BACK TO BASICS - AND STRONG ENDORSEMENT 23 OCTOBER 2014

The Minister of Finance presented a back to basics budget statement on Wednesday afternoon when he submitted the mini-budget (or Medium Term Budget Policy Statement - MTBPS - as the Treasury prefers it to be called).

And that is not my opinion, but the opinion of that ultimate judge, the bond market. My colleague and our bond market expert, Madalet Sessions, pointed out that bond rates dropped across the yield curve by between 8 and 12 points - giving investors a capital gain on the day of between 0.8% and 1%. She points out that some of it was also due to the good inflation numbers that also came out on Wednesday, but it was still a significant endorsement. Madalet is also of the opinion that this mini-budget creates space for monetary policy - meaning interest rates could move in a more subdued way.

Several economists expressed their satisfaction with the budget. Why such endorsements?

CONFRONTING REALITY

Although Minister Nene stated that global conditions are important for growth, he made it very clear that our low growth is of our own making: "... energy constraints, labour market disruptions, skills shortages, administrative shortcomings and difficulties in our industrial transformation" were all mentioned by name.

He was also clear that SA has to get a grip on the deficit and public debt ("restoring the nation's finances"); that investment must be boosted; and efficiencies improved.

Two sentences encapsulated it all: "We want to improve our export performance and shift away from consumption-led, debt-reliant expansion" and ".... achieve investment - led growth, which is the centrepiece of our development strategy"(my emphasis). The priorities cannot be clearer than that.

STICKING TO THE FUNDAMENTALS

To achieve the above, the minister inter alia focused on curbing government expenditure. The expenditure ceilings set in place in 2012/13 have been further cut by R25 billion over the next two years.

This was done through a three-pronged approach:

- freeze the budgets of non-essential services at 2014/15 levels (generating 40% of the savings); budgets for travel, entertainment, conference, communications, advertising and consultants have all been cut - relatively mundane amounts but important symbols;
- cancel personnel budgets for vacant positions and freeze the personnel head count for the next two years (20% of savings); and
- reduce the growth rate of transfers to public entities (40% of savings).

Will these new expenditure ceilings be adhered to?

The current expenditure ceilings were set in 2012/13 and expenditure has now been kept in line with these ceilings for the last 3 years. So clearly there is a grip. That gives confidence that the line can be held again. Also, the one upside of under-spending is that expenditure stays within budgets.

All this helps to keep the consolidated budget deficit at 4.1% this year, 3.6% next year and falling sharply thereafter to 2.6% of GDP. The debt to GDP ratio arises from 43% this year to 46% in 2017/2018. That should please the rating agencies.

TAX INCREASES

So far so good, but part of the effort to "restore the nation's finances" and achieve those lower deficits is to look for additional income of R12 billion in the 2015 budget. That clearly means tax increases of some kind, but which?

Looking at the words the minister used, it will probably not be VAT. He said: "We will not balance the budget on the backs of the poor". It will probably also not be company taxes, although the door was left somewhat open: "The revenue measures will be designed to limit as far as possible any negative impact on growth and job creation." It could be income tax on higher incomes. "The proposals will enhance the progressive character of the fiscal system, improve tax efficiency and realise a structural improvement in revenue."

Clearly the minister knows what he is going to do, he is just not telling us yet, leaving us to speculate. Put those three elements together ("progressive, efficiency, structural improvement") and they point for me to very high income earners. Reputedly, there are 2300 individuals in South Africa whose incomes are exceptionally large. I would speculate they (and their trusts) could be in the firing line for higher taxes. Various tax loop holes will probably be closed, some argue for the dividend tax to be increased and some expect a wealth tax. But everything in this paragraph is just my personal speculation, it is NOT in the budget statement. We will know in February....

"STRUCTURAL REFORM", THE NDP AND THE BUDGET

In May/June this year during the road show for Nedbank Private Wealth clients we discussed the topic "How to get out of the low growth trap". The way, we suggested, was "structural transformation", i.e. reform that involves innovation, higher productivity and higher growth. Well, the entire 50 pages of the MTBPS statement was in the spirit of structural reform. The term was used no fewer than six times and it formed a constant theme through the document.

Structural transformation also underlies the NDP and its stable mate, the 5-year Medium Term Strategic Framework (MTSF). We discussed the latter in the August newsletter where we summarised the nine objectives of the MTSF. On Wednesday it became clear that those objectives are also the corner stone of the medium term budget. There is strong alignment between the NDP (a sixteen year view), the MTSF (a five year view) and the budget (a 3 year view). The alignment means this budget statement is not just a temporary approach to be forgotten next year.

GROWTH

The budget assumes 1.4% growth for this year, 2.5% for 2015 then rising slowly to 2.8% in 2016 and 3% in 2017. Compare that to population growth of 1.3% and it is clear that per capita income can rise again after the malaise of the last few years can slowly be shaken off. But it is obviously not enough to curb unemployment.

WHERE ARE THE RISKS?

The MTBPS is very realistic about where the risks are:

- Economic growth slower than the 2.5% envisaged for next year and 2.8% and 3% for the subsequent two years. The statement is clear that if growth falters, the expenditure limits will have to be reviewed.
- Wage settlement in the public sector above projected inflation.
- Public entities that require bail-outs bigger than the proceeds of the sale of assets. The budget was done on the neutral assumption that non-core state assets will be sold to finance assistance to state enterprises. If assistance breaches that neutrality, it will undermine the budget.

The strong advantage of the budget process is that it is a collective cabinet responsibility. The discipline of collectivism will help that ministers stick to the targets. That helps to explain why the expenditure ceilings have been stuck to for the last 3 years.....

I also expect there will be serious discussions behind the scenes to convince the Cosatu unions representing civil servants to adhere to the budget guidelines.

BUSTING SOME MYTHS

A number of myths were busted in Wednesday's mini-budget. That tells us something about politics.

The first is the myth that Minister Nene is not a political heavyweight and that his cabinet colleagues will walk all over him. Clearly not.

The second is the myth that the Treasury is no longer the critical and strong institution it has become since democracy. Au contraire, its grip on public finances is now stronger than at any point since Mr Zuma became president. The test comes when money is tight and Wednesday gave us an indication of those test results.

Also busted is the myth that with the rise of the EFF we will see populism in government spending and that expenditure will run rife.

The myth that a collapse in tax income because of low growth will lead to unrestrained deficits, debt accumulation and some debt trap has also been busted. Fiscal policy is always a matter of context and Treasury responded strongly to the current context. Certainly, the bond market agrees.

SO WHAT?

- The mini-budget is a strong response to prevailing circumstances. We are not out of the woods, but at least a way out has been shown.
- As a result the risk of a downgrade by the credit agencies has been reduced, but they will remain concerned by low growth.
- This budget framework also creates some space for monetary policy - interest rates may move more subdued.
- Growth will slowly resume at levels higher than population growth, allowing for rising incomes, but not for lower unemployment.
- The strong alignment between the NDP, the 5 year medium term strategic framework and the 3 year budget framework makes the NDP a winner in this mini-budget. That will help ensure long term thinking and policy continuity.

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