Budget 2024
Austerity mission accomplished?

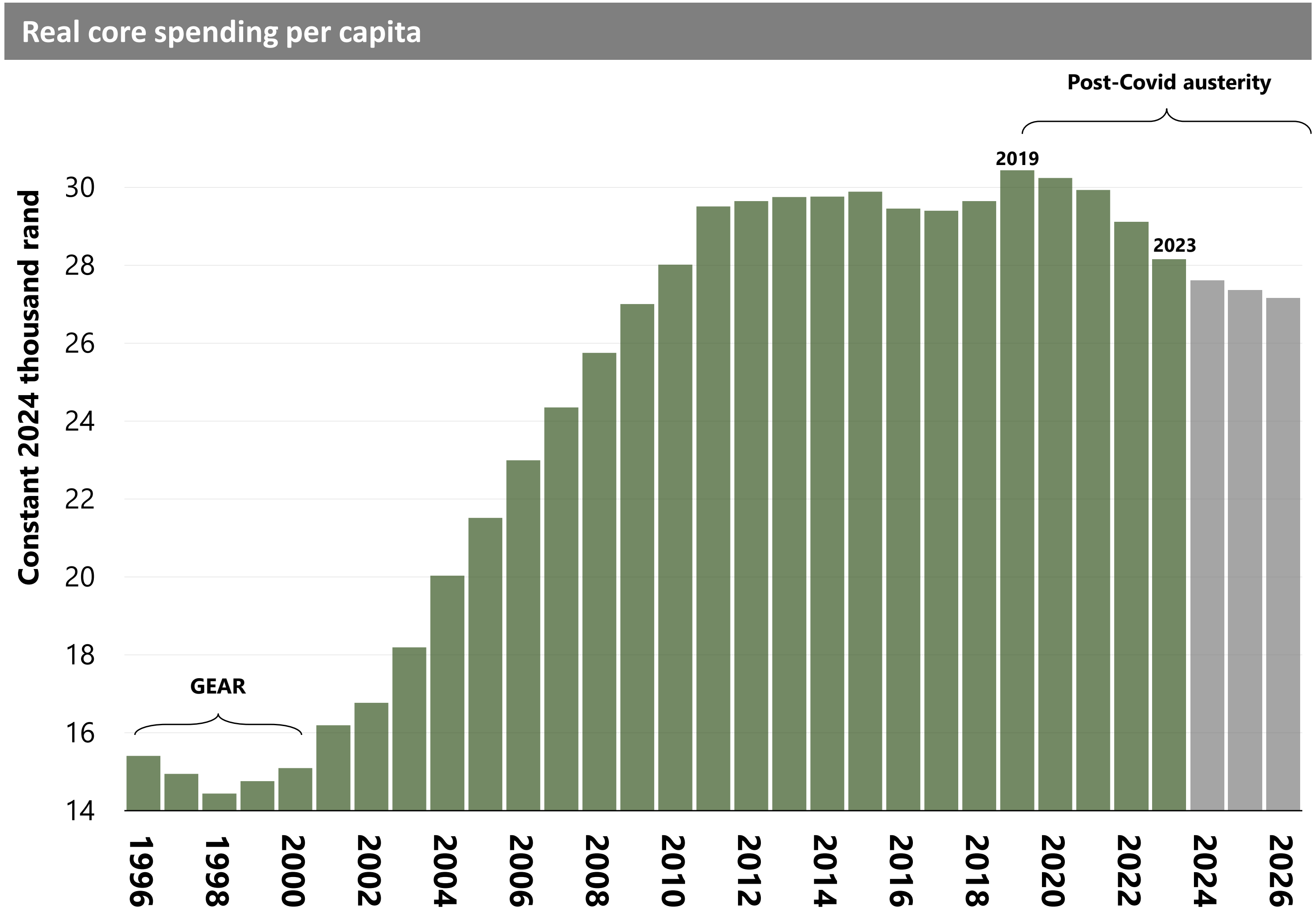
Public Economy Project Submission to Parliamentary hearing on the budget

Wednesday, 28 February [online]

VERSION 1: PRE SUBMISSION

Austerity mission accomplished?

- Government has reduced real spending per capita over the last five years
  - Since the COVID pandemic, core spending has fallen by R2,325 per South Africa from R30,440 (in 2019) to R28,116 (in 2023).
- This has been the largest expenditure reduction in South Africa's democratic history.
  - The last period of austerity associated with GEAR led to a 6.3% reduction in real per capita expenditure
  - The post-COVID austerity has already seen a reduction of 7.6%.
- The budget envisages a continuation of austerity, aiming to reduce expenditures per person a further 3.5%, or nearly R1000 per South African

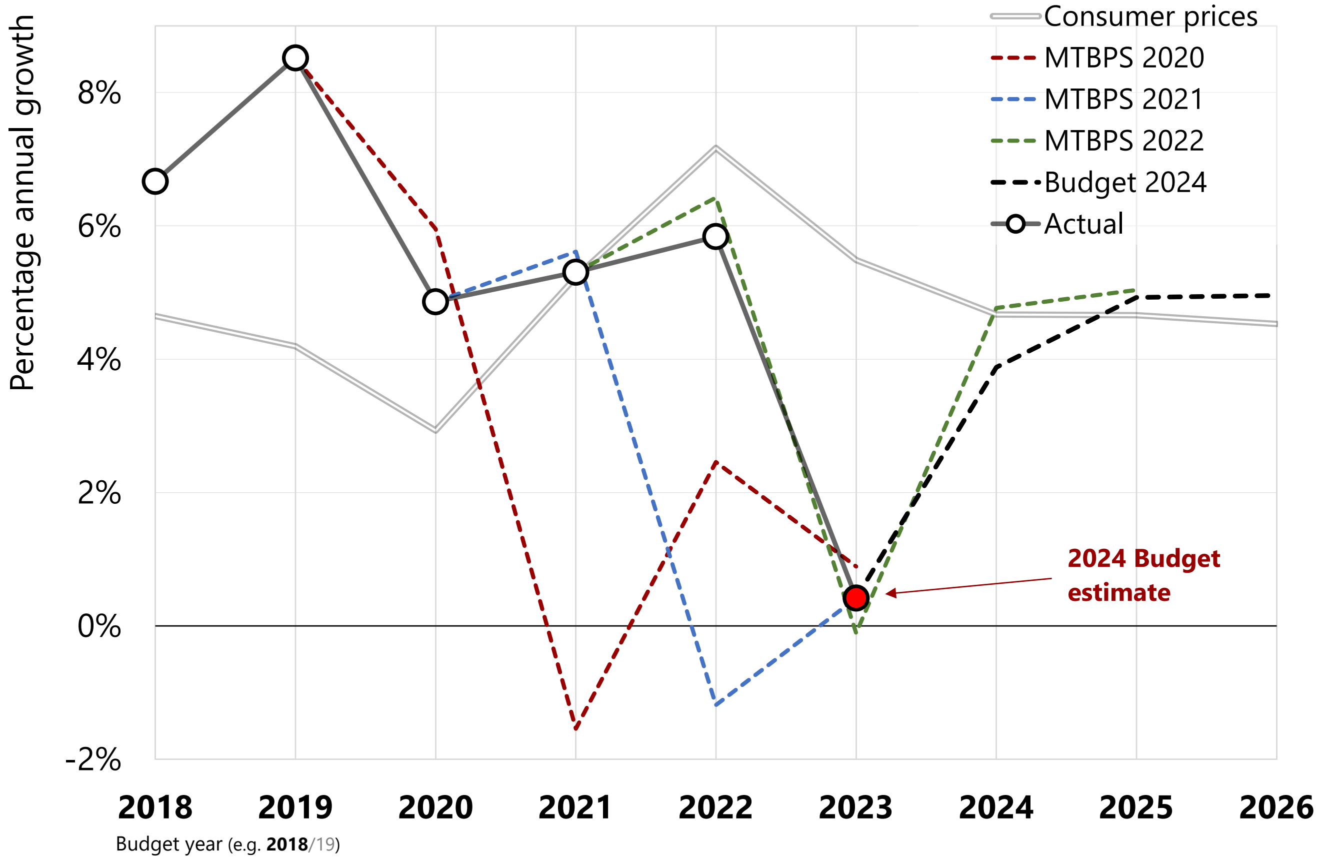


Source: PEP calculations using NT and StatsSA data.
Note: "**Core spending**" is main-budget, noninterest expenditure excluding capital transfers to state-owned companies, skills levy expenditure and fuel-levy sharing with metros.

2023/24: the crunch year that is nearly behind us

- Treasury stuck to its guns, bringing expenditure growth to nearly zero in 2023/24.
- This sharp shock was planned for three years but has finally been delivered.
- Tight control over the authority to use cash has forced departments and provinces to comply.
- For most government departments, February and March are critical for annual spending. It is likely that obligations will be shifted into April.

Expenditure ceiling: Planned and actual nominal growth rate

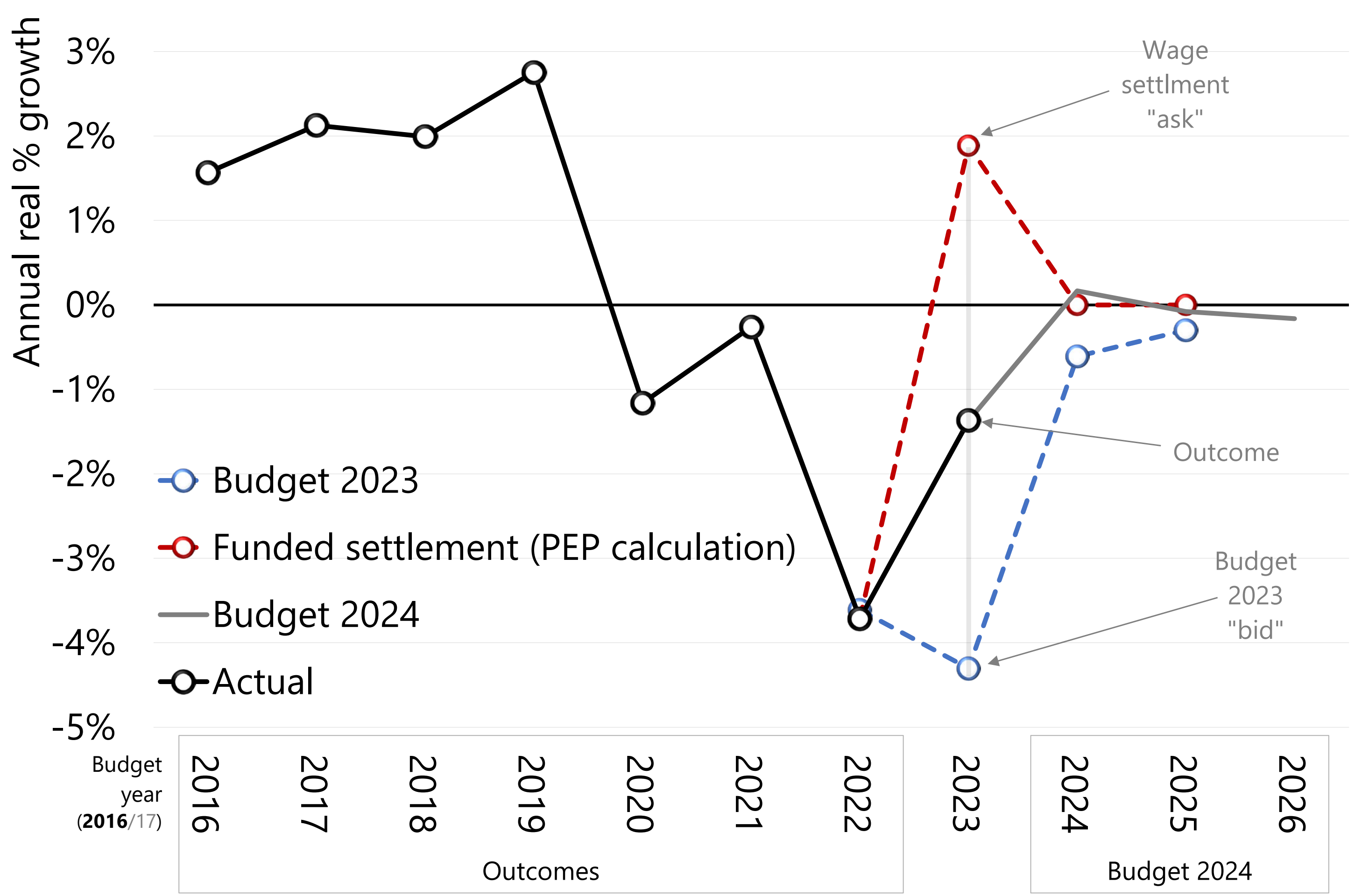


Source: Public Economy Project calculation based on National Treasury budget data

Salary bill contained

- Compensation spending has fallen in real terms for the last four years.
- Treasury's approach of using budget documents to negotiate a lower path of spending has paid off: The actual path of compensation spending is
  - higher-than-budgeted
  - but well below full funding of the wage agreement.
- Underfunding of the wage bill is **locked-in** to future budgets.
- If wage bill growth aligns with CPI from 2024 on, headcounts will need to fall, permanently reducing the number of government employees

Real growth of salary bill

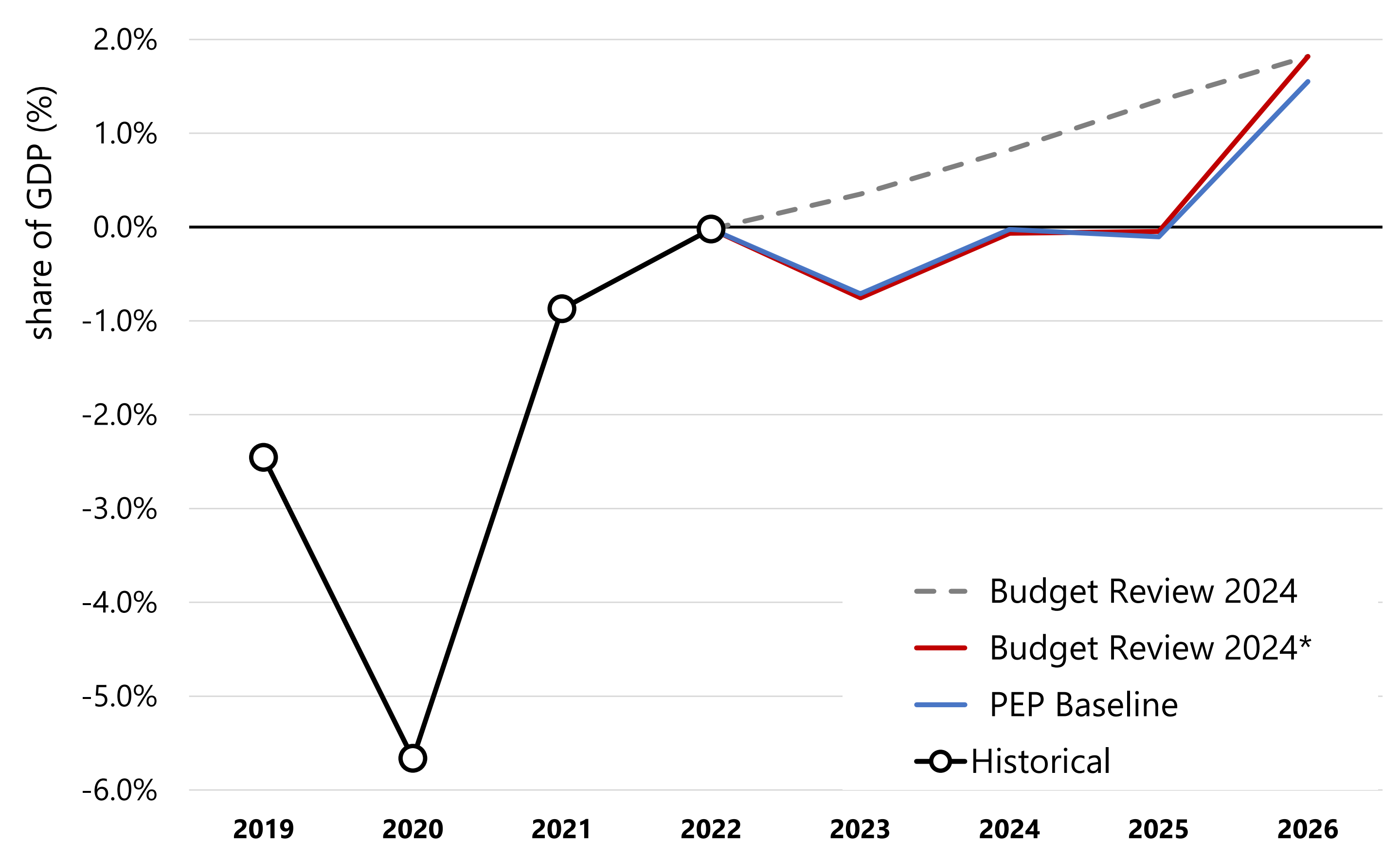


Source: PEP calculations, using National Treasury Budget Review, Table 5: consolidated national, provincial and social security funds (compensation of employees spending deflated with CPI

A more realistic path to consolidation

- Macro assumptions informing the fiscal framework are generally in line with market expectations, with risks to the upside
- Expenditure assumptions appear to be more plausible compared with previous budgets
- However, NT's exclusion of payments to Eskom from non-interest expenditure incorrectly suggests a primary surplus from the current year.
- Including payments to Eskom "above-the-line" suggests the elusive primary surplus will be realised in the outer year of the MTEF, allowing for debt stabilisation.
- This assumes that major funding to strengthen SOC balance sheets will not be required after 2025.

Primary balance as share of GDP

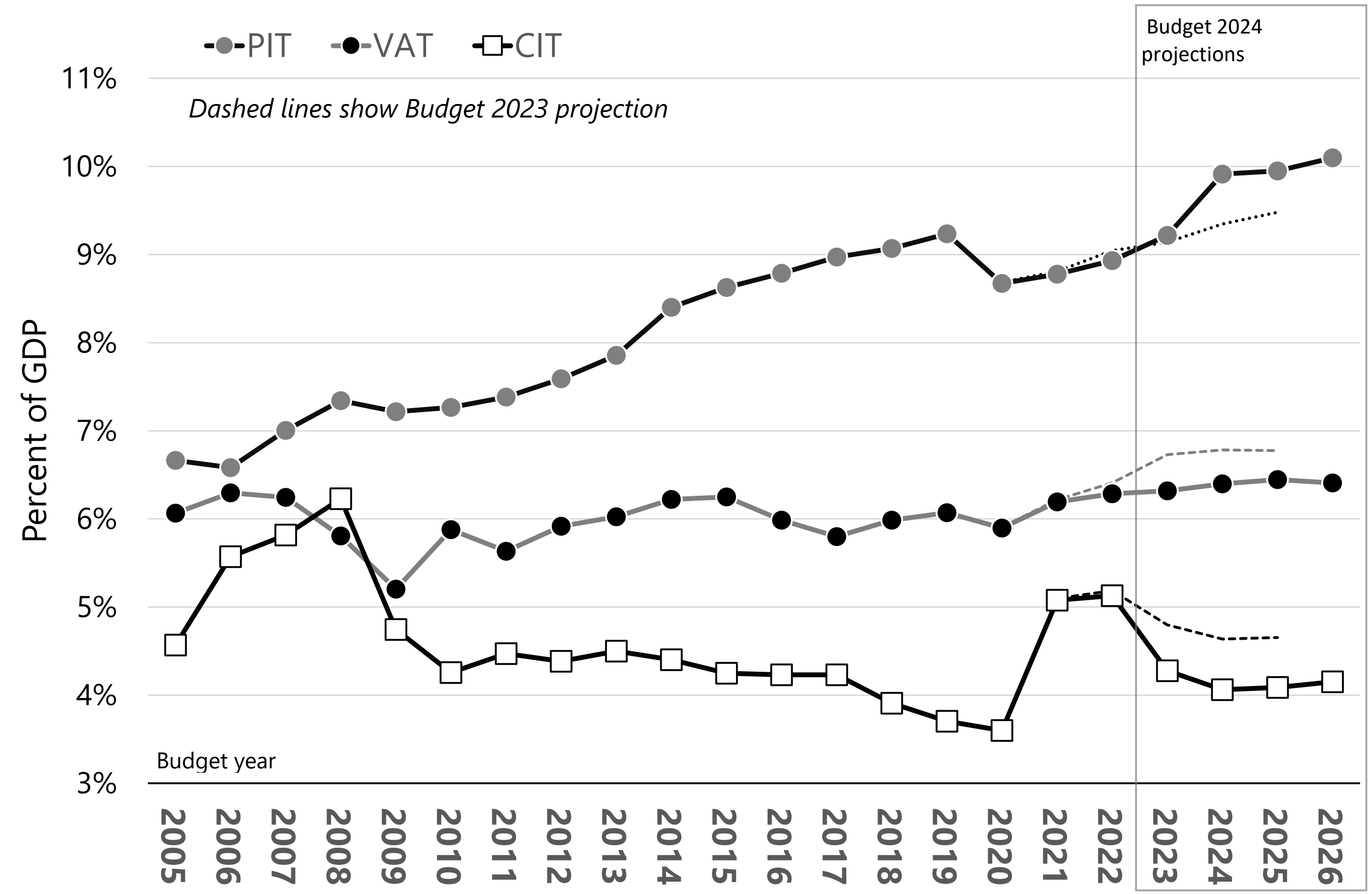


*includes payments to Eskom

PIT to the rescue once more

- Optimistic projections of CIT and VAT in last year's budget have been reversed.
- PIT takes up an increasing share of the tax burden. This year's PIT hike is through fiscal drag (see next slide)
- The shift towards greater reliance on PIT is a long-term trend:
  - This would make the overall tax system increasingly progressive (because PIT is the most progressive element of the system).
  - It is unclear how long it can last and what its limits might be.
  - The question of alternatives to PIT; other i.e. policy changes to other tax instruments remains important.

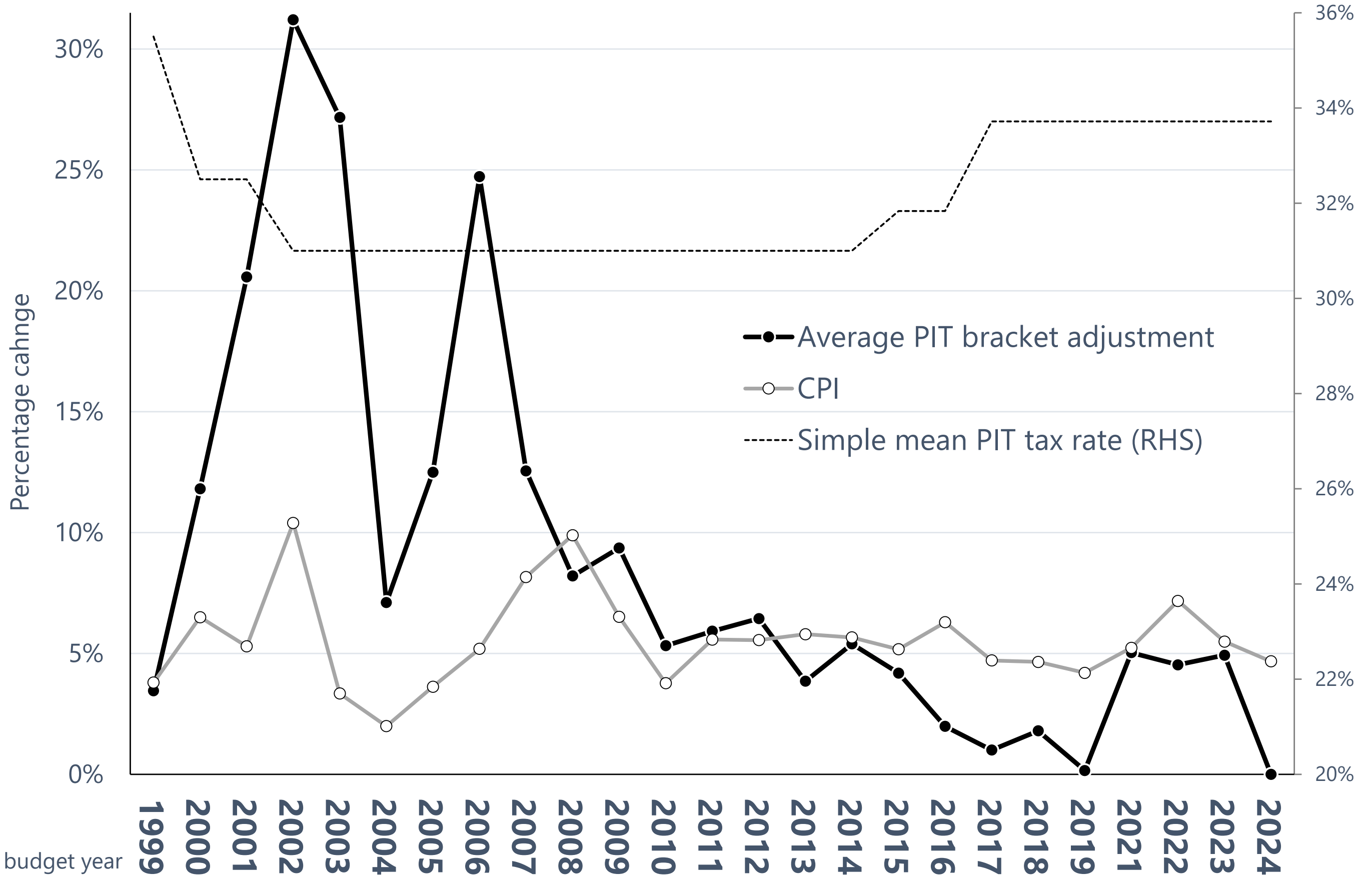
Main tax instruments: Tax take as a share of GDP



Fiscal drag is regressive and procyclical

- Resorting to fiscal drag is preferred to changes in PIT rates
- Unfortunately, it is exercised in a procyclical manner (i.e. adding to private demand during the boom and subtracting from private demand when times are tough (like now))
- Compared to (i) raising PIT rates or (ii) using other tax policy options; resort to fiscal drag is
  - Regressive, with its largest impact at the bottom brackets of the income tax schedule
  - Inefficient, and likely to be growth retarding compared to other tax policy options

Nominal adjustments to PIT tax brackets compared to CPI inflation



Source: Public Economy Project calculation based on National Treasury budget data

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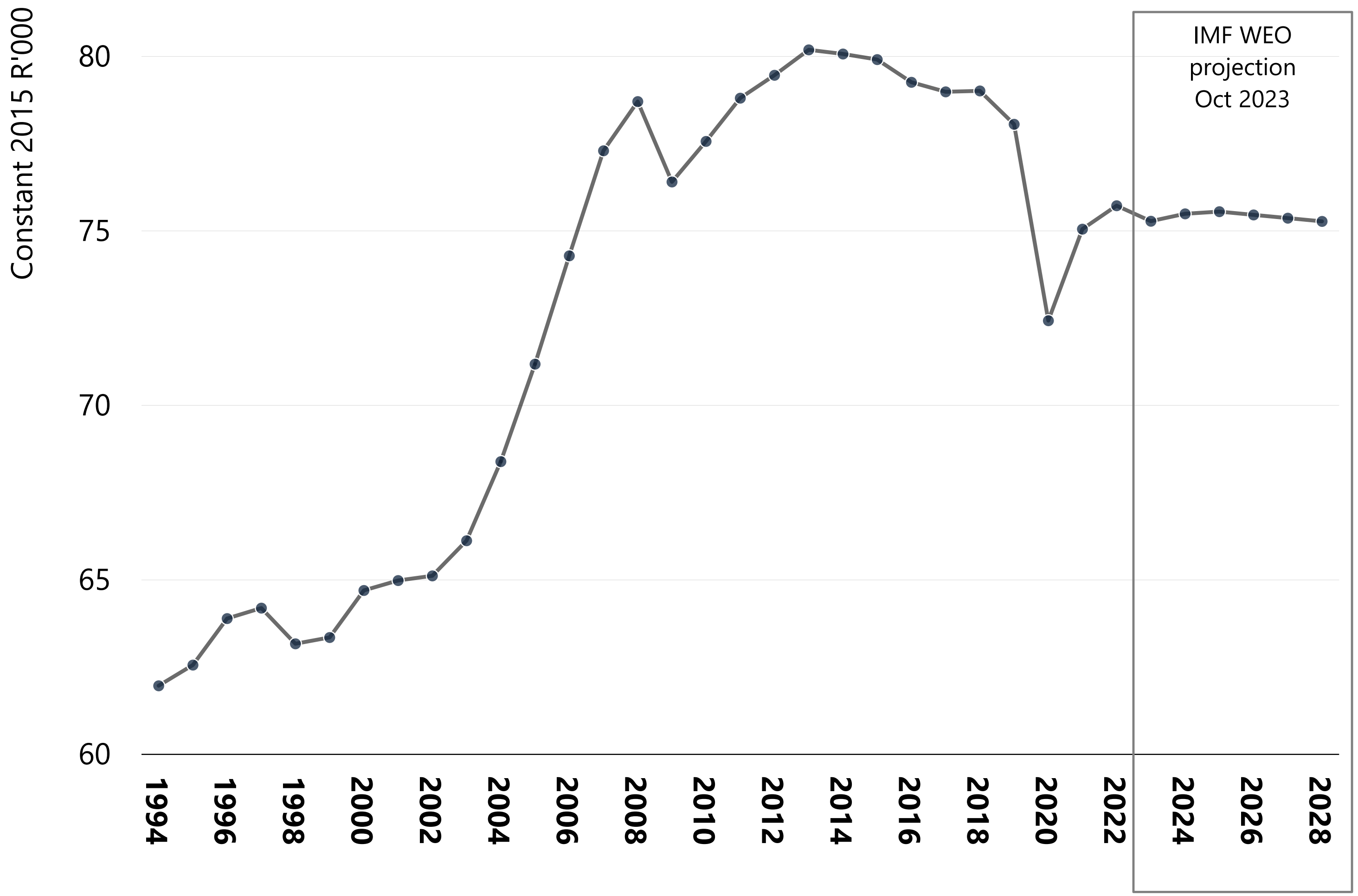
Context for austerity budgeting

Economic stagnation

- South Africa faces binding fiscal constraints because of a decade and more of economic stagnation
- Fiscal expansion does not appear to be the path out because
  - The economic crisis is long-term and structural in nature.
  - Right now, supply-side constraints appear binding, and market sentiment is negative.
  - Fiscal expansion is likely to raise (long-term) interest rates faster than it raises growth rates.
- In a best-case scenario, fiscal expansion could complement reforms (if government had a clear and credible reform plan)

GDP per capita at constant 2015 prices

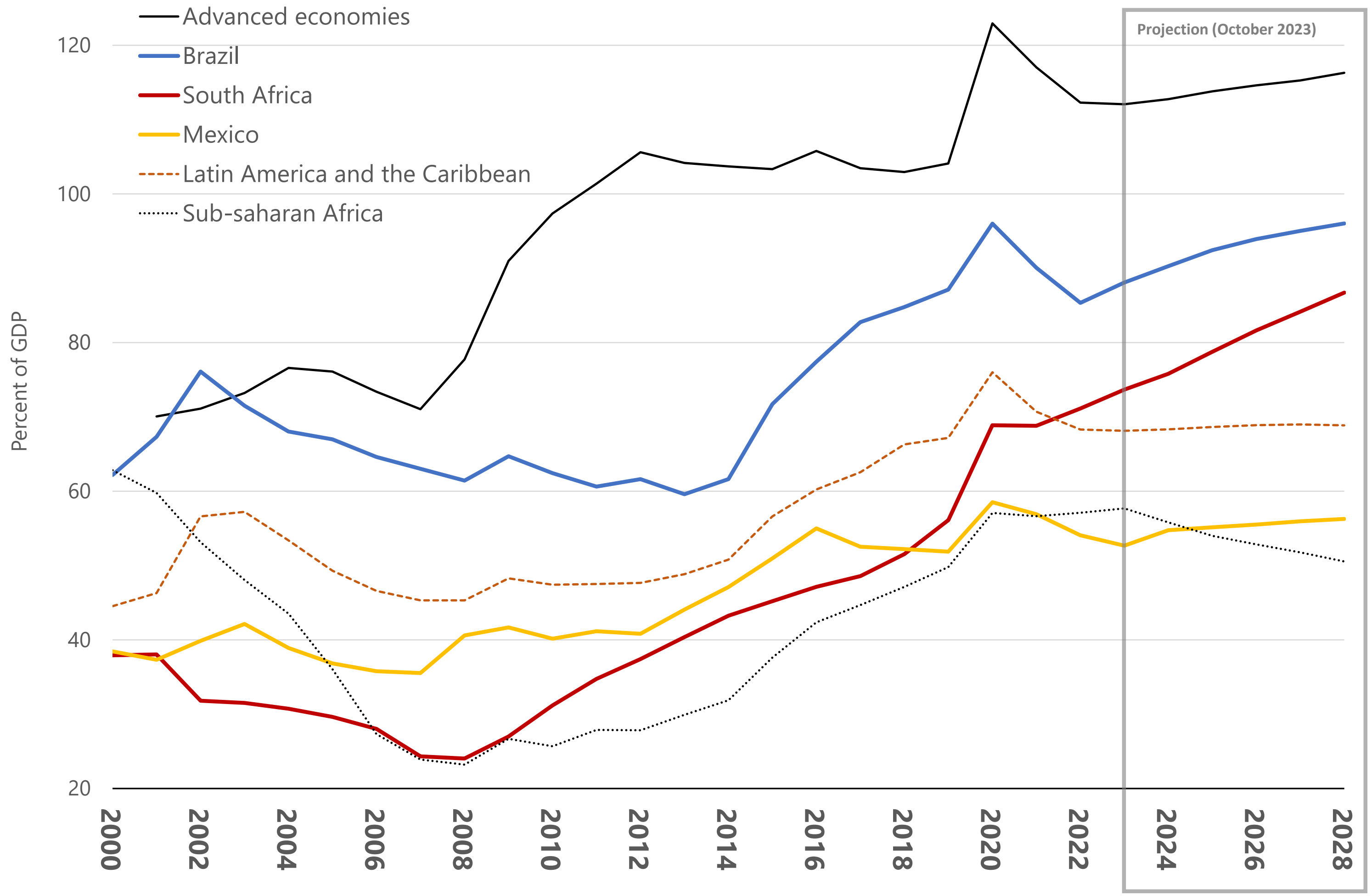


Source: SARB QB (S-160) - December 2023 No. 310, KBP6270y; after 2022, base is grown by annual % change in IMF GDP per capita estimate (WEO October 2023)

Debt rising faster than income for two decades

- South Africa's debt has been rising faster than income for more than two decades
- It remains likely that South Africa's debt will continue to rise into the future, as long as the economy continues to stagnate
- The combination of rising debt and economic stagnation means high and rising interest rates on debt

Debt-to-GDP ratio: 2000-2028

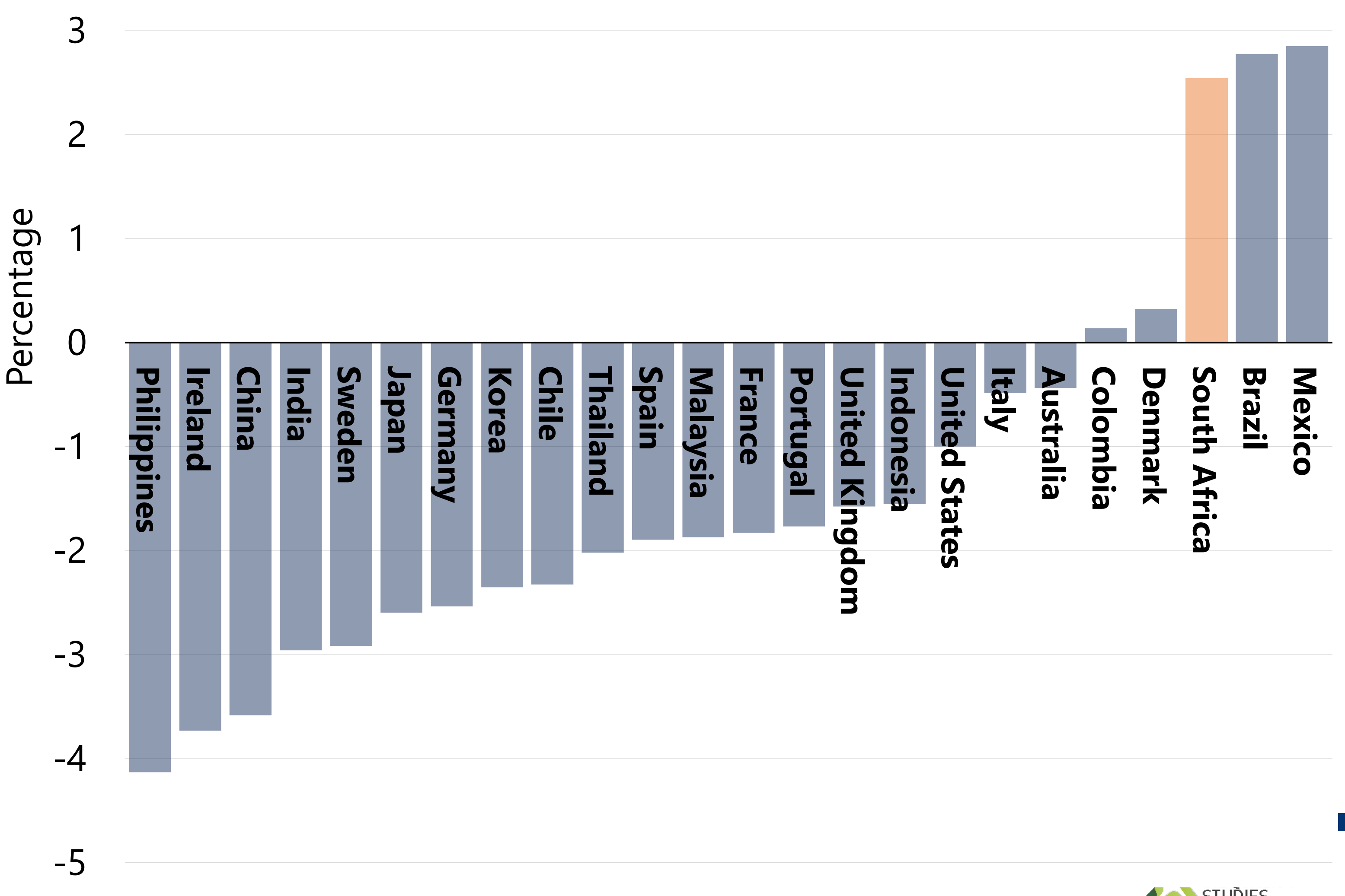


Source IMF (WEO October 2023)

Low-growth, high-interest trap

- Rent on debt is growing faster than national income.
- South Africa is in a low-growth, high-interest rate trap.
- The fact that r>g on a sustained basis, and by such a large degree, points to the unsustainable character of the current fiscal position and drives austerity.

Projected Interest Rate–Growth Differential, 2023–28 (percent)

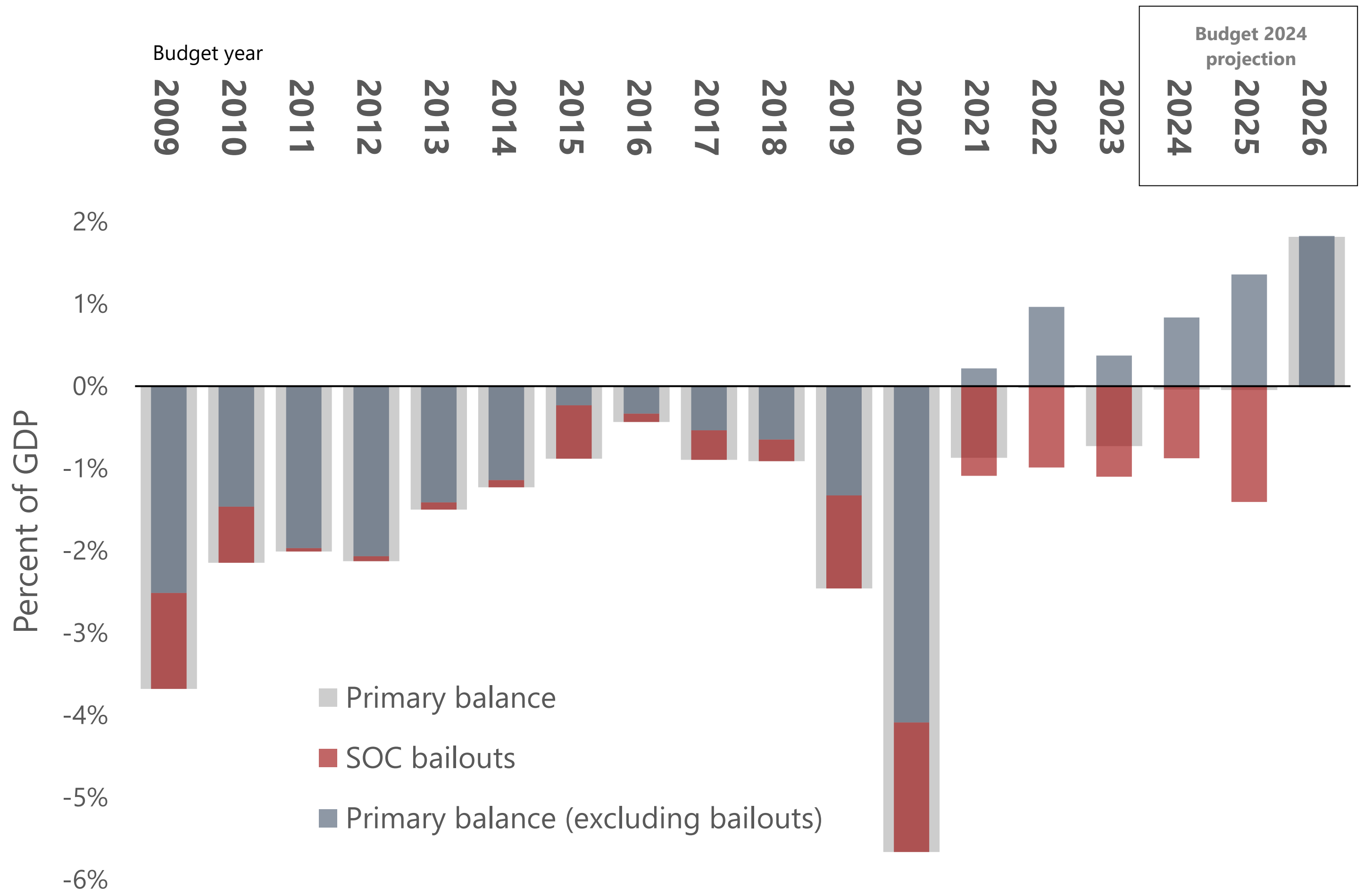


Source IMF (Fiscal Monitor October 2023)

A surplus to pay for SOC bailouts

- Balance sheets across the public sector need to be strengthened.
- The 'primary surplus' reported by the treasury excludes the Eskom bailout.
- Treasury is ensuring the primary surplus excluding bailouts is large enough to finance the Eskom debt relief.
- This requires core spending to be reduced, or taxes increased.
- The hope is that once the Eskom bailout is completed, expenditure will remain contained, resulting in a sustainable fiscal path from 2026
- A major assumption is that further funding of the SOC sector will not be required going forward.

The primary balance and SOC bailouts



Source: Public Economy Project calculations based on National Treasury budget data

Five phases of expenditure growth

1. **GEAR** [1996-2000]

2. **Rapid spending growth** [2000-2011]

   Rapid spending growth outpaces GDP, expansionary budgets increase the size of the state.

3. **Austerity 1.0** [2012-2019]

   Spending growth constrained and aligned with GDP, partially reversed by the sixth administration after 2017

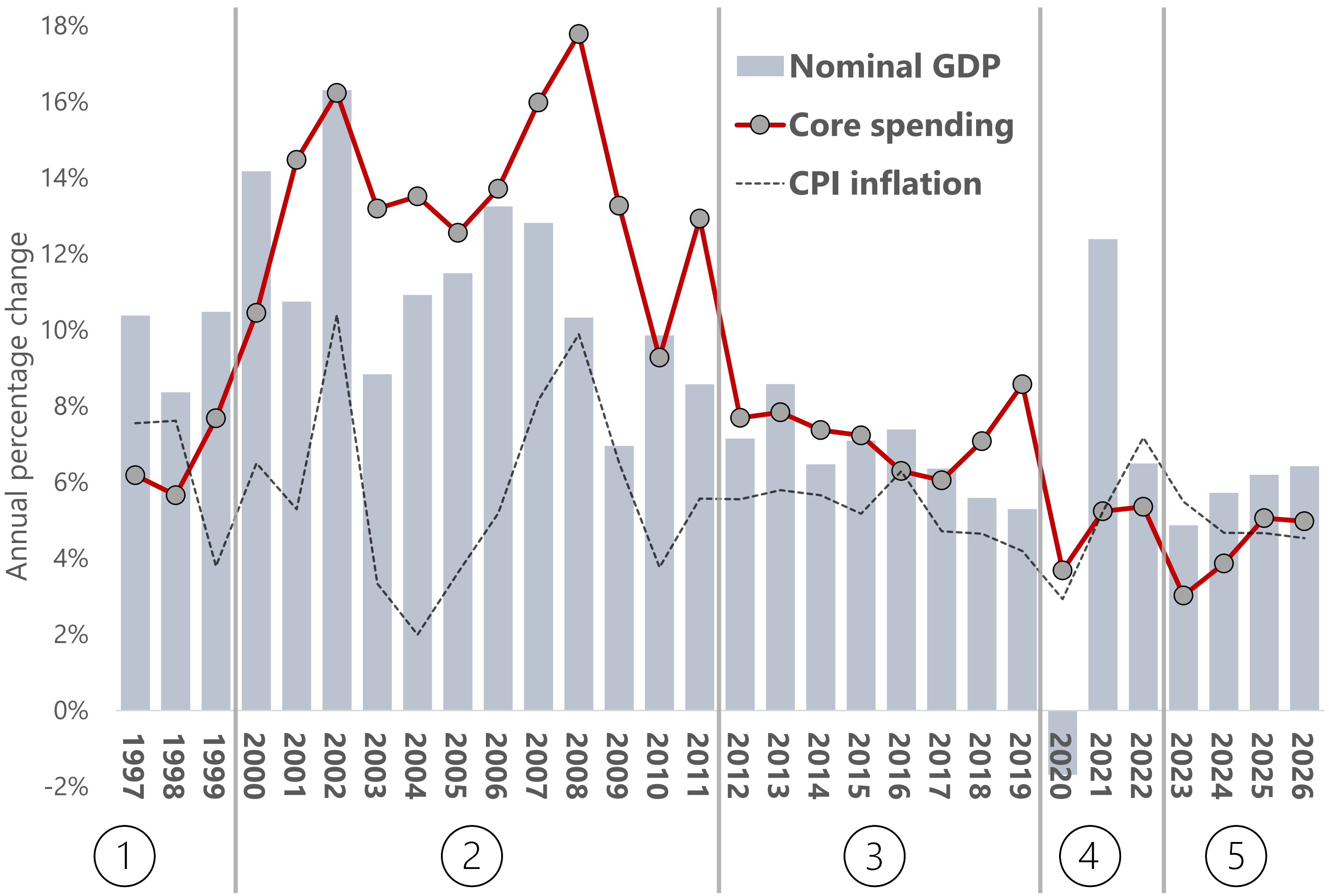
4. **Covid/Austerity 2.0** [2020-20220]

   Lowest-ever rate of spending growth in nominal boom in the covid recovery.

5. **MTEF/Permanent 2.0** [2023–2026]

   A new (historically) lower trajectory of spending growth aligned with CPI, slower than expected nominal GDP growth to continue reducing the size of the state.

Nominal growth of core spending and GDP



Source: Public Economy Project calculation based on National Treasury budget data;
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Conclusions

What the public-sector balance sheet can (and can't) do

- The public-sector balance sheet has considerable strengths:
  - Long maturity, domestic-currency dominance of debt structure, and large cash balances (including GFECRA)
  - Well capitalised and credible central bank
  - Significant other financial assets on the public sector balance sheet (i.e. institutions with a strong and positive net worth position), including the GEPF, UIF, and compensation funds.
- From a financial point of view, it is possible to mobilise the public-sector balance sheet in a variety of ways that could soften the blow of austerity. The deployment of GFECRA is one such measure. The strength of the public sector balance sheet means that a 'fiscal cliff' (i.e. an acute fiscal reckoning) is not a likely scenario in South Africa, at least not in the short to medium term. But if we remain in a low-growth, high-interest trap, South Africa faces a deepening and chronic fiscal crisis.
- Action that weakens the public-sector balance sheet (liquidates financial assets, erodes the composition of liabilities, or consumes other fiscal buffers) or mobilises private finance by relying on stronger regulatory control:
  - CAN deliver financial breathing space for economic action to revive growth and development or (in the absence of such a revival) ease the path of (downward) adjustment by slowing the pace of austerity and/or debt accumulation.
  - CANNOT resolve the underlying macro-fiscal crisis, which is rooted in the low-growth, high-interest regime.
  - COULD, if badly managed, add new risks and problems of financial stability to the government's long list of development headaches.

Austerity to reduce the size of the state

- Since COVID-19, spending growth has been reduced to its lowest-ever level, reducing the size of the state.
- Instead of resorting to balance sheet financing this year (2023/24), Treasury has imposed a historic cash crunch on government spending, in part by underfunding the wage bill settlement. This cash crunch will do significant damage to public services, disrupt operations and generate perverse incentives. In our view, this could have been avoided and comes at a significantly higher cost than the alternatives available (i.e. debt or asset disposal).
- Time will tell how much of the 2023 cash crunch results in real cuts to expenditure, or is confounded by:
  - Irregular overspending
  - Hidden deficits (e.g. accruals in provincial health departments) as obligations are settled in April, leading to further cash shortfalls next year.
  - Capital spending, recruitment or other spending being postponed but not cancelled
  - Diverting cash from essential maintenance, training, and other critical (but not urgent) spending items
- Budget 2024 aims to lock in the gains of the cash crunch by containing spending growth below CPI for the years ahead so that the size of government continues to fall relative to national income and in real terms per citizen.
- This will result in continuing retrogression in funding for social provision, with the main burden of austerity falling on core services such as basic education, healthcare and the criminal justice system.

Conclusion

- South Africa is caught in a low-growth, high-interest trap: this requires spending reductions or tax increases. Government is trying to run primary surpluses to finance large debt costs and to strengthen SOC balance sheets (in particular Eskom and Transnet), while at the same time attempting to reduce the funding envelope for government services.
- Austerity has been intensified since the COVID-19 pandemic, and 2023 is *the* critical year in this programme with a damaging cash crunch imposed on government departments. Budget 2024 locks in the cash crunch in future years, continuing the programme of austerity over the medium term. This will lead to the curtailment of government services and retrogression in resource allocation to social provision.
- Tax increases can offset required spending reductions and need stronger consideration: Resort to fiscal drag on PIT is regressive, shifting the burden of adjustment towards the lower half of the income tax brackets (i.e. formal sector employees with decent but low salaries)
- Assets on the balance sheet can provide temporary relief – and could have been deployed this year to prevent the cash crunch. But if the underlying crisis is not resolved, drawing down assets simply erodes the public-sector balance sheet and, just like adding to debt, will take South Africa a step closer to macro-fiscal vulnerability.

About

Public Economy Project

The Public Economy Project aims to build analytical capabilities on macro-fiscal policy and public economics to support deliberation and engagement between government, social partners, and civil society. The project is located within the ***Southern Centre for Inequality Studies (SCIS)*** *at the University of the Witwatersrand*

More about the project here: https://www.wits.ac.za/scis/research-projects/public-economy/

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