Budget 2018: An overview

23 February 2018

A strong signal of intent

This year's Budget speech was a widely anticipated event given the dramatic political changes of the past few weeks and the risk of a credit downgrade by Moody's. While South Africa's fiscal position remains fragile, Budget 2018 bought National Treasury (NT) the time to hopefully deliver on what is needed for a return to fiscal sustainability in the long term. It will take time, and will require a consistent effort to diligently implement conservative policy allocations going forward.

This is just the start - but it is a good start, under the circumstances.

How did we get here?

For the past decade there has been a steady deterioration in all the ingredients needed to sustain healthy fiscal policy: growth has been weak, and tax revenue has fallen; policies became fragmented; institutions weakened; business and consumer confidence fell; and efficiencies were undermined. Government kept spending more on less effective and productive outcomes. Economic policy became weak and confusing, with a proliferation of departments and ministries and of alliance partner objectives under ineffective leadership.

Debt ballooned from 26% of GDP in 2009 to 53.2% by 2016/17. In October last year, the Medium-term Budget Policy Statement (MTPBS) indicated that debt would continue to rise to more than 60% of GDP by 2021/22, with no signs of moderating.

At the time, government clearly signalled that the remedial action needed to arrest this process required unpopular political decisions in the form of heavy, broad-based tax increases (such as VAT), managing labour-related expenditure and prioritising governance at State Owned Companies (SOCs). After the shocking revelation of how fragile the actual fiscal position had become, and how quickly it had deteriorated, the Budget 2018/19 needed at a minimum to achieve two things:

1. Implement a heavy-hitting, durable tax solution to the revenue shortfall, not only to plug the hole, but to send a very strong message of political will and commitment; and
2. Create a conservative roadmap over the medium-term, which could put the country on a more sustainable path than that illustrated in the MTBPS.

The Budget achieved most of this.

What does the Budget deliver?

Government will raise R36 billion in tax revenue this year (up from R28 billion last year). The most important change was raising VAT by 1% to 15%, effective from 1 April 2018. This increase is estimated to raise R22.9 billion in revenue. Other measures introduced to raise additional revenue include:

- No adjustments to the top four income tax brackets (which results in more taxable income as earnings tend to increase with inflation). This is estimated to raise an additional R7.5 billion. In addition, to help offset some of the VAT increase, below-inflation adjustments were made to the bottom three brackets.
- An increase of 52c/litre for fuel
- An increase in ad valorem excise duties for luxury goods from 7% to 9%
- Increased estate duty, to be levied at 25% for estates above R30 million
- Increases in alcohol and tobacco excise duties of between 6% and 10%

The expenditure adjustments are perhaps the most disappointing, despite committing to a reduction of R85 billion over the medium-term. It is important to remember that for the fiscus to return to a sustainable path, the excessive growth in expenditure of the post-crisis period needs to consolidate, and most of this is concentrated in the public sector wage bill.

The majority of the cuts contained in the Budget are to infrastructure – which may cause other problems down the line. The balance is really redirected into spending on free tertiary education (estimated at R57 billion over the next three years, starting with R12.4 billion in the 2018/19 fiscal year). There was no change to the allocation for civil servant compensation at an average growth of 7.3% per annum. This is disappointing, but we understand that it is a very sensitive issue especially in the run-up to an election.

In addition to the large reallocation to education, government has earmarked an amount of R6 billion for national drought relief, and R26 billion over the medium-term expenditure framework (MTEF) to rebuild fiscal buffers in the contingency reserve. Social security increases will also be above inflation – on average 7.9% per annum over the MTEF – to provide an offset to the VAT hike.

Longer-term, the fiscal adjustment needs to be extended and entrenched. Conservative allocations need to be made, and irregular expenditures accounted for. A meaningful change in the composition of expenditure, away from compensation to capex and capacity building in a responsible manner, also needs to be agreed and implemented without much delay.
As a result of these amendments, the budget deficit has been revised smaller, albeit marginally. Current official projections are for the consolidated fiscal deficit to narrow from -4.3% of GDP in 2017/18 to -3.5% (-3.9%) by 2020/21.

MACROECONOMIC PERFORMANCE AND PROJECTIONS

	2014	2015	2016	2017	2018	2019	2020
Percentage change		**Actual**		**Estimate**		**Forecast**	
Real GDP growth	**1.7**	**1.3**	**0.3**	**1.0**	**1.5**	**1.8**	**2.1**
CPI inflation	6.1	4.6	6.3	5.3	5.3	5.4	5.5
Current account balance (% of GDP)	(5.3)	(4.4)	(3.3)	(2.2)	(2.3)	(2.7)	(3.2)

Sources: National Treasury and Reserve Bank

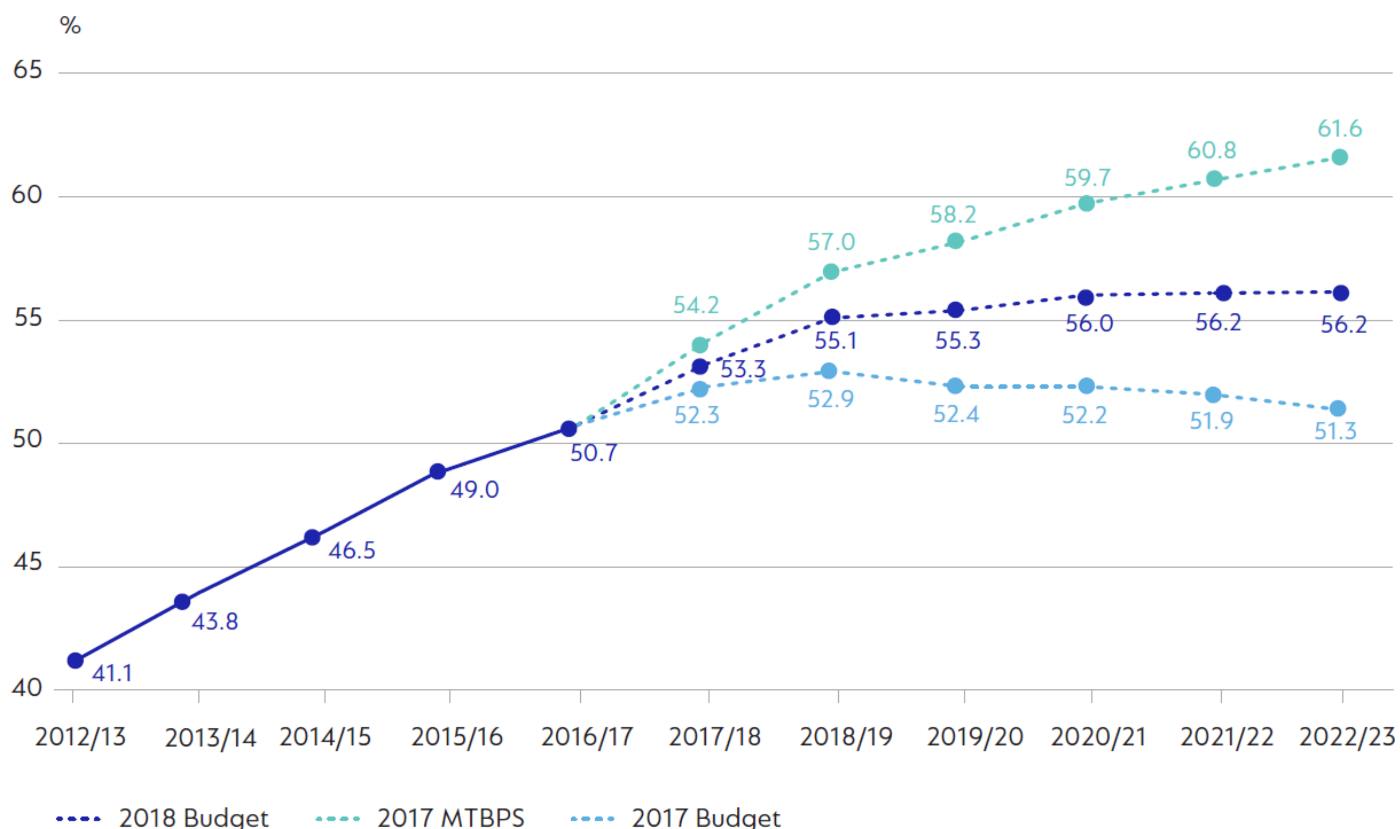
NT has also revised up its growth forecasts (see table). GDP is now expected to accelerate to 1.5% in 2018 (from 1% in 2017) and reach 2.1% by 2020. The drivers of this acceleration are rising private consumption, but more notably the expectation that capital investment should pick up quite quickly this year. Given the very depressed levels of consumer and business confidence, which have prevailed since 2012, it seems plausible that the political transition should lift confidence and induce some increase in spending. Households are more likely to change spending habits faster (even if inhibited by an increased tax burden) than companies which need time to plan further ahead, but even a small increase in inventories or replacement capex would boost growth.

In something of a break with tradition – but perhaps as a nod to both the dire need to address growth as well as fiscal sustainability, NT published a priorities list aimed at promoting growth and stability and restoring confidence. Encouragingly, there is a clear acknowledgement that policy uncertainty has undermined investment and confidence, especially in mining. It also included stated commitment to dealing with corruption, improving institutional efficiencies and reducing the risk posed by state-owned entities on Government's balance sheet. Other highlights looked at increasing the availability of broadband spectrum and lowering barriers to entry to encourage investment.

These combined revisions have had a meaningful and positive impact on the debt trajectory, which had

deteriorated so meaningfully in the MTBPS. Government now sees gross debt to GDP peaking at 56.2% by 2021/22 and then moderating slowly. Despite the improvement, this is still above the projection made in Budget 2017.

GROSS DEBT-TO-GDP OUTLOOK



Source: National Treasury

Is it enough?

If a good budget is one that leaves no one very happy and no one too miserable, then this is a good Budget. Certainly, it is more than just the numbers; it should be read as a strong signal of intent and aspiration after a long period of fiscal deterioration, economic weakness, institutional constraint and political malaise. If we assess South Africa against the harsh requirements of an investment grade rating, as Moody's is currently doing, perhaps not. But if we look at the intent in this budget together with the changes that have taken place since December - the material change in sentiment after the political transition, signalled policy changes, and the direct interventions into SOEs such as Eskom - then perhaps, for now, it is enough.

Kind regards,

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