MANUFACTURING CIRCLE
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Budget 2012/01

SUBMISSION TO THE STANDING AND SELECT COMMITTEES ON FINANCE

ON THE FISCAL AND REVENUE PROPOSALS AND DOCUMENTATION RELATED TO THE 2012/2013 BUDGET

BY BUSINESS UNITY SOUTH AFRICA (BUSA)

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BACKGROUND TO
THE MANUFACTURING CIRCLE

Formed in 2008, the Manufacturing Circle interacts with government and other stakeholders in order to review, debate and help formulate policies which will have a positive impact on South Africa's manufacturing base.

The Manufacturing Circle is made up of a number of South Africa's leading medium to large manufacturing companies from a wide range of industries. Some of the members are leading South African exporters of manufactured goods to markets around the globe, others are locally based and locally focused companies competing with the best in the world. There is one common denominator among them and that is a passion for manufacturing coupled with a fervent belief that for South Africa to be economically strong, its manufacturing sector must be strong. A strong and developing manufacturing sector will drive the creation of skilled and semi-skilled

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1. INTRODUCTION

The Manufacturing Circle welcomes this opportunity to make a submission on the fiscal and revenue proposals and documentation related to the 2012/2013 National Budget as tabled in Parliament by the Minister of Finance, the Hon Pravin Gordhan on 22 February 2012. However we may differ on dealing with the challenges underpinning South Africa’s economic prospects, we believe that an accurate assessment of South Africa’s position was offered by the Minister, both in terms of our domestic situation, as well as relative to the global economy.

As was the case with previous budget speeches, strong emphasis was placed on the social partners working together when the Minister stated that our road to recovery “requires an extraordinary national effort from all role-players… over the long haul.”

Whereas the Manufacturing Circle sees its role as supplementary to formal social dialogue as it takes place at the National Economic Development and Labour Council, it’s approach is nonetheless one of forming partnerships with government and labour in addressing priority issues. Our commitment to partnership with labour and government in reaching a common understanding on what actions need to be taken to move the economy and job creation forward, and our readiness to take those actions is unwavering. This is done either through direct consultations with government departments and labour unions, or via submissions to Parliament or other regulatory institutions and partnerships with state entities, such as Proudly South African, etc. And while we agree that full recovery and the promotion of sustainable job-creating growth will require long-term commitment, we also believe there are clear steps that can be taken to address the obstacles we face over the short to medium term.

In terms of its contribution to the economy, manufacturing may have been in decline since 1981, but it still remains one of the top three contributing sectors to the economy. It is a high-multiplier sector, with great potential to grow the economy in a way that will create jobs. The inputs contained in this document speak to the budget from the priority issues that challenge the growth and job-creating power of manufacturing in South Africa today and are, amongst other, informed by direct member inputs made at our most recent plenary meeting of 20 February 2012.

The Manufacturing Circle appreciates the Minister of Finance’s recognition of the importance of growing the manufacturing sector for South Africa to create jobs. We note the Minister’s assertion of the World Bank’s contention that 85 million manufacturing jobs may shift from China to other countries in the coming years. The Manufacturing Circle is not confident that this shift will indeed occur to the extent that it is foreseen. We do however identify strongly with the question posed by the Minister in his Budget speech, “Do we have the right policies, conditions and boldness to…

gain from these immense shifts…?" Indeed, it is central to the Manufacturing Circle's quest and lies at the heart of the inputs contained in this document.

2. MACROECONOMIC POLICY

The Manufacturing Circle appreciates that Treasury has established a solid practise around fiscal forecasting erring on the conservative side, often being much closer to actual outcomes than many estimates from non-government organisations and the private sector. While South Africa's economic momentum was admittedly modest prior to the crisis, Treasury's disciplined stance has undoubtedly yielded pay-offs in the degree to which we were able to whether the storms of 2008 and 2009 and in terms of what fall-out there has been subsequently.

We appreciate that the positive approach of the Budget, of writing a "new story" based on "building modern infrastructure, a vibrant economy, a decent quality of life for all, reduced poverty, decent employment opportunities" within the context of the difficult global environment. To achieve it will require courage and will exact immense skill and discipline in maintaining the right fiscal and monetary policy balance. In this regard, we would like to offer select comments with respect to our overall macroeconomic position.

2.1. FISCAL POLICY

The Manufacturing Circle concurs with the view that the counter-cyclical stance adopted by Treasury some years before the 2008/09 global financial crisis has subsequently proven its worth. Whereas worrying spending inefficiencies may have persisted, it has allowed South Africa to maintain allocations to public works programmes, infrastructure and support schemes for companies in distress and workers who became unemployed.

There has been some positive initial market reaction to the better than expected revised estimate of the Budget deficit for 2011/2012 of (4.8% of GDP, rather than the 5.3% predicted last year and the 5.4% expected in certain quarters ahead of the Budget). It may have been a function of Treasury's conservatism that the deficit was originally predicted to be higher than expected and that the revised estimate comes in lower, but we believe Minister Gordhan struck the correct tone in this regard in as far as perceptions from ratings agencies are concerned. However, it will be important to keep on consolidating trust in South Africa's capital markets, its ability to control state involvement in the economy, and to keep spending directed ever more firmly to productive activities that are supportive of economic growth and job creation.

Savings of R27bn proposed by the Budget over the medium term should further support positive market sentiment as far as South Africa's fiscal position is concerned. Revenue recovery is furthermore on par with rates being achieved by developing peers such as India and Brazil, driven by improvements in corporate (14%) and personal tax collections (10%). Of the additional R55.9bn in spending allocated for the next three years, it is also encouraging that the proportion that will go to job creation and infrastructure roll-out will increase from 28% (6% and 22% respectively) in 2012/2013 to 40% (8% and 32%) in 2014/2015. Public spending is still on a moderation path leading to lowering deficits (projected to reach 3.0% of GDP in 2014/15), with net debt now topping out 38.5% of GDP in 2014/15, encouraging net debt servicing costs to retreat somewhat to 2.7% of GDP in the same year.

We also note that Treasury remains on track to eliminate the primary deficit (deficit after deducting interest payments), which is forecast at only 0.3% of GDP for 2014/15. We urge strongly that we continue along this trajectory to ensure that as the following year come into the MTEF's view, we will be greeted with the prospect of returning to levels of government borrowing that will promote the supply of capital domestically.

We believe that greater clarity in respect of government's long-term fiscal position is becoming increasingly necessary and would have been greatly aided if the Minister provided a progress report or timelines for the fiscal review mooted by him in his 2011 Medium Term Budget Policy Statement. The Minister alluded then that such a review was necessary "to explore the implications for government finance of major long term priorities, including improved infrastructure investment and maintenance, social security and retirement reform, the establishment of national health insurance, the role of development finance institutions and the strengthening of our municipal finances." This is not only important in terms of pushing our consumption expenditure down, but also in terms of starting to pull more and more of the almost 16 million South Africans that currently require state support into productive employment.

To do this, we believe any pending a fiscal review should target facilitating ever greater levels of competitiveness for the private sector in general, and reducing business costs for high-multiplier industries such as manufacturing, mining and agro-processing in particular. In view of the strong cost-push of bunched-up administered prices in the current environment, as we engage in yet another push to accelerate infrastructure roll-out, we believe the Minister gestured at something very important when he said, "It is important to find the right balance between cost recovery from users of services, and general tax-funding."

While we do not suggest that users should not pay for the services they receive, the knock-on effects of administered prices set by a range of state entities without consideration to our national job creation goals, taking for granted the timing of other administered cost increases, is increasingly undermining the ability of our firms to compete. This situation needs to be addressed at an overall policy level as a matter of urgency.

2.2. MONETARY POLICY

A country's choice of an exchange rate regime determines, to a large extent, its economic growth rates as well as the dynamics of the economic structure. The fixed exchange rate regime enhances a more stable economic system but at a greater cost to monetary policy flexibility and exposure to speculative attacks. Whilst the floating exchange rate regime accommodates an independent monetary policy, and allows market fundamentals to effect continuous adjustments to the exchange rate via, inter alia, global capital flows across borders.

While each foreign exchange regime has its own pros and cons, de-industrialisation, loss of jobs, poverty intensification and socio-political ruptures are all the costs associated with free float, especially in times of market uncertainty and above average volatility in the global macro-financial environment.

The current trend of the rand-strength continues to erode the competitiveness of the economy as the currency maintains strong levels with high volatility. Not only are the export industries adversely affected via the erosion of global competitiveness, but also the local industry suffers due to import competition. When sustained, such import competition accelerates the process of de-industrialisation.

By way of possible policy options, it is proposed that the "permanent nature" of the global changes justifies policy intervention. To this end, timely government intervention in the foreign exchange market aimed at depreciating the Rand to a competitive level is crucial. It is proposed that alongside interest rates, quantitative interventions in the forex market is called for to smooth market volatility and retain a narrow band for currency movements.

The Manufacturing Circle believes that policy intervention is called for not only for export promotion, but also, and more importantly, it is required so as to ensure growth recovery and improve fiscal prospects – both of which are important considerations for the country's global sovereign rating.

3. SUPPORTING MANUFACTURING GROWTH AND JOB CREATION

The Manufacturing Circle believes that the overall focus of the budget should be on supporting higher levels of sustained, job-creating growth. While we do not doubt the intention of government to deliver on these objectives, the capacity of the state to execute the measures announced is not only an acknowledged general concern, but an overriding cause for unease amongst manufacturers.

A broad-ranging package of measures was announced, on which we would like to make select comments:

3.1. INFRASTRUCTURE

We welcome the spending plans in respect of improving rail and general transport infrastructure which, although focussed on supporting the primary sector, will provide spin-offs for manufacturing. These improvements will definitely address long-held concerns relating to:

- general inefficiencies, service predictability and equipment availability of the rail network;
- upgrading Transnet's rail and port infrastructure in order to boost capacity on the rail lines that transport coal and iron ore to export terminals;
- relieving congestion and damage on our road network system by shifting other goods from road back onto rail;
- providing appropriate inter-modal facilities that would facilitate seamless movement of cargo; and,
- enhancing competition amongst and within ports.

We must caution that cost recovery for such expansions must at all times be prioritised to be done as equitably, cost effectively and gradually as possible to avoid unnecessary cost shocks. This is particularly necessary in an environment where administered prices both drives inflation and undermines our competitiveness.

We further caution that if these infrastructure projects are to impact job creation positively and expeditiously, steady delivery momentum must be achieved and maintained. This has not been the case in previous years. In this regard, we believe the Minister struck the correct tone in noting the under expenditure (32% in 2010/2011) in infrastructure implementation so far and in urging for the implementation of infrastructure spending plans to be executed much more consistently.

This has a direct impact on local manufacturers, as the lack of consistent infrastructure spend prohibits local contractors from investing in locally manufactured equipment to “gear up” their capacity.

3.2. ADMINISTERED PRICES

The Manufacturing Circle has warmly welcomed President Jacob Zuma’s announcement in his State of the Nation address of a reduction in port charges for manufactured goods. Our port charges are currently amongst the highest in the world. Any reduction will therefore improve our competitiveness as an exporting nation. The Manufacturing Circle looks forward to receiving more clarity and detail on the commencement and quantum of these reductions. Consistent with our earlier comments in respect of the need for a fiscal review, we do find it regrettable that more clarity did not follow on what government plans to do in rands and cents to bring the determination of administered prices in general more into line with our national job creation goals.

Mention also needs to be made of the special allocation of R5.75bn allocated to reduce the burden on consumers who will face the impact of the Gauteng Freeway Improvement Project. This is welcomed as it demonstrated that government is willing to reconsider where its policies may have negative implications for consumers, for growth and jobs.

3.3. ELECTRICITY

In addressing the unemployment scourge, the President's focus on the need to bring down the cost of electricity price increases in support of economic growth and job creation was welcome. It was, however, regrettable that more detail was not available in the budget about what is planned in this regard. Urgent action that extends beyond behaviour changing incentives to actual absorption of electricity costs will save and even create jobs (see Box 1). The Manufacturing Circle will therefore be open to any pacts with government, labour and communities that need to be investigated to support such action.

BOX 1: ELECTRICITY ALLOWANCES: SHIELDS OR SWEETENERS?

Manufacturers seeking financial respite from steep electricity price increases have but two options: they can either apply for relief under the energy efficiency allowances provided for in section 12(l) of the Income Tax Act, or they can pursue assistance under Eskom’s demand side management (DSM) programme. But are these schemes bona fide shields against the three successive 25% increases Eskom has been implementing since 2010? Or are they really more suited to other aims?

A recent survey of Manufacturing Circle members in this regard yielded very similar responses across the board. In general, the feeling was that while the accessibility of Eskom DSM incentives was vastly better than section 12(l) of the Income Tax Act, both of these, quite true to their designations, were much better expected to yield behaviour change, rather than protection from the electricity tariff spike.

Manufacturers deem section 12(l) useful for energy efficiency projects of substantial value only, broadly for the following two groups of concerns:

- Accessing 12(l) funds is costly and complex because it involves executing projects at risk, and then having to have efficiency gains verified by costly, Treasury-endorsed teams. The overwhelming perception was that the monitoring and evaluation processes in themselves are complex and inequitable, since savings may not be restricted to specific equipment or plant sections.
- The incentives are then calculated by multiplying energy savings measured in KWh with the lowest feed-in tariff. In this regard, the belief is that since the Renewal Energy Feed-in Tariff (REFIT) has been replaced by competitive bidding (dubbed REBid), determining which clients could claim at Independent Power Producers (IPP) tariffs in this way would prove impracticable. It is also perceived as a disconnect against the average energy price paid by the consumer.

Manufacturers are concerned that making investments of the size that would justify navigating these processes are not prudent, generally, in light of the present economic climate, and more particularly, because of the cost-push experienced as result of steep increases in electricity tariffs. This is amplified by the insufficient tax shield provided, as at 28 % of the increased cost with an energy saving of only 10 % (as per the National Energy Efficiency Strategy), the net impact will be less than 50% absorption of the tariff. Even if business were to achieve the optimistic Maximum Market Potential for savings of 30% as estimated by Eskom, the consumer is still likely to pay three times as much for electricity in 2015, in comparison with 2009.

While Eskom's Standard Product DSM projects work better than the exclusive type projects (which require an 18 months approval period), the process remains laborious. The volume of projects per kWh saving is high, tying up a lot of man-hours and capital, thus negating capital availability for compliance with, for instance, the new Air Quality Act and the zero effluent requirements for South Africa. Furthermore, DSM is funded through electricity tariffs and therefore by the consumer, rather than by government.

Manufacturers view both 12(l) and Eskom's DSM incentives, in their simplest form, as retrospective funding sweeteners to promote investment into energy efficient technology, rather than a means to negate the impact of electricity price increases. As such, they are perceived to add to cash flow demands rather than reducing them.

3.4. JOB SUPPORT SCHEMES

Unfortunately, as with infrastructure, the announcement of allocations for schemes such as the Special Economic Zones and industrial development (R2.3bn) and the Competitiveness Enhancement Programme (R5.8bn), while hugely welcome, does not mean the policy and institutional readiness for their timeous implementation exists. Progress made with the R9bn, three-year jobs fund scheme, for which commitments of only “over R1bn” has been achieved in the first year while the amount of funds disbursed is yet unclear, is an example in this regard.

Manufacturing will be there to leverage these programmes for job creation as best we can, but we do urge haste and clarity with regard to questions such as whether tax relief schemes will be part of the intended Special Economic Zones dispensation or not, to ensure their maximum impact through maximum certainty for manufacturing investors.

3.5. PREFERENTIAL PROCUREMENT

While much mention has been made in successive budgets about procurement practises, these have largely focused on curbing abuse. While this is positive, much work also remains to be done to ensure that government departments are aligned on the urgent need to implement preferential procurement (see Box 2). Treasury plays an important role in facilitating this scheme, and the slow implementation thereof has only meant delays in staving off the deindustrialisation of the economy.

BOX 2: TYRES READY TO HIT THE ROAD WITH LOCAL PROCUREMENT?

Announcing government schemes closer to when the tyres are ready to hit the tar, with all relevant government departments and entities ready to do their bit to support implementation and roll-out, will do much to boost confidence across the manufacturing industry. Preferential procurement serves as a pertinent example in this regard.

While sectors seven sectors were to be designated in December of 2011, follow through only happened in respect of four those. Not all products that could sensibly have been designated for local procurement in those four sectors were designated. Expectations in terms of local content prescriptions were not met. While the law has been in power for two months already, tenders continue to be issued under the old rules, with the actual implementation seemingly awaiting the start of the new financial year on 1 April in the case of the national and provincial governments, and July in case of local governments. Government’s planned spend has also not yet been quantified. Finally, it also appears that not all departments will count themselves in a position to support this initiative until such time as they have received guidance on the price premium thresholds that are sensible for local procurement. In the meantime, the economy continues to deindustrialise.

Being used to long lean times in South Africa and cautious of the dire consequences when things go awry, manufacturers have always been cautious investors. Certainty and predictability is therefore essential for the manufacturing sector to grow more robustly. The more government can assist in facilitating this, the better their view of the state of our nation is likely to be.

4. TAX POLICY AND TRADE ADMINISTRATION

The Manufacturing Circle believes that tax policy should be used to stimulate investment in the South African economy. This approach will ensure that there is higher growth in the long run, and can so be useful in assisting government to generate higher revenues, by broadening the tax base. The excessive use of additional taxes and special levies as revenue generating instruments can be counter-productive, as it invariably reduces South Africa's competitiveness, by raising the costs of doing business. Further, we believe that they can distort economic activity leading to sub-optimal outcomes in the economy. It is in this light that we view the higher than expected capital gains tax, withholding tax on companies and fuel levy increase introductions with concern, especially in terms of what it will mean for savings promotion and business costs.

We would like to make specific comments in respect of the proposed carbon tax on industry emissions and tax and trade administration:

4.1. CARBON TAX

The Manufacturing Circle shares the views of other stakeholders that climate change poses a substantial long term risk and that it is therefore essential to move towards a low carbon economy. Due to the complexities of designing the lowest cost trajectory towards a sustainable future and the potential negative impact on the economy, it is essential to undertake a careful and detailed analysis of the risks, costs and opportunities inherent in this new policy direction.

We welcome further opportunities for engagement on the proposed Carbon Tax on industry emissions, as the introduction of such an instrument, especially if not part of a suite of tools to put South Africa on a lower carbons emissions trajectory sustainably, will hurt manufacturing and jobs.

4.2. TAX AND TRADE ADMINISTRATION

Many of the challenges faces by manufacturing emanates from South Africa's unequal trading position. This unequal position has not only resulted because of the subsidization of exports in other countries, but also because South Africa's trade administration dispensation has not kept up with demands of an open economy. While we acknowledge Minister Gordhan's indication that customs officials are tightening their focus on the under-valuation of imports, and that this has benefitted the situation of the clothing and textiles industry in particular, the situation even in that very industry remains precarious.

Overall, interactions with the South African Bureau for Standards, the National Regulator for Compulsory Specifications and our customs authorities have given rise to significant concerns that there is not sufficient co-ordination and unity of purpose between these institutions and out trade and tax authorities to ensure that substandard, unduly cheap and illegal imports do not make their way into our market. We are for instance aware that decisions get made on a month-to-month basis at SARS on the allocation of project rather than product codes for the importation of goods, and we are unsure to what degree the necessary level of co-ordination exists to ensure that these project codes are not used to bring in products that were not supposed to be allowed to be granted entry under those decisions.

BOX 3: FROZEN FOODS PROCESSORS HAMSTRUNG BY CHEAP IMPORTS

Cheap imports present a significant obstacle to growth and job creation in the domestic manufacturing industry. In this regard, the situation the local frozen foods category finds itself in is no different.

While local conversion costs are benchmarked to be competitive, the costs of raw materials at the factory gate can in certain instances be between 100% and 300% more expensive. At the moment raw potato is landing at Belgian and Dutch fry plants at between € 50-80 per ton (approximately R510 to R820 per ton) versus R2000 to R2400 in South Africa, mainly due to the subsidies European farmers enjoy under the Common Agricultural Policy. Stiff competition is also faced from China, where agricultural subsidies contributed up to 17% of farm income in 2010.

Domestic market share in South Africa can therefore be built easier based on cheap imports, rather than on establishing local production. The results are predictable: local production face significant obstacles in expanding. Cheap excess imports mean investments in upgrading plants can in certain instances not be justified. Where local production gets destroyed in this way, it does not get replaced with new production facilities. One processor alone reports recently cancelling the following investments in this manner:

- A R25m field processing depot for peas;
- A R35m pea processing line in Alrode; and,
- A R20m field processing depot for brassica crops (e.g. cabbage).

It is not only the expansion of processing capacity that gets undermined, but also investments higher up the value chain. Plans for seed laboratories, for BEE programmes for developing vegetable farmers, vegetable store handling facilities and transport infrastructure to transporting vegetables to processing plants never come to fruition. So jobs are not only cut or simply not created on the factory floor, they are also lost on the farms where the crops are grown.

This situation holds significant threats for local frozen foods processors expanding into other developing markets, notably into Africa. The opportunity to import cheap products in to Africa is the same if not better than in to South Africa. Logistics costs from Europe and the East are the onlylevelling factor and it is grossly insufficient. As no countervailing duties exist, the industry is currently applying for them to be instated.

Generally, South African factories find it too costly to compete in the majority of African markets given the costs of the networks required relative to the low demand for higher priced products. The only instances where they stand a chance are where the logistics costs (i.e. via road) are less onerous than from main ports to main markets.

Of course, given the raw material cost disadvantage it is highly unlikely that local processors in the frozen foods industry would be able to compete in markets originating cheap imports, such as China. The latter's excess capacity given their presence in the South African market confirms this.

Local frozen foods suppliers report that their manufacturing margins have almost disappeared. Al input costs are squeezed, including labour costs and the prices paid to farmers – some growing certain raw materials have not had an increase in the price they get paid in 4 years. The fear is real that reductions in volumes and profits will force frozen food processors to put price reduction pressure on service providers, and probably will probably end up in the termination of numerous outsourced relationships.

The quality of the imported products is generally significantly inferior. Retailers are listing the imports despite the distinct quality differences. The danger is that in order to survive South African manufacturers will lower their quality, leaving the consumer to suffer the consequences.