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2019 National budget preview: Parastatals' pressing financial needs raise concerns over SA's fiscal sustainability

Highlights

- Government is expected to reaffirm its commitment to efforts on fiscal consolidation and to reiterate the growth-enhancing measures, which were announced at the State of the Nation Address (Sona).
- A downward revision to nominal growth forecasts is anticipated, owing to a sluggish growth environment and a positive downward adjustment in the inflation trajectory.
- A revenue miss is likely given the year-to-date underperformance of company and personal tax receipts.
- A tepid growth environment leaves available fewer obvious additional revenue streams to be tapped. Limited compensation for bracket creep, higher fuel taxes and additional taxes on alcohol and tobacco-related products are likely avenues Treasury will take advantage of to boost revenue growth.
- After an extended delay, the Carbon Tax Bill is expected to become effective from 1 June 2019.
- There is a limited probability of a major breach in government's self-imposed expenditure ceiling, as Treasury attempts to reprioritise spending within the existing framework.
- Although the attrition rate in the public sector workforce is relatively high at 6%, government's wage bill continues to eclipse a large portion of consolidated spending, given above-inflation wage settlements.
- Government's onerous debt-servicing burden acts as an additional drag on expenditure, crowding out other forms of more useful spend.
- The poor financial standing of some of the country's key parastatals poses a risk to the overall debt trajectory.
- Momentum Investments expects the country's sovereign ratings to remain steady in the near team, in line with a projected improvement in growth and fiscal dynamics in the medium term, but only if additional guarantees to ailing parastatals are granted on a market-acceptable conditional basis.

Committed to fiscal consolidation

Finance Minister Tito Mboweni delivered the medium-term budget policy statement (MTBPS) in October 2018, following the resignation of former Finance Minister Nhlanhla Nene just weeks before. Nene had requested to be relieved of his duties, following unresolved accusations, which left Mboweni as the country's fifth finance minister in less than three years.

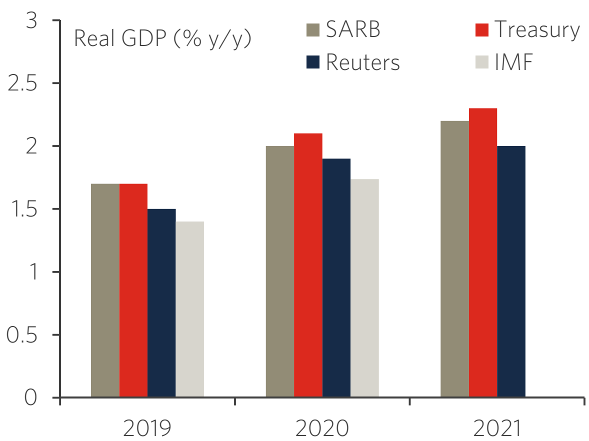
Mboweni is expected to table his maiden national budget on 20 February, in which he is expected to reaffirm government's commitment to fiscal consolidation in a growth-constrained environment. In a meeting in December 2018, Mboweni and other government officials (including the ministers of economic development and trade and industry) convened with local and international economists,

academics from universities and business leaders to brainstorm workable strategies on how to lift sluggish economic growth. These economic policy proposals were then submitted to Cabinet for its consideration. Although the shaky financial position of South Africa's (SA's) unstable state-owned enterprises (SoEs) are a key threat to longer-term fiscal sustainability, the timing of the national elections may delay the implementation of credible turnaround plans. In the October 2018 MTBPS, Mboweni admitted "poor governance, reflected in inefficiency, corruption and financial mismanagement reduces the impact of spending and increases pressure on the budget". He noted "government has begun the process of rebuilding important state institutions".
In view of these strong statements, Mboweni is likely to mention, in the February 2019 national budget, strides made in tackling corruption and investigating state capture in an effort to increase the productive use of taxpayer money.

Growth initiatives are essential to reinvigorate a downtrodden economy

Although economic activity in the global economy is expected to cool in the face of mounting headwinds, world growth should remain broadly favourable in 2019. However, the outlook for growth in the local economy remains sluggish. In its World Economic Outlook Update for January 2019, the International Monetary Fund (IMF) forecasted growth in SA of 1.4% for 2019, in line with Momentum Investments' projection.
Treasury expects the SA economy to grow by 1.7% in 2020, which is a touch below Momentum Investments' forecast of 1.8%.

Chart 1: Treasury's growth forecasts are likely to be clipped



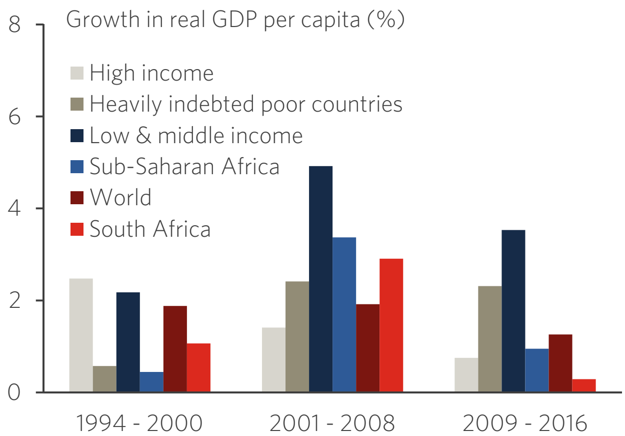
Source: Treasury, Sarb, Reuters, IMF (2019 and 2020 only), Momentum Investments

The IMF has warned that an escalation in trade tensions and a deterioration in financial conditions were key sources of downside risk to the growth outlook.
A sharper-than-anticipated slowdown in China and a potential consequent hit to SA's terms of trade (relationship between export and import prices) pose additional downside risks to growth.

In comparison, the median consensus forecast from the Reuters Econometer survey for January 2019 pitched growth in gross domestic product (GDP) for 2019 at 1.5% and 1.9% for 2020, while the SA Reserve Bank (Sarb) lowered its GDP forecasts between the November 2018 and January 2019 meetings from 1.9% to 1.7% for 2019, but kept its forecast for 2020 unchanged at 1.9% (see chart 1). As such, Treasury is likely to downwardly adjust its growth forecasts in the upcoming national budget.

SA's growth performance has deteriorated markedly since the global financial crisis (GFC), with growth in real per capita GDP broadly moving sideways between 2009 and 2016 (see chart 2).

Chart 2: Weak local growth trend diverging from more robust global patterns



Source: World Bank, Momentum Investments

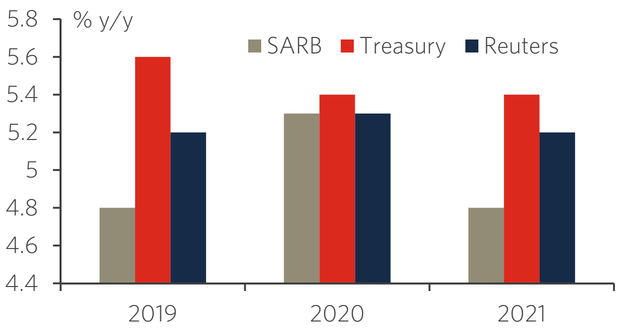
The IMF acknowledged government had adopted measures to dissolve corruption, strengthen procurement procedures and eliminate wasteful expenditure, but reiterated further reforms would be required to positively jolt muted growth rates. These include increasing policy certainty, improving the efficiency of SoEs, enhancing labour market flexibility, developing basis education and aligning training with business needs to achieve higher levels of employment.

A modest recovery in growth is likely in the near term as some governance and regulatory reform transpires, but politically unpopular reforms, which could steer the economy toward a higher growth trajectory, will take time to implement in Momentum Investments' opinion.

Moreover, Momentum Investments expects a downward revision to Treasury's inflation forecasts in the medium term. A significant decline in the international price of oil and a less depreciated exchange rate were behind the downward shift in the Sarb's inflation projections from 5.2% for 2019 to 4.8%, relative to Treasury's October 2018 forecast of 5.6%. The Sarb expects inflation to climb to 5.3% in 2020, before declining to 4.8% in 2021, in comparison to Treasury's forecasts of 5.4% for both years (see chart 3).

Administered price increases, a negative shift in investor sentiment towards emerging markets, a slowdown in global growth and volatility in international oil prices remain key upside threats to the inflation trajectory. In contrast, Momentum Investments sees headline inflation averaging 5.2% for 2019 (Reuters consensus: 5.2%), 5.5% for 2020 (Reuters: 5.3%) and 5.1% for 2021 (Reuters: 5.2%).

Chart 3: Headline inflation forecasts (% y/y)



Source: Treasury, Sarb, Reuters, Momentum Investments

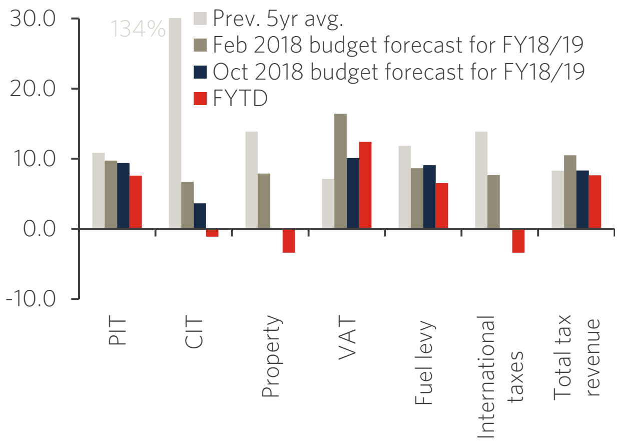
In its October 2018 MTBPS, Treasury estimated nominal GDP growth would average 7.3% between fiscal year 2019/2020 (FY19/20) and FY20/21. In comparison, Momentum Investments expects a broadly similar average of 7.2% for the corresponding period.

Weak personal and corporate tax collections indicate a revenue miss is likely

Growth in total tax revenue averaged 7.6% for the first nine months of fiscal year FY18/19 (see chart 4). As such, Treasury's target of 8.3% for the full fiscal year is unlikely to be met. This will require stronger departmental revenue growth to maintain the budget deficit targets, which were planned in October 2018.

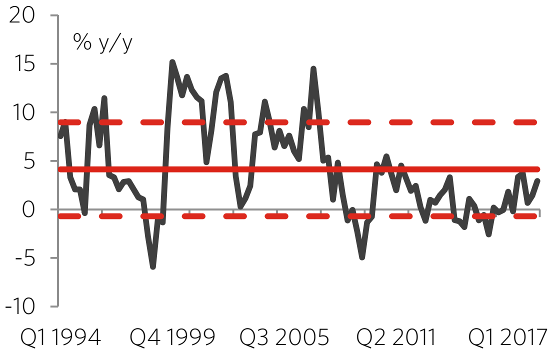
Corporate tax collections have been the biggest area of disappointment. According to data from the SA Reserve Bank (Sarb), real growth in corporate operating surplus averaged 2.2% for the second and third quarter of 2018 (latest data), which is below the longer-term average of 4.1% (see chart 5).

Chart 4: Property and company taxes are lagging



Source: Treasury, Global Insight, Momentum Investments

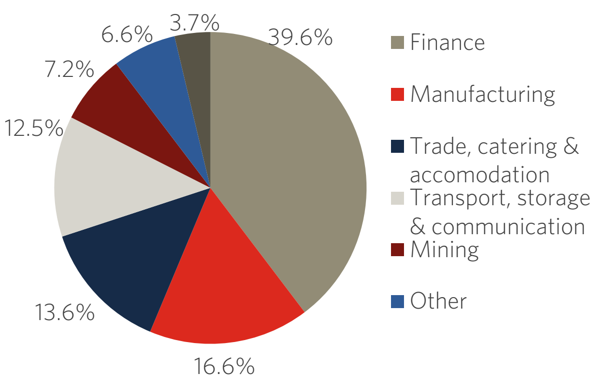
Chart 5: Real growth in operating surplus



Source: Sarb, Global Insight, Momentum Investments, data up to Q3 2018

Growth in operating surplus for these quarters was weakest in the agriculture and mining sectors, but strongest in the manufacturing and trade industries. The manufacturing sector maintained its position as the second-largest contributor to CIT in the 2018 Tax Statistics publication from the SA Revenue Services (Sars), while the financial services sector claimed the top spot. Meanwhile, mining accounted for only 7.2% of total company tax receipts (see chart 6).

Chart 6: Financial services is the largest contributor to CIT



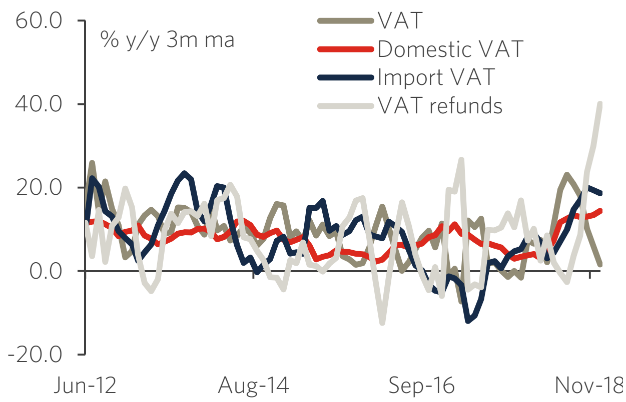
Source: Sars, Momentum Investments

December is an important month for tax collections from corporates, with year-on-year (y/y) growth in corporate tax revenue averaging 10.8% since 2003. However, growth in company tax receipts contracted by 6.6% y/y in December 2018, highlighting stress in the economy. On a fiscal year-to-date basis (FYTD), growth in corporate tax revenue declined by an average 1.1%, in comparison to the October 2018 MTBPS forecast of 3.6% and the February 2018 national budget estimate of 6.7% (see chart 4).

Personal income tax collections have increased by 7.6% on average on a FYTD basis. This is below the previous five-year average (and the October 2018 MTBPS forecast) of 9.4% and lower than the February 2018 national budget estimate of 9.7% (see chart 4).
The disappointment in PIT receipts is reflected in the slowdown in wage growth. The Sarb's unit labour cost measure decreased to 3.6% in the second quarter of 2018, which is significantly lower than the long-term average of 11.1%, since 1974. Similarly, wage data from Statistics SA (Stats SA) pointed to nominal wage growth declining to 5.6% in the third quarter of 2018, relative to the long-term average of 11.8%, since 2006.

In contrast, value-added tax (Vat) collections have outperformed Treasury's expectations at 12.4% on a FYTD basis. This was higher than the past five-year average of 4.6% and above the October 2018 MTBPS forecast of 10.1%, but below the February 2018 national budget forecast of 16.4% (see chart 4). Overdue Vat refunds may have created an upward distortion in the overall Vat data and may cause the higher-than-estimated growth figure to decline in upcoming months. Vat refunds jumped 15.5% in December 2018, using FYTD data, which is higher than Treasury's October 2018 MTBPS estimate for a 15.1% increase for the same period (see chart 7).

Chart 7: Vat revenue collection trends



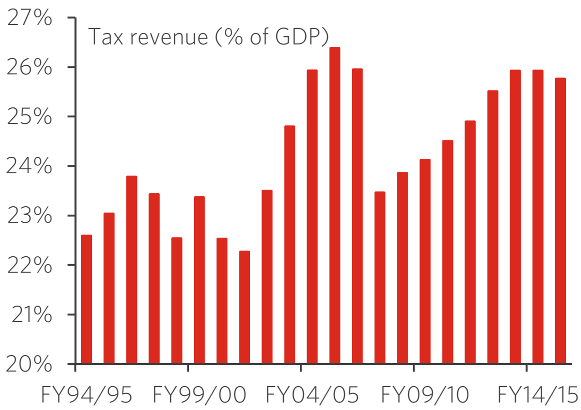
Source: Treasury, Global Insight, Momentum Investments

Revenue collections from fuel levies grew by 6.5% on a FYTD basis in December 2018, which came in lower than Treasury's October 2018 MTBPS target of 9.1% and lower than the past five-year average of 14%.

Additional revenue streams becoming less obvious

Soft economic growth and revenue shortfalls have led to a rise in the country's tax burden in recent years. The share of tax revenue to GDP or, in other words, the tax burden has increased from 23.5% in FY07/08, during the GFC, to 25.8% in FY17/18 (see chart 8), which is notably higher than the global average of 15%.

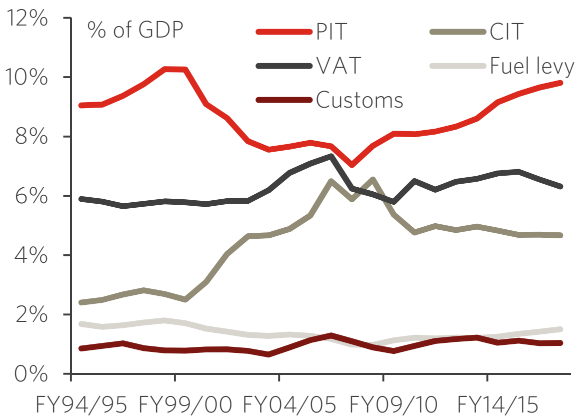
Chart 8: SA's tax burden has increased since the GFC



Source: Sars, Momentum Investments, data up to FY17/18

The tax burden declined during the fiscal years between FY98/99 and FY01/02, thanks to a cut in the top marginal tax bracket from 45% to 40% and a raising of the tax threshold. However, this was reversed in 2017, which left the share of PIT to GDP rising to 9.8% in FY17/18 (see chart 9).

Chart 9: Reliance on PIT has increased

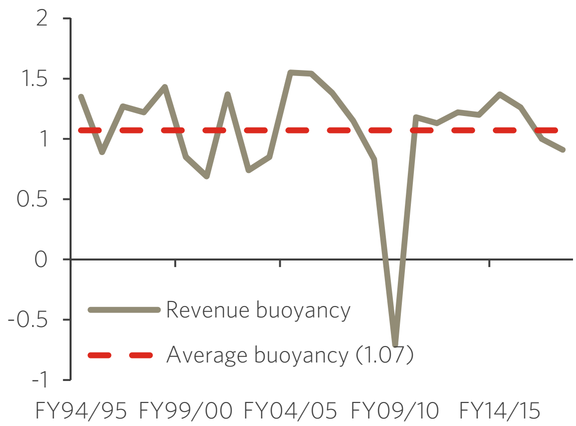


Source: Sars, Momentum Investments, data up to FY17/18

The share of Vat relative to GDP has remained steady since the GFC at 6.2%, while the share of CIT dropped from a peak of 6.6% to 4.7% in FY17/18.

After taking the latest PIT hike in 2017 (from 41% to 45% for the top-income-earning bracket) into account, Nedbank calculated the country may have passed the peak point of the Laffer curve using effective tax rates (tax collected divided by total assessed income). This suggests additional increases in the PIT rate could negatively affect tax collections, as cases of tax avoidance, tax evasion and negative growth spill-overs start to emerge. Evidence of this trend may already be visible with the tax burden rolling over slightly in the past two years in spite of additional tax measures being implemented (see chart 8). Similarly, this is confirmed in the decline in the tax buoyancy rate (how much revenue can be collected per unit of growth) for the past three years (see chart 10).

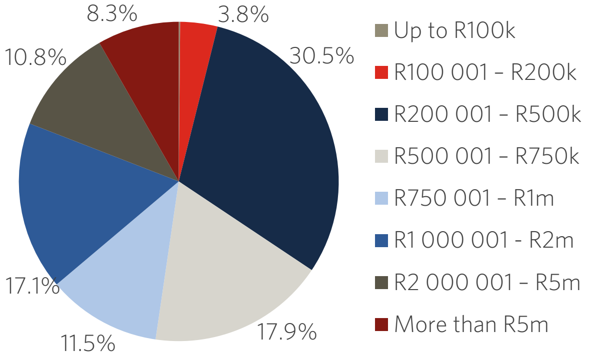
Chart 10: Deterioration in the tax buoyancy rate



Source: Sars, Momentum Investments, data up to FY17/18

The failure to provide economic opportunities for a broader range of the population has led to less inclusive growth and higher rates of inequality. As such, the PIT burden has become increasingly targeted at a smaller number of tax payers. According to the Sars 2018 Tax Statistics publication, more than 36% of yearly PIT collections arose from taxpayers earning more than R1 million year (see chart 11), which account for fewer than 55 000 individuals.

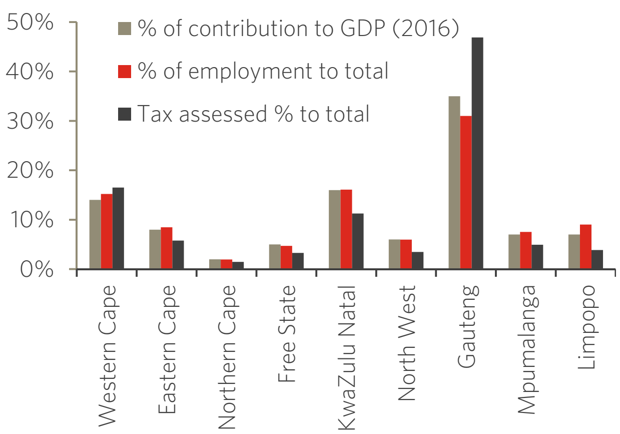
Chart 11: Narrow personal income tax base



Source: Sars, Momentum Investments, legend depicts various income-earning brackets

PIT collections appear to be concentrated on a geographical basis as well, with 47% of the PIT assessed originating in Gauteng, which accounted for 35% of the economy's GDP in the latest available data for 2016 (see chart 12).

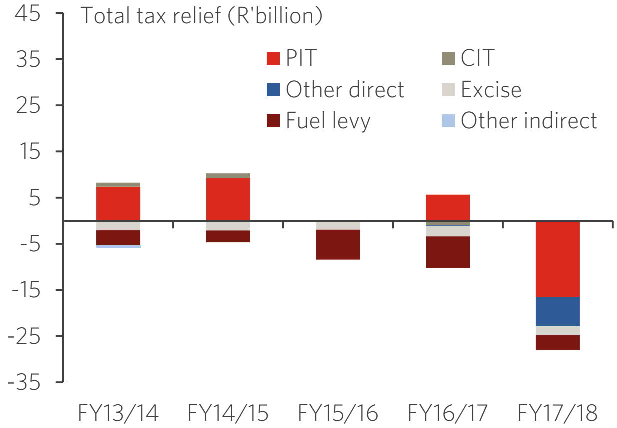
Chart 12: Gauteng contributes to nearly half of personal tax receipts '



Source: Sars, Stats SA, Momentum Investments

Although government is unlikely to announce an additional hike to the PIT rate, government can still increase its PIT revenue by not fully adjusting the tax brackets to offset the increase in worker wages caused by inflation. This is commonly known as bracket creep and has been a key contributor to PIT revenue in the past years, which has acted as a stealth tax on consumers (see chart 13).

Chart 13: Tax hikes and bracket creep have hurt growth



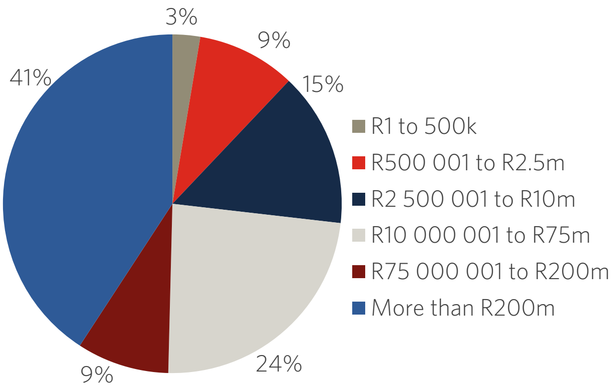
Source: Sars, Momentum Investments

Likewise, an additional increase in the Vat rate would be difficult to initiate in an environment of low growth and cash-strapped consumers, even though the rate (after having been increased to 15% from 14% on 1 April 2018) remains at the lower end of a global comparison. Concerns were raised about the effect of the increase in the Vat rate on low-income households, which led to a review of the list of 19 zero-rated basic food items by an independent panel of experts. After the review, government announced sanitary pads, bread flour and cake flour would be added to the zero-rated product list from 1 April 2019. Government expects to lose R1.2 billion in revenue once these additions to the zero-rated list have been made.

Treasury has indicated SA's CIT share of GDP at close to 5% is much higher than that of Africa and the countries belonging to the Organisation for Economic Cooperation and Development (OECD), which rank closer to 3%. Government's commitment to an Investment Summit to attract R1.3 trillion in new investments during the next five years could rule out the possibility of an increase in the CIT rate to preserve the country's investment attractiveness to foreigners.

The narrow tax base in SA does not only apply to individuals. CIT collections are also heavily concentrated in SA, with more than 41% coming from firms earning more than R200 million a year (see chart 14).

Chart 14: CIT collections are concentrated in SA



Source: Treasury, Global Insight, Momentum Investments, legend depicts firm revenue buckets

In its October 2018 MTBPS, Treasury acknowledged the large potential liability posed by the Road Accident Fund (RAF). Despite the 30c increase in the RAF levy in the February 2018 national budget, Treasury expected the fund's liability to increase from R206 billion to R393 billion by FY21/22. Treasury warned "the RAF will require further large increases to the fuel levy in each of the next three years to manage the short-term liability". As such, a further increase in fuel taxes are likely to be announced in addition to sin taxes on alcohol and tobacco-related products.

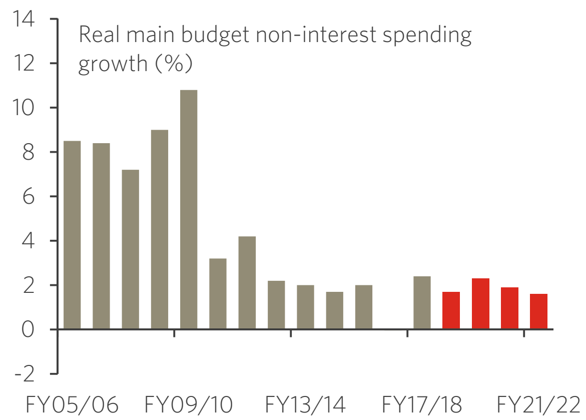
The carbon tax was first discussed in 2010, but has been delayed since. It is expected to be introduced in two phases. During the first phase, which will be run between 1 June 2019 and 31 December 2022, the carbon tax will be complemented by a package of tax incentives and revenue-recycling measures to minimise the effect on energy-intensive sectors. Treasury stated the effect of the tax in the first phase is designed to be revenue neutral, after taking the complementary measures into account. The second phase will run from 2023 to 2030.

A major breach of the expenditure ceiling is unlikely

Government is likely to keep expenditure growth below its self-imposed ceiling, in its effort to stay the fiscal course (see chart 15). In its October 2018 MTBPS, Treasury announced it would reprioritise R32.4 billion from non-performing areas. No further allocation was made to wage growth and departments were forced to absorb the R30.2 billion shortfall within their allocations, by managing overtime and performance incentives.

Government's wage bill swallows the largest share of the consolidated spending budget (35%) and continues to crowd out more useful forms of expenditure. Treasury calculated the public sector turnover rate was relatively high at around 6% due to completed contracts, resignation, retirement and death, but noted the largest driver of the wage bill has been above-inflation increases rather than an increase in employment.

Chart 15: Treasury likely to keep spending in check

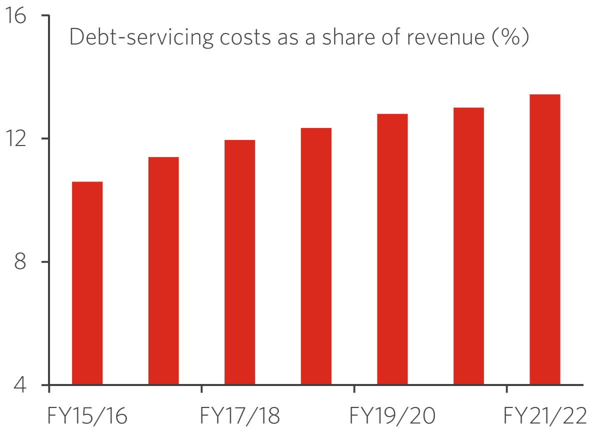


Source: Treasury, Momentum Investments

Elevated debt-servicing costs remain a challenge

The country's debt-servicing costs are the highest growing expenditure item in the budget. As a share of revenue, debt-servicing costs are approaching 15%, which is a key level monitored by the rating agencies (see chart 16).

Chart 16: Debt-servicing costs are approaching 15% of revenue



Source: Treasury, Momentum Investments

In real terms, Treasury expects debt-servicing costs to grow at an average of 9% between FY19/20 and FY21/22 in comparison to real economic growth of 2% for the corresponding period.

SoE financing is a risk to the longer-term debt trajectory

Although there has been an overhaul in the leadership of key SoEs, the financial position of a number of parastatals remains in a precarious position.

Key management posts have been filled at SA Airways (SAA), a stock count has been completed for the first time in years and the deadline to complete the asset register was pushed to June 2019. In December 2018, at least five SAA employees had been dismissed following forensic reports, while 21 were given final written warnings and two had resigned. Nonetheless, SAA remains in financial turmoil and requires R9.2 billion to repay short-term loans", which are maturing in March 2019.

In 2018, SA's public broadcaster, the SABC, suggested it needed a R3 billion bailout to pay salaries by March 2019. In addition, Nedbank has indicated Denel may need between R2 billion and R7 billion to fund its working requirements.

By far, the greatest funding requirements are from energy utility, Eskom. In its effort to improve its governance, Eskom finalised 858 out of 1 049 outstanding cases since April 2018, which resulted in 99 employee exits. 269 whistle-blow cases were under investigation and, at the end of October 2018, 75 were completed. Lifestyle audits of senior management are still in progress and all irregular supplier contracts are being investigated. Moreover, measures are being put in place to prevent a recurrence of breaches and procedures for reporting fruitless and wasteful expenditure are being reviewed.

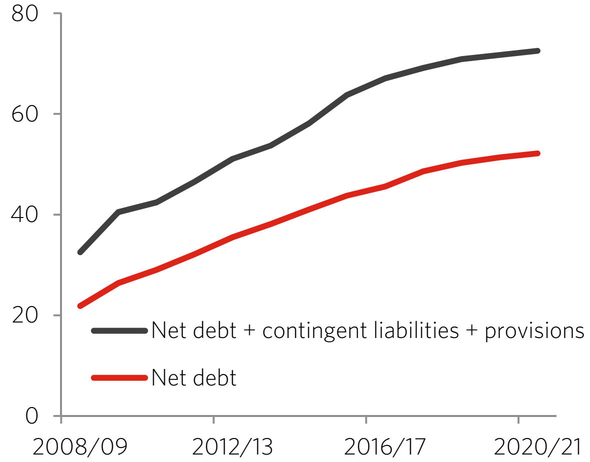
However, in its interim results presentation in October 2018, Eskom noted it was facing a number of financial challenges as a result of low tariffs, a decline in sales volumes, an increase in employee-benefit costs and further progress on the new build programme. While Eskom managed to contain its increase to coal costs to 7%, independent power producer (IPP) costs ratcheted 29% higher, due to volumes being up 25%. Moreover, employee-benefit expenses increased by 12% between 2017 and 2018, due to the 7.5% wage settlement granted and a once-off payment to unionised staff. In addition, Eskom acknowledged it was facing operational challenges, including reduced performance on generation, low coal stock levels and an increase in municipal arrear debt (R17 billion). Arrears of individual electricity subscribers in Soweto (with a payment ratio of less than 10%) sits at R13 billion and is unlikely to be fully recovered.

Eskom's chief financial officer predicts Eskom will make a loss of R20 billion in financial year (FY) 18/19 (compared to an earlier forecast of R15 billion and the R11.2 billion that was budgeted for). Compared to an earlier request for increases of 15% in each of the next three financial years, Eskom is now requesting steeper increases of 17.1% in FY19/20, 15.4% in FY20/21 and 15.5% in FY21/22. Nersa is expected to rule on Eskom's multi-year price determination (MYPD) 4 on 15 March 2019.

In the Sona, Ramaphosa stated to ensure the credibility of the turnaround plan (which focuses on cost compression, security of revenue and debt reduction), "Eskom will need to develop a new business model". This model will comprise of three separate entities (transmission, generation and distribution) under Eskom Holdings. Although it is not yet clear how Eskom's debt will be handled, Ramaphosa highlighted the tariff increases should be affordable for consumers, while safeguarding the fiscal framework and ensuring a "positive impact on our sovereign rating".

Eskom has a R350 billion government guarantee framework of which R252 billion has already been utilised on drawdowns and a further R84 billion has been committed. If Eskom were to have transferred R100 billon of its debt to government's balance sheet, it would raise the overall debt ratio as a share of GDP (see chart 17) by another 2%.

Chart 17: Total debt as a % of GDP



Source: Treasury, Momentum Investments

The Sona emphasised growth-enhancing initiatives to improve the economic trajectory

President Cyril Ramaphosa outlined a number of growth-enhancing measures in a reasonably business-friendly Sona on 7 February 2019 (see annexure 1).

No further announcements were made with regard to issues such as the nationalisation of the Sarb or the implementation of prescribed assets, which would have likely damaged sentiment.

Sovereign ratings likely to remain unchanged, but Moody's could lower outlook to negative

Moody's rating agency previously admitted it was looking for a gradual recovery in the SA economy and it was taking a wait-and-see approach to land reform, given that populist political posturing could be affecting the narrative.

According to Morgan Stanley and the Moody's ratings review model, SA would only be downgraded if its susceptibility to event risk was downgraded by two notches or if its economic strength and fiscal strength each dropped a notch.

With Moody's only looking for a stabilisation in debt in the medium term and not expecting a quick recovery in growth, Momentum Investments expects Moody's to leave the country's sovereign rating unchanged at the March 2019 review, following the February 2019 national budget, although there is a possibility it may lower the outlook from stable to negative (see table 1).

Table 1: SA's sovereign rating

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
Outlook	Stable	Stable	Stable

Key:

- Local currency rating
- Foreign currency rating
- Both ratings

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

The rating agencies have warned SA's sovereign ratings could drop if trend growth declines, if SoE debt migrates to government's balance sheet, if tensions in the ruling party derail policy making or if the rule of law or property rights weaken.

Ramaphosa has begun to restore confidence in government, by providing a clearer strategic direction. In Momentum Investments' view, Ramaphosa is managing competing interests from stakeholders within and outside of government and, as such, the implementation path of structural reform is likely to be slow and requires careful management to prevent risking a split in support in the ruling party.

Government is also working towards stabilising the financial position of SoEs, by overhauling the leadership in an attempt to improve governance. Strong regulatory oversight and clarifying the mandates of the SoEs are needed to place the ailing parastatals on better financial footing. Given the systemic importance of Eskom to the SA macro economy and to the sovereign's finances, the details on resolving Eskom's operational and financial challenges will be key to the ratings view. In Momentum Investments' opinion, rating agencies would be assured if additional government guarantees are accompanied by strong reforms and strict control over Eskom's expenditure and borrowing.

Annexure 1: Growth-enhancing measures announced at the Sona

Stimulus measure	Economic effect
Expanding exports and tourism	• Positive for exports and jobs growth
Licensing high-demand spectrum (to be announced shortly by the minister of communications)	• Promotes investment in the telecommunications sector • Reduces data costs • Increases competition • Once-off boost to government revenue (the consensus estimate is R25 billion)
Constitutional review process on land expropriation (recommendations to be submitted to government by the end of March 2019)	• Increases availability for agricultural land and industrial development • Releases strategically located land in urban and peri-urban areas for human settlement • Alleviates inequality through increasing land ownership
Township and rural development	• Broader economic development
Infrastructure fund, a second Investment Conference and the identification of provincial projects	• Boosts long-term growth • Draws in private sector investment (task team set up to eliminate investment constraints) • Improves quality of living
Competition Amendment Bill	• Tackles economic concentration • Prevents abuse of market power • Could dissuade foreign investment (merger and acquisition activity) • Promotes inclusion in the local environment
National Health Insurance Bill (to be submitted to parliament soon)	• Could possibly result in the scrapping of medical tax credits to fund universal health care • Health sector inefficiencies likely to result in a delay
New directorate within the National Prosecuting Authority	• Increases investigatory and prosecutorial capabilities • Positive in the fight against corruption and state capture
Size and structure of the state	• Reduces wasteful expenditure • Improves efficiencies and promotes coordination between government portfolios
Youth Employment Tax Incentive (extended for another 10 years)	• Promotes economic inclusion
Human Settlements Development Bank	• Increases the provisioning of housing • Alleviates poverty • Increases standard of living
eVisa regime	• Facilitates skilled immigration • Boosts tourism
Review of port, rail and electricity costs	• Improves the ease of doing business
National water plan	• Addresses water shortages and water quality • Promotes better project and infrastructure planning

Source: Sona, Momentum Investments