Budget 2005

Opportunity Knocks

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Introduction

> "My other piece of advice, Copperfield," said Mr Macawber, "you know. Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery. The blossom is blighted, the leaf is withered, the God of day goes down upon the dreary scene, and-and in short you are forever floored.
>
> Charles Dickens, David Copperfield

This note is based on a presentation done by Cannon Asset Managers that deals with the national budget for 2005-2006. Given that detailed line-by-line commentary is covered elsewhere adequately and extensively, the objective of our commentary is to provide a broader perspective on policy issues that are raised by the reading of the budget, and to examine some of the implications for the South African economy, businesses and investors.

In our commentary we highlight four issues that we believe are of particular relevance to the South African economy: foreign exchange controls and fixed investment spending; job creation; HIV-AIDS; and taxation of retirement funding. Whilst other issues demand attention, limitations of space and time confines our focus to what we believe are four important issues for the domestic economy.

Importantly, the budget was read against a backdrop of a track record of exceptional fiscal discipline that has been laid down by government over the past decade. At the same time, the picture is brightened by sound economic fundamentals, robust consumer confidence and an improving outlook for the South African economy. However, whilst the economic outlook is favourable, we are of the opinion that the four issues that we raise in this note have not received the necessary attention. Our thinking is that by addressing these issues government will not only aid the outlook for the economy, but also promote the instruments and vehicles of broad-based socio-economic upliftment.

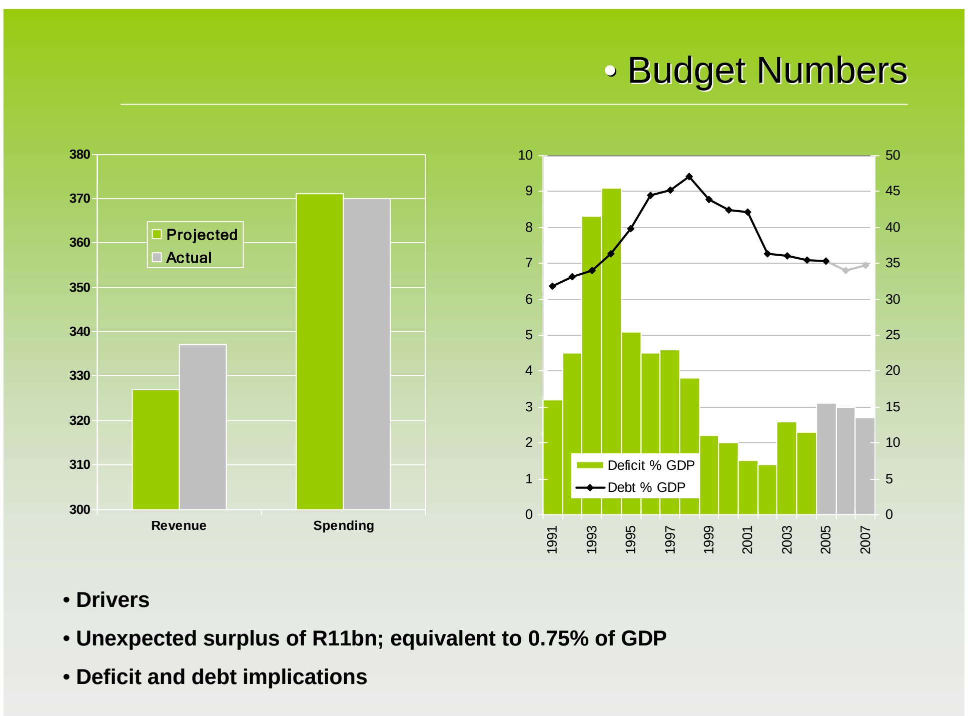
1. Budget Numbers

The task of fiscal policy, as guided by the national budget, is two-fold:

- to achieve specific short-, medium- and long-range objectives such as the provision of infrastructure, policing and judicial systems, education and health resources; and
- to deliver these objectives in a sustainable fashion that is promoting - not disruptive or retarding - of economic activity.

On this basis, the South African government has been relatively successful over the past decade. On a near-term basis, however, the numbers make for good reading (Slide 1, Figure 1):

- revenue which was projected at R327 billion (2004) came in at R337 billion (a R10 billion overrun); and
- expenditure which was projected at R371 billion (2004) came in at R370 billion (modest underspending of R1 billion).



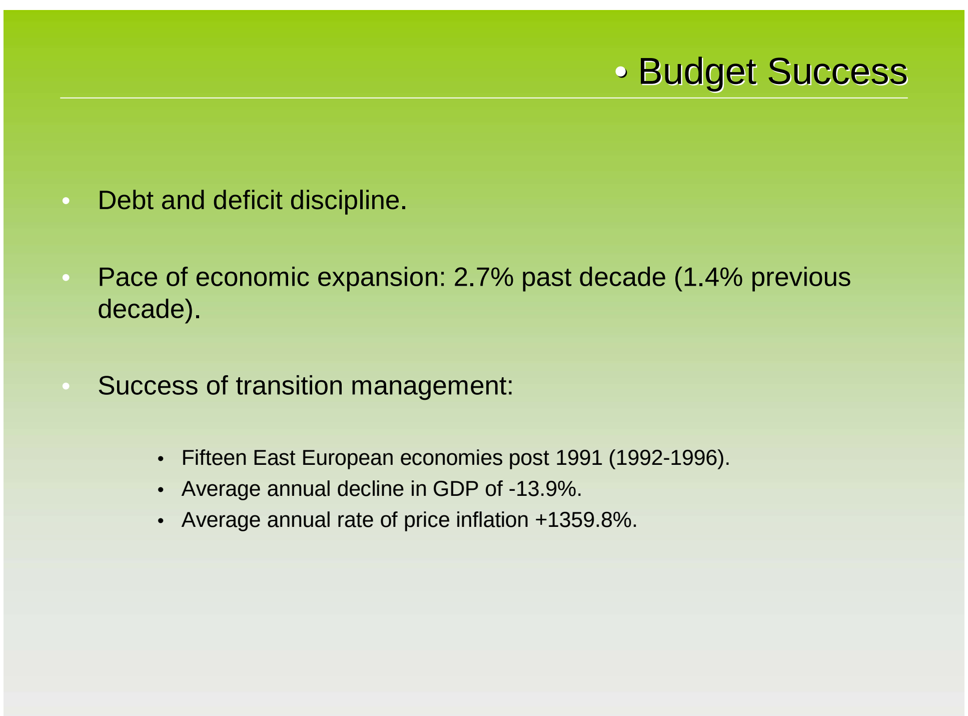
Thus, the budget shows an unexpected surplus of R11 billion, with the primary drivers of this overrun being higher VAT collections via the robust consumer economy; larger property tax receipts (monthly collections in 2004 were five times greater than five years ago); and individual and corporate tax receipts. Expenses were also slowed to some extent by reduced borrowing costs which came about as a consequence of lower interest rates and the stronger Rand (the latter reducing the offshore debt burden).

An interesting aspect of the budget that has emerged over the past decade is the extraordinary fiscal discipline that has been applied (Slide 1, Figure 2). Moreover, the healthy state of revenues suggests that we will see a budget deficit of below the golden figure of 3% of gross domestic product (GDP) for the foreseeable future. Thus, government finds itself in the unusual position of being able to cut taxes whilst simultaneously reporting a reduced budget deficit. This is a rare circumstance. The debt-to-GDP ratio also continues to show signs of improvement - and now stands a substantial distance away from the debt-trap figure of 60% that some feared could emerge in the 1990s (Slide 1, Figure 2).

2. Budget Success

Some of the successes achieved by the current administration over the past decade should not be underplayed. The deficit and debt numbers alluded to above are a case in point.

Furthermore, over the past decade the economy has expanded at an average rate of growth of 2.7% per annum. In the previous decade the economy expanded at just half that rate: 1.4% per annum (Slide 2).



Related to this, it can be noted that other economies that have recently undergone transitions similar to South Africa's have grappled with problems of a different magnitude altogether. A sample of 15 East European economies that underwent transition after the collapse of the Berlin Wall experience extraordinary disruptions in the early years of their transition. Specifically, over the four-year period 1992-1996 GDP in the 15 economies in our sample declined by an average of 13.9% per annum. These countries also suffered under the burden of hyperinflation with an annual average inflation rate of 1 359%. When cast in this light it is evident that whilst the South African economy is yet to enjoy the super-growth rates of India or China, the scenario could have been dismal.

3. Difficulties

However, whilst the transition can be regarded as relatively successful, the social and economic impacts are mixed. In terms of its human development index ranking, South Africa is located at about the halfway mark globally; and income equality (as measured by the Gini coefficient) ranks us as having one of the most unequal income distributions in the world (vying for last place with a handful of Latin American economies). Life expectancy numbers are not quickly agreed on, but it is our reading that the figure has begun to decline as a consequence of the HIV-AIDS pandemic (see Slide 3).

• Difficulties

- Impact of delivery mixed

Indicator	Rating
HDI	0.695 (107 out of 173)
Gini	0.59
Life Expectancy	52 years
Adult literacy	85%
Access to safe water	86%

At the same time, other indicators, such as adult literacy and access to safe water point to an improving picture. In a breath, though, the smooth economic transition has not translated into broad-based upliftment. This is a structural weakness that demands attention – and receives some attention in the 2005-2006 budget.

4. Areas for Attention

In a note of this nature, it is impossible to do justice to the intricacies or complexities of the macroeconomic tasks at hand, or to analyse in fine detail each of the points raised by Minister Trevor Manuel. However, there are at least four main issues which we feel demand specific attention.

In broad terms, we think that the four arenas demanding attention include:

- foreign exchange controls and, related to this, the need to stimulate investment spending;
- job creation;
- health, with an emphasis on the HIV-AIDS pandemic; and
- the retirement industry and related taxation issues.

Each of these topics is explored in some detail below.

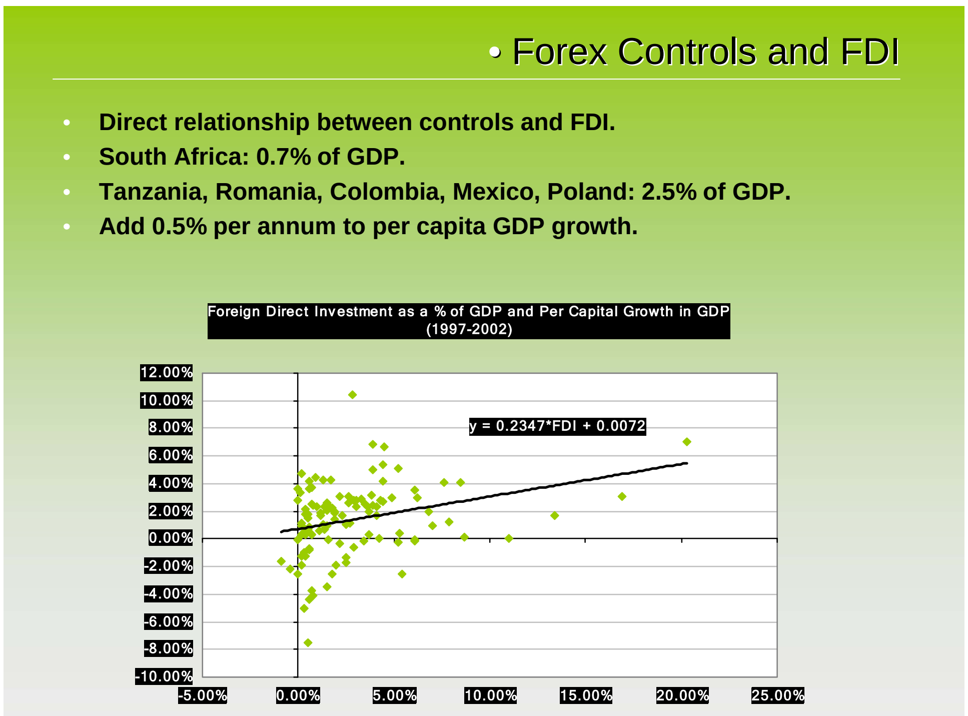
5. Forex Controls and FDI

No adjustments were made to foreign exchange controls. Although it is difficult to foresee adjustments to foreign exchange controls being made under the amnesty conditions, there can be little doubt that the time to scrap controls is now long overdue. Elsewhere in the world experience shows that the scrapping of foreign exchange controls is most successful where two preconditions have been met: the trade sector of the economy has been liberalised; and the macroeconomic displays signs of stability that include the existence of a developed financial system. The South African economy satisfies these preconditions with the trade sector having been substantially liberalised since the start of the 1990s; and the economy is inherently stable, boasting a highly developed financial system. Thus, the conditions necessary for successful relaxation of foreign exchange controls are in place, yet no moves were made.

Curiously, in an interview after the reading of the budget, Minister Manuel indicated that there was so little left by way of controls, and that they effectively have been scrapped. If this is the official view, then we beg the question: "Why not scrap controls in a big bang announcement?".

More to the point, we see foreign exchange controls as a drag on investment sentiment. Foreigners have numerous options when considering investment destinations, as do South Africans. For both sets of investors, the existence of controls, no matter how relaxed, are a tick in the “con” box.

As an aside, South Africa enjoys inflows of foreign direct investment (FDI) equivalent to about 0.7% of GDP per annum. Comparable countries, such as Romania, Colombia, Mexico and Poland, enjoy rates of FDI of almost four times this level. Our modeling efforts indicate that if the rate of FDI were to improve to these levels, South Africa would enjoy an extra 0.5% per annum in economic growth (Slide 4). Certainly, the scrapping of foreign exchange controls would not be a sufficient condition to achieve these inflows - but they are a necessary condition.



As a further point, on the timing of the scrapping of controls, we believe that a window of opportunity exists that is seldom as attractive as it is right now. Consumer and investor confidence in the South African economy are high; macroeconomic indicators - such as growth and inflation - are favourable; asset classes are enjoying broad-based success in delivering robust returns to investors; the Rand has ranked amongst the strongest currencies in the world for three years in a row; confidence in the US dollar - arguably the most obvious currency in which foreign investments would be held - is low; and prospects for asset classes in the rest of the world, especially developed economies, are far from enticing. This unusual blend of circumstances affords a better than usual setting for exchange controls to go.

Finally, in passing, we note that the amnesty conditions have created “unevenness” in the playing fields for South Africans who wish to invest abroad. As an example, an individual who wishes to invest offshore is limited by the foreign investment allowance of R750 000 per person. In contrast to this, a person who illegally moved funds offshore but has since been through the amnesty process can retain the full investment amount offshore (after the deduction of a small penalty). Effectively, then, the latter's funds are free of all exchange controls. Thus, the regulations around exchange controls treat individuals differently.

6. Relief from Forex Controls

Not unrelated to the above, it is instructive to note that many countries that have recently relaxed controls have enjoyed improved economic conditions. For instance, a sample of three countries - Estonia, Hungary and the Czech Republic - reveals that since relaxing exchange controls the rate of FDI and domestic fixed investment have increased, as has the pace of growth in per capita incomes (see Slide 5). In that sample, since lifting controls the rate of investment has climbed to between 22.3% and 28.5% per annum. This is at least 50% better than South Africa's figure of 15.1%. The pace of growth in per capita income over the period for the countries sampled ranged between 2.1% per annum and 6.5% per annum - shadowing South Africa's 1.8% per annum.

• Relief from Forex Controls

	Growth in GDP per Capita (%)	Level of Investment (% of GDP)
Estonia	**6.5**	**28.5**
Hungary	**3.6**	**22.3**
Czech Republic	**2.1**	**26.3**
South Africa	**1.8**	**15.1**

- Promote FDI via:
  - Reducing taxation.
  - Reducing regulatory burdens.
  - Abolishing exchange controls – inside of the window of opportunity.

Of course, as noted, measures other than relaxing exchange controls are necessary to attract investment. For instance, regulatory burdens must be lifted; and some progress was made in this regard, such as the scrapping of regional service levies and reduced administrative burdens in terms of VAT returns for smaller companies. But more needs to be done. Similarly, whilst the company tax rate was reduced by one percentage point, we think this was not enough and that it could have been better directed. The target for tax reduction must surely be secondary tax on companies (STC) – an instrument that is "foreign" to many investors and traps cash inside of South Africa's corporates. The reduction in company taxes also does not go far enough when compared to the global trend.

To illustrate this point, if one includes STC in the calculation, South Africa's company tax rate is now amongst that highest in the world (over 35%). The world average is under 25%. Countries with the lowest company tax rates, such as Ireland, Qatar, Singapore and Mauritius have rates under 12.5% with no exchange controls of any nature. Their labour laws are also flexible and immigration is simple and quick. In China's free trade zones there are no foreign exchange controls and no taxes. Countries' willingness to attract investment from abroad and encourage home-based investment is effectively demonstrated by the case of Romania which recently cut company taxes from 40% to 16%.

7. Relief from Forex Controls

Our point about job creation is a simple one. Governments do not create jobs – rather, they create environments in which jobs are created. A sample of 50 countries similar in make-up to South Africa reveals a reasonably strong relationship between government spending as a percentage of GDP and the rate of formal sector unemployment (Slide 6).

The explanation for the government spending-job creation relationship is simple. Globally, the evidence from countries shows that higher levels of government involvement in the economy are correlated with higher rates of unemployment. You can think of the old Soviet economies, or Cuba, as extreme examples. Taking the argument further, as governments step away from the economy and become less involved in "spending on things" they free the economy up for private sector participation. The economy becomes more nimble, it grows faster and the private sector also benefits from an often-associated reduced regulatory burden. Using the above-mentioned sample of 50 countries, the relationship that we estimate is as follows:

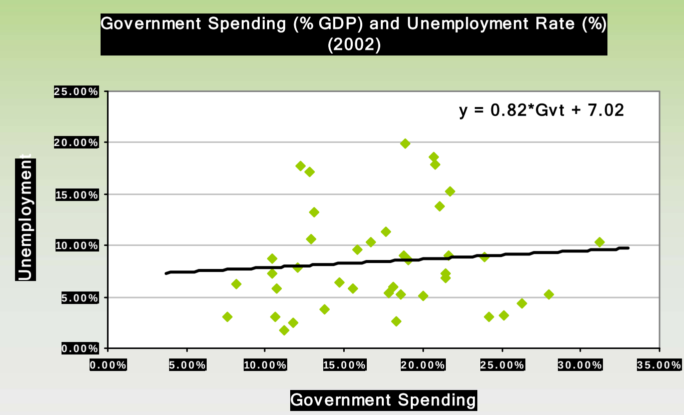
- each ten percent increase in government spending increases long run unemployment by 1%; and
- based on South Africa's spending figures, by reducing government spending by 3.0 percentage points the economy would "theoretically" create of the order of 450 000 jobs.

• Jobs

• Governments do not create jobs.

• Regulatory burdens and high tax rates destroy jobs.

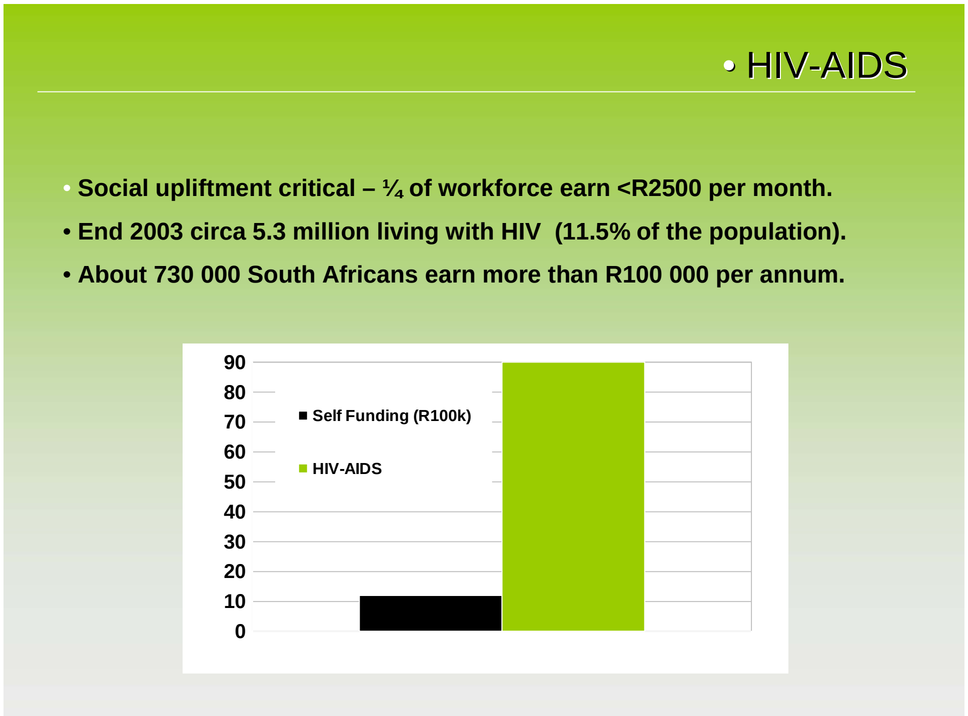
• Reducing spending by 3.0% “theoretically” create 450 000 jobs.



8. HIV-AIDS

Our numbers suggest that about one-quarter of the South African workforces earns under R2500 per month. The point of highlighting this figure is that R2500 per month can be considered the income level needed to enter what is being referred to as the “first economy”. Thus, efforts made in the budget to promote social upliftment must be recognised as critical to the success of the economy.

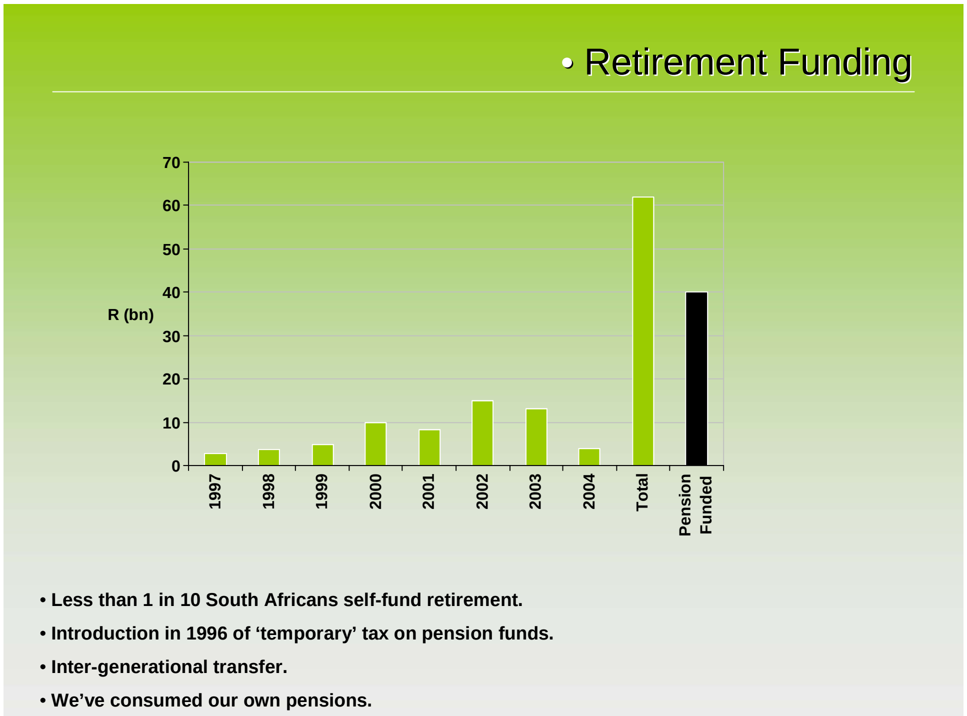
Not unrelated, at the end of 2003 it was estimated by UNAIDS that 2.3 million South Africans were living with HIV. Our analysis suggests that to self-fund HIV-AIDS treatment, a person requires an income of at least R100 000 per annum. Just 750 000 South Africans enjoy this privilege. Thus, the funding of the HIV-AIDS pandemic falls squarely on the shoulders of the public sector – individuals simply cannot afford to fund their own treatment.



To further illustrate the extent of the crisis, if we were to take all people who are infected with HIV and put them in football stadiums that seat 60 000 people, we would fill 90 stadiums. The number of stadiums filled by individuals earning more that R100 000 per annum amounts to just 12 (Slide 7).

9. Retirement Funding

In 1996 a tax on the retirement industry was introduced as a "temporary measure". Although the tax rate was reduced from 25% to 18% at the end of the 1990s, the tax remains in place. Since it was introduced, the tax has brought in R40 billion in revenues for government. Over this same period, individuals have received an estimated R65 billion in tax relief. Read in the light of the retirement fund tax, it becomes apparent that we have financed today's windfalls with tomorrow's savings. We have consumed our own pension funds. This outcome is alarming in a country where less than one in ten South Africans can self-fun their retirement. Moreover, the point highlights the need for the retirement fund tax issue to be resolved, having been under review for almost a decade.



10. A Note of Markets' Reactions and Economic Data

As an aside, it was interesting to note the reaction of the major markets to Wednesday's budget. In the case of the bond, equity and currency markets the reaction was consistent: negligible. In the case of the currency market in particular, the absence of any reaction is a favourable outcome for the domestic economy. A negative reaction could easily have raised an inflationary threat. We were sensitised to this by the exceptionally good consumer inflation numbers (3.6% increase year-on-year) that were released on Wednesday morning. When this inflation figure is read in conjunction with the producer inflation numbers that were released on Thursday (1.4% increase year-on-year), and the Rand's strength over recent weeks and stability since the reading of the budget, we are inclined to think that our earlier forecast of a 50 basis point cut in interest rates in April now looks conservative. Indeed, some analysts are now of the view that rates could fall by as much as 1% when the Monetary Policy Committee releases the results of its next meeting of 13-14 April 2005.

11. Analysis

In the final analysis, whilst government can be applauded for some of its economic and fiscal policy successes achieved over the past decade, the success is not universal.

Gaps remain that demand attention. Moreover, whilst the budget has addressed some issues of concern – such as the skills shortage and the need for infrastructural development, poverty alleviation, land redistribution and better health resources – there is much that still needs to be done. None of our suggestions is a panacea for this country's ailments – but we think that if introduced they would move our economy and society in the direction of growth and upliftment – for all.

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