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2023 National Budget Preview: Will tough fiscal decisions be left for another day?

Highlights

- In this year's State of the Nation Address (SONA), the president announced a number of interventions (particularly in the energy sector), which financial markets viewed as broadly favourable to enhancing economic activity against a slowing growth backdrop and intensifying global headwinds. The success of these interventions relies heavily on government funding and as such the upcoming national budget plays a pivotal role in getting the ball rolling on the implementation of these announced plans.
- The February budget will highlight revenue performance on a fiscal year-to date (FYTD) basis. Data from the South African Revenue Service (SARS) indicates that personal income taxes (PIT) remained resilient thanks to a modest uplift in employment and higher nominal wage growth. Meanwhile value-added tax (VAT) receipts are coming under pressure. Although corporate income taxes (CIT) performed well, more intense loadshedding is likely to weigh on collections in the coming months. As such, Treasury could downwardly revise its revenue assumptions, particularly if it cuts its outlook on SA growth. This could nevertheless be partly offset by higher projections on inflation.
- Rising expenditure pressures (including additional funding for diesel, a potential allocation to offset the negative effects of loadshedding on food prices for the poor and inflation-related adjustments to social grants) are likely to slow the pace of fiscal consolidation and could keep SA's debt ratio stickier for longer.
- We are expecting five key areas of concern to be elaborated on in the February 2023 National Budget, including:
    - **Eskom and loadshedding**: Insufficient energy supply poses the biggest downside risk to growth and investment in the economy. Announcements made in the SONA to resolve the insecurity of energy supply (including the imposition of a state of disaster to prevent a total shutdown of the energy grid, a dedicated resource in the way of a new Minister of Electricity to oversee government's Energy Action Plan to arrest the short-term crisis in energy and increased funding for diesel to lower the intensity of loadshedding in the near term) will likely be expanded upon in so far as there is a consequence for government financing. With financial markets growing impatient for a debt solution to Eskom's R397 billion elephant in the room, expectations are high for further detail on a debt transfer/restructuring.
    - **Continuing support for the most vulnerable in society:** While the resolution of the ANC Policy Conference in December 2022 and the SONA alluded to the need for a more permanent solution to respond to the needs of the most vulnerable, no specific details have been outlined. Indeed, Treasury has previously confirmed that a permanent extension or replacement would only be possible through a

reduction in spending elsewhere or a permanent increase in revenue (or a combination of the two) to ensure the stability of the public purse. However, policies aimed at shorter-term electoral gains remain a risk in the run-up to the 2024 national elections.

- **Public wage bill negotiations:** Treasury pencilled in a negative real wage increase for civil servants for the fiscal year 2023/24 (FY2023/24). However, high food and fuel costs are likely to see pushback from the public sector unions. Even though Treasury may maintain its initial assumptions on the public sector wage bill at the upcoming national budget, negotiations could drag on for months.
- **Structural reforms**: Reducing policy uncertainty and fast-tracking the implementation of structural reforms that have wide-reaching benefits to improve the country's growth trajectory and job outlook require a broader political consensus on what is needed to fix SA's ailing growth rate. Aside from a progress update on Operation Vulindlela, Treasury may announce funding that is required to fix financial inadequacies at other state entities, aside from Eskom. It may further elaborate on cost savings associated with rationalising government departments.
- **Ailing municipalities and their role in service delivery**: Treasury is likely to outline some of the interventions previously announced to improve professionalism in public service and will probably highlight the areas on which it is focusing to build capacity to improve service delivery.

Tax revenues running ahead of schedule

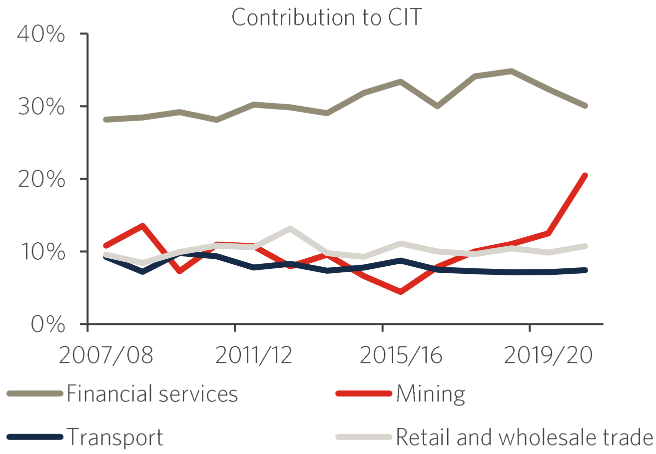
Gross tax revenues are running ahead of schedule based on collections between April and December 2022. PIT is outperforming due to a rise in nominal wages and a modest uplift in employment. Similarly, CIT has done well on a FYTD basis, likely stemming from high profitability in the mining and financial services industries. VAT collections are, however, lagging as consumers face elevated cost-of-living pressures that have dampened household spending. Moreover, a rise in VAT refund payments has dented net VAT collections.

The market is expecting a revenue overrun slightly smaller to what was announced previously. In the October 2022 medium-term budget, gross tax revenues were estimated to be R83.5 billion higher than the February 2022 assumptions.

The SARS Tax Statistics report for 2021 showed an outsized contribution from the mining sector of 21% to total CIT in FY2020/21. This compares to an average of 10% since the global financial crisis.

While buoyant profitability in the mining sector reported in December suggests another sizeable revenue windfall will be announced in the upcoming budget, rotational power cuts and abject logistics flops are likely to see SA failing to gain its fair slice of the international commodity cycle going forward.

Chart 1: Outsized tax contribution from the mining sector



Source: SARS, Momentum Investments

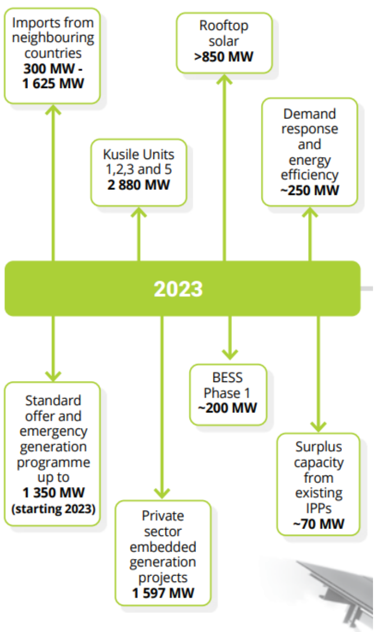
The SARS commissioner has been vocal about not wanting to raise taxes or instituting a new wealth tax. As such, we only consider a tax on alcoholic beverages and tobacco (less than R2 billion), a small general fuel levy increase (Nedbank estimates a R3.1 billion collection for a 15c/l rise), an inflation-adjusted increase in the sugar tax, an increase in carbon taxes and fiscal drag (between R11 billion and R14 billion) to be announced at the upcoming national budget.

Although revenues are running ahead of schedule, higher expenditure allocations suggest the budget deficit is likely to be slightly wider than government's estimates from the October 2022 medium-term budget.

Financial markets expecting details on an Eskom debt plan

One of the key focus areas of the National Energy Crisis Committee's short-term Energy Action Plan is to ease loadshedding in the near term by addressing the problem of Eskom's coal units failing at a faster rate than what new generation capacity can be added. In so doing, they aim to improve the currently low energy availability factor (see chart 2).

Chart 2: Plans to alleviate loadshedding this year



Source: National Energy Crisis Committee, Momentum Investments

The broad consensus across financial market participants is for government to assume between R200 billion and R250 billion of Eskom's R397 billion debt burden. This could be staggered across a number of years and would likely be contingent on Eskom filling essential vacancies with skilled individuals, undertaking critical maintenance, adhering to unbundling timelines and addressing municipal debt arrears (which are currently registering at R56 billion).

The net impact would be a higher debt ratio (between 2.5% and 3%), a higher debt-servicing ratio and consequently lower contingent liabilities as a share of gross domestic product.

Fixed income markets would likely appreciate this approach given the eventual opportunity for Eskom to tap capital markets in the future for funding for maintenance and spending on grid infrastructure.

Nedbank has presented an alternative solution to Eskom's financial woes and suggests ongoing liquidity injections to address the entity's cash flow strain could result in an allocation of R80 billion a year (of which R65 billion a year would address debt-service costs).

Government likely to delay incorporating a more permanent extension of social grant funding

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 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. This was reiterated by the president in the SONA, when he announced that 7.8 million people currently rely on the SRD grant and work was underway to develop a more permanent allocation for targeted basic income support for the most vulnerable. Morgan Stanley reports that with 7.8 million people receiving the grant, there is a likely cost saving of

R11.4 billion given an initial allocation by Treasury for 10.5 million beneficiaries amounting to R44 billion.

Moreover, the SONA noted that Treasury was also considering urgent measures to mitigate the effect of loadshedding on consumers and small businesses. The upcoming budget may shed further light on this plan and how it will be funded.

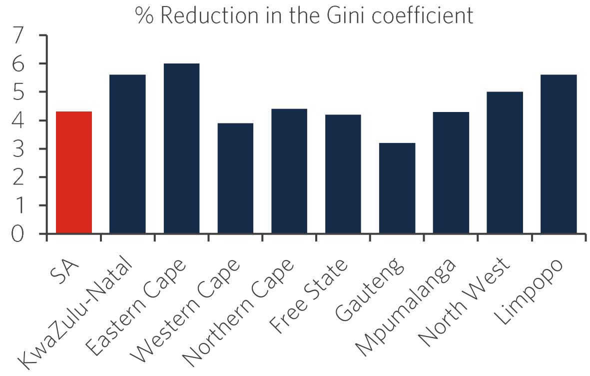
The Expert Panel's Basic Income Support Supplementary Modelling Report, published in December 2022, argues for an entry-level version of basic income support at the lower-bound poverty line (R890), with the eventual intention of eliminating poverty at the upper bound poverty line (R1 335). In 2021, the Pietermaritzburg Economic Justice and Dignity group postulated that 30.4 million South Africans lived below the upper-bound poverty line.

The panel ran four simulations on funding, including:

- An SRD grant outlay of R50 billion funded by a VAT increase
- An SRD grant outlay of R50 billion funded by an increase in PIT rates for the top three deciles
- A wage subsidy outlay of R50 billion financed through PIT increases for the top three deciles and allocated to the bottom four occupational groups
- A combination of an SRD grant and wage subsidy outlay to the value of R75 million financed through an increase in PIT

The study shows that a grant of this nature can reduce inequality in SA as measured by the 4.3% expected improvement in the Gini coefficient (see chart 2).

Chart 2: Further social assistance can reduce inequality



Source: Department of Social Development, Momentum Investments

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, Treasury has deliberated on how to offset any permanent increases in social grant funding with a combination of tax increases and credible cuts in other budget areas.

In our view, 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 contribute to plugging the gap.

Stale wage bill estimates until negotiations are firmly underway

In October's medium-term budget, government pledged a nominal wage increase for civil servants of 3%, on average, for the next three years. The R1 000 cash allowance is set to discontinue from April 2023.

Yet, with food and fuel costs burning a hole in consumers' pockets and with government unilaterally imposing a 3% increase for the current fiscal year, it is difficult to see Treasury sticking to its guns. Financial market participants are estimating a nominal wage increase of anywhere between 5.5% and 6.5%.

A looming election year introduces an additional challenge to curb the wage bill through real wage cuts or a meaningful dent to public sector headcount. Fewer professionals in education, health and security relative to the population unsettles government (see table 1).

As such, it intends to increase capacity in these critical areas.

Table 1: Pressure on public services

	FY15/16	FY18/19	FY21/22
Average number of learners per teacher	32.3	30.7	31.4
Nursing headcount per 100 000 uninsured population	299	287	294
Medical practitioner headcount per 100 000 uninsured population	85	87	95
Police officer headcount per 100 000 population	260	251	236

Source: Treasury, Momentum Investments

In our view, government can prioritise cost cutting while concurrently maintaining service delivery. This goal can be realised 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.

Jumpstarting SA's growth engine through structural reforms

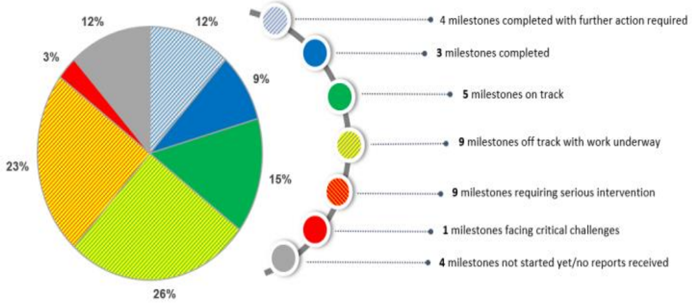
Treasury is likely to repeat the growth initiatives outlined in the SONA. In particular, we are interested in more detail around:

- The estimated R27 billion in cost savings gained if government departments are rationalised
- An infrastructure manager for the Transnet rail network
- The R18 billion roads contract issued by the National Roads Agency
- Plans for a R10 billion fund to support small business growth
- Any developments on the plans for a state bank to be formed (linked to the licencing of PostBank)
- A student model to address the 'missing middle'
- Any further (contingent) bailouts to support struggling state entities

The pace of implementation of structural reforms has disappointed the investor community, particularly against a backdrop of pedestrian growth and a slow recovery in jobs.

Operation Vulindlela was started in October 2020 to address energy shortages, the cost and quality of digital communications, sustainable water supply, competitive freight transport and visa regulations. The latest update suggests that 48% of reform milestones are either completed or on track (see chart 3). However, a significant number has not yet started or requires serious intervention (see chart 4).

Chart 3: Mixed progress on structural reform efforts



Source: Treasury, Momentum Investments

Chart 4: Areas of concern

Activity status	No. of activities	Reforms
	4	• Strengthen regulation of price and service standards in the water sector • Develop and implement a programme to enable private sector participation in source and bulk infrastructure • Expand visa waivers and explore visa recognition system • Develop a fit-for-purpose procurement regime for state-owned entities
	1	• Improve Energy Availability Factor (EAF) to over 70%
	9	• Procure new generation capacity in terms of IRP 2019 • Address institutional inefficiencies in municipal electricity distribution • Complete migration from analogue to digital signal • Finalise Rapid Deployment Policy and Policy Direction • Address institutional inefficiencies in municipal water distribution • Improve efficiency of ports • Expedite the issuance of title deeds for subsidized housing • Review and adjust the fuel price formula • Create a modern and efficient mining rights system

Source: Treasury, Momentum Investments

Addressing malfunctioning municipalities

In June 2022, the auditor general awarded a clean audit to only 16% of SA's 257 municipalities for financial year 2020/21, with Limpopo, Mpumalanga, Northern Cape, Free State and Eastern Cape ranking among the worst provinces. Only 61 municipalities have a better audit outcome than in 2016/17, with 56 municipalities having a worse outcome.

The auditor general notes that in its assessment of the municipalities, the senior management of only 11% of the municipalities was fully effective given instability in political and administrative leadership. Moreover, it assessed that only half of internal audit units had an impact on financial and performance management and compliance with legislation, given that managers were not implementing their recommendations at the other half.

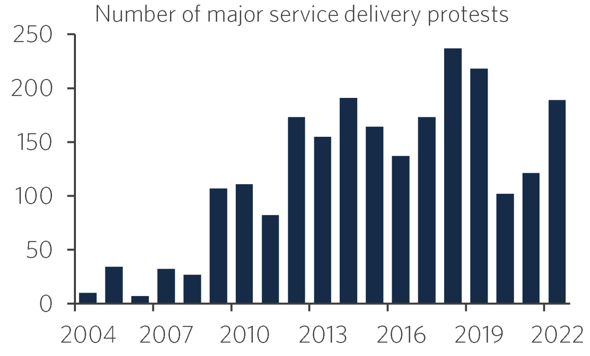
Municipalities spent a sizeable R238 million on financial reporting consultants for 2020/21, but the quality of financial statements remained poor given weak internal controls.

Government has responded to the weak state of its municipalities by implementing a District Development Model (DDM), which Cabinet adopted in 2019. Government found that operating in silos led to incoherent planning and implementation. Under the DDM, government aims to reduce duplication and fragmentation through a 'One District, One Plan and One Budget' system within the three spheres of government. This should also strengthen budgeting and implementation of more impactful service delivery.

Moreover, in dealing with the quality of public service, the SONA indicated that integrity assessments would be introduced to increase professionalism in public service and the Public Service Commission will guarantee that only qualified people are appointed to senior positions.

The failings of our defunct municipalities have driven up service delivery protests. The number of major service delivery protests reported by Municipal IQ picked up to 189 for 2022, up from 121 the year before, when activity was suppressed by COVID-19 lockdowns (see chart 4). Given that we are heading into a general election in 2024, the number of service delivery protests could increase further this year.

Chart 4: Major service delivery protests rise after a temporary COVID-19-related dip



Source: Standard Bank Group Securities, Municipal IQ

Treasury faces some tough financing decisions, but outcomes could be delayed

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 International Monetary Fund (IMF) expecting inflation to remain above pre-pandemic levels in more than 80% of economies in 2024, lowering interest rates to encourage higher growth in domestic demand remains constrained.

The IMF has cautioned that the next crisis could be around the corner and as such, emerging markets need to restore fiscal, external and financial buffers. Exercising fiscal rules and actively taking steps to reduce crushing public debt burdens can strengthen macroeconomic resilience.

In SA's case, this has become increasingly tricky in a torpid economy. Public investment requires funding and calls on government are sounding louder to expand the social safety net. This all has to be achieved in the context of narrowing the fiscal deficit and stabilising the country's debt ratio.

Government's inability to make tough decisions in the past have caused reason for apprehension. Against pedestrian growth, government decisiveness has become ever more urgent. Timeous implementation of economic plans, including better management of state entities, reducing regulatory and policy uncertainty, improving the ease of doing business, providing reliable services and executing on initiatives to boost investor confidence, can ease government's battle in counterweighting fiscal prudence with inclusive growth.