Budget 2022: Spending should be aligned with potential growth, not temporary windfalls

By Arthur Kamp, Chief Economist and Patrick Buthelezi, Economist at Sanlam Investments

Ideally the government's revenue windfall should be used to reduce debt issuance and contain the increase in the debt ratio, helping to pave the way, in time, towards improved sovereign debt ratings and lower debt servicing costs.

However, South Africa's high unemployment rate and widespread poverty cannot be ignored.

Ultimately, the key issue for Budget 2022 is the extent to which expenditure is aligned with South Africa's underlying trend GDP growth rate or not.

Less sovereign debt ratings risk and the perception of additional "fiscal space"

Indications are Main Budget revenue for 2021/22 may exceed the initial estimate published in February 2021 by more than R200 billion. This should help reduce the government's Main Budget deficit for 2021/22 to around -5 ¼ per cent of GDP, which is materially better than the deficit of -6.6 per cent of GDP published in the November 2021 Medium Term Budget Policy Statement (MTBPS).

At the same time, the government debt ratio is expected to decrease to 69 per cent of GDP at end March 2022, from 70.7 per cent of GDP at end March 2021, while the government's cash balance amounted to a significant R247.67 billion at end January 2022.

And, in the year ahead, gross domestic long-term loan issuance could be markedly lower than the R381.8 billion projected in the MTBPS for 2022/23, although the outcome will depend on the Treasury's preference for issuing short-term debt, foreign issuance and use of its cash balance.

Overall, these numbers suggest the threat of sovereign debt rating downgrades has been removed for the foreseeable future. This "breathing room" has already translated into some adjustment to the government's expenditure projections, reflected in the extension of the social relief of distress grant in the fiscal year ahead at an estimated cost of more than R40 billion. This was the right thing to do. It is clear poverty alleviation is the most urgent need.

Government spending should be aligned with potential revenue growth, not temporary windfalls

However, South Africa does not have a great deal of fiscal space. To start, it should be noted that although South Africa's government debt ratio may not look excessive relative to many other countries, the interest rate on our debt is high. Main Budget interest payments are expected to exceed 18 per cent of revenue in 2022/23, which reduces the resources available for spending on socio-economic development. In addition, to a large extent, the revenue overrun reflects the bounce in commodity export prices. We are the recipient of some good luck, which seems unlikely to be permanent.

The impact of this is reflected in the improvement in South Africa's current account balance, from a deficit of -2.6 per cent of GDP in 2020, to large surpluses, averaging +4.3 per cent of GDP in the first three quarters of 2021. The accompanying bounce in profits underpinned the increase in government tax revenue. Indeed, in the opening nine months of the current fiscal year, corporate income tax increased 74 per cent relative to the same period in fiscal year 2020/21, reflecting, in large part, taxes on the mining industry.

With South Africa's terms of trade seemingly holding up, commodity exports are expected to continue providing support in fiscal year 2022/23.

However, government expenditure should not be lifted in response. Rather, spending should be aligned with the underlying potential growth rate of the economy – especially since execution risk for the current medium-term expenditure framework is high. We estimate the projection for non-interest spending published in the MTBPS is consistent with a decrease in Main Budget non-interest spending to 23 per cent of GDP by 2024/25, from 26 per cent of GDP in 2021/22, with the focus on the wage bill restraint.

This is a tough task, especially since current projections imply government workers' real wages are set for a material downward adjustment over the next two years. Absent a finalised wage deal, this holds significant risk to the expenditure and overall fiscal outlook.

Also, South Africa's depression level unemployment rate implies sustained demand for increased government spending, including not only income support (in the form of a Basic Income Grant), but also spending on housing, education, and health care.

True fiscal consolidation is about more than lowering budget deficits and debt ratios

Over the medium term, assuming no slippage in the expenditure estimates (other than assumed maintenance of the Social Relief of Distress Grant, adjusted annually for inflation) and no additional revenue raising measures (either taxes or privatization), we estimate the Main Budget deficit decreases to -4.1 per cent of GDP in 2024/25. At the same time, the primary budget deficit improves from a deficit of -1.5 per cent of GDP in 2021/22 to a surplus of + 0.6 per cent of GDP in 2024/25.

Even so, given the high level of real interest paid on newly issue debt, relative to potential real GDP growth, the projected improvement in the primary budget balance does not stabilize the debt ratio, which continues to grind higher over time (following its current pause).

There are many moving parts that will determine the fiscal path over the medium term. Contingent liabilities relating to the Road Accident Fund and State-Owned Companies still lurk in the background, while the NHI initiative requires funding. Further, the likely duration of the commodity price boom is unknown.

Different outcomes are thus possible relative to the projections above. Even so, it is reasonable to argue that South Africa's potential real GDP growth rate needs to lift materially, probably to 3 per cent or more to stabilize and ultimately reduce the debt ratio, thus returning South Africa to fiscal sustainability.

Until it is clear the economy is on a materially stronger growth trajectory, it is best not to spend the current commodity-related windfall. There is an argument that positive multipliers imply the government should spend more to lift growth. However, the history of government spending since the Global Financial Crisis suggests the expenditure multiplier is not nearly as favourable as previously thought. In the end, the government has absorbed scarce savings for consumption spending, while sovereign debt rating downgrades have increased real borrowing costs. This has crowded out private sector investment spending and reduced economic growth.

Government will need to pay attention to the plight of the poor, but additional assistance should be deficit neutral. If this requires a larger tax take, it should occur within the context of an overhaul of the tax regime, which broadens the tax base, while ensuring the incentive to work, save and invest is not reduced.

Finally, it is imperative that South Africa's drive toward fiscal sustainability does not solely focus on the budget deficit and debt ratios. The persistent bailouts of state-owned companies in recent years have highlighted the importance of protecting the state's balance sheet, which also requires a change in the composition of spending from consumption to capital expenditure.

Glacier Financial Solutions (Pty) Ltd.

A member of the Sanlam Group
Private Bag X5 | Tyger Valley 7536 | Email client.services@glacier.co.za | Tel +27 21 917 9002 / 0860 452 364 | Fax +27 21 947 9210 | Web www.glacier.co.za | Reg No 1999/025360/07
Licensed Financial Services Provider | Glacier Financial Solutions (Pty) Ltd. is also a Licensed Discretionary Financial Services Provider FSP 770, trading as Glacier Invest | Sanlam Multi-Manager International (Pty) Ltd. | A member of the Sanlam Group

Private Bag X8 | Tyger Valley 7536 | Tel +27 21 950 2600 | Fax +27 21 950 2126 | Web www.smmi.com *|*Reg No 2002/030939/07
Licensed Discretionary Financial Services Provider, acting as Juristic Representative under the Glacier Financial Solutions FSP 770
Glacier International is a division of Sanlam Life Insurance Limited
Sanlam Life Insurance Ltd. | Email life@sanlam.co.za | Tel + 27 21 916 5000 / 0860 726 526 | Fax +27 21 947 9440
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