momentum investments

The Macro Research Desk

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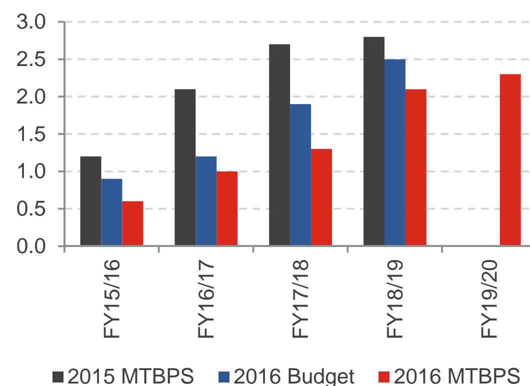
MTBPS 2016: Additional taxes and spending cuts used to negate weaker growth effect on fiscus

Sharper focus needed on structural impediments holding back the SA economy

In its 2016 Medium-Term Budget Policy Statement (MTBPS), South Africa's National Treasury unsurprisingly revised its estimates of real growth in the gross domestic product (GDP) lower to around 1.5% a year between the current fiscal year (FY2016/17) and FY2018/19, from 1.9% projected at the tabling of the February 2016 National Budget (see chart 1).
The downward revisions to growth were largely attributable to local structural constraints and persistently low confidence levels related to elevated political risk, clouding the direction of economic policy. In addition, excessive debt levels, a less commodity-intensive growth model in China and a rise in non-mainstream political parties have translated into an uncertain outlook on global economic growth. As such, muted commodity prices and stagnant global trade activity stemming from a tepid global backdrop are constraining the outlook for economic activity in SA.

Although Treasury's estimates of growth in real economic activity in SA are only marginally higher than Momentum Investments', the company sees further downside risks to growth in nominal terms (and hence fiscal revenues) given its more bullish view on inflation. Treasury anticipates an average headline inflation rate of 6.1% between 2016 and 2018.
Momentum Investments' embedded forecasts that incorporate relative currency strength in the corresponding time horizon (due to an expected mild uptick in commodity prices) and lower food inflation (in 2017, in particular), point to potential downside inflation risk of around 0.5%.

Chart 1: Treasury downwardly revises real GDP growth forecasts (%)



Source: National Treasury, Momentum Investments, MTBPS = medium-term budget policy statement

However, Treasury did allude to the potential bottoming out in cyclical GDP growth. It noted that additional sources of energy supply, a recovery in agricultural production following the drought (an additional R533.3 million has been provided for drought relief), an acceleration in exports and tourism receipts, as well as a reduction in strike action, all point to a recovery in GDP momentum. That said, Treasury acknowledges obstacles to achieving a higher rate of trend growth, which it notes has likely fallen from above 4% in 2012 to below 2%. Infrastructure bottlenecks, a lack of competition in key markets, a volatile labour relations environment, regulatory constraints, inefficiencies at state-owned enterprises (SOEs) and policy uncertainty were cited as the main stumbling blocks to achieving a higher growth trajectory. Treasury warns that a stable debt path will be difficult to sustain at the current level of expenditure, even if no new policy initiatives are taken, should real GDP growth remain stuck below 2% in the longer term.

Although Treasury acknowledged the importance of improving the policy environment, particularly in the fields of mining, immigration and communications, unfortunately, no new detail around labour reform or the Mineral and Petroleum Resources Development Amendment Bill was revealed.

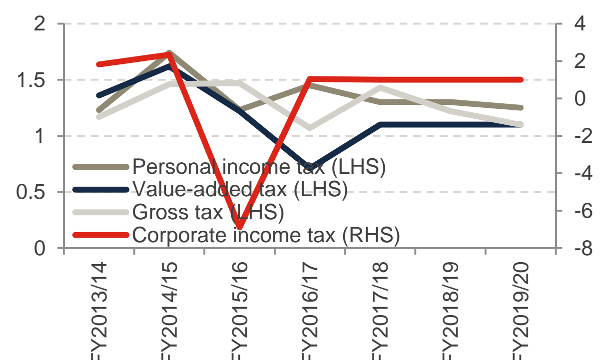
Disappointing growth results in fiscal slippage

Subdued economic activity has resulted in a widening of the FY2016/17 budget deficit from 3.2% of GDP estimated in February to a revised 3.4%. Further out, the deficit is expected to be 0.3% wider than the previously anticipated 2.4% share of GDP in FY2018/19. An increase in the revenue share of GDP from 29.7% in FY2016/17 to 30.4% by FY2018/19, accompanied by a stable expenditure share of GDP at around 33% for the same time period, ensures a narrowing of the fiscal deficit and a stabilisation in the debt profile in the medium-term horizon.

Sluggish growth has led to a shortfall in revenue collection for the first half of the current fiscal year, leading Treasury to cut its FY2016/17 tax revenue assumption by R22.8 billion. Personal income tax revenue was revised down by R12.5 billion, while projected value-added tax (VAT) receipts were cut by R7.9 billion. This is a reflection of increased consumer vulnerability on the back of elevated household debt burdens, rising food costs eroding real wages, muted credit growth and a depressed jobs market. In contrast, corporate income tax has performed better than expected thanks to higher provisional tax from the mining sector (no doubt related to rebounding commodity prices), resulting in a R2.5 billion upward revision by Treasury for FY2016/17.

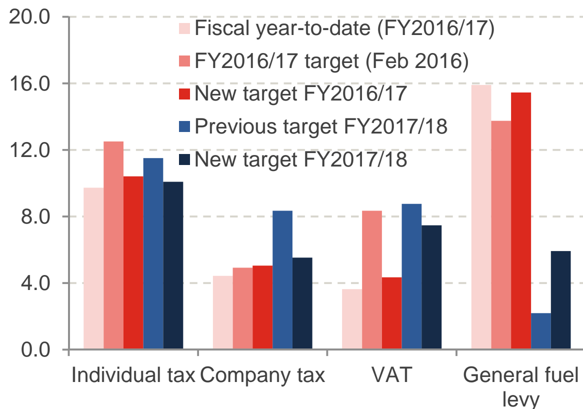
Tax revenue buoyancy, which describes the relationship between tax collection and economic growth, has averaged 1.25 since FY2010/11, implying that for every 10% growth in nominal GDP, 12.5% growth in revenue collection could be achieved. However, with moderate average wage settlements, declining wealth gains, anaemic employment growth, a rising likelihood of less tax relief being granted, weak import demand and the probability of rand strength, there is a risk that personal income tax and VAT buoyancy rates could decline by more than Treasury's assumptions in the medium term (see chart 2). Lower nominal growth assumptions (7.5% in the medium-term framework versus 8.2% estimated in the February 2016 National Budget) and a reduction in tax buoyancy ratios have led Treasury to downwardly revise its revenue growth targets for the three largest revenue sources, namely personal income tax, company tax and VAT (see chart 3).

Chart 2: Tax buoyancy ratios (actual and projected)



Source: National Treasury, Momentum Investments

Chart 3: Revenue targets adjusted lower (%)



Source: National Treasury, Momentum Investments

In an effort to avoid a low-growth trap, Treasury proposes a balanced solution to fiscal consolidation, including a number of additional tax policy measures (R28 billion in FY2017/18 and R15 billion in FY2018/19, including the proposals announced in the National Budget earlier this year), as well as a further cut in the expenditure ceiling (R20 billion in FY2017/18 and R31 billion in FY2018/19, including the proposals announced in the National Budget earlier this year). In Momentum Investments' preview of the 2016 MTBPS, a number of possible additional tax measures that could be announced in the February 2017 National Budget to bolster revenue growth were outlined. These include:

- An increase in wealth-related taxes (Macquarie estimates a doubling of the estate duty tax and an increase in the dividend tax rate from 15% to 20% could generate an additional R2.3 billion and R9.1 billion a year, respectively, while Pricewaterhouse Coopers (PwC) estimates that a new band taxing those earning above R1 million at a rate of 45% could add an additional R5 billion to revenues).
- A 1% tax increase across the board, but sheltering low-income earning brackets (PwC estimates this could add an additional R10 billion to revenues).
- An additional general fuel levy (particularly given that fuel prices are around 7.5% lower than levels two years ago).
- Limiting relief for fiscal drag (countering the effects of inflation on personal income tax) – government generated an additional R6.6 billion in revenues in the February 2016 national budget by only providing relief (including medical tax credits) to lower income brackets.
- Tax on sugar-sweetened beverages expected to come into effect in 2017 (Treasury's deputy director general estimates a R4 billion in additional revenues).

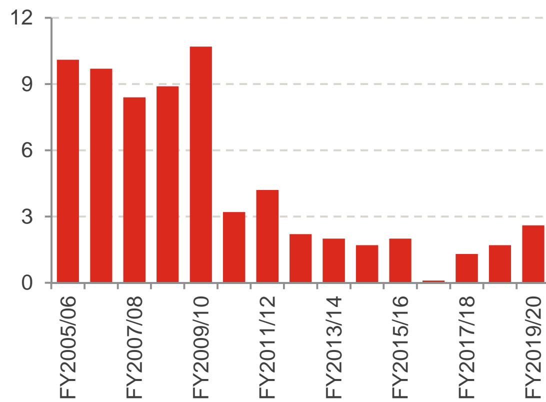
An environmental tax on emissions of carbon dioxide – Treasury intends to implement this tax in 2017, initially in a revenue-neutral manner (i.e. shifting rather than increasing the tax burden potentially to sectors that are already under pressure).

Expenditure ceiling lowered to mitigate fiscal risk

Government's self-imposed expenditure ceiling has been reduced by a further R51 billion, including the proposals outlined in the February 2016 National Budget. Non-interest expenditure is set to grow at an average real rate of 1.4% between FY2016/17 and FY2019/20 (see chart 4). In an effort to adhere to the expenditure ceiling, government has reprioritised spend and accommodated expenditure deviations via the contingency reserve (unallocated money used to accommodate changes to the economic environment or to meet unforeseen spending pressures).

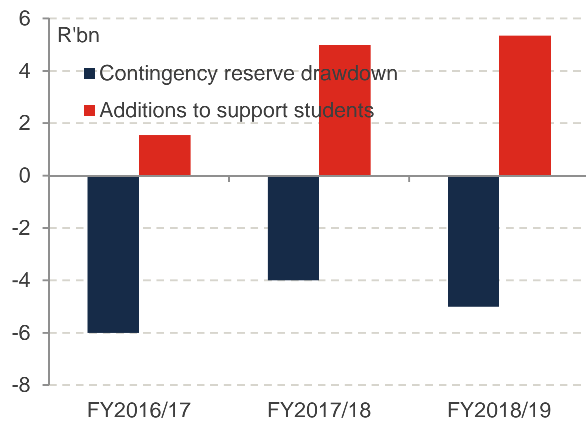
This time around, the contingency reserve drawdown (R6 billion in FY16/17, R4 billion in FY2017/18 and R5 billion in FY2018/19) was partly used to fund the revenue shortfall experienced in the current fiscal year, as well as to supplement an increase in subsidies for university students in the medium-term framework (see chart 5).

Chart 4: Real growth in non-interest expenditure (% y/y)



Source: National Treasury, Momentum Investments

Chart 5: Drawdown in contingency reserve cash



Source: National Treasury, Momentum Investments

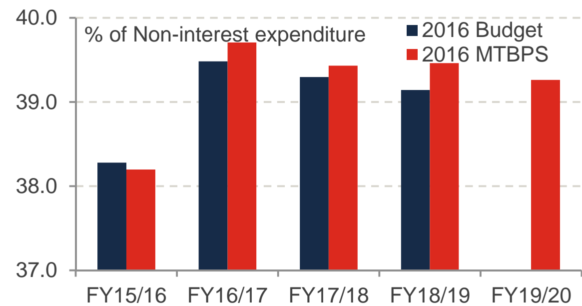
Government announced that it will fund the increase in tertiary fees (up to 8%) for the 2017 academic year. This includes a R9.2 billion allocation to the National Student Financial Aid Scheme, R7.8 billion in support for students from households earning less than R600 000 per year and additional money (R0.5 billion) for technical and vocational education and training colleges. Treasury noted in its fiscal risk statement that a 0% university fee increase in 2018 would likely result in a shift of resources from other priorities towards higher education.

Treasury has reiterated that any unforeseen spending pressures would result in the composition of spending changing, rather than an upward revision of the expenditure ceiling. Similarly, wage bill pressures are likely to be funded from non-core goods and services or from capital budgets. However, the reduction in capital budgets may not necessarily be growth-negative, given that infrastructure underspending has amounted to 5% of published infrastructure budgets in FY2015/16 on a national government level and 19% at the local government level.

Despite a cumulative R7.8 billion cut in the government wage bill between FY2016/17 and FY2018/19, employee compensation (as a share of non-interest expenditure) inched higher relative to estimates in the February 2016 National Budget (see chart 6).
The current multi-year wage civil servant agreement expires in March 2018. If a CPI-related deal is concluded between government and public-sector workers, the clamp down on public sector hiring may be eased, allowing for an increase in resources.

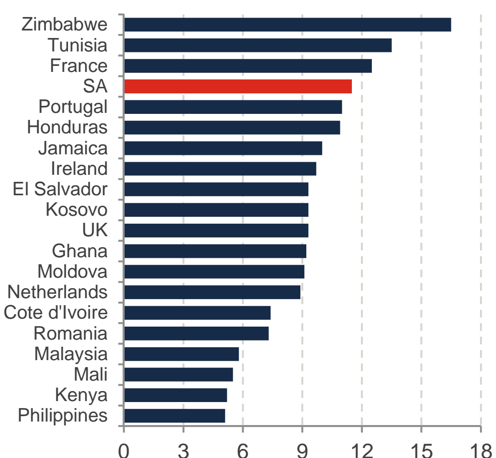
Nevertheless, judging from the consistent underestimation of the public sector wage bill, against a setting of solid public sector unionisation and a proposal for a national minimum wage, Momentum Investments expects the public sector headcount will have to continue being monitored closely.

Chart 6: Government wage bill



Source: National Treasury, Momentum Investments

Chart 7: Government wage bill (% of GDP)



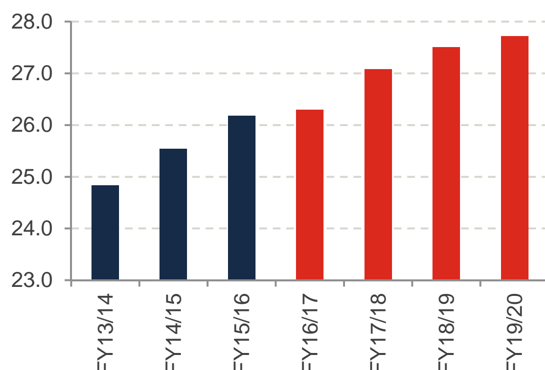
Source: IMF, Momentum Investments

SA's tax burden set to climb

In the absence of growth-enhancing structural reforms, SA will struggle to exceed or even return to its historical trend growth rate of 3.1%. A low-growth environment poses a threat to fiscal consolidation and debt stabilisation, particularly given the sticky nature of SA's expenditure. The number of social grant recipients has ballooned from 2.5 million in 1998 to nearly 17 million today and is set to grow further to 18.1 million by FY2018/19. Similarly, wage demands still account for a sizeable share of the non-interest expenditure bill. At 11.5% of GDP, SA's bloated civil servant wage bill ranks as the fourth largest (behind only Zimbabwe, Tunisia and France) in an International Monetary Fund (IMF) case study on managing government compensation and employment (see chart 7). The IMF warns that the level of wage settlements in SA's public sector ranks above the median country, while the size of the public sector work force is slightly smaller than that of the median country in the study. As such, SA's bloated public sector wage bill is attributable to excessive wage settlements rather than the number of people employed. Both of these spending pressures are tough to reverse in a struggling growth environment. As such, additional tax measures are inevitable, in Momentum Investments' view.

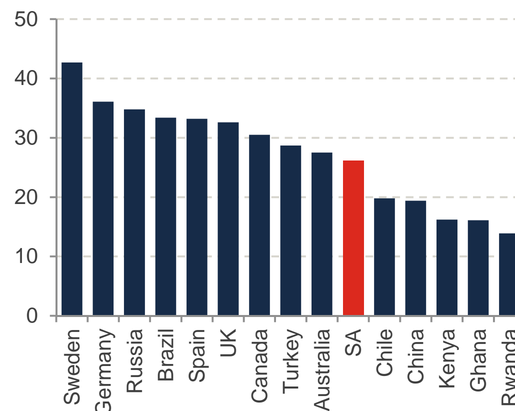
SA's tax burden is set to climb from 26.2% to 27.7% by FY2019/20 and could likely rise in the longer term, as government struggles to meet fiscal consolidation and debt targets. Relative to other economies, government views SA's tax burden as being roughly between that of developed and emerging countries (see chart 9).

Chart 8: Tax-to-GDP ratio edging higher (%)



Source: National Treasury, Momentum Investments

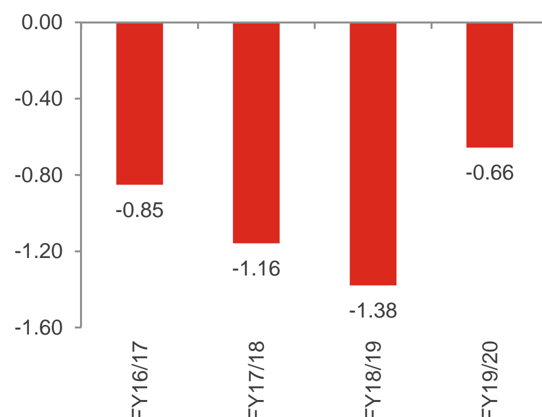
Chart 9: Tax burden in selected countries (%)



Source: National Treasury, Momentum Investments

The rising tax burden accompanying fiscal consolidation implies that the budget is removing spending power from the economy on a net basis between FY2016/17 and FY2019/20 and, as such, can be construed as contractionary for the economy. Furthermore, the fact that spending growth (averaging 7.1% a year between FY2016/17 and FY2019/20) is expected to lag revenue growth (averaging 8.2% p.a. in the corresponding period) also implies a net drain on economic activity (see chart 10) in the medium term.

Chart 10: Revenue growth expected to outstrip expenditure growth in the medium term (%)

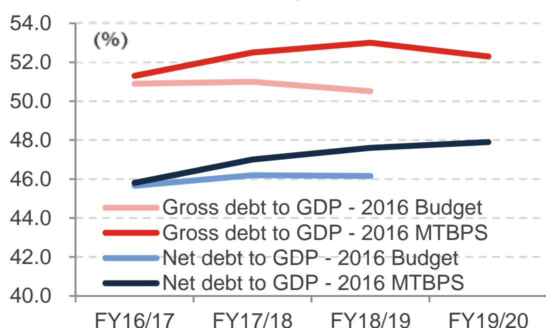


Source: National Treasury, Momentum Investments

Onerous debt costs crowd out more preferable forms of expenditure

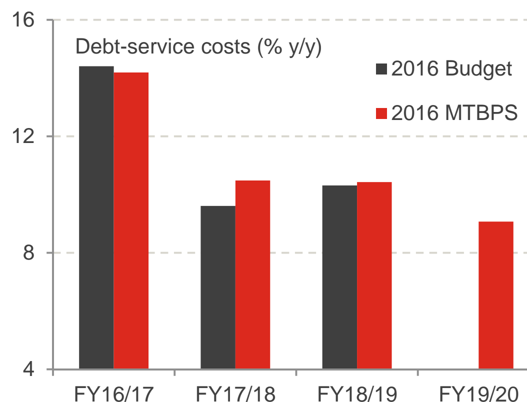
Nearly 12c of every rand of state revenue goes towards debt-servicing costs. Due to the increase in government borrowing (see chart 11), debt-servicing costs are expected to remain the fastest-growing expenditure item between FY2016/17 and FY2019/20, increasing at an average rate of 11.0% y/y per year (see chart 12). The rapid rise in debt-servicing costs is crowding out other (social and growth-enhancing) spending priorities and has been raised as a key concern by the rating agencies in the past.

Chart 11: Deterioration in government debt profile



Source: National Treasury, Momentum Investments

Chart 12: Fastest growing spending category



Source: National Treasury, Momentum Investments

Borrowing requirement revised slightly higher in FY2016/17

The borrowing requirement has increased by R8.6 billion in FY2016/17. Government expects to increase net issuance of short-term loans from R25 billion to R40 billion to finance the higher budget deficit in the current fiscal year. The increase takes short-term debt as a share of total local debt to 11.2%, relative to a strategic benchmark of 15%, implying that short-term refinancing risk remains reasonably low. Although the share of long-term debt, as percentage of fixed-rate and inflation-linked bonds (at 14.9%), remains low relative to a 25% benchmark, government remains committed to its bond-switch programme that aims to exchange short-term for longer-term debt. Government raised an additional US$2.3 billion in (new) foreign loans in September, which takes the foreign debt share of total government debt to 9.3%, well short of the 15% benchmark.

No update on longer-term spending projects

Little new detail on longer-term projects, including the National Health Insurance (NHI) plan and nuclear energy, was disclosed, except to confirm that an additional R9 million would be allocated to the NHI grant and that, while the nuclear power initiative will be led by Eskom, every effort would be made to ensure that procurement arrangements are transparent.

Although Eskom's revised projections show that cash reserves are likely to exceed R150 billion in ten years' time, there is still a significant risk, in Momentum Investments' view, that the need for government support may increase, raising fiscal risks in the long term.

New national procurement legislation bodes well for the fight against corruption

The Office of the Chief Procurement Officer (CPO) aims to improve efficiency of spend and eliminate opportunities for corruption. The introduction of a Public Procurement Bill in April 2017 could empower the CPO to review transactions across the public sector and conduct audits. The CPO has also driven an initiative to renegotiate contracts with airlines, hotels, software suppliers and property owners in an effort to curb wasteful expenditure amounting to an expected (but slightly ambitious, in Momentum Investments' opinion) R25 billion saving per year by FY2018/19.

Cost-containment measures have seen some success since their implementation in December 2013. In real terms, government spend on non-essential goods and services has fallen by 7.7%, including a 12.6% cut in consultant fees, a 5.1% drop in travel and subsistence costs and a 5.0% decline in catering and venue expenditure.

Sovereign foreign currency rating downgrade may be delayed until June 2017 in the absence of any further political shocks

While a commitment to the expenditure ceiling and achieving a primary budget surplus (excludes interest costs) could stave off a foreign currency rating downgrade in December by Standard and Poors Global Ratings (S&P), reduced fiscal flexibility will more likely than not lead to a narrowing of the current two-notch gap between SA's local and foreign currency ratings by the next review (2 December 2016). This would still leave SA's local currency debt rating at two notches above junk status. Exclusion criteria for the Citibank World Government Bond Index require SA to lose its investment grade status on its local debt by S&P and Moody's (which currently rank local and foreign debt at two notches above the investment grade threshold).

S&P has previously warned that a downgrade of the foreign currency rating could materialise as a result of weaker-than-expected growth, a further decline in wealth levels (in US$ terms), a weakening of institutions and a delay in structural reforms (in the labour, mining and SOE sectors), as a result of political interference or a further rise in SA's net debt and guarantees ratio to GDP above 60% in the next three years.

Even though the medium-term budget showed a commitment to fiscal austerity, lukewarm economic growth prospects (in the absence of structural reform or another commodity price boom) in the medium to longer term will likely struggle to keep up with population growth, leading to a minimal recovery in overall living standards and social inequality.

As such, Momentum Investments still sees a reasonably high likelihood of SA downgraded to sub-investment grade by S&P in the next nine months, as sluggish GDP growth poses a risk to fiscal consolidation and debt stabilisation in the medium term.

Although a kneejerk reaction by the currency is likely in the event of a downgrade to junk, JPMorgan suggests that rising country risk has a smaller effect on SA equities. Investec research implies that SA's five-year corporate default swap spreads (which gauge country risk) are more than fully discounting a downgrade to below investment grade, while ten-year government bond yields suggest that a downgrade has been fully priced in by the fixed-income market. That said, it is unlikely that markets are pricing in much more than a one-notch downgrade at this stage, although Momentum Investments assumes a downgrade to sub-investment grade to trigger a strong response from government to prevent a negative debt and credit ratings spiral.

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