WITS UNIVERSITY 100 1922 2022

SOUTHERN CENTRE FOR INEQUALITY STUDIES

Analysis and commentary on Budget 2023

1 March 2023

Key points (1)

1. The 2023 Budget is presented in the context of multiple crises facing South Africa. The growth outlook has deteriorated since the tabling of the MTBPS, with load shedding, rail export constraints, and the operational crisis of local government all playing a decisive role in constraining South Africa's growth prospects, in a context of global uncertainty.
2. There is notable uncertainty on the policy issues critical for proper fiscal planning. Political incoherence at the center of government makes effective planning, budgeting and oversight nearly impossible. This is taking an increasing toll on the quality of budget institutions and reporting.
3. Government proposes to reduce its consumption spending further over the MTEF
   - This will assist with fiscal consolidation to stabilize debt, but also reduce aggregate demand growth through an unprecedented negative shock to government consumption spending.
   - Resources for core government services – basic education, healthcare and criminal justice - will be reduced. This will have an adverse effect on the incomes of lower middle-income citizens, and reduce the consumption-basket of the poorest.
   - These effects might be somewhat offset by rising transfers for early childhood development, public employment programs and social grants, which are only partially included in the budget. However, the size the proposed contraction to government consumption will overwhelm these measures over the medium term.

Key points (2)

5. The allocation of R254 billion in cash will overcome Eskom's bankruptcy, creating a strong financial platform to address loadshedding, and invest in infrastructure necessary for electricity sector structural reforms to succeed in the context of a just energy transition.
6. The economics of the plan are sound, as electricity is a binding constraint on growth, but the restructuring and turnaround plan may prove challenging to implement. The increased cash transfers to Eskom could herald the permanent subsidization of coal-fired electricity supply, financed out of general taxation (a highly regressive fiscal move, at odds with the energy transition)
7. Aside from the Eskom bailout, fiscal measures that respond to the electricity supply disaster are few and paltry. Significant additional spending pressures that respond to the disaster may emerge during the year.
8. National Treasury reports an improvement in the budget deficit, suggesting a stronger fiscal footing. However, these improvements reflect the exclusion of likely expenditures from the framework, and a change in accounting practice that wrongly excludes Eskom bailouts from spending and the deficit. Once these factors are accounted for, the expectation of an improved fiscal outlook is more apparent than real. Debt is unlikely to stabilize over the medium term.

Eskom bailout changes the energy game

- Eskom's cash allocation is increased from R66 billion to R254 billion. This will take the form of cash advances over the next three years.
- This cash will rescue Eskom from bankruptcy, creating a strong financial platform to address loadshedding and invest in infrastructure necessary for electricity sector structural reforms to succeed in the context of a just energy transition.
- Given recent revelations by corrupt networks deeply embedded in Eskom's supply chains, a major course-correction is required and National Treasury has presented a strong programme to achieve this.
- Many of the restructuring conditions attached to the cash make sense:
  - Concessioning power stations to the private sector
  - Shifting Eskom's new build focus towards transmission and generation
- The key financial conditions for the cash are that "debt relief can only be used to settle debt and interest payments"; and "no new borrowing will be allowed from 1 April 2023 …"

Eskom bailout (continued)

- With respect to the conditions:
  - It is by no means clear that the rest of government is behind NT's vision of a market-based electricity supply industry, with extensive private participation in transmission as well as generation. Treasury's conditions on the funding are likely to prove controversial within government and the ruling party.
  - Success depends on a strong security intervention, but it is not clear that the state has the effective security capabilities required to intervene, especially if important fractions of the political class are directly implicated.
  - Doubts about the future tariff path remain, and the achievement of cost-reflective tariffs (required to prevent a further build up of debt on Eskom's balance sheet) is by no means guaranteed. The President himself has cast doubt on the regulatory process and the 18.7% tariff increase.
  - No clear provision has apparently been made to fund for short-term diesel requirements to reduce load-shedding. Neither has treasury explicitly provided funds for maintenance and refurbishment of the coal-generation fleet.
  - Eskom's municipal debt issue is yet to be resolved.
  - Over the next three years, Eskom will undergo a complex and contested set of structural reforms, splitting it into three separate operations; this process of fundamental change is laden with risks and uncertainties.
- Given these uncertainties, Eskom may well remain permanently dependent on fiscal subsidies beyond the three year horizon currently anticipated by National Treasury.

Bailouts for state-owned companies (% of GDP)

Source Data: National Treasury
Note: For 2002-2022, Payments for financial assets as a % of GDP, for 2023-2025: Payments for financial assets plus Eskom “debt relief”.

Other responses to the electricity disaster lack ambition

- The loadshedding disaster *should* have prompted strong fiscal action to:
  - Lower the intensity of loadshedding
  - Protect society and industry from its most damaging consequences
  - Incentivize demand management, create new sources of supply, and protect energy-supply security of the poorest and vulnerable
- Aside from the Eskom bailout, measures to address the loadshedding disaster are few and paltry:
  - R1.1 billion added to free basic electricity provision to help pay for the 18.7% tariff increase
  - Up to R15 000 tax deduction to help affluent households to shield themselves from loadshedding
  - Not addressed:
    - Diesel procurement, emergency procurement, energy imports or other sources of short term supply
    - Measures that support public facilities (e.g. hospitals and schools)?
- It is possible that costs and expenses associated with the disaster will only be know later in the year, and can be addressed in the adjustments budget.

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Broader spending uncertainty continues

- No clear policy direction on issues that are critical for fiscal planning, while practices that weaken the link between budget formulation and execution are deepening.
- Covid SRD grant continues to be effectively funded as an "unallocated reserve" beyond 2023/24.
- Public employment programmes are not included in the budget.
- Compensation budget assumes another three years of below-inflation compensation increases
  - Plausible path of compensation spending no longer projected forwards
  - Instead compensation spending is corrected backwards (e.g. this year through the second adjustment budget)
- Claims that capital spending is growing fast need to be checked against past performance.
- The danger is that underspending against overly ambitious capital budgets is used as a surplus to finance bailouts to state companies and implausible consumption budgets, which face inevitable correction in future years.

Elements of non-interest expenditure

- The primary balance is revenue minus non-interest expenditure
- Budget 2023 reports that non-interest spending will fall dramatically in 2023 (from 25.5% of GDP in 2022 to 24.1% in 2023)

Core spending
Skills levy and revenue sharing with metros
Payments for financial assets
Non-interest spending (Budget Review)

Percent of GDP

28%
27%
26%
25%
24%
23%
22%

Outcomes
Forward Estimates

2017 2018 2019 2020 2021 2022 2023 2024 2025

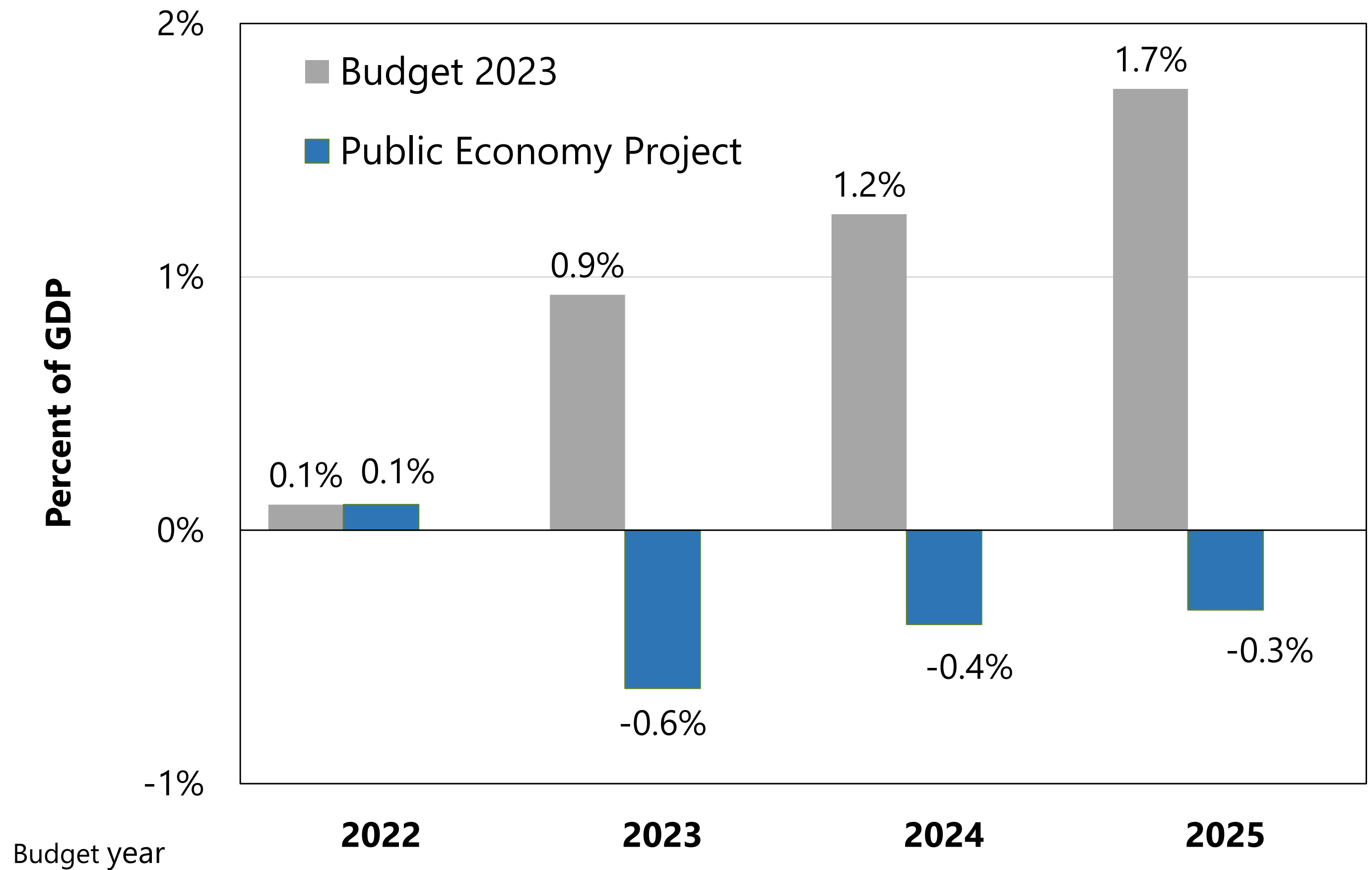
Actual / likely path of non-interest expenditure

This large adjustment is based on:

- Changed accounting for Eskom bailouts
- No longer including key spending pressures in the budget forward estimates (e.g. compensation)

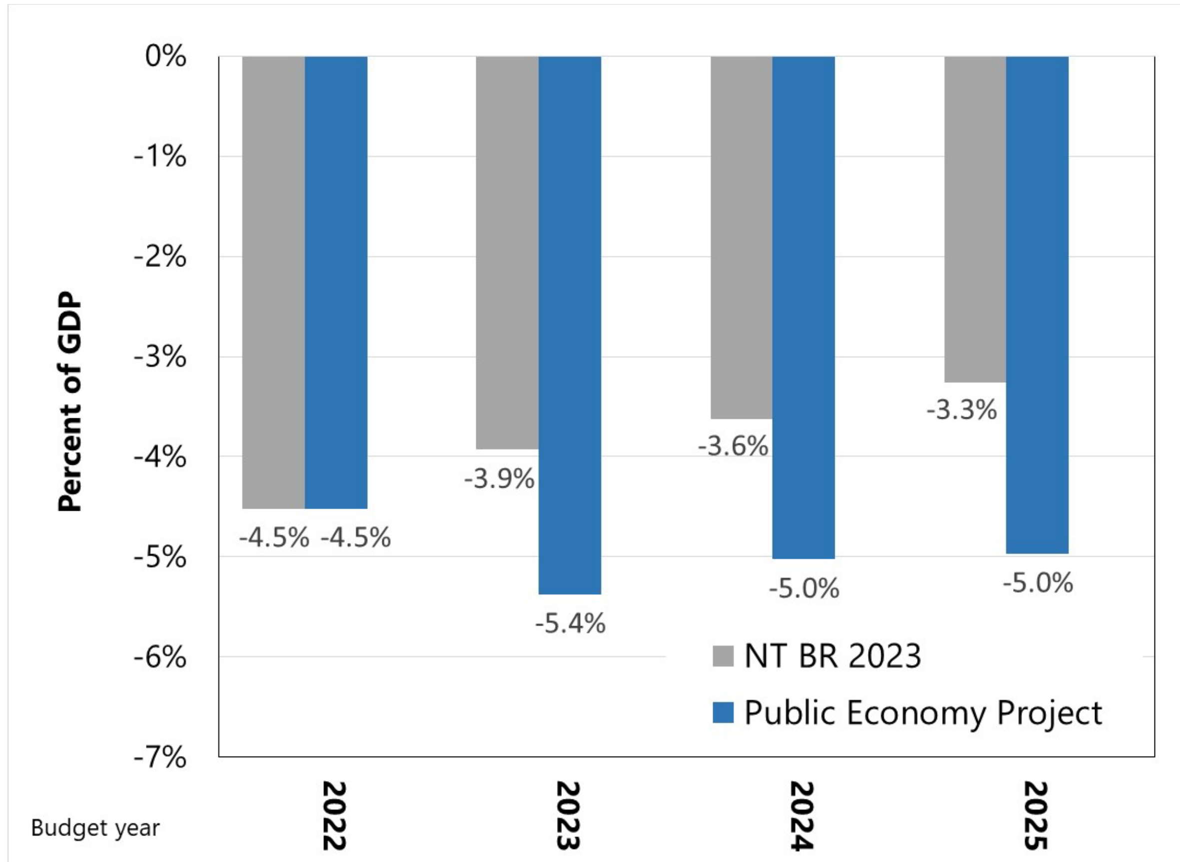
A more plausible and comprehensive fiscal outlook (1/2)

- **Expenditure assumptions in PEP alternate scenario**
  - Assumes that compensation budgets grow by CPI
  - Assumes public employment programmes implemented at Presidency minimum cost estimate from "Putting SA to Work" presentation
  - Eskom support is included as non-interest spending
  - Assumes that SRD grant is extended over the MTEF
  - Assumes unallocated reserve is allocated in full to fund the above expenditure pressures.

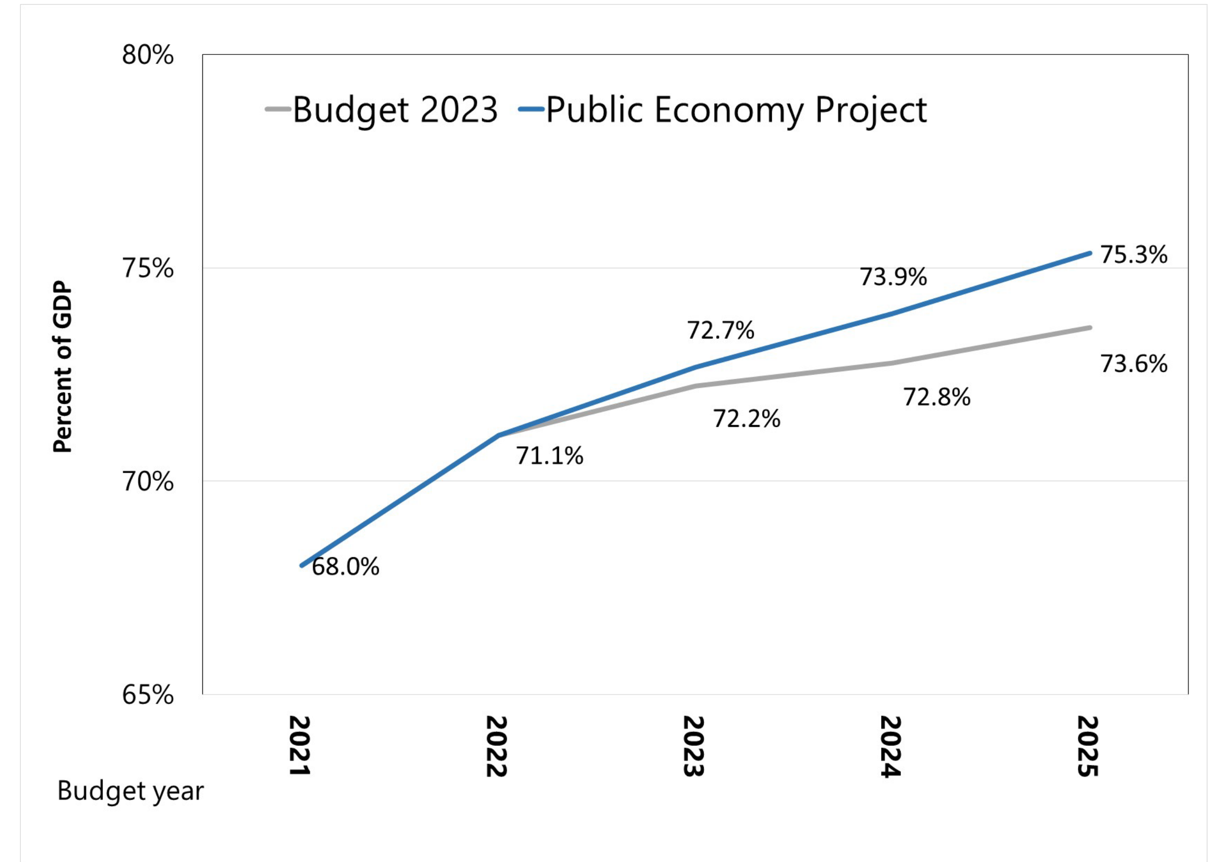


A more plausible and comprehensive fiscal outlook (2/2)

Main budget deficit increases across the MTEF compared with Budget 2023 estimates



Gross debt increases faster and does not stabilise over the MTEF



Macro-fiscal approach

- As part of its fiscal consolidation policy, government proposes to reduce its consumption spending leading to a lower level of fiscal resources per capita on core services over all three years of the MTEF
- If implemented, this will:
  a) Help to stabilise government and public sector debt
  b) Reduce aggregate demand in general, lowering the nominal rate of growth
  c) Have a direct impact on the incomes of lower middle-income citizens (i.e. the top 2-3 deciles outside the top 5%), through cuts to the real incomes of public sector workers (offset a bit with no fiscal drag, but reinforced if VAT were to be hiked)
  d) Have an indirect impact on the poorest citizens who consume core public services – basic education, healthcare and the criminal justice system – by lowering the level of resources made available to deliver these services
- However, the harsh consolidation envisaged in the budget may not materialise, as budgets are adjusted on a "pay as you go" basis each year

Larger contraction in consumption spending ahead

Annual percent change

22%
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%

National accounts
Consolidated budget
CPI

Budget 2023 projections and estimates

Budget year

2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025

Real spending per person to fall

Constant 2022 R'000

27
26
25
24
23
22
21
20

2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025

Budget 2023 projections

Spending priorities

Spending *growth* by policy function

Annual average growth | 2019–2025 | Nominal | consolidated budget

Debt-service costs
Community development
Economic development
Universities and colleges
Criminal justice system
Total
Basic education
Health
Social protection
Defence and state security
General public services
CPI

-2% 0% 2% 4% 6% 8% 10%

* Assumes “unallocated reserve” is allocated for further extensions of COVID SRD grant

Deteriorating real growth outlook

- Load-shedding remains the main issue
- Also domestic logistic constraints (Transnet), and a weaker global outlook
- Notable variance in updated growth outlooks
- SARB and BER lower than NT for 2023
- SARB lower than NT over the MTEF
- Potentially higher imports from renewable investment could deduct more from growth than assumed by NT
- Government's fiscal impulse, moves into stronger negative territory (subtracting more from growth)

Real GDP growth outlook - calender year*	2022	2023	2024	2025
National Treasury - MTBPS 2022	1.9%	1.4%	1.7%	1.8%
National Treasury - Budget 2023	2.5%	0.9%	1.5%	1.8%
South African Reserve Bank - September 2022	1.9%	1.4%	1.7%	-
South African Reserve Bank - January 2023	2.5%	0.3%	0.7%	1.0%
IMF - World Economic Outlook - October 2022	2.1%	1.1%	1.2%	1.4%
IMF - World Economic Outlook - January 2023	2.6%	1.2%	1.3%	-
Bureau for Economic Research - 1Q 2023	2.3%	0.5%	1.4%	1.8%

Nominal GDP growth outlook - calender year*	2022	2023	2024	2025
National Treasury - MTBPS 2022	6.1%	5.8%	6.5%	6.5%
National Treasury - Budget 2023	6.5%	4.5%	6.4%	6.5%
IMF - World Economic Outlook - October 2022	7.0%	4.8%	5.9%	6.1%
Bureau for Economic Research - 1Q 2023	7.0%	4.3%	6.7%	6.5%

*Growth projections correspond to publication date and not forecast date

Data: National Treasury, South African Reserve Bank, International Monetary Fund

Inflation and nominal GDP

- The 2022 budget benefitted from a nominal boom – rand depreciation and higher domestic inflation increased nominal revenues, improved debt metrics, and assisted consolidation.
- After peaking in 2022, CPI and GDP inflation are expected to moderate over the medium term.
- The moderation in CPI inflation assists with expenditure consolidation.
- The moderation in GDP inflation worsens key fiscal metrics expressed as a share of nominal GDP

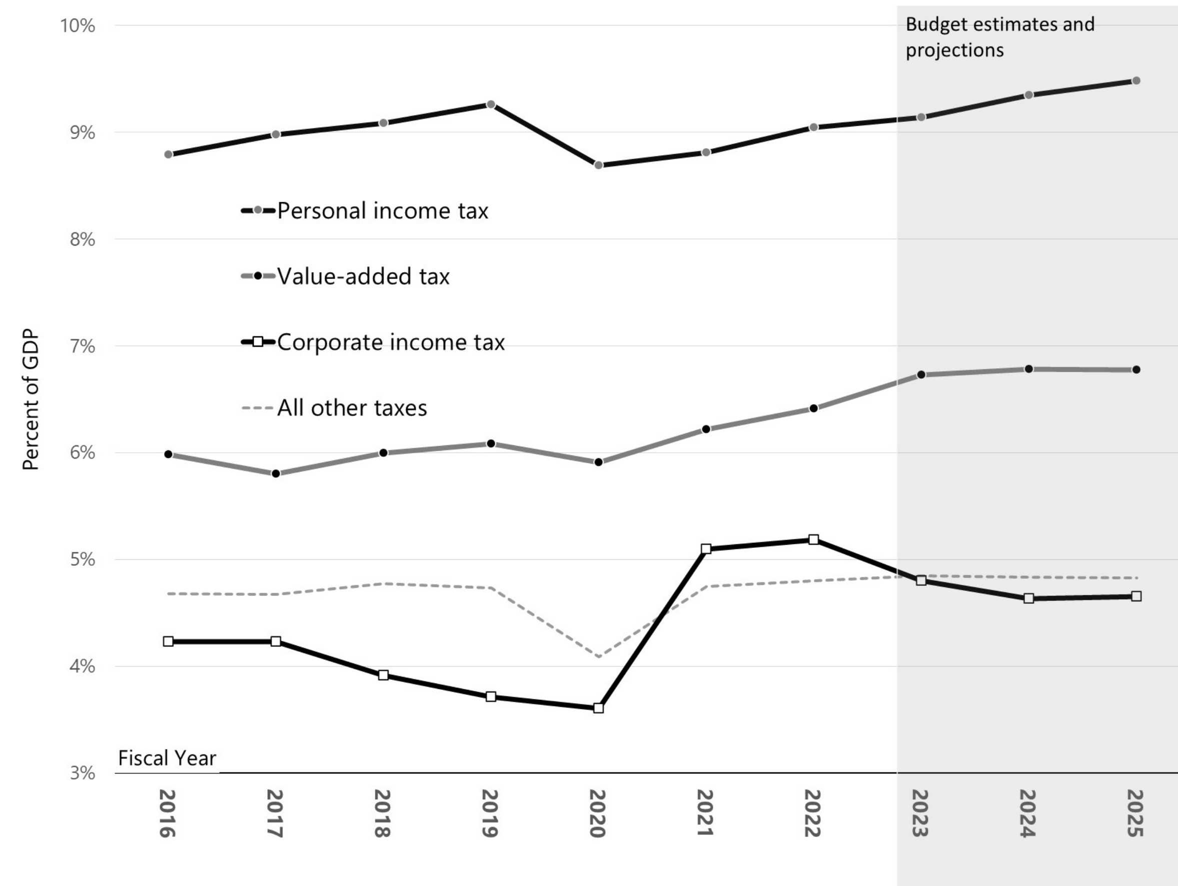
CPI outlook - calender year*	2022	2023	2024	2025
National Treasury - MTBPS 2022	6.7%	5.1%	4.6%	4.6%
National Treasury - Budget 2023	6.9%	5.3%	4.9%	4.7%
South African Reserve Bank - September 2022	6.5%	5.3%	4.6%	-
South African Reserve Bank - January 2023	6.9%	5.4%	4.8%	4.5%
IMF - World Economic Outlook - October 2022	6.7%	5.1%	4.7%	4.5%
Reuters Median - October 2022	6.8%	5.5%	4.5%	-
Bureau for Economic Research - 3Q 2022	6.9%	5.5%	4.3%	-
Bureau for Economic Research - 1Q 2023	7.1%	4.9%	4.6%	4.4%

GDP inflation outlook - fiscal year*	2022	2023	2024	2025
National Treasury - Budget 2022	1.1%	3.9%	4.5%	-
National Treasury - MTBPS 2022	4.3%	4.3%	4.8%	4.5%
National Treasury - Budget 2023	3.7%	4.3%	4.6%	4.6%
IMF - World Economic Outlook - October 2022	4.8%	3.9%	4.6%	4.6%
Bureau for Economic Research - 1Q 2023	4.9%	3.9%	5.1%	4.5%

Nominal GDP growth outlook - fiscal year*	2022	2023	2024	2025
National Treasury - Budget 2022	3.0%	5.7%	6.3%	-
National Treasury - MTBPS 2022	5.8%	6.2%	6.6%	6.4%
National Treasury - Budget 2023	5.8%	5.3%	6.4%	6.5%
Bureau for Economic Research - 1Q 2023	6.8%	4.4%	6.8%	6.5%
IMF - World Economic Outlook - October 2022	6.4%	5.1%	5.9%	6.1%

Revenue collection has been (surprisingly) buoyant

- Revenue collection has exceeded pre-covid levels
- NT expects revenue to remain at an elevated level – around 25% of GDP
- Apparent structural improvements in revenue collection arising from tax administration improvements are welcome
- Moderating commodity prices, slower economic growth and slow employment growth present risks to revenue collection
- Weaker terms of trade, and higher food inflation place downward pressure on domestic VAT



Problematic accounting for Eskom bailouts (1/3)

- Budget 2023 presented an improved deficit outlook, compared with Budget 2022 and MTBPS 2022.
- However, the improvement is largely the result of an accounting change:
  - Until now, cash support for SOCs was defined as "payment for financial assets" and reported as part of non-interest expenditure.
  - Budget 2023 changes this practice and classifies cash payments to Eskom as a debt redemption, not an expenditure item.
- In our view this departs from good government accounting practices and results in a better looking but wrong deficit number
- We explain why on the next slide

Problematic accounting for Eskom Bailouts (2/3)

1. In Budget 2023 a new, arbitrary category has been created, which amounts to a borrowing requirement that encumbers the national revenue fund and adds to the stock of debt but is not part expenditure or the budget deficit. Cash advances to Eskom over the next three years are to be classified in terms of this new accounting category.
2. It is justified to exclude cash advances to Eskom from the Public Sector Borrowing Requirement , as this reflects the accumulation of liabilities on the part of the whole public sector including government and state-owned companies. From this angle, the cash transfers (if used exclusively to redeem Eskom debt) do not increase the stock of debt held by the whole public sector. The debt is transferred from Eskom to governments balance sheet; two constituent parts of "the public sector".
3. However, excluding these payments from the main budget balance does not make sense. The main budget balance has (until now) reflected the liabilities accumulated by government against the National Revenue Fund. The significance of the NRF is that is the repository of government's income from *general taxation* (as opposed to Eskom's revenues which are garnered in exchange for the electricity sales). Debt redemptions against the NRF are reported separately ('below the line") and do not form part of the main budget deficit. But redemptions reduce or keep constant the nominal stock of liabilities held by government. Cash payments to Eskom may reduce Eskom's liabilities, but the NRF is increasingly encumbered by debt as a result. The flow creates new debt obligations for government but is inexplicably excluded from the deficit.
4. Treating Eskom payments as a debt redemption (rather than a cash payment) might be more justified if government bonds were exchanged directly for Eskom paper (or some special vehicle was set up to perform this function). However, government has chosen to structure the "debt relief" as a direct cash advance to Eskom. Conditions are imposed that seek to ensure that the cash is used only for debt redemption, but this outcome is contingent on a variety of factors over the next three years (as discussed in the slide 5 above). In any case, the cash is fungible on Eskom's income statement, which will be subject to numerous and complex pressures. Given all this, there is no guarantee that cash payments to Eskom will be cut off once "debt relief" is complete. Indeed, it is highly possible that these will need to continue
5. It is not clear why NT is treating the Eskom payments differently from cash transfers to other SOCs with similarly constrained balance sheets (e.g. SANRAL): The principal that defines payments to SANRAL as expenditure, but payments to ESKOM as debt redemptions is nowhere explained in the budget documents. Given this ambiguity, the door is now presumably open for government to define all cash payments to SOEs as some form of debt relief to be excluded from expenditure. This would be a highly regressive fiscal move.

Problematic accounting for Eskom bailouts (2/2)

- Why should we be concerned? Isn't this just an accounting issue?
- The consequences are that public deliberation and oversight on budget choices will become more obscure:
  - The non-interest expenditure and the budget deficit numbers reported in Budget 2023 are not comparable with the same numbers from previous budget documents.
  - The main and consolidated fiscal deficit do not represent the full extent of government's fiscal health and macroeconomic stance.
  - Those trying to gauge economic and fiscal developments will need to have two sets of numbers in mind - those provided by the authorities, and those adjusted to reflect a more consistent view of macro-fiscal intervention.
  - The door has been opened for future cash payments to failing SOCs being similarly recategorized to obscure the fact that these payments added to government's borrowing requirement. In other words, the reliability and authoritativeness of the official budget documentation has been opened to question.
- Most concerning, the reasoning for the change in practice appears ad-hoc and not thought through. It is not clear what the motivation is, leaving users of the budget documents to speculate on National Treasury's motive.

Need to guard against weakening of fiscal institutions

- The Public Economy Project has previously raised concerns regarding the overall weakening of fiscal institutions. Credible spending plans allow for effective planning and operations within government, and meaningful democratic deliberation, as required by the constitution.
- Fiscal projections rest on the credibility of the expenditure estimates, which are under the direct control of authorities.
  - The decision to exclude Eskom debt relief payments from non-interest expenditure (and therefore from the budget deficit) is a departure from good practice.
  - The decision to exclude anticipated adjustments in remuneration from the compensation of employees budget makes estimates of non-interest expenditure unreliable.
  - Increasingly regular resort to "special appropriations" (and now a "second adjustment budget") weakens the credibility and authority of the main appropriation (i.e. the annual budget).
  - The spending ceilings tabled in successive MTBPS documents are no longer a good guide to subsequent budgets.
  - Large unallocated reserves and the exclusion of key programmes from the budget obscure government's true policy intentions.
- All this points to a deterioration in the quality of forward guidance provided by the budget policy statement.

About

Public Economy Project

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

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

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