

Ref#:502969
Submission File

2 March 2015

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Dear Sir

**CALL FOR COMMENT: FISCAL FRAMEWORK AND REVENUE PROPOSALS
TABLED TOGETHER WITH THE 2015/2016 BUDGET**

We would like to firstly thank you for the invitation to present both written and oral comment on the fiscal framework and revenue proposals that was announced by the Minister of Finance on 25 February 2015.

General Comment

We commend the Finance Minister and his National Treasury team for producing a balanced budget under very difficult economic circumstances and conditions.

Specific comments regarding estimates of all revenue, budgetary and extra-budgetary specified separately, expected to be raised during that financial year

Tax is essentially a withdrawal from the economy to fund the country's collective and shared expenses. This withdrawal from the economy should be properly balanced to ensure no economic harm is created.

The NDP is the country's roadmap for collective investment into the future with the fiscal policy setting out the framework to fund this roadmap. To achieve the objectives of the NDP and maintain a balanced withdrawal from the economy in the form of taxes, South Africa will require growth rates in excess of 3%. Following the financial crisis, predications made by the World Bank, the IMF and National Treasury was that South Africa's growth rate would be above 3% for the 2015/16 year. These have been continually revised downwards. The 2015/16 budget proposals are now based on 2% for the 2015/16 financial year.



The tax revenue collection as a percentage of GDP has increased over the past five years (tax-to-GDP ratio) from 24.4% to 26.1% for the 2013/14 fiscal year. It seems that this upward trend will continue for the next three fiscal years. The ideal tax-to-GDP ratio should balance government's need to invest in the country's interest vs the private sectors need and ability to invest to grow the economy. The Katz Commission recommended that South Africa adopt as an unofficial target, a tax-to-GDP ratio of 25%. In this ratio determination, there are only two variables that can be controlled to reflect realities of the country and minimize long term harm to the economy i.e. the growth rate and revenue collections. The economic impact of the tax to-GDP ratio is underpinned by the various sources from which taxes are extracted namely personal income taxes; corporate taxes and indirect taxes (the tax mix). This tax mix should ideally be fairly distributed across the tax sources. The fairness of the contribution should in our view be determined by the applicable rate imposed and not necessarily by the quantum of the contribution as the latter is a reflection of uncontrollable variables such as the state of the economy and the rate of increase in labour costs or profits. The global average of marginal tax rates for individuals, as at Feb 15, across 154 countries has decreased from 29% to 28.9%. South Africa's marginal tax rate for individuals has however increased from 40% to 41%. In relation to corporate taxes the global average is 23.57% compared to South Africa's corporate tax rate of 28% whilst for VAT the global average is 15.83% compared to South Africa's current VAT rate of 14%. Though we acknowledge that the tax rates should be customised to local conditions, comparisons with the global position is highly informative given that South Africa forms part of the global economy. In this regard it is notable that South Africa's individual tax marginal rate substantially exceeds the global average whereas the VAT rate is lower than the global average. We agree that this disparity is in the short term unavoidable but in the medium to longer term should be equalised to better position South Africa within the global context.

As we are already exceeding the ideal levels of tax extraction from the economy it begs the question whether there should not be a review of the NDP goals to better reflect the South Africa's ability to achieve these goals.

Proposed solutions:

Increase our ability to produce manufactured goods from raw materials as manufacturing and beneficiation plants cannot be operated without skilled labour. This can be done through:

- Improving skills at both schooling and post-schooling levels;
- Improving and enhancing our road, rail and port infrastructure;
- Improved labour and business relations;
- Creating an enabling environment for business and individuals to trade by reducing administrative and compliance burdens.

To achieve these goals it would not only require proper budgeting, which is currently evident and in place, but efficient and prudent implementation.



Specific comments regarding estimates of all expenditure, budgetary and extra-budgetary specified separately, for that financial year

It is government's prerogative to allocate budget spend to reach its strategic goals. To date the budgeting process has been very robust, transparent and as a result not subjected to much criticism. Criticism has rather been focused on the utilisation and spend of the budgeted funds.

Set out below is therefore our view and preferences:

Infrastructure spend

Government's role in expanding the economy is to provide an enabling environment such as infrastructure.

Road

It is noted that the investment in road infrastructure will increase from 51.2 billion (2014/15) to a mere 52.8 billion (2017/18). This budgeted amount should be seen in the context of the fuel levy which for the 2015/16 fiscal year is budgeted to generate around R57.2 billion. As we have underspent on road infrastructure historically, it is concerning that we are not even spending the fuel levy collected. We should be spending even more than the fuel levy collected.

Port and Rail

The management and development of our port and rail infrastructure fall under Transnet (state owned enterprise). In our view, especially as pertains to rail infrastructure, expanded investment should be invested to expand our railway network which forms the backbone to facilitate the movement of bulk goods in our economy. The over use of our road infrastructure in this regard has led to the costly degradation of our roads at the cost of our economy.

Social protection expenditure

We commend government for the amounts committed to social protection expenditure as this confirms government's commitment to assisting those that are most vulnerable within our society. We would however like conduct further research as to whether the cash payment model is the most efficient and beneficial manner in achieving governments social obligation.

Education

We again commend government for allocating substantial resources to facilitate the expansion and upliftment of our education system. We are however concerned that too few resources are invested in upskilling the currently employable population. In our view mere academic education and employment without skills transfer will not uplift the current generation to support a production economy.

Specific comments regarding estimates of borrowing for that financial year

A government generally has to resort to borrowing when it spends more than it collects by way of taxes. This difference between spending and revenue is referred to as the fiscal deficit. This borrowing is added to the existing outstanding debt to determine the new outstanding debt of the state. Note that whenever a debt instrument matures, it is usually



"rolled" over — a new debt instrument is issued in its place and the deficit is not affected. Put differently, the cash-flow deficit is added to the existing debt pile every year and unless the state runs a surplus, debt will just keep going up.

In SAICA's submission to this committee in March 2014 we pointed out that our main concern is "that South Africa's debt is expected to increase from the 39.7% (for the 2013 / 14 year) to 41.9% in the 2014 / 15 year. In table 4.1 (on page 11 of the 2014 budget review) it is indicated that the projected state debt in 2016 / 17 will, as a percentage of GDP, be at 44.3%."

We also mentioned that "key for stability is that our sovereign credit rating does not move downwards."

According to Minister Nene "the net loan debt (i.e. gross debt less cash balances) is expected to stabilise at 43.7 per cent of GDP in 2017/18, about 2.6 percentage points lower than the 2014 MTBPS estimate."

The Minister mentions that the "total nominal gross debt stock is projected to grow from R1.8 trillion in 2014/15 to R2.3 trillion in 2017/18. When combined with redemptions, government's gross borrowing requirement is R229 billion in 2014/15, growing to R247 billion in 2017/18."

According to Dawie Roodt, at the end of December 2014, "total outstanding gross state debt amounted to R1.8-trillion, which is equal to about 47% of gross domestic product (GDP). This debt consists mostly of bonds but other instruments such as treasury bills and foreign loans are also included."

As indicated above the minister, however, prefers to subtract the state's cash balances from the gross figure to get "net loan debt" — which was about 41% of GDP in December.

We welcome Minister Nene's statement that "from 2015/16 onwards, government will close its current deficit – the difference between current revenue and spending on compensation, goods and services, interest, and current transfers and subsidies."

It is not clear how this is to be achieved. We agree with Dawie Roodt's comment that "should revenue again underperform or should GDP growth again disappoint, the debt-to-GDP ratio will be likely to exceed Finance Minister Nhlanhla Nene's expectations and could exceed previous highs during the next financial year." Some of our specific concerns in this regard are:

Key to meeting the deficit targets will be reaching the Treasury's economic growth forecasts. The Minister predicted economic growth of 2% for this year, sharply down from the 2.5% projected in October's medium-term budget policy statement. Electricity shortages and a weak global economy were largely to blame, he said. Growth is expected to rise to 2.4% in 2016 and 3% in 2017.



Slower growth has meant that tax revenue in the current fiscal year was R14.7bn lower than was estimated in last year's budget. Revenue projections for the next three years have deteriorated by R36bn since the October statement.

Eskom

Minister Nene mentions that medium-term support to help stabilise Eskom includes funding totalling R23 billion and that this is to be raised in a manner that does not widen the deficit. Eskom will receive allocations of R23 billion, to be raised through the sale of non-core government assets.

To stabilise the business, Eskom is working to improve productivity and reduce costs. It also plans to apply to the regulator for tariff increases that will move the price of electricity closer to the costs of its production.

The Minister stated that government's support for Eskom includes a medium-term funding allocation of R23 billion. Appropriations will be made to Eskom as funds from the disposal of non-core assets are realised, ensuring that there is no increase in government debt and no effect on the fiscal position. Government could also consider other interventions, such as converting its subordinated loan to equity to support Eskom's balance sheet.

We agree with the comment by this committee last year under the heading: Financial performance of state-owned entities. It was stated that "the sale of non-strategic assets, however defined, could be contested and could take time. However, some state-owned entities need financial assistance more immediately. The National Treasury will have to speedily finalise measures to separate the commercial and developmental aspects of the state-owned entities and other measures to assist the entities in ways that contribute to improving their financial position in the interim."

Public-sector borrowing

The Minister indicated that the public-sector borrowing requirement will be R246.8 billion, or 6.4 per cent of GDP, in 2014/15. This reflects an upward revision of R16.6 billion since the 2014 Budget as a result of higher borrowing plans by state-owned companies. Eskom increased its 2014/15 borrowing estimate by R10 billion, with the additional amount is accounted for by the South African National Roads Agency Limited (SANRAL).

Revisions to budgeted borrowing for 2014/15 are due to an additional R21 billion borrowed by the Development Bank of Southern Africa and the Industrial Development Corporation to meet their lending targets, and an additional R12.6 billion borrowed by Eskom and SANRAL to close revenue shortfalls in the current financial year.

The Minister indicated that most of the debt will be raised in the domestic market, but there is a concern regarding the significant proportion of foreign debt - averaging 36 per cent over the medium term.

Guarantees

The major state-owned companies benefiting from government guarantees are shown in Table 8.5 of the 2015 Budget review. A guarantee is a commitment to take responsibility for a loan



in the event of default; it enables the beneficiary to access funding that would otherwise be unavailable or to borrow at rates that reflect lower risk premiums.

We agree that high levels of contingent liabilities can lead to an increase in the risk premium on sovereign debt. We agree with the Minister that government should seek to maintain these liabilities within prudent limits.

As pointed out in our comments to this committee last year one needs to ask whether the present economic path is sustainable.

Specific comments regarding estimates of interest and debt servicing charges

According to Minister Nene the debt-service costs continues to be the fastest-growing component of main budget expenditure, increasing by 10.1 per cent in nominal terms over the medium term. The costs of financing government debt are projected to increase from R115 billion in 2014/15 to R153.4 billion in 2017/18, accounting for 3.1 per cent of GDP.

This is driven by the increase in government borrowing since 2008/09.

Minister Nene also indicated that, over the next three years capital will be the fastest-growing category of non-interest spending. He acknowledges, rightly so in our opinion, that rising debt-service costs, which amount to R115 billion in 2014/15 alone, threaten the sustainability of social gains achieved over the past decade.

Specific comments regarding the contingency reserve necessary for an appropriate response to emergencies or other temporary needs, and other factors based on similar objective criteria.

The purpose of the contingency reserve is to provide a cushion for emergencies and unforeseeable events. In the 2013 budget review (27 February 2013) government reduced the unallocated portion of spending by trimming the contingency reserve. It was then set at R4 billion, R6.5 billion and R10 billion over the three years of the MTEF (the R4 billion was for the 2013/2014 year and the R6.5 billion was for the 2014/2015 one). This was done because “unforeseen and unavoidable expenditure adjustments have, however, averaged just R4 billion in the last five years...”

In the 2014/15 budget review the estimate was revised to R Nil and the contingency reserve was adjusted to R 3 billion for 2015/16 year. Minister Nene adjusted the contingency reserve to R5 billion (15/16) and is set to increase to R15 billion (16/17) to R45 billion (17/18).

SAICA assume that the contingency reserve was adjusted downwards in 2014/ 2015 due to the drop in revenue collections and not because of overspending on other budgeted items.

SAICA believe there is a need for a contingency reserve to enable government to respond to emergencies or other temporary needs. One example of where this may be needed in this year is the drought in the northwest province.



In its very nature it would be difficult to provide an estimate for the amount of the contingency reserve, but we are not sure why the reserve is set to increase to R 15 billion in the next fiscal year and to R45 billion in the year thereafter.

The stated intention that “...wasteful expenditure” should be reduced is welcomed. It is also important that “... cost controls across government...” be implemented as mentioned by the Minister.

Small business relief

The budget review makes it clear that government aims to roll out procurement reforms, including an online tender system that enhances public scrutiny, strengthens competition and levels the playing field for small businesses. It is also stated that government’s immediate priorities are framed by the nine-point plan to boost growth and create jobs and it also includes unlocking small business potential.

It has always been SAICA’s view that the tax administrative and compliance obligations of small businesses are burdensome. We welcomed the fact the 2014 budget review acknowledged that “...red tape and bureaucracy are hindrances to doing business, especially for small and medium-sized firms” and that government aims to streamline the regulatory regime.” That budget review mentioned the introducing of reforms that “...would reduce compliance costs and facilitate access to equity finance...”

This was subject to public consultation during 2014, but other than the changes to the turnover tax regime for micro businesses, the 2015 budget review is silent on what will be done to meet the stated objectives.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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The South African Institute of Chartered Accountants