momentum
investments

The Macro Research Desk

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2018 National budget preview: Testing government's fiscal mettle

Highlights

- **Firmer growth expectations, higher revenue collection and deeper expenditure cuts should support faster fiscal deficit reduction in the medium term**
- **Value-added taxes (VAT) and personal income taxes are lagging projections in the current fiscal year, but corporate income tax is running ahead of target**
- **Government has other options available to address the revenue shortfall without increasing VAT**
- **The scope for major expenditure cuts is limited, unless discipline over the public sector wage bill is exercised and a phased-in approach is used for tertiary education financing**
- **There is a risk of more state-owned enterprise (SoE) debt migrating to government's bloated balance sheet**
- **The escalation in government's debt-servicing burden is troublesome**
- **Rating agencies want to see government addressing SA's growth and fiscal woes through the implementation of a credible adjustment plan**

Faster fiscal deficit reduction in the medium term is possible

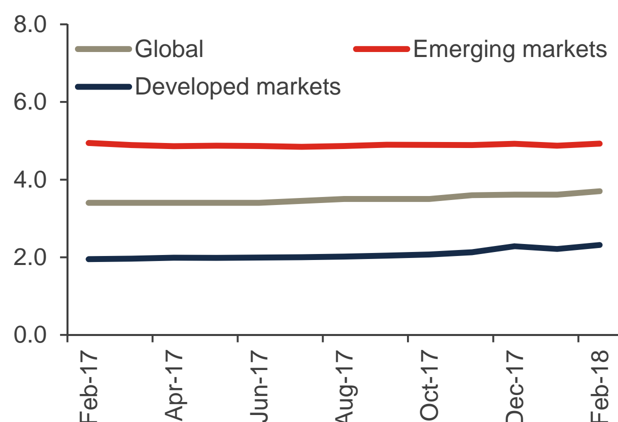
A further slide in business and consumer confidence in the domestic economy led to a significant deterioration in National Treasury's macroeconomic forecasts in the October 2017 medium-term budget policy statement.

Since then, international economic conditions have remained resilient, while the global outlook for 2018 has brightened (see chart 1). Going forward, Momentum Investments expects healthier domestic demand in SA's key trading partners and stable commodity prices (see chart 2) to support export growth.

Moreover, the result of the African National Congress (ANC) National Conference in December 2017 rekindled hopes for the implementation of growth-enhancing initiatives to shift SA's growth trajectory to a higher platform over time. Momentum Investments expects real gross domestic product (GDP) growth to improve to around 1.5% in 2018 from 0.9% in 2017. While recent events are likely to have bolstered confidence, a sustainable revival in sentiment is needed to kick-start growth.

your goal is our benchmark

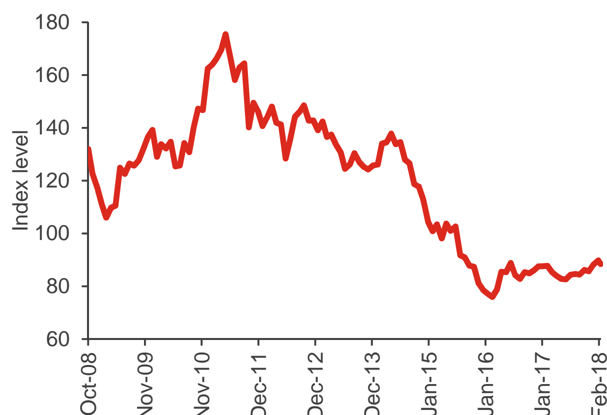
Chart 1: Brighter 2018 global (real) growth prospects (% y/y)



Source: Bloomberg, Momentum Investments

Relative to the October 2017 medium-term budget, the company expects an upward revision in Treasury's nominal GDP forecasts, which implies higher revenue growth and a faster reduction in the fiscal deficit ratio relative to that indicated in October 2017.

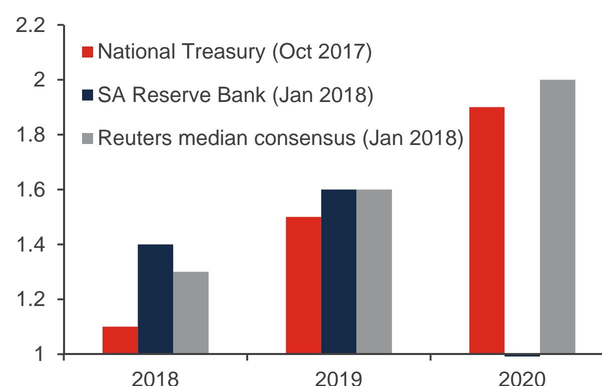
Chart 2: Stable international commodity prices



Source: Bloomberg, Momentum Investments

Treasury's real GDP growth forecasts are likely to be upwardly revised from the 1.1% and 1.5% prints (for 2018 and 2019, respectively) forecasted in October 2017 (see chart 3).

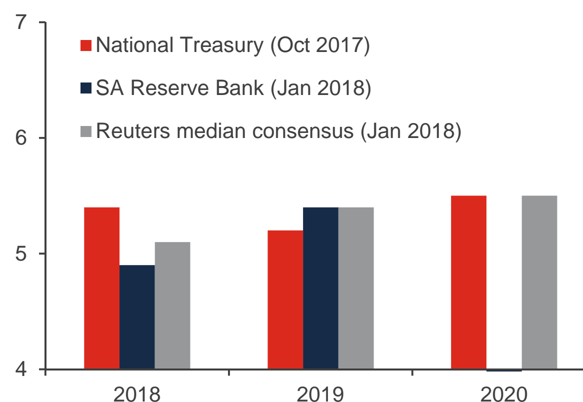
Chart 3: Real GDP forecasts (% y/y)



Source: National Treasury, SARB, Reuters, Momentum Investments

However, a downward revision to Treasury's inflation forecasts are also likely to materialise, given a lower-than-expected electricity tariff approval and a marked appreciation in the currency (see chart 4). Momentum Investments anticipates headline inflation to drop to 4.6% in 2018 from 5.3% in 2017, before accelerating again to 5.4% in 2019. This compares to Treasury's October forecasts of 5.4% for 2018 and 5.2% for 2019.

Chart 4: Headline inflation forecasts (% y/y)



Source: National Treasury, SARB, Reuters, Momentum Investments

Momentum Investments, hence, expects a marginally higher outcome for the average growth rate in nominal GDP between fiscal year (FY) 2018/19 and FY2020/21 (7.2%) compared to Treasury's 6.9% projection.

Upwardly revised fiscal deficit target for FY2017/18 remains on track

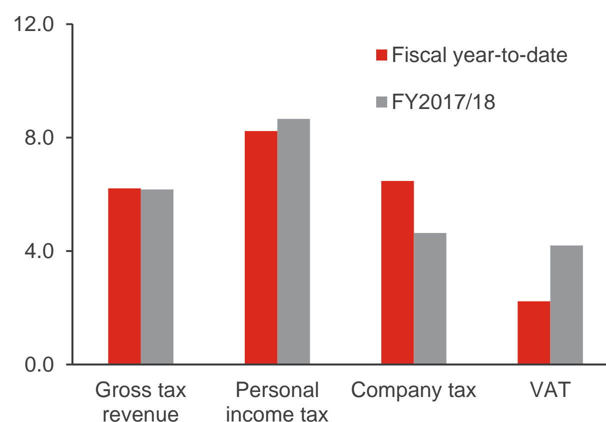
The latest December 2017 government budget data shows gross tax revenues (for the first nine months of FY2017/18) growing in line with the October 2017 revised full-year estimate of 6.2% y/y, while expenditure growth is running marginally behind at 8.0% y/y (see chart 5). A further breakdown of the tax revenue data shows personal income taxes lagging slightly (8.2% fiscal for the year to date [YTD] compared to the 8.7% full-year

estimate). The current run rate for VAT is also behind target at 2.2% YTD, relative to the October 2017 estimate of 4.2%. Thanks to a robust December 2017 print, growth in corporate income taxes is running ahead of target at 6.5% YTD (compared with 4.6%).

As such, the expected FY2017/18 deficit outcome is likely to broadly match Treasury's revised target of 4.7% outlined in October 2017.

Moderately firmer growth prospects, additional revenue measures and cuts to expenditure could, however, improve the pace of fiscal deficit reduction in the medium term.

Chart 5: Overall tax revenue on track to meet target



Source: National Treasury, Global Insight, Momentum Investments

Tax increases are inevitable to plug the gaping revenue hole

In November 2017, government announced additional steps would be taken to reduce its budget deficit by R40 billion in FY2018/19, through reducing expenditure by R25 billion and increasing revenue by R15 billion. This was in addition to R15 billion worth of additional tax hikes announced in the 2016 national budget and R31 billion in additional spending cuts announced in the 2016 (R15 billion) and 2017 (R16 billion) national budgets.

The latest monthly government budget figures for December 2017 suggest revenues are likely to undershoot February 2017's estimates by close to R50 billion, broadly in line with government's estimates outlined in the October 2017 medium-term budget.

The VAT rate in SA was last raised to 14% in 1993 (from 10%) and remains below a number of the country's emerging market peers. Moreover, SA's narrow tax base argues for a rise in VAT over a further increase in personal income tax rates. Treasury's tax statistics suggest around 1.7 million taxpayers were responsible for 78% of all personal income tax collected in FY2016/17. This points to a tax base, which is too dependent on a small number of individuals.

Although raising VAT is a more effective way of raising additional revenues, the country is facing a national election in 2019, making higher VAT rates a controversial decision. In Momentum Investments' opinion, a number of alternative revenue-raising options to raising VAT exist at this stage (see table 1). These include allowing for limited compensation for fiscal drag (government was able to collect R12 billion through this avenue in the previous fiscal year), removing the VAT zero-rating on fuel (this could raise up to R18 billion, but could prove contentious, as the taxi industry is a powerful constituency within the ruling party) and further sin taxes (taxes on alcoholic beverages and tobacco).
Government managed to raise R2 billion from the latter in the previous fiscal year.

In Momentum Investments' opinion, raising the top marginal tax rate from 45% would hurt already-fragile consumer confidence and subdued household spend. Similarly, the company does not expect a hike in the company tax rate (currently at 28%). Previously, the Davis Tax Committee alluded to a large gap between the headline and effective corporate tax rates in SA, suggesting a number of loopholes needed to be addressed before considering a hike in the company tax rate.

Government has additionally committed to implementing the Health Promotion Levy or sugar tax by 1 April 2018, which could raise an additional R2 billion.
Moreover, wealth taxes have been debated, but SBG Securities estimates this could raise between R5 billion and R8 billion, at the most. In the February 2017 national budget, government highlighted it was refining measures to prevent tax avoidance through the use of trusts, which could boost revenue collection at the margin.

Absa notes removing the VAT exemption on municipal property rates could be considered to generate

higher revenues. The February 2017 national budget shows this exemption amounted to R10.5 billion in FY2014/15.

While previously the Davis Tax Committee acknowledged VAT as a potential source of funding for additional spending needs, such as the National Health Insurance, recent comments made by the current health minister hinted at using medical tax credits as an alternative source of funding. The minister noted 8.8 million people belonging to a medical scheme. This could provide around R20 billion in tax credits per year, which would be sufficient to cover the health ministry's priority programmes (amounting to R69 billion over a four-year period).

Lastly, Treasury published a Draft Carbon Tax Bill for public comment, open until March 2018. The actual date of the carbon tax has not yet been announced, but Treasury noted it will be complemented by a package of tax incentives and revenue-recycling measures to minimise the effect on energy-intensive sectors in the first phase (up to 2022). Treasury stated the effect of the tax in the first phase is designed to be revenue neutral, after taking the complementary measures into account.

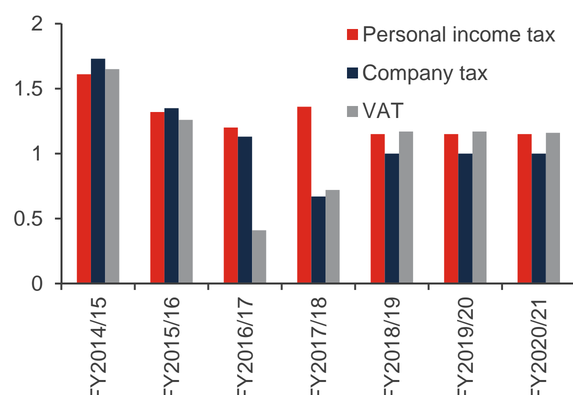
Table 1: Possible revenue measures

Possible revenue measures	Intake	Likelihood
Fiscal drag	R12bn (last year)	Very high probability
Fuel levies or VAT on fuel	R3.2bn (last year) or R18.2bn	High probability
Sin taxes – alcohol & tobacco	R2bn (last year)	High probability
Sugar tax	R2bn	Bill passed and due for implementation
Wealth tax	R5 – R8bn	High probability – delays?
Carbon tax	Initially revenue neutral	High probability – draft bill out for public comment
Removal of medical aid tax credit	R20bn or R2bn (above R750 000)	Moderate probability (higher in medium term)
Dividend withholding tax	R6.8bn (last year)	Moderate probability (increased previously)
Taxing top marginal bracket	R4.4bn (last year)	Low probability (steep increase previously)
VAT (0.5% increase)	R11.5bn	Low probability (higher in medium term)
Company tax increase	?	Low probability (negative business sentiment)

Source: Nedbank, RMBMS, SBG Securities, National Treasury, Momentum Investments

While the revenue shortfall for FY2017/18 is in large part due to lower growth outcomes, lower tax buoyancy rates (tax revenue growth per unit of GDP growth) exacerbated low revenue outcomes. Media reports have suggested the hit to institutional credibility at the SA Revenue Service has negatively affected personal and corporate tax morality. The overall tax buoyancy ratio dipped to 1.01 in FY2016/17, but Treasury anticipates a recovery to 1.31 in FY2018/19, before declining to 1.1 in FY2020/21 (still above the longer-term average of 1.08). A further breakdown of Treasury's tax buoyancy projections suggest a sharp pick up in the company tax and VAT buoyancy rates (see chart 6) in the medium term.

Chart 6: Tax buoyancy rates



Source: National Treasury, Momentum Investments

Scope for major expenditure cuts is limited, unless discipline is exercised over the public sector wage bill

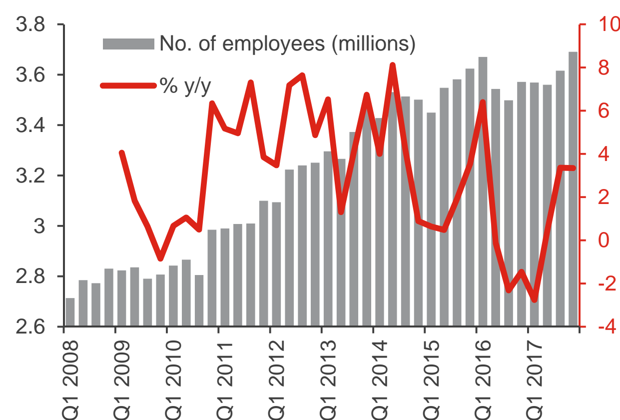
In Momentum Investments' view, the burgeoning civil servant wage bill poses one of the largest threats to curbing government expenditure. In the October 2017 medium-term budget, Treasury indicated employee compensation would reach 12% of GDP by FY2018/19, should the wage bill increase by 7% in the next fiscal year. Not only has this ballooned from 8.5% of GDP in FY2004/05, SA's wage bill as a share of GDP ranks higher than the 10.5% average for the countries in the Organisation for Economic Cooperation and Development (OECD) grouping and is out of line with many other emerging market peers.

Government negotiators tabled a draft agreement at the Public Service Coordinating Bargaining Council early in February 2018. While no agreement on salary adjustments had been concluded, Business Day notes government acceded to a number of demands, such as removing the spousal-benefits restriction, establishing a bursary scheme for children of public servants and creating a housing investment portfolio, which directs investment into a housing scheme, managed by the Public Investment Corporation. Meanwhile, trade unions have lowered their demands for housing allowance increases (from R2 500 to R1 500 per month).

According to Business Day, a standoff between government and labour on salary adjustments persists. Government offered to increase compensation by: Consumer price inflation (CPI) plus 1.5% (employee levels 1 to 7), CPI plus 1% (levels 8 to 10) and CPI (levels 11 to 12) for the first year of the three-year deal. Labour, however, demands CPI plus 3% (levels 1 to 7), CPI plus 2% (levels 8 to 10) and CPI plus 1% (levels 11 to 12).

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 (see chart 6). 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. The OECD has recommended that annual wage increases are capped by transferring civil servants to health and education, where the highest needs are.

Chart 7: Bloated civil-servant workforce

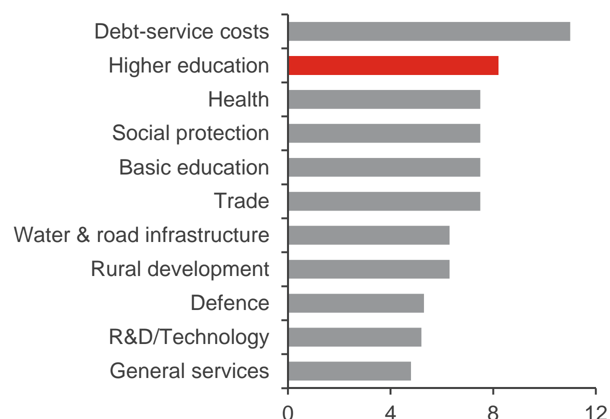


Source: Global Insight, Momentum Investments, data up to Q4 2017

The October 2017 medium-term budget noted growth in post-school education and training spend was the

second-fastest growing expenditure item after debt-service costs (see chart 8).

Chart 8: Average growth in expenditure over the medium-term expenditure framework (% y/y)



Source: National Treasury, Momentum Investments

Former President Jacob Zuma's promise to make higher education free is a further risk to roping in government expenditure. In his December 2017 announcement, Zuma indicated students from households with income of less than R350 000 would be granted free tertiary education (including tuition, books, subsidised accommodation and transport). The plan stipulated it would be phased in over five years starting in 2018. While a reversal on Zuma's free higher education announcement would be a political challenge, some adjustments are needed to augment its affordability in the context of a stretched fiscus. Details of the funding are yet to be announced by government, but SBG Securities estimates full funding for university and Technical Vocational Education and Training (TVET) students (with incomes below R122 000) will require an additional R17.8 billion per year, without considering any increase in the income threshold.

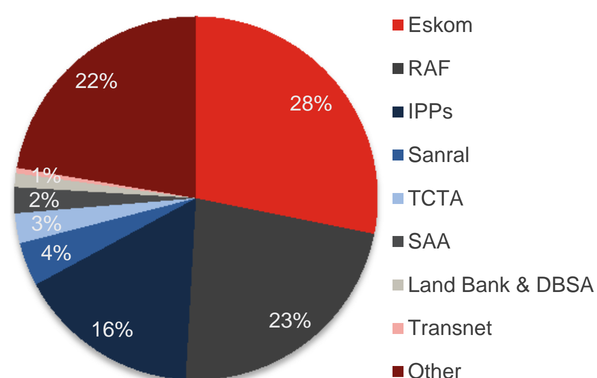
In November 2017, the Davis Tax Committee suggested the hybrid model for tertiary fees (as opposed to fee-free higher education) was the best option for university student funding. It calculated that a 0.5% increase in the skills development levy (recorded at R15.8 billion in FY2017/18) could raise an additional R8.8 billion in funding for higher education.

With government having drawn down on its contingency reserve (by R5 billion to R5 billion in FY2018/19 and by R10 billion to R10 billion in FY2019/20), limited wiggle room remains.

Risk of more SoE debt migrating to government's bloated balance sheet

All three major rating agencies have flagged the significant rise in government exposure to SoEs. Total contingent liabilities increased from R195.4 billion in FY2008/09 to an estimated R775.4 billion in FY2016/17, of which energy-utility Eskom, the Road Accident Fund (RAF) and independent power producers (IPPs) accounted for the bulk (see chart 9).

Chart 9: Contingent liabilities (% of total FY2016/17)



Source: National Treasury, Momentum Investments

Total debt (including provisions and contingent liabilities) reached 68.8% of GDP in FY2016/17. Although there was no update on contingent liabilities in October 2017, the February 2017 national budget suggested this ratio would track sideways in the medium term.

While Standard and Poor's (S&P) excludes the IPPs in its calculation of contingent liabilities (given the higher likelihood Eskom will not default on these payments), the remainder (including the substantial underfunding of the RAF, according to its actuarial valuation) is taken into account.

Government's largest exposure is to Eskom. Government allocated R350 billion in SoE guarantees to the energy utility, of which R218 billion has been used to date. In February 2017, government announced the guarantee would be extended to March 2023 to facilitate Eskom's build programme. More recently, in

February 2018, the Public Investment Corporation provided Eskom with a R5 billion loan to be settled within 30 days to meet liquidity requirements. However, Eskom's funding gap remains a risk longer term, particularly given the lower-than-expected electricity tariff adjustment of 5.2% for the current year.

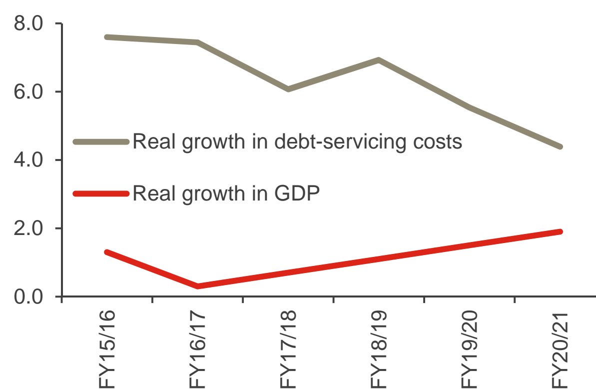
Governance efforts have been ramped up at the troubled power utility, with the appointment of a new board, a commitment to appoint a permanent group chief executive and group chief financial officer and an inquiry into the mismanagement of state funds at the SoE.

While some SoEs are making an attempt to replace compromised board members, more attention needs to be placed on greater accountability and performance management to reduce the burden of direct budgetary support or international funding needs. Smaller SoEs, such as Denel (which recently requested a R3 billion equity injection), also requires an overhaul at board level, given corruption allegations tainting confidence in the state arms manufacturer.

Worrying escalation in government's debt-servicing burden

In its October 2017 medium-term budget, Treasury warned gross debt-to-GDP would rise to 59.7% by FY2020/21. Momentum Investments expects Treasury to moderate its expected gross debt profile, from its October 2017 estimates, on an improved growth outlook, higher revenue assumptions and deeper expenditure cuts. Due to the rapid increase in government debt outlined in the October 2017 medium-term budget, the interest bill was expected to remain the fastest-growing expenditure item at an average of 11% per year in nominal terms and equating to 5.5% in real terms in the medium term. Debt-service costs are expected to rise to 15% relative to the main budget revenue inflow. Real growth in the interest bill is outstripping real growth in the economy (see chart 10), suggesting other (social and growth-enhancing) spending priorities are being crowded out. This has been raised as a key concern by the rating agencies in the past.

Chart 10: Real growth in interest bill outstripping GDP



Source: National Treasury, Momentum Investments

Rating agencies want to see government addressing SA's fiscal and economic woes through a credible adjustment plan

In Momentum Investments' opinion, low-hanging fruit need to be addressed to avoid a sovereign debt 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 would be viewed as positive by the rating agencies, while pressure in the medium term could weigh negatively on Moody's upcoming sovereign rating decision

on SA. Moreover, confidence in SA's independent state institutions must be restored, given SA's slide down the World Bank Governance Indicators related to transparency in policy making, public trust in politicians and corruption.

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).

While Momentum Investments is of the view that there is a slightly better-than-even chance for Moody's to keep SA's sovereign rating on hold at its upcoming review, a significant budget disappointment (including no clear economic plan to propel growth in the medium term) could be enough to trigger a downgrade.

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