

Medium-term budget review

30 October 2024

Early days for SA's GNU to make its fiscal mark but continued debt focus and reform push



Initial impressions

- Fixed income and currency markets reacted negatively to the announcement that government's main budget deficit ratio was revised wider by an average of 0.4% between fiscal year (FY)24/25 and FY26/27 in the medium-term budget policy statement (MTBPS) compared to the national budget in February 2024. This outcome was slightly worse than investors' expectations based on a slightly larger-than-anticipated gross tax revenue shortfall of R22.3 billion for FY24/25. Markets were disappointed in the unchanged stance on issuance in spite of large cash balances.
- The use of the gold and foreign exchange contingency reserve account (GFECRA) profits continues to allow for a projected stabilisation in the government debt ratio over the medium-term expenditure framework (MTEF).
- Government initially estimated that the two-pot retirement system would yield R5 billion in additional taxes collected in FY24/25 as fund members access once-off withdrawals (this was based on an assumption of R23 billion in withdrawals). As noted in the February 2024 budget, this was a conservative projection, but it was maintained in the MTBPS. In the economist question-and-answer (Q&A) session, the SA Revenue Service (SARS) confirmed that R7.1 billion had already been collected in additional taxes (based of 1.6 million applications received, of which 1.5 million had been processed). SARS pointed out that R750 million in debt that was owed was settled. The SA Reserve Bank (SARB) has modelled a moderate withdrawal scenario (R40 billion in Q4 2024 and R20 billion spread over 2025) which could lead to R19.9 million in additional personal income tax (PIT) in fiscal year (FY) 24/25. In their high withdrawal scenario, based on withdrawals totaling R100 billion in Q4 2024 and R40 billion spread over 2025, the estimated additional PIT for FY2024/25 rises to R41 billion. Industry estimates range between R10 billion and R15 billion in additional taxes raised, exceeding Treasury's estimates. This could lead to a positive surprise on revenues if materialised. Moreover, efficiency gains at SARS could drive additional positive revenue surprises over the MTEF.
- Despite the new administration navigating political hurdles, Treasury has demonstrated its resolve to uphold fiscal consolidation, keeping the primary balance in surplus over the MTEF. Nonetheless, market participants remain wary of the difficult fiscal choices ahead, particularly regarding the need for increased support to state entities, managing the rising cost of living impacting civil servants in future wage negotiations, and broadening government aid for the most vulnerable on a more sustainable basis.
- Treasury's revised medium-term economic outlook appears prudent, aligning closely with our forecasts and the consensus estimates from Reuters. Government's projected average growth rate of 1.5% for 2024 to 2026 (previously 1.6%; however, risks to the outlook are now seen as being more balanced than in February 2024) is only marginally below our expectation and the Reuters consensus of 1.6%. Likewise, Treasury's forecast for headline inflation at 4.5% (previously forecasted at 4.7% in February 2024) over the medium term is only slightly below our estimate of 4.7% and aligns with the Reuters consensus figure of 4.5%.
- The R22.3 billion expected undershoot in gross tax revenues for FY24/25 is largely driven by disappointing fuel levies and lower import value-added taxes (VAT). While lower diesel usage by Eskom has contributed to a lower collection in fuel levies, a significant R9 billion diesel rebate was the main contributor. Lower imported VAT collections were associated with energy supply improvements leading to reduced imports of alternative energy components (e.g. solar panels). In our view, corporate income tax (CIT) could get a boost in December, a seasonally strong month related to company reporting cycles, while PIT could jump on the September 2024 implementation of the two-pot retirement reform.

- Government predicts that the revenue buoyancy (growth in tax revenue per unit of economic growth) is expected to recover from 0.95 in FY24/25 (previously estimated at 1.33 in the February 2024 national budget) to 1.09 in the following two fiscal years from a previous estimate of 1.11. Government anticipates a recovery in tax buoyancy driven by improved economic growth and further gains in tax compliance/administration. CIT buoyancy is expected to peak at 1.35 in FY26/27, while PIT buoyancy is set to rise to 1.1 over the same period. Treasury's assumptions on key commodity prices are broadly in line with the Bloomberg median consensus forecast for the next three years but ongoing logistics woes are, in our view, likely to pose a risk to CIT buoyancy ratios.
- At a projected 5% of gross domestic product (GDP), SA's expected consolidated budget deficit ratio for FY24/25 (and 4.3% for the next) looks more concerning than the Reuters median consensus estimate of 4.4% for FY24/25 (and 3.9% for FY25/26). Government's forecasts, however, compare favourably with a 5.6% fiscal deficit projected for emerging markets (EM) in 2024 and 5.5% in 2025, as estimated by the International Monetary Fund (IMF) in its October 2024 World Economic Outlook update; as well as the 5% and 4.5% deficit ratios projected for developed markets (DM) for the same period. Although the Reuters consensus is more bullish on its fiscal forecasts in the near term than Treasury, its forecast for a narrowing in the deficit to 3.3% the outer year of the MTEF (FY27/28) broadly matches Treasury's projection of 3.2%.
- Treasury confirmed that its plans to maintain a primary budget surplus in the MTEF remain firmly on track, with this surplus projected to rise to 1.8% of GDP by the final year of the MTEF. Treasury estimates the gross debt-to-GDP ratio will peak at a higher 75.5% in FY25/26 (0.2 percentage points higher than February's estimate) before declining. This compares with an expected debt ratio of 69.9% for EMs in 2024, rising to 71.9% in 2025. Despite the average debt ratio in EM stacking up only slightly lower than SA's, Treasury noted that in 2023, SA's debt ratio ranked 18 percentage points higher than the median EM. Nevertheless, SA's debt ratio is still lower than the 109.4% projected for DMs in 2024, lifting to 111% by 2025. While the debt ratio itself is not particularly alarming compared to global standards, the increase in the debt ratio (rising by 48.1 percentage points between FY08/09 and FY2023/24), coupled with a corresponding rise in debt-service costs as a percentage of GDP (an increase of 2.7 percentage points over the same period) places SA at a disadvantage compared to its EM counterparts.
- No changes were made to government's plans to draw down an additional R25 billion each in FY25/26 and FY26/27 from the GFECRA to reduce borrowing, and which will consequently arrest the rapid growth in debt-service costs. Although the government asserts that this strategy will lower the risk premium, boost investor confidence, and increase the demand for domestic assets, we would have favoured a more defined application of the funds (for instance, addressing Transnet's capital expenditure challenges) that prioritised fixed investment (more conducive for sustainably higher trend growth) over recurrent expenditures.
- The country's rating strengths, such as its significant external asset position, minimal levels of foreign currency debt, diverse economy, strong financial system, deep and liquid capital markets and freely-floating exchange rate, indicate that the threshold for downgrading SA to a single B rating remains relatively high, while a further commitment to fiscal consolidation, tangible progress on energy supply, and the promise of further structural reform efforts to lift trend growth and alleviate poverty and inequality should help to lower the hurdle for a rating upgrade. While we could see a favourable shift in the outlook from neutral to positive as early as the first half of next year, rating agencies are likely to seek concrete evidence of implemented structural reforms and fiscal discipline that lead to a notable reduction in the budget deficit and a stabilisation of SA's debt ratio.



Effect on the economy and financial markets over the MTEF

- The tax burden (ratio of tax revenue to GDP) is projected to lift slightly from 24.5% in FY23/24 to 24.7% (previously 25.3%) in FY26/27. In our view, compliance efforts at SARS, which are not fully accounted for by Treasury, to improve revenue collections, close tax loopholes and enhance growth outcomes could result in an upside surprise.
- A contractionary budget in the medium term, dependent on the government adhering to its fiscal consolidation strategy, leads us to favour fixed-income assets over SA listed companies primarily focused on the domestic market (SA Inc. shares). A contractionary budget means that the government will extract more from the economy through taxes than it will reinvest through spending over this period. This is reflected in the main budget deficit decreasing by R46.7 billion between FY24/25 and FY27/28. Nominal GDP is forecasted to grow by 20.3% between FY23/24 and FY2026/27, slightly more than the 19.5% estimated in February this year. During this time, the government expects an average decline in real expenditure growth of 0.2% (previously estimated at negative 0.6% in the February budget) and an average increase in real revenue growth of 0.4% (unchanged).



Incorporating GFECRA into the funding strategy lowers government's borrowing requirement

- Government's gross borrowing requirement is anticipated to fall from R424.7 billion in FY24/25 (estimated at R457.7 billion in February this year) to R455 billion (previously R428.5 billion) by FY26/27. In FY24/25, the gross borrowing requirement will be financed through domestic short- and long-term loans, foreign currency-denominated instruments and cash balances. Treasury noted that domestic long-term bond issuance will remain steady, with cash balances likely to be utilised to stabilise issuance in the next fiscal year.
- The use of further GFECRA funds will be determined by foreign exchange fluctuations and the amount of interest on excess reserves (determined by the repo rate) as a result of the additional amounts held in the tax and loan accounts, which sit with commercial banks. As such, further disbursements are possible in the future but largely depend on these two requirements.
- **Debt management risks and sensitivities:**
 - A R1 change in the rand/US dollar exchange rate leads to a R29.6 billion change in gross loan debt.
 - A 1 percentage point change in headline inflation leads to a R10.2 billion change in gross loan debt.
 - A 1 percentage point change in short- and long-term interest rates leads to a R12.7 billion change in gross loan debt.
- Refinancing risks remain → average annual debt redemptions in the MTEF are expected to reach R211.5 billion compared with an average of R63.6 billion over the prior 10-year period → this places pressure on capital markets and pushes up borrowing costs.



Balancing spending demands with revenue pressures

Social expenditure

- The budget continues to prioritise redistribution, with 60.5% (previously 60.2%) of total expenditure allocated to health, education, housing, transport, social protection, employment and local amenities between FY24/25 and FY26/27.
- More than 30% of the population is expected to receive some form of social assistance from the government over the next three years.
- Treasury ensured that the vulnerable of society were protected against inflationary pressures → the February 2024 budget announced a 5.7% increase (2.2% real) in the SRD grant.

- Treasury's previous projection for social grants to rise to 3.8% of GDP by FY40/41, takes account of the SRD grant. As such, a permanent revenue stream will likely have to be considered going forward.
- No major funding shifts are expected in the MTEF in relation to the National Health Insurance (NHI) plan.

Civil servant wage demands

- The expenditure projections presented in the budget suggest an uplift to capital expenditure. Real growth in capital outlays is expected to average 6.4% (previously estimated at 5.4% in February 2024) between FY24/25 and FY26/27, while real growth in the compensation of employees is expected to lift on average by 0.3% (previously estimated at negative 0.1% in February 2024) during the same period.
- At the first Public Service Co-ordinating Bargaining Council (PSCBC) meeting on October 1, 2024, unions rejected a 3% salary increase offer, which was presented as a counter to their original demand for a 12% increase that the government had previously declined. The Department of Public Service and Administration has since adjusted its wage increase offer for approximately 1.3 million government workers to 4.7% for FY25/26, with future hikes linked to inflation for FY26/27 and FY27/28. *News24* reported that the Public Servants Association (PSA) trade union will reject the government's latest offer for an inflation-linked 4.7% and push for a 6% hike.
- Cabinet has approved an early retirement programme to aid a reduction in the civil servant wage bill. In our view, this is unlikely to unlock massive savings in the wage bill given a low take up of early retirement options in the past. This is expected to cost R11 billion over FY25/26 and FY26/27 and targets 30 000 workers.

Strengthening local government

- Government noted that 50 of the 257 municipalities in the country have active financial recovery plans → to improve municipal service provision, government is focusing on financial, institutional and management changes in metros.

Capital expenditure can boost jobs and economic growth

- Government noted that the construction sector has significant multiplier effects with between three and four jobs created for individuals with a matric certificate or higher qualification for every R1 million spent → this compares to one job in mining, two jobs in financing and three jobs in agriculture.

Onerous interest bill

- Since FY13/14, interest payments on debt have outpaced economic growth, indicating that the economy is not generating sufficient revenue to meet increasing interest expenses. Consequently, a substantial portion of government resources is directed toward servicing the interest bill rather than being used to deliver essential services to SA citizens. Real growth in debt-service costs of 3.3% (previously estimated at 2.7% in February this year) on average in the medium term is expected to outpace the average anticipated real growth in (consolidated) revenue of 1.6% (previously projected at 1.9% in the February budget).
- The interest bill is expected to stabilise at 5.2% of GDP in FY24/25 (16.2% of expenditure in FY24/25, rising to 17.2% in FY27/28; and stabilising at around 19.2% of revenue in FY24/25) in the MTEF. Debt-service costs will on average consume 22c of every rand government collects in the MTEF. Worryingly, by FY27/28, government will be spending R1.3 billion a day to service its escalating debt burden.
- Government spends more on debt-service costs than on basic education, social development, economic development, peace and security and health. At 7.8% (previously 7.3%), debt-service costs are the second-fastest growing expenditure item in nominal terms between FY24/25 and FY26/27. Nominal spending on the capital budget is expected to grow by an average 10.8% between FY24/25 and FY26/27 relative to a previous estimate of 10.1%.
- Spending on health and peace and security is expected to grow at a mere 3.8% (negative 0.7% real) and 4.2% (negative 0.5% real), respectively, over the same period. According to Treasury, the burden on public sector workers has increased. The number of nurses [police] per 100 000 of the population has declined from 312 [291] in FY09/10 to 269 [233] in FY23/24.



Financial challenges faced by state entities impede fiscal stability

- According to the *Daily Maverick*, Eskom's tariffs have increased 653% between 2007 and 2022, compared to a 129% increase in consumer inflation over the same 15-year period. With lower revenue, reduced reliance on the grid, a hefty debt book and an unsustainable rise in municipal arrears, Eskom has requested a 36.1% tariff hike from April 2025, a 11.8% increase for 2026 and a 9.1% rise in 2027.
- To address municipal arrears, debt relief will be granted in equal tranches over three years for the municipalities that comply with set conditions related to improving compliance with financial management and revenue collection → compliance has improved from 55% in March 2024 to 76% in August 2024.
- Eskom failed to dispose of the Eskom Finance Company by the agreed timeframe of 31 March 2024 → this resulted in a R2 billion reduction in the debt-relief allocation to R76 billion in FY23/24. This allocation was fully converted to equity. Eskom's allocation for FY24/25 will also be reduced by R2 billion to R64 billion should it fail to dispose of the Eskom Finance Company by 31 March 2025. Treasury is working with Eskom to finalise government's takeover of R70 billion of Eskom's loan portfolio by FY25/26.
- Transnet has been offered a financial support package consisting of a R47 billion guarantee facility, of which a portion has already been utilised for loans from the New Development Bank (R5 billion) and African Development Bank (R18.85 billion) for its recovery and growth plans. No further financial support measures were outlined by government. In our opinion, it is likely to take a few years before railway volumes can recover to levels that are commercially viable and growth enhancing for the economy.
- Transnet and the Passenger Rail Agency of SA are finalising a list of priority projects → requests for proposals that will be issued to the market in FY25/26.
- R3.2 billion (national government) was allocated to SANRAL for the Gauteng Freeway Improvement Project in FY25/26 and R10.1 billion (provincial) was set aside for debt repayment and addressing the maintenance backlog → this has contributed to the R16.8 billion increase in the expenditure ceiling for FY25/26 and FY26/27.
- No additional allocation was announced to the SA Post Office or Denel (turnaround plan incomplete).
- The Land Bank reported that it has reached an agreement with all lenders up to September 2028 to resolve the default.



Challenges in rebuilding fiscal reserves amid structural economic limitations

- Treasury explored two economic growth scenarios (asymmetrical in magnitude to the downside) around its current base case:
 - **Upside scenario (in which energy and logistics reforms enhance productive capacity):** GDP would be 2.4 percentage points above the baseline by 2032 due to productivity improvements and higher trade volumes. The primary fiscal balance would improve more rapidly than in the baseline, while debt-service costs would dip below 20% of revenue by FY30/31, centered on a decline in the debt ratio from a peak of 74.8% of GDP in FY24/25 to 60.7% in FY32/33.
 - **Downside scenario (in which slower-than-projected global growth heightens risk aversion):** Weaker global trade and a shift to safe-haven assets would lead to growth falling 0.5 percentage points below the baseline by 2032. In this scenario, the primary balance would deteriorate by R78.9 billion over the MTEF relative to the baseline. Debt-service costs would remain above 20% of revenue, while the debt ratio would stabilise at 77.4% of GDP in FY27/28 before declining to 71.4% by FY32/33.
- Treasury noted that economic reforms are beginning to bear fruit in the economy:
 - **Fiscal anchors:** A debt-stabilising primary surplus strategy to be used in the MTEF until a more binding anchor is agreed upon → further updates to be announced by the end of March 2025.
 - **Energy:** Project registrations at SA's energy regulator exceeded 8.5 GW by the end of August 2024.
 - **Water:** A Water Partnerships Office has been established to incorporate private sector investment for the construction and refurbishment of strategic water projects → water licence applications now take a reduced 90 days for large businesses and farms to obtain.
 - **Digital spectrum:** The cost of mobile data packages has been slashed by up to 51% between 2021 and 2023.

- **Public Procurement Act:** Public procurement accounts for nearly a fifth of consolidated government spending → the Act will allow for better labour absorption and a reduction in corruption.
- **Zero-based budgeting:** In the economist question-and-answer session, it was mentioned that hurdles remain high to exercising this approach in terms of increased administration capacity.
- **Improving the management and regulation of infrastructure:** Government is creating conditions to attract private sector participation → consolidation of project preparation and financial structuring expected from FY25/26 → financing instruments to include bilateral loans, concessional financing and infrastructure bonds, while government will source technical skills from the private sector → credit guarantee vehicles to start in the energy sector for private sector developers and lenders (this will reduce government's contingent liabilities and help to de-risk projects)
- **Reforms to strengthen budget structures:** Allowing for enhanced coordination and managing of unanticipated expenditures → to be implemented in FY25/26.
- **Operation Vulindlela (OV)** has made significant strides in the energy and transport areas of the economy during its first term. OV previously noted that projects completed under its first term have potentially unlocked R500 billion in private investment. These reform efforts could take growth up to 3.5% by 2029 (from a 2% baseline). OV's second term, focusing on strengthening local government, employing digital public infrastructure, integrating urban environments, implementing the mining cadastral system, clearing the backlog in affordable housing, commencing rail open access, expanding the electricity grid, building a private sector pipeline in the water industry and furthering visa reforms are likely to benefit economic growth further.



Budget likely neutral for now, but concrete evidence of fiscal discipline will be a positive further out

- According to the Financial Action Task Force, SA has now been considered to have largely or fully addressed 16 of the 22 action items in its Action Plan, leaving six remaining items to be resolved before the final reporting cycle, which concludes in February 2025. Three of these relate to demonstrating a sustained increase in the investigation and prosecution of complex money laundering and terror financing, with the remaining three relating to the timely access of beneficial ownership information in respect of companies and trusts. With the hurdle to completing these by February remaining high, it is likely, in our view, that SA's removal from the greylist would be deferred to the October 2025 reporting cycle.
- SA's journey toward fiscal consolidation and debt stabilisation continues to be challenged by constrained growth prospects and growing socio-political demands on government resources. However, economic reforms are starting to positively impact growth with failures in SA's network industries becoming less of a binding constraint on economic growth prospects. In our view, increased participation by the private sector will enhance SA's growth opportunities in the MTEF.
- Nevertheless, South Africa's (gross) debt burden is still significant, amounting to R89 222 (previously R87 632) per capita in FY24/25, and the difficulties in controlling spending while allocating extra funds to troubled state entities and struggling municipalities are considerable in the medium to long term.
- Consequently, while credit ratings are likely to remain stable in the short term, more tangible proof of implemented structural reforms and fiscal discipline that leads to a notable reduction in the budget deficit and a stabilisation of SA's debt ratio could lend itself to a ratings uplift in the medium term.



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