



SONA: Addressing democratic despondency with pre-election promises

Highlights

- While the rand and local bonds reacted only mildly to the State of the Nation Address (SONA), financial markets are expected to interpret the policy announcements as being generally positive, despite some criticism that the speech resembled an election manifesto. In particular, the announced Exploration Fund for emerging miners, a Climate Change Response Fund and investment models for the private sector to participate in establishing 14 000 kms of transmission network in the energy sector are likely to be welcomed by markets. Moreover, noting that the implementation of the National Health Insurance (NHI) will be incremental could calm market fears over a premature mass rollout when financing and capacity are currently lacking.
- The effectiveness of these announced interventions to tackle the challenges the country is facing is significantly dependent on government's willingness to execute these plans and the availability of fiscal resources.
- Aligned with the January 8 statement, the president allocated a substantial portion of the SONA to highlight the achievements attained by the ruling party since the advent of democracy, but he also switched focus to the recent governmental successes since the pandemic.
- South Africa's (SA) freedom of the press, electoral integrity, independence of institutions and separation of powers have allowed the country to continue to perform relatively well on global indices measuring democratic quality and political rights. However, citizens are voicing their discontent with democratic governance in the country due to significant challenges such as unemployment, crime, electricity shortages and water scarcity.
- The SONA outlined the steps that the government has already undertaken to close the energy capacity gap, including regulatory changes, restoring units of Eskom's fleet to operation and encouraging investment by the private sector. In our view, accelerating the delivery of transmission infrastructure is critical to ensuring energy security further out. The announcement that innovative funding models would be used to crowd in the private sector is seen as positive in this regard.
- The speech also emphasised the importance of attracting private sector participation in the network industries without relinquishing state ownership. In addition to the Cabinet approving the Freight Logistics Roadmap last year, we believe that the passing of the Regulation of Transport Bill is critical to improving operational performance. In our view, increasing efficiencies in the area of logistics remain a function of the vertical separation of Transnet and the introduction of third-party access across the railway network.
- The SONA further highlighted the shortcomings of our law enforcement agencies which have led to a rising level of lawlessness in the country. Consequently, government has set up a crime and corruption workstream,

partnering with the private sector to jointly combat crime and corruption. In our view, further capacitating the National Prosecuting Authority (NPA) and the Independent Directorate (ID) are important steps to concrete prosecutorial gains.

- In the way of legislative updates, the SONA reiterated the importance of implementing the NHI despite having yet to spell out details on how it will be financed. The National Council of Provinces passed the NHI Bill in December last year and it is currently awaiting sign-off by the president. Improving access to health care will likely remain a key tenet of the ruling party's election campaign, but political analysts are speculating that the president will defer the signing of the Bill until after the election. He still holds the option of sending the Bill back to Parliament to ensure that it passes constitutional muster.
- In addressing the country's social ills, the speech spoke about building onto the District Development Model to enhance the delivery of social services in poorly resourced municipalities. Moreover, government noted the importance of extending the Social Relief of Distress (SRD) grant to provide for basic incomes.
- To mitigate policy uncertainty and expedite the implementation of structural reforms with far-reaching benefits, there is a need for a broader political consensus regarding the measures necessary to address SA's sluggish growth rate and employment prospects. From our perspective, cultivating positive consumer, business and investor sentiment demands a collaborative effort to synchronise interests among government, business, labour and civil society. The SONA underscored that as a nation, we have yet to achieve this alignment.
- The objective remains to establish a social compact to drive collaborative initiatives in pivotal areas essential for economic advancement, in the context of a strained fiscal environment. As it's an election year, there's increased scrutiny on government's approach to fiscal consolidation, with concerns arising over the potential for a more populist approach given the current stage of the electoral cycle.

Network industry failures are paralysing growth

The government highlighted that electricity supply constraints, which have left Eskom's energy availability factor (EAF) at 51.6% year-to-date, remain one of the greatest impediments to growth and investment in SA.

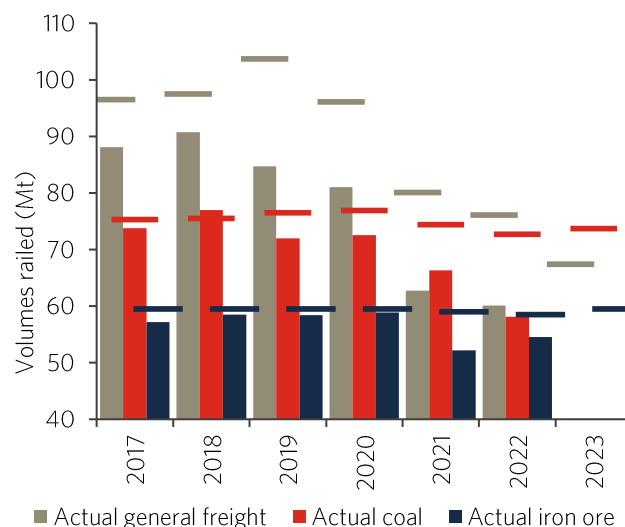
The SA Reserve Bank estimates that loadshedding detracted up to two percentage points from gross domestic product (GDP) growth in 2023, up from a calculated loss of 0.7 percentage points in 2022. Nevertheless, lower anticipated levels of loadshedding could translate into a smaller 0.8 percentage point deduction from GDP growth in 2024.

Implementing a debt relief package for Eskom, tabling of the Electricity Regulation Amendment Bill, undertaking critical maintenance and implementing regulatory reforms to enable private investment are among the key focus areas that the president raised in the SONA to ensure sufficient electricity supply in the near-to-medium term.

Government acknowledges that insufficient transmission capabilities pose a threat to longer-term

energy security and has pronounced that innovative investment models are being considered to include private sector investment in the 14 000 kms of new transmission lines planned in the coming years.

Chart 1: Transnet rail performance failing to meet targets



Source: National Treasury, Momentum Investments

SA's logistics challenges are nevertheless expected to outlive load-shedding's shadow on the local economy. National Treasury estimates that rail inefficiencies have cost SA around 6.5% of GDP in 2022 and could amount to close to 5.5% of GDP in 2023 as Transnet battles to meet its performance targets for general freight and coal, in particular (see chart 1).

With Transnet's cumulative rail infrastructure maintenance spending backlog rising to R30 billion (noted by Traxtion Africa to be close to the carrying value of R43 billion) since 2012, significant investment is needed to improve rail efficiencies. Transnet's annual financial statements alluded to a necessary investment of R85 billion in the next five years in the freight railway division, of which 80% would be used to address maintenance backlogs. Given a stressed fiscal position, attention will be focused on the National Treasury regarding potential additional funding for Transnet and the conditions attached to such financial support.

What this means: Eskom's generation turnaround plan and more investment appetite from the private sector for wind and solar suggests that the worst of the energy crisis is behind us. Furthermore, businesses have invested in backup and alternative energy

sources, enabling them to withstand reduced levels of loadshedding and mitigating the impact on economic growth. That said, significant investment needs to be made in transmission and distribution to close the energy gap over the longer-term. Crowding in the private sector is a positive announcement in this regard.

While the energy crunch is likely to alleviate over the next few years, SA's logistic challenges will continue to cripple growth prospects. The adoption of the Freight Logistics Roadmap is a significant step forward, but further legislation needs to be passed for Transnet's turnaround plan to gain traction. The passing of the Regulation of Transport Bill will be important to establish an independent regulator for the transport sector. Moreover, Traxtion Africa points out that providing an attractive entry point for private sector participation requires (1) optional membership of the Transnet Bargaining Council rather than making this mandatory, (2) ensuring that access rights match the longer-term nature of the assets and funding requirements, (3) providing access to the entire railway network for concessions and (4) introducing multiple infrastructure managers to adequately address the maintenance backlog.

Democratic despondency on the rise

According to Freedom House's Freedom in the World 2023 report, which captures political rights and civil liberties, SA ranks as a 'free' country with a score of 79 out of 100 (100 = most free). Similarly, the Economist Intelligence Unit's Democracy Index for 2022, which takes into account free and fair elections, a functioning government and an ability to participate in politics, rated SA with a score of 7.05 out of 10 (where 10 depicts countries that are the most democratic).

In contrast, surveys on the ground, such as Afrobarometer's in 2022, showed that 70% of South Africans were dissatisfied with the way that democracy worked in our country. The survey respondents continued to cite unemployment, crime/security, electricity, water supply and corruption as the most important problems facing SA. While the president emphasised that the number of employed persons has

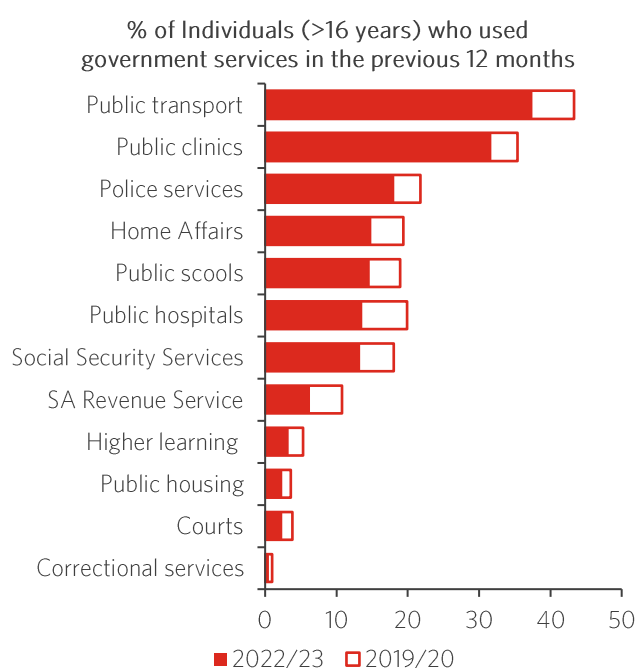
risen from eight million in 1994 to 16.7 million in recent data, the rate of unemployment remains staggering.

Other surveys, such as the SA Social Attitudes Survey, conducted by the Human Sciences Research Council in 2021, show strain on life satisfaction (with the lowest satisfaction rating among South Africans since data was collected in 2014). A record 39% of South Africans expressed despondency over their future, indicating that they believed their lives would deteriorate in the next five years. This trend was consistent across all racial and gender groups surveyed. Moreover, those who were dissatisfied with democracy had a more pessimistic outlook.

The survey found that those with a more positive outlook were also more satisfied with government's ability to effectively deliver a range of services.

Although Statistics SA's 2022 Census revealed an increase in formalised residences (88.5% of households reside in formal dwellings), a higher rate of school attendance (73.4% of persons aged five to 24 attend school in SA), increased access to electricity (94.7% of households have access to electricity for lighting) and increased access to water (82.4% of households in the country had access to piped water), there is a declining share of citizens that use government services (see chart 2).

Chart 2: Dwindling faith in the effectiveness of government services



Source: Statistics SA Governance, Public Safety and Justice Release October 2023, Momentum Investments

In November last year, the Auditor General of SA identified 268 material irregularities in the 2022/23 municipality audits amounting to c.R5.9 billion. Building on the District Development Model has been noted on government's agenda to address social delivery challenges.

Vulnerable households have remained in a precarious financial position in the aftermath of the pandemic and wars in Ukraine and the Middle East. In response, Finance Minister Enoch Godongwana announced an extension of the SRD grant for an additional year up to the end of March 2025, in the November medium-term

budget, giving government time to consider social security policy reforms and a viable funding model. The SRD grant was initially introduced in May 2020 as a temporary measure to support the most vulnerable, but the ruling party is in support of a more permanent income stream for financially exposed households, in its fight against poverty.

Research by Codera Analytics and Stellenbosch University suggests that funding a more permanent grant "through a reallocation of public expenditure, higher tax or higher debt is extremely limited". Instead, they put forward more sustainable policy options, including structural reform efforts, that leverage the private sector, to enhance growth and employment.

They find that if the SRD is simply converted into a basic income grant (BIG) (at a cost of R44 billion for 10.5 million recipients), it would have the least costly implication for debt levels and job losses in SA. Should the BIG be implemented at the food poverty line (R624, 2020 rand terms), for 10.5 million people, SA's debt ratio would climb by 8% at a cost of R79 billion (after accounting for a 0.5% increase in the value-added tax (VAT) rate, a 5% hike in the personal income tax (PIT) rate and a 0.5% increase in the company income tax rate (CIT)). Under this scenario, the country would have 200 000 fewer jobs in five years.

Taking it one step further, the study finds that the implementation of BIG at R840, for 33 million people, at a total cost of R333 billion, would result in a 40% increase in the debt ratio (taking into account a 2.5% hike in the VAT rate, a 12% jump in the PIT rate and a 1% increase in the rate of CIT). In this scenario, the country would have a million fewer jobs over the same timeframe.

What this means:

The SRD grant is likely to be politically entrenched, but disagreement persists regarding the adjustment of its amount once the grant expires at the end of March 2025. Funding the social grant continues to pose a challenge within the framework of the Treasury's dedication to fiscal consolidation in the medium term. This implies the necessity for either a permanent tax

adjustment or a reduction in other social expenditures to safeguard the government's finances.

In our view, rating agencies are unlikely to react negatively to making the social grant permanent, given its ability to offer significant redistributive opportunities, as proven by the World Bank (social assistance programmes in SA reduced the poverty gap by 31.9% relative to 26.7% for the typical upper-middle income country), as long as it can be

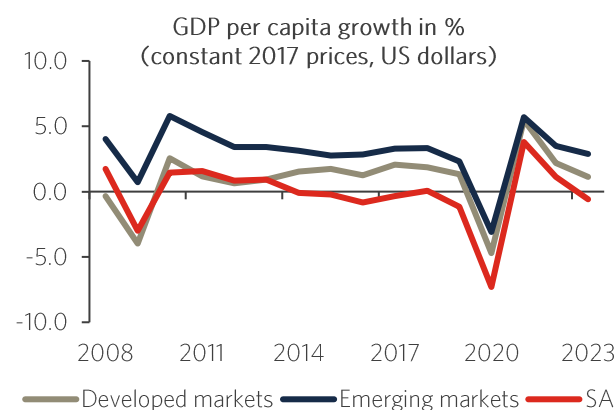
introduced in a manner that is fiscally and economically sustainable.

Nonetheless, studies from the World Bank (conducted in SA between 2006 and 2015) have further reiterated what the research above indicates — that labour income remains the most important source of reducing the level and depth of poverty.

Reviving the SA economy

SA's economic performance lags that of its global counterparts (see chart 3). Nurturing inclusive growth remains a key objective of the ruling party and featured once again in the January 8 statement.

Chart 3: SA's economic performance is trailing



Source: International Monetary Fund, Momentum Investments

The SONA highlighted some economic successes achieved and noted a number of initiatives aimed at accelerating growth:

- Addressing youth unemployment:
 - 1.7 million work opportunities created through the Presidential Employment Stimulus
 - SAYouth.mobi creates access to work and learning opportunities
- Mitigating climate change:
 - Special Economic Zones for green energy
 - Focusing on green hydrogen energy
 - Supporting electric vehicle manufacturing
 - Securing an increase in financing pledges for the Just Energy Transition to R240 billion
- Establishing a Climate Change Response Fund together with the private sector
- Improving ports and rail network:
 - Focusing on turning around five strategic corridors that are crucial for exports
 - Reducing congestion at the Port of Durban
 - Appointing an international terminal operator at the Port of Durban
 - Allowing private rail operators to access the rail network
 - Approving a framework for high-speed rail
- Enhancing water resource management:
 - In the process of finalising a number of water infrastructure projects (including the Lesotho Highlands Phase Two project)
- Infrastructure investment:
 - The five Investment Conferences have so far yielded R500 billion of inflows into SA
 - Modernising the mining rights licensing system
 - Launching an exploration fund to support emerging miners
 - Improving black ownership in mining from 2% in 2004 to 39% today
- Telecommunications:
 - The completed broadband spectrum auction has lowered data costs and improved network reach to the extent that 79% of SA households had internet access in 2022, up from only half in 2011
- Reforming the visa system
 - Less stringent requirements for police clearances

- Planning to introduce a nomad visa (people employed and paid by companies elsewhere – and earning above R1 million – can reside in SA for up to six months without paying tax)
- Creating inclusivity:
 - 25% of farmland is now in the hands of Black owners
 - Total worker ownership in companies has reached over half a million
- Improving education outcomes:
 - Devoting more resources to early childhood development
- Fighting crime:
 - Economic Infrastructure task teams are combatting cable theft and illegal mining
 - The launching of Operation Shanela is targeting hotspots and has resulted in c.285 000 arrests since May 2023
- Role in foreign affairs:
 - Engaging on the war in Ukraine via the Africa Peace Initiative
 - Supporting a two-state solution to the war in Gaza

- Hosting the G20 in 2025

What this means:

If executed efficiently, a considerable portion of these proposed reforms could generate additional employment opportunities, particularly through labour-intensive positions, improve the country's infrastructure and elevate service delivery standards. Nonetheless, the sluggish pace of implementation has been a source of disappointment for the investor community, especially amid pedestrian economic growth and a slow job market recovery. A lack of further detail around funding for the more permanent extension of the SRD grant, definitive funding strategies for Transnet and funding details around the implementation of the NHI perpetuates policy uncertainty, which has consistently undermined foreign and local investor confidence and inhibited growth in fixed investment.

Shortcomings in anti-corruption efforts

The World Justice Project Rule of Law Index measures the practice of the rule of law, based on the experiences and perceptions of the general public and in-country legal practitioners and experts in 142 jurisdictions. On this measure, SA's ranking has nearly consistently deteriorated since 2015, dropping to 56th place out of 142 countries in the latest report for 2023 from 36 out of 102 countries in 2015.

The index measures eight scores ranging between 0 and 1 (1 = best):

- Constraints on government powers (government powers are limited by the legislature and judiciary and officials are sanctioned for misconduct) – stabilising at a score of 0.62 out of 1 for the last three years, and above the global average of 0.54.
- Absence of corruption (bribery and misappropriation of public funds) – stable at 0.47 from the year before and below the global average of 0.51.
- Open government (citizen participation in public policy, quality of information provided by government in a transparent manner) – dropping to 0.62 from 0.63 in the previous reading and above the global average of 0.52.
- Fundamental rights (human rights) – stable at 0.63, and above the global average of 0.56.
- Order and security (security of persons and property) – a dip to 0.6 from the previous reading of 0.61 and well below the global average of 0.72.
- Regulatory enforcement (effective implementation and enforcement of regulations within and outside of government) – sliding further to 0.52, but only slightly below the global average of 0.54.
- Civil justice (accessible and affordable civil justice systems, which are free from discrimination and corruption) – a drop to 0.59 from 0.6 previously and marginally above the global average of 0.54.

- Criminal justice (actions against individuals for offences against society) – stable at 0.5 and slightly above the global average of 0.47.

Similar to the previous set of results, these indices show the most notable deviation from the global standard resides with order and security. Within this measure, the World Justice Project looks at effective limiting of civil conflict, violence to redress personal grievances and effective control of crime. SA ranks better than the global average for the effective limiting of civil conflict but falls short on the other two measures.

The President underscored the continuous fight against corruption, the dedication to rebuilding institutions weakened by state capture and the necessity to hold accountable those who are responsible. The SONA revealed that legal proceedings are underway against 200 individuals implicated in state capture, indicating a degree of advancement in addressing this issue.

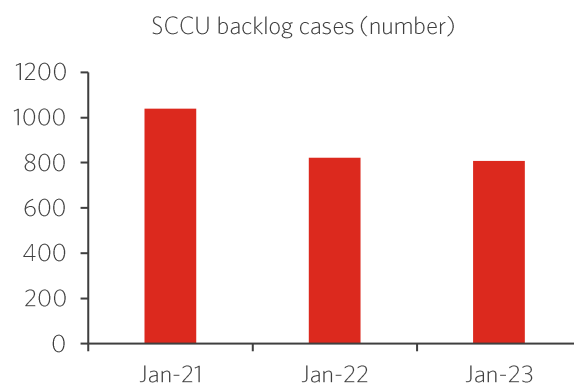
The NPA's Annual Report for 2022/23 noted that organised crime verdicts increased by 21% to 234, while 134 government officials were prosecuted on charges of corruption during the year (up from 130 in the previous financial year). During 2022/23, 85 cases involving money laundering were finalised with verdicts (steady from 86 in the previous year), while 96% of the 138 complex tax cases were convicted in the same period.

The report also found that the ID had authorised 97 new investigations in the past four years. The NPA further highlighted that its Asset Forfeiture Unit (AFU) had frozen assets to the value of R10.2 billion over the past four years and recovered c.R2.6 billion in state capture cases. The SONA called attention to freezing orders totalling R14 billion, which have been awarded to the AFU for cases related to state capture, while approximately R8.6 billion in corrupt proceeds have been reclaimed by the state.

The NPA, nevertheless, highlighted two key issues preventing greater success in eradicating crime and corruption. The inability to prosecute kingpins and a significant backlog of cases in the Specialised

Commercial Crimes Unit (responsible for prosecuting corruption, money laundering, cybercrime and serious complex commercial crime) remain key challenges (see chart 4).

Chart 4: Capacity constraints have kept the number of backlogged cases high



Source: NPA Annual Report 2022/23, Momentum Investments

Government's digital forensic capability, a collaborative effort with the private sector, is expected to provide support to the ID, while legislation is currently before Parliament to establish the ID as a permanent body.

What this means: Despite Ramaphosa's active portrayal of himself as an anti-corruption leader, it is evident that this is the area where there is significant underperformance. Allegations and instances of state capture, corruption, and mismanagement of public funds have diminished SA's appeal as an investment destination. Plans to strengthen institutions to address criminal activities are positive steps toward enhancing confidence in SA's rule of law. However, establishing a clear timeline is crucial to instilling confidence in the government's commitment to combating corruption. The NPA's admission that they are struggling to enrol cases involving kingpins erodes the inability of the institution to prosecute high-profile individuals and could spoil SA's chances of being removed from the Financial Action Task Force's greylist by 2025.

Public trust in state institutions is unlikely to improve unless there is a concerted effort to combat corruption, hold wrongdoers accountable, and demonstrate tangible progress in the performance of law enforcement agencies.

Weakening support for a troubled ruling party

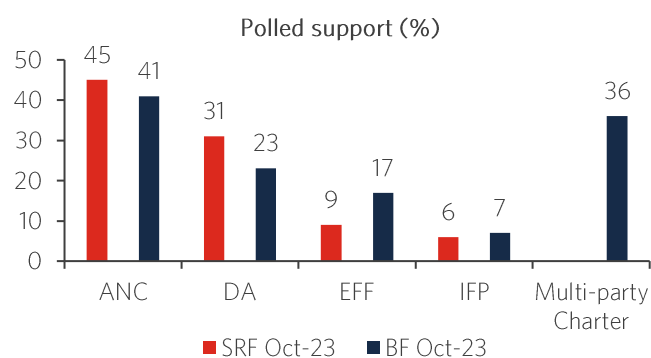
With ongoing electricity problems, logistical hurdles and ongoing criminal activity, amidst a backdrop of sluggish global growth, it is anticipated that support for the ruling African National Congress (ANC) will decrease in the upcoming 2024 national elections.

There is an increasing likelihood of a coalition government having to form at a national level. According to an October 2023 survey conducted by the Social Research Foundation (SRF), ANC support has likely fallen to 45% at a national level. This estimate is based on a survey of 1 412 registered voters and uses the assumption of a voter turnout of 66% (similar to the 2019 election when the ANC won 57.5% of the vote.)

The SRF survey projects a win of 31% of the vote for the official opposition, the Democratic Alliance (DA), while it anticipates that the Economic Freedom Fighters (EFF) would amass around 9% of the vote.

An October 2023 survey by the Brenthurst Foundation (BF) (1 500 respondents) places the ANC at 41%, the DA at 23% and the EFF at 17%.

Chart 5: ANC primed to lose a significant margin of electoral support



Source: SRF, BF, Momentum Investments

The latest February 2024 IPSOS poll places the ANC at 40.5% of the vote, the DA at 20.5% and the EFF at 19.6%, after reworking the 'refused to answer', 'don't know' and 'would not vote' responses.

In its January 8 statement, the ANC noted it persists in finalising sectoral agreements, which will serve as the foundation of a comprehensive social compact involving all stakeholders and should support the overarching approach and principles of the Economic Reconstruction and Recovery Plan.

The ANC pointed out that this social compact should delineate the responsibilities, pledges, and concessions required from the private sector, organised labour and civil society to facilitate a robust social and economic recovery.

What this means: The heightened level of disorderliness and sluggish progress in implementing structural reforms in specific sectors of the economy has widened the trust deficit between the government and other stakeholders. A more inclusive social compact involving all economic participants is necessary to ensure that the necessary compromises and agreements are taken into account to advance a successful social and economic recovery in SA.

Significant failures in the areas of network industries, eradicating poverty and unemployment and effectively dealing with crime and corruption are likely to cost the ANC votes in the upcoming national elections. We are likely to see the era of coalition politics at a provincial and possibly national level being ushered in.

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