Budget 2020

A step back to safety. But just the first.

March 2020

Introduction

The most sobering fact about the 2020 Budget is that, dramatic and painful as the cuts proposed by Minister Mboweni are, and as risky as is the political calculation that the president is making, debt will still be rising, both in absolute terms and in comparison to GDP, in three years' time.

That is a marker of the depth of the fiscal quagmire into which South Africa has been led, and a measure of the pain that will have to be borne if we are to get out of it.

The key messages of this report are:

- The 2020 Budget does precisely what CDE has called for over the past few years, embarking on an expenditure-biased fiscal consolidation driven by proposals to moderate the growth of government's payroll costs;
- There are legitimate concerns about whether government is able to deliver on this budget, partly because the growth projections continue to seem overly optimistic (especially in light of the coronavirus pandemic), and partly because its fiscal policy rests on government's being able to extricate itself from the third year of a three-year wage agreement;
- Even if these steps are all taken and growth exactly matches what government projects, we are still far from achieving a primary balance and, for that reason, we will continue to see debt rise both in absolute terms and in relation to GDP; and
- South Africa's public finances cannot be stabilised without faster economic growth.

But first let's step back and review what the budget proposes, how this departs from what had been laid out in the 2019 Budget, and the extent to which these proposals – brave and dramatic as they are – reveal the seriousness of the crisis we face.

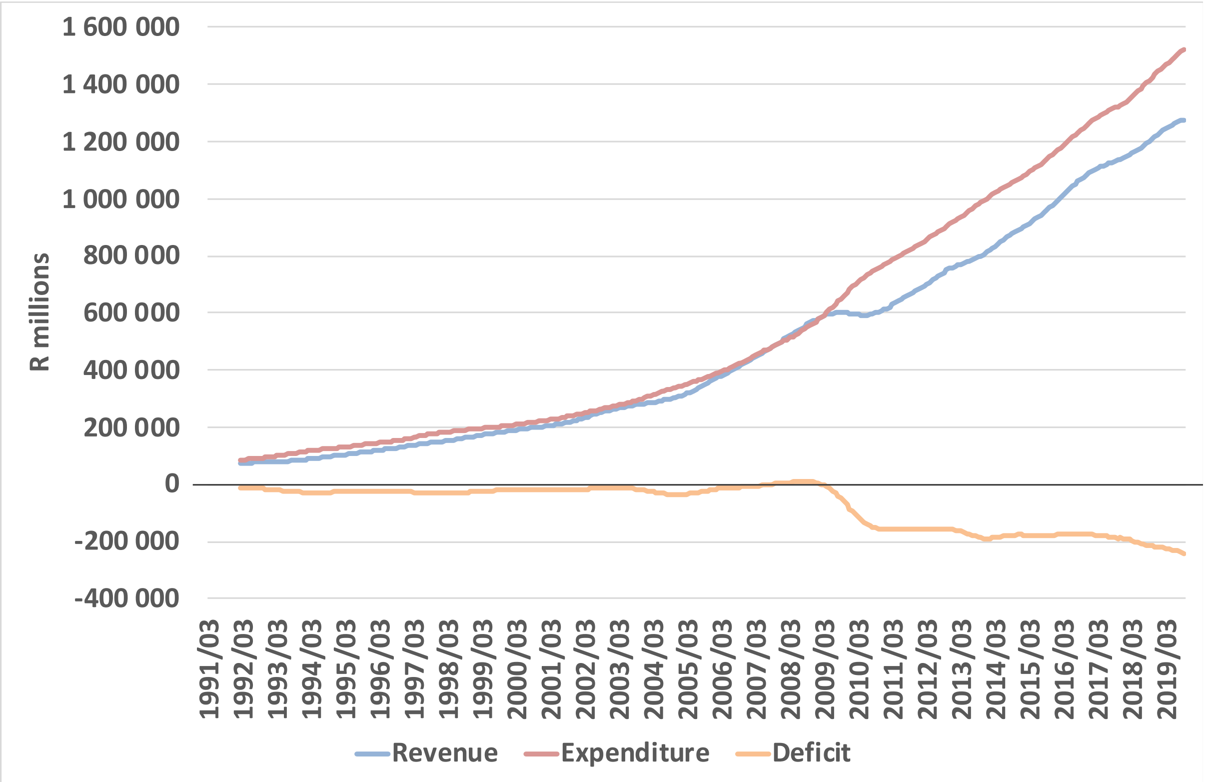
The 2020 Budget

In some respects, the 2020 Budget looks like the budgets that preceded it. It proposes to spend a large part of South Africa's gross domestic product (around R2 trillion in each of the next three years at an average of 35.4 per cent of GDP). This money will be used delivering infrastructure (roads, dams, buildings), goods (textbooks, computers, cars) and services (teaching, nursing, law enforcement) to households and communities. But government is unable to raise in taxes the full value of the R6.1 trillion it intends to spend over this period, expecting, instead, to be able to raise only R5.1 trillion (29.2 per cent of GDP on average). The remainder (just over R1 trillion over three years, or 6.2 per cent of three years of GDP) will have to be borrowed, adding to South Africa's already considerable mountain of debt. That mountain is expected to grow from R3.2 trillion at the end of 2019/20 to R4.4 trillion in 2022/23, or from 62 per cent of GDP to 72 per cent of GDP.

And these figures exclude the state-owned companies' borrowing requirements, which add another R200 billion in public sector borrowing needs over the next three years, or another 1.2 per cent of GDP. Contingent liabilities from the SOCs increases outstanding debt by just less than R1 trillion today (about 18 per cent of GDP) to around R1.2 trillion in 2022/23 (19 per cent of GDP).

As CDE has pointed out in a series of publications about the precarious state of our public finances, the immediate cause of the vast borrowings that government is engaged in is the large gap that opened up between its revenues and expenditure during and after the global financial crisis, and government's persistent inability and unwillingness to close this. The net result is an annual deficit averaging R170 billion a year for the past decade, and which has been widening at an alarming rate (Figure 1). Indeed, the budget deficit for the whole of 2019/20 is expected to be just over R320 billion, while the average for the next three years (even after the proposed reductions in spending growth) is over R350 billion.

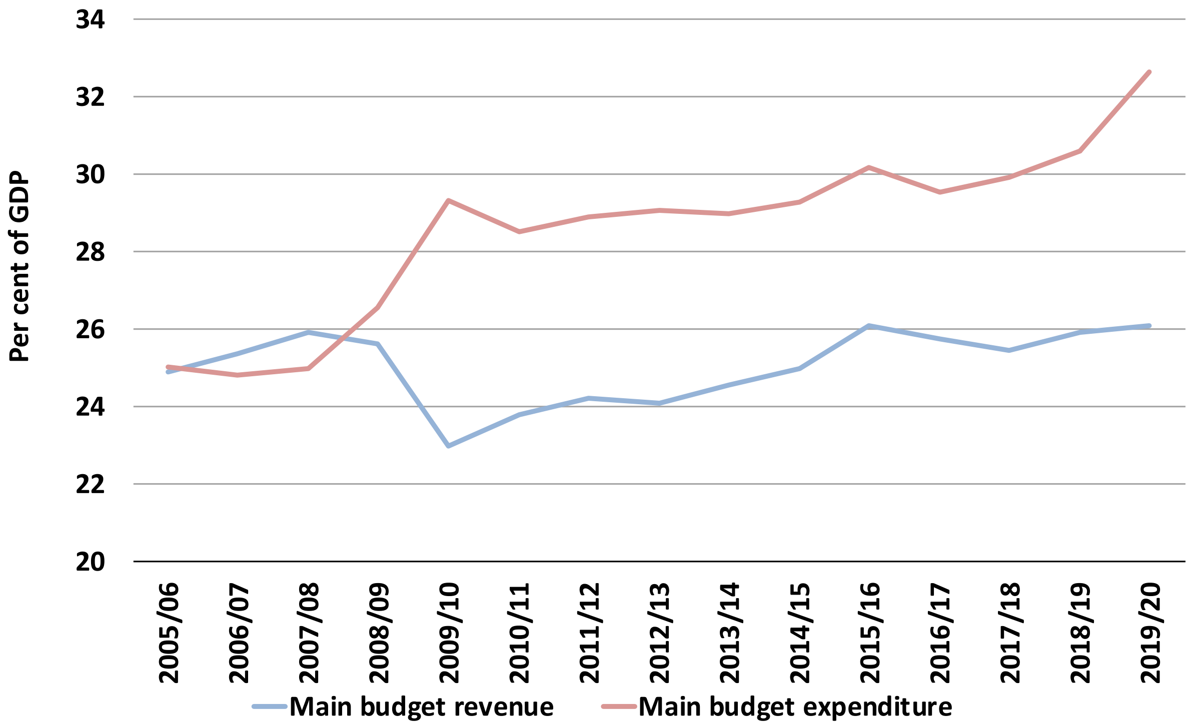
Figure 1: Rolling 12-month totals of national govt's monthly revenue and expenditure (Mar '92 to Sept '19)



Source: SA Reserve Bank database

As Figure 1 demonstrates, the essential problem is that since 2009, annual spending has far exceeded revenue. This divergence is the result both of rapid spending growth and of the deceleration of revenue growth, a deceleration that was not reversed by higher tax rates, which have been able to do no more than hold tax revenues constant as a share of GDP (Figure 2).

Figure 2: Main budget revenue and expenditure as a % of GDP (2005/06 to 2019/20)



Source: National Treasury, 2020 Budget

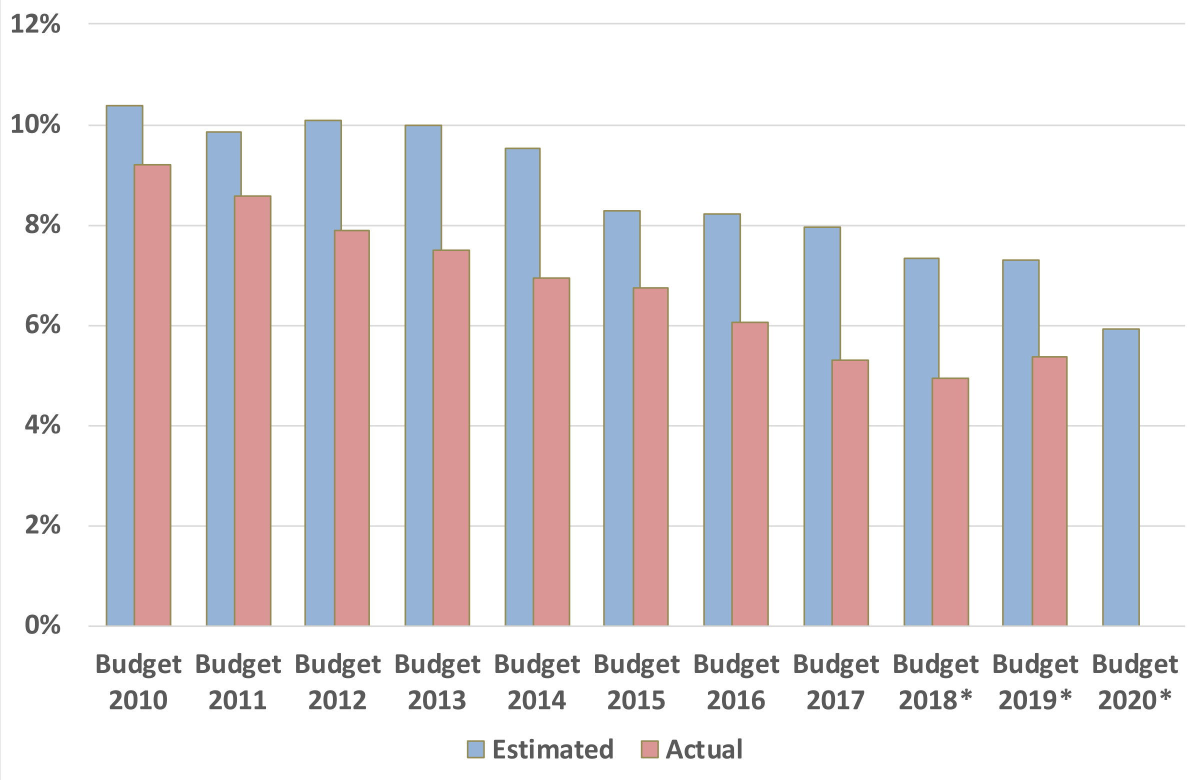
One reason that higher taxes have done so little to reduce the gap between revenue and expenditure is that the deceleration of economic growth has tended to offset any attempt to raise revenue more quickly. The deceleration of growth is something that seems constantly to take Treasury by surprise, and the result is that, even as it has lowered its growth forecasts for the following three years in every budget since 2010, their projections have consistently overestimated the rate at which the economy would grow (Figure 3, next page).

This overestimation of growth has had two malign consequences for the sustainability of public finances:

- An excessive tolerance of expenditure growth; and
- An overestimation of tax revenues, resulting in persistent undershooting of revenue targets.

The combined results of these effects can be seen both in the scale of the borrowings that the state has undertaken, and in the fact that spending has continued to rise as a share of GDP.

Figure 3: Three year forward estimates of nominal GDP growth vs actual nominal GDP growth (Budget 2010 to Budget 2020)



Source: National Treasury, 2020 Budget

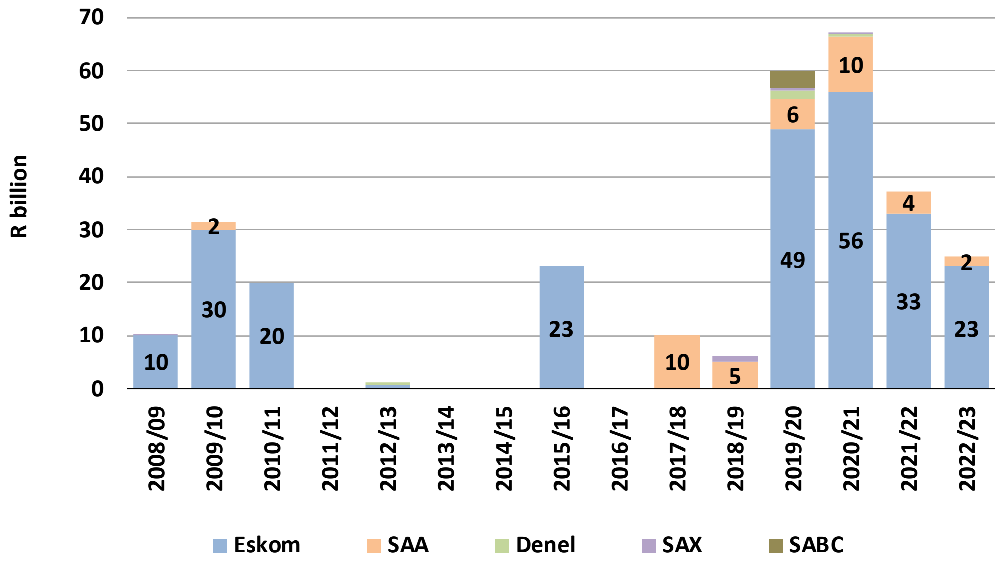
Drivers of spending growth

Although spending has grown across the board, the two items that have grown fastest have been debt service costs (which, for obvious reasons, have risen along with borrowings) and personnel costs. Since 2010/11, these have grown by 8.2 per cent a year and 12.4 per cent a year respectively, compared to average spending growth of 6.9 per cent a year on goods and services and 5 per cent a year on capital investment. Between them, higher personnel and debt service costs account for over half the increase in total spending between 2010/11 and 2019/20.

As budget after budget has made clear, the increase in compensation spending has been driven by the unsustainably rapid growth in remuneration levels in the public service, rather than by growing numbers of public servants. One measure of this is that over the past decade real per capita GDP growth has averaged less than a third of 1 per cent a year while real public sector salaries have grown an average of 3 per cent a year. So large a divergence between the pace at which the economy can afford increases and what public servants actually earn is the very definition of unsustainable.

While debt costs and personnel spending have driven the increase in aggregate spending, there are other sources of pressure on the budget. The most contentious and frustrating of these has been the frequent bailouts of the state-owned companies, especially Eskom, with cash injections from the fiscus amounting to R120 billion between 2010/11 and 2019/20, but which will rise to a total of R250 billion by 2022/23. These figures amount to only 1 per cent of spending between 2010/11 and 2019/20 and a further 2 per cent of spending between 2020/21 and 2022/23, but are enormous in absolute terms and reflect how hopelessly unsustainable these entities are as businesses.

Figure 4: Cash injections to SOCs (2008/09 to 2022/22)



Source: National Treasury, 2020 Budget

What is being proposed

Much of the above was known in October 2019 when the MTBPS was released. Indeed, CDE, along with many others, had been using every platform possible to call attention to the precariousness of our public finances and the unsustainability of the course on which we were on. While it appears Treasury knew and understood how dire the situation had become, the MTBPS itself offered no real way forward or any ideas about how to turn the situation around.

The 2020 Budget, on the other hand, has proposed some bold steps forward. Most notable – and controversial – of its proposals is for a near-freeze on aggregate personnel spending in the next financial year (with the budget permitting growth of a mere 1.5 per cent relative to this financial year), after which aggregate compensation spending would be constrained to grow at just under the expected rate of inflation rather than the 6 or 7 per cent at which it was projected to grow. Slowing growth in this way "saves" nearly R160 billion relative to the counterfactual of government's following the path as set out on the MTBPS, and reflected in Table 1.

Table 1: Compensation spending in billions before and after the cut announced in the 2020 Budget

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
MTBPS 2019	R473	R512	R547	R585	R631	R675	R718	R759
Budget 2020					R629	R639	R668	R697
Difference					-R2	-R36	-R50	-R62
Growth rate (MTBPS 2019)		8,1%	7,0%	6,9%	7,9%	7,1%	6,3%	5,7%
Growth rate (Budget 2020)					7,5%	1,5%	4,5%	4,4%
CPI				4,7%	4,1%	4,5%	4,6%	4,6%
Real growth (MTBPS 2019)				2,2%	3,1%	2,0%	2,2%	2,1%
Real growth (Budget 2020)						-3,0%	-0,1%	-0,2%

Source: National Treasury, 2020 Budget

Attempting to constrain the growth of aggregate compensation in this way puts government on a collision course with labour, and for a range of reasons:

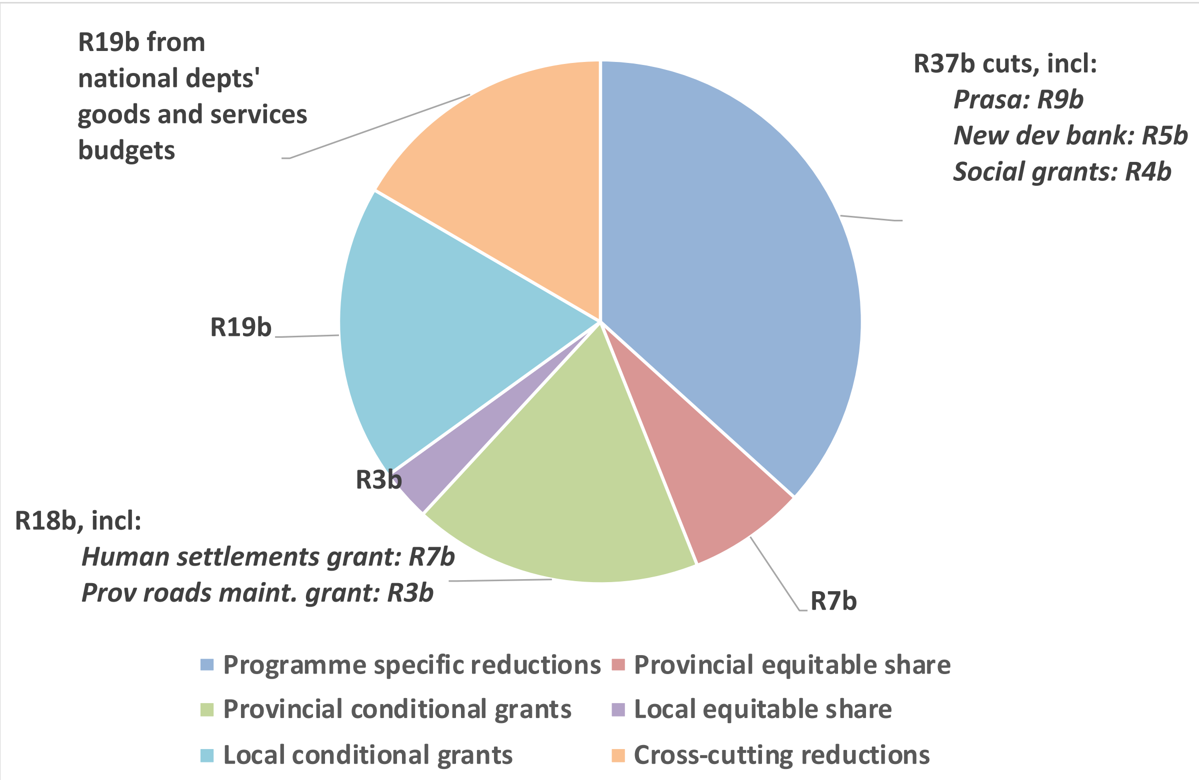
- Failing to budget for much more rapid growth in the compensation budget for 2020/21 implies that government will not honour the commitments it made to public servants when it signed the last three-year wage agreement in 2018, making this a contractually tricky, and potentially untenable, undertaking.
- Slashing the rate of growth of compensation spending conflicts in a direct and immediate way with the expectations that public servants have developed over the past 15 years. Failing to meet entrenched expectations of continuous improvement among key constituents is a hard choice for any leader.
- If reports about the failure to engage labour prior to the tabling of the budget are accurate, government has failed to take labour into its confidence, and is, therefore, potentially provoking an unnecessarily confrontational engagement with them.

All of which implies that there could be a public strike at some point, the timing, duration and costliness of which is an open question and which could lead to government's caving in to unions. Such a strike could also reshape politics within the ruling alliance, potentially weakening the president and strengthening many of those who would seek to stymie reforms or even to replace him.

However, if government were to cave in the face of a strike, it would suffer another costly blow to its credibility and to its creditworthiness, and it might make reform of the public sector wage bill an even more risky proposition for politicians in the future. Given these realities, the proposed cuts are nothing if not bold, but they may not be realistically achievable.

Nor were these the only cuts proposed, with an additional R100 billion in cuts from various spending programmes and from the share of the national budget allocated to provincial and local spheres of government.

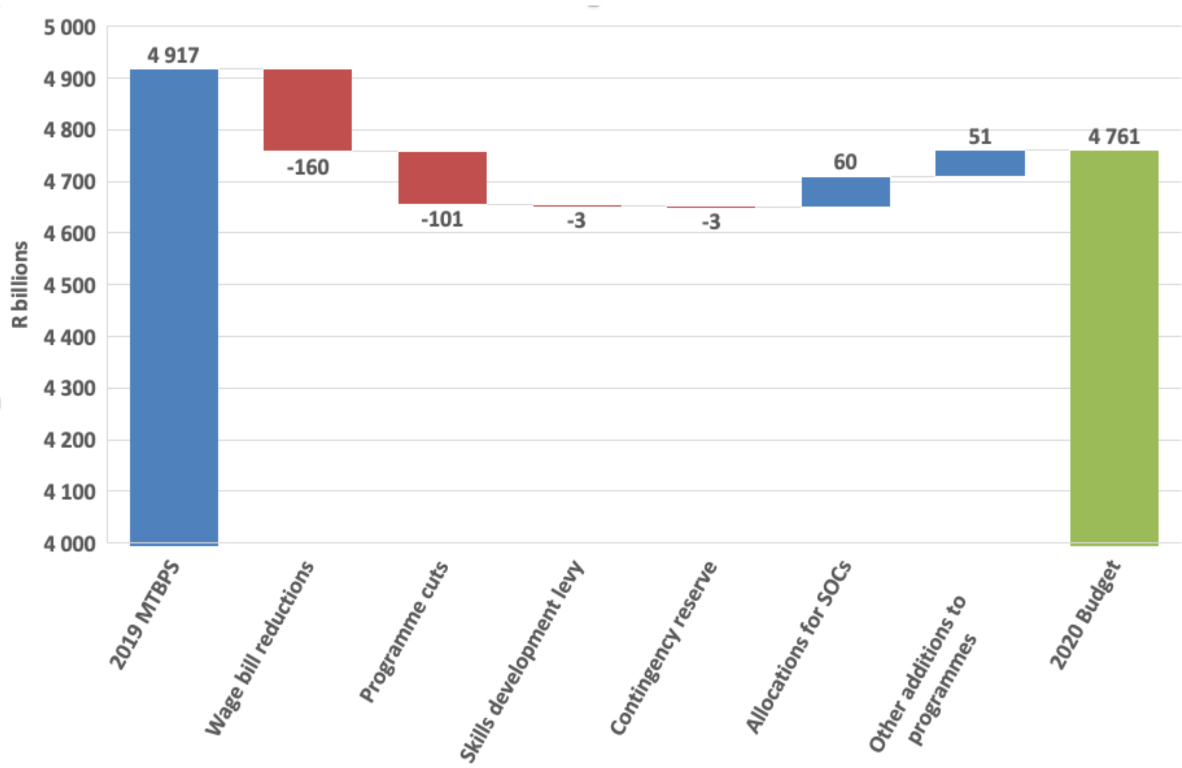
Figure 5: The other R100 bn in cuts announced in the 2020 Budget



Source: National Treasury, 2020 Budget

There are, therefore, R260 billion in cuts proposed in this budget relative to the numbers presented in the 2019 MTBPS. Those cuts are, however, partially offset by R110 billion in new allocations, including R60 billion for SOCs – mostly for Eskom – with the remainder largely driven by undoing the “savings” penciled into the 2019 Budget which were not achieved, as well as new, generally small, allocations for a variety of policy priorities such as the NPA and some statutory commitments. The net result is that spending plans for the three-year MTEF announced in the 2020 Budget are just under R160 billion lower than those proposed in the 2019 MTBPS.

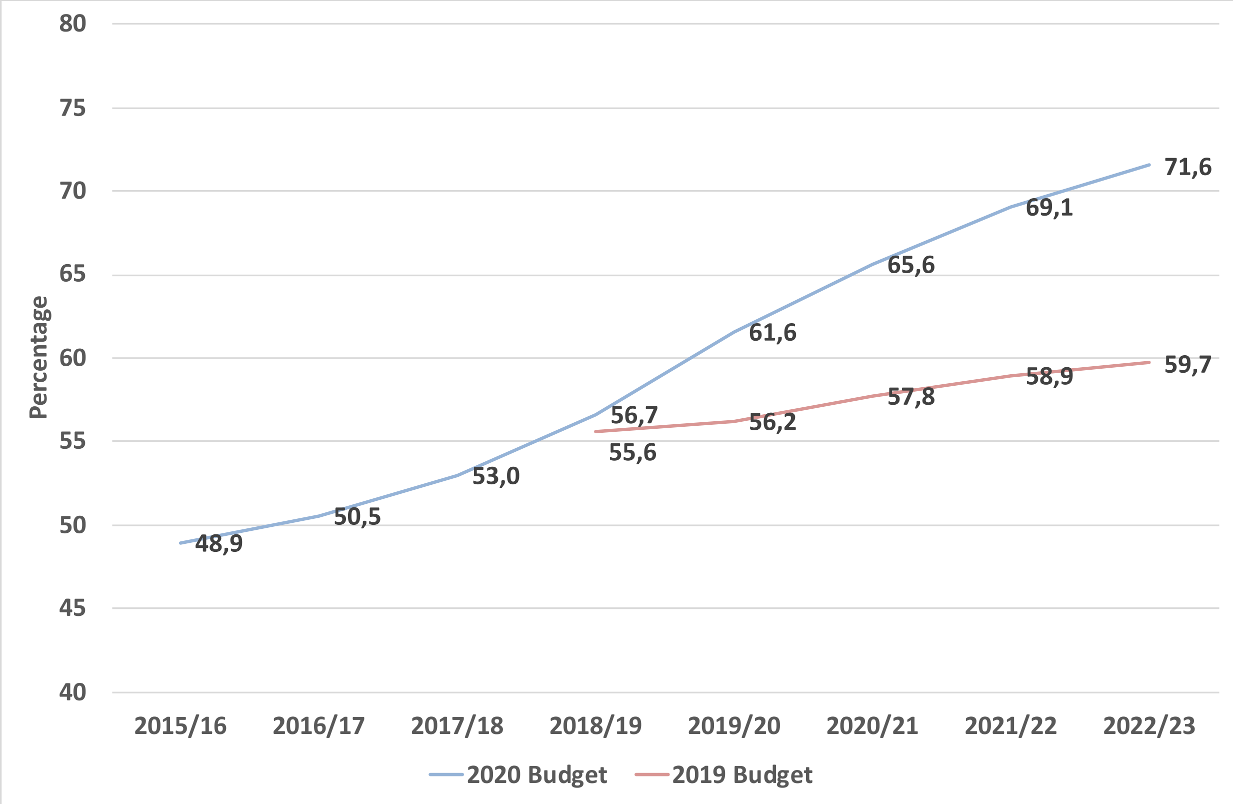
Figure 6: Changes to the medium-term consolidated budget: 2019 MTBPS vs 2020 Budget



Source: National Treasury, 2020 Budget

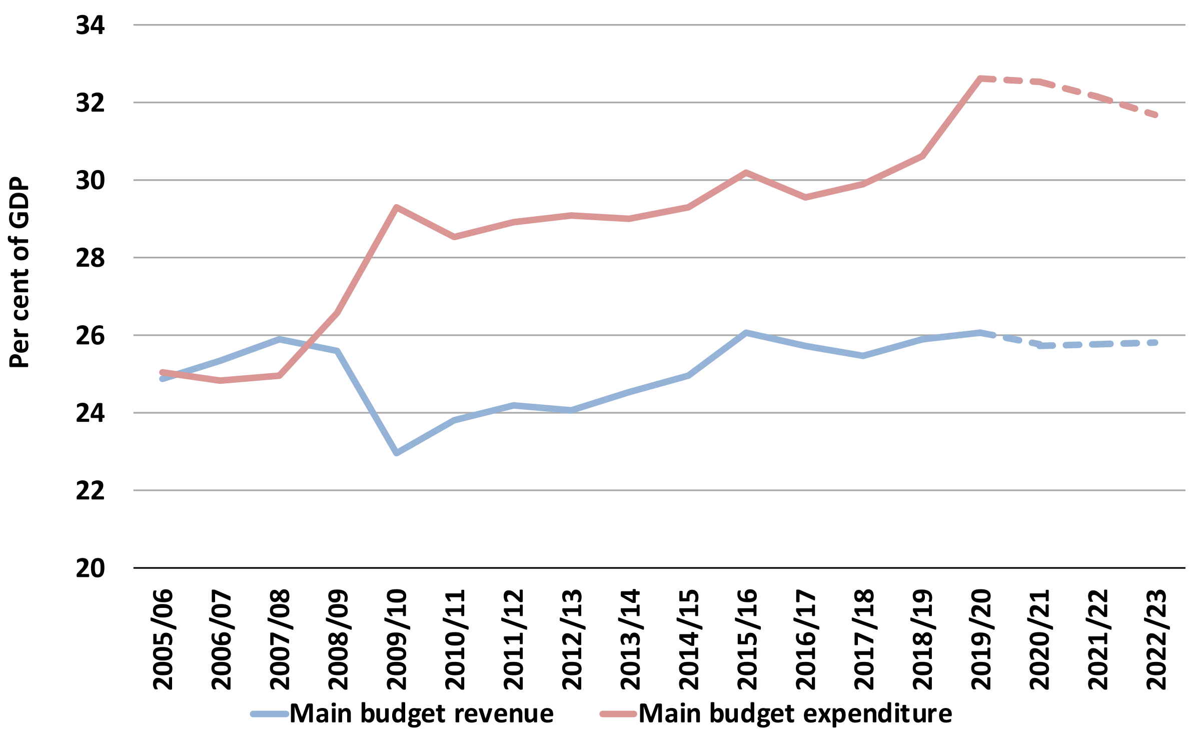
These are substantial cuts and they will reduce government’s capacity to deliver services, will increase the likelihood of disruptive strikes, and mean that some critical functions (such as road maintenance) will be even more underfunded than is presently the case. They will also mean real reductions in at least some services: the provision of RDP housing, for example, and the rollout of Prasa’s investment and maintenance plans. This could, however, pale into insignificance against the potential consequences of disruptive conflict with labour – a go-slow in health, for example, has enormous consequences for healthcare. Equally important, is the fact that all this likely pain does not solve the problem: even if fully implemented, the expectation is that the budget deficit in 2022/23 will still be in the order of 6 per cent of GDP, and the ratio of debt to GDP rises to 72 per cent without leveling off.

Figure 7: Gross debt to GDP (2020 Budget compared to 2019 Budget)



Source: National Treasury, 2020 Budget

Figure 8: Main budget revenue and expenditure as a percentage of GDP (2005/06 to 2022/23)



Source: National Treasury, 2020 Budget

And this is the fundamental problem: brave as the decisions taken are, painful as they will be to implement, and likely as they are to meet stiff resistance, they still do not do the job that is required. South Africa's debt and borrowing numbers remain unsustainable in 2022/23 and beyond.

What, then, has to happen?

Getting onto a sustainable trajectory

The one-word answer to the question about what it would take to get South Africa's public finances back onto a sustainable trajectory is "growth". The adjustment to public finances that we need is as large as it is precisely because growth has been so slow. Faster growth would result in more tax revenue, shrinking the budget deficit. As importantly, faster growth would result in a debt to GDP ratio lower than the dangerously high levels without it. Indeed, last year, CDE estimated that if growth had been one percentage point faster in each year since 2008, and assuming that spending levels were not changed, the ratio of debt to GDP would have been 44 per cent and falling rather than 63 per cent and rising.

There is a reasonable amount of consensus in the economic literature about the most salient features of societies whose economies have grown for a sustained period of time:

- Sound institutions (clean governance, the rule of law, property rights),
- The avoidance of macroeconomic populism,
- Active participation in global trade and supply chains, and
- A high-level of future orientation leading to high levels of investment in infrastructure and education.

This is a short list of critical commonalities, but achieving sustained growth – especially after a country has attained middle-income status – is difficult, as evidenced by the small number of countries that have actually done so. Keeping an economy on a fast-growing trajectory is not easy, in other words, so a certain amount of humility is warranted when making recommendations.

All the same, it is by now self-evident that South Africa has gone out of its way to violate every one of the key conditions for sustained economic growth:

- Historically, our institutions were deformed by apartheid, creating all kinds of economic distortions along with the gross injustices of systemic discrimination. Some of these were being undone by democratic governance, but the hard work post-apartheid to rebuild the state and expand its reach to all the population has been grievously undermined in the past decade. The result has been an almost fatal collapse of governance, the most egregious example of which is the network of power stations and distribution cables that provide homes and businesses with electricity which has undergone an unconscionable decline in capacity even as the price of its product has skyrocketed.
- Fiscal policy over the last decade, while not precisely populist, has undone all the efforts made to ensure that our economic fundamentals were sound.
- While increasingly liberal in our engagement with globalisation along some dimensions (capital market liberalisation and growing tourism and other exports), along other dimensions (most importantly our attitude to skilled migration), protectionist policies prevail.
- Savings and investment as proportions of the economy are very low by the standards of rapidly growing developing countries. More importantly, what investment we have undertaken has been grossly overstated by the quantum of corruption and waste involved in many of these projects (the building of Medupi and Kusile, Prasa's recapitalisation), and the very low rates of return we can expect on these investments. At the same time, the return on investment in education and training is widely acknowledged to be abysmal.

The level of self-sabotage reflected here is enormous, and it is little surprise that the economy is growing as slowly as it is. Indeed, it would be astonishing if growth rates had not collapsed.

In this context, there is only so much that a budget can achieve: while it can push public finances towards greater sustainability, it can achieve much less in relation to all the other conditions for economic growth. Indeed, in the short term, the consolidation in spending will likely have some contractionary effects, slowing growth as government spending retrenches. It is, nevertheless, essential: while sound public finances cannot guarantee growth, when they are unsound the effect on long-run growth is likely to be profoundly negative. This is a view CDE has argued consistently over the past two years, and nothing has happened in that period to change it.

All of which means that, as important (and brave and risky) as the proposals made by the Minister of Finance are, putting our public finances on a more secure footing can only happen if progress is made on a range of other policy fronts where the damage done to our growth prospects has been extensive, and which will not be improved merely by slowing the rate of growth of spending on government functions.

How to accelerate economic growth

Given the depths of the challenges government faces in sparking a growth acceleration, it is useful to try to identify what is most critical to achieving this. Here, five priorities present themselves.

1. *Get the fiscal consolidation done*
   Having announced plans for a fiscal consolidation – albeit one that does not actually close the primary deficit and which will leave debt metrics continuing to worsen after 2022/23 – it is critical that government deliver on it because failing to do so will irreparably undermine its credibility and creditworthiness.

   This doesn't necessarily mean that the payroll-costs moderation and the other cuts have to be achieved in full and over the precise timeframe set out in the budget, but it does mean that whatever is the outcome of negotiations with labour has to move the trajectory of public sector payroll costs onto a significantly more sustainable course. There is at least some evidence that organised labour understands the depth of the crisis in which we find ourselves – why else propose a pension-financed bailout of Eskom? – so it should be feasible to make some progress on the challenge of public sector wages that grow orders of magnitude more quickly than the economy does. Having said that, delivering on the proposals made in the budget will require the staring down of the unions, and government is going to have to steel itself for this.

2. *A plan for the SOCs*
   It is long past time for government to have laid out a workable plan for improving the finances and operational efficiencies of the SOCs, for introducing competitive pressures in the relevant markets in which these operate, and for divesting itself of SOCs whose operations would be more efficiently provided by private (or privatized) firms. As it stands, too many SOCs of dubious strategic value (SAA, SA Express, Denel) limp along, while critical SOCs (Prasa and, in particular, Eskom) founder.

   As a group, these businesses are run badly, destroying value, provide expensive and inadequate services, and make ever-increasing demands on the fiscus. Government must now get serious about this: appointing new boards (who are then disempowered by overly intrusive ministers and who are, in any event, often ill-qualified to play their fiduciary roles) is simply not good enough. Linking a credible plan for socialising Eskom's debt with a firm decision to close loss-making but inessential businesses would send a powerful signal of intent to markets and investors. In this regard, it is also essential to act on the commitments made in both the SONA and the budget to the effect that rules governing the generation of electricity will be substantially liberalized immediately. Apart from the signaling effect of this, such a step will unlock at least some large investment projects.

3. *Rethink the riskiest new proposals*
   This is not a time in which new spending proposals (NHI, very much included) should be considered or in which further assaults on property rights (such as the passage of expropriation-without-compensation constitutional amendments and laws) should be entertained. Hard as it is politically to walk back from these proposals, the president needs to do it. Clearly the architects of these proposals in his own party intend these to be the poison pills that kill his presidency. He should bite the bullet and tell his party that the risks of these policies far outweigh their potential benefit, and that he has to focus on accelerating growth.

4. *Accountability for state capture*
   The fact that no-one central to state capture has been prosecuted successfully continues to be a blot on President Ramaphosa's new dawn, and for more than one reason:
   - It reveals the weakness of South Africa's rule of law;
   - It implies impunity for wrong-doing on a grand scale, which, apart from anything else, means that would-be looters may remain undeterred; and
   - It means that opposition to President Ramaphosa within the ANC remains stronger than it would be if some of the leaders of the "fight back" factions had been prosecuted.

   For all these reasons, progress on this front is desperately needed.

5. *Get smart about the capable state*
   Reforming presidents need a game plan, a list of priorities, and a team of competent technocrats to drive the reforms needed. Successful reformers also need a compelling narrative that explains why changes – some of them harmful to some interest groups – are essential and how the pain will be mitigated and distributed fairly. They need a plausible plan to achieve this, too, as well as a political strategy for building the coalitions of interest groups needed to pull this off.

   None of this describes our current reality, and it is vital that the president put in place the critical building blocks he needs to be a successful reformer if that is, indeed, what he wishes to be. Reform packages are not self-executing, and unless the president gets much smarter about how he will manage the process, reforms will never happen.

Concluding comments: the role of business

South Africa is in desperate need of reform. If implemented as proposed, the 2020 Budget will make significant progress towards putting our public finances on a more sustainable footing. In the absence of growth-enhancing reforms elsewhere, however, even these proposals will fail in the longer term goal of stabilising the debt. It is vital, therefore, that government both succeed in fiscal consolidation and in implementing appropriate economic reforms.

And, given this, it is critical that all stake-holders in society seek to maximise the chances of success. This means that labour needs to approach re-opened wage negotiations with an understanding that what is at stake is not whether or not wages rise by 6 percentage points next year, but whether South

Africa can avoid the kind of economic crisis that would throw the economy into a deep recession and lead to even more job losses across the economy.

Business, too, needs to help: if reformers do not prevail now, it is hard to see how they will do so in the future, so business needs to help them. It can do so by helping government persuade the public of the need for reforms, by helping formulate and press for essential and sensible reforms in a manner than maximises the chances of success and minimises the pain that will be imposed, and, above all, by adopting as positive an attitude to investing as possible; as much as possible, they need to be looking for opportunities and reasons to invest. Growth and recessions are, after all, self-reinforcing processes in which the attitudes of investors and businesses have real consequences. To the extent that business has a lot to fear from reformers' potential failure, they should be doing everything they can to minimise its likelihood.

Please see CDE's earlier reports on the fiscal crisis, www.cde.org.za.

- **RUNNING OUT OF ROAD: South Africa's public finances and what is to be done (August 2019)**
- **NOW IS THE TIME FOR CR's ENDGAME! Statement by CDE on South Africa's growth and fiscal crisis (October 2019)**