

BER – IN THE MEDIA | 29 MAY 2025

Time for Taming - can SA's roaring debt levels be beaten back?

Claire Bisseker

South Africa has suffered through three budgets in three months. The debacle nearly broke the Government of National Unity, has undermined the authority of the National Treasury, and unnerved society. Was it all worth it?

The short answer is yes, maybe, but only if upcoming budgets show that the government realises that it cannot continue to hike taxes or borrowing each year to compensate for a failure to make hard political trade-offs over things that endlessly inflate the size of the state.

If upcoming budgets call a halt to the ANC's practice of kicking the can down the road; of hoping that South Africa will grow its way out of its fiscal problems, then it may all have been worth it.

If this means that the cabinet finally realises that the country is up against the limit of tax increases, resulting in not only better scrutiny of expenditure, but deep policy reform, then the February-March-May budget tussle could even mark a turning point for the better.

But is there anything in the May budget (Budget 3.0) that tells us that these lessons have been learnt, or did it just sweep a lot of stuff under the carpet?

Well, it really depends on what happens next, but many economists are not optimistic that hard lessons have been learnt other than the blatantly obvious - that VAT increases are off the table and that in future the finance minister will have to consult his GNU partners far more, and flag tax increases far earlier, months before budget day.

The first key thing to note is that while the May budget did slash the government's R232bn initial shopping list, it still added R74bn in new money to departmental baselines - and it did so by leaning heavily on the consumer.

To compensate for the scrapped VAT rate hike, other taxes are being relied upon, including the fuel levy and personal income tax. The decision not to allow for an inflationary adjustment to tax brackets, rebates and medical tax credits will take R53.4bn

out of consumers' pockets over the medium term. That is a hefty, planned erosion of consumers' income.

Furthermore, an additional R20bn in unspecified revenue-raising measures has been penciled in for next year unless the SA Revenue Service (Sars) is able to raise this amount through greater compliance efforts.

"We are left hoping Sars will improve tax administration even further," says Sanlam Investments chief economist Arthur Kamp, "If we do, however, need the additional R20bn, the door has effectively been shut on a VAT rate increase."

In Kamp's view a VAT increase would have been better than effectively hiking personal income taxes because VAT targets consumption, and zero rating reduces its regressive nature. The risk now is that we get more income tax increases down the line, which reduce the incentive to work and save.

The second big concern is that some of the May expenditure cuts may turn out to be temporary with economists suspecting that a good deal of the desired expenditure has been deferred rather than eliminated.

"Budget 3.0 has again deferred the tough decisions that are required," says University of Cape Town senior research fellow and former National Treasury deputy director-general Andrew Donaldson.

"A necessary VAT increase has been rejected, and at least some of the latest spending cuts will have to be reinstated in the adjustments budget or next year," he says.

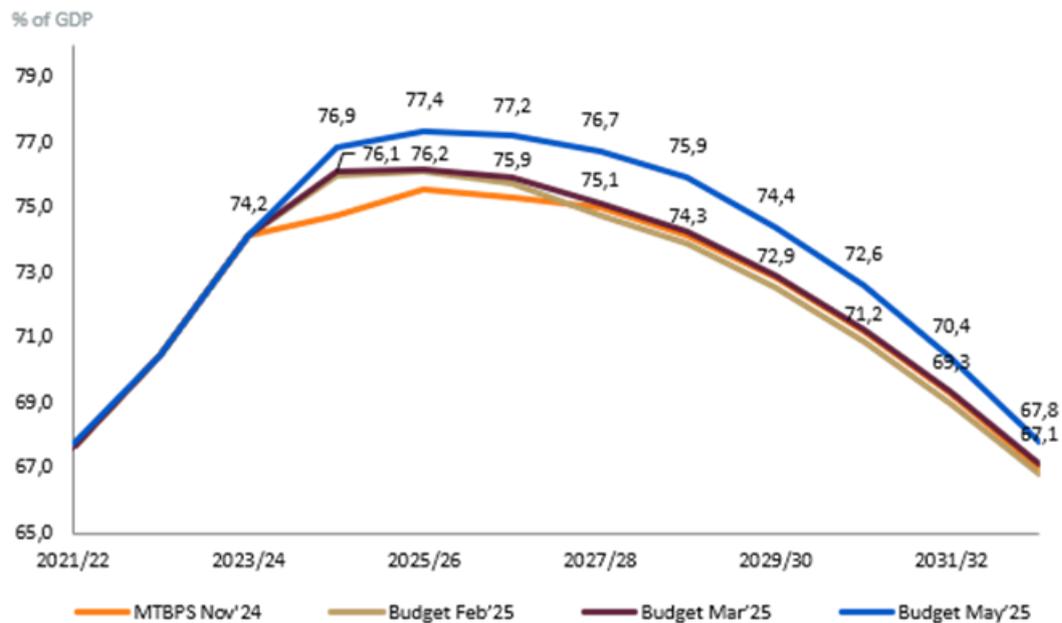
"[Moreover], the infrastructure allocations are inadequate to stimulate growth; the revised public-private partnership regime is not yet in place; compensation for USAID health spending is still being negotiated; and the obviously excessive spending proposals of extra-budgetary funds and entities have not yet been revisited."

But above all else, he points out that dysfunctional programmes have not been closed and the macro-organisational structure of the state has not been rationalised.

Wits adjunct professor Michael Sachs, a former head of the National Treasury's Budget Office, makes a similar point. While he believes the National Treasury will pull out all the stops to achieve its debt projection – which has gross debt peaking at around 77% of GDP this year and next – he fears that this could be short-lived - "a fiscal illusion" - if the government doesn't tackle the underlying imbalance between revenue and expenditure.

Fig 1: More fiscal slippage

Gross debt-to-GDP ratio



Source: National Treasury

“You can constrain the budgets of delivery departments,” he explains, “but that doesn’t mean fewer babies will be delivered or the corrupt procurement deals inflating hospital costs will disappear, unless reforms are made to the way hospitals are managed to ensure they use fewer resources.

“Because if you don’t solve the underlying problem, you just get what we have now - rising accruals (where hospitals defer paying their bills until the following fiscal year) or you erode the country’s asset base and services by deferring hospital maintenance and upgrades.”

So, will we finally tackle these deep-seated issues now? “Maybe,” says Sachs, “I’ll believe we’re in a different world when government announces that it’s reducing the size of the Defence Force or it decides on the shape and size of the SRD grant.”

In short, it is policy reform that will indicate whether the government is seriously tackling expenditure growth, not whether the debt ratio moves up or down by a few decimal points.

Summing up South Africa’s fiscal challenge

To have confidence in South Africa’s fiscal policy promise requires firstly, that government exhibits a clear intent to stabilise the debt ratio and, secondly, that it has a good track record of doing what it says it will do.

We have only the former.

An analysis of historical budget forecast errors by Codera Analytics shows that one of the main reasons for the sustained ratcheting up of public debt over the past 15 years has been lower-than-expected tax revenues and higher-than-expected government expenditure.

Codera CEO Daan Steenkamp notes that since the Covid pandemic, unexpectedly high commodity prices helped to raise tax receipts compared to what the Treasury was expecting, but higher expenditure on grants, wages of public servants, debt service costs and healthcare more than offset strong revenue growth.

Kamp points out that a high share of spending also reflects the country's high unemployment rate, directly through social grants and indirectly through increased pressure on services, notably healthcare. Of course, a high unemployment rate in turn reflects a growth problem.

Finance minister Enoch Godongwana has previously said that South Africa doesn't have a debt problem, it has a growth problem (in that it is not growing fast enough to service its debt burden).

But his analysis, while not incorrect, glossed over the role of expenditure. The 2025 budget debacle has highlighted that not only is the country's growth rate too low, but government spending is also structurally too high, given the size of the country's tax base.

Government spending has fluctuated around 32% of GDP for several years. Despite tax rate increases, tax revenue has struggled to breach 28% of GDP. The upshot is that budget deficits have become stuck at around 4% of GDP, causing borrowing and debt service costs to mount relentlessly.

The obvious conclusion is that if tax increases are to be avoided, spending must adjust to the reality of the tax base. If South Africa is to reduce its budget deficit to the more acceptable international benchmark of 3%, then spending cuts of at least 1% of GDP are needed.

But, most importantly, economic reforms must be urgently accelerated to raise the growth rate. If having been forced to run three budgets in three months allows that penny to finally drop, then the entire budget bungle may have been worth it.

Citi Bank economist Gina Schoeman neatly sums up the country's fiscal challenge: "There's no scope for tax hikes without serious pain of some sort. There's also no scope for more borrowing as National Treasury feels strongly against it and, anyway, it would come back and bite the country through higher debt servicing costs.

"That leaves two things: GDP growth surprising continuously to the upside, and expenditure efficiencies resulting in a slowdown in expenditure growth. And it's not about which *one* they choose, it's about choosing *both* without any of us doubting what the strategy is."

Bosa leader, Mmusi Maimane, the chairperson of parliament's standing committee on appropriations, would add a third prong – a credible and enforceable national debt management strategy.

Writing in *Business Day*, Maimane argues that "SA doesn't have a revenue problem alone; it has a spending and structural reform problem. Without a shift in approach, we risk drifting into a debt trap".

"There is an ever-worsening debt crisis in SA," he adds. "The country's ballooning debt-to-GDP ratio, now teetering near 76%, is a clanging warning bell. If ignored, it could choke off all aspects of growth and development we seek to accelerate."

First, he says, the National Treasury should set a formal debt ceiling or anchor as a guardrail against decline. It should be benchmarked to a sustainable level, such as 60% of GDP, and encompass corrective measures that are triggered if the ceiling is breached.

"While flexibility is important, predictability builds investor confidence and disciplines political decision-making," he points out.

Second, a new borrowing framework should restrict net new borrowing to growth-enabling capital projects founded on transparent cost-benefit analyses. State-owned entities should be barred from borrowing on state guarantees except for projects with a demonstrable commercial return.

Third, existing debt should be "reprofiled" to ease the burden by negotiating longer maturities, lower interest rates and reduced rollover risk.

"Multilateral lenders, climate finance instruments and debt-for-development swaps offer potential relief," he argues. "The Treasury must use its negotiation leverage to secure better terms and create breathing room for reforms."

Fourth, to enhance transparency, reduce political short-termism and boost market confidence, parliament should legislate the creation of a non-partisan fiscal council or watchdog to monitor government spending, debt targets and budget forecasts.

Finally, he notes that: "Debt reduction won't come from growth alone. It requires growth and real expenditure discipline to march in lockstep." This means curbing waste, freezing ministerial perks, rationalising failing SOEs and tightening procurement.

Getting down to the numbers

The May Budget revised down the country's growth and revenue outlook sharply in line with the deterioration in global and domestic economic conditions. The National Treasury's baseline real GDP growth forecast is now worse than its pessimistic scenario was just two months ago, with real GDP growth set to increase by 1.4% this year compared to 1.9% previously. (The BER's forecast is for growth of 1.5% this year compared to 2% previously.)

This deterioration, coupled with the removal of the VAT hike, forced the Treasury to slash the massive shopping list it presented in February into something far more manageable.

But although net new expenditure for 2025/2026 has been halved – from R142bn in March to R74.4bn now, departmental baselines have been protected.

As a result, taxpayers will still receive no inflation adjustment to their tax brackets or medical tax credits for the second year in a row, the fuel levy will now be raised after remaining unchanged for three years, and above-inflation increases to sin taxes will remain in place.

Furthermore, the Treasury warns that it will impose R20bn in additional tax measures in 2026 unless it is able to achieve the requisite savings through the expenditure review process and/or Sars is able to turn its R2bn additional allocation for 2025/2026 into R20bn of additional revenue by February next year.

Sars commissioner Edward Kieswetter told the budget press conference that he will hire 750 additional debt collectors by June 1, with the aim of raising at least R20bn. Both he and Godongwana are confident that even more will be collected, avoiding the need for further tax increases.

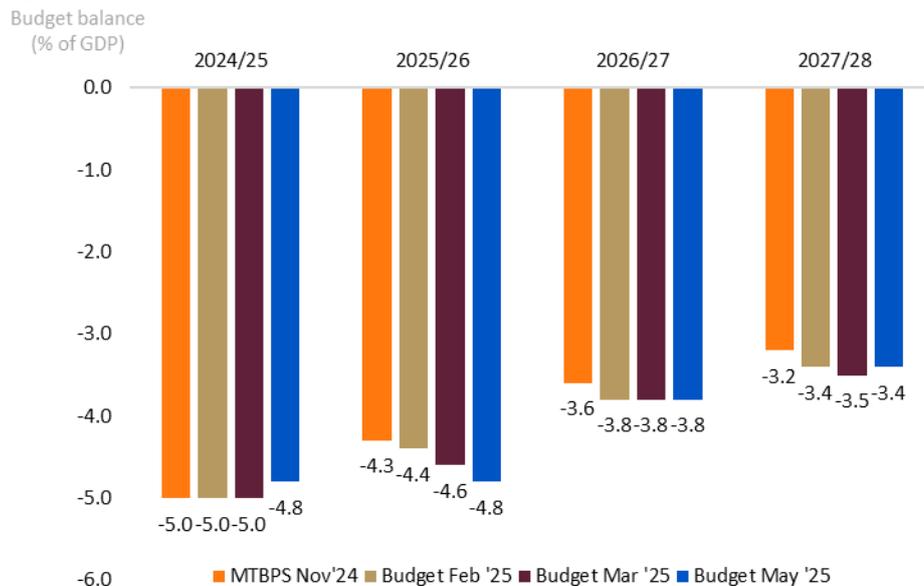
But even with these tax and expenditure adjustments, the gross debt ratio will now peak at 77.4% this fiscal year compared to the previous target of 76.2%, continuing a familiar pattern whereby the country incurs a little more fiscal slippage each year. This has been steadily eroding the country's fiscal credibility. In fact, this will be the 14th year that South Africa has missed its stated debt target since 2012.

Asked in the press conference whether this meant the government was losing the battle against debt, Godongwana said that, on the contrary, the political battle was being won as "an overwhelming majority in cabinet agree that debt is a major problem and that we can't increase borrowing in future".

At the same time, he conceded that if he was an investor he would ask in response to the shifting up of the debt ratio "aren't you guys shifting the goalposts?".

Treasury director-general Duncan Pieterse defended the fiscal stance, saying that the debt ratio will still peak this year as forecast and, over the medium term, primary surpluses will be higher, and both the gross borrowing requirement and the budget deficit will be lower than previously forecast.

Fig 2: Deficits remain sticky



Source: Bureau for Economic Research using National Treasury figures

It is important to unpack what has driven the higher peak in the debt ratio relative to the March budget, says Pieterse, noting that it is mainly a function of a downward revision to nominal GDP because of the lower real GDP growth and inflation outlook. (Over the next three years, nominal GDP has been revised down by R466bn relative to the March budget).

It is precisely because the debt ratio is so sensitive to nominal revisions that the Treasury targets a year in which debt will peak rather than the exact percentage at which it will do so, Pieterse insists. And on that metric, “the fiscal strategy remains on track”.

But with how much conviction does the Treasury stand by its forecast that the debt ratio will peak at 77.4% this year and then fall every year thereafter? “Unless there are similar large revisions to nominal GDP, we should be able to deliver the path we’ve set out here,” Pieterse tells the FM.

Unfortunately, with the risks to growth skewed to the downside, this is not a tail risk. (The Treasury has modelled a new downside scenario in which global trade tensions escalate and South Africa is hit hard by weaker demand, falling commodity prices and financial volatility. Risk premiums, borrowing costs and capital outflows all rise, limiting fiscal space and causing real GDP to come in at just 1% in 2025 and 1.25% in 2026.)

Taking a red pen to spending

As expected, numerous moderate cuts were made across the March shopping list, with infrastructure and frontline services bearing the brunt. Infrastructure got a R12.9bn cut, with the biggest individual loser being the Passenger Rail Agency of South Africa (Prasa) with a cut of R6.9bn over the next three years. Provincial education (-R9.5bn) and health departments (-R8.2bn) also saw reductions in their provisional allocations.

The Treasury also lopped R4bn off the disaster management budget, a further R5.5bn by slowing the pace of its early retirement scheme, R6.7bn off social grants (owing to the fact that the above-inflation adjustment required to offset the proposed VAT hike is no longer needed), R2bn off the metro turnaround scheme and another R2bn off the Defence budget (since the withdrawal of troops from the DRC has been expedited).

The spending areas that have been protected include the SRD grant (R35.1bn in 2025/2026), Sars (R3.5bn), eight large priority infrastructure projects (R11.8bn), the wage bill overrun (R23.2bn), and early childhood development (ECD) at R19bn.

The budget will still allow for the employment of 800 graduate doctors, safeguard about 4 700 health posts, and address shortages in medical goods, services and accruals. It will also safeguard about 5 500 educator posts and expand ECD coverage to an additional 700 000 pre-schoolers.

The upshot is that consolidated non-interest expenditure will increase at an annual average rate of 0.8% in real terms over the next three years, the same pace as in the March budget and almost as fast as the 0.9% envisaged in the withdrawn February budget.

This is a big shift from the original plan, in the 2024 budget, which was for spending to contract in real terms by 0.5% a year on average over the medium term in order to stabilise the debt ratio at 75% of GDP.

In sum, the May budget represents a political decision to protect frontline services in health and education, promote infrastructure, and shield pro-poor spending in exchange for significant tax hikes and a bit more fiscal slippage.

It will do as a holding budget but a return to sustainable public finances will require faster reforms to boost growth, a tougher debt management strategy, and meaningful spending cuts to reduce the size of the state.

It will be difficult, but we simply have to tame the beast of debt before it eats our children's hopes for a better future. It is still possible that the introspection invited by the 2025 budget crisis will turn out to mark a decisive turning point in winning that war.

This article first appeared in the Financial Mail on 29 May 2025

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