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Medium-term budget preview: The challenge of lifting the country's growth potential without risking fiscal consolidation

Highlights

- The credible appointment of former Reserve Bank governor, Tito Mboweni, to the helm of the finance ministry has been well received by the market.
- The weak performance of the economy in the first half of the year points to downward revisions to Treasury's growth assumptions.
- Softer-than-anticipated domestic growth prints are suggestive of a likely undershoot of Treasury's tax collection targets.
- A tepid growth environment leaves available fewer obvious additional revenue streams to be tapped.
- Limited probability of a major breach in government's self-imposed expenditure ceiling, as Treasury attempts to reprioritise spending within the existing framework.
- A sharp deterioration in municipal audit results sheds light on wasteful and fruitless expenditure, which could be redirected to promote sustainable and inclusive growth.
- Funding for government's long-term spending commitments underscores the need for the implementation of structural reforms to better the country's growth prospects.
- The poor financial standing of some of the country's key parastatals poses a risk to the overall debt trajectory.
- Momentum Investments expects the country's sovereign ratings to remain steady into the end of the year, in line with a projected improvement in growth and fiscal dynamics in the medium term, but only if additional guarantees to ailing parastatals are granted on a market-acceptable conditional basis.

New finance minister expected to toe the fiscal line

Former Finance Minister Nhlanhla Nene's request to be relieved of his duties, following unresolved accusations, resulted in South African (SA) President Cyril Ramaphosa accepting his resignation and appointing Tito Mboweni as the fifth finance minister in less than three years. Mboweni is expected to hit the ground running, with the Medium-term Budget Policy Statement (MTBPS) scheduled to take place on 24 October 2018.

Mboweni is well known to the investor and political communities, having served as the eighth governor of the SA Reserve Bank (SARB) between 1999 and 2009. Moreover, Mboweni served as the Minister of Labour between 1994 and 1998 in former President Nelson Mandela's cabinet. Mboweni was also a member of the African National Congress's (ANC) National Executive and National Working Committees and performed the role of Chairperson of the National Executive Committee's (NEC) Economic Transformation Committee, which co-ordinated the development of economic policies for the ruling party. He further served a two-year term as a non-executive director for SA on the board of the Brics New Development Bank.

His appointment was viewed as a low-risk event by the market and was welcomed by investors as evidenced by a strengthening in the local currency. Similarly, rating agencies are likely to be comforted by Mboweni's experience and trusted record in previous positions in the policy-making environment.

It should be noted Mboweni also holds a fairly substantial amount of political clout given his election at 11th position on

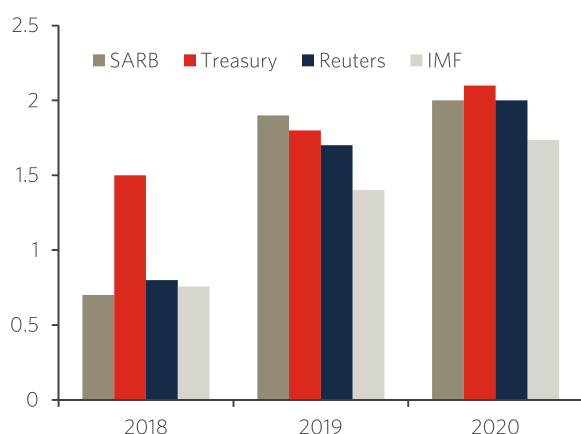
the ruling party's NEC, following the ruling party's 54th national conference in December 2017. In comparison, Nene has never served on the NEC and former Finance Minister Pravin Gordhan (current Minister of Public Enterprises) registered at 19th position.

Weaker growth prospects

A larger-than-expected rundown in inventories in the second quarter of 2018 led to a second consecutive quarterly contraction in real growth in gross domestic product (GDP). This resulted in a technical recession for the first half of the year, causing investors to downgrade their full-year assumptions.

The market's consensus growth estimate for 2018 has deteriorated since the release of the growth figure for the second quarter. According to the Reuters Econometer survey, the median estimate for growth in 2018 declined from 1.8% in May 2018 to 0.8% in September 2018 and from 2.0% in May 2018 to 1.7% in September 2018, for 2019 (see chart 1). Projections for 2018 from the International Monetary Fund (IMF) were similarly downgraded from 1.5% in the July 2018 World Economic Outlook (WEO) update to 0.8% in the October 2018 WEO. The IMF also pared back its 2019 growth assumption for SA from 1.7% to 1.4%.

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



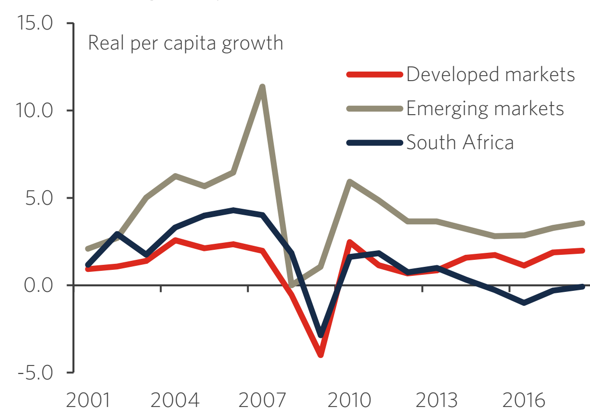
Source: Treasury, SARB, Reuters, IMF, Momentum Investments

The SARB has correspondingly cut its growth forecasts for 2018 from 1.7% in May 2018 to 0.7% in September 2018. Its 2019 growth estimate, however, edged higher from 1.7% to 1.9% in the corresponding period. In comparison, Momentum Investments expects the economy to grow at 0.8% in 2018 and 1.8% in 2019.

As such, Treasury's February 2018 estimate for growth in 2018 appears too stretched at 1.5% and is expected to drop in line with the consensus view.

Downward phases of business cycles in SA have had an average duration of 20 months since 1945. However, the current downward phase calculated by the SARB reached 58 months in September 2018, which exceeds the longest confirmed downward phase of 51 months that stretched across the early 1990s in the period preceding democracy.

Chart 2: Weak domestic growth trend diverging from more robust global patterns



Source: IMF, Momentum Investments, data up to 2018

The IMF confirms the average yearly increase in real growth per capita in SA has been lower than that of emerging markets (EMs) since 2001 (see chart 2). Real per capita growth in SA outperformed that of developed markets by an average of 1.4% between 2001 and 2009, but has significantly underperformed more robust global trends in the past five years.

Chart 3: Stable international commodity prices

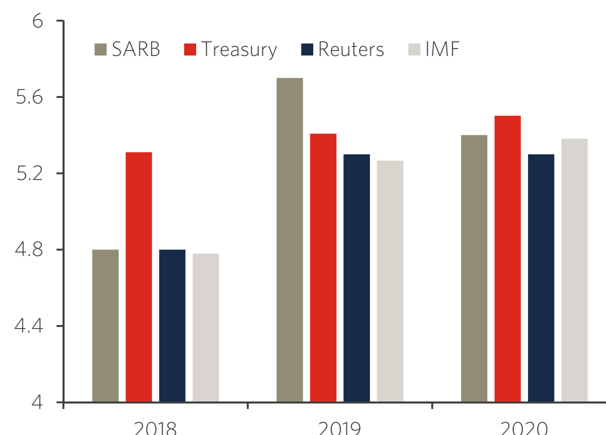
Source: Bloomberg, Momentum Investments

Going forward, Momentum Investments expects a mild improvement in domestic-led growth, as the policy and regulatory environment improves. Export growth could, however, remain moderate on rising protectionist measures, a slow rise in commodity prices (see chart 3) and softer global growth in 2020; the latter a consequence of an anticipated downturn in the United States economy.

Momentum Investments expects a downward revision to Treasury's inflation forecasts for 2018, which were previously estimated at 5.3% in February 2018 (see chart 4) and a slight upward adjustment to the 5.4% figure projected for 2019. Momentum Investments sees headline inflation averaging 4.8% for 2018, rising to 5.5% in 2019. Sustained rand weakness, geopolitically driven higher international oil prices and steeper-than-expected electricity tariff increases for 2019 continue to pose an upward threat to the inflation trajectory.

In its February 2018 national budget, Treasury estimated nominal GDP growth to average 7.3% between fiscal year (FY) 2018/19 and FY2020/21. In comparison, Momentum Investments expects a marginally higher average of 7.4% for the corresponding period.

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

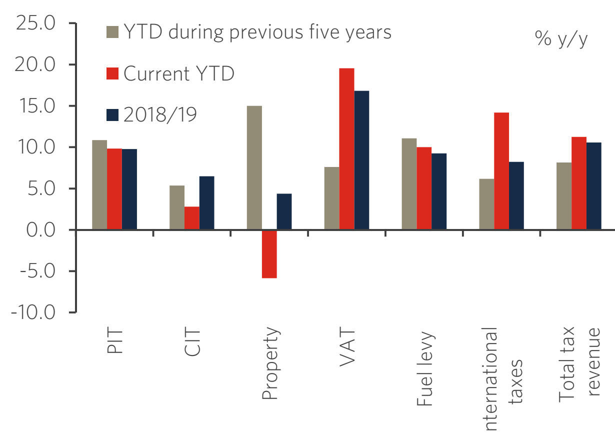


Source: Treasury, SARB, Reuters, IMF, Momentum Investments

Tax collection targets likely to be missed on downgraded growth outlook

Growth in total tax revenue recovered from an average of 9.9% for the first three months of FY2018/19 to a 13.8% average for July and August 2018.

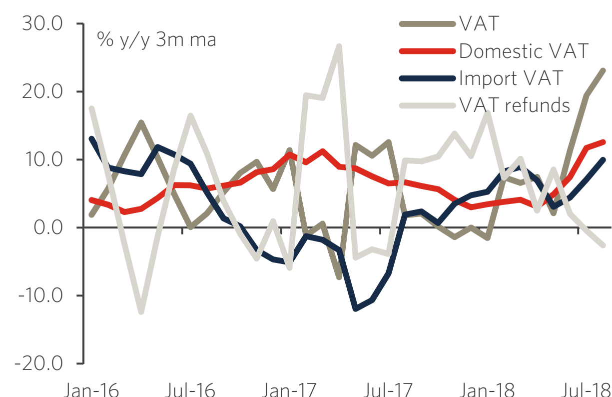
Chart 5: Property and company taxes are lagging



Source: Treasury, Global Insight, Momentum Investments

Although the year to date (YTD) average growth rate in total tax revenue (11.2%) suggests Treasury's February 2018 target for the full fiscal year (10.6%) could be met (see chart 5), an expected downgrade to Treasury's growth projection for 2018 and 2019 implies its February 2018 tax collection targets are likely to be missed. In its February 2018 national budget, Treasury warned the decline in tax buoyancy observed in the previous two years could take longer to increase than forecasted. It initially forecasted a tax buoyancy ratio (revenue growth to economic growth) of 1.51 for FY2018/19. In Momentum Investments' view, the tax buoyancy rate for personal income tax (PIT) and corporate income tax (CIT) could be lower than Treasury's assumption, while the value-added tax (VAT) buoyancy rate may be higher than Treasury's initial estimates.

Chart 6: VAT revenue collection trends



Source: Treasury, Global Insight, Momentum Investments

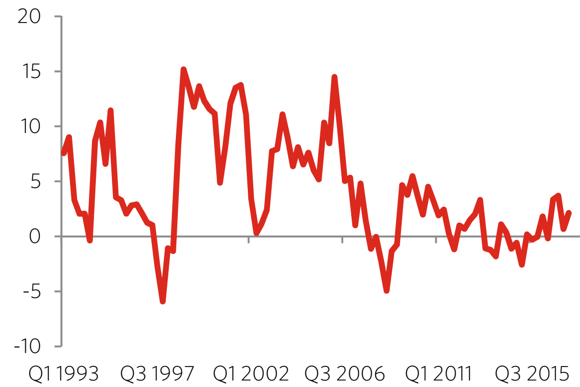
Growth in PIT collections for the first five months of FY2018/19 (9.7%) appear healthy relative to the previous five-year average (10.8%) on a fiscal YTD basis.
Upward adjustments to the VAT rate from 14% to 15% and additional fuel taxes announced in the February 2018 national budget have led to an outperformance in VAT (19.5%) and fuel levies (9.2%) collected YTD, while a poor economic

environment resulted in an underperformance in the collection of CIT (2.8%) and property taxes (negative 5.9%).

Within the VAT category, growth in domestic VAT performed reasonably well (12.2%) in spite of consumer stress (see chart 6) and import VAT grew at a robust 12%, in line with strong import growth registered by the SA Revenue Services. Growth in this category could, however, slow in line with softer import growth anticipated, as a consequence of a weaker currency. Growth in VAT refunds remained slow, which could lead to a partial reversal in the strong YTD VAT collections when the refunds are eventually paid out.

The underperformance in CIT revenues tallies with the SARB's data on growth in operating surplus, which has averaged a mere 1.4% in inflation-adjusted terms for the first half of 2018 (see chart 7). Growth in operating surplus was weakest in the agriculture, manufacturing and transport industries in the first half of the year and strongest in the trade and construction industries.

Chart 7: Real growth in operating surplus



Source: SARB, Global Insight, Momentum Investments, data up to Q2 2018

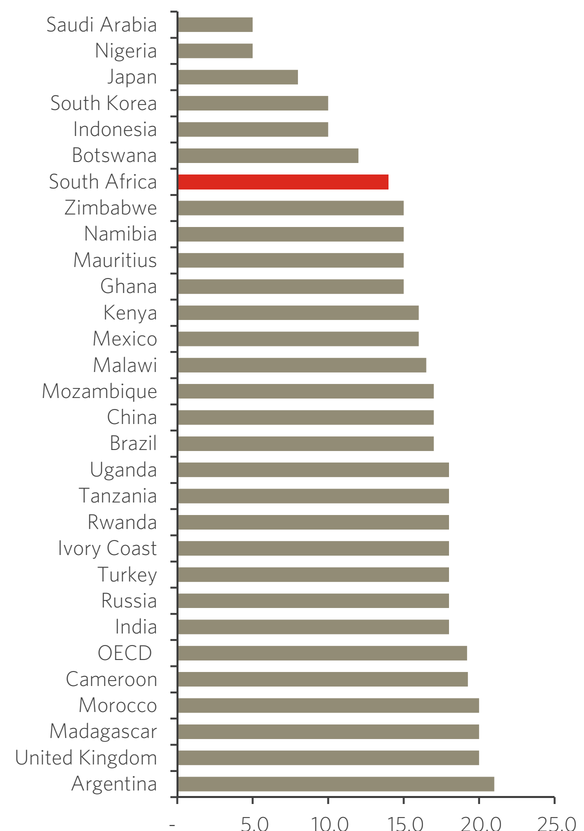
Additional revenue streams becoming less obvious

After taking the latest PIT hike (from 41% to 45% for the top-income-earning bracket) into account, Nedbank calculated the country may have passed the peak point of the Laffer curve using effective tax rates (tax collected divided by total assessed income). This suggests additional increases in the PIT rate could negatively affect tax collections, as cases of tax avoidance, tax evasion and negative growth spill-overs start to emerge.

Likewise, an additional increase in the VAT rate (the VAT rate increased to 15% from 14% on 1 April 2018, but still placing it at the lower end on a global comparison, see chart 8) would be difficult to initiate in an environment of low growth and cash-strapped consumers. Concerns have been raised about the effect of the increase in the VAT rate on low-income households. The independent panel reviewing zero VAT rating noted the increase in the VAT rate would cost poor households an additional R216 per year.

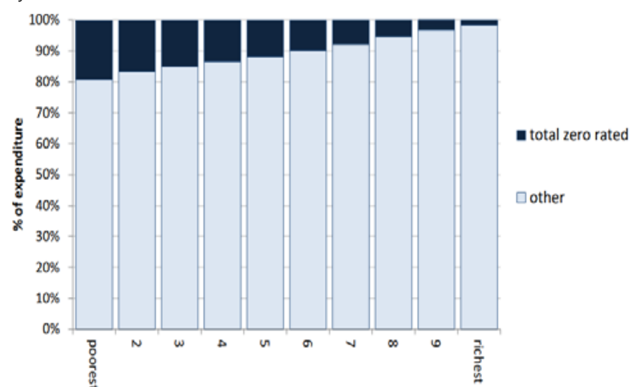
The current VAT system allows for the exemption of 19 basic food items, which are predominantly consumed by poorer households (see chart 9). The panel recommended white bread, white flour, cake flour, sanitary products, school uniforms and nappies be additionally considered to allow VAT to become more progressive, while not becoming too burdensome on the fiscus.

Chart 8: Global VAT rates comparison (%)



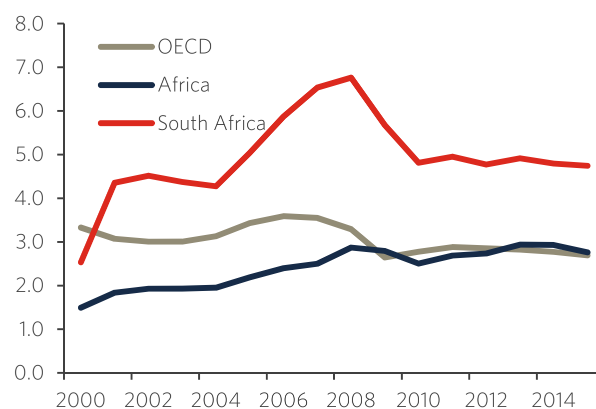
Source: Treasury, Momentum Investments

Chart 9: Share of expenditure on zero-rated goods by decile



Source: Treasury

Chart 10: Comparative CIT rates (%)



Source: Treasury, Momentum Investments, data up to 2015

Treasury has indicated SA's CIT share of GDP at close to 5% is much higher than that of Africa and the countries belonging to the Organisation for Economic Cooperation and Development (OECD), which rank closer to 3% (see chart 10). Government's commitment to an Investment Summit to attract R1.2 trillion in new investments for the next five years could rule out the possibility of an increase in the CIT rate to preserve the country's investment attractiveness to foreigners.

The Department of Energy's intervention into the fuel price in September 2018, to provide relief to the consumer, and currently high fuel prices may also prevent government from raising general fuel levies or the Road Accident Fund (RAF) levy in the February 2019 national budget.

As such, the only likely tax increases to emerge in the February 2019 national budget are sin taxes on alcohol and tobacco-related products and limited compensation for bracket creep (fiscal drag).

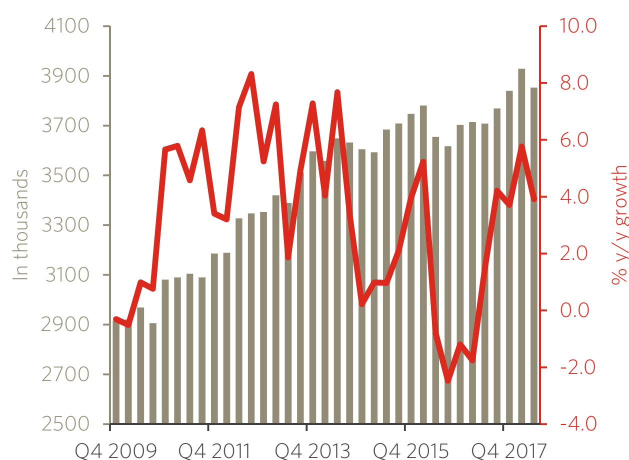
The carbon tax was first discussed in 2010, but has been delayed since. It was initially reviewed by the Davis Tax Committee in 2015, before Treasury published a Draft Carbon Tax Bill for public comment, which was open until March 2018. The February 2018 national budget indicated the actual date of implementation would be 1 January 2019 and 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.

A major breach of the expenditure ceiling is unlikely

Government is likely to keep its expenditure growth below its self-imposed ceiling. The contingency reserve (money set aside for uncertainties related to the economic outlook, the finances of state-owned enterprises (SoEs) and other spending pressures) is likely to be drawn down for FY2018/19 from R8 billion. An additional R8 billion was set aside for FY2019/20 and R10 billion for FY2020/21, of which less is likely to be drawn down given the greater need for contingency reserves further out, in line with an escalation in the level of uncertainty.

Government's three-year wage deal finalised in June 2018 exceeded the budget for the civil servant wage bill by R30 billion. Treasury noted cost containment measures and a reprioritisation of funding would have to be used to prevent a fiscal overrun.

Chart 11: Bloated civil-servant workforce



Source: Global Insight, Momentum Investments, data up to Q2 2018

Government's wage bill, which swallows more than 35% of government's budget, is likely to remain sizeable given the higher-than-anticipated three-year wage deal and a promise from government (announced at the October 2019 Jobs Summit) that there will be no forced retrenchments in the public sector, which accounted for 3.9 million employees in the second quarter data for 2018, after including jobs in the utilities sector (see chart 11).

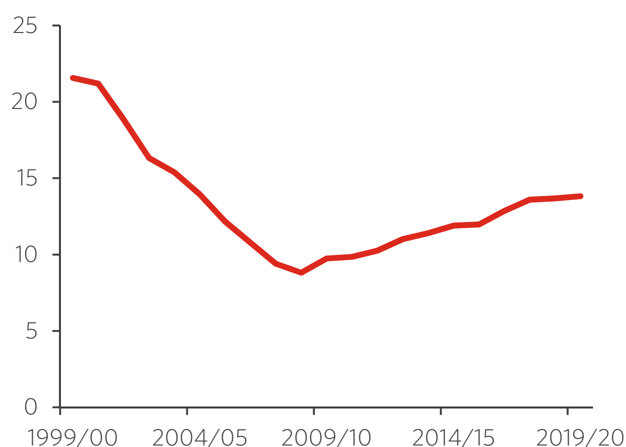
The recently announced stimulus package to uplift the economy is expected to cost R43 billion, but government noted it would be funded from "existing budgetary resources and the pursuit of new investments, while remaining committed to fiscal prudence".

While there are no obvious areas to reduce spending, cuts have to be made to balance the books. In addition to the R43 billion stimulus package, the announcement of a R400 billion infrastructure fund is expected to be funded by existing budget allocations to municipal, provincial and national infrastructure.

Higher growth prospects are needed to fund long-term spending commitments

The country's debt servicing costs are the highest growing expenditure item in the budget. As a share of revenue, debt servicing costs are approaching 15%, which is a key level monitored by the rating agencies (see chart 12).

Chart 12: Debt servicing costs are approaching 15% of revenue



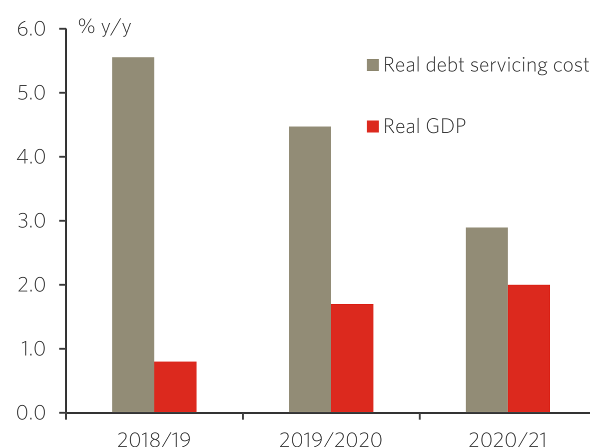
Source: Treasury, Momentum Investments

Real growth in debt servicing costs (using the Reuters consensus inflation expectation for the next three years) eclipses the market's expectations for real growth in the economy for the same period (see chart 13).

Aside from a burgeoning civil servant wage bill and onerous debt-servicing costs, government has highlighted three key spending commitments, which require a significant budget allocation.

Social grants are anticipated to peak at 3.5% of GDP (3.8% of GDP in a low growth scenario) in 2030, from 3.3% currently. While 17.3 million recipients receive a social grant, this is set to increase to 23.5 million by FY2030/31.

Chart 13: Real debt servicing costs are expected to outstrip real growth in the economy



Source: Reuters, Treasury, Momentum Investments

One of the fastest-growing expenditure items in the budget is post-school education and training. Treasury conducted an exercise, where it, together with the Department of Higher Education, estimated the total costs of providing financial aid to cover the full cost of studies for 30%, 50% and 75% of undergraduate students. The exercise was based on the White Paper, which assumes university enrolments would increase from 980 000 in 2015 to 1.6 million in 2030 and enrolments at Vocational Education and Training (TVET) colleges would increase from 730 000 students to 2.5 million in the same timeframe. The study revealed funding for the full cost of 75% of university and TVET students (and additional subsidies to poor and middle-income students) would increase to 4.1% of GDP by FY2030/31.

Finally, the White Paper for the National Health Insurance (NHI) published in June 2017 indicated the full implementation of the NHI would increase costs from 3.9% of GDP in FY2017/18 to 6.2% (6.8%) by FY2025/26 in an environment where long-term growth averages 3.5% (2.5%).

A sharp deterioration in municipal audit results

Auditor General Kimi Makwetu reported a significant deterioration in the audit results for the public sector for FY2017/18. The results revealed irregular expenditure at national and provincial departments and their entities increased to R50 billion from R45 billion in the previous year. Fruitless and wasteful expenditure more than doubled to R2.5 billion from R1 billion in the previous year, while unauthorised spending picked up by 38% to R2 billion.

Alarmingly, only 59 public sector entities achieved a clean audit for FY2017/18, compared with 85 in the previous year's audit. The Auditor General highlighted there were increased attempts to contest findings, suggestive of less accountability.

Although the Public Audit Amendment Bill has been passed by Parliament, it still needs to be signed by the president to allow the Auditor General to enforce accountability.

In Momentum Investments' opinion, it is imperative to curb irregular expenditure in the current strained fiscal environment and allocate spending to areas where it is needed most to support sustainable growth.

SoE financing is a risk to the longer-term debt trajectory

Although there has been an overhaul in the leadership of key SoEs, the financial position of a number of parastatals remains in a precarious position.

SA Airways (SAA) announced it required R21.7 billion in funding over the next three years in a combination of debt and cash from Treasury. In April 2018, it secured a bridging loan of R5 billion from Treasury. Media reports have intimated the entity will sell off its catering arm or SAA cargo to recoup some cash.

Denel, which has government guaranteed debt of R2.7 billion, requested an addition R1 billion guarantee and a cash injection to recapitalise its business.

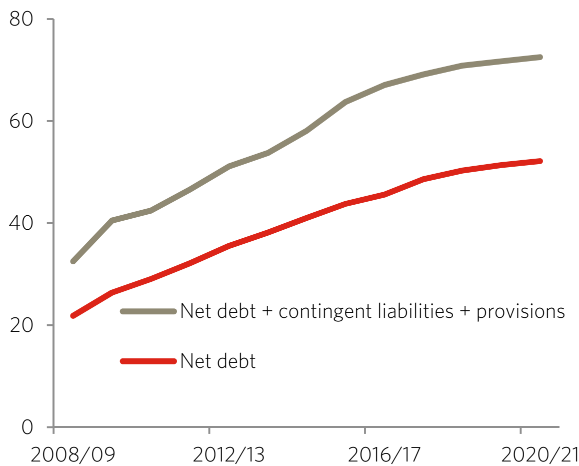
SA Express declared it needed an additional R1.7 billion to keep its aircraft flying, while Sanral's failed e-tolls model may cause the entity to require a capital injection.

From the SoEs in financial distress, Eskom poses the largest burden to the fiscus, given its relative size and the strategic role it plays in supplying 90% of the country's energy. While Eskom requires higher prices to prop up its revenue, higher prices have led to a reduction in customer demand, lowering volumes. Energy regulator, Nersa, has granted Eskom a 4.1% increase (effective from April 2019). The entity was allowed to recover R32.7 billion from three separate Regulatory Clearing Account applications, over a four-year period from FY2019/20. The fourth multi-year price determination (MYPD4), which covers a three-year horizon to March 2022 has yet to be published, but Eskom is widely expected to request a 15% increase.

Additional allocations to the SoEs could be done through the money available in the contingency reserve, where the budget outcome remains the same or through a special appropriation, which would keep the expenditure ceiling intact, but could cause a widening in the budget deficit. In either event, Momentum Investments believes credible turnaround plans are needed in exchange for additional guarantees to not be viewed as ratings negative.

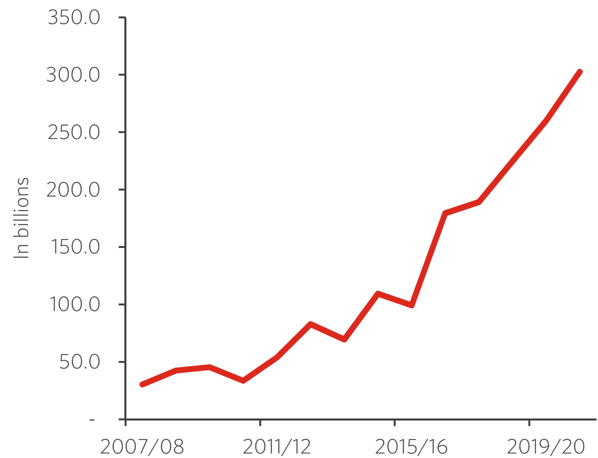
While Treasury anticipates the ratio of SA's net debt to GDP to increase to 52.2% by FY2020/21, the addition of provisions and contingent liabilities (including guarantees) takes the ratio of overall debt-to-GDP higher to 73% by FY2020/21 (see chart 13), which is significantly higher than the 60% limit often quoted as a threshold above which fiscal sustainability is threatened.

Chart 13: Total debt as a % of GDP



Source: Treasury, Momentum Investments

Chart 14: Growing RAF liability



Source: Treasury, Momentum Investments

The Road Accident Fund (RAF) contributed nearly a quarter to government's total contingent liabilities in FY2016/17. In the February 2018 budget, government assumed the RAF contingent liability would reach R302.3 billion by FY2020/21 (see chart 14).

With the total combined fuel taxes on petrol equating to 38.4% of the pump price in February 2018, funding the RAF liability through additional RAF taxes will be a tough ask.

Structural reforms are necessary to bolster inclusive growth

The IMF has outlined a number of key structural reforms (some of which are outlined in chart 15), which need to be acted upon to reignite strong and inclusive growth.

Chart 15: Structural reforms needed to reignite inclusive growth in SA

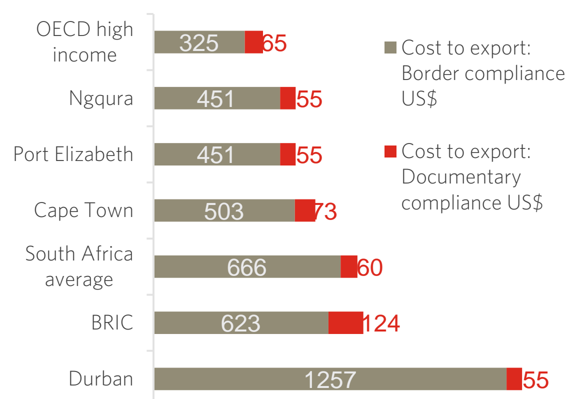
Agriculture & mining	*Electricity*	*Transport & comm.*	*Finance*	*Public sector*	*Education*	*Trade & tourism*
Growth-friendly land reform	Fix Eskom's balance sheet	Broadband spectrum	Use tech to increase competition	Cut wasteful expenditure	Improve basic education	Ease visa regulations
Clarity over mining charter	Optimise energy mix	Subsidies for poor	Reduce entry cost	Contain risk from decentralised entities	Train teachers	Limit exclusivity of business leases
Farmer access to credit	Involve private sector	Single regulator		Cut red tape	Align training with business requirement	
Cheaper agricultural insurance	Transparent tariff process	Disinvest in PRASA and Transnet		Improve efficiencies of SoEs		
Training for small-scale farmers	Reduce municipal reliance on electricity tariffs	Divest SAA				
Investment for beneficiation	Unbundle Eskom	Review of port and rail tariffs				

Source: IMF, Momentum Investments

The latest stimulus package announced by government touches on a few of these issues, including the easing of visa regulations, cutting wasteful expenditure, releasing broadband spectrum, directing investment towards beneficiation, providing clarity in the mining sector (with the announcement of the third Mining Charter and the scrapping of the Mineral and Petroleum Resources Development Act Bill) and reviewing the port and rail tariffs.

According to the World Bank, exporting through SA's ports is nearly twice as expensive as through OECD high-income economies that export by sea (see chart 16).

Chart 16: Cost to export is high in SA



Source: World Bank. Momentum Investments

Sovereign ratings likely to remain steady into the end of the year

In the aftermath of the Turkish turmoil, which led to further sovereign ratings downgrades in Turkey, Standard and Poor's (S&P) Global Ratings highlighted SA's differences with Turkey. It noted SA faced low external pressure and its monetary flexibility was viewed as a credit strength. In contrast, the ratings agency projected a sharp deterioration in Turkey's balance of payments (as a consequence of the steep sell-off in the Turkish lira) and stressed concerns over the lack of independence at the Central Bank of Turkey.

Earlier in the year, Moody's rating agency admitted it was looking for a gradual recovery in the SA economy and it was taking a wait-and-see approach to land reform, given that populist political posturing could be affecting the narrative.

According to Morgan Stanley and the Moody's ratings review model, SA would only be downgraded if its susceptibility to event risk was downgraded by two notches or if its economic strength and fiscal strength each dropped a notch.

With Moody's only looking for a stabilisation in debt in the medium term and not expecting a quick recovery in growth, Momentum Investments expects Moody's to leave the country's sovereign rating unchanged at the October 2018 review following the MTBPS, although there is a possibility it may lower the outlook to negative (see chart 17).

Chart 17: SA's sovereign rating

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
	BB	BB	Ba2
Outlook	Stable	Stable	Stable
Key:			
Local currency rating			
Foreign currency rating			
Both ratings			

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

The rating agencies have warned SA's sovereign ratings could drop if trend growth declines, if SoE debt migrates to government's balance sheet, if tensions in the ruling party derail policy-making or if the rule of law or property rights weaken.

In Momentum Investments' opinion, the new administration has addressed a number of low-hanging fruit to avoid a further sovereign ratings downgrade before the end of the year.

Ramaphosa has begun to restore confidence in government, by providing a clearer strategic direction. In Momentum Investments' view, Ramaphosa is managing competing interests from stakeholders within and outside

of government and, as such, the implementation path of structural reform is likely to be slow and requires careful management to prevent risking a split in support in the ruling party.

Government is also working towards stabilising the financial position of SoEs, by overhauling the leadership in an attempt to improve governance. Strong regulatory oversight and clarifying the mandates of the SoEs is needed to place the ailing parastatals on better financial footing.

The process of forging a new social compact and increasing engagement has already started in Momentum Investments' opinion, with the collaborative efforts on the third Mining Charter bearing testament. A Jobs Summit has been held to address the socio-economic issue of elevated levels of unemployment, while an Investment Summit is planned for October 2018, in which government aims to rebuild investor confidence and attract new investment.

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