Fix the fiscal crisis

ACTION THREE

PRIORITIES

FOR SA'S NEW GOVERNMENT

CDE

AGENDA 2024

About CDE

The Centre for Development and Enterprise, an independent policy research and advocacy organisation, is South Africa's leading development think tank. Since its establishment in 1995, CDE has been consulting widely, gathering evidence and generating innovative policy recommendations on issues critical to economic growth and democratic consolidation. By examining South African and international experience, CDE formulates practical policy proposals outlining ways in which South Africa can tackle major social and economic challenges. CDE has a special focus on the role of business and markets in development.

CDE disseminates its research and proposals to a national audience of policy makers, opinion formers and the wider public through printed and digital publications, which receive wide media coverage. Our track record of successful engagement enables CDE to bring together experts (local and international), senior government officials (national and local), business leaders, politicians and civil society organisations to debate critical challenges facing the country and the policy implications of research findings.

The AGENDA 2024 series

Series editor: Ann Bernstein

Reports in the AGENDA 2024 Series are based on CDE's many policy initiatives, commissioned research and think pieces, as well as consultations and workshops with experts and stakeholders.

This special project has been guided by the CDE Board, a select group of senior business leaders, a strategy group of analysts supplemented by other senior advisors.

This document and the other reports that will follow in the AGENDA 2024 series are available from CDE and can be downloaded from www.cde.org.za.

ACTION THREE: Fix the fiscal crisis has been written by the CDE team under the leadership of executive director, Ann Bernstein, and research director, Stefan Schirmer. CDE acknowledges with gratitude the assistance and support of experts in government, academia and business.

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AGENDA 2024: Priorities for South Africa's new government

AGENDA 2024 is based on CDE's extensive policy work and recent collaboration with experts, business leaders, former public servants, and others across our society. The project sets out to answer what is by far the most important question facing South Africa: **what can a new government do to get the country back on track after 15 years of stagnation and decline?**

We cannot afford to keep making the same mistakes while hoping for a different outcome. We need a new vision of how to govern South Africa and a carefully crafted strategy to make it happen. Confronted with a generational challenge to get tens of millions of people out of poverty, the new government must take bold action.

AGENDA 2024 makes the case for a policy agenda that is substantially different from what we have seen over the past 15 years. It consists of a series of carefully selected and crafted actions to signal a new approach to reform. We have to prioritise fixing the basics and sending strong signals that a new determination and focus will characterise the seventh democratic government. The right priorities are essential and the first step of reform is to appoint excellent people into senior government positions.

Our priority areas for action are:

- Fix the state
- Drive growth and development by freeing up markets and competition
- Build a new approach to mass inclusion
- Tackle the fiscal crisis
- Strengthen the rule of law

This report is the third in CDE's AGENDA 2024 series. See also:

- **ACTION ONE: Reorganise the Presidency and the Cabinet**
- **ACTION TWO: Appoint the right people in mission critical public sector jobs**

ACTION THREE: Fix the fiscal crisis

Introduction

This document is the third in CDE's new series of reports, **AGENDA 2024: Priorities for South Africa's new government**. For the country to realise its potential, we need to focus on critical actions that can catalyse wider change. That means we have to face an existential challenge, one that South Africa must overcome, no matter how difficult the task. Years of large structural gaps between government's revenues and its spending have wiped out the fiscal progress achieved in the first 15 years of democracy, and the country is now in a much worse position than at the start of the democratic era. South Africa's debt-to-GDP ratio declined from 50 per cent in 1994 to 24 per cent in 2008 but has now risen to 74 per cent. Resolving this requires a combination of higher revenues, spending cuts and economic growth. This is exceedingly difficult, not least because raising taxes or cutting spending tends to slow growth, at least in the short term.

To move forward, it is important to recognise the complicated and difficult choices the country faces while embracing the commitments necessary to get us out of this untenable situation. These commitments, furthermore, must go beyond official pronouncements and promises. Actions have to match the President's and his ministers' words.

That said, the recommendations made here cannot sensibly be defined as short-term goals: achieving fiscal sustainability is a long-term (indeed, perpetual goal), one that requires continuous and permanent commitments that cannot be achieved by pursuing any particular objective in the immediate term. Thus, while we have to start now, the recommendations here need to be thought of as commitments for the seventh administration's whole term.

"The costs of South Africa's unsustainable fiscal position are high and rising"

Finding a sustainable fiscal trajectory is critical

The costs of South Africa's unsustainable fiscal position are high and rising, and the failure to address it causes enormous harm to our long-term prospects.

In saying this, CDE is aware that there are no hard-and-fast rules that growth slows the moment a country hits a particular debt-to-GDP level. It is increasingly clear, however, that the speed at which public debt levels have risen in South Africa has had very significant effects on growth.

The three most important channels for this are:

- *Rapidly rising debt service costs*, which have grown far more quickly than nominal GDP, now absorb a fast-increasing share of tax revenues that are diverted from more productive uses

- *The very high level of real interest rates*, which increases the cost of borrowing and reduces investment levels for the country as a whole
- A range of distortions created by *misallocating resources and savings*, resulting in suboptimal use of capital in the economy. Scarce savings are directed from more-productive uses to less-productive by lowering private sector investment and directing resources to low-productivity spending (such as bailouts) in government

These effects mean that increased government spending now would further reduce the already poor growth prospects of the country, rather than improve them. It is also why high levels of deficit spending have failed to stimulate economic growth in the past 10 years. High levels of deficit spending that produce no additional growth also constrain the central bank's capacity to use monetary policy to support aggregate demand. It is for all these reasons that empirical evidence increasingly suggests that higher levels of government consumption as a percentage of GDP have resulted in lower economic growth.

"Higher levels of government consumption as a percentage of GDP have resulted in lower economic growth"

After 15 years of slow and falling economic growth, driven in part by government's failure to make the hard choices required to shift public finances towards a more sustainable footing, South Africa has no risk-free, unambiguously positive options. Making progress in this complicated context demands clarity of thought and action, both of which require a clear understanding of some core truths about the nature of our fiscal position.

The four main elements of the challenge are:

1. The fiscal crisis is chronic rather than acute

It is the consequence of structural weaknesses in the fiscal policy that have become deeply embedded over time and cannot be uprooted overnight. South Africa's position is much closer to that of an insolvent business than one that is merely experiencing cashflow problems. The difficulty government has in financing itself has already led it to experiment with more exotic "solutions", such as prescribing that pension funds must invest in public infrastructure or deploying the Unemployment Insurance Fund's assets to job-creation projects. This is a form of financial repression (which is the generic name for policies that seek to direct funds to government or preferred sectors of the economy at the expense of other sectors), distorting capital markets and reducing their efficiency. It has also led to the drawdown of the Gold and Foreign Exchange Contingency Reserve Account and increased borrowing from international financial institutions, steps that are symptomatic of fiscal weakness, not strength.

2. The fiscal crisis impacts on growth and expected growth through a number of channels

- Higher interest rates on government debt result in higher interest rates for the economy. This is because of the increase in demand for savings and because of the risk that the government might one day have to inflate its way out of the crisis
- High levels of government borrowing squeeze out lending to the private sector, transferring scarce savings from more productive to less productive activities
- In the absence of faster growth, high levels of debt and wide government deficits will require higher levels of taxation in the future, reducing present levels of investment because of the reduced expected after-tax returns

- Financial repression distorts and ultimately undermines the efficiency of capital markets raising the cost of capital further
- High levels of debt distort banks' balance sheets as they accumulate high-paying sovereign debt, which exposes them to increased default
- Failures to maintain a sustainable fiscal position is a symptom and evidence of poor governance, which undermines business confidence and investment

"Government should resist more forcefully the inexorable rise in public sector remuneration"

3. There is limited potential for raising more taxes, and doing so would weaken growth

This is a general finding in macroeconomic research and it reflects recent domestic experience, where increases in tax rates have tended to produce less revenue than expected. This is partly because the fiscus is already taking in as large a share of GDP as has ever been the case, resulting in few remaining low-hanging fruit for the revenue authorities to pluck. Some improvement in enforcement could generate additional revenues, but there is every reason to think that higher taxes will induce behavioural responses that will make tax collection less efficient and equitable. Indeed, this has already occurred: recent research shows that introducing a new maximum personal income tax band resulted in high-income earners finding ways to reduce their overall tax burden, including by choosing to work less hard. The result of imposing higher taxes will likely be a decline in the progressive nature of the tax system as high-income taxpayers are better able to structure their incomes in the most tax-efficient ways. The result is the opposite of what advocates of higher taxes imagine will happen.

4. There is limited potential for cutting spending in the aggregate

While much of the government's spending is unproductive and inefficient, and too much is misdirected or stolen, there are no easy ways to cut spending significantly. The vast bulk of non-interest spending is on healthcare, education, social security, and criminal justice. To the extent that this spend is wasteful and inefficient, the appropriate policy response is to seek to improve the quality of spending, not to cut it.

And, even where there are programmes and activities which might plausibly be cut, there are plenty of areas where increased spending (assuming it is efficiently done) would be welcome, particularly if the funds can be directed at growth-enhancing investment. Public infrastructure, for example, is deteriorating, and targeted investment in roads, sanitation, water and electrification would pay for itself if those projects were well-managed.

Significant cuts to aggregate spending are implausible at this point, though spending growth must be kept below the rate of nominal GDP growth. What is true, however, is that government should resist more forcefully the inexorable rise in public sector remuneration and seek to tie increases to increased productivity. Progress on this was made in 2020 and 2021, but agreements reached with unions more recently have allowed a degree of backsliding. Once addressed, more spending can be directed at infrastructure and capital spending.

CDE Recommendations: Two priorities

While there are no magic bullets for resolving the fiscal crisis, the government of national unity (GNU) can make meaningful progress along two dimensions that would help enormously: pursue faster economic growth and improve the quality of spending. Importantly, these two priorities interact with and reinforce each other.

Priority one: Improving the quality of spending

Although there are no plausible ideas for cutting spending in the aggregate, there is abundant evidence that government spending is deeply inefficient. Such evidence includes the poor performance of critical institutions from our schools and hospitals to our police and courts, from Home Affairs' offices to the maintenance of railway and power stations. Much of the problem here is managerial in nature, and the misuse of scarce resources is rooted in the breakdown of accountability systems. This can be fixed but requires committed leadership (see our previous reports: **ACTION ONE: Reorganise the Presidency and the Cabinet**, and **ACTION TWO: Appoint the right people in mission critical public sector jobs**). See also the forthcoming report on fixing state-owned companies (SOCs).

Improving the quality of spending also means fixing the procurement system. It is clear that where procurement budgets have not been looted, the emphasis put on meeting a wide range of transformation targets has led government agencies to overspend and underdeliver significantly on goods, services and infrastructure because the extraneous targets raise the cost of the goods, services and infrastructure procured. This, too, can be fixed, and requires a reconfiguration of the priorities of procurement spending that focuses much more on the operational needs of the agencies spending money and securing value for money. (See forthcoming report in this series on procurement reform.)

"A revised and strengthened Operation Vulindlela should oversee 'back to basics' programmes in government departments"

These are general solutions that don't do anything to change the composition of spending in government. But, here too, there is plenty of room for improvement given that, tough as the budgets of the past five years have been, they have been general "haircuts" rather than targeted cuts to unnecessary, low-priority or wasteful programmes. Treating every activity in more or less the same way implies that each is equally productive and equally important, which cannot possibly be the case. In recognition of this, some ministers of finance have promised zero-based budgeting. This is a fantasy that has no practical application in government budgets because government service commitments are not so easily turned on and off, and because much of the budget is committed in various ways that cannot easily be undone. The children in the public school system this year need to be taught next year and the year after; the teachers that teach them need to be paid next year and the year after. In a similar way, current spending implies future spending commitments across vast swathes of government activity.

A much more straightforward approach would be analogous to the approach adopted by the Reconstruction and Development Programme in the mid-1990s: all agencies would be expected to redirect 5 per cent of their budgets from self-identified low-priority activities to high-productivity, growth-supporting activities. A particular focus should be a 'back to basics' commitment that would seek to ensure more resources go to core functions, not small programmes designed to direct scarce resources to influential constituencies or to address niche concerns. A dedicated team of officials in the Presidency and the National Treasury (i.e. a revised and strengthened Operation Vulindlela) should guide and oversee this.

Finally, the proliferation of departments and the rising number of staff in the "centre of government" needs to be addressed: there is simply no reason for a country of our size and with its vast social and economic needs to deploy such significant resources to The Presidency, the Treasury, the Department of Performance

Monitoring and Evaluation, the Government Communications and Information Service, the Department of Public Service Administration, the Public Service Commission, the Department of Women, Youth and People with Disabilities, the Department of Cooperative Governance and Traditional Affairs, and the Department of Public Enterprises. This concentration of resources in the centre reflects the weaknesses of South Africa's systems of accountability and manifests significant redundancy. It is ripe for reconfiguration, consolidation and rationalisation, a process CDE recommended in **ACTION ONE: Reorganise the Presidency and the Cabinet**. Unfortunately, these recommendations were largely ignored in the configuration of the GNU.

"Government must refrain from making any new unaffordable spending commitments"

In brief then we are recommending that the GNU stick with the current fiscal strategy, which is broadly right. However, it should be strengthened and needs to be understood as an immediate and permanent commitment to fiscal sustainability. Strengthening actions should include:

- *Government must refrain from making any new unaffordable spending commitments*, a goal that includes avoiding agreements that raise public sector remuneration spending faster than the economy is growing so that it squeezes out other critical expenditure (e.g. on social grants or on other inputs into government service-delivery like medicine, positions for new doctors and medical equipment, fuel for police vehicles or textbooks in schools)
- *Government should improve the quality and productivity of spending by focusing on core business*, eliminating low-productivity activities, a process that should be led by Operation Vulindlela
- *Decision making at the centre of government needs considerable improvement*. Ensure that recommendations such as those in **CDE's ACTION ONE** on streamlining the Presidency and in **ACTION TWO** on the importance of making sure we have the right people in the senior mission critical public sector jobs (DGs and other members of the top teams in departments, or boards and chief executive officers of SOCs and other state institutions) are implemented speedily to ensure this happens
- The GNU should pursue *much greater value for the billions of rand spent on government procurement*. (See forthcoming report on procurement reform)
- *Maximise revenue collection* by investing in the enforcement of tax obligations against those who are evading their responsibilities
- *Institute productivity commissions in government functions* to identify practical ways to increase service delivery within current budget limits
- Local government across the country, with few exceptions is in crisis. Every year some 10 per cent of the national budget is transferred to municipalities and metros and there is almost universal consensus that this money is not being spent effectively. The President should urgently *appoint a high-level expert task team to relook at the structure and financing of this sphere of government* with recommendations for action to be discussed in parliament within six to eight months

Priority Two: Delivering faster growth

By far the most desirable way to improve the sustainability of the public finances is through economic growth. The effect of this on fiscal sustainability will be instantaneous because confidence in the future is almost as important as electricity for powering investment.

In our circumstances, achieving faster growth is not actually all that hard. It requires a government that is credibly committed to addressing the enormous governance deficiencies that exist – to cleaning up procurement, sending corrupt officials to jail, and demanding higher standards from public servants. These actions would instil greater confidence in the future and unlock a great deal of pent-up business spending on maintenance and investment. This is money that has not been invested in recent years precisely because of the abysmal governance record of previous administrations and their lack of credibility as a force for meaningful reform.

"Faster growth requires a government that is credibly committed to addressing the enormous governance deficiencies that exist"

A clear and credible commitment to sustainability in public finances is clearly part of this, but, critically, it is also self-fulfilling: a government that cannot credibly commit to sustainability cannot convince the private sector to invest and will not get the growth needed; a government that can credibly commit to sustainability will find that growth happens "naturally", making the achievement of sustainability much, much easier. This, ultimately, is the reason achieving fiscal sustainability is so important: in its absence, growth will never accelerate significantly.

Of course, the kind of commitment needed is not something that can be achieved solely through official pronouncements and promises; action must match the words. Such action would include the interventions into fiscal policy described above, but would have to extend to other domains, and should include:

- Network sectors play a key role in any economy. A lack of competition has created enormous economic costs as supply of transport and port services, energy generation, and other critical services are restricted by the monopoly positions of many SOCs. Addressing the crises in the SOC sector and, critically, doing so in a way that introduces far more competition into the markets in which the largest SOCs act as actual or near monopolists, particularly energy, ports and railways will generate far more growth momentum because customers of those SOCs will no longer be captive to their dysfunction. Action to sell some SOCs – South African Airways for example, would also help demonstrate commitment and credibility, as would devolution of the Passenger Rail Agency of South Africa to metropolitan governments (see forthcoming report on fixing SOCs).
- While there is much talk of leveraging private sector funding for infrastructure and delivery, the value of this needs to be properly understood: private sector financing of public infrastructure adds to government's liabilities and can undermine fiscal sustainability unless properly budgeted for. Leveraging private sector expertise in implementing projects can play a critical role in improving outcomes, and this should be the goal of working with the private sector in delivery.
- Changing procurement policies aimed at ensuring far more emphasis is placed on price/quality in competition between tenderers, rather than transformation and local content credentials (see forthcoming report on procurement reform).
- Real action to identify and dismiss officials involved in theft and corruption, including dismissal of officials credibly accused of wrongdoing (see **ACTION TWO: Appoint the right people in mission critical public sector jobs**).
- Identifying and implementing structural reforms to stimulate growth (see forthcoming report on markets and development in this series).

In sum, faster economic growth is critical to achieving fiscal sustainability. In the short-term, it can be achieved most rapidly through improved governance and a lot less corruption combined with continued work aimed at containing spending growth by the government and reforms aimed at strengthening the role of competition in the economy.

Final Thoughts

Ultimately, no society can avoid the necessity of limiting public spending to levels that are affordable. Obviously, the richer it gets, the more a society can spend and the more it can borrow. This is why growth is so vital for resolving our structural fiscal imbalances.

“No society can avoid the necessity of limiting public spending to levels that are affordable”

Broadly speaking, the current fiscal strategy is on the right path. The GNU must stick to the commitments that have been made regarding the direction of travel but ensure that the pressures to deviate from this path are resisted – whether these come in the form of excessive growth in public sector pay or a basic income grant or in any of the myriad other proposals for increased spending that are bound to be made. The essential point is that we must stay on a sustainable path now and forever, and this imperative needs to guide all current and future decisions.

Unless all economic actors believe that the public finances are going to be put on a sustainable footing, there is no way that levels of investment will reach the heights needed to generate faster growth. There is no trade-off between sustainable fiscal policy and growth: each is a precondition of the other. This, ultimately, is why moving more quickly to achieve fiscal sustainability is vital.

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