Review of the 2018 Budget

The 2018 budget was not quite a crisis budget, but it was the culmination of steady pressure on the fiscus and the South African economy that underpins it. The last few years of budgets have attempted to balance increasingly large debt burdens with the need to protect government's most important functions. A rapid contraction of spending or an increase in taxes could do damage to economic growth, and counteract the benefits of any budget change. Up until the 2018 budget, the balance of these two forces - protecting spending and reducing the deficit - has been biased towards protecting spending. This changed with the 2018 budget, which focused on a more aggressive approach to the tackling the deficit, with tax increases and continued cost containment. Understanding the implications of this budget, and the underlying causes of how we got to this fiscal predicament, is essential to President Ramaphosa's efforts to move the government onto a more stable footing.

2018 budget at a glance

The headline initiative of the 2018 budget was an increase in VAT, the first since 1993, from 14% to 15%. The VAT increase comes after almost a decade of bitter debate, and is highly controversial. VAT is generally regressive, hurting the poor more than the rich. This is because the poor spend a larger portion of their income on basic expenditure, like buying food stuffs, and therefore are affected more by a goods tax. While some economists argue that VAT exemptions on certain food products - like bread or maize - offset this impact, there is no reason to believe these exemptions prevent the poor from carry a disproportionate share of the burden of a VAT increase.

The real reason behind the change is a lack of alternatives. Tax policymakers, and the Davis tax commission in particular, argue that further increases in income or corporate tax will raise little additional revenue, because tax avoidance will offset increased revenue. This is a particularly serious worry given the disastrous reputation of SARS under Tom Moyane, which has damaged tax morality, the likelihood that people feel compelled to pay their fair share in taxes. While there is room to debate this position, and reason to believe income tax might have been a better alternative, the bottom line of the VAT change is that it is bad for the people of South Africa, but arguably necessary given the dire state of the South African fiscus.

The VAT increase was accompanied by some other small changes to revenue collection - such as an increase in sin taxes and the fuel levy, minor changes to estate taxes, and minor adjustments to the way tax brackets are treated. Beyond these revenue measures, little changed on the revenue side of the equation, with the single exception of an additional R57 billion set aside for fee free education. This was offset by a range of spending cuts, which are calculated as totalling R85 billion, although further details on these cuts are not immediately available. Ultimately, spending patterns have been determined by far greater, structural causes, such as a bloated cabinet and a broken system of municipal funding, and changes will only be possible through broader reforms of how government operates.

These reforms have been mentioned by President Ramaphosa, who in the State of the Nation pledged to “review the configuration, number and size of national government departments.” Such a review is an opportune time to look beyond the 2018 budget, and examine how South Africa’s budget came to look the way it currently does.

The underlying causes of the budget crisis

The initiatives of 2018 aside, South Africa’s fiscus remains in a dire state. With a R204 billion deficit in 2018, and a stock of debt of over R2 trillion, the government will be forced to divert R163 billion to debt service costs in 2018 alone. That’s money that can’t be spent on crucial social programmes, such as social grants or education.

While government debt isn’t necessarily bad, there is a need to distinguish between good and bad debt. Good debt, in this case, creates enough growth and opportunities to pay for itself in the long-term. Bad debt spends but doesn’t build. The distinction between these two types of debt cannot be seen on paper or in budget spreadsheets, and is only visible through careful planning and execution of impactful policy. It is in the effectiveness of policy that the intersection of the budget and governance meet.

In many ways, the governance failures of the Zuma administration are therefore inextricably linked to the current budget impasse. While other administrations may have spent as much, the wastefulness of so much of that spending meant that the budget wasn’t generating opportunities for businesses and individuals, and thus didn’t grow state revenues. This is a short-term explanation that doesn’t explain the whole of the budget deficit, but it certainly plays a part. Any number of issues can be raised here - such as the dire state of local government, the collapse of State Owned Enterprises, inconsistent policy implementation and the decline of institutional capacity in government - but the core of the matter is that a shift in governance can do a lot to stabilise the value derived from the budget.

Capitalising on the growth generated by budget spending is, however, dependent on having a working tax administration. The disastrous mismanagement of SARS by Tom Moyane is perhaps one of the most serious failings of the Zuma administration. SARS lost 506 employees in 2017 alone, and the damage done to vital operational capacity will be felt for years to come. Weakness in enforcement capacity is particularly worrying, as SARS has largely lost the ability to police complex financial instruments like trusts, which will blunt the impact of revenue changes such as an increase in the estate tax. Rebuilding the capacity of SARS much be a fundamental priority.

As appealing as it is to attribute the budget impasse solely to the Zuma years, there are deeper root causes, of which the most important was the response to the 2008 financial crisis. Amidst the crisis, government pledged to increase spending to protect the economy. This decision made a lot of sense: borrowing cost were very low, and government spending helped lessen the blow of the recession on the economy. And yet that spending contributed greatly the current fiscal crisis, for two reasons. First, commodity prices unexpectedly collapsed on a lag, meaning that just as government spending was picking up, income from mines and steel were rapidly declining, blunting the impact of the stimulus. This sequence of events was unexpected, and couldn’t reasonably have been predicted.

More worrying is the second cause: the fact that the spending after 2008 wasn’t strategic enough to drive growth. While spending on infrastructure, for example, is a good way to create jobs and improve the conditions for doing business in the country; broader spending patterns saw revenues diverted to wasteful expenditure. Better forward planning, in which strategic projects are identified before a crisis, would have resulted in more strategic use of the fiscal stimulus.

Aside from the crisis, structural problems must be addressed. The two most important area are to fix state owned enterprises and fix the funding model for municipalities. Both could be the subject of an article in their own right, but in brief: SOEs need sound management and a model that facilitates financial sustainability, and municipalities need funding models that relieve their dependence on energy revenues, and that aggressively push new monitoring and evaluation systems that promote improved governance at local government level.

At this critical juncture in the governance of South Africa, the budget must serve as a point of reflection. The lessons for President Ramaphosa and returning finance Minister Nene are clear: improve the quality of spending through strengthening governance, develop spending plans in advance of future economic crises, and address the core problems of SOEs and municipal finance. Each is an extremely difficult undertaking, but they are essential to building a budget that moves the country forward.