MINERALS COUNCIL SOUTH AFRICA'S POSITION IN ADVANCE OF SA's BUDGET STATEMENT

21 February 2020

MINERALS COUNCIL
SOUTH AFRICA

EXECUTIVE SUMMARY

Mining is a crucial sector of the South African economy. It contributes 8% to GDP and with all the multipliers, double that percentage. It is responsible for more than 20% of the country's exports, and if semi-fabricated mineral products are included, this rises to over 40% of exports, 17% of private fixed investment and creates jobs for more than 1.3 million people in the economy.

Yet, mining is not flourishing. It is smaller in real GDP terms in 2019 than it was in 1994. Its share of GDP has declined from 15.7% to 8% in the same period. The composition of the sector has changed dramatically in that period, with the large fall in gold production and employment being partially offset by growth in platinum, coal, chrome, manganese and iron ore production. While there has been growth in the non-gold commodity suite, two observations are necessary. The decline in gold production and employment could have been much smaller if the crisis of Eskom had not happened. But secondly, in the absence of a greenfields exploration boom due to the constraints of policy uncertainty, logistical bottlenecks unreliable and costly electricity, and growing criminal activity (illegal mining, armed attacks on facilities, community unrest and debilitating theft of public infrastructure) and uncompetitive and unreliable services from other various state-owned enterprises (SOEs) including Transnet, and municipalities, the non-gold mining sector could have grown at a much faster pace.

While South Africa's rating for investment attractiveness has improved from position 48/91 in 2018 to 43/81 in 2019, the country is still rated in the bottom half of the investment rankings. In terms of the policy scorecard South Africa has improved from ranking 81/91 to 56/81, a 25-place improvement, but it is still in the bottom half. While the direction of travel is right, there is still some way to go before South Africa is back in the top third of investor friendly destinations. The fact that South Africa accounted for a paltry 1% of global exploration expenditure in 2018 demonstrates the impact that poor policy choices and red tape have on exploration, which as we know is the lifeblood of the mining sector.

At the same time the economy is in a crisis, reflected by a 30-year low in business confidence, falling investment (now at 17.9% of GDP), low levels of growth (average 1.5% for the past 10 years), declining per capita GDP, a fiscal crisis caused by unsustainable growth in public sector expenditure (including wasteful bailouts of SOEs) and the debilitating public debt spiralling out of control, and an army of the unemployed (of which a large proportion is youth) not benefiting from the fruits of the economy.

There is clearly a need for a paradigm shift in policies to put the economy on a meaningful growth trajectory. Without such a shift, a sovereign credit downgrade is a certainty and will delay recovery to such a degree that social instability may derail the South African democratic project.

We are in a crucial period of our country's economic development and the National Budget is a vital instrument for government to change the trajectory of the country's economy and the lives of its people. It is also a vital signal to the international investor community (and ratings agencies) that South Africa understands and implements the necessary steps to put the economy back on a sustainable and higher growth path.

The Minerals Council is firmly of the view that the 2020 National Budget is a crucial event that will set the tone for whether the fiscal crisis will be addressed and the structural reforms concretised and to ensure that the country retains its sovereign investment grade rating.

SUMMARY OF MINERALS COUNCIL'S INPUT ON THE NATIONAL BUDGET

Urgent implementation of the Treasury Strategy on the economy

The practical approach shown by the National Treasury's strategy for inclusive growth, addressing the important policy issues in the real economy, is supported. Confidence will be greatly enhanced when real action is taken and is seen to be taken on resolving key constraints in infrastructure industries, maintaining a prudent fiscal and monetary policy stance and improving the competitiveness of the country to foster higher investment. The idea that the SOEs could be the engine of growth in the economy has not worked; the 'incapacitated state' has become the most important impediment for productivity improvement and economic growth. The reality is that the country's economy is functioning below its current capacity as a result, and this will lead to further job losses and companies closing down. The network industries must be fixed urgently. Private sector participation in these key network industries must be considered, beyond seeing it as a source of taxes or tariffs, if the country is to unlock its real growth potential.

Measures to address the electricity crisis

The Minerals Council is supportive of the Treasury allocation of R250 billion in fiscal support to Eskom over the next decade, as part of the process of the shareholder injecting capital to create a stable and competitive electricity company. These injections must be subject to strict criteria and performance by Eskom.

However, given that load-shedding will be a permanent feature for the next few years and given that over the next decade more than 11 GW of old generation coal plant will be closed, there will be a material electricity supply gap if various measures to support energy efficiency and the addition of least-cost private power are not supported. The Minerals Council hopes to see in the Budget some allocation of some resources towards the promotion of energy efficiency and demand management in the country. This could include incentives for the installation of energy efficient equipment and possible support/incentives for investment in renewable energy generation.

Measures to address the fiscal crisis

There must be progress in rectifying the fiscal crisis, which is damaging the country's growth potential. Government spending will have to be brought under control through curtailing its salary bill, and eradicating waste and fraud. It is critical that government stops destroying value and taxpayer funds through wasteful bailouts of dysfunctional SOEs. Given the country's already high corporate and personal income tax rates, the Minerals Council does not believe that further tax rate hikes will help the situation. Further hikes in these types of taxes will make South Africa a less competitive investment destination resulting in a further deepening of the economic crisis. It will also further exacerbate the exodus of critical skills required in the economy. Ultimately, government has to "cut its coat according to its cloth" and the biggest handbrake has to be applied to government expenditure growth.

Measures to start making South Africa tax competitive

South Africa is becoming an uncompetitive investment destination from a corporate tax point of view. In 2019, South Africa's headline corporate tax rate was 28% and its effective tax rate in 2017 according to the OECD is 27.1%. Since 2000, the average OECD corporate tax rate has fallen from 28.6% to 21.4%. In 2017, the average effective corporate tax rate in the OECD was 22.6%. South Africa's effective corporate tax rate is 4.5 percentage points higher than the OECD and shows how the country's tax competitiveness has declined. While South Africa faces a fiscal crisis, it is also facing an investment crisis. So while it may be necessary to sustain current corporate tax rates in the short term, it is also crucial for Treasury to start indicating the future trajectory of the corporate tax rate to make it more investment competitive, say over the next decade.

Measures to boost business and investor confidence

As already indicated, South Africa's investor and business confidence is at multi-year lows. According to Larry Summers the former Secretary of the Treasury in the US, "confidence is the cheapest form of stimulus". At the same time, an advisor to the Reserve Bank said, "Policy certainty is the cheapest form of stimulus". Efforts to create policy certainty are crucial to promoting greater confidence. Greater certainty on the issue of land expropriation without compensation and on the continuing consequences of previous BEE deals in mining are two such critical policy areas.

A further critical area that Treasury can use to help create policy certainty is the application of the full toolbox of measures to address climate change. At present Treasury has the carbon tax in place, and a draft carbon offsets bill is out for comment. The challenge is that there is no certainty on the performance incentives, carbon budgets, carbon offsets and tax-free portions when phase 2 of the carbon tax is implemented. This has serious implications for the investment decision processes of electricity intensive industries.

But another crucial area to install confidence is for there to be a big improvement in the prosecution of people (from the public and private sectors) for state capture, fraud and corruption. Prosecuting the culprits in the public and private sector should be prioritised by the allocation of extra funding for the institutions dealing with this scourge, including the Justice cluster and the NPA.

Measures to address the crime crisis affecting business

Crime, in all its manifestations must be addressed. Companies in the retail sector, manufacturing, construction, banking and mining (to name a few) are reporting on their losses and rising costs of protection and the huge cost of crime affecting their sectors. In 2019, there were 19 attacks on precious metals facilities involving highly organised gangs of 20-40 heavily armed perpetrators, resulting the murder of several security officials and the theft of over 100 kgs of gold bearing material. More than 50% of the reasons why railway wagons from Transnet rail freight do not arrive at mines that have ordered them is due to theft of copper cables on the railway lines. The impact of illegal mining and product theft on the industry and country has risen to unprecedented levels and are costing the country significantly. The mining industry is under siege and this detracts from production, employment and investment. The Minerals Council has engaged extensively with the Minister of Police and the security cluster, and the Council has proposed the establishment of a dedicated Mining Police Task Force to handle the crisis.

The Minerals Council is hoping that additional fiscal resources will be applied to help with the establishment of this special mining dedicated police unit and that further resources will be invested in the justice cluster to ensure that these criminals are brought to book and jailed.

Proposals to encourage a Greenfields Exploration Boom in South Africa

Exploration is the lifeblood of the mining sector. In 2018, South Africa accounted for a tiny 1% share of global exploration expenditures, compared to 14% in Australia, 14% in Canada and 13% in the rest of Africa. Of the 1% South African share, only 10% is greenfields grassroots exploration (i.e. only 0.1% global expenditure).

While there are many regulatory issues that need to be fixed to create smart tape and quick licensing for high level reconnaissance permits and prospecting rights, it is also crucial that government help create "pre-competitive" information for exploration companies and also create better incentives to create local venture capital funding. "Pre-competitive" information is the provision of high-resolution geophysical data online on an open and free basis, along with a mining cadastral system that enables all prospective explorers to ascertain potential deposits and then apply online to explore these deposits.

The Treasury funding of the Council for Geoscience's high-level geophysical mapping program is supported, and perhaps could be enhanced. In terms of encouraging the formation of more venture capital in South Africa, the enhancements to section 12J of the Income Tax Act and the possible introduction of a flow-through shares scheme should be considered by Treasury.

The proposal by government to establish a Sovereign Wealth Fund

The Minerals Council notes the President's statement that government is going to establish a Sovereign Wealth Fund. Normally such funds are established in countries that have significant oil deposits that when exploited create massive surplus rents. Countries like Norway and Saudi Arabia come to mind. One of the purposes of creating such a fund is to neutralise the impact of these oil earnings on the currency of the country concerned. A second reason is to establish a mechanism that will invest surplus rents that enable future generations to benefit for the resources currently being exploited. A third reason is to insulate the surplus rents from the fiscus to prevent the overuse of resources for recurrent expenditure.

The Minister of DMRE has indicated that the starting point of the Sovereign Wealth Fund could be the royalties paid by the mining sector. The Minerals Council has not yet formulated a view on the matter.

Let's realise South Africa's real economic and human potential

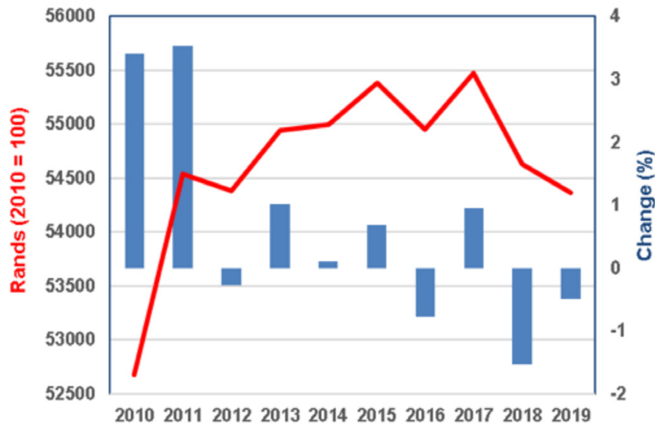
The country has so much potential; correct policies with action can unleash it.

BACKGROUND:

Summary of the economic crisis

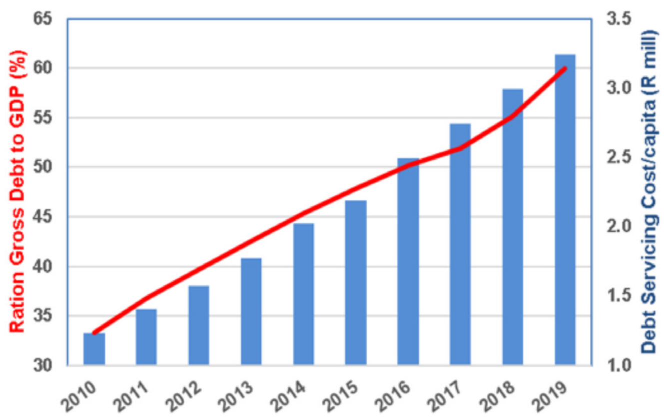
South Africa is facing an **unprecedented economic crisis**. The following numbers speak volumes about the dire situation we are in.

- The country is experiencing the longest economic downswing since 1945; it has lasted for 75 consecutive months since December 2013, according to the South African Reserve Bank.
- Economic growth has declined to a paltry 1.5% over last decade against a population growth rate of 1.5%. This means that we are regressing on a gross domestic product per capita basis. Other emerging market economies averaged 4% growth rates over the same period with world economic growth of 2.5% over the same period. Our economy could have been 10% to 20% bigger with the right policies. Unemployment has risen to 29.1% (10 million people unemployed); with the right policies unemployment could have been 5 to 15 percentage points lower.



Sources: South African Reserve Bank, Treasury

- In 2018, fixed investment fell by 1.4% to 17.9% of GDP (global investment average 26.3% of GDP), whereas it was at an all-time high of 28% of GDP in 2008.
- Business confidence hit a 20-year low in the 3rd quarter 2019, with political uncertainty at its highest with over 80% of the Bureau for Economic Research's Business Confidence Index survey respondents indicating this as an impediment to growth.



Sources: South African Reserve Bank, Statistics South Africa

- Government debt ballooned from 26% in 2008 to 56% of GDP in 2019. It deteriorated from an annual budget surplus to a deficit of 6% of GDP and at an annual growth rate of over 13%, is the fastest growing budget component.
- Hollowing-out of capacity in SARS, combined with a slow growing economy and higher tax rates have created a significant gap between revenue and expenditure.
- With the right policies tax income could have been R 500 billion higher with no budget deficit.
- SOEs are a significant source of fiscal and economic crisis (Eskom and SAA), with sovereign debt guarantees posing a threat to the global credit rating of the country.

The need to maintain our investment grade

The net result of these negative and deteriorating economic metrics, is that the country's credit rating may be finally downgraded to junk status. It is therefore of crucial importance that the budget signals decisive and credible action plans to arrest the downward trajectory.

On 1 November 2019, Moody's kept South Africa's credit rating at their lowest investment grade level but downgraded the outlook from stable to negative. That was a strong indication that their next evaluation (shortly after the budget speech) may not be as 'positive'. Their downgrading of South Africa's growth outlook is an ominous sign for the credit rating as well.

Without decisive action a downgrade to "junk status" by Moody's within six months is a certainty, confirming SA as a "junk" investment destination by all the relevant ratings companies. This will lead to portfolio outflows as foreign funds sell most of their R118 billion investment in South Africa's bonds and R2 trillion in South African equities over time. Rand exchange rate expected to weaken by 30% to 40%.

A downgrade, and continued economic downturn, will have a material detrimental impact on **government spending priorities** through:

- increased debt servicing costs for government,
- crowding out and limiting spending on healthcare,
- education,
- infrastructure, and
- undermining of pensions and social security nets, among others.

It will have a material impact on **ordinary South Africans** through:

- increased inflationary pressures,
- rising unemployment and
- poverty.

The **business sector** will feel the impact through

- higher borrowing costs,
- downward pressure on bonds and equities and
- higher costs of imported products.

The likely depletion of foreign reserves would

- worsen confidence,
- further weaken investment and
- lead to a material worsening of the economic crisis.

We need a constructive but austere national budget which more aggressively reduces deficits and slows down growth in debt.

The credibility of the government budget estimates is first and foremost of critical importance. Experience over the last number of years showed that Treasury consistently overestimates economic growth, and therefore potential tax income, and when the former does not materialize, tax take underperforms and the deficits overshoot. Coupled to this has been indications of, or intentions to reign in government spending at budget time, with nothing of the sort materialising in reality.

It is critical that a credible budget be presented which should be conservative and reigns in expenditure with the minimum of negative economic growth implications.

On the expenditure side, the clearest area for austerity is with regards to the public sector wage bill. The rates at which employment numbers and the costs of employment have risen in the public sector in recent years, are to a large degree at the heart of the fiscal problem, but also the heart of the economic growth problem due to its impact largely on consumption expenditure, and not on enhancing the growth potential of the economy through fixed investment.

The expeditious removal of wasteful expenditure is of equal importance. South Africans are regularly bombarded with

Figure 4.1 Average nominal growth in spending, 2020/21 – 2022/23

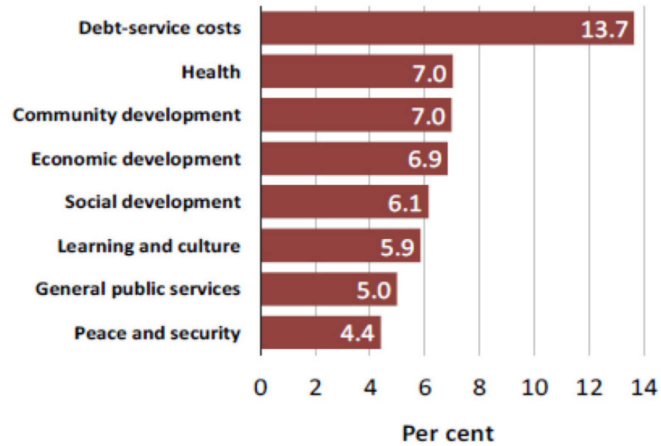
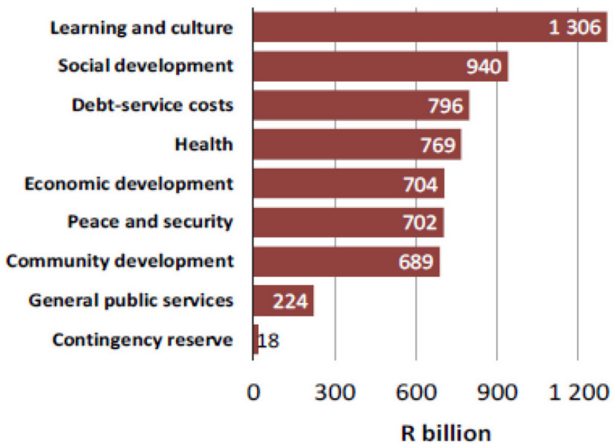


Figure 4.2 Consolidated government expenditure by function, 2020/21 – 2022/23



Source: National Treasury

cases of unthinkable numbers of wasteful expenditure, local authorities collapsing and simultaneously by the lack of service delivery. The strengthening of the new local government support model is therefore of crucial importance, amongst others.

It is critical to properly and expeditiously prosecute not only the state capture culprits (and we feel strongly that the net should be covering political rent seekers, fraudsters in the state-owned enterprises), but also the high-profile ones in the private business sector. An extra R1 billion should be allocated to the NDPP in the budget to prosecute these cases.

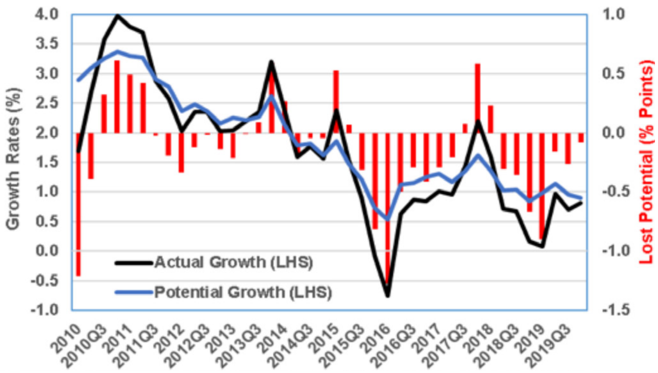
The institutional rebuilding of SARS is commended and their efforts to focus on crime and syndicates defrauding the state of billions of Rands is applauded and has be strengthened.

The scope for raising taxes is limited and will have no other effect than dampening growth. The tax base is too narrow.

No more wasteful bail outs for SOEs

The strong stance that Treasury took in the previous budget and the October 2019 Medium Budget Policy Statement that bailouts to SOE's will be severely restricted, should not be relaxed. The continued insistence on conditionalities must be reaffirmed.

Eskom should be forced to adjust is business model to 'live within its means', given the government support for its debt servicing. The restructuring of SAA should be allowed to continue without interference from government. The danger of a similar delay through political interference in its restructuring as the Eskom 'keeping the lights on at all costs' campaign and consequences showed, should be avoided at all costs.



Source: South African Reserve Bank

In more cases than not, the dire financial situation of SOEs and government results in dysfunctional institutions, which clearly has a detrimental economic growth impact. The reality is that the economy is functioning below its current potential capacity as a result, and in the process is losing jobs and in often the very capacity that is standing idle.

Critical action and decisions are needed on SOEs and other institutions to stop the rot and unlock private sector participation in funding and operation of infrastructure which can unlock economic growth. Not taking decisions to rectify these known problems is keeping the country's economic growth at ransom, and with that the potential of its citizens to make a decent living.

Structural Reforms and Fixing Network Industries

The need for fixing the network industries and unlocking the potential for growth has been eloquently contained in the National Treasury's document, 'Economic transformation, inclusive growth and competitiveness' which spelled out an agenda towards growth for the country. The Minerals Council supports this strategy and progress towards its implementation needs to be made urgently.

Dependency of Mining on Network Industries: 45% of Intermediary Costs

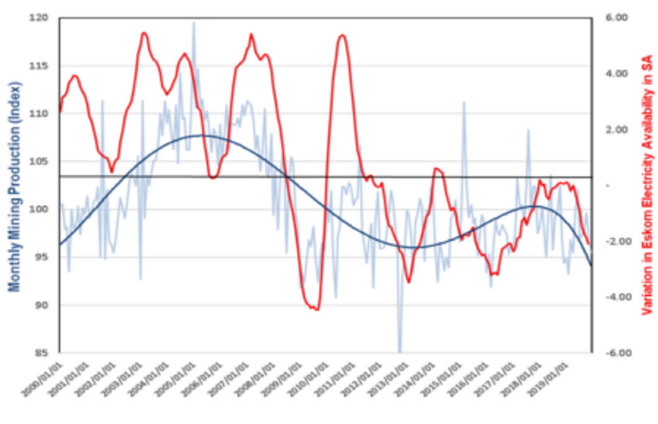
Water	Electricity	Harbours	Rail	Road	Housing
R8bn, 4% of input costs	R22bn, 10% of input costs	Transport and Storage, R71.6bn; 32% of input costs			R34.6bn, 22% of wages

Sources: Statistics South Africa, Minerals Council South Africa

Examples like the fact that Transnet cannot deliver wagons to the mining industry because of crime affecting the routes (theft of overhead copper cables) and because 200 locomotives are sitting idle because local spares are not available (the DTI is demanding that the spares be made locally) is inexcusable, can simply not be allowed to continue.

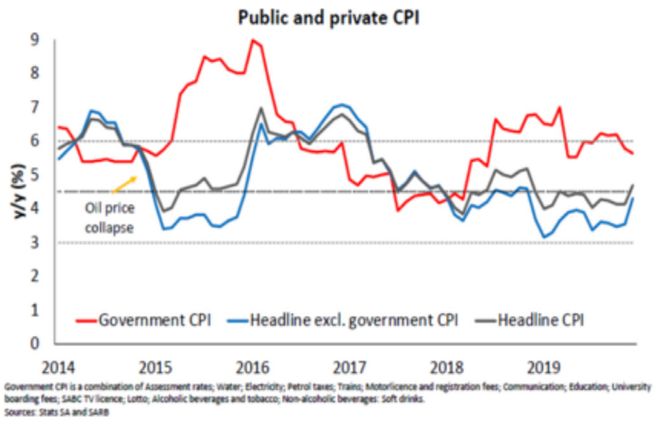
The contrast in efficiencies between the publicly run Durban port and the privately-run Richards Bay and Maputo port terminals is stark. Richards Bay terminal could handle 20 to 30 million tons more of exports had the railway line been able to deliver the cargo. Chrome miners are diverting their exports to Maputo on road due to Transnet's inefficiencies.

The country is estimated to be losing over a billion rand a day when load sheading takes place, of which there were 30 days during 2018/19. Mining companies are estimated to have lost between R 8 billion and R 12 billion worth of production due to load curtailment and load shedding during the 2018/19 financial year. Yet the resistance to self-generation by mining companies from government has only been softening since Eskom acknowledged that it would have to load shed for at least another two years to allow for critical repairs. Job are lost in mining companies and the smelting and refining industries and the sector is in danger of losing jobs faster if these bottlenecks are not removed urgently. Eskom's 'death spiral' is contagious!



Sources: Department of Minerals & Energy, Statistics SA, Eskom, Minerals Council South Africa

These are but some examples of inefficiencies and the resultant increased cost of doing business in South Africa. The South African Reserve Bank found that the already burdened consumers are also adversely affected through costs increasing due to inefficiencies and unreasonable increases in prices of products and services delivered by the state. The President's statement about the inculcation of proper performance contracts into cabinet and for directors general must bear fruit expeditiously.



Source: South African Reserve Bank

The improvement in the efficiencies of the network industries will go a long way in raising the long-term growth potential of the country. However, as part of the fiscal stabilisation, the country should strive to align its corporate tax rates with those of the OECD countries, but definitely ring it in line with competitor economies. This will encourage investment and growth.

Nurturing the contribution of the Mining Sector to the SA economy

The mining sector makes a substantial contribution to the economy of South Africa. The sector is estimated to have contributed 8.1% to the country's gross domestic product in 2019, and paid a bigger share of company taxes, namely R 24.3 billion or 11% of the total. If royalties paid to the state is included (R 8.6 billion), mining companies contributed over 14% of direct company tax to the fiscus. Mining exports accounted for dollar earnings of over US$24 billion which represents (in order of magnitude) about half of the country's foreign reserves at the end of 2019.

The bulk commodities are heavily dependent on transport and logistics. The implementation of the changes to the diesel rebate regime as applicable to mining companies has been unsatisfactory. Millions of Rands of rebates are outstanding with no end in sight for some of the disagreements with SARS on the matter. Several mining companies are, as a last resort, reverting to the courts to try and get the problems resolved. This should be addressed urgently.

One of the key issues that would contribute to the growth of the platinum mining sector is the stimulation of demand for its product. The Minerals Council South Africa has been trying for years to get approval for the production of a platinum coin by the SA Mint, and has received such, but an outstanding incentive that would make it viable is the zero VAT rating of such a coin. This will promote demand and will allow South Africa to join the ranks of many other countries (who do not have platinum) to benefit from a platinum coin. The success of the gold Kruger Rand is the potential awaiting the country if this can be achieved.

Exploration for minerals has declined to a trickle in South Africa; not because licenses have not been granted, but because funding mechanisms do not lead to results. The long-term survival and flourishing of mining in South Africa depend on this question being resolved. The modification of section 11J of the income tax act and the modification of a 'flow through share scheme' encourage venture capital investment in greenfields exploration is necessary.

The funding regime for junior miners needs addressing as well. The Minerals Council has completed a baseline study of these miners' role and constraints and will bring suggestions to Treasury on how to incentivize this sector better, in due course.