Fiscal Policy since the Great Recession

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South Africa entered the 2008/09 recession with a consolidated budget surplus, and government net debt down to 23 per cent of GDP. In the wake of the recession, the 2009 Budget provided for a 5.1 per cent a year real increase in expenditure and tax relief equivalent to approximately 0.5 per cent of GDP, viewed at the time as appropriately expansionary fiscal measures to offset the impact of the recession and restore the momentum of growth. A deficit of 4.2 per cent of GDP in 2008/09 was anticipated – it turned out to be 6.6 per cent.

The broadly expansionary fiscal stance continued until 2012. But growth and revenue outcomes continued to lag well behind budget projections. By 2013, the budget deficit was still over 4 per cent of GDP, net debt had increased to 36 per cent of GDP and the *Budget Review* signalled that there was no further room for fiscal stimulus. Spending cuts were proposed and real growth in expenditure over the medium term was reduced to 2.3 per cent a year. Economic recovery had to come from implementation of the newly released National Development Plan.

Outside of the national budget, the borrowing requirement of state-owned companies increased from 1 per cent of GDP in 2011/12 to 3 per cent in 2015/16. Much of the borrowing was by Eskom, for the construction of two large power stations and substantial expansion of the transmission grid. The finance required for these investments could not be raised without fiscal support. In 2008 a R60 billion allocation to Eskom was made from the National Revenue Fund, and the state guarantee underwriting Eskom's debt steadily increased from R26 billion in 2009 to R220 billion in early 2018.

In 2013, following another downward adjustment in growth and revenue projections, the Budget signalled a shift in policy aimed at stabilising debt by containing future expenditure within pre-announced ceilings and phasing in of a higher revenue-GDP target. By 2017, weak economic growth, the upward drift of the debt-GDP ratio, a crisis of confidence in economic policy and successive replacements of the Finance Minister had led to credit rating downgrades to below investment grade. Nearly a decade after the global recession, and despite the partial recovery of commodity prices and a more buoyant international outlook, South Africa remained stuck in an apparent low-growth trap, with unemployment rising to over 27 per cent in the third quarter of 2017.

Government's fiscal consolidation commitment was firmly reinforced in the 2018 Budget, which saw substantial spending reductions across most functions together with the first VAT increase in over twenty years. Although the Treasury's projections for growth averaged just 1.8 per cent over the 2017-2020 period, the budget framework leaves little room for fiscal stimulus. The Budget Review indicates several substantial risks over the period ahead – personnel spending pressures, education and health spending commitments, the weak financial position of state-owned companies and revenue administration challenges.

There are nonetheless important contributions that fiscal policy and the public finances can make to both a growth recovery and its distributional impact. These are about the details of tax, spending and financial support programmes, rather than the headline fiscal aggregates. They are about the interaction between government actions and market dynamics, and the indirect ways in which public policy reinforces – or undermines – investment, trade and employment trends.

Urban development and housing

Urbanisation is a powerful catalyst of growth. Productivity is higher in cities. And so, as emphasised by the Commission on Growth and Development in its 2009 study of *Urbanisation and Growth* – "making urbanisation work well is something that countries that want to grow quickly must learn to do."[1]

Greater priority will have to go to economic investment, trade, skills and enterprise development. Cities should be places of work opportunity, with the ease of doing business a key indicator of progress.

Urbanisation brings complex challenges. Realising its benefits depends on intelligent and well-coordinated engineering, logistical, social, organisational and fiscal capabilities. It takes time to mobilise these capabilities, and it is perhaps appropriate, therefore, that in the wake of South Africa's sweeping overhaul of the structure and functioning of local government beginning in the late 1990s the municipal fiscal framework has remained cautious and closely supervised.

Fiscal transfers to municipalities are currently largely directed to meeting basic service delivery requirements of expanding residential communities. This complements investment in low-income housing, and contributes to free or below-cost water, sanitation and commuter transport services.

If urban growth is to bring productivity and employment benefits in the decades ahead, however, the structure of local government finances and financial support from the national budget will have to change.

Greater priority will have to go to economic investment, trade, skills and enterprise development. Cities should be places of work opportunity, with the ease of doing business a key indicator of progress. Stronger engagement between civic leaders and local business chambers is needed on planning and financing urban growth. Centres of research, education and health expertise are prominent features of our urban landscapes, yet they play too limited a role in city development strategies.

Major investments in water and sanitation, transport infrastructure and services, power and communication are needed, both to expand urban capacity and to achieve a more efficient, densified and integrated urban landscape. These cannot be financed indefinitely through grants from the national fiscus – there has to be growth in local economic activity, incomes and municipal revenue. This requires a shift in emphasis in urban planning from residential upgrading, important as it is, to promotion of business investment, employment and enterprise development.

This calls for a transition from the present architecture of grant-funding for housing and urban infrastructure, heavily reliant on the national fiscus, to a blend of grant and loan-funding, and greater mobilisation of private finance through co-funding partnerships or concessions.

The Development Bank of Southern Africa (DBSA) is well-placed to serve as an intermediary between the national fiscus and municipalities, focused on long-term loans for basic infrastructure and co-funding or risk mitigation of private sector investment. The DBSA should also be mandated to support housing development, through a merger with the existing housing development finance institutions. But an expanded mandate will require a substantial capital enhancement. To achieve an appropriate scale as a regional infrastructure funder and to leverage greater private infrastructure investment, the DBSA needs a larger balance sheet.

Municipalities have room to borrow for necessary infrastructure and growth-enhancing investments. Their consolidated debt is low – under 15 per cent of total revenue – and the net borrowing requirement has averaged just R11 billion a year since 2014/15, or less than 0.3 per cent of GDP. But investment in rehabilitation and expansion of municipal infrastructure has remained well below requirements, reflected in under-spending of capital budgets by 20 per cent in 2016/17, for example.

However, sustainable urban development requires a growing revenue base. Improved revenue management is needed and progress in countering service charge boycotts. Changes in land and housing policies will also be required. Municipal services cannot affordably be provided if urban housing development continues to mushroom largely outside planned and rateable urban demarcations. Development has to be a financially viable proposition for municipalities, across the full income spectrum of household and business residents.

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Earnings, employment and social security

If South Africa is to make more rapid progress in reducing poverty and inequality, it must accelerate the pace of job creation.

As was argued by Professor Sam Bowles, advisor to the Labour Market Commission in the 1990s, the appropriate fiscal response to structurally entrenched unemployment is to subsidise the earnings of low-wage workers. This reduces the cost of job creation at the margin, and assists in meeting minimum wage or industrial agreement standards.

A well-designed employment subsidy has the added advantage of encouraging formalisation of earnings and employment – compliance with labour standards and tax obligations, and participation in social security arrangements.

The youth employment incentive introduced in 2013 and implemented through the PAYE tax platform has proved to be administratively viable, achieving a reach of over 30 000 firms and 600 000 individuals within two years. It has the right design for a market-compatible wage subsidy, with a peak value of R1 000 at an earnings level of R3 000-R4 000 a month, phasing down to zero when remuneration reaches R6 000 a month.[2]

But a temporary subsidy targeted at young work-seekers only is not an effective instrument for expanding the demand for labour. The enabling legislation provides for its extension to specific sectors or special economic zones, by agreement with the Minister of Trade and Industry. This would raise its costs considerably, but with the benefit of creating an effective bias in favour of employment-intensive growth and support for higher wages at the bottom of the earnings distribution.

Proposals for social security and national health insurance are currently under discussion at the National Economic Development and Labour Council (NEDLAC).[3] Details of the reforms and their cost implications are not yet clear. In both cases there is likely to be a call on the payroll tax base – this is a common approach to funding social insurance benefits internationally, and it is a comparatively under-utilised revenue source in South Africa at present.

But payroll taxes raise employment costs and lead, in many countries, to informalisation or irregular forms of employment in order to avoid these costs. A subsidy operating through the tax or collection system is both a counter to this tendency and a useful redistributive measure if it is well-targeted.

The deeper problem is that these are state-owned companies operating in network industries in which technology and competitive adaptation have shifted against slow-moving incumbents.

Administratively, a standard contributory retirement pension and death and disability benefits could be added to the unemployment insurance arrangement, financed in part for low-wage employees through a wage subsidy structured like the current youth employment incentive. Fiscally, implementation would be assisted by the current surplus generated annually by the UIF. But it would have to be accompanied by resolution of the escalating deficit of the Road Accident Fund, which is an unsustainable social security arrangement.

Together with mandatory health insurance cover, these would be very substantial shifts in South Africa's income support and redistribution programmes. Social insurance cannot realistically be regarded as a catalyst of growth. But if implementation is well-sequenced once more rapid growth is under way, progress in household income security would contribute to sustaining productivity and competitiveness in more labour-intensive activities.

Network industries and state-owned companies

Sustained long-run growth also requires ongoing investment in infrastructure and adaptation to changing requirements of the network industries.

The fiscal challenges here are immense, because past mistakes cast long shadows over the period ahead.

Transnet and Eskom have invested massively in expanded capacity, but market demand has not kept pace with expectations. Leadership failures, procurement blunders and corruption appear to have raised costs substantially. Eskom's construction of two of the largest coal-fired power plants in the world, Transnet's locomotive acquisition programme, SANRAL's Gauteng Freeway Improvement Programme and PRASA's rolling stock renewal programme all illustrate the "optimism bias" characteristic of so many large infrastructure projects.[4] A similar hubris is evident inSouth African Airways's recurring failures to achieve turnaround targets. The investments and operating losses have to be paid for, with an increasing likelihood that taxpayers rather than consumers will foot the bill.

The deeper problem is that these are state-owned companies operating in network industries in which technology and competitive adaptation have shifted against slow-moving incumbents. Restructuring proposals drawn up in the 1990s took account of these trends and sought to bring better regulation and competition into

the electricity, transport, water and telecommunications sectors, but the complexity of market structure transitions and political resistance to privatisation interfered with progress.

"Private sector participation" in infrastructure is again under discussion in 2018. But it is one thing to bring private investors in, through competitive processes, to build and manage new plants or services. It is quite another to invite private bids for existing assets, operations, staff and liabilities.

Nations cannot prosper or reduce economic vulnerability if they fail to secure water supplies and sanitation systems, if businesses are left without reliable electricity, if transport becomes congested in cities or if telecommunications lags behind digital opportunities.

There are many opportunities for efficiency-enhancing private participation in the infrastructure sectors, but these are difficult transactions to structure and manage. Replacement of public debt with private investment brings no advantages in itself, and typically leads to higher finance costs. The benefits lie in the hard work of specifying and contracting for operational efficiency, lower costs of delivery, better maintenance of assets, technological progress and greater responsiveness to customer needs.

Despite the somewhat chaotic trajectory of regulatory reform, these gains have been at least partially achieved in telecommunications. There are competing providers, costs have come down and Telkom has had to adapt without fiscal support. In public transport, useful lessons have been learnt in the first phases of implementation of bus rapid transit projects. It is not helpful to generalise about private participation in network industries – the regulatory and transaction management issues are complex and diverse. Technological and engineering considerations come into play, regional and international trends are relevant and the interaction between private and public good features are not straightforward. Getting things right in the evolution of network industry structures is immensely important. Nations cannot prosper or reduce economic vulnerability if they fail to secure water supplies and sanitation systems, if businesses are left without reliable electricity, if transport becomes congested in cities or if telecommunications lags behind digital opportunities. There is a place for government programmes and fiscal incentives in all of these sectors, but success is unlikely if the state's ambitions are to dominate through monopoly ownership or intrusive regulatory controls.

Conclusion

Although economic growth seems likely to strengthen over the 2018 to 2020 period, the fiscus will remain under stress – there will be little scope for expenditure increases or tax relief. Support for economic growth will have to come from more oblique instruments of policy: a policy environment that supports investment, promotion of urban development and industrialisation, a more employment-intensive policy mix and encouragement of private participation in infrastructure investment and services.

These are not straightforward policy shifts – the details are complex and important, and transition paths need to be carefully considered.

Shifts in public policy to strengthen growth and broaden its impact will take time to deliver results. These measures must complement – not substitute for – more accommodative trade, investment, empowerment and financial policies.

NOTES

1. Michael Spence, Patricia Clarke Annez and Robert M Buckley (eds.) (2009), Urbanization and Growth, The World Bank, p. xi.
2. Aroop Chatterjee and Catherine MacLeod, Employment Tax Incentive Descriptive Report, National Treasury August 2016.
3. Interdepartmental Task Team on Social Security and Retirement Reform, Comprehensive Social Security in South Africa: Discussion Document, March 2012, tabled at NEDLAC on 25 November 2016; National Department of Health, National Health Insurance for South Africa: Towards Universal Health Coverage, June 2017.
4. See, for example, Matti Siemiatycki, Managing Optimism Biases in the Delivery of Large-Infrastructure Projects: A Corporate Performance Benchmarking Approach, European Journal of Transport and Infrastructure Research, March 2010.