Preview of the National Budget 2008

Finance Minister Trevor Manuel will table the 2008/09 National Budget on Wednesday 20 February 2008. The budget comes at a time of much uncertainty. Higher interest rates, the current electricity crisis and fading global growth prospects are undermining confidence. The public will now turn to the budget for direction. On this front, government should start the new fiscal year on a strong financial footing, with the outcomes for 2007/08 likely to be broadly in line with the estimates set out in October's Medium Term Budget Policy Statement (MTBPS). However, the estimates for 2008/09 and beyond now seem unrealistic. The forecast for economic growth is likely be revised downwards, implying that revenue will probably come in significantly below October's expectations. Yet the pressure to improve services and address infrastructure constraints has increased. These realities will make it difficult to achieve the MTBPS's planned budget surplus. Given the commitment to fiscal discipline, Minister Manuel may opt for a small budget deficit, with a counter-cyclical element in the form of moderate tax relief and slightly more aggressive spending. The tax relief should be focused on companies. Such a move would bolster business confidence at a time when the economy is slowing and companies are expected to make significant sacrifices to overcome the electricity constraint. On the spending side, the focus will remain on social welfare and infrastructure spending. It is critical, however, that the budget deals with the current electricity constraint in a decisive manner, including incentives to encourage energy savings as well as support for short-term additions to electricity capacity.

Outcome of the 2007/08 fiscal year

Table 1 sets out the various figures for the fiscal year ending in March 2008. '*Budget*' refers to government's projections at the time of the last budget in February 2007; '*Revised MTBPS*' to the revised estimates presented in the MTBPS in October 2007; '*Outcome based on first 9 months*' applies the relevant percentage changes already experienced for revenue and expenditure in the year to December 2007 and '*outcome expected*' is our estimate for what might actually be tabled next week.

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Table 1: Expected outcome for the 2007/08 fiscal year

	2007/2008							
	Budget		Revised MTBPS		Outcome based on 1st 9m		Outcome expected	
	Rbn	*yoy%*	Rbn	*yoy%*	Rbn	*yoy%*	Rbn	*yoy%*
REVENUE	544.6	*14.5*	553.1	*14.9*	558.0	*16.0*	554.3	*15.2*
% gdp	*28.1*		*27.4*		*27.3*		*27.2*	
EXPENDITURE	533.9	*13.4*	542.4	*15.4*	541.9	*15.2*	542.1	*15.3*
% gdp	*27.5*		*26.9*		*26.5*		*26.6*	
BALANCE	10.7		10.7		16.1		12.2	
% gdp	*0.6*		*0.5*		*0.8*		*0.6*	
Gdp	1938.9	*10.5*	2019.1	*13.0*	2044.2	*13.1*	2035.5	*12.6*

Revenue is again likely to exceed the original budget estimate, mainly due to stronger than expected economic growth in the first nine months of last year. Personal income taxes were boosted by good income growth and higher employment levels, while company profits held up well thanks to record high commodity prices. If revenue continues to grow at the same pace that occurred in the first nine months of the fiscal year, revenue will overshoot the original target announced in the February 2007 National Budget by about R13 billion and adjusted target announced in the MTBPS in October 2007 by a more moderate R5 billion. However, revenue growth should taper off in the final quarter of the fiscal year as slower domestic demand contains growth in indirect and company taxes. As a result, growth in revenue of around 15% seems more likely, amounting to an overshoot of just below R10 billion.

Expenditure will also exceed the budget estimate. If expenditure continues to grow at the same pace as prevailed in the first nine months of the fiscal year, expenditure will overshoot the original budget target by about R8 billion, but it will fall short of the revised MTBPS target by about R500 million.

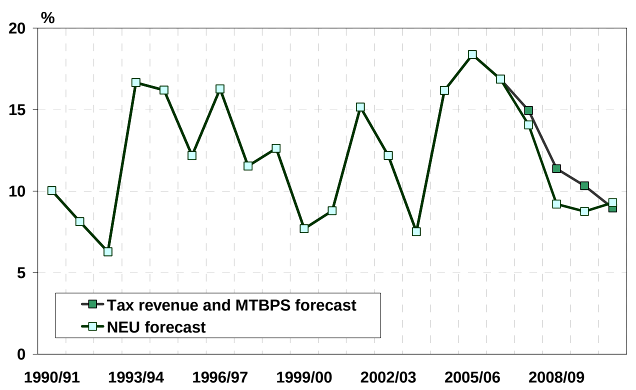
Our revenue and expenditure estimate suggest there will be a small ***surplus***, only slightly above the original estimate of R10,7 billion but largely unchanged as a percentage of gdp.

Expectations for the 2008/09 National Budget

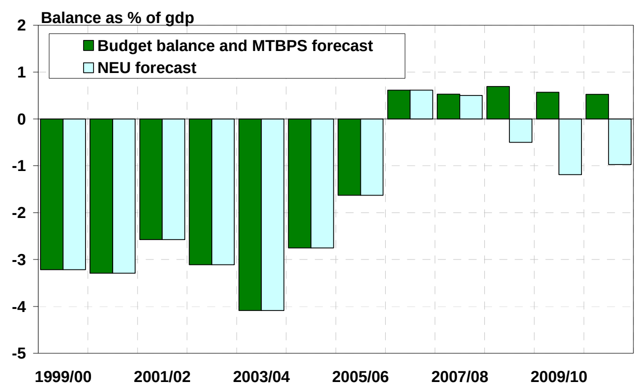
Over the past four years the economy has expanded at its fastest pace in more than two decades. This, and improved revenue collection have been the main reasons behind government revenue overshooting its targets. Unfortunately, the outlook for the economy has deteriorated more than anticipated at the time of the MTBPS in October last year, mainly owing to the ongoing electricity crisis. The greater-than-anticipated slowdown in the economy has made it necessary to revise the estimates of government revenue.

Graph 1 and 2 shows our forecast for growth in government revenue and the fiscal balance respectively against Treasury's October forecast. This suggests that with only a moderate increase in planned expenditure, the fiscal balance will record a deficit over the next three years. However, should the Finance Minister decide on a more stimulatory fiscal package, the deficit could be more substantial.

Graph 1: Growth in government revenue



Graph 2: Projections of the fiscal balance



More specifically, Table 2 below provides some possible outcomes for 2008/09. The first column of Table 2 shows government's revised forecast for 2008/09 set out in the MTBPS in October last year and the percentage changes are calculated using the figures for 2007/08 given in the MTBPS. This column shows that in October last year revenue and expenditure were still expected to remain relatively robust in 2008/09, ultimately producing a small budget surplus of 0,7% of gdp. The remaining columns show four possible scenarios based on our expected outcome for 2007/08. ***Scenario 1*** assumes unchanged tax and expenditure proposals as set out in the MTBPS but on our weaker economic growth assumption, and then calculates the budget balance. This scenario illustrates that it will be very difficult to achieve a surplus in the year ahead as slower economic growth will contain revenue. ***Scenario 2*** assumes a stimulatory bias is adopted as a counter-cycle measure. Here we assume that government will be comfortable with a deficit of 1,5% of gdp, and then calculate some possibilities around revenue and expenditure. In this scenario some tax relief is given, while expenditure is ramped up. ***Scenario 3*** assumes a conservative mindset prevails. We assume government tries to maintain a budget surplus of about 0,5% of gdp, and then calculate the implications for revenue and expenditure. This scenario illustrates that a small surplus will require that no tax relief is given while spending remains measured and contained. ***Scenario 4*** gives our expected mix for the year ahead.

Table 2: Possible scenarios for the 2008/09 fiscal year

	2008/2009									
	MTBPS proposals		Scenario 1: No policy change		Scenario 2: Stimulatory		Scenario 3: Conservative		Scenario 4 Expected	
	Rbn	*yoy%*	Rbn	*yoy%*	Rbn	*yoy%*	Rbn	*yoy%*	Rbn	*yoy%*
REVENUE	616.0	*11.4*	598.7	*8.0*	587.6	*6.0*	609.8	*10.0*	605.3	*9.2*
% gdp	*27.6*		*26.8*		*26.4*		*27.3*		*27.1*	
EXPENDITURE	599.9	*10.6*	599.9	*10.7*	621.1	*14.6*	598.6	*10.4*	616.5	*13.7*
% gdp	*26.9*		*26.9*		*27.9*		*26.8*		*27.6*	
BALANCE	16.1		-1.2		-33.4		11.1		-11.1	
% gdp	*0.7*		*-0.1*		*-1.5*		*0.5*		*-0.5*	
Gdp	2230.3	*10.5*	2229.9	*9.6*	2229.9	*9.6*	2229.9	*9.6*	2229.9	*9.6*

Our expected scenario assumes government's continued commitment to fiscal discipline, but also takes into account weaker economic growth and increasing pressure on government revenue. Given this, we think that government will probably settle for a small deficit of about 0,5% of gdp. The mix of tax and expenditure proposals is likely to be counter-cyclical, with limited tax relief and stronger growth in spending.

Revenue

This year's budget is not expected to reveal any major tax reforms, expect perhaps providing greater clarity on the new withholding tax on companies. Consumers have finally begun to respond to higher interest rates, so it seems unlikely that the government will want to encourage further spending by cutting personal taxes. Rather the government may want to stimulate the production side of the economy by reducing corporate taxes. Unfortunately a slowdown in the economy over the next three years will put a damper on revenue growth. This will leave the treasury with little leeway to cut taxes. The government's need to respond to the electricity crisis and meet longer-term objectives to reduce poverty will also limit the extent to which taxes can be reduced.

- Personal income tax relief is likely to be limited. The top marginal tax rate should remain unchanged at 40%. However, there will be the normal adjustments to the tax thresholds to compensate for the effects of inflation. Some tax brackets are likely to be adjusted more than others, with lower and middle-income earners receiving slightly more relief.
- The exemptions on domestic interest and dividend payments have been raised marginally every year to compensate for the effects of inflation. The exemptions currently stand at R18 000 for taxpayers under 65 and R26 000 for those over 65.
- If all goes according to the original time table, STC will be scrapped at the end of the year and the new withholding tax will come into effect. This leaves the corporate tax rate below the average of OECD countries, but still above that of emerging market competitors, which according to the KPMG International Tax Rankings have an average tax rate of 26,5%. Despite this, we do not believe they will make further adjustment in this tax year.
- Treasury may extend tax relief to small businesses, although there was no indication of this in the MTBPS. However, given the government's emphasis on the important role that small businesses can play

in job creation, treasury may decide to increase the turnover limit. The turnover limit was last raised in the 2005/06 budget to R14 million a year. The small business tax amnesty closed in June 2007, with initial estimates suggesting that there was a 22% increase in registered businesses. Further detail on the success of this initiative may be provided.
- Last year's budget provided some initial detail on a possible social security tax. The broad-based social security system aims to finance retirement savings, unemployment, disability and death benefits for all people in formal employment. The aim is to implement this compulsory earnings-related tax, with a wage subsidy for low-income workers. In the President's recent State of Nation address he reported that work continues on this proposal. This year's budget may provide more detail, but the new system is only expected to be implemented in 2010.
- The revised Mineral and Petroleum Royalty bill was released in December 2007, with the final bill due to be released later this year. The revised royalty system has been changed to take the mine's profitability into account and has reduced the proposed royalty rate. An allowance for beneficiation expenses has also been introduced.
- The VAT rate is expected to remain unchanged.
- There will be the usual above-inflation increases in excise duties.

Expenditure

In October's MTBPS the government already committed to increasing expenditure by R81 billion over the next three years, bringing expenditure growth in real terms to 8,4%. The focus of spending over the next three years remains firmly on accelerating investment in economic and community infrastructure and on broadening access to services. The MTBPS identified priority programmes as being associated with achieving the goals set out in ASGISA, the Joint Initiative for Priority Skills (JIPSA) and ensuring that the 2010 FIFA World Cup is held successfully. Apart from these key objectives, there is also a renewed focus on controlling costs and improving the efficiency of government departments. The President's commitment in the recent State of the Nation address to respond to the ongoing electricity crisis will also add to government's bill.

The MTBPS and the President's State of the Nation address indicate that the following will receive attention:

- Infrastructure spending on transport, communication, energy and water services. Government acknowledges that improving the country's infrastructure is vital to future growth prospects. The MTBPS talks about extensive improvements to hospitals and schools over the next three years. Economic infrastructure will get at least an additional R4 billion over the next fiscal year.
- The President, in his recent State of the Nation address, promised that the government would make additional funds available to support Eskom's energy efficiency campaign and investment programme. The Finance Minister is expected to provide more details on possible incentives and the degree and nature of support that will be provided to Eskom.
- Crime prevention and justice was due to receive an additional R2 billion. This figure could be increased given the continued national debate.
- Social services, which include spending on housing, education and health, should receive an additional R9 billion in order to help improve the quality of public services in rural areas.
- The social security system will be changed to allow men over the age of 60 to claim a pension, benefiting an estimated 500 000 people.
- Expanded public works programme will receive an additional R1 billion.
- More funds will also be made available to accommodate the higher than expected 2007 public service salary agreement.
- The new Industrial Policy Action Plan is expected to benefit from R2,3 billion allocated for industrial policy initiatives and an additional R5 billion in tax incentives over the next three years.

Financing the deficit

The consolidated national budget is likely to show a smaller deficit than the main budget estimates shown in Table 2. This is because of projected surpluses on the Unemployment Insurance Fund (UIF) and the Compensation Fund. However, public corporations will need to borrow more to finance the acceleration in infrastructure spending, which means that the public sector borrowing requirement will probably be larger than the R18,5 billion expected at the time of the MTBPS. There is possibility that government may announce guarantees on a portion of new Eskom paper to shore up the utility's credit rating, but such a move would affect the country sovereign risk rating. The larger borrowing requirement is not expected to place undue pressure on the local capital market, with most institutions sitting on plenty of cash and record low exposures to fixed income assets.

Other issues

No major changes are expected to ***exchange controls*** in this year's budget. The allowance for individuals will stay at R2 000 000, but there may be moderate adjustments to travel allowances to compensate for inflation and rand weakness. Controls on companies and institutions are also unlikely to change much. There may be some simplification of administrative requirements.

No changes to the 3% to 6% CPIX **inflation targets** are expected.