Economic Focus

Budget Speech 2017

STANLIB

A tough and taxing year ahead

The South African Minister of Finance, Pravin Gordhan, delivered a tough budget for 2017/2018, highlighting the need for significant tax increases, especially on wealthier individuals, while at the same time endeavouring to contain government expenditure.

Although the government's fiscal parameters are expected to remain largely under-control over the coming year, there is a lack of new initiatives to meaningfully stimulate the economic growth of the country. Under these circumstances, there is a real risk that tax revenue, once again disappoints budget in 2017/2018, and that government is forced to implement more radical tax and expenditure policy changes in the years ahead.

On Wednesday, 22 February 2017, the Minister of Finance presented his second National Budget since resuming office as Minister of Finance in December 2015. As usual, the Minister tried to balance a range of competing objectives, but with an overarching focus on raising a variety of taxes and controlling government expenditure in order to contain the budget deficit to around 3% of GDP.

The most significant tax changes included a jump in the top marginal tax rate from 41% to 45% for individuals earning more than R1.5 million a year, a sharp increase in dividend tax from 15% to 20% and a further rise in the fuel levy. Despite the increase in taxes, the Minister was unable to announce any large increases in key expenditure items, although there is a substantial increase in spending on tertiary education.

The international credit rating agencies are likely to welcome the Minister's intention to reduce the fiscal deficit as well as contain government debt, but they are likely to flag the disappointing growth trajectory and the fact that tax revenue has, once again, under-performed expectations. Foreign and local investors will be somewhat disappointed with the sharp increase in the dividend tax but are unlikely to disinvest, while the business sector will find little to boost confidence and instead will worry that the increases in taxes are likely to further dampen growth expectations, thereby hindering fixed investment initiatives. Unfortunately, the household sector, which is already under-strain, will face the bulk of government's tax changes. While it can be argued that the Minister specifically targeted wealthier individuals through a rise in the top marginal tax rate, the bulk of the additional R28 billion in tax revenue the Minister plans on collecting will be paid by middle-income earners.

The 2016/2017 budget numbers

For the 2016/17 fiscal year the Minister of Finance announced that the budget balance will have recorded a deficit of -3.4% of GDP. This is in-line with the deficit the Minister projected in the October 2016 Medium Term Budget Policy Statement (MTBPS). The deficit is then expected to decline to 3.1% of GDP in 2017/2018, before falling to 2.8% of GDP in 2018/19 and a mere -2.6% of GDP in 2019/20. It should be mentioned that the government's budget deficit is expected to fall over the coming year despite a sharp increase in the transfers to other members of the Southern Africa Customs Union (SACU) to the extent of almost R16.6 billion. This will assist with regional stability.

Unfortunately, while the reduction in the budget deficit over the next three years reflects an intention to adhere to fiscal discipline, South Africa's National Treasury has developed a reputation in recent years for not being able to achieve the intended reduction in the fiscal deficit and that each year there is some degree of fiscal slippage. It is clear that this fiscal slippage largely reflects the fact that economic growth persistently under-performs target.

The government also intends to maintain a primary budget surplus (which is the budget deficit less interest costs) of 0.4% of GDP in the current fiscal year. This would be a very welcome achievement, after recording a primary budget surplus of 0.1% of GDP in the past fiscal year, and will go a long way towards convincing the public, investors and credit rating agencies that government is serious about its intention to achieve a more disciplined financial framework.

The revenue side of the budget

In 2016/2017 tax revenue massively underperformed budget by an estimate R30 billion. This is significantly worse than the R23 billion under-performance the Minister highlighted in the October 2016 Medium Term Budget. A breakdown of the revenue shortfall shows that the under-collection has been very broad-based and includes a dramatic R15.23 billion shortfall in individual tax collection, a R11.26 billion under-collection of VAT and a R6.5 billion lapse in the collection of customs duties. In contrast, company tax collection has been stronger than expected (with an estimated revenue over-run of R6.8 billion), helped by a relatively modest initial budget increase.

Total government revenue is budgeted to increase by 9.0% in 2017/2018. This is after revenue grew by a mere 6.2% in 2016/17, hurt by a slump in economic growth. The Minister announced tax increases of R28 billion for 2017/2018, mostly in the form of personal income tax, dividend tax and the fuel levy. He further warned that taxes are likely to rise further in 2018/2019; possibly by a further R15 billion. The extent of the tax hikes were not a surprise since the Minister highlighted that he needed to collect an additional R28 billion in the October 2016 MTBPS.

The key tax changes announced included a sharp increase in the top marginal tax rate for individuals from 41% to 45%, specifically for those individuals earning more than R1.5 million. There are an estimated 103 353-taxpayers that will be impacted by this adjustment, representing a mere 1.4% of registered taxpayers. However, these 103 353 taxpayers are projected to contribute 26.3% of total individual income tax in 2017/2018.

Further changes to personal income tax included a below inflation adjustment to the tax brackets. This meant that the Minister did not compensate the taxpayer with the negative effectives of inflation (technically referred to as fiscal drag). The net result of the hike in the top marginal tax rate as well as the lack of adjustment to the tax brackets means that personal income taxes are expected to contribute additional R16.5 billion to total tax revenue.

There was also an increase in the dividend withholding tax from 15% to 20% (providing an additional R6.8 billion in tax revenue) as well as 30 cents per litre increase on the general fuel levy and 9 cents a litre rise in the Road Accident Fund (providing an additional R3.2 billion). Lastly the Minister announced the usual hikes in excise duties on alcohol and tobacco products, which should yield a further R1.3 billion in revenue.

Despite the relatively large array of tax changes, the composition of tax revenue is not expected to change significantly over the coming year, with the bulk of the revenue still being derived from direct taxes in the form of personal income tax (38.8% of total) and company tax (17.6% of total).

Revenue from indirect taxes, such as VAT and the fuel levy has grown steadily over the years (despite the VAT rate remaining unchanged at 14%) and now comprise an indispensable component of tax revenue. In fact, the revenue received from VAT (25.2% of total) consistently and significantly exceeds corporate tax receipts, with 2016/2017 no exception.

Overall, it is clear that tax revenue is under pressure and that government will most likely have to raise taxes further over the coming years if economic growth and employment do not improve. It is also clear that, for the moment, the income tax and fuel levy are being used as an alternative to increasing the VAT rate. However, this cannot be sustained indefinitely and ultimately the government will have to seriously consider raising the VAT rate. The average VAT rate in emerging markets is around 15% compared with 14% in South Africa.

The expenditure side of the budget

Over the next three years the Minister is projecting average expenditure growth of 7.9% a year. This is relatively moderate and only moderately above inflation, suggesting that government is focused on becoming significantly more disciplined. This focus on fiscal discipline is reflected in the fact that the government has largely stuck to its expenditure ceiling since it was established in 2012. In particular, the government continues to build on its efforts to control their wage cost including moderating wage increases, putting a hiring freeze on non-essential workers and embarking on discussions around early retirement of public sector workers.

Key areas of growth in government spending during 2017/2018 remain education, healthcare, and welfare (social grants), including housing and community development. The Minister specifically highlighted that the government has allocated R105.9 billion on transfers to universities, while the National Student Financial Aid Scheme will spend R54.3 billion helping students that have a household income of less than R600 000 a year. The Minister said “All poor students who applied and qualified for National Student Financial Aid Scheme (NSFAS) awards, and who have been accepted by a university or a Technical and Vocational Education and Training college, would be supported.”

The government’s healthcare budget will see a sizeable planned increase in expenditure of just over 8% per year over the next three years. Government has indicated that they are now ready to move into the next phase of National Health Insurance (NHI) and are considering the reduction of tax credits to medical scheme as a means of funding the future expansion of the NHI.

Unfortunately, there is still not enough in the budget to directly promote job creation. South Africa's unemployment rate remains far too high by historical and international standards, and clearly contributes much of the social tension and anguish experienced in South Africa on a daily basis. Increasing employment in South Africa has to be the number one economic/political/social objective.

Debt servicing costs continue to rise at a very rapid pace

While South Africa's public sector debt parameters remain fairly acceptable by world standards at around 50% of GDP, the total debt as well as the cost of servicing that debt is clearly on the rise. For example, back in 2009, government's gross debt totaled only 26% of GDP and is projected at 52.3% in 2017/2018. If left unchecked, government debt will quickly become a major hindrance to achieving many vital policy objectives.

In addition, a key risk to South Africa's ongoing fiscal stability is the increase in state debt cost. While the interest cost on state debt remains manageable at around 11% of total expenditure, it is now consistently the fastest growing component of government expenditure. In fact, nominal growth in interest and rent on land is expected to average well over 10 per cent over the next three years. Under these circumstances, a significant rise in bond yields, due to further credit rating downgrades, would put South Africa's fiscal position under increasing strain. Already the cost of debt exceeds the total budget allocation to public order and safety and is one of the fastest rising components of state spending.

Conclusion

The 2017 National Budget was presented under difficult economic and political circumstances. The dramatic revenue under-collection and weak economic growth meant National Treasury had to make a hard decision. Either it had to decide to allow the budget deficit to increase fairly sharply in 2017/2018 and thereby risk an almost certain ratings downgrade, or it had to decide to do the unpopular thing and raise taxes significantly. Treasury obviously chose the tax hike options, which has allowed them to report only modest fiscal slippage, giving South Africa some chance of maintaining its investment credit rating. The determination, on the part of the Minister of Finance, to maintain fiscal discipline has to be applauded.

However, and very importantly, the large tax hikes will hurt the already weak economic environment, potentially depressing the already subdued rate of economic expansion in key sectors of the economy.

From our perspective, in order to resolve this policy dilemma the government urgently needs to focus on lifting the key domestic factors constraining economic growth. Some of these constraints might be relatively easy to resolve, others would require a large degree of policy innovation such as the extensive use of private-public partnerships. Clearly, however, some of the constraints would prove more difficult to resolve the current political turmoil, including the ongoing uncertainty surrounding the role of Minister and Deputy Minister of Finance.