Main Budget 2018 Preview

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"Time for big, deep, lasting spending cuts in SA"

1. Introduction

Twenty-six years ago, the Minister of Finance, Derek Keyes, confronted his cabinet collegues with what he called "filthy pictures" illustrating the fact that the economy was, in his own words, "buggered" and that we were heading towards a "debt trap" in South Africa.

Well, the Minister of Finance, Malusi Gigaba, brought out his own "filthy pictures" when he tabled the medium-term budget policy statement illustrating the fact that the economy was, once again, "buggered" in South Africa.

The hard decisions necessary to hold the fiscal line were delayed and the medium-term budget policy statement was used to present what the minister called an "honest view" of the state of the economy.

This included weak economic growth, a breach of the expenditure ceiling, bailouts of "zombie" state-owned enterprises, forced selling of non-core state assets, a blow-out in the budget deficit and ballooning national debt.

The Minister's "maiden" medium-term budget policy statement and the "decision not to make any decisions" was a disaster, causing the major rating agencies to snap with:

- Standard and Poor's downgrading our sovereign credit rating with a long-term foreign currency rating of "BB" and a long-term local currency rating of "BB+" with a "Stable Outlook"; and

- Moody's affirming our sovereign credit rating with a long-term foreign currency rating, and long-term local currency rating, of "Baa3" with a "Negative Outlook".

We blamed the full horror of what was revealed in the medium-term budget policy statement on President Jacob Zuma's catastrophic mismanagement of the economy.

But now that President Jacob Zuma has been axed, the Minister will have to deal with the full horror by tackling a "six pack" of challenges.

These include a broken budget process, weak economic growth, ballooning national debt, dysfunctional institutions, "zombie" state-owned enterprises and long-term fiscal risks.

But dealing with the "six pack" of challenges will be made all the more difficult by a number of significant "known unknowns" including:

- the final shape, timeline and cost over the medium term of the new higher education policy;

- the final shape, timeline and cost over the medium term of the new national health insurance policy; and

- the final shape, timeline and cost over the medium term of the public sector wage agreement currently being negotiated.

- the final shape, timeline and cost of drought relief over the medium term following the classification of the drought as a "national disaster" by the Inter-Ministerial Committee on Drought Relief and Water Scarcity on 13 February 2018.

The stakes are high because Moody's has triggered a "review for a downgrade" and is circling us like sharks, monitoring every move, ready to downgrade us to "junk status", which would result in a giant sucking sound as capital flows out of South Africa.

2. "Six Pack"

So when the Minister tables his "maiden" main budget he faces a make-or-break moment and must deal with a "six pack" of challenges, including:

- a **broken budget process** by presenting a credible plan to restore control of the budget process to National Treasury;

- **weak economic growth** by presenting a credible plan to boost economic growth to average an average of at least 3%;

- a **budget blowout** by presenting a credible plan to stabilize national debt at a maximum 50% of GDP;

- **state capture** by presenting a credible plan to restore public trust in institutions in the "finance family";

- **"zombie" state-owned enterprises** by presenting a credible plan to reform failing state-owned enterprises so that national debt, taken together with contingent liabilities, does not exceed 60% of GDP; and

- **long-term fiscal risks** by presenting a credible plan to mitigate long-term fiscal risks such as the nuclear build programme.

What will define the success, or the failure, of the Minister's "maiden" main budget will, in the end, be whether he can give hope to the 9.2 million people who do not have jobs, or have given up looking for jobs, in South Africa.

2.1 <u>Budget Process</u>

The budget process is supposed to promote transparency, accountability and effective financial management.

However, the budget process is broken with:

- decision-making on budget priorities being centralized under the Minister of Planning, Monitoring and Evaluation, Jeff Radebe, who is now responsible for producing a "Mandate Paper", setting out long-term budget priorities in terms of a new budget prioritization framework; and

- decision-making on resolving competing budget priorities being centralized in a new "pop-up shop" called the Presidential Fiscal Committee.

The centralization of decision-making on the budget appears to have "defanged" the existing decision-making architecture including, most importantly, the Minister's Committee on the Budget, the Minister's Technical Committee on the Budget and National Treasury itself.

This is not to mention arbitrary "bolt-from-the-blue" decisions, such as the decision to provide free higher education for students from poor and working-class families being imposed on National Treasury.

> *We need to restore the integrity of the budget process and ensure that it is geared towards promoting transparency, accountability and effective financial management by restoring control of the budget process to National Treasury.*

2.2 Economic Growth

The medium-term budget policy statement forecasts economic growth of 1.1% (2018), 1.5% (2019) and 1.9% (2020) for South Africa.

However, we expect the economic growth forecast to be revised up in the main budget closer to 1.4% (2018), 1.6% (2019) and 1.9% (2020) because of an increase in investor confidence following the firing of President Jacob Zuma.

What this means is that the average economic growth rate over the medium term will be about 1.6%, which is well below the 3% required to begin increasing employment, decreasing poverty and stabilizing national debt in South Africa.

To boost economic growth and create jobs requires a fundamental change in economic policy in South Africa.

What we need is a "policy shock" to boost economic growth and create jobs in South Africa.

> That is why we believe the Minister should announce a package of structural reforms designed to boost investor confidence, and consumer confidence, and therefore private sector investment, including:
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> - withdrawing the current version of the Mining Charter and the Mineral and Petroleum Resources Development Amendment Bill;

- exempting small businesses employing fewer than 250 employees from complying with restrictive labour legislation, other than the basic conditions of employment;

- removing the extention of collective bargaining agreements to non-parties, who cannot carry the cost of wage agreements imposed on them;

- auctioning off the high-demand spectrum and using the proceeds to facilitate access to mobile internet and roll out fibre fixed-lines to support competitive technologies; and

- privatize, or part-privatize, “zombie” state-owned enterprises such as South African Airways and Eskom.

The fact is that unless there is a fundamental change in economic policy, there is no prospect of increasing employment, decreasing poverty and stabilizing national debt in South Africa.

2.3 Budget Blowout

The primary objective of fiscal policy is to stabilize ballooning national debt in South Africa.

However, part of the full horror of the medium-term budget policy statement was:

- a budget deficit of R193.1 billion (2018/19), R208.1 billion (2019/20) and R225.8 billion (2020/21); and

- a ballooning national debt over the medium term blowing out to a staggering R3.4 trillion, or 59.7% of GDP, by 2020/21.

This was before any additional fiscal pressure in the form of free higher education in South Africa.

To stabilize national debt will require “fiscal effort” in the amount of at least R39 billion, or 0.8% of GDP, in 2018/19.

This excludes the level of additional “fiscal effort” that may be required to fund free higher education, the public sector wage bill, and further “bailouts” to “zombie” state-owned enterprises in South Africa.

We expect the Minister to try to solve the “fiscal equation” on the revenue side, rather than the expenditure side, and to announce significant tax increases in 2018/19.

So, whether you are rich, and taxed directly, or poor, and taxed indirectly, the Minister is going to reach into your back pocket and help himself to more of your money in 2018/19.

However, there are options other than tax increases, including:

- implementing a package of austerity measures aimed at cutting current spending in the short term in 2018/19; and

- implementing a comprehensive spending review aimed at cutting spending and changing the composition of spending over the medium term between 2018/19 and 2020/21.

What we need to balance the books are big, deep, lasting spending cuts in South Africa.

2.3.1 Austerity Measures

We believe the Minister should implement a package of austerity measures, including:

- reducing the size of the cabinet by at least five ministries, which could save an estimated R122 million in 2018/19;

- the implementation of a 6% per year “haircut” on all mandatory cost containment items in national government, which would save an estimated R2.3 billion in 2018/19; and

- the implementation of a 6% per year “haircut” on all mandatory cost containment items in provincial government, which would save an estimated R3 billion in 2018/19.

However, if we are going to get serious about cutting spending we will have to confront the ballooning cost of “compensation of employees”, which is projected to be R587 billion in 2018/19.

We believe the Minister should consider implementing a “wage freeze”, for the period of one year, across the public service, including:

- a freeze on the salaries of all public service office bearers, which would save an estimated R547 million in 2018/19;

- a freeze on the payment of performance bonuses in general government, which would save an estimated R2.2 billion in 2018/19;

- a freeze on the salaries of all employees in local government, which could save an estimated R4.4 billion in 2018/19; and

- a freeze on the salaries of all employees in general government, which could save an estimated R54.9 billion in 2018/19.

This would save an estimated total of R67.47 billion in 2018/19 and go a long way to begin to “balance the books” in South Africa.

2.3.2 Comprehensive Spending Review

However, in addition to austerity measures, we believe the Minister should implement a comprehensive spending review, aimed at identifying sustainable savings, over the medium term, between 2018/19 and 2020/21.

A comprehensive spending review would be geared towards identifying saving by, for example:

- reducing the size of the executive, to about 15 ministries, which could save an estimated R4.7 billion per year, or R13.8 billion between 2018/19 and 2020/21;

- reducing the number of foreign missions by 69 from 125 to 56, which could save an estimated R1.2 billion per year, or a total of R3.9 billion between 2018/19 and 2020/21;

- running the provincial legislatures more efficiently, which could save an estimated R1.8 billion in 2018/19, R1.9 billion in 2019/20 and R2.0 billion in 2020/21, or a total of R5.8 billion between 2018/19 and 2020/21; and

- withdrawing from the New Development Bank, which would save an estimated R17.2 billion between 2018/19 and 2020/21.

A comprehensive spending review would also be geared towards selling off state assets, including:

- selling assets by privatizing, or part-privatizing, some of the 223 “public entities”; and

- selling, or leasing, “underutilized land parcels”, not well located for housing development, valued at about R12.6 billion, and which cost about R42 million in rates, taxes and maintenance in 2016/17; and

- selling government’s remaining shares in Telkom, which would raise an estimated R7 billion in 2018/19.

This is in line with the Presidential Review Committee on State-Owned Entities, especially “Recommendation 20”, which recommends more private sector investment in state-owned enterprises in South Africa.

The former Minister of Finance, Nhlanhla Nene, made a good start by selling non-strategic assets in the form of government’s stake in Vodacom, which raised R25.4 billion in 2015/16 to bailout Eskom.

The savings identified as a result of a comprehensive spending review should be allocated:

- to fund investment in infrastructure and skills development to support economic growth; and

- to cut the fiscal deficit in order to reduce national debt and debt service costs over the medium term between 2018/19 and 2020/21.

The fact is that the comprehensive spending review model has proved to be successful in Australia (Comprehensive Spending Review 2010), Canada (Strategic and Operating Review 2011), and the United Kingdom (Comprehensive Spending Review 2010).

2.4 State Capture

The fact is that public trust in the South African Revenue Service has been shattered, which, in part, explains the massive revenue shortfalls projected over the medium term, including R50.8 billion (2017/18), R69.3 billion (2018/19) and R89.4 billion (2019/20) in South Africa.

We need to act decisively to restore public trust in the South African Revenue Service by:

- firing the Commissioner of the South African Revenue Service, Tom Moyane, and appointing an Acting Commissioner of the South African Revenue Service, in terms Section 7 of the South African Revenue Service Act (No. 34 of 1997);
- implementing the recommendations on tax administration made by the Davis Tax Committee; and
- scrapping the proposed Commission of Inquiry into the South African Revenue Service announced by the Minister on 07 November 2017.

2.5 "Zombie" State-Owned Enterprises

The fact is that Eskom is "too big to fail" and a default on its R347 billion debt mountain, much of which is backed up by government guarantees, would be a systemic risk to South Africa.

There has been progress, including:

- the strengthening of corporate governance with the appointment of Jabu Mabuza as Chairperson and Phakamani Hadebe as Acting Chief Executive Officer;
- the firing of former Chief Executive Officer, Matshela Koko, and the former Chief Financial Officer, Anoj Singh; and
- the release of the interim financial statements for the six months ending on 30 September 2017.

However, the fundamental problem remains in the form of a looming “liquidity crisis” with cash balances declining to R8.5 billion, as of 30 September 2017, resulting in a scramble to raise R20 billion in short-term loans to manage cash flow and build a cash buffer at Eskom.

The looming “liquidity crisis” was perhaps even more acute than we imagined, with a projected cash shortfall of R10 billion this month at Eskom.

The Acting Chief Executive Officer, Phakamani Hadebe, was forced to get out his “begging bowl”, and ask the Public Investment Corporation for what he called an “investment” in Eskom.

The Public Investment Corporation were, of course, happy to oblige, dipping into the Government Employees Pension Fund and advancing a R5 billion “bridging facility” to Eskom.

But, given declining electricity demand, revenue shortfalls, massive cost overruns and redemptions due on a R347 billion debt mountain, the question remains what to do with Eskom.

The Acting Chief Executive Officer, Phakamani Hadebe, concedes that it is necessary to “restructure the balance sheet” at Eskom.

However, what he appears to have in mind is a “fake privatization” with public institutions, including the Public Investment Corporation, the Development Bank of South Africa and the Industrial Development Corporation, swopping debt for equity in Eskom.

We believe the Minister must act to reduce the “systemic risk” of “zombie” state-owned enterprise Eskom by:

- providing a further R20 billion “bailout” to deal with the “liquidity crisis”;
- unbundling the utility and ensuring that assets, such as power stations, are privatized; and
- making it clear that the R350 billion government guarantee currently in place is a hard ceiling at Eskom.

What we do not need is a “fake privatization” that puts pensioners’ savings at risk at Eskom.

We expect the “liquidity crisis” at Eskom to draw most of the “oxygen” when it comes to “zombie” state-owned enterprises, but there are others, including Denel (R3 billion), South African Airways (R4.8 billion) and the South African Broadcasting Corporation (R3 billion), that may require some sort of financial support between 2018/19 and 2020/21.

2.6 Long-term Fiscal Risks

The appointment of the Minister of Energy, David Mahlobo, signaled an intention to push through the proposed nuclear build programme, which may cost up to R1.2 trillion, over a period of perhaps 20 to 30 years, and has the capacity, by itself, to "blow up" the budget.

However, during the medium-term budget policy statement the Minister reiterated the view that:

"*With regard to nuclear energy, we reiterate that the programme will be implemented at a pace and scale that the country can afford*."

And President Cyril Ramaphosa did not mention a word about the proposed nuclear build programme during his State of the Nation Address on 16 February 2018 in Parliament.

There is, therefore, still lingering uncertainty about whether the proposed nuclear build programme will be implemented in South Africa.

That is why we believe the Minister should, once and for all, announce the termination of the nuclear build programme in South Africa.

3. Conclusion

We began by pointing out that the Minister faces a make-or-break moment and must take decisive action to deal with the "six pack" of challenges, including: a broken budget process, weak economic growth, fiscal slippage, state capture, "zombie" state-owned enterprises and long-term fiscal risks.

We believe that the Minister could deal decisively with the "six pack" of challenges during the main budget by:

- restoring the integrity of the budget process by announcing the return of control of the budget process to National Treasury;

- boosting economic growth by announcing a package of structural reforms to build investor confidence and stimulate private sector investment;

- stabilizing public finances by announcing a package of austerity measures and a comprehensive spending review;

- restoring the integrity of institutions in the "finance family" by firing South African Revenue Service Commissioner Tom Moyane;

- reforming "zombie" state-owned enterprises by privatizing, or part privatizing, Eskom; and

- mitigating long-term fiscal risks by terminating the nuclear build programme.

We believe this would go a long way to giving hope to the 9.2 million people who do not have jobs, or have given up looking for jobs, in South Africa.