempted from the tax.
- A number of tax measures were proposed to ease the administrative burden on small businesses. A turnover tax was introduced as an alternative to income tax and VAT for businesses with a turnover less than R1 million per year. The threshold for businesses and farmers who regularly have to submit VAT returns was raised from R1.2 to R1.5 million, while the VAT registration threshold will be increased from an annual turnover of R300,000 to R1 million.

Graph 2: PSBR set to rise, but remain under control



Source: Budget Review, 2008; Reuters

- R5bn in tax incentives over the next three years for labour-intensive industries and industrial policy.
- R7.7bn in personal income tax relief (R7.2bn direct tax relief, rest results from an increase in the monthly cap for tax-free medical scheme contributions). The relief fully compensates for the impact of higher inflation (so-called fiscal drag). The tax relief was again tilted mainly in favour of the lower income earners with a third of the relief going to taxpayers with an annual taxable income of less than R150,000.
- Electricity levy: 2c/kWh tax on the sale of electricity generated from non-renewable sources (90% of SA's power generation comes from coal), to be collected at the source by the producer/generators of electricity. The aim of the levy is to help manage the power supply shortage and it is also seen as being environmentally friendly. The levy is on top of the 14.2% electricity tariff increase for 2008.
- With effect from April 2, the fuel levy on petrol and diesel will rise by 6c/l, representing a 5% increase for petrol and 5.7% in the case of diesel. The Road Accident Fund (RAF) levy on petrol and diesel will also be increased by 5c/l. *From an inflation point of view this is not good news - the oil price is trading back at levels close to \$100/bbl and with a weaker rand, SA is already set to be hit by even higher fuel costs. Under current conditions, we would have liked to see a smaller rise in the petrol levy.*

In our view, both the tax and expenditure proposals strike a better balance between higher social expenditure and (supply side) initiatives to stimulate long-term economic growth. This is another welcome shift in focus as there are already more than 12 million South Africans that receive some sort of government support. This situation may become unsustainable and going forward the focus should rather be on stimulating growth and then hopefully employment.

More budget highlights

A long time in coming, the budget proposed that exchange controls on institutional investors (insurers, pension funds, collective investment schemes and investment managers) be replaced with a system of prudential regulations. The implication is the removal of the pre-application process for foreign investment, which is replaced with a system of quarterly reporting and monitoring of foreign exposures by the SARB. Furthermore, the foreign exposure limit for pension funds and the underwritten policies for long-term insurers were increased from 15% to 20% of total retail assets. The limit rises to 30% in the case of collective investment schemes, investment managers and the investment-linked business of long-term insurers. Further exchange control relief includes:

- Local banks will be able to undertake foreign transactions and investment within a prudential limit equal to 40% of a bank's liabilities.
- While the R2 million per annum limit for individuals to invest offshore remains in place, individuals will now also (on top of the R2 million) be given a R500,000 per year discretionary allowance for purposes of travel, gifts, donations and maintenance.
- Small businesses are also set to benefit from exchange control relaxation - the current application process for exchange control approval before undertaking FDI will be removed for company transactions less than R50 million per annum.

Macroeconomic implications

Although the Treasury is likely to (again) be criticized from the left for running a budget surplus despite the still alarming high poverty levels in SA, it was of critical importance that Minister Manuel reassures the financial markets and foreign investors (who dumped local stocks and bonds worth R33bn from November 2007 to end January 2008) that the sound fiscal policy of recent years will remain in place.

Following the negativity surrounding the power crisis as well as the adverse impact of slower domestic and external demand, the budget may provide a welcome boost to local business confidence. Perhaps the most gratifying aspect of the budget is the more concrete support given to the production side of the economy. As highlighted in the budget speech, while the infrastructure spending drive should provide a key support to GDP growth as consumer demand slows, it will result in a substantial import bill. In order to alleviate the demand for imported goods other than infrastructure inputs, a greater balance has to be found between domestic demand and supply.

This line of thinking may also provide an explanation why personal income tax relief was limited to only account for inflation, while we saw fairly generous increases on social expenditure i.e. for those consumers who do not pay taxes. The poorer part of the population mainly consumes non-durable goods, which do not have a large import component.

The 2008/9 budget proposals will hopefully be the start of an intensified effort to increase the attractiveness for business to operate in SA. The shift to business rather than consumer demand stimulus is also important from an inflation and interest rate point of view as it indicates that fiscal and monetary policy are more in sync. If the consumer was given substantial personal income tax relief, the SARB could have been forced to raise interest rates again to ensure that consumer demand does not add to an already worrisome inflation picture.

The rand weakened to R7.92 against the US dollar following the budget speech - the currency's weakest level since October 2006. While this may have been a knee-jerk reaction to fears that the exchange control relaxation may result in more money leaving the country, it should also be seen in response to a stronger US dollar on the day. While the question could be asked why the Treasury chose to announce long-awaited (and significant) exchange control easing at a time when the rand was already weakening², the timing may be the Treasury's way to show confidence in the local economy amid gathering storm clouds. If, over the longer term, the current and future easing of controls results in the rand stabilising at a more competitive level, it may also contribute to more balanced economic growth.

The exchange control measures announced in the budget could potentially result in substantial capital flowing out of the country at a time when SA needs every penny to finance the current account deficit. However, at this stage we are cautious not to take an overly negative view on the rand. For one, the US subprime mortgage market debacle indicates that it may be even riskier for pension funds etc. to invest offshore than keeping their clients' money in SA. Nevertheless, the rand has been weaker so far in 2008 than anticipated and combined with the budget announcements on exchange control, we have revised the currency forecast slightly downward. *The rand is now forecasted to weaken to an average of R8/\$ in 2008Q4 (R7.80/\$ previously expected) and R8.40/\$ during 2009Q4. This also results in a somewhat weaker rand/€ rate (R12,21) during the final quarter of 2008.*

It is too early to speculate on the likely impact of the electricity levy, but it may add to price pressures in the economy. On a lighter note this is one tax that (as Manuel mentioned in the budget speech) the Treasury will be pleased with if consumers/business can avoid having to pay it. Such a scenario could be an indication that SA is using electricity more productively.

In all, while the budget proposals will not prevent the economy from slowing down (in all likelihood significantly) during 2008, it may help to take away the sting of the negativity surrounding the economy of late. The budget can be termed as both pro-poor and pro-growth.

BER growth forecast

As explained in our latest forecast document (Economic Prospects, 1st Quarter 2008) we decided to work with two scenarios for GDP growth in 2008. It was also emphasised that the forecast would be updated as new information became available. The baseline scenario took the view that the electricity problems (especially the hit to the mining sector) would be contained to the first quarter of 2008 with a recovery expected in the second through fourth quarters. In this scenario GDP growth was expected

² There was certainly significant room to aggressively relax exchange controls when the rand was trading at levels closer to R6.00/\$ not that long ago (beginning of 2006).

to be poor during 2008Q1 (estimated at 2.3%), but to only moderate to 3.9% during calendar 2008 from an estimated 5% in 2007.

The alternative scenario took a more negative view that the power woes would be more sustained with the mining sector in particular unlikely to recover from the Q1 weakness. As this scenario assumed more sustained electricity problems, growth in the other major sectors of the economy was also expected to be weaker. Subsequent developments indicating that heavy industry will have to operate with only 90% of their normal power needs for the foreseeable future mean that the baseline 3.9% growth now seems unrealistic. *The result is that the BER's baseline GDP growth for 2008 is now 3.4%. Given the reality of power rationing and the accompanying adverse impact on growth, we also adjusted GDP growth in 2009 down to 4.3% from 4.8%.*

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