Public Economy Project

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MACRO FISCAL REVIEW:

Reflections on public finances ahead of the 2024 Budget Review

February 2024

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ABBREVIATIONS

BR	Budget Review
CHW	Community Health Workers
CIT	Corporate Income Tax
COVID-19 SRD	Covid-19 Social Relief of Distress Grant
CPI	Consumer Price Index
ENE	Estimates of National Expenditure
GDP	Gross Domestic Product
IMF	International Monetary Fund
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDP	National Development Plan
PEP	Public Economy Project
PRASA	Passenger Rail Agency of South Africa
REIPPP	Renewable Independent Power Producer Programme
SARB	South African Reserve Bank
SCIS	Southern Centre for Inequality Studies
UIF	Unemployment Insurance Fund
VAT	Value Added Tax
WEO	IMF World Economic Outlook

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INTRODUCTION

South Africa faces a range of economic, fiscal, and social challenges. The country's fiscal challenges are deeply rooted in its prolonged economic stagnation. Post-2000, a commodity supercycle boosted national income and eased financial strains. This allowed for increased expenditure and reduced tax rates. However, since the end of this cycle around 2012, following the aftermath of the 2008 global financial crisis, the country has witnessed stagnant per capita GDP, and deteriorating financing conditions. These factors, coupled with rising interest rates on government debt, have led to soaring debt service costs, and an unsustainable fiscal position.

The government's response to these mounting challenges has been to attempt to stabilise debt as a share of GDP, primarily through slowing government's spending growth. Despite continued efforts to consolidate public finances through curbing expenditure growth – with deleterious effects on providing public goods – government has been unable to stabilise debt.

The 2023 Budget Review and Medium Term Budget Policy Statement (MTBPS) proposed intensified austerity. This entailed harsh cuts to spending, potentially worsening economic growth by reducing aggregate demand, in its dogged pursuit of fiscal consolidation. This approach raises concerns about further disruptions to government operations, erosion of state capacity, and widening inequality. The Public Economy Project's updated fiscal outlook suggest, that despite the intensified austerity, debt will still continue to rise over the medium term.

The poor domestic economic environment – which has deteriorated since the last budget – and a tepid global economic outlook, presents additional challenges for government to realise its fiscal objectives. Whilst the outlook for the global economy has improved, the post Covid-19 pandemic recovery has been uneven, and ongoing geopolitical tensions continue to weigh down the growth outlook. For South Africa, these global forces are coupled with domestic structural challenges, particularly in electricity and export logistics. This further constrains economic growth, and limits the country's ability to exploit global upside developments. It also hampers the realisation of debt stabilisation.

The government's current approach to fiscal consolidation may exacerbate these challenges. Its approach may call for a re-evaluation of fiscal policies, and a stronger focus on equitable macroeconomic adjustments together with structural reforms. It is crucial for the government to outline a detailed, realistic plan in the upcoming February 2024 Budget. Such a plan should focus on implementing austerity measures over the next three years while protecting frontline services, such as healthcare, policing and education.

Government must assess the budget's impact on service delivery. It must consider alternatives to across-the-board cuts so that it can avoid undermining socioeconomic rights, and ensure that its fiscal policy supports sustainable development and helps build a common society. This would require slowing the pace of expenditure cuts, targeting expenditure cuts outside of core services on which the poor depend, shifting the balance of consolidation towards taxation, and making more intelligent use of the government's balance sheet to ease pressure on the bond market over the medium term.

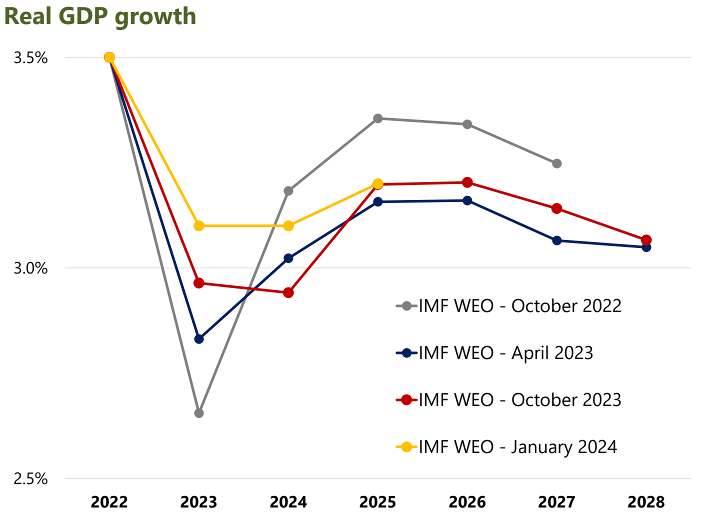
Such a strategy would certainly come with costs, both political and economic. Increased taxes on the affluent and the corporate sector will be difficult to realise. And a weakening of the public balance sheet may raise the cost of finance in the longer term. Targeted expenditure cuts are politically far more challenging to execute than blunt, across-the-board austerity. But compared to the damage the current strategy is likely to impose on poor South Africans and the balance sheets of low-income households, we think these costs are worth bearing.

This policy note, presented in anticipation of the tabling of the 2024 Budget Review, reviews global and domestic economic developments, and fiscal developments since the 2023 Budget Review and MTBPS was tabled. It considers the implications of these developments for public finances, and the realisation of the state's socioeconomic goals. This note discusses emerging expenditure pressures observed in the recent period, which would warrant government to consider in its formulation of the upcoming budget. It assesses government's key fiscal projections presented in the 2023 MTBPS and Budget Review. And it presents the Public Economy Project's own updated outlook for public finances – it incorporates updated economic and fiscal data, and adjusted expenditure assumptions. It further discusses the limitations of government's current approach to fiscal policy, and presents possible adjustments that would allow for a more equitable and sustainable path for public finances.

GLOBAL DEVELOPMENTS AND SOUTH AFRICA'S TERMS OF TRADE

The global economy has demonstrated a notable resilience in the wake of numerous challenges, including the aftermath of the Covid-19 pandemic, Russia's invasion of Ukraine, and high global inflation. Despite these challenges, the global economy is estimated to have grown faster in 2023 compared with previous estimates. Growth has been notably robust in major economies such as the United States and China. This resilience is attributable to a combination of factors. Key among these was the moderation in inflation. After peaking in 2022, inflation began falling more rapidly than expected. This mitigated its impact on employment and economic activity and was also helped by favourable supply-side developments and effective monetary tightening by central banks, which anchored inflation expectations.

Figure 1: Changing global economic outlook



Source: IMF World Economic Outlook

Over 2023, the high levels of global inflation declined substantially as consumer demand slowed and global supply chains recovered, allowing for a moderation in food and fuel prices. The restrictive monetary policy from advanced economy central banks to combat high inflation appears to be reversing. This could ease financing conditions for emerging market economies such as South Africa, and support higher global growth. The support to the global economy from advanced economy policy rate reductions will also be affected by real rates in the respective economies – which are expected to remain elevated for longer.

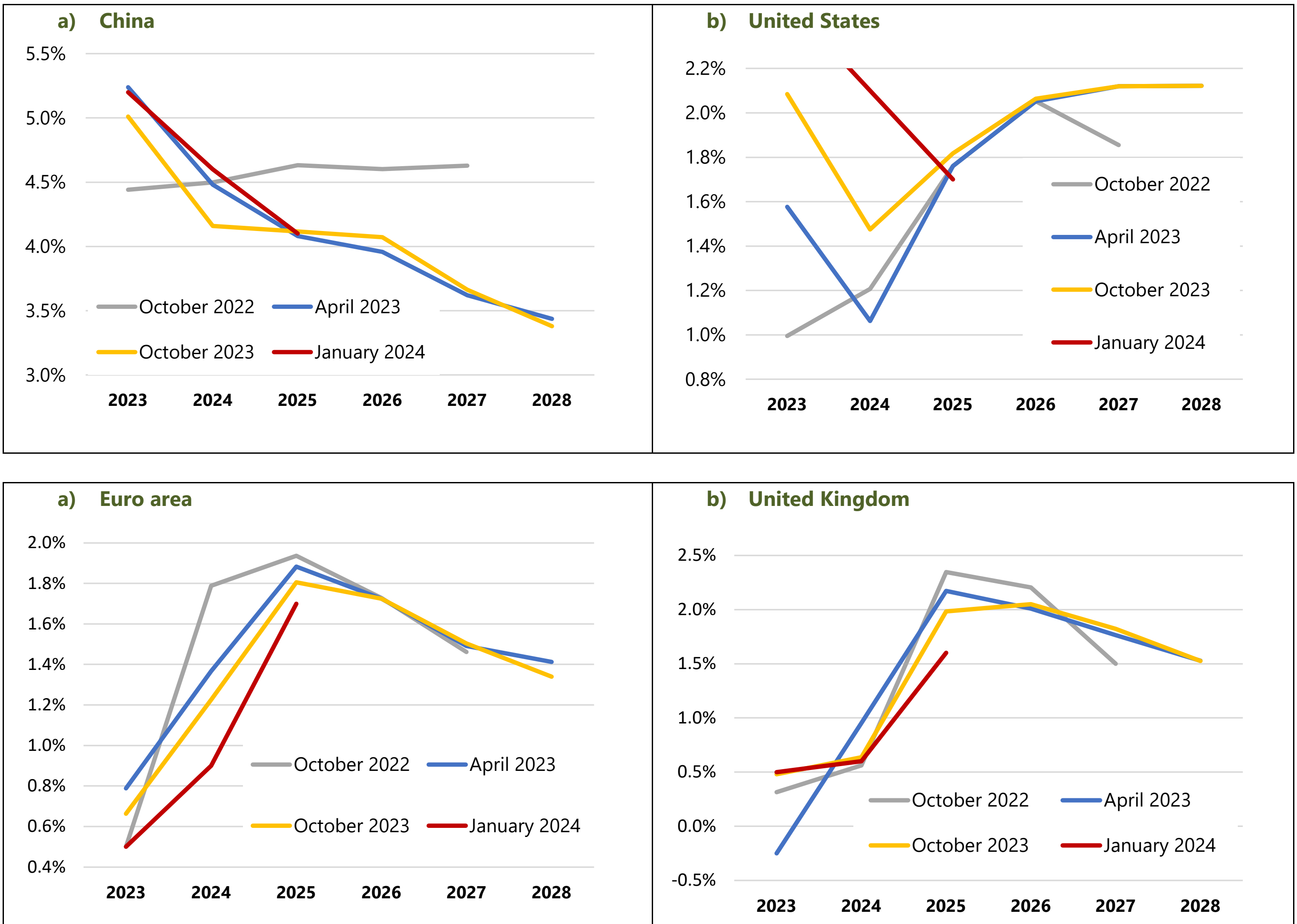
World trade growth in 2023 was effectively flat. It grew by a negligible 0.2% due to shifts in global demand, US dollar appreciation, and rising trade barriers. China's economic growth also lost momentum, with weakness in its real estate sector, softer foreign demand, and rising youth unemployment.

Looking ahead, inflation is anticipated to maintain its downward trajectory, supported by favourable supply-side developments and strong monetary policy actions. Despite moderating inflation, and a likely path of monetary easing, long-term borrowing costs remain elevated across both advanced and emerging markets, reflecting the risk associated with rising government debt. The IMF's January 2024 World Economic Outlook Update estimates global growth of 3.1% for both 2023 and 2024, with a slight increase to 3.2% in 2025. This projection has been revised upwards due to improved outlook for China, the US, and several large emerging markets. This more optimistic than the World Bank's January 2024 Global Economic Prospects which projects global growth of 2.4% in 2024 and 2.7% in 2025. The World Bank notes that should the global economy growth in-line with its forecast over the current year, this would mark a third successive year of growth deceleration.

Within the moderate outlook for global growth, advanced economies are expected to grow more slowly. While emerging market and developing economies are recovering to pre-pandemic levels they are still below post-2008–9 recession levels. This reflects the lagged effects of restrictive monetary policy and other headwinds, including tight global financial conditions, and weak global trade.

The IMF's projection in Figure 2(a) shows the Chinese deceleration continuing over the medium term. This will continue to soften metals prices, affecting commodity exporters such as South Africa. Global trade over 2024 will also be affected by the disruption to shipping routes in the Red Sea as the war in the Middle East threatens to spread, with rising instability across the region.

Figure 2: Growth outlook for South Africa's major trading partners

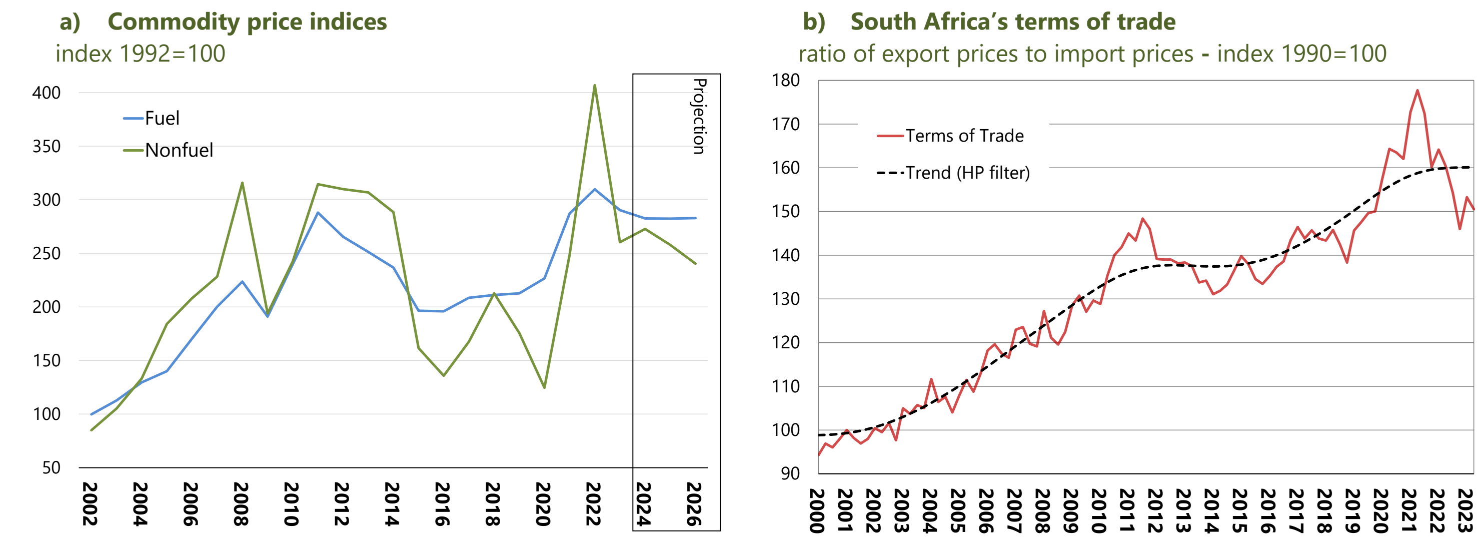


Source: IMF World Economic Outlook

Risks to the economic outlook appear to be more balanced compared with previous outlooks, which stressed downside risks. Downside risks include the potential for persistent inflation. Geopolitical tensions, such as the ongoing conflicts in Ukraine and the Middle East, could exacerbate inflation through its effect on supply chain and commodity prices – and contribute to global economic turbulence. China's economic performance remains uncertain, with potential for negative shocks, especially if the real estate sector continues to weaken. On the upside, the possibility of core inflation falling faster than expected would boost global growth through allowing for earlier policy easing, supporting global growth, and relieving pressure on borrowing costs.

These global developments continue to define South Africa's growth trajectory and impact directly on short term fiscal dynamics. In the absence of strong domestic drivers of economic growth through productivity improvements, global growth trends and commodity prices tend to define South Africa's path of recovery. The post Covid-19 commodity boom raised export prices for South Africa. This led to a positive terms of trade shock that supported the economy, boosted incomes, corporate tax collection, and nominal GDP, even while underlying supply conditions worsened. This support has largely unwound, and nonfuel commodity prices are expected to continue declining over the medium term – as China continues its deceleration – even while global turbulence and the war in the Middle East pushes up the price of oil.

Figure 3: Commodity prices and terms of trade in South Africa



Source: National Treasury; South African Reserve Bank, Public Economy Project own calculations

DOMESTIC ECONOMY

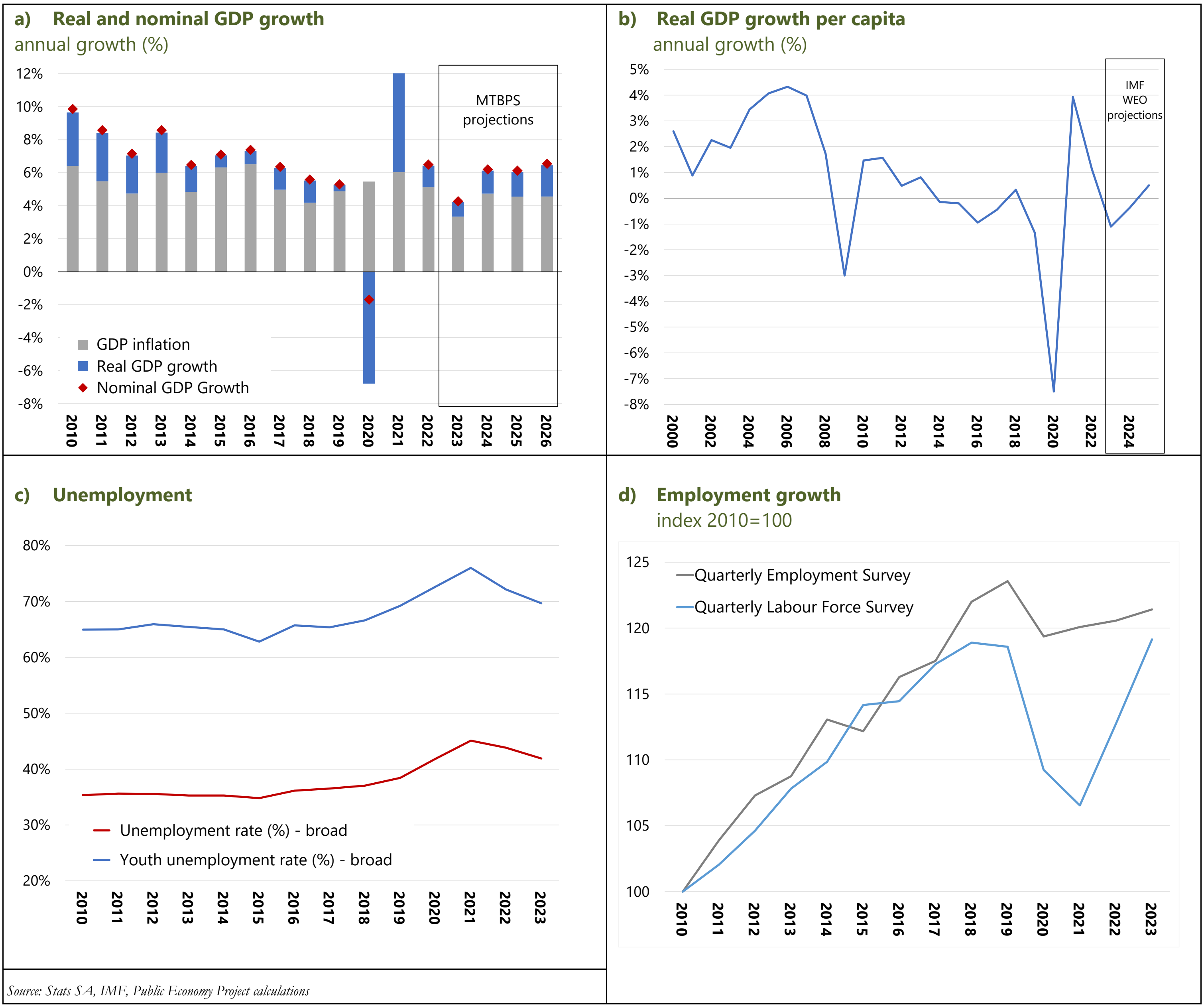
South Africa faces mounting economic and social challenges that have placed its economy and the sustainability of its public finances under strain. Following the 2008 Global Financial Crisis, the economy slowed considerably, growing at a meagre annual average of 1.5% between 2008 and 2018, compared with 4.5% over the previous ten years.

This poor growth performance has lagged population growth, resulting in declining real per capita income over the past 12 years. South Africa's economic and social challenges are accumulating, risking further long-term stagnation. This poor economic performance, combined with mounting fiscal pressures, weakened state institutions, and reduced public administration efficiency, has discouraged private investment, further weakening the economy's performance and prospects. Private investment levels have been low, averaging less than 14% of GDP over the past decade, one of the lowest levels among emerging market economies. Notably, investment is particularly low in network industries dominated by Eskom and Transnet. Their financial bankruptcy and operational weakness have brought ambitious investment programmes to a halt.

The country's sustained poor economic performance has meant that employment growth has been inadequate, failing to absorb the growing labour force. Unemployment – already amongst the highest in the world – increased substantially over the last 13 years, reaching record highs. In the wake of the Covid-19 pandemic, both the formal and informal sector saw significant job losses. There has been a recovery in employment since then, but permanent job losses were unevenly distributed and affected the economically vulnerable disproportionately. This included those informally employed, those employed in the informal sector, women, youth, and the less educated – groups that tend to be located towards the lower end of the income distribution. The jobs recovery from the Covid-19 pandemic, meanwhile, has been concentrated amongst formal-sector and high-skill employees (Kohler, 2023). The implication of this uneven and biased recovery is likely to be higher income inequality, social instability, and growing demands on public services.

The sustained slowdown in government consumption spending, and its meagre contribution to annual growth, is worth noting. Intensification of fiscal consolidation slows down national government's allocation of resources, which further strains municipal finances. Overall, government consumption spending has slowed along with its contribution to economic growth. The share of fixed investment in nominal GDP has been declining, from 22% in 2008 to 14% in 2022. This is well below the 30% envisaged in the National Development Plan (NDP). Investment in the public sector has been constrained by financial pressures on local government, corruption and bankruptcy in key state-owned entities, such as Eskom, Transnet, and Passenger Rail Agency of South Africa (PRASA). The latter three are responsible for much of national government's capital spending. Private sector investment has been similarly weak, as high interest rates and weak projections of growth mean there is little need to build additional capacity.

Figure 4: Faltering growth and economic performance



Source: Stats SA, IMF, Public Economy Project calculations

At the time of the 2023 Budget, government's outlook for the year appeared more optimistic than comparator forecasters, including the South African Reserve Bank (SARB) and the International Monetary Fund (IMF). After the budget was tabled, expectations about loadshedding worsened, and infrastructure constraints became more apparent, whilst commodity prices moderated. Government's outlook for the economy at the 2023 MTBPS remained roughly the same for the 2023 fiscal year, but was lowered over the medium term. Following the release of the third quarter GDP data for 2023, which showed an annual contraction of 0.7% compared with the previous year, and annual growth of 0.3% over the first nine months of the year, growth is expected to underperform 2023 Budget and MTBPS expectations.

Financing conditions also tightened since the tabling of the last budget with the rand depreciating 11% against the US dollar over 2023. The yield curve has shifted upwards, indicating an increased sovereign risk premium, and higher government financing costs. These conditions suggest that global investors see higher levels of risk in holding South African debt.

Table 1: Comparing growth outlook updates

Real GDP growth outlook - calender year*	2023	2024	2025	2026
National Treasury - Budget 2023	0.9%	1.5%	1.8%	-
National Treasury - MTBPS 2023	0.8%	1.0%	1.6%	1.8%
South African Reserve Bank - January 2023	0.3%	0.7%	1.0%	-
South African Reserve Bank - January 2024	0.6%	1.2%	1.3%	1.6%
IMF - World Economic Outlook - April 2023	0.1%	1.8%	1.6%	1.4%
IMF - World Economic Outlook - October 2023	0.9%	1.8%	1.6%	1.4%
IMF - World Economic Outlook - January 2024	0.6%	1.0%	1.3%	1.4%
World Bank - Global Economic Prospects - January 2023	1.4%	1.8%	-	-
World Bank - Global Economic Prospects - January 2024	0.7%	1.3%	1.5%	-
Bureau for Economic Research - 1Q 2023	0.2%	1.4%	2.1%	2.2%
Bureau for Economic Research - 3Q 2023	0.8%	1.6%	2.1%	2.2%
*Growth projections correspond to publication date and not forecast date				

South Africa's public finances benefitted from the post-Covid-19 nominal boom which was driven by elevated commodity prices, lower interest rates, and robust GDP inflation. However, this windfall has waned. Advanced economy central banks' interest rate hikes have decreased demand for emerging market assets – including government bonds – prompting reciprocal interest rate hikes by the South African Reserve Bank's Monetary Policy Committee. Coupled with a deceleration in household demand, this response has contributed to a moderation in South Africa's inflation outlook. This lower GDP inflation outlook translates into reduced nominal GDP figures. As a result, the once-favourable conditions for fiscal consolidation, which were underpinned by a sustained nominal boom over the past two years, are no longer present ahead of the 2024 Budget Review.

Divergences from the economic growth projections could come in either direction. On the upside, there has already been notable progress in structural reforms, especially in the electricity sector. There have been improvements in the licensing and registration processes and expanding energy procurement under the Renewable Independent Power Producer Programme (REIPPP), as well as fiscal support to Eskom and the separation of its transmission division. The easing of the energy crisis will support increasing economic activity, and indeed, reforms in this sector have already spurred investment in off-grid electricity. This has supported investment growth over the first quarter of 2023. On the downside, a further weakening of commodity prices, intensification of fiscal consolidation, and debt repricing could further weaken economic growth.

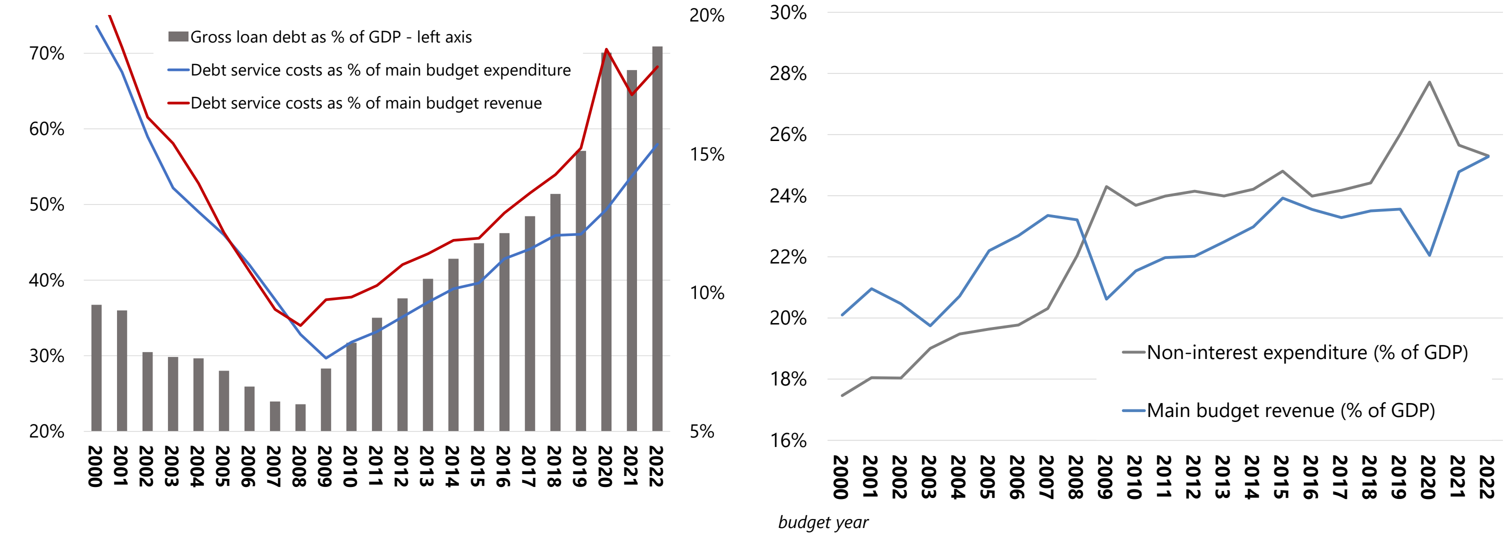
FISCAL CONTEXT

South Africa's public finances have been characterised by a persistent pattern of increasing fiscal pressures over the past 15 years, starting from the aftermath of the 2008 global financial crisis. Since 2009, as economic growth slowed, the country has had to grapple with the challenge of persistent fiscal deficits and the attendant continuous rise in government debt. This has resulted in debt service costs consuming an increasingly large share of public spending, whilst the country's sovereign risk premium increased. Gross loan debt has continued to increase – from 23% in 2008 to 71% in 2022 – and is expected to continue increasing over the medium term. The composition of main budget expenditure has continued to worsen, with debt service costs' share increasing from 7.6% in 2008 to 15.3% in 2022.

In response to these challenges, the government introduced measures aimed at stabilising the growth in debt to safeguard the health of public finances. The government transitioned from loose fiscal policy following the 2008 global financial crisis, to a policy of "fiscal consolidation" from 2012 onwards. This was an attempt to stabilise debt as a share of GDP through progressively reducing the gap between revenue and expenditure. Government executed this mainly through slowing the growth in spending, along with limited increases to key tax policy rates, notably the increase to the VAT rate in 2018. In 2013, the government introduced a nominal ceiling for non-interest expenditure, which led to a marked slowdown on core spending[i]. The picture is even more pronounced when expenditure is considered on a real per capita basis, with real core spending contracting on a per capita basis over eight of the last ten years. The cumulative effects of fiscal consolidation have a notable deleterious effect on quality and value of public services, as well as the country's basis for higher sustained economic growth (see Public Economy Project 2023).

Figure 5: Worsening fiscal quagmire

a) Debt and debt service costs | **b) Closing the "hippo's mouth"**

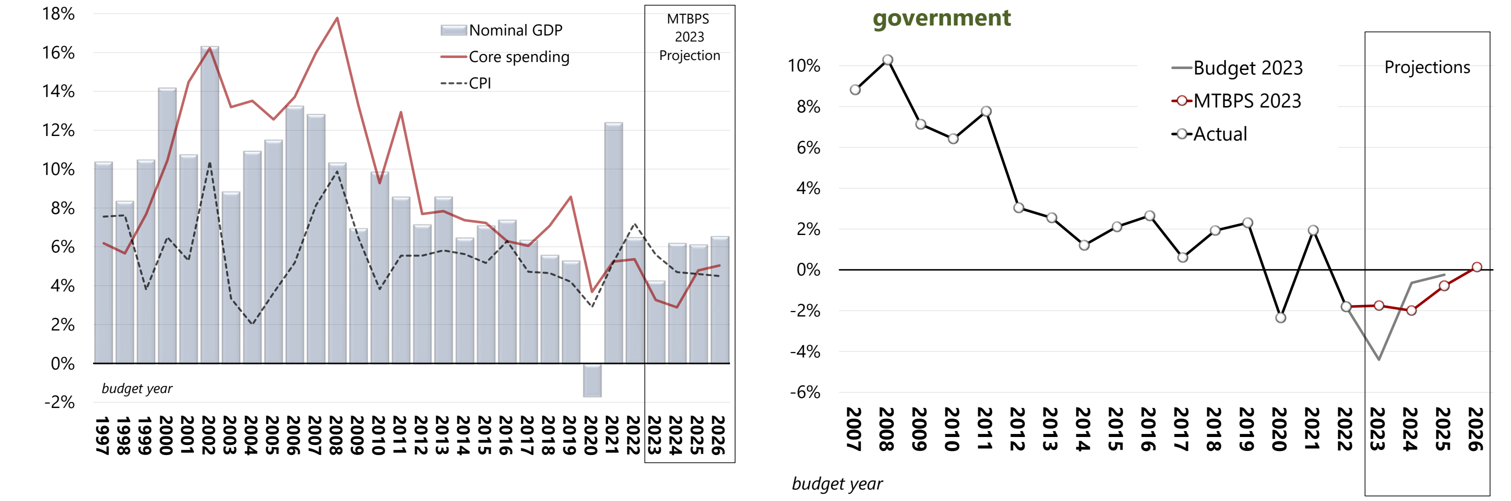


Source: National Treasury, Stats SA,

Despite continued attempts to stabilise debt as a share of GDP, these measures have only had a limited impact. A further slowdown in nominal GDP growth, often slower than government projected, meant that revenue collection also slowed, contributing to a smaller envelope of fiscal resources. Significant expenditure pressures, driven in part by outcomes stemming from public wage negotiations, and in part from the substantial portions of public resources allocated to support financially distressed state-owned enterprises (SOEs), contributed to the enlargement of fiscal deficits.

Figure 6: Revised spending outlook

a) Nominal spending growth (1997– 2026) | **b) Real growth of wage bill: national and provincial government**



Source: National Treasury, Stats SA, PEP own calculations

The Covid-19 pandemic placed further pressure on the sustainability of public finances. In the face of the pandemic's social and economic effects, government further reduced expenditure growth. At the same time, new programmes were introduced, intended initially to be a temporary response, notably the COVID-19 social relief of distress (SRD) grant, and a new set of public employment programmes, suggesting a permanent increase in fiscal commitments. Consequently, the pandemic not only accelerated debt growth, it also led to a structural and enduring rise in expenditure, posing challenges to long-term fiscal sustainability.

The February 2023 Budget sought to *frontload* the fiscal consolidation, substantially reducing government's consumption expenditure over the medium term. This represented a remarkable contraction of government consumption planned for 2023, and marked it as the most significant annual reduction in a quarter-century. The austere expenditure path of the 2023 Budget, combined with buoyant revenue performance in the period running up to 2023, led the Budget to anticipate an improvement in the fiscal outlook, projecting a main budget primary surplus of 0.9% of GDP for 2023, with a progressive improvement to 1.7% of GDP envisaged by 2025. This trajectory suggested that the government's fiscal objective of stabilising debt as a proportion of GDP was well on track. It signalled the imminent conclusion of its ongoing consolidation endeavours.

However, shortly after the tabling of the budget in February 2023, several factors changed the likely path of spending and the fiscal position. These include:

1. **Compensation bill.** The March 2023 wage agreement – which was an effective 3.3% nominal increase in government salaries (i.e. 3–4 points below inflation), resulted in a shortfall of R21 billion in 2023, and R77 billion over the MTEF. The Budget made no provision for a nominal increase in the average pay for government employees. Instead, it included an effective 4% contraction in the government's wage bill, citing the absence of a concluded wage settlement before the tabling of the 2023 budget.

2. **Extension of the COVID-19 SRD grant.** Ahead of the 2023 MTBPS there was no official direction on whether the SRD grant would be extended beyond the fiscal year, and, if extended, whether it will retain its current form, or be adjusted for inflation, or replace other social grants currently provided. Facing a national election in 2024, government opted to extend the grant for another year, further constructing a permanent fiscal obligation. At the same time, no policy clarity on its design features has yet been given, even at the most general level. And the intended end-state of the social grant system remains unknown.

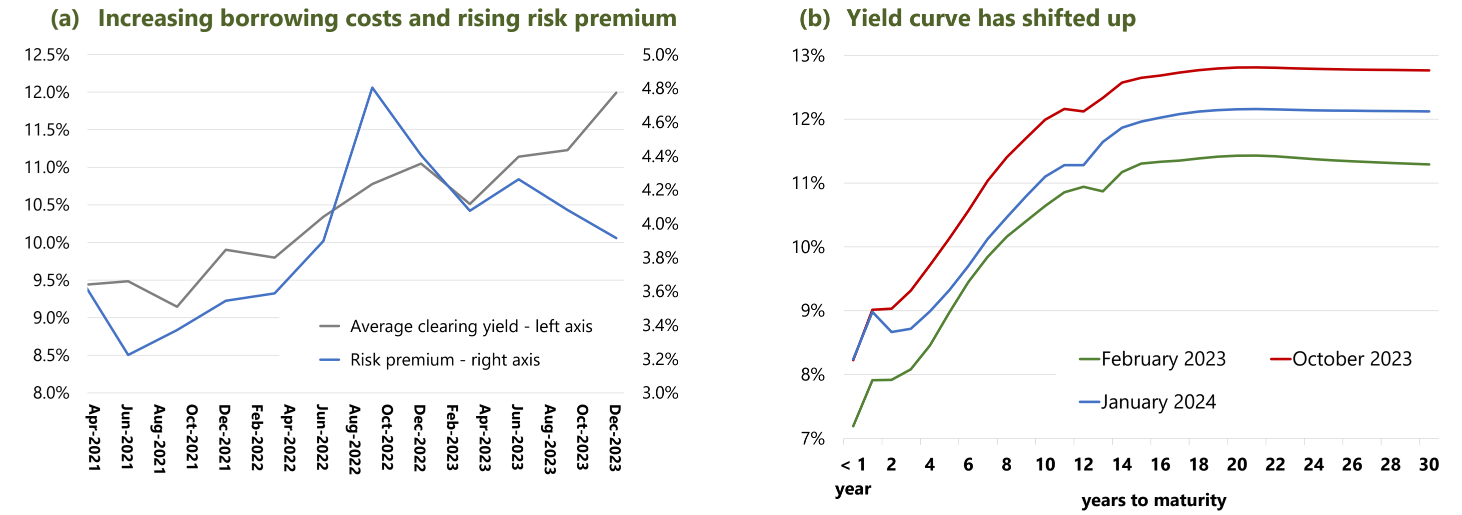
3. **In-year overspending (underbudgeting).** By the end of the first quarter, provincial reports indicated overspending of R24.8 billion. A substantial share of the projected overspending was attributable to the wage agreement, but the overspending (underbudgeting) was across the board. It affected capital, goods and services, and transfer payments.

4. **Revenue under-collection.** Ahead of the 2023 MTBPS, on a year-to-date basis (April–September 2023), gross tax revenue grew a dismal 2.4%, falling significantly short of the 2023 Budget estimate of annual growth of 6%. A major cause for concern was the performance of corporate income tax, which declined over the first six months of 2023 compared with the same period in 2022. This suggests that the strong performance of corporate income tax over 2022 have been a result of temporary gains attributed due to elevated commodity prices rather than a structural increase in corporate income tax receipts, as cautioned by the Public Economy Project (Public Economy Project, 2023).

5. **Worsening financing conditions and increased debt service costs.** The financing conditions for the South African government deteriorated since the tabling of the 2023 Budget. The yield on South Africa's benchmark ten-year government bond increased 0.7 percentage points over 2023, part of an upward shift in the yield curve across all maturities The performance of South Africa's government auctions reflected similar increases in risk-perception, with interest rates on newly-issued government debt edging higher compared with the beginning of the year. The observed tightening of financing conditions can be attributed, in part, to underlying fundamental factors: the deceleration in economic growth, deepening electricity supply constraints, and deteriorating export infrastructure raised concerns about future investment returns. Global investor sentiment also deteriorated on the back of South Africa's grey listing by the Financial Action Task Force and the Lady R debacle[1]. The consequence was a significant increase in debt service costs unanticipated in the budget.

[1] The "Lady R" incident in December 2022, involving the Russian cargo ship Lady R docking at Simon's Town Naval Base in South Africa with military cargo, stirred controversy and speculation about the nature of South Africa-Russia relations. Termed #LadyRussiagate, the incident's diplomatic implications remain unclear, with details and motivations not fully disclosed.

Figure 7: Tightening financing conditions

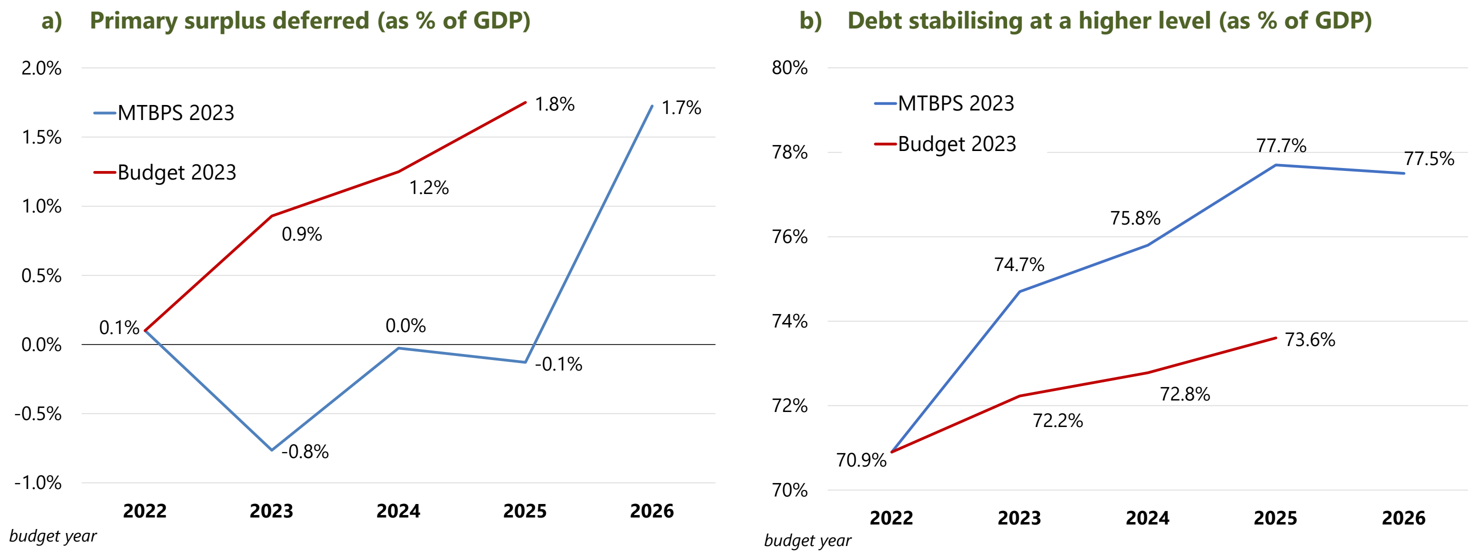


Source: SARB, National Treasury, Johannesburg Stock Exchange, PEP own calculations

GRIM DETERMINATION IN THE MTBPS

The 2023 MTBPS proposed large and significant reductions to planned expenditure over the current fiscal year and the medium term. This was to correct for changes in assumptions made in the 2023 Budget, and to respond to emergent economic and fiscal developments. Importantly, government decided to doggedly keep to its fiscal objectives and strategy set out in the 2023 Budget, with no change to borrowing contemplated. As in the 2023 budget, the 2023 MTBPS projected gross loan debt to peak in 2025, and to become moderate thereafter, albeit at a higher level.

Figure 8: Revised fiscal outlook



Source: National Treasury

Budget 2023 had assumed strong revenue performance on the back of higher commodity prices. The budget seemed to take this windfall as a structural improvement in revenue over the medium term. The 2023 MTBPS downwardly revised these projections for main budget revenue by R44.4 billion in the current fiscal year, and by R196 billion over the medium term contributing to deteriorating fiscal balances over the medium term. This closely aligned to

PEP's pre-MTBPS estimate of a total tax revenue shortfall of R59.6 billion relative to the 2023 Budget estimate, as well as PEP's January 2024 revised estimate (see Table 2).

The 2023 MTBPS's worsened medium term revenue outlook is despite additional revenue measures of R15 billion in 2024 to be announced in upcoming 2024 Budget Review. These revenue-raising measures will need to be further calibrated to balance the impact of consolidation across income groups. At the same time, government needs to limit the impact on growth and cost pressures faced by middle class South Africans. The easiest option would be to resort to fiscal drag – an inefficient and inequitable sharing of the burden. In contrast, changes to tax expenditures for example, rebates on retirement contributions, would ride on the relatively buoyant upper end of the personal income tax base. Increases to both corporate taxation and VAT should also be on the agenda, in our view.

Table 2: In-year revenue performance and outlook

	Preliminary outcome	Year to date (April - December 2022)		Budget 2023	MTBPS 2023	PEP January 2023	Year to date (April - December 2023)					
	R millions	**R millions**	**Share of preliminary outcome**	**R millions**	**R millions**	**R millions**	**R millions**	**Share of budget projection**	**projected annual growth y/y - Budget**	**projected annual growth y/y - MTBPS**	**projected annual growth y/y - PEP**	**Year to date growth - actual**
Personal income tax	600 367	425 323	70.8%	640 300	646 739	651 732	460 803	72.0%	6.7%	7.7%	8.6%	8.3%
Corporate income tax	344 660	269 733	78.3%	336 119	300 329	300 239	231 327	68.8%	-2.5%	-12.9%	-12.9%	-14.2%
Skills development levy	20 892	15 382	73.6%	23 027	22 713	22 893	16 788	72.9%	10.2%	8.7%	9.6%	9.1%
Value-added tax	422 416	299 875	71.0%	471 477	445 844	443 499	318 094	67.5%	11.6%	5.5%	5.0%	6.1%
of which:		-					-					
Domestic VAT	486 437	362 155	74.5%	522 881	521 426	523 865	389 248	74.4%	7.5%	7.2%	7.7%	7.5%
Import VAT	254 984	174 927	68.6%	251 185	277 308	271 661	188 979	75.2%	-1.5%	8.8%	6.5%	8.0%
Refunds	(319 005)	(237 206)	74.4%	(302 589)	(352 889)	(352 027)	(260 133)	86.0%	-5.1%	10.6%	10.4%	9.7%
Specific excise duties	55 155	37 273	67.6%	58 956	55 252	53 057	35 741	60.6%	6.9%	0.2%	-3.8%	-4.1%
Ad valorem excise duties	5 520	3 141	56.9%	4 699	6 620	8 116	5 718	121.7%	-14.9%	19.9%	47.0%	82.0%
Fuel levy	80 473	57 206	71.1%	90 408	92 020	93 106	68 428	75.7%	12.3%	14.3%	15.7%	19.6%
Import duties	73 945	50 740	68.6%	74 221	55 252	72 533	50 161	67.6%	0.4%	-25.3%	-1.9%	-1.1%
Total tax revenue (gross)	**1 686 697**	**1 222 547**	72.5%	**1 787 456**	**1 730 673**	**1 734 345**	**1 251 597**	70.0%	6.0%	2.6%	2.8%	2.4%
Less: SACU payments	**(43 683)**	**(32 763)**	75.0%	**(79 811)**	**(79 811)**	**(79 811)**	**(59 858)**	75.0%	82.7%	82.7%	82.7%	82.7%
Total tax revenue (net of SACU payments)	**1 643 014**	**1 189 784**	72.4%	**1 707 645**	**1 650 862**	**1 654 534**	**1 191 739**	72.0%	3.9%	0.5%	0.7%	0.2%

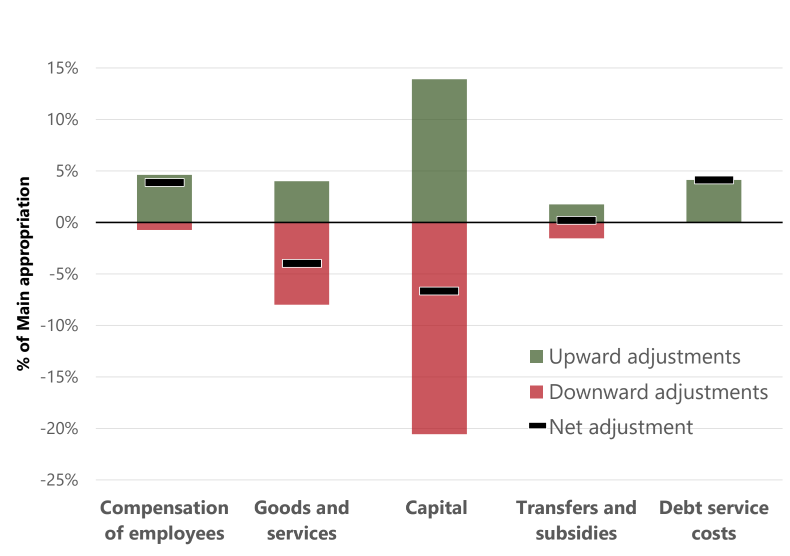
Source: National Treasury, PEP own calculations

Last year's budget did not make provision for a nominal increase in average pay. Government expected its departments to absorb any wage improvements within baseline. The MTBPS then characterised the March 2023 public sector wage agreement as an "unforeseeable economic and financial event", and, in response, proposed significant and far reaching adjustments to expenditure. This meant that government effectively stuck to its position that the wage agreement would be absorbed without any budget increase. To achieve this, the October 2023 adjustment budget proposed shifts totalling R72 billion in the resource allocation strategy for the remainder of the year. These reallocations go beyond the typical in-year adjustments. They necessitate what amounts to an entirely new budget at national and provincial levels, with spending frozen for the rest of the year. It also means large reallocations away from capital, transfers, and goods and services spending to accommodate the wage bill at both national and provincial governments. Conditional grants typically allocated for capital spending face substantial reductions, and probably require a freeze on existing projects, as well as a moratorium on new projects. It is unclear whether Treasury assumes that the capital spending freeze will continue into 2024, making it difficult to gauge whether the spending consolidation is temporary – aimed at hitting in-year borrowing limits – rather than a permanent reduction in the expenditure envelope.

Realising these in-year spending limits will require the steadfast implementation of cash conservation strategies across government departments. In many cases this will involve shifting spending from items with longer term impact such as maintenance, training and capacity building, and capital projects, towards compensation. It will also mean accumulating liabilities that are not recorded in the deficit. This will include financial liabilities such as government departments' accrued non-payment of services, which have already reached R30 billion, as well as contractual commitments that imply increased expenditure in future years. All this action will generally lead to perverse outcomes that weaken government's capacity to plan, budget, and execute its operations.

Over the medium term, the 2023 MTBPS suggested significantly reduced expenditure. Its targets imply a substantial negative fiscal impulse, with the proposed path of austerity deeper and more sustained than previous initiatives. Government consumption is projected to decrease by 3.2% in 2024, and by 0.5% in 2025. Real consolidated compensation spending is expected to decrease by 3% over the medium term, whilst real spending on consolidated goods and services is anticipated to fall by 6% during the same period.

Figure 9: Adjustments to 2023 budget



Source: National Treasury, PEP calculations

An unprecedented level of austerity poses significant challenges to core government services, and it indicates an intention to reduce the size of government, with critical services provision the most negatively impacted. This approach aligns with the need for fiscal consolidation. But it does raise concerns about the potential impacts on service delivery and social support mechanisms.

The compensation budget outlined in the MTBPS for 2024 – which doesn't raise spending to absorb the CPI-related increase agreed in the wage settlement – can only be achieved with a substantial decrease in the workforce. Using tabled budget estimates, we find that government would need to reduce its own workforce by approximately 40 000 employees over the next two years. This seems implausible. It suggests that departments may further redirect spending from other areas such as goods and services, maintenance, training, and capital spending to fund compensation, or the fiscal framework will have to again be adjusted to better accommodate wage increases. It is important to remember, in this regard, that cost of living adjustments for government employees have been far below inflation over the last four years, and further pay cuts would be challenging to achieve.

The reduction in compensation budgets, the disruption to annual targets, and the shift of resources away from capital, maintenance, training and goods and services will affect essential services. Particularly affected will be the basic education and healthcare sectors, which face budget reductions of R16 and R14 billion respectively. Government concedes that this will have large negative consequences for providing basic public goods. It noted that this could lead to "larger class sizes and higher learner-teacher ratios, possibly resulting in weaker education outcomes". To minimise negative effects of health sector cuts will require "improve[d] efficiency in areas such as overtime payments, medical supplies and security services, and to delay infrastructure projects." Provincial budget allocations for social development "will not increase in line with inflation, leading to a funding gap for core services and transfers to non-profit organisations." (National Treasury, 2023). These admissions are welcome although, in our view, National Treasury in particular, and government more widely, needs to provide a much stronger explanation of the impact of budget cuts on services and constitutional imperatives.

PEP'S ALTERNATE OUTLOOK FOR PUBLIC FINANCES

The Public Economy Project presents alternate projections for key fiscal metrics. We do this to assess the likely trajectory of public finances under economic and public finance assumptions PEP considers to be plausible. In this publication, we present projections over the Medium Term Expenditure Framework (MTEF). These projections, constituting a baseline, are developed assuming current spending commitments continue over the MTEF, with only assessed plausible adjustments made to the baseline. These are detailed in Figure 10.

PEP's overarching objective is to illustrate a likely fiscal trajectory under a plausible baseline as an assessment of the state of public finances and their sustainability. It should be emphasised that PEP's projections under the baseline are based on publicly available data and policy, and as such do not serve as a predictor of future policy decisions or outcomes.

Key fiscal variables, such as expenditure, revenue, and debt service costs, and the corresponding fiscal ratios, are contingent upon economic variables such as real economic growth, CPI inflation, GDP inflation, borrowing costs, and nominal exchange rates. Thus, PEP's fiscal projections are based on its assessment of the most recent median market estimates.

For the projection of debt service costs over the MTEF, based on its own estimate of primary balances, PEP calculates the difference in gross borrowing requirement between National Treasury's 2023 MTBPS estimates. The issuance profile of this additional borrowing is assumed to follow government's current profile (aligned to NT benchmarks). The interest on additional borrowing (over the MTEF) and new borrowing (over the long term) is based on PEP's model that incorporates all outstanding government debt obligations. These debts include principal amounts, maturity timelines, and applicable interest rates.

This model then integrates forecasts of future deficits, financing obligations, PEP's interest rate projections, and assessments regarding the composition of debt instruments issued to meet borrowing needs.

Assumptions informing Public Economy Project's baseline projections

1. There will be overspending (R10 billion) of non-interest expenditure in 2023, as the proposed effective freezes on non-compensation spending will be challenging to implement.

2. Compensation of employee budgets grow by the March 2023 agreement in 2024, and by CPI from 2025 onwards (CPI as per 2023 MTBPS projections).

3. Eskom support is included as an 'above-the-line' capital transfer (as part of non-interest expenditure), and therefore is part of the non-interest expenditure and the primary deficit. This is in line with best practice for official fiscal balances to reflect a comprehensive state of public finances.

4. Financial support for distressed SOEs continues across the MTEF, and does not conclude with the 2023 Eskom support package. This is also included as "above-the-line".

5. Assumes that the Social Relief of Distress grant is extended over the MTEF, and grant values grow according to the CPI.

6. Assumes the unallocated reserve is allocated in full to fund the above expenditure pressures.

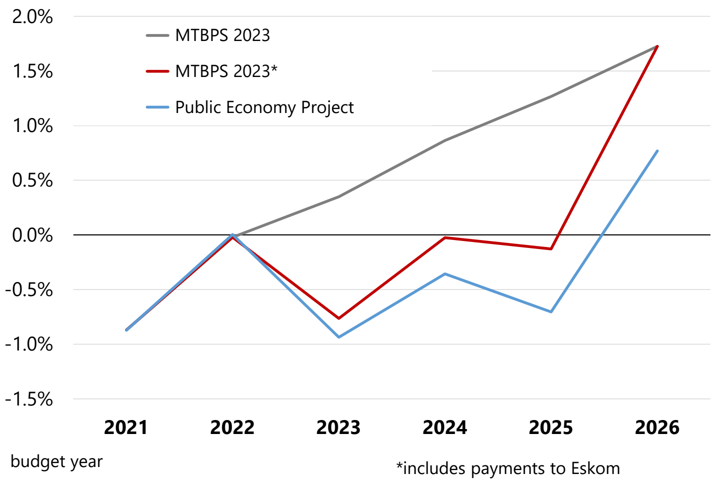
7. Revenue estimates for 2023 are based on PEP's in-year revenue projection tool. The tool makes use of historical monthly profiles of revenue collection on an instrument level to estimate annual collection. Revenue collections beyond 2023 are based on MTBPS estimates of revenue buoyancy, together with consensus views on real GDP and GDP inflation.

8. Macro assumptions are based on consensus forecasts.

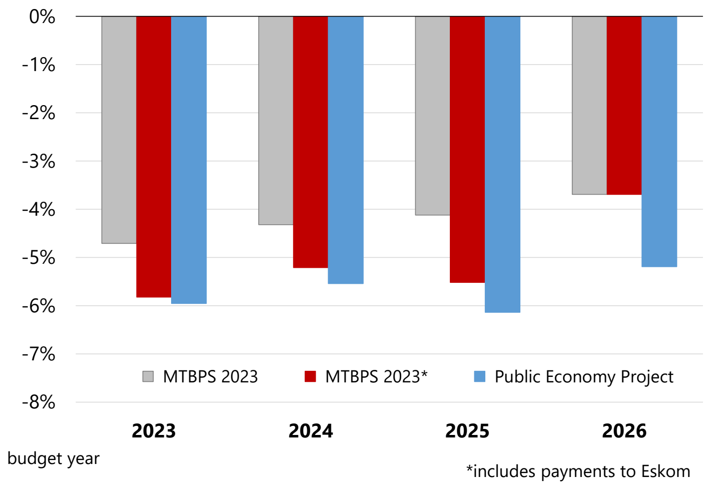
9. Expenditure additional to the 2023 MTEF are funded through additional issuance of debt, with no additional revenue raising measures assumed.

Figure 10: Fiscal outlook: 2023 MTBPS and PEP baseline

a) Primary balance

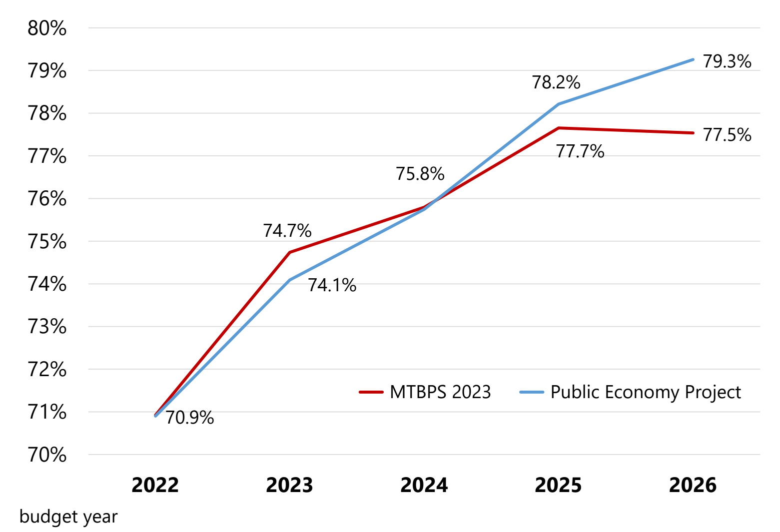


a) Main budget balance as a share of GDP (%)



Source: National Treasury, Public Economy Project own projections

Figure 11: Gross loan debt as share of GDP (%)



Source: National Treasury, Public Economy Project own projections

Public Economy Project's baseline projections

The Public Economy Project's baseline projections of fiscal balances diverge from government's estimates in the 2023 MTBPS. PEP's projections suggest that, contrary to government projections, the primary balance will remain in deficit over the current year and over the first two years of the MTEF (2024 – 2025). A primary surplus will only be realised in the outer year of the 2023 MTEF (see Figure 10(a)). With PEP's nominal GDP and revenue projections, which inform its fiscal outlook, closely aligned to those contained in the 2023 MTBPS, the divergence in the primary balance is due largely to plausible non-interest expenditure pressures over the current year and the 2023 MTEF not contained in the MTBPS.

It is important to note that when payments to Eskom are included as part of the 2023 MTBPS estimates of non-interest expenditure ("above the line"), the 2023 MTBPS estimates of a primary balance also turn to deficit. This illustrates how the government's departure from standard accounting treatment of non-interest expenditure obfuscates the true fiscal picture.

Corresponding to PEP's estimates of a worsened primary balance over the MTEF, our estimates of the main budget balance show deficits larger than those projected in the MTBPS (see Figure 10(b)). This illustrates the effect of higher non-interest expenditure combined with the attendant higher debt service costs incurred due to the borrowing required.

With PEP estimating primary deficits over the current year, and over the first two year of the MTEF, and larger main budget deficits compared with government's projections, we do not estimate a stabilisation of government's debt-to-GDP ratio over the current MTEF. This suggests that, in the absence of higher GDP growth with the corresponding revenue growth, the government's fiscal objective will not be realised over the current MTEF.

CONCLUSION

At the root of South Africa's fiscal crisis is the chronic stagnation of the economy. Since 2012 the economy has stagnated while the interest rate on government debt has increased. Since the Covid-19 pandemic, growth has fallen far below the interest rate, and debt service costs are increasingly crowding out social spending. Government has responded with across-the-board expenditure cuts. This intensified austerity is contributing to lower growth, rising inequality, and a weakened state.

A vicious cycle

Fiscal policy is now caught in a vicious cycle. Failure to contain the deficit will place further upward pressure on bond yields, and the rising risks associated with an unsustainable fiscal position will slow down growth. Indeed, a demand-led strategy to boost the economy is likely to make matters worse. The combination of supply-side constraints and adverse market reactions would choke off any multiplier effects through higher interest rates and inflationary pressure. But, on the other hand, blunt and overly aggressive cutbacks to spending could worsen the outlook. Their negative impact on aggregate demand will be felt in households least able to cushion themselves, and the result will be slowing growth. If cutbacks were to result in a lower bond yield, then some offsetting growth response might be expected. We do not believe that this is likely, because debt stabilized on is in any case highly unlikely while GDP per capita continues to stagnate. Rising bond yields are not simply a function of the budget deficit. They reflect fundamental uncertainties about South Africa's future as result of electricity supply shortfalls, trade infrastructure constraints, and concerns about longer term social cohesion. Expenditure cuts in place for the last decade, combined with slow and faltering structural reforms, have not stabilized the interest rate the public sector faced in previous years. And it is doubtful that it will be the case in the years ahead.

Required: A clear, credible, and effective programme of economic growth and transformation
Overcoming these conditions requires a clear, credible, and effective programme of economic growth and transformation. Having such a strategy in place, fiscal policy might deliver:

- an easing of longer term fiscal risks while ensuring that complex structural reforms are financed
- an appropriate level of aggregate demand which is maintained through a period of reform
- protection of the most vulnerable members of society in the short term

Critical questions to answer
An effective, credible, and coherent growth strategy is unlikely to emerge – at least not before the national general elections later this year. Acting alone, therefore, there is little fiscal policy can do to enable South Africa to escape this vicious cycle. In this difficult context, the key questions a fiscal strategy must answer are:

(a) Is the strategy likely to accelerate, or slow-down, the cycle of stagnation and debt accumulation?
(b) To what extent can the strategy soften the blow of macroeconomic adjustment, and distribute its consequences more equitably?
(c) Does the strategy build government's capacity to provide critical services, and preserve the credibility and strength of fiscal institutions to engage with these questions of the longer term?

Government's current fiscal strategy: questionable on all counts
In our view, the government's current fiscal strategy (as set out in the October MTBPS) is questionable on all three counts. Government's strategy is likely to intensify the downward cycle by imposing a large negative fiscal impulse on an economy that is struggling to overcome supply-side structural challenges – and while the economy is facing negative terms-of-trade shocks. Blunt, across-the-board expenditure cutbacks are likely to ensure that the pain of macro adjustment falls to an even greater extent on the shoulders of the poor and lower middle-class households and disrupt the delivery of public services. Setting out an implausible path of expenditure reduction, and prioritising cash preservation over long-term sustainability, is likely to erode the quality of budget institutions. In addition, the credibility of the government's fiscal strategy as consolidation will, in many respects, reflect illusory and temporary cutbacks that obscure, rather than resolve, underlying structural weaknesses in expenditure allocation.

An alternative fiscal policy?
The alternative would be a fiscal policy that attempts to soften the blow of macroeconomic adjustment, and ensure that its burden is distributed more equitably across South Africa's extreme income inequality profile. This would require:

- slowing the pace of expenditure cuts
- implementing difficult expenditure allocation decisions to protect basic services
- shifting the balance of consolidation towards taxation
- making more intelligent use of the government's balance sheet to ease pressure on the bond market over the medium term.

Such a strategy would certainly come with costs, both political and economic. The required expenditure decisions will not be popular with those who benefit from the current allocation. Increased taxes on the affluent and the corporate sector will be difficult to realise, and a weakening of the public balance sheet may raise the cost of finance in the longer term. But compared to the damage that the current strategy is likely to impose on poor South Africans – and the balance sheets of low-income households – we think that these costs are worth bearing.

It is therefore crucial for the government to outline a detailed, realistic plan in the February 2024 Budget. This plan should focus on implementing austerity measures over the next three years while protecting frontline services. Additionally, the government must assess the proposed budget's impact on service delivery, and consider alternative approaches to avoid undermining socioeconomic rights, ensuring fiscal policy supports sustainable development, and towards building a common society.

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[i] Public Economy Project defines "core spending" as main budget non-interest spending excluding self-financing items and payments for financial assets. It is intended as a measure of discretionary allocations for the provision of government services under the direct control of the central government, and which are financed from general taxation and bond issuance. In National Treasury data, the main budget is expenditure financed from the National Revenue Fund, established in s213 of the Constitution as the fund "into which all money received by national government must be paid, except money reasonably excluded by an Act of Parliament". Taking this as a baseline, we have excluded debt service costs, payments funded by the skills levy and the fuel-levy sharing with metros. All of these are "direct charges against the National Revenue Fund" (see Table 5 of the Budget Review), implying that they are not the subject of discretionary choices made in the context of the budget process, and are not appropriated by parliamentary vote. The skills-levy payments and fuel-levy sharing are also financed by a dedicated revenue stream and, therefore, by design have no effect on the deficit. They also replaced revenue and spending that was previously outside the main budget (skills levies to training boards and regional services council levies charged by large city governments respectively). We have also excluded payment for financial assets. This line is dominated by very large payments to Eskom in 2009, 2015 and 2018, and smaller payments to other state-owned enterprises. This exclusion is intended to ensure focus on government's underlying service delivery obligations.