Sanlam

Economic Overview for Business Owners

November 2017

A modicum of good news for SMEs amidst a dire fiscal position

The National Treasury's open, frank 2017 Medium-term Budget Policy Statement (MTBPS) leaves its readers with no doubt that the current trends in South Africa's fiscal position are unsustainable. Despite years of fiscal consolidation the government's debt ratio continues to increase, while a marked deterioration in the general government's fixed capital stock relative to its liabilities suggests it is borrowing to fund consumption, which is not economically sound.

It is often noted that the South African government's debt ratio is relatively low compared to, for example, many developed economies. This is true, but the problem is that persistent downgrades in the country's sovereign debt ratings have been accompanied by a marked increase in the real interest rate on newly-issued government debt relative to real GDP growth. In the absence of a material improvement in the Main Budget primary balance this, in time, implies the upward trend in the debt ratio will persist as government borrows to pay interest. The expected deterioration in the primary balance to a deficit of 1.2% of GDP in 2017/18 from a deficit of 0.5% of GDP in 2016/17 is, therefore, a concern.

Meanwhile, the untenable financial position of numerous state-owned enterprises (SOEs) has exposed the Treasury to material risk, given the debt guarantees it has extended to these enterprises. In the current fiscal year the National Treasury has injected R13.7 billion, in aggregate, into South African Airways (SAA) and the South African Post Office (SAPO). In the case of the former the Treasury notes R10 billion was transferred to avoid "a call on guarantees or the liquidation of the carrier".

Further, financial difficulties amongst SOEs are not limited to SAA and the SAPO. The Treasury indicates that there are also liquidity shortages at Denel, South African Express and the South African Broadcasting Corporation, which "will likely require some form of intervention from government". And, whereas "non-core" assets may be sold to fund SOEs, the aim of government asset sales should be to improve efficiency, rather than to provide support for ailing businesses.

Given current expectations for the path of income growth, revenue shortfalls of R50.8 billion in 2017/18, R69.3 billion in 2018/19 and R89.4 billion in 2019/20 are expected. This unfavourable state of affairs requires the implementation of additional fiscal consolidation measures in next year's budget. The MTBPS notes that additional spending cuts and/or tax hikes in the order of R40 billion would be needed just to stabilise the debt ratio below 60% of GDP within the next decade.

Although the Treasury will likely cut expenditure, its ability to do so will be constrained by emerging new spending priorities (for example, National Health Insurance and, possibly, fee-free higher education and training). Hence, additional revenue raising measures (over and above the R15 billion already announced for 2018/19) seem inevitable. The question is: "who pays?"

Noting that the Davis Tax Committee has been working on corporate income tax (including a review of tax incentives), expectations of additional raising measures are focused on personal income tax (for example, not fully compensating for fiscal drag, increasing the top marginal tax rate and possible

2/…

wealth taxes[1]), dividend income tax, the Health Promotion Levy (the proposed tax on sugary drinks), "sin" taxes, the general fuel levy and decreases in tax expenditure (for example, an adjustment to the medical tax credit to help fund NHI). The Treasury also notes that the revised Carbon Tax Bill will be published soon. This list of possible revenue raising measures is extensive and the revenue burden is expected to continue increasing relative to GDP.

Overall, there is little to cheer in the Mini-Budget and much to be concerned about. For, budding entrepreneurs there is, at least, a modicum of good news. Small business development (and hence job creation) remains a key expenditure priority. Also, a Government Technical Advisory Centre has been commissioned to establish a fund to support SMEs focusing on "start-ups" and public procurement. The Treasury notes provinces will procure around R600 billion in goods and services over the next three years, which will include purchases from small businesses. Already, in Gauteng the registered number of small business suppliers increased from 1 072 in 2014 to 8 268 in 2017. In the Western Cape, the provincial government has 5 500 suppliers of which 51% are small businesses.

And SMEs, more broadly, will be interested in the government's proposed shift to "de-concentrate industries dominated by few participants", although there is no substantive detail available as yet on what this implies in practice.

However, none of this can shield households and businesses from the currency volatility and higher real interest rates, which persistent sovereign debt ratings downgrades imply. Nor can it compensate the economy for the cost of infrastructure bottlenecks due to inadequate maintenance of assets, or insufficient funding.

Ultimately, as Minister Malusi Gigaba writes in his foreword to the MTBPS: "The most urgent task before our nation is to ignite inclusive, job-creating growth". One could not agree more. But, in the absence of the economic reforms needed to promote a sustained, robust increase in real economic activity, the National Treasury can be expected to lean heavily on South Africans, either by increasing effective tax rates, or by cutting benefits, or both.

Written by Arthur Kamp, Investment Economist, Sanlam Investment Management

[1] Alternative wealth taxes up for discussion include property tax, land tax and capital transfer taxes (donations tax and estate duty)