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Tax pressure increases

The South African economy is characterised by imbalances and it is especially noticeable when it comes to paying taxes.

We have a population of close to 54 million, yet a mere 3,3 million people pay 93% of all income tax in South Africa, according to Paul Joubert, senior researcher at Solidarity Research Institute.

Moreover, only one out of ten adults pay a notable amount of tax which means we have a very small tax base in our country.

Personal income tax is the largest source of tax revenue and in 2013 it increased to 34% followed by another increase in 2014/15 to 35.8%.

Tax relief for individuals is dwindling. In 2013, during the state budget speech, tax relief of R7 billion was announced for individuals and R9,3 billion in 2014. This year, the personal income tax, other than the rate of 18%, was, however, pushed up by a percentage point. You pay far more tax than you might be aware of. And in future you will even pay more.

Take corporate taxes. It is not paid by the company, but by the owners, employees and customers who buy the products. These are the same people who already have to pay personal income tax.

Consider import duties, fuel levy and of course VAT and it is clear that most taxes are paid by those who have the most purchasing power.

On the back of an extremely limited tax base and a fragile economy, the government is trying to appease a restless population with welfare payments and highly paid civil servants. About 15,5 million people in South Africa receive welfare grants and state officials have just received a 7% pay increase.

In addition, the net loan debt of the state grew to a whopping R700 billion. The debt was incurred at relatively low interest rates and the question is, how the interest burden will be managed when interest rates take a hike?

Interest rates... how does it affect your pocket?

Interest rates in America are likely to be increased for the first time in almost ten years by their Federal Reserve Bank.

How will this affect us in South Africa? What will the impact be on our economy which is already in a sad state?

A survey by The Wall Street Journal shows that 92% of economists and businessmen expect that the Fed will announce an increase of.25% on 16 December.

This comes after surprisingly positive unemployment figures were released last month. The unemployment rate in America fell sharply to only 5%, indicating that the US economy has recovered so well that interest rates can be increased.

US interest rates are at a historical low after the housing market and banking sector nearly collapsed in the period 2007-09 and a policy of "quantitative easing" or low interest rates was followed to prevent a looming depression.

The economy in that country is now "overheating" which means inflation/salary demands could increase. Interest rates or the cost of credit is then increased to slow down economic growth. Their low interest rates meant that global investment dollars were invested in developing countries such as South Africa, where higher interest rates were prevalent.

An increase in the American interest rates will lead to global investment dollars flowing from South Africa to America because the investment risk is less in that country.

This will urge our Reserve Bank to increase the repo rate (the rate at which it lends money to banks) to make South Africa's rates more attractive and to prevent the investment dollars from flowing to America.

The greater the interest rate differential between the US and South Africa, the more attractive it is for foreigners to invest in our capital market. This increases the demand for the rand which strengthens our exchange rate and therefore makes imports cheaper.

Increased interest rates also make it more expensive to buy on credit, which compels consumers to spend less. So there is a lower demand, which will lead to a drop in prices and inflation. If the Reserve Bank increases the repo rate, then the prime rate (rate at which banks lend money to customers) must also increase. In SA there is always a difference of 3,5% between the repo and prime rates.

The Reserve Bank increased the repo rate last month by .25% from 6.00% to 6.25% which increased the prime rate from 9.50% to 9.75. It was the third increase in the past year and the repo rate is expected to increase with at least a full percentage point next year. Apart from the impact of the American interest rate hikes, the drought in South Africa, weakening of the rand and the possibility of electricity tariff increases will push up interest rates.

The South African economy remains weak according to Lesetja Kganyago, governor of the Reserve Bank, and the mining and agricultural sectors continued to contract in the third quarter. The prospect of developing markets is bleak and the American rate hike will be a big challenge for developing countries.

The price of shares also drops when interest rates increase. This will have a negative effect on share portfolios and more specifically unit trusts.

Shares of retailers normally react negatively to interest rate increases, because a large part of their revenues is based on debt. Many clients cannot afford the increased payments and the bad debts of retailers often increase when interest rates rise. This brings down the share prices of these retailers.

A rate increase also makes it more expensive for companies who use debt to finance their businesses, because the cost of borrowing becomes more expensive. It could mean that they cannot afford new expansions or developments which stifles the growth of their companies.

It is often thought that an increased interest rate is to the benefit of banks. This is not so; because it leads to an increase in the cost of products such as credit cards, while many customers cannot afford the higher repayments.

The Reserve Bank's decision about interest rates will affect the pockets of all the consumers in South Africa.

What we can do to limit the impact of rate increases on our wallets, as we are clearly in a rising interest rate spiral for years to come:

Get rid of debt

It is better to pay off debt - especially credit cards – as soon as possible, because the costs of financing will continue to increase, owing to the rising interest rates.

Beware of large mortgages

Do not borrow on your bond, unless you can afford the growing instalments when interest rates are increased. It is a costly mistake to buy a house you cannot afford and then be forced to sell it. Having to downgrade and buying anew, will force you to pay all the costs of such a transaction all over again – die transfer costs alone increased this year from 8% to 11%.

Stay away from personal loans

The rates of personal loans will also increase as interest rates rise. Do not take the maximum loan offered. The average consumer already pays 75% of monthly income off on debt.

Invest in interest rate entrenched investment products

Invest in financial products linked to the prime rate. This means if the prime rate increases the income will increase. A good example is Ecsponent's Class C Preference Shares, offering a rate of Prime + 4% minus dividend withholding tax. In this case the monthly income will increase as the prime rate increases. If the prime rate decreases, then the monthly income will, however also decrease. This means investors in Class C in fact benefit from increased interest rates.