

# Nedbank

## Economic commentary

10 February 2010

### BUDGET PREVIEW

*Finance Minister Pravin Gordhan tables his first national budget on Wednesday 17 February 2010. The circumstances could hardly be tougher, with government finances under significant pressure following the rapid deterioration in the global and local economic climate in 2008 and in 2009. Along with his peers in many other countries, the Minister is faced with tough choices in a much more constrained environment than that prevailing for much of the past decade. The Minister has already set out the broad fiscal framework for the next three years in the October 2009 Medium Term Budget Policy Statement (MTBPS), but next week's announcement will provide the detail of how revenue and expenditure targets will be achieved and where government's emphasis will lie. In a world where many governments have taken the wrong lessons from the crisis, it will be an important statement on the general direction of policy.*

### Outcome of the 2009/10 fiscal year

**Table 1: Expected outcome for the 2009/10 fiscal year**

	2009/2010							
	Budget		Revised MTBPS		Outcome based on 1st 9m		Outcome expected	
	Rbn	yoy%	Rbn	yoy%	Rbn	yoy%	Rbn	yoy%
Revenue	643.0	5.2	570.9	-6.2	563.9	-7.3	567.0	-6.8
% gdp	26.0		23.7		23.2		23.2	
Expenditure	738.6	16.5	752.5	18.3	761.6	19.7	758.2	19.2
% gdp	29.9		31.3		31.4		31.0	
Balance	-95.6		-181.6		-197.7		-191.2	
% gdp	-3.9		-7.6		-8.1		-7.8	
Gdp	2474.2	7.4	2405.1	3.6	2427.8	4.6	2442.7	5.3

Table 1 presents the key variables for the fiscal year ending March 2010. 'Budget' refers to government's projections at the time of the last budget in February 2009; 'Revised MTBPS' to the revised estimates presented in the MTBPS in October 2009; 'Outcome based on first 9 months' applies the relevant percentage changes already experienced for revenue and expenditure in the year to December 2009 and 'outcome expected' is our estimate for what might be tabled next week.

The figures show how dramatic the deterioration in government finances has been. The final outcome for **revenue** will probably show a contraction of just under 7%, a massive R76 billion short of the original budget estimate and almost R4 billion less than the revised MTBPS estimate. The big shortfall is mainly due to a sharp drop in VAT and company income tax receipts as the global recession of late 2008 and 2009 hit the local economy much harder than most expected, placing considerable pressure on company earnings

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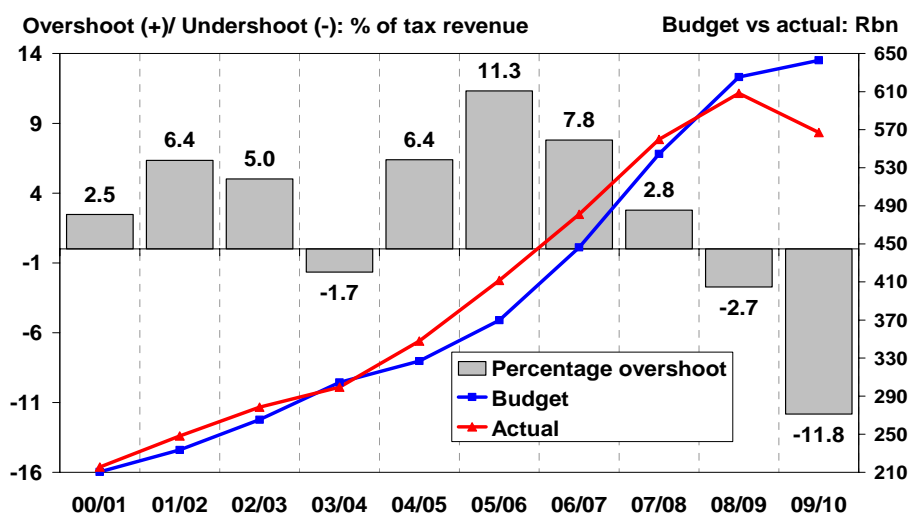
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and resulting in significant job losses, which undermined confidence and spending throughout the economy.

While tough economic times automatically bring higher dependency on the state and the government wanted to increase spending to ease some of the discomfort and offset the impact of weaker private sector activity, the growth in **expenditure** has been alarmingly rapid. In the first nine months of this fiscal year, expenditure grew by a massive 19,7% compared with the same period a year ago, which is substantially faster than the 16,5% budget target and even the aggressively upwardly-revised MTBPS estimate of 18,3%. According to National Treasury, the faster than expected growth in spending was mainly due to higher public sector employment, sharply higher salary increases in education and healthcare, as well as increased transfers from government to households through welfare payments. The final outcome for expenditure is therefore expected to overshoot the budget estimate by about R20 billion and the MTBPS estimate by around R6 billion, probably amounting to around R758 billion, an increase of close to 19%.

**Graph 1: Budgeted revenue versus outcome**



Our revenue and expenditure estimates point to a **deficit** of around R191,2 billion or 7,8% of gdp, roughly double the originally-budgeted deficit of R95,6 billion or 3,9% of gdp and about R10 billion more than the MTBPS estimate of R181,6 billion or 7,6% of gdp.

**Expectations for the 2010/11 National Budget**

The need to reduce the sizeable deficit in a still-fragile economic environment with off a limited tax base severely restricts the government’s choices in the year ahead. The revenue estimates will depend on the Treasury’s forecast for economic growth in 2010/11. In the MTBPS, the Treasury worked on a very modest recovery in gdp growth to 1,5% in 2010 followed by an equally tame 2,7% in 2011. We expect a slightly better growth outcome, with gdp forecasts of 2,4% in 2010 and 3,2% in 2011. Treasury is likely to edge its growth forecast up a notch or two to around 2% as the world recovery has generally been stronger than most anticipated, supporting some improvement in local exports and helping the economy emerge from recession in the third quarter of last year.

Our estimates of possible budget outcomes for 2010/11 are presented in Table 2 and all these estimates are based on the assumption of around 2% real gdp growth in calendar 2010. Revenue is therefore expected to improve, helped mainly by a bounce in company income tax receipts, which are likely to be boosted by the benefits of aggressive cost cutting in 2009 and improving margins in line with the recovery in commodity prices. VAT receipts will also do better, with household spending likely to be stronger than Treasury anticipated in October given the stabilisation of the labour market, and as debt levels return to more manageable levels, asset prices improve off a low base and interest rates remain relatively low. Added to this, the 2010 FIFA World Cup will also provide a significant boost to VAT and other indirect taxes.

The first column of Table 2 shows government's revised forecast for 2010/11 set out in the MTBPS in October last year and the percentage changes are calculated using the figures for 2008/09 given in the MTBPS. This column shows that in October last year the government was already starting to adjust for a modest recovery in revenue while curbing spending to more sustainable levels, which produced a budget deficit of 6,4% of gdp. The second column reflects a possible '**populist**' scenario within the broader framework of deficit reduction. Here the government opts to raise taxes to push up revenue growth, while allowing for more aggressive spending growth of around 10%, pushing the budget deficit to 6,6% of gdp. However, raising taxes in the current environment would probably be counterproductive, because it will choke off the economic recovery, which is still very fragile and has not yet gained any convincing momentum. The arithmetic also shows how limited the scope is to increase spending given its already high base and size relative to revenue. This means that taxes would have to be raised disproportionately to fund very limited spending increases. Despite these problems this outcome is still a possibility given the intense political pressure to expand and improve service delivery, which may convince government to raise taxes on perceived easy targets rather than cut spending more aggressively.

The third column shows our **expected scenario**, where tax rates are left unchanged and revenue growth accrues mainly from the turn in the economic cycle, while spending is curbed, where possible, and some efficiencies are achieved, producing a deficit of around 6,5% of gdp, only slightly worse than the estimate set out in the MTBPS. In this scenario, there may be very limited scope for relief to offset the effects of fiscal drag, but of course for no real changes to the tax regime. The fourth and final column illustrates the implications if fiscal sustainability was the primary priority. In this scenario, the deficit target is set at the MTBPS's target of 6,4% of gdp and projections of revenue growth are adjusted to more realistic levels of around 13,5%, which implies that growth in government spending would have to slow to only 7,5%, which would not only require substantial discipline in wages and other consumption expenditure, but would probably also require effective spending cuts and significant efficiency gains.

**Table 2: Possible scenarios for the 2010/11 fiscal year**

	2010/2011							
	MTBPS proposals		Scenario 1: 'Populist'		Scenario 2: Expected		Scenario 3: 'Sustainable'	
	Rbn	yoy%	Rbn	yoy%	Rbn	yoy%	Rbn	yoy%
Revenue	646.1	13.2	657.7	16.0	646.4	14.0	643.5	13.5
% gdp	24.7		24.6		24.2		24.1	
Expenditure	813.7	8.1	834.0	10.0	821.1	8.3	815.1	7.5
% gdp	31.1		31.2		30.7		30.5	
Balance	-167.6		-176.3		-174.8		-171.5	
% gdp	-6.4		-6.6		-6.5		-6.4	
Gdp	2620.1	8.9	2672.6	9.4	2672.6	9.4	2672.6	9.4

### Revenue

There will probably be very little tax relief in this year's budget. Government is not expected to hike taxes in this fiscal year as such a move could derail the economic recovery. However, the risk of higher tax rates over the next two years will increase as government struggles to bring the deficit under control because of a relatively subdued recovery, limited scope for further substantial gains in tax administration, and strong expenditure demands.

Some of the possible measures expected in this year's budget are outlined below:

- Personal income tax relief will be limited, with individuals being at least partially compensated for bracket creep or the effects of inflation. Inflation moderated over the past year and this implies that tax relief for individual taxpayers is likely to be well below the R13,6 billion granted last year. However, low and middle-income taxpayers are likely to get more relief than the high-income earners.
- The tax threshold is likely to be lifted from the current R54 200, but the top marginal tax rate should remain unchanged at 40%.

- The exemptions on domestic interest and dividend payments have been raised marginally every year to compensate for the effects of inflation and we expect this to continue. The exemptions currently stand at R21 000 for taxpayers under 65 and R30 000 for those over 65.
- No reduction in the company tax rate, which was dropped by 1% to 28% in the 2008/09 budget. We do not anticipate further relief for companies given that the economy is recovering.
- The VAT rate should remain unchanged at 14%.
- There will be the usual above-inflation increases in excise duties.

## **Expenditure**

In 2009 strong growth in government spending helped to offset some of the harm inflicted by the global recession. Capital spending by general government continued but at a much slower pace, while consumption spending accelerated rapidly mainly on the back of higher public sector employment, large salary increases in education and health care as well as increased transfers to households through social welfare.

In the fiscal year ahead, Treasury wants greater austerity and aims to restrict spending growth at the consolidated level to below or around 8% from growth of close to 19% last year. This will be a very difficult task as the sharp increase in wages over the past few years is a recurrent cost, and reductions in social welfare spending will politically be almost impossible to reverse. Consequently, the planned moderation in total spending will have to be achieved through a combination of effective spending cuts where possible, and substantial efficiency gains across all levels of government. The key risk here is that government finds 'savings' by cutting infrastructure and other capital expenditure, which would ultimately be counterproductive, capping the economy's future ability to grow and to create jobs, thereby effectively limiting the tax base and potentially increasing dependency and therefore the burden on the state.

In the MTBPS, Minister Gordhan opted for 'efficiency gains', stressing repeatedly that government needs to 'do more with less'. The plan is to improve efficiency by:

- Cutting spending on non-core functions and activities and shifting resources from administrative components to frontline services
- Rationalising public entities and agencies
- Reviewing public spending to stop underperforming programmes, low priority activities and ineffective policies
- Reforming procurement systems to reduce corruption and better value for money
- Changing the culture of the public service to reduce waste, prevent extravagant spending, improve work ethics and weed out corruption

Within the framework of considerable resource constraints, the MTBPS identified the following priorities:

- **Employment creation:** Apart from plans to introduce a 'training layoff scheme', expand the public works programme, and establish an 'industrial development and job creation fund', government also aims to shift more resources towards labour-intensive sectors and create jobs directly in the delivery of public services. Exactly how private resources will be shifted to labour-intensive sectors is unclear.
- **Social security:** Over the next three years the child support grant will be extended to poor children up to age of 18 from 15 previously. National Treasury expects the extended age to add around R7 billion every year to the cost of running the child support grant over the next three years.
- **Education:** Government will fund workbooks for grades 1 to 7, which is estimated to start with 3,5 million pupils in 2010 and to end with around 5,5 million by 2012. Government will also expand the school nutrition programme to reach more pupils, improve the general quality of the meals, and shift the funding of the Further Education and Training (FET) colleges to national government.
- **Health care:** The plan is to improve management, increase and retain professionals, accelerate the rollout of ARVs to HIV/Aids patients and promote public-private partnerships in healthcare.
- **Rural development:** The future direction will be determined by the lessons learned from a two-year pilot project launched in Limpopo around August last year. However, government broadly aims to provide more and better support to emerging farmers by offering grants, equipment and training through employing additional 1000 civil servants.
- **Housing:** The housing subsidy will be increased and the current financial incentives for township regeneration will continue.

- **Crime:** An additional 22 447 police personnel will be recruited by 2012/13 while the number of investigators at the new Directorate for Priority Crime Investigation will increase from 350 in 2009/10 to 2 400 in 2012/13.
- **Infrastructure:** In the MTBPS National Treasury indicates that growth in capital expenditure by general government is set to moderate, but that infrastructure expansion by public corporations notably Eskom and Transnet will continue.

### **Financing the deficit**

In last year's MTBPS, the budget deficit for 2009/10 was revised up sharply from February's estimate of 3,9% of gdp to 7,6% of gdp, while the public sector borrowing requirement, which includes Eskom's and Transnet's borrowing to fund their infrastructure expansion, was revised up from the original estimate of R197,8 billion or 8% of gdp to a daunting R284,5 billion or 11,8% of gdp. The funding burden mostly fell on the domestic bond market. Based on our 'best guess' of the budget deficit for 2009/10, the public sector borrowing requirement is likely to be higher than the revised MTBPS estimate. The bulk of the funding will come from the domestic bond market, but National Treasury will also try to increase foreign loans. The local bond market will accommodate the higher issuance, but bond yields will increase to reflect the deterioration in the underlying supply and demand dynamics, the generally weaker fiscal fundamentals, worries about future inflation and growing concerns about sovereign debt in general.

### **Other issues:**

Minister Gordhan relaxed **exchange controls** considerably in October last year. Consequently, no major concessions are expected in this year's budget, but the Minister indicated in October that proposals to modernise the exchange control regulatory framework will be announced.

**Inflation targeting** has been very unpopular with COSATU and other segments of the ANC alliance. The Reserve Bank's focus on inflation in response to surging global oil and food prices during 2007 and much of 2008 also evoked substantial criticism and hardened alliance opinion against this approach to monetary policy. Recently Minister Gordhan stated that he will announce proposals or changes to the monetary policy framework that have been agreed with the central bank, which could consist of changes that broaden the Reserve Bank's mandate to include growth and employment along with inflation in determining the course of interest rates.

In our view any significant changes to the current framework would increase the risk of subpar growth over the medium term. For example, raising the current inflation targets significantly from the current 3% to 6% may give the Reserve Bank scope for cutting interest rates in the very short term, but would quickly lead to higher structural inflation as expectations and behaviour start to adjust. This in turn implies that through-the-cycle interest rates would be higher, hurting indebted consumers over the medium term. Similarly, a move away from inflation targeting altogether would immediately boost inflation expectations and lead to a similar result.

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