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BUDGET 2025 PREVIEW

Pressures and tensions along the austerity road to fiscal sustainability

Public Economy Project

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PUBLIC ECONOMY PROJECT | WITS UNIVERSITY | SOUTHERN CENTRE FOR INEQUALITY STUDIES

Introduction

This policy brief, ahead of the tabling of the 2025 Budget Review, considers the policy context and the fiscal and economic environment in which the Budget will be tabled. It considers the merits, limitations, and likely consequences of the government's approach to budget policy over the medium term, as contained in the 2024 Medium-Term Budget Policy Statement (MTBPS), which redoubled efforts to consolidate public finances while attempting to promote capital spending. Since the MTBPS, several material expenditure pressures have emerged, some of which were flagged in the Public Economy Project's (PEP) 2024 MTBPS analysis, and the economic outlook has been revised. Based on this, the Public Economy Project's revised outlook for public finance finds that the government's ambitious plan to stabilise debt over the medium term is unlikely to be realised.

Policy baseline: a declining size of the state amid rising uncertainty

The government's policy baseline for the next ten years reduces the size of the state. Such a reduction will have notable implications for service delivery and for testing the durability of South Africa's social contract. Figure 1 shows that *core spending increased* substantially in the decade before 2012, marking a period of state expansion[1].

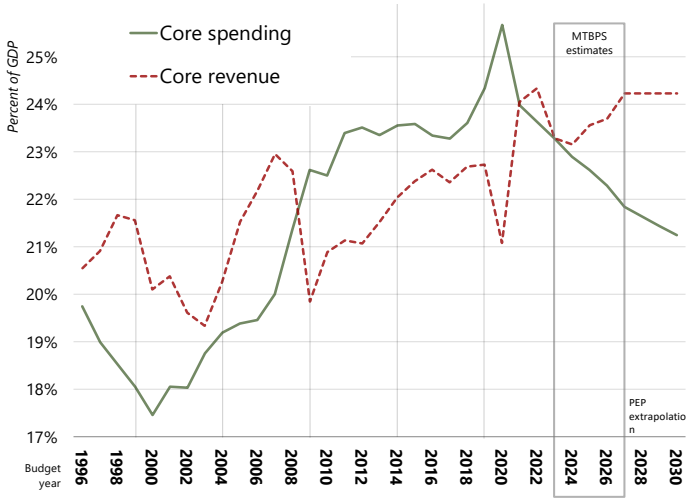
Spending stabilized as a share of national income after 2012, but since the COVID-19 pandemic, the state's share of economic activity has consistently declined. Core spending as a share of GDP is now at its 2012 level, and the Treasury's budget plan is to cut it down by two percentage points further.

Underpinning this approach is a *de facto* fiscal anchor that limits the maximum growth rate of government consumption spending to the sum of population growth and CPI inflation. Assuming that revenue remains moderately buoyant, this will generate a large enough primary surplus to stabilize government debt.

As the state's income share declines in the year ahead, it is hoped that GDP growth will be driven by growing corporate investment and household consumption, rebalancing the national economy towards the private sector, and enabling the extension of markets. Along this path, increases in the (nominal) size of the economy do not unlock increased resources for public spending and, arguably, will result in significant under-provision of critical public goods.

Figure 1: Budget policy baseline

Core spending and revenue as share of GDP



Source: National Treasury budget data; Public Economy Project calculations

Note: The graph shows the policy assumptions that underpin the fiscal stance if it is maintained in line with treasury assumptions set out in the MTBPS, October 2024. The graph extrapolates the path assuming that revenue remains constant and spending aligns with the Treasury's "fiscal framework assumptions for the long-term main-budget baseline". Real non-interest expenditure grows by 1.2 per cent annually from 2028/29 onwards, informing the debt projection. (see MTBPS p65)

[1] Core spending shows appropriations towards government goods and services in terms of tabled budgets. We define it as the main budget expenditure, excluding interest payments, capital transfers to state-owned companies (i.e. "payments for financial assets"), skills development levy and fuel levy sharing with metros.

Fiscal policy will act as a structural headwind to aggregate demand expansion over an extended period. The disinflationary forces that fiscal consolidation will set in motion could be reinforced if an inflation target reduction, as proposed by the central bank, is implemented. Fiscal consolidation could be more difficult to achieve in this scenario for several reasons. Revenue buoyancy will be directly and immediately impacted by an inflation slowdown. But a falling inflation rate doesn't automatically lower government spending: Many elements of public expenditure are inflexible downwards, and very little of it is explicitly index-linked. Holding down publicly administered prices has proven difficult to achieve over a very long period, and salaries and other costs must still be negotiated. A move towards further disinflation makes this task more difficult to achieve, especially in the short term. If the impact on spending lags behind revenue, the deficit could widen in the transition to a lower inflation rate. In addition, lower inflation will raise the nominal burden of past deficits, which will loom even larger over progress in cutting current imbalances. While, in the long run, lower inflation might mean lower debt service costs, this effect is likely to be muted relative to the impact of fiscal ratios on the sovereign risk premium.

A lower inflation target means slowing nominal growth rates, a wider gap between expenditures and revenue, and a more difficult path to debt stabilization. At a time when a growth revival is sorely needed, we believe the combination of fiscal and monetary contraction would be counterproductive.

Such a strategy could succeed if government borrowing costs fall substantially and economic growth accelerates on the back of attenuated risks. However, intensified efforts at fiscal consolidation are more likely to occur in the context of continued anaemic growth, high interest rates (on government bonds), global volatility, and rising debt. These conditions describe South Africa's experience over the last decade, and accelerating down a path of fiscal consolidation and monetary deflation is not guaranteed to resolve the crisis and, instead, could make it significantly worse.

Service delivery and accountability

The current approach to budget reductions has been described as a "lawnmower" method of uniform cuts across all budget items. This method is widely recognized as the least efficient and most damaging approach to expenditure consolidation.

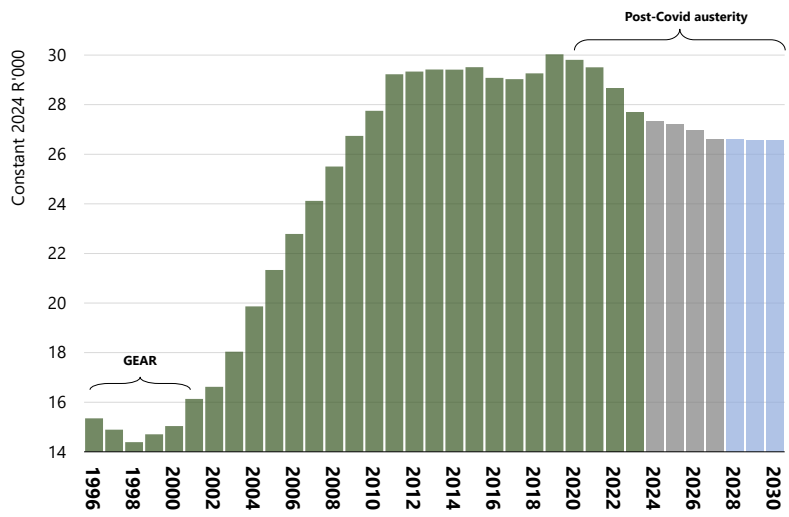
To the extent that expenditure consolidation is targeted, this is strongly concerned with the input side of the Budget. Treasury aims to lower the cost of government employment and shift the composition of purchases away from "consumption" towards "capital" spending. This targeting choice has consequences for the composition of the government's outputs because spending on government services such as education, healthcare and criminal justice is inherently dominated by consumption spending. Consequently, the fiscal consolidation will continue to reduce the quantity and quality of inputs available for these consumption-intensive departments. Holding other factors constant will inevitably result in diminished outputs over the medium term, meaning lower service levels and worsened performance against policy objectives. In practical terms, it implies poorer learning outcomes in schools, longer queues for service in hospitals and the court system, and fewer professional staff relative to the effective demand faced by government services overall.

There are massive inefficiencies, corruption and waste in government services, and more decisive action against these ills might help offset the impact of budget cuts on services. Currently, however, there is no credible program to realize such goals. Expenditure reviews have identified several potential efficiencies and other reforms to public services but have failed to generate new fiscal space. We looked at the reviews in healthcare and concluded that, while they identify critical reforms needed

to improve the efficiency of hospital services, these reforms will be complex, lengthy and unlikely to realize substantial savings for the Treasury. At a sector level, their fiscal impact would hardly dent the overall path of declining resources. In any case, to be sustainable and effective, the fiscal gains from better government efficiency should be passed onto the underfunded sectors that succeed in realizing these gains. A policy of redirecting efficiency gains to finance the deficit is a powerful disincentive against its own objectives.

If unmitigated, this trajectory of decreasing allocations using a "lawnmower" approach could exacerbate unemployment, inequality, and poverty, undermining South Africa's constitutional commitment to socio-economic rights. Given the extent and duration of expenditure restraint that has been proposed in the Budget (and if this path does not change fundamentally in budget 2025), it is imperative that the government provide detailed assessments and projections on the implications of medium- and long-term expenditure plans. Thereby, clearly articulating the expected consequences of the fiscal path for the quantity and quality of government outputs is critical for transparency and accountability. Departments should explain the anticipated impacts on public services, performance indicators, and broader social outcomes across key sectors such as education, healthcare, and social development. Each department must also disclose the projected effects of budget cuts on the government's human and physical capital, including staffing levels, workforce composition, maintenance and infrastructure spending, and the essential goods and infrastructure required to maintain adequate public service provision.

Figure 2: Wither service delivery?



Source: National Treasury budget data; Public Economy Project calculations

Plans for accelerated early retirement and recruitment freezes, and the impact of these plans on services need to be more clearly disclosed for the whole public service and individual departments. The government should explain how it plans to mitigate the potential loss of frontline services, experienced personnel, and management capabilities. A critical issue here is whether these workforce changes are intended as permanent reductions in headcounts or whether the department plans to substitute older employees with the recruitment of younger personnel.

It is the constitutional duty of accounting officers to account for these factors. The constitution also provides an excellent forum for public deliberation of the choices involved through parliamentary debates and votes on each budget line.

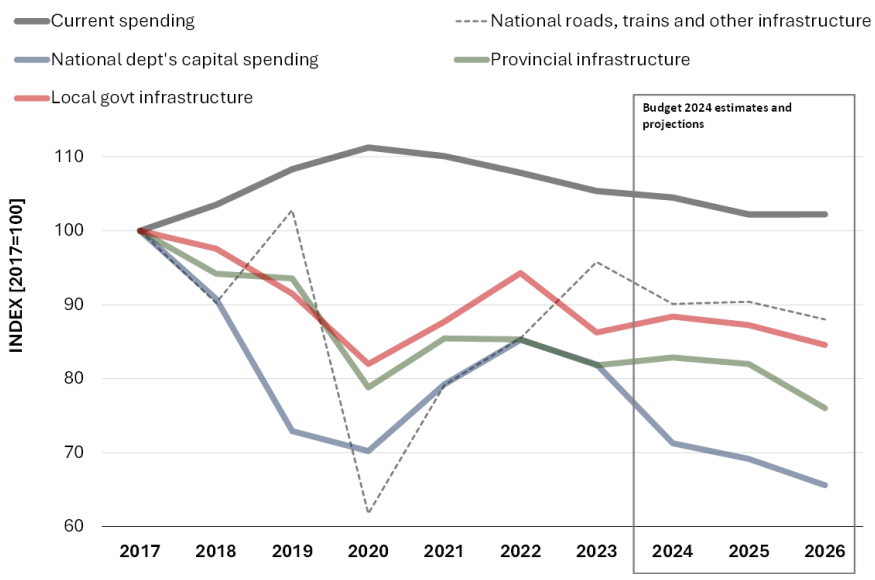
Cuts to social capital and shifts to "blended finance"

Since 2017, capital budgets have been cut back significantly. Planned further cuts to capital spending over the medium term contribute significantly to fiscal consolidation (see Figure 3). National department's capital spending (which is largely for courts, police stations and prisons) is projected to

be 30% lower in real terms in 2026 compared with 2017. Conditional grants that finance provincial and local capital spending are also declining, and adverse consequences are likely to follow for education, healthcare facilities, and community infrastructure. Recent budgets have seen strong growth in financing for capital spending by Prasa and Sanral, and for water infrastructure (i.e. national roads, trains and other infrastructure in Figure 3). But even here, allocations are set to fall.

Figure 3: Less and less in the Budget for capital

Index of real capital and current spending financed by the main Budget



Source: National Treasury budget data; Public Economy Project calculations

Reduced spending on social infrastructure will adversely affect economic growth, service delivery, and social stability. This sharpens concerns about the potential trade-offs between short-term fiscal consolidation and long-term investment needs. This trade-off is starkly illustrated in the case of higher education, where infrastructure allocations have been brought to almost nothing (see Figure 4). This is at odds with the government's stated policy of expanded TVET facilities and new universities. Suppose budgets are cut, but enrolment continues to increase, driving rising infrastructure demand. In that case, it is likely that the cuts will not be politically sustainable and will be reversed in future years. On the other hand, if this stance is maintained over the next decade, the implication is that the government intends to reduce the quality of higher education facilities permanently. Similar concerns apply to other social infrastructure spending cuts, especially in healthcare and local government amenities.

In contrast with the Treasury's austere approach to on-budget social infrastructure, it has opened the window to joint investments with the private sector where feasible. The 2024 MTBPS emphasizes a "de-risking" of public infrastructure projects through credit guarantees and similar instruments.
The MTBPS also announced several restructuring initiatives aimed at mobilizing private sector capital to complement public investment in infrastructure. This includes a unified approach that brings together the Public-Private Partnership office, the Capital Projects Appraisal Unit of the Government Technical Advisory Centre, and the Infrastructure Fund from the Development Bank of South Africa.

These are laudable attempts to crowd-in private capital investment in the context of a constrained fiscal environment. To this end, the 2024 MTBPS proposed to exempt allocations to the "infrastructure fund" from the strictures of austerity. This raises important questions about allocative efficiency and equity in South Africa's budget system. Decoupling operating spending from capital spending can result in inefficient outcomes and must be monitored carefully.

"Blended finance" mobilizes private capital that must earn a financial return and often relies on user charges. As a result, project selection can be biased toward more affluent households. Budget equity could be undermined because blended finance depends critically on fiscal subsidies out of general

taxation to subsidize poor users and guarantee financial returns. Taken in combination, the government's approach amounts to forcing down spending on social infrastructure (for services that are free at the point of delivery) while opening the door to unlimited funding for projects attractive to private capital and benefit relatively affluent citizens.

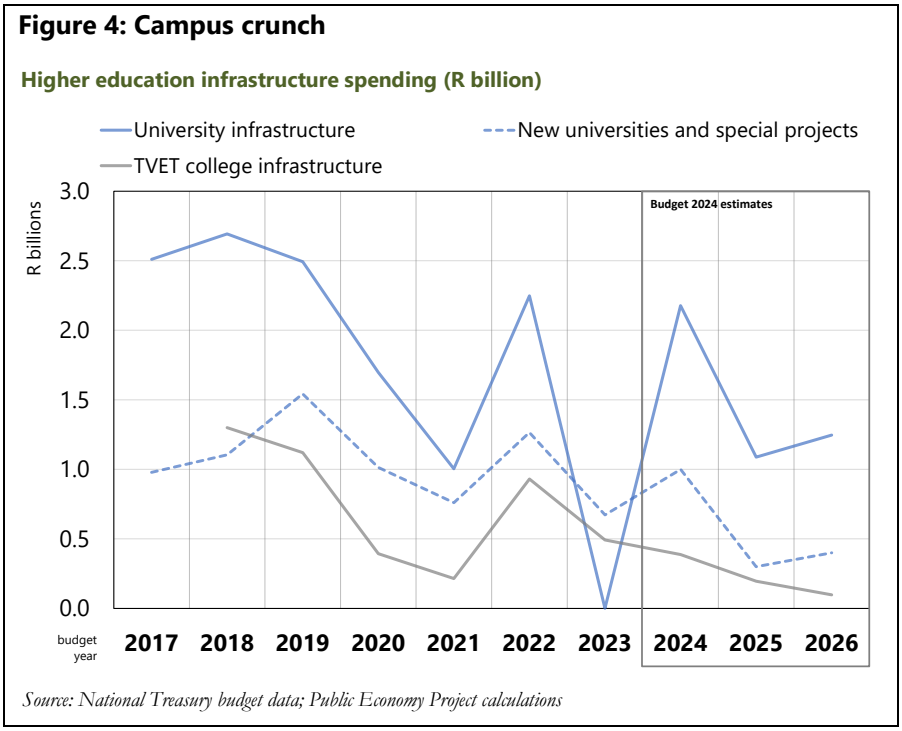
Key spending pressures facing the Budget

Spending pressures are manifest across various sectors, particularly in education, health, criminal justice and social protection. Wage increases for civil servants have been lower than inflation since 2020, meaning that the real purchasing power of government workers' salaries is falling over time. The 5.5% wage settlement in 2025 is significantly above the government's budget envelope. Accommodating the wage settlement in full would result in higher spending, a smaller fiscal surplus, and higher levels of debt. Not accommodating it raises other risks, with the potential for reduced headcounts in essential services like health and education raising alarms about the future quality of these services.

In the education sector, initiatives such as the Teacher Assistant program have been financed off-budget, raising questions about the sustainability of such programs. Moreover, the universalization of Grade R and adequate funding for existing headcounts remain unresolved policy issues that could significantly impact educational outcomes. Provincial departments of education face funding shortfalls, even before additional spending is considered. The government's policy vision regarding Early Childhood Development also appears to be an unfunded strategy.

Health services face similar challenges, with the government's "2030 Human Resources for Health" plan increasingly at odds with budget realities. The Department of Health is exploring ways to improve efficiency, but there are rising accruals in provincial health departments, pointing to both insufficient budgets and financial management weaknesses. The cut to PEPFAR funding will impose difficult choices on budget planners. The status of Community Health Workers will also need to be resolved, as the combination of uncertainty about PEPFAR funding and recent legal rulings that redefine their employment status as permanent employees. Moreover, the current MTEF does not include any allocations for NHI despite an ambitious "first phase" of implementation legislated in the NHI Act and recently agreed by cabinet.

Figure 4: Campus crunch



Source: National Treasury budget data; Public Economy Project calculations

Another potential concern is the bailouts of state-owned entities. The fiscal framework assumes no funding for SOCs and that funding for Eskom will end in 2025. However, given NERSA's tariff

adjustment and the accumulating local government Eskom debt, it is becoming increasingly clear that this support will likely extend well beyond the current year. The government's "tough love" approach promises no further funding, but Eskom, Transnet, and others will test that.

The government has yet to decide on the policy framework for the Social Relief of Distress Grant, which was introduced on an ad-hoc basis during the Covid-19 Pandemic. This failure to define policy has opened the door to judicial intervention, with a recent court judgement pointing to the arbitrary character of these allocations despite the tens of billions of rands that are annually appropriated.

Further funding dilemmas reflect policy contradictions that the government has been unable to bridge. National Treasury has effectively defunded the defence force, contributing to recent military setbacks. The government needs to decide whether it intends to continue with its regional security role, which will require significant funding, or withdraw from its continental obligations. For the police, significant funds were made available at the time of the MTBPS to increase police numbers, even while the rest of the Budget remains dedicated to reducing employee headcounts across government. The crisis in the court system is increasingly visible as cuts to both capital and operating budgets are resulting in chronic and systemic failures.

De Jure fiscal anchor deferred; *de facto* anchor announced

The government has been gesturing at a potential fiscal rule or anchor for several years now but has to date not made any formal proposal, possibly due to the difficulty in achieving consensus amongst social partners, and in the 2024 MTBPS the government again deferred proposing a legally encoded fiscal rule to the 2025 budget. However, the 2024 MTBPS proposed what is a *de facto* fiscal anchor. This *de facto* fiscal anchor comprises two key objectives: achieving a debt-stabilizing primary surplus over the next three years and stabilizing government debt over the remainder of the decade.

There is, however, a need for greater clarity and consistency on the proposed *de facto* fiscal anchor. First, it is unclear how the primary balance is defined. In its latest Article IV report (2024), the staff of the IMF estimate that South Africa will have a primary deficit until 2027, whereas the National Treasury reports a primary surplus. This is mainly because the National Treasury incorrectly treats the Eskom bailout as though it were not spending. This is a matter of accounting, but also substantive because it is becoming increasingly clear – given NERSA's tariff adjustment and the accumulating local government Eskom debt – that this support will likely extend well beyond the current year.

Secondly, to develop its de facto fiscal rule, the National Treasury must be transparent about its estimates of the "debt-stabilizing primary surplus". In our view, past estimates tended to be overly optimistic about the relationship between the primary balance and the achievement of debt stabilization. If this relationship is unclear, it weakens the credibility of the government's commitment and limits the scope for public deliberation.

A third issue concerns the government's longer-term fiscal target. Over the next decade, it is unclear whether the government's goal is to "stabilize" debt at a particular level or significantly reduce the debt-to-GDP ratio and, if so, to what lower level. This choice has significant consequences for the required path of spending reduction. These issues should be resolved to ensure a coherent and transparent fiscal framework and to enable proper policy formulation by the rest of the government.

The economic and fiscal outlook

South Africa's growth outlook has been improving, with most forecasters expecting the country to grow around 2% over the medium term, and the output gap is projected to fall to zero. This more positive outlook is underpinned by a stable electricity supply and reforms within key network industries and informs the Treasury's anticipation of a path of debt stabilization.

Continuing the policy trajectory of restraining expenditure growth, the last published National Treasury forecast sees real government consumption falling in the next two years. This could potentially constrain overall economic growth by dampening aggregate demand. Many analysts are projecting a recovery in investment and household consumption that will offset the negative fiscal impulse. Indeed, the National Treasury's assumptions for household consumption and investment appear more conservative than the broader consensus, suggesting some upside risk to the growth projections. Notably, the lower trend inflation forecast will also make the task of fiscal consolidation more challenging.

The global environment, however, poses major downside risks to the country, which have increased since the inauguration of Donald Trump. Whilst inflationary pressures in both advanced and emerging economies have abated, allowing for monetary easing to support a global recovery, radical policy changes emanating from the US threaten to disrupt global trade, stoke inflation, and upend the existing global economic and political order. South Africa, along with several countries in particular, appears to be in the crosshairs of a US administration less committed to multilateral trade and development. Whilst there is much uncertainty on the full suite of actions and policies that the new US administration will implement, making it impossible to model, these policies will adversely affect South Africa's economic prospects.

Pronouncements and policy changes from the new US administration have already had an impact on South Africa. The 90-day halt to all foreign aid from the US means the future of PEPFAR (the US President's Emergency Plan for Aids Relief) in South Africa, which supports the South African government in combating HIV/AIDS, is now in jeopardy. This funding amounts to about R7 billion and, whilst South Africa is better equipped to absorb the costs of such donor-funded programs compared with lower income countries, in the context when the government is trying to consolidate the fiscus and budgets (health in this case) have experienced several years of real cuts, having to fund unplanned expenditure presents a crisis for national and provincial health budgets in the absence of additional resources being made available.

In the 2024 MTBPS, the Treasury reported a primary surplus in 2023 and projected an increasing surplus across the MTEF, with debt peaking in 2025 and declining thereafter. This projected path of debt stabilization of government was despite poor revenue growth and instead reflected the widespread suppression of expenditure growth across the government. Government expectation of debt stabilization was also based on several assumptions regarding expenditure that appear to be unrealistic.

The Public Economy Project's projection ahead of the 2025 Budget Review is based on updated economic and Budget data, as well as emergent expenditure pressures. The PEP projection makes the following key assumptions:

- Government and public sector unions agree on a 5.5% wage deal in 2025 and CPI + 1.5% thereafter.

- Eskom support is included "above-the-line" and continues to the tune of R30 billion a year after 2025/2026.
- Ongoing financial support for other SOEs is assumed over the MTEF (amounting to R45 billion over the MTEF).
- Government steps-in to fund previously USAID and global fund health programmes over the MTEF, as per estimates from the Department of Health.
- The SRD grant is extended beyond March 2025 across the MTEF and remains at its current level. Grant recipients, however, increase to include 50% of the estimate of those previously excluded, bringing the total number of recipients to 13.1 million in 2025.
- The contingency reserve and other unallocated funds are fully deployed to offset expenditure pressures.
- It is based on the budget policy baseline announced in the MTBPS, with non-interest expenditure growing by CPI +1.2% beyond the MTEF.
- Macro assumptions are based on consensus forecasts.

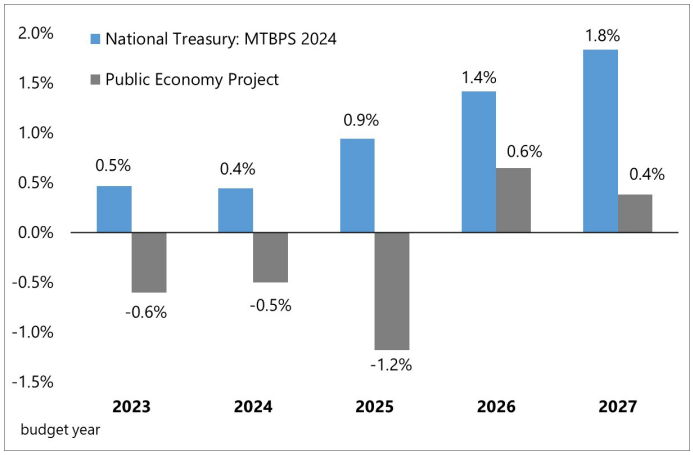
The Public Economy Project's baseline estimates the primary balance only swinging from a deficit to a surplus in 2026, reflecting both the inclusion of financial support to Eskom above-the-line, as well as the several emergent expenditure pressures. Over the medium term, the country is expected to realize a more moderate primary surplus than the government's projections from the MTBPS.

In contrast to the government's expectation of gross loan debt peaking in 2025 at 75.5% and thereafter gradually declining, the Public Economy Project does not expect debt as a share of GDP to peak during the medium term; instead, it increases to almost 80% by the end of the MTEF.

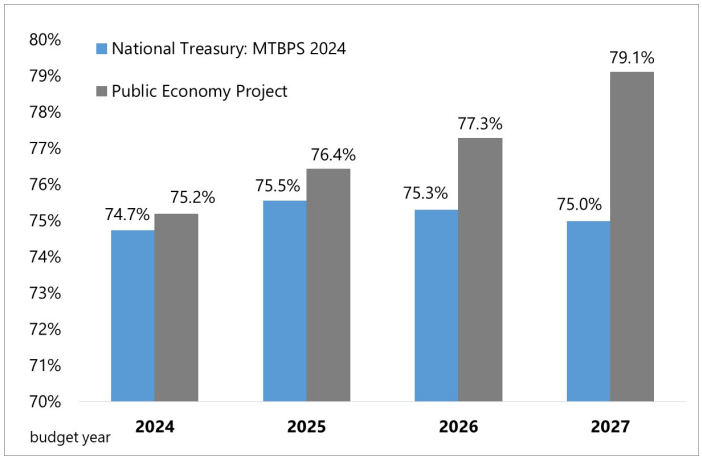
Based on its baseline, PEP estimates a 0.9% primary surplus is required across the medium-term expenditure framework for debt to fall to the National Treasury's projection of 75% of GDP by the end of the MTEF. However, this would necessitate an additional fiscal effort of around R75bn over the MTEF, which seems unlikely.

Figure 5: Public Economy Project's Outlook

a) Primary balance as a share of GDP



b) Gross loan debt as a share of GDP



Source: National Treasury budget data; Public Economy Project calculations

Conclusion

The current budget policy outlines a path towards a smaller state, with significant implications for service delivery and South Africa's social contract. The reduction in the size of the state means that any GDP growth in the coming years will not ease fiscal constraints. Instead, the current fiscal stance prioritizes maintaining a lower spending trajectory while allowing GDP to grow faster than government expenditure, effectively delinking growth from increased public spending and creating a structural headwind to aggregate demand and economic growth over the medium to long term.

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The projected fiscal consolidation will likely lead to a substantial reduction in the quantity and quality of public services. The "lawnmower" approach of uniform budget cuts across all sectors is particularly inefficient and detrimental to service delivery, potentially resulting in diminished outputs and worsened performance across sectors. This trajectory of decreasing per capita allocation could exacerbate unemployment, inequality, and poverty, undermining South Africa's constitutional commitment to socio-economic rights.

In this note, we have also highlighted the decline in capital spending, which is essential for infrastructure development and economic growth. While the government emphasizes de-risking public infrastructure projects and mobilizing private sector investment, the long-term impact of reduced public investment in social infrastructure remains uncertain.

The last budget statement proposed a fiscal anchor, a *de facto* fiscal anchor: a debt stabilizing main Budget primary surplus to stabilize the debt to GDP ratio. It remains to be seen whether Budget 2025 will entrench this position. If it does, a more detailed and transparent framework is needed to ensure the government's commitment to stabilizing debt and achieving a primary surplus is credible and sustainable.

South Africa faces a challenging fiscal outlook in the years ahead. In our view, a more gradual path to debt stabilization would allow for less debilitating expenditure adjustments and a more credible outlook. This is particularly important in light of the fiscal slippage and increasing main budget deficit projected by the PEP in 2025, as well as the PEP's estimate of gross debt increasing faster and not stabilizing over the MTEF. A more balanced and policy-driven approach that prioritizes fiscal sustainability and social well-being is essential to ensuring South Africa's sustainable future.