'Both directions at once': fiscal policy in South Africa

By Michael Sachs

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Michael Sachs investigates the inconsistency of government fiscal policy, which lies in its attempts, on the one hand, to stabilise public debt by constraining expenditure, while on the other hand, showing unwillingness to reduce publicly financed consumption. While this contradiction is being played out, new policy initiatives are announced, often without clear consideration of the resource implications.

John Coltrane once described his approach to the improvised solo as "start in the middle and move both directions at once".[1] This is an inspired approach to artistic creation but not a good basis for fiscal policy. Yet government is doing just this, attempting to move backwards and forwards at the same time. The consequences are pulling apart the public sector.

South Africa's public finances are in a deep and increasingly intractable crisis. If left to fester there will be fundamental consequences for government's ability to guide national development in the decades ahead. Two alternative responses have been suggested. The first is a sudden and decisive fiscal contraction. The second is sudden and decisive fiscal expansion. In my view both are likely to fail. Instead of resorting to a macroeconomic policy fix, South Africa needs to address underlying political constraints. The only path forward is to negotiate through these constraints by recognising the need for real sacrifices and agreeing on how they should be distributed. In the meantime, we should accept that fiscal policy is neither the core problem nor the primary solution.

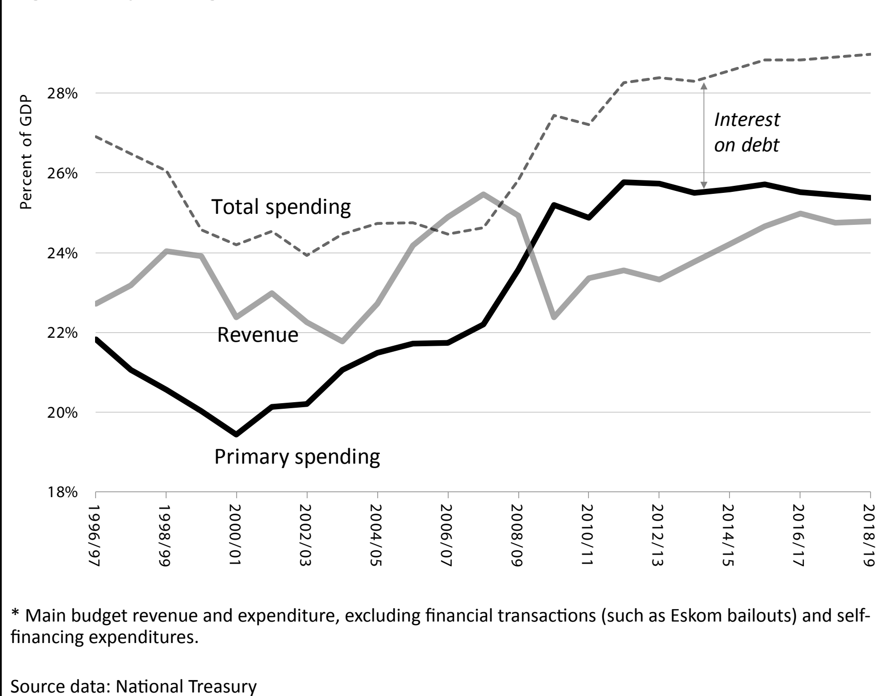
AN INCONSISTENT POLICY STANCE

At the heart of the current fiscal challenge is an inconsistent policy stance. On the one hand, government is (unsuccessfully) attempting to stabilise public debt by constraining expenditure. On the other hand, it is unwilling to reduce publicly financed consumption. While keeping a lid on total spending, it improves the pay of public servants, while also attempting to extend the scope and coverage of government services. Nothing is wrong with either of these objectives as such. But you cannot have your cake and eat it.

Over the last decade, primary spending – that is all spending except interest payments and financial bailouts – has been held steady as a share of GDP, while the effective burden of taxation has risen (see figure 1). Initially, tax increases looked like they were closing the deficit, but tax collection began to falter after 2015. As a result, increasing emphasis has been placed on expenditure control. Each budget announces a new raft of expenditure reductions in an attempt to stabilise the rise in debt.

The last decade has seen sustained gains in the pay of public servants. The "occupation-specific dispensations" agreed in 2007 led to large once-off

Figure 1: Spending and revenue as a share of GDP*



* Main budget revenue and expenditure, excluding financial transactions (such as Eskom bailouts) and self-financing expenditures.

Source data: National Treasury

improvements. Since then, bargained cost-of-living increases have been higher than inflation by a significant margin. Added to this the bulk of public servants qualify for automatic annual promotions which raises pay by another 1.5%. The share of public servants in the lowest four ranks of the salary scale has declined from 31% in 2006 to 19% today. All in all, average remuneration in the public service has increased by inflation plus 3.5% each year.[2]

The point is not to argue against improved pay for teachers, nurses and police officers (although questions might be asked about the link between pay and performance). It is that these improvements have not been fully funded. Government maintains a firm lid on primary spending from above. But from below it agrees to large cost escalations. On top of this a stream of new policy initiatives is announced, often without clear consideration of resource implications.

The result is an erosion of public capabilities. Faced with hard budget ceilings, a rising salary bill and a blizzard of new "priorities", departmental finance managers are left to square the circle. Some are able to shift the problem off-budget onto other departments, spheres of government, state-owned companies or public agencies. This leads to rising payments imbalances across the public sector.[3] Departments owe rates and service charges to local government. Local governments fail to pay electricity and water bills. Eskom or regional water boards face financial distress and lobby for bailouts.

But this is just the start. As financial pressure mounts liabilities are passed onto government's suppliers and service providers. Maintenance budgets are cannibalised. Salaries are funded with resources intended for capital, research, systems improvement or workforce skills development. The real pay of senior managers (who fall outside collective bargaining) is systematically

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eroded,[4] inducing a brain drain to the private sector. Eventually, the only option left is to reduce headcount, by slowing the intake of new recruits and leaving key positions vacant. The result is lengthening queues in hospitals, bigger class sizes in schools or a failure of crime prevention.

An army without an operational budget, without investment in the development and upgrading of weapons systems, and without the constant renewal of its human capabilities cannot be an effective army. The same is true of a large hospital or a district school system. In some cases – such as the size of school classes – the erosion of public provision is easy to see.[5] Less observable, but even more pernicious, is the creeping depletion of capabilities and systems as hidden liabilities rise in the public healthcare sector.

Instead of making a choice one way or another and facing the political consequences of that choice, government takes the path of least resistance. But the underlying contradiction remains, and the consequences are shifted onto those least able to resist, those without an effective voice who depend on public services: mental health patients, school children in the poorest provinces or victims of crime. »

AN EXPANSIONARY CONTRACTION?

There are calls for government to dramatically curtail expenditure to avert fiscal crisis and place the economy on a new trajectory of growth. Although reduced government spending tends to slow economic growth by lowering demand, the argument goes that a positive response by private investors will offset the contraction. Government's creditworthiness improves if creditors are convinced that a real and permanent reduction in spending has taken place. The bond yield – the interest rate on government borrowing – would fall. Since the bond yield is a key benchmark, this leads to falling interest rates for all borrowers and increased private investment. The result is a boost to growth, which translates into improved revenues for government. A new virtuous cycle of development is inaugurated.

It's a nice story, but it misses an important point. It is not enough for the Minister of Finance to cut spending and appeal for nebulous efficiency gains ("doing more with less"). To be effective, fiscal consolidation must be backed by actual reductions in quality or quantity of public services, the size of social transfers, the pay of public servants or the rents distributed to small businesses through the tender system. All of these options entail significant political costs. Public services and transfers dominate the consumption profile of the African population.[6] Acting to reduce already low consumption levels of the African population would entail large political risks, since the burden would be borne almost entirely by constituencies on which the fragile governing coalition depends. Thus far, there is little evidence that government is serious about negotiating along these lines.

But without action to reduce consumption, expenditure cuts only shift the location of risk. Debt issuance might slow down, but the social and financial risks associated with the erosion of public services, depletion of public assets and build-up of hidden liabilities will continue to grow. Eventually, fiscal consolidation will be reversed, whether as a result of political pressure or economic necessity.

In such circumstances, astute investors will smell the wind. The hope for an investment bonanza – an "expansionary contraction" – is mistaken. All that will be left is a sharp contraction in aggregate demand in a context of rising social dysfunction and intensifying political tension. This, moreover, is not a setting in which an agenda of structural reform – which entails another set of difficult trade-offs and complex negotiations – is likely to succeed.

BORROWING FOR A BETTER LIFE?

Others have suggested the opposite course of action – a macroeconomic expansion, led by fiscal policy and accommodated with lower interest rates, to shift the economy onto a higher growth path. There are three factors to consider in evaluating this position. First, government debt is already rising, and the consequences are increasingly problematic. Second, it is quite likely that fiscal expansion would be offset by a contraction in private investment. Third, while more public investment would help, the current lack of infrastructure spending has more to do with political failures than budget constraints or implementation challenges.

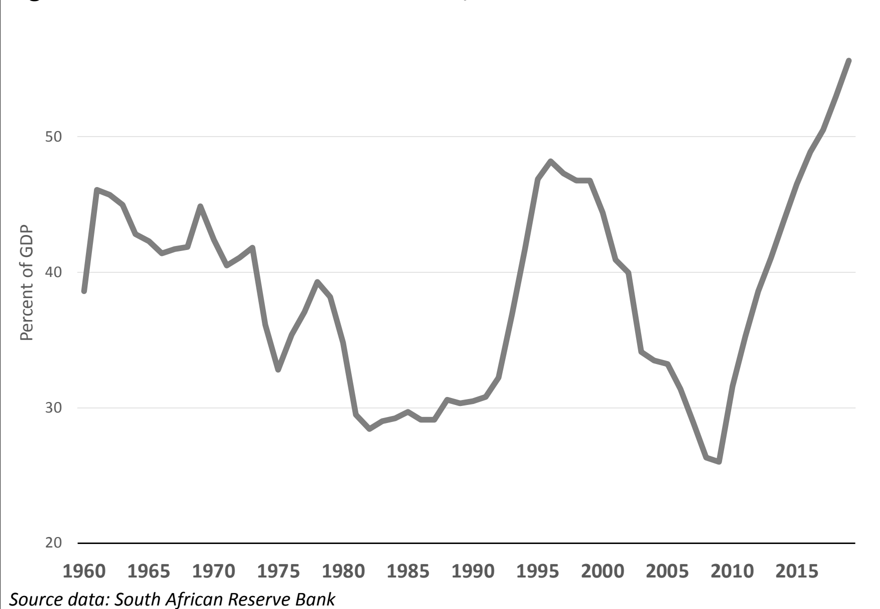
South Africa's debt-to-GDP ratio has been rising since 2008 and government lacks a credible strategy to stabilise it (see Figure 2). There is no threshold beyond which the level of debt becomes a fetter on economic growth or induces a generalised financial crisis. But the argument for accelerated debt accumulation is weakened by government's failure to stem debt increases in the decade since the financial crisis. Given that a large rise in debt has done little to change the trajectory of growth, why would even more debt work?

Although there is no magic threshold, rising public debt does impose costs on the public finances and the economy more generally. Debt creates a self-reinforcing pattern of dependence on debt. As tax revenue is shifted to fund interest payments, more debt is needed to finance the consequences of previously issued debt. This leads to fiscal structures that are increasingly regressive, inflexible and vulnerable in the event of crisis.

South Africa is blessed with a highly progressive tax system compared to similar economies.[7] Resort to debt-finance instead of taxation makes the budget increasingly regressive. When government borrows money, it creates a property right (in the form of a bond) which entitles the holder to a share in the stream of future government revenue. In general, these property rights are held and traded by the wealthy and (for them) government's debt costs are a reliable source of income.

Interest payments are a transfer – a redistribution of income – much like social grants. In the case of social grants, government taxes the relatively affluent and transfers the proceeds to the poorest South Africans. In the case of interest payments, government taxes the relatively affluent and transfers the proceeds to the richest South Africans and foreign investors. Today, nearly 4% of national income is transferred in this fashion and the amount is increasing each year, faster than any other element of the budget. As well as rendering the budget increasingly regressive, debt service payments crowd out other expenditure priorities. For every rand of tax revenue that government extracts from the South African economy today, 15 cents are deducted for interest payments. Again, this burden increases year after year as debt rises.

A second problem with a debt-fuelled expansion is the source of borrowing in a savings-constrained



economy. Since South Africa spends more than it earns, it relies on foreign savings to finance its investment. Figure 3 shows that since 2008 government borrowing has been funded largely by foreign savings, with the domestic private sector in a supporting role. When government and the private sector borrow simultaneously a greater reliance on foreign savings is required. When this happens, foreign claims on the national economy accumulate, making the country more and more vulnerable to the whims of international investors. A sudden reversal of capital inflows is always possible but difficult to predict. It depends on sentiment about South Africa (which is often fickle and ill informed) or generalised global instability (which is frequent and violent).

Private savings are available for government to the extent that South African companies and households do not wish to invest themselves. If government was to accelerate borrowing to finance a fiscal expansion, and if this coincided with a surge of private investment (as proponents suggest it would), this would need to be financed by a massive inflow of foreign capital.

To sustain such an inflow, government would need a credible story about the future of economic growth; a story that can convince the private sector and foreign investors that government's additional spending will generate sustained improvements in productivity and incomes. Without such confidence the most likely outcome of a sharp fiscal expansion would, in my view, be a large contraction in private investment and an outflow of foreign capital. This would wholly offset the aggregate demand effect of fiscal expansion, and result in a very deep recession. In the end, the country would find itself back at square one, but with a much higher level of government debt.

CAN GOVERNMENT MOBILISE INVESTMENT?

If a debt-fuelled expansion in aggregate demand succeeded in placing South Africa on a new growth path, then all these concerns are less salient. In such a scenario, the rise in debt would be brought to a halt by the acceleration of GDP growth. Foreigners would surely finance an investment boom if

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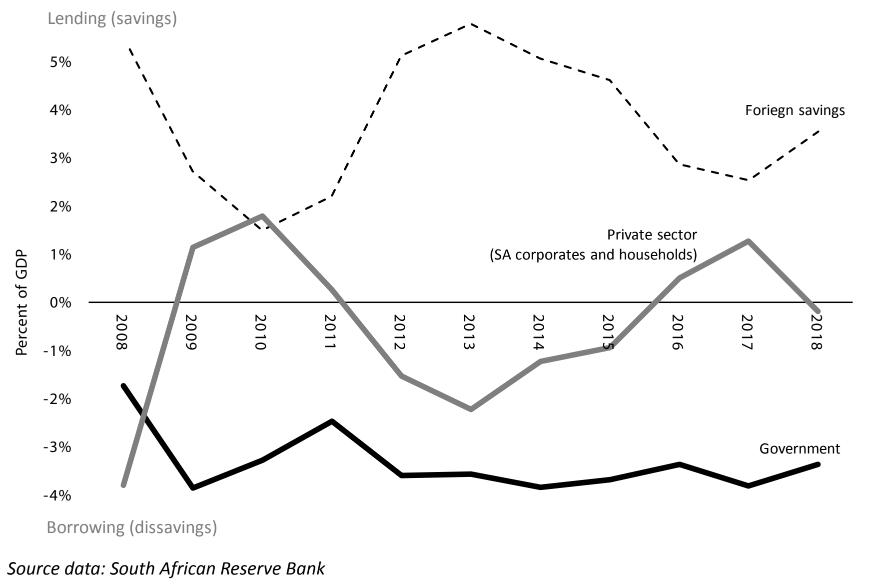
a credible case could be made that, as a result of such investments, a brighter future of growth and development is emerging. In that case, the key question is not how investment is financed, but whether government is able to identify and execute an investment mission that generates social returns that are higher than the cost of borrowing.[8] The record of South Africa's government, especially in the last decade, provides little evidence of this.

It is assumed that the fundamental constraint on public infrastructure is financial or technical. Government responds by creating infrastructure funds, establishing political committees to overcome technical obstacles or reallocates budgets to capital spending (thus adding to pressure on essential consumption spending). It is true that the absence of a professional and politically autonomous public service severely hampers South Africa's ability to select and execute large investments. But solving this problem means separating the public service and economic regulators from the destabilising embrace of political parties, a reform for which there appears to be little appetite amongst political parties.

That aside, the immediate blockage to stronger infrastructure spending is political failure, and the policy paralysis and institutional collapse that political failure generates. Here are a few examples. Road construction ››



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in urban centres is stalled because of the unresolved policy debate about e-tolling, which has dragged on for five years and left a policy vacuum in its wake. Government has an agency which can access financial markets and build water infrastructure, but the responsible department is fundamentally dysfunctional. Large resources are devoted to public housing but these resources – which are a critical element in provincial patronage networks – are deployed in a manner that reinforces apartheid settlement patterns. In 2006, government decided on digital migration to unlock key investments in new technologies. The political failure to agree on allocations of rent between incumbents and new entrants has led to endless prevarication, stalling the process for more than a decade.

Granted, government is working to resolve some of these problems. But doing so requires decisions that might upset key constituencies. Government is unwilling to confront these trade-offs because it is politically weak. Establishing special funds, "war rooms" or one-stop shops is unlikely to unlock higher levels of investment unless government is prepared to grasp the nettle.

NEGOTIATING REAL CHOICES

Some believe that South Africa's fiscal position is the key problem. In their view, a sharp fiscal contraction is necessary to ignite growth. For others, fiscal policy is the solution: a flood of borrowed money will place South Africa on a higher growth path. Both these approaches neglect political constraints. Fiscal consolidation cannot be made real unless government is prepared to re-negotiate public sector wages and reduce consumption financed through the budget. It is not. Fiscal expansion will be offset rand for rand (or worse) by capital outflows and a collapse in private investment, unless it is possible to convince investors that government has an effective and sustainable investment mission. That's a hard sell.

Shifting South Africans to a path of higher growth requires real sacrifices in current consumption in favour of investment. These sacrifices would need to be made by real people across a broad base, including the white elite, the black middle strata and public sector workers. This requires hard negotiation and acceptance of real costs by each of the parties. Until the country's leadership gets real about the need for these sacrifices, defines a clear national mission and begins to negotiate how the burden should be distributed, South Africa is unlikely to exit from the current path of slow but inexorable decline.

(ENDNOTES)

1 Charles Waring (2019): 'Both Directions At Once': Lost Coltrane Album Provides Revelatory Insights https://www.udiscovermusic.com/stories/both-directions-at-once-coltrane-review/

2 Altbeker, Boraine and Engela (2019): "Trends and drivers in public sector compensation spending: 2006 to 2018: Presentation to ESSA 2019".

3 See for instance National Treasury (2018): 'Medium Term Budget Policy Statement Annex A: Fiscal Risk Statement' and similar statements in the last few years.

4 See National Treasury (2017): 'Medium Term Budget Policy Statement Annex B: Compensation Data'.

5 The links between rising wage pressures and class sizes are documented in Gustafsson, Martin (2017): 'Personnel spending pressures Hiring and promotion cuts with enrolment growth'. Unpublished report; and Lilenstein, Adaiah and Spaull, Nic (2019): 'Rising Wages, Rising Class-sizes The case of South Africa 2008-2021'. Presentation at RESEP QER Conference, STIAS.

6 Oosthuizen, M. (2019): 'Race-disaggregated National Transfer Accounts for South Africa, 2015' SA TIED Working Paper #32.

7 Inchauste, G., Lustig, N., Maboshe, M., Purfield, C. and Woolard, I. (2015) 'The Distributional Impact of Fiscal Policy in South Africa', World Bank Poverty Research Working Paper, 52.

8 This logic, including its dependence on the expectations of entrepreneurs about future growth and development prospects, is set out in Mazzucato, M. and Deleidi, M. (2018): 'Putting Austerity to Bed: Technical Progress, Aggregate Demand and the Supermultiplier', IIPP working paper, 2018-01, 35. NA