

Reflections on Aspects of Public Finance and Fiscal Policy in South Africa

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At the time of writing, i.e. during the Covid-19 lockdown period, South Africa faces huge fiscal challenges – some recent or new, some reflecting a rather long path dependency. The purpose of this paper is to highlight a few things that are currently debated intensively or surface from time to time. These are issues that should receive serious attention so that, when we look back over a number of years, we can say – to reverse Charles Dickens’s (1859) words pairwise:

It was the worst of times, it was the best of times, it was the age of foolishness, it was the age of wisdom, it was the epoch of incredulity, it was the epoch of belief, it was the season of Darkness, it was the season of Light, it was the spring of despair, it was the winter of hope, we had nothing before us, we had everything before us, ...

As a backdrop to the rest of the paper, it is appropriate to present a few stylised facts to illustrate the current state of affairs in the public finances. Thereafter we explore a few features with a view to contemplating changes.

STYLISTED FACTS

A reminder of a few salient facts about South Africa’s fiscal history is in order. Table 1 shows the pattern since 1960 of public sector resource mobilisation² as a percentage of GDP.

Table 1. Average size of the SA public sector, various indicators for selected periods, calendar years 1960-2019 (market prices, as % of GDP)

Indicator	1960- 69	1970- 79	1980- 89	1990- 94	1995- 99	2000- 07	2008- 17
Taxes	14.7	17.8	21.1	22.6	23.3	23.9	25.1
GG consumption	10.6	12.6	16.2	19.1	18.8	18.7	20.2
Transfers	3.1	3.7	4.6	5.6	6.1	7.2	8.9
Interest on government debt	0.8	1.5	3.2	4.4	6.0	4.0	3.5
GG* investment	7.7	10.2	7.1	4.2	3.0	2.7	3.2

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² The total of final consumption and investment by the public sector, as well as resources mobilised by government to be used as transfers or subsidies and of which the final spending is by households or private businesses.

PC investment	1.9	4.2	4.1	2.3	2.2	1.9	4.0
GG** resource mobilisation***	22.2	28.1	31.3	33.3	34.0	32.6	35.8
Total public sector resource mobilisation	24.1	32.3	35.3	35.7	36.2	34.5	39.8

Notes: *GG = general government; **PC = public corporations; ***resource mobilisation is the total of consumption, investment and transfer expenditure.

Source: Calitz, Steenekamp & Siebrits (2019: 13).

As in many countries, the share of government in the South African economy has been growing for decades. For example, in 1938, just before World War II, the final expenditure by the public sector (i.e. excluding subsidies and transfers), amounted to 16.4% of GDP (Houghton, 1973:206). As shown in Table 1, the share increased until the end of the previous century, somewhat reminiscent of Wagner’s (1883) law that the income elasticity of government expenditure exceeds one (1). Thereafter (1980-2007) it stabilised around 35-36%. This lasted until the great recession of 2007-2008. This flattening of the long-term rising trend occurred at and after the time when full democracy was constitutionalised. Meltzer and Richard (MR) (1981) argued that with an extension of franchise, the median voter plays an important role in determining the size of the government sector in a democracy. The reason is that there will be pressure for redistributing income if the income of the median voter lies below the average income. What was different when the extension of franchise occurred after South Africa’s political transformation in 1994, is that neither the tax burden, nor general government expenditure behaved according to the M-R prediction of a rising government share. There were at least three reasons for this:

- high economic growth (averaging 4.3 % per annum) during the age of great moderation (2000-2007);
- a significant reprioritisation of government expenditure towards formerly disadvantaged and destitute groups in society, as reflected in the increase in transfer payments as a percentage of GDP (from 3.1% in the 1990s to 7.2% in 2000-07), as well as a reallocation of funds towards vulnerable and previously disadvantaged groups within the functional categories of government expenditure (such as education and health); and
- a significant reduction in the investment-to-GDP ratio of general government (from 10.2% in the 1970s to 2.7% in 2000-2007).

Table 1 shows that the stabilisation of the government’s share in the economy was undone during and following the international financial crisis. Recently the Covid-19-virus dramatically increased government’s resource mobilisation further. Even if one were to argue that recent increases in the share of public resource mobilisation in the economy reflect a delayed M-R prediction, the ability of the tax base to finance this, is at issue. We comment on this after Table 2.

The growth in government expenditure outstripped the growth in tax revenue, resulting in ever rising government budget deficits, public debt and interest payments. The original 2020 budget (before the Covid-19 adjustment was presented to Parliament) envisaged a deficit-to GDP of 6.3% in FY 2021³, compared to a budget surplus-to-GDP of 0.7% in 2007, just before the great recession. Admittedly, the 2007-result was unique: a better financing outcome than any other time in the previous 47 years. But it provided a cushion (fiscal scope) to weather part of the storm that was coming, a recourse that was totally lacking in 2020. The public debt position obviously showed a similar picture. Yes, previously there were also high debt-to-GDP ratios, such as 48.2.% in 1996 when the post-apartheid government amongst

³ In this paper the notation followed is to choose the last of the split numbers of a fiscal year as the date of identification, for example, FY2021 refers to the 2020/21 fiscal year.

other things incorporated the debt of the former homelands into the national government debt.⁴ Even so, the average debt-to-GDP ratio over the period from 1960 to 2008 was 37.5% and never exceeded 50%. The budgeted 2020 ratio (before prospective Covid-19 related adjustments) is 62.2% and higher ratios have been envisaged for subsequent years. Estimates of Covid-19 deficits are rife; some as high as 16%. Moreover, the poor performance of the capital stock of the public sector – in particular, the assets of state-owned enterprises, led to a significant deterioration in the public sector balance sheet (i.e. the net worth of government) (Burger, Siebrits & Calitz, 2016). In addition to repeated budgetary support to various state-owned enterprises, the fiscal picture was worsened further by guarantees (contingent liabilities) to these enterprises, together with all the risks of default. The most prominent of these types of support are shown in Table 2. If all these commitments were to end up as government debt in 2020, for example, the gross government debt could rise above 80%.

Table 2. Summary of recapitalisations and bailouts of as well as government guarantees to state-owned companies (R billion, projected 2020 prices*)

Fiscal year**	Eskom (1)	SAA (2)	Denel (3)	SA Express (4)	SABC (5)	Total (6)
A. Capitalisations and bailouts (top beneficiaries)						
(1) 2008-19	185.1	25.2	2.5	2.4	3.3	218.5
(2) 2020-22	83.7	16.1	0.6	0.2	0.0	100.6
(3) 2008-22	268.8	41.2	3.1	2.6	3.3	319.0
B. Government guarantees and other contingent liabilities (selected beneficiaries) (2020 prices)						
Fiscal year**	Eskom (7)	SAA (8)	SA National Roads Agency Ltd (SANRAL) (9)	Road Accident Fund (10)	Independent power producers (11)	Total (all SOEs) (12)
(4) 2020	296.5	8.0	44.2	343.1	163.5	1 041.9

Notes: * Budget figures in years before 2020 (section A) were inflated by the CPI in order to express all amounts in 2020 prices, for aggregation and comparison purposes. Totals may not add up due to rounding. ** Fiscal years run over two calendar years. FY 2021, for example, runs from 1 April 2020 to 31 March 2021.

Source: Budget Review (2020: 91, 213)

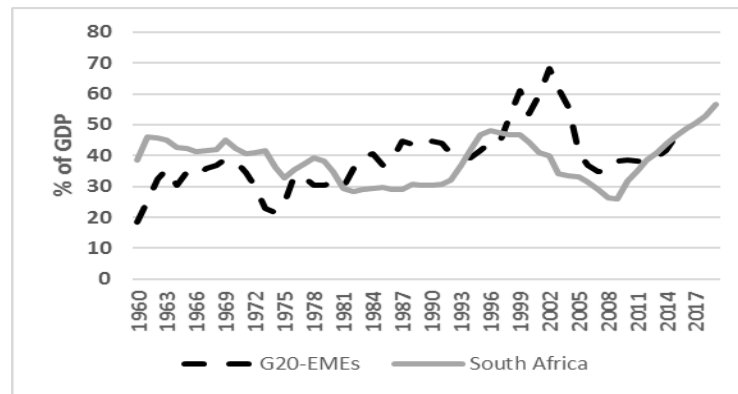
How does South Africa compare to peer countries? IMF (2019) data indicate that only five emerging economies carry heavier tax burdens (general government revenue as % of GDP) than South Africa, namely Brazil, Cyprus, Tonga, Malta and the Seychelles, while 20 emerging markets collect less revenue as percentage of GDP than SA. The latter include China, Thailand, Indonesia, Kenya and Uganda. South Africa also has a higher total revenue-to-GDP ratio than the US, Switzerland, South Korea, Australia and Israel, all of which are developed economies (Burger and Calitz, 2019).⁵ As far as government debt is concerned, South Africa was in a better position than, for example, the G20-emerging market economies⁶ at the beginning of the international financial crisis but lost that advantage subsequently. Since the crisis South Africa's upward trajectory was much steeper, with no flattening or turnaround in sight. See Figure 1.

⁴ Incidentally, at the time the thinking was that the ratio was approaching 60% and only after the revision of the National Accounts methodology that estimated GDP to be higher than thought previously, did the debt ratio seem much lower – we slashed 10 percentage points from the ratio by upwardly adjusting our GDP estimate. In lighter vein, revision of national account data remains the most effective way of reducing the debt-to-GDP ratio!

⁵ The tax-to-GDP ratios of the developed economies include social security taxes.

⁶ They are Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea and Turkey.

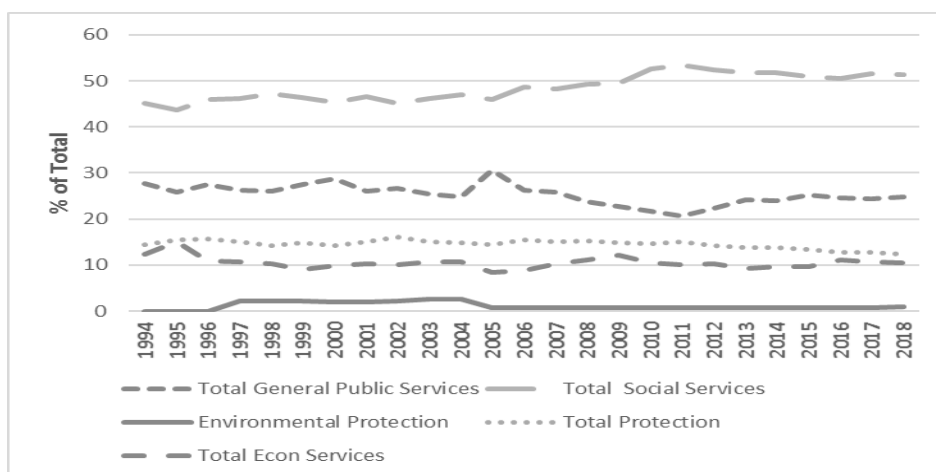
Figure 1. General government debt, South Africa and G20 Emerging Economies (incl SA), 1960-2019 (% of GDP)



Source: IMF (2020)

The functional composition of general government expenditure has clearly shifted towards social services (see Figure 2), in line with the Gear⁷ document (RSA, 1996), which emphasised redistribution via the expenditure side of the government budget. Social services as a percentage of total general government expenditure increased from 45.2% in 1994 to 53.5% in 2011, before receding somewhat. This was largely instrumental in the fiscal reduction in the Gini coefficient from 0.69 to 0.47 (Van der Berg, 2009). Despite this, the Gini coefficient in South Africa *after* fiscal redistribution was still higher than in another highly unequal country *before* their fiscal redistribution, namely Brazil (Lustig, 2016). Expenditure in public health, education and social transfers to low-income households and the aged were the categories with the biggest contribution to the South African fiscal redistribution. The number of beneficiaries from social transfers increased from 2.8 million as at 31 May 1995 (RSA, 1997: Chapter 7, Paragraph 4) to an estimated 18 million in FY2020 (National Treasury, 2020: 56), which indicates state dependence of about 30% of the population. StatsSA (2020) reported that the “bottom 60% of households depend more on social grants and less on income from the labour market”. Even though the fiscal redistribution has reduced the Gini coefficient, the primary Gini coefficient⁸ has not improved, reflecting both low and non-inclusive economic growth.

Figure 2. The functional composition of general government expenditure in South Africa, 1994-2018 (% of total general government expenditure)



Source: SARB (various years).

⁷ Acronym for Growth, Employment and Redistribution.

⁸ This refers to the income distribution that results from income earned in the labour market, i.e. before government intervention – basically personal income before tax and government subsidies or transfers that benefit individuals.

Turning now to the interface between structural and macroeconomic stabilisation policies, we note a number of things. Firstly, South Africa has never introduced numerical fiscal rules in the formal (legislative) sense of the word since 1976 when the revenue and loan accounts of the government budget were amalgamated (Calitz, Steenekamp & Siebrits, 2019: 437).⁹ The fiscal framework was rather one of strong self-proclaimed fiscal guidelines by the executive, including the adoption in 2011 of an annual target for the structural budget balance consistent with long-term growth, the desired level of public debt and inter-generational considerations (National Treasury, 2011: 50)¹⁰. The transparency and disclosures required by the Public Finance Management Act, No 1 of 1999 as amended (RSA, 1999), fitted the mould of transparency-enhancing discretion (see Siebrits & Calitz, 2004: 778-781) rather than rules in fiscal policy-making. The establishment of the Parliamentary Budget Office¹¹ in 2013 was a further attempt at enhancing transparency and building checks and balances into the budgetary system. Its real contribution has however not yet been assessed.

Regarding fiscal cyclicity, evidence is ambiguous. Thornton (2007) analyses data from 1972-2001 and finds fiscal policy to be countercyclical. Swanepoel (2004), by contrast, analysed (almost similar) data from FY1973 to FY2003 and found procyclicality. Du Plessis, Smit and Sturzenegger (2007) uses a structural vector-autoregression approach and finds evidence of fiscal pro-cyclicality since 1994, especially in the more recent period, though the pro-cyclicality of fiscal policy seemed to have had little destabilising impact on real output.

The extent and effectiveness of coordination between monetary and fiscal policy varied over the years, but interaction was quite close during the 1970s and 1980s. These were times when the cabinet decided on a devaluation of the currency and the SARB was very much involved in advising the Finance Minister on policy and had a senior central banker seconded to the National Treasury who even wrote the Finance Minister's budget speech. The constitutional independence of the South African Reserve Bank (SARB) in 1996 and the introduction of inflation targeting in 2000, institutionalised a less interactive monetary and fiscal policy regime, resembling elements of the neoclassical assignment approach¹² to policy coordination (Steinbach, 2014: 32-33). In practice, however, regular consultation between the National Treasury and the SARB continued, each party building reaction behaviour of the other into their formal or intuitive modelling of policy measures. Globally, the separation of monetary and fiscal policy became quite blurred in recent times, with the fiscus (taxpayer) directly or indirectly having to pick up the bill for unconventional monetary policies such as quantitative easing and bailouts of financial institutions.

SELECTED ISSUES OF NOTE PERTAINING TO THE FISCAL STATE OF AFFAIRS AND PUBLIC FINANCE IN SOUTH AFRICA

Against the background of the stylised facts, we explore a number of issues that impact the public finances in South Africa. Hopefully, these remarks are viewed as diagnostic instead of ideological, as an attempt at charting a future direction. Each subsection begins with a remark (bold and in italics) that relates it to contemporary policy debates.

1. Inadequate macro fiscal risk management

The debate is about whether macro fiscal policy is sustainable, whether government should spend more or less and the kind of adjustments that are required. This paper takes the view that fiscal policy is not

⁹ These accounts came into being when the Union of South Africa was formed in 1910.

¹⁰ For an example of the associated macro ceilings contained in the medium-term budget policy statement, see National Treasury (2017: 67-74).

¹¹ In terms of the Money Bills Amendment Procedure and Related Matters Act No.9 of 2009, Section 15(1): "There is hereby established a Parliamentary Budget Office headed by a Director, the main objective of which is to provide independent, objective and professional advice and analysis to Parliament on matters related to the budget and other money Bills."

¹² The point of departure of this approach is that there is no interdependence between the policy areas. Both neoclassical and monetary variants of macroeconomic theory advocate clear assignment of responsibilities – and that is it!

sustainable and that macro fiscal risk management can be sharpened in different ways.

Table shows that government resource mobilisation as a percentage of GDP is at its highest level in 60 years. Interventionists argue that slow economic growth is the reason and that fiscal austerity, which curtailed aggregate demand, was self-defeating. The 'free market' argument is that, due to fiscal indiscipline, we are using a growing share of our resources in a very inefficient fashion. The productivity of the economy is declining, partly because of crowding out effects, but also because government has raised the overall riskiness of the economy. Combined with mismanagement of state-owned companies (SOCs), and a host of economically destructive policies, we are getting into a debt spiral. Both schools of thought generally agree that our major problem is low economic growth, but the major differences are about how to increase growth. In this paper I take the view that fiscal policy is not sustainable and present some views about economic growth in Subsection 4 below.

At the macroeconomic level, the maintenance of fiscal sustainability depends on fiscal solvency and the likelihood that an historically successful track record of tax financing and expenditure control can credibly be forecast to hold in future. This requires a few things.

There has to be an umbilical cord between the head of government and the finance minister, one that is not severed by in-fighting in cabinet, political faction fighting or rent-seeking self-interest. There is no fiscal rule that can substitute for this. South Africa has had at least two instances where this cord had been severed. During the apartheid years President PW Botha announced salary increases for government employees prior to an election while Finance Minister Barend du Plessis was abroad, with severe adverse implications for the budget. In the Zuma-years free education was announced by President Zuma which totally upset the budget¹³ that had already been approved by Cabinet, with severe long-term affordability implications.

The fiscal structure has to embody macro risk management, which could come about in various ways, such as: conservative forecasting of economic growth and the tax yield; a contingency reserve that is accessible only under very strict conditions and should not serve as a substitute for bad budgeting; a very conservative approach to providing guarantees¹⁴ for SOEs and private entities; and an approach to tax incentives that protects the fiscus from tax base erosion.¹⁵ None of these appears to have consistently been in operation or very effective. For example, Calitz (2019: 24) estimated that though quantifiable tax base-broadening measures added R1.7 billion (in 2018 prices) more to tax revenue from 1994 to 2018 than what was lost due to base-erosion measures, the latter's revenue loss of R50.9 billion was nonetheless still huge. The sharpening of these tools of macro risk management deserves further attention.

Budgetary forecasts have to be credible. National Treasury (2019: 48) itself has admitted to overoptimistic growth forecasts and, consequently, too high revenue estimates between 2011 and 2018. This not only reflects the problem of forecasting turning points when an economy reaches a business cycle peak, but universally the problem of predicting volatile economic growth. There have been at least two budgets in recent times that came under huge pressure because of overoptimistic revenue estimates. One was in FY1993, when the South African economic slump turned out to be much deeper than expected by most economists when the budget was presented, with the eventual result of a deficit Of 7.3% (Calitz, Steenekamp & Siebrits, 2019: 433). The other was in FY2020, when the Covid-19 virus played havoc with

¹³ The resignation towards the end of 2017 of Michael Sachs, the highly regarded Head of the Budget Office of the National Treasury, was related to this.

¹⁴ In view of the cost-saving value of government guarantees, they are not free. In FY 2014, for example, Government received fees of R152 million on various guarantees provided (National Treasury, 2014: 74). Apparently, this cost was not high enough to prevent moral hazard behaviour by SOEs.

¹⁵ It is amazing what society collectively expects from the tax system. It amounts to a washing line of excessive expectations. Expectations abound, such as that the tax systems should: generate higher revenue for government; generate higher economic growth; effect the desired distribution of income and wealth; promote saving; provide environmental benefits; stimulate regional development; support the development of selected sectors; allow for special treatment of education-related matters; provide for welfare benefits; give special allowances for religious considerations; promote research and development; and give special treatment to vulnerable sectors, regions, groups and individuals.

economies all over the world and caused the South African Finance Minister to announce that a revised budget to Parliament was to be presented (still outstanding at the time of writing). There were opposite outcomes as well, however. Between FY 2002 and FY2011 National Treasury *underestimated* GDP in ten of the 11 years (Calitz, Siebrits & Stuart, 2016: 336). It may be fine to use a conservative GDP forecast as a way of containing government spending, but forecasting with a consistent underestimate bias entails the risk of losing credibility.

The right steps have to be taken to regain fiscal sustainability. Economic research on the experience of developed countries shows that sustainable fiscal consolidation occurred when government expenditure and, in particular, current expenditure such as remuneration is appropriately curtailed. This has been more successful than cutting public investment or social benefits to vulnerable groups, or raising tax rates. Nonetheless, cuts in transfers and salary bills and increases in revenue are not the only elements of successful fiscal consolidations in developing economies. Baldacci et al. (2004) and Gupta et al. (2003) found that protecting or even increasing the share of capital spending in total government outlays during consolidation efforts increases the probability of success and persistence. These findings are related to Easterly's (1999: 57) statement that "[f]iscal adjustment is an illusion when it lowers the budget deficit or public debt but leaves government net worth unchanged". According to Easterly (1999), the fiscal consolidations required by the International Monetary Fund and the World Bank as elements of their adjustment programmes have often turned out to be illusory: many governments have reduced deficits in part by reducing asset formation and by accumulating hidden liabilities of various kinds. Developing countries with substantial tax gaps (that is, the difference between revenue collected and what could be collected, given the tax base and tax rates) would, however, have some scope of raising tax revenue without rate increases. This requires reducing tax evasion and tax avoidance, the latter including base erosion through inappropriate or unnecessary tax exemptions or avoidance opportunities.

No doubt, National Treasury had all the right intentions to maintain fiscal sustainability, as reflected in the following proposals to Government (National Treasury, 2011: 50), namely:

to adopt an annual target for the structural budget balance consistent with long-term growth, the desired level of public debt and inter-generational considerations, to make explicit the costs of existing and new programmes that require a long-term commitment, and to set out a timeline to bring the budget back on target following large fiscal shocks. The aim was to ensure countercyclicality, long-term debt sustainability and intergenerational equity¹⁶.

Unfortunately, things did not work out that way: the government wage bill soared, public investment was reduced in real terms and a rising spiral of debt and debt-service-cost ensued. Even though government expenditure led and tax lagged or followed the fiscal adjustment to contain rising budget deficits, as shown by fiscal reaction function analyses (Burger and Calitz, 2019), the brunt of the adjustment was public investment. ¹⁷It was only in 2020 that government appeared to come to grips with the inevitable step to contain remuneration. Even so, the announced cut only amounted to a reduction in what the projected wage bill had been previously, but still amounted to a projected real increase in 2020 (of 2.8%) and also in subsequent years. The jury remains out on the future contribution of the salary bill to regaining fiscal sustainability.

¹⁶ These three goals are also specified in the introduction of the chapter on fiscal policy in various other Budget Reviews, for example, in 2013 and 2014. In the latter year, however, the emphasis shifted explicitly to fiscal *consolidation* (National Treasury, 2014: 31), implying the need to *regain* fiscal sustainability.

¹⁷ This did not happen because the National Treasury was unaware of the economic implications of cuts in public investment or lacked the fiscal instruments to prevent the undersupply of infrastructure – a kind of fiscal anguish somewhat reminiscent of Arthur Burns's (1979) anguish of central banking.

2. Public debt management and sustainability

The debate is about the optimal size of public debt. This paper does not put a value to this but recognises various danger signals and especially the adverse impact of SOEs on the fiscus, as highlighted in the first main part of the paper. South Africa's downgrade to junk status in international financial markets is an important part of the story.

During the past 35 years the reform of public debt management reflected a shift towards more market-related actions and, to some extent at least, a clearer dividing line between fiscal and monetary policy, on the one side, and debt management, on the other. The removal of prescribed assets in 1987 underpinned this orientation, but also served to release the Public Debt Corporation (as investors of government pension funds) from the shackles of 'regulated' low-yield assets. The development of the bond market and the establishment of private market makers for government bonds are further evidence of a more business-like approach to the management of the government's assets and liabilities. This was also accompanied by charging state-owned enterprises for government guarantees, which unfortunately does not seem to have been a restraint on moral hazard behaviour by the SOEs.

In National Treasury's (2014: 65) stock-taking of public debt management a positive state of affairs was still reported at the time, as quoted below (words that did not survive due to subsequent developments in *italics* and underlined).

In 1994, the new government began developing a debt management strategy that would enable it to borrow sustainably at reasonable cost to support its development objectives. Government has worked to deepen the domestic debt markets, broaden its investor base, diversify its financing instruments, integrate cash and debt management, and coordinate monetary and fiscal policy. Over time, South Africa has established itself as a credible global borrower, securing financing at competitive rates and establishing benchmarks for local firms to borrow abroad. Risk is prudently managed using benchmarks for domestic and foreign debt, and fixed and non-fixed rate debt. The maturity profile is smoothed through switch and buy-back programmes. Debt management has contributed to broader policy objectives, including reversing the country's foreign exchange reserves from a negative net position to current levels of about US\$50 billion. To enhance its creditworthiness, government has gradually increased oversight of borrowing by state-owned companies. Steps in this area include monitoring borrowing plans and debt-maturity profiles; compiling a treasury best-practice manual; approving borrowing limits; managing contingent liability exposure; and meeting regularly with the treasuries of these companies. Over time, government's approach resulted in improved global credit ratings. While sovereign ratings have been under pressure in recent years, South Africa's ratings remain at investment grade.

Generally, the scholarly verdict was that fiscal policy was sustainable until about 2008, after which warning signals became increasingly clear (see Siebrits, Du Plessis & Calitz, 2014), after which the wheels started to come off (Burger & Calitz, 2019). The deterioration was strongly captured in the fiscal element of the debt-to-GDP ratio (D/Y), namely public debt. Thereafter reduced economic growth (i.e. lower ΔY), given expenditure commitments, became the main culprit. In the final analysis, in 2020 a downgrade of South Africa's international sovereign rating to junk status by all the credit rating institutions had been completed. Even before the Covid-19 crisis, Burger and Calitz (2019: 13) presented a fiscal consolidation scenario whereby, on the assumption that real economic growth improves to 2.5% by 2023 and remains on average at that level subsequently, an improvement of the primary balance from -1% in 2019 to 2.5% in 2025 and beyond, will be needed to reduce the debt-to-GDP ratio to below 40%, but that will only be achieved by the mid-2030s. With Covid-19 the debt-to-GDP ratio is likely to exceed 80% probably this year or in 2021 and, given the difficulty to move towards a large enough primary surplus to stabilise the debt-to-GDP ratio, this ratio is unlikely to stabilise before it reaches 95% later in the decade. A daunting task indeed.¹⁸

It takes long to regain an investment rating. Countries like Croatia, Iceland, Ireland, Korea Republic, Latvia

¹⁸ This scenario does not even incorporate any additional public debt should SOEs default on government guaranteed debt.

and Slovenia regained investment grade in three years or less; it took Colombia, India, Indonesia, Turkey and Uruguay more than a decade (Viljoen, 2016). Amongst other things, high public debt, public governance issues, the financial collapse of state-owned enterprises, low economic growth and high unemployment need to be addressed in a credible manner in South Africa and in the context of appropriate political, social and economic policies.

3. State capture

The devastating impact of state capture is widely accepted, although the beneficiaries apparently still have substantial political clout.

Irrespective of how state capture came about, there is no doubt about the extensive damage that rent-seeking, nepotism, corruption and fraud had caused the fiscus and the economy.¹⁹ The evidence before the Zondo Commission²⁰ tells it all, but judgment and convictions are still largely lacking. This, of course, reflects badly on the present government, especially given the adverse impact on government finances.

4. Too much expected of macro fiscal policy

The fiscal picture is in many respects the reflection rather than the cause of fault lines in the economy, and an improvement in the fiscal state also requires corrections outside of the public finances.

There are limits to what macro fiscal policy can achieve, especially when the fiscal house is not in order. If the economy could not be stimulated with budget deficits of 5% before the Covid-19-crisis, how can one expect 10% or higher Keynesian deficits to be more successful? The question is no longer one of closing the output gap, which is the difference between what the economy is structurally able to produce (the potential output) and what it is actually producing. What is at issue is to realise that the gap has shrunk because the potential output is less. In this regard, the latest forecast by the reputable Bureau of Economic Research (BER) at Stellenbosch University is that the GDP will shrink by 9.5% in 2020 and that the pre-Covid-19 GDP level will only be reached in the fourth quarter of 2025. The issue now becomes one of shifting the production possibilities curve outwards. Macro fiscal policy by itself, given the BER's projected deficit-to-GDP ratio of 16% in FY2021, can achieve little by way of structurally enhancing the economic growth potential, unless domestic and foreign investors are convinced of serious steps to regain good governance, of a plausible return to fiscal sustainability and of implementing credible economic measures.

The real changes that are required lie in the micro dimensions of fiscal policy as they relate to increasing productivity in the economy, and of underpinning the appropriate industrial and labour market policies with public goods and services that the private sector will not provide (i.e. goods and services that are indivisible, nonrival in consumption and nonexcludable). But the lead needs to come from the competitive functioning of markets for goods and services and the regulatory framework within which they operate.

Two issues stand out. First is the need for efficient public investment, that is, spending on infrastructure that crowds in private investment. There is of course the view that government infrastructure spending is inefficient to the point that it destroys wealth. In addition, government cannot simply build infrastructure, it needs a clear infrastructure plan, which has been lacking. Moreover, the only institutions that still have a track record of building infrastructure do not have the balance sheets to undertake new programmes, either because they are hampered by policy indecision (e.g. SANRAL) or corruption (e.g. PRASA). But government failure does not obliterate market failure. The solution lies in building efficiency in

¹⁹ Allegedly the idea was floated that the apartheid government had the opportunity to enrich itself; now it is the post-apartheid regime's chance.

²⁰ The Judicial Commission of Inquiry into Allegations of State Capture, Corruption and Fraud in the Public Sector including Organs of State. It was appointed on 23 January 2018 by President Zuma and hearings are still taking place.

government and SOEs, given that their functions can be justified on market failure or externality grounds.

Secondly, the belief by political leaders and economists that a growth strategy could emulate developmental state thinking as in some east-Asian countries, requires reassessment. There are features of those success stories that do not characterise the South African economic landscape, such as a capable state²¹, quality education, work ethic and wage levels that facilitate international competitiveness.²² To turn around South Africa's premature deindustrialisation²³, dated by Rodrik as beginning in the early 1980s, will not be easy. Maybe Rodrik's (2004: 14) suggestion is worthy of consideration, namely to select – with appropriate criteria – economic activities at individual firm level with potential viability and mindful of positive externalities, rather than sectors or sub-sectors. Unavoidably, losers may be selected. The art is not to avoid selection for fear of choosing losers, but to be able to identify losing activities soon enough to terminate their continued subsidisation early on. In short, a sustainable, inclusive growth path is a precondition for an improvement of the primary Gini coefficient, without which the secondary (fiscally adjusted) Gini coefficient will in any case not be maintained.

There are also limits to the ability of the tax system to change the primary Gini coefficient – more generally, to change the distribution of income and wealth. Bird and Zolt (2005) argue that there is a better chance to change the income distribution through public expenditure programmes than income tax. This line of thinking has become quite pervasive, but the international financial crisis triggered a renewed focus on personal taxes, such as the universal wealth tax promoted by Piketty (2013). In South Africa the Davis Tax Committee (2018) considered the viability of a wealth tax and reported that it was timely for South Africa to consider a range of ways in which wealth inequality can be reduced, but ultimately found that the introduction of a wealth tax was not feasible in the short term (Businesstech, 2018). The rather extensive taxing of different elements of wealth in South Africa was also noted. As discussed in the first main section above, there does not seem much scope for further tax progressivity and higher tax burdens when South Africa is appropriately compared to competitor countries. The solution lies with higher tax revenue from economic growth, and more efficient and aptly prioritised government expenditure. This, in fact, resonates with the earlier mentioned GEAR strategy of the mid-1990s (RSA, 1996).

5. Fiscal frameworks

This is related to macro fiscal risk management. The question is whether and which fiscal frameworks can guarantee the desired fiscal outcomes.

The budget process has improved much over the years. The improvement effected by the Public Finance Management Act is a case in point. The International Budget Partnership (IBP) (2019) ranked South Africa's budget process as the most transparent among 100 countries in 2010, the second most transparent in 2012 and jointly first (with New Zealand) among 117 countries in 2019. Even though more recent IBP rankings did not reflect that, South Africa has lost much of its fiscal standing. Much of these gains were unfortunately lost recently. To name a few: the destructive management of SARS, widespread corruption in government and the state-owned companies during the Zuma presidency, together with the inability of Parliament and parliamentary committees such as the finance committee to respond; and the

²¹ A committed, credible and capable government was a common feature of the group of 13 countries with an average growth of more than 7% over a period of 25 years, at some stage between 1960 and 2005, as identified by the Spence Commission on Growth and Development (2008: 21).

²² See, in this regard, Burger's (2014) insightful assessment of the question about the usefulness of the developmental state concept for South Africa. But the true policy conviction about industrial policy in South Africa in terms of developmental state thinking remains obscure. As a former high-ranked Treasury official is reported to have said: "The Department of Trade and Industry pretends to have an industrial policy and the Treasury pretends to finance it."

²³ This refers to the decline in manufacturing's share in GDP and employment in developing countries at a much lower level of per capita income than when the same deindustrialisation occurred at earlier times in developed economies. This meant that developing countries turned into service economies without having gone through a proper experience of industrialisation. See Rodrik (2016).

attempts by the then President to undermine the National Treasury with incapable political appointees. The State President Zuma's idea of the umbilical cord referred to earlier, was not to have a strong Finance Minister in office, but to deploy a yes-man.

An obvious question is what can be done to forestall fiscal delinquency. Three fiscal frameworks present themselves: fiscal discretion, fiscal rules and fiscal councils. Our contention remains that the nature of fiscal policy is such that fiscal rules are not a guarantee of fiscal prudence or good fiscal outcomes. Rules are easy to circumvent and are easily discarded when adverse fiscal and other economic shocks hit the economy. When there is compliance with the conditions for effective fiscal rules, fiscal discretion can safely do the job – and with more flexibility. For example, when an economy faces a severe negative external demand shock that necessitates recourse to an escape clause under fiscal rules, the required analysis is similar to and takes as long as what would be required to justify the presentation of a revised budget to parliament or to act timeously under some or other provision for abrupt action. In fact, if leeway is restricted by rules (even with escape clauses), fiscal policy is handcuffed in ways that result in procyclical actions; discretion is not, and an appropriate countercyclical policy may result.

The more useful route is to put in place other checks and balances to safeguard the country from fiscal abuse. (1) Parliament as custodian of the public purse cannot really be empowered with a line veto of budget items in a system where party discipline reigns supreme. At best, this will only have a chance of functionality in a democracy where a decisive proportion of parliamentarians are elected by decentralised constituencies that hold them accountable and where it will then make sense to have the budget be decided by conscience vote. (2) Rules could be a necessary condition for fiscal prudence when it serves as a commitment device, especially when government is weak, but it will not be sufficient. The rule is unlikely to guarantee dynamic or time consistency.²⁴ Ironically, the very time that the institutionalisation of fiscal rules may be most desirable, would either be when the country is in a fiscal mess (in which case the office-bearers are unlikely to introduce a measure that restricts them) or when the fiscal position is sound (in which case politicians may argue that it is not necessary to mend something that is not broken). (3) Fiscal councils have received attention as another useful measure and has been instituted in a number of countries. In South Africa the nearest we have come to something approaching a type of fiscal council, are the Financial and Fiscal Commission and the Parliamentary Budget Office. None of them has acquired the independent status and reputation that convinces this author that any Fiscal Council will be allowed to operate with sufficient independence to be an effective countervailing power for poor fiscal policies.

6. Performance auditing and expenditure inefficacy

Macro fiscal prudence cannot succeed if micro populism is not managed and public service delivery is ineffective and inefficient.

Government has over the years made substantial progress in moving from a cash to an accrual base of accounting and auditing. The introduction of performance auditing, pioneered by New Zealand and other countries in the 1970s and 1980s (Nath, Karen and Van Peurse, 2005: 17-18) intended to enhance effectiveness and efficiency in the management of government programmes. Performance auditing unfortunately did not achieve the desired results in South Africa. The goals that were accepted and monitored by National Treasury or provincial treasuries, ended up as compliance exercises rather than informing strategic and operational goals and decentralised management decisions, and did not allow sufficient scope for in-year changes as and when circumstances demanded that.

But the biggest threat to fiscal prudence was microeconomic populism, which came in various forms, such

²⁴ Dynamic or time inconsistency is a situation in which the optimal plan of a decision-maker made at one point in time is no longer optimal at a later point in time. Ironically, a kind of dynamic inconsistency might be useful when the constraints of rules results in procyclical fiscal policy when countercyclical policies are actually required.

as official announcements of nuclear energy generation, free tertiary education, a national pension scheme and national health insurance. None of these and the expectations that they created were, before being announced, collectively and transparently assessed in the context of an affordable multiyear fiscal plan and tempered accordingly. Microeconomic populism succeeded in blowing the lid off the macro fiscal pressure cooker. Because of the deteriorating economic growth performance, the predictable rising budget deficit and debt – both as ratios of GDP – were unavoidable when the umbilical cord between President Zuma and the Finance Minister was stretched to the point of snapping. In circumstances like this the Finance Minister becomes a very lonely figure and no fiscal rules, fiscal councils or fiscal transparency will be able to put Humpty Dumpty together again.

7. Centralisation, good governance, effectiveness and efficiency

Excessive centralisation of service delivery and tax revenue pose a threat to effective service delivery and accountability, but failure at all levels of government is possible when government agencies are incapable.

Calitz and Essop (2013: 133) identified various fiscal centralisation trends in South Africa, going back many years. They concluded (Calitz and Essop, 2013: 148-149):

(T)he indicators show that sub-national government faced increased fiscal centralisation for the period 1973 to 2011. There can be little doubt that provincial governments have been greatly centralised, rendering them de facto administrative offices of national government. Increased fiscal centralisation also holds for local government, but less than for provincial government. With regard to both provincial and local government, however, the unfunded mandate, defined as the difference between the cost of delivering on their constitutional mandate and the constitutional revenue sources, is growing.

In terms of the assignment literature (see Musgrave's (1983) guidelines) the functions of allocation and distribution were quite appropriately assigned to national and subnational governments, respectively, in the South African constitution. Instead of the constitution's clear decentralisation leaning, the de facto outcome was actually one of centralisation, both with regard to revenue sources and expenditure functions. The non-assignment to provincial governments of income-tax sharing and fuel levies and the centralisation of the government's tender process are cases in point. Admittedly, subnational efficiency and effectiveness especially at local government level have largely been lacking and even deteriorating. Reports by the Auditor-General testify to this. The Auditor-General (2018: 8), for example, with reference to municipalities for the 2017-18 financial year, stated that "...the accountability for financial and performance management (of municipalities) continued to deteriorate." Further, "material non-compliance with key legislation at 92% of the municipalities" was reported. Municipalities with material compliance findings on supply chain management increased from 72% to 81%. These are the highest percentages of non-compliance since 2011-12. Irregular expenditure remains high but decreased from R29,7 billion (in the previous year) to R25,2 billion..." Only 8% (or 12) municipalities obtained clean audits (eight of the 12 being in the Western Cape province). Occurrences of fiscal disobedience and tax revolt at local level therefore were not surprising.

Not that the prospect of centralisation sounds very promising, either. The Auditor-General's (2019: 10) report reflects as follows on the previous five years with respect to national government departments and state-owned companies:

We experienced that accounting officers and authorities have been slow in implementing our recommendations and in certain instances even blatantly disregarded these. Our recommendations did not require more than what they were legally obligated to do by the Public Finance Management Act and other enabling legislation, in areas such as planning and budgeting, establishing internal controls, effectively dealing with transgressions, keeping proper records, credibly reporting on their finances and performance, and using the resources with which they are entrusted in an effective, efficient and transparent manner. We also did not always experience the correct tone and level of oversight from

executive authorities and oversight structures that would enable accountability, transparency and good governance.”

Arguably, the solution to subnational shortcomings is not necessarily the extreme alternative of centralisation, but rather a flexible balance: on the one hand, improving subnational capabilities, a constitutional responsibility of provinces; on the other hand, allowing for differentiation: pragmatic decentralisation where it works, and centralisation where it does not – but always with guidelines whereby decentralisation can be “earned” when clear and transparent criteria are met.

8. The attractiveness and pitfalls of exceptions: how to deal with the trade-offs?

There are dangers to bending rules as well as not to bend them. If government deviates from good practice guidelines, the ability to get back on track is an important consideration. Admittedly, unanimity about what good practice is, is rare.

No one will object that special circumstances warrant special measures. If a government does not deviate from standard approaches or relax rules to show compassion for the sufferings of individuals and groups when exposed to unforeseen or unpredictable circumstances (adverse exogenous shocks), criticisms of inflexibility and rule-boundedness are bound to surface rapidly. The downside risk of exceptional measures is the difficulty to reverse them once the reason for their introduction disappears – a phenomenon that the Peacock-Wiseman displacement theory of the growing size of government (Calitz, Steenekamp & Siebrits, 1999: 131-132) captures. Currently, in alleviating the adverse impact of Covid-19, cases in point are the option to take recourse to inflationary (money-creating) financing of the national budget and to increase welfare payments; all of these ostensibly temporary. How realistic is this prospect? A brief comment on each is in order.

One of the reasons why Keynesian active fiscal policies lost their traction during the 1970s was precisely because budget deficits during an economic slump were not cancelled out by budget surpluses when the economy became overheated. The international financial crisis of 2007-2008 revived Keynesian active fiscal policy to an extent, but also in the new guise of quantitative easing (QE), which incidentally blurred the dividing line between fiscal and monetary policy. In 2020 the SARB also resorted to reversible quantitative easing (QE), rather than supplying “helicopter money” as was proposed in certain quarters, on account of the Covid-19 epidemic with a view to stimulating economic recovery, in addition to large interest rate cuts. The risk of these and other stimulatory²⁵ macroeconomic policies for inflation targets did not immediately signal concerns. The implications of the fiscal stimuli of R500 billion (equal to 10% of the GDP)²⁶ are of definite concern, both for fiscal sustainability and because of the valid doubt whether the huge budget deficit will contribute to increasing real economic growth. South Africa just does not have the fiscal scope to enable a credible stimulation of economic activity on a wide scale. It is not disputed, however, that the monetary and fiscal measures in combination should assist in avoiding further economic deterioration.

The second issue is welfare payments. In addition to the poverty gap and dependency risks that accompany welfare payments, a temporary additional payment is going to be very hard to terminate in a social context when the beneficiaries and their lobbyists argue that the standard welfare payments were too low in any case. On the other hand, it has to be acknowledged that the delivery channel of these payments is well developed in South Africa and thus probably preferable to other alternatives. The need for reversability suggests a case for a legislative sunset clause, rather than merely an executive decision. When comparing consumer benefits in the form of goods with 0% VAT to that of welfare payments,

²⁵ In a sense, calling it an economic stimulus package is a bit of a misnomer – it is not meant to stimulate the economy, but rather to limit the size of the contraction.

²⁶ This was announced by President Ramaphosa on 21 April 2020. See Mail and Guardian (2020).

Jansen and Calitz (2016: 66), calculated that the benefit-cost ratio of welfare payments was far superior to that of further zero-rating. Welfare payments target intended beneficiaries better even though the economic incidence remains uncertain.

9. Privatisation and nationalisation

The debate about the respective comparative advantage of government and business to allocate and distribute economic resources is as old as economics and flares up often in South Africa. It relates critically to the growth of and inequalities in the economy. Pragmatism has a better chance of breaking deadlocks than ideology.

Debates on the institutional location of business activity in South Africa often grinds to a halt on the ideological stone of capitalism versus socialism in their extreme varieties. During the political transition of the early to mid-1990s the “restructuring of state assets” was used to avoid the blasphemous word “privatisation” and, may we add: “profit”. This sounded much like the custom during the middle ages in Europe to avoid using the real name of something bad, in fear of drawing bad luck on yourself. But the ideological commitment to be in control of the ‘commanding heights of the economy’ is still very much alive in South Africa almost 30 years later: apart from ideology, the choice of an alternative economic system is obviously highly influenced by one’s experience with the present one. The ‘veil of ignorance’ of Rawls²⁷ immediately springs to mind.

The empirical evidence on the perceived benefits of privatisation is not unambiguously conclusive, but clear benefits on a case-by-case basis have been recorded. At the same, time it is unambiguously hugely costly to keep various SOEs nationalised (i.e. in government ownership) in South Africa, as they are virtually bankrupt. The art is to deal with individual cases on the basis of thorough analysis of both the activity, the economic sector and the regulatory environment. In essence, benefits derive from competition, which is the spur for innovation, effective resource use and quality services. The natural monopoly elements of so-called decreasing cost industries are the only activities that need to be undertaken by the state. Then important efficiency conditions still need to apply in order to safeguard the consumer of the service (and the taxpayer) against rent-seeking, corruption and fraud and – one needs to add – exploitation in the form of monopoly prices and the development of an adequate regulatory ability.

10. Intergenerational equity and generational accounting

In a world of mass utilisation of natural resources, fiscal policies need to take into account the impact on future generations

Equity does not only pertain to the difference in income and wealth between different groups in society at any point in time. It also pertains to life-span differences, differences between successive generations and differences between overlapping generations. Fiscal policy in South Africa has been very much focused on the first-mentioned type, that is, mostly comparing distributional changes within a generation over time – whether by way of time series analysis or panel studies, but not so much between generations. Auerbach, Kotlikoff and Leibfritz (1999: 1) describe generational accounting as a method of long-term fiscal analysis and planning of which the goals are “are to assess the sustainability of fiscal policy and to measure the fiscal burdens facing current and future generations.” This method relates both to fiscal sustainability issues and balance-sheet accounting. It began in 1991 and at the time of their

²⁷ In a kind of mind experiment of how to achieve social justice, Rawls (1971) – to put it briefly - asks his readers to imagine a situation in which the contracting parties, representing the entire community, are asked to indicate their preferences for a dispensation as if behind a veil of ignorance about their position in the new dispensation.

writing, 22 countries were applying generational accounting.²⁸

The question about the need for generational accounting reminds of the remark by the American President, Edgar Hoover: “Blessed are the young for they shall inherit the national debt.” National Treasury in South Africa has not been oblivious of the long-term budgetary demands and available resources, as reflected in their medium-term expenditure planning and other attempts at coming to grips with the impact over longer time horizons of demographic changes and urbanisation on the demand for public services. Formal generational accounting, which is not without shortcomings, nonetheless seems imperative and should be transparent in order to capture comprehensively and in a systematic manner the fiscal impact of issues of rising concern, such as the cost of social and private pensions²⁹, free education, public health, depletion of non-renewable natural resources and various contingent liabilities.

CONCLUSION

South Africa faces a fiscal mountain that almost looks insurmountable. The problems will not be solved quickly. But it must and can be solved. Many of the problems experienced in the public finances originated outside of the fiscus and have to be addressed at source, that is, where they arose. Neither fiscal discretion, nor fiscal rules or any fiscal framework, will be effective unless there is collective commitment by the incumbent government. But it can be done. All the political, social and economic policy instruments are involved and have to be harnessed. This paper highlighted a few issues and indicate the direction in which some solutions may be found. Of course, solutions will become clearer once the task gets seriously done and there is collaboration in the national interest of as many committed groups in society as can be mobilised. And the entire bureaucracy needs to function with the same commitment as well, an ethos of national service that is or should be unrelated to party-political views and sentiments. Ideologies (to the left or the right) should not be allowed to grind progress to a standstill.

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²⁸ Argentina, Austria, Australia, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Thailand, the United Kingdom, and the United States. Chile, Israel, and Mexico were to start soon.

²⁹ Particularly since life expectancy is increasing. Also, due to HIV and AIDS up to a few years ago life expectancy was below 60. Now at 63, more people will need to plan for retirement and do the necessary saving to ensure provision is made for retirement. In the absence of that, government will have to pay more old-age pensions. This point is attributed to Philippe Burger.

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