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MEDIUM-TERM BUDGET POLICY STATEMENT

IS SOUTH AFRICA HEADING FOR A 'FISCAL CRISIS'?

SUMMARY OF FINDINGS

- Data indicates that South Africa is not on the precipice of an acute fiscal or budget crisis. At the same time, the current trajectory, without meaningful economic expansion, is unsustainable over the medium term.
- We estimate a revenue shortfall of R67.2 billion, if no changes are made for the rest of 2023/24. This is within historical norms, comparable to the shortfalls in 2017/18, 2018/19, and 2019/20, and far less than the R241 and R123 billion in revenue overruns in 2021/22 and 2022/23 respectively.
- The revenue shortfall is predominately explained by a decrease in corporate income tax, value-added tax, and mining royalties. Other sectors, as well as personal income tax, have performed in line with expectations and could compensate for some of the shortfall in coming months.
- We also project a R67.9 billion expenditure overspend on current trends. The largest share of this is R37.5 billion from the predictable but unbudgeted public sector wage bill increase. The overspend is also comparable to other years, but the revenue shortfall and expenditure overspend compound one another.
- National Treasury should have budgeted for items included in the overspend and if this overspend is a 'crisis' then it is one entirely of National Treasury's own making.
- It would be incorrect to characterise South Africa's current debt levels as being at 'crisis' proportions. South Africa's debt-to-GDP ratio (at 71.4% in 2022/23) is in line with the emerging market and middle-income country average (of 69% in 2022/23). However, the debt trajectory is of concern if there is no credible growth strategy.
- The critical issue facing South Africa's borrowing is the cost of debt, that is, relatively high interest rates. On other measures, such as currency denomination, South Africa fairs well.
- The only credible manner to tackle debt levels is through economic expansion.

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SUMMARY OF RECOMMENDATIONS

- Make use of some of the R459 billion owed to the South African government in the SARB's somewhat obscure Gold and Foreign Exchange Contingency Reserve Account to close the budget mismatch.
- Close a portion of the budget mismatch through increased borrowing. Even if the entire mismatch was closed in this way it would only increase debt levels by 1-2 percentage points and keep them well below recent estimates.
- Raise additional revenue in the short-term by: a removal of tax breaks for high-income earners; a removal of select tax breaks for corporates; and restoring the corporate income tax rate to 28%.
- Explore raising additional taxes through: increased taxation on wealth and income from financial assets; tackling illicit financial flows; and capturing rents and windfalls.
- Do not raise VAT which would make the tax mix more regressive, fail to raise the sums needed, and disproportionately burden poor and low-income earners.
- Reduce the cost of borrowing through: yield curve management (more medium-term borrowing), targeted debt renegotiation; preferential or prescribed lending; and interest rate management.
- Institute a considered, transparent, consultative, and evidence based expenditure review process.

These recommendations are elaborated on and sequenced in Section 6.

1. INTRODUCTION

South Africa's National Treasury has sounded an alarm over a potential budget shortfall and instructed departments and entities across the state to dramatically and immediately cut expenditure. This Policy Brief analyses the reported budget shortfall and proposes ways it can be managed in a manner that improves economic performance and both safeguards and expands vital service provision over the short and long run.

It is important to distinguish between the potential of an immediate 'fiscal crisis' and what this year's revenue and expenditure trends signal for the medium-term sustainability of the fiscal trajectory. With respect to the immediate and acute reported 'fiscal crisis' it should be stated unequivocally that this is being exaggerated for political purposes. As will be shown below, the budget mismatch (on both revenue and expenditure ends) is within historical norms, considerably below recent revenue windfalls, and well within government's ability to close without resorting to chaotic budget cuts. The numerous avenues for closing this budget mismatch are unpacked below. We will also show how the expenditure overruns have been caused by (reckless, and seemingly deliberate) poor planning on the part of the National Treasury. Closing the revenue gap would be far preferable to rushed expenditure cuts whose medium-term impact is likely to be destructive and self-defeating.

At the same time, the budget mismatches currently playing out are a warning. A situation of repeated revenue shortfalls and expenditure overruns would be unsustainable. In the medium term we could run out of road to meet these through increased revenue. The only credible way out of this quagmire is a viable path for economic expansion. The debt-to-GDP ratio – the most common measure of debt levels – is determined by both debt and GDP levels. If GDP rises faster than debt, the debt-to-GDP ratio falls. The volume of economic activity is also a key determinant of tax receipts. Appropriate fiscal management must be a crucial plank of any credible growth strategy.

The reality is that budget cuts run the risk of causing economic contraction. Recent research shows that fiscal contraction larger than 1.5% of GDP generates a negative effect of more than 3% on GDP even after 15 years. The drop in GDP reaches 5.5% for fiscal contractions larger than 3%.[1] Recent research by the IMF also highlights that, "[o]n average, fiscal consolidations do not reduce debt-to-GDP ratios".[2] Despite this, National Treasury maintains a dogmatic and ideological commitment to austerity, with achieving primary budget surpluses through expenditure cuts as the overriding objective of fiscal policy.

This does not mean there is no room for an expenditure review, state restructuring, or targetted expenditure reduction. But it does mean this must be undertaken within a developmental fiscal framework whose primary purpose is service delivery, economic growth, employment creation, social protection, and structural transformation in a considered and transparent manner. This means all options – including raising additional revenue and expanding expenditure in key areas that are under-resourced – should be on the table. The fiscus has a critical role to play in achieving a better and more inclusive economy, it must be managed to ensure it is part of the solution, not contributing to the problem.

This Policy Brief has five further sections. Section Two quantifies and analyses the immediate revenue shortfall, looking at its size, cause, and likelihood of self-correction, as well as how it compares to previous years. Section Three approaches the potential expenditure overrun in the same manner. Section Four does a deeper dive into South Africa's debt dynamics, identifying areas of strength and vulnerability. Section Five tackles a range of policy proposals for raising additional revenue, including through funds lying idle at the Reserve Bank, increased borrowing, raising tax revenue, and reducing borrowing costs. Section Six concludes with sequenced policy recommendations.

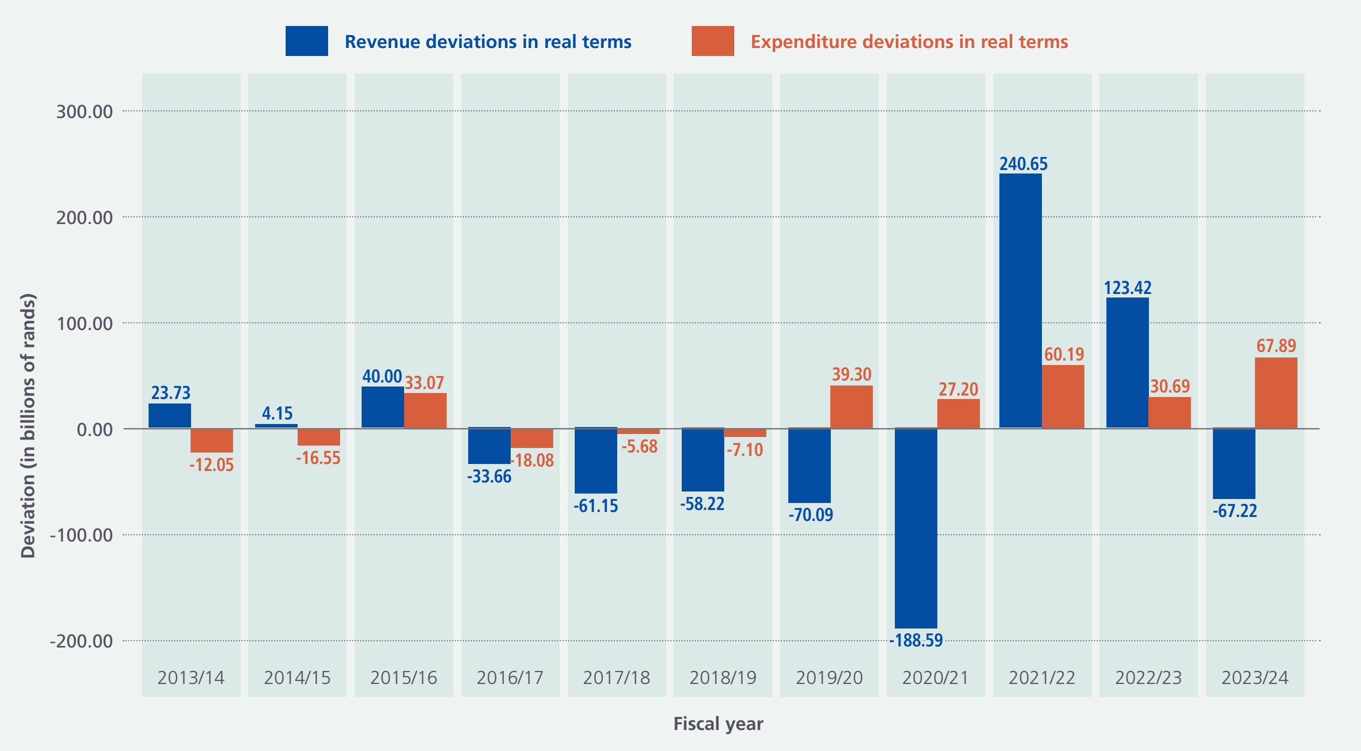
2. REVENUE SHORTFALL

2.1 THE SCALE OF THE POTENTIAL REVENUE SHORTFALL IN HISTORIC PERSPECTIVE

Revenue collections in 2023/24 so far suggests that there will be a revenue shortfall of approximately R67.2 billion. We calculated this by comparing the percentage of revenue usually received in the first four months of the year (the period for which there is data available) and compare that to the percentage of the budgeted revenue actually received. Between April and July 2023 we estimate a shortfall of R19.6 billion. The latest figures from National Treasury indicate a shortfall of about R22 billion for the first five months of the fiscal year, congruent with our calculation.[3] If the current trend continues – and that is by no means a certainty – government should expect a further shortfall of around R47.6 billion for the remainder of the fiscal year. This would bring the full fiscal year shortfall to approximately R67.2 billion.

This projected revenue shortfall is not abnormally high. As visible in Figure 1, in the four fiscal years (2016/17 – 2019/20) prior to the onset of the Covid-19 pandemic and the associated lockdowns, total revenue came in lower than Government expectations. Moreover, the size of those revenue shortfalls (in April 2023 rands), ranging from R34 billion to R70 billion, are comparable to the projected R67.2 billion shortfall for 2023/24.

Figure 1: Revenue and expenditure deviations in real terms (April 2023 rands) (2013/14 – 2023/24)



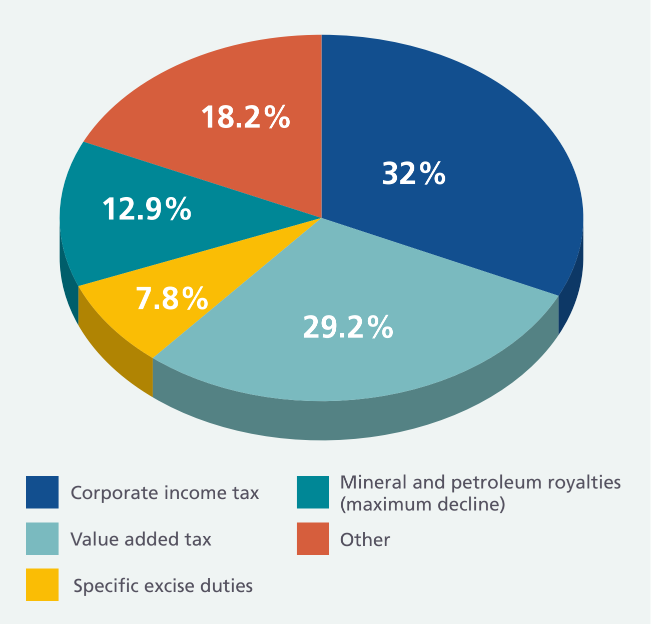
Source: National Treasury, various Budget Reviews, Annexure Table 2, own calculations

Curiously, the manner in which National Treasury responded to previous and anticipated revenue shortfalls failed to reverse these and even sharper revenue shortfalls followed. Anticipating full-year revenue shortfalls by the end of 2016/17, 2017/18, and 2018/19, government intervened by instituting reductions to the spending ceiling,[4] the reprioritisation of funds,[5] and an acceleration of austerity, among other measures. In the years that followed, revenue shortfalls were even steeper. This runs counter to the supposed benefits of fiscal consolidation. This trend in revenue under-performance was only halted by dramatic downward revisions to revenue expectations under Covid-19 and the unanticipated boom in global commodity prices which led to R364 billion in unplanned revenue in 2021/22 and 2022/23 combined. In sum, fiscal consolidation has, in recent years, not helped close revenue gaps.

2.2 EXPLAINING THE REVENUE SHORTFALL

The revenue shortfall is predominantly the result of under-collection of corporate income tax, value-added tax (VAT), and mining royalties; together these account for over 70% of the revenue shortfall. Notably, corporate income tax is a disproportionately higher share of under-collection relative to its share in total revenue. This role in the revenue shortfall is substantially driven by the increasingly higher share that the mining sector has contributed to corporate income tax collection since 2020/21. The weak performance of the mining sector has also had an effect on another source of revenue, mineral and petroleum royalties.

Figure 2: Main source of revenue shortfall (assuming post 2020/21 trends)



Source: National Treasury, various Monthly Releases, own calculations

Note about Figure 2: This assumes that mining royalties were budgeted to be spread over the year in the same manner as occurred in 2021/22 and 2022/2023. This seems a reasonable assumption given that the budgeted revenue trajectory for 2023/24 follows that of those two years (see Table 2 in Budget Review appendix).

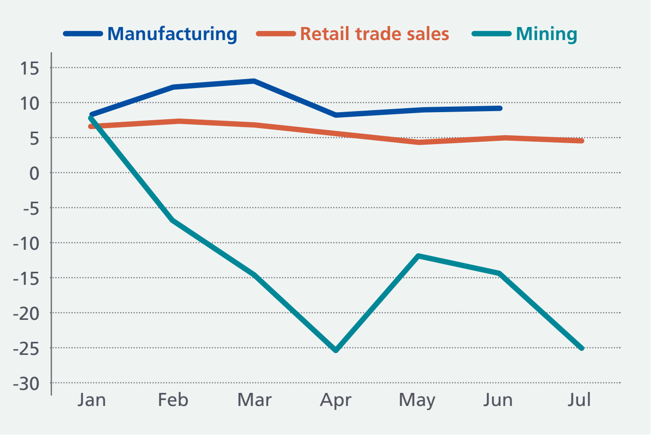
Despite the weaknesses in corporate income tax and VAT, not all revenue sources have disappointed. At the end of July 2023/24, monthly revenue collections suggest that personal income tax – which is the biggest contributor to total revenue – will come in at figures that match budget expectations. The fuel levy, which makes up around 5% of revenues, is set to out-perform expectations.

2.3 UNPACKING THE FALL IN CORPORATE INCOME TAX AND WHETHER IT MAY BOUNCE BACK

Between 2020/21 and 2021/22, corporate income tax collections grew by 51.8% in real terms.[6] This is not only due to abnormally low collections during the Covid-19 lockdown year of 2020/21, as, in real terms, 2021/22 receipts were also 40.8% higher than in 2019/20. The increase in corporate income tax revenue from 2020/21 to 2021/22 was driven by increased tax receipts from the mining, manufacturing, and financial services sectors, with nominal growth of R47.2 billion, R20.6 billion, and R24.7 billion, respectively.[7] Analysing trends in these sectors is therefore important. In 2023/24, while the mining sector has performed dismally, manufacturing and the financial sector have performed better by comparison, maintaining strong revenue growth.

The mining and quarrying sector, which made up around 28% of corporate income tax revenues in 2021/22 and nearly 30% in 2022/23,[8] has experienced a torrid year in 2023. This is apparent in Figure 3, showing how seasonally unadjusted growth of sales fell year-on-year from 7.7% in January 2023 to -24,7% in July 2023 (that is, in comparison with June 2022).[9] In addition, seasonally adjusted mining production decreased by 1.7% year-on-year. Although the mining sector performance has waned, retail trade and manufacturing sales have remained strong, with an average growth of 5.8% and 8%, respectively, in the first half of 2023. Seven of the ten manufacturing subsectors reported positive growth in the three months ending July 2023, compared with the previous three months.

Figure 3: Sales growth in key sectors year-on-year, January – June 2023



Source: Stats SA 2023, own calculations

These sectors, together with financial services have contributed positively to GDP in the second quarter of 2023.[10] The manufacturing sector increased by 2.2% in the second quarter, and contributed 0.3 percentage points to GDP growth. The finance services sector increased by 0.7% in the second quarter, contributing 0.2 of a percentage point to GDP growth – maintaining its strong performance from 2022. As a recent report by PwC shows, the South African banking sector, a key subsector in the financial services sector, has reported its highest combined earnings ever in the 2022 financial year of R100 billion, or a 16% increase in nominal terms compared to 2021.[11]

While the consistent positive performance by the manufacturing, retail trade, and financial sectors is encouraging, it is not yet clear whether this will be sufficient to reduce the projected revenue shortfall. There are no indications yet that the manufacturing and retail trade sector will experience a significant boost in demand going into the latter half of 2023/24. Meanwhile, the main source of the record high profits in the financial sector, which has been the interest rate hikes from the Reserve Bank, may start to have a waning effect as major banks report increases in loan impairments[12] and interest rates stabilise due to disinflation. Given their importance, It is important that monetary and fiscal policy be supportive of expanding tax-revenue generating sectors.

3. EXPENDITURE OVERRUN

3.1 THE SCALE OF THE POTENTIAL EXPENDITURE OVERRUN IN HISTORIC PERSPECTIVE

There is also a potential discrepancy between what was budgeted for 2023/24 and spending to date. Using the same method as captured in Figure 1, we estimate the potential for a full-year expenditure overrun of R67.9 billion. This method is a little less reliable when applied to expenditure (as compared with revenue) but we do not expect the potential overspend would be greater than this, and likely somewhat less. This estimate is based on no change in expenditure plans.

Similarly to the revenue shortfall, the projected expenditure overrun for 2023/24, and its scale, is not unprecedented. In each of the past four fiscal years, 2019/20 to 2022/23, the government has seen expenditure overruns ranging from R27.2 billion to R60 billion (see Figure 1). Admittedly, what is difficult is that this year sees both a revenue shortfall and expenditure overrun, thereby compounding one another. This, however, is also not unprecedented, but differs from the last two years in which expenditure overruns were easily accommodated within revenue windfalls. With respect to the recent revenue windfalls, it should be noted that government – once again – missed an historic opportunity to implement windfall taxes in the wake of both Covid-19 and the commodities boom, and is now trying to saddle the public with the consequences of that failure.

3.2 THE REASONS FOR THE POTENTIAL EXPENDITURE OVERRUN

Breaking down the expenditure overrun is difficult because, as far as we are aware, National Treasury does not make budgeted monthly expenditure data - how much is budgeted to be spent each month – publicly available. We do, however, know that the public sector wage settlement came in R37.46 billion higher than what was budgeted for. We also know that National Treasury has reported a further R26 billion in "unfunded budget submissions" for 2023. We also estimate that foreign loan redemptions and interest will rise by R5 billion due to exchange rate depreciation.

The majority of this shortfall, is therefore, the predictable outcome of National Treasury's poor planning, and therefore the question needs to be asked – was this under budgeting deliberate to pave the way for further cuts? Considering the consistently above 5% inflation rates since 2021 – reaching almost 8% towards the beginning of 2023 – it was unrealistic and irresponsible to budget for a 1.6% public sector wage increase (the final increase was 7.5%) and this would, naturally, result in a spending overrun. In addition, the "unfunded budget submissions" include, in 2023/24, R17.4 billion for provincial health and education, funds that should also have been included in the 2023 National Budget in the first instance.

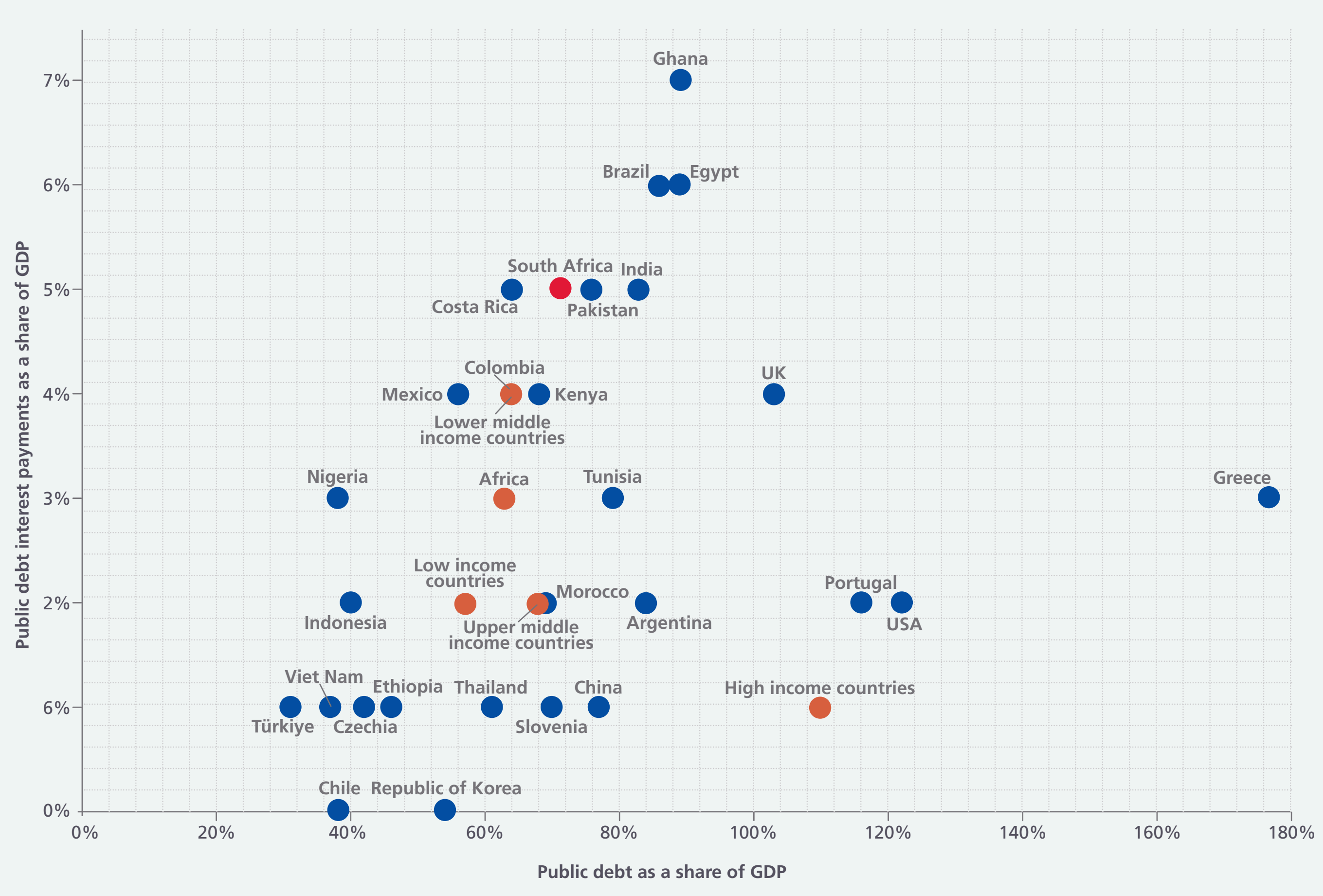
A similar lack of responsibility is displayed for 2024/25 and beyond. In 2024/25, National Treasury reports "unfunded budget submissions" of R40 billion for the Social Relief of Distress (SRD) grant, R342 million to align grants to inflation, a further R25.6 billion for provincial health and education, and R10.8 billion for the Presidential Employment Initiative. As with the above, to exclude completely foreseeable expenses from the Budget and then raise concern over pending shortfalls is deliberately manufacturing your own 'crisis', seemingly to force through spending cuts, in order to terminate, or limit, programmes which Treasury are opposed to, including the SRD grant and the Presidential Employment Initiative.

This takes place in the context of a pattern of real budget cuts to public services and key economics sectors since 2012. In 2020, proposed cuts to previously planned spending on government programmes amounted to R66 billion in 2020/21, R88 billion in 2021/22, and R107 billion in 2022/23. Real growth in non-interest expenditure per capita, which measures government's commitments to public services, has had negative year-on-year growth since 2020/21. Most recently, between the October 2022 MTBPS and February 2023 National Budget, the 2023/24 main budget expenditure total was cut by R7 billion. These cuts have affected the quality of public services such as healthcare and education.

4. DEBT ANALYSIS

Despite hostile international conditions, South Africa does not face an immediate debt or liquidity crisis. Bloomberg financial services currently places the debt default risk below a 10% likelihood. There are, however, a few worrying trends that need to be addressed. Unpacking South Africa's debt dynamics assists us in assessing whether this is an appropriate justification for the severe proposed budget cuts.

Figure 4: Public debt and interest payments as a share of GDP for select countries, 2022



Source: UNCTAD, 2023[13]

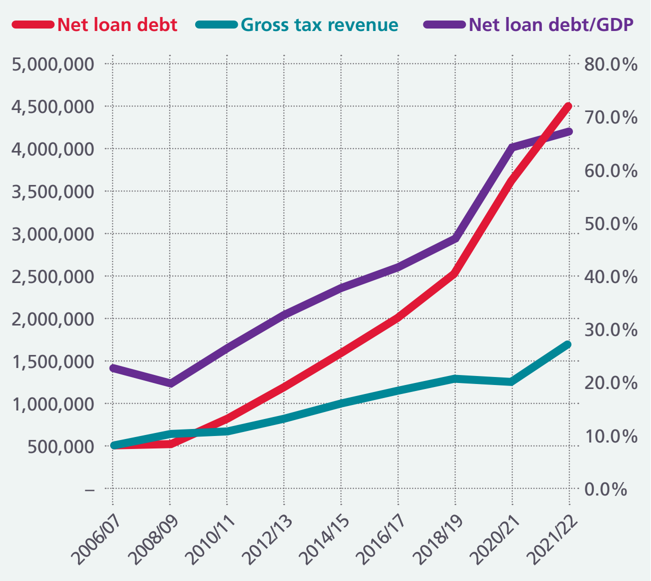
4.1 SOUTH AFRICA'S DEBT AND DEFICIT LEVELS

While large numbers are thrown around to emphasise the scale of borrowing, so far this year South Africa has not borrowed more than was budgeted. Over the last eight years (excluding 2020/21), the first four months of the fiscal year have seen South Africa borrow between 48% and 53% of total borrowing undertaken in that fiscal year, with an average of 50.6%. Over these months in 2023/24, National Treasury borrowed 51.4% of expected borrowing. Therefore, our rate of borrowing in 2023/24 has so far not been abnormal.

South Africa's debt-to-GDP ratio is on par with comparator countries – in 2022/23 it stood at 71.4%, in line with the emerging market and middle-income country average of 69%.[14] This is illustrated in Figure 4 where South Africa's comparative debt-to-GDP level is indicated by its place on the horizontal x-axis. As noted in Section 5 below, even if South Africa covered the entire budget mismatch by raising additional debt, our debt levels would remain within global norms. We take up the issue of borrowing costs – also shown in Figure 4 – in Section 4.4 below.

Although it is now widely accepted that there is no debt-to-GDP level at which debt, de facto, has negative economic impacts,[15] South Africa's debt trajectory raises some concern. Debt has been on a strong upward trajectory since 2009/10 and has consistently exceeded the growth of revenue. Shown in Figure 5, the growing gap between the tax revenue (green line), and the net loan debt (red line) – even taking growth into account (as the purple line does) – is concerning. Without economic expansion, debt levels may surpass the ability of the government to service it.

Figure 5: The trajectory of South Africa's debt and tax receipts



Source: National Treasury, Budget Review 2023[16]

4.2 SOUTH AFRICA'S DEBT PROFILE

Two important indicators of South Africa's debt profile are worth considering. First, and positively, South Africa borrows overwhelmingly in rands. Currently, only 11.7% of outstanding government debt is in foreign currency. This is in line with the average of 10% in the past decade. This is also below the government's official benchmark for foreign currency debt to make up 15% of total debt. The National Treasury projects this ratio to be 10.2% in the medium term although this is likely to be an underestimation, given that last year financing of the national government's gross borrowing requirement was under-estimated by R17 billion.[17] As part of the growing debt stock, net foreign debt as a proportion of GDP is also increasing, climbing from 1.2% of GDP in 2012/13 to 6.3% of GDP in 2022/23. Foreign debt represents external risks to monetary policy in the developed world, that has not been favourable to South Africa. Exchange rate movements between January and September 2023 mean an additional R5 billion in foreign debt servicing costs. Given the recent depreciation of the rand the government should reduce exposure to foreign denominated debt by as much as the balance of payments constraint allows.

Second, the overwhelming majority of South Africa's debt is long-term in nature, around 90%. This means South Africa has one of the longest debt maturity profiles of emerging market peers. In 2020, for example, the average maturity on South Africa's outstanding debt was 14.8 years, compared to the emerging market average of eight years. However, recent research by the SARB indicates this is a double-edged sword. On the one hand, long-term debt is argued to reduce vulnerability to debt crises. On the other hand, as shown below, longer-term debt is considerably more expensive in South Africa. The Reserve Bank has recently cautioned against the concentration of lending at the "ultra-long end" of the yield curve and the switch auction programmes that have contributed towards these (see Section 5.4).[18]

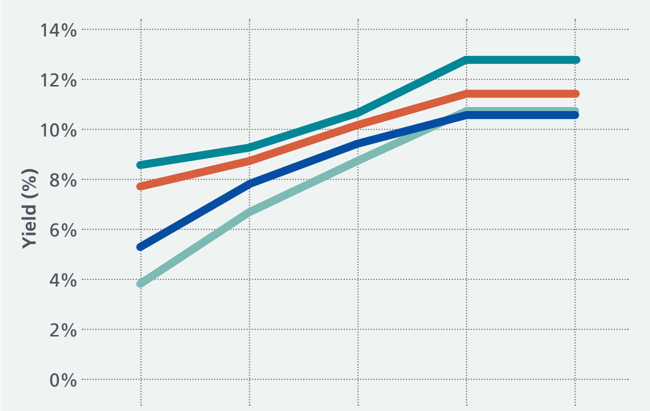
4.3 GLOBAL FINANCIAL INTEGRATION

As a small open economy, occupying a subordinate position in the global financial architecture, the commitment by the government to open capital markets and an inflation targeting regime means exposure to a range of external vulnerabilities.[19] First, interest rates and exchange rates are strongly influenced by international factors, including inflation, interest rates of developed countries, and global investor sentiment. Second, this results in costly policy responses, such as the accumulation of foreign exchange reserves or monetary tightening (increasing interest rates). Rising interest rates in core developed economies has made local bonds relatively less attractive. The SARB has chosen to compete by increasing the prime lending rate, thus strangling local investment. Debt service costs in 2022/23 were R5.4 billion more than expected mainly due to the Reserve Bank increasing the policy rate.[20] Third, as 40% of the debt is held by foreigners, this exposes South Africa to the risk of capital flight and potential subsequent exchange rate depreciation. Recently, foreign demand for new issuance of state debt has weakened. On a net of sales basis, non-residents dropped R20.3bn worth of their South Africa bond holdings in the first half of the year alone (having sold only R19.6bn in total during 2022).[21] Fourth, many of these investors are trading South African bonds for short-term speculative gains. These vulnerabilities are visible, for example, in the high level of carry trade on South African government bonds.[22] Policy options for accessing large pools of domestic financing are taken up in Section 5.

4.4 SOUTH AFRICA'S BORROWING COSTS

While the government is unlikely to lose access to capital markets anytime soon, the cost of borrowing is steadily increasing. This has also been the case during 2023, with 10-year bonds attracting an interest rate of 9.7% in January 2023, compared with 10.7% as of September 2023.[23] Figure 6 shows that the cost of borrowing for a range of debt maturities increased between 2020 and 2023. We also see that long-term borrowing is consistently more expensive than short-term borrowing. About 90% of the state's local debt is in the form of medium-to-long-term government bonds with 10% in the form of shorter-term Treasury Bills. The upwards shift in the 'yield curve' relates to both international – see above – and domestic factors. On the domestic front, weak demand for new issuances of government bonds by non-resident investors, growing fiscal risk related to a wider-than-expected deficit, a tax revenue shortfall, state-owned company bailouts, persistent power shortages, weakening domestic growth prospects, and social instability have all raised concerns, particularly for medium-to-long-term borrowing. The manner in which longer-term borrowing has been issued – via switch auctions – is also likely to have raised borrowing costs.

Figure 6: South African Yield Curve

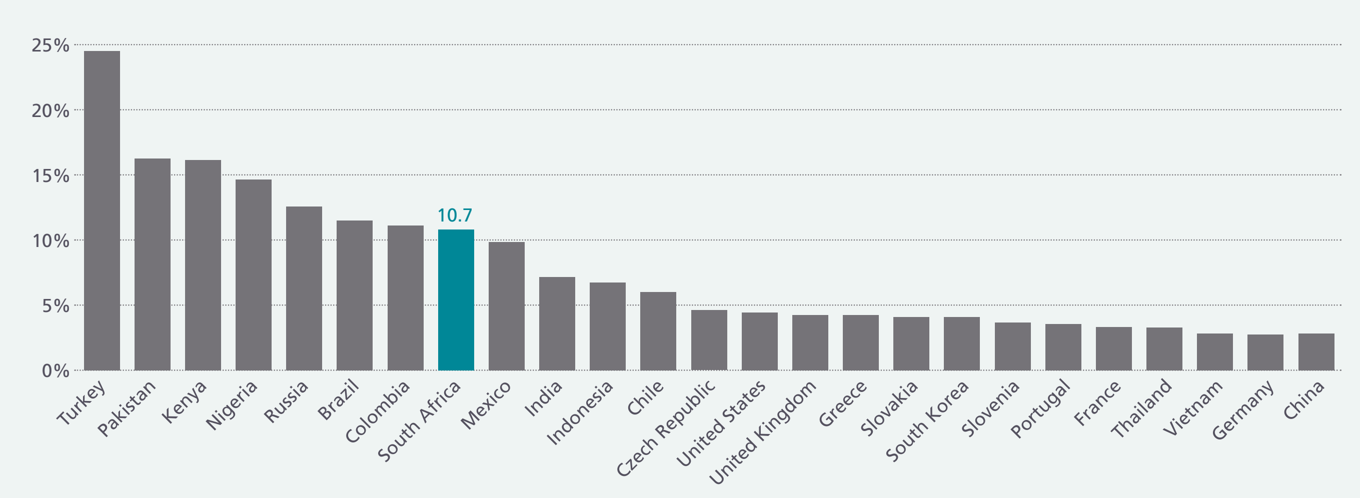


	3-month	5-year	10-year	20-year	30-year
▬ 2023	8.7%	9.3%	10.7%	12.8%	12.8%
▬ 2022	7.7%	8.8%	10.2%	11.6%	11.4%
▬ 2021	5.3%	7.9%	9.4%	10.6%	10.6%
▬ 2020	3.8%	6.7%	8.7%	10.8%	10.8%

Source: World Government Bonds[24]

International comparisons also raise some concern. On average, as shown in Figure 4, upper-middle income countries in 2022 paid 2% of GDP in interest payments, compared with South Africa's 5%. The vertical y-axis in Figure 4 shows the percentage of GDP paid on servicing debt across countries and comparator groups. This relatively high cost of capital can also be seen in Figure 7 which shows interest rates on 10-year government bonds across countries. While the relatively higher rates makes these bonds more attractive it also makes them more expensive to service.

Figure 7: International Comparison of South African 10-year Bond Yield



Source: World Government Bonds[25]

In the broader context of weak economic growth and middling tax receipts, this makes the trajectory of government's borrowing concerning. The growing quantum and increased cost of South Africa debt combine to result in debt interest payments being a rising and larger share of GDP and a larger share of revenues. For example, debt interest payment as a share of GDP rose from 2.2% in 2010 to 4.5% in 2022, debt interest as a share of revenues rose from 9.3 to 16.4% over the same period.[26] This is concerning as this crowds out other spending priorities. The critical policy challenge, therefore, is to reduce the cost of debt, and to advance a credible growth strategy. This is taken up in Section 5 below.

4.5 DEBT CHALLENGES IN CONTEXT

South Africa's debt story is one of the failure to utilise the expanded borrowing that has occurred to finance long-term structural change. The use of debt for fiscal spending is not currently increasing investment or levels of productive capital stock sufficiently, nor sufficiently improving employment or social outcomes. This has led to weak growth and weakened the demand for local bonds. By contrast, debt and growth can be mutually reinforcing if the borrowing is put to productive purposes. On the flip side, reducing resources available for the provision of critical economic and social priorities, will not improve those outcomes. Financial crime, corruption, and poor management cannot be 'budgeted away'. Reducing expenditure on infrastructure and social services will reduce the overall size of the economy over the medium-to-long-term.

The state needs growth to sustain a larger debt stock, but sometimes also needs to incur debt to sustain aggregate demand and make the necessary investments that underpin growth. The ability of the state to implement policies to grow and develop the economy in part relies on its ability to raise resources for the fiscus through debt. In other words, if the government is to embark on projects that sustainably expand the economy's productive capabilities, it needs to be able to issue debt at reasonable interest rates.

The crisis we face is therefore not a debt crisis but a growth crisis, alongside an associated social crisis. In the short term, South Africa's debt will not lead to a crisis. However, without monetary financing, increases in tax revenue, or economic growth, the increasing interest rates and related interest payments on government debt will crowd out provisioning on other critical budget items. We turn now to exploring solutions to this impasse.

5. POLICY OPTIONS

There are a number of avenues through which the government could tackle the immediate budget mismatches. These include increased borrowing, raising additional revenue, reducing expenditure, leveraging existing pools of funds, and reducing the cost of borrowing. Some of these are more short-term measures and others more medium term. The current year's budget mismatch can be solved relatively easily.

The longer-term issues may not all be solved through the proposals below. Ultimately, it is essential to devise and present a credible plan for economic expansion. Without the right sort of economic growth, debt may continue to rise, pockets of ineffective expenditure may be left untouched, and room to increase revenue will run out. A paradigmatic shift is required.

Critically, we need to see fiscal revenue raising and expenditure as part of the solution, not part of the problem. National Treasury takes the opposite approach, presenting revenue raising as onerous and unaffordable and spending as ineffectual. While this may be the case for limited forms of revenue and expenditure it is not, and need not be, the case in general.

Fiscal policy – within a coherent developmental macroeconomic policy framework and complemented by mutually reinforcing monetary, industrial, and labour-market policy – has a positive role to play. The fiscal policy objectives must be defined in developmental terms: spurring employment, maintaining demand, expanding the supply-side of the economy including both human and physical capital, reducing inequality and poverty, staving off destitution, and building social cohesion. These coherently fit within an agenda of structural transformation. In this way, future growth in the economy and tax revenue can be secured.

The proposals below are considered in that light – both providing avenues for closing the current budget mismatch, and fitting within a broader developmental agenda.

5.1 THE SARB'S GOLD AND FOREIGN EXCHANGE CONTINGENCY RESERVE ACCOUNT

A completely costless means of closing the entire budget mismatch is drawing down on the R459 billion owed to the South African government in the SARB's somewhat obscure Gold and Foreign Exchange Contingency Reserve Account (GFECRA). The GFECRA essentially records profits (or losses) made based on movements in foreign exchange rates and gold prices. More technically, the SARB notes: "The GFECRA, which is operated in terms of section 28 of the SARB Act, represents net revaluation gains and losses incurred on gold and foreign exchange transactions, which are for the account of the SA government." The SARB 2022/23 audited financial statements report the "Balance currently due to the SA government" as R459 billion.[27] Three points should be noted here.

First, National Treasury could easily access these funds. Indeed, when the account was in deficit in 2002 an Act – the Gold and Foreign Exchange Contingency Reserve Account Defrayal Act of 2003 – was passed without fuss and National Treasury paid R28 billion into the account over four years. Second, the fact that this money hasn't already been paid to the National Treasury is an international anomaly. As the private sector consulting firm Intelledix (soon to be Krutham) writes in a recent newsletter: "The whole thing is an anomaly because no other major central bank works like this – their realised and unrealised gains form part of a central bank's profits and so get remitted to their Treasury's each year."[28] Third, Intelledix, noting that this is "a policy altering amount of money" that "could pay for the SRD for 10 years" and that both National Treasury and the SARB are well aware of it, sheds light on why it is never touched:

> "Because of worries over nationalisation agenda (if SARB Act were to be amended), the fact part of it is unrealised gains, worries from the SARB and NT that it provides a free lunch that prevents deeper fiscal reforms and simply because that's just always the way its been with agreements between successive Ministers and Governors."

Essentially, Intelledix argues that the National Treasury's desire to implement austerity stops it from accessing money at its disposal.

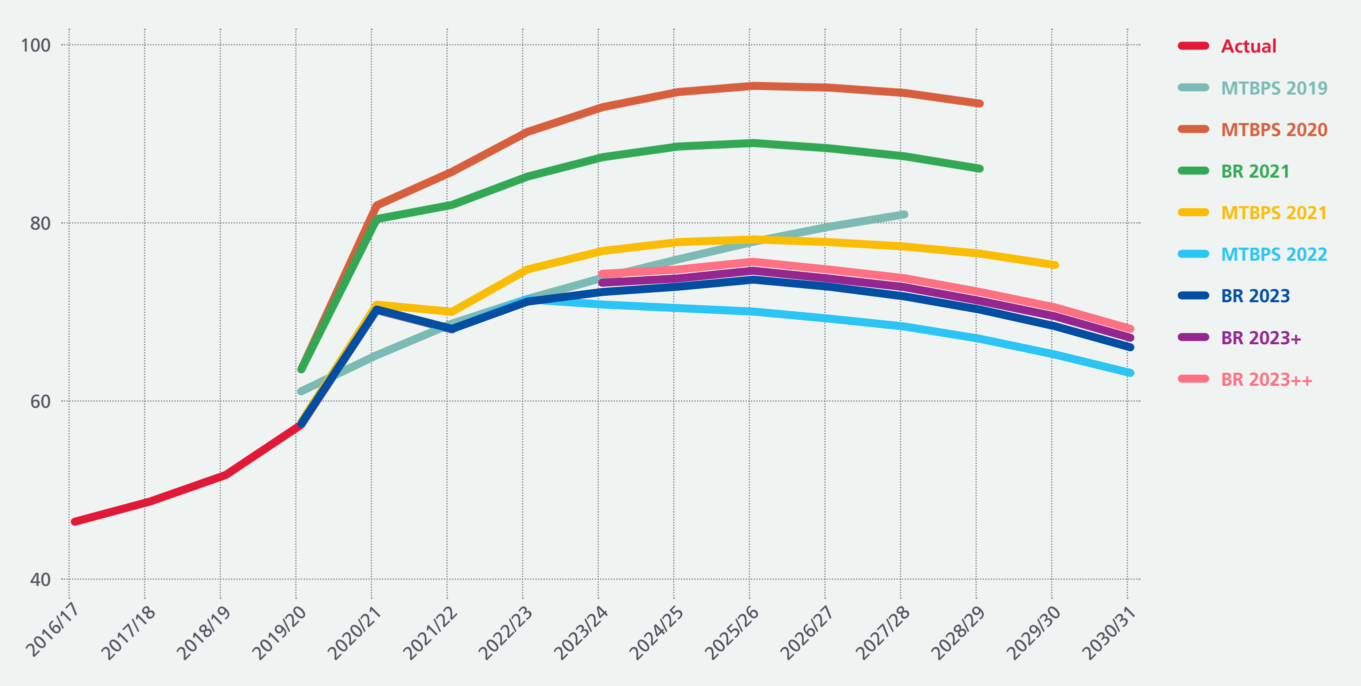
5.2 RAISE BORROWING

Another straightforward solution is to raise additional revenue through borrowing. A number of arguments are levelled against this.

First, opponents argue that borrowing is 'becoming more difficult'. It is unclear exactly what is meant by this but, as noted above, South Africa retains strong access to capital markets on favourable terms vis-a-vis debt currency denomination and maturities. The critical issue, identified above, is relatively high interest rates, a topic tackled below.

Second, the quantum of debt required is relatively modest. If the full budget shortfall was absorbed in additional borrowing this would only increase the gross debt-to-GDP ratio by approximately one percentage point (BR 2023+ in Figure 8). If the full revenue shortfall and full projected overrun in spending were covered by additional borrowing this would increase the gross debt-to-GDP ratio by approximately two percentage points (BR2023++ in Figure 8 below). In either case, The debt trajectory would also still be considerably lower than that forecast in 2019, 2020, and 2021.

Figure 8: Debt-to-GDP growth projections in different MTBPSs and National Budgets



Source: National Treasury, various Budget Reviews and MTBPSs, own calculations

The 2021 National Budget considered the stabilisation of debt at 88.9% in 2025/26 as "a sound platform for sustainable growth",[29] and the 2021 MTBPS was pleased to project lower levels. Absorbing the entire projected shortfall by increased borrowing would still keep gross debt-to-GDP 14.3 percentage points below the 2021 National Budget projected high. It would also be 3.5 percentage points below the much-reduced 2021 MTBPS projection. (These numbers would be one percentage point less if the full potential spending overrun was also incorporated.)[30]

It is curious, to say the least, that significantly higher debt levels were considered previously acceptable but now a shortfall that would necessitate a small debt-to-GDP increase is considered a fiscal crisis.

Third, it is argued that increased borrowing would limit growth by 'crowding out' private sector investment, either through limiting the pools of funds available to the private sector and/or raising interest rates. This theoretical argument – for which there is little credible evidence – relies on the theoretically incoherent idea that investment in the economy is exclusively funded by pre-existing pools of limited savings. By contrast, much investment in South Africa is actually financed by bank lending (not directly constrained by pre-existing pots of money) and/or by international capital.

What limits investment is the willingness of investors to invest or lenders to lend, and the availability of sound investment opportunities. This is distorted in South Africa due to the financial sector's preferences for large, established businesses, and the political and economic conditions that make potential investment risky. This is why credit in the economy needs to be more targeted (see below) and basic economic conditions improved. Therefore, if increased public sector borrowing (and associated spending) can be situated within a credible plan for development and economic expansion, it will be both available and beneficial.

5.3 RAISE TAXES

An alternative or complement to increased borrowing is raising additional tax revenue. Again, it is useful to understand that an erroneous theoretical position guides National Treasury's approach here. National Treasury adopts the views that: a.) taxation is a 'deadweight loss' to the economy; and b.) income and wealth taxes are more 'distorting' of the market than indirect taxes, such as VAT. The first claim is easily dispensed with as the aggregate and medium-term impact of taxation obviously depends on what the money is used for. If taxation diverts funds away from private-sector expenditure of relatively limited utility, to public expenditure that grows the economy, the aggregate impact is positive. Taxing and spending is essentially the state directing funds from one place to another. You can only believe this is de facto harmful to the economy if you believe in the fairy tail of the 'perfect market' that should be left alone to allocate resources as it sees fit.

The second proposition, to favour indirect taxes over direct taxes, arises out of four decades of an economy (and economic theory) designed to favour corporations and the rich. Indirect taxes – such as VAT – disproportionately impact poorer and lower-income households, while direct taxes are usually more progressive, with higher-income earners, the wealthy, and corporations, bearing more responsibility. The empirical evidence suggests that favouring indirect taxes while lowering direct tax rates (as South Africa has done) increases inequality with detrimental long-term consequences.

VAT

The proposal (or threat) to raise VAT is deeply problematic. First, raising VAT would make the tax mix more regressive, increase inequality, and have a disproportionately negative impact on the poor, particularly women and children.[31] It would place significant pressure on key consumer goods in the context of recent relatively high levels of inflation, particularly for food. Second, the last VAT increase failed to generate the promised revenue. In 2018 the VAT rate was raised from 14 to 15%. The 2018 National Budget projected that VAT tax receipts would rise in nominal terms by R49.1 billion. R22.9 billion of this would be because of the increased rate, the rest due to inflation and changes in expected spending patterns. In reality, VAT collections increased by only R26.8 billion, R22.3 billion short of the estimate.[32] Effectively, the increase yielded a pitiful R617 million more than what National Treasury would have projected without increasing the rate at all.

Removal of tax breaks

Reducing income support to the highest earners in South Africa – granted through various tax breaks – could also raise considerable revenue. In 2023, we estimate that these tax breaks will amount to around R305 billion. The largest share of these is retirement fund benefits (R232 billion) and medical aid rebates (R32 billion). Those earning above R500,000 will benefit to the tune of R144 billion, and those earning above R750,000 by an estimated R83 billion.

Table 1: Tax breaks (R 000s thousands)

	2021 TAX YEAR	2023 EQUIVALENT ESTIMATE	2023 EQUIVALENT ESTIMATE > R500,000	2023 EQUIVALENT ESTIMATE > R750,000
Donations	1,356	1,534		
Travel expenses – fixed cost – business cost claimed against allowance	18,753	21,216	14,462	8,592
Travel expenses – actual business cost	1,164	1,317	524	329
Other	2,540	2,874	1,807	1,336
Subsistence allowance – local	41	46		
Depreciation	137	155		
Home office expense	869	983		
Retirement fund contributions	205,698	232,713	113,620	65,859
Employer provided vehicle expenses	3,888	4,399	2,480	1,431
Employer provided vehicle expenses (operating lease)	179	203		
Other	6,980	7,897		
Medical Tax Credits Rebate	20,633	23,343	8,104	3,927
Medical Tax Credits Rebate – additional expense	7,521	8,509	3,159	1,596
	269,759	**305,188**	**144,155**	**83,072**

Source: SARS 2022 Tax Tables, own calculations

Interestingly, National Treasury had previously strongly considered reducing the Medical Aid Tax Credits. In the 2017 Budget Speech, Finance Minister Pravin Gordhan said that "consideration is being given to possible reductions in this subsidy in future, as part of the financing framework for national health insurance".[33] In the years that followed, however, little was done to reduce these tax credits.

Considering the vast sums of income support offered to the highest earning 30% in South Africa (those paying tax), National Treasury's campaign to defund the SRD grant is even more pernicious. It is also revealed for what it is – an ideological assault on social security based on prejudicial notions that the poor are not 'deserving' and that such grants create 'dependence', claims thoroughly dispelled by the available evidence, while accepting that subsidies for the rich are somehow defensible.[34]

Tax subsidies

In addition to tax breaks to individuals, various corporate tax subsidies should also be reevaluated.[35] Principal amongst these is the Employment Tax Incentive, a subsidy given to businesses on the basis of hiring young persons, irrespective of whether a person of another age would have been hired for that job anyway. In 2021/22 this cost the fiscus R6.6 billion.[36] Research has repeatedly shown that this subsidy has been ineffective in achieving its objective.[37]

Under taxation of wealth / income from wealth

Compared to OECD and Latin American countries, South Africa currently under-taxes wealth and the income derived from wealth, as well as the trading of financial assets. While the use of net wealth taxes has decreased significantly in Europe compared to past decades,[38] the few that remain generate significant revenues from this instrument. From 1965 to 2021, Spain, Sweden, Norway, and Switzerland, have on average generated annual net wealth tax revenues to the tune of 0.47%, 0.49%, 1.36%, and 4.7% of their respective GDP. In contrast to Europe, net wealth taxes have been growing in usage in Latin America. The revenues generated in Latin American countries have been comparable to those in Europe. As a share of GDP, revenues have averaged 1% in Argentina since 1990, 1.98% in Colombia since 2002, 0.207% in Ecuador since 2009, and 3.5% in Uruguay since 1990.[39]

Wealth taxes have also been deployed during times of economic crises, such as in the aftermath of the two World Wars and the Great Depression in the 1930s.[40] If National Treasury truly believes that the country is facing an unprecedented fiscal crisis, then history suggests that there may not be a more opportune moment to introduce a net wealth tax.

Researchers from the Southern Centre for Inequality Studies recently made a strong case for implementing a progressive wealth tax. According to their estimation, when levied at moderate, progressive rates from 3% to

7%, such a tax could raise between R70 and R160 billion in additional revenue.[41] By their 2021 estimation, that revenue would be 1.5% to 3.5% of GDP, which would be in line with the contribution of wealth taxes in both Europe and in Latin America.

Previous estimates by DNA Economics in 2021 show the significant potential for raising additional revenue through other taxes on wealth or financial incomes and assets.[42] Aligning tax paid on large pools of inherited wealth to the upper tax brackets would yield an additional R1.87 billion; modestly increasing the Securities Transaction Tax rate brings in R1.41 billion; instead, lowering the STT rate and broadening its base to a wider financial transaction tax could raise R41 billion; and a currency transaction tax stands to raise R3.75 billion.

Table 2: Proposed tax changes to income from, and trading of, financial assets

TAX	POLICY MEASURE	REVENUE POTENTIAL FOR 2023/24 (R BILLIONS)
Estate duty	· Estates valued between R3.5 million and R30 million are taxed at a rate of 36%, · Estates valued between R30 million and R146.8937 million are taxed at a rate of 41%, and · Estates above R146.89 million are taxed at a rate of 45%.	R1.87
Securities Transaction Tax	· Increasing the STT from 0.25% on all security transfers to 0.3%.	R1.41
Financial Transaction Tax	· Lower the STT rate to 0.1% but broaden the base to include the equity, interest rate, interest rate derivatives, and commodity derivatives markets	R41.00
Currency Transaction Tax	· CTT of 0.005% on all domestic over-the-counter foreign exchange rate instruments.	R3.75

Source: DNA Economics, 2021

Restoring corporate income tax

In 2021, National Treasury proposed the reduction of the corporate income tax rate from 28% to 27%, and this was implemented from 2022. The stated reasons for this were to encourage investment and decrease tax avoidance. There is little evidence that this has, or will, occur. At least two considerations need to be made in assessing the likely effects of a tax cut on investment – the effect on the effective tax rate and investment decisions. Given that the statutory and effective tax rate are closely aligned for most companies in South Africa and that for most companies tax exemptions play a minimal role,[43] reducing the tax rate is likely to lower taxes paid and hence lower the cost of capital. However, the rate reduction is unlikely to encourage investment as it does little to outweigh other factors dragging down investment levels. Taxes are only but one of the costs that companies face. Companies that are based in South Africa, especially in recent years, have seen a rise in other cost pressures. Reliable electricity, good port and rail services, a safe environment, a strong skills base and so on, are far more important determinants of investment than a one percentage point cut in tax rates.

Moreover, the wholesale use of tax cuts as a strategy to attract business is indicative of a weak growth plan. Taxes are one of the key costs faced by any company, meaning that the government can use taxes, as part of an overall industrial policy, to extract concessions from companies and bring about the kind of investment that leads to economic upgrading, greater employment and working conditions, and upskilling. Instead, if tax cuts are extended to all businesses, then they will also fall on companies who use the extra profit on things that do not add any social or economic value, such as share buy-backs.

In conclusion, the way in which the tax cut has been done is unlikely to yield any meaningful investment into the South African economy. This is not even considering demand constraints that South Africa faces as a result of high income and wealth inequality and low wages. This is not to suggest that a deeper rate cut is needed. Rather it indicates that, in this context, a) other measures – particularly tackling long-standing structural weaknesses in the economy – are more important for spurring investment; and b) the rate reduction has served simply as a measure to maintain company profits to the detriment of tax revenue, and with no gain to the economy.

Estimating the loss to the fiscus is complicated because of potential behavioural changes. However, a crude measure shows that taking account of the general reduction in CIT collected, the rate cut has cost the fiscus R12 billion. This comes on top of R13 billion tax foregone in 2022/23.

Table 3: Estimates of tax foregone from CIT rate reduction (2022/23 and 2023/24)

2022/23 tax foregone	R13
2023/24 Budgeted tax foregone	R12.7
2023/24 projected tax foregone	R11.9

Source: National Treasury, National Budget Review, 2023, own calculations

Tackling Illicit Financial Flows

An ongoing problem for the fiscus is tax evasion. Illicit financial flows (IFFs) drain the fiscus and the economy of much needed resources. From 2010 to 2014, it was estimated that the government lost about $7.4 billion annually in tax revenue due to trade misinvoicing.[44] In 2012 alone, illicit financial outflows from South Africa were estimated to be just above US$29 billion.[45] For the period 2000 to 2011, illicit financial flows made up about 4% of GDP in South Africa.[46] Illicit financial flows in South Africa are most prevalent in the tradable sector, in particular precious metals and stones, and electrical machinery and equipment. According to a recent estimate by UNCTAD, net illicit financial outflows in 2017 amounted to US$18.4 billion, with cumulative illicit financial flows at US$62.3 billion.[47]

The financial returns to improving the legal and institutional framework, as well as building the capacity to curb IFFs, are very promising. In one instance, South African tax authorities successfully reclaimed $2 billion in tax revenue from a multinational company.[48] Thus, the capacity of SARS and specialised law enforcement – including through additional funding – needs to be increased. In addition to this, the "Report of the High Level Panel on Illicit Financial Flows from Africa" made a number of recommendations to stop IFFs, some of which can be implemented with relative ease. These include, the use of Automatic Exchange of Information between African countries, investing in specialised units that focus on transfer pricing, and enforcing beneficial ownership disclosure.[49]

Capture the gains from commodity booms

While not a solution to the immediate budget mismatches, the recent commodities boom shows the importance of ensuring that the fiscus sufficiently benefits from inflated commodity prices. The most appropriate vehicle for this is a resource rent tax (RRT). This is a special tax levied on 'economic rents' in the commodities sector. Economic rents can be thought of as additional profit resulting from factors beyond the firm's influence and not due to any special effort or innovation on their part. Therefore, if an RRT is implemented, it will, by definition, have no impact on investment decisions as it will theoretically only be levied on the portion of profit above the investors' required rate of return.

Gains from an RRT could be considerable. Work by DNA Economics published in June 2021 – not considering the recent commodities doom – estimated a potential tax intake of R38 billion for this financial year with an RRT rate of 25%. During the recent boom, the gains would likely have been larger.

5.4 REDUCE THE COST OF BORROWING

As noted above, the critical factor impacting South Africa's debt profile is not its size, maturity, or currency, but the interest rates that South Africa faces on borrowed funds. It is therefore essential to secure access to credit on more favourable terms. This can be approached in, at least, four ways.

First, yield curve adjustment. Given that longer-term borrowing is much more expensive, South Africa should shift a higher share of its debt stock to medium-term bonds. National Treasury should also cease its switch auction programme whereby it repurchases or switches a bond before it matures in exchange for bonds of a longer maturity as this has been shown to drive up yields.[50]

Second, debt renegotiation. The terms of debt are often renegotiated in the face of debt defaults and restructurings. We do not believe that South Africa is anywhere near this point. However, there may be particular debts appropriate for such. Most notably, National Treasury should have entered into debt renegotiation with Eskom's creditors as part of the Eskom debt relief measures. These would have sought to reduce the quantum of debt owed, lower the rates to match sovereign bonds (where they do not already), and restructure the payment terms, including offering interest holidays and/or extending the payment date significantly. This would have provided both Eskom and the fiscus more favourable terms and greater breathing room and would have been entirely appropriate in the context of loans made to corrupt parties and an entity undergoing restructuring. This is still an option which should be acted upon.

Third, preferential or prescribed lending. Through various mechanisms the government influences the flow of investment and credit in the economy. For example, caps exist on the percentage of funds that can be invested abroad. Prescribed assets were reintroduced to public debate in the ANC's 2019 election manifesto. This refers to a government policy that requires investors, like retirement funds, to hold a certain amount of investments in government-specified assets, such as government or state-owned entities' bonds. Such a policy was previously in place in South Africa until 1989. At its peak, pension funds were mandated to invest up to 77% of all their assets between government bonds and state-owned enterprises. The asset management industry in South Africa has approximately R7 trillion assets under management and assets in pension and provident funds (public and private), short- and long-term insurers, and unit trusts combined amounts to R13 trillion.[51] Regulations could prescribe a fraction of these funds be held in government bonds at stipulated (reduced) rates. This would mean safe, guaranteed returns for public and private investors, the deployment of funds for developmental purposes, and a lowered cost of borrowing for the state.

Fourth, accessing capital on more favourable terms. Monetary policy has a strong role to play in managing interest rates on government bonds. These can be reduced by the purchase of government bonds by the central bank (within limits). The central bank could also issue subsidised credit to particular targeted sectors or institutions, such as Development Finance Institutions or state-owned enterprises, and these could finance certain development projects. Further, credit controls – as have been successfully used, across Europe, to finance government debt at lower interest rates[52] – should be put in place. Capital management techniques have played a similar role in successful developing countries, for example, Singapore.[53] All of these policy options should be openly explored and acted upon where appropriate.[54]

5.5 REVIEW EXPENDITURE

National Treasury consistently laments that their "attempts at fiscal consolidation has never resulted in the scrapping of a single sub-programme or spending unit in government".[55] Effectively, once a programme is set up it becomes difficult to close down, even if ineffective. This is indeed an undesirable situation. It should be a matter of course that spending on successful programmes is increased to meet identified needs while unsuccessful ones are revamped, or, if no longer appropriate, closed.

Over a reasonable time frame, and with adequate consultation within and outside of government, it is appropriate to undertake a thorough spending review and assess genuine needs and how best the fiscus can be deployed. This is important to any credible growth strategy. However, this cannot be prejudiced by a predetermined agenda of hyper austerity. Such a review might find that the most growth, rights, and development enhancing strategy is to strategically increase spending overall. It may find the opposite. Such a process must be considered, transparent, consultative, and evidence based, wherein the pros and cons of all options to raise revenue and/or realign expenditure are carefully assessed. Proposals to 'reconfigure' the state through merging or closing departments, functions, and entities, as recently proposed by National Treasury should be part of this, and some of these have merit. However, National Treasury's current actions – efforts to run roughshod over everyone else and ram through their long-standing preferred expenditure cuts and across the board spending reductions, which have damaging effects on key delivery areas – do not constitute an appropriate process.

6. CONCLUSION AND SEQUENCING OF RECOMMENDATIONS

With appropriate political will, the current budget mismatches are relatively straightforward to resolve. At the same time, further pressures are on the horizon. The current impasse therefore provides an opportunity for the fundamental reform of South Africa's fiscal framework. This needs to centre the role and potential of the budget in advancing developmental priorities – something we have expanded on substantially in other publications.[56] With this in mind, we recommend the following mix of policy tools, all of which have been used successfully internationally, and would be effective if introduced and sequenced appropriately.

IMMEDIATE RECOMMENDATIONS

1. **Revenue:** Both the expenditure and revenue gaps are closed by drawing from the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) surplus and/or issuing relatively short-term debt (with an approximate duration of one year).
2. **Cost of borrowing:** Shorten the maturity on government debt slightly by pausing the switch auction programme whereby National Treasury repurchases or switches a bond before it matures in exchange for bonds of a longer maturity.

SHORT-TERM RECOMMENDATIONS (AS OF FEBRUARY 2024 NATIONAL BUDGET)

1. **Redefining of priorities**: The priorities of fiscal policy are redefined to prioritise development, growth, and public services, with other considerations (such as, debt reduction) being subsidiary to achieving these outcomes.
2. **Revenue:** The corporate income tax rate is restored to 28%.
3. **Revenue:** Tax breaks for higher-income taxpayers are reduced by at least R50 billion.
4. **Revenue:** Estate duty on large estates is aligned with the upper personal income tax brackets.
5. **Revenue:** The Employment Tax Incentive is eliminated.
6. **Cost of borrowing:** Negotiations for haircuts and debt restructuring are entered into with Eskom creditors and any other appropriate creditors.
7. **Cost of borrowing:** The maturity profile of government debt is made somewhat more medium-term.
8. **Expenditure**: A government-wide transparent, consultative, and evidence-based expenditure review is initiated, including on 'state restructuring'.
9. **Expenditure:** Increased funding is given to SARS and dedicated financial crimes units to tackle tax evasion, improve tax collection, and reduce illicit financial flows.
10. **Expenditure:** Expenditure that provides for service delivery, economic growth, employment creation, social protection, and structural transformation is protected and expanded.

MEDIUM-TERM RECOMMENDATIONS (AS FROM FEBRUARY 2025 NATIONAL BUDGET ONWARDS)

1. **Revenue:** A sequenced introduction of a net wealth tax, taxes on trading of financial assets, and a resource rent tax takes place.
2. **Revenue:** The remainder of the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) is drawn down on to finance development priorities, possibly through allocation to a dedicated ring-fenced fund for stipulated usage.
3. **Cost of borrowing:** The Reserve Bank is mandated to reduce the cost of borrowing, including through bond purchases or differentiated lending windows, with the amendment of any laws made to accommodate this.
4. **Cost of borrowing and credit allocation:** Targeted capital controls, capital management techniques, and credit allocation policies are put in place to reduce the cost of borrowing and channel credit to priority sectors and entities.
5. **Cost of borrowing and credit allocation:** Prescribed assets for public and private institutional investors are put in place targeting state and quasi-state safe assets with reasonable returns that will provide affordable credit for development priorities.
6. **Expenditure:** Expenditure is adjusted, upwards or downwards across expenditure items, and the state restructured, based on the outcome of the expenditure review.
7. **Planned fiscal policy:** A coordinated and coherent plan is implemented to leverage fiscal policy for growth, development, and rights realisation.

While a number of these policy tools may seem highly technical, and somewhat complex, with the proper planning and sequencing our fiscal and monetary authorities are capable of effectively implementing all of them.

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