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ECONOMIC WRAP:
The Budget Speech and Beyond

Foreword

The Minister of Finance, Tito Mboweni on the 26th February 2020 presented the inaugural budget speech in which he detailed government's revenue collection and expenditure strategy in its quest for sustainable social and economic development. The Minister had the unenviable position of presenting the plans to deal with the challenges faced by key state-owned entities, labour and business. challenges pertaining to widening inequality and service delivery deficiencies, as well as proposals to detail the spending and cost reduction priorities to position the economy for growth.

A few days later, the Statistician General, Risenga Maluleke, presented the 2019 fourth quarter GDP numbers confirming that the South African Economy is now in a technical recession following two consecutive quarters of negative growth. The third quarter had shown the economy shrinking by 0.8% (revised) and the fourth quarter contracted by 1.4%; this is the third recession since 1994, with seven out of the ten industries showing a contraction.

And South Africa's first case of the Coronavirus disease (COVID-19) was detected on 5 March 2020, followed by the second case in Gauteng days later, with the latest numbers reported at 62 as of 17th March 2020 - adding to the global tally of 167 515 reported cases and 6606 fatalities as of 16 March 2020, according to the World Health Organization Situation Report 56. Despite 3.9% fatality rate at 17 March 2020, the impact of this health outbreak on the demand side and supply side of the global economy is already being felt. The World Health Organization (WHO) has officially declared the Coronavirus outbreak a global pandemic. We have since seen reserve banks globally injecting liquidity into their economies to ease the impact of the outbreak on businesses, households and economic activity.

The United States Federal Reserve Bank on 3 March 2020 initially convened an emergency policy meeting, following which the Fed Chair Jay Powell announced a half percentage point (50 basis points) decrease to their interest rates to shore up waning demand as a result of the spread of the Coronavirus. They subsequently met again and agreed

another decrease of one percentage point (100 basis points) as well as a $700 billion economic stimulus package. According to the Caixin Media Group, the Chinese manufacturing and services purchasing manager's index (PMI) fell to all-time lows on the back of factories shutting down and reduced consumption of goods and services. Many countries have since put in place travel bans, instructed closure of businesses amongst many preventative measures that will see tourism, manufacturing, retail, agriculture and transport industries take a big economic and employment knock.

Despite these challenges, there are green shoots of opportunities in the economy that will likely play a pivotal role in cushioning the impact of operating in tough economic conditions. The Eskom challenges have propelled a faster move towards cleaner and more sustainable energy mixes in the country as well as an industry economic opportunity that will be realized through the demand for self-generation solutions. Another opportunity presented is to optimize the size and quality of the public service. The bloated public wage bill has held the spotlight for some time given 35.6% of the budget was funding the wages of 1.2 million public servants. In addition, the move to not increase the major direct taxes (personal income tax and corporate income tax) and the largest indirect tax (value added tax) will bring a much needed reprieve to households. And capital spending has been the fastest growing item of non-interest expenditure, and complemented by the infrastructure fund, there is an opportunity for a revival of capital investments in the economy. On balance the economy must certainly swallow some bitter medicine.

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Chief Economist, IQbusiness

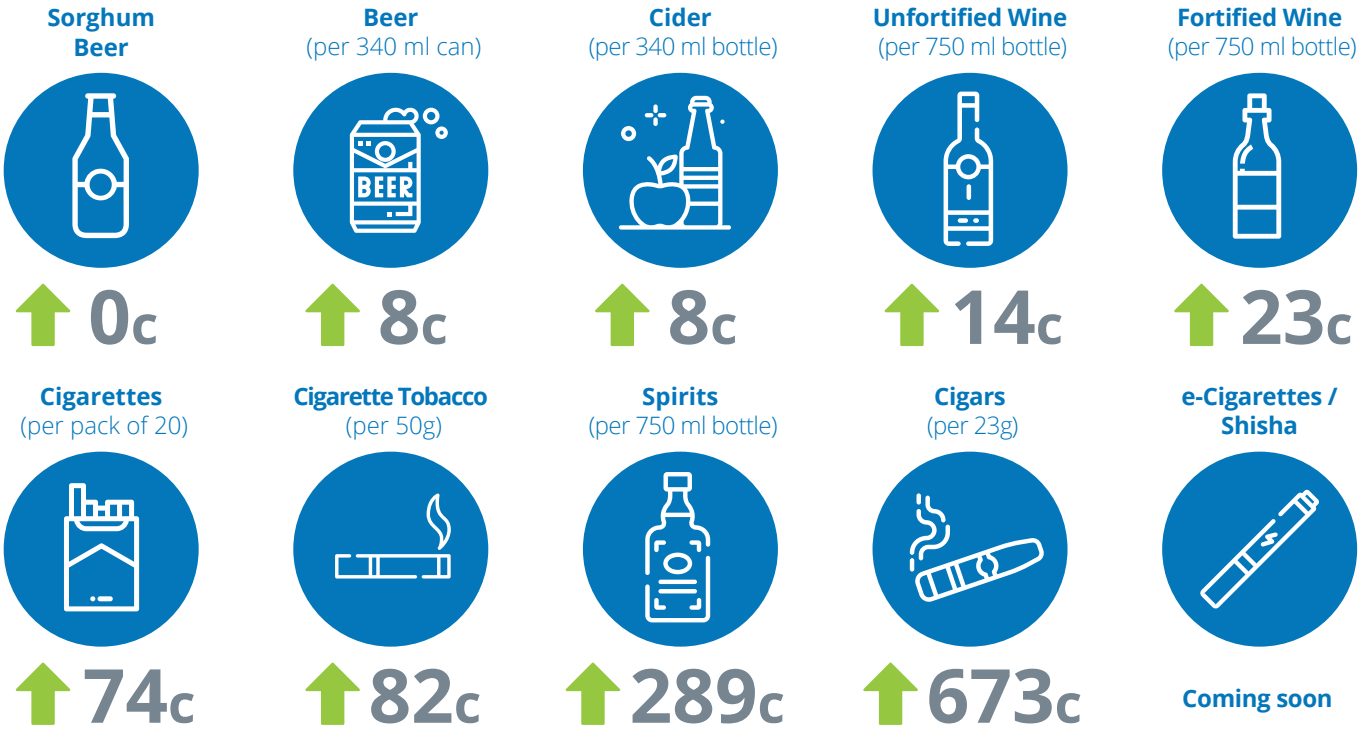
Budget Speech Highlights

Collection

Tax collection continued to be a challenge for government and the South African Revenue Service (SARS), with the budget shortfall now expected to be R63.3 billion, having collected R25 billion less personal income tax than it had projected for the 2019/2020 tax year. Over the last three fiscal years, government has continued to miss its revenue targets while corporate earnings on average have also continued to slide over the same period. SARS has introduced a team of "chief disruptors" whose mandate is to study developments and evolution of the ICT sector and for them to find innovative ways to solve for tax compliance issues. In 2019 they announced a technological overhaul that would enable them to respond more effectively to an increasingly digitised economy.

Sin taxes are of course the one channel where government gets the least amount of resistance when taxes are raised, with the exception of the sugar industry regarding the sugar tax (also known as the health promotion levy) introduced on 1 April 2018, primarily levied on the purchase of sugary beverages. The infographic below details the increases to sin taxes in the latest budget:

SIN TAX PROPOSALS (INCREASE IN CENTS)



Expenditure

Government expenditure over the medium-term is expected to grow at an average annual rate of 5.1% primarily driven by rising costs of debt servicing. Approximately 18 million people are recipients of social grants in South Africa and as such, social spending continues to be a key consideration for government with R396.4 billion budgeted towards Learning and Culture, R229.7 billion towards Healthcare, R212.3 billion towards Community Development and R309.5 billion towards Social Development. Social spending accounted for 59% of total consolidated government expenditure.

Over the medium-term R55.6 million is targeted towards the Department of Health to enable the introduction of phase 1 of the National Health Insurance (NHI) scheme, although this low-level of funding seems to indicate that there can be little progress on the NHI. The Minister was relatively mum on the eTolls issues besides a reiteration that government stays committed to user pay principles.

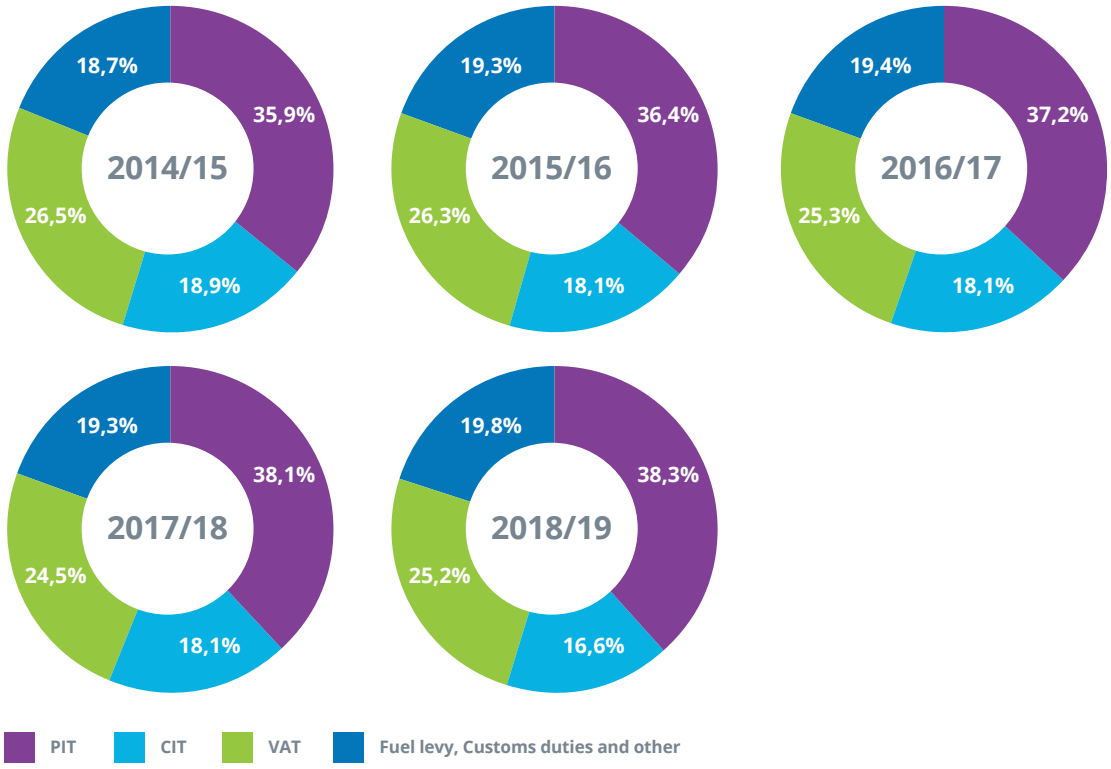
Over the medium-term fiscal year, government reiterated its commitment to shoring up struggling SOEs with R112 billion budgeted for Eskom, R16.4 billion for SAA, R576 million for Denel and R200 million for South African Express.

Reaching the Top of the Laffer Curve – No More Room For Taxation

The Laffer Curve, famously named after Economist Arthur Laffer, details the relationship between rates of taxation and total revenue collected. Beyond a certain rate of taxation, an increase in tax actually results in lower revenues collected. We are likely approaching the peak of that curve in South Africa.

The minster announced that there would be no corporate, personal income and value added tax increases – collectively these make up approximately 80% of the tax revenue amongst the tax options that were on the table, a move to increase any of these three primary sources of revenue would risk killing the geese that lay the golden eggs. Figure 1 below show that personal income tax (PIT) has been contributing a larger proportion to the total tax revenue increasing from 35.9% in 2014/2015 tax year to 38.3% in the 2018/2019 tax year. A mere 1.5 million individuals out of a total of 4.9 million were assessed for taxed-earned income in excess of R350 000 per annum, and collectively this group contributed 83% of PIT. Corporate tax income (CIT) on the other hand has been contributing smaller proportions to the total tax revenue over the years. In the 2014/2015 tax year CIT contributed 18.9% to total revenue and by the 2018/2019 tax year it had only contributed 16.6% of total revenue. In a similar case to PIT, of the 3.2 million companies registered with the CIPC, only 814 000 paid tax.

FIGURE 1 - RELATIVE COMPOSITION OF MAIN SOURCES OF TAX REVENUE, 2014/15 – 2018/19



Source: SARS Tax Statistics - 2019

A Credit Rating Balancing Act

An excerpt from the 01 November 2019 statement by Moody's changed South Africa's outlook to negative from stable and affirmed the Baa3 ratings with the following perspective:

*"While **high unemployment, income inequality** and the **social and political challenges** they imply for policymakers are long-standing features in South Africa, the **obstacles that they pose to the government's plans to raise potential growth and contain fiscal deficits** are proving more severe than expected a year ago. **Acute financial stress for state-owned enterprises** (SOEs), in particular Eskom Holdings SOC Limited (Eskom, B2 negative), continues to require sizeable ongoing support from the government. **The development of a credible fiscal strategy** to contain the rise in debt, including in the 2020 budget process and statement, will be crucial to sustain the rating at its current level."*
– Moody's Investor Services

Then a few days before the budget speech Moody's revised its growth expectations for the South African economy to 0.7% for 2020, despite National Treasury expecting the economy to grow at 0.9% in 2020. And most recently (6 March 2020) Moody's again revised economic growth expectations for the South African economy to 0.4% for the year, citing the impact of the Coronavirus outbreak on economic growth.

The statement from Moody's later detailed that:

"South Africa's ratings would likely be downgraded were Moody's to conclude that those conditions will not be met, and that South Africa's fiscal and/or economic strength will continue to erode"
– Moody's Investor Services

On the back of this, the risk to a rating's downgrade is to the upside given the unemployment, growth, debt and SOE challenges that the country is still working itself through.

The Big Public Wage Bet

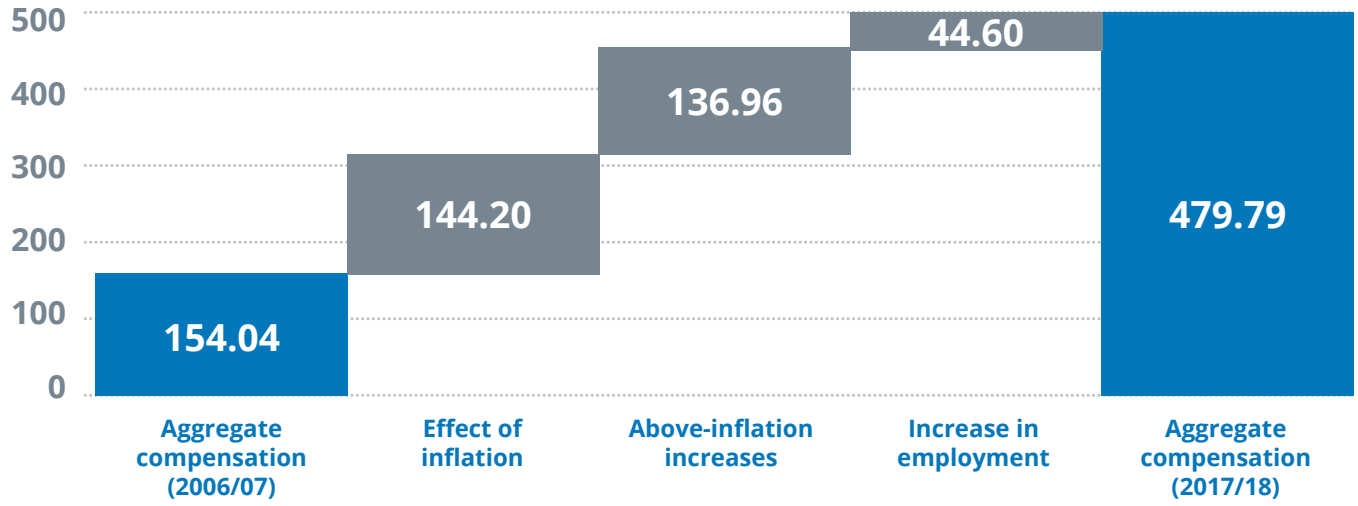
In his budget speech, the minister committed a R160.2 billion reduction in the wage bill of national and provincial public servants. This is 61.4% of the total baseline spending reductions budgeted of R261 billion in the medium-term. This he plans to achieve through a R37.8 billion reduction in the 2020/21 fiscal year, R54.9 billion in 2021/22 and R67.5 billion in 2022/23.

According to The National Treasury, between 2007 and 2018, compensation spending has increased more than three times from R154 billion to R480 billion with KwaZulu Natal accounting for the largest portion of the public sector wage bill growth and personnel. The figure below shows that above inflation increases in wages accounted for R136.96 billion in wage expenditure increases over the 10 years. Interestingly however, the largest personnel growth was in education, health and the justice system.

In response, the Congress of South African Trade Unions (COSATU) declared the statement from the Minister as "an ambush and declaration of war", while the Public Servants Association (PSA) has threatened strike action against the government's intention to cut the wage bill. COSATU has a membership base of approximately 1.8 million workers, while the PSA reported 230 029 members in the 2016/17 fiscal year.

This commitment to reducing government expenditure predominantly through public wages is arguably the biggest bet as well as the largest risk item to achieving the budgeted R261 billion in the medium-term.

FIGURE 2 – PUBLIC SECTOR WAGE GROWTH (R BILLION)



Source: National Treasury (PERSAL data)

Strengthening Institutions Potential for 10x Growth

Literature has broadly shown a positive relationship between quality of institutions and economic development. South Africa has slid from a World Bank Ease of Doing Business ranking of 32nd in 2008 (its best ranking) to 84th in 2018. The evident decline can largely be attributable to weakening in the quality of institutions. High institutional quality is positively related to higher and better incentive structures for consumption and investment activities. High institutional quality is also associated with better protection of property rights, freedom of choice, higher FDIs, improved efficiency and productivity and ultimately higher long term sustainable economic growth.

Minister Mboweni has in a few instances been criticised for singing praises about Rwanda, while challenging South Africans to aspire towards their principles. Rwanda in 2019 ranked 29th in the World Bank Ease of Doing Business – the only low-income country in the top 30. The country's GDP per capita income was $146 in 1994 and approximately $820 in 2019. A focus on political stability and strengthening governance within public service institutions are the factors that have been attributed the rise of the Rwandan economy and South Africa ought to learn something if we are to reignite the economy to truly be the economic gateway into the continent.

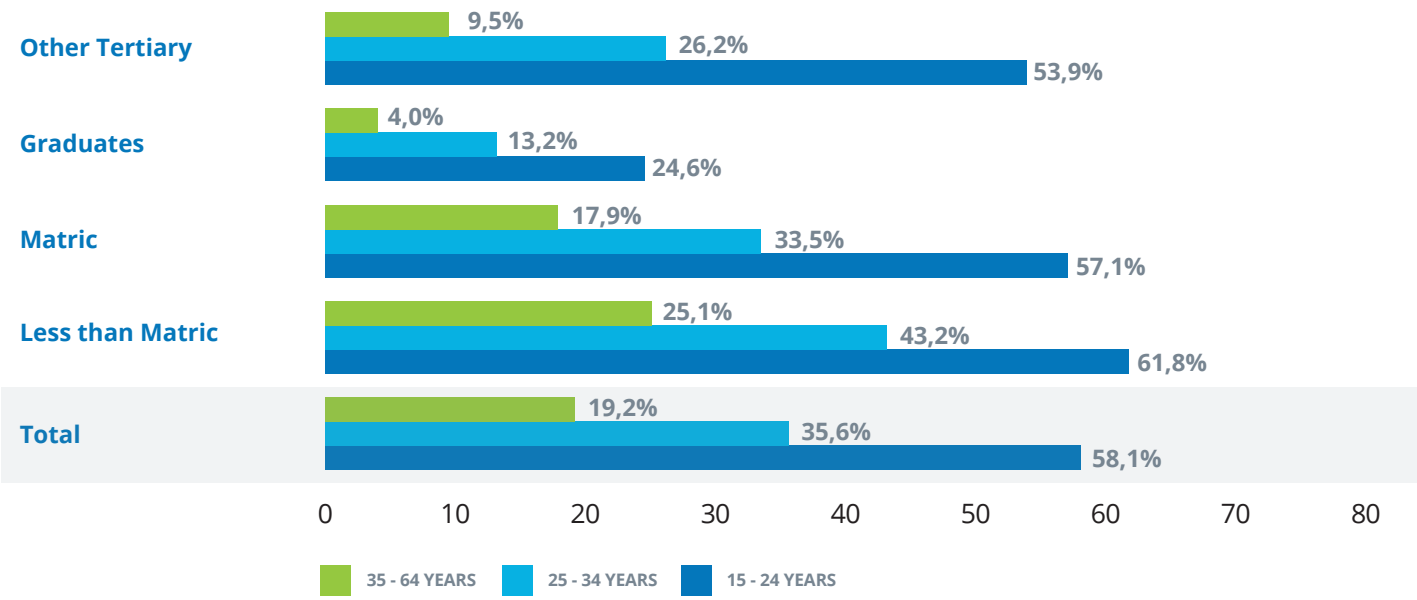
The emphasis of building capacity within state owned entities therefore cannot be overemphasised given the kind of impact it can have on exponential economic growth. In the 2018/2019 fiscal year 211 out of 257 municipalities underspent on their operating budgets and 214 underspent on their capital budgets. Interestingly, the highest expenditure rate was in the municipal infrastructure grant, yet this is one of the items that saw reductions (R2.8 billion) in the latest budget presented by the minister, R13.2 billion reductions public transport spending and R14.6 billion from human settlements. National Treasury has committed to help build capacity of more than 70 municipalities to help them comply with minimum competencies regulations for financial management. While this is a positive start, National Treasury ought to detail a more comprehensive plan on the capacity building programme for municipalities to ensure they play the role they need to play in positioning the country for long term sustainable growth.

The Youth Unemployment Challenge

South Africa is home to the world's highest youth unemployment rate of 58.1% (recorded at 53.6 in 2013), associated with a primary and secondary school dropout rate of 50% - meaning that roughly half the pupils who start the schooling curriculum do not make it to matric. This results in a bulge in the unskilled youth and creates a social risk that needs serious attention. Since 2013, the labour force has grown from 20 million in the 4th quarter to 23.1 million in the 4th quarter of 2019, of which new entrants have mostly been youth. Figure 3 below shows that youth unemployment is more pervasive than other age groups irrespective of education level.

Minister Mboweni reiterated the comments from President Ramaphosa in his State of the Nation Address that 1% of the budget would be allocated toward Youth Programmes. The detail of these programmes were yet to be fully fledged out but the commitment seems to be there to deal with the problem. The promise is that at the medium-term budget policy statement, details of the youth interventions would be provided. An innovation fund is to be established that would be funded by R1.2 billion over the medium-term as a means to reinvigorate the country's industrial strategy. In addition, 65% of the 175 000 jobs created by the Jobs Fund were jobs for youth – but these were clearly not enough to offset the rate of growth of the labour force that is attributable to youth.

FIGURE 3: UNEMPLOYMENT RATE BY EDUCATION LEVEL AND AGE GROUP



Sources: Stats SA – Quarterly Labour Force Survey Q4:2019

Policy Opportunities

Monitoring and Evaluation:

We would encourage the Minister of Finance and the President of the Republic to consider a monitoring and evaluation framework that not only details the trends in economic development but also trends in the social development indicators. It holds true that a country can for example have jobless growth, so growth in and of itself may not suffice in informing long term sustainable development of the economy and its people. One such approach has been developed by the Social Progress Imperative www.socialprogress.org and is being applied by developing and developed economies around the world to good effect.

Trade and Sector Incentives:

We would encourage the DTI to consider a more targeted approach to sector incentives – particularly sectors that have high employment multipliers and are labour intensive to ensure that economic growth can result in lower unemployment.

Public Sector Capacity Building:

We continue to be in support of the initiatives that are directed to improve the level and quality of institutional quality, governance, transparency and accountability. We would also encourage a capacity building framework for municipalities, which recognises the role they play in catalysing economic activity in South Africa.

Labour Migration Strategy and Capacity Building:

We encourage the Ministry of Employment and Labour to consider capacity building programmes to futureproof the economy for skills it needs in a local and global marketplace that leverages trends from the Fourth Industrial Revolution. Not only do we envisage this will result in productivity gains for the economy, but it will also ensure that the right steps are taken to move the economy towards full employment in the long run.

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