Business applauds Manuel's tax cuts

Elements of Thatcherism in the budget herald a change in tack from active industrial policy and Gear to a purer approach,

writes **Greta Steyn**

FINANCE Minister Trevor Manuel ended his budget speech yesterday with a quote from African socialist revolutionary Amilcar Cabral. He could also have included a quote from Margaret Thatcher or Ronald Reagan, the western leaders whose names became synonymous with supply-side economics in the 1980s.

Tax cuts to stimulate the production side, or "supply" side, of the economy are a key element of supply-side economics. Yesterday's cut in the company tax rate from 35% to 30% is a classic supply-side move, designed to get companies spending on investment in plant and capacity which will, in turn, generate economic growth and jobs.

The move, which has deservedly elicited effusive praise, forms part of an interesting change of tack. Government appears to have ditched active industrial policy in favour of a purer approach; existing tax breaks for investment spending as well as tax holidays will not be renewed when they expire on September 30 this year.

These targeted tax breaks were included in the growth, employment and redistribution (Gear) strategy, which appeared to favour a more active industrial policy. Now government has turned its back on that more interventionist approach, siding instead with the Katz commission on taxation.

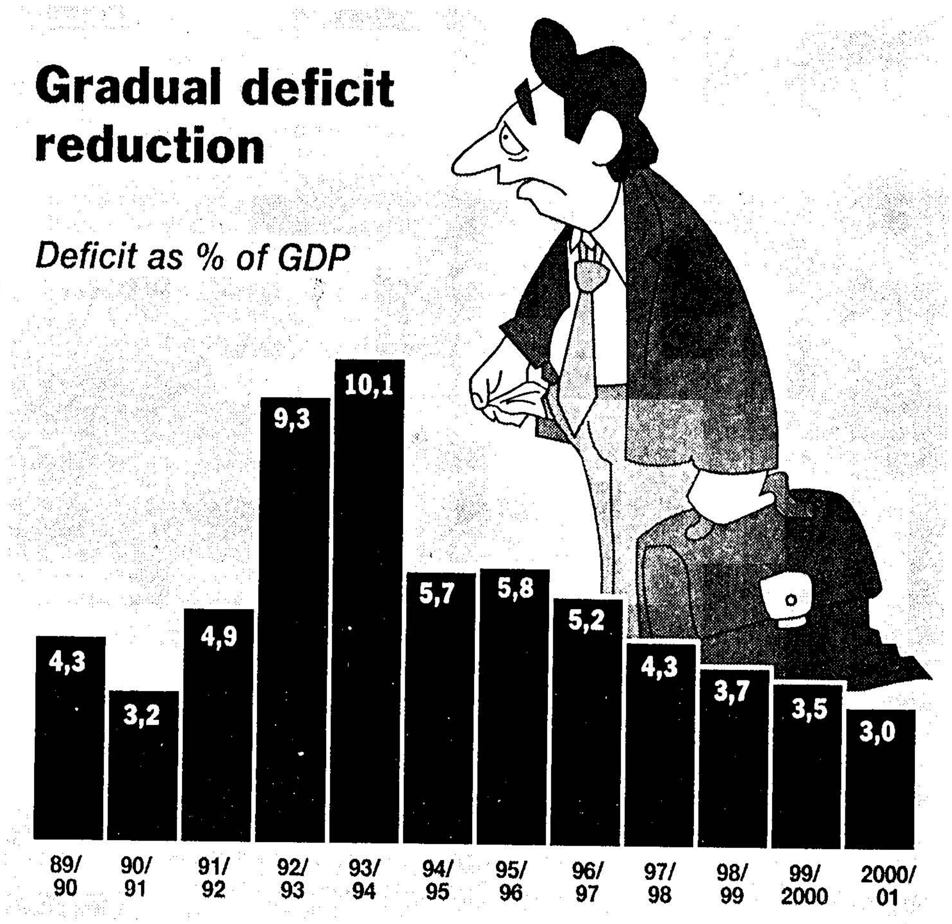
The budget review says: "Government aims to eliminate special tax preference schemes which only benefit particular industries or narrow sectoral interests and which, in the long run, compromise horizontal equity." This is an important policy statement as it differs from Gear.

Purist economists would argue in favour of a neutral tax system with no exceptions as a means to arrive at the most efficient allocation of resources.

But aside from economic theory, there are practical arguments in favour of doing away with exceptions such as those that are now in place. The more exceptions there are to the corporate tax system, the more clever schemes there will be aimed at outwitting the tax man. Moreover, the administrative burden is obviously bigger the more fine print there is.

Government deserves credit for ditching an interventionist industrial policy approach and following a more modern policy; no doubt foreign investors have sat up and taken notice.

Where that leaves Gear, which appears to be in tatters anyway, is a different story.



Graphic: KAREN MOOLMAN Source: RESERVE BANK

Perhaps lip service will be paid to industrial policy, but there is no sign of any substantial resources going towards that kind of interventionism."

When government cuts taxes as it did yesterday, the question is always what else it could have done with the money. In economics, there are always trade-offs; it might be a cliché to say so, but fiscal policy is a balancing act — a question of give and take.

If Manuel had been intent on cutting the deficit to 3% of gross domestic product (GDP), as had been the original plan, he could have used the extra revenue to reduce the deficit — instead of cutting taxes.

No one was expecting a cut in the company tax rate. No one would have been disappointed if it had not happened.

Manuel could have used the R2,5bn that he is giving away to the corporate sector to produce a more impressive deficit before borrowing. That amount, plus a tiny bit here and a little bit there, could have yielded a deficit of 3% of GDP.

Manuel made deficit reduction his mantra when he took over as finance minister in 1996. It was his one refrain, repeated over and over like a hypnotist hoping to lull those capricious dealers in the financial markets into a sense of security about SA.

As a former outspoken socialist who did not boast the Harvard education in economics that many of his counterparts in Latin America have, it was essential that he establish his credentials as a fiscal disciplinarian of the first order.

In a globalised world where a fiscal deficit of 3% of GDP is by no means small, SA's looming debt trap and profligate provinces went down like a lead balloon. But more than a publicity stunt, deficit cuts are a necessity to get out of the debt trap.

Spending on the interest bill at national and provincial level is budgeted to surge almost 11% in the next fiscal year — compared with the increase of about 4% in non-interest spending. Obviously, borrowing just to service state debt is preventing government from spending more on other things, such as social services, infrastructure and fighting crime. Government has no option but to borrow less and go all out to reduce state debt if it wants more room to manoeuvre.

Moreover, SA has a shockingly low savings level and government can improve the situation by cutting the deficit. To the extent that government borrows long-term capital to finance current expenditure, it erodes SA's available savings and reduces the amount of capital available to corporate borrowers. Public sector dissaving — the extent to which savings have been used to finance consumption expenditure — is projected at R10,5bn in the 1998-99 fiscal year.

Although dissaving has fallen, it is still a problem which is all the more acute because foreign capital has become scarce and parastatal borrowing is on the rise.

Manuel chose to spend the R2,5bn he had to spare on cutting corporate taxes rather than making a radical dent in the deficit. Far from making a fetish out of the deficit, Manuel has shown an impressive ability to adjust to radically changed circumstances.

With the economy in an unexpected recession, business confidence in the doldrums and foreign direct investment conspicuous by its absence, an imaginative move was required.

Manuel delivered by cutting the corporate tax rate. He struck a perfect balance between fiscal prudence and kickstarting the languishing economy.

The personal income tax relief announced yesterday will help stimulate the economy at a time when a shot in the arm is desperately needed.

Manuel's approach to personal income tax is highly redistributive; in this sense he cannot be accused of being a Thatcherite despite his move on corporate taxation.

Of course, none of these imaginative tax changes would have been possible without the huge amounts of extra revenue being harvested by the SA Revenue Service. Despite an economic recession, revenue has remained unbelievably buoyant.

The achievement is, in Manuel's words, phenomenal. It is in line with an overall approach to squeeze as much as possible from government's available resources. Where there is fat, Manuel is finding it and using it.

The focus on the spending side is also moving increasingly towards improving efficiency rather than throwing money at the problem. Hence social spending is budgeted to fall slightly as a percentage of the overall budget to 46,2% by the 2001-02 fiscal year from 47,7% in fiscal 1998-99.

The use of the financial surplus of the political risks insurer, Sasria, to reduce government's overall borrowing requirement is further evidence that all the resources that the state can lay its hands on are being used.

Ironically, the use of the Sasria fund is seen in the markets as privatisation, when in fact it is actually nationalisation. Government's private sector partners in the fund were less than keen to part with it. The challenge for government is to make progress on real privatisation, but Manuel can nevertheless not be faulted for using everything he can lay his hands on.

The trouble is that there will be an end to the efficiency gains and the once-offs. By their very nature, these gains cannot last for ever and there will come a point when the tax system will respond to the economic cycle in the normal way.

When that point comes, overspending as occurred in the previous fiscal year will be glaringly apparent. Many departments face drastic cuts in spending; past experience suggests some of them will overspend.

However, even though challenges remain, they have become fewer and fewer. Provincial finances have been brought under control, the deficit has been cut and a kickstart provided for the economy. The budget is much more transparent than in previous fiscal years, with off-budget spending funded by foreign donors now shifted on budget.

Manuel could be faulted for doing nothing on exchange controls, but that is not likely to be a big issue. No one really believes that free and unfettered capital flows have to be pursued at all costs in the midst of an emerging markets crisis.

Full marks to Manuel for showing that revolutionaries can be prudent economists too. As Margaret Thatcher would say: "It's a funny old world."