

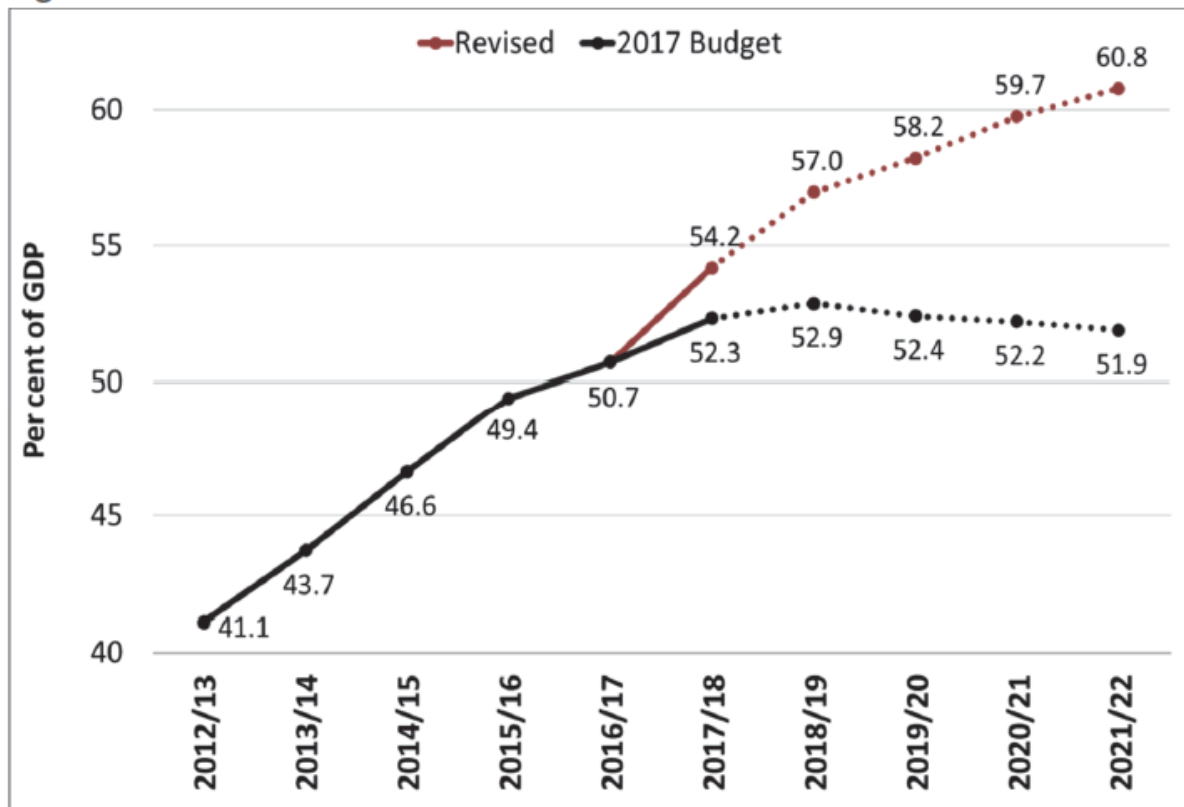
Mini-budget reminds us of the need to state-proof our lives

MTBPS analysis for AfriBusiness by ETM Macro Advisors

Analysts and the media have lambasted the mini-budget presented to Parliament by Malusi Gigaba, finance minister, on Wednesday as demonstrating the current administration's lack of commitment to fiscal discipline. The most alarming revelation is that the government's total borrowing requirement over the next three fiscal years ending in 2020/21 will rise by nearly R1 trillion, taking gross national debt from the present R2,4 trillion to R3,4 trillion, and up to 60% of GDP from 50% of GDP in 2016/17. This is roughly R300 billion more in national debt by 2021 than was forecast in the February 2017 budget.

The chart that has captured most attention is the following one, because it shows a dramatic departure from the fiscal projections of the Pravin Gordhan Treasury as recently as February 2017.

Figure 3.1 Gross debt-to-GDP outlook without additional fiscal measures



Source: National Treasury

Now, the February 2017 budget delivered by Pravin Gordhan, former finance minister, was only 245 days ago. In this short time, have economic and political conditions deteriorated to such an extent that this picture seems to reflect? We think the answer is no.

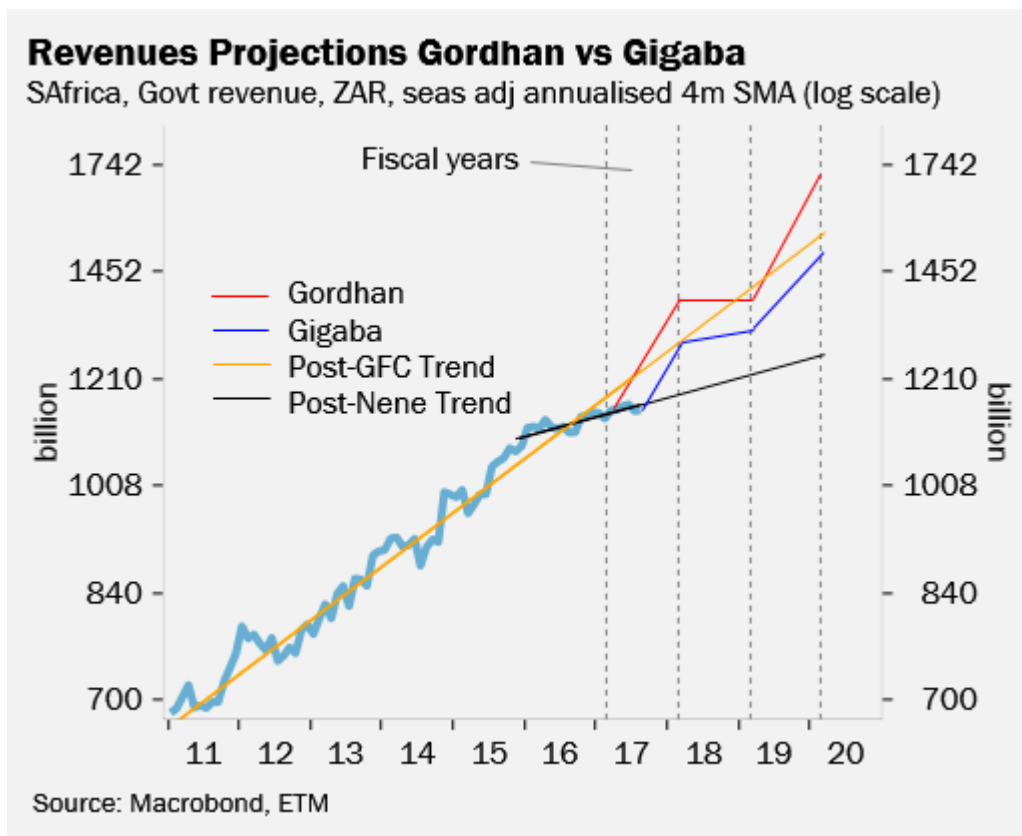
Eight months ago, as Gordhan was tabling his budget before Parliament, the economy was already in recession and tax receipts had already declined sharply from their mid-2016 peaks. Gordhan's Treasury was well aware of the difficulty of collecting more taxes from an already highly taxed economy. The core features of the country's structural growth decline had already been in place for years, thanks in part to Gordhan himself and the cabal of current or former Communist Party members at the helm of critical organs of economic policy.

Instead, the dramatic worsening in fiscal projections seems to represent a refreshingly more honest assessment of South Africa's fiscal situation under the Gigaba Treasury. Economic growth and tax revenue projections have been reduced significantly. The mini-budget report does not mince its words about the precarious state of the economy and the risk that South Africa may get caught in a "cycle of weak growth, mounting government debt, shrinking budgets and rising unemployment".

It turns out that Gordhan's projections for tax collection and economic growth for the 2017/18 fiscal year were hopelessly optimistic. If it were only optimism that would be one thing, but we think it was likely the use of fiscal smoke and mirrors to distort the real picture of South Africa's creaking finances. The smoke and mirrors were by and large removed in the mini-budget and, while jarring, this could be seen as ultimately constructive in the same way that being fully aware of a poor health condition is better than being unaware of it.

The other note of encouragement we would take from the mini-budget is that it did not strike an aggressive tone on raising taxes, but instead acknowledged that raising taxes could lead to lower compliance and a weaker economy and that further tax increases could be counterproductive. The minister projected that new tax proposals would raise an extra R16 billion in the next fiscal year, which is only around 0.3% of GDP and seems to imply that additional taxation will result from tweaks of the present tax system, rather than major and draconian increases. Of course, any higher taxes are bad news and unconstructive, and one must be prepared to for new and higher taxes to come from many different quarters.

However, while one can appreciate the benefits of more fiscal transparency in the mini-budget, one can equally lament the lack of understanding in government about how an economy grows. Moreover, one wonders if even Gigaba's more pessimistic projections could ultimately prove too optimistic. In the chart below we show tax revenue and projections under Gordhan and Gigaba as compared with an extrapolation of the trends since the sacking of finance minister Nhlanhla Nene in late 2015 and the 2008 global economic crisis. To achieve even Gigaba's 2017/18 fiscal year revenue projections will take an immediate marked improvement in revenue collection of around 15% by March. Moreover, this requires a profound improvement on the post-Nenegate revenue trend and a catch-up back to the post-financial crisis growth trend. Given the underlying assumptions of a tapped-out tax base and a weak economy, this appears like a potentially optimistic trajectory.



Additionally, as the mini-budget noted, Gigaba’s spending estimates remained unchanged from Gordhan’s. These forecasts notably exclude potential expenditure liabilities on unplanned SOE bailouts; possible legal liabilities for state medical malpractice (which have soared into the tens of billions of rand); Road Accident Fund insolvency; high public sector wage settlements; rapidly mounting unpaid provincial government invoices; and municipal bankruptcy.

Most worrying on the expenditure side is the seemingly total lack of desire to meaningfully reduce the size and scope of the state, a firm continuation from the Gordhan era. This leaves expenditure liability exposure in a particularly fragile situation. Combining this outlook with that of the risk of persistently low revenue growth, implies that even Gigaba’s alarming rise in the debt-to-GDP ratio could be a good-case scenario. And indeed, Treasury admits as much in a candid set of scenario forecasts laid out in the mini-budget document and the charts reproduced below. The chart on the right confirms that the mini-budget projection is quite close to Treasury’s best-case Scenario C. Alarmingly, Treasury’s scenario of a local currency rating downgrade and global downturn – hardly an outlandish scenario – causes the debt-to-GDP ratio to spiral into what would essentially be an outright sovereign debt crisis.

Figure A.2 GDP growth scenarios

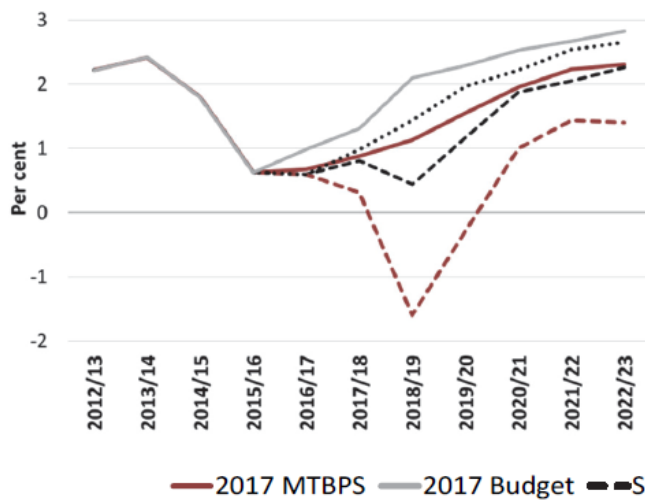
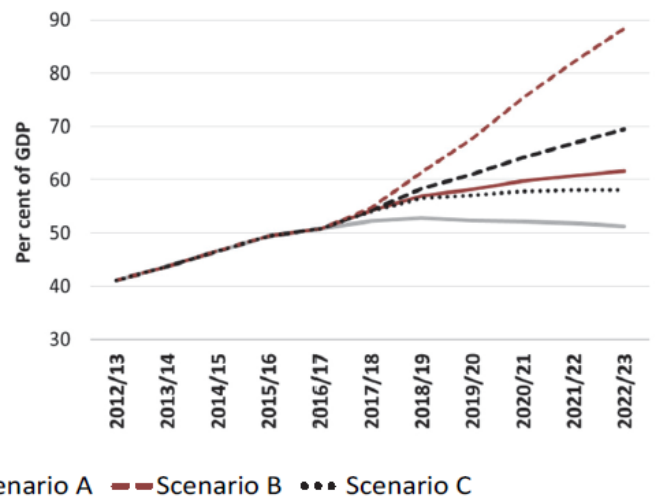


Figure A.3 Gross loan debt to GDP scenarios



Source: National Treasury

What is also noteworthy is that in each of the above scenarios Treasury does not at all consider spending cuts as a remedy for its fiscal stress. Instead, it implies that spending levels are sacrosanct to the detriment of financial and economic stability and the tax burden on the private sector. Once again there is an implicit honesty in this. The government is essentially saying in these scenarios that it is unwilling or incapable of reducing the size and scope of the state. The dramatic rise in debt-to-GDP in the weaker A and B scenarios may even imply that Treasury has built in a Keynesian 'stimulus' philosophy into its projections, which is yet more evidence of state hubris in these times and a continuation of the Gordhan era.

These elements are reinforced in the mini-budget's economic analysis and proposals to get the economy growing faster. In every instance, the proposed remedies are in our view either toothless or corrosive of growth and economic dynamism. This represents another continuation of the Gordhan era. Treasury keeps circling back to tried-and-failed concepts of forced income and wealth redistribution, state regulatory and fiscal intervention, industrial winner-picking, and economic xenophobia. These types of policies have been the bedrock of ANC economic policy in one form or another for two decades and are the very cause of economic dynamism grinding to a halt. They are not the cure.

How then should one react strategically to the mini-budget? We suggest three simple strategic takeaways for South African businesses and citizens.

1. If it was not obvious before, it should now be abundantly clear that doing business with government departments and being exposed to late or non-payment is becoming a potentially acute business cashflow risk. We would suggest that one consider putting in place or strengthening strategies to completely de-expose your business to reliance on government contracts and revenue. Tactical approaches would be to require full payment in advance or significant advance payments with extra retained cash to provide a buffer.

2. Secondly, it should be clear that the government will not be able to meet an increasing list of its promised financial and service obligations. Reliance on state services in the delivery of your product or service is becoming a growing systemic business risk and relying on the state to meet your personal needs exposes you and your household or community to significant lifestyle disruptions, health and security threats and added costs. It is critical to take the time to consider how you can 'state-proof' your commercial interests and lifestyle. This will likely come at an upfront cost but must be assessed against the potentially far higher costs of inaction.
3. Not only does fiscal deterioration heighten currency vulnerability, but it also places the central bank at risk of being used nefariously to print money to fund state financial gaps. Although the South African Reserve Bank is not presently used in this way, fiscal deterioration often begets monetary decline. This risk requires thinking about hedging one's exposure to the rand over the longer term. Foreign currency liabilities funded out of rand revenue streams make your business more fragile. Not owning inflation-protecting assets could lead to significant disadvantages. Understanding modern currency innovation like cryptocurrency is likely to prove useful.

In summary, the mini-budget was surprisingly honest. There are deeper questions as to precisely why the finance minister decided to depart from Gordhan's smoke and mirror ploy and show a more brutally honest and ugly fiscal picture, but we leave this riddle for another day. In the meantime, all are left to grapple with a very sobering fiscal and economic reality in South Africa, but we think that the benefit of this is that it can and should catalyse more urgent demand to state-proof your lifestyle, your business and your money.

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