SUBMISSION ON SOUTH AFRICA'S FISCAL POLICY CHOICES

By the Centre for Development and Enterprise
To National Treasury
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Introduction

Like National Treasury, CDE believes that SA's public finances are not sustainable. The country has a large, persistent deficit which emerged after 2009, and which has resulted in a rapid increase in debt. This, ultimately, reflects government's inability or unwillingness to live within the country's means as the rate of economic growth has declined from the historical highs of the 2000s to something less than population growth in recent years.

The fact that SA's public finances are unsustainable is the principal source of sovereign risk in the economy, and the reason that interest rates are far higher in SA than they are in most of the rest of the world. These reflect, ultimately, the extent to which government's creditors are increasingly concerned about its creditworthiness and about the economy's capacity to generate the resources needed to ensure full repayment of loans that have been made to government. That, in turn, means that all borrowers in the economy pay unusually high interest rates, slowing investment and growth.

There are only two ways to address the unsustainable character of our public finances: accelerated fiscal consolidation and faster economic growth.

In CDE's view – and in the view of most analysts – the rapid growth in revenues in the mining sector reflect a range of temporary conditions, which means that the unexpectedly rapid recovery in tax revenues this year needs to be treated as a temporary windfall. In any event, even with this windfall, SA's deficit will remain extremely wide.

We are already paying the price for our unsustainable public finances in the form of higher interest rates and the opportunity cost of an ever-rising share of our scarce public resources having to be devoted to debt service costs (which will run to over R200 billion this year) rather than service delivery. Left unchecked, the relentless rise in debt will eventually lead to even steeper costs that will involve some combination of a fiscal crisis (when the state will not be able to pay its bills), a financial crisis (when one or more banks is rendered insolvent by the repricing of government debt), a crash in asset prices, and/or a rise in inflation (if the Reserve Bank steps in to finance the deficit). Alone or in combination, a crisis that manifested in any or all of these forms would devastate SA's economic prospects for a generation. In the face of this risk, we simply cannot afford complacency. We must address the country's underlying macroeconomic imbalances.

The strategy laid out in the budget must be implemented

The fiscal policies set out in the 2021 budget, and which were prefigured in earlier budgets (albeit before the Covid-19 emergency), are framed around the urgent task of reducing the level of debt as a proportion of GDP. The 2022 budget must continue this work, even if StatsSA's revision of GDP data and the somewhat better performance of the economy and of tax revenues in 2021, mean that our debt metrics may not look quite as bad now as they did six months ago. Although the level of debt as percentage of GDP has declined, the rate of increase has not, and it is this, ultimately, that is the crucial variable that must be brought under control.

The 2021 budget sought to achieve this goal through measures aimed at stimulating economic growth (including modest reductions in tax rates) combined with continued determination to reduce upward growth in spending (primarily by capping growth in payroll costs at very low levels for all three years of the MTEF).

At the time, the 2021 budget seemed both over-ambitious and overly timid. Its over-ambition was manifest in its commitment to a path of compensation spending that amounted to all but freezing wages of public servants for four years. This seemed an heroically optimistic assessment of what was realistically possible in a system of collective bargaining that has delivered real wage increases to government workers in every year since the mid-2000s with the exception of 2020. Its timidity, on the other hand, was reflected in the fact that, tough as the budget was on containing spending growth, not a single programme in government was deemed a low-enough priority as to be worthy of elimination.

It is worth noting that there has already been some significant slippage from the fiscal path staked out in the 2021 budget, especially in relation to the decision to pay public servants a R1 000 per month gratuity, a decision which has the effect of raising compensation costs by about 4 per cent this year, and which was not budgeted for. Whether or not this will be funded from cuts to other spending items, it reflects the danger of a fiscal policy that is over-reliant on wage moderation before an agreement has been signed and sealed. Such an approach leads to a marked loss of confidence in the credibility of fiscal policy commitments.

There are many other spending pressures that must be faced

Apart from the fiscal slippage embodied in the post-budget decision to pay public officials gratuities, there are a range of additional spending demands that Treasury faces and which must be managed. The most significant of these pressures – and the one with the greatest long-term consequences – is for the establishment of a basic income grant (BIG), but there are others, too, including:

- proposals relating to the health-related costs of Covid-19 pandemic as well as the provision of further support for businesses and workers affected by lockdown restrictions,
- proposals to assist businesses affected by July's violence; and
- the on-going recapitalisation needs of public entities and state-owned companies.

The tragedy of SA's position is that these are all desirable spending programmes but, because our finances are unsustainable, they cannot be funded without raising the risk of fiscal and financial crisis and, in the process, slowing growth even further. In our view, government needs to approach decisions on these spending needs with exceptional prudence, and on the principle that, while temporary increases in spending might be affordable, SA cannot afford to implement a BIG of any significant size at this time.

There are participants in the debate about macroeconomic policy who believe either that a BIG can be funded on the basis of higher taxes or that the Reserve Bank can simply print the money government needs to pay for it. Neither of these views is credible:

- Local proponents of the view that SA, like some countries in the developed world, can effectively borrow an indefinite amount of money at zero interest rates appear to believe that the unusual (and temporary) circumstances that pertain in those countries have revealed new economic rules that are applicable to all countries. Those circumstances – a surplus of savings leading to very low interest rates that are also below the rate of economic growth, combined with institutions imbued with very high levels of confidence and trust – do not obtain in SA. As a result, attempts to use the Reserve Bank to finance government will lead to very different outcomes to those that are evident in the US and other advanced countries.
- Proponents of the view that a BIG large enough to make a meaningful dent in poverty can be financed through higher taxes are also mistaken. While the ratio of tax to GDP is not excessive in SA, the tax base, as a result of high levels of unemployment, is very narrow and, as a result, taxes account for a large fraction of tax-payers' incomes. Tax-payers are increasingly disaffected by the "return" they get on the taxes they pay as a

result of government waste, inefficiency and corruption. In these circumstances, raising tax rates is unlikely to generate increased tax revenues. And, indeed, that has been evident in recent years.

Fiscal consolidation is necessary but not sufficient

Important as fiscal consolidation is for the sustainability of SA's public finances, and important as the sustainability of our public finances is for long-run growth, fiscal consolidation is no more than a necessary condition for faster growth. It is not a sufficient condition for growth. For that, we need a coherent, plausible growth strategy. Such a strategy needs to go beyond the reforms that are currently being championed by Operation Vulindlela, welcome as those are. Critically, they need to address manifold weaknesses in governance in SA that are reflected in decaying infrastructure, unreasonable delays in decision-making processes across government, high levels of corruption, and profound policy uncertainty and variability.

These are not easy challenges to address, but, in our view, it is these weaknesses that are the most important drivers of the decline in both actual growth and potential growth in SA. The precariousness of our public finances are, in many ways, a symptom of this deeper and more profound malaise.

Apart from improving governance, a plausible and implementable growth strategy would have to focus on a range of levers to accelerate economic growth, among them:

- Policies that facilitate faster and more inclusive urbanization
- Strengthening our education and skills-production systems
- Reforms to labour market regulations that would de-risk the decision to hire workers
- Reforms to our migration policies to encourage and facilitate skilled immigration.

Concluding remarks

South Africa is in a very difficult position, with enormous demands on a fiscus that is already over-stretched and increasingly precarious. This is not the time for government to lose its nerve and adopt policies based on flawed and implausible economic theories. There is, in our view, no short cut to greater prosperity: we need to create the conditions for economic growth and then nurture and stick to them over a sustained period. Anything less than that will raise the risk of fiscal and financial crisis.

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