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2018 BUDGET: RIDE THE RALLY AT THE LONG END

The Budget is unlikely to be growth positive, neither is it likely to be consumption friendly. However, we believe the Budget is likely to provide further momentum for the current bond rally, and by implication, should also provide some support for the currency. **We believe the Budget will attempt to stick to the expenditure ceiling while at the same time try to keep the budget deficit in line with what was signalled in the MTBPS, and even marginally improve the proposed deficit in the outer year.** It won't be an easy task but if achieved would reduce the chance of further credit rating downgrades in the near term. We believe the National Treasury (NT) would need to find an additional R42.3bn in 2018/19 and R180bn over the MTEF to keep the deficit unchanged at -3.9% of GDP (**Table 1**).

Consolidation measures for 2018/19 in our view, are likely to come via tax revenue measures of circa R20bn – R 25bn (of which R15bn was already signalled in previous budgets), and expenditure cuts of circa R20bn – R25bn (eg provinces underspent R4.5bn last year while cost-containment measures amounted to R21bn). **Our estimate points to a main budget deficit not too different from the 2017 MTBPS, which leaves the borrowing requirement largely unchanged**. We think this would be seen as a positive.

Tactically, we believe the Budget is likely to reinforce the positive momentum in the local bond and currency market. Tighter fiscal policy via expenditure cuts and higher tax revenue (which culminates into marginally lower budget deficits over the MTEF), combined with lower inflation, should provide the SARB more flexibility to cut interest rates by at least 50bps in 2018. **On a three to six month view, we favour the long end of the curve and believe the belly of the curve will struggle on a relative basis (Chart 1)**. We would not be surprised to see the R2048 yield closer to 9.20 – 9.30%. **Arguably, the biggest risk to our tactical bullish view is the government sector wage negotiations** which hold a much greater threat to fiscal consolidation than the funding of higher education, in our view.

We temper our expectations on a strategic, multi-month view. SOE concerns continue to loom large in the background and while Eskom seems to have enough liquidity (for now) despite the NERSA ruling, other smaller SOEs are likely to require funding. Capital markets remain inaccessible or very expensive for most SOEs. In the past few years, the bias over the MTEF was always firmly towards fiscal slippage (ie once data was realised relative to what was presented in the Budgets). As a result, our base case would be to again assume greater issuance than what is forecasted and what will be presented in the 2018 Budget. **On a multi-month view, we would fade any rally below 8.30**%. On the flip side, we would look for real value at only around 9.20% and higher (this is based on an UST10y of 2.70%, a SA credit risk premium of 300bps, and an inflation risk premium of 350bps).

Table 1: Consolidated measures needed to keep deficit in line with MTBPS estimates

	2018/19	2019/20	2020/21
2017 MTBPS consolidated budget deficit (% of GDP)	-3.9	-3.9	-3.9
Estimate of consolidated budget deficit without intervention (% of GDP)	-4.4	-4.6	-5.1
Revenue and/or expenditure cuts needed to keep deficit in line with 2017 MTBPS	**42.4**	**55.8**	**82.5**
Of which:			
Tax revenue measures already announced (Rbn)	15.0	16.0	17.3
Additional consolidation measures needed (Rbn)	27.4	39.8	65.2

Source: Nedbank CIB Markets Research, National Treasury

Chart 1: We believe there is upside for longer-dated bonds that arguably reflects country risk better

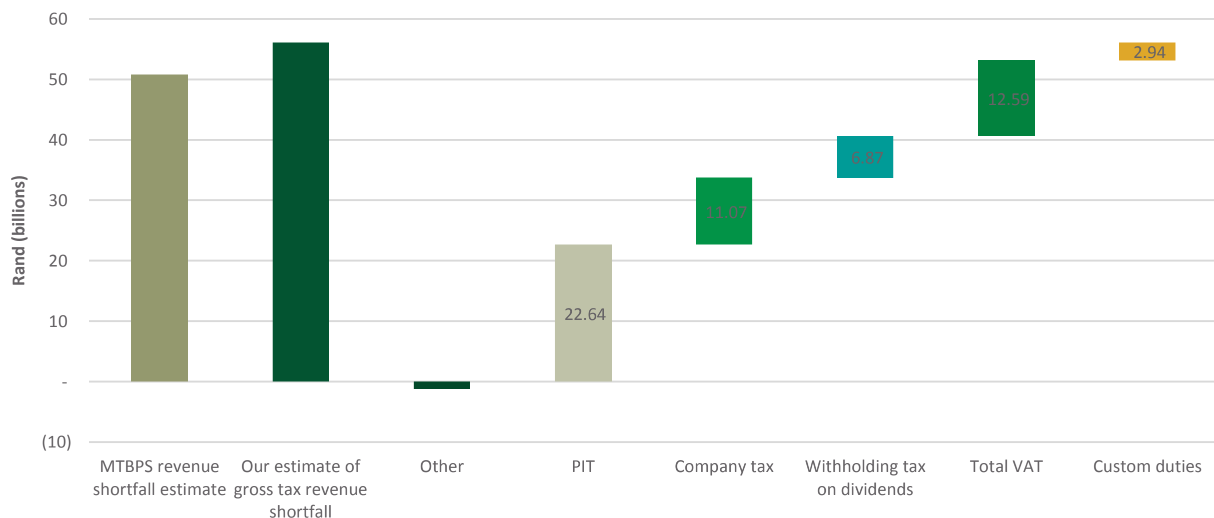
Source: Nedbank CIB Markets Research, Bloomberg

THE DETAIL – SHORT ON REVENUE, LONG ON EXPENDITURE

The current fiscal year may be heading for an even wider deficit than the MTBPS estimate

Our estimate, using the latest monthly Budget figures up until November 2017, suggests that revenue continues to disappoint. Where the MTBPS signalled that revenue may disappoint by R50.8bn this year relative to the 2017 Budget, it may be closer to R54.9bn in our opinion (Chart 2). The tax revenue shortfall continues to be broad based, however personal income tax (PIT) is the largest contributor to the decline in revenue growth. This would imply that the main Budget deficit for 2017/18 may be closer to 4.8% of GDP rather than the projected 4.7% in the MTBPS, inclusive of expenditure overruns. However, our concern lies beyond the current fiscal year.

Chart 2: Estimate of the 2017/18 revenue shortfall by source, relative to 2017 Budget, now stands at R54.9bn

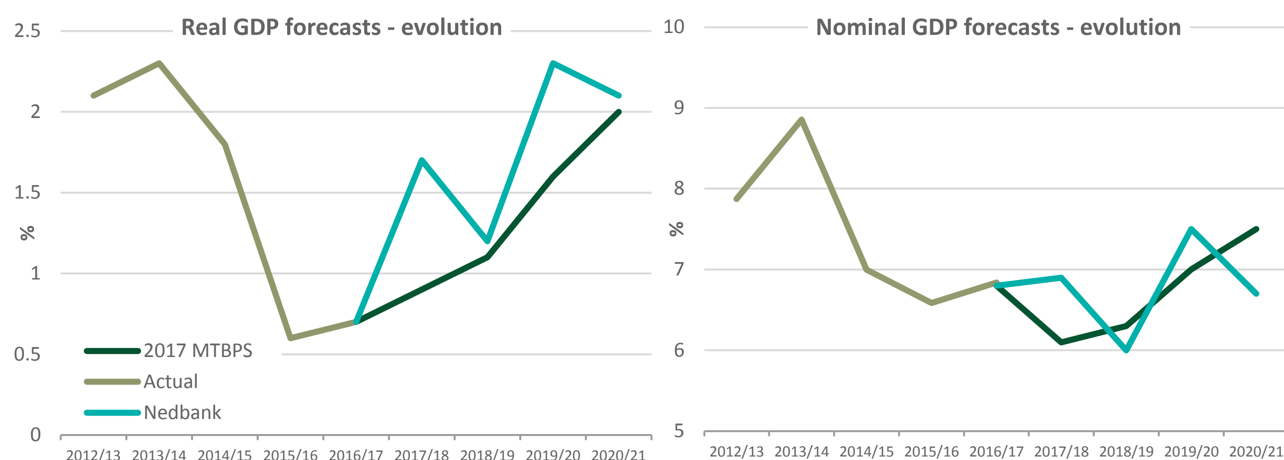


Source: Nedbank CIB Markets Research, National Treasury

Beyond the current fiscal year we believe the growth outlook has improved marginally

Nedbank's growth forecast indicates that real growth may outperform the NT estimates over the MTEF. Chart 3 provides these growth estimates. By implication, higher growth implies a narrower deficit than the MTBPS estimates suggest – but that is before accounting for additional expenditure pressures. However a lower GDP deflator assumption and lower buoyancy expectations imply a lower nominal growth forecast, and lower tax revenues from 2018/19 onwards.

Chart 3: Relative growth forecasts



Source: Nedbank, National Treasury

Of importance in our tax revenue forecast is that we have revised our assumption for the tax buoyancy rate marginally lower (Table 2). Tax buoyancy has been under pressure in recent years. For example, for the current fiscal year using the monthly budget data, we believe the actual tax buoyancy rate is closer to 0.87 – well below the 1.02 assumed by NT. However, we do believe the eventual buoyancy rate will be closer to 0.95 as tax revenues improve in the last quarter of the current fiscal year. This decline in tax buoyancy during the current fiscal year comes despite our more optimistic growth forecast and points towards a less efficient SARS and greater tax avoidance.

Table 2: Our revenue and expenditure estimates without any interventions

		2016/17	2017/18	2018/19	2019/20	2020/21
Nedbank CIB Markets Research	Gross Tax Revenue Buoyancy	-	0.95	1.20	1.10	1.10
2017 MTBPS	Gross Tax Revenue Buoyancy	-	1.02	1.31	1.12	1.10
Nedbank CIB Markets Research	Total Consolidated Revenue	1 298.2	1 368.3	1 469.6	1 591.2	1 692.3
2017 MTBPS	Total Consolidated Revenue	1 298.2	1 363.6	1 477.5	1 594.2	1 709.3
Nedbank CIB Markets Research	Total Consolidated Expenditure	1 445.20	1 577.68	1 689.54	1 839.05	1 983.38
2017 MTBPS	Total Consolidated Expenditure	1 445.2	1 566.6	1 670.0	1 802.3	1 935.1
Estimate of total consolidated revenue surplus / (shortfall)		**0**	4.7	-7.9	-3.0	-17.0

Source: Nedbank CIB Markets Research; National Treasury

While revenue may improve, expenditure pressures are huge; the most notable pressures are from tertiary education and the government wage bill

While revenue growth could surprise on the upside because of a marginal pick-up in growth, it pales in comparison to the expenditure pressures that are currently being exerted on the Budget. We look at the two areas where expenditure pressure may exert itself the most in coming months.

Tertiary education – if funded in non-deficit neutral manner, it may push the deficit to 4.2% of GDP in 2018/19 relative to the MTBPS deficit estimate of 3.9%

- The presidency announced in mid-December 2017 that from 2018 the government would fund the full cost of study for technical and vocational training (TVET) college as well as for university students (for families earning less than R350,000 per year).

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- Details of the programme are sketchy at best but indications are that the programme would cover students from approximately 90% of South African households (data is not yet available on exact student numbers from these households). The proposal also indicates that all current NSFAS loans would be converted into grants.
- Government has further indicated that the programme would be phased in over a period of five years and that all eligible students who have a firm acceptance from universities would be considered for funding.
- On a phased in approach, we estimate funding the full cost of study would add R88bn to expenditures over the next three years, which could keep the budget deficit close to 4.2% in 2018/19 should this additional expenditure not be funded in a deficit-neutral manner.
- These estimates do not take into account additional infrastructure development and other related costs, which would likely place further upward pressure on government expenditures.

Table 3: The cost of the higher education plan

Higher education	2017/18	2018/19	2019/20	2020/21	Potential impact over MTEF
2017 MTBPS consolidated budget deficit as % of GDP	-4.3	-3.9	-3.9	-3.9	
Additional free education cost estimate (Rbn)	2.8	15.3	30.6	39.8	88.4
Consolidated budget deficit if not funded in deficit neutral manner	**-4.4%**	**-4.2%**	**-4.4%**	**-4.6%**	

Source: Nedbank CIB Markets Research, National Treasury

Government sector wage bill – negotiations on-going, but union demands are steep and even larger than the cost of the free higher education programme

- The current Budget provides for the wage bill to rise by 7% in 2018/19 and 7.15% in 2019/20.
- At the first round of negotiations, government has offered salary increases equal to CPI for lower earning workers, and CPI less 1% for higher earning workers. **We estimate government's offer would alleviate cost pressures by about R90b nover the MTEF.**
- However, the unions have rejected this offer. Their demands are broadly for a 12% increase across the board in 2018/19 plus an increase in the housing allowance of R2,500. **We estimate the union's current demand would add R146bn to the MTEF and raise the budget deficit to 5% in 2018/19** if this is funded in a non-deficit-neutral manner. The impact of the current government proposals and that of the unions are shown in Table 4.

Table 4 : The potential impact of government wage negations on the budget

Salary/wage negotiations	2017/18	2018/19	2019/20	2020/21	Potential impact over MTEF
2017 MTBPS consolidated budget deficit as % of GDP	-4.3%	-3.9%	-3.9%	-3.9%	
2017 MTBPS consolidated budget employee compensation (Rbn)	549.3	587.9	629.9	677.8	
Union's current demand (12% plus additional R2500 housing allowance in year 1; CPI plus 1% in subsequent years)		57.4	50.03	38.9	146.33
Consolidated budget deficit if not funded in deficit neutral manner		**-5.0%**	**-4.8%**	**-4.6%**	
Government's current offer (CPI related increase)		-13.9	-28.4	-47.3	-89.6
Consolidated budget deficit if not funded in deficit neutral manner		**-3.6%**	**-3.4%**	**-3.1%**	

Source: National Treasury, Nedbank CIB Research Markets Research

How much revenue must be raised to keep the deficit in line with the MTBPS?

There are many permutations around how much expenditure should be cut and how revenue should be raised for any given budget deficit.

We ask the question: **How much additional tax revenue is necessary over the MTEF in order to keep the budget deficit forecast in line with what has been projected in the MTBPS,** after accounting for the costs that may materialise with a high degree of certainty, while at the same time assuming government makes no additional expenditure cuts?

What do we account for on the expenditure side?

- We account for higher education expenditure (ie R15bn in 2018/19 using our estimate), as well as additional equity funding for SAPO (R3.5bn) and SAA (R4.80bn) in 2017/18.
- We do not account for a wage settlements that are higher than the budgeted figure (although we provide cost estimates above).

At the same time, the 2017 MTBPS confirmed a revenue increase via tax hikes of at least R15bn in 2018/19 and this needs to be raised over and above any additional shortfall incurred since the 2017 MTBPS.

We believe that at least R42bn of tax revenue measures must be announced for 2018/19 if no additional expenditure cuts are made. Over the MTEF, additional tax revenue measures needed are about R187bn inclusive of 2017/18. Our estimate of R42bn in 2018/19 consists of R19.3bn that comes from the additional expenditure pressures (education and higher debt service costs), while R15bn is from the already announced tax revenue measures (Table 6), and R8.5bn is due to lower gross tax revenues due to a lower tax buoyancy.

While NT may raise R42bn additional tax revenue on paper, we doubt they can raise this in practice.

Table 6: A comparison of our forecasts without any interventions – budget balances and debt ratios, and the size of the consolidation measures needed

Headline indicators		2017/18	2018/19	2019/20	2020/21
Nedbank CIB Research	Main Budget balance	-225.65	-249.49	-282.89	-330.57
2017 MTBPS	Main Budget balance	-219.29	-222.07	-243.10	-265.34
Nedbank CIB Research	Main budget balance as % of GDP	**-4.8%**	**-5.0%**	**-5.3%**	**-5.8%**
2017 MTBPS	Main budget balance as % of GDP	-4.7%	-4.5%	-4.6%	-4.6%
Nedbank CIB Research	Consolidated Budget deficit	-209.36	-219.92	-247.89	-291.03
2017 MTBPS	Consolidated Budget deficit	-203.0	-192.5	-208.1	-225.8
Nedbank CIB Research	Consolidated budget deficit % GDP	**-4.4**	**-4.4**	**-4.6**	**-5.1**
2017 MTBPS	Consolidated budget deficit % GDP	-4.3	-3.9	-3.9	-3.9
Nedbank CIB Research	Gross debt as a % of GDP	**53.88**	**57.24**	**58.41**	**60.80**
2017 MTBPS	Gross debt as a % of GDP	54.16	56.96	58.21	59.75
Nedbank CIB Research	Net debt as a % of GDP	48.63	51.62	53.43	55.83
2017 MTBPS	Net debt as a % of GDP	49.10	51.70	53.87	55.62
Tax revenue/expenditure cuts to keep deficit at MTBPS target		6.4	27.4	39.8	65.2
Tax revenue measures already Budgeted for		0.00	15.00	16.00	17.30
Total consolidation measures needed		**6.4**	**42.4**	**55.8**	**82.5**

Source: Nedbank CIB Markets Research, National Treasury

Potential revenue sources that could be targeted over the MTEF

About the R15bn additional tax revenue measures confirmed in the MTBS: The Davies Tax Committee estimates a possible breakdown of the R15bn promised increase in the 2017 MTBPS. The breakdown comprises of raising the top marginal PIT rate by 1.5% (generating R5.1bn), increasing the CGT inclusion rate for corporates from 80% to 100% (R1.4bn), and a 0.5% increase in the Skills Development Levy (R8.8bn).

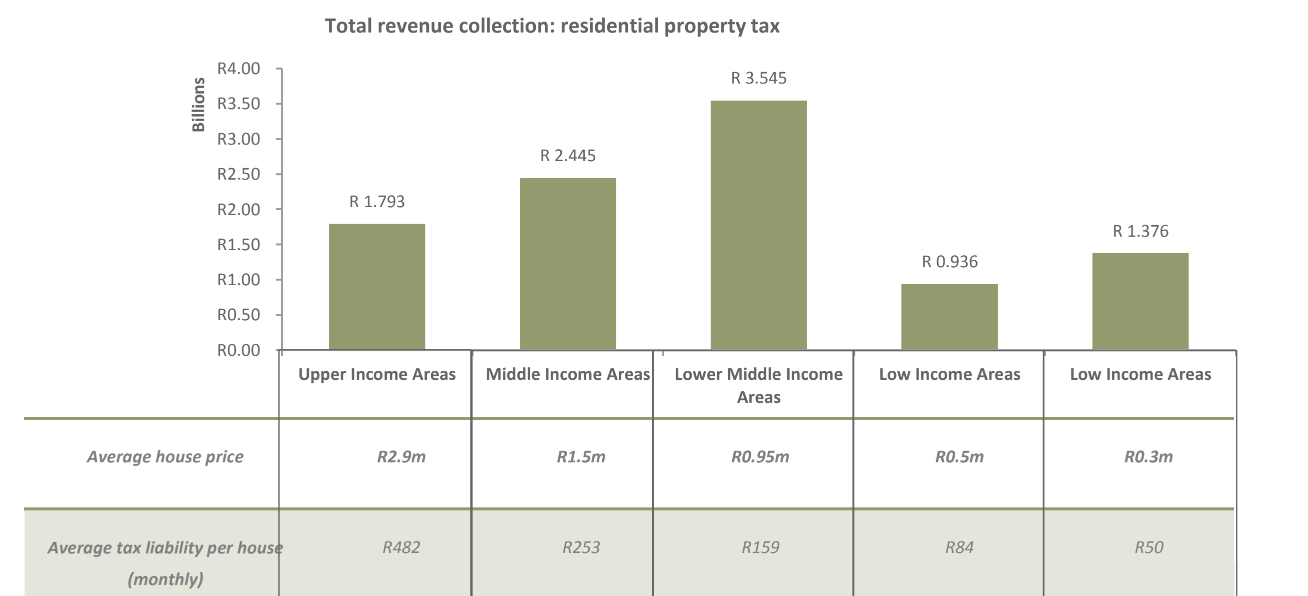
Other sources of tax revenue

A headline VAT rate hike remains unlikely in our view as it will be viewed as regressive. However, there are other sources of income that may be targeted.

- **Wealth tax on residential property – R6bn potential revenue**: Implementation of a general wealth tax is arguably extremely complex because of a few reasons. Firstly the definition of wealth is vague, uncertain and open to various interpretations. Secondly, there already exists various forms of wealth taxes (CGT, rates and taxes on property, inheritance tax, dividend withholding tax etc) which could introduce the problem of double-taxation. Lastly wealth transgresses borders, which makes it harder to quantify. Nonetheless, we believe that one of the ways of raising revenue from wealth is through the taxation of residential property.

According to the Centre for Affordable Housing Finance, the number of registered residential houses in SA was 6.2m in 2015. In the 2015/16 municipal fiscal year, total residential rates and taxes collected was R26.7bn, as per the latest data from Stats SA. If NT were to enforce a 20bps hike on the value of residential property for all houses in the lower middle, middle and upper income areas, we estimate this could generate around R7.8bn in additional 'wealth' tax revenue" from households – the bulk of which would come from the lower-middle and middle income areas. This assumes a 100% compliance rate, which is unrealistic. Hence actual collection could be closer to R6bn in 2018/19.

Chart 4: Estimate of a residential property tax of 20bps on value of property



Source: FNB, Centre for Affordable Housing Finance, Stats SA, Nedbank CIB Markets Research

- **Imposing 14% VAT on fuel consumption – R10.5bn from petrol, if diesel is included an additional R11.7bn could be gained:** SA fuel is currently a zero-rated product. However in the 2017 Budget Speech, NT indicated that they are considering imposing a 14% VAT on fuel. The fuel price is made up of the basic fuel price (BFP), various levies, storage, as well as wholesale and retail margins. We think that if VAT were to be imposed on the fuel price, it would be on the BFP component as this is the only unregulated component. Assuming a slightly higher BFP for petrol (R6.60/litre in 2018/19 vs R6.52 currently), the potential revenue generation could be around R10.5bn in 2018/19 if we assume current fuel consumption (petrol = 11.3bn litres consumed in 2016/17) grows in line with our real GDP forecasts.

  This assumes a BFP of R7.50/litre after the VAT is included. NT has also indicated that if the zero-rating on the petrol price is removed, then the other levies making up the retail petrol price (eg RAF and fuel levies) are unlikely to rise.

Table 7 : VAT on fuel estimation

Product name	2018/19 Total Consumption (litres)*	BFP per litre*	14% VAT on BFP	Potential Revenue (Rand)
Diesel (All grades)	12 358 972 593	R 6.80	R 0.95	**11 765 741 908.16**
Petrol (All grades)	11 657 098 466	R 6.60	R 0.90	**10 491 388 619.72**

**estimated*

Source: Central Energy Fund Group, Department of Energy, Nedbank CIB Markets Research

- **Not adjusting PIT brackets for inflation – R12bn:** The current fiscal year raised R12bn in PIT revenue as no adjustments for inflation were made to the different tax brackets. We assume a similar magnitude is raised in 2018/19 from not adjusting for inflation.
- **Sin taxes – R2bn:** We assume that there will be another increase in sin-taxes, ie excise duties on tobacco products and alcoholic beverages. In the 2017 Budget, the additional estimated revenue from these items combined was R1.9bn. We assume that in the 2018 Budget, the additional increase will be roughly the same, at R2bn.

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- **Removal of the Medical Aid Tax Credit – R17.4bn**: In 2016/17, the tax credit amounted to R17.4bn and the Minister of Health has indicated intent to remove the credit to fund the shortfall in the NHI funding (we highlighted estimates of the funding shortfall above). However the Davies Tax Committee argues that this can only be removed once the NHI is fully operational. However if NT is desperate to raise revenue to fund higher education, it may cancel this rebate already and allocate this resource to funding education in the interim.

SOEs remain the single biggest risk – additional R8.9bn still needed for current FY

In the 2017/18 fiscal year:

- SAA required a bail out of R10bn, of which a total of R5.2bn has been paid (to SAA) as at November 2017. This is over and above the R19.1bn in government guarantees that it has already exhausted.
- A further R3.7bn has been promised to the SA Post Office by government, which has not yet been paid over.
- This means that a cumulative R8.9bn is still needed to bail out SOEs in the current fiscal year.

Additional funding requirements in 2018/19 are unclear but the burden is set to grow:

- The 2017 MTBPS stated that Denel, SA Express, the SABC and several other SOEs face liquidity shortfalls and will likely require some form of government intervention in 2018.
- The stress to the fiscus may be muted because of the small size of exposures – the abovementioned SOEs make up only 0.55% of total government guarantees.
- To put this into perspective, Eskom and IPPs make up about 78% of government guarantees. Nonetheless, blind bail-outs may signal to other SOEs that they can expect the same and may encourage financial mismanagement.

NT has indicated that it will sell part of its R14bn Telkom stake to fund the bail-out, however it has not provided any further details regarding this. Time is running out to ensure the bail-outs are deficit-neutral in the current fiscal year. Assuming a sale of R4bn worth of Telkom shares, this would imply lost income to the state to the tune of annual dividends of R230m.

On Eskom specifically:

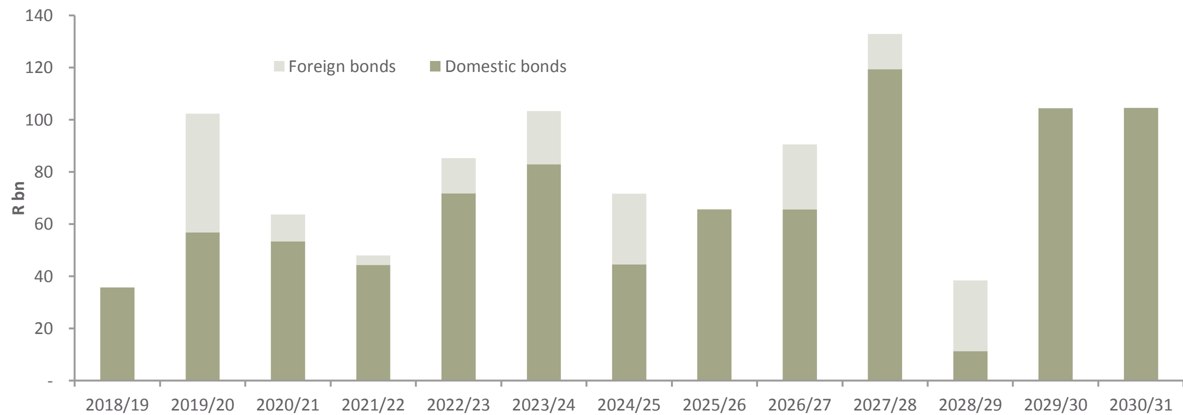
- Given the lower-than-expected tariff hike provided to Eskom, the utility has indicated that it has approached various DFIs for funding lines and that for this fiscal year its liquidity position is manageable (and as a result would not require a bail-out by government at this point). Eskom indicated that undrawn liquidity lines available to them amount to around R22bn.
- Furthermore, Eskom is yet to apply to NERSA to process the RCA submissions to recover the R60bn shortfall. If granted, this would likely be phased in in the form of electricity tariff hikes over a few years.
- The local bond market for Eskom remains all but closed. However, the utility indicated that it intends to utilise an additional R60bn to R70bn of its government guarantees. Currently R260bn of a total of R350bn is utilised.

Borrowing requirements – In line with MTBPS forecast but bias firmly for greater issuance while large redemptions loom

- **In 2017/18:** The borrowing requirement, which is the main budget balance plus redemptions, is expected at R248.7bn in 2017/18 (R248bn in the 2017 MTBPS) as a result of the additional expenditure pressures net of the marginal gross tax revenue overshoot in 2017/18 (if we assume a higher tax buoyancy than what has materialised in this FYTD, ie 0.95 vs 0.87).
- **In 2018/19:** Our estimate points to a main budget deficit of R249.5bn (vs R222bn in the 2017 MTBPS), which brings the borrowing requirement to R265bn (vs R270.7bn in the 2017 MTBPS). This assumes R20bn of the R35.7bn R204 redemption is switched.
- These imply borrowing requirements in line with MTBPS forecasts of 5.3% and 5.4%. However the bias is for some slippage to materialise if buoyancy disappoints or expenditures overshoot our estimate.
- **Redemptions this calendar year stands at R35.7bn for the R204** government bond in December 2018. We believe NT will likely switch a large proportion of this total, as it had done with the R203, to alleviate funding pressures (Chart 5).

- But the real **pressure for redemptions are in 2019/20 where in excess of R100bn** is due (that coincides with a projected reduction in the government's cash balance).

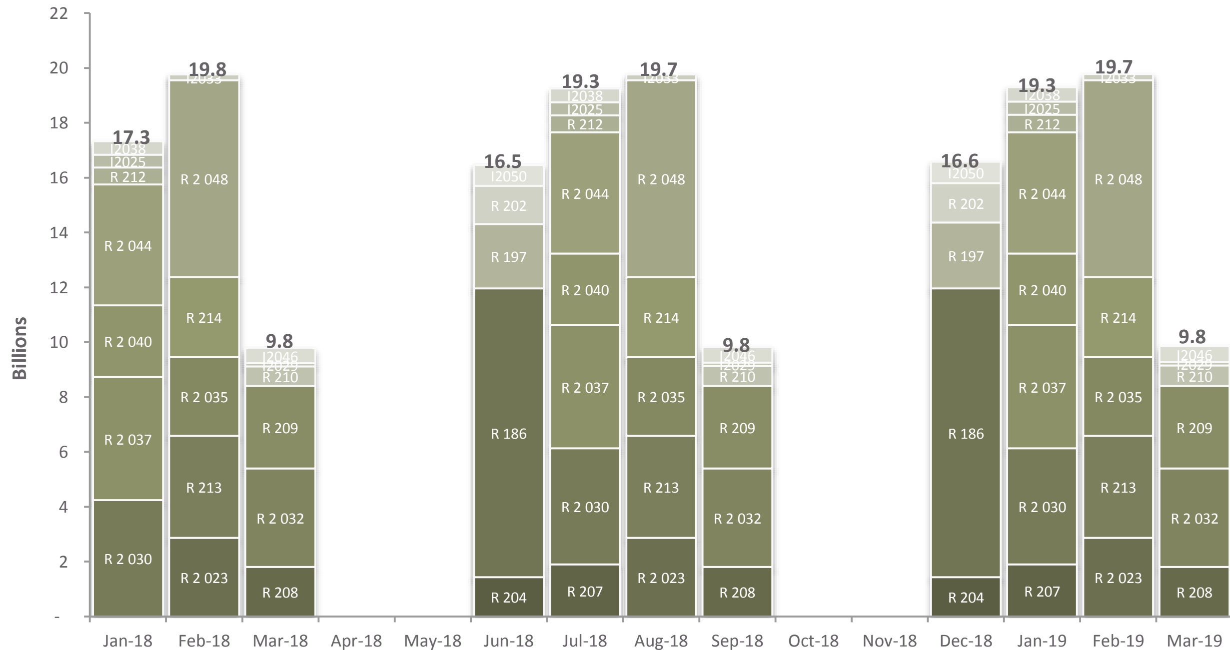
Chart 5 : Maturity profile of government debt



Source: National Treasury, 2017 MTBPS

- **Furthermore, plenty of coupon payments are due and 1Q18 is stacking up to present significant funding pressures**. Over and above the R2.8bn that may be needed to fund higher education during the quarter, cumulative coupon payments of R46.7bn are due. For 2018/19, coupon payments amount to R130bn (Chart 6).

Chart 6 : SA government rand-denominated debt coupon payment profile



Source: Bloomberg, Nedbank CIB Markets Research

- We believe a **bulk of the issuance profile will continue to be skewed towards long-term bonds** (which make up about 80% of total issuance), of which ILB issuance is capped at 20% (of total bond issuance). The balance of the borrowing will

come from T-bill issuance (between 8% to 13%) and foreign currency debt. Expect switches to feature ahead of the R204 redemption in December 2018.

How do we think about SAGBs going into the budget and beyond? We favour the long end.

Tactically, we believe the Budget is likely to reinforce the positive momentum in the local bond and currency market. Tighter fiscal policy via expenditure cuts and higher tax revenue (which culminates into lower budget deficits over the MTEF), combined with lower inflation, should provide the SARB more flexibility to cut interest rates.

On a three to six month view, we favour the long end of the curve and believe the belly of the curve will struggle on a relative basis. At the front end, at least one cut is already priced into local markets. That said, we believe there could be at least 50bps of cuts in 2018. At the same time, we believe the long end, eg R2048s, reflect South Africa's credit and inflation risk much better than for example the R186 (see SA trends that should reassert). We hold this view irrespective of the threat of WGBI exclusion.

Arguably, the biggest risk to our tactically bullish view is the government sector wage negotiations which hold a much greater threat to fiscal consolidation than the funding of higher education, in our view.

We temper our expectations on a strategic, multi-month view. SOE concerns continue to loom large in the background and while Eskom seems to have enough liquidity (for now) despite the NERSA ruling, other smaller SOEs are likely to require funding. Capital markets remain inaccessible or very expensive for most SOEs.

In the past few years, the bias over the MTEF was always firmly towards fiscal slippage (ie once data was realised relative to what was presented in the Budgets). As a result, our base case would be to again assume greater issuance than what is forecasted and what will be presented in the 2018 Budget.

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