30 October 2019

Medium Term Budget Policy Statement Review.

Tough decisions lie ahead

Introduction

Earlier today Finance Minister Tito Mboweni delivered South Africa's 23rd Medium Term Budget Policy Statement (MTBPS) of the democratic era. In sum, the statement highlighted that chronically poor economic growth is putting excessive pressure on tax revenue collection, while expenditure demands continue to mount as the government continues to offer assistance to ailing state-owned entities (particularly Eskom). Eskom remains the biggest risk to the economy and the fiscus. The combination of these factors has put the government between a rock and a hard place, as sovereign debt continues to rise at increasingly unsustainable levels.

Expenditure

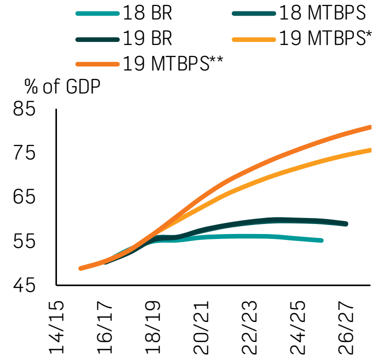
In-year expenditure adjustments showed that main budget non-interest spending increased by a net R23 billion in 2020/21 (to 28.4% of GDP) while it decreased by R8.2 billion in 2021/22 (to 27.4% of GDP). In the outer years of the Medium Term Expenditure Framework (MTEF) period, however, expenditure is expected to increase in line with inflation, which we anticipate will remain within the 3% to 6% band.

The increase in non-interest spending was attributed to Eskom as the Special Appropriation Bill allocated R26 billion to the utility. In addition, there were reversals of the estimated savings from compensation measures (these were expected to generate savings of R12 billion per year in 2020/21 and 2021/22) and the reorganisation of government, which were announced in the 2019 Budget Review. Mitigating these increases were expenditure reductions in goods and services and transfers (R21 billion in 2020/21 and R28.5 billion in 2021/22) as well as wage growth, which was reduced in line with lower CPI projections.

It was no surprise that the dominant theme for expenditure was the precipitous rise in spending on state-owned entities, particularly for Eskom. The restructuring of the utility into three distinct entities – generation, transmission and distribution – is intended to improve its overall operational viability and efficiency which, so far, have had an adverse effect on its debt profile. Thus far, experts have been appointed to ensure cash flow management efficiency, while there are deferrals in some capital expenditure initiatives.

Over the MTEF the government has made provisional support of R49 billion (2019/20), R56 billion (2020/21) and R33 billion (2021/22) towards Eskom. The minister explicitly mentioned that going forward, any additional financial

Figure 1: Gross debt

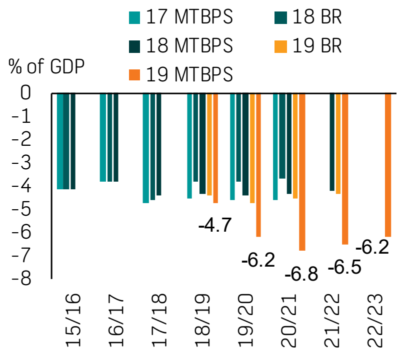


Source: National Treasury

** Without financial support for Eskom.*

*** With financial support for Eskom.*

Figure 2: Main budget balance



Source: National Treasury

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assistance to Eskom will no longer be in the form of equity cash injections, but rather in the form of loans. In addition, the government will only offer further assistance if there is evidence of cost reduction and satisfactory progress in the unbundling process.

Other SOEs

Over and above this, additional funds were also allocated to South African Airways (R5.5 billion), the South African Broadcasting Corporation (R3.2 billion), Denel (R1.8 billion) and South African Express (R300 million) for the current financial year.

Debt-service costs

The government's debt-service cost is expected to surpass the 2019 Budget Review estimates by R1.5 billion in 2019/20, R8.7 billion in 2020/21 and R17.2 billion in 2021/22. In line with the expected rise in gross debt, government debt-service costs are predicted to consume 18.4% of the main budget revenue by 2022/23, from 15% in 2019/20. This is a disconcerting trend as interest payments have begun divesting spending relative to other areas of priority. This also rings true for the public sector wage bill, which accounts for an estimated 46% of tax revenue this financial year.

Revenue

On the revenue front poor economic growth, inefficiencies and structural weaknesses at SARS have adversely affected collection rates. Indeed, there was severe under-collection among almost all the major tax categories. During the 2018/19 fiscal year tax revenue collected undershot the 2018 budget estimate by R57.3 billion. Accordingly, this marks the worst under-collection since 2009/10.

Over the medium term, the government has revised down its revenue collection expectations on the back of a poor employment outlook, weak corporate profits, as well as subdued household consumption. Table 1 shows the deep cuts in government's expected revenue collections over the medium term. Over and above expectations for weak economic growth, there remains downside risk to revenue collection. The MTBPS notes that there is a risk that the sale of non-core assets valued at R7 billion will not be completed by the end of the 2019/20 fiscal year.

Table 1: Revised revenue projections

R billion	2019/20	2020/21	2021/22	2022/23
2019 Budget	1 422.2	1 544.9	1 670.4	
Buoyancy	1.31	1.17	1.08	
Revised estimates	1 369.7	1 460.9	1 555.7	1 658.2
Buoyancy	1.08	1.09	0.99	1.00
Change since 2019 Budget	-52.5	-84.0	-114.7	

Source: National Treasury

Main Budget framework and conclusion

Over the MTEF period the main budget expenditure is projected to average 32.4% of GDP with the revenue average estimated at 25.9%. This brings the main budget balance to a significantly weaker deficit of 6.4% to GDP (see Table 2), compared to the 2019 budget estimate of a 4.7% deficit for 2019/20. The fiscal deficit is forecast to peak in 2020/21 at 6.8% of GDP before narrowing to 6.2% in 2022/23.

This deterioration in the fiscus led to adjustments in the government's borrowing strategy. National government's gross borrowing requirements were lifted in line with the higher budget deficit and maturing debt. In fact, gross loan debt is expected to increase from R3.2 trillion (60.8% of GDP) in 2019/20 to R4.5 trillion (71.3%) in 2022/23 (see Figure 1). Although the increased borrowing is mainly geared towards financing the budget deficit, other key drivers of this increase include fluctuations in borrowing costs, inflation and exchange rates.

In all, the severe deterioration in the fiscal deficit is credit negative and may well embolden Moody's to place SA's sovereign rating on a negative outlook. Moreover, we are of the view that the likelihood of a downgrade to sub-investment grade over the coming months has risen substantially.

Discouragingly, downside risks to the fiscal outlook remain stubbornly entrenched if 1) economic growth continues to deteriorate, 2) the government fails to contain the fiscal deficit, and 3) Eskom's financial and operational metrics worsen much further than currently anticipated.

Table 2: Main budget framework

R billion/percentage of GDP	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Outcome			Revised	Medium-term estimates		
Main budget revenue	1 137.9	1 196.4	1 274.7	1 359.1	1 425.9	1 525.6	1 627.9
	25.7%	25.5%	25.9%	26.1%	25.8%	25.9%	25.9%
Main budget expenditure	1 305.5	1 405.0	1 506.7	1 683.4	1 801.2	1 909.5	2 017.7
	29.5%	29.9%	30.6%	32.3%	32.6%	32.4%	32.1%
Non-interest expenditure	1 159.0	1 242.3	1 324.9	1 479.6	1 568.5	1 644.9	1 718.6
	26.2%	26.4%	26.9%	28.4%	28.4%	27.9%	27.4%
Debt-service costs	146.5	162.6	181.8	203.7	232.8	264.6	299.1
	3.3%	3.5%	3.7%	3.9%	4.2%	4.5%	4.8%
Main budget balance	-167.6	-208.6	-232.0	-324.3	-375.3	-383.9	-389.8
	-3.8%	-4.4%	-4.7%	-6.2%	-6.8%	-6.5%	-6.2%
Primary balance	-21.1	-46.0	-50.1	-120.5	-142.5	-119.3	-90.7
	-0.5%	-1.0%	-1.0%	-2.3%	-2.6%	-2.0%	-1.4%

Source: National Treasury

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