A Proposal for Fiscal Consolidation and Structural Adjustments: A South African Perspective

(Words: 3792)

1. Introduction

The fiscal environment in South Africa has been deteriorating over the last few years due to various factors such as, large accumulating debt burdens, policy uncertainty, weak economic growth and large social burdens like unemployment and poverty. These factors have placed the fiscal credibility of the South African government under threat. South Africa's new leadership has somewhat quelled the concerns surrounding poor fiscal credibility by showcasing its commitments to stabilising the public debt burden in the *2018 Budget Speech*. However, the South African government still has large fiscal and economic challenges that put fiscal credibility at risk. Unemployment, poverty and inequality levels are extremely high and the capacity for inclusive, broad-based and transformative growth are limited due to South Africa's need for large structural adjustments. The following analysis proposes that fiscal consolidation, or debt reduction, must not only be aimed at stabilizing debt, but significantly reducing it to allow for more fiscal capacity and to reduce the potential risks associated with high levels of debt. Secondly, the analysis showcases that the proposed fiscal consolidation requires a budget restructure in which state expenditure must be prioritised towards structural interventions aimed at stimulating economic growth. While there may be a short-term period of austerity and economic contraction in the consolidation process, the long-term gains will be substantial.

2. A South African Economic Outlook

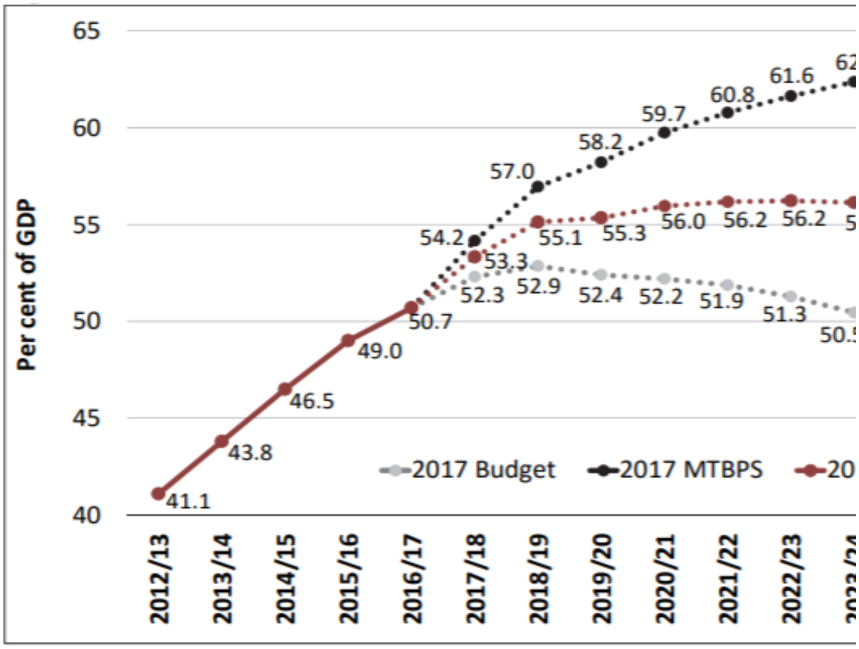
South Africa finds itself, in 2018, at a critical time where a renewed sense of optimism has spread amongst the South African people following the rise of new state leadership. The economic outlook for South Africa has greatly improved following the economy's exit out of a severe recession and achieving a year-on-year Gross Domestic Product (GDP) growth rate of 1.3% in 2017 (National Treasury, 2018: 1). The International Monetary Fund (IMF), in April 2018, has increased its projected forecast of GDP growth for 2018, from a prediction of 0.9% to 1.5% (IMF, 2018). Additionally, growth has been projected, over the medium-term, to reach 2.1% by 2020 (National Treasury, 2018: 1). Business and investor confidence is on the increase and is evident in the results of 2018 Business Confidence Index, which jumped significantly from 34 in the last quarter of 2017 to 45 for the first quarter of 2018 (Bureau for Economic Research, 2018).

Although the overall mood for the South African economy is positive and optimistic, there are still massive economic and fiscal challenges that threaten the fiscal credibility and future sustainability of the state. Fiscal credibility refers to the perception of whether citizens and markets believe that a state has the capacity to follow through on its proposed actions or will implement them effectively (Calitz and Siebrits, 2014: 368). Growth may be on the increase, but there is still concern and scepticism as to whether this growth is sustainable in the long-run and can truly transform a structurally divided nation. With unemployment currently standing at 26.6% and the youth unemployment rate at nearly 65%, economic growth is constrained by the inability of the economy to absorb people into the labour market. With alarmingly high unemployment rates, which has become synonymous with high poverty levels, the state has a large social burden to bear. Projected economic growth rates are far too low to meaningfully transform a very unequal society, reduce unemployment and poverty, and ensure that growth is inclusive of all individuals in society (National Treasury, 2018: 1).

A mounting threat to the fiscal environment is the alarming acceleration of gross national debt. Following the 2008 global financial crisis, which resulted in a severe economic recession, South Africa started running large structural budget deficits and the state's aim to eliminate the deficit within a few years did not materialise. Although ten years have passed, the deficit is still persistent due to ineffective policy choices, large social spending pressure as well as weak economic growth. Moreover, the public debt burden has increased substantially where it is currently estimated at R2.5 trillion and was projected to reach 60% of GDP by 2022. Due to higher GDP growth than previously forecasted, the debt-to-GDP outlook has improved slightly and thus revisions have projected that debt will stabilise by 2022 at approximately 56.2% (National Treasury, 2018: 2).

The 2018 Budget Speech showcased the state's various strategies for fiscal consolidation which have also contributed to the revised debt stabilisation projection. These strategies include a 100 basis point increase to Value Added Tax (VAT), spending reallocations as well as a reduction in the expenditure ceiling by R26.1 billion over the next three years. Figure 1 showcases the revisions to public debt ratio which is projected to stabilize at 56.2%, as a percentage of GDP, over the medium term. (National Treasury, 2018: 3). Despite the projected stabilization of debt, this level of public debt is still a risk to the credibility of the fiscal environment seeing as unemployment is extremely high, state-owned enterprises (SOEs) are largely failing and the social burdens of the country are becoming increasingly large. The fiscal consolidation plan of the state also relies greatly on forecasted or predicted economic growth that may never materialise (National Treasury, 2018: 3).

Figure 1: Gross debt-to-GDP



Source: (National Treasury, 2018)

The downgrade of South Africa's sovereign debt by various ratings agencies has accelerated the concern of rising public debt as well as the credibility of fiscal environment. *Standard & Poor's* rating agency downgraded South Africa's foreign currency rating to two notches below investment grade at 'BB' as well as downgraded the local currency rating into junk territory during 2017. *Moody's* decided to keep South Africa under review and left the sovereign debt rating at investment grade but changed the outlook from stable to negative. Following suit, *Fitch* downgraded South Africa's foreign and local currency to one notch below investment. The main motivation for South Africa's sovereign debt rating downgrades stemmed from weak economic growth, expected deterioration of the state's fiscal environment, and rising public debt levels (Donnelley, 2017).

In the review of South Africa in March 2018, following *the 2018 Budget Speech, Moody's* decided to keep South Africa's sovereign debt rating at investment-grade. The outlook on the rating, which had been negative since June 2017, was upgraded to stable due to improved economic prospects, greater institutional clarity in the country's new leadership and decline of the state's debt burden over the medium-term (Niselow, 2018). The fiscal credibility of the South African state has been critically under threat since the investment downgrades. Although, credibility has improved following *the 2018 Budget Speech* as it showcased the state's commitment to fiscal consolidation, credibility is still at risk considering the large tasks and challenges the state still has to address, including high unemployment and poverty. The growth projections of 1.5 % may be just enough to stabilize debt in the medium term. It is, however, not enough structurally transform a very unequal society. Furthermore, the following analysis proposes that fiscal consolidation must be the priority of the state, but government expenditure must be directed towards areas that will stimulate inclusive, broad-based and transformative growth.

3. The detrimental consequences of high debt

A sovereign debt rating indicates of the ability of a state to service its debt and a downgrade showcases that the probable risk for a state defaulting on its debt payments has increased. The cost servicing its debt has now risen for South Africa as the interest rate premium on debt has grown synonymously with risk. Due to the rating downgrades, debt service costs have jumped to R163.2 billion for 2017 and 2018 (National Treasury, 2018: 81). The higher cost of debt means that less money is spent on critical needs within the country, such as education, health and housing, and more state revenue and taxes have to be directed to servicing its debt (French, 2018). It is very easy for a country, in such a situation, to enter into a vicious circle or debt trap. As debt increases, the risk of defaulting becomes higher, promoting increases in the interest rate as market fears intensify. Due to the increased cost of debt, more money needs to be borrowed to fund its debt, causing the debt ratio to accelerate. Markets become more worried and thus interest rates are hiked further, causing a vicious circle. Such circumstances make it difficult for the state to pay off its debt and the risk of defaulting becomes increasingly probable (Blanchard and Johnson, 2014: 605).

The accumulation of debt, at moderate levels, is a very helpful and essential tool to assist economic growth and development. However, if debt is used irresponsibly, over-borrowing can have detrimental effects and can hinder the ability of a state to deliver essential needs and services to its citizens. If debt ratios exceed a certain threshold, financial crises become more probable and severe. According to Cecchetti, Mohanty, and Zampolli (2011: 1), if government exceeds a debt-to-GDP ratio of 85% of GDP, debt starts having an adverse effect on growth. Although South Africa has not reached this point, the fast accumulation of debt has raised concern. As debt levels become high and start accelerating, the main objective for states should be reducing debt to a level that is sustainable and not merely just stabilizing debt. The objective to maintain debt at sustainable levels gives an economy greater resilience to withstand any given shock that may increase the debt level further and limit the ability of the state to initiate countercyclical policy as a corrective instrument (Cecchetti et. al, 2011:

4). If a negative shock occurs within the economy, debt levels may become higher and thus the probability of defaulting becomes higher too. Borrowers, in these circumstances, may be regarded as uncreditworthy, leading to falls in consumption and investment as a country is unable to borrow from lenders. Defaults, dampened demand, and high unemployment may be the result (Cecchetti et. al, 2011: 4).

With the above reasons in mind, the following analysis proposes a long-term sustainable growth strategy for South Africa going forward. The first priority for the government is to restore fiscal credibility by reducing the government's debt burden to levels that are sustainable and that reassure investors and the South African people. Significant debt reduction will require a restructuring of the budget where government spending must be reduced, while at the same taxes revenues must be increased without disincentivise actors within the economy. Secondly, the composition of expenditure within budget must be directed towards necessary structural adjustments that gear the economy for sustainable growth. This growth must ensure that the gains are inclusive of all South Africans and that those who were historically excluded are able to effectively participate in the main-stream economy. Most specifically, fiscal policy must focus on supply side interventions or structural reforms that address issues, such as the lack of growth- enabling infrastructure, SOE inefficiency and lack of productivity (Deloitte, 2018).

4. The Mechanics of a Debt Reduction

The allocation and distribution of resources are crucial decisions made by the state and are reflected within fiscal policy and the budget. There is, however, conflict, in the decision-making process between government expenditure allocations towards policies that strive for equity, versus the implications of such policies on long-run economic growth which may comprise fiscal credibility and sustainability. Fiscal policy-making is described by Calitz and Siebrits (2014: 344), as a "juggling act of balancing 'unlimited demands' with limited resources". South Africa finds itself in a hard predicament as society is vastly unequal and large amounts resources are needed to rectify structural inequalities caused by South Africa's past. At the same time, the South African economy faces severe fiscal constraints and such resource expenditure cannot be sustained in the long-run as the debt-to-GDP accelerates.

Fiscal consolidation and the promotion of growth are critical to reducing the debt ratio. Fiscal consolidation aims to create a primary surplus which will, in turn, reduce the amount of funds needed to be borrowed by the government, and thus will gradually reduce the level of debt (Abbas et. al, 2013: 12). South Africa's proposed budget for 2018 still produces a large deficit of R180.5 billion as shown in figure 2. Two components within the budget can be restructured

Figure 2: Consolidated budget balance

R billion	2014/15	2015/16
Main budget	-166.4	-168.4
Social security funds	11.6	10.1
Provinces	6.2	0.6
Public entities	8.6	7.7
RDP Fund[1]	0.4	-1.0
Consolidated budget balance	**-139.7**	**-151.0**

Source: (National Treasury, 2018)

in order to ensure that primary surpluses are achieved. To produce a primary surplus, government spending must be significantly reduced, and tax must be increased, but not beyond a level that disincentivises the economy. Expenditure must be prioritized and directed to areas that will promote growth and does not crowd out private sector activity. There needs to be considerable reductions in wasteful government expenditure. Unfortunately, less expenditure must be directed to social spending which makes it a hard decision for policymakers (Saxegaard & Torres, 2014: 35).

In the short term, the hard decision to reduce government spending will bring about a period of austerity. Reduced government spending and increased taxes will have negative impact on growth, and possibly increase the debt-to-GDP ratio in the short-run. However, as the sustainability of budget improves, the interest rate will drop. Lower interest rates will promote consumer and investor spending, GDP growth will recover and the debt-to- GDP ratio will be reduced (Abbas et. al, 2013: 12). While fiscal adjustment may bring about a contractionary effect in the economy, it is essential to bring South Africa onto the correct sustainable growth- trajectory and the long-term gains will significantly outweigh the short-term costs. The reduced debt levels as well as reduced the cost of servicing debt will mean that more funds can be directed to critical social development.

5. The Accommodation of Monetary Policy

The fiscal environment can be rather unpredictable in times of debt reduction. It is important that monetary policy remains accommodative to the accompanying conditions associated with debt reduction. Generally, fiscal consolidations have an adverse on growth and thus monetary policy needs to provide expansionary stimulus to the economy in order to constrain the output gap. Monetary stimulus requires the central bank or monetary policy authorities, with inflation expectations remaining stable, to ensure that the interest rate remains low to inject liquidity into the economy (Abbas et. al, 2013: 26).

6. Structural Interventions to Stimulate Growth

Improving spending effectiveness, prioritising structural reforms to enable growth and ensuring that there is monetary accommodation to facilitate such a transition can reduce the short-run costs of debt consolidation (Saxegaard & Torres, 2014: 34). Fiscal consolidations can severely deteriorate growth and possibly worsen debt levels in the short-run, depending on how large the multipliers are within the economy. Thus, structural adjustments are vital to offset the contractionary effects of significant debt reduction by improving the structural primary balance and thus improving growth (Abbas et. al, 2013: 26). South Africa has significant areas of weakness with regards to structural elements within the economy, including the lack of growth-enabling infrastructure, failing SOEs and an unproductive labour force. The scope paper does not cover other structural issues, but issues such as, barriers to entry, excessive red tape, regularity burdens and labour market inefficiency are also important areas the state must address (Deloitte, 2018).

6.1 Growth-enabling infrastructure

The prioritisation of the budget should be to direct greater funds towards growth-enabling infrastructure. South Africa's weak infrastructure is a critical issue that needs to be addressed as it severely hinders the economy's capacity for productivity and growth. Infrastructure is an instrumental factor in promoting the well-being of the economy and as well as the economy's capacity for growth. Gross fixed capital formation (GFCF) as a percentage of South Africa's GDP was only equivalent to 19.5% for 2016 (National Treasury, 2018: 1). This investment is far too low when considering that China, a large economy which is achieving growth levels of 7%, is investing approximately 44.4 % of its GDP into GFCF. In order to promote sustainable and inclusive growth, a greater share of public expenditure needs to be directed towards growth-enabling infrastructure. For example, greater funds must be directed towards transport, electricity and communication networks as they are critical underpinnings of effective and competitive business operations and prosperity (Deloitte, 2018).

Large potential returns lie in the state directing funds toward long-term investments that are too risky and expensive for the private sector to undertake, and at the same time does not crowd out private sector investment. For example, the Chinese state has been successful in promoting job creation, innovation, productivity and growth through its investments into "Special Economic Zone" (SEZs). While South Africa has made attempts to replicate China's SEZs, the process has been limited. Larger investments towards these industrial hubs will speed up the process and will promote significant gains to growth as it will stimulate greater development and industrial activity. In addition, barriers to trade such as border tariffs and significant regulation should be reduced in order to promote greater industrial activity in South Africa (Chipfupa, 2018).

6.2 State-Owned Enterprises

The financial position of state-owned enterprises (SOEs) has severely deteriorated and present significant risk to the further acceleration of the public debt burden if there is need for more state bail-outs. The public-sector borrowing requirement is R329.1 billion for 2017 and 2018, which is already R77.4 billion greater than what was projected in the budget of 2017 (National Treasury, 2018: 11). According to the National Treasury (2018: 25), if these risks do materialize, it could prompt a fiscal crisis and possibly promote further sovereign debt downgrades. Further downgrades would increase the costs of borrowing as markets become fearful and interest rate premiums are hiked. This would have detrimental consequences for South Africa as it could cause a severe contraction in growth, rather than a projected increase in growth, as consumption and investment decreases and thus aggregate demand declines (National Treasury, 2018: 25). If this scenario were to occur, the fiscal credibility of the state would severely deteriorate.

The solution rectify SOE inefficiency has become a highly debated issue. Privatisation has been proposed as a means to promote the efficiency and reduce the state dependency of SOEs. The consequence of privatisation is the significant job loss that would arise in this process. However, SOEs have become a contingent liability on the state's balance sheet. SOEs must be restructured in order to enhance their position as a source of growth and so that it becomes an asset on the state's balance and contributes to reducing the budget deficit. To make SOEs more efficient, they must be given hard budget constraints, must not receive state subsidization, and should not receive bail-outs from the state as this promotes complacency (Deloitte, 2018).

In Singapore, Government Linked Corporations (GLCs), are not completely privatized companies. The state is limited in its ability to interfere with the budgets of SOEs, but still remain a large shareholder. Like the private sector, these companies are still expected to be profitable, provide returns to the shareholder, are exposed to the same regulation and market forces as other private sector businesses and do not receive subsidies or receive preferential treatment. In this way, the companies are forced to be profitable and competitive. At the same time, the state can use these revenues as a means to fund greater social and economic development (Tan and Ramírez, 2003: 4). The transformation of SOEs into GLCs may be a potential option for South Africa as opposed to complete privatisation. By transforming an SOEs into profitable and successful GLCs, the SOEs could be removed as a liability and become an asset on the state's balance sheet.

6.3. Enhancing the Productivity of the Labour Force

There is a large amount of uncertainty surrounding the state's proposal for free higher education, especially in a time where the state fiscal capacity is very limited due to large debt and high social burdens. The state has made an allocation of R57 billion towards free higher education which will be will funded by the increase in VAT (National Treasury, 2018: 27). The state hopes that the funding of higher education will have significant gains in the long-run by increasing the employability of many poorer individuals, reducing unemployment and thus stimulating growth. However, recent evidence suggests that expansions in higher education do not necessarily have a causal effect on growth.

Higher education may increase an individual's income earning potential, but if cognitive skills, which underpin the productivity of a society, do not rise in the process, there will be little impact on growth. Growth is founded by the knowledge capital that is established in the early years of schooling. Early childhood education is where mathematical and scientific abilities and skills are developed (Hanusek, 2016: 55). According to Hanusek (2016: 55), "one does not get electrical engineers and computer scientists without investing in higher education. But, one gets better engineers if universities start with students with stronger skills". The focus on developing tertiary education and theoretical knowledge creates a small sector of specialised knowledge. Diverse skills development should rather be promoted to create diverse labour networks and enhance productivity (Deloitte, 2018).

Firstly, the weak performance of primary educational institutions within South Africa need to be addressed. It requires more than just a shift of fiscal resources, but rather ensuring that schools are able to translate inputs into output and that the managerial efficiency of schools is effective. If the performance of schools is addressed, the cognitive skills development of South African pupils will be enhanced allowing for a more skilled and productive labour force (van der Berg and Moses, 2012: 134). Secondly, more expenditure must be directed towards diverse skills development to promote productive and complementary labour networks. For example, developing the entrepreneurial skills of students will increase the potential of small and medium business development and growth.

7. Conclusion

In conclusion, it has been shown that fiscal credibility is still under threat despite the efforts of South Africa's new leadership to stabilize the public debt burden. Projected growth may never materialize, SOEs are a largely failing and are placing financial burdens onto the state, unemployment is still concerningly high and there are large structural weaknesses that hamper South Africa's capacity for growth. Thus, the proposal of this analysis is that the state must prioritise fiscal consolidation in order to produce a budget surplus. A continued budget surplus will enable the state to significantly reduce the public debt burden. Fiscal consolidation requires significant budget restructuring in which state expenditure must be directed towards structural interventions and wasteful expenditure must be reduced. The aim of structural interventions is to offset the contractionary period associated with fiscal consolidation and, will at the same time, increase the South Africa economy's capacity for growth. These structural interventions include increasing infrastructure investment, SOE restructuring as well as productivity enhancement. Monetary policy must be accommodating to the conditions of fiscal consolidation and provide expansionary stimulus during periods of low growth. The aim is place South Africa's economy onto sustainable growth trajectory and ensure that fiscal credibility remains intact.

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