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South Africa's fiscal handcuffs

Following the National Budget presented by the Minister of Finance to Parliament on 22 February 2023, consensus opinion was that it is a fair budget but that its success depended on Government's ability to follow through on the 3% salary increases to government employees included in the Budget.

Subsequently, Government agreed to a 7.5% salary increase for government employees in 2023, which means the cost of total compensation for government employees could increase by more than 8% because of increases linked to promotions and new appointments. This will increase government expenditure by more than R35 billion in fiscal 2023-24.

How strong is South Africa's fiscal position?

Not as robust as one would have wanted.

The national budget deficit for 2023-24 is likely to be worse than presented to Parliament in February this year, and it may be necessary for Government to borrow more than anticipated in the Budget.

The contribution from personal income tax to the fiscus is becoming more important, as the global commodity cycle is turning down and corporate income tax revenue is under pressure. It is noteworthy that fewer than one million individuals out of South Africa's population of sixty-one million contribute 17% of Government's consolidated budget revenue through direct tax (personal income tax). These taxpayers also pay value added tax on their consumption and conceivably contribute 23% more to consolidated budget revenue through indirect tax (VAT).

At the same time, Government's thirst for more revenue is almost unquenchable, with big ticket expenditure programmes that may be launched in the not-too-distant future (for example, a levy to fund National Health Insurance and increased tax or a levy for a possible basic income grant). The fiscus already spends an estimated 75% of consolidated budget revenue on debt servicing, government employee salaries and social grants. About 14 million South Africans depend on the national government for salaries or social grants monthly.

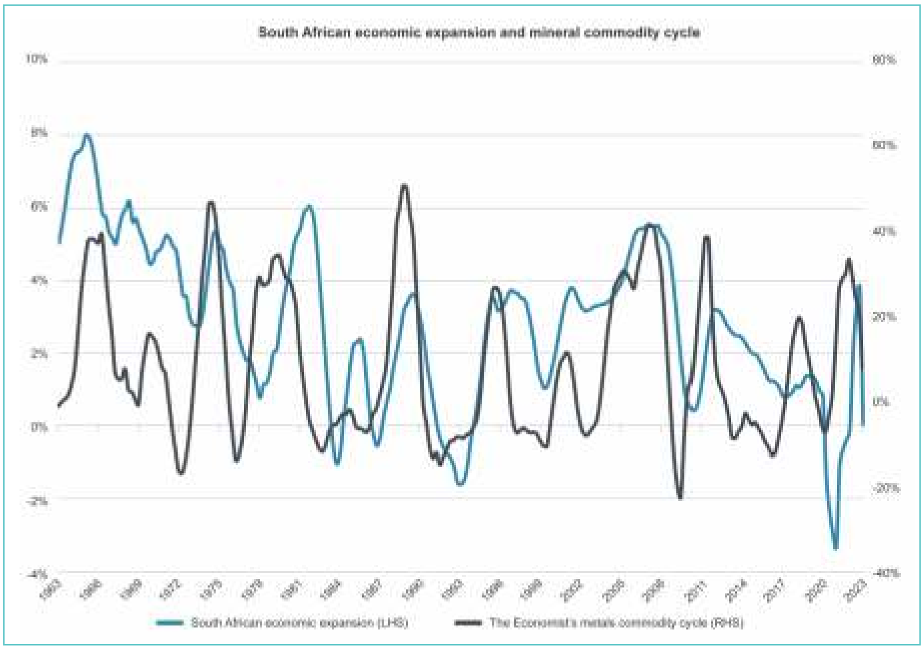
While capital markets may be able to absorb Government's additional borrowing requirements, it will come at a higher cost, as new debt will have to be issued at market related interest rates. This will push up debt servicing costs.

According to the National Budget, the debt-to-GDP ratio for 2023-24 is 72.2%. National Treasury expects this ratio to peak at 73.6% in 2025-26, whereafter it is expected to decline. Analysis shows that the ratio could go as high as 73.5% this year already, and possibly even higher towards 2025-26. A debt-to-GDP ratio of 75% is considered unsustainable, as the cost of servicing that much debt will cripple Government's expense budget. Government is living beyond taxpayers' means.

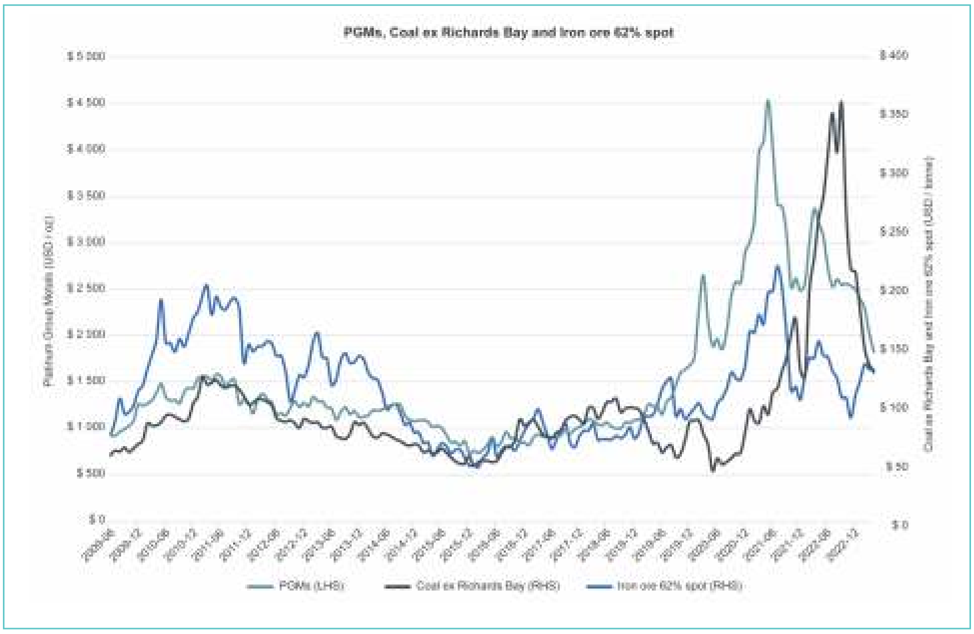
(Please note: The expected outcome for investment markets in the next few years is not linked exclusively to South Africa's fiscal prospects. Investors can invest in domestic and offshore rand-hedge opportunities to diversify their risk and possibly boost their investment return prospects.

Economic cycle

South Africa's fortunes are closely linked to its mineral wealth. As the commodity cycle goes up, so the South African economy grows. The chart below shows how the South African economy follows the commodity cycle, and that the economic cycle usually peaks shortly after the commodity cycle has peaked.



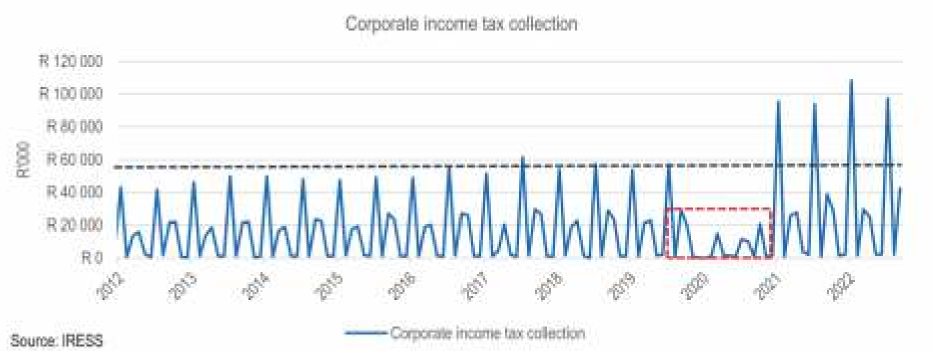
More than two-thirds of South Africa's mineral production and sales come from platinum group metals (PGMs), coal and iron ore. The chart above reflects the sharp decline in the prices of platinum group metals, coal and iron ore. PGM and iron ore prices peaked in 2021 and the price of coal peaked a year later, in 2022, after Russia invaded Ukraine.



To draft the Budget, National Treasury used the following assumptions about mineral prices:

Commodity/mineral	Assumption in 2023-24 National Budget	Recent price
Platinum ($ / oz)	1 050	1 005
Palladium ($ / oz)	1 800	1 465
Coal per tonne ($ / tonne)	150	130
Iron ore per tonne ($ / tonne)	118	118

As a result of the high mineral prices that prevailed in 2021 and into 2022, the corporate income tax collected by the South African Revenue Service increased sharply as depicted in the next chart. The chart also shows the contraction in revenue from corporate income tax during the lockdown period in 2020.



Source: IRESS

The higher corporate income tax revenue in the period from 2021 to 2022 clearly corresponds with the higher commodity prices that prevailed during the same period.

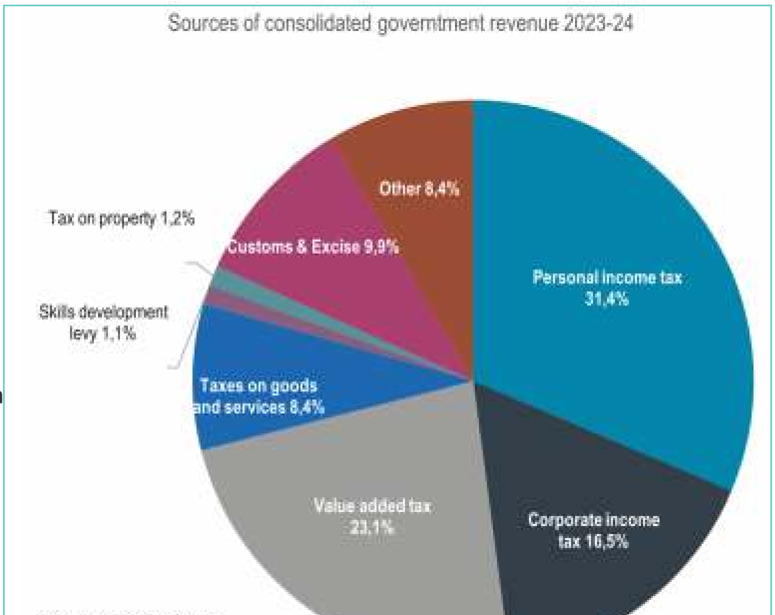
Government's consolidated budget revenue

In the 2023-24 fiscal year, corporate income tax is expected to generate government revenue of R336 billion (down 2.5% from R345 billion in 2022-23). The Minister of Finance and National Treasury acknowledge that "...[gains] will be partially offset by an expected decline in commodity prices and moderating compliance improvements." The concern is whether National Treasury has sufficiently allowed for falling commodity prices in its budgeted corporate income tax revenue for 2023-24. The concern is further exacerbated by the widely held expectation that South Africa's electricity crisis may lead to lower corporate profits, as corporates spend many millions of rand on diesel to keep the lights on and continue their operations. It has been reported that the electricity crisis could reduce the consolidated budget income (R1 958.9 billion) by as much as R60 billion in fiscal 2023-24.

Corporate income tax is expected to contribute 16.5% of consolidated budget revenue in 2023-24, with personal income tax and value added tax contributing 31.4% and 23.1% respectively. National Treasury budgeted for an increase of 6.4% in personal income tax revenue and a 10.6% increase in revenue from value added tax for the same period.

It is evident that South Africa depends heavily on the household sector's contributions to the fiscus in terms of personal income tax and value added tax.

The expected 10.6% increase in the contribution of value added tax to consolidated budget revenue in 2023-24 appears to be reasonable (9.1% in 2022-23), as does the 6.4% increase in the contribution of personal income tax to consolidated budget revenue.



Source: National Treasury

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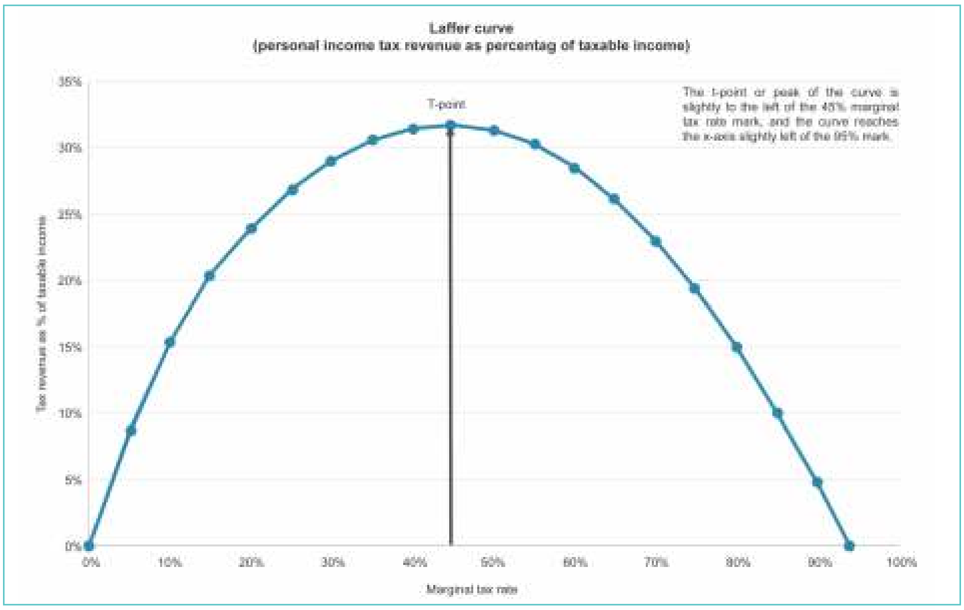
The Laffer curve in the chart illustrates the relationship between tax rates and total tax revenue. The curve suggests that total tax revenue will not reach a maximum when tax rates are at 100%, as a high tax rate disincentivises individuals from engaging in economic activity. So, raising personal income tax rates is not likely to produce a substantial amount of additional tax revenue and the there is a real possibility that tax revenue may even decline.



The average person

National Treasury expects to raise personal income tax of R640.3 billion in fiscal 2023-24. According to StatsSA's Quarterly Labour Force Survey for Quarter 4 of 2022, there are 10 977 000 employed individuals in the formal sector in South Africa. In Tax Statistics 2022, the South African Revenue Service (SARS) noted that 5 508 525 individuals are paying personal income tax. The average personal income taxpayer earns taxable income of R382 740 a year and pays income tax of R82 086 a year (R6 840 a month). The top 988 706 individuals in the country with taxable income exceeding R500 000 a year, pay approximately 75% of all personal income tax, which equals 17% of South Africa's consolidated budget revenue.

These 988 706 individuals also make a significant contribution by paying value added tax and it would not be unrealistic to conclude that these individuals contribute up to 40% of consolidated budget revenue in total.

The average person paying monthly PAYE of R6 840 may ask how the money is spent. The R6 840 monthly contribution to the fiscus is spent as follows:

Expenditure items covered by the average person's monthly PAYE payment	Government expenditure	Government income
Average person's monthly PAYE		R6 840
Less: Interest on government debt (18.7%)	R1 281	
Salaries of government employees (37.5%)	R2 571	
Social grants (19.3%)	R1 332	R5 184
Balance remaining		R1 666

That leaves a further R1 666 of the average person's PAYE contribution for expenditure on consumables and capital for schools, hospitals, police and other government services.

The South African Social Security Agency (SASSA) reports that it pays 18 778 923 social grants to 11 451 387 recipients every month. The average grant recipient receives R1 490 a month (excluding Social Relief of Distress grants) and the average grant paid by SASSA is R910 a month.

The average PAYE-paying person contributes R1 322 towards social grants per month and the average social grant paid per month is R910. This means the average person's PAYE contribution funds more than the average social grant per month.

Unfortunately, government spending does not stop there. Expenditure in the National Budget amounts to R2 242.6 billion for fiscal 2023-24. Allowing for the higher than budgeted increase granted to government employees, government expenditure is likely to be R2 276.6 billion. Consolidated budget revenue for fiscal 2023-24 is projected at R1 958.9 billion. It should be noted that consolidated budget revenue may be lower by R60 billion because of the national electricity crisis. This means the budget deficit could increase from the published R283.7 billion to R317.7 billion.

For every R6 840 revenue received monthly from the average person's PAYE, Government spends R7 777, which translates into a deficit of R937 per average taxpayer per month. So, Government borrows R937 every month on your behalf.

Government's initiatives such as the National Health Insurance (NHI) and a basic income grant (BIG) are aimed at improving the living conditions of many South Africans. As indicated earlier, the NHI might be funded by a National Health levy, and it would not be surprising if a basic income grant is similarly funded by a basic income levy.

The Laffer curve shows that there is not much scope to increase personal income tax, even if such increases are euphemistically called a National Health levy or a basic income levy. Increases in company tax and value added tax will be equally unproductive, effectively handicapping South Africa's revenue growth.

More government debt

In the run up to the general elections in 2024, it is possible that political parties may vie for votes by promising to pay more and/or higher social grants when (re-)elected to Government. These political parties would be well advised to present funding plans for any such promises made to the citizenry because there is no room for higher taxes.

As the shoe pinches more and more, there is a risk that Government may resort to increased borrowings to fund ongoing consumption expenditure, thus introducing additional fiscal risk to the South African financial system. Net government debt stands at R5 060.2 billion and the budgeted debt servicing cost amounts to R340.5 billion. This means the total interest paid by Government on its debt is 6.7% per year.

If consolidated budget revenue has been over-estimated by as much as R60 billion, and as we adjust government expenditure for the higher salary increase to government employees, it may be necessary to borrow R100 billion more from capital markets in 2023-24. Government cannot issue new debt at an interest rate of 6.7%. Prevailing interest rates on short dated government debt are approximately 8.5%, and higher on longer debt instruments. Funding an additional R100 billion of debt at 8.5% would add a further R8.5 billion to debt service cost and government expenditure.

We should be sensitive to the challenges faced by the fiscus, but less income, higher expenses and borrowing more is not a sound financial strategy. Now is a good time to rethink our fundamental approach to managing the country's economy. South Africa is not over the proverbial fiscal cliff yet, but it certainly is in handcuffs being frog marched in that direction.