STRIKING THE RIGHT BALANCE: FISCAL **CONSOLIDATION WITHOUT CHOKING GROWTH**

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ABOUT **THE AUTHOR**

As Sake Economist of the Year, Rian's insight into and forecasts of how macroeconomic developments impact financial markets inform our top-down views.

This year's National Budget Speech was unquestionably the most anxiously anticipated of any in the post-1994 period.

This is because of the troublesome background against which it was drafted and there existed a considerable risk of "getting it wrong" in some way. In short, the Budget needed to convincingly re-impose fiscal consolidation without aggravating the downward pressures on the already slow-growing economy while, at the same time, finding extra money to allocate to tertiary education institutions.

The Medium-Term Budget Policy Statement (MTBPS) of October 2017 produced a massive shock when National Treasury not only revealed a huge hole in the 2017/18 Budget (on account of severely underperforming tax revenue growth), but also indicated that, due to more downbeat assumptions for both the real economy and tax revenue growth over the next number of years, the planned narrowing of the budget deficit and stabilisation of government debt would no longer occur. Instead, the budget deficit, on the then existing spending plans and tax framework, would remain large and government debt would continue to rise relentlessly through to 2025, by which time it was forecast to reach 63% of GDP – a dramatically worse outcome than the previous projection of government debt peaking at little over 52% in 2018/19 and then slowly easing to below 50% by 2025.

KEY TAKEOUTS

- FISCAL CONSOLIDATION IS BACK: HIGHER TAXES, LOWER SPENDING
- VAT INCREASE THE BETTER OPTION
- POOR BUFFERED BY VAT-EXEMPT GOODS
- HOPEFULLY SA HAS SKIRTED A DOWNGRADE

The message was clear: South Africa was in deep fiscal trouble and something had to give to avoid a full-blown disaster.

It came as no surprise when ratings (as per pp 7 & 9) agencies reacted to the MTBPS with several downgrades to SA's foreign and local currency debt. When the dust finally settled, SA was left with only one sovereign investment grade rating, namely the lowest investment grade by Moody's on SA's local currency government bonds. However, Moody's had signalled that the rating could be downgraded to non-investment grade within months, an event that would eject South Africa from the Citi World Government Bond Index and could trigger large-scale selling of SA's government bonds and the rand… with all the potential inflation and interest rate complications that one would normally expect. So, the Budget had to convince Moody's not to downgrade and this required returning to fiscal consolidation, while still leaving room for the economy to grow faster over the next few years.

The fiscal situation was, of course, massively complicated when then President Zuma announced in December 2017 that free tertiary education would be introduced for students from low-income families. Not only was National Treasury saddled with finding ways to return to fiscal consolidation without doing too much damage to the economy, but it now also had to find tens of billions of additional rands to channel into tertiary education institutions.

So, against this background, how did the Budget fare in juggling all these requirements?

As was expected, the key focus of the Budget was indeed fiscal consolidation, through a combination of tax increases and expenditure cuts. The new projections now call for the budget deficit to decline moderately over the next few years and for government debt to stabilise at little over 56% of GDP in 2022, and to decline moderately thereafter to 55.5% by 2025. While notably better than the MTBPS projection of a relentless rise to 63% by 2025, the latest projections are still considerably worse than the February 2017 projection of debt easing to below 50% by 2025.

UP WITH TAXES, DOWN WITH SPENDING

The fiscal consolidation was achieved by a combination of higher taxes and a cutback in planned future spending growth. The spending cutbacks amounted to a net R85 billion over the medium-term expenditure time horizon of three years. The axe fell mostly on spending on capital projects (which was cut by about R140 billion) in order to accommodate almost R60 billion of additional spending on education. On the tax side, the most important measures were the increase in the VAT rate, a further rise in the personal tax burden through fiscal drag (where inflation-linked salary increases push people into higher tax brackets) and increases in various smaller taxes. The VAT increase will generate additional revenues of around R23 billion in 2018/19, and more thereafter. Within the medium-term framework, the Budget implicitly assumes a moderate acceleration in economic growth and, with it, an improvement in tax collections.

THE PROOF WILL BE IN THE PUDDING

The more fundamental questions are whether the Budget will hurt the economy, whether the fiscal situation has finally taken a turn for the better and whether it will stave off the much-feared downgrade by Moody's.

While the lower debt projections came as a relief after the MTBPS shock, South Africa's fiscal situation unfortunately remains very troublesome and is by no means out of the woods. Importantly, there is very little room over the next three years to accommodate unanticipated spending increases, while faster economic growth is required to merely meet the current projections of higher tax revenue growth. Any deviation in either of these two – higher spending or lower tax revenue growth – will catapult the fiscal situation back into crisis.

As said earlier, while the debt trajectory is better than what was predicted at the MTBPS, it is still notably worse than the projection in February 2017. We believe that a tougher budget to generate a faster debt trajectory decline would have harmed the economy through a too aggressive cutback in spending and/or too draconian tax hikes. Still, tighter fiscal policy in whatever form will extract a price from the economy. However, we believe that there will be some offset as, together with the stronger rand, room is being created for the South African Reserve Bank to lower interest rates, perhaps even as soon as March.

I am of the opinion that Moody's will indeed not downgrade SA's local government bond rating to sub-investment grade in its upcoming review. This view goes beyond merely the better budget projections. More important is the Cyril Ramaphosa victory at the ANC's elective conference in December 2017, as it brings with it the promise of a confidence recovery, greater policy certainty, a clampdown on corruption, reinstating the independence of our institutions, drastic action to turn around financially troubled state-owned enterprises and, ultimately, the prospect of faster economic growth, more jobs and a rising living standard for all. Ratings agencies take a long view and I believe the implications of Mr Ramaphosa's win are indeed far more important than merely the budget numbers.

VAT: THE BEST BAD CHOICE

A few words are warranted on the decision to raise the VAT rate. While heavily criticised in some circles, I fully support the move and I have, in fact, been calling for a VAT hike for the past two years. The fact is that Government only has three main sources of tax, namely, personal income tax, VAT and corporate tax. Together, these account for about 75% of all tax collections. The personal income tax burden has already increased substantially in recent years, especially on the higher income groups – something the Minister alluded to in his speech. The problem is that while raising taxes on higher income groups is politically popular, there comes a point where it becomes counterproductive – through tax avoidance and evasion – and also runs an undeniable risk of the wealthy and entrepreneurial classes emigrating. We suspect that the authorities have started to see elements of this, realising that imposing further tax increases on this category of taxpayer may well be increasingly counterproductive.

Raising corporate taxes was also not an option, as SA's tax rate is high in a global context (also mentioned by the Minister) and this would have made life much more difficult for a corporate sector already struggling in a slow-growing economy.

This left VAT as really the only option to generate substantial additional amounts of revenue and the case for an increase in the rate was strong. Not only has the VAT rate remained unchanged for two decades, but various studies showed that SA's absolute and effective VAT rate is low in a global context and indirect taxes' (or taxes on spending) share of total tax revenue is also low in a global context. Moreover, while VAT is undeniably a regressive tax (affecting the poor more than the rich), various studies have found that while VAT is indeed regressive on an item-by-item basis in SA, the overall impact on the poor is not regressive – owing to a large number of basic commodities that are exempt from VAT. This was also highlighted by the deputy minister's comment that 85% of all VAT revenues collected are actually paid by only 30% of taxpayers, or the higher income groups. Moreover, a part of the additional revenues can be channelled back to the poor through increased social spending, something that was indeed effected through above-inflation increases in social grants.

Data sourced from National Treasury

In summary, the anxiously awaited 2018 Budget provided some relief, but not a solution, to SA's fundamental fiscal challenges. The only way to "solve" the fiscal problem over time is to create an environment conducive to faster economic growth – naturally generating more tax revenue through more taxpayers, more VAT collections from increased spending and higher profits generated by companies – and more efficient government spending. There is still far too much inefficient spending by Government – way too much money is lost through corruption and wastage and the public service remains overstaffed. But, fiscal ships turn slowly and this year's Budget, and especially the seemingly fundamental change in direction of economic prospects for South Africa, may well mark the beginning of a brighter future, both in the fiscal situation and the welfare of the people at large.