SUBMISSION TO THE STANDING AND SELECT COMMITTEES OF FINANCE

PUBLIC HEARINGS: 2014 NATIONAL BUDGET (FISCAL FRAMEWORK AND REVENUE PROPOSALS)

BY THE MANUFACTURING CIRCLE

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Contact Information

The Manufacturing Circle
1st Floor, Training and Human Resources Building
28, 6th Street, Wynberg, 2090
South Africa

Post to: PO Box 1955,
Bramley, 2018
South Africa

Tel: +27 11 445 3166
Fax: +27 86 269 0781
WWW.MANUFACTURINGCIRCLE.CO.ZA

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 jobs in the South African economy.

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1. INTRODUCTION

The Manufacturing Circle appreciates the opportunity to make a submission to the Standing and Select Committees of Finance afforded during these Public Hearings on the Financial and Fiscal Proposals forwarded by the Hon. Minister of Finance, Pravin Gordhan and the National Treasury. The manufacturing community has made significant efforts to become more involved in the debate around the policies that define the space in which they go about their activities, particularly since the 2008 financial crisis spelled the destruction of hundreds of thousands of manufacturing jobs in South Africa. To this end we have met regularly with a range of high-level officials in the South African governance system, including the South African Reserve Bank Governor, the CEO of Eskom, the Minister of Economic Development and the Minister of Trade and Industry, but also the Minister of Finance. We are happy to report to the committee that we have enjoyed constructive relations with Minister Gordhan, that he has proved a tough negotiator, but that he has also been accessible, empathetic, enlightened and responsive.

Stakeholders in business often raise the criticism that there is a lack of policy coherence and co-ordination across government when it comes to the formulation and execution of policy. In the case of a National Treasury, which also has to act as a check against the spending of other departments and government entities, it would not be entirely comforting if harmony were always there to be found. However, as the Manufacturing Circle, we have predictably spent a lot of energy during our interactions with the Minister of Finance to try and promote a single understanding and unity of purpose between the National Treasury and the Department of Trade and Industry.

In governments across the world, as well as it is between international institutions of governance and co-operation, there is often friction between the Treasury-type institutions who carry responsibility for the execution of macro-economic policy, and those that are the custodians of industrial policy. This is often so because of ideological differences between these institutions, because of the incomplete dissemination of information and a lack of common understanding, and because the deployment of industrial policy support may clearly have macro-economic impacts and vice-a-versa. We are happy to report, that as far as National Treasury and the Department of Trade and Industry's efforts in this regard is concerned, the understanding between these departments have only grown over the course of the current administration, and we believe that the primacy of manufacturing and industrial policy in the Ministers speech of 26 February reflects this consolidated understanding. Understandably, as an organisation representative of manufacturing, and for the important role played by manufacturing as a sector with significant multiplier effects in the broader economy, we were very pleased with this aspect.

Whereas we now turn to the substance of our submission, we also acknowledge that this budget marks the end of an administration with which we have often enjoyed a fruitful working relationship. This is no more so than the earlier acknowledged exchanges with Treasury, than it has been with the Select and Standing Committees of Finance, in front of whom we appear to present our submission for the third time today. We appreciate the hearings you have granted us. We look especially forward to engaging you in the next term as we are sure the newly-created budget office will add a lot of meat to these interactions, of which our shared economic imperatives could not be more deserving.

Our message to the Minister of Finance prior to the budget was to focus on cutting costs in the economy, nursing the manufacturing base and enact measures to help grow the market. The remainder of the document will first provide a case brief case study to outline that we arrived at this message. We will then present our message of expectations prior to the budget as well as our initial budget reaction. This document will be supplemented by a presentation, which will be made available to members on the day of the Hearings to expand on our submission.

2. MANUFACTURING SINCE 2008: A CASE STUDY

South Africa has suffered many years of bunched-up administered price increases to fund, finance and recoup the costs for infrastructure maintenance and provisions. This is particularly so in the area of water, electricity and transport logistics. It is a matter that is of multi-dimensional concern, not only because costs have escalated, but because the escalations have accrued at a time in which markets have collapsed after the 2008 Global Financial Crisis and have struggled to recover the business volumes the have formerly enjoyed. This means that the economies of scale formerly enjoyed are no longer there to provide the margins that were necessary to ensure that business could invest with the ease they formerly enjoyed in promoting their own efficiency and competitiveness.

For South Africa's dynamic manufacturers, the experience manifested in a very particular way. We would like to illustrate how it has impacted them through a case study of a real manufacturer with numerous plants and installations in coastal areas such as Port Elizabeth and Cape Town, and in northern locations such as Ekurhuleni and Garankuwa.

Costs, Context and the Fiscal System: How Costs Drift and International Developments are Undermining Manufacturing Competitiveness

After the Global Financial Crisis, rand strength quickly recovered to beyond R7.50/UDS. A particular case study for a manufacturer with numerous coastal installations (Cape Town and Port Elizabeth) and plants in numerous locations in Ekurhuleni and Garankuwa, showed electricity end-user increases of more than 21% per annum sustained since 2008, above-inflation wage increases for every year except 2009. The cost increases in electricity were still being absorbed at the end of

2012 as Eskom advocated for further five-year round of increases of 16% per annum. At the very same time Brazil enacted a 29% discount to industrial users in that country, which Chinese exports of manufactured goods to South Africa surged on the back of stronger rand, and very strong incentives in China, which meant products which our domestic manufacturer manufactured in certain of their installations, were being landed year at prices that were cheaper for which the raw materials could be sourced in South Africa. During the course of these developments, Ekurhuleni municipality contacts the manufacturer to advise that they need to increase the R600 000 utility deposit for their plant that they had been paying every electricity bill for the last 70 years to R4 million, without any explanation. After numerous efforts to find an out-of-court solution, the manufacturer along with other companies in the area is also left with no option but to institute legal action against the Nelson Mandela Bay Municipality for what they deem to be unprocedurally set electricity price increases in that area. This was some months after these very municipalities under South African Local Government Association (SALGA) motivated for a local tax on business to try and obtain a revenue instrument for municipalities with which they could determine the rate free of treasury intervention. The reason they advanced was that since the RSC levies were scrapped, municipalities had received some claw-back from VAT exemptions and allocations from the fuel levy, but that they were left without instruments to ensure that revenue resulting from local development successes accrued back to them. In these and other municipalities, the operations of this manufacturer are often interrupted due to electricity and water outages, especially where the relevant municipality supplies these services. After realising that one operator had lost 30 working days in a single financial year due to such interruptions and that these costs would now have to be quantified for annual reporting purposes, a meeting is convened with the Ekurhuleni Municipality. Numerous manufacturers participate, only for it to emerge that water outages occur due to crumbling infrastructure, which an Ekurhuleni-based manufacturer present in the meeting manufactured to standard, but which the municipality had been procuring elsewhere.

From the above case study, there are numerous conclusions that we draw.

1. Since the global financial crisis, manufacturers have been left vulnerable by a fiscal system that is not succeeding in containing costs
2. While there were numerous inefficiencies in municipal governments, the fiscal system also did sufficiently respond to the challenges they were dealing with, to the extent that manufacturing entities were targeted bear costs through higher rate charges and deposit requirements or failing services.
3. There are numerous opportunities to grow the market that were not being leveraged, because communication between government and the private sector were lacking and local procurement were not being prioritised.
4. While the best way to grow manufacturing was to cut costs and grow the market, competitor economies were much quicker to provide industrial policy support to their manufacturers, which along with our small open market, created an unequal playing field.

5. We needed better protection from unfairly incentivised imports.

3. BUDGET EXPECTIONS

As a result of these conclusions South African manufacturers were keen to see how Finance Minister Pravin Gordhan would use the budget to promote growth conditions for manufacturing. The best ways to do this was to use the opportunity provided by the budget to cut costs, nurture the existing manufacturing base and help grow the market for manufactured goods. We believed the event of the National Budget Speech provided Minister Gordhan with three key opportunities to intervene:

1.) Announce a full fiscal review

Manufacturers across industry have for the full tenure of Minister Gordhan at National Treasury indicated the negative impact of bunched-up administered prices on the cost-base and therefore competitiveness of South African manufacturers. In many instances, such as in terms of our electricity price increase trajectory and in respect of port charges, South Africa was out of kilter with its competitor markets, and has therefore seen its export competitiveness eroded. Highly marked up municipal rates and electricity and water supply outages due to municipal infrastructure failures made manufacturers incur further costs. It was clear South Africa was out of sync with competitors and on an unsustainable path when it came to the financing, funding and recoupment of funds for infrastructure provisioning and maintenance, as well as ensuring sufficient financial management and supply provisions for many local governments, certain provincial governments and certain departments and government entities. This could be rectified through a full fiscal review, to ensure not only that our spending was productive, but that it was done in a way that does not undermine the productive sectors of the economy with out of kilter charges and bunched-up cost escalations.

2.) Support Innovative Industrial Policy

There were firm hopes that Minister Gordhan should announce himself and his department in full support of innovative industrial policy to help dynamic local manufacturers to grow. We need the 5% of manufacturers that are responsible for 93% of our exports to invest in product innovations and the many other manufacturers who export minuscule amounts to start exporting more. This could be achieved through flexible and appropriate industrial policy interventions, which had to receive Treasury's support. More exports would relieve fiscal pressures, as it would help to narrow the current account deficit. It would also promote job creation and growth.

3.) Enforce Local Procurement

Promoting local procurement was an important way, sanctioned by international financial institutions; to grow our market for manufactured goods, yet government-wide compliance with preferential procurement provisions and international finance agreements sometimes undermined this. Treasury had recently appointed a national Chief Procurement Officer, which had to be leveraged to enforce compliance with preferential procurement initiatives to supplement the efforts of the Department of Trade and Industry and the Presidential Infrastructure Co-ordinating Commission in this regard. It would therefor have been appropriate for the Budget Speech to acknowledge that limited premiums (confirmed by research) may often be justified for locally manufactured goods in relation to their imported equivalents, in light of the economic benefits to the fiscus. Growing the market in this way would create space for competition in local manufacturing to emerge, which will encourage competitiveness and exports.

4. BUDGET REACTION

In the budget presented on 26 February, we believe Finance Minister Praveen Gordhan presented a picture of fiscal predictability and did well to frame it with the National Development Plan and global economic uncertainties. The prioritisation of cooperation with and the promotion of dynamic businesses for the sake of growing our export competitiveness were heartening, but the budget proved a missed opportunity to announce initiatives to cut high administered costs and benchmark us better against our competitors.

1.) Industrial support good, but no cost cutting announced

The endorsement of the Industrial Policy Action Plan by the Finance Minister gave manufacturers confidence. The Manufacturing Circle was not supportive of the exclusivity of the Special Economic Zones (allocated R3, 6bn over the MTEF), but the strengthened manufacturing investment incentives and competitiveness allocations (accumulatively R25.5bn over the MTEF) would help to nurture our manufacturing base.

We agree growth of 5% of GDP or higher were imperative to grow employment and ensure our debt levels (projected to stabilise at 45% in 2016/17) would not become a debt trap. Confirmed additions to our electricity generation capacity and the exploration of shale gas had to be expedited to achieve these aims. Growing our local market would be key to encourage the required growth and productivity rates. To achieve this we needed to promote preferential procurement, which the budget rightly affirmed. Better customs administration efforts announced in the budget to keep out unfairly incentivised imports and apply the right tariffs already had positive impact in this regard.

It was disappointing that there would be no initiatives to drive down high administered costs, which undermine manufacturing competitiveness. A review of the funding, financing and recoupment of costs for infrastructure and benchmarking against competitor markets is needed but was not prioritise. It was also discouraging that local governments, the vanguard of implementation and service delivery, remain unworthy of more than a 9% allocation of the national budget. The constant insecurity of key utility services in leading manufacturing municipalities provided unfortunate evidence of this.

Relating to high domestic production costs, the increase in the fuel levy was regrettable.

2.) Infrastructure promises good, but implementation key to save the economy

Infrastructure investments and the promotion of capital expenditure to the quickest growing expenditure category would support competitiveness, provided government improved its implementation record significantly as Minister Gordhan rightly emphasised. Without better implementation we will never realise our potential as an exporting nation, despite the weak rand, leaving our trade deficit to widen. Whether government improved its implementation therefore had direct bearing on whether we become more or less vulnerable to global economic vagaries going forward.

3.) International economy and international institutions

In reflecting on the international economic policy narrative and the role of international financial and development institutions, we would encourage the Minister to promote the idea that a definition for currency manipulators be finalised, so that offenders can be penalised. This will ensure that international trade measures are not frustrated, thereby undermining the manufacturing competitiveness of small open economies such as South Africa.