



## Medium-term budget preview: Balancing the books with emptier coffers

### Highlights

---

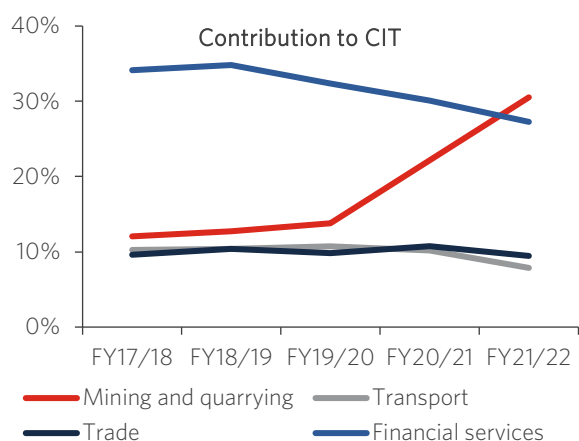
- Gross tax revenues are running behind schedule based on collections between April and August 2023. This is largely owing to an underperformance in corporate income tax (CIT) collections.
- The South African Revenue Service (SARS) Tax Statistics report for 2022 showed that the mining sector acted as a large contributor to CIT previously. However, a slump in SA's key exported commodity prices has likely driven this contribution lower.
- Although a higher cost base has weighed on SA firms, due to diversifying their energy sources away from Eskom, corporate profitability has held up relatively well.
- Personal income taxes (PIT) have outperformed due to a rise in nominal wages, in the public sector in particular, and modest employment gains across the economy.
- Domestic value-added taxes (VAT) have increased by 6.5% year-on-year (y/y) fiscal year to date (FYTD). This is only marginally lower than government's February 2023 national budget full-year assumption of 6.7%. This highlights resilience in household spending despite elevated cost-of-living pressures facing consumers.
- SARS' strategic intent to encourage voluntary compliance is also gaining momentum, with taxpayer behaviour improving and trust in SARS climbing further.
- Treasury's expenditure ceiling has lost some standing as a key fiscal anchor given that non-interest expenditure has exceeded government's self-imposed limit in recent years.
- Any announcement on the potential extension of the Social Relief of Distress (SRD) grant could be delayed to the February 2024 national budget and as such may not reflect in projected government expenditures laid out in the medium-term budget.
- Aside from the accumulative contingency reserve and allocated reserve funds of R95.2 billion between FY2023/24 and FY2025/26, which could cater for part of the expected expenditure overrun, government has proposed a public sector headcount freeze, alongside the potential for outright job cuts and a halt in advertising new procurement contracts for all infrastructure projects, to address the shortfall in revenue collections.
- With real government spending in per capita terms stagnating over the past decade, proposed austerity measures are likely to weigh more heavily on the fragile social fabric of the country. This risks an elevation in service delivery protests in the medium to longer term, in our opinion.

- In addition to rising social demands and defunct municipal finances, government will also likely need to deal with requests for funding from frail state-owned enterprises (SOEs). The state-owned rail and freight logistics provider, Transnet, in particular, faces poor financial performance amid a leadership crisis.
- The market consensus view is for T-bill issuance to play a significant role in financing the larger-than-anticipated budget deficit given the steepness of the yield curve, making T-bills a cheaper funding source relative to fixed-rate, longer-dated government bonds.
- Government's fiscal deficit is expected to remain sticky and exceed Treasury's February estimates by between 1% and 2% in the next few years, which could result in a notable widening of the deficit over the medium-term framework. This will prevent stabilisation in government's debt ratio, keeping the interest bill high and crowding out other forms of more useful expenditure.
- Compared with the International Monetary Fund's (IMF) baseline scenario, they recommend additional consolidation measures of 3% of gross domestic product (GDP) to curb government's debt ratio to improve fiscal and debt sustainability in SA. These measures include rationalising the public sector wage bill, SOE reform, reviewing procurement policies and limiting subsidies for tertiary education.

## Resilience in the broader tax take outside of CIT

Gross tax revenues are running behind schedule based on collections between April and August 2023. This is largely owing to an underperformance in corporate tax collections. Although the mining sector acted as a large contributor to CIT in FY2021/22 (see chart 1) according to the SARS Tax Statistics report for 2022, a slump in SA's key exported commodity prices (see chart 2) will likely drive this contribution lower in FY2022/23, closer to the longer-term average of around 10%.

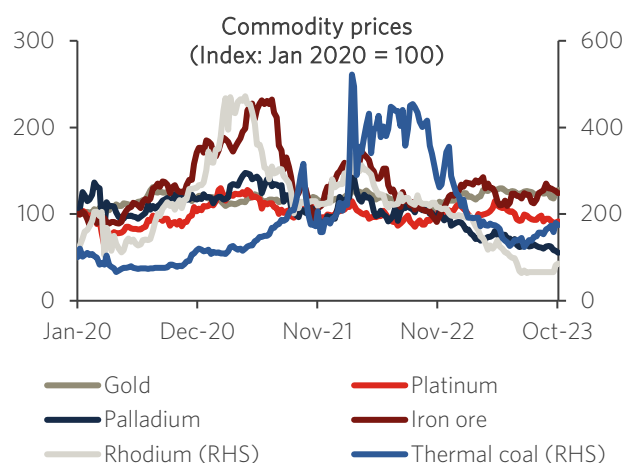
**Chart 1: Mining was a larger CIT contributor previously**



Source: SARS, Momentum Investments

Metal industries have been added to mining and quarrying  
Vehicles, parts and accessories have been added to transport  
Trade includes wholesale and retail

**Chart 2: Commodity prices slump**

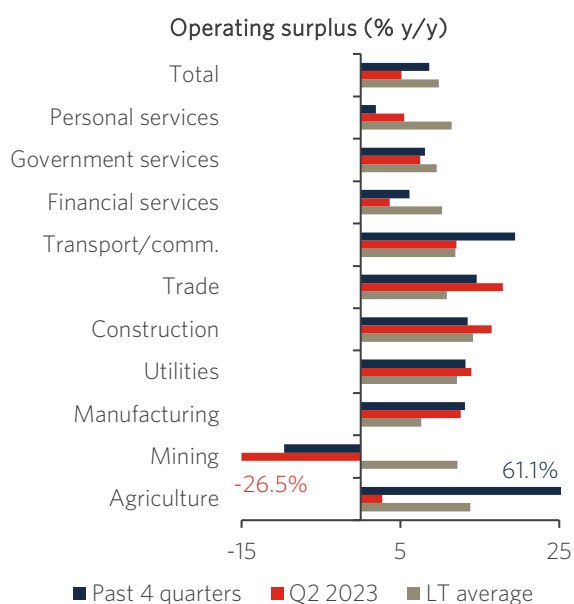


Source: Bloomberg, Momentum Investments

In April 2023, *Business Day* reported that electricity minister Kgosisentsho Ramokgopa spoke at a public lecture at the University of Pretoria, noting that load-shedding was expected to cost the economy R400 billion more than last year and reduce the tax take by R77 billion. He also estimated that persistent electricity shortages could amount to 860 000 job cuts in 2023.

Although a higher cost base has weighed on SA firms, due to diversifying their energy sources away from Eskom, corporate profitability has held up relatively well (see chart 3).

Chart 3: Corporate profitability reasonably firm



Source: Global Insight, Momentum Investments

Chart truncated

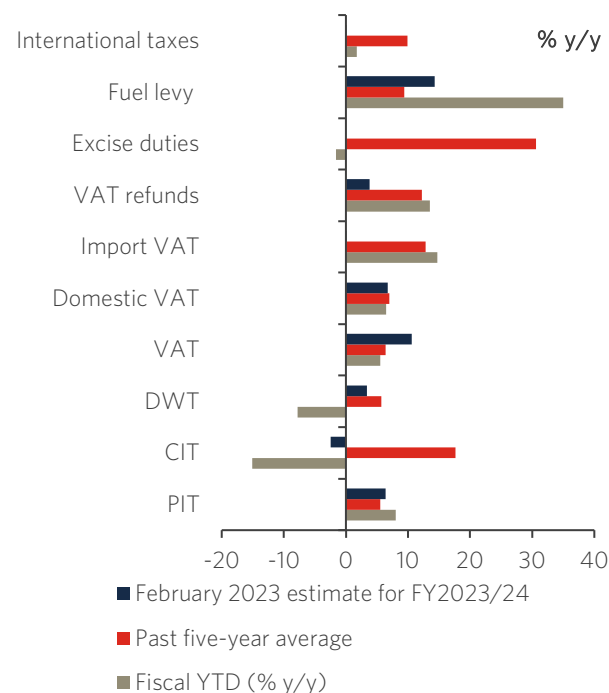
LT = long-term from 1994

Outside of the corporate tax take, tax collections have displayed general resilience overall. PIT has outperformed due to a rise in nominal wages in the public sector in particular and modest employment gains. PIT is running ahead at 8% y/y FYTD compared with a lower 6.4% full-year estimate projected in the February 2023 budget (see chart 4).

Similarly, international taxes (including customs duties) have done better than expected on a FYTD basis, increasing by 1.8% y/y relative to a broadly flat forecast in the budget. Morgan Stanley attributes this to higher imports of solar panels, batteries and inverters to mitigate power outages.

Although VAT collections are seen to be lagging at an overall level of 5.6% y/y FYTD compared with an assumed 10.6% y/y in the budget, part of this is due to higher-than-expected VAT refunds, which increased by 13.5% y/y FYTD relative to government's February full-year estimate of 3.8%. Domestic VAT has increased by 6.5% y/y FYTD. This is only marginally lower than government's February assumption of 6.7% for FY2023/24, highlighting resilience in household spending despite elevated cost-of-living pressures.

Chart 4: Tax performance surprisingly resilient outside of CIT

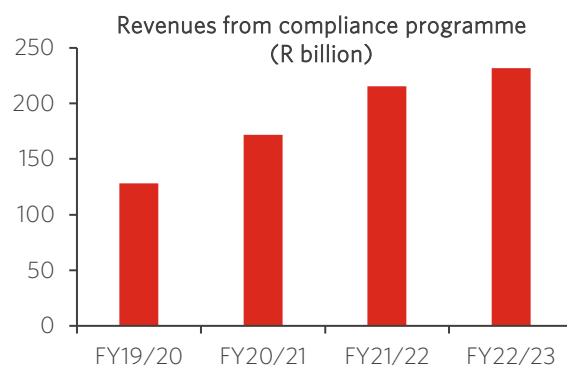


Source: Global Insight, SARS, Treasury, Momentum Investments

In a presentation to the Standing Committee on Finance on 18 October 2023, SARS Commissioner Edward Kieswetter noted that SA's tax buoyancy rate (the ratio between growth in tax revenue and growth in the economy) has averaged above one over the long term, indicating that the extraction of tax revenue has been efficient.

He also noted that revenue from SARS' compliance programme has yielded significant results (see chart 5) in the past few years and this assists in closing the tax gap in a meaningful way.

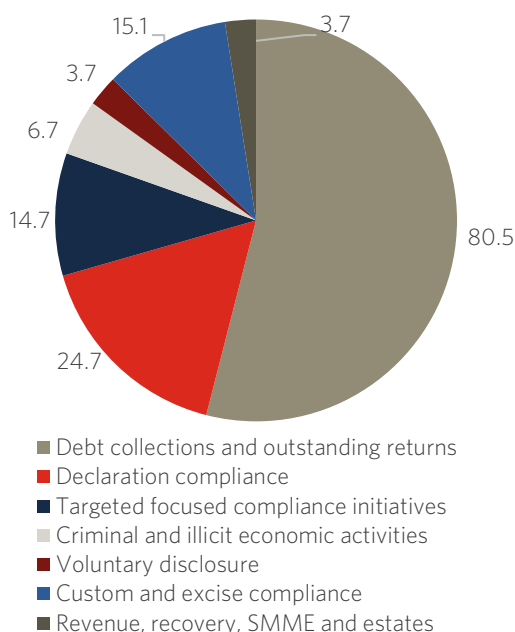
Chart 5: Closing tax loopholes



Source: SARS, Momentum Investments

Of the R231.8 billion in compliance gains estimated for FY2022/23, R15.1 billion came from custom and excise compliance, while R6.7 billion arose from a clamping down on criminal and illicit economic activities (see chart 6).

**Chart 6: Promising compliance gains**



Source: SARS, Momentum Investments  
SMME = small, medium and micro enterprises

SARS' strategic intent to encourage voluntary compliance is also gaining momentum, with taxpayer behaviour improving and trust in SARS climbing further (see chart 7).

Despite compliance gains and relative resilience in profitability in the corporate tax base outside of the mining sector, the market is still expecting a revenue

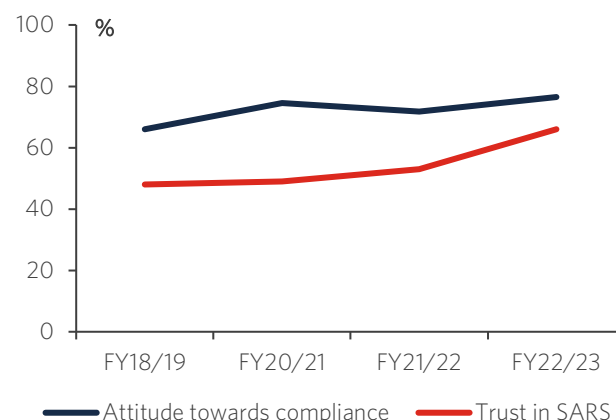
## Growing strains on social welfare spending

Government's expenditure ceiling has lost some standing as a key fiscal anchor given that non-interest expenditures have exceeded the self-imposed limit in recent years.

In the medium-term budget in October 2022, Finance Minister Enoch Godongwana announced an extension of the SRD grant for an additional year until the end of March 2024. The SRD grant was initially introduced in

undershoot of between R30 billion and R60 billion based on seven macro inputs from sell-side economists.

**Chart 7: Attitude towards compliance is improving**



Source: SARS, Momentum Investments

While new tax proposals are not typically announced in the medium-term budget policy statement, we expect that bracket creep (when the income thresholds defining tax brackets are not adjusted for inflation, causing people to pay a higher percentage of their income in taxes) will be the main source of additional revenue when the February 2024 budget is announced. Additional PIT increases would likely be tricky to introduce in the face of subdued consumer confidence.

A cut to company taxes to 27% was announced in the 2021 national budget, effective for tax years ending on or after March 2023. As such, it is unlikely that we will see an increase in CIT rates. Similarly, we attribute a low probability for an increase in VAT for next year given the tenuous political backdrop of the 2024 national elections.

May 2020 as a temporary measure to support the most vulnerable.

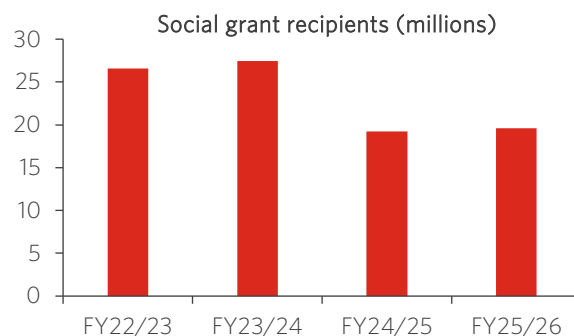
The ANC December 2022 policy conference concluded that to foster economic empowerment, the grant should be indexed to the lower-bound poverty line and the financing strategy should include a wealth tax, closing tax loopholes, addressing base profit shifting by corporates and a transactions tax. The ruling party confirmed its stance that it wanted the social grant to

continue in the form of a basic income grant after the SRD lapses in March 2024.

Late in October, *IOL* reported that Minister of Social Development, Lindiwe Zulu, confirmed her department's proposal to extend the SRD grant until the end of FY2025/26.

Any announcement on the potential extension of the SRD grant could be delayed to the February 2024 national budget and as such may not reflect in projected government expenditures laid out in the medium-term budget. BNP Paribas estimates that the SRD grant of R350 per month paid to around eight million recipients comes at a cost of R36 billion. BNP Paribas further notes that government's expected downward shift in the total number of social grant recipients in FY2024/25 looks unrealistic given the socio-political difficulties associated with rescinding grants from a number of individuals who earn less than R624 per month, particularly when considering that the food poverty line, as calibrated by Statistics SA, stands closer to R760. According to Treasury, after excluding the COVID-19 SRD grant, social grant coverage is expected to increase from about 18.6 million beneficiaries in March 2023 to 19.6 million beneficiaries by March 2026 (see chart 8).

**Chart 8: A drop off in social grant recipients unlikely given the political context**



Source: Treasury, Momentum Investments

In our view, SA's budget remains highly redistributive in nature, with the social wage (i.e. spending on free housing, services and social grants) nearing 60% of non-interest spending. As such, the debate remains on how to offset any permanent increases in social grant funding with a combination of tax increases and credible cuts in other budget areas.

Current economic hardship nevertheless argues against raising revenues through higher taxes. Instead, addressing non-payment by wealthier individuals, collecting revenue lost through base erosion, profit shifting and recouping tax gains from illicit trade can possibly contribute to plugging the gap, until a longer-term solution is found.

## Wage bill overrun contributes to expenditure overshoot

The union's reported 7.4% wage bill agreement was concluded after the February 2023 national budget announcement, which had catered for a 1.6% increase. According to J.P. Morgan, the 7.4% settlement included a 3% nominal increase (plus the conversion of the cash gratuity into a pensionable salary) and 1.5% grade inflation. As such, J.P. Morgan estimates an unbudgeted wage bill expense of between R27 billion and R32 billion.

Aside from the accumulative contingency reserve and allocated reserve funds of R95.2 billion between FY2023/24 and FY2025/26, which could cater for a part of the expenditure overrun, government has proposed a public sector headcount freeze, alongside

outright job cuts and a halt in advertising new procurement contracts for all infrastructure projects, to address the shortfall in revenue collections.

Departmental spending is running well ahead of Treasury's February 2023 estimates. Given that we are heading into an election year, a meaningful cutback in government expenditure, particularly on government headcount, seems unlikely. The market is expecting an expenditure overrun of anywhere between R10 billion and R64 billion based on seven macro inputs from sell-side economists.

Additional cuts to government's capital expenditure programme (capex) compromises long-term growth in

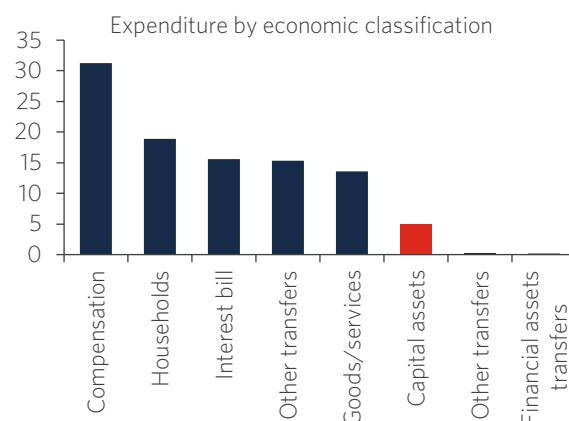
SA given the importance of a higher level of capex in growing the productive capacity of the country.

According to Treasury, out of every R100 of government spending, only R4.90 was projected to be spent on government's capital assets in FY2023/24. Meanwhile, R31.27 was expected to go into the public sector wage bill, R18.90 into social grants and other transfers to households, and R15.58 was estimated to be spent on government's interest bill (see chart 9).

Prioritising cost cutting while concurrently maintaining service delivery can possibly be attained through reviewing excess administrative and managerial staff, matching pay to equivalent skills in the private sector, assessing allowances and pay progression and rationalising committees and institutions across the various spheres of government.

With real government spending in per capita terms stagnating over the past decade, proposed austerity measures are likely to weigh more heavily on the fragile social fabric of the country and risks an elevation in service delivery protests, in our opinion.

**Chart 9: Government expenditure per R100**



Source: Treasury, Momentum Investments

## Tough financing decisions, but significantly higher issuance could be delayed to next year

The market is currently projecting a funding gap of around R60 billion to R95 billion from our estimates, suggesting that while the market anticipates a widening of government's fiscal deficit by around 1% for FY2023/24, the market would likely be negatively surprised if the extent of the widening exceeded 1.5%.

Government's fiscal deficit is expected to average between 1% and 2% wider over the medium-term framework relative to Treasury's February projections. This will likely prevent stabilisation in government's debt ratio, keeping the interest bill allocation high as a share of revenue, expenditure and GDP.

The market consensus view is for T-bill issuance to play a significant role in financing the larger-than-anticipated budget deficit given the steepness of the yield curve,

making T-bills a cheaper funding source relative to fixed-rate government bonds. External concessional financing could also likely be an option.

Market participants have raised the option of using the gains from the revaluation of gold and foreign exchanges. These gains are paid into the Gold and Foreign Exchange Contingency Reserve Account (GFECRA). The GFECRA has increased to around R458 billion, which would more than cover the FY2023/24 fiscal deficit. However, the amount in the GFECRA changes each year depending on gains and losses due to market movements. Moreover, this is not a costless option and a policy-rate related interest amount would be due on a recurring basis, even if only a partial drawdown is considered.

## Investing in fiscal strength

Fiscal policy space has shrunk in a post-pandemic world. The COVID-19 pandemic was a painful reminder of the importance of reinstating financial buffers during healthier economic periods. Countries around the globe

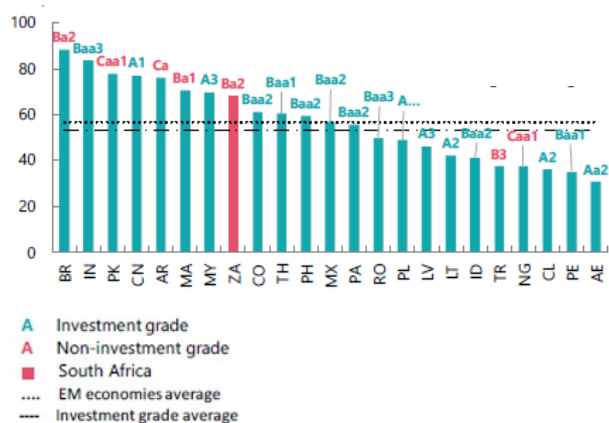
are staring down wider fiscal deficits and inflated debt ratios. With the IMF expecting inflation to remain above central bank targets in more than 89% of economies in



2024, lowering interest rates to encourage higher growth in domestic demand remains constrained.

In its Article IV statement on SA, the IMF warned that SA's public debt ratio is among the highest in emerging markets (see chart 10) and is expected to continue rising based on current policies.

Chart 10: SA's debt ratio ranks on the high side



Source: IMF

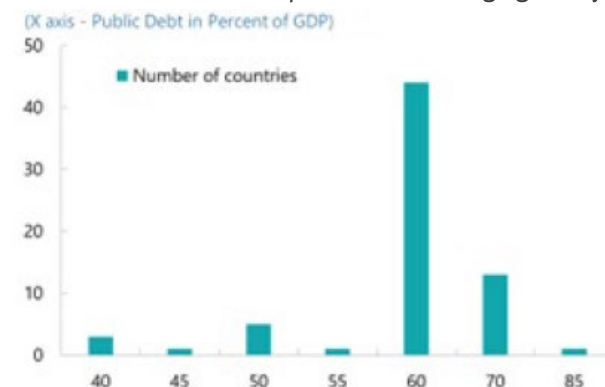
Bars depict general government (gross) debt-to-GDP ratios

Countries from left to right: Brazil, India, Pakistan, China, Argentina, Morocco, Malaysia, SA, Colombia, Thailand, Philippines, Mexico, Panama, Romania, Poland, Latvia, Lithuania, Indonesia, Turkey, Nigeria, Chile, Peru and United Arab Emirates

The IMF has encouraged stronger fiscal consolidation efforts under a credible medium-term framework. They emphasised the importance of placing SA on a path whereby public debt continues to decline while productive investment and optimally-targeted social spending are simultaneously preserved. The IMF notes that in SA's case, reforms to the fiscal framework, procurement system and better public investment management are required.

At current debt levels, the IMF warns that SA is left with limited fiscal space to deal with shocks from contingent liabilities, social spending needs or climate-related events. The IMF guides SA to progressively contain its debt ratio closer to the most common debt ceiling levels of between 60% and 70% as seen in the rest of the world (see chart 11).

Chart 11: Distribution of public debt ceilings globally



Source: IMF

Compared with the IMF's baseline scenario, they recommend additional consolidation measures of 3% of GDP, including:

- Wage bill rationalisation (c.2% of GDP): Containing public sector employee compensation through below-inflation wage adjustments, a reduction in allowances and pay progression and introducing an evidence-based approach to pay-setting
- SOE reform (c.1.5% of GDP): Divesting, liquidating and restructuring entities, while focusing on procurement and wage bill costs
- Procurement (c.1.3% of GDP): More efficient procurement processes
- Limiting tertiary education subsidies (c.0.5% of GDP): Reviewing income eligibility criteria.

With regards to the latter, Treasury estimates that the spending on fee-free higher education and training will increase from R64.2 billion in FY2023/24 to R72 billion in FY2025/26. As such, cost savings in this area of the budget could make a meaningful difference to the fiscal outlook. While reforms in this area could occur more quickly (in a phased approach), SOE reform is expected to take far longer. In this light, the National State Enterprises Bill (published in September 2023 after a five-year delay) is a step forward in improving how SOEs are managed to alleviate pressure on the fiscus.

In the interim, support to SOEs, which has grown sharply since FY2017/18 to 1.5% of GDP in FY2023/24, is likely to remain a drag on the fiscus in the coming years given the weak financial state of many state entities including Transnet, Denel and SANRAL.

Government's historical reluctance to make difficult choices has raised concerns. In the face of sluggish economic progress, it is increasingly crucial for government to act decisively. Timely execution of economic strategies, enhanced oversight of SOEs, reduced regulatory and policy ambiguities, an improved business environment, dependable service delivery and the successful implementation of initiatives to enhance investor trust can alleviate the government's struggle to balance fiscal responsibility with inclusive growth.



The information used to prepare this document includes information from third-party sources and is for information purposes only. Although reasonable steps have been taken to ensure the validity and accuracy of the information contained herein, Momentum Metropolitan Life Limited does not guarantee the accuracy, content, completeness, legality or reliability of the information contained herein and no warranties and/or representations of any kind, expressed or implied, are given to the nature, standard, accuracy or otherwise of the information provided.

Neither Momentum Metropolitan Life Limited, its affiliates, directors, officers, employees, representatives or agents (the Momentum Parties) have any liability to any persons or entities receiving the information made available herein for any claim, damages, loss or expense, including, without limitation, any direct, indirect, special, incidental, punitive or consequential cost, loss or damages, whether in contract or in delict, arising out of or in connection with information made available herein and you agree to indemnify the Momentum Parties accordingly. For further information, please visit us at [momentum.co.za](http://momentum.co.za). Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.