CHAPTER 1

Budget Consolidation in South Africa: Balancing Growth and Socioeconomic Rights

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1.1 Introduction

Currently, South Africa's fiscal space[5] is narrowing. Since the 2008/09 crisis, fiscal policy (together with a helpful monetary policy that has kept interest rates low over the same period) provided stimulus aimed at improving weak demand and the negative output gap.[6] However, economic recovery in South Africa has been slow and exacerbated by the economy's inability to create jobs as well as by other factors, such as recent industrial unrest and credit downgrades. In addition, renewed deceleration in global economic growth presents substantial uncertainties and downside risks to the South African economy. All these factors, combined with the narrowing fiscal space, further indicate the need to rebuild the fiscal buffers that helped to moderate the effects of the 2008/09 recession by giving Government the necessary fiscal space to act in a countercyclical manner.[7] With the above in mind, a thoughtful debate is warranted on the optimal approach to fiscal consolidation in South Africa[8], especially as the growing state debt in the medium term poses a risk to the sustainability of public finances, which are already burdened by rising social expenditure needs.

Government is already investigating alternative initiatives aimed at bolstering the credibility of long-term fiscal sustainability. These initiatives include fiscal guidelines and long-term fiscal reporting, measures that the Commission supports, as indicated in the Annual Submission for the 2012/13 Division of Revenue.

Sound public finances are a prerequisite for sustainable economic growth and for maintaining welfare. Therefore, growth-friendly fiscal consolidation (i.e. a fiscal consolidation path that takes in account economic growth and development trends) can create a solid foundation for future growth and even help achieve a more even income distribution in South Africa[9]. The Commission's theme for 2014/15 is *Fiscal Levers for National Development*. Growth-friendly fiscal consolidation is one of the levers that could be used to unlock long-run economic development in South Africa, while mitigating the impact on short-run growth as much as possible. The structural reforms proposed in the National Development Plan (NDP) and the New Growth Path (NGP) are aimed at creating faster economic growth and a more inclusive economy, and imply a strong role for government – proposing a tighter fiscal policy combined with a looser monetary policy and labour market reforms. Fiscal policy[10] is crucial to these strategies because it has the potential to influence economic growth through its effect on private sector behaviour and on (human and physical) capital formation.

Fiscal consolidation is a tool that can be used to close budget deficits and to achieve better macro-economic outcomes (i.e. higher productivity, economic growth, economic development, etc.) through its focus on public expenditure and revenue reform. For example, through using public revenue more

[5] Fiscal space can be defined as the financial resources available to a government for policy initiatives through the budget and related decisions (Schick, 2009:2).

[6] Output gap is the difference between the actual output and the potential output. When the output gap is negative, actual output is below the potential output, and hence the economy is not using its resources fully (i.e. the economy is not at its full productive potential).

[7] Countercyclical fiscal policy refers to policy that is moving in the opposite direction to the economic cycle – i.e. fiscal policy that increases (decreases) debt and deficits when the economy is weak (strong).

[8] Although the South African Government has reiterated its commitment to fiscal consolidation, the Commission noted in its response to the 2012 Medium Term Budget Policy Statement (MTBPS) that the pace of fiscal consolidation has slowed down significantly since 2009. This may potentially undermine Government's plans, particularly in the eyes of the international community.

[9] For example, recent section 100 interventions could have targeted expenditure items that are less politically contentious, such as maintenance, training and expenditures designated for research and development activities. However, such actions would have achieved fiscal discipline at the expense of future growth (i.e. would have undermined economic growth). This example serves to illustrate that achieving a growth-friendly fiscal consolidation is a delicate exercise that requires balancing social objectives and economic objectives, which may at times be mutually contradictory. Thus, such a fiscal consolidation would need to be built around some social compact. Sustaining growth and preserving a fiscal compact in an era of fiscal consolidation will require a strong political consensus, so that sacrifices can be made in the short run in order to achieve economic growth and development in the medium to long run.

[10] Fiscal policy is concerned with (i) allocation of resources, (ii) efficiency in the use of resources (to achieve economic stability and growth, for example), and (iii) redistribution of income. This paper aims to provide recommendations on (i) and (ii).

efficiently, investing revenue to achieve Government's broader development objectives, and targeting public resources to the most vulnerable, etc. Public expenditure reform is particularly important in the current South African context, as the government is making efforts to change the composition of expenditure through tapping into savings in the fiscal framework, in order to encourage productive expenditure (e.g. infrastructure investment) while maintaining social support to vulnerable groups.

This chapter focuses on whether the government should consolidate the budget through spending cuts (and if so, what spending cuts?), tax increases (and if so, what tax increases?) or by decreasing debt. The approach taken is to disaggregate the components of the budget and state debt and examine their effects on the budget consolidation process and also on economic growth. The two primary objectives are to examine (i) what economic factors are important (i.e. contribute positively or negatively) to fiscal consolidation, and (ii) what combinations of these factors are most likely to achieve a growth-friendly fiscal consolidation in South Africa?[11]

1.2 Findings and Analysis: Levers for Successful Fiscal Consolidation

This chapter defines a successful fiscal consolidation as the simultaneous reduction in the budget deficit, reduction in the overall level of debt and increase in GDP growth. The effects of different tax and expenditure levers on fiscal consolidation are examined. Table 1 summarises the main results.

Table 1: Impact of Different Levers on Successful Fiscal Consolidation

Variable	PIP	Posterior mean	Posterior SD
Intercept	100	0.826	7.362
Inflation	100	-1.044	0.372
Output gap	22.3	0.106	0.245
PIT	5.3	-0.018	0.12
CIT	3.9	0.000	0.044
VAT	50.2	0.621	0.79
Government consumption (gc)	54	-0.289	0.339
Government investment (ig)	8.6	-0.048	0.08
Government other consumption (gcoth)	39.7	0.005	0.021
Government subsidies (gsub)	4	0.000	0.003

Notes: Commission's estimations. PIP refers to the inclusion probabilities. The posterior mean represents the average coefficient value for the relevant variable with the standard deviations (i.e. Posterior SD) presented in the last column.

As Table 1 shows, government consumption, VAT rates, inflation and the output gap are the most consistent variables that explain fiscal consolidation in South Africa. The two most significant fiscal variables that have an impact on fiscal consolidation are government consumption and VAT rates. An increase in government consumption (which mainly consists of the government wage bill) decreases the probability of fiscal consolidation. This finding is consistent with conventional wisdom: that a decrease in the public sector wage bill would result in a more successful fiscal consolidation. Increasing the VAT rate also increases the probability of a successful consolidation. VAT is a flat rate on consumption goods and so, unless goods are sold on a cash basis, consumers are unlikely to be able to avoid paying taxes on consumption. An increase in personal and corporate income tax (PIT and CIT) decreases the probability of a successful fiscal consolidation. This implies that increasing PIT and CIT rates does not necessarily lead to higher tax collection, and that tax payers could possibly be diversifying their income into other types of taxes with preferential rates. Inflation has a negative relationship with the fiscal consolidation variable. One argument is that inflation should increase the probability of a successful fiscal consolidation, as it erodes real debt and deficit. However, strict inflation targeters increase interest rates with increases in inflation. In turn, an increase in interest rates increases debt

[11] The Technical Report (Chapter 1) contains more detailed discussion of the relevant literature, research methodology and results discussed in this section.

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service costs and, hence, results in a higher debt and deficit. Furthermore, higher inflation decreases economic growth. Thus it would appear that the inflation effect in this model justifies the stance for an accommodative monetary policy (i.e. monetary policy that tolerates a certain level of inflation).

The results suggest that reducing government expenditure (consisting mainly of the government wage bill) and increasing VAT are the best way of consolidating the budget without damaging economic growth in South Africa. The first result is a welcome finding, particularly as Government has committed itself to managing the increases in the public sector wage bill as part of its expenditure reprioritisation programme. If implemented successfully, over the medium term this may effectively relieve some of the pressure on the fiscal envelope. The second result is potentially unpopular because VAT can be considered a regressive tax, being a burden that is borne by both the rich and the poor. However, it should also be noted that VAT collection as a percentage of GDP has remained constant since 1994, while the shares of PIT and CIT to GDP have increased. In addition, VAT should still be considered as a fiscal consolidation instrument in South Africa because it is only one component of a broader fiscal framework used to achieve redistribution objectives.[12] The discussion on this issue should focus on the design of the proposed VAT changes. Some options to consider include broadening the VAT base (i.e. re-examining the categories of consumption that are exempt from VAT – for example, banking services that are physically performed outside of South Africa, certain services that are supplied to non-residents, etc.) and exempting from VAT certain consumption goods that bring significant relief to the poor.

1.3 Conclusion

This chapter addresses the question of which fiscal levers would be best used to successfully consolidate the budget in South Africa. Disaggregated components of the budget and state debt are modelled in order to examine their effects on the budget consolidation process and on economic growth in South Africa. This chapter broadens the conventional definition of fiscal consolidation (i.e. debt reduction) to incorporate the effect of fiscal consolidation on GDP. This is done in a framework that analyses consolidation in an uncertain economic climate.

1.4 Recommendations

With respect to **fiscal consolidation**, the Commission recommends that:

- Government continues its efforts to moderate the growth in expenditure components such as the public sector wage bill (which constitutes some 60% of government expenditure), as decreases in government expenditure increase the probability of a successful fiscal consolidation in South Africa. More effort must be made to improve the effectiveness of public finances, through greater and more rigorous oversight to ensure the elimination of fruitless, wasteful, and unauthorised expenditure, and corrupt practices in managing public finances.

- Government explicitly considers economic growth as an important factor for fiscal consolidation in South Africa. The most obvious manner in which South Africa could improve its fiscal situation is if the economy grew faster. This would help generate higher growth in tax revenue and thus budget deficits could decline a lot faster, and public debt would begin to reduce accordingly.

[12] This is essentially an issue that has to do with creating an optimal tax framework, which falls beyond the scope of this paper. In theory, negative distributional effects that arise as a result of an increase in VAT could be offset by changes in other taxes and/or policies. Hence, the tax system should be viewed holistically, as opposed to merely considering the effects of changes in individual taxes.