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National budget preview: Charting the seven Cs

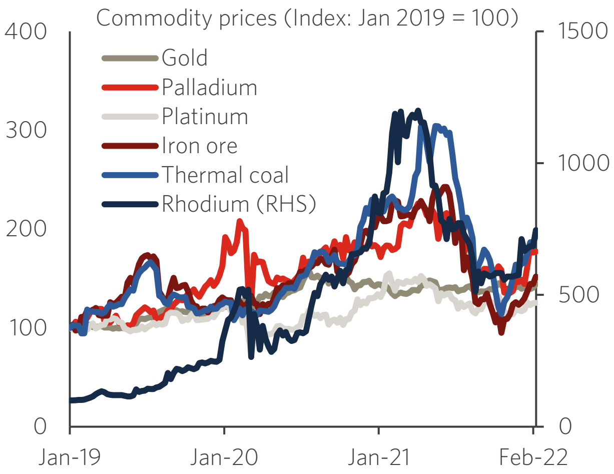
Highlights

1. **Commodity prices catapult corporate revenues:** Although prices of South Africa's (SA) exported commodities have rolled over since their peak, prices have bounced off their lows and remain higher than before the onset of the COVID-19 pandemic. Higher mining revenues are expected to buoy corporate income taxes (CIT) in the near to medium term, but the likely temporary nature of the commodity price windfall heralds a warning for introducing permanent expenditure line items that are not matched with an equivalent permanent revenue stream. Even though the rate of deterioration in SA's fiscal situation has abated markedly, with no additional permanent revenue structures in place to cater for rising expenditure risks, risks to fiscal consolidation remain elevated in the medium to longer term.
2. **Consolidation trends could improve in the near term:** SA's fiscal and debt situation has improved on account of the recent commodity price boon underpinning stronger revenue growth. This should allow for progress in government's fiscal and debt ratios in the near to medium term. Nonetheless, potential slippage on the government wage bill, a larger and more permanent form of basic income support and additional bailouts to fragile state-owned enterprises (SOEs) remain key risks to fiscal consolidation and debt stabilisation in the medium to longer term.
3. **Cost of servicing debt remains elevated:** While the pace of debt accumulation is likely to slow, SA's overall debt burden and associated interest bill remain high. For every R1 of revenue, nearly 20 cents is directed towards the cost of interest on government's debt pile, which crowds out spending on essential policy priorities.
4. **Containing the civil servant wage bill remains an upside risk to expenditure:** Government has shown its resolve to curb the wage bill by refusing to pay the increase in the third year of the 2018 multi-year wage agreement. Yet, it reneged on its firmer stance against unions' demands by granting a generous cash bonus, which is pencilled in for the next fiscal year as well. Moreover, government workers are unlikely to settle for a wage increase that comes in below inflation, posing upside risk to the overall wage bill despite restraint shown on headcount.
5. **Curbing the rise in equality through an extension in social grants:** Lower levels of social unrest and higher than expected household consumption spending during 2021 signal the success of the Social Relief of Distress (SRD) grant in reducing inequality and alleviating poverty. However, introducing a more permanent expansion of the grant system may necessitate a more permanent revenue stream to limit the drag on the fiscus.
6. **Contingent liability risks are a function of unbudgeted bailouts:** The extent to which government digs in its heels to curb additional expenditure on unstable SOEs will determine how successful it is in stabilising the debt ratio in the medium to long term.
7. **Credit-neutral budget outcomes expected in the near term:** The likelihood of smaller government deficit and lower government debt ratios for the current fiscal year and next should alleviate rating agency concerns in the near term. Low trend growth, sluggish reforms and medium-term fiscal risks nevertheless paint a more bearish picture for sovereign ratings in the medium to longer term.

1. Commodity prices catapult corporate revenues

Although commodity prices have rolled over from their peak levels in 2021, they have recovered from their latest trough and remain significantly higher than the beginning of 2019 (see chart 1).

Chart 1: Prices of SA's exported commodities still higher than pre-COVID-19 levels

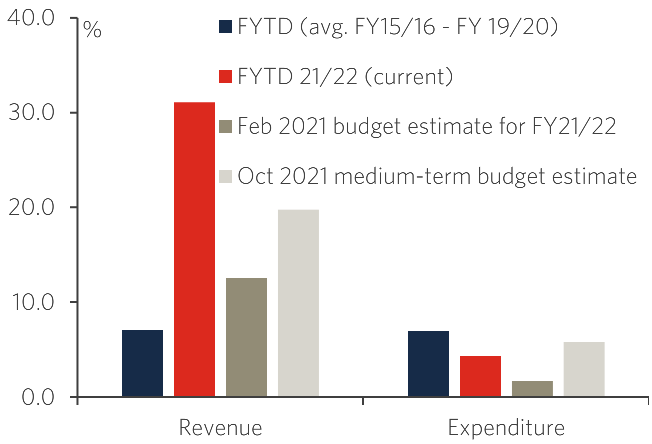


Source: Bloomberg, Momentum Investments

At the time of writing, gold prices have bounced 8.5% since their most recent trough, palladium 23.6%, rhodium 31.3%, platinum 9.2%, iron ore 37.4% and thermal coal 40.9%.

Robust commodity prices and a quicker-than-anticipated rebound in economic growth have led to an upside surprise in government revenues (see chart 2). Year-on-year (y/y) growth in government revenues on a fiscal year-to-date (FYTD) basis rose 31.3% in December 2021. This far exceeded the five-year average recorded between FY2015/16 and FY2019/20 (for the corresponding period). We have excluded FY2020/21 from the historical comparison given the damaging effects of the pandemic (and resultant government-induced lockdowns) on fiscal revenues. The FYTD growth rate is also significantly higher than what government proposed for the full FY (12.6% y/y) in the February 2021 national budget and the October 2021 medium-term budget (19.8% y/y).

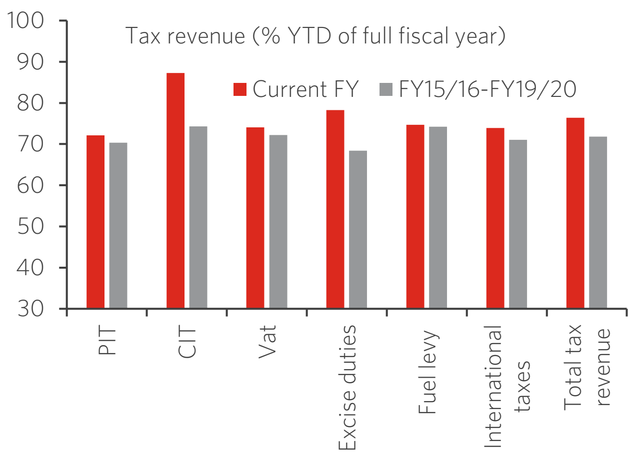
Chart 2: Growth in government revenue and expenditure compared to past average and government targets



Source: Global Insight, Treasury, Momentum Investments

Chart 3 shows that all of government's major tax revenue streams have surprised to the upside. The largest overshoot FYTD has nonetheless been in the corporate income tax (CIT) segment, where 87.2% of the budgeted amount for FY21/22 has already been collected. On average (FY15/16 to FY19/20), only 74.3% of the full fiscal year would have ordinarily been collected for the first nine months of the fiscal year.

Chart 3: Tax collections are running ahead of the average run rate

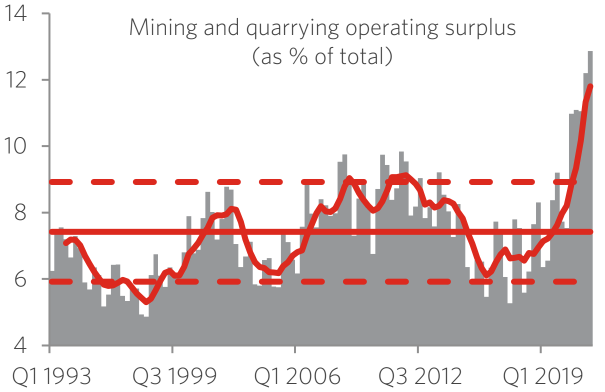


Source: Global Insight, Treasury, Momentum Investments
PIT = personal income tax, VAT = value-added tax

Charged commodity prices have underpinned the outsized performance in corporate income taxes. RMB Morgan Stanley (RMBMS) estimates the mining sector is likely to contribute 27% to corporate taxes this year from an estimated 38% in the previous year.

Data on the operating surplus from the SA Reserve Bank (SARB) shows that the mining sector's contribution to economy-wide profits climbed to 11.8% of the total, which is significantly higher than the 7.4% average calculated since 1993 (see chart 4).

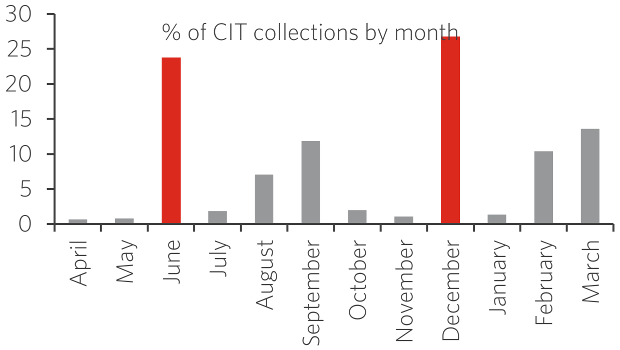
Chart 4: The mining sector's contribution to economy-wide operating surplus has soared (%)



Source: SARB, Global Insight, Momentum Investments
Data up to Q3 2021

Data on tax revenue collected throughout the year shows that CIT collections are lumpy given that many companies have their financial year-end in June or December. On average, more than half of all CIT collected in the year is collected during those two months (see chart 5).

Chart 5: Share of CIT collections throughout an average FY



Source: Global Insight, Treasury, Momentum Investments

Outside of the mining sector, the manufacturing and finance and business sectors are also likely to make a meaningful contribution to CIT.

Consumer related taxes have additionally surprised to the upside. The current YTD run rate of PIT suggests 72.2% of the total budgeted PIT has already been collected in the first nine months of the current fiscal year relative to an average of 70.4% between FY2015/16 and FY2019/20 (see chart 3).

Data from Standard Bank shows that although lower-income earners have been disproportionally hit during the pandemic, employment for upper-income earners has largely recovered to pre-pandemic levels. This has likely contributed to the marginal outperformance in PIT relative to Treasury's February and October 2021 targets. Improved compliance with the SA Revenue Services (SARS) may have also played a role given the recent improvement in administrative abilities, although this is harder to quantify. The extension of the SRD grant further provided a buffer for households, while higher-than-budgeted public sector wages likely also strengthened PIT collections.

We are not expecting any new tax announcements to be made at the upcoming budget, outside of fiscal drag for the higher income-earning groups and possibly additional duties on alcoholic beverages and tobacco and a marginal increase in fuel levies (bearing in mind the current high price of fuel). In our view, the expected revenue overrun should accommodate any increases on the expenditure side.

Outside of taxes, government revenues could be boosted by mining royalties and revenue from SA's spectrum auction. RMBMS calculates that the robust commodity price performance could lead to mining royalties outperforming at R30 billion. Meanwhile, Investec notes that SA's spectrum auction should raise R12 billion in revenue for government. RMBMS forecasts this amount to be smaller at R6 billion to R9 billion and estimates it will affect the revenue figures for FY2022/23.

The growth rate in government expenditure for the first nine months of the current fiscal year (4.3%) is below that of the average experienced between FY2015/16 and FY2019/20 (7%). The run rate also falls short of Treasury's expectations of 5.8% (as set out in the October 2021 medium-term budget), see chart 2.

Expenditure for FY2022/23 is likely to be higher than Treasury's estimates at the time of the medium-term budget in October 2021 due to an extension in the SRD grant as well as potential overspending on the wage bill. In our opinion, given previous rounds of reprioritisation, it is becoming trickier to find obvious areas where expenditure can be cut without negatively affecting service delivery.

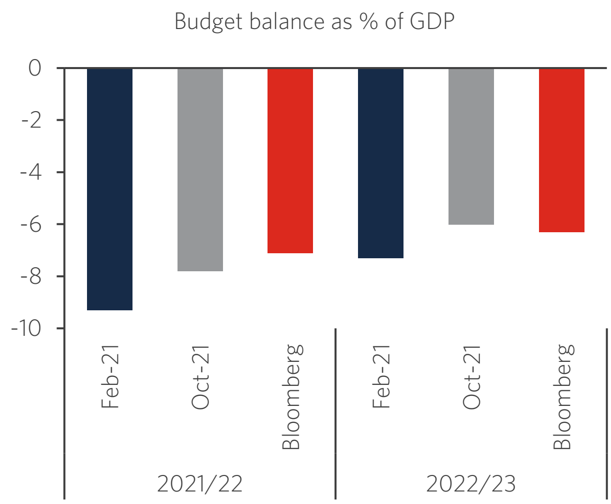
2. Consolidation trends could improve in the near term

The commodity price windfall has contributed to a stronger revenue stream but outside of the short to medium term, SA's terms of trade may become less supportive of fiscal revenues. As such, long-term expenditure decisions must take fiscal sustainability measures into account.

We continue to view a potential overrun on the government wage bill, larger and permanent additional basic income support measures and further transfers to fragile SOEs as the key risks to the expenditure side in the medium to longer term. Nevertheless, SA's near to medium term fiscal and debt profile is likely to surprise positively relative to Treasury's October 2021 estimates.

The Bloomberg median consensus expects a narrowing in the fiscal deficit to 7.1% of GDP in FY21/22 relative to Treasury's October 2021 estimate of 7.8% and Treasury's February 2021 estimate of 9.3% (see chart 6).

Chart 6: Lower anticipated fiscal deficit ratio



Source: Bloomberg, Treasury, Momentum Investments

3. Cost of servicing debt remains elevated

Large budget deficits since FY2009/10 have resulted in a steep rise in the stock of government debt from R805 billion in FY2009/10 to R3.9 trillion in FY2020/21. Over the same period, the associated interest bill has climbed from R57 billion to R232.6 billion.

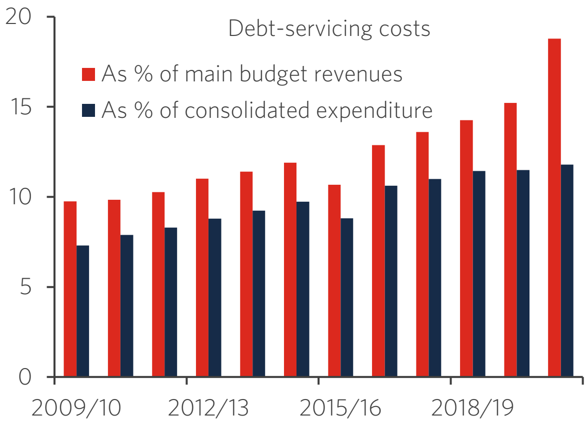
With more money allocated to the servicing of SA's debt burden, expenditure on essential services such as health, social development and peace/security has been crowded out. Treasury notes that this has lowered government's ability to alleviate poverty and create a foundation for faster economic growth.

Debt-service costs accounted for 11.8% of total consolidated expenditure in FY2020/21 (see chart 7), which exceeded spending on all other functions aside from learning and culture and social development. The amount of R232.6 billion spent on the interest bill in FY2020/21 exceeded the R259 billion spent on health and the R218 billion allocated to community development.

The October 2021 medium-term budget outlined government's expectations for debt-servicing costs to grow at a nominal rate of 10.8% on average for the next three fiscal years, while the next highest growth item (community development) was projected to increase at an average rate of only half of that in the medium-term fiscal framework.

While a lower projected debt ratio than initially forecasted by Treasury could lower debt service costs, the interest bill as a share of government revenues is likely to remain close to 20% in the medium term. It remains imperative for government to arrest the rise in public debt to prevent an ever-increasing share of tax revenue being transferred to bondholders and to free up space to address more pressing social and economic priorities.

Chart 7: Government's climbing interest bill



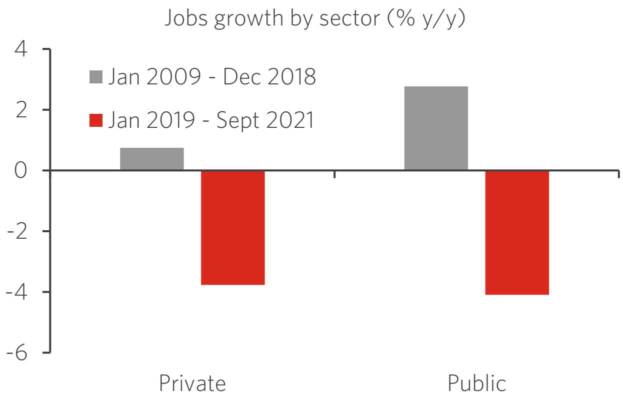
Source: Treasury, Momentum Investments, data up to FY2020/21

4. Containing the civil servant wage bill remains an upside risk to expenditure

According to the February 2021 national budget, public-service compensation absorbed 41% of government revenues in FY2019/20 and 47% in FY2020/21. Data from Statistics SA (Stats SA) shows that government's rate of hiring has slowed to an average of negative 4.1% since the start of 2019, relative to longer-term history of 2.8% since 2009 (see chart 8). This compares with jobs growth of 0.8% since 2009 in the private sector which decelerated to negative 3.8% on average since the start of 2019. These figures equate to 1.5 million jobs being shed in the private sector, while the public sector cut around 437 000 jobs over the same period.

While this shows restraint on expanding the headcount at government level, the wage increment still poses a risk to the overall civil servant wage bill. Government's decision to not pay the increase related to the third year of the 2018 multi-year wage agreement highlights Treasury's resolve to curb the burgeoning civil servant wage bill, but partly covering the wage bill overrun in the current fiscal year with an allocation from the Infrastructure Fund is viewed as negative.

Chart 8: Government hiring has slowed



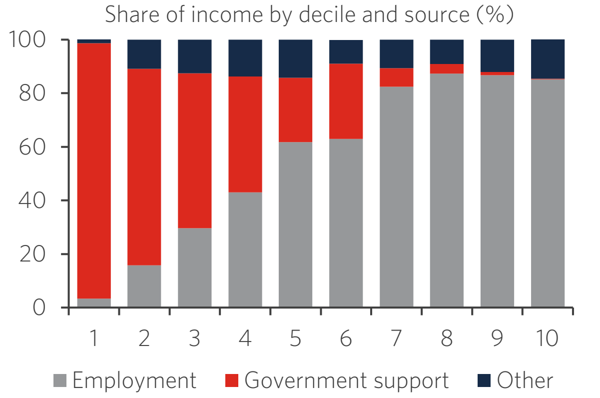
Source: Stats SA, Momentum Investments

Treasury had indicated it had pencilled in a continuation of the cash gratuity for FY2022/23 (an additional R9 billion was allocated to FY2022/23 in the medium-term budget) but risks are that labour unions will not settle for a wage increment that comes in less than inflation. The new round of wage negotiations has worryingly not started yet with the current wage deal expiring at the end of March 2022.

5. Curbing the rise in inequality through an extension in social grants

A significant portion of SA's lower income-earning deciles is reliant on government support (see chart 9).

Chart 9: Four lowest per capita disposable income deciles are the most reliant on government

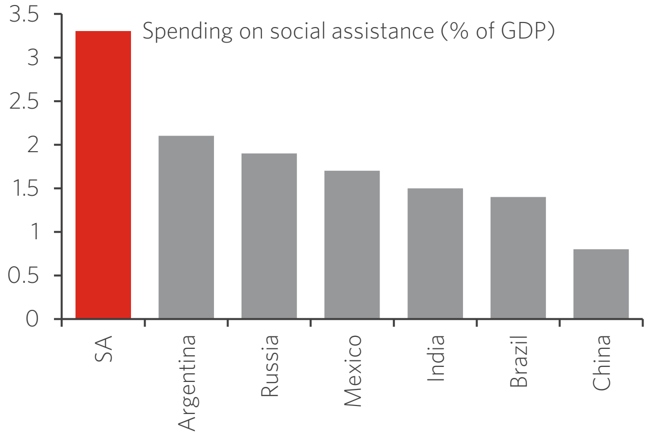


Source: Wits School of Governance, Momentum Investments

The Social Assistance Programmes and Systems Review report by the World Bank suggests that SA is one of the biggest spenders, globally, on social assistance as a share of GDP (see chart 10). At 3.3% of GDP, SA spends 2.9 times the global median on social assistance. This share is the fourth highest in Sub-Saharan Africa and the tenth highest across 124 countries globally. The report found that SA spent 6.5 times the median share of GDP on school feeding and 6.3 times the median share on public works. Relative to other upper-middle income countries, SA spent 6.2 times the median country on social pensions and 4.7 times the median on unconditional cash transfers.

Towards the end of July 2021, President Cyril Ramaphosa announced that the R350 COVID-19 SRD grant would be reinstated until the end of March this year. In his 2022 State of the Nation Address, he reported an extension in this deadline by an additional year. The Department of Social Development reported 9.5 million people were approved for the SRD grant. Nedbank estimates an extension of the SRD grant will add R42 billion to government expenditure for FY2022/23.

Chart 10: SA is one of the biggest relative spenders on social assistance



Source: World Bank, Momentum Investments

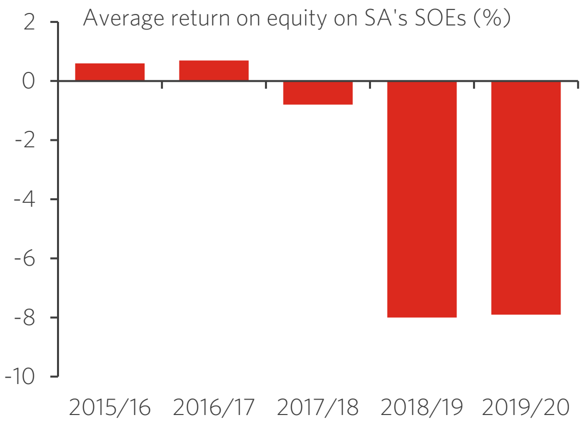
Many academics and civil society groups are arguing for a permanent expansion of the grant system to draw people, who had previously been excluded from state assistance, into the broader social protection network. Ramaphosa hinted at further detail on a more permanent structure in the upcoming budget.
If a more permanent expansion of the grant system is decided upon, it is likely that a more permanent revenue stream may have to be considered to limit the drag on the fiscus.

6. Contingent liability risks are a function of unbudgeted bailouts

Although government stood firm on the issue of additional bailouts for SOEs at the medium-term budget in October 2021, we believe the adoption of a tough stance on SOEs will be tested in the medium term as a number of critical SOEs continue to struggle with operational and financial inefficiencies.

In its February 2021 national budget, Treasury reported the average profitability (measured by return of equity) for SA's SOEs remained relatively unchanged at negative 7.9% in FY2019/20 (see chart 11) but had likely deteriorated in FY2020/21 as many entities operated below capacity and faced lower demand for goods and services. Treasury noted that weak revenue and high costs left little room for capital investment in these entities.

Chart 11: Weak revenue and high costs erode SOE profitability



Source: Treasury, Momentum Investments

In our view, SOEs that are not of critical national importance should be coupled with strategic equity investors and a turnaround plan developed in conjunction with the private sector to resolve operational and financial mismanagement. On numerous occasions, government has mentioned plans to consolidate some of the smaller SOEs that make sense to merge from an operational perspective, however no new developments have been announced.

Progress on SOEs of critical national importance should, in our view, be monitored and held to account so that targets missed can be addressed earlier, allowing for more proactive engagement upfront.

Eskom

In its 2021 Article IV report on SA, the International Monetary Fund advised that a meaningful reduction in procurement and personnel costs would be necessary for a successful restructuring and unbundling of the energy utility. In an interview with the *Daily Maverick* in December 2021, Eskom Chief Executive Officer, André de Ruyter stated that Eskom had reduced its headcount by 3 916 since March 2020, but with the wage bill accounting for more than 15% of Eskom's revenue, further wage containment and a reduction in headcount is necessary, in our opinion.

With Eskom unlikely to be successful in its application for an electricity tariff hike of 20.5% for the 2023 financial year (with *News24* reporting an additional 5% to recover costs from previous years), there could be pressure on government to extend additional support to Eskom in the medium term given that the entity continues to struggle with additional costs to ensure the security of energy supply and to run summer maintenance projects.

7. Credit-neutral budget outcomes expected in the near term

The path toward fiscal consolidation and debt stabilisation has improved since the rating agencies last opined on SA's sovereign rating. In our view, the rating agencies will assess the credibility of the national budget to impose fiscal discipline on the expenditure side given Treasury's relatively conservative estimates on the revenue front. The large revenue windfall is primarily a function of commodity prices and as such it should be viewed as favourable that Treasury's estimates do not extrapolate the extra budgetary space given the potential temporary nature of currently favourable commodity prices.

An extension in social transfers is likely to be viewed as a positive by the rating agencies insofar as they extend the social net for the most vulnerable groups in SA, but a more permanent plan on basic income support must consider government's longer term financing conditions.

Rating agencies are furthermore likely to scrutinise any overrun on the government wage bill and additional transfers to SOEs, particularly if they are not in a deficit-neutral manner.

Fitch rating agency unexpectedly shifted the outlook on SA's sovereign rating from negative to stable in December 2021 (see table 1). It cited a faster-than-expected economic recovery and a surprisingly strong fiscal performance as the main reasons behind its favourable decision. While our growth forecasts are in line with those of Fitch for 2022, we see downside risks to their view on growth in 2023 of 2.4%. Nevertheless, the realised fiscal deficit may surprise positively relative to Fitch's forecasts on the consolidated fiscal deficit of 7.7% for FY2021/22 and 6.2% for FY2023/24.

Although SA's fiscal and debt ratios are likely to show a notable improvement, debt remains at elevated levels and the pace of reform efforts remains modest against a backdrop of pedestrian growth. Fitch warned its estimate of potential growth remains at 1.1%, which reflects delays on stabilising power supply and other measures to boost investment.

Given sticky medium-term fiscal and growth risks, we believe the bias to SA's sovereign rating outlook is to the downside in the medium term, despite an improved near-term outlook.

An upgrade in ratings would only be likely in our view if progress on structural reform efforts boost the outlook for potential growth, allowing government to make inroads into the country's high rates of inequality and unemployment and/or if faster fiscal consolidation and a lower debt ratio materialise in the medium term.

Table 1: Sovereign rating matrix

Long-term rating	S&P (30 April 2020)	Fitch (15 December 2021)	Moody's (20 November 2020)
Investment grade (IG)	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-IG	BB+	BB+	Ba1
	BB	BB	Ba2
	BB-	BB-	Ba3
Outlook	Stable	Stable	Negative

Local currency rating
Foreign currency rating
Both ratings

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