SPECIAL BUDGET REPORT

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BUDGET 2021 -THE FISCAL SCENARIO REMAINS BRITTLE…

By Mike Schüssler, Consulting Economist to Brenthurst Wealth

Finance Minister Tito Mboweni delivered the 2021 National Budget on Wednesday, February 24, amid an economy that contracted the most in decades in 2020, poorly performing State-Owned Enterprises (SOEs), growing spending pressures due to the impact of the Covid-19 pandemic and ongoing pressures from international credit rating agencies that government should stem the tide of rising government debt.

Public finances have been in an unsustainable position for years, with government continuously spending more than the economy can afford, and consequently borrowing at an increasing rate to fund the shortfall. The outbreak of the Covid-19 pandemic just made the scenario even worse, as the combination of increased government expenditure to cushion the economy, amid a severe lockdown to stem the virus from spreading, and reduced revenue collection given the severe contraction in the economy resulted in a consolidated budget deficit to GDP ratio of 14% in FY21, the worst ratio since 1914's shortfall of -11.6% of GDP (1940: -10.4%).

If the country needs to borrow money to fund non-interest expenditure (as is evident from graph 1), the debt burden will continue to rise, as is expected for at least the next three fiscal years. Minister of Finance, Tito Mboweni mentioned in this speech that government endeavours to have a primary surplus in FY26, though it just falls outside of the MTEF time period and thus are not reflected in any of the printed tables.

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INSIGHTS INTO THE 2021 BUDGET SPEECH

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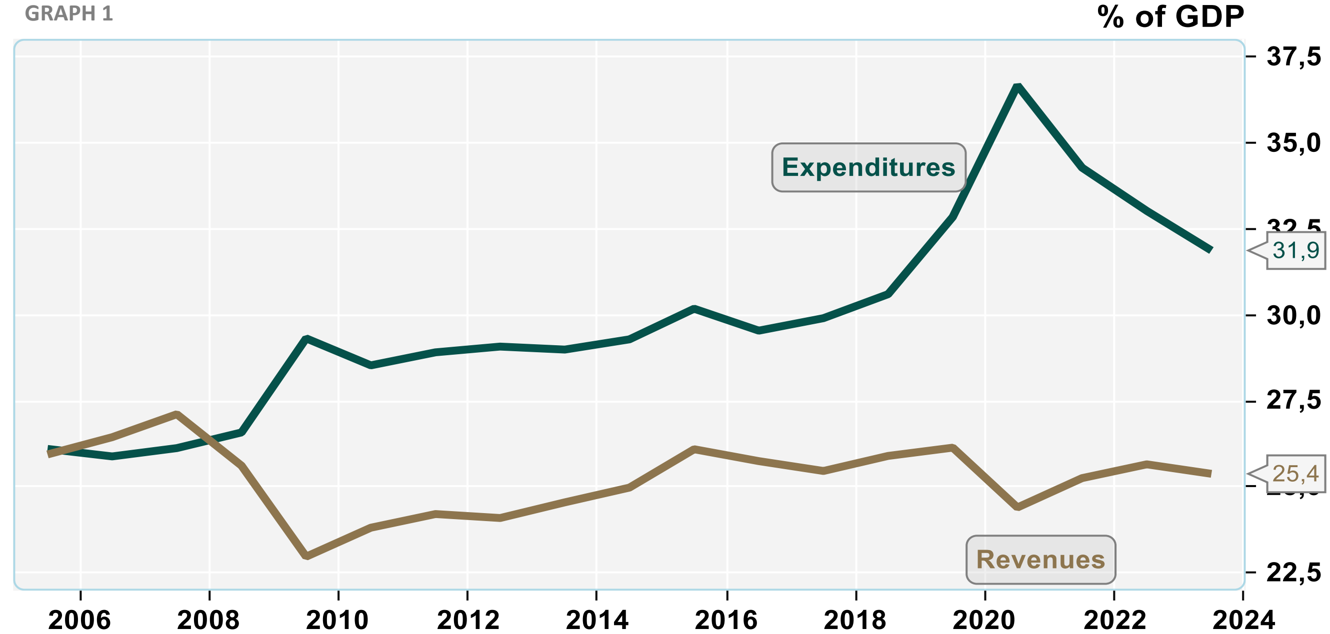
There are, however, multiple risks to this view, as it hinges to a large extent on an improvement in economic growth to foster tax revenue collection, whereas on the spending side, it depends crucially on government's ability to contain the ballooning state wage bill, which is by no means a given (especially in an election year…).

Should either of these expectations disappoint, the likelihood of the gross debt to GDP ratio stabilising around 89% of GDP (reflected as the base case in the budget), would become a distant dream and a worst case could still become a nasty reality for South Africa (think further credit rating downgrades, a possible debt default etc).

So, although the 2021 National Budget looks encouraging on paper, execution risk remains exceptionally high in a fiscal context described by the Finance Minister as "dangerously stretched". There are absolutely no room for complacency or celebration, South Africa's fiscal situation is certainly not out of the woods yet.

LONG TERM TREND IN MAIN BUDGET REVENUE VS NON-INTEREST EXPENDITURE AS % OF GDP

GRAPH 1



BrenthurstWealth / economistscoza / Treasury

THE NATIONAL BUDGET & YOUR INVESTMENTS

Director and investment strategist of Brenthurst Wealth, Magnus Heystek, with Brenthurst consulting economist, Mike Schüssler, and business and macroeconomic analyst Phumlani Majozi analyse the 2021 budget and share their insights.

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AWARD WINNING ECONOMIST

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BUSINESS & MACROECONOMICS ANALYST

BUDGET SPEECH REVIEW

WEBINAR: 25 FEBRUARY 2021 14:00 - 15:30

There are typically three options to respond to fiscal slippage, as witnessed in the past fiscal year:
1) Reduce government expenditure;
2) Increase tax revenue by either increasing the tax rates and/or tax collection;
3) Increase borrowing.

Typically, governments use a combination of these options to steer its fiscal outcome. However, in South Africa's case the scenario is plagued with complexities. To reduce government expenditure is politically unpopular as the ruling party and its followers got spoiled over the years by always getting more and more (in the form of social grants, SOE bailouts and above-inflation public sector wage increases), irrespective of whether the country could have afforded such an ongoing spending spree. To change this trend is obviously painful for the masses.

On the other hand, an ever-shrinking tax base has also been exhausted, thus increasing the tax burden is no longer a viable option for government. To increase the debt burden and subsequent cost of debt unduly, however, also has a double negative impact as the higher interest costs crowd out other much-needed state expenditure and a shrinking piece of the cake really gets to the economy in the form of expenditure on education, health, transport (thus expect an unenviable further deterioration in service delivery).

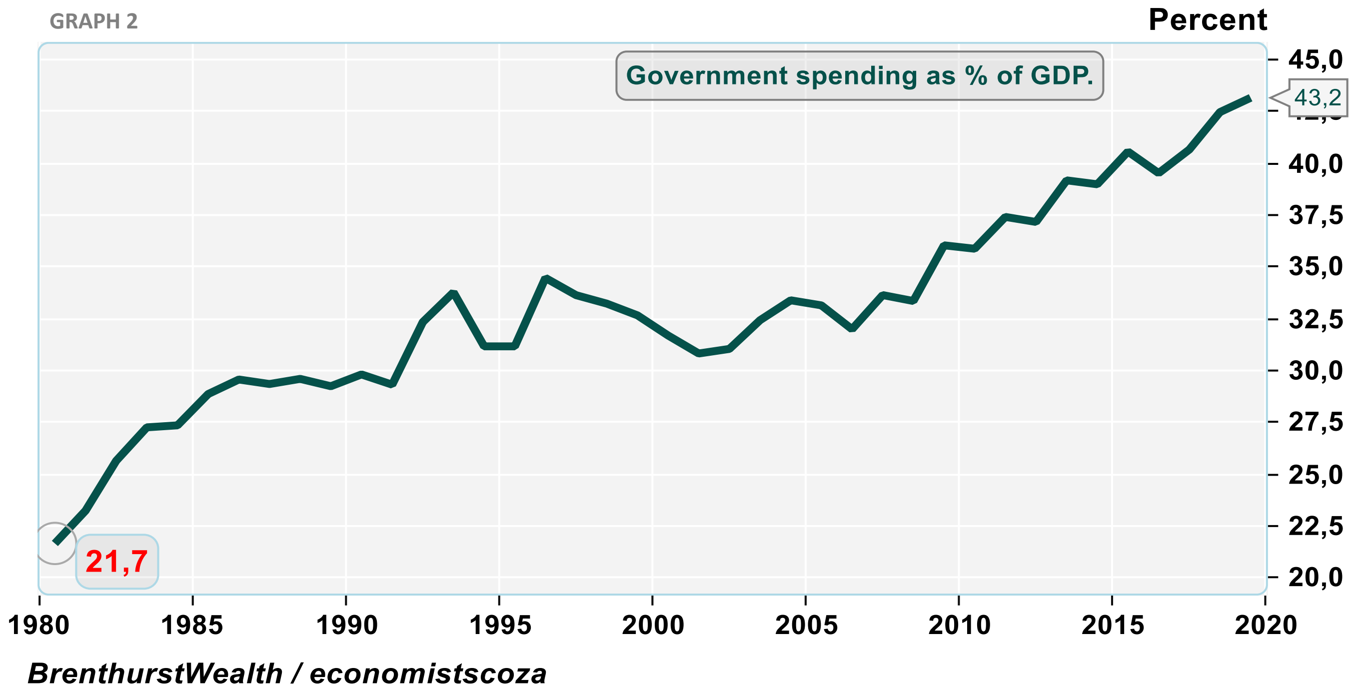
Furthermore, credit rating agencies are zooming into government's finances, ready to cut the country's sovereign credit rating further into sub-investment grade if they get the impression that government debt is on an irreversible upward trend, a scenario that increases the cost of debt even further and add to an ongoing vicious cycle, in which there are no winners.

For many years, government has been postponing the difficult task to tackle the thorny issues particularly relating to the skewed composition of state expenditure, hoping that by miracle, the economy would start to grow, and that the dire unsustainability would ease somewhat. The outbreak of the Covid-19 has certainly speeded up an end to the "kicking-the-can-down-the-road" strategy, as the road has reached an end.

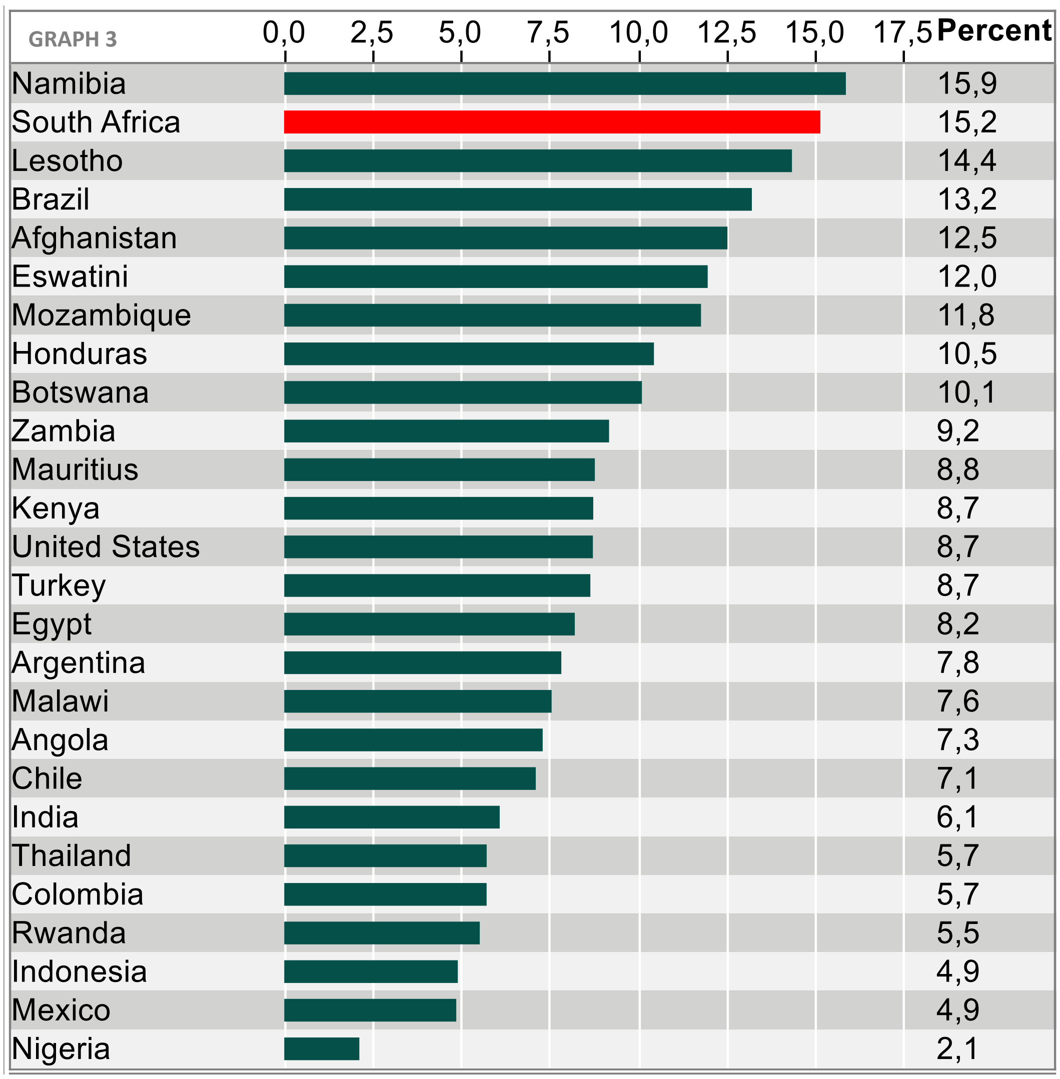
In this regard, there were some encouraging developments, particularly relating to maintaining a hard-line on the need to stabilise the state wage bill (which were introduced at the previous budget) and refraining from increasing the tax burden further. However, to change the fiscal structure is a medium to longer term project, which could take some more years (of taking a prudent approach) and the situation is still fragile at best.

To illustrate, an ever-increasing portion of tax revenue (21c out of each R1 tax revenue) will be used in FY21 to cover interest on state debt. Furthermore, if the compensation of employees (47c out of each R1 tax revenue) and transfers to households (read SASSA grants) are added, a mere 20c of each rand of tax revenue will be available for productive economic activity/service delivery. From a different angle, at current projections, debt service costs will, in nominal terms, exceed the health budget in 2021/22.
Clearly, an unacceptable scenario in a country with vast socio-economic challenges.

GENERAL GOVERNMENT SPENDING AS % OF GDP



GOVERNMENT COMPENSATION OF EMPLOYEES AS % OF GDP



General Government (or central government & local/ state combined)

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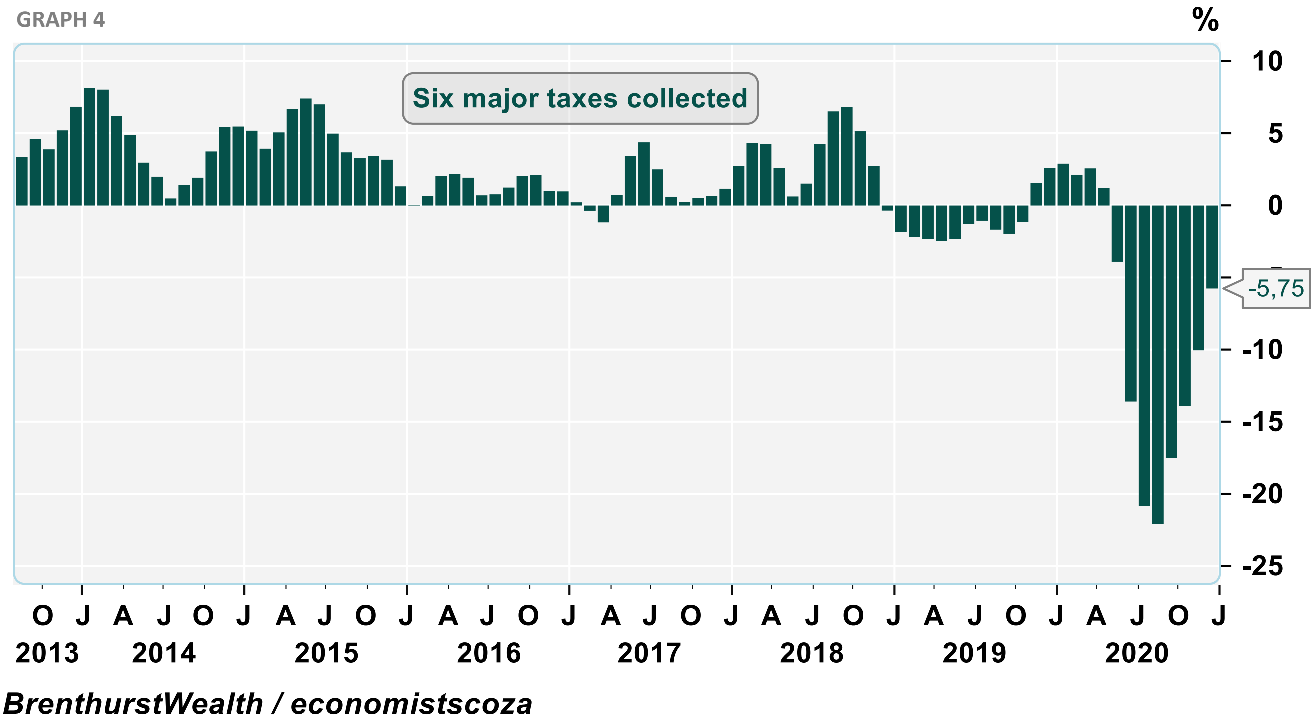
ZOOMING INTO REVENUE TRENDS

The impact of the COVID-19 economic contraction on South Africa's public finances will be felt for years to come. Government tax revenue amounted to R1.212trn in FY21 (R1.356trn in FY20), R213bn lower than what was expected at the time of the 2020 National Budget, the highest shortfall on record, as all major income categories (personal income tax, corporate income tax, excise duties and VAT receipts) were hit hard by the impact of the measures to address the Covid-19 pandemic.

The revenue shortfall in FY21 reflected tax relief measures amounting to R26bn in foregone revenue implemented as part of the COVID-19 relief package, but more significantly the shortfall reflects the tax base that has temporarily (or likely more permanently) shrunk as businesses closed and people lost their jobs. The latest Quarterly Labour Force Survey, released on 23 February, indicated that 1.4m employment opportunities were lost in 2020, while the unemployment rate spiked to 32.5% in Q4 2020. This also spells bad news for future revenue collection, as it will take some years for the job market and the broader economy to recover to pre-Covid levels.

ANNUAL CHANGE IN THE 6 BIGGEST TAXES COLLECTED (REAL)

GRAPH 4



It has become increasingly difficult to collect taxes in a declining economy, while the South African tax base is already beyond "over-taxed".

South Africa has the tenth largest overall tax burden of all countries with a population over one million people and ranks second highest if compared to the emerging market universe (see graph 5). Some may not believe it, but the database kept by the UNWIDER university is clear and concise for the general government.

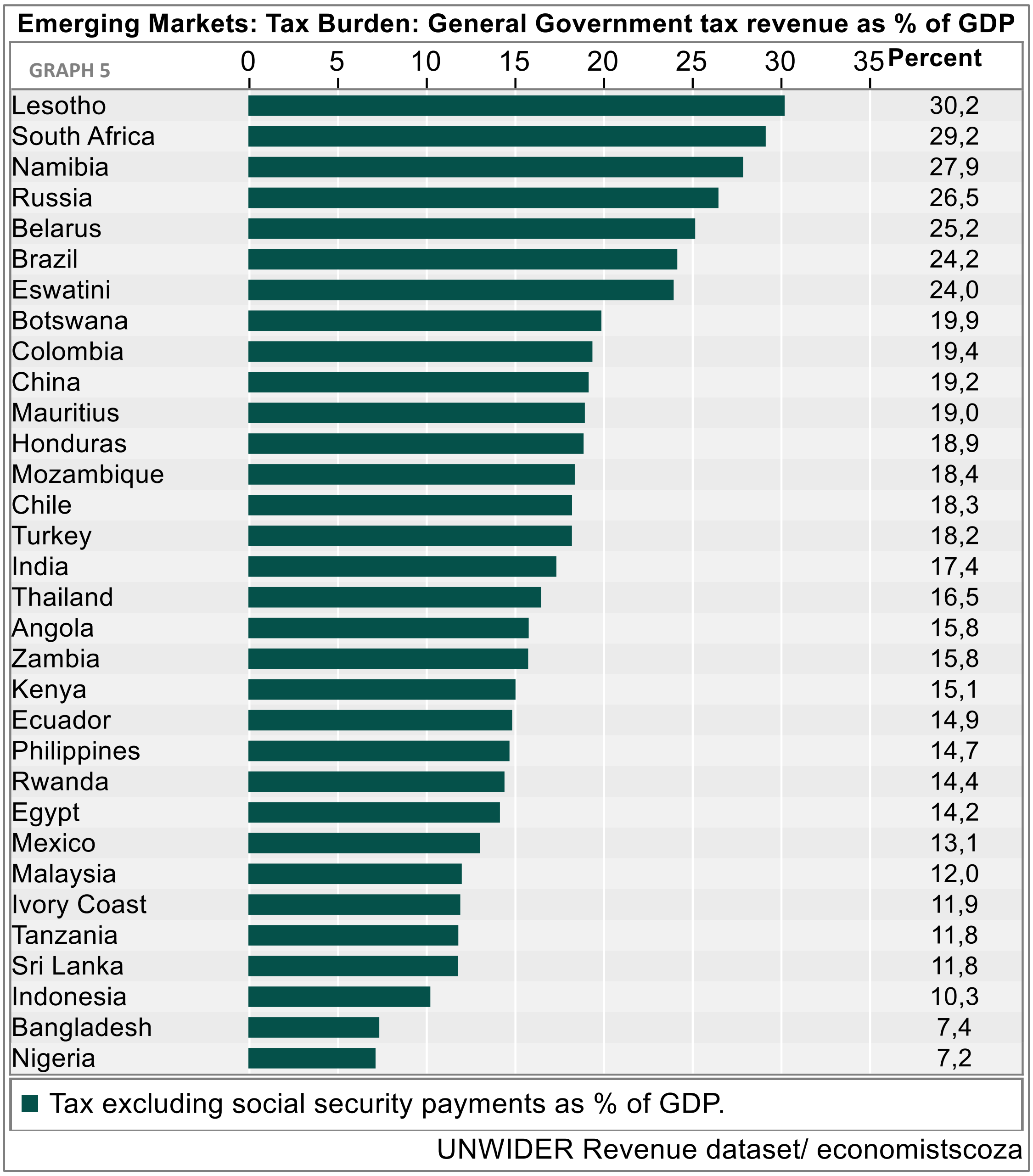
(General government includes all three levels of government plus agencies that do work on behalf of government such as ICASA.)

Moreover, the largest tax category, Personal Income Tax, is regarded as the most "progressive" in the world by none other than the esteemed OXFAM (Oxford Committee for Famine Relief founded in 1942). For the ratio PIT to GDP, SA ranks the 10th highest in the world.

South African Personal Income taxpayers are also very likely to be the smallest share of the population of any country for which data is available. This is easy to prove as our taxes start way above the median income and we have one of the smallest employed to population ratios in the world.

At present, about one in eight South Africans are registered for PAYE, while more than one in three receives a grant. Another way of analysing this data is that one in ten of the population is in the private sector and pay personal income tax, while one out of every two and a half people receive their income from the state. Clearly, this cannot economically be feasible for long.

TAX BURDEN COMPARISON AMONG EMERGING MARKETS



This background and the windfall in tax receipts relative to the October 2020 MTBPS expectations, probably explains why government has refrained from announcing major new taxes or notable increases in existing taxes. In fact, government has also retracted on previously announced tax increases worth R40bn, which were planned to be implemented over a four-year period. The major tax related announcements in the 2021 National Budget include:

- ⇒ **Personal income tax relief of R2.2bn given bracket creep relief (tax brackets increased by an above inflation 5%)**
- ⇒ **Steep increase of 8% in sin taxes (excise duties on alcoholic beverages and tobacco)**
- ⇒ **Increases in both fuel levy (15c/l) and Road Accident Fund levy (11c/l)**
- ⇒ **Introduction of an export tax on scrap metal**
- ⇒ **Announcement of a reduction in corporate tax rate in FY23 (from current 28% to 27%), as part of a broader revenue neutral corporate tax restructuring**

Still, given that it will take some years for the level of GDP output to recover to pre-Covid levels (according to our calculations, it will probably take until 2024), it will also take years for the tax to GDP ratio to recover. Furthermore, government did not help businesses much during the Covid-19 crisis, so do not expect to see tax morality recovering meaningfully anytime soon.

ZOOMING INTO EXPENDITURE TRENDS

Given the Covid-19 outbreak, government's spending priorities as proposed in the 2020 National Budget had to be shuffled as government prioritised saving lives and took the difficult step of severely restricting economic activity at a time when GDP growth was already weak.

South Africa, like other middle- and low-income countries without large savings, had to balance essential public-health interventions – such as prolonged lockdowns – with severe economic effects – such as job losses, lower tax revenue and higher poverty. In March 2020, government initiated a wide-ranging relief package to manage the immediate impact of the virus, which involved scaling up capacity in the public health system and mitigating the effects of restricted economic activity for households and businesses in the form of Temporary Employment Relief System and subsistence grants to unemployed people. The result of these extraordinary measures, among the "normal" expenditure trends, resulted in consolidated government expenditure increasing by a notable 12.6% to R2.053trn in FY21 vs R1.822trn in FY20.

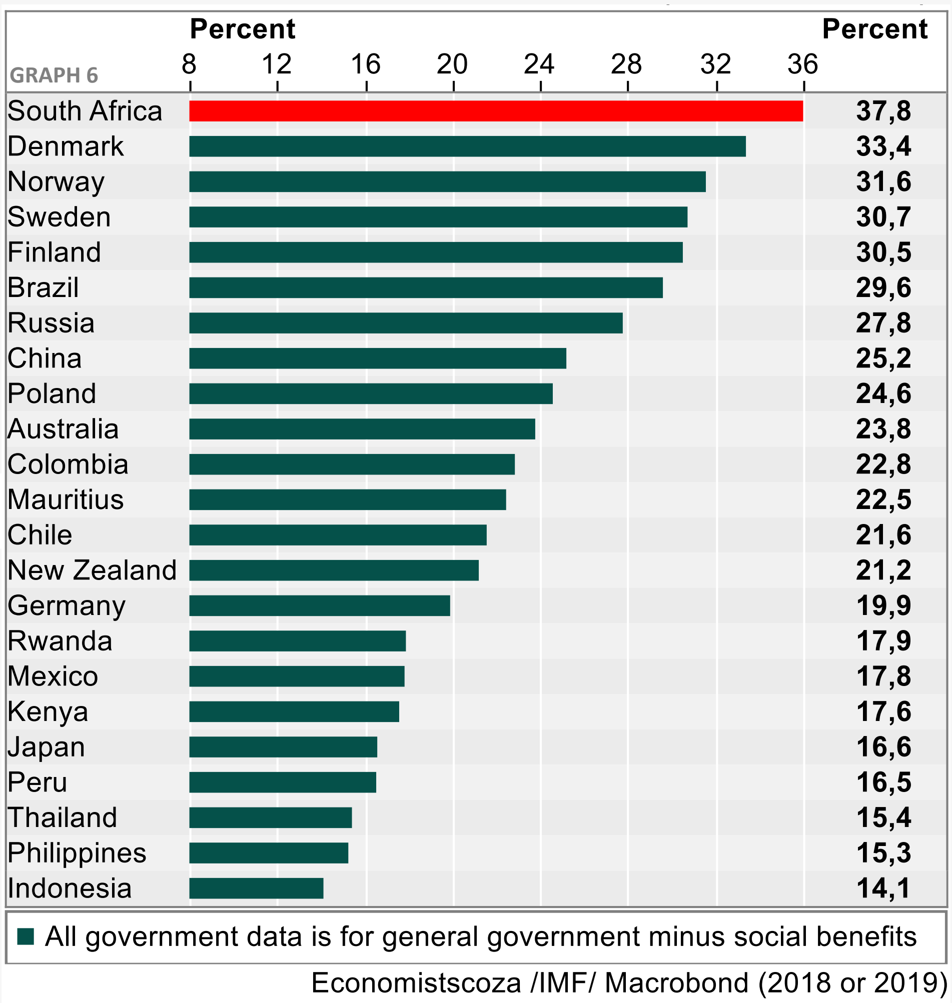
In the last few years South Africa has by far the highest government spending of all countries with data available on a general government level, if one removes social benefits such as SASSA grants and housing subsidies. The data shows that SA government expenditure represents a larger share of GDP than any Scandinavian country, EU member and any other country with comparable data. South African government expenditure is at least 10% larger than Denmark, which is the next in the ranks on government expenditure ex social benefits. Not that SA government social benefits are that low for a developing country either. This is probably the best indicator to measure the cost of government of the country. Not only does it include all three levels of government, but also agencies such as PRASA and SANRAL along with universities.

Not only the level, but also the skewed composition of state expenditure remains a thorny issue for the South African economy. If the compensation of public sector employees, transfers to households in the form of social grants and interest on government debt be added together, these three spending items account for about 80c of each rand of tax revenue received, with a mere 20c available for productive activity/service delivery in the economy.

Government, at least the National Treasury team, seems to have started to realise that this is unsustainable. Quoted from the supplementary Budget of June 2020.

"Over the medium term, compensation and debt-service costs would be the largest expenditure items, and outstrip the investments government makes in human capital, social and economic infrastructure, and service delivery."

GOVERNMENT EXPENDITURE (EXCL SOCIAL BENEFITS) TO GDP RATIO

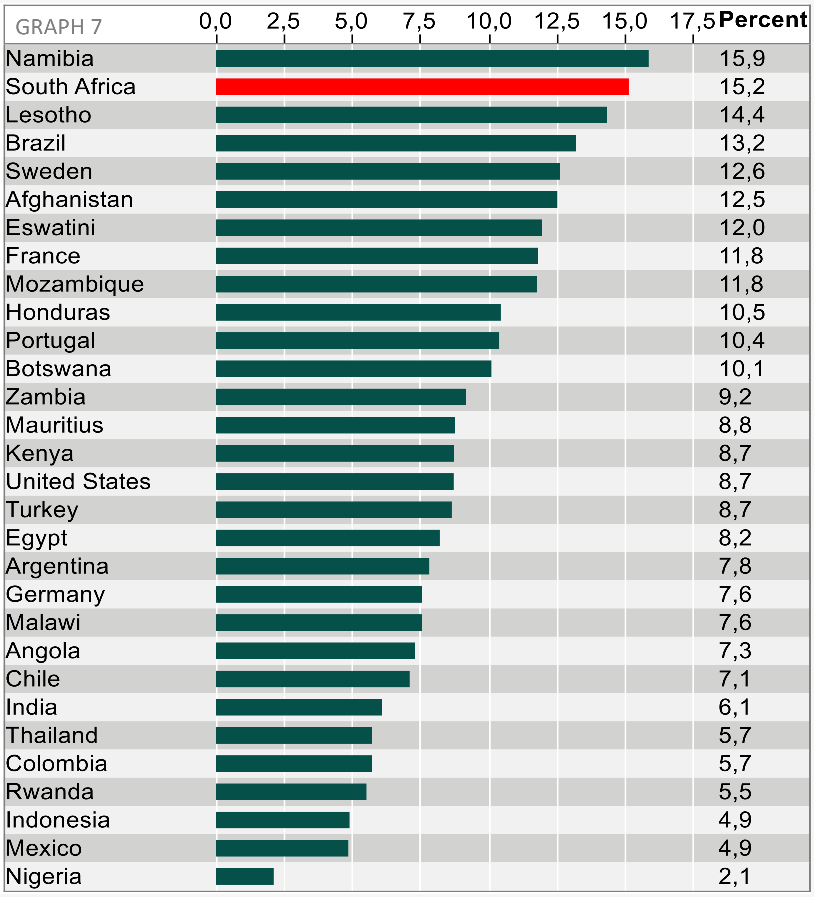


Compensation of civil servants as % of GDP in South Africa is the 2nd highest in the emerging market universe, while also among the top 10 countries overall, even higher than most EU and Scandinavian countries!

At the time of the 2020 National Budget (Feb 20), after five consecutive years of notable tax increases, government recognised that higher taxes will only harm the economy further and opted to focus its fiscal stabilisation efforts on significant expenditure reductions, the bulk of which would have to come from a notable reduction in the public sector wage bill over the medium term. While it was generally welcomed as the first step in the long road to return South Africa's fiscal position to a healthier state, we all knew it will be an uphill battle.

Following a strenuous process, the Labour Appeal Court recently vindicated government's decision not to implement public sector salary increases of between 4.4% and 5.4% in April 2020 (part of a three-year wage agreement, which was signed by the government and trade unions in 2018), based on its view that the increases were unaffordable for a fiscus that has deteriorated markedly due to the Covid-19 pandemic. However, trade unions representing public servants have digged in their heels and have escalated their fight with the government over inflation-beating salary increases to the Constitutional Court, adding another twist to a protracted wage dispute that has the potential to completely derail the fiscal framework presented.

COMPENSATION OF GOVERNMENT EMPLOYEES AS % OF GDP



The court ruling did strengthen the hand of Finance Minister Tito Mboweni (at least in the near term), who effectively proposed a three-year wage freeze to cut government spending by R300bn and bring ballooning state debt under control. In the light of these developments, it was heartening to note that Mboweni did hold the line on the wage stabilisation proposal when he presents the 2021 National Budget, though the execution risk of his plan remains very high as a new multi-year wage agreement still needs to be negotiated between trade unions and government in coming months and it likely to be a fierce affair.

General Government
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ZOOMING INTO SOE ASSISTANCE

Though details were thin, another round of bailouts shines the light on one of South Africa's crucial fiscal pitfalls i.e. under-performing SOEs, many of which are unable to operate as stand-alone businesses and are dependent on ongoing state handouts. Not only bailouts as part of government expenditure, but also the fact that government has guaranteed large portions of SOE debt, which could become part of government's debt obligations in the event that a SOE fail. Government's guarantee exposure consists of the sum of the outstanding value of loans, accrued interest and adjustments to inflation-linked bonds. The total amount of approved guarantees is expected be R581bn by the end of March 2021, with Eskom constituting the largest exposure, at 77.2%. Incidentally, government has referred to this as one of the risks to the fiscal framework as presented.

"The medium-term debt redemptions of state-owned companies total R182.8bn. Without rapid improvements in financial management and the resolution of longstanding policy disputes – including the user-pay principle – they will continue to put pressure on the public finances."

INDICATIONS OF SUPPORT TO SOES INCLUDE:

Land Bank – the Bank was allocated R5bn in 2021/2022 and R1bn in each of the following two years for the process of recapitalisation.

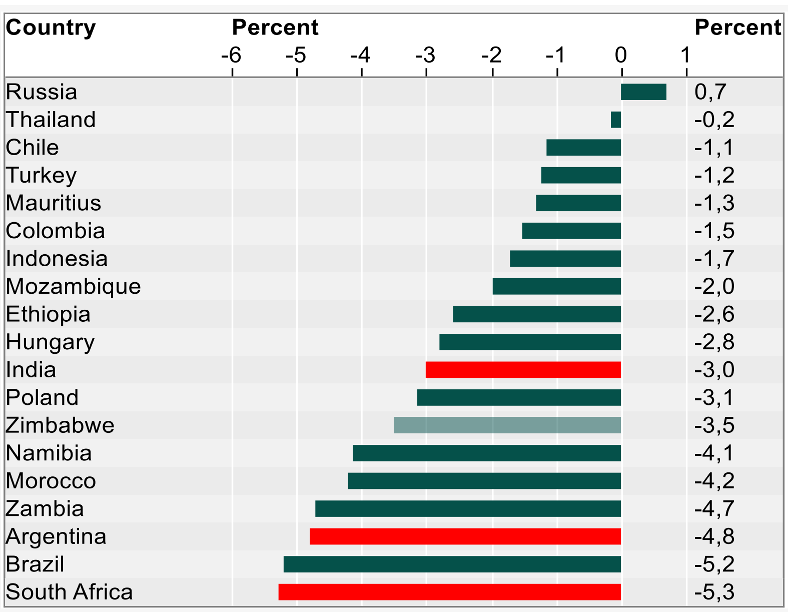
SAA has made a plea for more money, asking for another R3.5bn from the budget, but finance minister Mboweni has said he is yet to decide on the validity of the request. The additional funding is required to fund the business rescue process, the cost of which has risen from R10.5bn, when originally agreed, to R19.3bn, the Treasury said in the Budget Review. No surprise that was considered to be the last payment to SAA, was clearly not the last payment into the black hole.

Eskom, which is on a programme of annual rolling bailouts from the Treasury, was allocated R31.7bn in the budget vs support of R56bn in 2020/2021. In February 2019, government said it would provide R23bn a year in support, but this has in the meantime morphed into larger amounts in a stopgap approach to Eskom's debt crisis as the energy company has accumulated R488bn of debt, which it is unable to service from operations. In the absence of a plan to deal with Eskom's mountain of debt, the utility is likely to remain a drag on South Africa's finances for years to come.

BUDGET DEFICIT AND DEBT LEVELS

Given that government has for years now continue to spend more than the economy could afford, while ever so often having to bail out under-performing SOEs, the fiscal shortfall has grown in size as has borrowing to balance the books and subsequently government debt levels have spiked in recent years. Obviously, the outbreak of the Covid-19 pandemic just made the scenario even worse, as the fiscus was hit by a double whammy of having to increase expenditure to address the unfolding health and economic crisis, while tax revenue simultaneously plummeted. The consolidated budget deficit to GDP ratio of 14% in FY21 is the worst ratio since 1914. In fact, for near a decade SA has run one of the highest budget deficits in among emerging markets, clearly suggesting that "living-above-our-means" have long been the norm in South Africa.

To finance the ongoing shortfall on the budget, government borrowing has escalated notably in recent years, to the extent that international credit rating agencies have seen red and cut South Africa's sovereign credit ratings into sub-investment grade (or "junk status") to reflect a growing risk that the South African government might not be able to honour its obligations to lenders in future. This unenviable reality has the added negative consequence that bond investors demand a higher return for lending to the South African government, resulting in rising bond yields, despite very low local and international short-term interest rates. In Government's own words…quoted from the Supplementary Budget in June 2020…" Even as South Africa responds to the current health and economic crisis, a fiscal reckoning looms. The public finances are dangerously overstretched. Without urgent action in the 2021 budget process, a debt crisis will follow. Failure to contain ballooning debt and debt-service costs, and narrow the budget deficit, would damage the country's long-term economic prospects." Gross government debt as % of GDP escalated to 80.3% in FY21, from 63.3% in FY20, a significant spike. In the 2021 National Budget, government has projected that the government debt to GDP ratio will stabilize at 88.9% in FY26 (somewhat lower than the MTBPS estimate of 95.3%), but the projection is subject to multiple risks (e.g., economic under-performance, state wage deal deadlock, higher interest rates, lack of political support etc) and the jury is out on whether it will be attainable.



10-YEAR AVERAGE OF GOVERNMENT BUDGET BALANCE AS % OF GDP

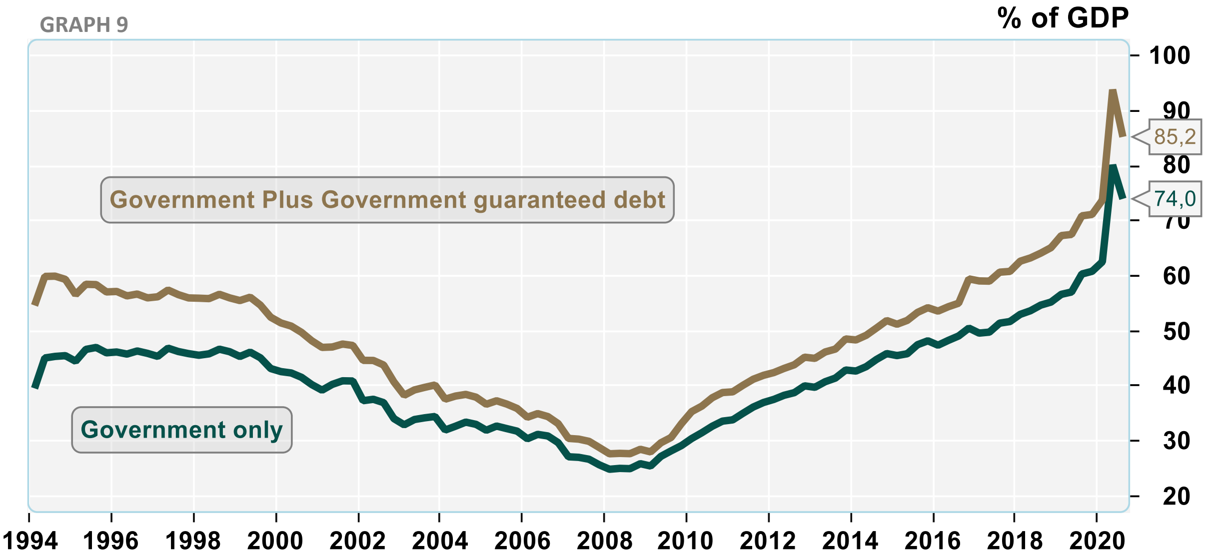
GRAPH 8

Budget balance % of GDP.
Pink indicates estimates for 2019

Economistscoza / IMF / budgetdata national sources, Macrobond

SA STATE DEBT AS % OF GDP OVER 27 YEARS

GRAPH 9



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MACROECONOMIC IMPACT OF 2021 NATIONAL BUDGET – IN A NUTSHELL

ECONOMIC GROWTH – On balance the budget could be considered marginally growth-friendly, specifically given personal income tax relief worth R2.2bn following bracket creep relief i.e. an above inflation adjustment to tax brackets. Also, the focus on infrastructure spending and job creation programmes could add to growth while ample allocation for the country's vaccination drive should also support the economic recovery. We believe that the growth in GDP for this fiscal year may surprise a little on the upside, but more reform is needed for substantial structural growth changes.

HEADLINE INFLATION – The cumulative increase of 26c/l to be recovered in fuel prices effective April 2021 (an increase of 15c/l in fuel levy and 11c/l in the Road Accident Fund levy) in combination with an 8% increase in excise duties on alcohol and tobacco products will be slightly inflationary. Headline CPI is forecast to average 4.2% in 2021 vs. 3.3% in 2020.

RAND EXCHANGE RATE – Following the initial positive reaction with the rand exchange rate strengthening somewhat following the release of budget info, gains faded quickly, and the rand is more likely to be driven by global than local factors in the foreseeable future i.e. in the bigger picture the Budget is probably a non-event in forex markets.

BOND MARKET – The better than expected revenue collection for FY21 have bumped up the government's cash balances and will result in National Treasury reducing its bond issuance this year, which should relief some pressure off the bond market. Expect a positive reaction on the bond market given the reduction in supply.

CREDIT RATING AGENCY VIEWS – Sticking to a path of fiscal consolidation via expenditure restraint will likely satisfy the credit ratings agencies in the short term, though implementation of the proposed fiscal framework is key and government will be watched closely to see if implementation follows from what seems to be a credible plan.

AWARD WINNING ECONOMIST JOINS BRENTHURST

AWARD WINNING ECONOMIST, MIKE SCHÜSSLER JOINED 2020 TOP WEALTH MANAGER BRENTHURST WEALTH AS A CONSULTING ECONOMIST TO PROVIDE HIS EXPERT ECONOMIC INSIGHT AND ANALYSIS TO THE COMPANY'S CLIENTS AND ADVISORY TEAM.

Mike's innovative research on employment and household issues has earned him much praise. He is the most quoted and endorsed economist in SA for his insights from Academia to Analysts the world over. His innovative approach has led to new economic measurement indices and management tools such as Transport cost adjustment and logistics indices, the BankservAfrica transaction index and the ABSA SMME Index. Mike has won the Economist of the Year competition twice; one of only three economists to have won this competition more than once in the past 25 years.

INSIGHTS INTO THE 2021 BUDGET SPEECH

The highly anticipated National Budget announced by the Minister of Finance on 24 February 2021 gave South Africans some idea of the government's plans to revive the economy and address the poor state of the government's finances. The response to the budget was mixed but the concern about the road ahead is universal. What does the Minister's approach mean for investors?

Speakers Magnus Heystek, Mike Schüssler and Phumlani M Majozi reviewed the budget and shared their analysis in the Brenthurst Wealth 2021 National Budget Webinar. If you missed the event, or attended and want to view it again, **find the recording here:** **2021 Brenthurst Wealth Budget Webinar**

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