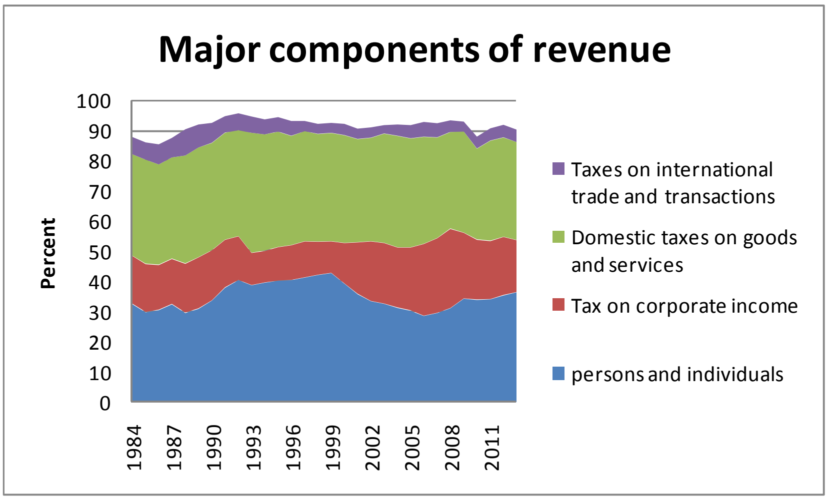
2011/12 Budget

Business as usual – no shocks, no gifts but fiscal discipline reason for concern

1. BACKGROUND

The extent to which the South African economy had been protected from the world financial crisis became clear when Minister Pravin Gordhan read his budget in Parliament on 23 February. Economic growth, the basis from which government plans its expenditure allocations and expected revenue, has improved substantially from -1,8% in 2009 to 2,8% in 2010 and Treasury expects the growth rate to excel further to 3,4% in 2011 and 4,5% up to 2013/14. At first glance the budget seems to be "conservative" but only if the rather optimistic expected growth rate is achieved and maintained and the revenue base expands accordingly. If not, public debt will become unsustainable fuelled by deficit/GDP ratios in excess of 6%. The fact is that room for fiscal maneuverability is limited and fiscal policy has to be executed within the margins of a "stable and predictable economic environment, offsetting shocks as far as possible". The Minister indicated that "fiscal policy will continue to be implemented in a countercyclical manner within a sustainable long-term framework ensuring inter-generational equity considering the cost of long term spending programmes on future generations". Against this background the following budget proposals are notable:

2. TAX PROPOSALS:



The tax burden as a percentage of the GDP remains fairly constant at 28% but the composition of the revenue base will gradually change over the next few years. As a percentage of total tax revenue, individual tax is on the increase (from 29,8% in 1985/86 to 36,4% in 2013/14) while the share of company tax will decline (from 21,8% in 2009/10 to only 17,2% in 2013/14). Apart from the normal provision for bracket creep, individuals will experience little improvement in their living standards as a result of discretionary tax policy changes. This is meaningful, especially in a year of local government elections which normally spell populist expenditure behavior. The income threshold for individuals in the age group below 65 years increases from R57 000 to

R59 000. The implication thereof is that when the rebate for this group is deducted from tax payable those with taxable income below the threshold won't have any tax liability. For individuals over 65 years the threshold increases from R88 528 to R104 261. According to estimates by the Department of Economics at the University of Pretoria, the R8 billion tax relief for individuals will merely protect taxpayers from the impact of "bracket creep" or "fiscal drag" (caused by inflationary increases in income which push taxpayers into higher tax categories, thereby increasing their tax liability without any improvement in their living standards).

Taxpayers in the lower income groups will get more relief than those in higher income groups. According to the department's estimates the tax liability of those in the income groups below R150 000 will actually decline while those in the income group R150 000 – R235 000 will increase, despite an average tax reduction of R1 148 – mainly as a result of expected inflationary adjustments to their salaries. The implementation of a third category of taxpayers namely those in the age group above 75 will have little impact on the revenue base but will benefit many in that group suffering to make ends meet due to the impact of inflation on their pension income.

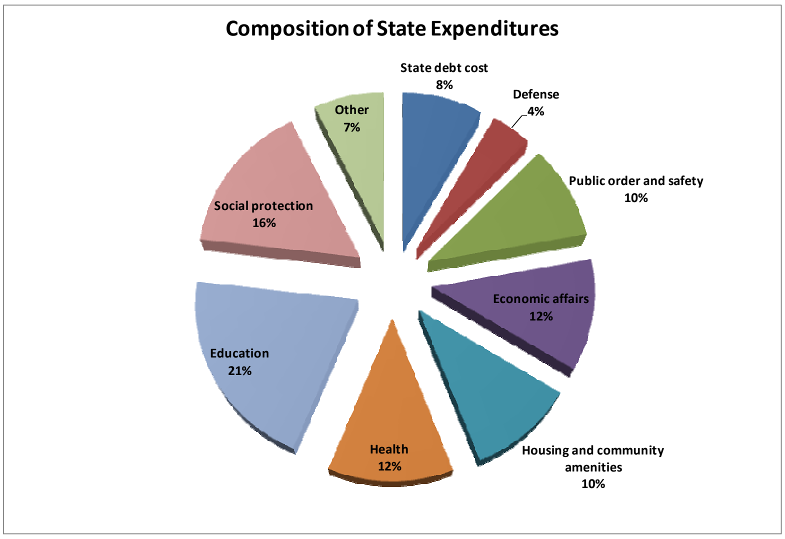
In addition to income tax, individuals will also benefit from adjustments in exclusion amounts on capital gains. For example, the exclusion amount for individuals and special trust funds increases from R17 500 to R20 000; on death from R120 000 to R200 000 and on the disposal of small businesses if the taxpayer is above the age of 55 from R750 000 to R900 000. So-called "sin" taxes such as excise on tobacco and liquor will negatively affect consumption while an increase in 18 cents per liter in the fuel price will exert more pressure on input cost and therefore inflation. This should be seen against the background of rising oil prices and the introduction of a new toll system on Gauteng highways. In an attempt to promote saving behavior the threshold on interest income is increased from R22 300 to R22 800 for individuals under the age of 65 and from R32 000 to R33 000 for those above 65 years. Other tax reform measures include the conversion of deductable medical expenditures into tax credits as from March 2012 while as from this year onwards, the threshold for medical expenses will be increased from R670 to R720 for the first two beneficiaries and from R410 to R440 for additional beneficiaries. In addition, from 2012 the tax treatment of contributions to retirement schemes will also be adjusted so that individuals will be allowed to deduct up to 22,5% of their taxable income for contributions to retirement schemes.

As expected, company tax rates remain unchanged, mainly due to globalization and international harmonization of company tax rates caused by tax competition amongst trading countries. Value Added Tax also remains unchanged at 14% with a number of goods and services either exempted or zero rated.

2. EXPENDITURE HIGHLIGHTS

- **Composition and trend**

Total consolidated government expenditure as a percentage of GDP has reached relatively high levels (33,6%). Thus, one third of value added in this economy is through government intervention of some kind. Budget priorities are reflected in the composition of Consolidated State Expenditure (including provinces and transfers to local authorities) and from the figure it is clear that Education is priority with 21% of the budget followed by Social Protection (16%) and Health and Economic Affairs with 12% each. As a percentage of total expenditure spending on capital (which does not include expenditure on maintenance or capital transfers to municipalities and non-financial enterprises) has increased from 5,2% in 2002/03 to 6,7% in 2010/11. Total public–sector infrastructure expenditure hovers around 8,4% over the period 2011/12 – 2013/14.



- **Social assistance**

The number of individuals relying on grants from government has now grown to approximately 15 million and in total they will receive more than R97 billion in the 2011/12 fiscal year. The Minister announced a reform of the means test to qualify for such grants in an attempt to ensure that the support is provided to beneficiaries who need it. Social grants are actually very low (state old age grant is now R1 140 and child support grant is R270 per child) but the mere numbers cause this to be a relatively big expenditure item on the budget.

- **Job creation and growth of the economy**

In his State of the Nation speech, president Zuma announced that job creation has been identified as a priority spending area and the budget outlines the following initiatives to support this objective:

- R10 billion for job creation, small enterprise development and youth employment;
- R9,5 billion for investment in further education and training (FET) colleges – expansion of enrolment, curricular improvements and improved access to student financial assistance;
- Stepped-up training for work-seekers under the auspices of Sector Education and Training Authorities and the National Skills Fund;
- Expansion of public works programme activities (R73 billion over the next three years), including community-based projects, and maintenance of roads and infrastructure;
- Renewed tax incentives for manufacturing investment, with a focus on job-creation potential;
- Increased investment in housing, and residential infrastructure and services

- A Jobs Fund to co-finance innovative public- and private-sector employment projects
- Initiatives to promote rural employment, and stepped up support for agricultural producers, particularly emerging farmers
- Support for renewable energy, environmental protection and "green" economy initiatives.

- **Performance monitoring and evaluation**

Minister Gordhan referred to the importance of performance monitoring and evaluation of departmental outputs. Procurement policies and tax concessions to boost the economy are useful but should be executed within a corruption free environment by efficient officials. The importance of this issue cannot be overstated. The impression is that the public administration is featured by a high level inefficiency, incompetence, bad management and lack of delivery. A case in point is the problems experienced in the Health and Education departments not to mention the problems at lower spheres of government such as the bills issue in Johannesburg. Taxpayers are entitled to hold government accountable for the way in which taxes are spent.

3. BORROWING

The gap between government revenue and expenditure is financed through borrowing both on local and international markets. In the 2010/11 fiscal year borrowing amounted to R141 billion, obtained mainly from domestic long term loans (R139 billion). Domestic short term loans amounted to R35 billion while cash and other balances increased by R31 billion. Net foreign loans contributed negatively with an outflow of R2,3 billion. It should be noted that the borrowing requirement excludes loan redemptions (the repurchase of bonds at or before maturity) which also have to be financed. In 2011/12 this amount is expected to increase to 18,2 billion compared to R16,2 billion in 2010/11. However, government seems to be concerned about the term structure of the debt and has actively engaged in loan redemptions in an attempt to manage refinance risk through domestic switch programmes (risk is reduced by exchanging maturing debt before due date for longer dated bonds).

Overspending and deficit financing result in an accumulation of public debt because of interest payable on the debt as well as exchange rate movements on the foreign component of the debt. As a result the budget provides for an increase in total net loan debt from R822 billion (30,8% of GDP) to R1 388 billion (39,3% of GDP) in 2013/14. In 2010/11 debt service cost amounted to R66,6 billion and this amount will grow to R104 billion in 2013/14. In addition to national government, state-owned entities such as Eskom, Transnet, the Central Energy Fund, the National Roads Agency, the Airports Company, etc. will also engage in heavy borrowing activities. In this regard Treasury projects capital expenditure by the major state owned entities to amount to R634 billion over the period 2010/11 and 2014/15. However, it is expected that loans will mainly be financed through internally generated resources (42%), government funding (5%) and the balance from borrowing (the bulk of which is from the domestic market).

Such levels of increased borrowing by the state amidst an expected strong reviving economy may have implications for private borrowers given the low savings capacity of the South African economy and dependency on international capital inflows. The longer term interest rates are therefore set to increase but given the underlying policy to restore the deficit/GDP ratio to the 3% range by 2013/14, it should not be too much of a concern. Of greater importance is the need to expand and maintain infrastructure as long as borrowed funding is used for this purpose only.

4. CONCLUSION

The underlying tone of the 2011/12 budget is one of a disciplined fiscal approach but it remains to be seen whether the objectives of job creation and improvements in the social dispensation will be achieved. The expected economic growth rate may be too optimistic and the rate at which government spending is on the increase, especially current expenditure (salaries in particular) is a reason for concern. Nevertheless, a number of initiatives have been identified that necessitate tax reform and switched priorities. In this regard job creation should remain at the top of the list and although it is not government's responsibility to create jobs (neither does it have the capacity to do so), the budget should contribute towards creating a more conducive environment that would encourage employers to increase their work force. In addition, funds allocated in this budget should contribute positively to improving the quality of a large number of job seekers through training and better living conditions.