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The 2010/2011 National Budget – a good balancing act under difficult circumstances

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Kevin is currently employed as the Chief Economist at STANLIB Asset Management having joined Liberty Asset Management in September 2001. At STANLIB he focuses on Macro Economic research. He also provides input into the Asset Allocation process, Fixed Income, Property and various Equity Franchises.

On 17 February 2010, the Minister of Finance, Pravin Gordhan, managed to present a solid and carefully judged budget, amidst a particularly challenging economic environment.

In terms of the macro-economic environment, the Minister is forecasting GDP growth of 2.3% in 2010, rising to 3.6% by 2012. The improved growth outlook is supported by a R845 billion increase in public infrastructure investment over the next three years.

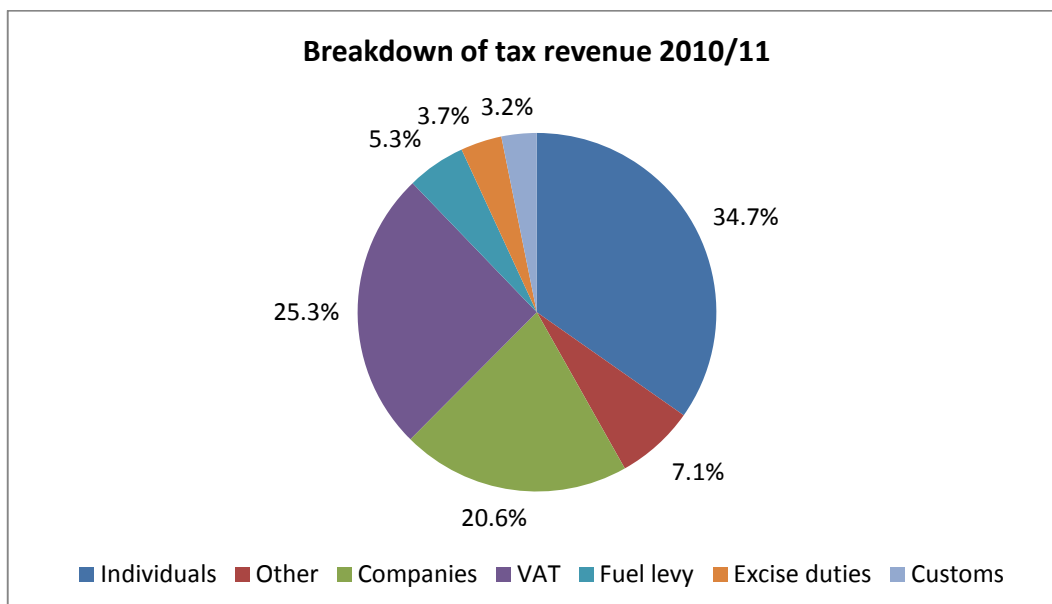
In terms of inflation, the government is forecasting an average of just below 6% for the next three years, while current account deficit is expected to widen modestly to around 5.8% of GDP by 2012.

The improved growth outlook, coupled with a renewed focus on fiscal discipline has allowed the Minister of Finance to table an expected budget deficit equivalent to 6.2% of GDP in 2010/2011, falling to 4.1% of GDP by 2011/12. These projections are in sharp contrast with the 2009/2010 fiscal year, which saw the deficit widen to a concerning 7.3% of GDP from only 1.2% of GDP in 2008/2009.

The fiscal deficit in 2009/2010 equals the worst budget deficit South Africa has recorded since at least 1961.

The main reason for the large increase in the deficit during 2009/10, was that government revenue undershot budget by a massive R69 billion. This is in stark contrast with earlier years when revenue collection consistently exceeded budget. The R69 billion shortfall was mostly due to the effects of the recession, with the majority of the under-collection coming from a combination of lower corporate taxes (-R32.5bn) and lower VAT collection (-R22.5bn).

For the 2010/2011 budget the Minister is expecting tax revenue collection to rise by a relatively modest 9.7% y/y. This is reasonable given the government's upwardly revised GDP forecast of 2.3% in 2010.



Interestingly, total government revenue (which is broader than just tax collection) is budgeted to increase by a more impressive 12.6%/y in fiscal 2010/2011. The difference between the tax revenue estimate and total revenue estimate is the payment made to the Southern African Customs Union (SACU). Given the significant reduction in international trade, the Minister is projecting that the transfer under the SACU revenue sharing agreement will drop sharply from R27.9bn in 2009/2010 to only R15.0bn in 2010/2011; a decrease of R12.9 billion. This reduction will have a hugely negative impact on the National Budget's of Lesotho, Swaziland, Namibia and Botswana (all members of the SACU agreement). Transfer to these countries, in terms of the SACU agreement, represents a very significant portion of their National Budgets.

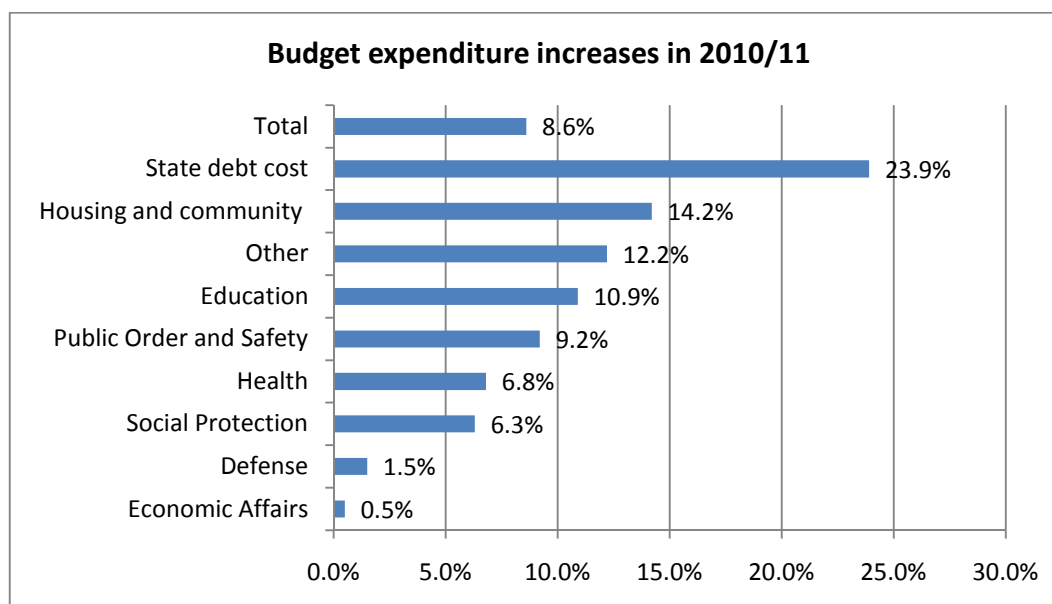
The Minister announced very few tax changes in the 2010/2011 National Budget, which was in-line with expectations. The largest tax change was an adjustment to the thresholds and tax brackets applicable to individual income tax. This is really to alleviate some of the effects of inflation, or what is referred to as 'fiscal drag'. The value of this adjustment is R6.5 billion, which is not enough to fully compensate for effects of inflation or fiscal drag; and well below the R13.0 billion tax relief to individuals that was granted in 2009/2010. The Minister left the top marginal tax rate of 40% unchanged, although the threshold at which this is reached was increased modestly from R525 000 to R552 000 (a rise of only 5.1%). The change in threshold/brackets means that someone earning R100 000 a year will get an annual tax relief of R504 (0.5% of income), while someone earning R1 000 000 will get tax relief of R3 534 a year (0.35% of income).

Other tax changes included an unexpected 25.5c/l increase in the fuel levy; 7.5c/l of this is partly to pay for the new fuel pipeline from Durban to Gauteng and 8c/l for the road accident fund. The increase in the fuel levy is expected to raise an additional R3.6 billion in revenue. The customary increase in excise duties should provide the government with an additional R2.25 billion in revenue during 2010/2011.

While the Minister provided some relief to individuals in order to compensate for the effects of fiscal drag, this was mostly offset by the increase in the fuel levy as well as the excise duties. Overall the tax revenue projections appear achievable and there were no surprises, however, this was not an especially consumer friendly budget, which ultimately reflects the need for the Minister to maintain fiscal discipline.

The rate of growth in government expenditure is set to slow significantly from a spectacular 17.2% annual average over the past four fiscal years to an envisaged annual average of about 8.2% over the next four fiscal years.

Key areas of growth in government spending during 2010/2011 include housing and community development, education and public order and safety. The Minister also announced a potential wage subsidy for younger workers aged 18 to 24. Recent conversations with National Treasury suggests that government is looking at providing a wage subsidy of around R700 a month for two years, which they hope will create an additional 800 000 jobs.



As mentioned above, another key area of public sector spending will be infrastructure development. In terms of the latest projections, government is hoping to increase investment spending by a massive R845 billion over the next three years, with spending on public works programmes amounting to R52 billion.

There was also some focus on the upcoming Soccer World Cup, which is expected to contribute a meaningful 0.5 percentage points to South Africa's economic growth in 2010.

While there was little that South Africa's fiscal authorities could do to avoid a dramatic blow-out in the deficit during 2009/10, the expansion of the deficit has proved to be very expensive. Government debt has risen from a low of 27% of GDP in 2008/09 to 32.5% of GDP in 2009/10 and to 37.1% of GDP in 2010/2011. This is the largest debt level, as a ratio of GDP, that South Africa has had since 2001/2002.

The higher the debt the higher the interest cost associated with that debt. In South Africa's case, the interest cost of state debt is projected to rise to a significant R71.4bn in 2010/2011. That is a massive increase of 23.9%/y/y, making the cost of state debt the fastest rising expenditure item in the budget.

Fortunately, the cost of South Africa's state debt remains very acceptable at well less than 10% of the budget and 2.6% of GDP. As a comparison, Greece, which is at risk of defaulting on its state debt, has a public debt to GDP ratio of around 113% with the interest cost of that debt that amounts to around 5% of GDP.

While South Africa's public sector debt parameters remain very acceptable by world standard, the total debt as well as the cost of servicing that debt is clearly on the rise. If left unchecked, government debt will quickly become a major hindrance to achieving many vital policy objectives. Already the cost of debt exceeds the total budget allocation to police services. Hence the Minister's decision to focus on maintaining fiscal discipline, under difficult circumstances, has to be applauded.

Glacier Research wishes to thank Kevin Lings for his contribution to this week's Funds on Friday.