National budget review

8 March 2023

Major debt relief for Eskom eclipses the budget, but difficult budgeting trade-offs lie ahead to maintain fiscal restraint.

Initial impressions

- There was a broadly positive response from fixed income and currency markets, with government pledging significant financial support to energy utility Eskom. Given no tax implications (no fuel levy increase and only inflation-related increases in sin taxes), full compensation for bracket creep (R15.7 billion) and inflation-related increases in grants, the outcome for South African (SA) equities should be largely favourable. Although Treasury stuck to its guns on fiscal consolidation and adhered to a prudent approach to spending, market participants remain wary of the tough fiscal decisions that must be taken to further support other state entities, to address the cost-of-living crisis that civil servants face and to increase government's financial reach to the most vulnerable.
- Treasury's medium-term economic forecasts look reasonable. Its expected average economic growth rate of 1.4% between 2023 and 2025 is broadly in line with our own expectation and that of the Reuters median consensus estimate of 1.6% and 1.4%, respectively. Treasury's projection on inflation of 5% over the same period further broadly matches our expectation of 5.1% (Reuters consensus: 5%).
- Treasury's estimates on the anticipated revenue overrun for the current fiscal year have been upwardly revised from R83.5 billion in October to R93.7 billion (relative to February 2022) due to an extended period of elevated commodity prices supporting corporate income tax collections from the mining sector. The bulk (80%) of the expected tax overshoot comes from corporate income taxes, while personal income taxes and dividends taxes account for a further 15% and 9% of the overrun, respectively.
- Fifty seven percent of the higher-than-expected revenue will be used to reduce the fiscal deficit.
- Treasury estimates a R93.2 billion (-R1.4 billion) and a R100.1 billion (R0.4 billion) tax revenue overrun in FY23/24 and FY24/25, respectively, relative to estimates in February 2022 (October 2022) on resilient personal incomes and corporate profitability.
- Government has not funded additional diesel costs and must be found within Eskom's existing expenditure budget.
- Government predicts that the revenue buoyancy (tax collections per unit of economic growth) is expected to drop to an average 1.07 in the next three fiscal years from 1.42 in the current fiscal year. Lower commodity prices (Treasury's assumptions on key commodity prices do not deviate too widely from the Bloomberg median consensus forecast for the next three years) and damaging loadshedding are expected to drive down the tax buoyancy ratio in the medium-term expenditure framework (MTEF).
- Expenditure estimates outlined in the budget comfortingly show that the spending balance has been tilted in favour of growth-enhancing expenditures. Real growth in capital outlays is expected to average 9.7% in the next three fiscal years, while real growth in the compensation of employees is expected to decline on average by 1.5% during the same period. This will bring the share of employee compensation to non-interest spending down from 31.8% in FY22/23 to 30.7% by FY25/26. Nevertheless, cost-of-living pressures and a renewed threat of strike activity by nine public sector unions raise risks for a higher-than-budgeted wage increase. Unions are demanding a 12.5% increase in comparison to government's offer of 4.7% in FY23/24. News24 reports that six of the nine unions are classified as essential staff and cannot legally strike.
- At 4.2% of GDP, SA's fiscal deficit ratio for FY22/23 was more favourable than the Reuters consensus of 4.5% and compares favourably with a 5.4% deficit projected for emerging markets (EM) in 2023 and 5.5% in 2024, as estimated by the International Monetary Fund (but less favourably against 3.7% and 3.8% projected for developed markets (DM) for the same period). Although Treasury projects a significantly

narrower government deficit ratio of 3.2% in the outer year of the MTEF, the Reuters consensus takes a more bearish view on the success of fiscal consolidation efforts and sees the deficit ratio narrowing to only 3.9% in the same period.

- Treasury noted we have reached a primary budget surplus for the first time since FY08/09, which is expected to be maintained over the medium term. Treasury estimates the gross debt-to-gross domestic product (GDP) ratio will peak at 73.6% in FY25/26 (previously 71.4% in the current fiscal year) before declining. This compares with a debt ratio of 67.5% in EMs for 2023 (70.2% by 2024 and 72.6% by 2025) and 111.3% in DMs for 2023 (112.4% by 2024 and 112.7% by 2025).
- Although the negative growth implications of more intense loadshedding pose a risk to the near-term outlook on sovereign ratings, we expect the rating agencies to keep their ratings intact. Moreover, rating agencies are not likely to alter SA's rating solely based on the outcome of the greylisting decision of the Financial Action Task Force.

Effect on the economy and financial markets over the MTEF

- The tax burden (ratio of tax revenue to GDP) is projected to increase mildly from 25.4% in FY22/23 to 25.7% in FY25/26. With no new revenue measures outlined, compliance efforts at the SA Revenue Service and closing tax loopholes could likely contribute to this expected marginal rise.
- Government has not yet decided on a fiscally-responsible way forward on the Social Relief of Distress (SRD) grant for 7.8 million recipients, which will expire at the end of March 2024. Government notes that this will have to be funded through a reduction in spending elsewhere or a permanent increase in revenue.
- A contractionary budget over the next three years contingent on government's adherence to fiscal consolidation favours fixed income assets over SA listed companies, whose primary business is in SA (SA Inc. shares). Government extracts more from the economy through taxes than it injects back through spending over the MTEF. This is evident from an estimated declining budget deficit in absolute terms (R24 billion smaller between FY22/23 and FY25/26) and as a percentage of GDP (1% smaller). This is expected to be effected through an average 0.3% reduction in real expenditure growth versus a 0.8% real increase in revenue in the next three fiscal years.
- Government's gross borrowing requirement will reach R555 billion by FY25/26 due to elevated redemptions and Eskom's announced debt relief. Cash balances are expected to be increased from R27.9 billion in the current fiscal year to R86.3 billion in the next before being drawn down to R13.5 billion by the end of the medium-term horizon.
- On balance, the market is expecting unchanged to a slight increase in issuance.

Expenditure demands delayed not defeated

- Notwithstanding slower forecasted growth in expenditure, the budget still places redistribution in the spotlight, with 60.2% of total expenditure allocated to health, education, social protection and community development over the MTEF. No new announcements have been made regarding a more comprehensive funding model for student funding in higher education and training for the so-called 'missing middle'. This additional outlay poses a risk to expenditure growth in the medium term.
- Although government has taken a firm stance against public sector unions, the high cost of living merely delays a likely wage bill overrun. A looming election year introduces an additional challenge to curb the wage bill through real wage cuts or a meaningful dent to public sector headcount. Fewer professionals in education, health and security relative to the population pose a further risk to service delivery. Government has offered an increase of 4.7% (relative to a 3.3% nominal increase or a negative 1.5% real increase pencilled into the budget on average for the next three years) but unions are sticking to a 10% demand and threatening strike activity.
- Moreover, government has only accounted for the SRD grant for the most vulnerable up until the end of March 2024 but has not catered for a continuation of this grant in its budget numbers. Debt-service costs continue to eat into more useful forms of government expenditure.

Growth in debt-service costs at 4% in real terms on average in the medium term is expected to outpace the average anticipated real growth in revenue of 0.8% due to a weaker currency, a still wide deficit and higher borrowing costs. The interest bill is expected to rise from 4.6% of GDP (15.3% of expenditure and 18% of revenue) in FY22/23 to 5% of GDP (17.5% of expenditure and 19.8%

- of revenue) in FY25/26. Debt-service costs will on average absorb more than 19c of every rand government collects in the MTEF. At 8.9%, debt-service costs are the fastest growing expenditure item in nominal terms between FY22/23 and
- FY25/26, with spending on health expected to grow at a mere 2.7% over the same period. Debt-service costs are the third largest expenditure item after learning and culture and social development.

Major Eskom debt relief plan announced but financial woes at other state entities remain a risk

- Eskom has received a whopping R263.4 billion in bailout funding since FY08/09.
- A debt relief package of R254 billion (R168 billion in capital and R86 billion in interest) announced, over the next three years, which addresses 60% of Eskom's current debt, split as follows: R78 billion in FY23/24, R66 billion in FY24/25 and R40 billion in FY25/26. In FY25/26, government will directly take over R70 billion of Eskom's loan portfolio.
- The debt plan is contingent on electricity tariffs which the regulator has approved.
- The advance of funds will be done as interest-free subordinated loans to be settled in Eskom shares rather than cash.
- Government's R350 billion guarantee framework expires on 31 March 2023. Government will not guarantee new debt issued off Eskom's balance sheet.
- Government is in discussions to address R56.3 billion in municipal debt arrears and is considering conditional debt write- offs, a further rollout of prepaid metres and municipal revenue management tactics.
  - Conditions for the debt solution include: (1) Eskom cannot implement remuneration adjustments that negatively affect its financial position, (2) debt relief to be used to settle debt and interest payments only, (3) no derivative contracts to structure new debt or loans, (4) guarantee framework expires at the end of March this year with no further guarantees being granted, (5) no new borrowing allowed from April 2023 until end of the debt relief period, (6) Eskom cannot use sale proceeds of non-core assets for capital and operating needs and (7) no greenfield generation projects allowed during the debt-relief period (maintenance and spending on adjustments for minimum emissions allowed).
- The amount of R1 billion allocated to SA Airways to assist business rescue process (payment of historic debts to creditors).
- The amount of R2.4 billion allocated to the SA Post Office to implement its turnaround plan.

Rebuilding fiscal buffers are challenging against the backdrop of a torpid economy

Treasury explored three economic scenarios around its current base case:

- Upside scenario in which energy interventions resolve the electricity crisis by the end of 2023: Growth is expected to be 0.4% higher than the baseline, on average, between 2023 and 2025 as increased business operations and consumer spending support economic activity.
- Downside scenario in which power cuts intensify this year and next: Growth is expected to slow to 0.2% in 2023 (against the SA Reserve Bank's estimate of 0.3%) only recovering to 1.3% by 2025 (the SA Reserve Bank expects growth of 1%).
- Downside scenario in which the globe experiences a sharper slowdown: Tighter financial conditions, heightened global risk aversion and higher inflation for longer hurts growth in SA. Growth averages 0.3% lower than the baseline scenario.

Treasury noted progress on structural reforms in a number of areas in the economy:

- Energy: Licensing threshold raised for embedded generation and pipeline has grown to more than 100 projects (9 000 MW), aiming to establish the Energy Security Bill (relieves regulatory impediments for independent power producer), R4 billion in tax incentives for household rooftop solar (for one year) and a R5 billion extension of renewable energy tax incentives for businesses (for two years), implementation of a wheeling framework and grid capacity rules to provide certainty to private producers, Energy Bounce Back Scheme to be announced in April 2023, government will guarantee solar-related loans for small businesses and R728.8 billion allocated for support to new energy vehicle initiatives.
- Skills: Remote worker visa and special dispensation for high-growth start-ups will be introduced.
- Logistics: White paper on National Rail Policy finalised and Transnet National Ports Authority corporatised.
- Corruption efforts: Government aims to strengthen capacity of the state by funding investigative and prosecutorial agencies to fight corruption and advance prosecutions related to state capture. The amount of R7.8 billion allocated to the police budget, R1.3 billion to the National Prosecuting Authority and R100 million for the Special Investigating Unit.
- State entities: New framework to manage bailouts will be published in March 2023 for further consultation.
- Public-private partnerships: Fast-tracking regulatory framework recommendations.
- Research and development: Tax incentives extended for another 10 years.

Despite a number of economic and political reform efforts, SA has shown no improvement on its relative ranking in the World Justice Project Rule of Law Index particularly on the order and security measure, where we remain well below the global average. Moreover, insufficient energy supply cripples SA's growth trajectory. As such we maintain our longer-term potential growth rate of between 1.5% to 2% given the current pace of structural reform efforts which continue to disappoint market expectations.

Budget likely credit neutral in the interim but risks biased to a lower sovereign rating further out

- Government previously acknowledged that SA's tepid forecasted growth profile, undermined by energy and logistics deficiencies, is inadequate to tackle high poverty and inequality. Despite the level of economic activity shifting back to pre- pandemic levels, as noted by the president in the State of the Nation Address, growth in SA is steadily falling behind its peers to the extent that growth on a per capita basis has moved largely sideways since the global financial crisis.
- While growth in GDP on a per capita basis averaged 4.6% for DMs over the past decade and 2.9% for EMs, growth in per capita GDP has declined by 0.4% on average for SA.
- The size of SA's debt burden is still large and risks to restraining expenditures and increased allocations to struggling state entities and failing municipalities remain high in the medium to longer term, with many tough fiscal decisions merely being postponed.
- A total of 169 municipalities were declared to be in financial distress at the end of FY21/22 (up from 66 of 257 in FY10/11). Municipalities owe R15 billion to SA's water boards and R39.8 billion to Eskom, while households owe R182 billion to municipalities. Poor financial management at SA's municipalities will come under further strain in an environment where the country is placing more emphasis on renewable energy.
- The pace of reform efforts remains underwhelming particularly against a backdrop of pedestrian growth, arguing for more momentum behind implementation. Low growth remains a fiscal risk in the context of a more fragmented voter base and rising socio-political demands on the public purse in pursuit of upward mobility in the absence of sufficient employment opportunities. As such, SA's path toward fiscal consolidation and debt stabilisation continues to be wedged between low growth outcomes and rising expenditure pressures.
- Consequently, even though ratings are likely to remain unchanged in the near term, lingering fiscal and growth risks in the medium to longer term point to downside risk to SA's sovereign rating outlook further out.

Sources:
Momentum Investments

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