momentum
investments

National Budget 2022

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Correctly cautious on commodity windfall but longer-term cost containment a concern

Initial impressions

- Treasury's medium-term economic forecasts appear credible. Its expected average economic growth rate of 1.8% between 2022 and 2024 is broadly in line with our own expectation and that of the Reuters median consensus estimate of 1.9%. Treasury's projection on inflation of 4.6% is further broadly in line with our expectation of 4.5% (Reuters consensus: 4.6%).
- Gross tax revenue has exceeded government's February 2021 assumption by R181.9 billion but is also R61.7 billion higher than the revised assumption in the November 2021 medium-term budget. A tide of rallying commodity prices has supported buoyant mining revenues and led to the upside surprise in corporate income taxes accounting for 58% of the tax overshoot relative to February 2021. Meanwhile, a faster-than-anticipated recovery in household earnings and low interest rates supported the 21% contribution in personal income taxes to the overrun.
- Revenue buoyancy (the relationship between tax collections and economic growth) is realistically expected to drop to an average of 1.07 over the medium-term expenditure framework (MTEF) from 1.93, given the reduction in the corporate income tax rate and an expected deterioration in the terms-of-trade as SA's exported commodity prices fade.
- Government's upward revisions to expected gross tax revenues in the next two fiscal years err to the conservative side in our opinion, with its assumptions on key commodity prices not deviating too widely from the Bloomberg median consensus forecast for the next three years.
- A portion of the tax revenue overrun has been directed at reducing the fiscal deficit and lowering the borrowing requirement, while the rest addressed the country's social challenges. Given that the overrun was not completely allocated to an increase in expenditure or used to support larger cuts in taxes suggests an element of fiscal discipline. Adhering to the fiscal consolidation framework should result in a positive response from financial markets.
- Treasury's expenditure estimates intimate that the spending balance has been tilted in favour of growth-enhancing expenditures. Real growth in capital outlays is expected to average 8.1% in the MTEF, while real growth in the compensation of employees is expected to decline on average by 2.6% during the same period. This will bring the share of employee compensation to non-interest spending down from 35.7% in FY13/14 to 30.8% by FY24/25.
- SA's fiscal deficit ratio beat the Bloomberg consensus and compares favourably with a 5.7% deficit projected for emerging markets (EM) in 2022, 5.1% in 2023 and 4.8% in 2024, as estimated by the International Monetary Fund (but less favourably against the 4.8%, 3.6% and 3.2% projected for developed markets (DM) for the same period).
- Treasury anticipates reaching a neutral primary balance by FY23/24. With this envisaged level of fiscal consolidation in place, Treasury estimates the gross debt-to-GDP ratio will peak at 75.1% by FY24/25 and decrease to 70.2% by FY29/30. This compares with a debt ratio of 64.8% in EMs for 2022 (66.9% by 2024) and 119.3% in DMs for 2022 (119.1% by 2024). Nonetheless, SA's debt burden remains high and Treasury calculates that real debt is equivalent to R69 291 for every person in the country and has tripled since the global financial crisis. Moreover, the real interest cost of this debt has increased more than twofold over this period to R4 278 per person per year.
- A narrower-than-anticipated deficit and a faster-than-forecasted economic recovery should avoid further sovereign rating downgrades this year. However, longer-term growth and fiscal concerns will continue to weigh on the rating in the longer term.

Effect on the economy and financial markets over the MTEF

- Household consumption expenditure will likely be supported by inflationary relief of 4.5% in the personal income tax brackets and rebates (R13.5 billion in foregone revenue), no change to the general fuel levy or the Road Accident Fund levy (which will further lower consumer headline inflation), average annual growth of 1.5% over the MTEF in the number of social grant recipients and a 12-month extension of the Social Relief of Distress grant. Nevertheless, slightly above-inflation related increases in sin taxes and negative real increases in child support grants (negative 2.8% over the MTEF) and old-age grants (negative 2.3%) will dent purchasing power, particularly at the low end of the income-earning spectrum, while negative real growth of 2.6% for the compensation of government employees could reduce spending potential in the middle segment.
- SA corporates will be pleased with the decision to lower the corporate income tax rate by 1% to 27%. In previous years, the Davis Tax Committee alluded to the gap between actual (marginal) rates of corporate income tax and the effective rate. Government expects the lowering of the corporate income tax burden to create space for further investment and jobs growth, while curbing base erosion and profiting shifting activity. This move is not expected to drastically reduce corporate income tax collections as government aims to widen the base. An extension to the first phase of the carbon tax will likely also be viewed as positive.
- A contractionary budget over the next three years amid fiscal consolidation favours fixed income assets over 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 MTEF. This is evident from an estimated declining budget deficit in absolute terms (R51.5 billion smaller between FY21/22 and FY24/25) and as a percentage of GDP (1.5% smaller). This is expected to be effected through a 1.3% reduction in real expenditure growth versus a 0.3% real increase in revenue in the next three fiscal years.
- The budget outcome is positive for the government debt market given the R97.5 billion reduction in the borrowing requirement between FY22/23 and FY24/25, as a function of a narrowing in the fiscal deficit. Cash balances are expected to be drawn down by R85.5 billion over the same period to partly fund the borrowing requirement.
- On balance, the market is expecting no change in issuance.
- Government is expected to raise US$11 billion in the medium term in global capital markets. Although government remains committed to a new floating rate note and a rand-denominated Sukuk bond, no further detail was unveiled.

Treasury's resolve to restrain spending likely to be tested in the longer term

- A legal battle ensuing between public-sector workers and government on the third year of the 2018 wage agreement is likely to be ruled in favour of Treasury. If not, Treasury acknowledged this could add R75 billion in unbudgeted expenditure by FY22/23. If translated into headcount reductions, between 30 000 and 35 000 jobs could be affected unless further reprioritisation in the budget is assumed.
- Notwithstanding slower growth in expenditure, the focus is still on social services, with 59.4% of total expenditure allocated to health, education, social protection and community development. An additional R32.6 billion has been allocated to address the increasing demand for fee-free higher education.
- Debt-service costs will continue increasing at a faster average pace (6.2% in real terms) than revenue growth (0.3%) and economic growth (2%) in the MTEF due to a weaker currency, a still wide deficit and higher forecasted interest rates. The interest bill is expected to rise from 4.3% of GDP (14.2% of expenditure and 17.3% of revenue) in FY21/22 to 5% of GDP (17.3% of expenditure and 20.5% of revenue) in FY24/25. Debt-service costs will on average absorb 20c of every rand government collects in the MTEF. At 10.7%, debt-service costs are the fastest growing expenditure item in nominal terms over the MTEF. Debt-service costs are the third largest expenditure item after learning and culture and social development.
- Government has not revealed any detail on charting a way forward on a permanent basic income support other than the additional R44 billion allocation in FY22/23.

State-owned enterprises (SOEs) still facing financial malaise

- The average return on equity for SOEs has averaged a staggering rate of negative 10.8% in the last three fiscal years due to higher employee salaries, elevated debt-service costs and the damaging effects of the pandemic on demand.
- The budget speech highlighted that more than R308 billion has been directed to bailing out SOEs. No additional funding allocation was made to SOEs in the MTEF (with the exception of a R5 billion allocation in the contingency reserve for Land Bank) but we continue to flag this as a risk given the perilous state of many of the prominent entities.
- The Minister reiterated the formation of a company to review government's stake in SOEs and assess which need to be consolidated, rationalised or partly privatised. No detail has been given to date on which SOEs this exercise is likely to affect.

Pro-growth reforms necessary for a faster economic growth path

- Treasury explored two economic scenarios around the current base case:
  - **Upside scenario in which economic reforms are accelerated:** Growth is expected to be 0.7% higher than the baseline in 2024 and 2.1% higher than the baseline by 2029 due to improved energy security, a reduction in red tape, lower costs of doing business and enhanced transport and communication infrastructure, which would lead to easing sovereign risk, higher levels of confidence and lower borrowing costs.
  - **Downside scenario in which global growth remains weak and inflation remains persistent:** Growth is expected to be 0.4% weaker relative to the baseline by 2024 and 1% lower than the baseline by 2029 due to tighter global monetary policy, higher risk aversion, higher borrowing costs, lower investment and a weaker rand.
- Treasury noted progress on structural reforms in a number of areas in the economy:
  - **Infrastructure:** Reformed policy framework for public-private partnerships to be implemented in the next 24 months to expedite project approvals.
  - **Electricity:** Renewables programme expected to drive investment of R128 billion over the medium term, while lifting the embedded generation gap should unleash 4 000MW in the mining sector alone.
  - **Corruption efforts:** Public Procurement Bill will be tabled in FY22/23, while Treasury is actively addressing illicit trade.
  - **SOEs:** Treasury to publish a framework for criteria for government funding of SOEs in FY22/23 to increase transparency and accountability.
  - **Cutting red tape:** Property registration, cross-border trade and construction permits.
  - **A number of reforms in the areas of logistics, water, tourism and telecommunications were further announced in the State of the Nation Address and reiterated in the budget.**
- Despite a number of economic and political reform efforts, relative governance indicators have yet to show a marked improvement on a global comparison and most show a deterioration relative to a decade ago. As such we maintain our longer-term potential growth rate of between 1.5% to 2% given the current pace of structural reform efforts.

Credit neutral in the near term but longer-term sovereign rating risks loom

- While the growth rebound from the COVID-19 pandemic has surprised positively, SA's tepid forecasted growth profile suggests a high likelihood of SA underperforming the bottom quartile of global countries in the medium term.
- Though fiscal and debt ratios have improved since the latest rating reviews by the major rating agencies, the size of SA's debt burden is still large and risks to restraining expenditures and increased allocations to struggling SOEs and failing municipalities remain high in the medium to longer term.
- The pace of reform efforts remains modest against a backdrop of pedestrian growth, particularly in an environment of a more fragmented voter base and rising socio-political pressures on the expenditure envelope.
- Despite an improved near-term outlook, which is likely to leave ratings unchanged this year, lingering fiscal and growth risks in the medium to longer term point to downside risk to SA's sovereign rating outlook further out.

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