Dealing with the Budget Crisis
CDE recommendations

Introduction
The rejection of National Treasury's proposed VAT increase last week was a crisis waiting to happen. Government has been living beyond its means for too long. For at least the last 15 years, it has spent significantly more than it raised in tax revenues, in the process driving debt levels from less than 25 per cent of GDP to more than 75 per cent.

The additional borrowing was used to finance higher salaries in the public service, to introduce "free" higher education and the SRD grant, and, increasingly, to cover debt service costs. The latter is, by far, the fastest growing spending item on the budget. Even with all this additional spending, the budget failed to make provision for other inevitable costs. For example, the Medium-Term Budget Policy Statement (MTBPS) makes no provision for State Owned Company (SOC) bailouts, even though most are in financial crisis.

This is the definition of an unsustainable fiscal policy. It has long been a cliché in economics that things that cannot go on forever, won't go on forever. That's why the crisis that now besets the tabling of a budget that the legislature will approve was bound to happen at some point. (See CDE report *Running out of Road: South Africa's public finances and what is to be done*, August 2019; *ACTION THREE: Fix the fiscal crisis*, July 2024.)

In this context none of the options that the government of national unity (GNU) faces is painless. It must pass a budget that does one or more of three things: raises taxes, lowers spending or leads to increased debt. There is no fourth option.

In this short report CDE will put forward a realistic approach that combines

- essential spending cuts
- an approach to new revenue that does not involve a VAT increase
- a firm commitment by the GNU to cut more wastage from government expenditure during 2025 so that we are not in the same situation early in 2026
- a compact on speeding up and implementing fundamental reforms for growth as a condition of passing the budget.

Hope is not a strategy
Growth-promoting reforms (preferably those that do not require significant up-front spending) are urgently needed. Without an acceleration of growth, South Africa's public finances will never be returned to a sustainable footing.

But a budget cannot be drafted on the basis that hoped-for growth will materialise as actual growth. To do so risks producing a budget that lacks credibility and which is premised on assumptions that are impossible to justify and actions that are out of the Ministry of Finance's control.

No-one would – or should – believe a budget based on promises of faster growth, and it would be seen as a weakening of fiscal policy and an acceleration of the rate of growth of debt. Acting as if hoped-for growth is guaranteed will raise debt and defer necessary fiscal adjustment. Hope, as they say, is not a strategy.

There is, furthermore, a wide consensus that government spending is grossly inefficient:

- Too many low-impact programmes are on the budget;
- There are too many senior people in government leadership positions who cannot do their jobs or use the money allocated to best effect;
- There are too many public servants who do not (or cannot) do their jobs;
- Too many failing SOCs are run inefficiently and continue to fail because they expect to be bailed out at some point; and
- There is too much corruption and elite looting of the state.

Significant as all these factors are, once again, a budget cannot be drafted that is premised on the *assumption* that hoped-for savings as a result of the elimination of waste and inefficiency will be achieved. These are, in many cases, complex challenges overseen by a state that remains deeply corrupt and weak. They can't be expected to be solved quickly enough to affect spending meaningfully in the coming financial year.

Ultimately, the budget cannot duck the need to provide guidance on what the trajectory of our national debt will look like. To work that out, technocrats in the Treasury will need estimates of how much we will spend, how much we will raise in revenue, how much we will we borrow this year and in subsequent years, and how much will the economy grow. The variables they plug into these models can't be sucked from Cabinet's collective thumb in the expectation that capital markets will believe them.

The next budget and the medium-term expenditure framework (MTEF)

Rather than short-term fixes or a budget based on overly optimistic expectations, we need a budget that finds real solutions to the difficult situation the country now faces. The basic problem is that there is a R190 billion hole in the three-year MTEF (ie the budget for next year and projections for the following two financial years) that needs to be filled. This is a substantial sum.

Borrowing is not an option

The rapid increase in government's borrowing over the last fifteen years is a major reason why South Africa is stuck in the current low growth permacrisis. We have to break out of this cycle and cannot therefore borrow our way out of trouble. The main reason for this is that when government borrows as much as ours has, the risk of macroeconomic crisis increases and interest rates rise, both of which lead to less investment and, therefore, less growth. Higher debt levels raise the risk of rare but very serious outcomes: rapidly increasing inflation, currency depreciation, a credit crunch, sustained periods of negative growth. The rise in these risks means that firms and households become less willing to invest because the future is less and less certain. All of that means that if we are to get the growth we desperately need government needs to provide strong signals that it is returning to a more sustainable fiscal path. Substantial rises in taxes or resorting to an increased rate of borrowing indicate that the opposite is true and make faster growth less likely.

Raising taxes is not an option either

Given that SA is already highly taxed and that government's credibility as a provider of basic services is

catastrophically low, a substantial rise in taxes is also undesirable. Tax hikes will almost certainly lead to a reduction in the willingness of the public and/or firms to pay, while the negative impact on growth will substantially reduce the amount of revenue that government can generate through any tax increase. VAT is seen as a way to mitigate these effects, although implementing the Treasury's proposed two percentage point increase will almost certainly have growth retarding effects, while also hurting the poorest households the most.

The emphasis, therefore, has to be on cutting spending. That means substantial cuts are required. There are no easy choices. Our leaders will have to confront tough decisions.

A realistic path out of the crisis

Government must find large, credible cuts and couple those with less regressive and damaging ways to raise revenue than the rejected proposal to raise VAT by two percentage points to 17 percent.

ONE: Large credible cuts in government expenditure

Public sector wages: Given the scale of the challenge and remembering that one of the biggest causes of government's failure to live within its means has been the large increases in public sector wages over the past 15 years, there is only one way to make a large enough dent in the three-year fiscal hole while also providing the right signals to investors. It's important to remember that public sector wages are high compared to the private sector and international comparator countries and that government performance is in far too many cases dismal.

Government should consider withdrawal from its recently agreed (above inflation) wage agreement (5.5 percent) and implement, instead, a 3.5 percent wage increase. Limiting compensation spending increases to 3.5 percent in 2025/26 and allowing wage increases equivalent to CPI in 2026/27 and 2027/28 would save R100 billion over the next three years compared to the budget presented to Cabinet last week. Even if an amount was allocated to accommodate the need to employ additional doctors and teachers, savings of R60 billion over the MTEF would be possible.

Reduce procurement costs: Government should change procurement practices like set-asides and localisation requirements which inflate procurement costs. If government said that goods and services budgets will rise by 3.5 percent in each of the next three years instead of the 5.4 percent a year pencilled in the rejected budget, savings would amount to R50 billion. This would not harm service delivery if the changes to the budget were combined with policy reforms, such as the elimination of localisation rules, that lowered the cost of procurement in government. In this regard, we note that in 2023/24 government set a precedent by allowing Eskom to cut out middlemen and contract directly with original equipment manufacturers, overriding localisation requirements. This was done in order to get the power plants working more effectively, leading to a year of almost no load-shedding. This exemption worked and should now be applied to the rest of the state.

Close down the SETAs: Over R80 billion will be spent by the SETAs over the next three years. This is despite the fact that it is impossible to find anyone who is not employed by these organisations who has anything positive to say about them. These funds should be redirected to the National Revenue Fund, and the SETAs and National Skills Fund should be shut down.

State funding for small business is hopelessly ineffective and could be cut in half. The remaining funds would then be allocated to private sector fund managers for investment in high-potential small- and medium-sized businesses. We estimate that this could save R9 billion over the MTEF with more to save if we include the reduction in staff who implement these programmes. (See CDE, *ACTION EIGHT: Let the private sector drive small business development*, February 2025)

"Ghost" workers: There are persistent rumours of "ghost" workers drawing salaries in government. Government should immediately commit to an urgent review of payrolls aimed at identifying any such payments within six months, coupled with a transparent report to parliament. It should commit that half of all savings identified in this way will be retained by affected departments to be used as one-off bonuses for actual staff in those departments, which would help incentivise efforts to identify ghost workers. Unfortunately, there is no way of estimating the value of the savings that might be achieved in this way since no-one knows for sure what the scale of the problem is.

Cut other programmes: There are bound to be other examples of low-impact programmes that could be cut with little risk of impacting negatively on SA's development. However, it would be a mistake to underestimate the challenges in identifying these programmes, build the necessary evidence to demonstrate the lack of impact/importance of the activities to secure cabinet support for the cuts, and then implement these. There are also bound to be costs associated with the restructuring that such cuts entail (e.g. severance payments). Setting in place a realistic process for identifying these programmes and committing to achieving a target of, for example, R40 billion in cuts over the MTEF, would help close the budget gap.

Ensure these cuts actually take place: Experience over the past 15 years tells us that commitments to achieving particular budget outcomes should not inspire confidence. It is critical, therefore, that some mechanism is found to bake these changes into the budget credibly. In the absence of this, these would be no more than hoped-for savings. To this end, we would propose the immediate establishment of a small Cabinet subcommittee consisting of members of at least the ANC and DA tasked with identifying and motivating for these cuts and willing to defend them publicly. That committee could be tasked with consulting with external experts such as former senior public servants or businesses executives.

The suggestions set out above could fill the hole in the MTEF, but only if they are implemented immediately and we achieve the full savings set out above. That is unlikely and impractical in some cases, so government will have to look for new revenue, too.

TWO: New revenue

Revenue collection: The best and least harmful way to raise more revenue is to improve the efficiency of revenue collection. In this regard, the GNU should immediately provide SARS with more resources so that it can pursue tax evaders and tax debtors. It is not clear what the numbers are exactly, but **to the extent that there are unpaid taxes in the system that could be recovered, doing so before asking law-abiding taxpayers to pay more should be a priority.**

Tax rebates: To back this approach up and in a context of uncertainty about how much can actually be saved through efforts to cut government expenditure, some tax adjustments can be considered. Here, the obvious thing to do is to reduce targeted tax rebates, especially those whose benefits are highly concentrated among

the better-off. This is much more reasonable than a two percentage point rise in VAT, which is highly regressive and bound to have destabilizing political effects.

- **Halving the medical aid rebate** would be a much better bet and would return about R50 billion to the budget over the MTEF. Depending on the individual tax-payer's medical circumstances, this would increase annual taxes by about R1,800 per dependent covered by the medical aid.
- **Halving the rebates received by the automotive industry** for tariffs paid on wholly imported vehicles sold locally would also yield significant revenues, the precise value of which is hard to estimate based on available information.

These changes are preferable to raising VAT or income taxes on people or businesses, but they should be implemented only to the extent necessary, depending on the additional revenue SARS can bring in as quickly as possible.

South Africa needs a growth strategy: Bold actions required

The steps set out above are not enough. Hard as they appear, even if they were done well, they will not resolve the polycrisis into which SA has fallen. At best they will slow the rate of decline of the public finances.

What the GNU really has to do is get serious about growth.

So far, the attitude of many in the GNU leadership seems to be that the mere existence of a coalition government amounts to a growth strategy. It doesn't.

South Africa needs the GNU to enter into a growth compact in the immediate wake of approving a new budget.

Starting the day after the finalisation of the 2025 Budget, the GNU needs to sit down and map out a path to a plausible growth strategy. That should be a condition of passing the budget.

Pushing the country onto a higher growth trajectory is the only sustainable way to deal with the many development challenges and budgetary demands we have – from more teachers and nurses to infrastructure to enable further growth, to putting a real dent in poverty and unemployment.

The GNU should commit to implementing some big bold changes in the next six months. We cannot fix everything at once but the proposed priority actions, emerging out of **CDE's Agenda 2024** reports, would be an excellent start – sending important signals to investors and citizens that fundamental change is starting.

The list of actions CDE has recommended with respect to core reform goals include:

Action: Make government less costly, more efficient

- Publicly announce the end of cadre deployment
- Establish a smaller, less expensive cabinet so that it can act decisively and deliver required reforms
- Identify senior executive leadership positions (mission critical jobs) essential for implementing a vigorous reform agenda, and make sure they are occupied by the best available people.

Action: Deal with inefficient, debt ridden SOEs

- Appoint a team, led by business leaders, to conduct a financial review of all major SOEs. The review must propose asset sales and generate a flow of income from privatisation.
- Amend the newly revised PPP regulations to ensure that private partners can be brought into SOE activities wherever desirable.
- Develop an overarching competition policy for public goods that identifies as many places as possible where competition can be intensified and therefore costs reduced.
- Establish a small, new, highly skilled department, led by the right people, committed to competition, to manage the SOEs and ensure there are effective boards and that policies ensuring competition and regulating SOEs effectively are implemented

Action: Start to restore the rule of law

Focus on the NPA and strengthening its capacity to stop elite looting of state coffers

- The President should
    - Appoint a retired judge to assess the NPA's leadership, performance, structure and independence. This review should make recommendations on the appointment process of the new head of the NPA
    - Respond to the National Director of Public Prosecutions' request to suspend a Regional Director in August 2023
    - Instruct the Minister of Justice to immediately release the full archive of the Zondo Commission, including its witness statements and investigation materials, to the NPA.
- The Minister of Justice should request the Chief Justice to discuss with the Judge Presidents of the High Courts to
    - Set up special corruption courts, drawing on retired and acting judges to obviate delays, without placing extra pressure on the ordinary work of the courts.

Action: Rethink growth, jobs and the DTIC

- Create a much more competitive economy with more South African based firms enabled to produce for global markets, expand and create more jobs:
- Reform the tariff system and reduce protectionism. Immediately eliminate all tariffs on goods not made by any South African firm.
- Establish an independent review of all support provided to the motor vehicle industry
- Get rid of masterplans which reduce competitive pressures on domestic firms and raise costs for consumers and downstream users of protected goods.
- Work with business to establish productivity councils to help firms move into export markets.
- Revoke the Minister of Trade and Industry's powers to intervene on public interest grounds in mergers and acquisition hearings at the Competition Commission and keep market inquiries to an absolute minimum.
- Abandon localisation policies – an approach that reduces the competitiveness of the SA economy and raises costs.

Action: Let the private sector lead on small business development

- Close the Department of Small Business Development and massively reduce government activities in this area (it is estimated that R6 billion is spent on this each year)
- Provide – through transparent competition - R9 billion over the next three years to strengthen private sector small-business funders.

- Subject all regulations to an 'SME test' to determine the extent of their impact on small businesses. Establish a unit in the presidency (combining existing units/task forces) to implement the test and to push through meaningful regulatory amendments.
- Eliminate the power of the Minister of Labour and Employment to extend collective bargaining deals to non-parties. This harms small and non-metropolitan firms as well as new firms.
- Make small business funding and deregulation transparent. Annual event in parliament where public and private agencies account for expenditure and report on results, including impact of regulatory change.

These five areas of action do not constitute a comprehensive reform programme or growth strategy. However, set in motion with vigour and speed and implemented effectively, they would provide strong signals that real change is taking root in South Africa, leading to the required accelerations in growth, investment and jobs.

Conclusion

Fifteen years of fiscal imbalance and policy failure have a cost, one that has to be paid at some point. What is clear from the debacle last week is that things cannot go on as they have been. Our public finances are broken and, while the language of insolvency is not always appropriate for a state, it is a reasonable analogy for where we are. To take it further: if this were a company, its directors would be personally liable for reckless trading if they did not make substantial changes.

The GNU has been very disappointing so far in delivering growth promoting reforms. This budget crisis presents an opportunity to change that, and to win commitment to big reforms. Without reform, this will merely be the first in a series of budget crises which will become harder and harder to solve. The time for real change and action is now.

CDE Board: S Ridley (chairman), A Bernstein (executive director), A Ball, C Coovadia, B Figaji, I Liddle, I Mkhabela, M Morobe, M Nkosi, S Nkosi
CDE Patron: L Dippenaar

Published in February 2025 by The Centre for Development and Enterprise
5 Eton Road, Parktown, Johannesburg 2193, South Africa | PO Box 72445, Parkview, 2122
Tel +27 11 482 5140 | info@cde.org.za | www.cde.org.za