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South Africa's mid-year budget update:
Fiscal policy at the rubicon

- Finance Minister Gigaba is due to unveil the Medium Term Budget Policy Statement (MTBPS) on 25 October at 14:00 local time. Although growth has bounced back from the Q4 16 – Q1 17 recession, tax collections are faltering, and a large fiscal slippage is likely, in our view. The 6.1% growth in tax receipts so far this year compared to a targeted growth rate of 10.6% points to a big revenue shortfall. Gigaba cannot really change taxes in the middle of a fiscal year, but he might possibly seek some offsetting mid-year expenditure cuts. We think the deficit slippage will be c.R35bn, or about 0.8% of GDP, but the risks are clearly tilted in the direction of a larger fiscal slippage.
- Contingent liabilities via Treasury guarantees on troubled state-owned enterprises' (SOEs) borrowings are starting to crystallise onto the fiscus. Although the R13bn bailout requested by South African Airways is fairly small overall and can probably be accommodated within the existing expenditure programme, Treasury's use of Section 16 of the Public Financial Management Act to organise parts of the payout sets a worrying precedent, especially given the scale of other SOEs' funding challenges. One of Gigaba's key challenges in the MTBPS will be to convince the market that the government has a viable plan for financially troubled SOEs.
- We see several other challenges for Gigaba in the MTBPS. First, he will be expected to provide a progress report on implementation of the government's inclusive growth action plan published in July. Second, he will have to provide numbers on the public service employee wage bill in 2018/19, although the current pay negotiations have not yet been concluded. Third, the markets will want to hear the Treasury's updated views on big potential future spending commitments like nuclear power, free university education and National Health Insurance.
- Rating agencies will scrutinise the MTBPS carefully. However, on balance, we think they will wait for the outcome of the ANC's December electoral conference and the 2018/19 Budget in February before taking further action. Although the ANC's national elective conference is just eight weeks away, its outcome is highly uncertain, yet absolutely key to South Africa's fiscal and creditworthiness prospects.
- Overall, we think Finance Minister Gigaba will struggle to present an MTBPS that is both reassuring and credible. There are no easy answers to the fiscal challenges. Although we do not think the market has very high expectations, it would likely view negatively any further attempt from National Treasury to finesse the fiscal numbers with a gradual and measured adjustment. Rather, bold action is needed.

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PLEASE SEE ANALYST CERTIFICATIONS AND IMPORTANT DISCLOSURES STARTING AFTER PAGE 7

In our *Quarterly Perspectives Q4 17: Countdown to the ANC conference*, 3 October, we argued that South Africa's fiscal situation is precarious. This report seeks to analyse this issue in more detail, especially given the looming MTBPS on 25 October. This key event will see Finance Minister Gigaba outline some broad expenditure and revenue parameters for the 2018/19 Budget to be unveiled in February, without detailing which specific tax levers and/or spending cuts he will implement. Gigaba will probably also provide an update on the government's progress on its action plan for inclusive growth that was published on 13 July and a programme for tackling growing contingent fiscal risks in certain troubled SOEs. We are concerned that Minister Gigaba will struggle to paint a reassuring picture. This report first looks at the broad macroeconomic context to South Africa's fiscal challenges, then analyses in more detail the fiscal performance so far this year, and finally outlines our expectations for the MTBPS.

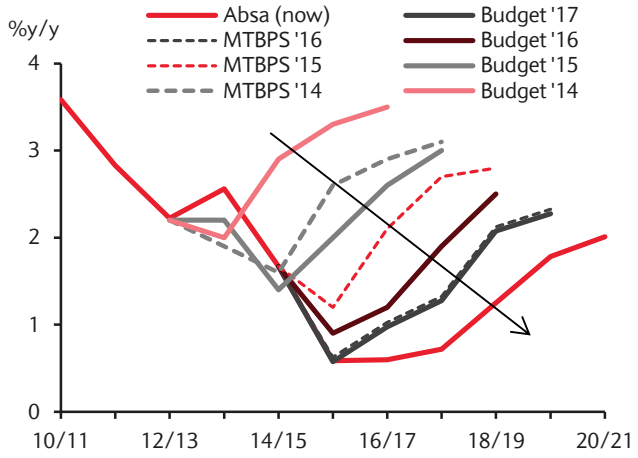
Weak growth since the GFC is the root cause of South Africa's fiscal strains

Tax collections have generally disappointed budget projections, owing to weaker-than-expected growth

South Africa's challenges in fiscal stabilisation since the global financial crisis (GFC) are mainly due to its failure to generate adequate economic growth. In the current fiscal year, for example, real GDP growth is likely to come in at just 0.7%, the third successive fiscal year of real growth below 1%, and a material undershoot compared with the 1.3% growth rate assumed by National Treasury for FY 17/18 as the macroeconomic backdrop to its fiscal programme. Indeed, growth outcomes have persistently disappointed since the GFC in 2008/09 (Figure 1). As growth has disappointed, tax revenues have tended to undershoot their original budget targets, except in a couple of years. For example in 2014/15 personal income tax (PIT) receipts outperformed their budget target by R17bn, or about 0.4% of GDP, owing to above-inflation wage settlements, and perhaps some better collection efficiencies by South African Revenue Service (SARS).

FIGURE 1

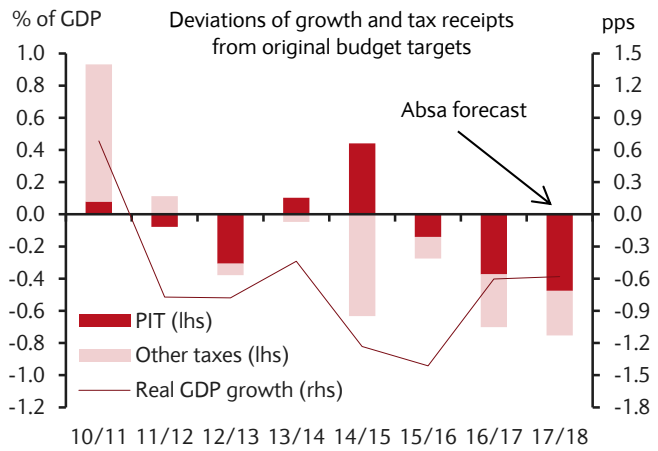
Growth forecasts have been persistently revised down…



Source: National Treasury, Absa Research

FIGURE 2

…with growth disappointments undermining tax collections



Source: National Treasury, Absa Research

FIGURE 3

When real GDP and/or nominal GDP undershoot budget targets, generally so do tax receipts

	Real GDP			Nominal GDP			Gross tax receipts				Personal income tax receipts			
	Budget	Actual	Deviation	Budget	Actual	Deviation	Budget	Actual	Deviation		Budget	Actual	Deviation	
	%y/y	%y/y	Pps	%y/y	%y/y	pps	Rbn	Rbn	Rbn	% of GDP	Rbn	Rbn	Rbn	% of GDP
07/08	4.8	4.8	0.0	10.5	13.7	3.3	557	573	16	0.7	155	169	13	0.6
08/09	4.0	2.0	-2.0	11.8	10.8	-1.0	642	625	-17	-0.7	191	195	4	0.2
09/10	1.4	-1.0	-2.4	7.4	5.9	-1.4	659	599	-61	-2.4	208	205	-2	-0.1
10/11	2.9	3.6	0.7	10.2	10.5	0.3	648	674	26	0.9	225	227	2	0.1
11/12	3.6	2.8	-0.8	9.3	9.1	-0.2	742	743	1	0.0	253	250	-2	-0.1
12/13	3.0	2.2	-0.8	10.2	7.9	-2.4	826	814	-13	-0.4	286	276	-10	-0.3
13/14	3.0	2.6	-0.4	9.7	8.8	-0.9	898	900	2	0.1	306	310	4	0.1
14/15	2.9	1.7	-1.2	9.4	7.0	-2.4	994	986	-7	-0.2	336	353	17	0.4
15/16	2.0	0.6	-1.4	8.0	6.6	-1.4	1081	1070	-11	-0.3	394	388	-6	-0.1
16/17	1.2	0.6	-0.6	7.7	7.0	-0.8	1175	1144	-31	-0.7	441	425	-16	-0.4
17/18*	1.3	0.7	-0.6	7.5	5.4	-2.1	1266	1231	-35	-0.8	482	460	-22	-0.5

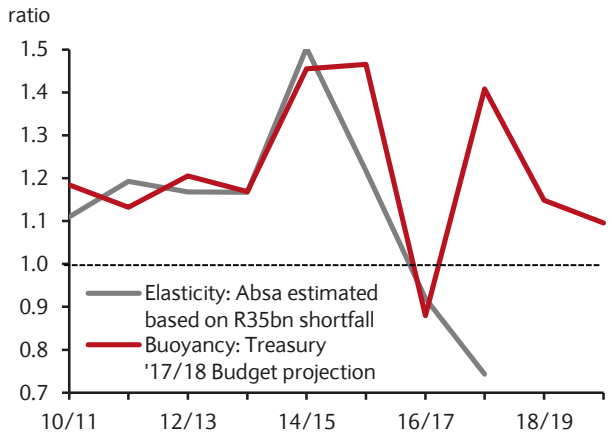
* Absa forecast in "Actual" and "Deviation" columns shown by grey shaded cells. Source: National Treasury, Absa Research

Tax buoyancy exhibited a worrying collapse in FY 16/17, but seems to be recovering this year due to big tax hikes

One way of analysing the relationship between growth and tax collections is through the concept of tax buoyancy, defined as the ratio of the percentage change in nominal tax revenues to the percentage change in nominal GDP growth. Since the GDP concept in this measure is nominal, inflation is incorporated as well as real growth. Tax buoyancy dipped sharply in 2016/17 to below 1 for the first time since the GFC. However, the 2017/18 Budget projected a rise in buoyancy above 1 again in FY 17/18, and despite the likely large shortfall this year in tax receipts (we project R35bn, recently revised up from R28bn, about 2.8% of targeted collections), tax buoyancy is likely to stay above because GDP growth has also underperformed the budget target. Real GDP growth is projected to undershoot the budget target by 0.6 pp in the current fiscal year, while the undershoot of nominal GDP growth is a sizeable 2.1 percentage points. However, the projected recovery of tax buoyancy is largely because of the huge R28bn (0.6% of GDP) above-baseline tax hikes, mainly in PIT, which were pushed through in the 2017/18 Budget.

FIGURE 4

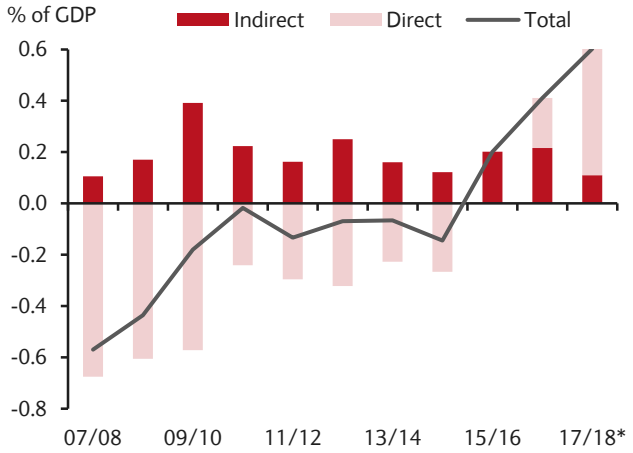
Tax buoyancy picked up due to big tax hikes in 2016/17



Source: National Treasury, Absa Research

FIGURE 5

Tax take rather than tax break from 2016/16 onwards



Source: National Treasury, Absa Research

Tax elasticity, however, remains under pressure and this should worry the fiscal authorities

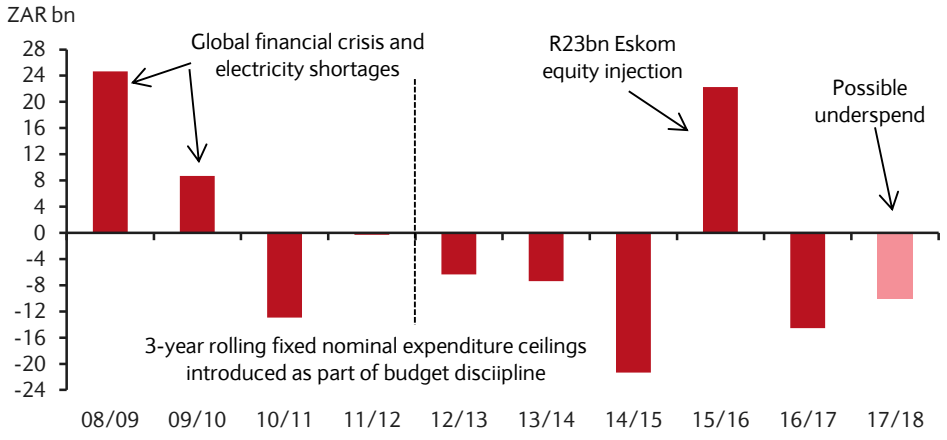
There is a stricter concept called tax elasticity, which basically strips out the effects of tax policy changes, and hence is a better measure of the intrinsic robustness of the tax system. National Treasury only report tax buoyancy, perhaps because tax elasticity is a little tricky to calculate since it is hard to divvy up any disappointments or windfalls in tax collections relative to their targets between the tax regime before and after tax policy changes. But we think it is a fair enough approximation to divide the shortfall proportionately between the projected tax take prior to tax policy changes and the projected net of the tax policy changes to get a rough measure of tax elasticity. Doing this presents a very different picture than the relatively optimistic one presented by tax buoyancy, with tax elasticity plunging further in 2017/18 (see Figure 4). This deterioration might have something to do with the running disputes between SARS and National Treasury, at least when Finance Minister Gordhan was at the helm, which was a reflection of the factional battle within the ANC, and resulted in a high number of key staff leaving important divisions of SARS, such as the high net worth individual and corporate transfer pricing units. The outlook for the elasticity of South Africa's tax system is as key for its fiscal performance as the outlook for growth – and as murky.

In a strict budgetary accounting sense, expenditure control has so far been pretty good

Notably, South Africa's fiscal weakness has not been due to expenditure overruns. In 2012 National Treasury introduced fixed expenditure ceilings as a means of enforcing a measured deficit consolidation path. Initially defined in relation to all noninterest government expenditure, in the 2015 MTBPS the expenditure ceiling definition was redefined in reference to all noninterest spending from the National Revenue Fund, excluding the skills development levy, the R23bn Eskom equity injection (financed in a deficit-neutral way from the sale of Vodacom shares), South Africa's contribution to the BRICs bank, and transactions linked to debt management. Thus, although actual spending breached the original target in 2015/16 owing to the Eskom bailout, the expenditure ceiling held, even in 2015/16 when the government was saddled with a much higher-than-anticipated wage settlement, which caused a major scramble to reallocate fiscal resources.

FIGURE 6

Government has typically under-spent its original budget targets



Source: National Treasury, Absa Research

Fiscal performance so far this year has been worryingly weak

Weak growth has – again – hobbled South Africa's fiscal performance

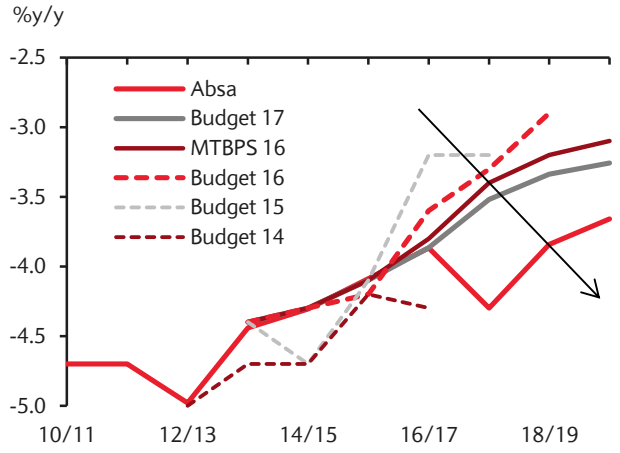
The fiscal challenges posed by weak growth are not a new issue, but arguably they have intensified this year, especially given our growth projection to come in at just 0.7%, some 0.6 percentage points weaker than the Treasury's already modest GDP growth forecast of 1.3% made in the 2017/18 Budget published in February. Thus, we see a significant risk of a large slippage on the main budget deficit target, which was set in February at R166.8bn or 3.5% of GDP. (While we prefer to analyse the main budget data, the MTPBS will likely continue to focus mainly on the consolidated budget numbers, which include the provinces and extra-budgetary institutions, such as the social security funds. These entities tend to run a small fiscal surplus in aggregate. Thus, the main budget deficit target of 3.5% of GDP corresponds to a consolidated budget deficit target 3.1% of GDP.)

Tax collections YTD are up by 6.1%, a disappointing performance compared to the 17/18 projection of a 10.6% growth rate

Regardless of which deficit measure is analysed, South Africa's performance YTD suggests that a large slippage is highly likely. The main budget deficit in the April-August period was at R141.4bn, about 84% of the original budget target. By way of comparison, the deficit in the first five months of FY 16/17 was about 70% of the full-year outcome. In FY 16/17, the tax shortfall ended up being about R31bn, but the main budget deficit slipped by only R12bn due to some unexpected nontax receipts and expenditure coming in about R11bn below the budget target. This year, the main reason for the deterioration of the fiscal position is again the weakness of tax receipts, which seems primarily a function of much softer-than-expected growth, but has possibly been exacerbated by difficulties at South African Revenue Service (SARS) with widespread turnover in senior staff positions. Gross tax collections (before transfer payments to other countries in the Southern African Customs Union and before nontax revenues) in the first five months of the fiscal year have grown by 6.1% y/y, well below the budgeted growth rate of 10.6% for FY 17/18, and a disappointing pace of collection given that R28bn of new above-baseline tax increases were introduced in the 2017/18 budget. Tax receipts are falling short of target in all of the major tax categories, which collectively account for 92% of planned receipts in the current fiscal year.

FIGURE 7

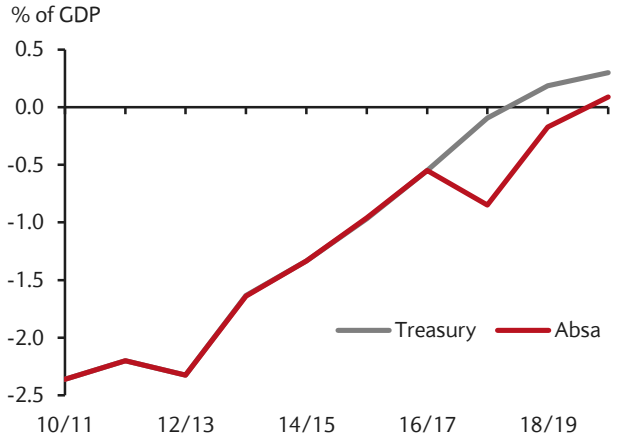
Deficit targets have been widened out over time



Source: National Treasury, Absa Research

FIGURE 8

And the primary budget balance is still in deficit



Source: National Treasury, Absa Research

FIGURE 9

Tax collections are falling short of their 17/18 Budget targets in all main categories

	Share of total tax collections FY 17/18	FY 16/17 Actual growth, %	FY 17/18 budgeted growth, %*	FY 17/18 YTD avg. growth, %	Projected shortfall, Rbn*
Personal income tax	38.1	9.4	13.2	8.0	-23.7
Corporate income taxes	17.3	6.9	6.6	4.4	-5.3
Value added tax	24.7	2.9	7.9	5.6	-7.4
General fuel levy	5.6	12.9	12.5	11.2	-1.1
Customs duties	4.2	-1.8	8.7	-2.9	-7.9
Dividend withholding tax	2.7	30.6	32.4	-0.3	-4.1
Gross tax revenue**	100	6.9	10.6	6.1	-51.1

* Budgeted growth is calculated off the '16/17 estimate presented in the '17/18 Budget, not from the '16/17 actual outcome. Conversely, the projected shortfall (at current collection rates) is calculated from the '16/17 actual outcome.
** Gross main budget tax revenues before SACU payments, departmental receipts, and financial transaction proceeds
Source: National Treasury, Absa Research

We have lifted our estimate of the likely tax shortfall to R35bn, given the weakness of growth and the pace of under-collection so far this fiscal year

Forecasting South Africa's tax receipts for the full fiscal year is tricky, especially with seven months of tax collection data for FY 17/18 yet to be published. Simplistically applying the current YTD growth rate for each tax collected to last year's outcomes would suggest a total gross tax shortfall for the main budget of R51bn, over 1% of GDP. This is the same order of magnitude as various press reports suggest (Fin24, 'Gigaba faces R50 billion budget shortfall', 1 September; Business Day, 'Downgrade alarm as revenue shortfall could hit R50bn', 21 August). However, we think there are some reasons to believe that the pace of tax collection will pick up a little in the second half of the fiscal year. For one thing, the weak pace of collections in the early part of the current year partly owed to a change in the dividend withholding tax rate that caused a number of trusts and the like to retroactively declare dividends as having occurred in FY16/17, thereby pulling revenues out of the current fiscal year into the previous one. Also, the recovery from the recession might serve to boost tax receipts, particularly those related to consumer spending and income, compared to the April-May period. It will be interesting to see National Treasury's projections in the MTBPS, especially since it will have the as yet unpublished September budget data to hand. We had been forecasting a tax shortfall of R28bn, but have been concerned that it may prove a bit too optimistic and have decided to nudge up our forecast shortfall to R35bn, and we feel there is still some upside risk to this forecast.

The tax amnesty programme provides only a tiny offset to the tax shortfall, many potential participants perhaps having chosen to emigrate, rather than declare their offshore assets to SARS

The potential revenue upside the mooted sugar tax, which could have raised up to R5bn depending on its precise parameters, has not yet been introduced and now it seems unlikely in the current fiscal year. Regrettably, the Special Voluntary Disclosure Programme has not turned out to be a fiscal golden goose either. In September, Gigaba revealed to parliament that by the 31 August deadline, there were over 2000 applications under the Special Voluntary Disclosure Programme, covering R35bn of assets. Gigaba said that the total tax collections from the programme could amount to over R4bn, a little less than 0.1% of GDP. Although welcome, this is nowhere nearly enough to offset the expected shortfall in regular tax collections. The intense political uncertainty over the past year may have undermined the programme to some degree; it is plausible that individuals with significant offshore assets might have chosen to emigrate rather than regularise their tax affairs with SARS.

Expenditure growth remains within the budget target so far in FY 17/18 and could conceivably undershoot the target a little, either by accident or design

The main budget expenditures have grown by 6.9%, a little short of the 7.8% projection in the 2017/18 Budget. South Africa's budgeting processes have tended to ensure that the government does not breach its expenditure ceilings. From 2012, National Treasury adopted a policy of never revising upwards any of its preannounced nominal noninterest expenditure ceilings in its three-year fiscal planning framework. From 2015, National Treasury began making outright cuts to those ceilings in an effort to bring the deficit under control (see Figure 2) and in general, even within a given fiscal year, Treasury has tended to undershoot its planned fiscal expenditure (see Figures 6 and 7). While we have argued that there would

appear to be little scope for Gigaba to introduce changes mid-year that would start boosting the revenue side of the budget immediately, he may be able to trim some spending. There are large chunks of the budget that Gigaba cannot touch – interest payments, public sector employee wages, social transfers to name a few – but he might conceivably try to curb or defer government investment spending, budgeted at R101bn this fiscal year, even though this would likely undermine growth potential.

Main budget deficit outcome likely to be 4.3% of GDP this year, versus the original budget target 3.5% of GDP

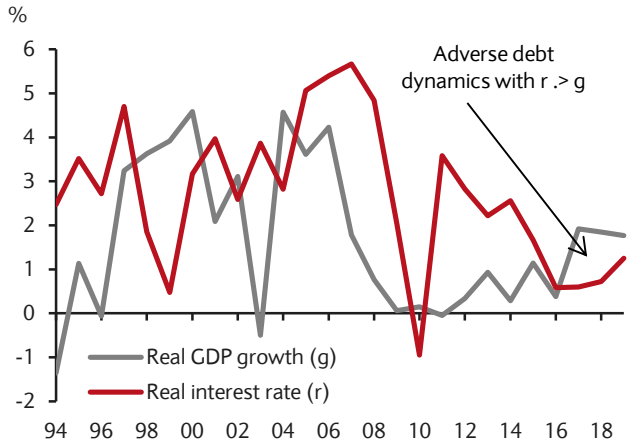
Where does all of this leave our projection for the current fiscal year? It is clear that there is going to be a sizeable revenue shortfall, although its exact magnitude is unclear. As we mentioned before, we raised our forecast of a R28bn tax shortfall to R35bn but feel the risks to this number are still tilted to the upside. However, we also see some prospect of weaker-than-budgeted spending. On balance, we expect National Treasury to revise its deficit target upwards by R35bn. Positively, recent high-frequency activity data for Q3, especially manufacturing and mining output and retail sales, have been surprisingly strong, suggesting some upside risk to our GDP forecast of 0.7% y/y in the current fiscal year. We will obviously look to update our forecasts after Treasury has published its more detailed analyses in the MTBPS, but for now we project a main budget deficit for FY 2017/18 of 4.3% of GDP (see Figure 8), compared to the original 2017/18 Budget target of 3.5% of GDP. This would leave the primary budget balance still deep in the red to the tune of 0.8% of GDP. The consolidated fiscal deficit, which includes the balances of the provinces and social security funds, is therefore forecast to be 3.9% of GDP this year.

The Treasury's projections of a stabilisation in the debt-to-GDP ratio look too optimistic; South Africa's debt dynamics are slippery

The fiscal slippage in the current year has derailed the National Treasury's plan in the 2017/18 Budget to stabilise the debt-to-GDP ratio at 52.9% by the end of FY 18/19. Even in February, we considered National Treasury's forecast to be too optimistic. Now, with our still relatively conservative estimate of a deficit shortfall this year of R35bn, we see the government's gross debt-to-GDP ratio rising to over 56% of GDP with no clear peak, even assuming a large fiscal adjustment package in the FY 2018/19 Budget in February, and no major expenditure ceiling breaches due to SOE guarantees crystallising onto the National Treasury's balance sheet. With South Africa's primary budget balance in the red to the tune of 0.9% of GDP, and the true real interest rate on government debt (coupons plus amortisations of below-the-line yield for bonds issued at a discount to par less adjustment for inflation) currently around 2.5-3% compared to a real GDP growth rate of about half a percentage point, South Africa's fiscal debt and debt dynamics look perilously slippery.

FIGURE 10

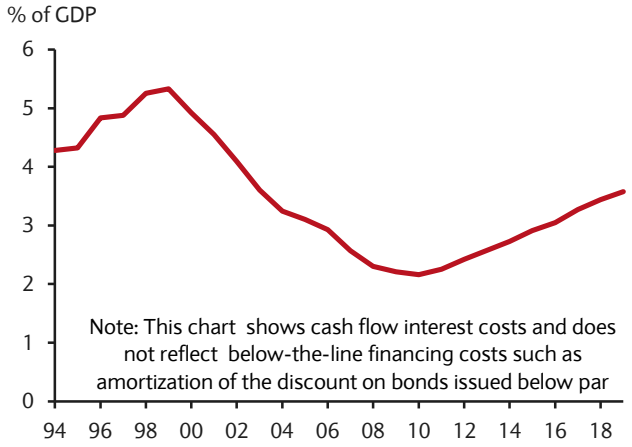
Real interest rate now exceeding real GDP growth rate



Source: National Treasury, SARB, Absa Research

FIGURE 11

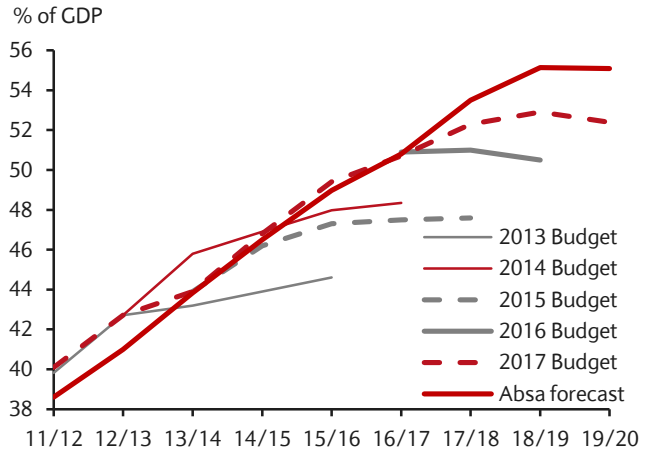
Government's debt-service costs are rising steadily



Source: National Treasury, StatsSA, Absa Research

FIGURE 12

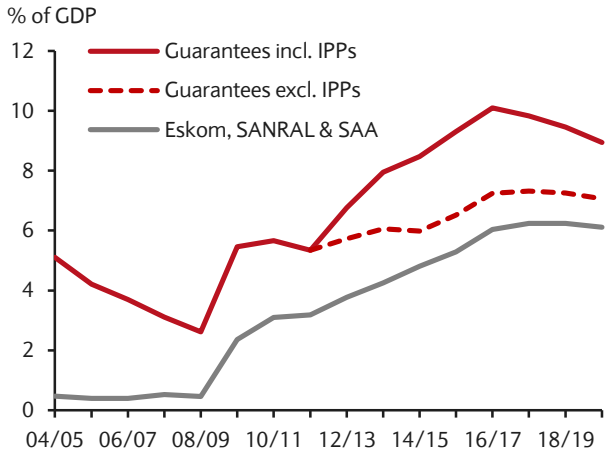
Each fiscal iteration pushes the debt trajectory up and out…



Source: National Treasury, Absa Research

FIGURE 13

…and SOE usage of Treasury guarantees has risen too



Source: National Treasury, Absa Research

The most important part of the MTBPS is what is signalled for next year

We think that Gigaba will have to signal another adjustment programme worth about 1% of GDP at MTBPS

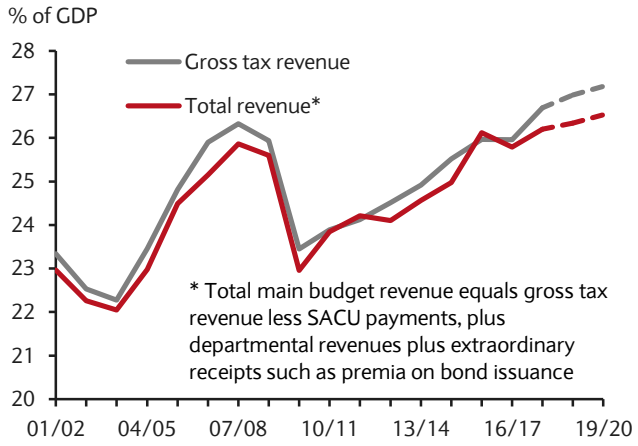
While there will doubtless be interest in the Treasury's updated projections for the current fiscal year, by far the more important part of the MTBPS is what Treasury signals about how it aims to respond to the slippage when it unveils the 2018/19 Budget in February. In line with past practice, this MTBPS will see the Finance Minister extend the rolling three year fiscal planning horizon to 2020/21 and give broad-brush parameters for revenue and expenditure measures he plans to implement in FY 18/19. In the 2016/17 Budget, then Finance Minister Gordhan introduced 0.6% of GDP in new taxes and 0.4% of GDP in expenditure cuts. In order to credibly signal that the relentless growth in the debt-to-GDP ratio since the GFC will finally be brought under control, we think Gigaba will have to signal an adjustment package of broadly the same order of magnitude as Gordhan did last February. However, Gigaba is unlikely to detail the exact tax levers or spending cuts that will be used until the budget is presented in February.

Signals regarding the composition of an adjustment package are as important as its overall magnitude

But it is not just the overall size of the package that matters, but its composition. Our view is that any attempt to deal with the fiscal imbalance principally through a combination of both more and higher tax rates will further undermine confidence and growth, and thus will not be very effective. Although we argued that, in a strict accounting sense, National Treasury has exercised good expenditure control, this is not an argument to say that, in a policy sense, the level of spending is optimal. South Africa's tax take as a share of GDP has risen materially over the years, and is currently quite high compared to that of other similar middle-income countries, suggesting that there is less scope for dealing with the fiscal imbalances through the revenue side of the budget, at least via taxation. The appropriate response to South Africa's current fiscal challenges probably lies more on the expenditure side of the budget rather than the revenue side, politically challenging as this may be. International experience shows that fiscal consolidation programmes, which focus on wasteful recurrent expenditure, tend to be the most successful in terms of restoring budget balance and market and investor confidence. Thus, while National Treasury has over the last three years cut the noninterest expenditure ceiling by R31bn from its level envisaged in the 2015 MTBPS, more probably needs to be done.

FIGURE 14

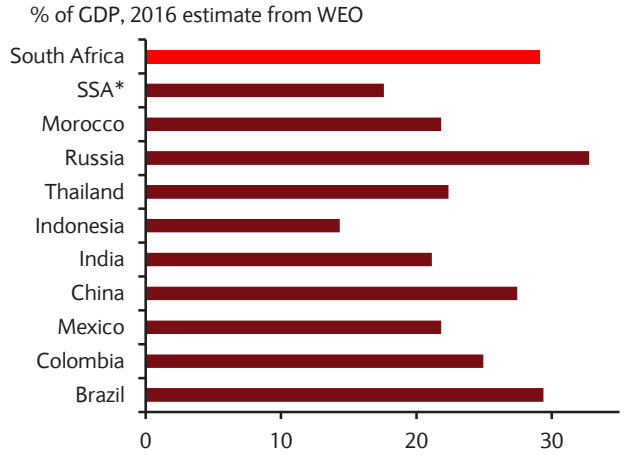
2017/18 Budget aimed to boost the tax take further



Source: National Treasury, Absa Research

FIGURE 15

South Africa's tax take is high by EM standards



* Subsaharan Africa Source: IMF, Absa Research

FIGURE 16

Redefined nominal noninterest expenditure ceilings have held firm

Rbn	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
2013 Budget Review	1016	1093				
2014 Budget Review	1014	1091	1168			
2015 Budget Review	1007	1081	1153	1250		
2015 MTBPS	1002	1078	1153	1250	1354	
2016 Budget Review	1002	1077	1153	1240	1339	
2016 MTBPS		1075	1144	1230	1323	1435
2017 Budget Review		1075	1144	1230	1324	1435
Total reduction in spending ceiling	**-14**	**-18**	**-24**	**-20**	**-31**	**0**

Source: National Treasury, Absa Research

Cutting expenditure will be very challenging politically for the weak government, just 18 months ahead of a general elections

However, cutting expenditure, particularly recurrent expenditure, is going to be very challenging for the current administration, which is politically weak and divided, in the throes of a factional battle and about 18 months away from having to face the voter in general elections. In particular, it is hard to see how expenditure can be materially reduced without a proper retrenchment programme to reduce the public sector headcount, given that the government has no legal room to cut civil service pay, which has materially exceeded the inflation rate for years, an excess of about 1.8 percentage points per annum between 2008/09 and 2015/16. Now, at a consolidated government level, employee compensation amounts to R550bn, about 35% of total government consolidated spending, or 12% of GDP. The government has relied on strict hiring controls and natural attrition to shrink the national and provincial government headcount by nearly 55k or 3.5% from its peak of 1.58mn in Q3 14. (We strip out the extra-budgetary institutions here because they include entities like Statistics South Africa and the Independent Electoral Commission whose payrolls are periodically swollen by events like the census or elections, respectively.) However, a more vigorous attempt to cut the public sector wage bill will likely require a more proactive attempt to reduce headcount. The 2017/18 budget noted that the National Treasury and Department of Public Services and Administration were working "with departments to reduce headcount, including testing the idea of voluntary severance packages", but as far as we are aware little progress has been made on this front after President Zuma fired Pravin Gordhan as Finance Minister on 31 March and replaced him with a close ally, the incumbent, Malusi Gigaba.

Public sector pay negotiations are a key fiscal risk, but it is not likely that the Treasury can offer any encouraging news on this front

As regards the expenditure side of the fiscal consolidation plans, the National Treasury's signal regarding the ongoing public sector wage negotiations will be key, with the current three-year deal expiring at the end of March. The government has never yet managed to negotiate a below-inflation wage increase, and the 2017/18 Budget pencilled in a 7.0% increase in "compensation of employees" for 2018/19. However, given pay negotiations are handled by the Department of Public Service and Administration, headed by close Zuma ally, Faith Muthambi, rather than the National Treasury, there is some cause for concern about the ability of the government to contain expenditure here. Nonetheless, the MTBPS line item for employee compensation (which covers consolidated government and therefore excludes municipal administrations) is key to watch, given that the government is in the process of negotiating a replacement to the current three-year pay deal that expires at the end of March. It is unlikely, but not impossible, that Minister Gigaba will say anything specific about the state of public sector pay talks, but it will be interesting to see if he picks up the initiative regarding a more proactive approach to downsizing the public sector headcount. Again, it would not be something that National Treasury could implement unilaterally and forced redundancies do not seem to be politically possible right now.

Many other types of fiscal expenditure are also hard to reduce

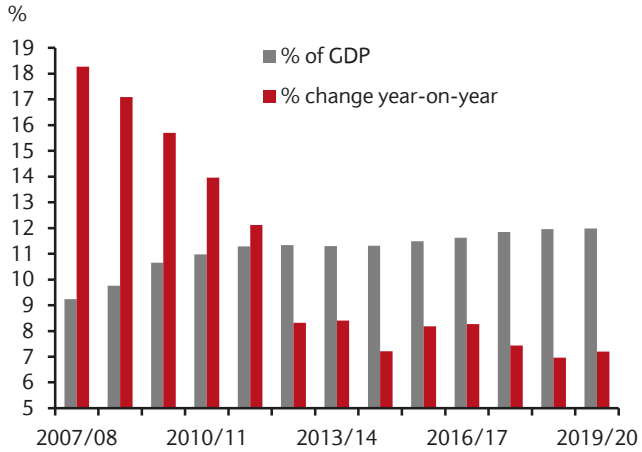
There are also limitations on other key areas of expenditure. For example, there is no legal scope to cut back on interest payments, which rose by 15.9% y/y in the first five months of FY 17/18, making above-the-line debt costs (ie, excluding discounts on bonds issued with a coupon lower than the market yield) the fastest-growing item of expenditure in the government budget, worth just shy of 3.5% of GDP. Furthermore, given South Africa's extremely high levels of poverty and income inequality, there is little socio-political room to cut back on social protection expenditure, amounting to a budgeted 3.2% of GDP in 2017/18.

So-called "tax expenditures" perhaps offer some scope for fiscal savings but it is not clear that Gigaba will specifically address this in the MTBPS

We think the elimination of tax loopholes and concessions might be able to contribute to the fiscal consolidation effort. Annexure B of the 2017/18 Budget detailed estimates of so-called "tax expenditures", essentially tax revenues forgone as a result of legislative provisions that deviate from standard tax treatment. Examples include medical tax credits, pension contribution tax deductions, motor vehicle industry import rebates, and zero rating of certain goods and services (eg fuel, certain basic foodstuffs) for VAT. Total tax expenditures in 2014/15 were estimated at R139bn, about 3.6% of GDP, or 14.1% of gross tax revenue, and thus would seem to have some potential to generate the necessary fiscal savings. The 2017/18 Budget itself mooted the idea of ending the zero rating on fuel (which would be worth nearly R19bn, or about 0.5% of GDP) but it is not clear if National Treasury has pursued this idea since the Budget. Tax expenditures on medical tax credits are worth nearly as much, and this would be an item worth watching (although the government has previously signalled that it might want to use these to help fund the introduction of National Health Insurance).

FIGURE 17

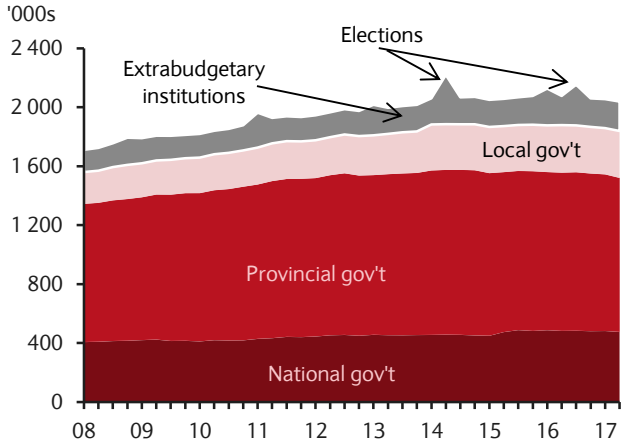
Government employment costs are now 12% of GDP



Source: National Treasury, Absa Research

FIGURE 18

Government payroll is hard to shrink without retrenchment



Source: StatsSA, SARB, Absa Research

FIGURE 19

Tax expenditures would appear to offer some room for fiscal savings

	Rbn	% of GDP	% of gross tax revenues
Person income tax	50.6	1.3	5.1
Pensions and retirement annuities	25.9	0.7	2.6
Medical	18.5	0.5	1.9
Other	6.2	0.2	0.6
Corporate income tax	5.2	0.1	0.5
Value added tax	52.4	1.4	5.3
19 basic food items	21.5	0.6	2.2
Fuel	18.9	0.5	1.9
Municipal property rates	10.5	0.3	1.1
Other	1.5	0.0	0.2
Customs and excise	31.0	0.8	3.1
Motor vehicle industry	23.5	0.6	2.4
Other	7.5	0.2	0.8
Total	139.1	3.6	14.1

Source: National Treasury, Absa Research

Also key to watch is Treasury's stand on state-owned enterprises

Treasury's plan for bailing out SAA will be unveiled at the MTBPS and should be watched closely for the precedent it sets for other troubled SOEs

Another key issue to watch out for in the MTBPS will be the National Treasury's plan for bailing out South African Airways (SAA). Developments at SAA seem to have caught National Treasury off-guard. In June, when Standard Chartered refused to roll over a R2.2bn loan, Minister Gigaba invoked Section 16 of the Public Financial Management Act (PMFA), which governs access to the National Revenue Fund for emergency purposes (see box), to prevent a default, which would likely have triggered cross default clauses, not only on SAA's other borrowings but on those of other SOEs as well. Gigaba had to do the same again at the end of September, tapping the National Revenue Fund for R3.0bn under Section 16 of the PMFA, when Citibank refused to roll over a R1.8bn bridging finance loan. (The additional R1.2bn was handed over to SAA for "immediate working capital needs". Yet the Treasury's use of Section 16 of the Public Financial Management Act to bail out SAA is concerning, since the airline's woes are hardly a new and sudden emergency. Parliament's own legal advisor opined yesterday that Treasury's approach here is probably not lawful. And SAA is likely to need more cash injections, with other domestic lenders having reluctantly agreed in negotiations to roll over R5bn in claims due at end September to end-October, although there is some provision in the deal struck with National Treasury to defer repayments still further, subject to satisfactory steps towards stabilising SAA's governance and finances. Most importantly, however, now that National Treasury seems to have abandoned its initial plans to sell its shares in Telkom to fund a cash injection, it not clear how it can provide the required support to SAA in a deficit-neutral way. Abandoning this fundamental tenet of the Treasury's approach would be a serious blow to market confidence. Thus a lot is riding on Minister Gigaba's plan for SAA, to be unveiled in the MTBPS. It will be interesting to see if Gigaba touches upon the idea of accessing the R1.8tn funds under management at the Public Investment Corporation to help fund troubled SOEs. Any initiative in this regard will be likely to unsettle markets, in our view.

Section 16 of the Public Finance Management Act, 1999 – Use of funds in emergency situations.

(1) The Minister may authorise the use of funds from the National Revenue Fund to defray expenditure of an exceptional nature which is currently not provided for and which cannot, without serious prejudice to the public interest, be postponed to a future parliamentary appropriation of funds.

(2) The combined amount of any authorisations in terms of subsection (1) may not exceed two per cent of the total amount appropriated in the annual national budget for the current financial year.

(3) An amount authorised in terms of subsection (1) is a direct charge against the National Revenue Fund.

(4) An amount authorised in terms of subsection (1) must

(a) be reported to Parliament and the Auditor-General within 14 days, or if the funds are authorised for the deployment of the security services, within a period determined by the President; and

(b) be attributed to a vote.

(5) A report to Parliament in terms of subsection (4) (a) must be submitted to the National Assembly for tabling in the Assembly and made public.

(6) Expenditure in terms of subsection (1) must be included either in the next adjustments budget for the financial year in which the expenditure is authorised or in other appropriation legislation tabled in the National Assembly within 120 days of the Minister authorising the expenditure, whichever is the sooner.

It is not clear what approach the government will take to other heavily indebted SOEs who face financing difficulties

SAA may be the most immediate concern, but it is far from the only SOE to present serious fiscal challenges for Minister Gigaba. The National Treasury's Inclusive Growth Action Plan, published on 13 July, listed 46 "interventions" in 14 broad areas (see Figure 22). Some of the interventions detailed by National Treasury are rather vague, but others are quite fairly specific. A number of them focus on state-owned enterprises (SOEs), one way or another. For example, the action plan targeted the recapitalisation of the South African Post Office (SAPO) by August but it is not clear if this has been completed or not. Treasury reported that Eskom had a deadline of July for developing a case for "soft support" (without explaining exactly what this means) and submitting this to Treasury and the Eskom board.

The particular issue of Treasury guarantees on SOEs borrowings warrants close attention

Also notable were the Sept 17 deadline for Cabinet to approve the terms of reference for a committee to determine SOE remuneration standards and the 17 October deadline for Cabinet to "reduce the issuance of government guarantees, especially for operational reasons", by the end of October 2017. Previous MTBPS's have not provided a table of contingent liability projections, but the heightened interest in the issue now as well as the action plan commitment might motivate Treasury to be more forthcoming this time. In the 2017/18 Budget, National Treasury projected that its contingent liabilities would peak at 17.6% of GDP at the end of 2016/17, of which government guarantees to SOEs and independent power producers (IPPs) would account for 10.1% of GDP, of which Eskom's utilised guarantees alone accounted for nearly 5% of GDP. Updates all the on these initiatives, as well as various others mentioned in the action plan, might reasonably be expected from the MTBPS, with the action plan having stated that "these interventions are the beginning of a response programme that will be unpacked in the MTBPS and the 2018 Budget…It is critical that we go into the MTBPS having demonstrated progress in unlocking growth."

Government is leaning towards costly commitments on nuclear power, free university education, and a National Health Insurance scheme

There are plenty of near-term issues for investors to worry about as regards the MTBPS, but it would be wise to keep an eye out for the longer term as well. In particular, investors should wait to see whether Minister Gigaba makes any particular binding pronouncements regarding three policy areas with huge potential consequences for fiscal policy in the long run, with government leaning towards costly future commitments. For example, President Zuma's cabinet reshuffle earlier this week suggests he may be preparing to push again to sign an expensive and controversial procurement of nuclear power. In the wake of the #feesmustfall protests, South Africa's government has indicated that it is open to exploring the idea of free tertiary education (which would cost about 1% of GDP) and also a National Health Insurance scheme. Whatever the moral and social merits of the last two, it is concerning that the commitments are advancing faster than the government's thinking on how they can be funded in a way which does not further destabilise the fiscus. Investors should also watch for any comments from Gigaba on his plans for the centralised procurement office within National Treasury. The market is still waiting for a permanent appointee as Chief Procurement Officer and Gigaba caused some concern earlier this year when he seemed to indicate the price should not be the main determinant of a procurement decision.

Rating agencies will be keenly interested in the MTBPS but will likely wait until 2018 before deciding on further rating downgrades

All three credit rating agencies are due to review their sovereign credit ratings again before the end of the year. With fiscal imbalances and problems at SOEs central to their concerns, the agencies will scrutinide the MTBPS carefully. However, on balance, we think they will wait until 2018 before deciding on their next rating move because the most important fiscal question is not what happens at the MTBPS but what happens at the ANC's electoral conference in December, and how that plays out into the 2018/19 Budget due in February. (We do think, however, that Fitch, which currently rates South Africa's local and foreign currency debt ratings BB+, might conceivably change its outlook from Stable to Negative.) Although the ANC's national elective conference is just eight weeks away, its outcome is highly uncertain, yet absolutely key to South Africa's fiscal and creditworthiness prospects.

FIGURE 20

Credit rating agencies likely to wait until 2018 before possible further downgrades

	S&P	Moody's	Fitch
Foreign currency	BB+	Baa3	BB+
Local currency	BBB-	Baa3	BB+
Outlook	Negative	Negative	Stable
Date assigned	03-Apr-17	09-Jun-17	07-Apr-17
Next scheduled review	24-Nov-17	24-Nov-17	Flexible – but probably last week November or first week December
Absa forecast	Will hold off but another downgrade is more likely than not in 2018	Another downgrade in 2018 is more likely than not in 2018	May change the outlook from Stable to Negative at the next meeting

Source: S&P, Moody's, Fitch, Absa Research

A lot is riding on the MTBPS and this is Minister Gigaba's inaugural budget document, coming in a year where there has been considerable turmoil at Treasury. Overall, we think Gigaba will struggle to present an MTBPS that is both reassuring and credible, not just in terms of the pure fiscal numbers, but also in terms of Treasury's plan for SOEs and its plan for kickstarting growth. There are no easy answers to the South Africa's current fiscal challenges. Although we do not think the market has very high expectations, it would likely view negatively any further attempt from National Treasury to finesse the fiscal numbers with a gradual and measured adjustment. Rather, bold action is needed.

FIGURE 21

The MTBPS may provide an update on implementation various growth plan initiatives (due or past due items in bold)

Intervention	Responsible authority	Timelines
Fiscal policy		
Finalise a sustainable wage agreement	Minister of DPSA	Feb-18
Finalise infrastructure budget facility	**Minister of Finance**	**Oct-17**
Financial sector and tax policy		
Convene Financial Sector Summit to quantify transformation targets	Minister of Finance	Dec-17
Bring down banking costs by implementing Twin Peaks	Minister of Finance	Feb-18
Work with DTI on targeted debt relief for most vulnerable (e.g. in cases of reckless lending)	Minister of Finance	Feb-18
Introduce micro-insurance framework and review Cooperatives Bank framework	Minister of Finance	Feb-18
Leverage public procurement		
Implement Preferential Procurement Regulations, which took effect on 1 April 2017	**Minister of Finance**	**Jul-17**
Finalise Public Procurement Bill	Minister of Finance	Mar-18
Finalise complementary government fund aimed at financing SMMEs in start-up phase	Minister of Small Business	Feb-18
Recapitalisation of SOEs and government guarantees		
Continue engagements on framework for the disposal of non-core assets	Minister of Finance	Mar-18
Conduct audit of non-strategic assets of SOEs aimed at strengthening SOE balance sheets	Minister of Finance	Mar-18
Finalise recapitalisation of South African Airways and South African Post Office	**Minister of Finance**	**Aug-17**
Reduce the issuance of government guarantees, especially for operational reasons	**Cabinet**	**Oct-17**
Determine the consequences of SOE non-adherence to the guarantee conditions	**Cabinet**	**Oct-17**
Broader State Owned Entity (SOE) reforms		
Implement private sector participation framework	Minister of Finance	Mar-18
Implement the remuneration framework	Minister of DPE	Mar-18
Finalise the board appointment framework	Minister of DPSA	Mar-18
Table draft Shareholder Bill	Minister of DPE	Mar-18
Implement a framework for the determination and costing of developmental mandates	Minister of Finance	Mar-18
Approve terms of reference for the Remuneration Standards oversight committee	**Cabinet**	**Sep-17**
Private Sector Participation (PSP) Framework		
Engage other departments on PSP framework	**Minister of Finance**	**Jul-17**
Provide guidance on PSPs and decide whether sector specific PSP frameworks are needed	**All Shareholder Ministries**	**Oct-17**
Present potential PSP projects to government departments and committees	All SOEs	Nov-17
Approve PSP projects as outlined in the governance framework proposed in the PSP framework	All Shareholder Ministries	Mar-18
Include PSP projects in Shareholder Compacts and Corporate Plan for subsequent implantation	All Shareholder Ministries	Mar-18
Costing Developmental Mandates		
Consult other SOEs on costing of developmental mandate	**Minister of Finance**	**Aug-17**
Implement mechanisms to effect outcomes through Corporate Plans (e.g. Instruction notes)	**Minister of Finance**	**Aug-17**
Roll-out the template for inclusion in the 2018 corporate plans	**Minister of Finance**	**Sep-17**
Monitor implementation through quarterly reports, annual reports and corporate plans	Minister of Finance	Mar-18
Energy		
Approach NERSA regarding Eskom hardship	**Eskom**	**Jul-17**
Submit case for Eskom soft support until tariff adjustment in 2018 to Treasury and Eskom Board	**Eskom**	**Jul-17**
Finalise lowest cost IEP and IRP	Minister of Energy	Feb-18
Review the pace and scale of electricity services rollout	**Minister of Energy**	**Aug-17**
Review the level of participation by black industrialists and develop a strategy to increase it	**Minister of Energy**	**Aug-17**

Intervention	Responsible authority	Timelines
South African Airways (SAA)		
Finalise CEO Appointment	**Minister of Finance**	**Jul-17**
Finalise and implement 5 year Turnaround plan	Minister of Finance	Dec-19
Negotiate with lenders to extend debt to longer-term	**Minister of Finance**	**Oct-17**
Telecommunications		
Conduct high level study on WOAN spectrum needs and license the remainder to the industry	**Minister of DTPS (CSIR)**	**Aug-17**
Issue policy directive mandating ICASA to commence the licensing process	Minister of DTPS	Dec-17
Complete the spectrum licensing process	Minister of DTPS	Dec-18
Direct Competition Commission to investigate the data prices	**Ministers of DTPS & EDD**	**Jul-17**
Commence rollout of phase 1 of SA Connect Broadband programme	**Minister of DTPS**	**Aug-17**
Other areas		
Amendment of the enabling legislation for licensing of Postbank.	Ministers of DTPS & Finance	Dec-17
Finalise Mineral and Petroleum Resources Development Act Amendment Bill	Minister of Mineral Resources	Dec-17
Conduct further engagements with civil society, labour and industry on Mining Charter	Minister of Mineral Resources	Gazetted
Table Regulation of Land Holdings Bill in parliament	**Minister of Rural Development**	**Oct-17**

Source: National Treasury, Absa Research

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