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30 June 2020

Mr Allen Wicomb
Parliamentary Standing Committee on Finance
90 Plein Street
Cape Town
8001

BY E-MAIL: Allan Wicomb, SCoF (awicomb@parliament.gov.za)
Teboho Sepanya, SCoF (tsepanya@parliament.gov.za)
Nkululeko Mangweni (nmangweni@parliament.gov.za)

Dear Madam and Sirs

PARLIAMENTARY PUBLIC HEARINGS - COMMENTS ON THE 2020 SUPPLEMENTARY BUDGET REVIEW

1. We present our comments and submissions on behalf of the South African Institute of Chartered Accountants (SAICA) National Tax Committee on the 2020 Supplementary Budget Speech released by Minister Mboweni on 24 June 2020.

2. We once again thank the Standing Committee on Finance (SCoF) and the Select Committee on Finance for the ongoing opportunity to provide constructive comments in this regard. SAICA continues to believe that a collaborative approach is best suited in seeking solutions to complex challenges.

ICEBERG AHEAD – TIME TO CHANGE COURSE

3. In our previous submission on the 2020 Budget, we pointed out that when an iceberg is spotted, the captain of the ship must make some very quick decisions which will have important consequences as the iceberg that is visible above the water is only about one third of the iceberg – the rest can't be seen. None of us could have imagined that beneath the iceberg was one more unseen obstacle – COVID-19.

4. We realise that COVID-19 forced government to adjust its division of revenue and departmental allocations and this led to the Supplementary Budget on 24 June 2020.

5. In this regard, we must commend the Minister for:

   5.1 Responding to the pandemic by providing large-scale economic relief measures and support that was targeted at the most vulnerable South Africans;

NPO-020-050 VAT No. 4570104366
17 Fricker Road, Illovo, Sandton, Johannesburg, 2196 POSTAL ADDRESS PO Box 59875, Kengray, Johannesburg, 2100
TEL +27 11 621 6600 FAX +27 11 622 3321 CALL CENTRE 08610 SAICA (72422) EMAIL saica@saica.co.za WEB saica.co.za | accountancysa.org.za
Member of the International Federation of Accountants (IFAC), Pan African Federation of Accountants (PAFA), Global Accounting Alliance (GAA), Chartered Accountants Worldwide (CAW) and Investors in People. Proudly South African.

5.2 Proposing to use zero-based budgeting as a guiding principle for the medium term economic framework and the phasing out of programmes that have little impact on economic performance or service delivery;

5.3 Improving tax revenue collections by primarily focusing on improved tax collection enforcement; and

5.4 Taking the “active approach” to fiscal consolidation and debt stabilisation rather than the “passive approach”.

6. Despite the above, in respect of the 2020/21 fiscal year, government is expected to spend **R709.7bn** more than it will earn and the following year it will overspend by **R495.6bn,** if it can contain costs as planned. Government needs to run zero budget deficits if it wants to meaningfully reduce debt.

7. There are three options in order to achieve this: Option one, increase tax revenue. Option two, reduce expenditure and option three, a combination of options one and two. Option one can now, in the short term, only be used to a limited extent due to the substantial reduction in the tax base as businesses close and jobs are lost due to COVID-19. Government has therefore acknowledged that tax revenue collections will have to primarily be improved by focusing on improved tax collection enforcement with the assistance of additional collections of R40 billion over the next four years.

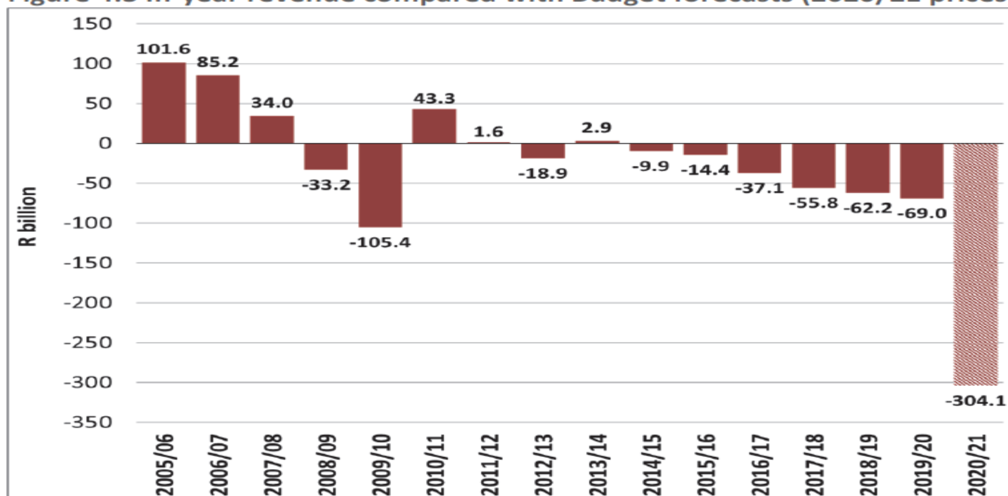
8. We hope, however, that SARS will achieve this focus on tax collection without implementing measures that will add even further to the administrative burden of tax compliant businesses. It is important that the focus be on business that are not tax compliant.

Overly optimistic projections of revenue and GDP growth

9. We are concerned with the estimations of tax revenue considering that the estimates are based on growth rates of 2,6% for 2020/2021 (2021/22: 1,5%), which is higher than other predictions from Moody’s (2%) and the World Bank (1,4%). This difference (1,2% or 0,6% conservatively) may appear to be relatively insignificant, but using the current estimated tax to GDP ratio it leaves a (conservative) additional R7,8bn shortfall in 2021 and R8,3bn shortfall in 2021.

10. National Treasury’s worsening track record over the last decade in relation to overly optimistic tax revenue estimations is evident from the Figure below and leaves a lot to be desired.

Figure 4.3 In-year revenue compared with Budget forecasts (2020/21 prices)



Source: National Treasury and SARS

11. Furthermore, National Treasury expects that the tax to GDP ratio will fall by a similar margin to that in the global financial crisis and that thereafter there will be a steeper recovery. However, this fails to take into account that there was almost a total shutdown of the economy during the National Lockdown, which was not the case with the global financial crisis. It also does not take into account the structural problems in our economy after the global financial crisis in 2010 and the consequence that the country's growth rate has been steadily declining since then. There is therefore a chance that the initial fall in the tax to GDP ratio could be steeper than the projected 15% would result further revenue shortfalls. Treasury's forecast seems to be based on the best case scenario.

12. If nominal GDP performance is worse than projected by National Treasury, the shortfall will obviously be even worse, which is a further risk to the revenue outlook.

13. The Minister is correct, drastic change needs to happen and new ways of thinking need to apply and that includes new thinking and new ways at National Treasury as well.

14. Submission: Considering the trend of underestimations in tax revenue predictions, we urge National Treasury to review thoroughly the data that underpins its tax revenue estimates and GDP ratios. If these estimates are inaccurate, there is a knock-on effect on the budgeted expenditure levels in each year.

15. As the Minister said, we need to start living within our means, but we need to know what those means are. We do not have the luxury anymore of basing revenue (and also expenditure) forecasts on best case scenarios. Living within our means requires realistic estimations even if that paints a bleaker picture.

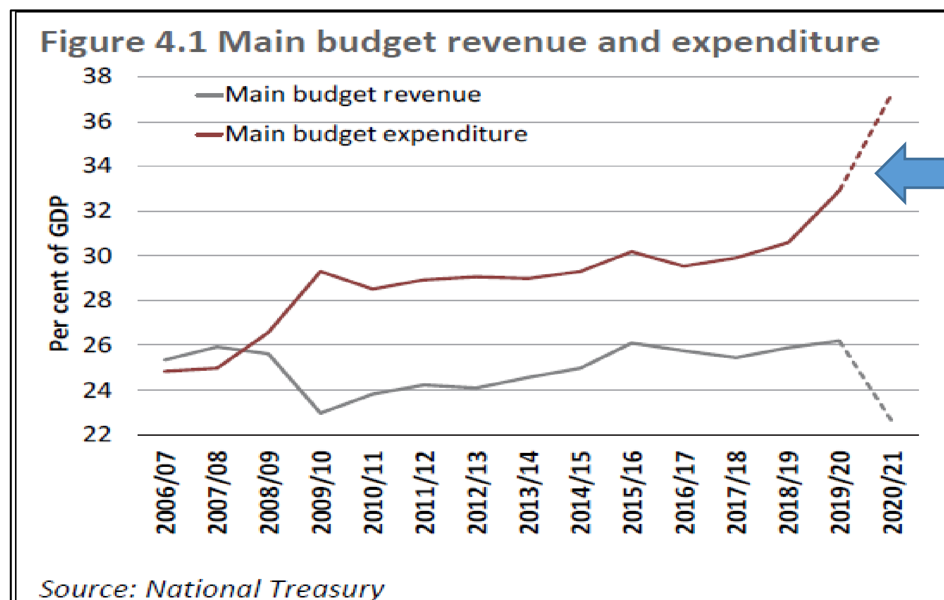
16. We agree with the Minister that our ability to show our creditors and rating agencies that we can turn the ship and responsibly manage our finances is even more important now.

Overspending and estimations

17. A major consequence of inaccurate revenue forecasts is that government expenditure is based on estimated GDP and tax revenues. Therefore, over-estimating GDP and tax revenue leads to further overspending.

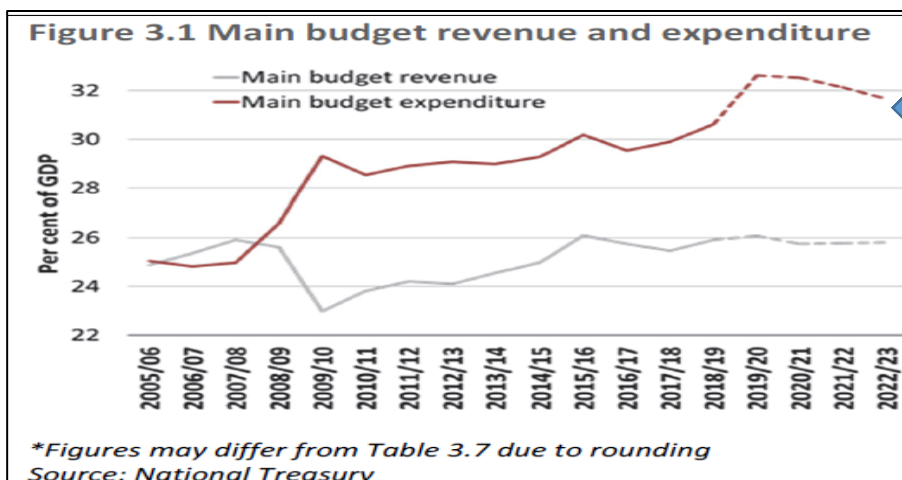
18. South Africa can no longer afford to implement spending plans that are based on overly optimistic revenue forecasts.

19. Overspending is a reality that we have been experiencing for many years now, as is evident from the figure below.



20. As mentioned earlier, option one (increasing tax revenues) is not a viable option at this stage to reduce the budget deficit and hence neither is option three, leaving us with only option two – reducing expenditure.

21. The February 2020 budget anticipated that expenditure would decrease in the short term as a percentage of GDP as follows:



22. The February budget, however, also showed that the actual amount of expenditure would increase year on year:

Table 3.3 Adjustments to main budget non-interest expenditure since 2019 Budget

R million	2020/21	2021/22	2022/23	MTEF total
2019 Budget non-interest expenditure	**1 545 500**	**1 653 077**	**1 736 538**	**4 935 115**
Skills development levy adjustments	-1 025	-1 722	-500	-3 246
Change in contingency reserve	-1 000	-1 000	-1 000	-3 000
Baseline reductions and reallocations	**-66 045**	**-88 149**	**-106 801**	**-260 995**
Programme baseline reductions	-28 238	-33 219	-39 341	-100 798
Wage bill reductions	-37 807	-54 929	-67 460	-160 196
Baseline allocations	**59 293**	**29 981**	**21 843**	**111 117**
Financial support for state-owned companies	44 042	14 309	1 777	60 128
Net change in adjustments announced in 2019 Budget[1]	7 753	7 620	11 953	27 326
Programme allocations	7 499	8 051	8 113	23 663
2020 Budget non-interest expenditure	**1 536 724**	**1 592 186**	**1 650 080**	**4 778 991**
Change in non-interest expenditure since 2019 Budget	-8 776	-60 890	-86 458	-156 124

1. Includes reversal of savings from wage bill measures and national macro-reorganisation of government, adjustments due to lower CPI and early retirement savings in police

Source: National Treasury

23. Government has acknowledged that it has endorsed the target of a primary surplus by 2023/24, meaning revenue will exceed non-interest expenditure. This will require spending reductions and revenue adjustments amounting to approximately R250 billion over the next two years. Specifically, the active scenario assumes:

23.1 Tax increases of R5 billion in 2021/22, R10 billion in 2022/23, R10 billion in 2023/24 and R15 billion in 2024/25.

23.2 Spending reductions amounting to about R230 billion are thus required in 2021/22 and 2022/23, followed by further reductions in 2023/24.

24. The expenditure estimates were adjusted as follows in the Supplementary Budget:

Table 4.1 Active scenario medium-term budget balances

R billion/percentage of GDP	2020/21 Revised	2021/22 Medium-term estimates	2022/23
Main budget revenue	**1 099.5**	**1 268.2**	**1 378.8**
	22.6%	*23.8%*	*24.5%*
Main budget expenditure	**1 809.2**	**1 763.8**	**1 809.3**
	37.2%	*33.1%*	*32.2%*
Non-interest expenditure	1 572.7	1 500.6	1 508.2
	32.4%	*28.2%*	*26.8%*
Debt-service costs	236.4	263.1	301.1
	4.9%	*4.9%*	*5.4%*
Main budget balance	**-709.7**	**-495.6**	**-430.5**
	-14.6%	*-9.3%*	*-7.7%*
Primary balance	**-473.2**	**-232.4**	**-129.5**
	-9.7%	*-4.4%*	*-2.3%*

Source: National Treasury

25. Although the expenditure estimates have reduced since the February 2020 budget, it would appear that actual expenditure amounts have not reduced by the R230 billion in 2021/22 and 2022/23 as mentioned above. The revenue forecasts seem to be the primary reason for the reduction in budget deficit in those two years. Furthermore, cognisance should be taken of the fact that these estimates are based on growth rates higher than what could potentially be realised.

26. Hence the reduction in expenditure may still be insufficient to reduce the budget deficit as required.

27. Submission: We fully support the proposed reduction in spending, however, we note that this might not be enough to prevent further increases in the budget deficit.

28. SAICA also fully supports the zero-budgeting approach to ensure that reductions are made to government spending – only expenditure that provides value for money and for which there is no cheaper alternative should be permitted. This principle should be implemented immediately despite the challenges involved since this approach should have been adopted many years ago.

29. SAICA undertook an analysis of expenditure by Department (see SAICA's February Budget 2020 submission) to determine where Government is spending, what it is spending on and whether it is getting value for money. We examined eight of the separately disclosed expenses in the national Budget (compensation being one of them), and provide high-level insight on these. This analysis could also be used as a starting point for determining expenditure reductions.

30. We once again urge the Standing Committee on Finance to prevail upon the various Government departments to exercise proper oversight over their portfolios to ensure fiscal discipline and effective spending. Each projected project spend should be interrogated and where departments have not met their targets, misspent their budgets and/or they have received qualified audit reports, they should be held accountable. The individuals responsible should be black-listed and be prevented from being redeployed at other government departments. This measure is essential to ensure the sustainability of South Africa's finances.

Iceberg below the water – Unbudgeted expenditure

31. We have also warned National Treasury and Parliament that the iceberg below the water is unknown and rarely budgeted for.

32. These matters have included:

32.1 State guarantees becoming government debt, especially for State owned enterprises (SoE's);

32.2 More SoEs and Scheduled Entities becoming reliant on government bail-outs;

32.3 Municipal failures becoming national and provincial government burdens;

32.4 Water and sewage infrastructure that is imploding and destroying drinkable water (more than 37% of drinking water is lost to leaks according to the CSIR) and river systems in South Africa, which is a water-scarce country. This is expected to lead to water shedding in the near future;

32.5 Wage increases over the last decade have exceeded budgets by more than 40% (average amounts budgeted for were on average 6,5% but actual wage increases have been nearly 10%). Little support for the Minister seems to come from the Public Services Commission in this regard.

32.6 The GEPF will more than likely be under-funded after COVID 19 as equities and interest investments declined by nearly 40% during lockdown. As of June 2020, equities have recovered and are only down 9% since January 2020, however, dividend flows from these investments will take some time to recover. Interest bearing investments will remain depressed given the low repo-rate over the medium term.

32.7 In this regard, the GEPF funding policy states that the trustees should strive to maintain the long-term funding level at or above 100%. The long-term funding level of the fund at the valuation date as per the March 2018 Actuarial Valuation Report was 75.5% with a minimum funding level of 108.3%. The minimum funding level is defined as a funding level determined excluding any contingency reserves. The funding policy requires the trustees to take steps to ensure that the minimum funding level is always above 90% and to strive to maintain a long-term funding level at or above 100%. Thus as at 2018, the minimum funding level was met, however, with the decline in the economy in South Africa, even the minimum funding level would be under pressure and could slip below the required funding level of at least 90%.

32.8 In addition to the above, although the GEPF, as at the valuation date in 2018, meets the minimum funding level, it *does not meet its long-term funding objectives* (75,5% versus the required 100%).

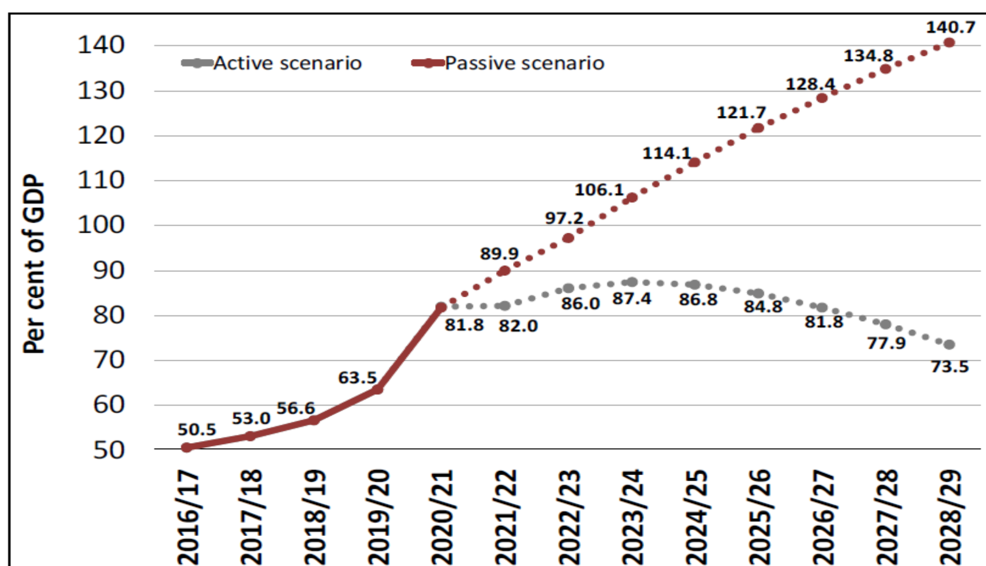
32.9 Given that the government was already underfunding the required contributions by 2,9% in 2018, this situation will be significantly worse after COVID-19.

32.10 Based on the 2018 valuation report, should government be required to contribute an additional 2,5% to the fund, this would equate to approximately R8 billion and should the required contributions be 5%, this would equate to approximately R16 billion. Both these numbers exceed the proposed tax increases of R5 billion in 2021/2022 and R10bn 2022/2023.

32.11 Submission: An updated actuarial valuation of the fund is necessary as government's contributions towards the fund would need to increase further to ensure that it meets its long-term funding objectives. It would appear that this has not been taken into account in the budget and would be something that the IMF would want to re-evaluate should South Africa enter into a sovereign debt crisis.

Burgeoning debt levels

33. If the overspending problem persists, debt will have to be used to fund the shortfall but this becomes an unsustainable formula. In the active scenario, debt stabilises at 87.4% of GDP in 2023/24.



34. This analysis, however, excludes debt in relation to the guarantees that have been extended in favour of State Owned Entities, which in reality take the above figure to around 100% of GDP by 2023/24.

35. Government has revised its financing strategy and will now also source funding from international financial institutions, as the local market is under pressure.

36. No details of the funding terms of these loans have, however, been made available.

37. Submission: Although we realise that there is no alternative at this stage but to borrow internationally, this will cost the country more as not only are these loans subject to potentially higher interest rates, but they are also subject to volatile currency fluctuations.

38. The lending terms of the international loans should be disclosed to the public.

39. There is also no indication of what "active intervention" means and why it could be successful when previous attempts have failed, largely due to a lack of accountability, as detailed in the Auditors Generals annual reports for both the PFMA and MFMA.

Proper long term planning and the credibility of the State

40. It was stated that another purpose of the Supplementary Budget was to set out government's commitment to strengthen the public finances and to position the economy for faster and inclusive growth.

41. In order to strengthen the public finances, which had reached an unsustainable position even before COVID-19, the Minister proposes to prepare a set of far reaching reforms over the next several months. The implementation of these reforms are promised to stabilise public debt, contain the budget deficit and fully restore economic activity to build confidence, increase investment and promote job creation.

42. Although we note that the Supplementary Budget is a bridge to the October 2020 Medium Term Budget Policy Statement, promises of similar reforms have been given numerous times, yet the actual reforms never seem to materialise.

43. In 2018, Parliament requested input on what it would take to grow the economy. **SAICA proposed 7 key areas** that need to be resolved that included:

    46.1. Agreement as to what **government's role** should be and the size of its role in participating as player, rather than facilitator, in the economy. This role should be mainly determined in relation to growth priorities and not merely political ideology;

    46.2. Agreement on principles and measures to create **stable employment relations**[1] and is ranked **137 out of 137** by World Economic Forum. South Africa has one of the most violent and unstable employment relations in the world which is further reflected in our low productivity rates (**OECD 2018 report**: *South Africa has the lowest productivity growth rate among emerging economies and together with Brazil and Argentina, the only negative rates*);

    46.3. Agreement as to the principle of **long term currency stability** and is the most volatile currency in the world[2]. Business can operate in strong currency

[1] https://www.business-humanrights.org/en/world-economic-forum-index-ranking-137-countries-shows-so-africa-has-the-worst-labour-employee-relations

[2] https://businesstech.co.za/news/finance/334927/the-rand-hits-new-levels-of-volatility/

environments like UK and USA and also in relatively weak currency environments like Japan and China. What is critical for business and foreign investors is a stable currency that removes uncertainties in relation to cost and investment return. Though the Reserve Bank Act makes this SARB's primary function, SARB has instead chosen inflation targeting as its main function. However, if inflation is subject to external pricing factors, the SARB has little control over inflation;

46.4. Agreement on what **quality education and skills** actually are, factors hindering the implementation of quality education and skills and how skills that add value over the long term are created. South Africa in 2016 ranked 56 out of 61 countries surveyed[3]. We do not require more unskilled and unsuitably skilled labour but labourers that can fully participate in the economy of the future. We spend proportionally some of the highest amounts on basic education yet produce some of the most illiterate learners in the world. The apparent lack of accountability from government officials and organised labour to these conditions remains problematic;

46.5. Agreement on principles and measures to bring about **long term political and policy stability** (we have had 7 long term economic policies in 24 years), including agreement on appropriate measures of accountability and efficient enforcement for government, labour and business. South Ranked 108 out of 147 by the World Economic Forum for policy stability[4]. The more than 20 political murders in the 2016 municipal elections and the violent political wrangling in Nelson Mandela Bay, Tshwane and Johannesburg created much anxiety, not only among foreign investors but also local investors;

46.6. Agreement on an urgent plan for **reduction in the crime rate**, including white-collar crime, which is an inordinate burden on society. South Africa is ranked 123 out of 163 by the Global Peace Index as the one highest country in the world for violent crime[5] (top 10) and low rankings for corruption[6] and white-collar crime is undermining our economy. Small business disproportionally carries this burden as they are unable to mitigate this impact and logistics involved in moving goods and attracting clients become costly;

46.7. Agreement on the **infrastructure build priorities** for the country and how such build will be achieved without creating an unmanageable debt burden. These infrastructure projects should be aligned to our economic value-driver priorities and should not be undertaken merely for the sake of capital spending.

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[3] https://businesstech.co.za/news/lifestyle/116230/south-africans-among-the-most-illiterate-in-the-world/
[4] https://www.dailymaverick.co.za/opinionista/2020-01-14-lack-of-economic-freedom-holds-south-africa-back/#gsc.tab=0
[5] https://www.iol.co.za/capeargus/news/sas-violent-crime-murder-rate-cause-for-low-ranking-on-global-peace-index-49401232
[6] https://tradingeconomics.com/south-africa/corruption-index

44. The above points raise the question as to why NEDLAC has not addressed and agreed these outcomes for the country and whether it has failed in its purpose.

45. The NEDLAC Act states the purpose of NEDLAC as follows:

5. (1) The Council shall-

(a) strive to promote the goals of economic growth, participation in economic decision-making and social equity;

(b) seek to reach consensus and conclude agreements on matters pertaining to social and economic policy;

(c) consider all proposed labour legislation relating to labour market policy before it is introduced in Parliament;

(d) consider all significant changes to social and economic policy before it is implemented or introduced in Parliament; and

(e) encourage and promote the formulation of coordinated policy on social and economic matters.

46. Submission: The acceleration and expansion of structural reforms to support economic growth are urgent and need to be introduced as soon as possible with clear and detailed action plans.

47. An improvement in economic growth will also support improved tax revenues. Tax increases should be minimised so as not to further harm economic growth and tax morale and should be done in the least distortive and economically harmful manner (i.e. through indirect taxes, including VAT) and taxes that support environmental and health objectives.

48. We urge government to ensure that all expenditure be aligned to a proper economic plan (not merely a "wish list" of ideals) with full accountability by political leadership and employees, including the introduction of individual performance management and reward systems.

49. A proper economic plan will inform planned reductions in expenditure and in which areas we are spending too much and in which we are spending too little. The economic plan, however, needs to be informed by a realistic vision. Issues such as the role of the state in creating economic value, defining our strengths and targeted economic areas for development, living wages, labour relations and productivity and societal goals such as housing and healthcare need to be considered.

50. Currently NEDLAC is meant to be a forum to address these fundamental issues but the effectiveness of this forum needs to be reconsidered.

51. This forum should be the place where such discussions take place and it is agreed how to address concerns on the public sector wage bill (which has grown to over 40% of tax revenue without a similar growth in efficiency), state-owned enterprises (that need to be

sold or liquidated if not viable) and also what our priorities for infrastructure spending should be.

CONCLUSION

52. The iceberg under the water was big in February but it is now even bigger. The issues of deteriorating water infrastructure including sewage and river systems, state debt guarantees that are fast becoming state debt (at the SOEs for instance) and the deterioration in services offered by municipalities, have not disappeared. The pressure of COVID-19 on the health care system and the economy have increased the size of the iceberg under the water, however, the full extent of it is not yet known.

53. The time has come to change the direction of “Ship SA” to avoid a sovereign debt crisis i.e. crashing into the iceberg.

54. Despite Minister Mboweni demonstrating his courageous leadership once again when he warned that borrowings are not revenue, Ship SA is still missing a comprehensive map of the route it will take.

55. A coherent overall policy framework which includes policies that will fast-track the fiscal consolidation of Ship SA is still lacking. Clear steps are needed as to how the government will handle the following issues: partnering with the private sector, the fate of underperforming state-owned entities, crime, the reduction of the public wage bill and infrastructure spending.

56. Talks of green technology and infrastructure are encouraging and we eagerly await further clarity on how this will help increase the capacity and reliability of key services like electricity, transport and municipal services and in so doing, increase the capacity of the economy as a whole.

57. We mentioned National Treasury’s track record in relation to revenue estimations. Track records matter, as is evident from Moody's statement that South Africa's track record in reducing government debt and budget deficits shows that the country will struggle to fulfil Minister Mboweni's promise to stabilise its debt levels within the next three years.

58. The eyes of the country and the world will be on the South Africa government as to whether it has the credibility and tenacity to do what is necessary. Hard and politically sensitive decisions like reducing the public wage bill and a zero-base budget approach are not about costs alone, but also about demonstrating government’s willingness and ability to implement “active intervention”.

59. Now is the time for Ship SA to change its course and by so doing, start a new track record – one that is heading in the right direction.

Yours sincerely

David Warneke
Chairperson: National Tax Committee

Sharon Smulders
Project Director: Tax Advocacy

The South African Institute of Chartered Accountants