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Budget 2020/21 and beyond: Our initial thoughts

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We tuned in eagerly as Finance Minister Tito Mboweni delivered his 2020 Budget speech, deliberating on how National Treasury would reach the more than R150 billion additional adjustments required to attain a main budget primary balance surplus over the medium term. Our eagerness quickly turned into surprise and then to apprehension as the Budget's headline figures started filtering into our newsfeeds.

Good news, but is it?

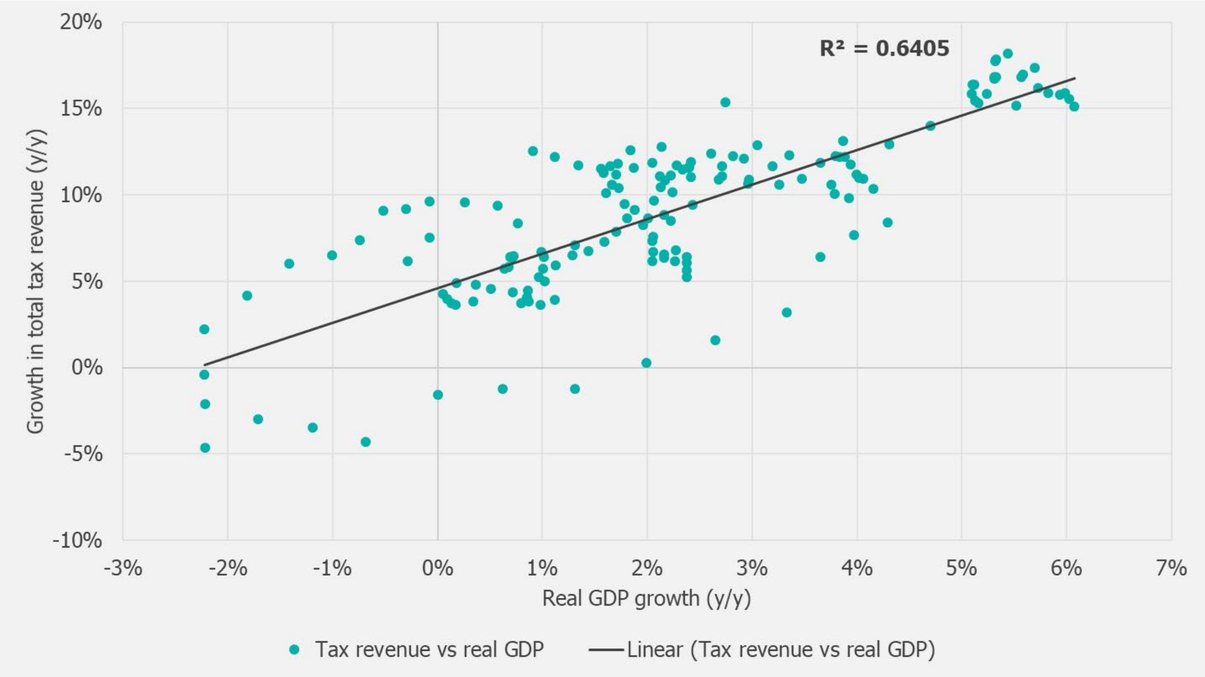
In the end, National Treasury certainly delivered on additional adjustments, choosing a welcomed austere approach which resulted in cuts of R160 billion being tabled to the burgeoned public sector wage bill. However, based on the historical power struggle between trade unions and the government, with unions emerging as the victor more often than not, we found ourselves asking each other: just how credible are these significant cuts?

The 2020 budget saw a deviation from National Treasury's historical policy stance of relying heavily on the tax base for carrying a significant portion of the fiscal brunt. Surprisingly, we saw only minor revenue adjustments over the medium term, suggesting that National Treasury has come to realise that increasing tax on an already stressed tax base is likely to impair revenue further. We see this as a tacit acknowledgement that we are well past the peak of the Laffer curve[1]. The lack of fiscal drag was contrary to our expectations, as National Treasury has in the past relied on this indirect tax stream to help offset further fiscal slippage. With the lack of fiscal drag having provided some tax relief in the form of adjusting personal income tax brackets upwards to account for inflation, it is envisaged that aggregate demand will pick up as a result of increased disposable income – a minor positive for economic growth. One of the less prominent points was the ongoing rebuilding of the South African Revenue Service (SARS) following a brief but noticeable period of institutional decay. The re-establishment of the large business unit along with anecdotal evidence of improved collection is an encouraging development, in our view.

Conversely, gross tax revenue was revised lower by R138 billion over the medium term, in addition to the R251 billion reduction announced in the Medium Term Budget Policy Statement (MTBPS) of 2019. This was more negative than our forecasted shortfall of R81 billion. The lack of additional tax measures (apart from increased fuel levies and excise duties - which collectively will only bring in about R4 billion) along with lower growth and inflation forecasts relative to MTBPS 2019 accounts for the bulk of the lower revenue forecast. With little prospect for improvements in growth and a benign inflation outlook, revenue collections are expected to grow more moderately at an average of 5.8% over the medium term (see Graph 1). Having said that, continued efficiency gains at SARS may spur slightly faster revenue growth.

1. Laffer curve: The Laffer Curve describes the relationship between tax rates and total tax revenue, with an optimal tax rate that maximizes total government tax revenue. https://www.investopedia.com/terms/l/laffercurve.asp

Graph 1: An undeniable strong correlation – if GDP falters, then tax collection suffers



Source: Futuregrowth

On the expenditure side, we believe targeting the wage bill was the most appropriate area for reducing expenditure. The cumulative 40% real increase in wages over the past 12 years came without productivity gains and resulted in crowding out much-needed capital expenditure. This stance is also indicative of the government's willingness to make tough decisions. Delaying a reduction in the wage bill would only have led to a more precarious fiscal environment down the line.

Our scenario analyses

In preparation for the budget, we conducted scenario analyses on possible ways in which National Treasury could go about reducing the public sector wage bill as a means of reaching the fiscal target. Our analysis included four scenarios, where assumptions were made on inflation, real increases and pay progression[2]. These scenarios are outlined in Table 1 below. Based on our assessment of historical wage negotiations between the government and trade unions, we thought scenario two was the more plausible one. Unilateral approaches in setting public wages have in the past been met with fierce resistance. The carnage born out of recent strikes at Eskom following an attempted implementation of a wage freeze, as well as at South African Airways following proposals to cut the workforce, bear testimony to this.

2. Pay progression: progression to a higher notch within the same salary level/scale. Pay progression is not automatic, but based on the achievement of at least a satisfactory performance rating for the mentioned period in line with departmental specific performance management systems.
http://www.dpsa.gov.za/dpsa2g/documents/rp/2017/18_1_p_19_09_2017%20Incentive%20Policy%20Framework.pdf

Table 1: Public sector wage bill scenarios

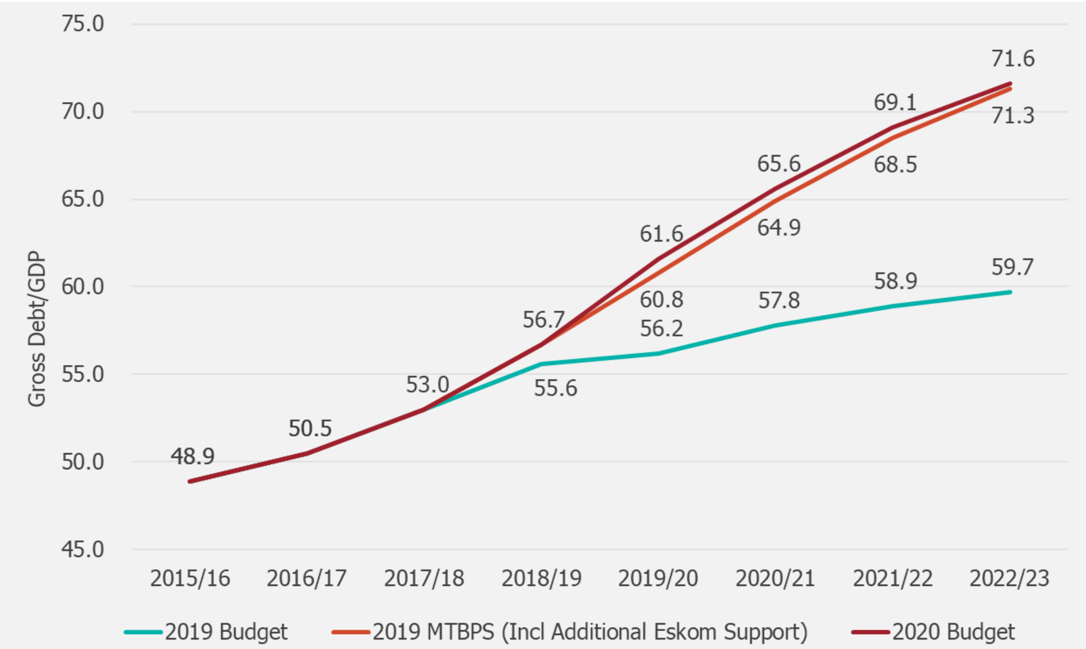
Scenario		Savings over MTEF
1	Limiting CPI to 4.5% while keeping real increases as per the existing wage and pay progression2 of 1.5%	R18 billion
2	Limiting CPI to 4.5%, assuming no real increases and pay progression of 1.5%	R32 billion
3	Limiting the increase to CPI of 4.5% and assuming no real increases or pay progression	R52 billion
4	Assuming no real increases, no pay progression and a wage freeze for all pay grades in the outer years	R132 billion

Source: Futuregrowth

Our base case entailed limiting the increase to the wage bill to CPI of 4.5% + pay progression of 1.5%; resulting in a saving of R32 billion over the medium term, which accounts for only 21% of the required +R150 billion. The biggest differentiator in our analysis and what was tabled in the budget was that we assumed that no changes would be made in the 2020/21 fiscal year as it had been included (and concluded) in the 2018 wage negotiations, where an increase of 6.5% was pencilled in. A large portion of the expenditure cuts is dependent on the wage negotiations for the current fiscal year being reopened and renegotiated down to 1.5% – something we view as highly unlikely and therefore a significant risk.

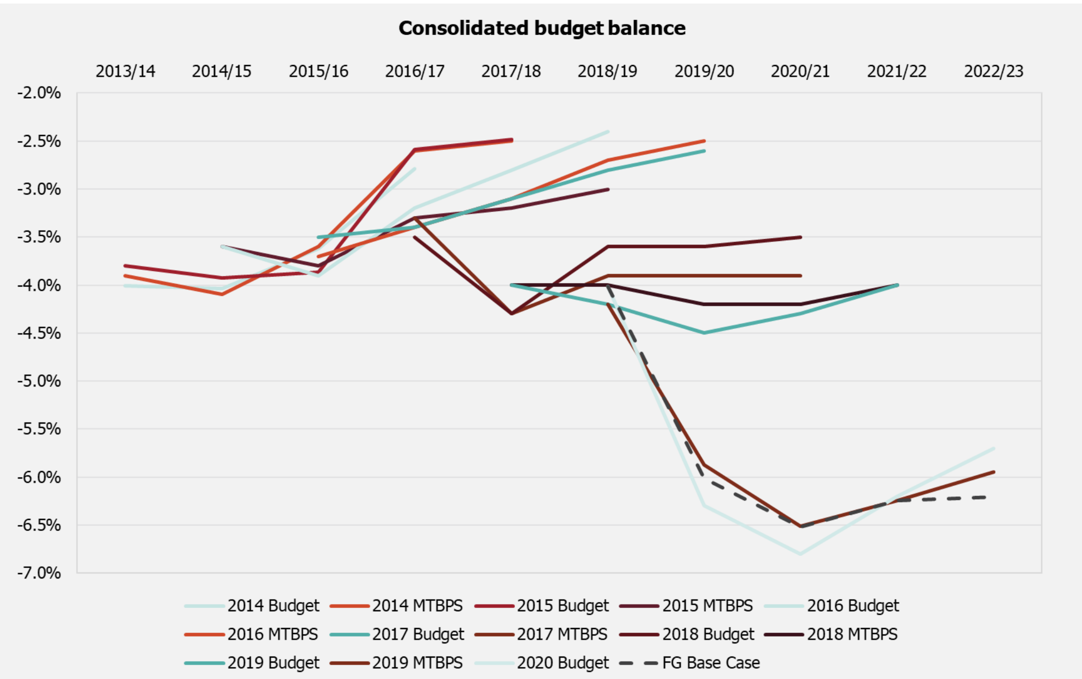
Although the consolidated budget deficit is expected to contract from -6.8% of GDP to -5.7% of GDP over the medium term, the government's debt burden is still not expected to stabilise. When taking a longer-term view, it becomes clear that National Treasury's medium-term forecasts should be taken with a pinch of salt. Despite forecasts for deficit consolidation in the outer years, the overarching trend has been for the budget balance to become more negative over time (see Graph 2). The gross debt-to-GDP ratio is projected to peak at 71.6% in fiscal year 2022/23, which is marginally higher than the 71.3% forecasted in MTBPS 2019 (Graph 3). Moreover, we do not see the fiscal target of achieving a main budget primary surplus by 2022/23 being met. Our analysis suggests that to achieve a primary balance we need a combination of growth of +1.75% growth and a complete nominal wage freeze on public sector wages for the outer years. Looking at our prospects for the medium term, we can deduce that both of these requirements are a tall order.

Graph 2: Debt profile doesn't stabilise under current fiscal assumptions



Source: Futuregrowth, National Treasury

Graph 3: Budget balance has become more negative over time, despite consolidation forecasted by National Treasury



Source: Futuregrowth, National Treasury

A shift in the right direction, but unlikely to succeed

Unlike the overly optimistic revenue forecasts of previous budgets, this year's budget acknowledges the persistently weak economic backdrop and its effect on the tax base. National Treasury's approach in shifting away from heavily taxing a small, but relatively robust tax base to focusing more on reducing expenditure is refreshing and signals a fiscal policy shift. Instead of driving deficit consolidation via higher revenue, fiscal policy is now aimed at driving consolidation via lower expenditure, signalling a more austere approach. Although we wholeheartedly agree with the government's efforts to reduce the wage bill, we're concerned with the magnitude of the reduction as well as the approach taken. The entire fiscal plan hinges on the labour unions agreeing to a substantially lower public sector wage bill in the current fiscal year. The lower expenditure figures are encouraging and signal strong intent by government on reigning in inflationary spending, but we remain doubtful that labour unions will accede to such audacious demands.

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