momentum
investments

The Macro Research Desk

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2018 National budget review: Tackling the fiscal wounds

Highlights

- The contractionary nature of the budget is expected to steer the country towards a more sustainable fiscal trajectory
- A brighter economic outlook is anticipated, in response to a robust global economy and a tentative revival in sentiment
- The tax burden is forecasted to rise further, placing a drag on the consumer
- The increase in the value-added tax (VAT) rate contributed the most to government's tax-revenue proposals
- Regrettably, government's spending composition is still shifting away from capital expenditure and towards consumption
- The process around planning and execution of large infrastructure projects are expected to improve, while private-sector participation is expected to increase
- The outcome of the public sector wage agreement poses a significant threat to the expenditure ceiling
- A narrower budget deficit, a firmer currency and lower borrowing costs have led to an improvement in South Africa's (SA) debt ratios in the Medium-Term Expenditure Framework (MTEF)
- The likelihood of a near-term state-owned-enterprise (SoE) default is less likely given government's step up in governance efforts
- A number of credible, growth-enhancing reform efforts were mentioned by government
- Rating agencies are more likely than not to leave SA's sovereign rating unchanged

The budget was well received by financial markets

In an immediate reaction to the budget announcement, the rand appreciated by 0.8%, while SA government bond yields (R186) rallied by 9 basis points. Hopes for an economic revival, through the acceleration of structural reform, were raised after the favourable market outcome at the December 2017 African National Congress (ANC) National Conference and were reinforced when Treasury outlined a number of economic measures in the February 2018 national budget to rekindle confidence and steer the country towards a more sustainable fiscal trajectory.

Robust growth in SA's key trading partners and stable commodity prices have bolstered SA's growth prospects, while hopes for a sustainable bounce in sentiment could provide some uplift for growth forecasts in the medium term.

your goal is our benchmark

Treasury acknowledged growth remained tepid relative to its longer-term average and noted the costs associated with fee-free higher education and public-service compensation were still uncertain and could pose a downside risk to the numbers presented in the budget.

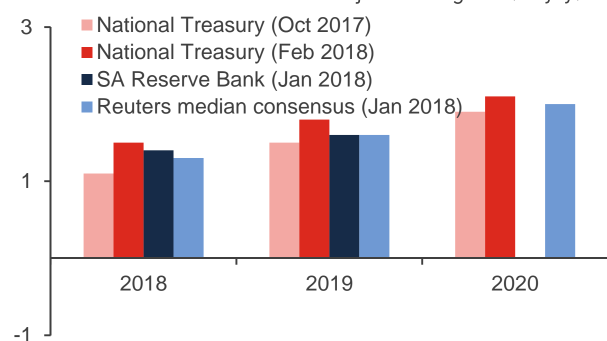
The FTSE/JSE All-share Index rose 1% in reaction to the budget announcement. The equity market was supported by gains in industrial and financial shares, while resources initially declined on a firmer currency. Financial shares were likely buoyed by government's renewed commitment to fiscal consolidation, leading to more upbeat expectations around Moody's upcoming sovereign rating review.

A dire fiscal reality left the authorities with little choice but to produce a contractionary 2018 budget. Not only does the budget deficit fall in the coming years, but revenue growth is expected to exceed expenditure growth, with the tax burden also rising. As such, the 2018 budget has to be characterised as growth-unfriendly and equity-market-negative in the interim, while an improving fiscal prognosis is supportive of the bond market. However, the initiation of some growth-enhancing reforms announced in the budget should provide more support for the equity market in the longer term.

A brighter economic outlook is anticipated

Supportive global growth and a renewed sense of optimism are expected to drive growth higher in the medium term from an estimated 1.0% in 2017. Treasury caught up to the rest of the market, increasing its real gross domestic product (GDP) projections for 2018, from 1.1% to 1.5% and from 1.5% to 1.8% for 2019 (see chart 1). Government remains aware the sustainability of higher levels of sentiment depends on the implementation of reforms, a resolution of governance and operational woes at SA's SoEs and the prosecution of those involved in corrupt activities.

Chart 1: Real GDP forecasts adjusted higher (% y/y)

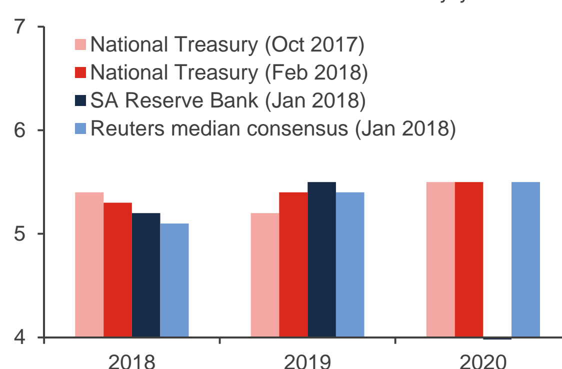


Source: National Treasury, SARB, Reuters, Momentum Investments

Treasury's revised headline inflation forecasts recorded a tad higher than that estimated by the Reuters consensus (see chart 2). This is possibly due to the implementation of the VAT increase, which is likely to affect inflation in its first year of implementation.

Treasury's latest estimates place the average increase in nominal GDP at 7.3% (previously 6.9%) between FY2018/19 and FY2020/21. This is only marginally higher than Momentum Investments' expectation of 7.2%.

Chart 2: Headline inflation forecasts (% y/y)



Source: National Treasury, SARB, Reuters, Momentum Investments

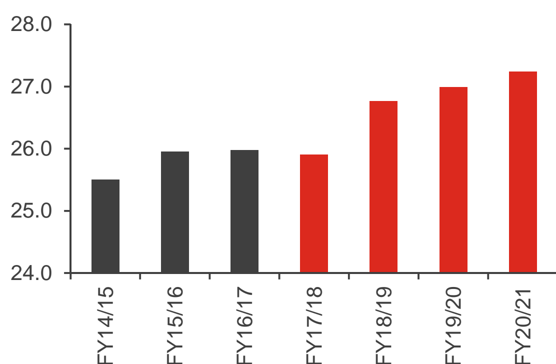
Three alternative scenarios have been sketched out by Treasury, quantifying some of the upside and downside risks to the baseline growth forecast. In the first scenario, a sovereign rating downgrade by Moody's is considered. Here, higher borrowing costs, reduced investment and lower consumption are expected to result in GDP growth of 0.7% in 2018 and 1.3% in 2019. In the second scenario, government assumes risks in SoEs materialise, prompting a fiscal crisis and a sovereign rating downgrade. In this scenario, growth contracts by 3.1% in 2018 and 0.3% in 2019. Finally, government calculates a third scenario, in which global growth improves by 0.5% on average and SA's risk premium declines by 50 basis points for the same period. This scenario results in more vibrant growth of 2.1% in 2018 and 2.9% in 2019.

Tax proposals set to raise R36 billion in additional revenue for FY2017/18

Treasury's revenue shortfall was revised from R50 billion in the October 2017 medium-term budget to R48.2 billion in February 2018. This, in part, allowed government's main budget deficit for FY2017/18 to be revised from 4.7% to 4.6%. Relative to Treasury's October 2017 projections, the fiscal deficit in the outer year of the MTEF is expected to narrow to 3.7% as a share of GDP (previously 3.9%).

The latest tax proposals are expected to see a further rise in SA's tax burden. SA's tax-to-GDP ratio is set to climb from 25.9% in FY2017/18 to 27.2% in FY2020/21 (see chart 3).

Chart 3: SA's tax burden set to rise further



Source: National Treasury, Momentum Investments

In spite of politically driven concerns, Treasury, in a bold move, raised the VAT rate from 14% to 15% (effective from 1 April 2018). In Momentum Investments' budget preview, the company argued the VAT rate in SA remains below a number of the country's emerging-market peers. Moreover, the VAT rate had been steady since 1993, when it was raised from 10%. SA's narrow tax base further argued for a rise in VAT over an increase in personal income tax rates. Treasury anticipates the rise in VAT to raise an additional R22.9 billion in tax revenue in FY2018/19. In Momentum Investments' opinion, government's decision to raise consumption taxes is an encouraging step towards supporting savings and investment over consumption in the economy.

Although VAT is expected to hurt consumer spending, Treasury noted the zero-rating of basic food items mitigates the effect of the tax increase on poorer households. Moreover, Treasury suggested vulnerable households would be compensated through a positive real increase in social grants (expected to average 2.5% in the MTEF). The lowest-three income-earning brackets were granted tax relief (R6.8 billion) in an effort to place the burden on higher-income households.

Treasury also raised taxes on fuel (a 22c/l increase in the general fuel levy and a 30c/l increase in the Road Accident Fund levy). A 6% to 10% increase in excise duties (sin taxes) is expected to raise an additional R2.6 billion in tax revenue. In a further attempt to keep tax increases redistributive, government raised estate duty rates (on estates of more than R30 million) from 20% to 25% (expected to generate R150 million in FY2018/19), increased donations tax (from 20% to 25%) on donations exceeding R30 million and hiked excise duties on luxury goods from 7% to 9% (expected to produce R1 billion in FY2018/19).

Government adjusted medical tax credits below inflation for the next three years, which should raise a further R4.2 billion, ring-fenced for the national health insurance (NHI) plan.

The overall impact of the tax proposals announced is expected to be negative for the SA consumer on a net basis. In monetary policy terms, the proposed tax initiatives equate to a 1.8% increase in interest rates, assuming a limited change in spending habits. However, government likely assumes little change in spending patterns, given the expected rise in the tax buoyancy ratio. As such, the overall effect on consumer spending is likely to be far less than the equivalent increase in interest rates, given VAT applies to all goods and services, whereas the interest rate increase would only affect credit purchases.

Treasury is expected to implement its Health Promotion Levy (sugar tax) in April 2018, which will add R1.9 billion to revenue in FY2018/19, while the implementation of the Carbon Tax Bill has been set for January 2019.

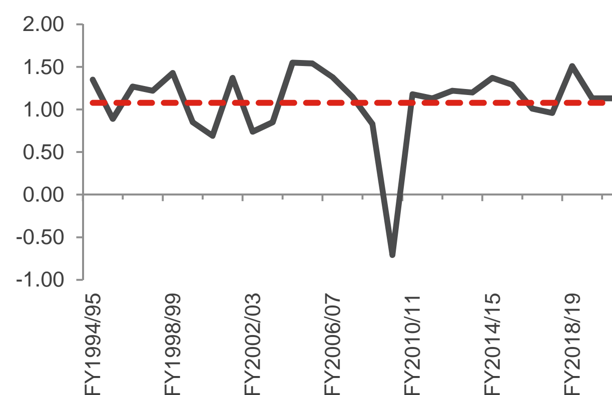
Government alluded to the erosion in tax payer morality, triggered by the corruption and wasteful expenditure in the public sector. A commission of inquiry into the

governance of the SA Revenue Service (SARS) will be undertaken to restore trust in SA's tax authority.

While no increase in corporate taxes was announced (in line with expectations), government mentioned efforts to combat base erosion and profit sharing. The six additional special economic zones implied a R350 million tax break for corporates.

Treasury highlighted it expects the overall tax buoyancy (the relationship between tax revenue growth and economic growth) to increase to 1.51 in FY2018/19 (due to the tax proposals), before declining closer to its longer-term average in the latter two years of the MTEF.

Chart 4: Overall tax buoyancy rates

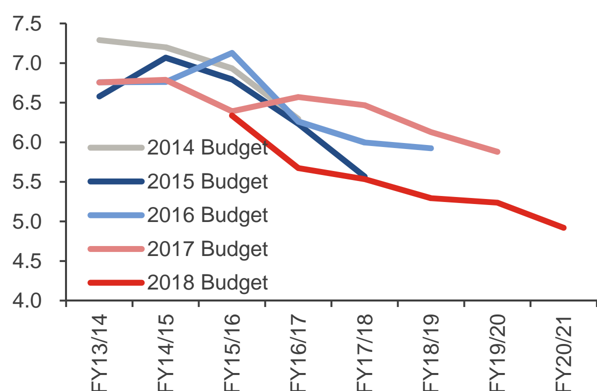


Source: National Treasury, Momentum Investments, data up to FY2020/21

Spending cuts result in spending composition shifting away from capital and towards consumption

Worryingly, Treasury notes 47% of the reduction in expenditure for the medium term consists of cuts to capital transfers. It clarified this statement by suggesting the bulk of the cuts were related to capex underspend. Government's public sector infrastructure spend, as a share of GDP, is expected to drop from 5.5% in FY2017/18 to 4.9% in FY2020/21 (see chart 5).

Chart 5: Public sector infrastructure as a % of GDP



Source: National Treasury, Momentum Investments, data up to FY2020/21

Treasury has also launched a Budget Facility for Infrastructure to improve the planning and execution of large infrastructure projects. This facility includes the Presidential Infrastructure Coordinating Commission and the Department of Planning, Monitoring and Evaluation and has successfully reviewed 38 large infrastructure projects already.

Treasury admitted government and banks cannot fund SA's infrastructure programme without the help of the broader private sector. From 2018, the JSE will allow the listing of "project bonds", which will provide institutional investors the opportunity to participate in ring-fenced infrastructure or energy projects.

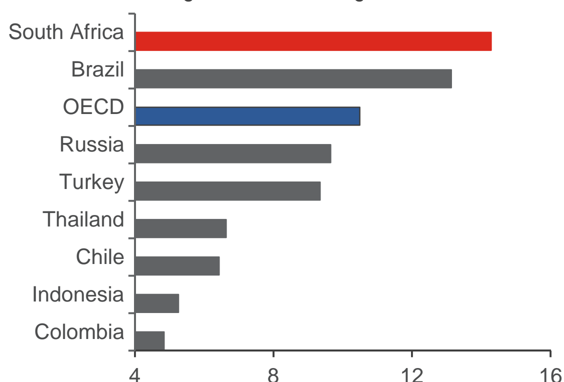
Government is working to ensure the public wage agreement does not disrupt compensation ceilings

SA's wage bill ranks as one of the highest among its emerging-market peers (see chart 6). The public sector wage bill increased from 32.9% of total expenditure in FY2007/08 to 35% in FY2017/18.

Treasury's baseline assumption is in line with the 2016 budget proposals to reduce the compensation ceilings of national and provincial departments by R10 billion in FY2017/18 and R15 billion in FY2018/19.

In Momentum Investments' budget preview, the company highlighted the current impasse between unions and government on salary increases.

Chart 6: Bloated government wage bill (% of GDP)



Source: OECD, Momentum Investments

Government's compensation budget remained unchanged from its October 2017 forecasts at 7.3% on average in nominal terms in the next three fiscal years, equating to a 1.8% average increase in real terms for the same period.

Despite a freeze on public-sector employment since 2015, SA's public-sector workforce remains bloated at 3.7 million employees. Stats SA reported year-on-year (y/y) growth of 3.3% in public-sector employment in the latest data for the fourth quarter of 2017. Reducing employment growth in the public sector is likely a tough task in the run up to the 2019 national elections, but it remains imperative to curb the overall wage bill.

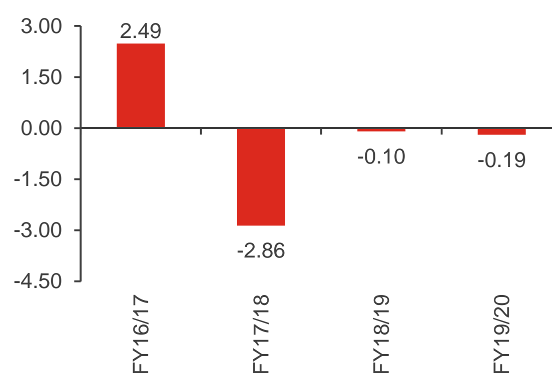
Government shows prudence by making substantial cuts to government expenditure

Treasury announced a downward revision to its self-imposed expenditure ceiling over the medium term (by R1.5 billion in FY2018/19, R3.8 billion in FY2019/20 and R0.5 billion in FY2020/21), despite a breach in FY2017/18, driven by the recapitalisation of SA Airways (SAA) and the SA Post Office. The recapitalisation of these institutions was partly funded by a drawdown in government's contingency reserve. The contingency reserve has been adjusted to R8 billion in FY2018/19 (previously R10 billion), R8 billion in FY2019/20 (previously R20 billion) and R10 billion in FY2020/21.

With revenue growth outstripping expenditure growth on average between FY2018/19 and FY2020/21, this budget is seen to be contractionary in nature (see chart 7). This recommitment to fiscal consolidation in the medium term is likely to appease the rating agencies, in Momentum Investments' view.

The downward adjustment to expenditure, in part, financed the increased allocation to the Department of Higher Education and Training. Government aims to phase in free higher education to limit the effect on the fiscus. Additional funding of R57 billion has been allocated to fee-free higher education and training between FY2018/19 and FY2020/21. This leaves higher education and training as the fastest-growing expenditure line item in the MTEF at 13.7% y/y. All new first-year students, with a family income below R350 000 per year at universities and Technical and Vocational Education and Training (TVET) colleges, will be funded for the full cost of study (tuition fees, study material, meals, a certain level of accommodation and/or travel allowances).

Chart 7: Excess expenditure growth over revenue growth (%)



Source: National Treasury, Momentum Investments

Improved outlook for SA's debt profile

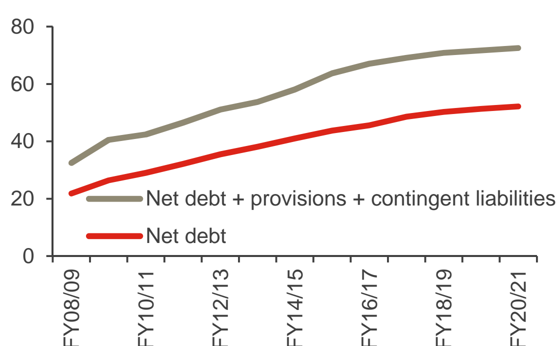
Treasury pointed out the improvement in SA's debt-to-GDP ratio (relative to the October 2017 MTBPS numbers) was largely the result of higher anticipated economic growth, a narrowing in the fiscal deficit, a firmer currency and lower borrowing rates.

Government's gross debt ratio (as a share of GDP) is expected to increase from 53.3% in FY2017/18 (previously 54.2%) to 56% in FY2020/21 (previously 59.7%). Net debt as a share of GDP is expected to increase from 48.6% to 52.2% in the same period.

All three major rating agencies have flagged the significant rise in government exposure to SoEs as a key risk. Total contingent liabilities and provisions are expected to rise from R965.2 billion in FY2017/18 to R1.2 trillion in FY2020/21, of which energy-utility Eskom, the Road Accident Fund (RAF) and independent power producers (IPPs) account for the bulk.

Total debt (including provisions and contingent liabilities) reached 67.1% of GDP in FY2016/17 and is expected to climb to 71.7% in FY2019/20 (previously 73.2%) (see chart 8).

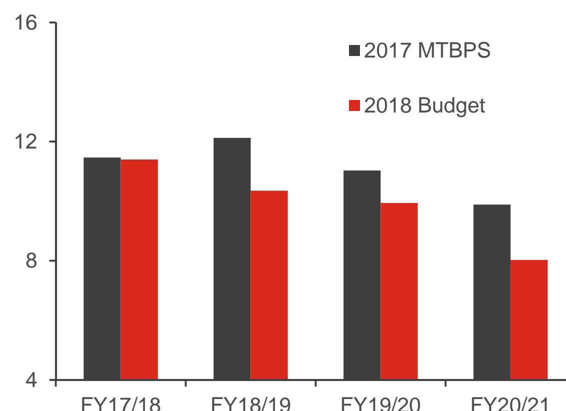
Chart 8: Total debt as a % of GDP



Source: National Treasury, Momentum Investments

Alongside the downward revision in government's debt-to-GDP, the debt-servicing burden has lessened. Debt-servicing costs are expected to increase from an estimated R163.2 billion in FY2017/18 (10.5% of total expenditure) to R213.9 billion in FY2020/21 (11% of total expenditure). This results in a 9.4% (4% real) increase on average in the next three fiscal years (see chart 9).

Chart 9: Lower nominal increase in debt-servicing bill (% y/y) relative to October 2017



Together, the wage bill and debt-servicing burden are expected to stabilise at a whopping 45.9% of total expenditure in the medium term, suggesting a significant crowding out of more useful capital expenditure at the expense of an increase in current expenditure.

Likelihood of a near-term SoE default less likely given government's step up in governance efforts

Government is in the process of developing a framework to reduce new guarantees to SoEs and has been working with the World Bank to increase SoE monitoring and reduce the risk of these contingent liabilities materialising. Although government warns further financial support may be required by SA's troubled SoEs, it plans on using a combination of disposals of non-core asset and underutilised government properties, strategic equity partners and direct capital injections to provide for the potential funding shortfall.

Eskom has recently been instructed by the Minister of Energy to conclude all power-purchase agreements with independent power producers, while a new board and acting chief executive have instilled confidence at the state energy utility. The unallocated portion of Eskom's R350 billion guarantee (R96 billion) was previously extended to 2023, but a lower-than-expected electricity-tariff approval of 5.2% and poor financials indicate Eskom's funding gap remains a risk longer term.

With regards to SAA, an additional R10 billion has been granted to settle the SoE's short-term obligations. On the governance front, a new board, chief executive officer and restructuring officer have been appointed. Several loss-making routes have been closed and the schedules reduced to improve SAA's profitability ratios.

Transnet will be using the private-sector participation framework recently approved by Cabinet. It intends to develop partnerships to build several port terminals to prevent straining its balance sheet or to require additional support from the fiscus. From a governance angle,

government admits Transnet will have to address concerns about its supply-chain management practices. Denel is yet another SoE that has experienced lapses in corporate governance. It is working closely with the Department of Public Enterprises and National Treasury to increase its corporate governance framework in an attempt to alleviate funding pressures.

A number of credible structural reform efforts mentioned

Government recognises the need to clarify SA's economic policy backdrop to lift investor sentiment. It therefore aims to finalise mining sector policies (by addressing stalemates reached in earlier discussions) and telecommunication reforms (ending the delay in the licencing of spectrum), as well as support labour-intensive sectors (including tourism and agriculture), while improving competition in product markets through the lowering of barriers to entry.

Moreover, a number of measures will be introduced to improve efficiency in the transport sector. An interim rail regulator is expected to build regulatory capacity in the sector, while a Single Transport Economic Regulator Bill should help to further improve efficiencies. Government has also approved an additional six special economic zones to boost investment through tax incentives.

In an effort to improve on government's procurement processes, large deviations from normal processes will be carefully scrutinised. By allowing for fewer deviations, Treasury hopes to reduce anti-competitive behaviour and corruption.

A renewed commitment has been made by government to resolve governance and financial issues at SA's SoEs. Cabinet has approved a private-sector participation framework and government has committed to reviewing the funding models of troubled SoEs.

A broader social compact is seen as essential for the successful implementation of reform in SA. Greater collaboration between government, business, labour and civil society is expected to drive the implementation of the new administration's economic plan.

Rating agencies are more likely than not to leave SA's sovereign ratings unchanged

In Momentum Investments' opinion, a healthier fiscal outcome relative to Treasury's October 2017 estimates and some headway on credible structural reforms should be sufficient to avoid a sovereign rating downgrade into junk territory by Moody's. Since the favourable outcome of the ANC National Conference in December 2017, a number of positive changes have transpired, including an attempt to begin to restore good corporate governance at key SoEs, an ongoing investigation into state capture and upward revisions to growth forecasts.

The recent resignation by the former president has raised hopes for a Cabinet reshuffle, which could see the removal of underperforming ministers (including mineral resources, public enterprises, energy and social development).

President Cyril Ramaphosa has admitted increased clarity around the mining charter and land reform is necessary and has quashed unaffordable nuclear considerations.

While acknowledging free post-school higher education as critical for accessing economic opportunities, Ramaphosa pointed out that free tertiary education will be phased in "to ensure sustainability of government finances".

A sharper fiscal correction through deeper expenditure cuts is likely to be viewed as a prudent approach to fiscal policy by the rating agencies, while a narrowing in the fiscal deficit and a stabilisation in government's debt ratios in the medium term should further support the decision for no change in sovereign ratings.

In Momentum Investments' opinion, the inquiry into state capture is a move closer to curbing corruption in the country. A restoration of trust in SA's Chapter nine institutions, through a credible leadership at the National Prosecuting Authority and SARS, would further instil public trust in key institutions.

A downgrade in SA's local currency rating to junk status by Moody's would trigger SA's exclusion from the Citi World Government Bond Index (WGBI), which could prompt significant capital outflows from the SA government bond market. Estimates of potential outflows range anywhere between R85 billion and R130 billion. Citi notes that, while SA bond buying by foreign investors in the run up to the 2012 index inclusion might have been staggered, the rush for the exit door could be crowded. Furthermore, re-entry into the index will be difficult to achieve. The Citi WGBI requires a minimum credit quality of A- by S&P and A3 by Moody's for the country's local currency rating (four notches above junk status).

However, given the above arguments, Momentum Investments is of the view that SA's sovereign rating is likely to be unchanged by Moody's in its review on 23 March 2018. Standard & Poor's is expected to review SA on 25 May 2018, while Fitch Ratings has not released its review dates for SA.

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