2023 RSA National Budget Analysis

Issuers Commentary

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"The budget is not just a collection of numbers, but an expression of our values and aspirations."
– Jack Lew

RSA National Budget Analysis 2023

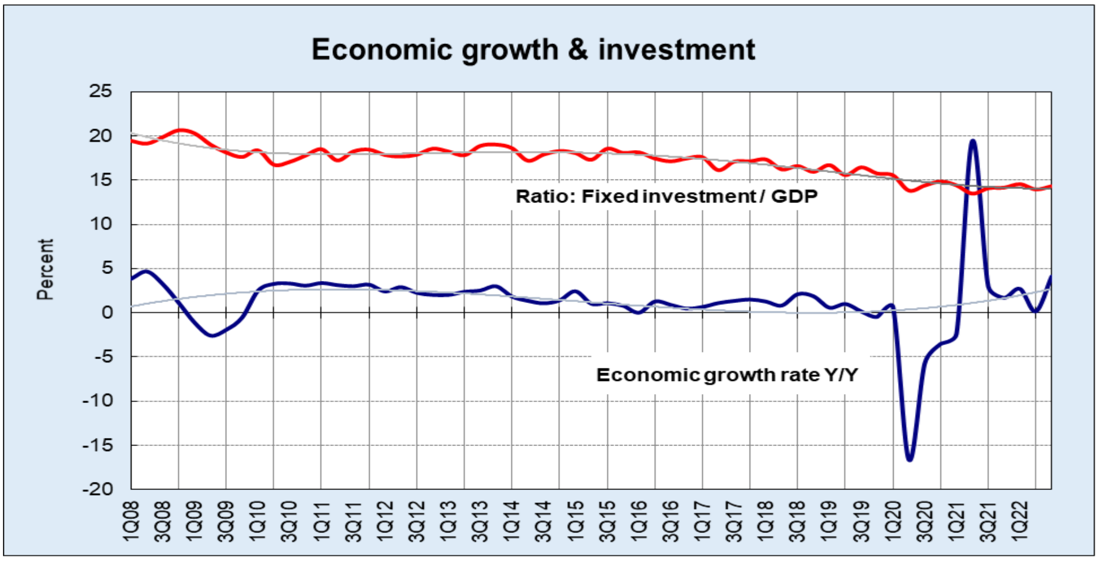
The Minister of Finance of the Republic of South Africa, Mr. Enoch Godongwana, presented the national budget of the country on the 22nd of February 2023, which the Sovereign Africa Ratings (SAR) has gone on to analyse. The objective of this analysis is to identify key economic factors that could have an impact on the country's credit standing in both the short and long term. It is important to note that this analysis is presented solely for informational purposes. The following subject areas have been covered:

- Economic Growth
- Fiscal Policy
- Taxation
- Fiscal Framework – Extractive Industries
- Anti-money Laundering
- Sustainability and Climate Change
- Infrastructure
- Research, Innovation, and Development

Economic Growth

It has been estimated that South Africa's economy experienced a growth of 2.5% in 2022, a positive revision from the 1.9% projection that was stated in the 2022 Medium Term Budget Policy Statement (MTBPS). The primary drivers of economic growth in South Africa are gross fixed capital formation (investment), consumption expenditure, and exports. The relationship between economic growth and investment is illustrated in the figure below.

Figure 1: Economic Growth and Investment in South Africa, 2008-2022



Source: StatsSA

The National Treasury has projected the following economic growth (real GDP growth) figures:

- 2023/2024: 0.9%
- 2024/2025: 1.5%
- 2025/2026: 1.8%

In its October 2022 World Economic Outlook Report, the International Monetary Fund (IMF) revised its global economic growth forecasts for 2023 down to 2.7%. Furthermore, South Africa's growth forecast for 2023 was projected at 1.1%. In its January 2023 Monetary Policy Committee (MPC) meeting, the South African Reserve Bank (SARB) projected growth of only 0.3% for 2023.

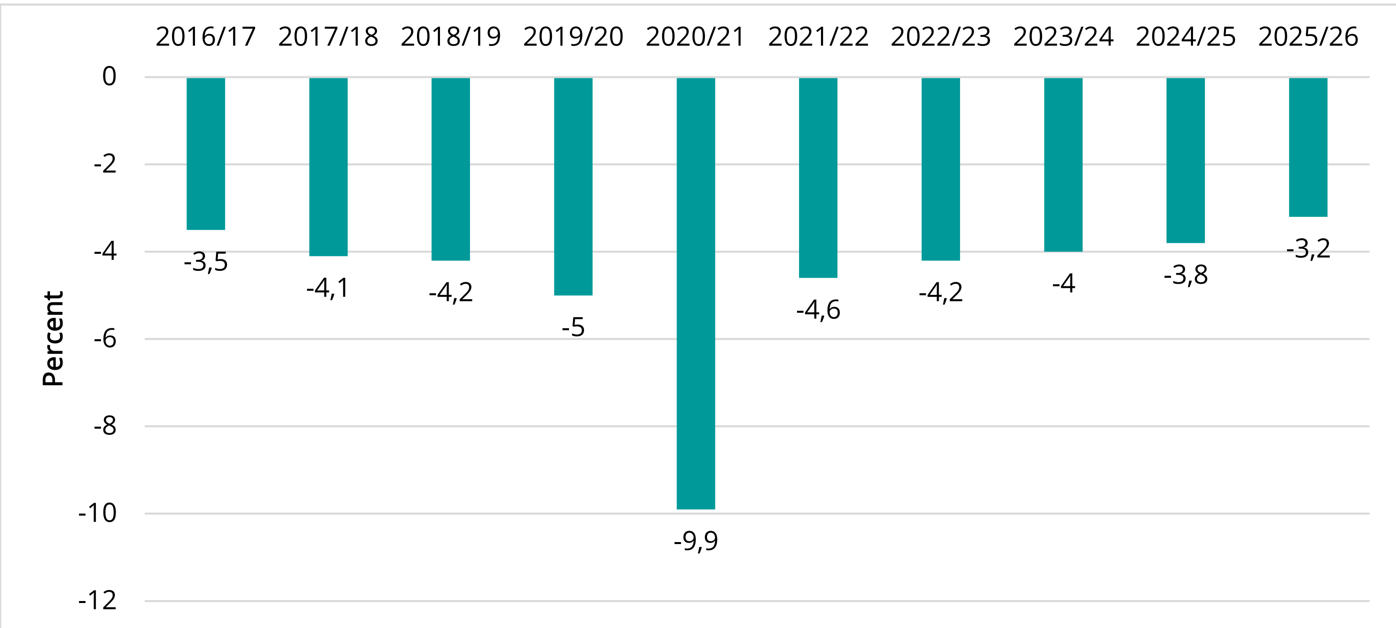
The reduction in economic growth prospects, coupled with the unfavourable operating conditions faced by the South African economy, as evidenced by the levels and trends of these indicators, are likely to have a negative impact on fiscal revenues, making them credit negative.

Fiscal Policy

Fiscal Balance

Figure 2 illustrates the historical and projected performance of the fiscal balance for Budget 2023/24. Budget 2023 shows a slight improvement in the expected deficits.

Figure 2: Fiscal Balance in South Africa as a percentage of GDP, 2016/17-2025/26



Source: National Treasury

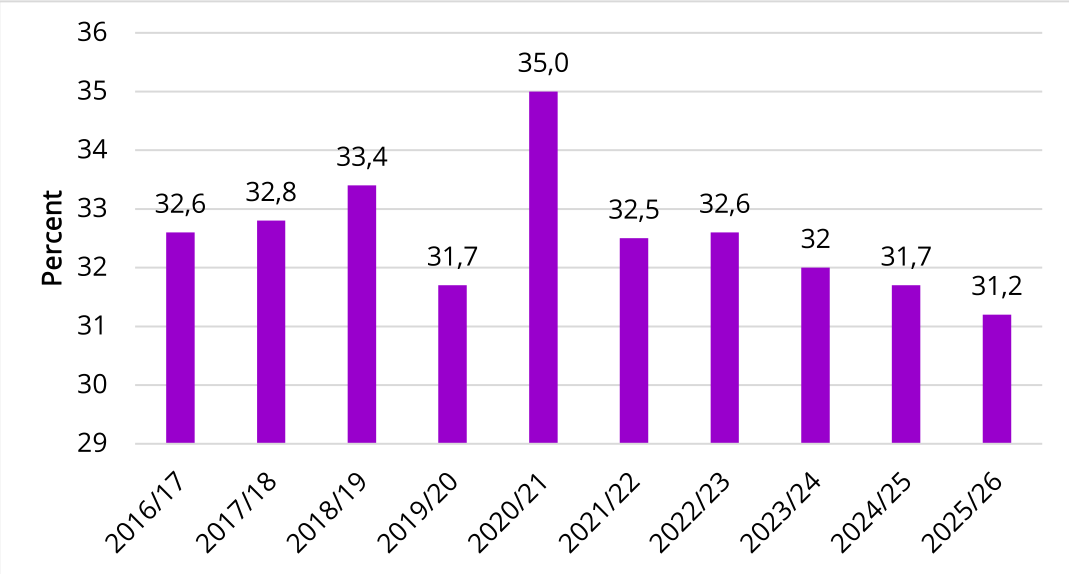
SAR has acknowledged the government's fiscal projections, which indicate a reduction in deficits, and regards them as credit-positive. The consolidated budget deficit for 2022/23 has decreased from 6% to

4.2% of GDP between the 2022 and 2023 Budgets. The primary budget deficit is projected to reach 3.2% in 2025/26. Sustained deficits in the long term can have adverse effects on economic growth and stability and could necessitate borrowing to fund the deficit.

Expenditure

SAR observed that Budget 2023 aims to make improvements in the medium term and that the composition of consolidated spending is shifting towards capital expenditure rather than current spending. This is a positive development, as gross capital formation, particularly by the public sector, has been decreasing in South Africa since 2013.

Figure 3: Government Expenditure as a percentage of GDP in South Africa, 2016/17 -2025/26



Source: Compiled with Data from National Treasury

Gross fixed capital formation is a significant macroeconomic indicator in the National Accounts framework. Real gross fixed capital formation is a key driver of growth in real gross domestic expenditure and a major contributor to growth in real gross domestic product. Unfortunately, the ratio of gross fixed capital formation to GDP decreased from 18.6% in 2013 to 13.1% in 2021.

SAR recognised the finance minister's strong commitment to expenditure restraint, particularly with regard to social grants, social relief grants, basic income grants, and the public sector wage bill. However, there are significant risks to expenditure, including state-owned enterprises (SOEs) such as Eskom, SANRAL, Denel, and Transnet, as well as the public sector wage bill, funding for the Just Transition Programme, and infrastructure upgrades for electricity, water, roads, rail, telecommunications, education, and health.

Taxation

The 2023 National Budget includes numerous tax changes and announcements, the most noteworthy of these being:

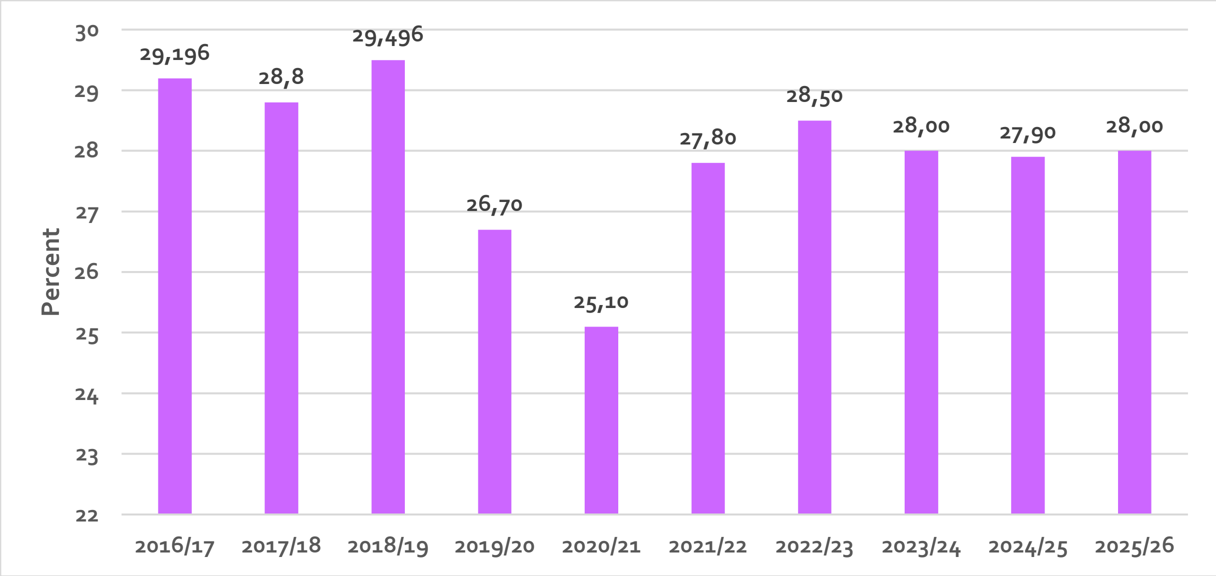
- Effective 1 January 2023, the carbon tax rate has increased from R144 to R159 per tonne of carbon dioxide equivalent, which plays a vital role in mitigation.
- Refinements have been made to the provisions related to the impact of International Financial Reporting Standard 17 Insurance Contracts (IFRS 17) on the taxation of insurers.
- The general fuel levy and the Road Accident Fund levy will not be raised this year.
- The personal income tax brackets will be fully adjusted for inflation, leading to an increase in the tax-free threshold from R91 250 to R95 750.
- Medical tax credits will be increased by inflation to R364 per month for the first two members and R246 per month for additional members.
- The retirement tax tables for lump sums withdrawn before retirement and for lump sums withdrawn at retirement will be adjusted upwards by 10%, leading to an increase in the tax-free amount that can be withdrawn at retirement to R550 000.
- The transfer duty table brackets will also be increased by 10%, enabling properties below R1.1 million to avoid any transfer duty payments.
- The government proposes a 4.9% increase in excise duties on alcohol and tobacco, in line with anticipated inflation.
- The 2023 Budget provides tax relief to support the clean energy transition, increase the electricity supply, and mitigate the impact of consistently high fuel prices.
- Households installing solar panels receive R4 billion in relief, while companies are granted R5 billion through an expansion of the renewable energy incentive.

The tax proposals in Budget 2023 offer tax relief of R13 billion, aimed at supporting the clean energy transition, increasing the electricity supply, and mitigating the impact of high fuel prices. Furthermore, the budget includes inflation-related adjustments to personal income tax tables, retirement tax tables, and alcohol and tobacco duties. It is important to periodically review and evaluate enacted measures to ensure they are effectively meeting their objectives at an acceptable cost. SAR noted the government's continued investment in providing the South African Revenue Service (SARS) with more tools and resources to combat tax evasion and aggressive tax avoidance.

Revenue

The proportion of government revenue as a share of GDP has been volatile in recent years, with a peak observed during the 2018/19 financial year, followed by a significant decline in 2020 owing to the financial crisis caused by the COVID-19 pandemic. Projections indicate that it will stabilise at 28% between 2023 and 2025.

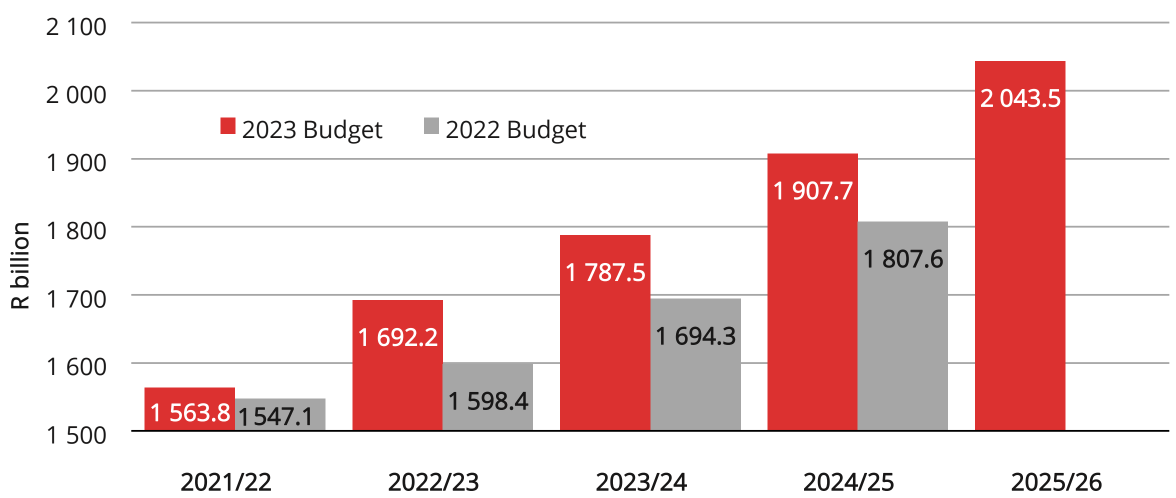
Figure 4: Government Revenue as a percentage of GDP in South Africa, 2016/17 -2025/26



Source: Compiled with Data from National Treasury

The projected gross tax revenue for the fiscal year 2022/23 is expected to be R1.69 trillion, R93.7 billion higher than the 2022 Budget estimate, indicating an upward revision of R10.3 billion from the 2022 Medium Term Budget Policy Statement (MTBPS) estimate. Moreover, the tax-to-GDP ratio, which had dipped due to the financial crisis induced by COVID-19, is expected to recover and reach 25.4% in 2022/23. SAR considers this development to be credit positive.

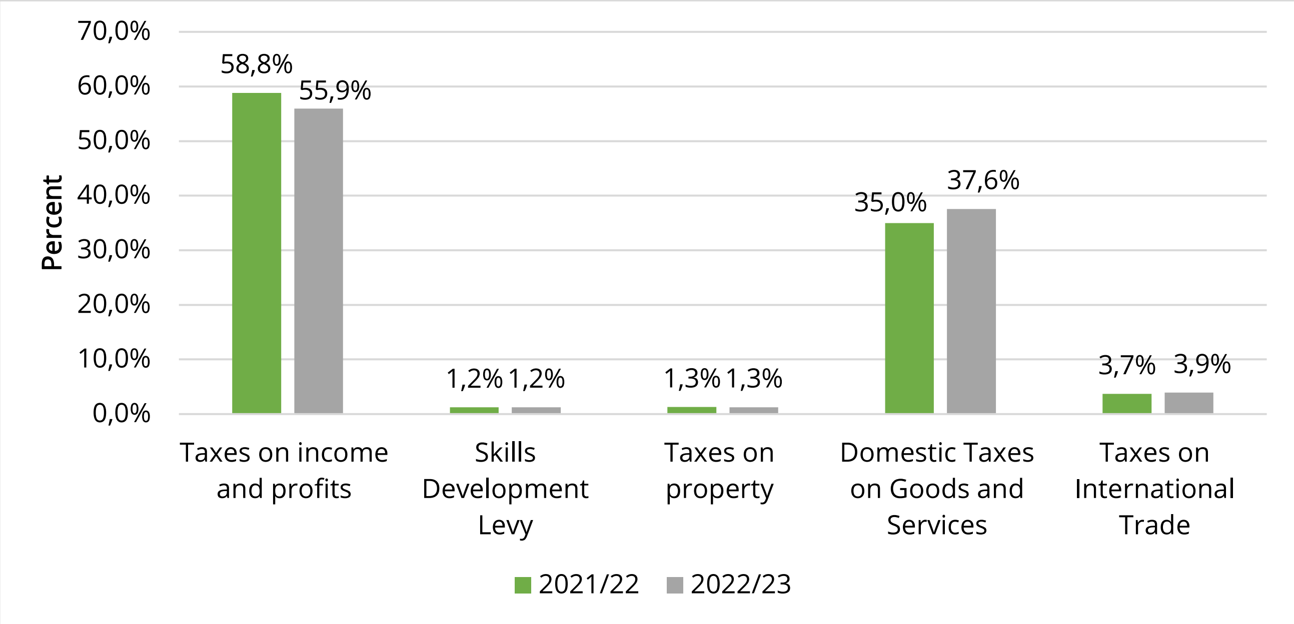
Figure 5: Medium-Term Gross Tax Revenue Outlook



Source: National Treasury

During the second half of 2022/23, there was a sustained broad-based recovery in tax collections. The majority of revenue collected by SARS is from taxes on income and profits, as well as domestic taxes on goods and services. However, there has been a decline in taxes on income and profits in Budget 2023 compared to Budget 2022, which SAR considers credit negative.

Figure 6: Revenue Outcomes



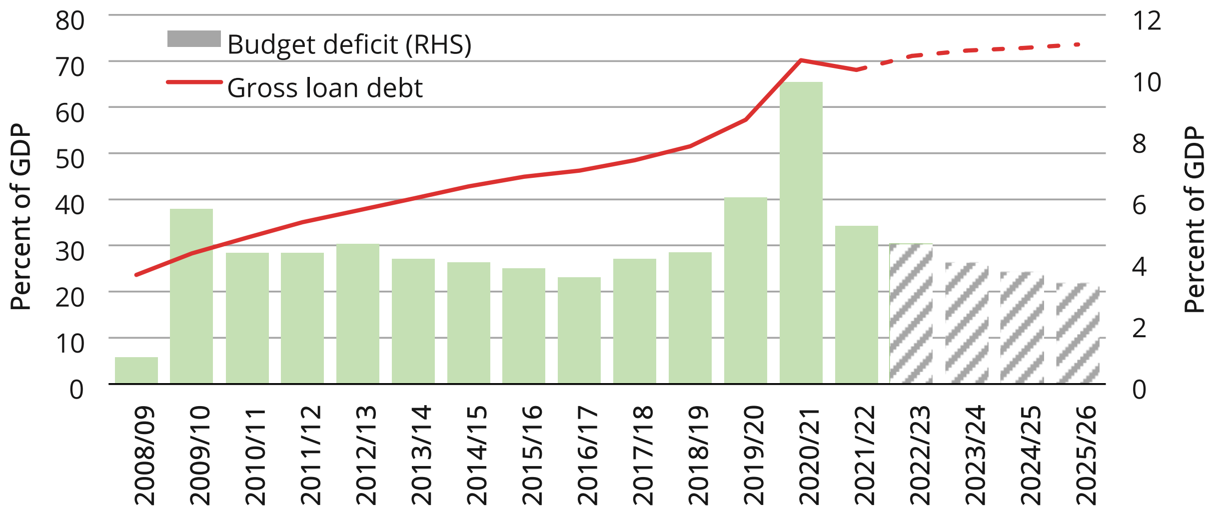
Source: National Treasury

The projection provided by Budget 2023 regarding gross tax revenue for the 2022/23 fiscal year, estimated to reach R1.69 trillion, is noteworthy due to its potential impact on the financial stability and liquidity of the government.

Government Debt

The 2023 National Budget report emphasises that the Eskom debt-relief arrangement will result in an increase in gross loan debt from R4.73 trillion in 2022/23 to R5.84 trillion in 2025/26. This development is a source of concern for SAR as the debt-to-GDP ratio will rise. Nevertheless, it is anticipated that the ratio will stabilise at 73.6% in 2025/26 and decline for the remainder of the decade.

Figure 7: Gross loan debt as a percentage of GDP in South Africa, 2008/9-2025/26

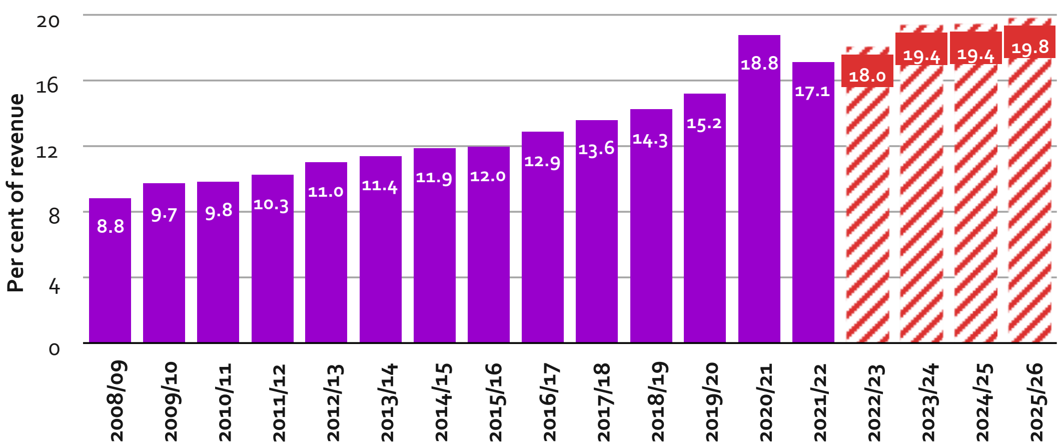


Source: National Treasury

The 2023 Budget has proposed a comprehensive debt-relief plan for Eskom, which will result in a substantial increase in public debt. Gross loan debt is expected to rise from R4.73 trillion in 2022/23, equivalent to 71.1% of GDP, to R5.84 trillion (73.6% of GDP) in 2025/26, before declining thereafter. Although this will lead to an increase in government debt, the fiscal balance is expected to improve over the medium term, with the fiscal deficit projected to decline from 4.5% of GDP in 2022/23 to 3.3% in 2025/26. This, however, will increase the debt burden of the sovereign.

Debt-servicing costs, as a proportion of main budget revenue, are expected to reach their peak in 2025/26 (as shown in Figure 8), and the budget deficit is expected to narrow over the medium term. The debt-to-GDP ratio is projected to stabilise in the same year. Over time, stabilising the debt will enable the government to reduce the crowding out of essential services caused by debt-service costs.

Figure 8: Debt-service costs as a share of main budget revenue, 2008/9-2025/26



Source: National Treasury

The escalation in the expenses associated with servicing the debt, from R307.2 billion in 2022/23 to R397.1 billion in 2025/26, highlights the need to prevent any expansion in the disparity between government expenditure and revenue.

Fiscal Framework – Extractive Industries

SAR recognises that the sustainability of a country's natural resources, particularly mineral resources such as oil and gas, is crucial for enhancing the tax revenue base, promoting economic growth and development, and improving the fiscal position of a sovereign state. Achieving this requires optimising resource rents and prudently using the fiscal framework and regimes, such as royalty rates, resource rents, and company tax, to support local economic and industry development, import substitution, reinvestment in other sectors of the economy, and reducing sovereign debt.

SAR believes that South Africa's fiscal framework for extractive industries, such as oil and gas, needs to be reformed to enhance its current fiscal instruments. The threshold for fiscal instruments, including resource rents and royalty taxes (currently capped at 5%) and government take (capped at 10%), as well as the most appropriate tax regime for the oil and gas industry, requires reform and policy certainty. Budget 2023 highlighted that, after a review and consultation last year and considering the impact of the Upstream Petroleum Resources Development Bill, the minimum royalty rate for oil and gas companies will be increased to 2%, while the maximum rate of 5% remains unchanged. Reforming the fiscal regimes of extractive industries in South Africa will enhance the tax revenue base, and higher fiscal regimes can be channelled towards paying off debt, funding capital and infrastructure programmes, and supporting economic growth and development.

Anti-money Laundering

Budget 2023 outlined a set of measures aimed at preserving the soundness of the financial system and safeguarding South Africa's finances and national security. Of paramount importance are reforms to enhance the effectiveness of investigations and prosecutions of money laundering activities. In response to South Africa's grey-listing, the finance minister has made a firm commitment to address all deficiencies swiftly and diligently. To this end, two laws, namely the General Laws Amendment Act of 2022 and the Protection of Constitutional Democracy Against Terrorist and Related Activities Amendment Act, have been enacted to address 15 of the 20 legislative deficiencies identified by the Financial Action Task Force (FATF).

Further interventions will be implemented to manage emerging threats, including legislative changes to counter digital money-related risks in South Africa. Extending anti-money laundering and anti-terrorist financing requirements to all businesses conducting financial transactions in South Africa would be a welcomed measure. Failure to address the grey-listing could lead to increased costs of doing business in the country, potentially affecting investor and business confidence, and hampering capital inflows. On the other hand, this will affect South Africa's foreign reserves and could adversely affect economic growth.

Sustainability and Climate Change

The 2023 Budget acknowledges the pressing need to address climate change as it poses a significant threat and impediment to sustainable economic growth in South Africa; SAR recognises that failure to manage environmental sustainability could jeopardise a country's financial, economic, and socio-economic position.

The adverse effects of global warming, including droughts, floods, and other environmental disasters, can have far-reaching impacts on the fiscal position of a country, particularly in terms of off-budget and unplanned expenditure items such as contingent liabilities. Furthermore, reconstruction and recovery interventions triggered by natural disasters can lead to budget expenditure outlays that may weaken the government's fiscal position.

On the other hand, Budget 2023 notes that addressing climate change will require increased borrowing. In 2022/23, South Africa raised US$3 billion in international capital markets, €454.4 million from the World Bank, and €600 million from Germany and France through the Just Energy Transition Investment Plan to support policy and institutional reforms related to climate change. However, this borrowing will add to the sovereign debt burden of South Africa.

Infrastructure

SAR has observed that Budget 2023 places significant emphasis on infrastructure programmes. It is estimated that the public sector will spend R903 billion on infrastructure over the medium term, with the majority of this expenditure, approximately R448 billion, to be incurred by state-owned entities, public institutions, and public-private partnerships. These spending plans are focused on strategic projects within various sectors:

- Transport and logistics will spend an estimated R351.1 billion, including improvements to the road infrastructure network by SANRAL.
- Water and sanitation, which plans to spend R132.5 billion over the next three years, mainly through the water boards.

Infrastructure investment is crucial for a country's economy, but constraints and inefficiencies related to transport, rail, ports, energy, water infrastructure quality, and maintenance pose significant risks. Poor quality rail, transport corridors, and port infrastructure negatively impact key and strategic commodities exports, resulting in adverse effects on the country's current account, foreign currency earnings potential, trade competitiveness, and tax revenues. Insufficient investment in water infrastructure leads to natural resource risks, which affect economic sectors that require a high level of water supply assurance, such as agriculture, mining, and manufacturing, ultimately reducing production, exports, revenues, and tax-earnings potential. Inadequate electricity supply also negatively affects GDP growth.

Investments in sustainable infrastructure and other priority areas of sustainable development can significantly enhance a country's continued economic growth, sovereign creditworthiness, and debt-carrying capacity. While these investments may increase public debt levels in the short-term, they should stimulate growth and improve a country's ability to repay its debt obligations in the medium-to-long term.

Research, Innovation, and Development

Budget 2023 has introduced a new R&D tax incentive to promote private-sector investment in scientific and technological R&D in South Africa. This incentive offers a 150% deduction for eligible R&D expenditures carried out in the country.

Budget 2023 includes a range of measures to strengthen the innovation support ecosystem. It is noteworthy, however, that the budget emphasises the importance of long-term, sustainable economic growth. This can involve reducing taxes for small businesses, continually reviewing tax support for R&D and intellectual property (including scientific research), and expanding the intellectual property regime, among other things. Throughout the budget, the language suggests that the government understands and prioritises long-term growth.

Conclusion

SAR has observed that Budget 2023 shows marginal improvements in reducing upcoming deficits. The South African government aims to decrease the government debt over the medium term and intends to stabilise the debt-to-GDP ratio, however, without specifying a range of limits or targets. SAR acknowledges the improvements in the government's fiscal forecasts, which have led to smaller deficits and reduced the weight of the government's debt on the economy.

SAR expects South Africa to have a comprehensive long-term plan to manage its energy crisis, deteriorating infrastructure, debt, and deficits, with consideration for economic growth, and fiscal and monetary health variables such as inflation and interest rates. It is our view that the benefits of attracting foreign trade and Direct Foreign Investment may dissipate if the energy crisis is not meaningfully addressed. Immediate attention should be given to improving Eskom's current capacity constraints and restoring its full generating capabilities as the reliable supply of energy, particularly electricity, is crucial for the functioning of the economy and production processes.

The absence of any plans regarding incentives to enable the South African Automotive Industry to produce electric cars, particularly for the export market, is concerning to SAR. Additionally, the issue of the debt related to e-tolls remains unresolved. SAR will continue to monitor progress in established measures to facilitate South Africa's debt repayments.

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Contributors:

- David Mosaka | Chief Ratings Officer | david@saratings.com |
- Bekithemba Ndimande | Rating Analyst | bekithemba@saratings.com |
- Lomanja Malaba | Rating Analyst | lomanja@saratings.com |