Budget 2018

Bold decisions and good intent

Aligning the tax structure with the growth objective

The outstanding feature of Budget 2018 is the decision to raise the VAT rate by 1%, which nets the fiscus an additional R22.9 billion in 2018/19. Together with another increase in the fuel levy and excise duty increases in excess of inflation it ensures the dominant share of the additional R36 billion collected in taxes in 2018/19 will come from indirect taxes.

VAT is widely considered a regressive tax and a draconian measure, since low income earners spend a larger portion of their income on consumption. That said, given zero ratings and exclusions, the tax is arguably mildly regressive or even progressive.

Note, too, the decision was partly motivated by the Treasury's view that increasing the tax burden on individuals would have a greater negative impact on real economic activity than a VAT rate increase. But this does not necessarily imply the abandonment of wealth taxes, however, as reflected in the increase in estate duty for estates worth R30 million and higher.

Meanwhile, the Budget Review notes that at 28% South Africa's corporate tax rate is becoming an outlier amid lower corporate tax rates globally. In any event, the Treasury also questions the extent to which corporate tax increases are paid by shareholders, given the incentive to cut labour costs or increase product prices.

Concomitantly, social economic zone incentives are expected to "cost" the fiscus R350 million in 2018/19, while controlled foreign company tax exemption is being reviewed for a possible reduction. Against this the tax deductibility of interest payments on "excessive" debt financing is also being reviewed.

Overall, although the shift to consumption tax is limited, the emphasis on taxing consumption rather than savings and the reward for work is a step in the right direction. After all, taxes on income and savings discourage the behaviour needed to grow the economy.

The Treasury re-affirms its intent to stabilise the debt ratio

In Budget 2018, the Treasury delivered on its promised fiscal consolidation. The future path for the primary budget balance (revenue less non-interest spending), which improves from a deficit of -1.2% of GDP in 2017/18 to 0% of GDP by 2020/21, implies a markedly lower increase in the debt ratio than previously indicated - to 56% of GDP by 2020/21 (with net debt at 52.2% of GDP). Bear in mind that this relies on the Treasury's projected increase in real GDP growth and its ability to maintain a relatively subdued real interest rate on government debt.

In essence, the Treasury has re-affirmed its intention to stabilise its debt ratio, but its track record has been dented in 2017/18 with the deterioration in the primary budget balance to -1.2% of GDP, from -0.5% of GDP in 2016/17. It needs to re-establish this record in the fiscal year ahead.

Increasing taxes to maintain spending

It is encouraging to note expenditure cuts were made elsewhere to accommodate the roll-out of fee-free education, so that the government's expenditure ceiling remained just about unchanged over the medium term. However, successful fiscal consolidations usually reflect a decline in expenditure relative to GDP and the South African government's non-interest spending is projected to stay high at around 29.5% of GDP over the next three years.

It also remains to be seen whether government's compensation bill can be limited to average increases of 7.3% per year over the next three years, while the additional allocation to National Health Insurance (NHI) is modest and does not yet reflect the potential cost if the programme is fully implemented.

And, whereas the shift towards taxing consumption is an important development, the bottom line of Budget 2018 is that the share of taxes in GDP continues to increase, against the background of a sustained upswing in the business cycle, in order to maintain government spending at a high level. Relying on a marked increase in tax buoyancy, partly due to tax increases, the share of taxes in GDP is projected to increase from 25.9 % of GDP in 2017/18 to 27.2% % of GDP in 2020/21 – a higher level than in the previous business cycle upswing when economic growth was strong.

Spending on higher education is the fastest growing component of the Budget. Human capital development is critical to lift South Africa's growth potential and the adjustment to incorporate fee-free higher education (R57 billion over the next three years) is in keeping with this objective. One risk associated with fee-free education, though, is that the supply of higher education services may be overwhelmed by demand leading to upward pressure on fees. Indeed, the National Treasury estimates the number of higher education students (universities and TVET) could increase to 4.1 million by 2030 from 1.71 million in 2015.

SOCs and contingent liabilities

Finally, at least government guarantees on public institutions' debt have edged lower over the past year, but are expected to remain elevated at R477.7 billion at end March 2018 (of which the central government's exposure is R308.3 billion due to guarantees already taken up). The immediate liquidity problems of ailing state-owned companies (SOCs) are expected to be addressed through the sale of non-core assets or equity injections or by involving strategic equity partners. But a return to health and improvement in operational efficiency and profitability is likely to be an arduous journey, implying risk to the Treasury from SOCs is likely to linger.

Is this the nadir in South Africa's fiscal deterioration?

On balance, risks associated with government finance have eased, but have not been eliminated entirely. If the Treasury makes good on the intentions contained in this Budget, though, South Africa has probably seen the worst of its fiscal deterioration. But there is no scope for additional spending demands. We seem to have reached the limits to increasing the tax burden and the only plausible way forward is to broaden the tax base through markedly stronger economic growth.
