Tough fiscal choices ahead

By Professor Philippe Burger

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PHILIPPE BURGER explains the tightrope act of the new Minister of Finance, as he edged his way through the Budget speech last month! Recent economic research shows that simply increasing government expenditure will not lead to growth. This was not an austerity budget -- the budget deficit is large and 48% of the population now receive a grant. However, he points out that payment of grants is no substitute for income-generating jobs, and here is where the 2022 budget completely failed.

Presenting his first budget as Minister of Finance, Enoch Godongwana, walked a tightrope. His speech followed years of state capture, during which economic growth all but stagnated and unemployment rose. It also followed two years of the Covid-19 pandemic during which more than two million people lost their jobs. In

the third quarter of 2021 the official unemployment rate reached a record 34.9%, while the unemployment rate according to the expanded definition (which includes discouraged individuals who wish to work, but who have given up looking for jobs) reached 46.6%.

While 16.4 million people were employed in the first quarter of 2020, employment fell to 14.2 million in the second quarter of 2020. It improved to 15.0 million in the first quarter of 2021, before falling back to 14.3 million in the third quarter, still 2.1 million lower than pre-Covid levels.

In the face of such high unemployment and poverty, Minister Godongwana faced significant pressure to expand the South African welfare state. Several commentators and activists argued for the introduction of a permanent Basic Income Grant (BIG) that would replace the Social Relief of Distress Grant (SRDG). The latter was introduced to provide relief for the large numbers of people who lost their jobs because of the economic fallout from the Covid pandemic. He refrained from introducing a BIG, instead extending the SRDG (R350 per month) by another year.

Minister Godongwana also faced pressure to lead efforts from National Treasury's side to implement structural reforms that would kickstart economic growth. Between 2014 and 2019 the South African economic growth rate never exceeded 1.5% per annum, and averaged 1%, well below the average population growth rate of 1.5% for the same period. Furthermore, in 2020 the economy shrunk by 6.4% because of the Covid crisis, with only a partial rebound of 4.8% in 2021. Thus, at the end of 2021 Gross Domestic Product (GDP) had not yet regained its 2019 pre-Covid level.

The budget projects economic growth to be 2.1%, 1.6% and 1.7% in the 2022/23, 2023/24 and 2024/25 fiscal years. The low growth rates, particularly in the outer two years, represent a return to the low growth environment of the 2014-19 period. Indeed, there are questions about whether these growth rates used in the budgetary planning might not be too optimistic, particularly given the electricity constraints under which the economy functions. The International Monetary Fund (IMF), for

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instance, projects growth of only 1.9% and 1.4% per annum for 2022 and 2023.

The low-growth environment of the South African economy raises the question about what role fiscal policy plays in stimulating economic growth. Specifically, does the budget provide sufficient support for higher growth?

Increase expenditure to support growth?

Commentators and activists clamouring for the introduction of a BIG also argue that the South African government is pursuing an austerity budget that will curtail economic growth. They argue, therefore, that not only does the government not provide sufficient support for higher economic growth, but that its “austerity budget” undermines growth.

Being firm believers in the power of the expenditure multiplier, they argue instead for higher expenditure, believing that such expenditure will result in higher levels of output. They are not too concerned if such an increase in expenditure results in higher public debt, because, so the argument goes, by stimulating GDP growth, the higher public debt might not necessarily result in a higher public debt/GDP ratio (since both denominator and numerator of the ratio will be growing).

There are, though, empirical studies by Janse van Rensburg, De Jager and Makrelov, as well as by Kemp and Hollander, that show that the expenditure multiplier is not all that potent, meaning that increasing expenditure might not result in all that large an increase in output. Indeed, my own research with Estian Calitz shows that the expenditure/GDP ratio exceeds the level at which an increase in the ratio raises economic growth, and, in fact, reduces economic growth.

Some proponents of higher expenditure also argue that should higher expenditure result in higher debt, the Reserve Bank can merely monetise the debt, i.e. buy the government bonds with money it newly creates. This view, though, ignores the portfolio dimension of money.

The new money created through higher government expenditure will end up as assets on balance sheets of financial institutions and individuals. Having such low-to-no-interest earning assets on financial institution balance sheets will trigger a reallocation of their portfolios towards higher-earning financial assets and commodities, raising the price of such assets, and therefore potentially creating financial asset and commodity price inflation. Individuals with such cash in their portfolios will act similarly, buying higher yielding financial assets, or buying consumer goods, causing a rise in consumer inflation.

The higher consumer price inflation currently seen in the US and Europe is not only the result of disrupted supply chains following the Covid crisis; it is also the result of such monetisation of the large fiscal deficits governments ran in reaction to the Covid crisis.

If higher expenditure financed with debt does not initiate a sufficiently large increase in the economic growth rate to keep the debt/GDP ratio stable, and if financing such expenditure through monetised debt risks creating inflation, the third option would be to finance such expenditure through higher taxes. However, raising taxes removes purchasing power and therefore reverses to a large extent whatever stimulatory effect the increase in expenditure has.

Furthermore, South Africa finds itself in a competitive world. While its tax burden (i.e. the sum of revenue collected in taxes expressed as ratio of GDP) is lower than that of most developed countries, it is at the high end of tax burdens in emerging economies. These are the economies with which South Africa competes for both domestic and foreign direct investment. Thus, there is not all that much room to raise tax rates. Indeed, to stimulate investment, Minister Godongwana announced a reduction of one percentage point in the corporate income tax rate to 27%.

Is the budget an austerity budget?

Although there is no room to increase expenditure, would it be accurate to characterise the budget as an austerity budget? At 10% in 2020/21 (largely because of the Covid crisis), 5.7% in 2021/22 and projected at 6% in 2022/23, the overall budget deficit can hardly be said to be small. It still contributes to a rising debt/GDP level. Even the 4.8% and 4.2% budget deficits projected for 2023/24 and 2024/25 are not small. The latter, though, are projected to be smaller than in preceding years because of a falling expenditure/GDP ratio.

Expenditure of consolidated government as ratio of GDP is projected to fall from 33.2% in 2021/22 to 31.5% in 2024/25. Though both the nominal rand values of expenditure and GDP are projected to increase, expenditure is projected to increase at a lower rate than nominal GDP, resulting in the drop in the ratio to 31.5%. Furthermore, with the budget projecting average Consumer Price Index (CPI) inflation for the 2022-2024 calendar years at 4.6%, the average nominal increase of 3.2% in the nominal rand value of expenditure translates

into a decrease in real terms (while revenue in real terms remains more or less constant).

The lower average increase in nominal expenditure compared to GDP results from the lower average projected growth of compensation of employees, goods and services, and transfers and subsidies at respectively 1.8%, 2.6% and 0.7% per annum from 2022/23 to 2024/25. The lower growth in the compensation of employees follows a decade of above-inflation salary increases for the public sector that resulted in the consolidated government salary bill reaching 11.4% of GDP in 2020/21. It is projected to fall to 9.7% of GDP in 2024/25, carrying the bulk of the downward adjustment in the government expenditure/GDP ratio.

A further significant contributor to the lower nominal increase in expenditure over the period 2022/23 to 2024/25 is the projected abolition of the SRDG. The grant was extended for the 2022/23 fiscal year and amounts to R44 billion, but then, according to the budget, falls away from 2023/24 onwards. As a result, social grants as percentage of GDP are set to fall from 3.9% in 2022/23 to 3.1% in 2023/24.

With 2022 being an internal leadership election year in the ANC, it was politically unlikely that the government would have terminated the SRDG in the 2022 budget. However, whether the government will be able to terminate the SRDG in the 2023 budget without replacing it with a BIG is also questionable. Having by then paid this grant for almost three years, the negative political fallout of abolishing it without replacing it with a BIG will probably be quite significant, rendering it politically unpalatable. Therefore, unless expenditure is cut elsewhere or taxes are raised, the likely introduction of a BIG in the 2023 budget will put upward pressure on government expenditure, and therefore on the deficit and debt as percentages of GDP.

Thus, with budget deficits that remain large, the budget is not an

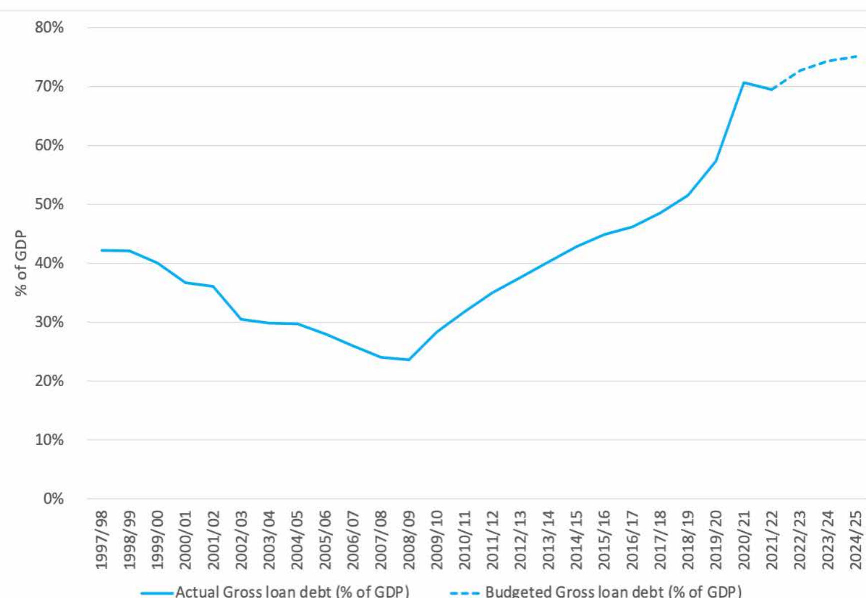

Figure 1: Gross Loan Debt (% of GDP) of the South African government

austerity budget. Having said that, the real decrease in expenditure and the planned stabilisation of the debt/GDP ratio does mean that less stimulus is pumped into the economy.

Public debt and fiscal sustainability

According to the 2022 budget, the reduction in the budget deficit will slow down the rate at which the public debt/GDP ratio increases, with the ratio projected to peak at 75.1% in 2024/25 (see Figure 1). This is a year earlier than projected by the government in 2021.

Note that in previous budgets the debt/GDP ratio was projected to approach 90%. However, with the revision of the country's National Accounts in 2021 the value of GDP was adjusted upwards, which had the effect of reducing the debt/GDP ratio.

In addition, government's revenue displayed a higher level of buoyancy in reaction to the bounce back in economic growth in 2021. This resulted in higher-than-expected tax collections, which, in turn, resulted in a smaller-than-expected deficit and a slower increase in debt. The government also collected more revenue because of higher commodity prices. Increased tax buoyancy and higher commodity prices resulted in the government in 2021/22 collecting R182 billion more in revenue than expected in the 2021/22 budget. This amounts to an additional revenue collection of 2.8% of GDP. Approximately 40% of the additional R182 billion goes to lowering the budget deficit.

Compared to what it expected in its 2021/22 budget, the government expects the higher collection of revenue to continue into the medium term, resulting in an additional R141 billion and R146 billion (equals to 2.1% and 2% of GDP) to be collected in 2022/23 and 2023/24. These additional revenue flows are expected to assist the government in reducing the deficit and stabilising the debt/GDP ratio.

However, if the government introduces a BIG, a real question is whether it will do so without raising taxes or reducing expenditure to keep the debt/GDP ratio stable.

This question will become more of a burning issue if economic growth also

> **The low-growth environment of the South African economy raises the question about what role fiscal policy plays in stimulating economic growth.**

falls short of government's projections of 2.1% and 1.6% for 2022/23 and 2023/24, putting further upward pressure on the deficit. In short, there is a very real possibility that the deficit will come in higher in the medium term than projected by the government, and that this will result in the debt/GDP continuing to increase.

Lower expenditure and socioeconomic rights – education expenditure

In 2020 and 2021 some commentators expressed concerns that a reduction in expenditure in real terms might represent a roll back of the socioeconomic rights enshrined in the Constitution. The South African Constitution defines a number of socioeconomic rights. The right to basic education is one such right. Every child has the right to receive basic education. Should the government spend less on basic education in real terms, the question is whether it violates the child's right to basic education.

Education is also the largest non-interest expenditure item in the budget, and it is one of the main drivers of long-term economic growth. Specifically, Hanushek and Woessmann have shown that countries with better quality education have higher economic growth rates. Education also improves social mobility, meaning that with education the children of the poor are less likely to also be poor.

Ascertaining whether or not a socioeconomic right such as education is realised is more complex than simply looking at the amount of money spent on it, and whether that amount increased or decreased. It also depends on how that money is spent, and thus on the quality of education (the element that Hanushek and Woessmann highlight as important for long-term economic growth). The question then becomes how low the quality of education, and, therefore, how low the level of learning by children must be for society to judge government in breach of the constitutional requirement to provide each child with an education.

Unfortunately, when considering the state of basic education in South Africa, large numbers of children might already be in a position where little or no learning takes place (in fact, many schools might not be much more than day care centres, with little learning taking place). As Nic Spaull noted, studies show that 78% of Grade 4 learners cannot read for meaning. There are several reasons for this, including inadequate school infrastructure and large numbers of teachers who lack the skills to teach the subjects they are supposed to teach. In 2020, 5,771 (24.8%)

of the 23,267 schools in South Africa still had pit toilets (and 3,415 schools had *only* pit toilets). Only 20.3% of schools had internet for teaching and learning, only 31% had a computer centre, and only 22% had a library, while a mere 14.7% had a science laboratory. And regarding the skill levels of teachers, Venkat and Spaull found that 79% of mathematics grade 6 teachers have a content knowledge of mathematics lower than what Grade 6 learners should possess.

The response to this under performance should not necessarily be an increase in expenditure on education. Indeed, the real problem might not primarily be one of resource availability, but rather resource management and allocation.

Thus, judging the extent to which socioeconomic rights are realised is not as simple as merely looking at the amount of money spent on it. It is possible, as has indeed been the case in the past, to increase expenditure in real terms by merely paying teachers above-inflation salary increases. Doing so did not reduce the learner-to-teacher ratio or improve the quality of education. It also does not guarantee that the teacher is more skilled. The same is true for a real reduction in expenditure resulting from paying teachers below-inflation salary increases. Doing so may leave the learner-to-teacher ratio unchanged and therefore not represent a deterioration in the quality of education. Assessing the quality of education therefore requires the consideration of a whole set of indicators, only some of which are financial.

Education in the consolidated government budget is set to increase by 4.6% in 2022/23, 1.1% in 2023/24, and 2.8% in 2024/25, averaging at 2.8% per annum, which is significantly lower than the 4.6%. average CPI inflation the government projects for the 2022-to-2024 calendar years. However, part of this reduction results from planned reductions in the rate at which salaries are budgeted to increase, which will not necessarily affect the quality of education.

Is the budget a growth budget?

As mentioned above, empirical evidence suggests that government expenditure as ratio of GDP already exceeds the level at which an increase in the ratio contributes to higher economic growth. Indeed, the evidence shows that a reduction in the ratio will likely result in higher economic growth.

Using National Revenue Fund data to estimate the relationship, Estian Calitz and I have shown that the government expenditure/GDP ratio varied between 22% and 32% in the period between 1995 and 2019. We then showed that for as long as the level of the expenditure/GDP ratio was below 29%, an increase in the expenditure/GDP ratio led to an increase in economic growth. Above 29% the relationship turned negative. The government expenditure/GDP ratio has exceeded the 29% level since 2015.

The negative relationship points to the use of funds in ways that do not support economic growth. To improve economic growth the choice therefore is to either reallocate funding in the budget to more growth-enhancing items, or to reduce the expenditure/GDP ratio to a level that does not curtail economic growth.

Improving economic growth through a reallocation of resources will involve a reduction in current expenditure in favour of an increase in capital expenditure.

In 2021/22 only 4% of consolidated government expenditure went to the payments for capital assets. This is set to increase to 5.2% in 2024/25 fiscal years. Although this increase represents a budgetary reallocation towards capital expenditure, as percentage of GDP it represents only a small increase from 1.3% to 1.6%. A significantly bigger reallocation will be needed to create public infrastructure that supports economic growth.

National Accounts data shows that gross investment by general government as ratio of GDP fell from 3.9% in 2008 to 2.7 in 2019 and 2.5% in 2020 (the first Covid crisis year). Investment by public corporations rose slowly from 3% in 2008 to 3.5% in 2013, mostly because of the construction of the Medupi and Kusile power stations, before falling to 1.6% in 2019 and 1.4% in 2020. Gross private sector investment as ratio of GDP fell sharply from 14.7% in 2008 to 11.1% in 2019 and 9.8% in 2020.

In a recent study I showed that for every additional percentage point increase in the private sector's investment/GDP ratio, economic growth will increase by a third of a percentage point. Thus, increasing the private investment/GDP ratio from 11% to 14% could add a whole percentage point of economic growth per year to GDP growth. However, private sector investment requires, among other things, sufficient infrastructure investment, a role that the government typically performs. To perform this role will require a significant reallocation of resources in the budget away from current and towards capital expenditure. Alternatively, the government should put together a policy and plan to let the private sector take up this role.

Tough choices ahead

If it wants to introduce a BIG *and* kickstart economic growth through higher government investment, the South African government faces tough choices, particularly since it operates under a budget constraint. It can try to increase tax rates to finance a BIG and investment. However, doing so with a tax burden that is already high compared to other emerging economies, will scare off investment. And borrowing the funds to finance a BIG and investment is expensive as South African government bonds carry a higher interest rate because of the government's junk status credit rating.

Furthermore, because of the »

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country's electricity constraints, economic growth will also be constrained for the foreseeable future. Constrained growth, in turn, will limit the revenue growth of government. Even though President Ramaphosa in his 2022 State of the Nation address announced plans to expand electricity production, such plans will take time to implement. Thus, the prospects of higher economic growth in excess of the 1.3%-1.7% range in, say, the next five years, is rather limited.

To introduce a BIG in the 2023 budget will therefore require a reallocation of resources away from current expenditure on salaries, goods and services. Even at a mere R350 per month per recipient the SRDG currently costs R44 billion, or 0.7% of GDP, for 10.5 million people. In addition to the 10.5 million recipients of the SRDG, there are 18.3 million beneficiaries of other grants, such as the Child Support Grant. With a population of roughly 60 million, the total of 28.8 million people receiving grants means that almost 48% of the population receive a grant. Having half the population on grants is not a sign of a healthy economy.

Increasing expenditure on capital will also require a reallocation of resources away from current expenditure on salaries, goods and services, and grants towards growth-supporting infrastructure development.

Photo credit: Flickr

If the government cannot see its way open to do this reallocation, it will have to create a policy as well as an enabling framework for the private sector to finance and construct such infrastructure.

One point with which to conclude though, is that the payment of grants is no substitute for income-generating jobs. Thus, in the absence of sustainable and inclusive economic growth that generates jobs, the payment of grants will not ensure longer-run political stability. A grant may alleviate hunger in the short run, but people also need hope of a better future. That is something a job, not a grant, can deliver. Therefore, even though we can debate whether or not to introduce a BIG, the real question is how to get the economy growing so it can create jobs. The 2022/23 budget falls short in answering this question.

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