Economy & Business

BOARD OF ECONOMISTS

MANUEL'S FINE BALANCING ACT: INVESTOR SPUR VS SOCIAL NEED

But can government's fiscal conservatism bring needed growth?

The *FM* Board of Economists assesses the Budget and its aftermath. Members this time are Sandra Gordon (chief economist, Nedcor Investment Bank Asset Management), Brian Kantor (UCT) and Kau Msimango (corporate economist, Iscor). As always, Raymond Parsons, now of Wits University, puts the questions.

***Parsons:* Broadly speaking, was the Budget speech one of "indicate left, turn right" or vice versa? Or was the balance spot-on?**

Kantor: The road had been well marked in advance. I'm filled with admiration at the ability to make and meet the plans, which are supply-side and designed to attract foreign savings because the key presumption is there aren't enough domestic savings. Revenue growth has been significantly better than expected, and this has given the opportunity, after some severe restraint, to raise non-interest expenditure. That is a legitimate reward for fiscal conservatism. The plan for non-interest expenditure going out is also highly conservative, which will be a major contribution to economic efficiency, releasing resources for private use.

Gordon: One theme of recent Budgets has been a careful balance of the competing objectives of creating an investment environment, yet addressing social issues.

Msimango: I continue to be impressed by the credibility in detail of the Budget.

***Parsons:* Are you comfortable with a fiscal deficit target of 2,2% by 2002, when government "dissaving" will be eliminated? Is this still important?**

Gordon: Dissaving is probably more important than the deficit, so the trend towards reducing it is positive. I don't think there's any need to accelerate the rate at which the deficit is coming down. Government has to retain broad support for the whole restructuring process.

Msimango: I'm comfortable with a fiscal deficit of 2,2%.

Kantor: It's the right idea to raise government investment spending. Roads and bridges and dams and things like that are productive, and investment spending financed by government borrowing is an old-fashioned virtue. Primary Budget surpluses are growing substantially — that is, government revenues in excess of government expenditure net of interest — and that means government debt as a percentage of GDP is falling, which has helped reduce the interest expense. The strategy is to bring down that expense to have government spending on more popular things. The risk is that fiscal conservatism is not seen to deliver — by which one means economic growth. But the numbers on growth and planned-for capital inflows are conservative.

***Parsons:* Will fiscal planning and spending allocations translate into more effective "delivery"? Why are there such widespread negative perceptions about delivery?**

Msimango: There is a concerted effort to keep up the capacity of all government institutions to deliver. Provincial governments had problems with deficits last year, but now they're in good shape. There's delay in delegating to local authorities, which can't yet deliver on certain aspects of social services. There are negative perceptions about the quality of spending. If you look at education, for example, is it aligned to the skills we need? Such doubts will persist. Accountability and transparency are important issues, as well.

Kantor: The one area where there has been effective delivery is revenue collection. Delivery means more than money, though, it means management capacity, and clearly there have been major problems with the transition to black management in the public sector. Some of the people originally appointed didn't have experience or track records. Now, one is seeing a more meritocratic and effective system of appointing management — and Cabinet Ministers, as well.

Gordon: The first phase was creating the framework for reallocating resources. Now we're moving into the second phase: the efficiency of the resources available to government. I hope the next couple of years will establish credibility in delivery.

Msimango: The clustering that's happening among government departments will eliminate contradictions in policies.

Kantor: The most effective delivery to the poor is giving them cash, especially in the rural areas.

Parsons: **Will the reduction in personal tax change the structural pattern of savings and consumption? To what extent does it address fiscal drag?**

Kantor: Bringing down inflation is the most important contributor to reducing fiscal drag. Marginal tax rates are still high and kick in too soon. There's a gradual move to broaden bands, raise thresholds and reduce marginal rates. I would like to see more of that. Savings in SA are almost all corporate and are bound to go up strongly this year because corporate earnings will rise strongly through this upward swing in the business cycle.

The risk is that fiscal conservatism is not seen to deliver — by which one means economic growth

Brian Kantor

Gordon: The Budget is not enough to create major structural change, but it's definitely a first step in the right direction.

Msimango: We're coming from a period where interest rates peaked at 25,5% and people accumulated debt just to maintain living standards. Probably nearly half the latest tax relief will go towards debt servicing; after that, it will be consumed. In the absence of a social welfare system, many people continue to cross-subsidise.

Kantor: I'm surprised that we emphasise personal savings. South Africans own corporations which save on their behalf, so to understand savings, you have to understand what happens inside financial institutions. The return to savings within those has been affected by taxes. You don't want to undermine the savings system.

Gordon: Where would you want government to put the emphasis to increase savings? I concentrate on individuals because I know we tend not to save.

Kantor: We do save. We put nearly 17% on average of formal-sector incomes into pension funds. That's probably enough; what happens after that is largely irrelevant. Savings are a function of income. Tinkering with the tax system doesn't make much difference.

Parsons: **Should more be done to promote savings? Would you raise Vat?**

Gordon: We knew that in this year's Budget the main theme was to be tax relief and we've heard that the main theme next year will be the savings industry. There isn't a culture of savings among individuals in SA. We've made a couple of steps in the right direction, but not enough. Introducing capital gains tax has been seen as a front-runner to raising tax rates on retirement funds, which would level the playing fields and remove what many see as a disincentive to saving. But if you want to encourage the man in the street to save, you will probably have to make savings bank deposits tax-free; you'll have to get creative in ways of locking together individual savings. Vat will ultimately have to be hiked as government moves away from direct to in-

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direct tax. When it is happier with the social security net, there will be scope for that. Also, it'll have an impact on inflation, already rising because of high oil prices.

Kantor: We should recognise our strengths: an amazingly well-developed system of contractual savings which would be the envy even of developed countries. Vat is only mildly regressive. This idea that some taxes are more or less regressive than others is a bad idea. The tax system has little to do with the distribution of income.

***Parsons:* So you would raise Vat?**

Kantor: No, not if I were a politician. It's a judgment largely about how efficiently you collect taxes. We have effective collection of taxes through Paye (pay as you earn). The Vat system is complicated, it takes a lot of bookkeeping, it's tough on small businesses. In this Budget, we have an increase in the fuel tax that'll raise an extra R700m. That's an indirect tax. They'll look for things with low collection costs and not too much refinement of principle.

Msimango: It will be politically difficult to justify raising Vat. If government tries to compensate the poor through increased social security, the problem is that there has been a lot of fraud there.

Kantor: You don't have to raise the rate, you can just remove exemptions. Most food is eaten by rich people, but poor people will object because their costs will rise. You may offer them cash in exchange, but they won't believe you.

***Parsons:* How substantial are the arguments behind a capital gains tax? Or are they mainly symbolic?**

Kantor: The Minister didn't make much of the redistribution effects. He referred to technical reasons to discourage arbitrage between income and capital gains. At these rates of tax, there is still an incentive to convert, but I think the real reason is to become internationally respectable. Most major industrial countries do it. It's a complicated tax and will be expensive to collect. It's a pity because most capital gains accrue within financial intermediaries and the benefits are paid out in pensions. So it was an incentive to the contractual savings industry that has gone. But it encourages buying and holding, which is not a bad idea: the incentive is to achieve nontaxable, nonrealised capital gains and maybe raise debt levels to consume off them and expense some of the interest.

Msimango: If the casualties are basically contractual savings institutions, that's bad. I'm also worried about the cost of collection.

***Parsons:* Do you welcome graduated company tax for small and medium-sized enterprises?**

Msimango: The primary objective is to create jobs. The lower the tax rate to small and medium-sized businesses who do that, the better.

Gordon: It was an innovative touch which none of us had been expecting. We were looking for other incentives, maybe for venture capital or subsidised interest rates for start-ups. Ultimately the whole thrust of policy, to create a low interest environment, is in the right direction.

Kantor: It is positive, especially for job creation, but you must watch possible abuse. Excluding providers of services is rubbish — somebody's trying to be too clever. It'll be difficult to administer. But bringing people into the tax net is important. Now there is a huge incentive to be taxed as a company rather than an individual. This will be an incentive to a small business to incorporate.

***Parsons:* What are the conditions for successful inflation targeting? How will it affect wage and price-setting expectations?**

Gordon: The primary requirement is some measure of buying-in from the social partners. If you look at clothing and footwear, household appliances, that kind of thing, inflation is already within the target range. It's administered prices, like health, education, household occupation rates and taxes, where government has a role to play, even indirectly or through the parastatals, that'll be crucial. Inflation there is 12%-14%, and that's preventing the whole structure from coming down. Because the Reserve Bank and government's credibility now hinge on the inflation target, they'll have to address that problem.

Then we need greater transparency. We need to know what the Reserve Bank inflation model is. Even if it doesn't give us details of the monetary policy committee meetings, I would like to see it specifying the inflation target or forecast for the next three months.

Finally, we need more efficient monetary policy. The floating repo rate hasn't worked particularly well in a market dominated by a handful of banks.

Msimango: There is a credibility gap and there is not much you can do to prove that inflation targeting is good for you.

Kantor: I don't share the enthusiasm for inflation targeting. I don't see how it can be anything other than exchange rate targeting, which is a bad idea. While the outlook for the exchange rate is good, there will come a time, and it may be just at the time that these inflation targets are being implemented, that the commodity price cycle turns around and the exchange rate comes under significant pressure because we've had too much monetary growth in the interim. Money supply targeting is a good idea but we're not doing it; money supply is growing much too fast. I like the idea of low inflation but I don't think we'll necessarily get it this way. Most inflation in SA is in administered prices, and that's tax increases by another name. Retail inflation is only 2% now.

Gordon: But isn't it easier now that we're in a time of low global inflation?

The clustering that's happening among government departments will eliminate contradictions in policies

Kantor: Low global inflation has helped, but commodity price expansion is off a low base. We'll get a lot of real and monetary stimulation and a booming economy. It'll be hunky-dory provided the exchange rate holds up. But when it comes under pressure, it'll be the old story all over again.

Parsons: **Privatisation seemed to come through strongly in the Budget. How much further do we need to go?**

Msimango: It'll be a slow process. Government wants to add technology and skills to existing corporates to enhance their prices. The partial sell-offs are also linked to the empowerment exercise. What worries me is that as you privatise, you need a regulatory environment so that monopolistic practices don't continue and deprive us of the benefits of lower prices, better savings and things like that. I'm happy that local authorities are leading the way with private-public-sector partnerships. Yes, there are problems in terms of capacity, but it's the right tool.

Kantor: If there was one disappointment in the Budget, it was that the signal about privatisation wasn't stronger. Budgeted receipts are around R5bn. Last year, it was R6bn, mainly Sasria. Telkom doesn't seem to be in those numbers at all. Privatisation revenues will be much larger and a significant boost to the reduction in debt ratios. But why didn't they make more of it?

Gordon: A White Paper is scheduled. There seems to be a tendency in government not to steal somebody else's thunder. But we need foreign direct investment (FDI) funds and privatisation is the route.

Parsons: **How would you evaluate the further steps in exchange control liberalisation? Are they enough?**

We need foreign direct investment funds and privatisation is the route

Kantor: In effect, the corporate sector is now free of exchange control. That may remove some of the incentive to list offshore. Taxation of foreign dividends is designed to discourage offshore listings. Corporates were the main lobby for exchange control relief. The fund management industry doesn't want exchange control reform. We must get rid of exchange control and it's a pity that didn't happen in the past few months when conditions were totally propitious. A special conversion has long been needed for the R15bn of blocked rands.

Msimango: Eliminating controls is necessary to create credibility with foreign investors especially, but relaxation on individuals will come more slowly.

Gordon: Institutions didn't get anything near what they were expecting, but the reactions don't seem to be too negative. Government is choosing to use capital inflows to unwind the forward book in preference to easing up on exchange controls. For foreign investors I've spoken to, the forward book seems more of an obstacle than exchange controls.

Kantor: Capital inflows have been excellent, portfolio and otherwise, but outflows have also been significant. The net flow hasn't been particularly impressive.

***Parsons:* What is the outlook for the rand over the next few months?**

Msimango: I'm looking for further depreciation, to R6,40/US$ by year-end. Fundamentals are good but, unfortunately, the dollar is strong against the euro and yen. Also, as we're in an upswing, the current account will come a little under pressure. Interest rate differentials will remain positive, so there will still be capital inflows, but not enough to strengthen the rand.

Gordon: In the short term, the outlook for the rand reflects the dollar. At some point, the dollar will lose ground, but I've also got R6,40 by year-end. Longer-term, the rand will depend on what government does to attract substantial inflows to help offset easing of exchange controls.

Kantor: The fundamentals for the rand are strong. In real terms it's almost as undervalued as in 1986. You can't just look at the dollar exchange: 50% of our trade is with Europe. But the Reserve Bank will continue to act against rand strength; it doesn't want it. Our competitive advantage is the undervalued exchange rate.

***Parsons:* Does the Budget create more, or less, room for further interest rate cuts?**

Gordon: In the very short term, the Budget probably created less scope for interest rate cuts. Cyclical forces are dominating at the moment and I think there'll be no more interest rate cuts. The only reason prime isn't going higher is that the Budget is part of the longer-term thrust to create an environment for short-term rates to move lower.

***Parsons:* The Budget helped SA to gain the much-coveted Standard & Poor's investment grade rating. What must we do to consolidate on this?**

Kantor: The markets gave us an investment grade rating long before S&P. The sovereign risk premium was down to about 2%. I hate the idea of having to pay inexperienced analysts for a debt rating, and some of the stuff I've read is pathetic. In fact, the market does it. Our fiscal policy deserves a five-star rating The Budget reduced the share of government spending of resource flows and will continue to do so, which is important. The total government tax ratio has fallen from just under 30% in 1994 to about 24% — a significant reduction, even if on higher GDP numbers. I worry about monetary policy, and labour.

Msimango: We need to improve the quality of spending by more co-ordination.

Gordon: One reason we were worried we wouldn't get an investment credit rating is the structural problems: the skills shortage, the lack of savings, the rising Aids infection rate. And it's not enough to say we're growing, we want jobs to go with it.

Kantor: We won't get the jobs because of the way we measure employment.

***Parsons:* What is your forecast now for inflation in 2000?**

Msimango: 6% average for the year.

Kantor: The GDP deflator will be 5,5%.

Gordon: 4%, on headline inflation.

Kantor: Core is unlikely to be below 6%, and that's what people will focus on.

***Parsons:* And real GDP growth?**

Gordon: 3,1%.

Kantor: Between 4% and 4,5%. The official forecast is 3,6% for the fiscal year, and I can't see it being below that.

Msimango: 3,5%. ■