South Africa Viewpoint

2024 Budget Preview: can't squeeze tight enough; deficit widens

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Grip on expenditure slips; deficit guidance likely missed

In October 2023, the government presented a better-than-expected fiscal path by pledging to squeeze spending growth, while adjusting revenue forecasts to more realistic levels. The latest set of December fiscal data shows that the spending squeeze has not been tight enough to align with government fiscal projections. We anticipate a likely overrun of ZAR40bn. In our view, the Treasury is likely to miss its main budget deficit guidance of -4.7% of GDP in 2023/24 and -4.3% for the 2024 budget. We now lower our deficit projections, excluding Eskom support, to -5.3% in 2023/24 and -5.4% in 2024/25.

No major tax hikes – already at high levels

On February 21, the Finance Minister is set to present the 2024 Budget. We expect no major hikes on personal income tax, or corporate tax and value-added tax (VAT), which contribute around 80% of total tax revenues. Rates are already high. Furthermore, it's election year. However, less inflation adjustment to tax brackets could be a source of revenue gains, while fuel taxes could be increased since they were not altered in previous budget cycles when international oil prices were high.

Big expenses: wage bill, and debt

Spending risks remain largely from the wage bill, higher debt servicing costs and likely new allocations to Transnet. As a result, we project an ZAR80 billion gap from the government baseline, likely to be funded by increasing domestic issuances and external concessional sources.

Profits from FX reserves could be way out – or bonds

An unlikely tailwind could be from the Gold & Foreign Exchange Contingency Reserve Account (GEFECRA), which is the unrealised gains from trading in gold and foreign exchange reserve account (ZAR450 billion) kept at the central bank on behalf of the government. It could reduce borrowing in the short-term depending on the size and timing. Absent GEFECRA drawdowns, borrowing on fixed rate bonds look likely to increase.

Stage 6 power cuts weaken 2024E GDP to 1.3% from 1.5%

The baseline of increased energy supply in 2024 relative to 2023 is now being challenged by the emergence of stage 6 power cuts, despite authorities projecting that the end of loadshedding is within reach. We cut our 2024 GDP growth projection to 1.3% from 1.5% on renewed stage 6 concerns. Weak fiscal and economic performance are incorporated in the BB- rating. We don't expect downgrades in 2024E unless inconclusive electoral outcomes substantially weaken governance, the economic outlook and the ZAR, among other metrics.

Refer to important disclosures on page 8 to 10.

2024 Budget Preview: remain bearish

Starting with in year performance review

2023/24 fiscal in year performance still underwhelming.

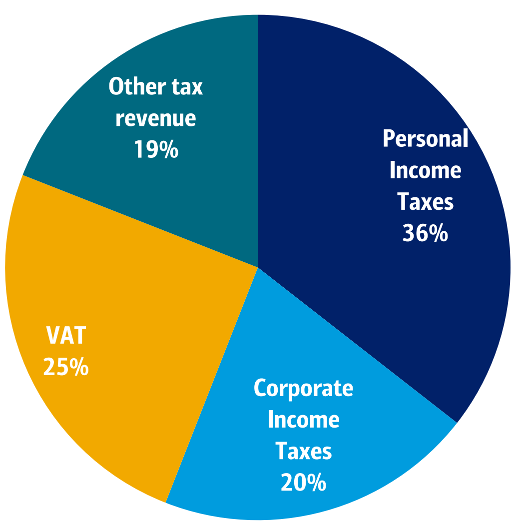
Post December 2022 fiscal data, we revise down tax revenues by about ZAR10 billion, reducing likely overcollection to only ZAR5 billion from ZAR15 billion previously. We increase our base-cast forecast of an expenditure overrun to ZAR50 billion.

Fiscal revenue performance is generally weaker compared to 2021 and 2022 fiscal years. Fiscal year to date, tax revenue growth is flat at 0%, compared to 7.7% in 2022 and 30% in 2021. Economic growth has slowed considerably, while corporate tax revenues, associated with higher profitability, have declined along with international commodity prices. Positive terms of trade are substantially lower in 2023 compared to 2021 and 2022. On the other hand, expenditure growth has remained high at 7.7% in 2023 compared to around 4% in 2021 and 2022, largely due to recurrent items – wage bill, debt service, etc.

While debt service projections remain unchanged in the current fiscal year, they need substantial upward revision in 24/25. In the current fiscal year, debt service payments have grown by 17% compared to an average of 14% in the last 3. Eskom support to date in the current fiscal year amounts to ZAR44 billion out of ZAR78 billion allocated to end of March. If the pace of drawdowns is not escalated in the three remaining months, then the full allocation could be missed.

On a net basis, the fiscal deficit is likely to be around ZAR40 billion weaker than the MTBPS baseline, largely on the expenditure overrun. As a ratio of GDP and excluding Eskom support, we expect the deficit to be -5.3%, vs -5% previously and compared to the National Treasury's baseline of -4.7%. All in, the main budget deficit, including Eskom support, remains above 6% of GDP reflecting our view of weak public finances.

Exhibit 1: Tax Revenue distribution across major taxes
The combination of PIT, CIT and VAT contribute around 80% of total tax revenues. No major changes expected on tax rates.



Source: Haver, BofA Global Research

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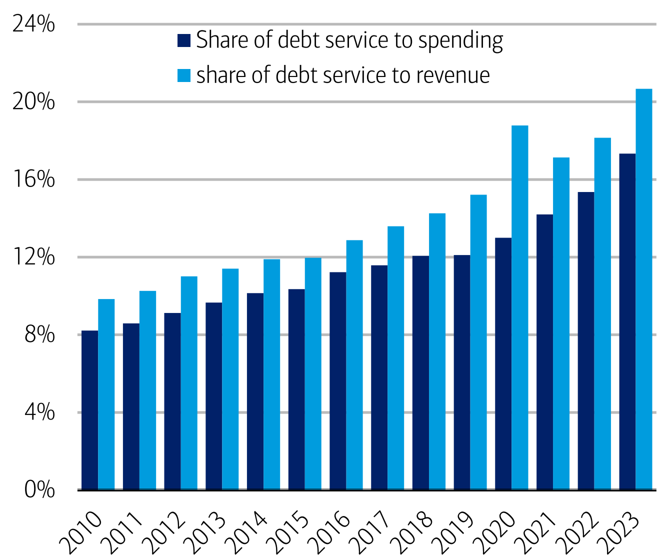
Exhibit 2: Debt Service to revenue and expenditure
Remains rising in both cases reflecting unsustainable growth in debt service.



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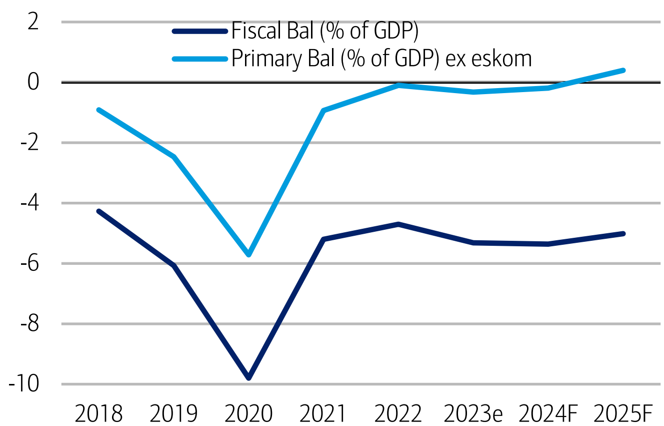
Budget 2024 outlook: slower consolidation

The 2024 budget on February 21 will be announced in an election year, where public finances and economic performance are both weak, (0.5% in 2023 and 1.3% real growth in 2024). Revenue forecasts are largely in line with medium-term economic forecasts. However, it is expenditure uncertainties that could derail the fiscal path. Expenditure pressures remain on the wage bill, social grants, and likely higher transfers to weak state-owned enterprises. For instance, we estimate that Transnet will probably receive a new allocation removing the ZAR47 billion guarantee.

Exhibit 3: Fiscal Balances to GDP

Pace of consolidation has slowed since 2022, and likely to be weak over medium term



Source: Haver, BofA Global Research

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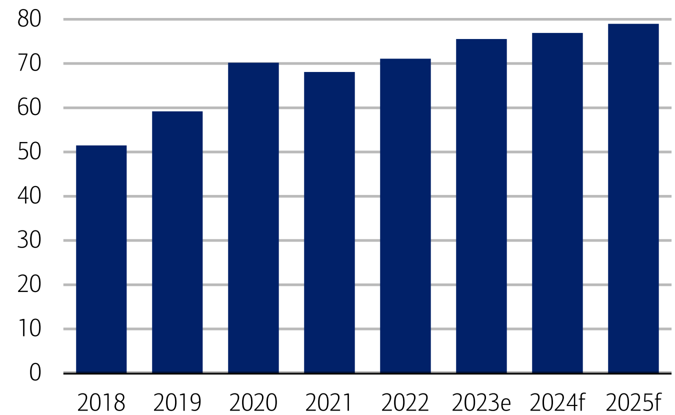
Exhibit 4: Debt to GDP trends

Remains on a rising path over the medium term



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No major tax increases anticipated – already high

The baseline budget framework potentially has ZAR15 billion in additional tax revenue, likely thanks to bracket creep, i.e., less inflation adjustment for tax brackets. The three main tax instruments – personal income, corporate and value-added tax –contribute about 80% to total revenues (see Exhibit 1). When tax revenues were underperforming during a period of low growth in 2016-19, personal income tax rates were increased to 41%, and finally 45% in 2017. A higher level is not under consideration. Similarly, the VAT was last increased to 15% in 2018, and is one of the highest rates among peers. On the other hand, corporate tax is on a declining path towards 25%. In the last fiscal year, it was reduced to 27%. Given constraints on the pace of revenue growth, the Treasury may choose to wait to reduce corporate tax rate any further.

Fuel taxes may rise again

The 2022 and 2023 Budgets were under pressure to provide some relief in fuel taxes due to high oil prices at the time. The 2023 Budget kept nominal fuel taxes unchanged in nominal terms. International oil prices have since moderated leading to a decline in nominal local fuel prices. Therefore, we could see an increase in fuel taxes in the budget given the flexibility created by lower international oil prices. Fuel taxes are mainly the general fuel levy and the road accident fund levy. These contribute about 30% to the total pump price.

Debt service likely to be higher than baseline

Debt service remains the fastest-growing item on the expenditure side. as a share of both spending and revenues, it has reached around 20% (see Exhibit 2). In 2024, we think debt service costs are likely to rise by ZAR25 billion– the current budgeted baseline growth is 8% and debt servicing will require an upward revision closer to ZAR400 billion, which exposes the Treasury to overspending risks if no adjustments are made in the budget numbers.

Exhibit 5: Nominal debt service costs
On a rising trend with no near-term turnaround

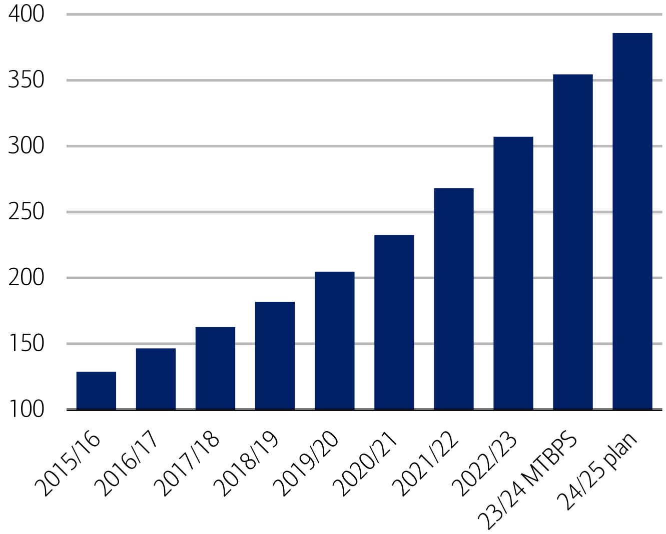

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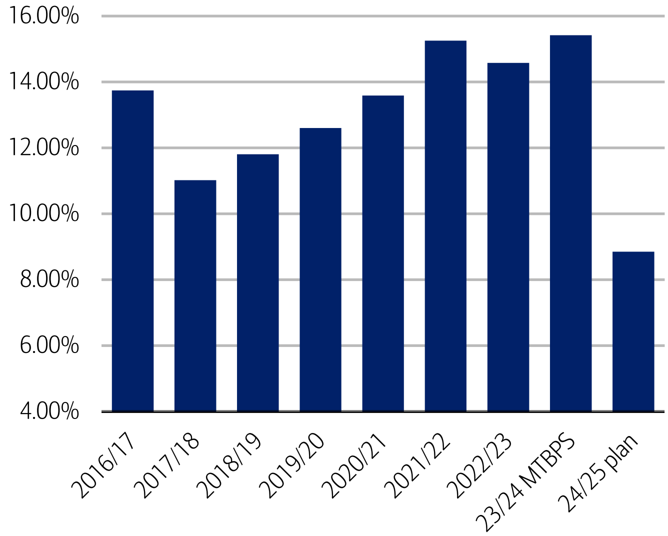
Exhibit 6: Year on year percentage changes in debt in service costs
Based on historical trends, 24/25 shows underbudgeting of debt service costs.



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Transnet likely new allocation – below the line

On November 30, the National Treasury announced a ZAR47 billion guarantee facility, drawing down ZAR22.8 billion immediately for liquidity support. The government is still mulling over the options of equity injections and cash transfers. The guaranteed framework represents just over 0.6% of GDP. We think that government is likely to provide a direct allocation to Transnet rather than a guarantee. In our view, extending a guarantee was an eleventh-hour decision to support Transnet to underscore its 'too big to fail' status. If the request had come early enough in the budget process, the Treasury would have allocated it into the budget. Similarly to Eskom, it could be treated as a financing item, below the line. Transnet's total debt is about ZAR130 billion or close to 2% of GDP. Government direct support is likely to be limited to servicing upcoming and, to some extent, a turnaround plan to keep the entity well capitalised. We think that overall exposures to Transnet should not exceed 1% of GDP. This, combined with Eskom, could cost the government close to 5% of GDP.

Medium-term spending risks: wages + basic income grant

The 2025 spending outlook will likely be weighed down by more expenditure risks – new wage negotiations resulting in increases above the National Treasury baseline, and permanent implementation of the social relief distress grant as the basic income grant.

In 2023, the government agreed a two-year wage increase of about 7.5%. This was about 3% higher than 4.5% embedded in National Treasury forecasts (3% baseline increase + 1.5% automatic adjustment). 2025 will bring similar increases – above inflation and below the National Treasury baseline.

Unions are generally powerful in South Africa, and less likely to accept below-inflation wage adjustments. Given high unemployment levels at above 30%, it is difficult for an ANC-led government to adopt a strategy of reducing the size of public sector. According to National Treasury data, the wage bill costs about 13.6% of GDP, which is the third highest after Iceland and Denmark. The OECD average for wage bill spending is 10% of GDP. Wage bill reform has proved elusive so far.

The primary reason for the high wage bill relative to peers is high real wage growth rather than high public sector employment numbers. The main contributors are occupation-specific increases in scarce skills sectors, pay progression increases over the cost-of-living adjustments, pension contributions as well as benefits and allowances. Considerations to trim wage bill will be focused on these areas.

2025 is likely to be the darkest before dawn – expenditure risks materialising + highest and final Eskom support. The financial support is set to be scaled up to ZAR100 billion in 2025 compared to ZAR78 billion in 2023, ZAR66 billion in 2024.

Exhibit 7: Financing Outlook- Treasury vs BofA Expectations
Total financing is set to increase to over R600 billion. The R50 billion increased financing could be covered by a mix of increase in domestic and external financing without a change in fixed rate issuances.

Financing outlook	Mid-term 23/24	Budget 2024 baseline	BofA 2024
Main budget balance	-330.1	-322	-403
Redemptions	-155.5	-171.8	-171.8
Eskom debt relief	-78	-66.2	-66.2
Total financing required	**-563.6**	**-559.6**	**-641.0**
Financing items			
Domestic long term	375.8	419.1	474.45
Domestic short term	48	47	54
External borrowing	45.9	36.9	55.9
Use of cash	93.9	56.6	56.6
Total financing	**563.6**	**559.6**	**641.0**

Source: National Treasury, BofA Global Research

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Bigger deficit = increased issuances

We estimate a higher borrowing requirement by ZAR80 billion compared to the October 2023 MTBPS baseline, or over 1% of GDP. If our baseline were to materialise, this would require increasing both domestic and external borrowings. Total domestic long-term issuance is likely to reach ZAR376 billion in fiscal 2023/24. The baseline for the government in 2024/25 fiscal year is an increase to ZAR419 billion in long-term issuances. Given our ZAR80 billion additional funding required, long-term domestic issuances may need to increase to a high of ZAR474 billion. This number is similar to the government's plan for 2025 domestic long-term borrowings.

In this scenario, we would see fixed rate bonds increasing to ZAR1.5 billion per auction instead of the current ZAR1.3 billion. Fixed-rate bonds are the most commonly used long-term borrowing instrument followed by inflation-linked bonds. Fixed-rate bonds meet close to 70% of total domestic funding needs. Increasing fixed rate issuances will likely be a last resort as they are used as a benchmark to assess the strain of fiscal financing.

Other domestic issuances would also be scaled up, such as floating rate notes and inflation-linked bonds. With domestic interest rates likely to decline in 2H24, issuing FRN notes could be partly beneficial to lowering the government's debt servicing costs. Inflation-linked bonds could be increased to ZAR1.2 billion, from ZAR1 million per week currently, as in 2021 and 2022.

In our view, the final amount of domestic financing will likely depend on how much cash savings are deployed to finance part of the deficit, and how much support is given to Eskom. Should other innovative measures be used – such as using one-off revenues from asset sales – the issuance scenario would change to a reduction of borrowing amounts. For example, tapping into central bank profits from foreign exchange reserves.

Financing – GEFECRA tailwind but not our baseline

Drawing down on the Gold & Foreign Exchange Contingency Reserve Account (GEFECRA) is a tailwind that could temporarily reduce bearish fiscal views, particularly for 2025 financing. The GEFECRA account has about ZAR450 billion in balances from unrealised gains in the holdings of gold and foreign exchange reserves. The size of the drawdowns largely depend on what could be used to finance the budget – or other one-off support to Eskom and Transnet, or to reduce issuances. A GFECRA study is set to establish rules around the transfer of profits to the Treasury from the ZARB. In our baseline view, we don't think any drawdowns are likely in the near term but could be considered for 2025. However, if any drawdowns were to be done, they could reduce the amount of borrowings.

No external market access in 2024, likely in 2025

South Africa is not planning a Eurobond issuance in 2024, similar to its 2023 stance. We see a market issuance as likely in 2025. In the meantime, the last issuance was $3 billion in April 2022. South Africa is likely to repay upcoming foreign-denominated maturities using dollar deposits. We estimate about $2.6 billion worth of maturities in the 2023/24 fiscal year. The government plans to borrow $2 billion largely from concessional lenders.

In the context of fiscal rule, the government has, in the past, used nominal expenditure ceilings in the face of tax revenue shortfalls in a low-growth environment. It is considering establishing new fiscal anchors to stabilise public finances. Options should be around achieving primary surpluses as fiscal anchor.

2024 State of the Nation

Its election season, President Ramaphosa presented a bullish future despite a weak past and present. A child born in 1994, born free, would now be 30 years old – the same amount of time the ANC has been in power. In that time, the ANC has had four substantive presidents: Nelson Mandela, Thabo Mbeki, Jacob Zuma, and Cyril Ramaphosa. All governed with an outright majority in parliament. Their successes have been mixed. They have improved the provision of basic services – housing, water, electricity, and education. However, the government has not kept up with demand for electricity and water provision. Service delivery failures in recent years disenfranchise young voters from the ANC-led government.

President Ramaphosa wants to sign the National Health Insurance Bill and implement incrementally. This would rattle the private health care sector but is unlikely to change anything in the near term. The government does not have the financial capacity to initiate new policy priorities into the budget framework. Other policy reforms include the visa system and improving mining rights licensing system.

After electricity generation, transmission is the next stage of investment. The new generation, particularly from renewables, needs to be transmitted across the country to ensure energy supply. It will likely rely on private sector financing rather than the state, given weak public finances. President Ramaphosa mentioned that 14000km of transmission lines will be required by 2032 costing up to ZAR400 billion. while the state intends to keep ownership of transmission grids, private sector financing may be accommodated within private-public partnerships.

Headline CPI likely 5.3% yoy, core 4.6% yoy

After printing 5.1% year on year in December, we expect headline CPI to increase to 5.3% yoy, 0.2% mom. Core inflation like to marginally increase to 4.6% yoy, from 4.5% in December 2023. CPI is likely to increase despite domestic petrol prices declining by close to 3% in January. There are other components driving the increases, such as services and food inflation. Generally, food components experience revisions in January each year which pushes up food prices. Increase in food prices could be broad based reaching 1% month on month. Medical inflation is likely to have spiked in January 2024. Usually, medical insurers raise prices in February, but they have brought forward their annual price adjustments by a month, with firms having announced average increases of around 7% from January: 7.5% for Discovery Health, 6.9% for Bonitas and 6.9% for Momentum. The overall pain could be moderated by seasonality effects in administrative prices that usually subtract from inflation in January. In 2024 we expect headline inflation to average 5%, while the SARB starts cutting in July with three cuts of 25bp each in 2024 and two cuts in 2025.

Exhibit 9: Key Macroeconomic forecasts

Revised economic growth projection downwards to 1.3% from 1.5%.

	2019	2020	2021	2022	2023e	2024f	2025f
Real GDP growth (%yoy)	0.3	-6.0	4.7	1.9	0.5	1.3	1.5
CPI average (%yoy)	4.1	3.3	4.6	6.9	5.9	5.0	4.6
Policy rate (%, end of period)	6.5	3.5	3.8	7.0	8.3	7.5	7.0
Fiscal Bal (% of GDP)	-6.1	-9.8	-5.1	-4.7	-6.4	-6.2	-6.4
Primary Bal (% of GDP)	-2.5	-5.7	-0.9	0.0	-1.4	-1.1	-1.0
Debt (% of GDP)	57.2	70.2	68.0	71.1	75.5	76.9	79.0
Current Account Deficit % of GDP	-2.6	1.9	3.7	-0.5	-1.5	-2.5	-2.5
Exchange rate (USD/ZAR end period)	14.0	14.7	15.9	17.0	19.0	17.8	18.4
Exchange rate (USD/ZAR avg)	14.5	16.5	15.0	16.5	18.6	18.2	18.1

Source: Haver, BofA Global Research

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