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AUSTERITY WITHOUT CONSOLIDATION

Fiscal policy and spending choices in Budget 2023

Public Economy Project

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Abbreviations

AIDS	Acquired Immuno-Deficiency Syndrome
ART	Anti-Retroviral Therapy
BR	Budget Review
CHW	Community Health Workers
CIT	Corporate Income Tax
Covid-SRD	Covid19 Social Relief of Distress Grant
CPI	Consumer Price Index
CWP	Community Works Programme
DBE	Department of Basic Education
DOD	Department of Defence
DPSA	Department of Public Service and Administration
ECD	Early Childhood Development
ENE	Estimates of National Expenditure
EPWP	Expanded Public Works Programme
FATF	Financial Action Task Force
GDP	Gross Domestic Product
FFC	Financial and Fiscal Commission
GEAR	Growth, Employment and Redistribution Strategy
HIV	Human Immunodeficiency Virus
IMF	International Monetary Fund
LTSM	Learner and Teacher Support Material
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDOH	National Department of Health
NDP	National Development Plan
NGO	Non-Governmental Organisation
NHI	National Health Insurance
NPO	Non-Profit Organisation
NSF	National Skills Fund
NSFAS	National Student Financial Aid Scheme
ODI	Overseas Development Institute
OECD	Organisation For Economic Cooperation and Development
PEP	Public Economy Project
PRASA	Passenger Rail Agency of South Africa
PSET	Post-School Education and Training
RAF	Road Accident Fund
SANDF	South African National Defence Force
SANRAL	South African National Roads Agency Limited
SARB	South African Reserve Bank
SASSA	South African Social Security Agency
SCIS	Southern Centre for Inequality Studies
SETA	Sector Education and Training Authority
SOC	State-Owned Company
TB	Tuberculosis
TCTA	Trans-Caledon Tunnel Authority
TVET	Technical And Vocational Education and Training Centre
UIF	Unemployment Insurance Fund
VAT	Value Added Tax
VIP	Very Important Person
WEO	IMF World Economic Outlook

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FISCAL POLICY AND SPENDING CHOICES IN BUDGET 2023

Public Economy Project | June 2023

INTRODUCTION

Government's budget is a critical instrument for building a common society and overcoming the segregation and inequality that thwarts growth and development in South Africa. It is also a vital element of the social contract, transferring income and providing services that hold our fragile society together. South Africa, however, finds itself in a worsening fiscal impasse. Continuous austerity over the last decade has eroded the quality and value of public services on which the majority of South Africans rely. Spending cutbacks have been strongly intensified since the Covid-19 pandemic, with pay increases for government employees held well below the rate of inflation, and across-the-board spending reductions cutting deeply into healthcare, basic education, criminal justice, and social services.

Funding for social provision depends on rising national income, but South Africa has been stagnating for a decade. Recently, the growth outlook has deteriorated further, as the dire implications of the failure of electricity supply and commodity export infrastructure have become clearer. Real economic growth is now even lower than the miserable estimates anticipated in the budget. Meanwhile, financial conditions have tightened as capital outflows have stabilised at higher interest rates, with South Africa facing an elevated country risk premium on top of global rate hikes.

After several years of painful efforts to stabilise the public finances, this weakening of macro-fiscal conditions has made the goal of debt stabilisation even more distant. Despite intensifying austerity, South Africa appears no closer to consolidating its fiscal position. Slower growth and higher interest rates require further cuts in spending or tax hikes to counterbalance rising debt service costs. A sharp slowdown in spending and buoyant revenues since the pandemic resulted in a tentative primary surplus. But the economic "recovery" from Covid has consisted of a nominal boom that boosted key fiscal metrics, coinciding with a significant weakening of real growth prospects which have undermined fiscal sustainability.

Efforts to stabilize the increase in debt take place in a context of policy disarray at the centre of government. This has resulted in a growing divergence between the budget plans and their execution. Annual spending far exceeds the targets set out in the February budget, and the spending ceiling is no longer an effective limit on cash allocations over the medium term. Treasury has begun to see the MTEF as a bargaining position rather than an accurate costing of government's programme (which, if it were to be costed, is wholly inconsistent with the path of fiscal policy). Spending targets are set at unreasonably low levels in the annual budget. Although these targets are impossible to achieve (and are indeed exceeded each year) the overall path of spending growth has been substantially reduced. The budget's expectation of a salary freeze was never going to be realised, but pay increases for government employees have been held below inflation. Attempts to roll back pandemic-related expenditures – such as the Covid-19 Social Relief of Distress grant or the Presidential Employment Stimulus – are supported by an approach that denies that funding is available for these interventions in future budgets.

This response to policy incoherence has eroded the credibility, performance, and quality of the medium-term fiscal framework. Budget credibility is a core element of the ability to achieve social change by mobilising the state apparatus behind government's programme. Over time, a weakening of budget credibility can impact on a broader set of fiscal institutions, including centralised fiscal authority, effective public administration, and clear oversight and control of budgets. These institutions are critical underpinnings of South Africa's constitutional democracy. If they are weakened, the ability of the state to redistribute resources and access long-term capital at low interest rates will be undermined.

Three years after the introduction of the Covid-SRD grant, government has not clarified the policy framework governing the grant, or decided whether it will be the basis of a more extensive system of income support. In the interim, reliance on ad-hoc regulation and annual budget extensions creates uncertainty and confusion. Access to the grant has been tenuous, while its value is eroded by inflation. Funding is made available for teacher assistants in schools, even while funding for teachers and textbooks is cut, without any policy statement about what this implies for the future of the public education system. The budget implies a significant contraction in the public healthcare system, with hospitals facing the largest cuts. NHI funding is focussed on the construction of new hospitals even while spending on healthcare workers, medical equipment, and operational budgets are cut. Universities and colleges are having core funding and infrastructure finance cut, yet the Minister of Higher Education is committed to a programme of "massification", which includes the construction of two new universities. A more prominent role in regional security is sought, while the defence force is effectively defunded. The President announces a large increase in police numbers even while his government's budget implies a substantial reduction in headcounts.

The budget does contain some important spending choices, and makes valiant attempts to signal changed policy direction in certain areas. Funding for water infrastructure and roads is substantial and grows rapidly, as do the resources available for new schools and hospitals. Funding for Eskom, Transnet and Sanral should help unlock further rounds of infrastructure investment. The tentative extension of the social grant system to working-age citizens is maintained, and the budget creates a back-pocket to fund it in future. Significant additional funding is allocated to early learning programmes, and the school feeding programme is protected from cuts. The National Prosecuting Authority's budget is spared from the deep cuts imposed on the rest of the criminal justice system. The budget for science and innovation also grows faster than inflation.

But, now that the macro-fiscal context has worsened, further cuts to spending appear to be on the cards. South Africa faces large and sustained macroeconomic headwinds from the combination of fiscal, financial and monetary tightening. Buoyant nominal conditions and surprise inflation supported the goal of fiscal consolidation over the last four years. Consolidation in the years ahead will have to operate in conditions of disinflation, as the central bank battles supply shocks and balances capital flows, while moving towards a lower *de facto* inflation target. Lower inflation will make the task of implementing spending reductions much harder. Over the longer term, it is not clear how much further and how much longer spending growth can be curtailed without aggravating South Africa's deep political fissures, leading to social unrest.

For now, South Africa faces a cul-de-sac of permanent austerity without consolidation. This position is steadily eroding the capabilities necessary for the state to realise the potential that fiscal action promises. The chronic fiscal squeeze, coupled with failing public services and growing debt, casts a gloomy shadow over the country's development prospects.

There is no easy road to getting beyond the fiscal crisis. In respect of the expenditure consolidation, a clearer plan backed by explicit policy choices is required. The very wide gap between government's fiscal programme and its policy agenda needs to be addressed. This means grappling with questions of programme design in the public sector, and implementing institutional reforms that ease rather than exacerbate fiscal constraints. Any reform programme requires an effective executive authority working through a capable policy machinery. Therefore, serious public service reforms are urgently needed. In a context where clearer choices are made in respect of spending and programme design, the question of a more appropriate balance between taxes and spending in the consolidation process also needs reconsideration.

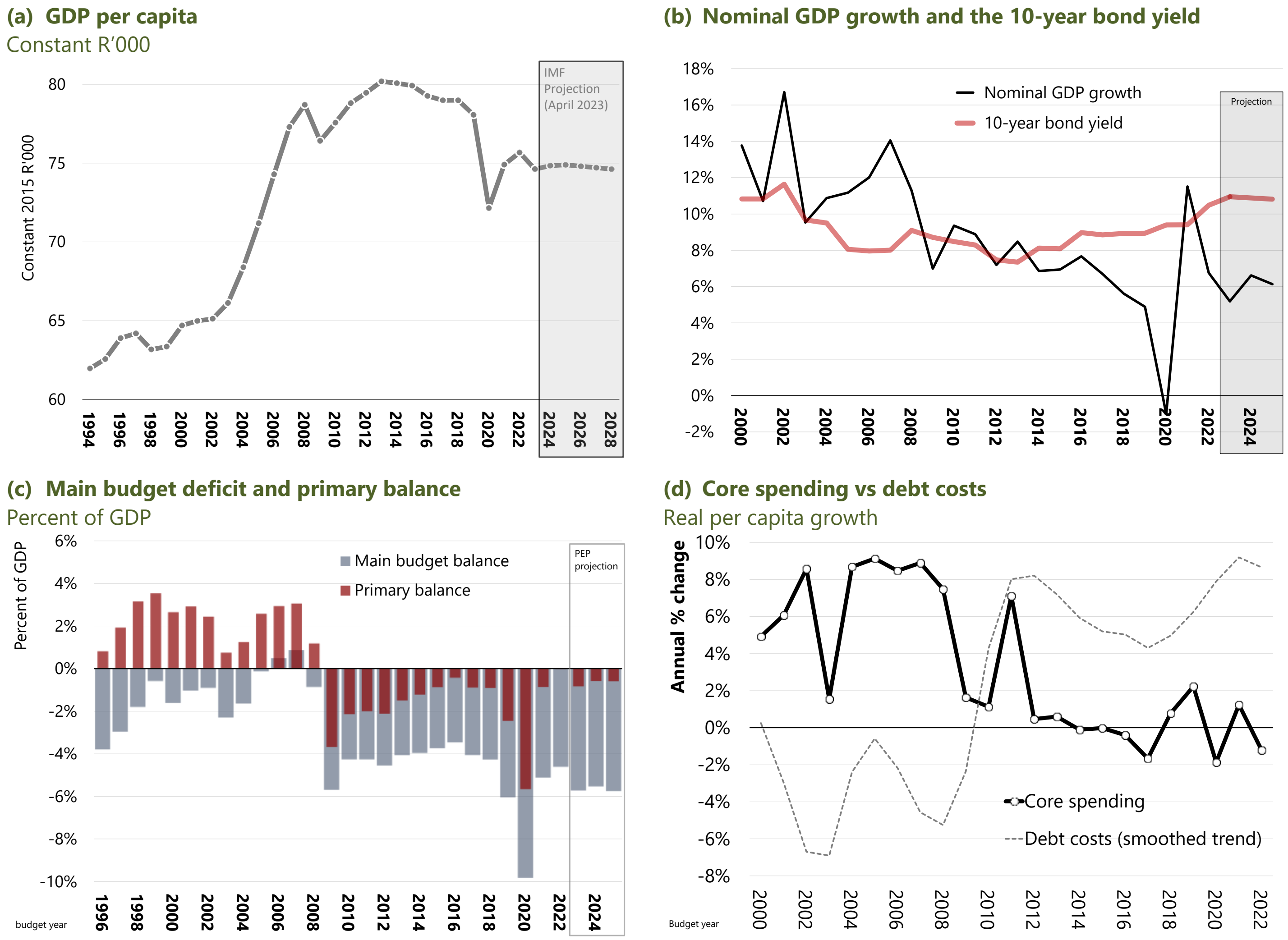
To achieve fiscal consolidation, however, South Africa must see a sustained improvement in economic growth and an easing of financial conditions. While GDP per capita continues to decline there is little hope of slowing the retrogression in access to social and economic rights which is currently taking place. Renewed growth requires action to fix the electricity supply constraint, restore critical export infrastructure, and most importantly, articulate and implement a clear and consistent programme of structural reform and transformation to create the conditions for a growing economy in a common society.

PART 1: MACRO-FISCAL CONTEXT – A WORSENING FISCAL IMPASSE

Fiscal policy can play a crucial role in fostering growth and development by ensuring the sustainable delivery of essential public services. Managed effectively, government's budget can help us build a common society and overcome the segregation and inequality of the past, without which sustained economic growth seems unlikely. It can also respond to temporary macroeconomic shocks to aggregate demand and livelihoods. South Africa however finds itself in a worsening fiscal impasse (see Figure 1). There is continuous austerity, dating back more than a decade, but South Africa appears no closer to achieving fiscal consolidation. This position is steadily eroding the fiscal capabilities necessary for the state to realise the potential that fiscal action offers. Instead, the budget is increasingly becoming a drag on development.

GDP per capita has stagnated and fallen for at least a decade. Slowing growth has been accompanied by rising interest rates on government debt. In these conditions, rising debt service costs must be offset by higher taxes or reduced non-interest spending. Austerity is weakening the capabilities of the state and society that are necessary for sustained growth and inclusive development. It has eroded the public services on which the poor depend yet has failed to stabilise debt. Instead, doubts about the solvency of the sovereign have continued to rise and, in this context, the fiscal position itself has become a critical constraint on faster growth.

Figure 1: Faltering growth and deepening fiscal imbalances



Projections reflect the release of preliminary figures for main budget revenue and expenditure, as well as GDP for the 2022 budget year

"Core spending" is main budget non-interest expenditure excluding captial trasnfers to state-owned companies (i.e. "payments for financial assets"), skills development levy and fuel levy sharing with metros.

Source: National Treasury budget data; Bond Exchange South Africa, Stats SA, Public Economy Project calculations

Consolidating spending

Attempts at fiscal consolidation have focussed largely on containing spending. A nominal (i.e., cash) expenditure ceiling was introduced to limit spending growth.[1] The aim was to discipline the annual budget planning cycle, which is largely concerned with cash allocations over the three-year medium term expenditure framework (MTEF)[2].

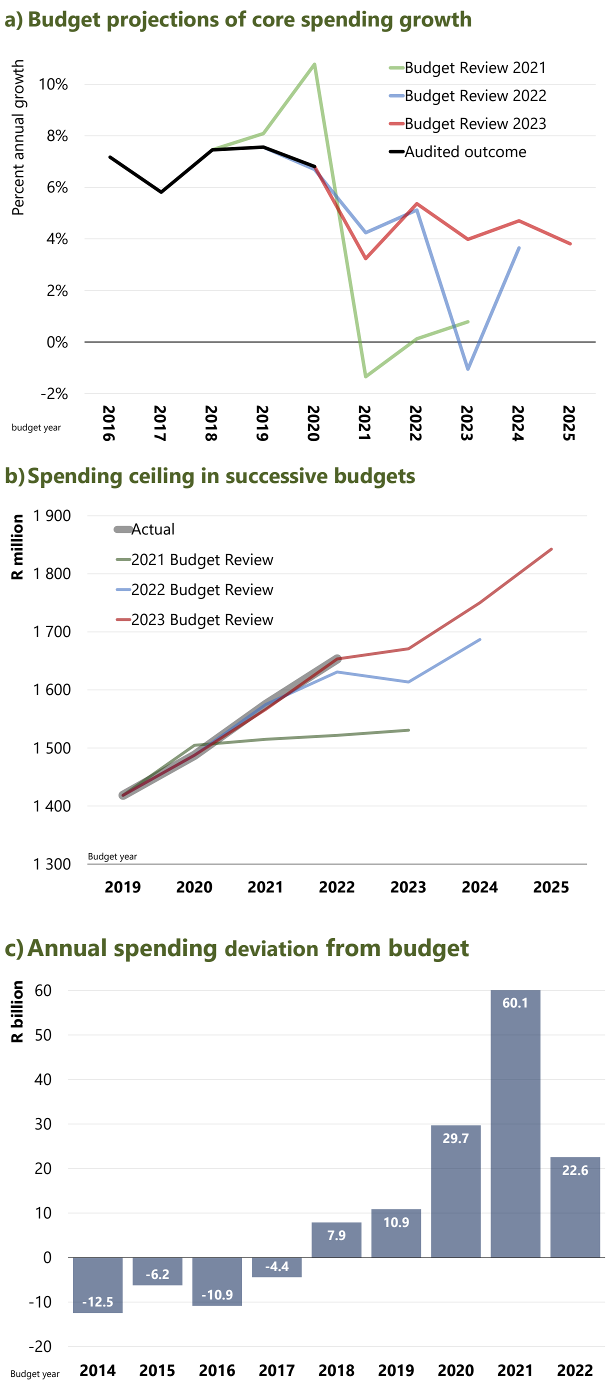
Spending grew on average at around 14% per annum between 2000 and 2010, far outpacing GDP growth and leading to a doubling of real spending per citizen (see Figure 3a on the next page). Since the introduction of the spending ceiling in 2012, however, there has been a significant slowdown in the nominal growth of spending growth.

The fiscal strategy since the Covid-19 pandemic sought to achieve a sharp nominal contraction of expenditure allocations in a single year. This aimed to reverse spending introduced as temporary support during the pandemic and restoring the sustainability of the public finances in one-fell swoop. A sharp contraction frontloaded in the first year of the MTEF would, it was believed, restore sustainability, and allow the consolidation to come to an end.

This approach has delivered contradictory outcomes. On the one hand, government has failed to remain within the spending limits set in annual budgets. This has opened a wide gap between budget plans and spending outcomes, which has been problematic in respect of compensation of employees – the most critical target in the consolidation plan. On the other hand, nominal spending growth has been reduced to its lowest rate ever, and compensation growth brought far below inflation for the first time since 1994.

Figure 2a shows that the nominal contraction has not been delivered as planned. Successive budgets postponed the consolidation or revised-up expenditure estimates by billions of rand relative to the previous iteration, or both. The spending ceiling is no longer an effective limit on cash allocations over the medium term (Figure 2b). Even the annual budget has become an unreliable guide to spending in the current year, as there are large deviations between spending estimates tabled each February, and the outcomes for the year (Figure 2c). A large gap between budget plans and budget execution has opened. We discuss the reasons for this outcome, and the implications for budgets going forward, in greater detail in Part II.

Figure 2: Budget plans and budget outcomes



Source: National Treasury budget data; Public Economy Project calculations

[1] The spending ceiling is a nominal total set for each of the three forward planning years of the MTEF. It is defined as main budget non-interest expenditure excluding payments directly financed by dedicated revenue sources and others not subject to policy oversight. These exclusions include payments for financial assets financed by asset sales in the same financial year, payment transactions linked to the management of debt and direct charges related to specific payments made in terms of legislation that provides for the collection and transfer of such receipts outside of the main budget, including the skills development levy contributions.

[2] Through the budget process departments and agencies negotiate with Treasury on cash limits to their spending commitments. Once agreed and tabled by the Minister of Finance, Parliament votes to enshrine the rand value of allocations into law for the current year and endorses nominal spending limits over the next three years in a medium-term expenditure framework (MTEF).

But while medium term and annual targets have been exceeded, the post-pandemic period *has* witnessed a further and substantial slowdown in nominal spending growth. Figure 3a shows that since the pandemic the growth in core spending has been brought below the expansion of nominal GDP for the first time in decades. So, while government has been largely unable to meet its own budget targets, the strategy of setting stretch-targets for reduced cash allocations has created a context in which spending growth has been substantially curtailed, even below its post 2012 trajectory.

Added to this, unanticipated inflation has helped achieve consolidation by raising the nominal growth of GDP, increasing the tax take and cutting back on the real growth of spending. This buoyancy partly reflected the commodity price boom that followed the pandemic. Global inflationary conditions combined with domestic supply limits (arising largely from loadshedding) created a surprise inflationary shock.

Cash spending targets are always set with reference to treasury CPI forecasts in mind. These have been significantly below realised inflation for the last three years (see Figure 3b). With the help of unanticipated inflation, execution risks have been mitigated, and expenditure consolidation targets have been partially achieved. Surprise inflation has been a key factor behind revenue buoyancy and acted to ease the financing conditions faced by government, lowering the real return on nominal bonds, and slowing the rise of debt service costs.

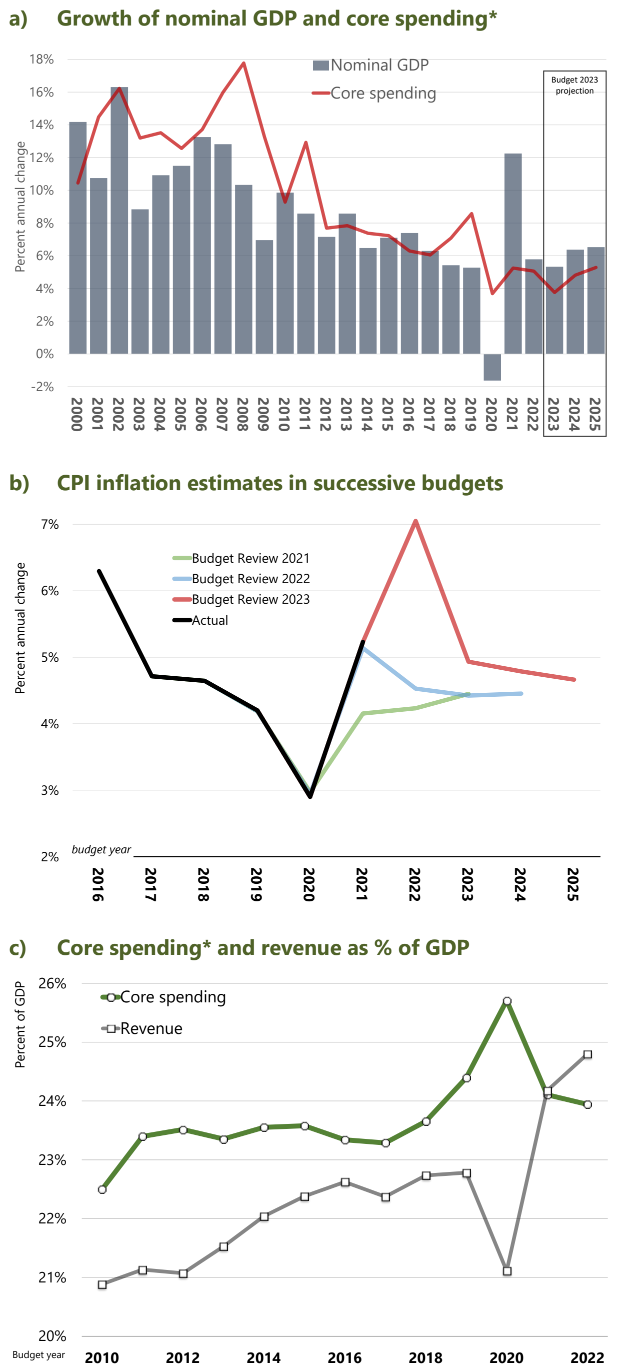
In combination, these factors have "closed the jaws of the hippopotamus" (See Figure 3c). Spending growth has been brought below the rate of nominal economic expansion, lowering the ratio of spending to GDP. Nominal GDP expansion has buoyed revenues. If we exclude capital transfers to state-owned companies, a small primary surplus was achieved in 2022.

But while the price shock has helped government achieve its fiscal consolidation targets in the short run, nominal buoyancy has gone together with continued real stagnation of the economy. This suggests a worsening fiscal position in the long run, a point to which we return below.

Containing government's wage bill

The government wage bill is one area where the contrast between the failure to meet nominal targets on the one hand, and the achievement of a large slowdown in spending growth on the other hand, is most notable.

Figure 3: Spending growth and inflation



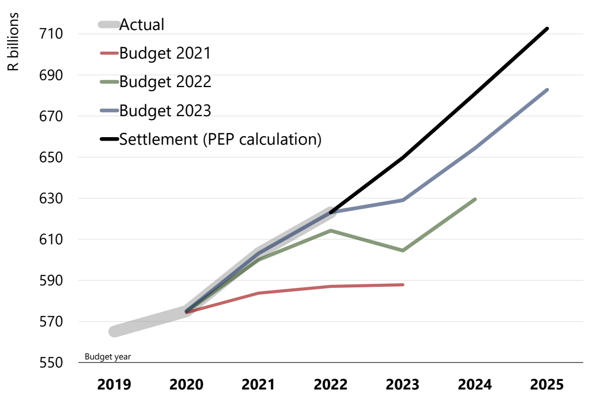
** "Core spending" is main budget non-interest expenditure excluding capital transfers to state-owned companies (i.e. "payments for financial assets"), skills development levy and fuel levy sharing with metros.*

Source: National Treasury budget data; Public Economy Project calculations

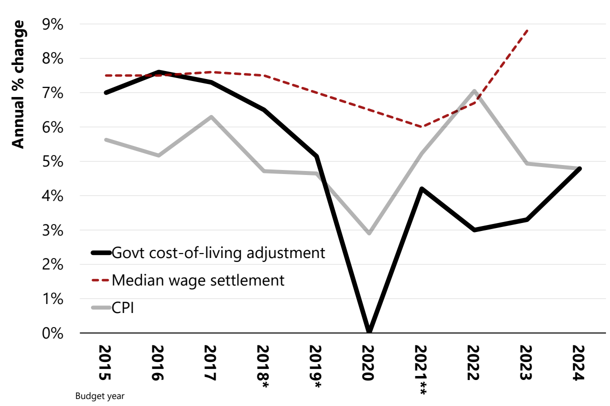
Compensation ceilings are presented as fixed nominal limits in each budget. However, subsequent budgets have added large amounts to the salary bill, and also to the equitable share of provinces - a significant share of which is allocated to salaries (see Figure 3a). These additions were prompted by the realisation that deep cuts to cash allocations would not be possible to achieve without substantial reductions in service delivery and employee headcounts, particularly in labour intensive services such as basic education, healthcare, social development, and criminal justice.

Figure 4: Government wage bill trends

a) Wage bill budget estimates and outcomes



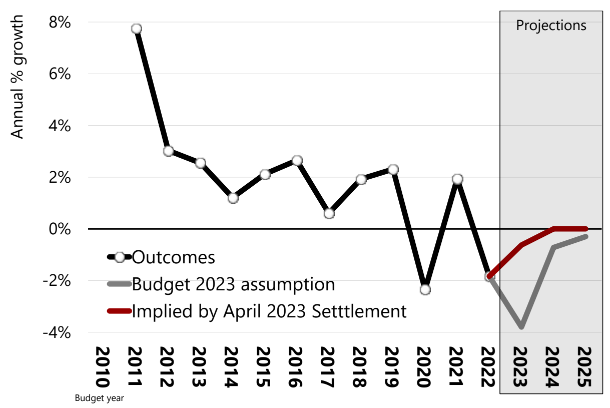
b) Govt employees' cost-of-living adjustments.



* Adjustment was on a sliding scale, we take the average adjustment

*** There was no cost-of-living adjustment in 2021, but a non-pensionable cash gratuity was awarded equivalent to a 4.2% increase which was then extended into 2022 and integrated with base pay in 2023.*

c) Real growth of compensation spending



Source: National Treasury budget data; Labour Research Service (median settlement derived from the percentage increases recorded in collective agreements), DPSA circulars (annual cost-of-living adjustments), StatsSA, Public Economy Project calculations

Despite large nominal deviations from budget targets, spending growth on compensation of employees *has* been strongly curtailed, and indeed kept below the rate of inflation. This has led to an erosion of the real incomes of government employees. Salaries were frozen in nominal terms in 2020. In 2021 government conceded a cash gratuity, costed as an equivalent of a 4.2% increase[3], far below the rate of inflation of that year. In 2022, government unilaterally implemented a 3% increase, and this year's wage agreement implies another 3.3%. Since the Covid-19 pandemic government employees have (on average) experienced a 9% fall in their basic pay relative to consumer price inflation. Figure 3b shows that cost-of-living adjustments for government employees are below inflation and far below median pay settlements across the economy. Looking to the spending figures in the budget, compensation contracted in real terms in 2020 and 2022 (see Figure 3c). There was no wage settlement concluded before Budget 2023, so the Budget assumed there would be no pay increase, and pencilled-in an effective 4% contraction in the salary bill. However, the 2023 wage agreement resulted in a shortfall of R21 billion in 2023 and R77 billion over the MTEF[4].

Following the budget the Minister of Finance declared that the settlement is a substantial blow to the fiscus and warned that government will be "executing difficult trade-offs [that] may entail a rationalisation of staffing levels and deployment of headcount management strategies as a means to curb the wage bill … a higher than-budget wage agreement means less space for the recruitment of staff". The National Treasury guidelines for the 2024 MTEF indicate that the carry-through effects of the 2023 wage agreement are to be funded within the existing baselines (National Treasury 2023b).

In real terms then, the incomes of government employees have been substantially reduced. Salaries have not been cut as aggressively as treasury had planned, and wage bill spending continues to exceed targets. But cost-of-living adjustments have been held far below inflation over the last four years, with an adjustment aligned with inflation agreed for next year. Moreover, wage improvements for government employees have strongly diverged from private sector settlements.

This has been a key element in reducing the overall growth of expenditure to historically low levels. Unfortunately, despite having achieved a historic cut in government pay, and an unprecedented slowdown in spending growth, the goal of fiscal consolidation now seems more distant than ever. This is because macroeconomic conditions unrelated to the budget have substantially worsened.

[3] See DPSA circular 15 of 2021. The cash gratuity was extended without increase in 2022 and was integrated into the pensionable salary in 2023. National Treasury continues to report this reallocation from "cash gratuity" to "pensionable salary" as amounting to another salary increase in 2023. This is highly misleading and has created considerable confusion in public deliberation about this issue, which is at the centre of the budget programme. The reallocation between budget definitions in 2023 may have resulted in additional costs, for instance because it implies additional resources to the employer's pension contribution. From the point of view of government employees, however, the reallocation from one accounting treatment to another adds nothing to their take-home pay.

[4] Treasury has continued to report the settlement as an "above inflation" shock amounting to 7.5% and reflected the materialisation of a significant fiscal risks. This has the effect of creating the impression that public servants pay has escalated much faster than is in fact the case. It has also confused the public debate about the fiscal issues and served to focus renewed attention on the salary bill.

A changed macro-fiscal outlook

A sharp slowdown in spending growth since the pandemic, combined with buoyant revenue on the back of a nominal boom, has supported the achievement of a tentative primary surplus (excluding capital transfers). Unfortunately, while inflation has been surprisingly high, real economic growth has been even lower than the miserable estimates anticipated in the budget. A nominal boom has coincided with a significant weakening of growth prospects, undermining longer term fiscal sustainability. In recent months financial conditions have tightened, pointing to a worsening of the sovereign risk premium and an increase in the financing costs faced by government. After several years of painful efforts to stabilise the public finances, therefore, this slowing growth and tightening financial conditions have rendered the goal of debt stabilisation even more distant.

Since the presentation of the 2022 Medium Term Budget Policy Statement (MTBPS) and 2023 Budget, the medium-term outlook for real growth in the country has deteriorated. Expectations of the intensity and duration of loadshedding have worsened. The extent of infrastructure constraints to increased commodity-export volumes has become apparent. There is now a significant discrepancy between the outlook published in the budget and updated growth forecasts for the current year, which reflects the uncertain economic impact of load shedding. The National Treasury's GDP growth forecasts for the medium term (2023: 0.9%) are considerably higher than those of other forecasters and are expected to be revised downwards in October.[5]

Table 1: Revised GDP growth outlook

Real GDP growth outlook - calender year*	2023	2024	2025
National Treasury - MTBPS 2022	1.4%	1.7%	1.8%
National Treasury - Budget 2023	0.9%	1.5%	1.8%
South African Reserve Bank - November 2022	1.1%	1.4%	1.5%
South African Reserve Bank - May 2023	0.3%	1.0%	1.1%
IMF - World Economic Outlook - January 2023	1.2%	1.3%	-
IMF - World Economic Outlook - April 2023	0.1%	1.8%	1.6%
Bureau for Economic Research - 4Q 2022	0.5%	1.4%	1.8%
Bureau for Economic Research - 1Q 2023	0.2%	1.4%	2.1%

*Growth projections correspond to publication date and not forecast date

Data: National Treasury, South African Reserve Bank, International Monetary Fund, Bureau for Economic Research

Not only has growth slowed, but financing conditions have worsened since the budget was presented in February. While the alarmed market sentiment that took the rand close to R20 to the US dollar in the wake of the "Lady R" imbroglio appear to have eased, it has done so only with interest rates that are significantly above previous expectations. The tightening of financial conditions probably reflects underlying fundamental factors. The most significant of these is the slow-down in growth itself. In addition to generating pessimism about longer term sustainability and future returns on fixed investment, the combination of electricity constraints and the deterioration of South Africa's export logistics platform has raised concerns about the current account deficit, adding to the pressure on external financing. This comes as commodity prices have slowed and the recent terms of trade gains look to be reversed, raising the cost of external financing for commodity producers, including government bond yields.[6]

Added to this, South Africa's "greylisting" by the Financial Action Task Force (FATF) shortly after the budget created new concerns about the financial and economic implications of weakened state capacity and the growing threat posed by criminal networks. It has since become increasingly apparent that meeting the requirements to be removed from this greylist may be challenging, and the financial greylisting is likely to remain in place for an extended period[7]. Added to all this, doubts about South Africa's non-alignment in global affairs became elevated in

[5] The National Treasury provide two public updates to the forecasts informing the fiscal framework – in February and October.

[6] See, for instance, Aslam et al. 2016; Drechsel and Tenreyro 2018; Shousha 2016 for consideration of the negative correlation between commodity prices and external financing conditions in emerging markets.

[7] Several of the factors that led to greylisting concern the performance of the criminal justice system. Strategic deficiencies identified by the Financial Action Task Force (FATF) include increasing investigations and prosecutions of serious and complex financial crimes, improving identification, seizure and confiscation of proceeds from a wider range of crimes and increasing outbound Mutual Legal Assistance requests. Other deficiencies might be address through reforms to legislation or financial governance and effectively implementing targeted financial sanctions while improving identification of individuals and entities for domestic designation. These include enhancing risk-based supervision of Non-Financial Businesses and Professions; ensuring access to accurate Beneficial Ownership information; boosting requests for financial intelligence for money laundering/terrorism financing investigations; updating its counter-terrorism financing strategy based on risk assessments.

a context of growing international concerns about the implications of geo-economic fragmentation.[8] The previously unthinkable possibility of financial or trade measures being taken against the country by its most important trading partners became suddenly salient. Against this backdrop, the South African Reserve Bank added a new element to its risk matrix: that of 'capital outflows and declining market depth. and liquidity'. Noting that the proportion of government bonds held by local institutions had increased from 58% in 2018 to 75% in 2023, the SARB reported in its Financial Stability Review that:

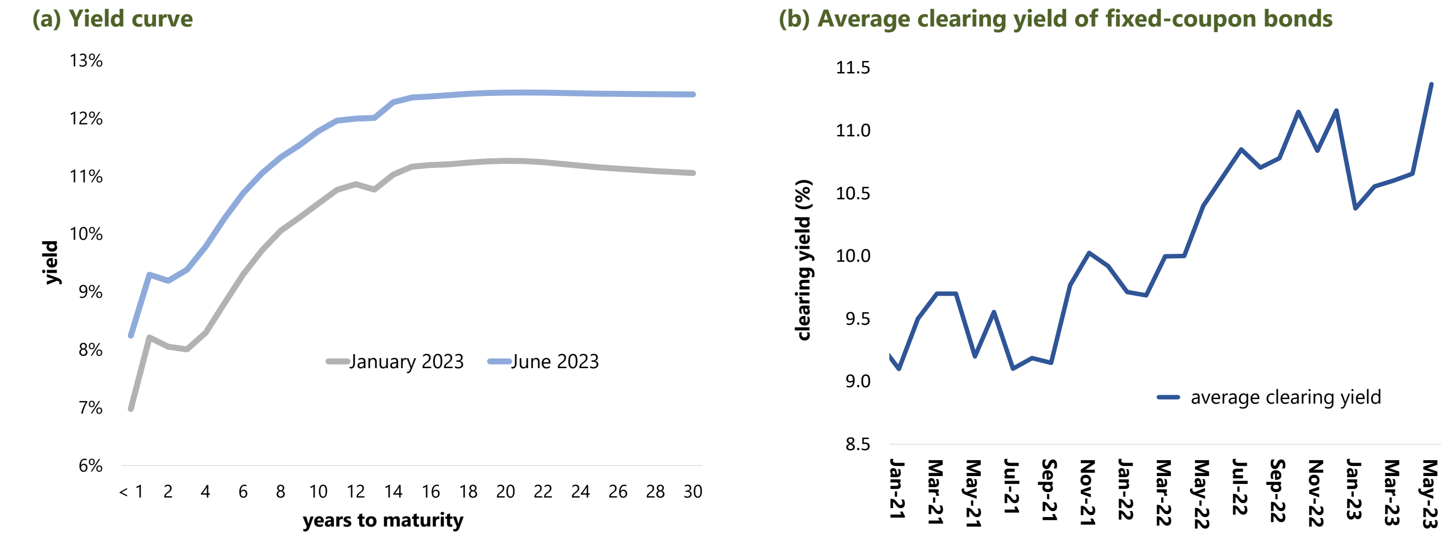
> "This is a significant structural shift, especially considering the significant increase in government bonds issued during this period. It raises concerns about the capacity of South African investors to continue absorbing new issuances of SAGBs in future. As local participants increasingly step in to absorb the declining appetite for new SAGB issuances by non-residents, this raises financial stability concerns regarding market liquidity, increased volatility and higher domestic government bond yields. South Africa's non-investment grade status and recent greylisting by the FATF could contribute to non-resident sell-offs from local markets, with non-resident investor behaviour becoming increasingly speculative in relation to South African assets." (SARB 2023:6)

We expect these underlying factors to persist over the medium term. Rather than constituting a temporary shocks, therefore, global capital markets have effectively downgraded South Africa by an additional notch. This downgrade will increase the government's financing costs until the several conditions that led to the downgrade are addressed.

Given risk of higher bond yields and slow economic growth, achieving the primary balance required to stabilize the debt appears to be an even more challenging task. It would necessitate significant spending cuts or tax increases, over and above the consolidation achieved so far. A slower growth path over the current year and the medium term, with the spending and revenue proposals from the 2023 budget intact, *will* result in a primary balance that does not improve as suggested by the 2023 Budget. Instead, the primary balance could worsen over the medium term, primarily due to lower revenue collection, rendering the consolidation planned in the 2023 budget inadequate. If government is to achieve its objective of stabilising debt as a share of GDP, a continuation of the policy of fiscal consolidation would be necessary beyond the current MTEF.

The February 2023 Budget presents a picture of *frontloaded* fiscal consolidation by reducing government's consumption spending over the next three years, with a large cut in spending in the first year. Treasury projects government consumption to contract by 2.2% in 2023, its largest contraction in 25 years. The budget also presented an improved fiscal outlook for the medium-term expenditure framework (MTEF)[9] compared with the 2022 Budget and MTBPS.

Figure 3: Tightening financial conditions



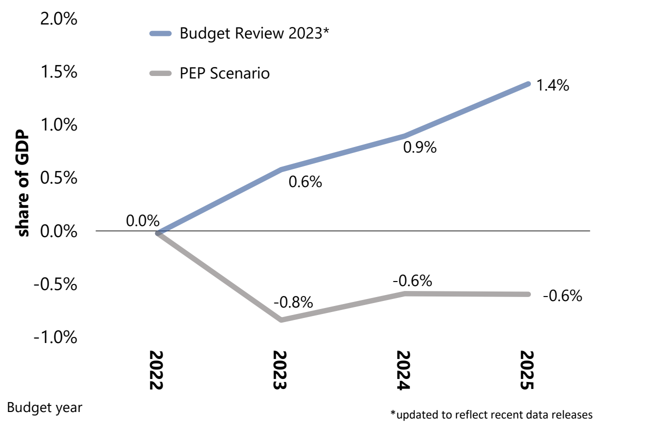
Source: National Treasury; Bond Exchange South Africa

[8] See IMF 2023b for a discussion of the later

[9] The three-year spending plans of national and provincial governments, published at the time of the Budget.

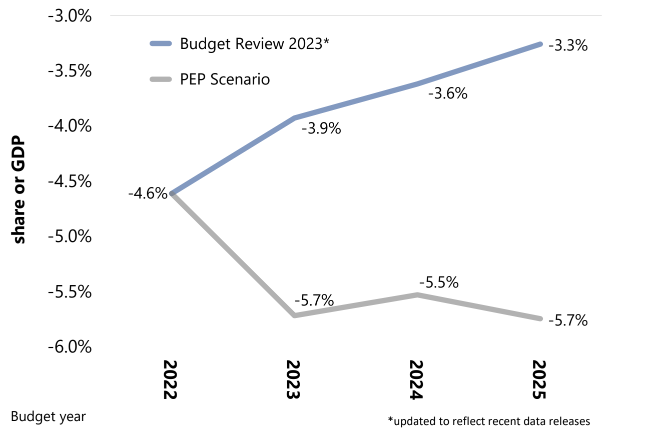
Figure 5: Fiscal outlook: Budget 2023 and PEP baseline

a) Primary Balance



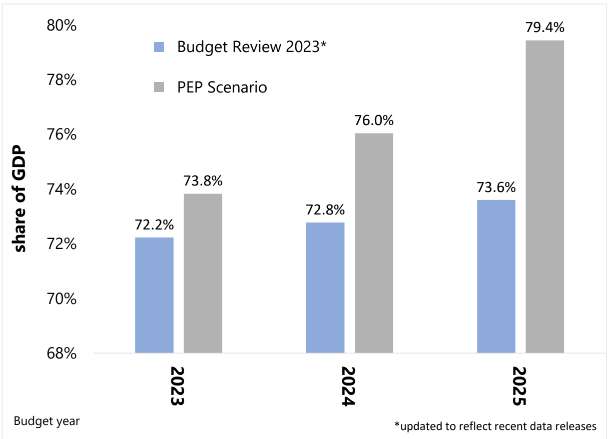
Source: National Treasury budget data; Public Economy Project calculations Both the PEP and BR 2023 projections reflect the release of preliminary figures for main budget revenue and expenditure, as well as GDP for the 2022 budget year

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



Source: National Treasury budget data; Public Economy Project calculations

c) Gross loan debt as a share of GDP



Source: National Treasury budget data; Public Economy Project calculations

This was partly due to strong monthly revenue collections recorded in 2022, prompting upward revisions to revenue estimates over the MTEF. The Budget projects a main budget primary surplus for 2023/24 (0.9% of GDP), improving over the MTEF to 1.7% of GDP in 2025/26, suggesting that government's fiscal objective of stabilising debt as a share of GDP will be realised, and consolidation will *indeed* "soon come to a close".

But as already mentioned, updated projections indicate lower economic growth in the years ahead, leading to further stagnation of per capita income. With slowing growth comes a need to revise the revenue outlook. Also, considering that the fiscal balances outlined in the budget do not present the complete picture of the government's expenditure path, PEP presents a fiscal trajectory which assumes that:

▪ Compensation budgets will grow by the March 2023 wage settlement agreement, for 2023 and 2024, and by CPI inflation in 2025.

▪ There will be an extension of the Covid-SRD grant beyond 2023 across the MTEF, and that the value of the grant will grow by CPI.

▪ The unallocated reserve is allocated in full to fund the Covid SRD grant across the MTEF. However, this is insufficient, resulting in a shortfall of – R4.1 billion in 2024; R318 million in 2023 – which is funded through additional borrowing.

▪ Public employment programmes are extended and implemented at the minimum cost estimate from the Presidency presentation "Putting South Africa to Work".

Our numbers take also into account the latest releases of macroeconomic and public finance outcomes and assume nominal GDP growth over the medium-term in-line with updated consensus forecasts, with the attendant effects on tax-revenue. Our revenue estimates assume Budget 2023 GDP inflation and revenue buoyancy. This assessment also assumes Budget 2023 estimates of government's interest rates – an assumption over which there is considerable uncertainty. We also treat financial support to Eskom announced in the budget as an 'above-the-line' capital transfer, and therefore are part of the non-interest expenditure and the primary deficit.

Although budget 2023 projected successively larger primary surpluses over the MTEF, by applying these more realistic assumptions PEP estimates primary deficits for every year of the MTEF, and a worsening main budget balance over the medium term. The debt ratio does not appear to stabilise over the medium term. Gross loan debt as a share of GDP increases at a faster rate over the medium term when compared to Budget Review 2023 projections, without stabilisation or even a moderation over the medium term.

PEPs baseline fiscal trajectory implies that despite the intention of government to *frontload* the previously postponed fiscal consolidation in the current fiscal year, the large real cuts to expenditure fall short of accomplishing the government's medium-term fiscal objective of stabilizing debt as a share of GDP. Indeed, achieving this goal would necessitate even larger and more harmful spending reductions, which would likely prove socially and politically implausible to enact. This underscores the importance of fostering economic growth to complement expenditure measures which are directed at fiscal consolidation.

PART II: MEDIUM TERM ALLOCATION AND POLICY CHOICES

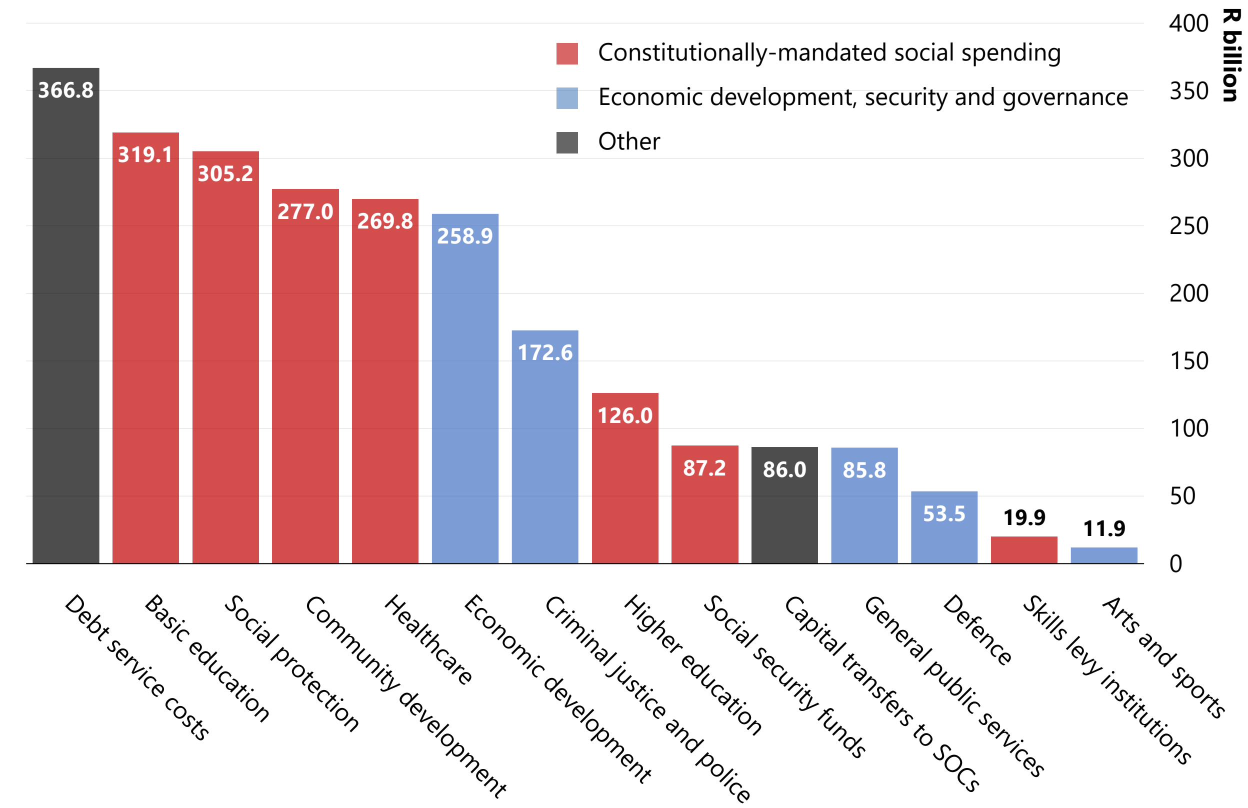
Introduction

Every year, the budget gives concrete numerical form to policy goals It shows citizens the choices government is making about investments and the provision of services and investments. It enables government departments to plan to use these resources effectively. These spending choices, and how they are financed, have direct consequences for the welfare of citizens and the distribution of income. The quantitative nature of budget choices means trade-offs between policy goals are made clear and explicit. Despite our concern about the credibility of spending estimates (see Part I), in this section we take these estimates largely at face value and ask what they can tell us about policy intentions. How have allocative choices been reflected within the constraints imposed by the budget process.

Figure 6 shows planned spending over the medium-term expenditure framework (MTEF). Government will pay R333 billion each year on average to services its debts in the next three years, the consequence of previous deficits. The largest policy function is basic education, which will spend about R320 billion each year. Social protection, community development and healthcare are the next largest priorities showing that (at this broadest level of resource allocation) the budget is aligned to constitutional principles with the lion's share going to mandated social spending. Compared to last year, community development has overtaken healthcare as the third largest allocation[10] This reflects government's intention to contain consumption spending and accelerate infrastructure spending. It also reflets the strong growth of funding for the municipal sphere of government, which continues to face operational and fiscal crisis.

Figure 6: Annual spending by policy function

Average over MTEF (2023–2025) | consolidated budget



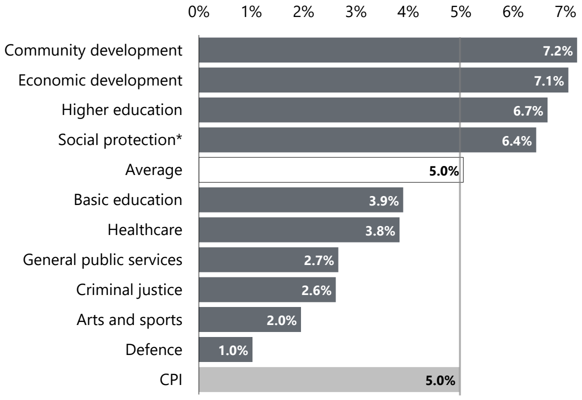
Source: National Treasury budget data; Public Economy Project calculations

Note: Social protection includes "unallocated reserve" on the assumption it will fund extensions of Covid-SRD grant. "Policy functions" differs from National Treasury's "budget groups". Here, home affairs is included in the General Public Services function (security cluster in Treasury documents); Skills levy contributions are separated from universities and TVET colleges; Capital trasnfers to state owned companies reflects amounts defined by Treasury as "payments for financial assets" as well as the Eskom debt relief package.

[10] The numbers here assume that the "unallocated reserve" is used to fund the extension of the Covid-SRD grant.

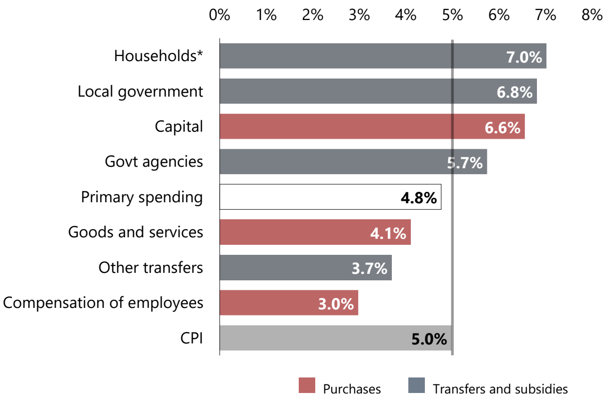
Figure 7: Medium-term spending growth (2019-2024)
Annual average compound growth

a) Policy function
Consolidated government



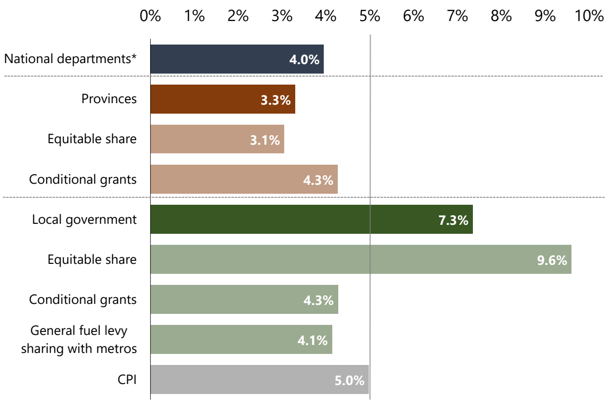
** Assumes the "unallocated reserve" funds an extension of the Covid-SRD grant*

b) Type of purchase (economic function)
Consolidated national, provincial and social security funds



** Transfers to households includes thee "unallocated reserve" funds an extension of the Covid-SRD grant*
Note: Interest payments and capital transfers to SOCs are not shown

c) Sphere of government
Division of revenue



** Excludes interest payments and bailouts to state-owned companies*

Source: National Treasury budget data; Public Economy Project calculations

Budget allocations are enormous, and a large share of spending is attached to long-standing obligations that cannot be easily changed in a single year. This means that shifting spending allocations towards new policy priorities requires consistent choices over several budget cycles. Expenditure trends over the medium-term give a sense of how the budget is changing over time, reflecting the underlying policy choices. which are difficult to discern from the static allocations shown in Figure 6 .

Figure 7a shows average annual **growth of spending by policy function** between 2019 (the year before the coronavirus pandemic) to 2024 (the middle year of the MTEF). It omits debt-service costs, already the largest share of spending, and growing each year by more than 12% on average. In terms of policy functions, growth rates reveal the following:

- Community development, economic development and higher education absorb a rising share of spending, growing faster than the average and faster than inflation.
- Social protection is also growing faster than inflation. This reflects the extension of the social protection system that has resulted from the introduction of the Covid-SRD grant (and we are assuming the grant will continue to be funded).
- Healthcare and basic education will see significant declines in real resource allocation and will be reduced as a share of the budget.
- The criminal justice system, defence and general public services will see very large declines in real resource allocation.

In the sections that follow we dig deeper into the consequences of these choices in respect of individual policy functions.

Choices about the growth of policy functions are bound together with choices about the **type of inputs** which must be purchased to deliver government services. Transfers to households grow strongly on the back of the extension of the Covid-SRD grant and support for students in higher education. Capital spending is budgeted to grow robustly, and transfers to government agencies include allocations for water and road infrastructure, which drive spending in the economic development function. Transfers to local government also include large infrastructure funds. The budget shows a reduction in the share of consumption spending, including employee compensation and goods and services. These elements of the budget are used intensively to provide basic education, healthcare, social services and criminal justice.

Lastly, choices are made about allocating budgets to different **spheres of government**, shown in Figure 7c. Again, this intersects with choices about policy functions. Education and healthcare are funded from provincial budgets; criminal justice, defence and social protection are national functions, while community development is largely delivered by local government. On average, therefore, spending by provincial governments grows at the slowest rate. The provincial equitable share, which mainly funds education and healthcare, grows by only 3.3% per year between 2019-2024, while conditional grants grow slightly faster, reflecting the fact that many of these grants support capital and investment activities.

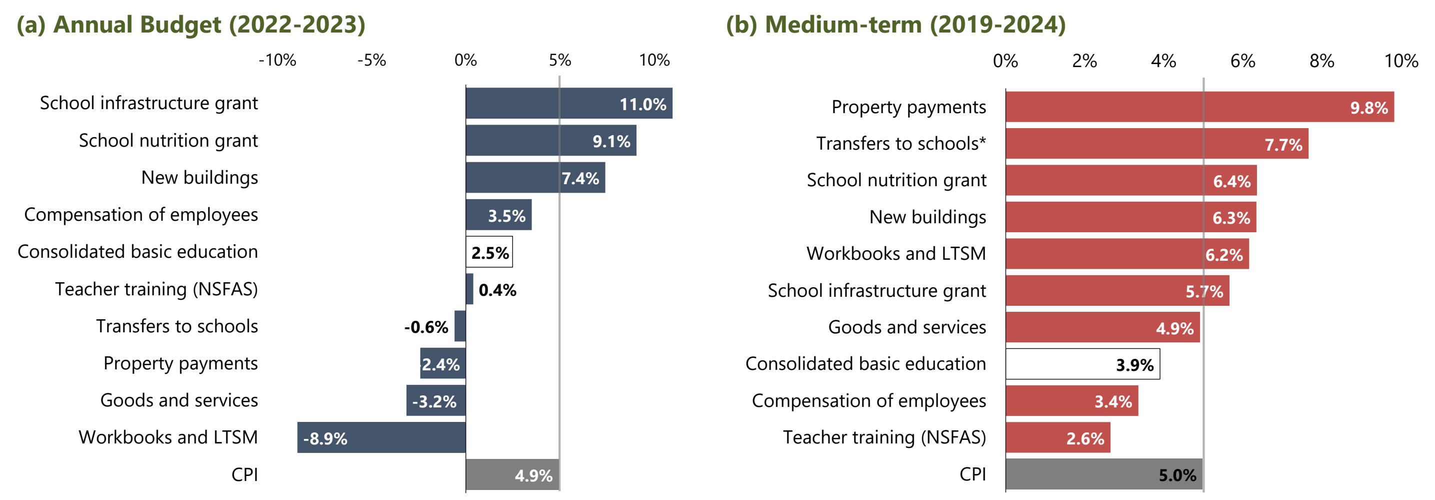
The fastest-growing element is the local equitable share, which is an unconditional grant aimed at subsidising free basic services for poor households, although used to fund operational spending in many municipalities. In a context where many municipalities appear unable to pay for bulk purchases of electricity, and where poor households face large economic shocks as a result of loadshedding. Funds were added to the local equitable share to offset rising electricity tariffs, and this is welcome support. However, funding for local government has been growing rapidly for more than a decade, and yet its fiscal, operational and governance crisis has continued to intensify. The recent move to forgive municipal debt to Eskom, attached to ostensibly stringent conditions, may also relieve financial pressure on the most insolvent local authorities. However, without a clear agenda to reform the municipal sphere of government and its fiscal arrangements, it is likely that these funding pressures arising will deepen requiring increased funding out of the national budget.

Education

In **basic education**, reductions in real spending per learner are expected to intensify in the period ahead. Real consolidated basic education spending for each enrolled learner was more than R24 000 in 2020 but will fall to R21 635 by 2025. This comes against the backdrop of significant learning losses associated with schooling lockdown during the Covid-19 pandemic. It is notable that no clear plan or budget has been tabled to reverse the impact of the school shutdown, or catchup on learning losses. A recent review concluded that "There has been no attempt to recoup time to remediate learning losses, apart from very recent attempts in one province. The insistence on a largely business-as-usual approach to curriculum implementation fails to recognise and address the severe educational impact of the pandemic, especially on learners in the poorest communities" (Hoadley, 2023: p1).

Budget estimates for basic education illustrate how lack of clarity about key budget issues make it very difficult to gauge government's policy intentions from the budget numbers (see Figure 8). On the one hand the budget proposes to cut spending on workbooks and other learning materials from R6.4 billion last year to R5.9 billion in 2023. Cash transfers to schools (which cover a sizable share of their operational costs) are also lower in nominal terms. Estimates for school property payments decline too, despite rising utility bills. All these items, however, have grown robustly in recent years and – if medium-term projections are to be believed – the cuts in 2023 will be fully reversed over the following years. Funding for new school buildings is also set to increase over the medium term. The school feeding schemes is protected in the budget, retaining its value both after inflation and taking account of the rise in learner numbers. Allocations by the Department of Basic Education to fund teacher training through NSFAS bursaries, however, have been falling for some time (in constant price terms) and this trend looks set to continue.

Figure 8: Basic education spending growth



* *Excludes provision for teacher assistant programme*

Source: National Treasury budget data; Public Economy Project calculations

These estimates are placed into doubt, however, by the conclusion of the 2023 wage agreement which, by our estimate, creates a basic education shortfall of R7.4 in the 2023 and R30 billion over the MTEF. This shortfall might be funded by reducing employment in the sector, which would have a huge and negative impact on learning outcomes (as is acknowledged very clearly in (National Treasury 2021:59, 2022b:42, 2022a:58). Alternatively, the shortfall might be funded by reduced funding for new school buildings, school nutrition, learning materials, or transfers to schools over the medium term. A third possibility is that resources will be added to the budget to make up for the shortfall. Indeed, past practice suggests that this will be the case: budget 2023 allocated an additional R20 billion to the provincial equitable share "mainly to cover shortfalls in basic education compensation budgets"(National Treasury 2023a:60). This follows similar action in the previous year's budget, which added R24.6 billion for the same purpose (National Treasury 2022a:53).

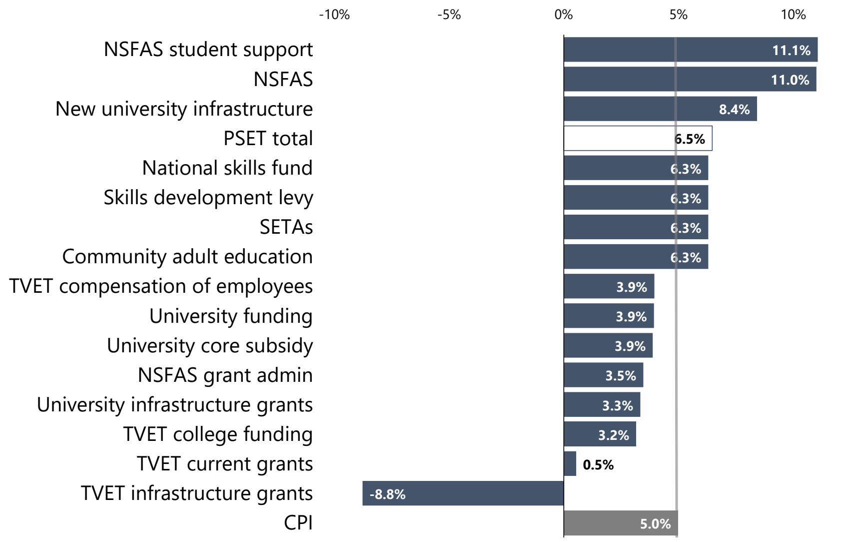
It is likely that a balance between these three options – reducing headcounts, defunding other line items to support compensation spending, or adding new resources into the education budget - will be sought during the year, resulting in a combination of these measures.

Added to all of this is uncertainty about the funding for teaching assistants, which makes up the lion's share of the President's flagship employment stimulus. A table in an online annex to the budget review indicates that R6.5 billion will be added to the equitable share in 2023 to fund the programme, but no resources are envisaged in 2024 and beyond. While evidence points to the potential benefits of teacher assistants when carefully selected and properly supported (see Ardington and Henry 2021), the significant resources allocated to this programme needs to be set against the concurrent fall in educator numbers and their real incomes, and the failure of government to allocate a budget to catch up from learning losses arising from the Covid-19 pandemic.

The subsidies going to **early learning** centres are significantly extended. The Early Childhood Development grant was allocated R520 million in 2019, increasing to a planned R1.7 billion in 2024 (a 30% increase). Relative to need however, the amounts remain small. The national grant is sufficient for 238 000 learners in 2022 rising to 486 000 by 2025[11]. However, it is estimated that there are more than 1.6 million eligible children (World Bank and DBE 2022). Moreover, the value of the grant is insufficient, and needs to be roughly doubled to be adequate programme operating costs at a minimum level of service (Ibid). Instead, the grant has been fixed at R17 per child per day since 2019, implying an 18% fall in its real value since then. There are also serious question marks about the shape of the ECD sector going forward. While the subsidy is currently channelled to independent ECD centres, the Minister of Basic Education said in her budget speech that "the current model of funding ECD programmes must be reviewed… it is important that a new holistic and inclusive model includes all communities of trust in the ECD space" (Motshekga 2023). It is unclear what this implies, but the Minister is keen to stress the role of state departments over independent service providers and appears to favour an downward extension of the formal schooling system, building on the success of grade R enrolments over the last decade. An ECD system based in government schools would be in stark contrast with the current approach and, if implemented, would likely involve a significant escalation of the programme's costs.

Figure 9: Post-school education spending growth (2019-2024)

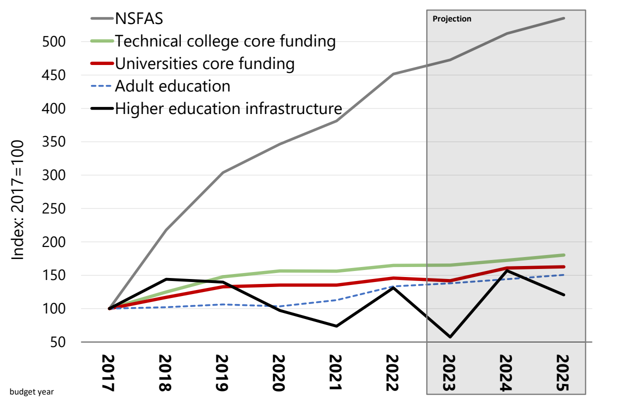
Selected items | Average annual nominal growth rate



Source: National Treasury budget data; Public Economy Project calculations

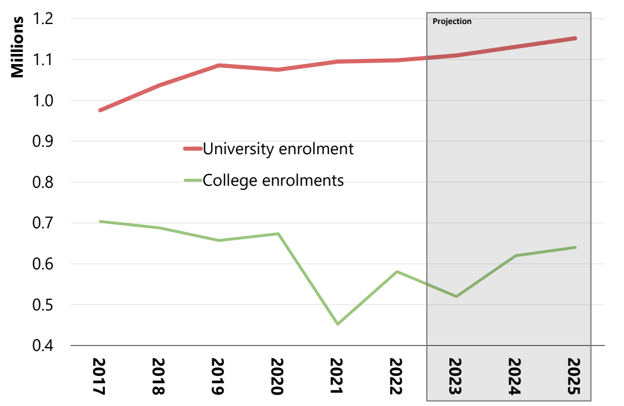
[11] This reflects the number of children that the national ECD conditional grant can finance. These funds are, however, complemented by provincial allocations out of the equitable share, which raise the number of learners benefitting from government programmes to the region of 630 000. Nevertheless "provinces report insufficient budget to reach all children eligible for the subsidy" according to the recent expenditure review (World Bank and DBE 2022:ix).

Figure 10: Index of Higher education spending growth



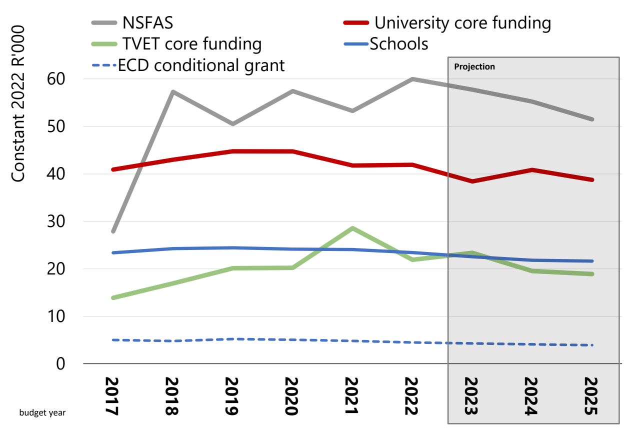
Source: National Treasury budget data; Public Economy Project calculations

Figure 11: Students enrolled in universities and technical colleges



Source: Estimates of National Expenditure

Figure 12: Real spending per learner



Source: National Treasury budget data; StatsSA, DBE, Public Economy Project calculations

Funding for the increase in the ECD grant was partly found by reducing the budget for **higher education**. The ENE reports that cabinet-approved decrease of R1.8 billion to the 2023 baseline to fund early childhood development. This has mainly been drawn from the capital budgets, with funding for university infrastructure slashed in 2023 to just R673 million, down from R3.5 billion last year. Although the medium-term plan is to return to normal funding levels in 2024, the budget pencils in an amount for university infrastructure grants in 2025 that is below the amount spent in 2017. Capital allocations for construction of the new Sol Plaatjies and Mpumalanga universities have also been cut in all three years of the MTEF, as has the budget for technical college infrastructure. Funding from these infrastructure budgets has (in addition to supporting ECD grant) also been shifted to finance the construction of nine Community Colleges, which aim to provide learning opportunities for adults.

Against this backdrop, it is surprising that the Minister of Higher Education said in his budget speech that the construction of two new Universities would commence "in the next year or two" (Nzimande 2023). The wisdom and feasibility of establishing a new "University of Science and Innovation" in Ekurhuleni and Crime Detection University in Hammanskraal, seems flawed and based on populist impulses rather than clear policy choices. At the very least, it is wholly inconsistent with the numbers presented in the department's own budget.

The cuts to capital budgets for universities and technical colleges come as funding for new student enrolments through NSFAS massively outpaces the rest of the budget (see Figure 10). The implication could be that a rising number of university undergraduates face a dwindling resource base as spending for lecturers, infrastructure and operating payments is cut. Such imbalances may lead to a deterioration in the quality of learning and teaching at higher education institutions, while the ability of universities to sustain research and post-graduate learning is also likely to come under continued pressure.

Despite this, expanded enrolment is clearly top of mind for the minister, who also declared that "the time has arrived for us to drastically increase intake in TVET and Community Colleges" (ibid). The first goal of the national PSET plan is the "massification" of the sector, with targets of 1 million enrolled in Community Colleges and 2.5 million learners in public and private technical colleges by 2030. These claims, however, are not backed by the performance targets reported in the ENE, which see robust growth in university enrolment contrasting with recent falls in technical college students. Although college enrolments are planned to increase, by 2025 they would not have reached the level of enrolment recorded in 2020 (see Figure 11).

Even assuming these modest enrolment figures, the budget for higher education implies a falling real spending per learner Figure 12). NSFAS looks to be stretching each rand further, allocating less resources per learner in the period ahead. Core funding for universities and technical colleges will fall faster, with real funding per learner dropping by 9% and 3% respectively between 2019 and 2024. Schools, on the other hand, face a much larger real cut over this period, amounting to 11%. The value of the national ECD grant per early learner will have fallen by 22% by 2025.

These are powerful indicators of inverted spending priorities in the education sector. The recent finding that 81% of learners in grade 4 cannot read for meaning in any language underscores the strong argument that failures at pre-school and foundation phase reverberate powerfully throughout the whole education system, and largely explain the high costs and poor learning outcomes of senior and post school education. Yet government continues to prioritise funding to the latter, in a perhaps futile attempt to reverse the consequences of failure to allocate greater resources to the former.

Healthcare

The Covid-19 pandemic left large backlogs in treatments and procedures in its wake. This adds to the pressure the health system faces in a context of rising poverty and hunger, and health crises triggered by failing social infrastructure. If Budget 2023 is executed as tabled in February, the public healthcare system faces a large contraction in 2023. This comes after a decade of falling real spending per capita on healthcare, with a modest reversal to fight Covid-19 (see Public Economy Project 2022).

The healthcare sector will lose R4 billion in funding in 2023 as temporary Covid-19 programmes come to an end. Table 2 shows these direct allocations since 2020. This includes spending on vaccines and grants to district health system to manage the pandemic.

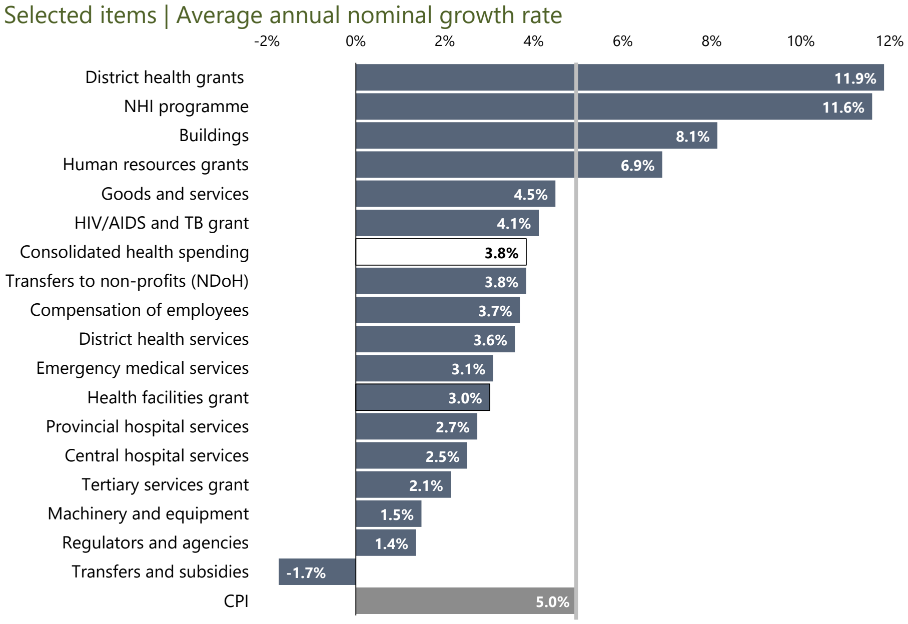
Table 2: Temporary Covid-related expenditures

R billion	2020	2021	2022
Vaccines and other medical inventory	0.5	7.6	2.1
COVID-19 component of the district health grant	3.4	1.5	1.9
Total	3.9	9.1	4.0

The path of compensation spending is highly uncertain in the wake of the pandemic. Provincial health departments employed additional staff on a temporary basis and it is not clear how many of these will be absorbed into permanent employment. On a consolidated basis, the budget estimated that compensation would fall from R164.4 billion in 2022 to R163.6 billion in 2023. This nominal drop reflects two assumptions. First, no cost-of-living adjustment included. Second, temporarily contracted staff – or at least a large proportion of them – will be let go. The first assumption has proven incorrect as an effective 3.3% cost-of living adjustment has been agreed. By our calculations, this gives rise to an R5.4 billion spending pressure in the sector in 2023, and R23.6 billion over the MTEF. In this context, there are serious concerns about the need to avoid paying for salary increases by defunding other components of health consumption (such as medicines, equipment machines, and services).

Figure 13: Healthcare spending growth (2019–2024)

Selected items | Average annual nominal growth rate



Source: National Treasury budget data; Public Economy Project calculations

The second assumption will be tested as provinces struggle with critical unfilled vacancies, and health workers struggle to find employment in the public sector. The last decade has seen falling employment in the sector, with many critical posts left vacant to meet budget pressures. The combination of a shortage of clinical staff and an unemployed surplus of trained personnel is difficult to sustain. National health policy supports a large expansion of employment to meet sufficient levels of clinical, professional and nursing staff, with the 2030 Human Resources for Health Strategy concluding that the shortfall in essential health workers will worsen by 2025 if health workforce expenditure only increases in line with inflation."(NDOH 2020:19). In this context it is likely that some proportion of contract staff will see their contracts renewed or be absorbed into permanent establishments. Another wildcard in the government health employment picture is the absorption of 50 000 community health workers onto governments payroll. The National Department of Health is working to permanently engage these contract workers, including them in collective bargaining arrangements. This approach is strongly supported by unions, and provincial departments are already acting to bring CHWs onto governments payroll.

Figure 13 shows how the health budget is changing over the medium term. It abstracts from the impact of the Covid pandemic by showing annual average growth between 2019 and 2024. Only four items grow in real terms (i.e., faster than CPI). Two of these are conditional grants from national government. The district health grant is relatively small: R3bn in 2023 in a district health services budget of R113 billion. Its rapid growth signals government's continued commitment to primary health care.

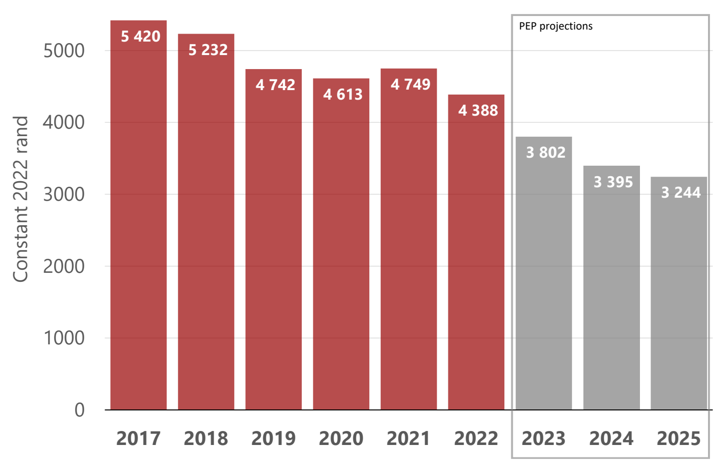
The second are human resources conditional grants, which have been increased to absorb medical interns and fill of community service posts, which are critical for student-doctors to complete their training, but also contribute to service delivery. Ideally, absorbing more medical interns and community services doctors should be balanced with employment of medical practitioners and specialists to train and supervise them.[12] In a context where the budget for compensation implies significant headcount reductions, the direction of travel may well point rising imbalances. More broadly, the sharp constraints on compensation and the intended resort to attrition to reduce headcounts and pay can adversely affect the balance between clinicians, nurses and auxiliary staff, all of whom are vital to an effective hospital services.

Overall, hospital services bear the brunt of the cuts to operational budgets, with central hospitals facing particularly intense financial pressure. While much of this reflects (assumed) cuts to employee compensation in the next two years, the budget also implies real cuts to spending on machinery, equipment, goods and services. This amounts to an across-the-board reduction in the resources available for hospital services at district, provincial and tertiary level

Funding for the NHI programme expands rapidly and this largely directed at capital expansion plans overseen by the National Department, including the construction of the Limpopo Central Hospital in Polokwane (funded from NHI indirect grant). The national department's budget for capital spending has doubled from around R750 million each year prior to the pandemic to more than R1.5bn each year over the MTEF. Financing for provincial infrastructure improvements grows at a far slower pace.

Expanded resources to revitalise existing facilities and build new hospitals may be a case of building in advance of demand. Allocations for healthcare workers, medical equipment and operating budgets are contracting in real terms and it is not yet clear when this decline will come to an end. Government will need to consider how expanded infrastructure will be brought into operation, the additional calls on the resource base of the system that are likely to be generated, and the reallocation of people and finances this may entail. When considering ambitious capital expansion programmes, it is important to remember that that capital budgets are often underspent. Until now, most facilities spending has mainly been provincial there is perhaps a chance that the national department will make a better showing, but this remains to be seen.

Figure 14: Real spending per user on anti-retroviral therapy



Source: Estimates of National Expenditure *Note:* District health programmes grant: Comprehensive HIV/AIDS component, deflated with CPI and divided by "number of clients remaining on antiretroviral treatment"

The HIV/AIDs and TB grant constitutes a large share of funding for district services, allocated for very specific purposes. Once we take account of increase in the number of people on antiretroviral treatment, the value of the grant per beneficiary looks set to fall. This might reflect savings in the procurement of drugs, but in the context of a depreciating exchange rate, the estimates of need look conservative.

[12] Lencoasa, Mapipa, and Chaskalson (2022)

Finally, it is worth noting the fall in transfers and subsidies over the last five years. This reflects three factors. First, pay-outs for medico-legal claims appear to have stabilized, and new legal approaches to settlement count ensure that this is a permanent shift. Second, provincial allocations to NGO's providing health services has also declined significantly, even while national funding for NGOs (reflected separately in the graph) have broadly kept pace with the budget. Third, provincial allocations to support municipal health services have also declined.

Social protection

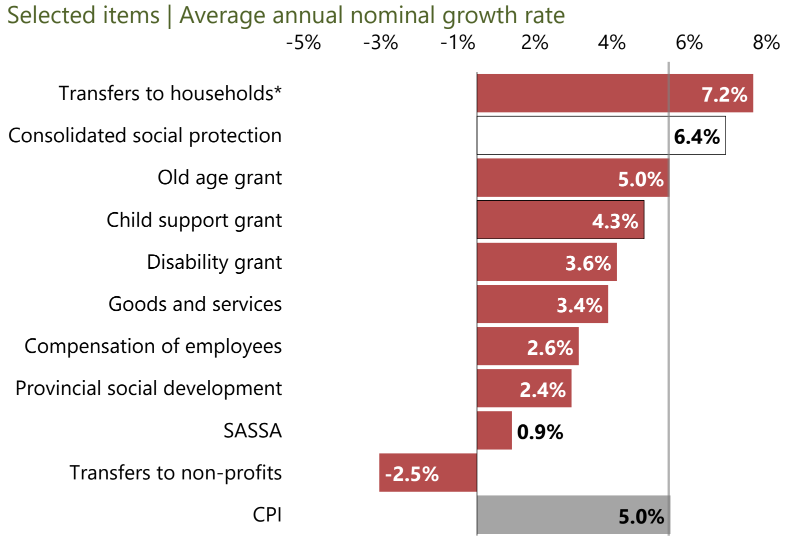
Government aims to influence the course and pace of development by directly intervening in society to address the challenges of poverty, underdevelopment and the marginalisation of vulnerable individuals and communities. National and provincial departments of social development play a critical role in addressing inequality, poverty, gender-based violence, and femicide in the country. To do this government allocates resources for social protection in the form of cash transfers, social services and social security funds. While national government manages the provision of cash transfers, social services are provided directly by provincial departments, and indirectly through a system of transfers and subsidies to nonprofit organisations. Social security funds are national entities governed by their own legislation.

The consolidated budget for social protection increases in real terms over the medium term (see Figure 15). This is largely driven by the introduction of the Covid-19 Social Relief of Distress grant (Covid-SRD) grant, which we assume will be extended beyond 2025. This grant required government to extend income support to working-age adults. More than 7.5 million people received the grant in 2022 (down from more than 10 million in 2021), and research shows that the Covid-SRD has provided much-needed help to the unemployed.[13] Three years since the pandemic, however, and government is yet to clarify the status and future of the grant. Not only have the number of beneficiaries fallen as more exclusionary regulations are enforced, but the monetary value of the grant has not been adjusted for inflation since its introduction at R350 per month in 2020.

The budget has not made any allocation for the grant beyond 2023 but the "unallocated reserve" of R35.6 billion in 2024 and R44.5 billion in 2025 almost exactly covers the shortfall in the event (which we deem highly likely) that the grant continues to be extended over the medium-term. Factoring in moderate beneficiary growth and assuming the grant will be adjusted for inflation in 2024, we estimate that there could still be a shortfall of R4.5 billion in 2024 adding to spending pressures facing the budget. The policy and legislative framework governing the current grant remains unclear, and government is yet to agree on whether it will be terminated, extended, or replaced by a more extensive and comprehensive system of basic income support for people of working age.

Figure 15: Social protection spending growth (2019-2024)

Selected items | Average annual nominal growth rate



** Transfers to household assumes that the "unallocated reserve" is used to fund the extension of the Covid-SRD grant*

Source: National Treasury budget data; Public Economy Project calculations.

Figure 15 shows that total spending on the old age and child support grants (which account for more than 70% of grant spending (even include the Covid-SRD) broadly tracks inflation over the period 2019-2024. Figure 16 shows value of monthly cash payments per recipient in terms of real purchasing power over a longer period. We have deflated monthly grant values with a weighted CPI index to reflect the price pressures facing grant recipients. As can seen the real value of both grants will be substantially below their 2019 level by 2024. The size of the real cut is particularly large in the case of the old age grant. For both grants, the erosion of the value of the grants will continue over the medium term with just in-line inflation increases, which will put pressure on poor households, particularly children, especially if food inflation continues to increase by

[13] (Patel, Dikoko, and Archer 2023)

double digits.[14] It can be seen, however, that grant values rapidly increased in the years prior to Covid-19, and the current course appears to be unwinding those gains.

The allocation for the South African Social Security Agency (SASSA), which administers and pays social grants on behalf of the department, falls in real terms over the medium term. This raises questions about the capacity of SASSA to deliver on its expanding mandate as the grant system is extended. Provision of social grants has also been affected by load-shedding, leading to interrupted services, and contributing to backlogs and longer waiting times for beneficiaries.

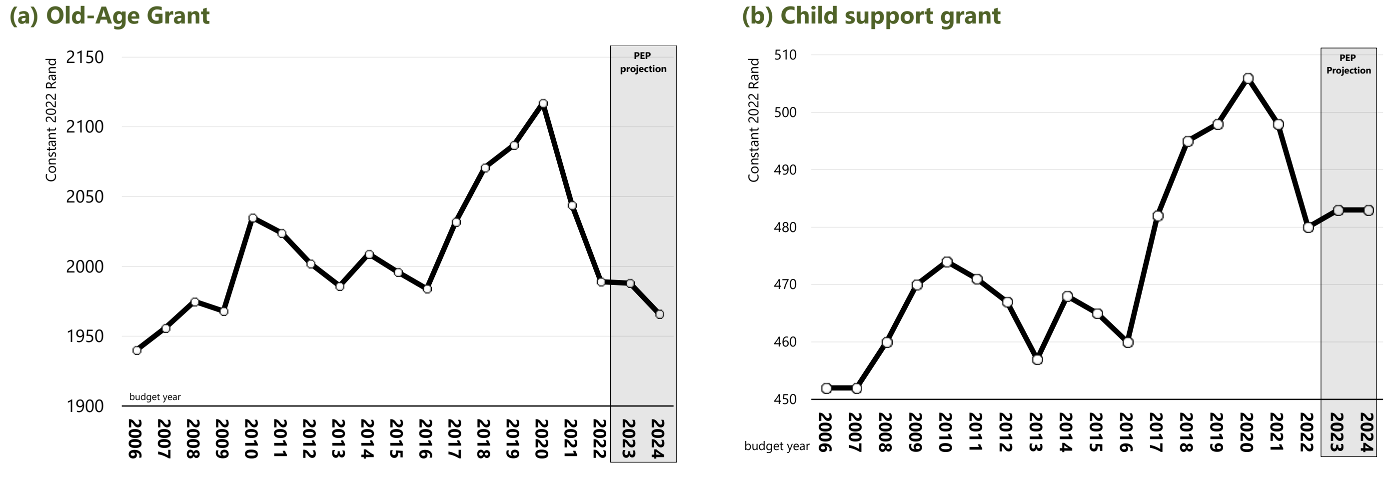
Unlike cash transfers, care services that respond to the social impacts of poverty, unemployment, drug addiction, abuse and violence against women and children depend on the employment of social workers, psychologists, and other social service professionals. As is the case for health, basic education and criminal justice, the 2023 budget implies an erosion of services with negative consequences for social development outcomes. Provincial social development departments, which provide social services, are seeing real cuts in spending while transfers to non-profit service organisations are being cut back severely.

The National Development Plan (NDP) envisaged a doubling of the social protection workforce nationwide by 2030 to 55 000 social workers. Currently, government employs approximately 18 948 social workers, with a small number contracted for a short-term period through the Presidential stimulus package. The department of social development estimates that the sector's workforce needs are underfunded by R9.6 billion and believes that new employment will be phased into over the next six years[15]. But the compensation budget is falling in real terms, as is the allocation to provincial departments who are the main employers of social care workers. This is another situation in which policy intentions and budget realities are walking in opposite directions. On current trends, the budget allocation could lead to a deterioration in the quality of services and, in some cases, a lack of service provision.

Transfers to non-profit organisations (which are an alternative to government-provided social services) face a large nominal cut in spending. In addition to its own social workers, government uses a pool of social workers in the non-profit sector. These NPOs provide critical restorative and social welfare services to children and families, HIV services, the elderly, child protection, and people with disabilities at the provincial level. Government's transfers to non-profits have been cut from about R7.3 billion in 2019 to just R76 billion in 2023.

The combination of falling employment of social workers and cuts in subsidies to nonprofit care services will reduce the availability of social welfare services to poor communities in South Africa. These shortfalls will increase the burden of care faced by household or family members, shifting responsibly from government to underpaid and unpaid women.

Figure 16: Real monthly value of old-age grant and child support grant



Source: National Treasury budget data; StatsSA (CPI inflation indices by decile). Public Economy Project calculations

[14] https://www.statssa.gov.za/?p=16254

[15] See Parliament of South Africa (2023)

Criminal justice and Defence

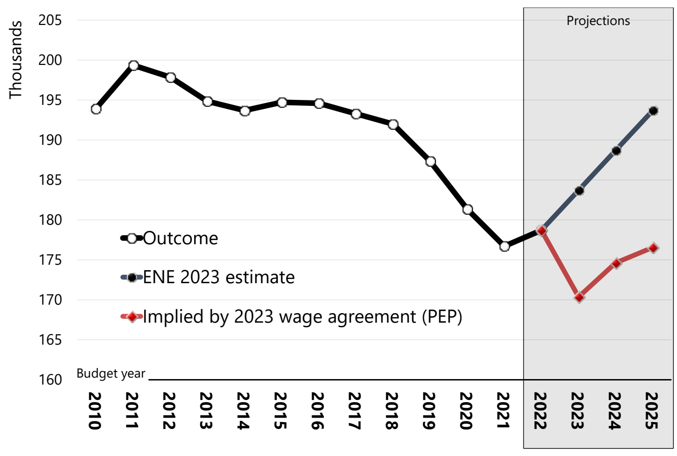
Real spending on criminal justice and defence will decline in the 2023 Budget. Nominal spending increases by an average of 2% between 2019 and 2024, far short of CPI and implying a real decline in spending of 2.9% per year over the period. The decline is not evenly distributed, as can be seen in Figure 18 below. Real spending on the National Prosecuting Authority and the Special Investigative Unit will grow by an average of 6.7% per year, which hopefully should support more effective prosecutions. All other components of spending will fall on a real basis, and spending on the air force and prisoner care will decline on a nominal basis. These nominal cuts will have a direct impact on service delivery.

Criminal justice, policing and defence are inherently labour-intensive activities, and spending on compensation of employees accounts of 70% of its budget. Goods and services account for a further 22% of spending. This means that these services will be severely impacted by the unbudgeted wage settlement, and government's overall commitment to reducing consumption spending.

It is important to note that the sector has already faced significant headcount reductions. Police headcounts have declined about 20 thousand personnel since the world cup in 2010 (see Figure 17). In contrast to previous budgets, which projected a continuation of falling headcounts, the 2023 ENE projects a reversal of this trend. The headcount projections show particularly strong growth in visible policing, detectives and crime intelligence, while slightly reducing the numbers of bureaucrats and VIP protectors. In his budget vote speech, the Minister of Police said that "a total of 10 000 police trainees have been enlisted in the 2023/24 financial year with the additional funds allocated in the previous and current budget allocation to SAPS. A total of 10 000 police trainees will be recruited annually for the next two financial years which will bring a total of 30 000 new police recruits in the MTSF period" (Cele 2023).

However, the headcount numbers in the ENE are not supported by the allocations for compensation of employees in the same document. Once we take account of the impact of the 2023 wage settlement, the budget implies a force reduction of about 8 000 personnel in 2023. This is unlikely to happen but gives an indication of the spending pressure faced by the department in the current year. Indeed, it is difficult to see how the police or the defence force will be able to accommodate the wage increase within the current baseline, and it is probable over the next year there will be cuts to budgets for capital, equipment and training, reduced employment through attrition and budget adjustments to prevent overspending.

Figure 17: Police employment



Source: Estimates of National Expenditure, Public Economy Project calculations

South Africa's crime epidemic has many causes, and there are strong and justifiable concerns about inefficiency, maladministration and corruption within the police service. Reform to police operations, particularly those that separate political from operational authority, and stronger efforts to root out corrupt and criminal networks are clearly required. However, any process of significant reform and change management is likely to be lengthy and difficult. In the meantime, declining budget allocations will directly impact service provision and add additional strains to the reform effort.

The South African National Defence Force faces similar challenges, but to an even larger degree, with the Minister of Defence indicating in her budget speech that the compensation budget was "underfunded by approximately R2,6 billion based on the actual feet on the ground". Last year the department of defence spent R2.5 billion more than its budget allocation, mainly on salaries. This follows expenditure overruns amounting to R3.2 billion in 2021 and R2.2 billion in 2020.[16] Yet its budget will be reduced further in nominal terms in each of the next two years. It is not clear how the defence force can continue to sustain operations in the face of such large declines, including critical peacekeeping operations in the Democratic Republic of the Congo and Mozambique that are vital to stability and security in the region. Again,

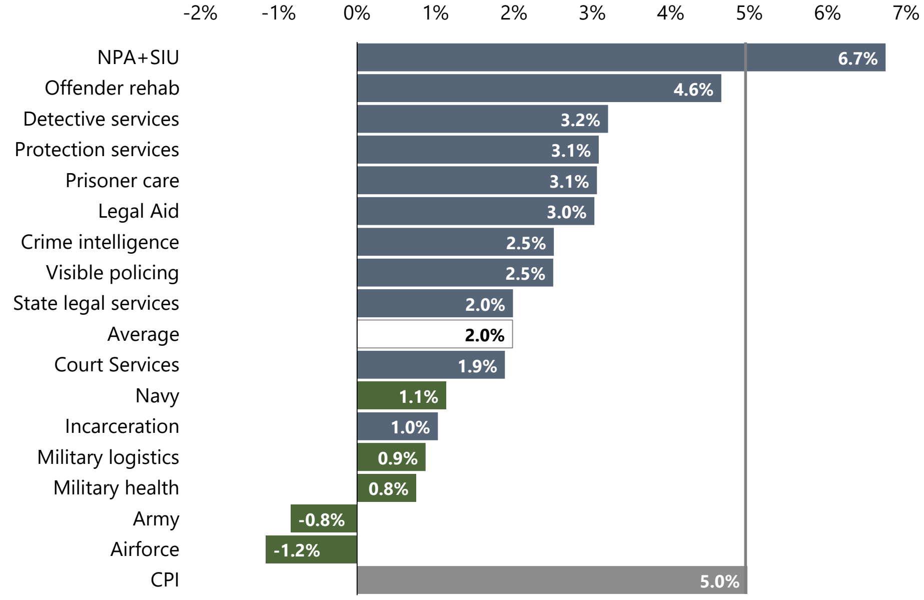
[16] Spending more the allocation provided by Parliament results in unauthorised expenditure. Compensation of employees is a special case because this allocation is ringfenced by Parliament, so overspending on compensation of employees results in irregular expenditure.

unlike other departments covered in this report, the Minister of Defence is unusually forthright the consequences of funding shortfalls for the capacity of the state, saying that: “A scientific evaluation of the SANDF has painted a bleak picture of our diminishing capabilities, largely because of persistent budget cuts. The ravages of underfunding and unserviceable capabilities against escalating tasks has had a devastating effect” (Modise 2023)

The solution to this acute fiscal squeeze involves a clear agenda of reform to force levels and operations. The increasing age of the SANDF means that fewer full-time soldiers are available for deployment, resulting in the use of reserve forces. The retirement of significant numbers of personnel, backed by a plan to permanently reduce the size of the force, and the nature of its operations is needed if the defence force is to operate within budget. As articulated by the Minister: “Every appreciation process of the DOD points to the inevitable need for more boots on the ground to execute the many tasks given to the Department. To the contrary, Government directs the downward manage of the human resource baseline. It is our duty to reconcile these mutually exclusive positions. Sustained funding of the SANDF remains an unavoidable requirement.” (Ibid)

Figure 18: Criminal justice and defence spending growth (2019-2024)

Selected items | Average annual nominal growth rate



Source: National Treasury budget data; Public Economy Project calculations

The prison system continues to house 33% more inmates than it has capacity for. This average hides the variation between facilities and in some cases, prison facilities must accommodate inmates up to 245% of capacity. Tuberculosis is endemic and understaffing results in prisoners spending much of the day locked up, sometimes with only a few minutes of exercise outside of their cells. This results in higher levels of self-harm amongst prisoners and injuries to others. There are higher levels of aggression, violence, drug use and other health issues. There is also evidence that overcrowding has resulted in an increase in gangsterism and smuggling of contraband, including drugs, negatively impacting the safety of prisoners who are not gang members (Sibisi and Olofinbiyi 2021). Prison officials are also sometimes harmed, and the Department has targeted keeping injuries to prisoners below 4.55% of the prison population.

The allocation for incarceration will grow with inflation over the medium term, but the allocations for other components of the department of corrections, for instance, the allocations for prisoner care and rehabilitation, face declining real spending. Any substantial improvement in prisoners’ living conditions is unlikely. Access to rehabilitation programmes or skills programmes that could be used for making a living outside of prison will be reduced. Increasingly, the corrections system could be forced into focusing only on detaining prisoners but doing less and less to help those prisoners become reintegrated into society once they have served their sentences. To reduce overcrowding, it is imperative that more prisons are built and staffed appropriately, but the Department of Corrections has a poor track record of completing infrastructure projects, underspending 30% of its capital budget over the last three years.

Public infrastructure and government buildings

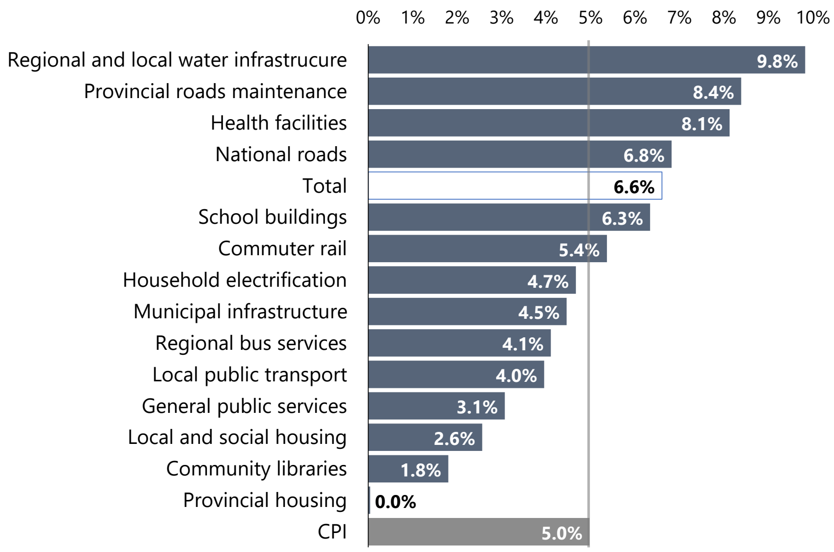
Government’s commitment to expanding infrastructure delivery is evident in the relatively strong growth of spending on several facets of public infrastructure (see Figure 19). Additions to the capital stock funded directly from the budget includes social infrastructure (such as school buildings, health facilities and housing), municipal infrastructure (funded by conditional grants) and the capital spending programmes of key public agencies such as the water boards, SANRAL (national roads), PRASA (commuter rail). Figure 19 also shows the growth in spending for public transport systems.

During the Covid-19 pandemic in 2020, most infrastructure budgets were cut but allocations were restored in 2021. Among the directly funded infrastructure programmes reflected in Figure 19, national roads account for the largest share, with spending averaging R48 billion per annum over the MTEF. It is also one of the fastest growing programmes across the whole budget. In additional to this strong commitment to road building, government allocated R24 billion to SANRAL as a capital transfer in 2022 to help repair its balance sheet, which has been damaged by the e-tolls fiasco. Allocations for the maintenance of provincial roads amount to another R12 billion annually, but this budget grows far below the rate of inflation.

Water infrastructure funded by direct allocations from the budget also increases.[17] The budget for local and regional water infrastructure grows rapidly, increasing from R8 billion in 2019 to a planned R17.1 billion in 2025. Spending on national water infrastructure is far smaller (around R3.5 billion per annum on average over the MTEF) by also increases faster than inflation. The budget for commuter rail has been increased since 2022, and this is retained over the medium term (although the increase in 2023 is meagre). Subsidies for regional and local bus services grow far below the rate of inflation. Given the sharp increase in petrol prices over the same period this must surely imply a significant reduction in service levels unless provinces and municipalities are offsetting the cut from their own resources. Expenditure on human settlements infrastructure is stagnant. Provinces spent R20 billion on housing in 2017, yet by 2025 the budget plans only R20.5 billion. Grants to local governments hardly grow faster and support for community libraries is similarly lacklustre.

Figure 19: Public infrastructure spending growth (2019-2024)

Selected items | Average annual nominal growth rate



Source: National Treasury Budget Data; Public Economy Project calculations

There are several risks to these ambitious infrastructure targets. The first is the high likelihood of underspending capital budgets. This is especially true when financing takes the form of conditional grants. The second is that the estimates in the outer year of the MTEF – which are the main driver of rapid medium term growth rates – may be moderated in future years to accommodate above-budget consumption spending. Lastly, executing infrastructure programmes requires effective state institutions. This is a serious constraint as instability in the water sector, governance failures in commuter rail and funding uncertainty for national roads have all led to poor outcomes in the past, despite substantial allocations.

Economic development and public employment

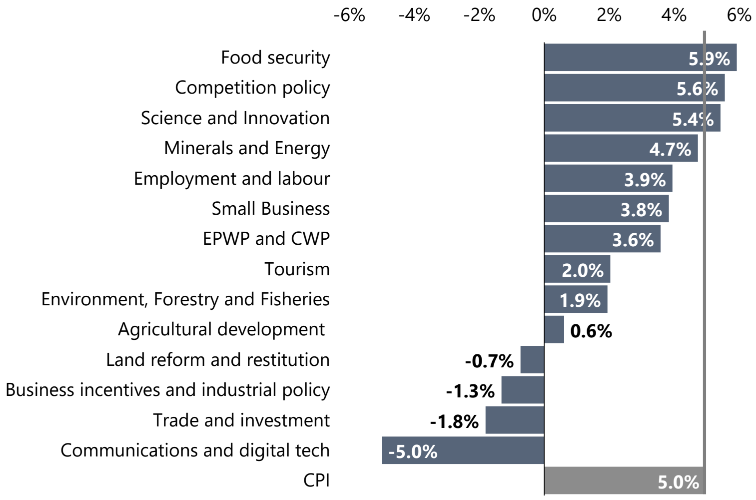
Spending on economic services and development policy is undergoing a major contraction. Only a few items will grow faster than inflation over the medium term – the department of science and innovation, the department of agriculture's food security programme, and competition policy. Otherwise, all elements of this group face substantial budget pressures. Many of the economic services are employee-intensive and the contraction is no doubt part of the broader planned reduction in government consumption spending and reflects the unrealistic salary assumptions that beset the core public services. On the other hand, this does not explain the very large reductions in allocations to land reform, industrial and trade development policy, and the department of communications.

Despite governments proclaimed commitment to expanding public employment programmes, the Presidents' flagship employment stimulus is unfunded beyond 2023, while the budgets for the legacy programmes (EPWP and CWP) grow far below the rate of inflation, even as they adjust to higher minimum wages.

[17] Note that this excludes infrastructure projects financed regional water boards on their own account.

Figure 20: Economic servcies spending growth (2019-2024)

Selected items | Average annual nominal growth rate



Source: National Treasury Budget Data; Public Economy Project calculations

The allocation for food security is one of the few in the budget group that is growing faster than inflation. Much of the spending on food security is conditional grants to fund farmer support, the Comprehensive Agricultural Support Programme and Kaonafatso ya Dikgomo, but not all provinces are able to use the allocation. While this is an obvious policy priority, the food security function has not been able to spend their allocation in the last two fiscal years, so it remains to be seen if the increased allocation will be spent.

In addition to the challenges of stagnant allocations to the department of agriculture, the sector has also had to deal with financial problems within the Land Bank, which has had to curtail lending. The department partners with the Land Bank on a blended finance scheme to support small commercial famers and has also announced a similar programme to enable farmers to generate their own electricity, an agro-energy fund. This is another example of the costs of the electricity crisis as government funds need to be diverted from their traditional function.

The allocation to land reform and restitution declines on a nominal basis, even as both processes appear to be failing. Given current levels of funding, the land restitution process is still decades away from being finalised.

Spending on business incentives is projected to decline by an average of 1.3% over the medium term. This will result in smaller subsidies for manufacturing enterprises. The flagship programme of industrial incentives, the automotive development plan, is mostly funded through tariff rebates[18] so this will not be impacted by the reduced allocation. Most of the benefits from the automotive scheme go to the large car manufacturing companies. Thus, the reduced allocation for industrial incentives is likely to be felt by smaller films rather than the major plans.

The department of communications and digital technology had a substantial cut in 2020, due to reallocations to fight Covid-19 and the allocation was not subsequently restored. The allocation remains small and this is clearly not a policy party for government. The allocation for 2025 (R2.6 billion) is predicted to be lower than that allocation of 2020 (R3.2 billion), even on a nominal basis.

[18] Tariff rebates on motor vehicles in 2020 reached R26.2 billion. By comparison, industrial incentives were only R4.9 billion.

PART III: IMPLICATIONS AND CONCLUSIONS

In this concluding section we consider three implications of the preceding analysis. First, decades of austerity budgeting in the context of rising policy incoherence is eroding the high quality of fiscal institutions in South Africa. Second, further austerity measures will be even harder to achieve in the context of macroeconomic disinflation and asks whether this approach is socially and politically sustainable. Finally, we ask what might be done over the longer term to break from the fiscal impasse that South Africa finds itself in.

The budget as an opening gambit amidst policy disarray

ChatGPT tells us that a credible budget "refers to a budget that is realistic, transparent, and trustworthy. It is a financial plan that accurately reflects the government's revenues, expenditures, and financial obligations. A credible budget is crucial for effective governance and economic stability, as it enables the government to allocate resources efficiently, implement policies effectively, and maintain public trust".[19] It is critical that the spending plans contained in the budget represent what will be executed, whilst fiscal balances estimated in the budget represent the most likely outcome, and the full extent of government's fiscal health and macroeconomic stance. The credibility of the budget is a core element of the capability of the state to coordinate resource allocation and manage an array of institutions in a manner that achieves clear policy goals that impact on social and economic outcomes.[20]

Over the last three years, annual spending has been between R20-R60 billion above the estimate tabled in the February budget. The spending ceiling is no longer an effective limit on cash allocations over the medium-term. Last year, the Minister of Finance tabled two adjustment budgets, and two special appropriations later in the year. This legislation changed the initial budget framework substantially.

Several factors lie behind this growing gap between budget plans and execution. First, most obviously, there have been pandemics, floods, social unrest, loadshedding, deteriorating transport infrastructure and global turbulence. All these uncertainties and unexpected shocks have made accurate budget forecasts exceedingly difficult in recent years. The flexibility of the budget system in this context is a boon. Had South Africa adopted an overly rigid fiscal rule prior to the crisis than necessary, warranted spending may have been prevented. At the same time, while uncertainty about the economic trajectory, revenue collection or the debt path is difficult to mitigate, government has direct authority over the spending plans it tables. Aside from the year of the pandemic, which called for major adjustments to annual spending plans, unforeseen developments do little to explain why annual limits should be exceeded to such a large degree.

A second factor, made clear in Part II of this report, is the growing gap between government's fiscal consolidation efforts and its broader policy agenda. A credible budget depends on a capable state with an effective executive authority. In the absence of clear and effective executive authority, the connection between budgeting and policymaking has become increasingly tenuous. Budget plans cannot but lack credibility where policy is incoherent.

Three years after the introduction of the Covid-SRD grant, government has not clarified the policy framework governing the grant, or decided whether it will be the basis of a more extensive system of income support. In the interim, reliance on ad-hoc regulation and annual budget extensions creates uncertainty and confusion. Access to the grant has been tenuous, while its value is eroded by inflation. Funding is made available for teacher assistants in schools, even while funding for teachers and textbooks is cut, without any policy statement about what this implies for the future of the public education system. The budget implies a significant contraction in the public healthcare system, with hospitals facing the largest cuts. NHI funding is focused on the construction of new hospitals even while spending on healthcare workers, medical equipment, and operational budgets are cut. Universities and colleges are having core funding and infrastructure finance cut, but the Minister of Higher Education is committed to a programme of "massification", which includes the construction of two new universities. A more prominent role in regional security is sought, while the defence force is effectively defunded. The President announces a large increase in police numbers even while his government's budget implies a substantial reduction in headcounts. (The list could go on)

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[19] ChatGPT answer to the question: "What is a credible budget for government?" https://chat.openai.com/share/5efb26f4-bc61-4c5d-ad76-98db3ca64bb5

[20] See Fölscher (2006); FFC (2011), Simson and Welham (2014)

Third, Treasury has begun to see the MTEF as a bargaining position rather than a reliable cost estimate of government's programme. It is an opening gambit in a process of policy negotiation that rarely reaches conclusion by the time the budget is tabled. Policy disputes are settled in budget adjustments or continued on the terrain of budget execution. The negotiating budget has been deployed in relation to the many uncertainties that bedevil the budget process. The Covid SRD grant is not directly funded in the 2023 MTEF, although provision is made for this in an "unallocated reserve". Public employment programmes, a central element of government's announced policy intentions to combat unemployment and revive economic growth, is still not included in the budget for 2023 and beyond. The most obvious and consequential case is in respect of the compensation of employees, where recent budgets have assumed a nominal wage freeze lasting over several years.

From Treasury's point of view, this bargaining strategy has delivered important results. While tax revenues have far outperformed budget estimates, nominal spending growth has been substantially curtailed. While cost-of-living adjustments have not been zero, they have ended up well below inflation; a significant shift from the previous path. The prospect of reversing government's commitment to a permanent extension of the social grant system has been kept alive. Negotiations for the design of new commitments are premised on the assumption that there is no fiscal space.

Already, planning for the 2024 budget has begun, with the release of the National Treasury's technical guidelines.[21] The starting point is that no additional resources will be provided to accommodate the unbudgeted salary agreement. Reliance is placed on reducing headcounts through attrition and reduced recruitment, and/or defunding other line items to support compensation spending. If the recent past is any guide, it is likely that new additional resources will be added, but only as an in-year adjustment that accommodates the lowest feasible amount. This will serve to contain compensation spending further yet result in spending outcomes that departs considerably from the budget.

What is being sacrificed in the process is the credibility, performance and quality of the foreword guidance provided by the medium-term fiscal framework. Human resource planning is severely compromised as sector departments are unable to gauge what their annual budget will effectively be and, while attrition systematically weeds out the best performers and those with portable skills. Pressure to fund the (unfunded) compensation budget will drive the build-up of accruals, and the neglect of maintenance and training expenditures. More broadly, government's own estimates of the fiscal trajectory are less credible to the extent that the expenditure path they are based on, is unlikely to materialise.

Is permanent austerity feasible?

The path proposed in Budget 2023 entails a large reduction in spending per capita over the next three years. Despite claims that this will "bring the fiscal consolidation to a close"[22], the plan appears to keep the rate of real spending growth below the population increases over the medium-term. This was even before the Minister of Finance warned, not two months after the tabling of the budget, that "the macro-fiscal position presented in the budget has changed adversely and significantly"[23]. Slowing growth and tightening financial conditions have now meant that even the austere path proposed in the budget may be insufficient to achieve debt stabilisation.

The IMF has proposed additional consolidation measures of 3 percentage points of GDP. This amounts to a nominal spending cut of R210 billion over the next three years. The bulk of the additional cuts proposed are targeted at compensation of employees, with the Fund advising government to (continue to) apply below-inflation cost-of-living adjustments while reducing allowances and pay progression to save 2 percent of GDP over the medium term.[24] Already departments have been advised to fund the wage bill through attrition and cuts to other budgets.[25]

If past behaviour of the system is any guide, further attempts to push down the wage bill with across-the-board cuts will result in a curtailment of services, a reduction in employment of nurses, teachers and police officers and deterioration of the public systems that support them. Continued austerity – whether warranted or not – certainly implies the further erosion of South Africa's social state. Over the longer term, then, it is not clear how much longer

[21] National Treasury (2023b)
[22] National Treasury (2022b:iii)
[23] Godongwana (2023)
[24] IMF (2023a:18, 94)
[25] National Treasury (2023b)

spending growth can be curtailed without grating against South Africa's deep social fissures or provoking political turbulence.

Attempts to sustain austerity will also face a much more difficult macroeconomic terrain. As we noted in Part I, unanticipated inflation over the last four years helped government to achieve limited fiscal consolidation. While the reduction in nominal spending limits must be explicitly and painfully negotiated, inflation reduces spending across all line items by stealth. Inflation is anticipated to moderate over the next few years, and the central bank appears determined to lower its effective inflation target over the same period. Government will be forced to implement the more (politically) difficult task of reducing nominal expenditure (i.e. larger cuts to departmental baselines) rather than rely on the broad sword of inflation.

Over the medium term, South Africa faces large and sustained macroeconomic headwinds from the combination of fiscal, financial and monetary tightening. The attempt to lower the inflation target while also enacting larger cuts to nominal spending seems to be an unattainable combination. In the absence of a sustained acceleration of real economic growth, fiscal consolation in the face of disinflation is likely to be politically dangerous terrain to cross. Indeed, the campaign to lower the inflation target may reflect the realisation in the banking and financial sector that the budget will be unable to deliver the necessary consolidation. In that context, a path of rising interest rates may be judged a substitute for debt stabilisation.

The path of more sustained and deeper austerity will slow economic growth in the short term, and widen inequality and social deprivation permanently. As government service provision is reduced, further space will be created for the private sector to come in and extend its own provision of education, healthcare security, and other collective goods, allowing for the growth of those sectors. However, such growth is likely to be highly inequitable because those who shift towards private provision will have to pay for services that were previously accessed free of charge. At the same time, those whose incomes are too low to access private services will see a direct erosion in the economic value of the government services that they rely on.

Escaping the fiscal impasse?

In this context, how should South Africa think about overcoming the current fiscal impasse? In respect of the expenditure consolidation, **a clearer plan backed by policy choices is required**. One way or another, government needs to bridge the chasm between its policy agendas and its fiscal consolidation plans. Spending cuts should be backed by clear and explicit plans that protect frontline services and limit the fall in government employment. This means identifying services and programmes that are to be curtailed to maintain frontline services and (far more challenging) ensuring political backing for the process. It means accepting the need for a fundamental redesign of government programmes to improve effectiveness and achieve productivity gains. This amounts to a structural reform of the public sector, changing the way key institutions – including hospitals, local governments, the defence force, or infrastructure agencies – operate and are financed. If government continues to lack clear policy direction or fails in the attempt to reform the public sector, it will be forced to feed increasing public resources into growing dysfunction simply to prevent the collapse of systems. The alternative is to add defunding to dysfunction, which could tip social systems over the brink of collapse.

Second, government should consider reforms of **fiscal institutions** that restore the credibility of the budget. The most important dysfunction in this regard is the relationship between centralized bargaining and budget planning. A reform of fiscal institutions that anchors expectations of growth of the salary bill should be considered. This would enable a better alignment between fiscal objectives and the need to sustain the services which form a core part of South Africa's fragile social and political compact. The current structure of collective bargaining focuses solely on the value of annual cost-of-living adjustments, without any meaningful discussion of productivity. Instead, government could negotiate a longer-term compact with its employees that balances the need for decent pay, sufficient employment and measures that improve productivity.

Third, in a context where hard choices are being made about spending priorities, the question of a more appropriate **balance between taxes and spending** in the consolidation process needs to be reconsidered. Removing the tax expenditures on retirement income (which largely benefits the most affluent households) and medical aid contributions could between them yield 1.5% of GDP. An increase in VAT may also be required to finance new social obligations. User charges and cost recovery for non-poor users of public services and infrastructure also needs reconsideration. This needs to go together with a rethink of the local government system, which remains mired in a crisis of non-payment that is shifting an ever greater burden of financing onto general taxation.

Finally, it is important to remember that the **fundamental factors** driving the unsustainable fiscal position – slow economic growth and high interest rates – are more important than fiscal policy itself. Stabilising the increase in debt requires a sustained improvement in economic growth, and an easing of financial conditions. This will require action to fix the electricity supply constraint, restore critical export infrastructure and, most importantly, articulate a clear and credible plan for growth and development.

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