BUSA
BUSINESS UNITY SOUTH AFRICA

National Office
Unit FFN09, Block 9 Bentley Office Park
67 Wessels Street, Rivonia, Johannesburg
P.O. Box 652807, Benmore, 2010
Tel : +27 11 784 8000| Fax : +27 (0)86 609 8248
Email : busa@busa.org.za | Website : www.busa.org.za
Registration Number : 2014/042417/08

Parliamentary Office
9 Church Square, 1st Floor Graaffs Trust Building
Cape town CBD
P.O.Box 3867, Cape Town, 8000

BUSA SUBMISSION TO NATIONAL TREASURY IN ADVANCE OF THE NATIONAL BUDGET 2018

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Background

BUSA is a confederation of business organisations including chambers of commerce and industry, professional associations, corporate associations and unisectoral organisations. It represents South African business on macro-economic and high-level issues that affect it at the national and international levels. BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development and transformation and to create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive.

As a principal representative of business in South Africa, BUSA represents the views of its members in a number of national structures and bodies, both statutory and non-statutory. BUSA also represents businesses' interests in the National Economic Development and Labour Council (NEDLAC).

Introduction

The background to the 2018 National Budget is one of weakening economic growth, with growth for 2017 projected to be 0.6% by the South African Reserve Bank. This is in a context of declining business and consumer confidence (demonstrated by low levels of investment), stubbornly high and unsustainable levels of unemployment and inequality, an improving yet uncertain global economic environment – and the possibility of yet further sovereign ratings downgrades, with a strong likelihood of all three major ratings agencies downgrading South Africa's local currency debt to sub-investment grade. This follows the Fitch and S&P sovereign ratings downgrades on 23 and 24 November 2017 respectively. The S&P downgrade in particular means that an estimated US$ 3.7 billion of South African bond exposure has been cut from the Barclay's Global Bond Indices. Exclusion from the World Government Bond Index (WGBI) will occur once Moody's downgrades South Africa's local currency sovereign credit rating to sub-investment status too. In this regard, key risks for South Africa are as follows:

- Overall appetite for emerging market bonds wanes.
- South Africa experiences further downgrades as fiscal metrices decline further, particularly if SOEs are unable to borrow. Both of these would effectively increase the risk of default by the sovereign.
- Central bank intervention.

The impact of the downgrades on investors and consumers will be felt over the long term once borrowing costs increase. Higher interest rates will affect consumers in the form of higher costs on home loans, car loans, as well as business loans. Inflation will increase due to higher costs for imported fuel, clothing, electronics, etc. Consumers, already under considerable pressure, will experience reduced standards of living due to downwards pressure on living standards. This impact will be worsened should further increases in Personal Income Tax (PIT) be considered as a revenue raising measure.

For some time, National Treasury, together with the Reserve Bank, have reassured markets and ratings agencies of South Africa's commitment to a stable macroeconomic framework and fiscal sustainability. However, recent moves by the ratings agencies together with declining economic growth and weak business confidence have shown that South Africa can no longer afford to rest on past achievements in relation to the credibility of fiscal consolidation targets, revenue collection or the strength of its institutions. The threat of increases in the debt-to-GDP ratio associated with, *inter alia*, further deterioration in the finances of State-Owned Enterprises (SoEs) – itself a symptom in most cases of governance shortcomings – should constitute the key preoccupation of Treasury in developing the 2018 National Budget. It is now more important than ever to demonstrate fiscal prudence and the leadership inherent in making the trade-offs necessary to balance the budget.

General

Business has consistently warned that the budget deficit and steadily increasing debt-to-GDP ratio are approaching unmanageable levels. Indeed, if Treasury guarantees to SOEs are added to overall government debt, the figure rises to just below 70% of GDP. This is significantly higher than both the projected peak in public debt of 53% in 2018/2019 and the international benchmark of manageable debt levels of 60% of GDP.

In advance of the 2018 National Budget, the multiplying demands on the budget arising from social spending and the precarious state of SOE finances constitute the most likely impediments to sustainable fiscal consolidation. It is worth reiterating that our viability as a sovereign borrower and status as a fiscally responsible citizen depend on the success of Treasury's previous fiscal consolidation targets. Business believes that the targets can be met without compromising the socio-economic development of the country. Indeed, with 13c out of every rand in revenue government collects now going towards debt repayment (a figure that is steadily rising further), fiscal consolidation is a necessary precondition to increases in social spending and addressing the challenges of lacklustre economic growth, and high levels of poverty, inequality and unemployment.

Business has been consistent in the recent past in calling for the following principles to guide the budget process:

- A firm commitment to macroeconomic, fiscal and institutional stability.
- Rooting out of corruption, as well as irregular, fruitless and wasteful expenditure.
- Improved and consistent communication on the part of government and its agencies.

- A stable, certain regulatory environment.
- Reliable and affordable infrastructure.
- Coherent policies across departments, ministries and agencies.
- Functioning and competent, fit for purpose SoEs.
- Improved skills and education to drive competitiveness.
- Clear and tangible progress on the implementation of government initiatives to address economic growth and confidence, such as the Inclusive Growth Action Plan ("14-point" plan).
- A strong pact between government, labour and business.
- Positioning of business as a national asset, particularly to boost entrepreneurs and small businesses.

In the immediate future, two broad avenues to reach fiscal sustainability are available, namely reductions in expenditure and increases in revenue. What follows are broad proposals for Treasury to consider in relation to tax policy and expenditure.

Tax Policy

South Africa's fiscal sustainability has largely been supported in recent years through a steady growth in tax revenues (mainly in the form of personal income tax (PIT)), at a rate far in excess of economic growth. According to the South African Revenue Service however, first quarter tax collection was R13.1 billion short of target. By the end of the financial year, a tax collection deficit of approximately R50 billion on current projections is possible. This is in addition to the forecast shortfalls in the budget projected for 2018 / 2019 of R15 billion.

In business' view, these statistics point to a particular challenge confronting South Africa at present: there is limited scope for manoeuvre with respect to tax policy. Evidence is emerging that tax increases are beginning to reach levels where further increases would be self-defeating through their negative impact on economic growth and levels of compliance. A prominent example of this is in revenue collections from PIT: While the 2017 Budget sought to extract additional tax revenues of R16.5 billion from PIT in FY 2017/2018, projections now suggest that PIT collections will fall short of the target by approximately R20 billion. Simply put, South Africa has run out of space to further increase taxes in its current socio-politico-economic environment without doing undue harm to the economy. In business' view, fiscal consolidation at this juncture should be achieved through reductions in expenditure, to be achieved not through reductions in social spending but rather generating efficiencies within government. This may involve, *inter alia*, disposing of stakes in non-core assets where appropriate in order to reduce debt.

Notwithstanding the above, business understands that tax increases may be required in order to balance the budget over the short- to medium-term. Business supports an efficient, fair and progressive tax system that minimises disruption to sustainable economic growth. Whilst business notes the conclusions reached by bodies such as the Davis Tax Committee's (DTC's) unequivocal position that it does not support an increase in VAT, business nonetheless agrees with the DTC that a rise in VAT would have a less negative impact on GDP and employment than increases in either PIT or CIT. According to the DTC:

"*Raising VAT will have a (albeit very small) negative impact on inequality, but will be much more efficient than an increase in direct taxes. It is also important to consider the longer-term: increases in direct taxes dampen growth, which in turn leads to reductions in tax revenues and constrains the ability of the state to reduce inequality through the expenditure side of the budget"*[1].

The DTC's first interim report on VAT goes on to state the following:

"Should it be necessary to increase the standard rate of VAT, it will be important for the fiscal authorities to think carefully about compensatory mechanisms for the poor who will be

[1] Davis Tax Committee: First Interim Report on VAT. Available at http://www.taxcom.org.za/mediacentre.html

adversely affected by the increase. A range of measures should be considered, such as increases in social grants or the strengthening of the school nutrition programme."[2]

Business, similarly to the DTC, is concerned about the potential negative impact on inequality of a rise in VAT and the fact that a modest increase in VAT will in itself not be enough to address revenue shortfall in 2018 / 2019. Sustainable revenue collection therefore needs to strike an appropriate balance between limiting negative impacts on economic growth (a likely result of any increase in CIT or PIT) and inequality (a likely result of an increase in VAT). To partially secure the revenue required for 2018 / 2019, the following is proposed:

Tax	**Percentage Increase**	**Rand amount obtained**	**Compensatory Mechanism for Poor**
Sugar-Sweetened Beverages	N/A	Approximately R2 billion	N/A
Donations Tax on Interest-free Loans to Trusts		Approximately R1 billion estimated	N/A
Value Added Tax	2%	Approximately R40 billion (gross); approximately R30 billion (net) when combined with compensatory mechanisms for the poor	• Increased social expenditure (e.g. enhanced social protection). • Increased, targeted zero rating of basic goods.
Total	N/A	Approximately R33 billion in 2018/2019	Reduced inequality through expenditure/tax relief.

Additional (albeit limited) revenue could be raised through limiting fiscal drag relief for PIT. This is important to demonstrate that the vast majority of the burden of tax increases is to be borne by higher-income earners and not by the poor. It is apparent however that these

[2] Davis Tax Committee: First Interim Report on VAT. Available at http://www.taxcom.org.za/mediacentre.html

measures would not be sufficient to balance the budget, and therefore reductions in expenditure are required.

Expenditure

A balanced budget that incorporates cost containment measures with sustainable levels of revenue collection holds the only prospect of sustaining over the long-term government's pro-poor, pro-growth policies. Whilst tax increases have been part of the solution in recent years, ongoing reductions in expenditure are another key component. With this in mind, business urges government to urgently implement measures to ensure that the current poor governance that continues to plague certain SOEs are urgently addressed, particularly in the context of weak economic growth and declining revenue.

The latest figures presented by the Minister of Public Enterprises paints a bleak picture of a lack of control over spending in key SOEs:

Description	**Irregular expenditure**		**Fruitless and wasteful expenditure**	
	2016/17	**2015/2016**	**2016/2017**	**2015/2016**
Denel	R146M	R49M		
ESKOM	R4bn	R106m	R547m	R93m
Transnet	R900m	R25m	R21m	R3.9m

Other SOEs, such as SAA and the SABC complete a worrying picture of chronic overspending. There is no doubt in business' view that poor governance and plays a significant role in the increasingly poor financial performance of SOEs, particularly those involved in the electricity sector.

With this in mind, efforts at eradicating wasteful and fruitless expenditure and curtailing losses of State-owned Enterprises (SOEs) require urgent support and implementation. Business remains profoundly concerned about continued loss-making by SOEs, bail-outs and applicable guarantees by Treasury. Business perceives this to be an ongoing threat to the fiscal consolidation process and urges government to implement measures to ensure that SOEs are governed responsibly and sustainably. The current fiscal space simply no longer allows for public funds to be channelled to chronically underperforming entities which contribute questionable value to the economy over the long term. In view of this, business urges government to consider making use of other sources of revenue over the longer term, including the disposal of stakes in non-core assets where appropriate in order to reduce debt or fund core SOEs, provided that appropriate governance structures and feasible business plans are put in place. The recent bail-outs of South African Airways (SAA) by National Treasury – in the absence of implementable, time-bound measures to either address governance shortcomings or commence the process of disposal of the airline – are of concern to business. In short, South Africa at this juncture simply does not have the funds necessary to channel funds to chronically underperforming SOEs. It goes without saying that there is an additional opportunity cost involved, where funds redirected towards SOEs could have been utilised for social / developmental spending. Business therefore welcomed the publication of the Inclusive Growth Action Plan ("14-point plan") insofar as it relates to SOEs, but equally notes the limited progress made in key objectives of the Plan so far.

Energy sector

In respect of expenditure in the energy sector, business welcomed announcements made by the Minister of Finance in the recent MTBPS in relation to the nuclear new build programme. However, any decision on the composition of South Africa's energy mix going forward should be on the basis of a least-cost, sustainable and evidence based Integrated Resource Plan (IRP) and Energy Plan (IEP). In light of this, the apparent contradiction between a least cost generation mix and recent pronouncements by the Minister of Energy regarding nuclear is of concern. This is particularly so at this juncture, when no new generation capacity will be required for some years into the future due to the current oversupply and declining demand.

Eskom

Business agrees with the statement made by the Minister of Finance in the MTBPS that the financial unsustainability of Eskom poses arguably the most significant risk to the fiscus. In view of this, it may be useful to consider the financial sustainability within the context of global trends in the electricity sector. The past three decades have seen fundamental reform and restructuring of electricity sectors in countries all over the world. The old model of a vertically integrated, state-owned monopoly has been challenged and new institutional models have been explored and adopted that involve different levels of integration / unbundling, competition and public or private ownership. It is striking that South Africa's electricity sector has been largely immune to these global developments, although recent years have seen private investment in a large number of independent power projects (IPPs), mainly renewable energy and cogeneration.

First generation IPP prices were high, and more expensive than Eskom tariffs. It is these prices that Eskom often quotes. However, in four years, bid prices in South Africa's Renewable Energy IPP Programme (REIPPP) have fallen around 60% for wind energy and nearly 80% for solar photovoltaics. The cheapest prices bid in the latest expedited round of the REIPPP are 62c/kWh for both wind and solar energy, far below Eskom's average selling price. Recent international tenders show that even lower prices could be achieved. For example, prices bid for solar PV in Abu Dhabi and Chile are less than half Eskom tariffs. Government is also in the process of procuring coal and gas IPPs. A combination of solar, wind and gas provide flexible and reliable power to meet both baseload and peak demand.

Consideration of these trends lead to a number of questions that should be posed during the current phase of the budget cycle. Could even more investment be attracted through private

IPPs, lessening the burden on National Treasury? Would more competition drive down costs and prices? Does the existing electricity supply structure facilitate or inhibit competition and private investment? Do we need to retain Eskom's near monopoly, where its generation, transmission and distribution functions are vertically integrated? Or will a level of unbundling create more focus, competition, efficiencies and lower costs?

The answers to these questions should be unshackled from ideological predispositions. It is necessary to consider restructuring proposals only in terms of whether they will support national economic and social goals. In this respect, business opposes distorting policy decisions such as the proposed 1% levy on solar energy.

<u>Other Spending: Policy Priorities</u>

Alongside efforts to address the fiscal burden presented by underperforming SOEs, caution also needs to be exercised by government in undertaking new spending commitments. Prominent among these is the public-sector wage bill. In this regard, business urges government to index increases in line with the CPI. Business would also like to see further work by National Treasury, the DPME and DPSA to develop and implement a framework for measuring productivity in the public sector aimed at benchmarking improvements over the medium to long term. We eagerly anticipate the finalisation of the framework as announced in the 2016 National Budget, as well as the release of the remuneration reform aimed at creating a link between wage settlements and performance at both an individual and institutional level. Business believes that government can and should do more to eradicate fruitless and wasteful expenditure, corruption, as well as to terminate non-performing and non-priority government programmes.

With regard to other spending priorities, programmes such as National Health Insurance (NHI) and Comprehensive Social Security (CSS) are acknowledged as important objectives alongside complementing the commitment to education and health. Business supports the view that we need to create the fiscal space to fund the implementation of these programmes, recognising the critical contribution of business to the fiscus and addressing the challenges of poverty, inequality and unemployment. We continue to advise caution in government's policy announcements with significant future expenditure commitments, such as NHI, CSS and the nuclear build programme. Credible cost-benefit analyses must be undertaken as a part of any consideration of fiscal commitments now and in the future. In particular, business believes that notwithstanding its support for universal health care, it is imperative for the Budget to at least recognise that the financial implications of the model proposed in the recently released White Paper on National Health Insurance, if adopted, would pose significant risk to the debt to GDP ratio.

Whilst business recognises that there is very limited fiscal space available to support the economy, part of the solution to growing the economy and enhancing the investment environment involves, where possible, supporting companies and sectors that are in a position to contribute to key national development objectives. One option to consider would be a tax holiday for companies that carry export potential, boost export earnings and reduce the trade deficit. Support for this could be provided by a tax rebate system to ensure that the tax benefit would only be based on incremental export growth. This could be administered through relatively simple and uncostly mechanisms that already exist in SARS. Similar schemes could be considered for employment growth, or other defined metrics with proven benefit to the wider economy. Finally, business urges government to exercise due caution in reviewing existing incentive schemes as the benefits of such schemes in the vast majority of cases far outweigh the costs. Where on balance the economic and long term fiscal benefits of incentives outweigh the costs, business is in principle supportive of incentives.

The shortage of skilled labour, often cited as a key constraint, could be addressed by easing requirements for the inward migration of skills. This could unlock value in a number of areas whilst South Africa works towards building these skills domestically.

Tourism is still viewed as having great potential. Easing requirements for tourism from visas to tax incentives for new operators could have substantial economic benefit and create employment opportunities for the unemployed.

The cost of red tape needs to be reduced at provincial and local government levels. Small business should be encouraged and with administrative efficiency, we should see lower costs to engaging government.

The mining sector charter and regulation around mining need to be addressed urgently to re-energise this sector. Although resources do not attract the prices enjoyed around the time the National Development Plan was written, the lifespan of some of our resources are fast coming to an end as environmental consciousness begins shaping our industries and therefore procrastination will negatively affect our ability to sell our resources in the future.

Broadband also requires attention as there are significant benefits for an implementable national digital strategy, led by government. Creating an appropriate platform could enable new ideas to grow and the benefits of digital innovation in the form of improved efficiency would also energise the private sector. A smart, agile government would be well positioned to embrace the fourth industrial revolution.

As South African firms run out of opportunities in South Africa, driven by a combination of factors from policy uncertainty and policy incoherence to legislative impediments, they are increasingly seeking higher rentals offshore. This is seen as an investment boycott, however until a proactive approach to labour legislation reforms and other domestic impediments have been resolved we will not be able to align our markets to those countries that we compete with, and not be able to attract domestic investment flows that will create jobs.

Property rights are seen as a key underpin to domestic investment and the increasingly interventionist policies by the state undermine the notion of a prosperous mixed economy. This does not bode well for public private partnerships and promotes a distrust between business and the state.

Channelling capital flows and savings into the real economy should require moderate policy interventions. This is not the case in South Africa and with limited cohesion in policy choices and priorities, the threat of increased taxes and a burgeoning state, limited success in managing state owned entities and political uncertainty, makes for an unproductive environment.

Conclusion

In summary, the risk of economic headwinds arising from the recent (and further) sovereign rating downgrades is likely to present challenges for some time. Business agrees with the Governor of the South African Reserve Bank's recent comments that this would have devastating indirect consequences for South Africa, particularly the poor[3], with fewer resources available for priority areas such as education, infrastructure development, SME promotion and social transfers. The policy direction towards sustainable public finances and continued economic development and transformation therefore remains an imperative. Continued over-spending, a lack of political will to stabilise debt and address governance challenges will inevitably result in an extended period of (ultimately) enforced austerity, reduced social spending and a deteriorating economy. Fiscal consolidation over the medium term through cost containment measures holds the only prospect of sustaining over the long-term government's pro-poor, pro-growth policies.

[3] Keynote address by Lesetja Kganyago, Governor of the South African Reserve Bank, at SAICA's Courageous Conversation Session, available at https://www.bis.org/review/r170927g.pdf [Accessed 4 October 2017].