momentum

investments

The Macro Research Desk

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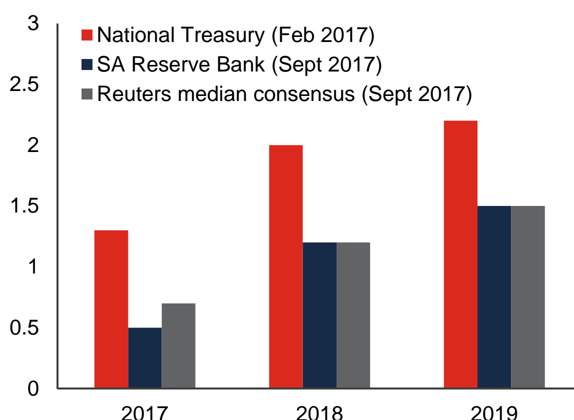
Medium-term budget preview: Walking the fiscal tightrope to avoid adversely affecting growth, while healing SA's public finances

National Treasury faces difficulties in plugging the revenue gap in a slow growth environment

Since the tabling of the national budget in February 2017, downside growth risks to the domestic economy have materialised. In its February 2017 budget review, Treasury projected 2017 and 2018 growth at 1.3% and 2.0%, respectively. However, consensus estimates have migrated considerably lower to 0.7% and 1.2%, respectively, according to the September 2017 Reuters consensus poll (see chart 1).

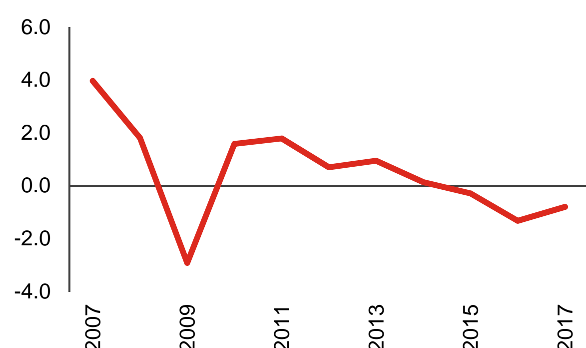
Chart 1: Real GDP growth projections (% y/y)



Source: Reuters, National Treasury, Reserve Bank, Momentum Investments

Between 1994 and 2010, SA growth matched global trends closely. However, since 2011, SA economic growth diverged markedly from more robust global activity. The SA Reserve Bank's (SARB) October 2017 Monetary Policy Review finds low confidence and lower real commodity prices to be the main reasons underlying the underperformance in SA growth. On a per-capita basis, growth in real gross domestic product (GDP) peaked in 2011 and has been tracking in negative territory since 2015 (see chart 2).

Chart 2: Growth in real GDP per capita (%)

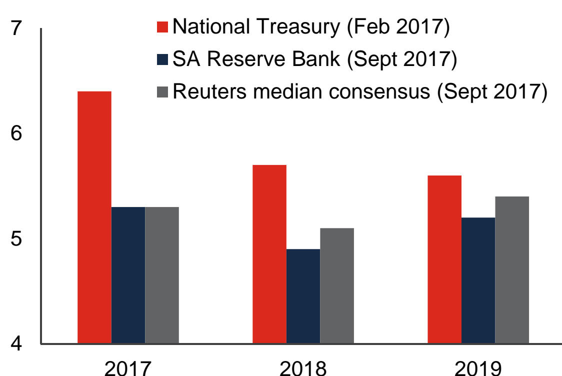


Source: IMF, Momentum Investments

The rating agencies have highlighted the slow pace of economic growth as a weakness to SA's sovereign rating. After identifying supply bottlenecks and much-needed reforms in SA's highly concentrated economy, Standard & Poor's (S&P) assessed the delivery of reform as piecemeal to date. The potential for political interference could delay the implementation of necessary reforms, dampening already modest growth prospects. Ongoing political tensions are weighing negatively on firms' capital investment and hiring decisions, which would have otherwise supported higher rates of economic activity.

Treasury's February 2017 growth forecasts appear to be too high, even in nominal terms, after taking inflation into account. Relative to estimates from the SARB and the September 2017 Reuters consensus poll, there is significant downside risk to Treasury's earlier headline inflation forecasts (see chart 3).

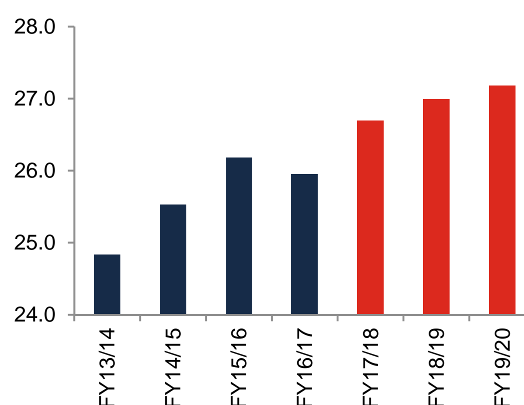
Chart 3: Headline inflation projections (%)



Source: Reuters, National Treasury, Reserve Bank, Momentum Investments

subdued economic growth leaves SA with very little room to manoeuvre fiscally. SA's tax burden (tax revenue-to-GDP ratio) is already at 26.0% and is expected to climb over the medium-term expenditure framework (MTEF) to 27.2% (see chart 4). In the current year, personal income tax (PIT) for the highest income-earning bracket was raised from 41% to 45%. This has raised the question of whether or not the country has reached the downward-sloping portion of the Laffer curve, which illustrates a decrease in tax revenues after an optimal tax rate has been reached.

Chart 4: SA's rising tax burden (%)



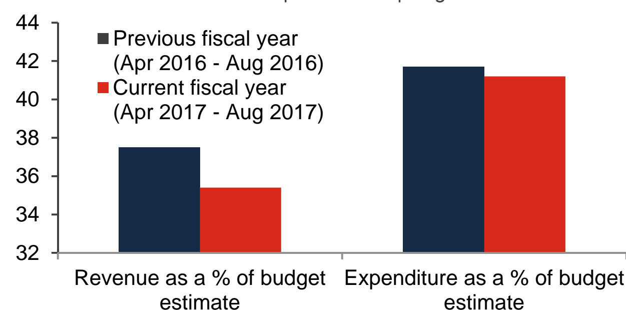
Source: National Treasury, Momentum Investments

The SA Revenue Service (SARS) has voiced its concerns over a disturbing trend, where tax compliance levels are deteriorating. Multiple allegations against the authorities at SARS may have eroded trust in the institution, which could negatively affect tax morality going forward and worsen the pressure on revenue collection in a low growth environment.

Tax collections undershooting Treasury's February 2017 projections

Revenue collection as a share of the budget estimate for the first five months of the current fiscal year (FY2017/18) appears to be falling slightly behind (35.4% of the original budget estimate), when compared to the same period in the previous fiscal year (37.5% of the original budget estimate). However, trends in expenditure are broadly in line with the same period in the previous budget year (see chart 5).

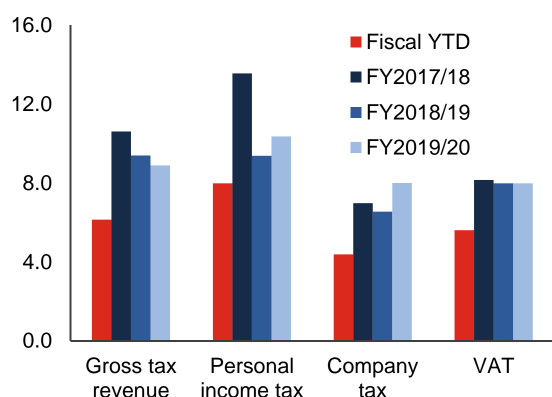
Chart 5: Revenue and expenditure progress (%)



Source: Global Insight, National Treasury, Momentum Investments

The largest revenue disappointment has been in PIT. The13.6% year-on-year (y/y) projection for PIT in FY2017/18 (see chart 6) would have included fiscal drag measures and the rate increase announced for the highest marginal tax bracket from 41% to 45%. However, a moderation in average wage settlements and sluggish employment growth has contained the year-to-date (YTD) increase in PIT at 8.0% y/y.

Chart 6: Key government revenue projections (% y/y)



Source: Global Insight, National Treasury, Momentum Investments

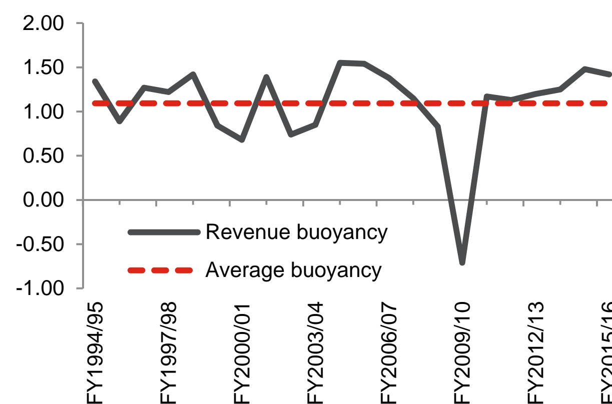
Company taxes increased 4.4% y/y YTD, which is also notably lower than government's full-year 7.0% projection. The run rate may, however, improve into December 2017, when seasonal lumpy receipts are generally noted. The YTD run rate in value-added taxes (VAT) is also behind schedule. VAT receipts are 5.6% higher relative to the previous fiscal year on a YTD basis, while government's target is a more optimistic rate of 8.2%. According to Macquarie, the weakness in VAT is largely owing to a disappointment in VAT on imported goods and an underperformance in domestic VAT.

Overall, government previously projected an increase in gross tax revenues of 10.6% in FY2017/18, relative to the previous fiscal year. Currently, gross tax revenues are undershooting and are only tracking at 6.1% y/y. If the current YTD average growth rate is extrapolated for the remainder of the year, the annual gross tax revenue shortfall would amount to R51 billion. The shortfall is likely to be lower owing to seasonal factors and some acceleration in the underlying economy for the remainder of the fiscal year. Citi estimates the annual shortfall to be around R33 billion based on historic seasonal revenue trends between September and March, which equates to a widening of the main budget deficit ratio (as a share of GDP) from Treasury's February 2017 estimate from 3.5% to 4.3%.

This, however, does not take into account the current expenditure shortfall, which is likely to more than halve the extent of the fiscal slippage just based on the expected revenue shortfall. Total government expenditure is growing at 6.9% y/y YTD, which is softer than the 8.1% projected rate. If this shortfall persists, government expenditure could amount to R14.9 billion less in FY2017/18 than initially estimated in the February 2017 national budget. Moreover, Treasury is likely to reprioritise a portion of its non-interest expenditure and may even announce further cutbacks in expenditure.

In Momentum Investments' view, tax buoyancy rates are likely to disappoint. Overall, the tax buoyancy ratio averaged 1.28 between FY2010/11 and FY2015/16 (see chart 7), implying that for every 10% growth in nominal GDP during that period, 12.8% growth in revenue collection was achieved on average. However, a persistent negative output gap is likely to drive the tax buoyancy ratio even lower than the average 1.2 forecasted by Treasury over the MTEF. In addition, revenue shortfalls owing to a weak growth environment are expected to persist in the medium term. Though government alluded to an additional R15 billion in tax revenue measures in FY2018/19, more may be necessary to help offset fiscal slippage.

Chart 7: Tax revenue buoyancy ratio

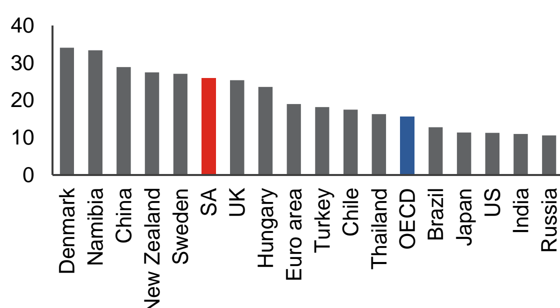


Source: National Treasury, SARS, Momentum Investments

Tapping additional tax avenues

At 26%, SA's tax burden (or tax-to-GDP ratio) is considerably higher than the average rate for the Organisation for Economic Co-operation and Development (OECD) member countries (see chart 8). In particular, SA's personal and corporate income tax rates are comparatively high, when ranked against the same sample set of countries, while SA's VAT rate is much lower than in other jurisdictions, especially when considering those with a high level of social spending.

Chart 8: Tax burden in selected countries (%)



Source: World Bank, Momentum Investments

The low growth environment makes increasing the VAT rate a politically unpalatable choice, especially with the 2019 national elections looming. In February 2017, the Davis Tax Commission (DTC) indicated an increase in VAT would be inappropriate at this stage, as tax measures should not unduly prejudice poor households. The DTC previously estimated a 1% to 2% increase in the VAT rate could reduce real GDP growth by between 0.2% and 0.4%.

While previously the DTC 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).

Other means to close the revenue gap include a potential wealth tax in the form of either an annual wealth tax, a national tax on the value of property (over and above municipal rates) or a land tax. Very few developing countries have an annual tax on wealth. Even in the OECD composite, the number of member countries implementing a wealth tax dropped from 50% in 1990 to only France, Norway and Switzerland in 2010, given the administrative burden. Since this tax is targeted at a smaller number of wealthier individuals, collections are likely to be limited to between 1% and 2% of total revenues (see table 1). Nevertheless, given the diversity of opinions on the desirability and feasibility of such a tax, implementation may be delayed.

Table 1: Additional revenue streams

Possible revenue measures	Intake	Likelihood
Fiscal drag	R12bn (previous budget)	Very high probability
Fuel levies or VAT on fuel	R3.2bn (previous budget) or R18bn	High probability
Sin taxes – alcohol & tobacco	R2bn (previous budget)	High probability
Sugar tax	R2bn	High probability – delays?
Wealth tax	1-2% of revenue	High probability – delays?
Carbon tax	Initially revenue neutral	High probability – delays?
Removal of medical aid tax credit	R20bn	Moderate probability (higher in medium term)
Dividend withholding tax	R6.8bn (previous budget)	Moderate probability (increased previously)
Taxing top marginal bracket	R4.4bn (previous budget)	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, Macquarie, National Treasury, Momentum Investments

Aside from the high likelihood of fiscal drag (amounting to R12 billion in the February 2017 national budget) and an increase in sin taxes (R2 billion previously), removing the zero rating on fuel has been raised as an option to generate additional revenue. In the February 2017 national budget, government hinted at expanding the VAT base in 2018/19 by removing the zero rating on fuel. It announced this tax would be subject to consultation leading up to the 2018 budget. To mitigate the effect on transport costs, Treasury will consider combining this proposal with a freeze or decrease in the fuel levy. According to Nedbank, this option could generate up to R18 billion in additional revenues.

The DTC previously revealed effective tax rates paid by companies (at around 18%) are much lower than the official 28% rate, on account of incentives that reduce the effective rate. While there is unlikely to be a corporate tax increase in the near term, curbing transfer pricing and base erosion profit sharing, which the DTC is addressing, would be a step closer to closing the gap between the official and effective corporate tax rates.

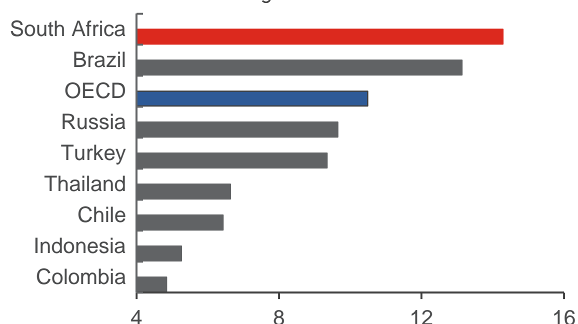
Public sector wages up for renegotiation

The three-year wage agreement signed with the public service unions in 2015 included a 7% wage increase in the first year and inflation plus 1% in the latter two years. The actual increase was 2% higher than negotiated after additional benefits were included.

In the first pillar of a rehashed 14-point plan, Finance Minister Malusi Gigaba outlined the need for government to finalise a new sustainable wage agreement by February 2018, before the current deal expires in March 2018.

At 14.3% of GDP, SA's civil servant wage bill ranks higher than OECD and emerging market averages (see chart 9).

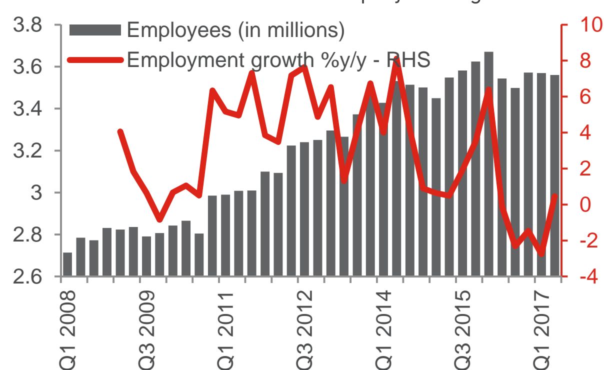
Chart 9: Government wage bill (% of GDP)



Source: OECD, Momentum Investments

SA's public sector workforce peaked at 3.7 million in the first quarter of 2016, but over 110 000 workers have been shed since, in line with government's strategy to limit hiring (see chart 10). The OECD proposes, in addition to freezing the recruitment of civil servants (with the exception of indispensable workers), the SA government should make a concerted effort to limit wage increases. In the February 2017 national budget, Treasury pencilled in an average 7.2% growth rate in the wage bill over the MTEF.

Chart 10: Government sector employment growth

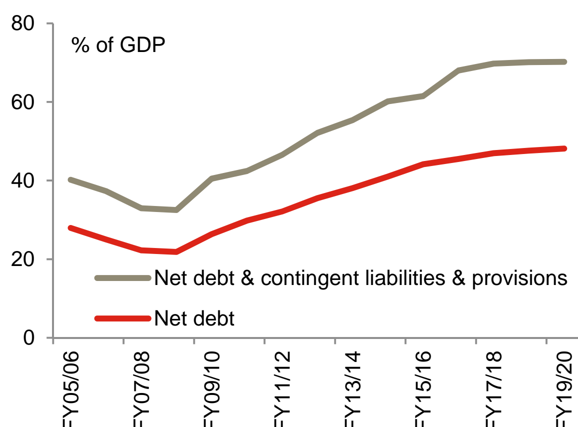


Source: Global Insight, Stats SA, Momentum Investments

Maladministration and financial concerns at some of SA's large state-owned enterprises (SoEs)

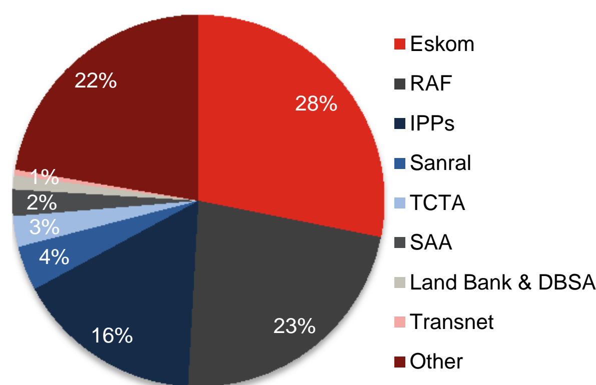
Government net debt increased rapidly from 21.8% of GDP in FY2008/09 to an estimated 45.5% of GDP in FY2016/17 (see chart 11). The OECD notes sustainable debt management tends to limit debt targets to between 40% and 55% of GDP, depending on the individual country's ability to raise revenue, its trend growth and types of fiscal risks the country faces. The OECD points to the April 2017 ratings downgrade into junk status and rising contingent liabilities as the main risks to SA's debt sustainability.

Chart 11: Government debt and guarantees



Source: National Treasury, Momentum Investments

Chart 12: Contingent liabilities (% of total FY16/17)



Source: National Treasury, Momentum Investments

Moody's ratings agency has 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) account for the bulk (see chart 12). 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, as it has allocated R350 billion in SoE guarantees to the energy utility, of which R218 billion has been utilised to date. In February 2017, government announced the guarantee would be extended to March 2023 to facilitate Eskom's build programme.

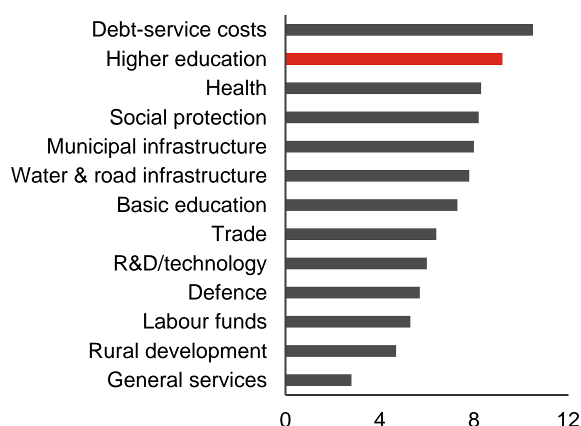
The perception of rising corruption at SA's SoEs has triggered an increase in shareholder activism, which could pose difficulties for raising local funding. This, in turn, would increase the burden on either direct budgetary support or international funding needs. While some SoEs are making an attempt to replace compromised board members, more attention needs to be placed on greater accountability and performance management. The ratings agencies are closely monitoring continual government bailouts (including R5.0 billion handed to SA Airways (SAA) in the past two months), the threat cash injections and guarantees pose to government's fiscal balances and policy priorities and whether or not government will take a firmer stance against ailing SoEs.

Higher education funding remains a structural challenge

Although direct government funding has declined to 40% of universities' overall income in the past 15 years, indirect government funding through the National Student Financial Aid Scheme (NSFAS) has increased in the same period. Nonetheless, the OECD shows spending per student in SA is still well below the OECD average and other emerging countries. Moreover, the total subsidy does not fully cover staff costs, forcing universities to increase student fees. Confronted with rising higher education fees, students engaged in a protest in 2015, calling for free education.

In 2016, fees were frozen at 2015 levels, with government covering the shortfall. Government recommended a maximum university fee increase of 8% in 2017. In the February 2017 national budget, government allocated a total of R117.7 billion to higher education over the MTEF, which leaves higher education as the second-fastest growing expenditure item, outstripped only by the growth in the interest bill (see chart 13).

Chart 13: Average growth in expenditure over the MTEF



Source: National Treasury, Momentum Investments

Government quashed the notion of a graduate tax as the sole solution to funding higher education.
Treasury estimates a 1% increase in new graduates' tax rates would raise around R200 million in the first year or R3 billion if the increase is applied to all graduates.
This pales in comparison to the R59.8 billion spent by 26 public universities in 2015. The commission investigating the feasibility of fee-free higher education and training in SA (established in January 2016) has finalised its report and handed over its recommendations to the Presidency, which is expected to make the report public after reviewing it.

A worsening in fiscal dynamics poses a risk to SA's sovereign rating

S&P and Fitch downgraded SA's foreign currency rating to sub-investment grade in April 2017, following a damaging cabinet reshuffle, which raised the risk of an adverse change in the direction of economic policy and fiscal policy management. However, the ratings, which matter most for SA's inclusion in the Citi World Government Bond Index (WGBI) are the local ratings by S&P and Moody's, which still rank one notch above sub-investment grade (see chart 14).

Chart 14: SA's sovereign ratings

LONG-TERM RATING	S&P	FITCH	MOODY'S
INVESTMENT GRADE	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
SUB-INVESTMENT GRADE	BB+	BB+	Ba1
OUTLOOK	Negative	Stable	Negative

Red = foreign rating
Gray = local rating

Source: S&P, Moody's, Fitch, Momentum Investments

While the rating agencies may choose to remain on hold at the upcoming November 2017 reviews (in anticipation of the highly-uncertain outcome of the African National Congress National Elective Conference in December 2017), weak growth and fiscal concerns point to a higher-than-even chance of further negative ratings action by June 2018. Potential growth remains muted and real GDP growth will likely struggle to outpace population growth in SA in the next few years.

Low levels of real GDP per capita will add to social spending pressures in Momentum Investments' opinion. Aside from low economic growth, rising political tensions are accentuating economic and social vulnerabilities.

Although prudent monetary policy, quality fiscal institutions and SA's floating exchange rate regime (acting as a shock absorber) have in the past been noted as vital pillars of strength in SA, rising perceptions of political interference in key spheres of government institutions threaten SA's macroeconomic performance. SA's potential growth profile and overall governance could be negatively affected by political infighting, distracting policymakers from adhering to sound fiscal management and maintaining a healthy investment climate through the implementation of growth-enhancing policy initiatives.

A downgrade in SA's local currency rating to junk status by S&P and Moody's would trigger SA's exclusion from the Citi 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 buying into the index inclusion might have been staggered, the exit door could be crowded. 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).

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