THE DEVIL AND THE DEEP BLUE SEA

South Africa's 2021 Budget[1]

Michael Sachs[2] | 8 March 2021

South Africa's 1994 project sought to mobilise society on a foundation of non-racialism and unity. For the first decade of the new century, this vision was underpinned by rising real incomes for public servants, increasing public consumption and transfers to impoverished people, lower taxation, rising asset prices, falling interest rates and increasing investment.

But those days are gone. The Congress movement is unable to lead and its once hegemonic vision is in tatters. A decade of gnawing austerity has eroded public value while failing to stabilise public debt. Any collective attempt to resolve these problems must face facts squarely and negotiate a painful social compromise.

Much ink has been spilt over the extent of the government's "fiscal stimulus" since a special budget in July 2020 sought to respond to a world torn apart by the Covid-19 pandemic and ensuing lockdown.

The fiscal policy debate since has focused on whether government spending has done enough to offset the massive contraction in economic activity and jobs. But it has failed to appreciate that the challenge we face is a real dilemma.

On the one hand, the government's commitment to reducing its budget deficit will mean forcing down the real income of public servants, and real hardship for millions of South Africans. On the other, we need to take the problem of debt, and debt sustainability, seriously.

In global capitalism, power is rooted in hierarchical relations of money and finance. An apparently unending rise in how much of our tax revenue and national income is spent paying the interest on debt poses a central problem to the political economy of South Africa's development.

The impasse cannot be wished away. It is not the result of errors in economic theory or constructed ideological tropes. Any solution will be difficult to design and even more difficult to carry through.

Penny-wise and pound-foolish

Debates about the role of the budget have missed the mark. Those demanding that the government "fill" the output gap in the economy failed to grasp that the Covid-19 shock is entirely different to any normal economic cycle. The reason for the collapse of output is not insufficient demand but the closure of whole sectors of the economy: aviation, alcohol, hospitality and other services that rely on human interaction.

Even once the lockdown was eased, death and sorrow made a return to normal behaviour unlikely. In this context, the government's role was not to stimulate aggregate demand but to maintain incomes, ease suffering and prevent the collapse of private balance sheets. The top-up of social grants, rollout of the new Covid-19 grant and extension of Unemployment Insurance Fund (UIF) payments played a critical role in this, as did financial and monetary easing. The government was forced to suspend a huge range of activities and it made sense to reallocate spending towards these new needs.

[1] This is a version of an article first published in New Frame (www.newframe.com) on 22 February 2021 It has been updated to take account of Budget 2021, which was tabled on 24 February 2021.

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The size of the discretionary stimulus in 2020 fell well short of the R500 billion that the government continues to claim. But it is a mistake to measure success according to whether state spending multiplied the goods and services produced in the economy, or by how far those goods and services fell short of potential economic output.

That said, more could have been done. It was clear from the outset that financial constraints on the health response should have been regarded as a second-order problem. Government dithering on vaccine funding has epitomised the idiom penny-a wise and pound-foolish. Support to sectors of the economy that were forced to close by policy choice, like taverns, could have been far more generous, and prevarication on the extension of grant top-up and UIF payments was unnecessary.

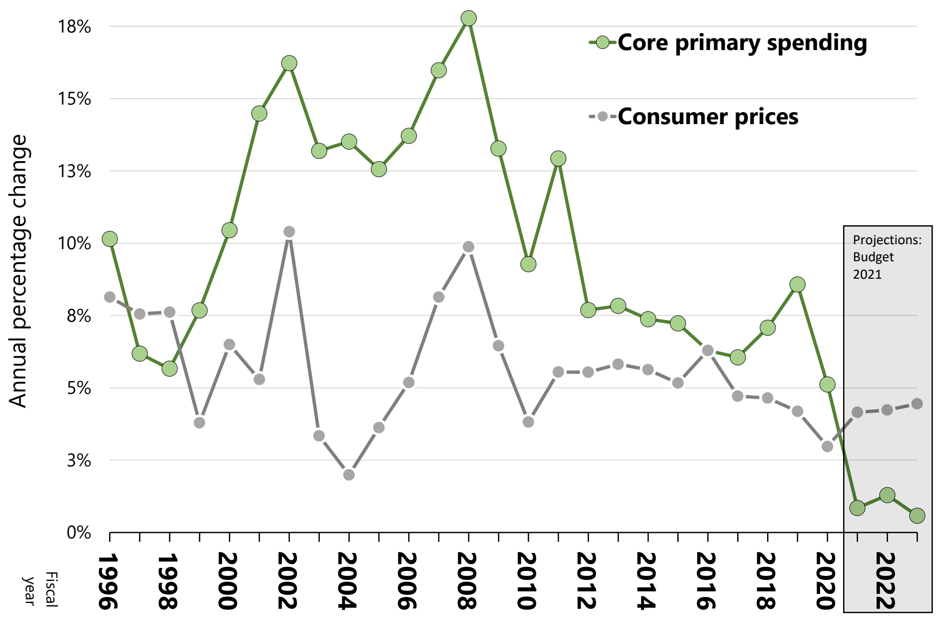
The government's iron-clad determination to stay within expenditure limits set prior to the pandemic was a mistake. While the austere approach taken in the special adjustment budget was perhaps understandable in the wake of the financial market shock South Africa faced in April 2020, capital subsequently flowed back in and the government has faced no problem financing its deficit.

Meanwhile, elevated commodity prices have pushed tax revenue far ahead of initial expectations. The rebound in economic activity and return to pre-pandemic levels of employment happened sooner than expected. In hindsight, a much stronger easing of expenditure restraint in 2020 was warranted and possible to achieve without permanently damaging South Africa's fiscal position.

What lies ahead?

The most important shortcoming in the debate about the 2020 stimulus has been a short-term focus on expenditure allocations that prioritised the immediate response while neglecting the dangers and choices that lie ahead. The government's most important policy shift has been to strengthen constraints on expenditure into the future. So, the budget we should really be concerned about is not last year's, but the one tabled on 24 February 2021.

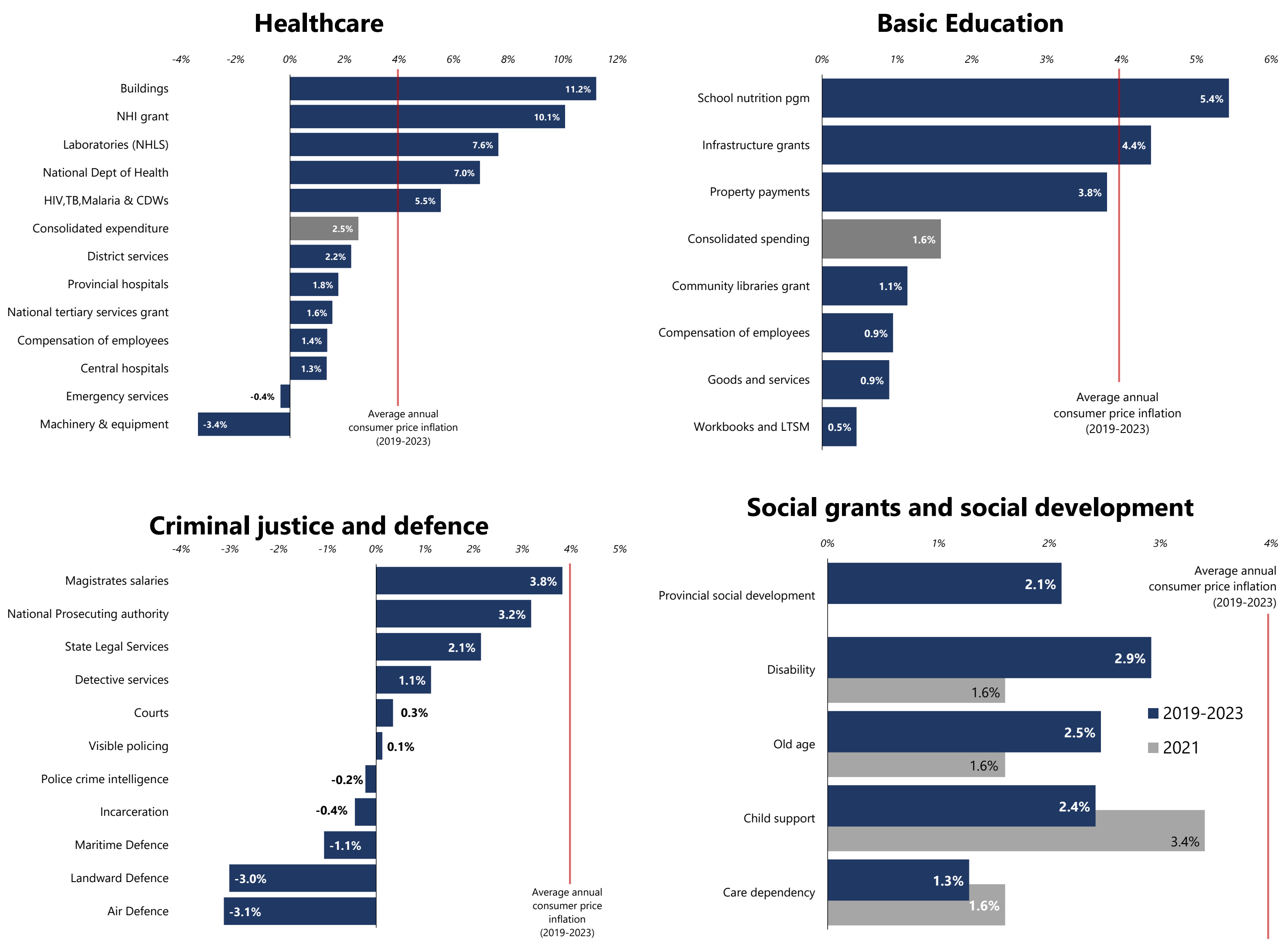
Figure 1 Spending growth and consumer inflation (1996-2023)



Source: National Treasury (Budget Review 2021), StatsSA, IHSMarkit and authors calculations

Notes: Main budget core primary spending. It is primary spending because debt service costs are excluded. It is core spending because payments for financial assets (largely state-owned company bailouts) and several items of self-financing expenditure (which are budget deficit neutral) are excluded

Figure 2 Average annual nominal growth of spending (2019 – 2023), Selected items



Source: National Treasury (Budget Review 2021 and 2020)

Notes: The 2019 base year is chosen because there was significant reallocation of budgets in response to the pandemic in 2020 (e.g. social grants were topped up, financed by large reductions in capital spending). These temporary interventions skew the medium-term growth rates if 2020 is used as a base. I have used pre-pandemic 2019 expenditure, taking the revised estimates contained in the 2020 Budget Review as the base. For social grants the numbers reflect the budget divided by beneficiaries (both projected over the medium term). Other items are nominal growth rates of the budget itself.

Figure 1 puts the 2021 budget into historical perspective. Growth in budgeted spending has fall below consumer inflation before. But this will be the first real contraction of this size, and the first to be sustained over such a long period. In term of its size and duration it far exceeds the contraction associated with the 1996 Growth, employment and redistribution programme (GEAR).

This has two implications. First, fiscal policy will be leaning against government's commitment to economic recovery. If macro stabilization means returning to a path of per capita income growth last seen before 2011, this will need to be done in the face of fiscal retrenchment over the next five years. Government consumption amounts to about one fifth of total demand in South Africa's economy. The plan is for this huge aggregate to contract in real terms by around 1.5 percent each year over the medium term.

It is possible to imagine a scenario (like the one reflected in the treasury forecast) in which other elements of demand offset this shock. Private households emerging from the constraints of the lockdown are likely to add significantly to growth in demand. A strong rebound in international demand is also likely this year, while elevated commodity prices add to South Africa's export income. But these factors cannot be depended on beyond the current year, and the treasury forecast anticipates a revival in capital formation to drive the recovery from 2022 on. This is possible but by no means guaranteed, especially if the promise of debt stabilisation is not delivered on (a point I return to below).

The second impact of Budget 2021 is that core elements of public provision – basic education, healthcare, social grants and the criminal justice system – will be fundamentally weakened. Figure 2 shows medium term plans for nominal spending growth in selected elements of these policy areas. In healthcare, priority is given to construction of new buildings and vertical interventions under central government authority, such as procurement of drugs to combat HIV and TB. But the public health system, its hospitals and clinics, are run by provincial governments, and this is where expenditure is expected to fall in real terms over the next three to five years.

Provincial health budgets have been insufficient to cover medicines and other essential consumables for several years. Together with salaries and maintenance, these elements of "consumption spending" face deep real cuts, while budgets for medical equipment – which are often underspent - faces the largest cut. In combination this raises the prospects government unveiling new "hospitals" without health workers, medicines or equipment. Similar dynamics can be seen in the budgets for basic education and criminal justice, while the real value of social grants to children and old-age pensions will be cut.

The budget for community development (i.e. housing, water and electricity) beats inflation over the medium term, the only major policy area to do so. This, together with a preference for new construction over maintenance and ongoing support to state owned enterprises, is said to favour the public sector's "investment" drive. The consequence is that "consumption" spending (i.e. basic education, health, the criminal justice system) and transfers to the poor face cuts that are even deeper than the average.[3]

The government intends to erode much of this value by forcing down the real incomes of nurses, doctors, police officers, magistrates, court officials, prison warders and teachers, along with auxiliary and support workers in these sectors – public servants who account for 70% of the government wage bill. This will have consequences for the quality of human capital in the public sector, especially since no similar adjustment is looming in the private sector and so the relative value of public jobs for teachers, health workers, security officers and lawyers will fall.

In addition to falling incomes, the cuts to compensation budgets can only be achieved by also reducing the number of employees, particularly in basic education, the criminal justice system and the defence force. Considering that the population they serve is increasing, the real value of these services will decline. The Budget Review is frank about the impact on basic education: "Low compensation growth … combined with early retirements, will reduce the number of available teachers. This, coupled with a rising number of learners, implies larger class sizes, especially in no-fee schools, which is expected to negatively affect learning outcomes."[4]

So, the government is attempting to move in opposite directions at the same time. Fiscal policy would impose a large shock to aggregate demand and erode the value of core public services, but the government is promising a strong and inclusive economic recovery, while holding out the prospect of continuing expansion of social provision. For instance, transforming institutions in the public health sector to create a national health insurance is still an explicit goal of policy. This would be no mean feat at the best of times but will be near impossible as the state moves to reduce the real income of nurses, porters and laundry workers over the next five years. More generally, a large and sustained reduction in government consumption contradicts the proposed expansion free tertiary education, improvements in the quality of education or more effective efforts to fighting crime and corruption. The contradiction is most stark – bordering on doublethink – in claims that the government is about to embark on a "presidential employment stimulus" even as it reduces public employment and aggregate demand.

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[3] It is worth noting here that, in statistical terms, "government consumption" is a misnomer (see Lequiller and Blades, 2014: p138-140). The output that is produced by the public education system, the courts or healthcare is not consumed by government, but by households who depend on these services. Affluent South Africans consume these services in the private sector (or can finance private arbitration in the case of criminal justice) but most citizens have only the public option, and it is the value of their consumption is directly reduced by budget cuts or inefficiencies in resource use.

[4] National Treasury, Budget Review, 2021, p59

What lies beneath?

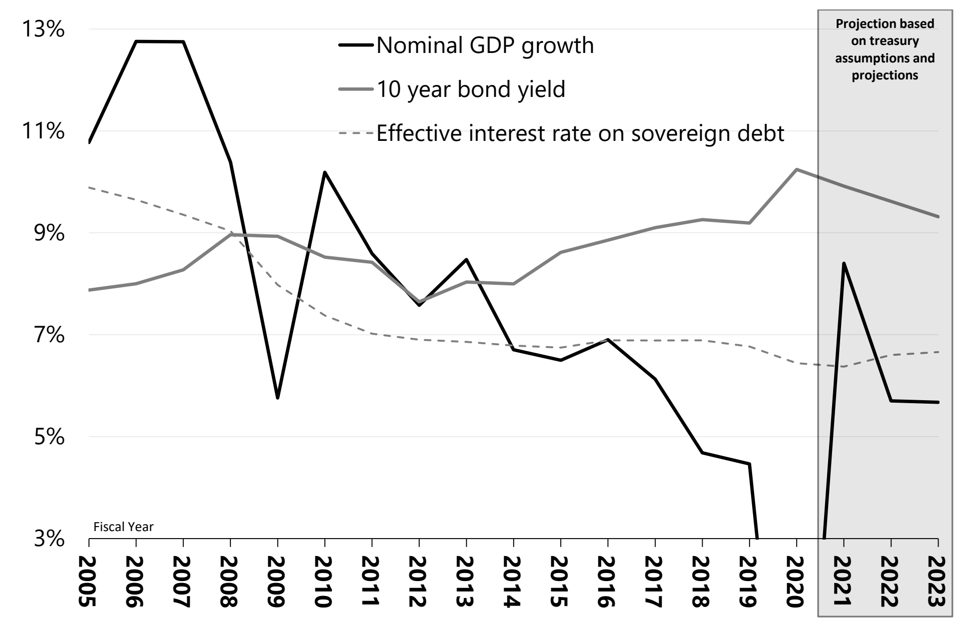
Despite this aggressive approach to expenditure reduction, the medium-term plan is unlikely to achieve fiscal consolidation. The budget seeks to stabilise the increase in debt (through a sufficiently large primary surplus) in 2025, implying that reductions in social provision are set to continue beyond the medium-term planning framework. But the truth is that all this austerity is unlikely to achieve its primary aim – the stabilisation of debt.

A new fiscal consensus has emerged in recent years implying a fundamental rethink about the salience of public debt. This does not, in the main, reflect widespread acceptance of new approaches to economic theory. Rather, it is grounded on changed facts. Mainstream theory has generally assumed that interest government debt (r) grows tends to grow faster than national income. Since government's tax revenue depends on national income, this implies that the interest burden can impose increasing fiscal stress even if deficits are held in check. For many economies, the assumption that r is greater than g is no longer valid. Interest rates have fallen to zero and are expected to remain there for several years. As a consequence, the orthodoxy about debt sustainability has been turned on its head.

But there are two important aspects of South Africa's debt position that distinguish it from the rest of the world. The first is that the country faces high interest rates on government debt that are far above the rate of economic growth. The new fiscal consensus, which has counselled greater acceptance of public debt in the Global North, assumes that growth rates exceed interest rates. In South Africa, as Figure 3 shows, this is far from the truth. The 10-year bond yield – a benchmark interest rate on government debt – has been rising for years, while economic growth has fallen into the mire.

The second is that the debt level is not stable. There is no threshold of the debt-to-GDP ratio that should concern us, but debt that rises without limit is unsustainable, period. And so, where other countries have accepted a once-off increase in their level of debt to fund their pandemic response, South Africa faces a continuous escalation of debt without credible prospects for stabilisation.

Figure 3 Nominal GDP growth and the 10-year bond yield



Source: South African Reserve Bank, National Treasury IHS Markit and authors calculations

Notes: The 10-year bond yield is the average of 12 months of the monthly average. The projection follows the trend given for the sovereign risk premium that underpins treasury's three-year economic forecast in the October 2020 MTBPS. The nominal GDP growth forecast is also that in the MTBPS.

As a consequence of this unsustainable fiscal position, the public sector's financial solvency will continue to erode. Most would agree that, in a time of crisis, the government should be prepared to risk its financial net worth if this contributes to economic recovery. But using the public-sector balance sheet as a bridge across troubled water makes little sense if the opposite shore is so far away that its very existence is in doubt.

It might be said that the real danger is not the government's solvency (which in any case is difficult to define), but the risk of a liquidity crisis in which debts can no longer be rolled over. It is then that the International Monetary Fund or other exceptional measures come into play.

There are several reasons why – even if South Africa does not resolve its underlying fiscal and economic maladies – a sudden crisis of debt distress may not occur over the medium term. For one, global investment is exuberant and, in a world with zero interest rates, the return on a South African bond is high. Second, the Reserve Bank has agreed to stand by the bond market as a buyer of last resort, something it has the credibility and the balance sheet to do. Finally, the broader South African sovereign balance sheet is strong. The state could resort to drawing down financial assets – the Government Employees Pension Fund, for instance – long before it is forced into defaulting on its debt.

So, global conditions remain supportive, local institutions are resilient and domestic markets can absorb the turbulence. Given these factors, should we even be worried about sovereign debt? The answer is yes. Even without a liquidity crisis, the slow grind of sovereign bankruptcy will exert forces over time that will be difficult for South Africa to contain.

The real measure of debt is not how much we owe but the burden of our interest payments. These are payments of output towards a form of rent that worsens income inequality, saps incentives to productivity and diverts capital away from fixed investments. Interest payments will soon absorb to 25% of revenue – 5 percent of national income – and it will continue increasing unless the debt level stabilises or interest rates fall below economic growth. Until this happens, government must either continue to force down public consumption (with the aforementioned implications), raise taxes each year to finance the rent on debt, or renege on its obligations.

There are several ways a state can try to renege on its debt obligations. Not only is the government the biggest issuer of debt in the economy but it also has regulatory authority over debt contracts. Macro financial policy can be brought to bear to erode the value of outstanding debt and influence the interest the government pays on it. Historically, this has involved depreciation of the currency and inflation, capital taxation, capital controls and various forms of state direction of private finance.

In effect, the country would be trying to force its interest rate down to its woefully low rate of economic growth. In this case, the ability and willingness of the treasury to honour its obligations will be questioned, the balance sheet of the South African Reserve Bank will be placed in doubt, eroding its credibility and authority, and questions will be raised about the capacity of the state to underpin private financial institutions. All this points to an increasing prospect for financial disorder that could add a new an dangerous dimension to South Africa's many development challenges.

Is the state able?

There are circumstances in which macroeconomic reflation – some combination of credit easing, increased public spending and reduced taxation – can kick-start a new cycle of growth. The fundamental issue is the response of private fixed investment. Capital formation is the engine of economic growth and if macro policy easing leads to an upsurge of investment, both private and public, concerns about the consequences of debt (or monetary) financing are less salient as future income will enable the state to unwind these positions.

This engine of capital formation is attached to the level of aggregate demand that drives profitability in the country's industrial base, through mining, manufacture and the vast services sector. The government can influence these dynamics by spending more and stretching private credit, even as it builds new public capabilities. But while fixed investment is the engine that must get the economy back on its feet, accumulation in a modern capitalist economy is a car that is driven by finance capital.

Money, in South Africa and globally, is a hierarchy through which financial power rests firmly on sovereign political foundations in a world of unequal state relations. This power is regularly and effectively wielded. Do we have a state that is able to take on domestic and global finance, simultaneously, while also crowding in a private bonanza of fixed capital formation? Will global finance support South Africa's attempts? Could the private sector be cajoled into joining the public sector, sharing investment risks even as the state embarks on a path of financial repression? Will investment be financed as the government appears poised to renege on its financial obligations?

It may be that these contradictions can be resolved by resort to compulsion, state direction of private investment and expropriation of finance. But considering the current capacity of the state, and the social forces that undergird it, this would be a fool's errand.

Real compromises, not projects

The problem of the state's rising bankruptcy cannot be overcome by monetary fiat or the conversion of treasury to a new ideological posture. It is real. It is material. It is rooted in the institutional power of modern capital. And unless it is faced, the future for South Africa's development is bleak.

The country's fiscal position contradicts the government's broader aims of increasing social provision. It is not possible to have another half a decade of austerity while also achieving the Constitution's promise of progressive realisation of social and economic rights. Taxes will certainly have to rise, but increased taxation will be largely absorbed into paying the rent on debt.

On our current trajectory, stabilising debt means eroding social provision. But the opposite must also be kept in mind: increasing social provision in a manner that avoids reckoning with debt and the power of modern finance does not avoid the problem and might very well make it much worse.

The only way out of this situation is a sustainable revival of nominal gross domestic product growth. To rely on monetary and fiscal reflation to achieve this is an adventurous posture in the best of times. At the current moment in history, there is room for doubt in the global north and its most powerful state. In South Africa there is little room for optimism.

If it is to be achieved it will require the kind of social solidarity that can only be built on solid political foundations. It requires real compromise on wages and rents. For twenty years, social compacting and state action has been conceived as agreement on projects and overcoming the technical constraints to 'implementation' of "win-win" solutions. This has been tried with no apparent success for more than a decade. It is now time to put bold compromises on the agenda as part of a new unifying vision.

Sources and references

Many ideas in this paper are discussed in Sachs, Michael (2021, in proofing) *Fiscal Dimensions of South Africa's Crisis*. Public Economy Project Working Paper #1, Southern Centre for Inequality Studies.

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