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# Now to find the fat: the VAT U-turn means big spending cuts

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Finance minister Enoch Godongwana has finally been forced to do what he should have done from the start – concede to scrapping the Vat hike and tabling a less expansive budget. He now has a third opportunity to get the 2025 budget right. But will he take it?

The problem with both the budget withdrawn in February (Budget 1.0) and the one subsequently tabled March (Budget 2.0) was that they slapped a three-year shopping list on the table totalling more than R230bn.

This unexpected spending splurge was to be funded mainly out of Vat hikes and by failing to adjust personal income tax brackets for inflation (fiscal drag) – measures that would have hurt consumers and dampened economic growth.

Society (and most political parties) balked, even after the initial proposed 2 percentage point (ppt) Vat hike was trimmed to a 1ppt hike spread over two years.

Godongwana initially dug in but last week was forced to climbdown, just a day after defending his Vat hike in court against a challenge brought by the DA and EFF.

Late on Sunday, the parties reached an out of court settlement which was made an order of the Western Cape High Court. It sets aside the Vat hikes as well as parliament's adoption of the fiscal framework. In short, the DA and the EFF won, with costs, and the National Treasury will go back to the drawing board to redraft the budget – for the third time.

The big question is whether Budget 3.0 will be an improvement on its predecessors, and whether the country's fiscal position will be any better than it was before. It really depends on where the budget is cut.

In announcing the minister's U-turn, ANC secretary general Fikile Mbalula said (without any sense of irony) that the March iteration was "the perfect budget" - if you excluded the Vat hike.

This, he said, was because it both supported growth and cushioned the poor. The latter was achieved by investing in social expenditure, retaining the SRD grant and granting above-inflation increases in social grants, said Mbalula. It did all this while protecting frontline services in health and education.

Now, faced with a R75bn Vat-sized hole over the next three years, the coming tussle will centre on how to find commensurate spending cuts while still cushioning the poor and protecting frontline services.

Removing the Vat hike means the budget should detract less from growth, though personal income taxes are still presumably going to be increased through fiscal drag. (Arguably, that the Vat hike would have been less bad for growth than failing to compensate taxpayers for fiscal drag since hiking Vat shifts the terms of trade from consumption to investment and favours exports).

The Treasury's first step must be to revise its growth and revenue forecasts lower given the deterioration in the domestic and global economic outlook since February.

Then, the Treasury was forecasting domestic real GDP growth of 1.9% for 2025. Now the country will be lucky to grow by 1.5%, given the anticipated slowdown caused by US President Trump's tariff tantrum. It is being compounded in our case by his particularly jaundiced view of South Africa and domestic fears over the future of the government of national unity (GNU).

Domestic inflation forecasts have also tumbled given the anticipated falloff in demand. Happily, this means nominal spending growth can also be revised downwards. But lower growth and inflation means that anticipated revenue will also need to be revised down, so the ultimate revenue undershoot may exceed the R75bn implied by the withdrawal of the Vat hike.

The bottom line is that the Treasury needs to take a scalpel to spending.

There are two opposing ways to do this. One would be to take a short-term view which seeks to put Budget 3.0 to bed in a few weeks by being highly selective about what the country really has to fund this year and what can be postponed.

Many economists think this could be done fairly easily by making numerous small cuts to the government's expansive new shopping list to free up R13.5bn in 2025/2026 (the equivalent of the 0.5ppt Vat hike).

After all, few of these new spending items were on the table at the medium-term budget in October last year. Moreover, for 2025/2026 a significant R36.7bn worth is marked as "provisional". This means the Treasury has not yet allocated it to departmental votes, which suggests that the items were added at the last minute and/or it is unclear whether the relevant departments can even spend all the money.

This provisional list includes R5.8bn to rebuild passenger rail, R4.4bn for early retirement costs, R8.1bn for expanding early childhood development and teachers' wages, and R9.3bn to bolster provincial health departments and hire more doctors.

Even though no party wants to denude frontline services, there is scope to whittle this list down.

However, taking a narrow, near-term view would mean putting off difficult fiscal decisions like whether the SRD grant should be made permanent or how to reform the Road Accident Fund (RAF), Sector Education and Training Authorities (Setas) or the Special Economic Zones (SEZs).

The other approach would be to use the crisis to chart a more credible path for medium-term revenue and expenditure that is backed by an explicit fiscal agreement in the GNU. However, this would mean tackling the big fiscal debates head-on at a time of immense global uncertainty in a governing coalition that is barely hanging together.

Wits University adjunct professor Michael Sachs, a former head of the National Treasury’s budget office, doesn’t think this is a good opportunity to try and fix everything, especially given the uncertainty created by the global tariff shock. He is more concerned about protecting the institutions of budgeting, warning that “by not sticking to it, the whole budget cycle becomes degraded”.

“All you can do is grasp onto the short end of the problem,” he says, “You’ve got to narrow the scope of what you need to agree on right now just to put the 2025 budget to bed and maintain a semblance of order in the budget, which we were in the process of losing.”

So, while he agrees that South Africa faces “terrible” fiscal problems that must be addressed at some point, right now he favours a more tactical approach that lops R13.5bn off the current fiscal year to provide certainty and close out the budget.

#### **Where should expenditure be cut?**

The most common suggestions include cutting the size of cabinet, VIP protection, and the number of diplomatic missions, restructuring the RAF and the Setas, closing delinquent state-owned enterprises and non-performing programmes, reviewing public procurement, reining in public servants’ remuneration, and eliminating corruption, inefficiency and wastage.

**Table: Where could some of the savings come from?**

<b>Spending item</b>	<b>Potential Annual Saving</b>
VIP protection	R1bn-2bn
Holding public wage increases to inflation	R7.3bn
SETAs	R20bn – R24bn
Closing non-performing programmes	R12bn (with a lag)
Holding social grant increases to inflation	R1.6bn
Delaying the expansion of ECD*	R5bn

Source: National Treasury

\*ECD = early childhood development

The public's perception is that the government bureaucracy is bloated and that billions worth of savings can be achieved overnight by taking a chainsaw to spending. However, it's not that simple.

While blanket cuts across all departments have succeeded in containing expenditure growth in recent years, it has also caused distress in service delivery, especially in the personnel-intensive functions of police and provincial education and health departments.

It is partly this deterioration in frontline services that the previous two budgets were trying to correct with an additional allocation of R70.7bn over the next three years – the biggest portion of the proposed R232bn in new medium-term expenditure.

Another large chunk (R46.6bn) of the new money was intended for infrastructure, including passenger rail and school building programmes; R35bn to extend the SRD grant; and R23,3bn for the wage-bill overrun.

**So, the real question is: where is the fat that can be cut without hurting service delivery?**

In seeking to answer this question, attention has swung to the nearly 240 spending reviews conducted by the Government Technical Advisory Centre (GTAC) since this small, independent unit was established in the Treasury in 2013.

According to a GTAC presentation to the standing committee on public accounts in March, the expenditure reviews it conducted between 2017 and 2020 into about R300bn worth of expenditure found about R40bn of possible savings, 13% of the amount analysed.

Some of that low-hanging fruit has, however, already been realised. To achieve further savings, the reviews would have to be repeated using updated data. Many of their recommendations would also require legislative and institutional changes, all of which would take time.

Moreover, the old reviews largely skirted some of the most problematic areas where the government could get the biggest bang for its buck: reviewing procurement processes and the wage bill.

Despite the Treasury's success in slowing wage bill growth in recent years, it remains the most potent driver of rising public sector costs. It is set to grow faster than nominal GDP in 2025/2026. (In education and health, the policy trade-off is unavoidable: if salaries rise by more than inflation then the numbers of teachers and doctors and nurses can't increase to meet service delivery needs.)

The public procurement system must also be reviewed. According to GTAC, the cost of goods and services procured is unduly high because of skills deficiencies, poor management oversight of contracts, and the involvement of middlemen - some of which is clearly corruption related.

### GTAC's other key findings include:

- Government policy is often designed with too many ambitious objectives but little or no consideration as to the costs or trade-offs involved.
- While programmes face burdensome performance reporting requirements, they don't meaningfully measure value for money.
- Little attention is paid to minimising programme costs and ensuring efficient resource use. For instance, GTAC discovered in 2013/2014, after reviewing nearly 1,000 government office leases, that 60% were too high, with the average paying a 45% premium above market rates. If changes had been made immediately, the state could have saved R1.6bn – R2.3bn.
- Government seldom closes or reassesses ineffective projects and programmes. In the decade to 2019, the number of public entities exploded from 100 to 279. Some expansion was critical, but some institutions have overlapping mandates.

GTAC estimates that about 1% of total spending (around R20bn a year) delivers below average social value and if these under-performing programmes were phased out, the country could achieve annual savings of around R12bn by 2029/2030, after restructuring costs.

This is clearly far from the R75bn needed over the next three years to compensate for the removal of the Vat hikes. To get those kinds of savings is going to require a far more aggressive and completely different approach.

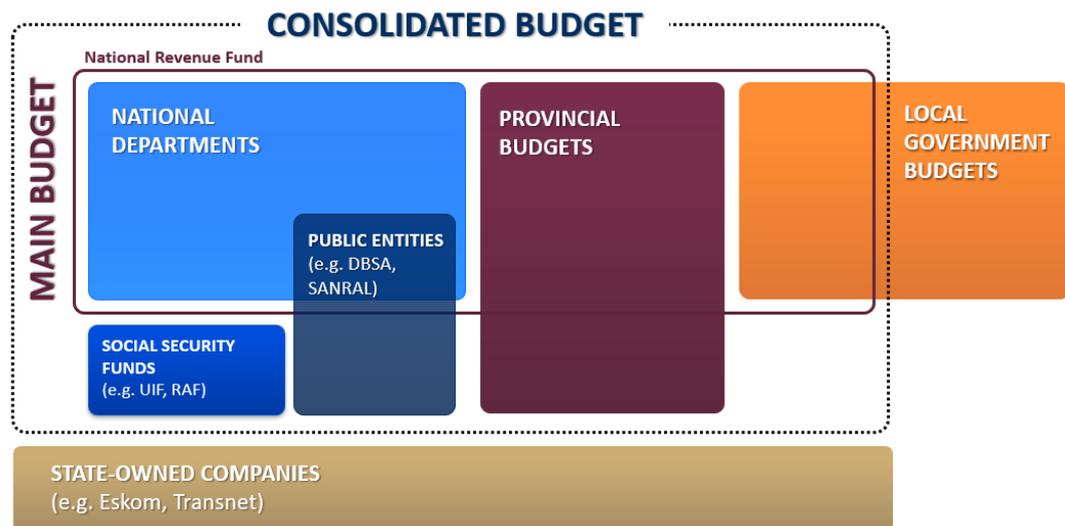
Andrew Donaldson, a former deputy director general at the National Treasury and the initial head of the GTAC, stresses this point. In his view, expenditure reviews are no substitute for political decisions on spending priorities and the curtailment of programmes that are dysfunctional or ineffective.

Donaldson argues, in a recent BER research note, that one of the best places to look for savings is among the extra-budgetary funds and public entities that are not directly controlled by the Treasury or subject to appropriation by parliament. Some of the largest spending increases are "hidden" in this less examined part of the fiscal framework.

Consider these stark disparities (based on March 2025 budget figures): main budget expenditure in 2025/2026 is 3.1% higher than the 2024 budget's forward estimate for the same year. However, the additional spending attributed to provinces, social security funds and public entities, as published in the Treasury's summary of the consolidated budget, is set to increase by a staggering 24.2% or R52bn.

Similarly, the consolidated budget deficit was R22bn larger than the main budget deficit in 2024/25 and is expected to be R16.5bn larger than the main budget deficit in 2025/26.

Figure 1: The difference between the consolidated and main budget



Source: National Treasury

There are 195 entities of various kinds in the consolidated budget estimates. They include social security funds, the Setas, the National Skills Fund, the SA National Roads Agency (Sanral), the Passenger Rail Agency of SA (Prasa), the national science councils, several water boards and a wide variety of regulatory and service delivery agencies.

Their revenue includes user charges, statutory levies or taxes and, in many cases, transfers or operating subsidies from national departmental votes. The problem is that they are not subject to statutory appropriation by parliament and the Treasury doesn't exercise control over public entities' spending plans or revenue projections.

Take the example of the Unemployment Insurance Fund (UIF). Its budget was set to explode to R44bn in 2025/2026 from R24bn in 2023/2024. This is mainly because it plans to expand into business rescue and labour activation programmes, which are not part of its statutory mandate.

"It's a blow-out of spending that is entirely under the discretionary oversight of the department of employment and labour (DEL), which disposes the accumulated surplus funds of the UIF," says Donaldson. "This is not good budget practice."

It may be that Treasury has turned a blind eye, assuming this additional expenditure is not a cost to the main budget because it draws on surplus UIF funds. But this interpretation "is just plain wrong," according to Donaldson: "All UIF spending and revenue is part of the consolidated budget and, as such, is part of the broader fiscal framework that parliament needs to approve."

#### The UIF's March 2025 budget included some eye-watering increases:

- spending on administration rises from R1.6bn in 2021/2022 to R6.1bn in 2025/2026
- spending on labour activation programmes explodes from R347m in 2022/23 to R11bn in 2025/2026

- compensation of employees leaps from R1.7bn in 2023/2024 to R3.2bn in 2025/2026
- the average salary almost doubles from R485 000 in 2023/2024 to R945 000 in 2025/2026

According to the Treasury's Estimates of National Expenditure (ENE), the UIF plans to implement 331 labour activation programmes to create more than 1m employment opportunities over the medium term, including for 140 000 teacher assistants. This is set to cost R4bn in 2025/2026.

In addition, the fund plans to provide support to distressed businesses seeking to retain their employees through a R4.6bn temporary employer/employee relief scheme (Ters). It will pay 75% of an employee's basic salary (up to a maximum of R17 119 per month) for a maximum of 12 months.

It seems strange that the Treasury has not asserted control by invoking the Public Finance Management Act. It would be well within its rights to inform the UIF that its spending increases look unreasonable and must be revised down. It could even instruct the UIF to desist from discretionary programmes.

The use of social security funds like the UIF for unregulated discretionary purposes is just one example of uncontrolled spending trends in government.

**Other examples include:**

- Board remuneration and executive salaries that often substantially exceed remuneration levels in the regulated public service
- Diversion of funds to address budget programme shortfalls. For example, the use of National Skills Fund and Seta surpluses to finance student financial assistance
- A substantial expansion of expenditure by the Sanral, financed by drawing on cash reserves and an implausibly large increase in toll revenue estimates
- Prasa's increased operating costs, accommodated mainly by larger transfers from the main budget
- Large increases in borrowing and expenditure by the extra-budgetary water resource agency, the Trans-Caledon Tunnel Authority (TCTA)
- Further growth in the unfunded liabilities of the RAF, for which reform proposals made 22 years ago by the Satchwell Committee have not yet been implemented

"Whatever the merits of these and other spending activities of off-budget funds and public entities, it seems clear that stronger executive and parliamentary oversight of their spending plans is needed," says Donaldson.

The problem, however, with focusing on the reform of off-budget entities for a source of savings right now is that it is not of immediate interest to the bond market.

Take the RAF. Its total liabilities top R370bn but to restructure it would mean spending considerable political capital taking on powerful interest groups. But even if government did succeed it wouldn't make any difference to bond issuance this year.

"The bond market doesn't care about the deficit on the RAF," says Sachs. "It only cares about the number of bonds you're issuing this year, not broader moves on government's balance sheet. The same goes for the Setas or the UIF or anything off the main budget."

In other words, if South Africa wants to restore its credibility with the bond market right now it needs to keep issuance in check by dialling back spending. This means getting a fiscally conservative but pro-growth Budget 3.0 through parliament soon and with as much unanimity as possible.

### **Will South Africa's fiscal position be any better now?**

Hopefully the contestation over the 2025 budget will lead to more thoughtful approaches to the way taxpayers' money is spent.

In Donaldson's view this must include a more disciplined approach to public service remuneration (the single biggest issue), stronger oversight of extra-budgetary entities, greater private sector participation and improved cost recovery in several sectors.

He feels it is also possible that better analysis and public engagement over expenditure trade-offs and policy priorities could contribute to better budgeting and more sustainable public finances, while Treasury's and parliament's budget reform initiatives could lead to positive institutional change.

But ultimately whether the country is at an inflection point, which will lead to greater fiscal sustainability, is fundamentally a political question. To put it simply, we need a series of political decisions that focus on achieving value for money, choosing spending priorities and curtailing unnecessary or ineffective programmes.

It is not clear, however, that when push comes to shove there will be much political appetite for closing low-performing programmes or anything that would disrupt preferential procurement contracts or scuttle well-paid executive positions in extra-budgetary agencies.

But this is where we are, fiscally – a situation where there are no good options, only different ways of apportioning pain. Because if both tax hikes and higher borrowing are off the table, and the economy continues to stall, then the government really has no choice but to make the harsh policy trade-offs.

Unfortunately, all the parties in parliament have been too engaged in political gamesmanship during the budget debacle to grapple with the substantive fiscal issues. That needs to change. South Africa can and must do better.

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