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Medium-term budget review

1 November 2023

A test of fiscal prowess amid challenging economic prospects and mounting social needs

Initial impressions

- Fixed income and currency markets moved slightly firmer in response to government revising its main budget deficit ratio wider by an average of 0.8% between fiscal year (FY)23/24 and FY25/26 after taking into account a number of austerity-related budget measures (non-interest expenditure cut by R154 billion in the next three FYs) and proposing moderate tax measures. As is common with the medium-term budget policy statement, there was no explicit announcement on what these tax measures would include, but we assume these are likely to be titled towards lower compensation for bracket creep, rather than the implementation of new tax measures.
- South African (SA) equities moved slightly higher on the budget speech but will likely take its direction from global markets given no major announcements for the consumer, other than an extension of the Social Relief of Distress (SRD) grant amounting to R33.6 billion for another year.
- While Treasury has demonstrated its determination to maintain its commitment to fiscal consolidation, market participants continue to be cautious about the challenging fiscal choices required to provide additional support to state entities, tackle the surge in living costs affecting civil servant workers and expand government's assistance to the most vulnerable.
- Treasury's medium-term economic forecasts seem reasonable and are in close alignment with our expectations, as well as with the consensus estimates from Reuters. Specifically, their projected average economic growth rate of 1.1% for the period spanning 2023 to 2025 matches our expectation of 1.1% and is broadly in line with the Reuters median consensus estimate of 1.2%. Moreover, Treasury's headline inflation projection of 5.2% for the same period broadly mirrors our expectation of 5.1% as well as the Reuters consensus of 5%.
- Revenue collections are running lower than budgeted. Treasury estimates the anticipated gross tax revenue undershoot for the current fiscal year at R56.8 billion due to a softer commodity price cycle and loadshedding costs weighing on mining and manufacturing tax collections. While facing a surge in the cost of living, personal income taxes have shown remarkable resilience (expected R6.4 billion overrun), while the run-rate in custom duties (anticipated at a R3.5 billion overrun) remains strong due to the import of solar panels and inverters.
- Treasury estimates a R53.7 billion and a R67.7 billion tax revenue undershoot in FY24/25 and FY25/26, respectively.
- The R85 billion in proposed expenditure cuts over the next two years is split as follows:
    - FY24/25: R37.3 billion → Wage bill adjusted up by R27.9 billion and an additional SRD grant allocation of R33.6 billion → but this is more than offset by a R63.7 billion cut in provincial allocations and a R35 billion reduction in unallocated and contingency reserves.
    - FY25/26: R47.7 billion → Wage bill adjusted up by R29.3 billion, but no extension of the SRD grant allocation → but this is more than offset by a R69.9 billion cut in provincial allocations and a R42.3 billion reduction in unallocated contingency reserves.
- Government predicts that the tax buoyancy (growth in tax revenue per unit of economic growth) is expected to drop to 0.61 in FY23/24 (previously estimated at 1.06) and average 1.09 in the next three fiscal years from 1.21 in FY22/23. Government notes that stronger economic growth and further gains in tax administration are needed to improve tax revenues going forward. Unexciting commodity price projections (Treasury's assumptions on key commodity prices do not deviate too widely from the Bloomberg median consensus forecast for the next three years) and persistent infrastructure limitations are

likely behind government's projected drop in the corporate income tax (CIT) buoyancy ratio from 4.98 in the current FY to 0.67 in FY24/25.

- At a projected 4.7% of gross domestic product (GDP), SA's expected fiscal deficit ratio for the current FY (and 4.3% for the next) looks more favourable than the Reuters consensus of 5.1% (and 5.2% for the next FY). This also compares favourably with a 5.6% deficit projected for emerging markets (EM) in 2023 and 5.5% in 2024, as estimated by the International Monetary Fund (IMF), as well as the 5.2% and 4.4% projected for developed markets (DM) for the same period. Although Treasury projects a significantly narrower government deficit ratio of 3.7% in the outer year of the medium-term expenditure framework (MTEF), the Reuters consensus takes a more bearish view on the success of fiscal consolidation efforts and sees the deficit ratio narrowing to only 4% in FY26/27.
- Treasury noted we have reached a primary budget surplus for the first time since FY08/09, which is expected to be maintained over the medium term. Treasury estimates the gross debt-to-GDP ratio will peak at 77.7% in FY25/26 (4.1% higher than February's estimate) before declining. This compares with a debt ratio of 68.3% in EMs for 2023 (70.1% by 2024 and 72.3% by 2025) and 112.1% in DMs for 2023 (112.7% by 2024 and 113.8% by 2025). Although the debt ratio in itself does not compare too unfavourably on a global scale, the rise in debt (an increase of 47.2% of GDP between 2008 and 2022) and the associated jump in debt-service costs (an increase of 2.6% of GDP over the same period) disadvantageously sets SA apart from its EM peer group.
- We expect the rating agencies to look through the near-term dip in growth and keep SA's sovereign rating intact. SA's ratings strengths, which include a substantial external asset position, low levels of foreign currency debt, a diversified economy, a robust financial system, deep and liquid capital markets and a freely-floating exchange rate, does suggest that the hurdle to downgrading SA to a single B rating is still relatively high. Nevertheless, continued implementation of structural reforms, the effective management of public finances and government's ability to address socio-economic challenges while maintaining a prudent approach to fiscal policy remain important, particularly given the 2.6% rise in debt service costs-to-GDP between 2008 to 2022, which exceeds a wide range of EM peers.

Effect on the economy and financial markets over the medium-term expenditure framework (MTEF) markets

- The tax burden (ratio of tax revenue to GDP) is projected to drop slightly from 25.1% in FY22/23 to 24.7% in FY23/24 before climbing back to 25.1% by FY26/27. In our view, compliance efforts at the SA Revenue Service, closing tax loopholes and improving growth could likely contribute to the ratio ticking higher.
- Government has not yet revealed plans on a fiscally-responsible way forward to permanently extend the SRD grant for 8.5 million recipients. It did nonetheless announce a one-year extension at a cost of R33.6 billion. With Treasury estimating that social grants will cost 3.8% of GDP by FY40/41 (inclusive of the SRD grant), a permanent revenue stream will likely be required.
- A contractionary budget over the MTEF, contingent on government's adherence to fiscal consolidation, tilts the preference towards fixed income assets as opposed to SA listed companies, whose primary business is in SA (SA Inc. shares). Government extracts more from the economy through taxes than it injects back through spending over the medium term. This is evident from an estimated decrease in the main budget deficit as a percentage of GDP (0.5% smaller). In absolute terms, the main budget is expected to expand by R15.6 billion between FY22/23 and FY25/26, while nominal GDP increases by 17.5% over the same period. The contractionary nature of the budget over the medium-term framework is expected to be effected through an average 1.2% reduction in real expenditure growth and a 0.8% real decrease in revenue.
- Government's gross borrowing requirement will rise to R563.6 billion in FY23/24 (R515.6 billion previously) and drop to R478.2 billion by FY26/27. The average funding cost has increased to 9.5% given higher monetary policy rates and inflation. Cash balances are expected to be drawn down from R93.9 billion in the current fiscal year to R25.1 billion by FY25/26. Treasury announced it would raise US$2.4 billion through concessional funding in FY23/24 to meet its foreign-currency commitments and it will use its foreign exchange balances (not related to the Gold and Foreign Exchange Contingency Reserve Account) over the next two years.
- Treasury announced that they will keep the size of their weekly domestic bond auctions unchanged. This suggests that there may be an increased likelihood of additional switch auctions and greater funding than what was initially anticipated from the scheduled Sukuk bond and floating-rate note auctions.

Spending demands postponed but not thwarted

- Notwithstanding significant cuts to expenditure, the budget still places redistribution in the spotlight, with 61% of total expenditure allocated to health, education, housing, transport, social protection, employment and local amenities over the MTEF.
- Treasury proposes extending the SRD grant for the most vulnerable up until the end of March 2025, but there are no further provisions for its continuation in their budget figures, posing an additional risk to expenditures in the MTEF.
- Expenditure estimates outlined in the budget reassuringly show that the spending balance has been tilted in favour of growth-enhancing expenditures. Real growth in capital outlays is expected to average 6% in the next three fiscal years, while real growth in the compensation of employees is expected to decline on average by 1% during the same period. Nevertheless, there was an upward adjustment made to the civil servant wage bill, which will send the share of employee compensation to non-interest spending higher from 40.5% in FY22/23 to 42.1% by FY26/27. With allowances nearly accounting for a third of civil servant remuneration, the IMF has recommended scaling these back to more effectively rein in government's outsized wage bill.
- Interest on debt has exceeded economic growth since FY13/14, implying that the economy is not generating sufficient revenue to cover additional interest costs, resulting in the interest bill consuming government resources that could be better utilised in providing services to SA citizens. Growth in debt-service costs at 4.2% in real terms on average in the medium term is expected to outpace the average anticipated real growth in revenue of 1.7% due to a weaker currency, a still wide deficit and higher borrowing costs. The interest bill is expected to rise from 4.6% of GDP (14.4% of expenditure and 18.2% of revenue) in FY22/23 to 5.4% of GDP (17.6% of expenditure and 22.1% of revenue) in FY26/27. Debt-service costs will on average consume a whopping 22c of every rand government collects in the MTEF. At 8.7%, debt-service costs are the fastest growing expenditure item in nominal terms between FY23/24 and FY26/27, with spending on health and peace and security expected to grow at a mere 3.1% and 3%, respectively, over the same period. Government spends more on debt-service costs than basic education, social protection and health.

Financial troubles at state entities pose a threat to fiscal consolidation in the medium term

- Changes to the debt-relief programme made to Eskom include a conversion of the interest-free loan to an interest-bearing loan, while government intimated it may reduce debt relief to Eskom going forward. This could pose a challenge given Eskom's net loss after tax of R23.9 billion for FY22/23.
- Regarding the failures in the logistics industry, government calculated that coal and iron ore exports forfeited could have added 1.3% to the current account balance, with rail inefficiencies costing SA R411 billion last year.
- In response to the logistics crisis, government announced that a Transport Economic Regulator will be established in early 2024, which will allow for the crowding in of private sector investment through fairer access and more transparent pricing.
- Further financial support will only be considered once the Freight Logistics Roadmap has been kicked off (includes increasing efficiencies, introducing competition, selling off non-core assets and leveraging the private sector for financial and technical support).

Obstacles to replenishing fiscal buffers against the backdrop of structural economic constraints

Treasury explored two economic scenarios (asymmetrical in magnitude to the downside) around its current base case:

- **Upside scenario in which global supply chains ease further:** Lower inflation pressures reduce interest rates and borrowing costs. Consumption and investment prospects improve on lower inflation and lower funding costs, respectively, leaving growth 0.4% higher than the baseline, on average, between 2024 and 2026. The debt ratio would stabilise at 76.3% in FY25/26 in this scenario.

- **Downside scenario in which China slows significantly and oil prices remain:** Imported inflation induces further interest rate tightening, while the country risk premium increases, sending the rand weaker. As such inflation only returns to the baseline by the end of 2026. Growth is expected to be 0.5% weaker than the baseline, on average, between 2024 and 2026 as consumer purchasing power dips. The debt ratio would only stabilise at 79.8% in FY27/28 under these economic circumstances.

Treasury noted progress on structural reforms in a number of areas in the economy and these likely inform their view on longer-term trend growth of 2.1%:

- **Review of conditional grants system:** A more prudent way to support service delivery.
- **New funding models for municipalities:** Allows municipalities to continue earning revenue through the clean energy transition.
- **Industrial development:** Collaborating with other African countries to develop battery production capacity.
- **Completed review of the Public-Private Partnerships framework:** Regulations to be published before Budget 2024 and will outline guidelines on sustainable financing arrangements and contract and project management.
- **Widening scope for concessional borrowing for infrastructure projects:** Allows for multilateral institutions to co-invest with government, including social infrastructure projects.
- **Tabling of the Public Procurement Bill:** Enables the fight against corruption.
- **Fiscal anchors:** To address the failures of not meeting the expenditure ceiling (more detail will be revealed in February).
- **Addressing deficiencies highlighted by the Financial Action Task Force (FATF):** Good progress made on 17 of the 22 action items and have addressed 5 of the 20 technical deficiencies → nevertheless, more work needs to be done in terms of combatting money laundering and terror financing.

Despite various economic and political reform initiatives, SA has made no progress in its comparative ranking in the World Justice Project Rule of Law Index, particularly on the order and security measure, where the country continues to trail the global average by a significant margin, highlighting risks to SA being removed from the greylist in the 2025 review by the FATF. While insufficient energy supply and logistics constraints cripple SA's growth trajectory, Operation Vulindlela has made significant strides in the energy and transport areas of the economy suggesting that growth in the medium-term could approach a 2% handle.

Budget likely credit neutral in the interim but financing risks a threat further out

- Government had previously acknowledged that SA's modest projected economic growth, hampered by energy and logistics shortcomings, is insufficient to address the pressing issues of high poverty and inequality. Despite the return of economic activity to pre-pandemic levels, SA's growth is consistently lagging behind that of its counterparts, to the extent that per capita growth has remained largely stagnant since the global financial crisis.
- While growth in GDP on a per capita basis averaged 1.4% for DMs over the past decade and 2.7% for EMs, growth in per capita GDP has declined by 0.4% on average for SA.
- SA's debt burden remains substantial (R84 446 on a per capita basis) and the threats to controlling spending and providing additional funds to troubled state entities and struggling municipalities are still significant in the medium to long run. Many challenging fiscal decisions are essentially being delayed rather than addressed, in our view.
- A number of municipalities remain in financial and operational disarray. Local government arrears climbed to R99.9 billion in FY22/23 from R89.7 billion in FY21/22, while uncollected revenues increased from R255.4 billion to R313.2 billion. Money owed to Eskom, the Department of Water and Sanitation and the water boards increased from R63.5 billion in FY21/22 to R88 billion at the end of June 2023.
- 67 Municipalities have applied for debt relief for arrears debt owed to Eskom amounting to R56.8 billion (97% of the total municipal debt owed). To date, 28 have been approved.
- The speed of reform efforts remains disappointingly slow, especially in the face of sluggish economic growth, making a stronger push for implementation essential. With low growth posing a fiscal risk amidst a more divided voter base and increasing socio-political demands on government resources, particularly in the pursuit of upward mobility due to insufficient employment opportunities, SA's path to fiscal consolidation and debt stabilisation is squeezed between limited growth prospects and mounting expenditure pressures.
- Consequently, while credit ratings are likely to stay stable in the short term, the persistent fiscal and growth risks over the medium to long term suggest a potential downside risk to SA's sovereign rating outlook in the future.
- Treasury highlighted a number of long-term fiscal risks, which include lower potential growth, difficulty in executing government's borrowing strategy and spending pressures (particularly at local government level and at the state entities).