



National budget preview: Focusing on five fiscal flags

Highlights

- Pledging to uphold sustainable public finances remains arduous amid a geopolitically fraught global backdrop, less supportive growth in the world economy and ongoing energy and logistics impediments locally. These factors collectively imperil government revenue growth, widen the budget deficit and elevate the country's debt ratio.
- South Africa's (SA) gross government debt ratio stood at 67.8% in fiscal year (FY) 2021/22, notably lower than the 112.3% average for developed markets (DMs) and only slightly higher than the average of 65.3% for emerging economies. Nevertheless, the country's debt ratio has deteriorated at a faster pace compared to many of its emerging market (EM) counterparts since the global financial crisis (GFC), leading to an escalation in debt-service costs. This situation has been worsened by tighter global monetary conditions and an elevated risk premium, resulting in a shift of resources from critical policy priorities to servicing the government's debt pile.
- Government's efforts towards fiscal consolidation persistently face challenges due to an extremely uncertain economic and political environment, a tax base that is narrow and overextended, and escalating demands for government spending to expand social welfare and rescue financially distressed state-owned enterprises (SOEs).
- In line with this backdrop, we focus on five fiscal flags that are likely to feature in the upcoming national budget to be tabled on 21 February 2024 by Finance Minister Enoch Godongwana.
- **Flag #1: Fiscal run rate and finding ways to fortify revenues:**
Gross tax revenues are only running marginally behind schedule based on collections between April and December 2023. We anticipate that any significant opportunities for generating new revenues will likely be constrained by the fact that 2024 is an election year. Consequently, apart from customary excise duties and smaller inflation adjustments to tax brackets, we foresee limited room for significant shifts in tax policy this year.
- **Flag #2: Further demands on government's strained fiscus:**
The local economy faces continued strain, attributable to supply-side limitations within the domain of energy and logistics. Concurrently, government expenditure is growing, driven by a hefty public wage bill and heightened demands for expanded social welfare provisions, while compounded by irregular and wasteful spending.
- **Flag #3: Fiscal support pressurising the fiscal framework:**
Given Transnet's significance to economic growth, officials might perceive limited alternatives but to intervene. However, extending financial aid to Transnet at a time when fiscal policy is expected to become less stringent ahead of this year's election will only exacerbate the challenge of establishing SA's public finances on a sustainable path.
- **Flag #4: Financing options to fill the fiscal gap:**
Government's main budget balance could end up being nearly 1% wider than the medium-term budget estimates pencilled in for FY2024/25 to FY2026/27. The market broadly expects T-bill issuance to play a significant role in financing the larger-than-anticipated budget deficit. Extending floating rate notes, an additional Sukuk issuance,

switch auctions and external concessional financing could also be likely funding options. Analysts have raised the option of using the unrealised gains from the Gold and Foreign Exchange Contingency Reserves Account (GFECRA) to either cover redemptions on maturing government debt or to finance government expenditure. While this option does not resolve SA’s structural fiscal challenges, which depend on the implementation of key reforms to generate faster and more sustainable economic growth, it could help to either reduce government’s budget deficit and/or alleviate government’s debt burden.

- **Flag #5: Fiscal risks undermining the sovereign rating further out:**

Risks to government’s fiscal consolidation and debt stabilisation plans continue to include a weaker global backdrop, structural impediments to local growth, maladministration and financial strains at municipalities and SOEs and higher borrowing costs due to an elevated country risk premium and tighter global monetary conditions. The extent of projected fiscal slippage in the upcoming national budget is unlikely to trigger sovereign rating downgrades in the near term, but risks are higher further out.

Fiscal consolidation amid formidable macro factors

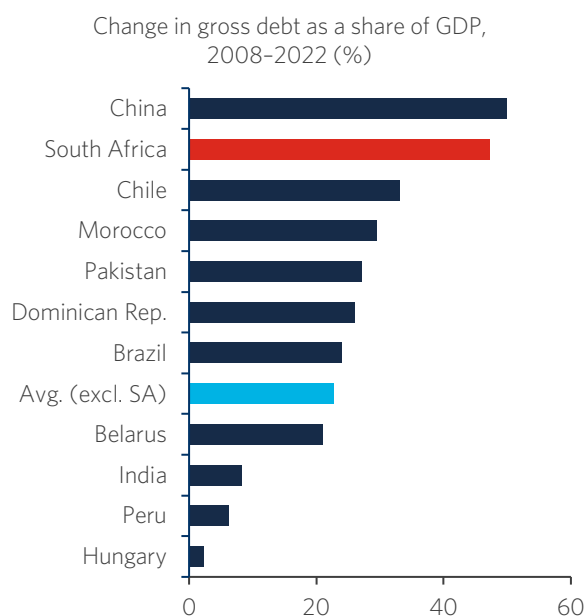
Upholding sustainable public finances proves daunting amid a globally tense geopolitical atmosphere, sluggish growth in the world economy and ongoing local obstacles in energy and logistics, which continue to hold back potential growth.

These factors collectively dampen economic growth prospects, jeopardise government revenue growth, widen the already-sizeable budget deficit and elevate the country’s debt ratio.

and slightly higher than the average of 65.3% for Ems, according to data from the International Monetary Fund (IMF). However, the country’s debt ratio has deteriorated faster than many of its EM counterparts since the GFC (see chart 1).

The amount of debt on a per capita basis has climbed from around R14 755 in FY2007/08 to an estimated R99 130 in FY2022/23 (see chart 2).

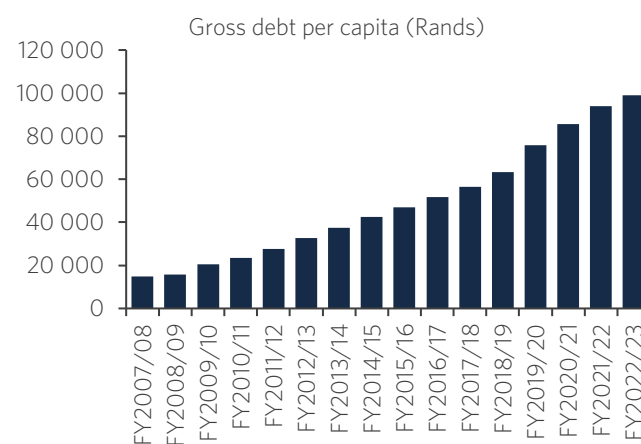
Chart 1: SA’s deteriorating debt profile



Source: National Treasury, Momentum Investments

SA’s gross government debt ratio reached 67.8% in FY2021/22, notably below the 112.3% average for DMs

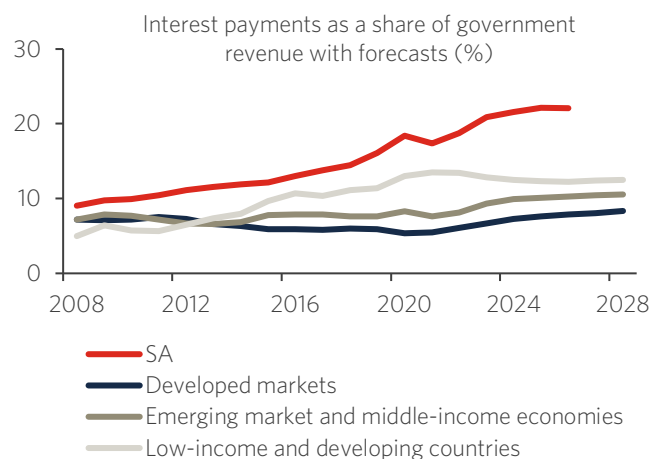
Chart 2: Value of government’s debt attributable to each SA citizen



Source: National Treasury, Statistics SA, worlddata.info, Momentum Investments

A larger debt pile, coupled with tighter global monetary conditions and an elevated risk premium, has led to a sharp rise in debt service costs since the GFC, which diverts resources from crucial policy priorities (see chart 3).

Chart 3: Sharp escalation in debt-service costs



Source: IMF, Momentum Investments

The amount that the SA government has spent on servicing the debt bill daily (including weekends) over the past few years has similarly climbed from R145 million in FY2007/08 to an estimated R842 million in FY2022/23 and will likely climb to over R1 billion a day by FY2025/26 (see chart 4).

Government's pursuit of fiscal consolidation consistently encounters challenges due to an exceptionally uncertain economic and political environment, a narrow and overstretched tax base, and mounting demands for government spending to bolster social welfare and assist financially struggling SOEs.

Fiscal flag #1: Fiscal run-rate and finding ways to fortify revenues

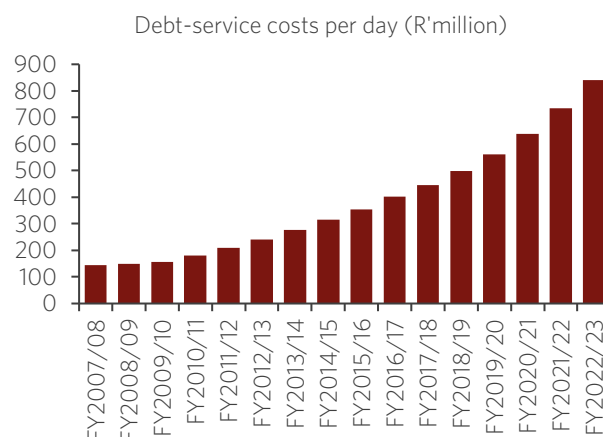
Gross tax revenues are running marginally behind schedule based on collections between April and December 2023. This is largely owing to an underperformance in corporate income tax (CIT) collections. CIT collections were down 14.2% year on year (y/y) on a FY-to-date (FYTD) basis. National Treasury is expecting a shallower drop of 13% y/y for the full FY2023/24. A decrease in receipts from the mining industry has been driven by softness in commodity prices. As such mining's share of CIT is coming off its recent high (see chart 5).

Outside of the corporate tax take, tax collections have displayed general resilience overall. Personal income

National Treasury vocalised its support for the implementation of a fiscal anchor, which could involve a fiscal rule to keep debt metrics below a pre-determined threshold or to target a primary budget surplus. In our view, this would add credibility to government's fiscal consolidation efforts, particularly at this juncture of the election cycle.

Against this backdrop, we highlight five key fiscal concerns likely to feature in the forthcoming national budget presentation on 21 February 2024 by the finance minister.

Chart 4: Government's daily cost of servicing its debt pile



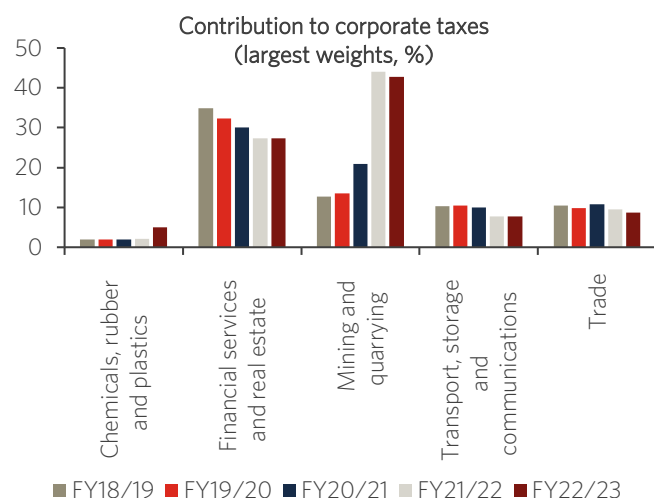
Source: National Treasury, Momentum Investments

taxes (PIT) are running ahead at 8.3% y/y FYTD compared with a lower 7.8% full-year estimate projected in the November 2023 medium-term budget.

Value-added tax (VAT) collections are up 6.1% y/y FYTD compared with an assumed 5.5% y/y for the full year in the budget, underpinned by firm domestic VAT receipts and a moderation in VAT rebates. Import VAT was nevertheless weaker.

Fuel levies are running well ahead of schedule at 20% y/y FYTD, while port congestion issues dampened customs duties which dipped 0.6% y/y FYTD up to December 2023.

Chart 5: Mining's share of CIT coming off the recent high



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

In the medium-term budget, however, Godongwana announced that National Treasury would look to raise an additional R15 billion in additional taxes in FY2024/25.

We anticipate that any significant opportunities for generating new revenues will likely be constrained by the fact that 2024 is an election year. Consequently, apart from customary excise duties and smaller inflation adjustments to tax brackets, we foresee limited room for significant shifts in tax policy this year. Furthermore, raising fuel taxes could be another potential source of tapping additional revenues particularly as international oil prices have retraced from previous highs.

Government agreed to keep these taxes steady in the past two years to alleviate the strain on the cost of living.

Fuel levies

The general fuel levy is currently at R3.95 per litre (around 18% of the retail price), while the Road Accident Fund is at R2.18 (around 10% of the current retail price). *BusinessTech* notes that should an inflation-related increase be considered by government, motorists could be facing an additional 27 to 37 cents per litre more in the way of fuel taxes by April 2024.

PIT

At the World Economic Forum in Davos earlier in January this year, Godongwana noted that tax increases for households and companies would add strain at a time when they are already under financial pressure. PIT constitutes the largest portion of all tax revenue collected by the SA Revenue Service (SARS), at a share of 35.5% in the 2022 Tax Statistics report. Raising PIT remains a challenge given the narrow tax base even though raising taxes for the top income-earning brackets would be more palatable than considering a more regressive form of PIT increases across the income-earning spectrum for eligible taxpayers. In a 2021 Afrobarometer survey, 16% said that taxes for ordinary people were too little, while a greater 34% said that taxes for the rich were too little. Increasing rates at the highest tax brackets only target a few and would unlikely yield significant additional revenue.

CIT

Moreover, CIT, which accounts for 20.7% of total tax revenues is unlikely to be raised given that rates were lowered from 28% to 27% in April 2022. It is more probable that this rate would decline over time to increase global competitiveness and to encourage inward direct investment.

VAT

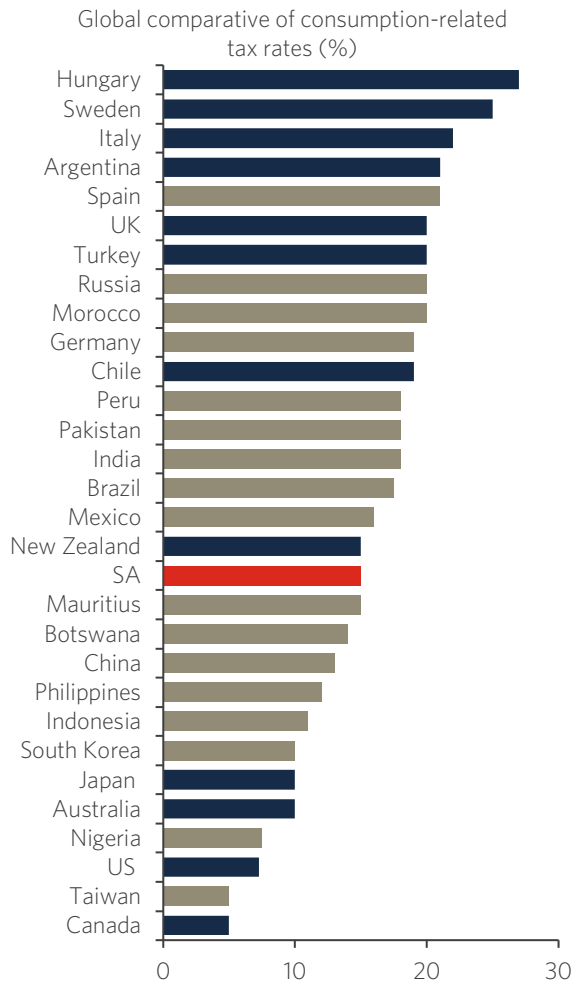
While we think it unlikely that the VAT rate would be hiked in an election year, higher VAT rates may be used in the future to fund more permanent streams of expenditure such as to provide funding for the implementation of the National Health Insurance (NHI) Bill or to cater for a more permanent extension of the Social Relief of Distress (SRD) grant. Unlike PIT rates, by a global comparison, SA's VAT rate is not among the highest (see chart 6). ENSafrica calculates that a 1% hike in the VAT rate can yield up to R15 billion but the amount collected would likely be lower after catering for an extension of zero-rated products to shelter more vulnerable households, given the regressive nature of VAT hikes.

Medical tax credits

Outside of these top contributing tax components, there is a chance that medical tax credits could be adjusted as a potential mechanism to fund the NHI plan. *BusinessTech* reported that total medical tax

credits for FY2020/21 amounted to R28 billion, with an additional amount of R7.5 billion related to out-of-pocket medical expenses. The SA Institute of Taxation estimates that this works out to R4 400 per year for an individual taxpayer and up to R14 000 per year for a family of four, which is received in the form of a non-refundable rebate that reduces total tax paid.

Chart 6: Global consumption-related tax comparison



Source: SARS, Momentum Investments
 Navy = developed economies, Grey = emerging economies

Carbon taxes

The first phase of the carbon tax was extended to the end of 2025. The passing of the Climate Change Bill by the National Assembly could have implications for a higher rate from 2025 onwards.

Fiscal flag #2: Further demands on government’s strained fiscus

There is unlikely to be much enthusiasm for austerity measures in crucial areas during an election year. Nonetheless, the finance minister may opt for minor

Removal of tax incentives

Previously, the Parliamentary Budget Office noted the need to remove tax incentives in areas of the economy where they are no longer effective.

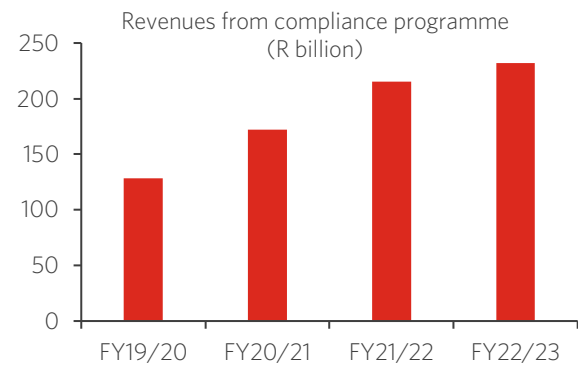
Progressive taxes on wealth

While these may not be considered for the upcoming budget, government may look into expanding the property tax base or increasing capital gains tax, donations tax (currently 20% on a donation under R30 million), estate duties tax (currently 20% on an estate under R30 million) or dividend withholding tax (currently 20%) in the future. While these taxes are unlikely to massively shift the dial on revenue collection, it could be a signal to indicate that progressive taxes are being targeted first.

Increasing compliance

Revenue from the SARS compliance programme has yielded significant results (see chart 7) in the past few years and this assists in closing the tax gap in a meaningful way.

Chart 7: Closing tax loopholes



Source: SARS, Momentum Investments

‘Two-pot’ retirement system

The commencement date for the changes to the retirement system has been officially set for 1 September 2024. This revised structure will enable taxpayers to access a portion of their retirement funds, potentially impacting PIT revenues.

adjustments. Without substantial reductions, government borrowing is nonetheless poised to persist.

The challenge inherent in an environment marked by rising costs and expenditure, compounded by a growing debt burden, is that affordability becomes increasingly problematic, while more critical areas of expenditure are curbed.

The local economy faces continued strain, largely attributable to supply-side limitations within the energy and logistics domains. Concurrently, government expenditure is escalating, driven by a hefty public sector wage bill and heightened demands for expanded social welfare provisions, while compounded by irregular and wasteful spending. The *Citizen* reported on the Auditor General's findings in November last year that government wasted R22 billion due to wasteful expenditure and irregularities, as well as suspected fraud and corruption during the incumbent President's term.

Nedbank notes that a slippage in expenditure looks likely at this stage with government departmental spending up 6.4% y/y FYTD up to December 2023. This is despite National Treasury's commitments to scale back on baseline budgets.

Key risks to government's medium-term expenditure profile remain debt-service costs, the public sector wage bill, a more permanent extension of the SRD grant and additional funding commitments to ailing SOEs, including Transnet.

Public sector wage bill

The outcome of the wage negotiations at the 2023 Public Sector Coordinating Bargaining Council resulted in a broad consensus on a two-year agreement, entailing a 7.5% increment. It was agreed that the cash allowance would be converted into a pensionable salary with an additional raise of 3.3% for FY2023/24, followed by an inflation-linked increase for FY2024/25. The nature of the two-year agreement lowers the propensity for a public sector-wide strike on wages.

Extension of social grants

Following the impacts of the pandemic and conflicts in Ukraine and the Middle East, vulnerable households continue to grapple with financial instability. In

response, the finance minister announced an extension of the SRD grant until March 2025 in the medium-term budget. This extension allows the government sufficient time to deliberate on social security policy reforms and develop a sustainable funding model. Initially introduced in May 2020 as a temporary measure to assist the most vulnerable, there is now a push from the ruling party to establish a more permanent income stream for financially precarious households as part of its anti-poverty efforts.

In our review of the SONA, we highlighted the budgetary impact of an extension of the SRD grant at various poverty lines as part of a study conducted by Codera Analytics and Stellenbosch University. They concluded that keeping the grant at R350 per month for 10.5 million recipients (roughly R44 billion) would be the least costly for debt levels and job losses in SA.

An IMF paper, entitled "The Link Between Social Grant and Employment in South Africa", published in June 2023 noted that the World Bank projects that transfers represent roughly 60% of household spending for the bottom fifth of the SA population, a figure notably higher than the estimated 7% for the entire population, implying that grants are effectively targeted at the more vulnerable households. The World Bank estimates that social grants have reduced the poverty rate in SA anywhere between 10% and 40%, depending on the chosen official poverty line. Social grants have been proven to lower the Gini coefficient (a measure of inequality) by an estimated 7%.

The IMF paper then went on to prove that younger members of households, who receive grants indirectly through income-sharing, often exhibit lower probabilities of employment compared to other indirect recipients. This observation may stem from limited job prospects and a lack of motivation among youth to seek employment. Additionally, given that younger individuals typically possess lower skills and income levels, increased income from grants may further deter them from seeking work. This effect is likely exacerbated for those experiencing spatial inequality, which can elevate the costs associated with job searches.

As such, the IMF proposes strategies aimed at sustainably boosting employment and reducing job creation costs through initiatives such as improving the transition from school to employment, enhancing the employability of inactive labour force participants and optimising the job search process. Additionally, interventions aimed at enhancing entrepreneurial skills, elevating basic education levels, and reforming social housing policies could enhance economic participation among residents in remote and traditional settlement areas. These measures would complement efforts to minimise rigidities, foster competition in product and labour markets, stimulate growth and increase the demand for labour.

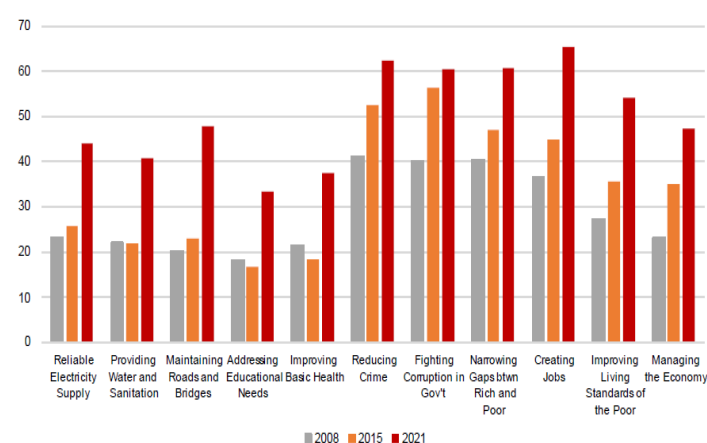
Cost cutting

Balancing cost reduction with continued service delivery may be achievable by reassessing surplus administrative and managerial personnel, aligning salaries with equivalent private sector skills, evaluating allowances and pay advancements, and streamlining committees and institutions across different levels of government.

Considering that real government spending per capita has remained stagnant over the past decade, proposed

austerity measures are expected to place greater strain on the nation's delicate social structure. This could increase the likelihood of service delivery protests, in our view, given that many citizens already believe that government's handling of services is "very bad" (see chart 8).

Chart 8: Share of respondents indicating government handling as "very badly" (%)



Source: Ricardo Haussman (Growth through inclusion in SA, November 2023), Afrobarometer Surveys

Fiscal flag #3: Fiscal support pressurising the fiscal framework

BusinessTech reported on the Auditor General's findings late last year, which found that only the Development Bank of SA (DBSA) received a clean audit out of the country's major 19 SOEs. Among the entities that performed poorly were those under the Department of Public Enterprises, which include Eskom, Transnet, Alexkor and SA Airways (SAA).

Eskom

We are not forecasting any financial assistance provided to Eskom above the R254 billion granted over the upcoming three-year period, with R44 billion already having been distributed to the company. A dedicated task force has been formed to oversee adherence to the terms of the bailout and to provide quarterly assessments on Eskom's eligibility for converting the loan into equity.

Transnet

Transnet received an unqualified audit with findings in the Auditor General's report late last year, indicating its ability to produce high-quality financial statements but facing challenges in producing quality performance reports and/or complying with all key legislation. Late last year, the finance minister unveiled a R47 billion guarantee facility for Transnet, aimed at assisting the company in managing its near-term debt commitments and bolstering its logistics transformation strategy.

According to a report by *Business Day*, ratings agency Fitch stated on Friday that it anticipates the National Treasury will provide Transnet with R50 billion over the next two fiscal years, either through a capital injection

or debt transfer to free the company from its R130 billion debt pile.

Given Transnet's significance to economic growth, officials might perceive limited alternatives but to intervene. However, extending financial aid to Transnet

at a time when fiscal policy is expected to become less stringent ahead of this year's election will only exacerbate the challenge of establishing SA's public finances on a sustainable path.

Fiscal flag #4: Financing options to fill the fiscal gap

Government's main budget balance could end up being nearly 1% wider than the medium-term budget estimates pencilled in for FY2024/25 to FY2026/27. The market broadly expects 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. Extending floating rate notes, an additional Sukuk issuance, switch auctions and external concessional financing could also be likely funding options.

GFECRA

Market participants have raised the option of using the unrealised gains from the revaluation of gold and foreign exchanges to either cover redemptions on maturing government debt or to finance government expenditure. While this option does not resolve SA's structural fiscal challenges, it could help to either reduce government's budget deficit or alleviate government's debt burden.

Revaluation gains are paid into the GFECRA. According to SBG Securities, the balance in the GFECRA has increased to around R500 billion (or close to 7% of GDP as estimated by RMB Morgan Stanley), which would more than cover the fiscal deficit.

However, the amount in the GFECRA changes each year depending on gains and losses due to market movements. Given the rand's current undervalued position, it is expected to appreciate in the coming quarters due to cyclical factors. This currency movement could see a reversal in the gains of the GFECRA). SBG Securities outlines a more extreme

scenario in which the currency strengthens to R10 to the US dollar.

Under these circumstances SBG Securities calculates that the GFECRA would transition from having a balance of R500 billion to being in deficit, potentially pushing the SA Reserve Bank (SARB) into a negative equity position. Such a scenario could jeopardise the credibility of the SARB. As such, a buffer would need to be left in the account to accommodate for swings in the currency.

This is however not a costless option and a policy-rate-related interest amount would be due regularly, even if only a partial drawdown is considered. SBG considers a scenario in which the SARB monetises the transfer (rather than raising cash through the sale of foreign exchange reserves, given a comparatively low balance of reserves on global standards). This would increase the amount of rands in the system and therefore sterilisation methods would have to be considered to avoid an inflationary impact on the economy. As such, this raises an interest cost on the SARB's balance sheet. SBG calculates that at the current repo rate, a R100 billion GFECRA monetisation would double the SARB's interest expense.

There is a general consensus across market participants that employing funds from the GFECRA should not significantly erode credibility, but this should be viewed as a windfall. Leaving a buffer in place is also viewed as necessary to avoid the potential for a negative equity position for the SARB. Moreover, a clear and transparent framework would have to be devised, particularly if GFECRA funds are phased in over time.

Fiscal flag #5: Fiscal risks undermining the sovereign rating further out

National Treasury previously highlighted that the main challenges to the fiscal forecast in the upcoming decade included diminished potential growth, challenges in implementing the government's borrowing plan and expenditure pressures in local government and SOEs. Additionally, the sustainability of social commitments poses a risk amid a backdrop of sluggish economic growth.

Moderating global growth

Despite the IMF shifting its outlook on the global economy to a higher probability of a so-called 'soft landing', it expects growth in the global economy in the next two years to fall short of the historical average of 3.8% experienced between 2000 and 2019. Elevated central bank policy rates aimed at combating inflation, reduced fiscal assistance amid high debt levels impeding economic activity and sluggish underlying productivity growth have contributed to this view. Moreover, the IMF further warned in its January 2024 update that geoeconomic fragmentation is starting to affect global trade volumes.

Local growth impediments

Against this backdrop of softer global growth and rising trade tensions, the outlook for local growth remains reasonably pedestrian. Structural constraints in the energy and logistics sectors, locally, further hamper growth prospects. The SARB estimates that loadshedding detracted 0.7 percentage points from growth in SA in 2022 and up to two percentage points in 2023. Similarly, logistic impediments have dragged growth lower. The Journal of Transport and Supply Chain Management reported that disruptions and failures at Transnet's rail and port operations amounted to R505 billion in 2022, equivalent to 7.4% of GDP.

Ailing SOEs and municipalities

Support for 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. 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. Nevertheless, SOE reforms are likely to take some time to bear fruit.

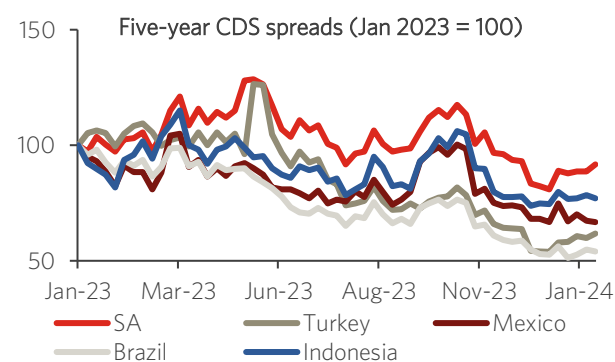
Moreover, financial concerns at local government level induce additional fiscal risks further out. The Auditor General's outcomes for municipalities for FY2021/22 revealed that only 29% of the expenditure budget of local government managed to achieve a clean audit status. At the State of the Nation Address, the president noted the success of the District Development Model and government's aim to roll this out further to more adequately address social delivery challenges.

Long-term social commitments

In a low-growth environment, government's ambitions for longer-term social commitments remain at risk, particularly in the absence of a sizeable fiscal buffer. In the medium-term budget, government noted that an extension of the SRD grant in its current form would result in social assistance accounting for 3.8% of GDP by FY2040/41. Spending on public healthcare could rise to 6% of GDP by the same time horizon if the NHI policy is implemented. Similarly, above-target inflation in higher education would leave this sector demanding 1.5% of GDP by FY2040/41.

Fiscal risks in SA have arguably contributed to the larger relative movement in the country's five-year credit default swap (CDS) spread in the past year (see chart 9).

Chart 9: SA's five-year CDS spread has traded above its peers



Source: Bloomberg, Momentum Investments

While the extent of projected fiscal slippage in the upcoming national budget is unlikely to trigger sovereign rating downgrades in the near term from current levels (see table 1), SA’s relative growth underperformance against a range of EM peers and worsening fiscal and debt metrics could lead to a downward adjustment in ratings further down the line.

Table 1: Poor macro fundamentals pressure ratings further down the line

Long-term rating	S&P (Mar 2023)	Fitch (Dec 2021)	Moody's (Apr 2022)
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
	BB-	BB-	Ba3
Outlook	Stable	Stable	Stable

Local currency rating
Foreign currency rating
Both ratings

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

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