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IN THIS ISSUE

"If South Africa does not make this radical shift, then I am afraid we will end up in the poorest 20 countries on earth where our neighbour, Zimbabwe, now finds itself. Ask Rwanda, it takes decades to crawl out of that hole, even with very high growth."

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ECONOMIC REALITIES OF THE SOUTH AFRICAN MIDDLE CLASS

By Mike Schüssler, Brenthurst Wealth Consulting Economist, and Elize Kruger

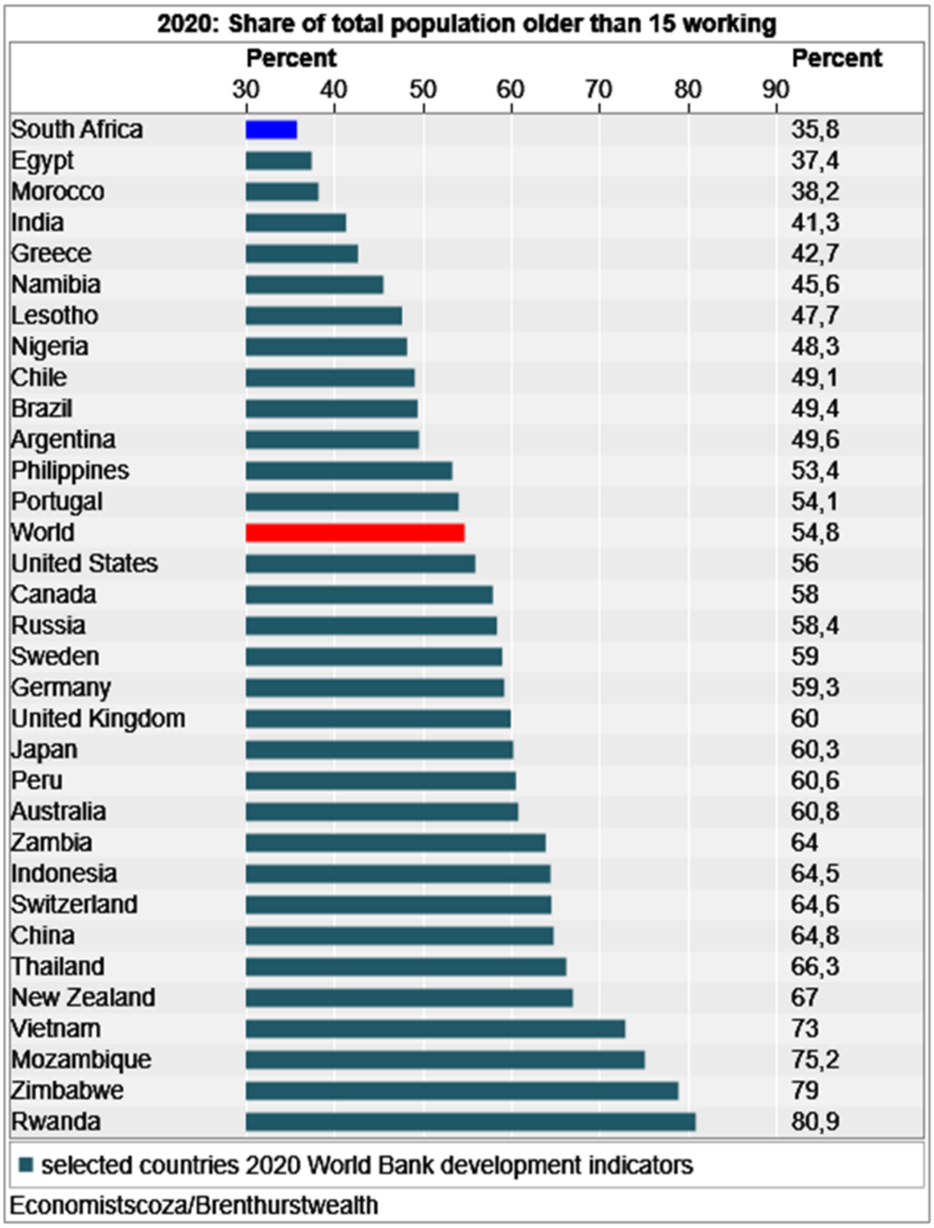
We often refer to the middle class, but who is the middle class? Although there is no single universal definition, for South Africa we prefer to define the middle class as the group of people who would, at least, be those who work. Usually, one would refer to formal work, but with so few people who have work, work will have to do.

The percentage of people working in South Africa is one of the lowest in the world. In 2020, less than 36% of the South African population above 15 years of age were working, according to the World Bank. Since 2020 it seems that SA has regressed by about 200 basis points to less than 34%, if one uses the latest Quarterly Labour Force Survey data.

Unemployment in RSA rose to a record 35.3% in the 4th quarter of 2021. The number of unemployed people increased by 278 000 to 7.9 million. This should be a big worry for not only the Government of South Africa, but for each and every citizen. If this trend continues, which seems to be the case, the unrests we have seen in July 2021 will be the tip of the iceberg.

Brenthurst Wealth Management (PTY) LTD FSP No. 7833

GRAPH 1: SHARE OF THE EMPLOYED AS A PROXY FOR THE SIZE OF THE OVERALL MIDDLE CLASS



This also indicates that South Africa has a very small middle class.

Moreover, at present about two-thirds of the employed in South Africa work in the formal market, which is relatively high for a labour force in the developing universe. However, as a result of so few who work, it means that overall, less than 25% of adults over the age of 15 actually get a regular paycheck from a formal employer (excluding domestic and farm workers).

In most countries, the person who earns a typical salary would pay personal income tax, but that is not the case in South Africa. Hence, in the case of South Africa, those that pay personal income tax can be considered upper-middle class. However, this does not translate to being rich, as upper-middle class is then effectively classified as a working person who earns an annual income upwards of just R87 000.

The irony is that many of the top 10% of earners in South Africa would fall into the lower-middle class in many other countries. Yes, upper-middle class is a relative term in SA because, in this country, so few people even earn a regular formal salary.

According to the World Competitiveness Report, South Africa has the 4th lowest share of employed people who pay income tax. Combined with being in the bottom 5% of countries with regard to the percentage of the population who are employed, South Africa should have the smallest share of the population paying personal income tax (at least as a share of the adult population) in the world today.

The upper-middle class are typically the people in formal jobs, earning fixed salaries and paying PAYE every month. They are the people that buy cars, houses and often have young children and some form of medical aid cover. They are the group of people that, idiomatically speaking, keep the wheels of the South African economy rolling.

This small upper-middle class in world terms collectively has the 10th highest personal income tax burden in the world, yet they must use their own after-tax income to give them a sense of security, schooling of an international standard, reasonable medical care and a host of other things, as the government cannot always provide these. A good example would be a generator power backup system, guards at office parks, etc.

This small middle class pays personal income tax which makes up approximately 38% of government's income. Data from the OECD shows that only five other countries have a similar or higher share of personal income tax that is paid to the government.

As a share of the adult population, less than 20% are liable for personal income tax. This is roughly one in six adults. I know of no other personal income tax paying country where such a small share of the adult population pays the bulk of all tax income and receives so little in return.

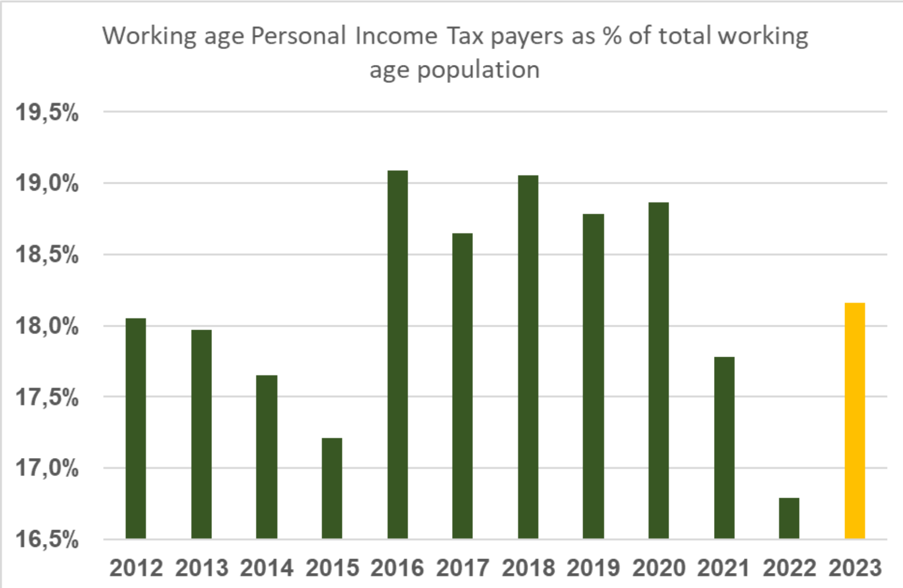
The problem is that the middle class has been squeezed over the last two years, with one in eight jobs lost and very little inflation adjustment for many of the salaried employees, while commitments such as medical insurance, school fees and the like increase.

Given the importance of the middle class in South Africa, the small size of the middle class is of particular importance. Following statistics, as published annually in the National Treasury's Budget Review, there has been a clear downward trend in the number of registered taxpayers with earnings above the annual tax threshold. In the fiscal year ending March 2022, there were 6.8 million taxpayers, compared to 6.95 million 5 years ago and just 6.3 million 10 years ago.

In 2021 the bulk of the registered taxpayers, a notable 69% of the total taxpayers, earned between R87 300 and R350 000 per annum. However, taxpayers who contribute towards the personal income tax (PIT) revenue constitutes only 18% of the total working age population. Interestingly, in the 2022 tax year, one only had to earn a taxable salary of R87 300 per year, or a little less than R7 500 per month, to be liable to pay personal income tax in SA.

In many developed countries, and quite a few developing countries too, this income would not even lift the person out of the lowest third of earners overall. It seems that most SA personal income taxpayers would, in many cases, not make the top 50% of the working population. It is a well-known fact that the higher income categories i.e., individuals earning more than R1m per year, constitute only 4% of all taxpayers and less than 0.5% of the population, yet they contribute 37.7% of all PIT.

GRAPH 2: SHARE OF ACTUAL PIT PAYERS AS A SHARE OF WORKING-AGE ADULTS AS A PROXY FOR SA'S UPPER MIDDLE CLASS



SOURCES:

BUDGET REVIEWS – CHAPTER 4, QLFS FOR THE NUMBER OF WORKING-AGE ADULTS.

The actual number is an adjustment of the estimate of the actual number of people liable for income tax in the relevant earning category.

The 2022 figure is an estimate for both the adult population and the number of PIT payers.

The 2023 figure is a forecast based on the last budget presentation in Parliament.

The increase in the number of PIT payers in 2023 is probably due to Treasury forecasting a return to work of the many who lost jobs due to Covid-19 lockdowns. However, there does not seem to be any prospect that the upper middle class in SA will ever make up more than 20% of the adult population, unless multiple reforms take place. There will be more pressure on the upper middle class in the form of tax burdens and having to pay for more of their own services in the years ahead.

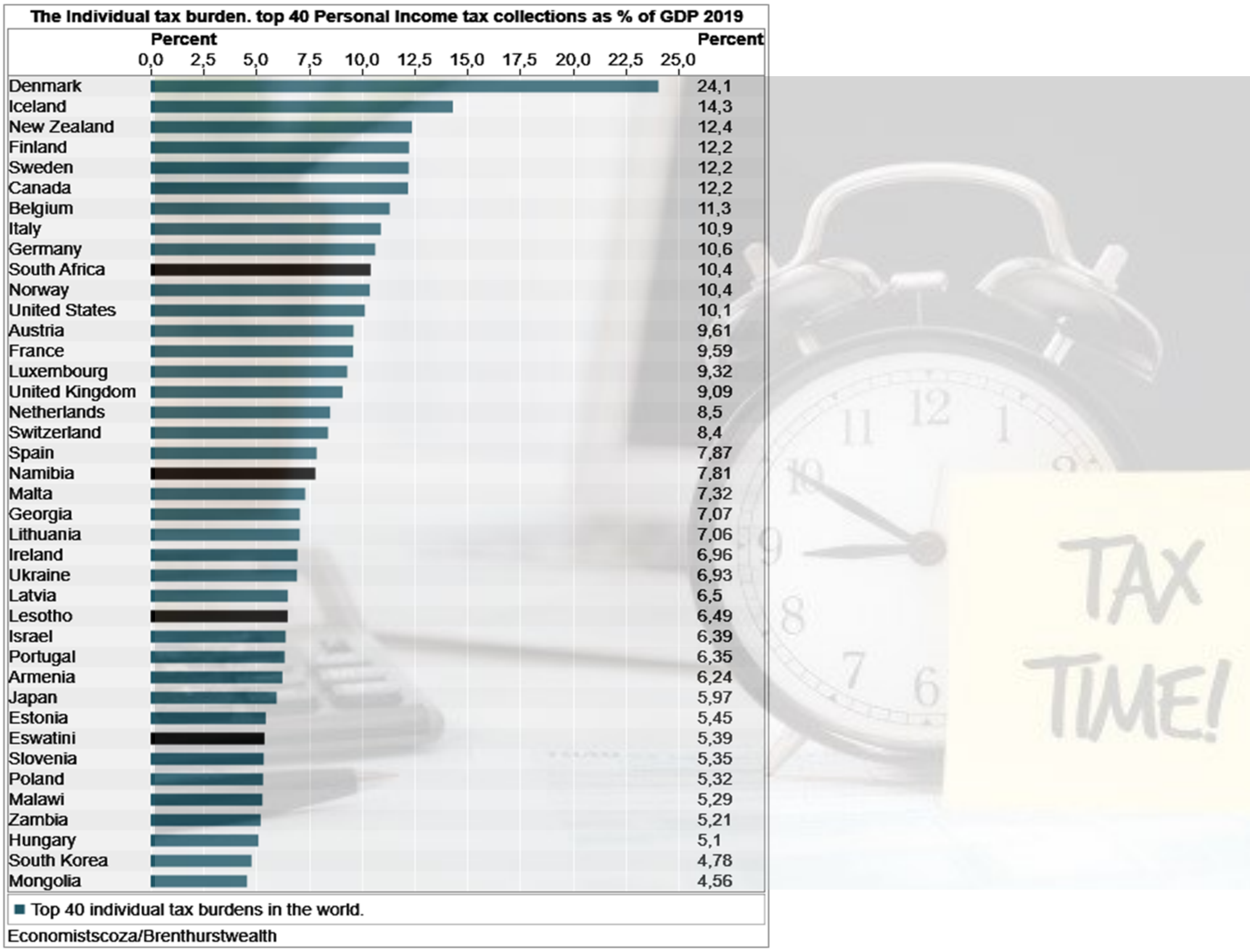
Basically, one of the world's smallest middle classes pays the world's tenth highest personal income tax to GDP, as can be seen in the graph below. The data comes from the world's biggest and longest running tax database kept at the UNU-WIDER university.

It is generally well known that South African PIT payers get very little back, but it is less well known that this is one of the smallest shares that a middle class has in the world today. Yes, South Africa is certainly not equal and has high inequality, but that is not because it has a rich middle class or a very rich upper middle class.

The problem is that the share of people working in jobs with regular paychecks is very low and, even worse, that less than 36% of the total adult population works, according to World Bank data.

More worrisome is that this middle class is shrinking and has not grown for a number of years now, and the share of people working has dropped from just above 50% to below 36% in less than 25 years!

GRAPH 3: THE 40 HIGHEST PERSONAL INCOME TAX REVENUE AS % OF GDP



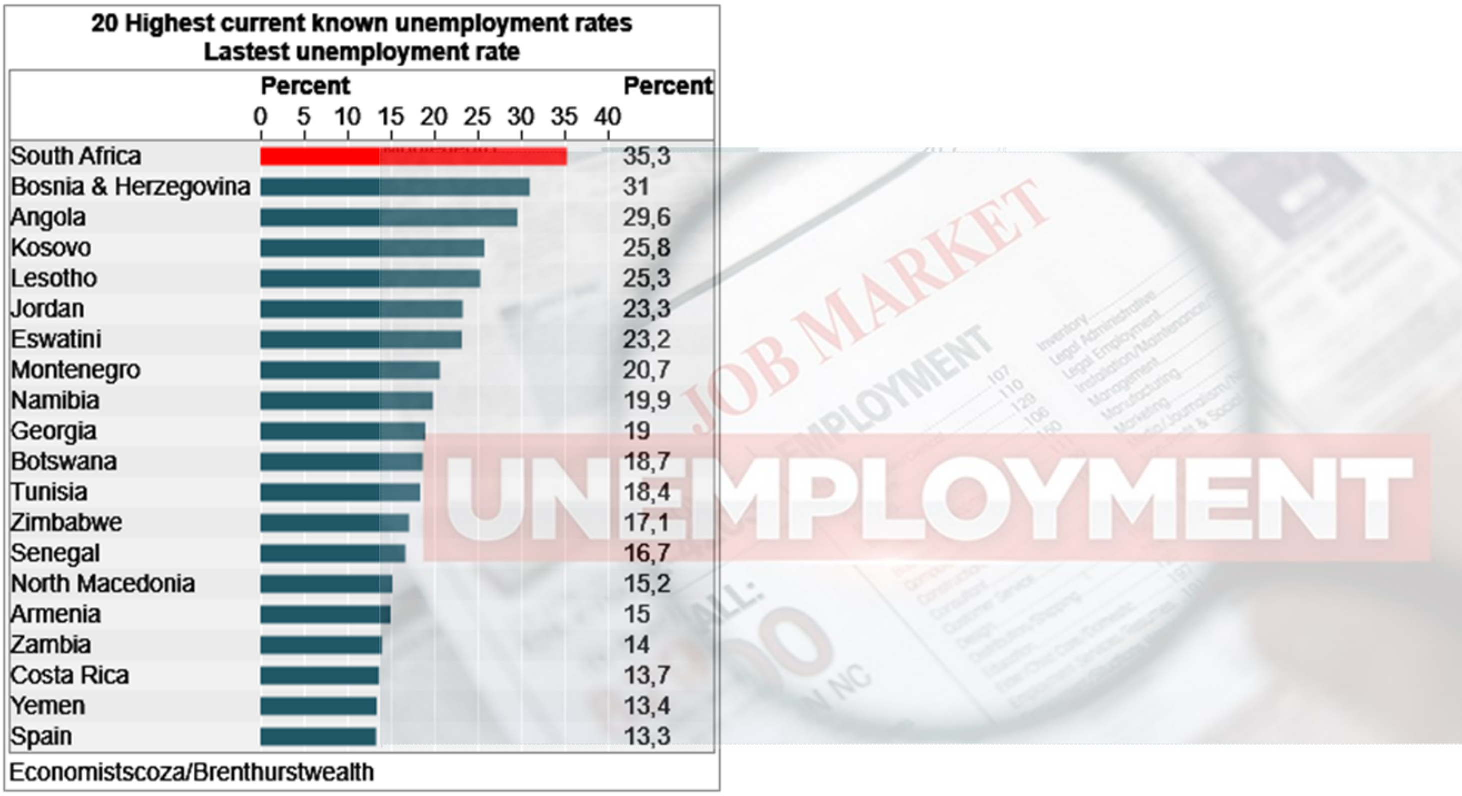
THE LAST FEW YEARS, EVEN BEFORE THE COVID-19 PANDEMIC HIT US, HAVE BEEN CHALLENGING FOR THE MIDDLE CLASS. WE WILL FOCUS ON A FEW OF THE CURRENT ASPECTS SO AS TO HIGHLIGHT THE ECONOMIC REALITIES EXPERIENCED BY THE MIDDLE CLASS, IN PARTICULAR.

➲ LABOUR MARKET STRESS

While the economy recovered to some extent in 2021, with real growth of 4.9% recorded after the recession of 2020 (-6.4% contraction in 2020), the job market has not shown similar growth compared to the broader economy.

By Q4 2021 total employment levels were still 480 000 lower than one year earlier, while the number of unemployed persons increased by 700 000. Although many job losses were centered on lower income (probably not income tax paying) individuals, there was also a section of the formally employed population that were hit by retrenchments, downscaling, furloughing and an inability to find suitable employment in the aftermath of the pandemic. Furthermore, firms want ever high skills while SA does not always produce enough skills of a high quality.

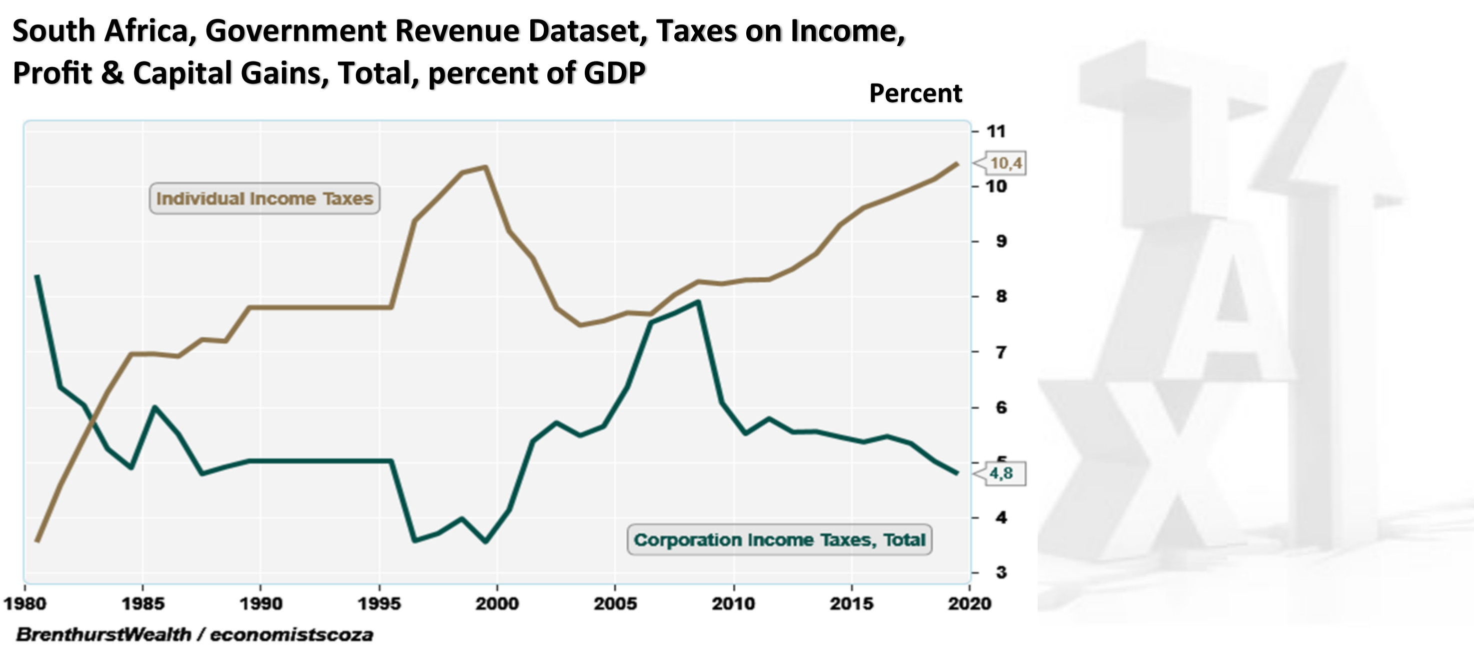
GRAPH 4: HIGHEST RECENT UNEMPLOYMENT RATES



➲ RISING TAX BURDEN

In South Africa the personal income tax burden is one of the highest in the world – see Graph 3. Furthermore, given the inability of our government to provide the services that tax revenue is supposed to finance, for example security, health services, education etc., as mentioned earlier, many middle-class households end up having to make additional payments for services such as private security services, private medical aid cover, etc. These could be considered as additional "taxes" on top of what is already evident as a high tax burden.

GRAPH 5: PERSONAL VS CORPORATE INCOME TAX AS PERCENTAGE OF GDP



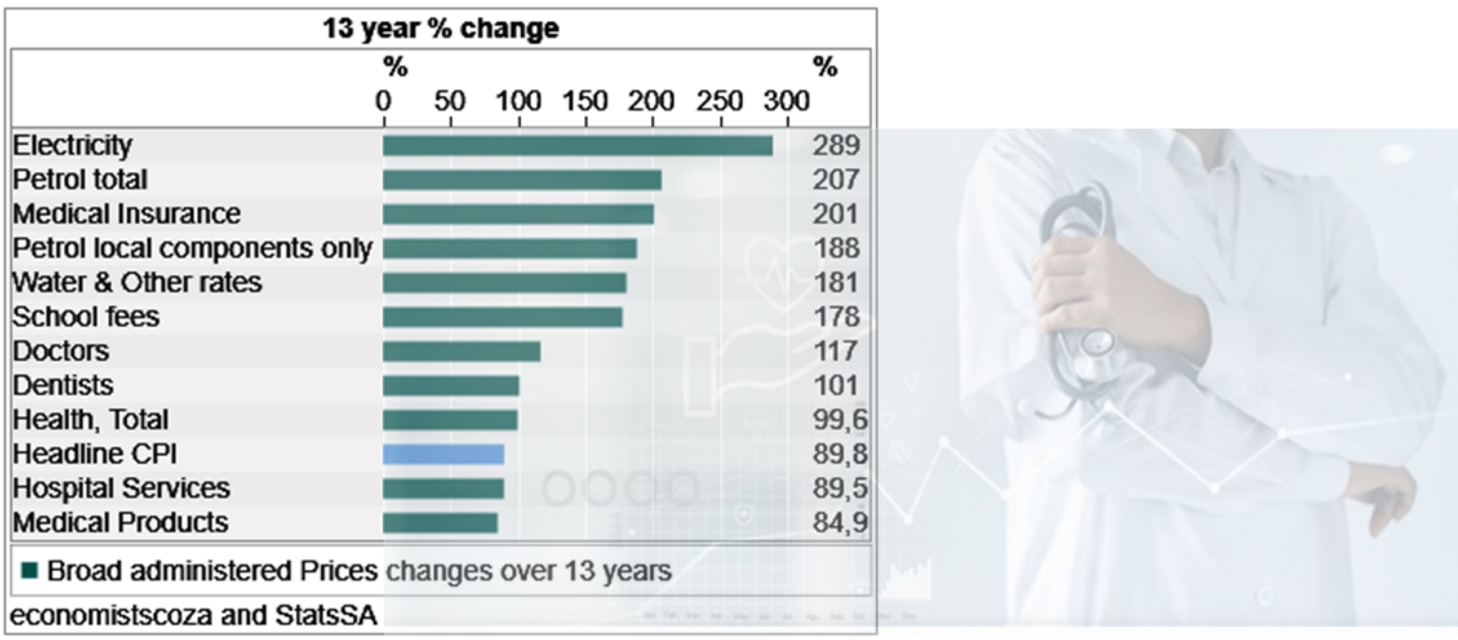
➲ HIGHER ADMINISTERED PRICES – EDUCATION, UTILITY BILLS, MEDICAL AID

Looking at the trends of a couple of the big-ticket spending items of a typical middle-class household indicates that the middle class's spending power has been under pressure for some time.

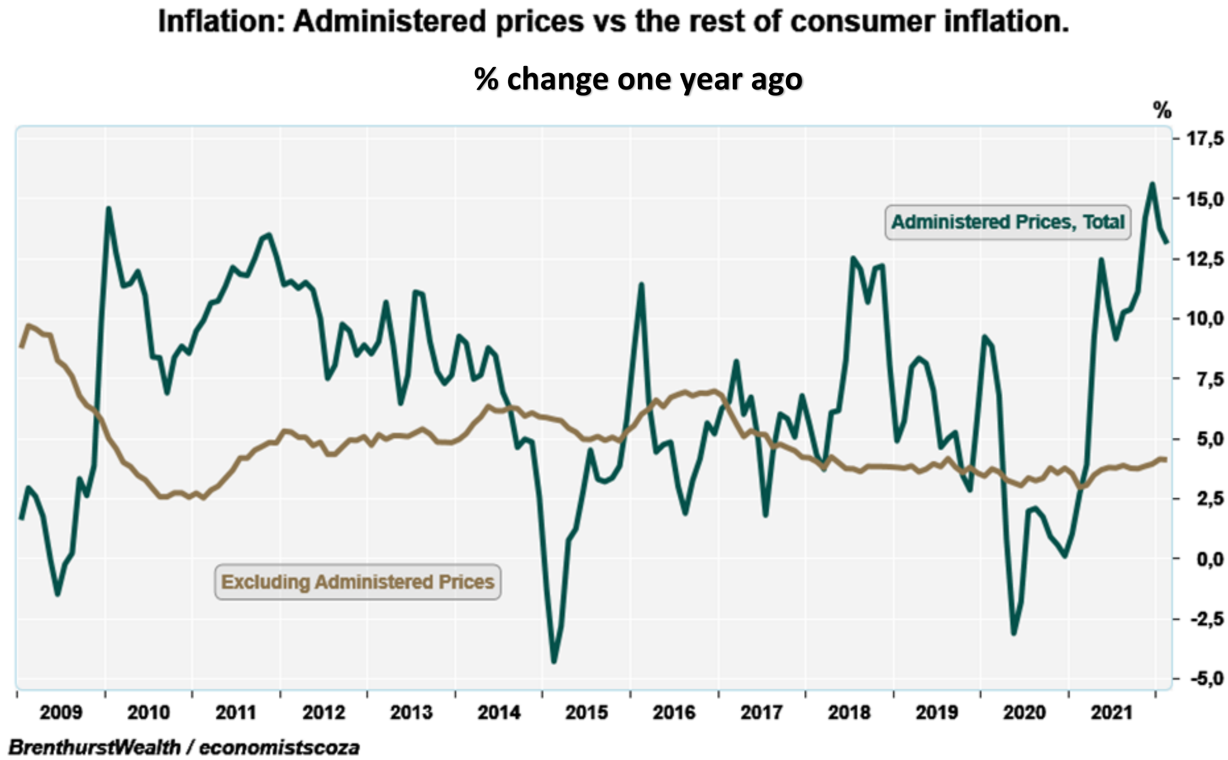
Property taxes, power, water and health insurance, along with school and security service fees, are essentially an additional burden in South Africa. These grudge purchases are, however, needed to maintain a lifestyle that is similar to other developed countries' lifestyles or other upper middle-income lifestyles in developing countries. The middle class has been given a small tax break to help make up for the inflation, but with the rising debt burden this will not be easy in future without new government revenue streams, which will be difficult to establish.

The small overburdened upper middle class, who are the personal income taxpayers, already start paying taxes at an annual income of less than R90 000, which in most other countries would not actually give rise to any form of PIT. In most of the rich world, this taxpayer would probably be eligible for handouts from the government in the form of housing benefits, food vouchers or tax credits. One is concerned that any shocks to the small SA tax base would hurt government income and, therefore, all its social development agendas too.

GRAPH 6: LONG TERM INCREASES IN EDUCATION, MEDICAL INSURANCE AND ELECTRICITY TARIFFS



GRAPH 7: HEADLINE CPI VS ADMINISTERED PRICES



➲ IMPACT OF RUSSIA/UKRAINE WAR TO HIT THE MIDDLE CLASS

Whilst the afore-mentioned issues had already pressurised the middle class, the next challenge hit us on 24 February 2022 – the Russian invasion of Ukraine with the resultant negative impact on energy prices, which is already filtering through as higher consumer inflation and higher interest rates.

The result is that the disposable income of the middle class is under renewed pressure, which will have a detrimental impact on the average household's spending and savings abilities, and thus on many sectors of the economy that have exposure to the well-being of the middle class, such as the motor vehicle, restaurant, and tourism sectors.

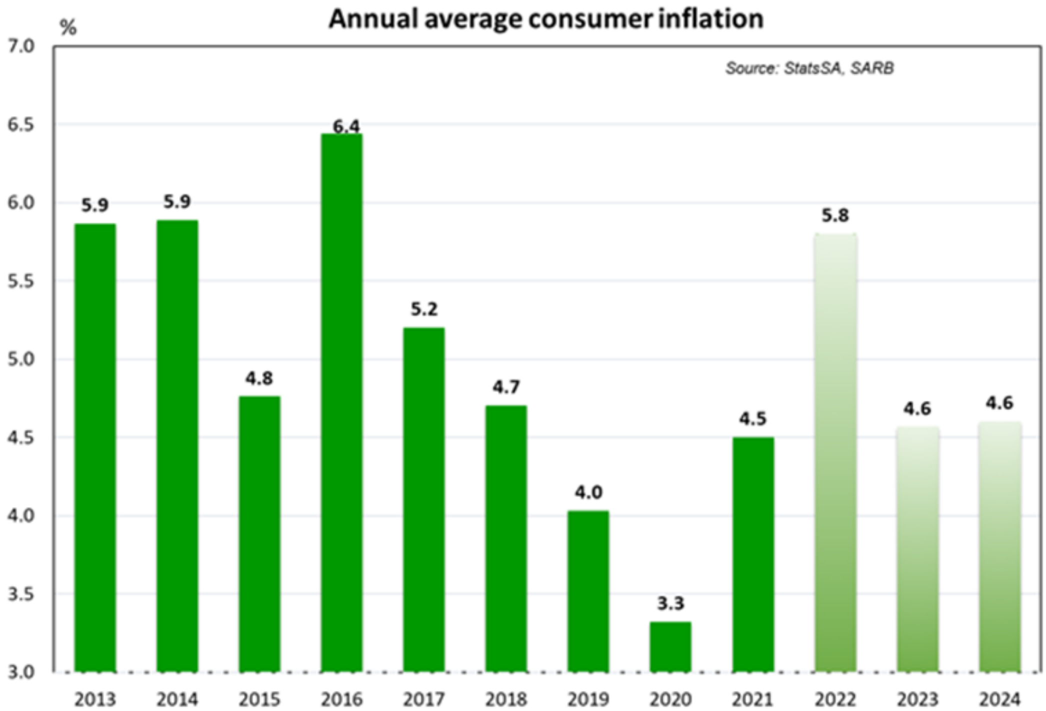
Many personal services such as domestic workers, hairdressers, car guards etc. are already seeing job destruction as the small middle class can no longer afford many of these services.

➲ UPWARD PRESSURE ON HEADLINE CPI DUE TO HIGHER ENERGY AND FOOD COSTS

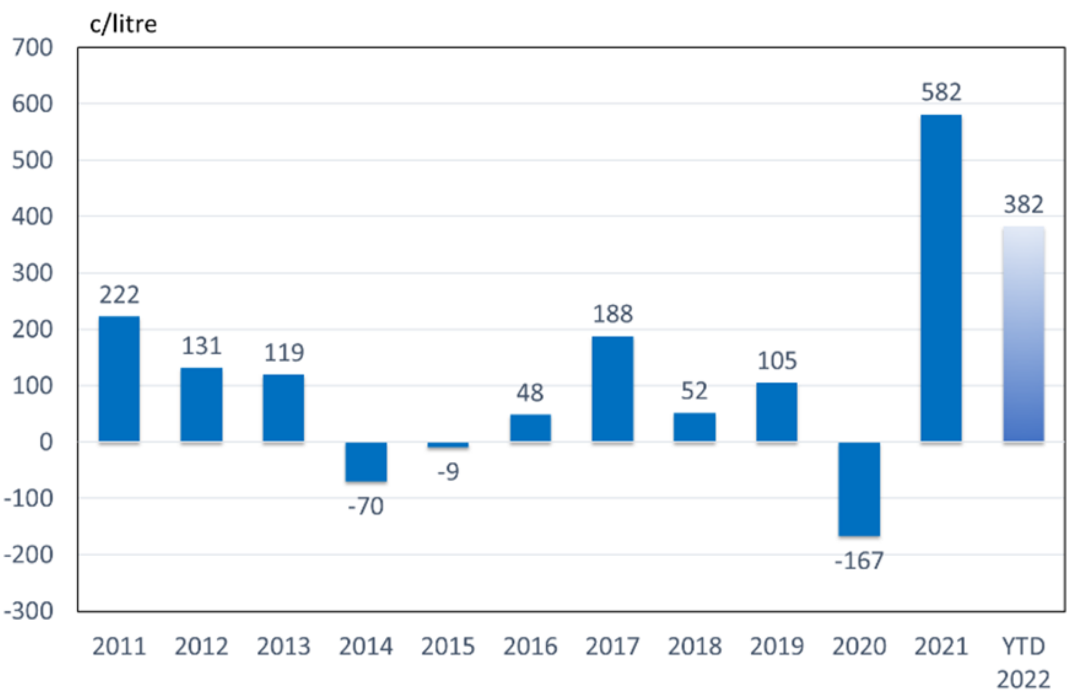
Headline CPI is forecast at 5.8% in 2022 (SARB's latest view, but indicated with upside risk), notably higher than 2021's average of 4.5%, and close to the upper level of the SARB's 3% - 6% target range. Headline CPI is forecast to breach the upper target level of 6% for a few months in Q2, maybe even Q3 2022, before subsiding somewhat due to favourable base effects. While currently headline inflation is predominantly driven by higher fuel prices, there is a growing probability that the hefty fuel price increases will filter through to the broader CPI basket, resulting in a widespread upward tendency in prices, also referred to as second-round effects.

That, in turn, could bring a price-wage spiral into play, where workers demand higher wages to compensate for the higher inflation, which then adds to the cost base of the economy and results in even more pricing pressures. Food price trends are also closely watched for the impact of the Russia/Ukraine conflict on global food price trends, which will filter through to local markets via import and export parity pricing. The linkages between higher global prices and end-user prices are complicated and intertwined. For example, the higher global maize price will end up in higher prices for local chickens in South African stores, as maize is an important feedstock in the poultry business.

GRAPH 8: AVERAGE HEADLINE CPI SINCE 2013



GRAPH 9: CUMULATIVE ANNUAL PETROL PRICE INCREASE (YTD 2022 ON THE GRAPH INCORPORATES AN ESTIMATE FOR APRIL 2022)



➲ ACCELERATING INTEREST RATE INCREASES

In its latest Monetary Policy Statement, the SARB signaled that it will accelerate monetary policy tightening if inflation surprises to the upside, or if signs of second-round effects appear. The SARB has already increased its benchmark repo rate by 75bp since Q4 2021 and consensus forecasts suggest at least 3 to 4 further 25bp hikes are still on the cards through the course of 2022, with the SARB also indicating that the increment could be increased to 50bp, should inflation trends dictate.

So, the era of unprecedented low interest rates for a prolonged period is coming to an end, in line with global interest rate trends, and thus this benefit will fade for the middle class.

The prime rate is forecast at 8.5% by end of 2022. It is likely to be higher in 2023 and that will result in less spending on its own, but with the world inflation genie out of the bottle, interest rates will not be the only pressure.

WHICH SECTORS IN THE ECONOMY IS MORE LIKELY TO FEEL THE MIDDLE-CLASS PAIN?

- MOTOR INDUSTRY
- TOURISM, HOSPITALITY AND RESTAURANTS
- DURABLE GOODS SECTORS
- PROPERTY MARKET
- PERSONAL SERVICES

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WHERE TO FROM HERE FOR THE MIDDLE CLASS AND SA POLITICS?

The middle class will have to deal with rising inflation and rising interest rates, and more severe than previously expected, due to the impact of the Russia/Ukraine war. This will lower the standard of living once again and, much like a bad 1980 horror movie rerun, the middle class will not be able to carry the coming burdens in both taxes and government spending. The middle class will see higher real taxes in future as the debt burden grows, and it will remain under pressure.

ONLY IF CONDITIONS ARE RIGHT WILL THE MIDDLE CLASS BE ABLE TO GROW AGAIN, AND THAT IS WHAT SOUTH AFRICA NEEDS.

SA does not need higher taxes on a smaller middle class, but lower taxes on a growing middle class, which will make SA more sustainable. But unlike early 1990, one has to wonder whether the actual political will of the ruling party is there? It has become extractive rather than enabling, at present. If the government chooses a more enabling route, the country can get back on a sustainable growth and job creation path.

It will take decades to wipe out unemployment, but at least growing numbers of employed people will create a bigger share of people to carry the exceptionally high tax burden that is likely to increase in the future.

Hopefully the shrinking middle class does not just present an economic problem, but will be the driving force of political change. One does, however, wonder whether the politics of needed reforms or politics of the slogan will win the day. This is the real question which we need answered. Fixed capital investors and government bondholders are probably wanting that answer too.

Without reforms, the middle class will soon be buried under evermore taxes that will make life in SA a lot harder for them, and many more will seek to leave in the next few years. However, should reform take place, we can expect an increase in the middle-class numbers, with more people able to share the high tax burden which, in effect, will become lower than before.

Mike Schüssler

BRENTHURST CONSULTING ECONOMIST

Provides expert economic insight and analysis to the company's clients and advisory team.