COUNTERCYCLICAL OR COUNTERPRODUCTIVE?
THE PURE AND POLITICAL ECONOMY OF FISCAL POLICY IN SOUTH AFRICA

[3718 Words]

Contents

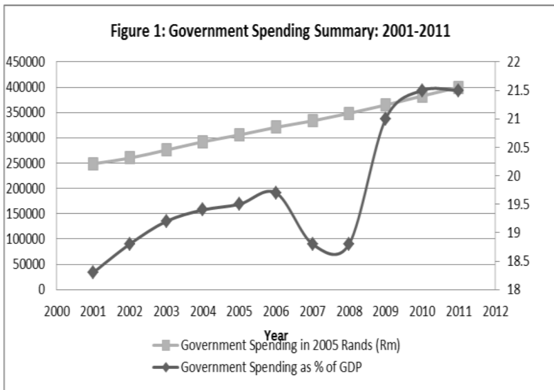
1. INTRODUCTION

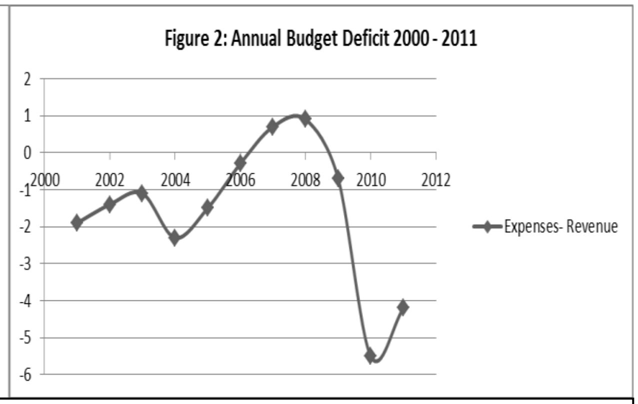
In his 2009 budget speech, then Minister of Finance Trevor Manuel announced his response to the unfolding global economic crisis. With the overarching priority of the South African fiscus remaining in job creation and growth acceleration, some new changes to the budget were announced with the aim to "reinforce macroeconomic stability... and provide a temporary cushion to the South African economy" (Manuel, 2009:10). The changes he made were larger budget allocations to social welfare spending, to state employment and job creation initiatives, and finally to increased public works investment. Three budget speeches later, economists are now in a position to critically evaluate the success of the measures implemented from 2008-2012. This essay will assess the effectiveness of countercyclical spending in South Africa before moving to a discussion of the wage bill and infrastructure outlays in the context of South Africa as a developmental state. The analysis starts with the broadest measures of success and gradually disaggregates the components of the national budget to reveal the hidden conflicts inherent in any matter of public choice.

2. DID THE STIMULUS WORK?

2.1. Countercyclical response to crisis

Since the Keynesian analysis of the 1950s it has become widely accepted that the economic role of the government is not confined only to prudent financial management and balancing. Ocran (2011:604) describes the role of fiscal policy as stimulating economic and social development. In an economic downturn, lower levels of economic activity, lower employment and growth levels and shrinking tax revenue make this goal harder to achieve. Countercyclical fiscal policy entails the notion that during downturns the government should increase measures aimed at employment creation and income subsidisation to compensate for losses (Worral, 2009:2). In this system, increased government spending has the additional effect of increasing income both directly and through the consumption multiplier.



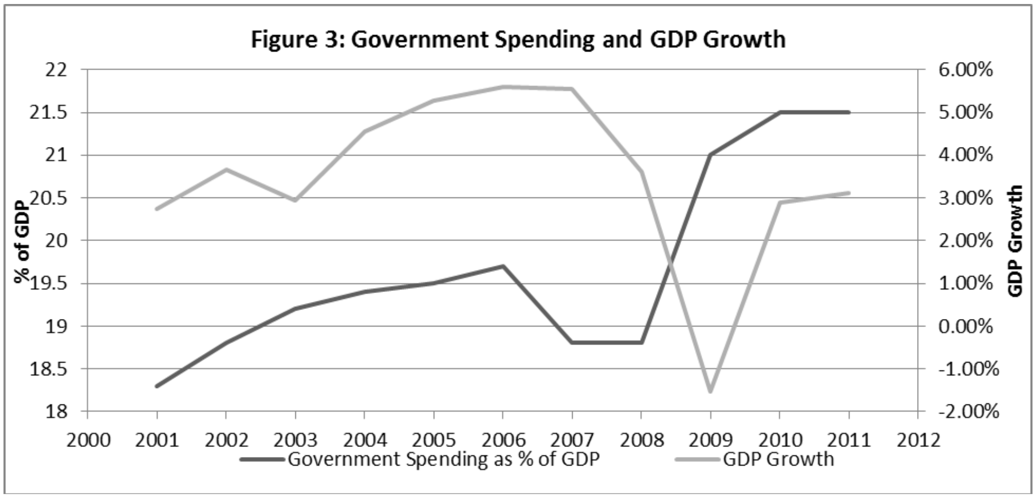


Source: SOUTH AFRICAN RESERVE BANK: *Time Series Query* [Online]. Available: http://www.resbank.co.za/Research/Statistics/Pages/Statistics-Home.aspx Accessed 17 May 2012

It is beyond doubt that South Africa moved into a period of countercyclical policy in response to the global recession that began in the US housing and financial sectors in 2008. Figure 1 shows total real government expenditure in 2005 Rand and as a percentage of GDP. Note that from 2008 the proportion of government spending to GDP increased rapidly from 18.5% to 21.5% in 2011. This was due in part to negative growth in GDP over the period and in part to deliberate increases in spending by the treasury (Manuel 2009:11). Despite declining tax revenue due to the downturn, real expenditure continued to increase at a steady rate from 2008 to 2011. Figure 2 shows the growing budget deficit over the period, a reversal of the gains made throughout the previous decade. The crisis hit at a time when a headline budget surplus of near 1% had been realised. This was quickly reversed as the extent of the crisis became apparent, hitting a low of 5.5% in 2010 and remaining high at 4% in 2011. South Africa's total debt stood at 29.2% of GDP at the end of 2011 (SARB, 2012:1). This is less than the 41% in 2001 and is respectable by international standards. The USA for instance had total indebtedness in 2011 of 94% of GDP, Greece 165% and Japan 220%.

2.2. Growth Responses to the Stimulus

First the responsiveness of the GDP growth rate to the fiscal stimulus will be analysed. Conventional theory divides the effects of increased government spending into two components. This first is the direct contribution of government outlays to national income via public service wages and transactions for goods and services rendered. The second is the consumption effect that follows the initial outlay (Froyen, 2009:381). Government spending is multiplied by a consumption effect when it maps to GDP.



Source: SOUTH AFRICAN RESERVE BANK: *Time Series Query* [Online]. Available: http://www.resbank.co.za/Research/Statistics/Pages/Statistics-Home.aspx Accessed 17 May 2012

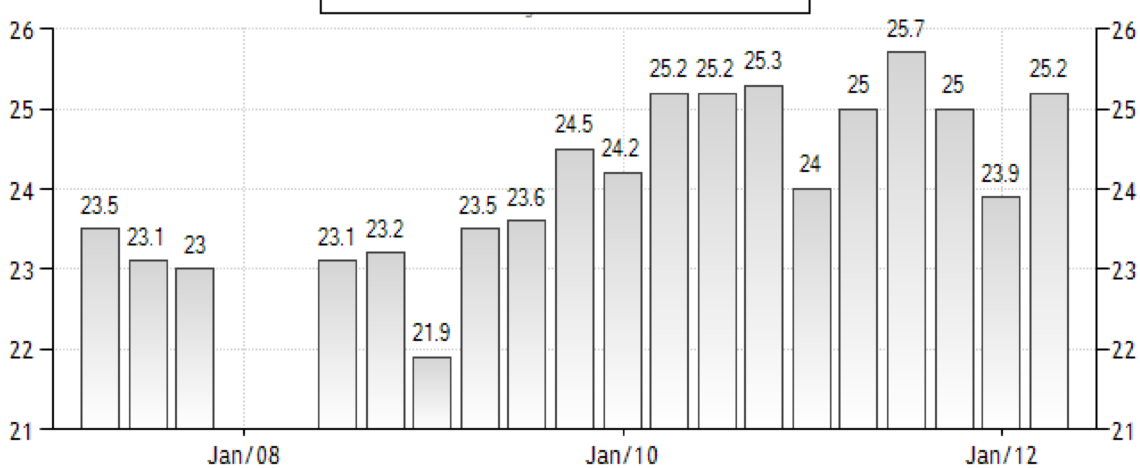
Figure 3 plots government expenditure as a proportion of GDP (black) over the same time period as GDP growth (grey). In the period 2001 to 2007, GDP grew at an increasing and relatively stable rate. In 2007 growth began to slow, and in 2008-2009 GDP growth reversed into full decline, with the economy shrinking by a total of 1.5% in 2009. From 2010 onward growth steadily recovered, reaching 3% in 2011. Over the 2001 to 2007 period, it seems that growth and government expenditure were positively related. The second difference of GDP roughly matched the rate of growth of government spending as a proportion of GDP. From 2007 onwards this trend was drastically reversed. In 2008, one period after GDP began to decline, government spending rose sharply as a proportion of GDP as countercyclical policy was enacted. This growth trend continued in 2009 and 2010 and then levelled off at 21.5% of GDP. One period after government expenditure began to increase rapidly, GDP followed the same trend. The reader will notice the almost parallel slopes and flattening-off of the curves, with GDP lagging by 1 period. Changes in government spending as a proportion of GDP are multiplied to cause an overall change in GDP in the next period.

From the strong relationship between government expenditure and GDP growth, the conclusion can be drawn that countercyclical government spending was effective in pulling South Africa out of recession and towards stable, albeit slow, economic growth. Several other facts combine to make this conclusion more convincing. Gross capital formation declined from 2009 to 2010, while trade imbalances worsened (SARB 2010:107). These two factors would alone cause a decrease in GDP. This gives good reason to believe that the bulk of recovering growth was due to increased government spending, thus strengthening the conclusion that countercyclical fiscal policy was successful.

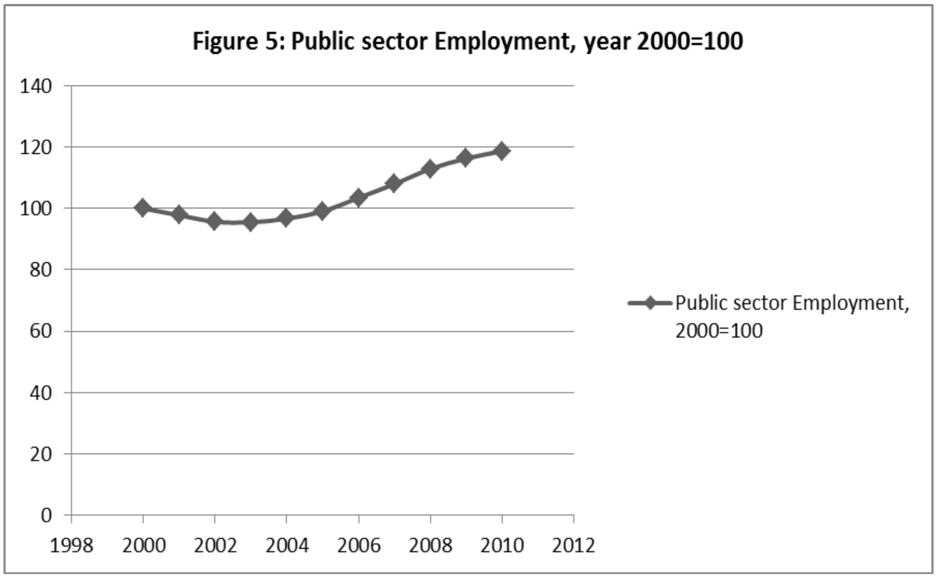
2.3. Employment 'Responses' to the stimulus

Positive GDP a good indicator, but it is essentially meaningless in the context of a recession unless it creates employment, or at the very least reverses job losses. Economic policymakers must always be mindful of the real effects of their actions. Hence, a stricter and more humane measure of the success of countercyclical fiscal policy must unemployment figures. Figure 4 is a bar chart of unemployment levels from 2007 to the present. What is clear from 2008 onwards is a gradual increase in unemployment from an average of around 23% to an average of around 25% until around 2010. From 2010 onwards, unemployment was stable around the 25% mark. The initial loss of jobs correlates with the early stages of the recession. For the policy developed after this to have been successful, this trend would need to be reversed to form an "A" shaped bar graph. In reality, unemployment stops increasing, but does not recover. There has been a structural loss of employment of 2% of the labour force since 2008. The stabilisation of employment figures correlates to the period of growth recovery seen above. Many authors, such as Kreisler and Lavoie (2007:388) see employment as positively correlated to growth. At most, the conclusion that can be drawn from this is that countercyclical policy, possibly through effects on economic growth rates, was successful in curbing job losses, but has not been successful in recovering these jobs. Certainly the promise of continued employment growth in the 2009 budget speech (Manuel, 2009:10) was not realised. Countercyclical policy is therefore judged as a failure with respect to unemployment.

Figure 4: Official Unemployment.



Source: STATISTICS SOUTH AFRICA (2012). *Quarterly Labour Force Survey*. Statistics South Africa, Pretoria.



Source: SOUTH AFRICAN RESERVE BANK: *Time Series Query* [Online]. Available: http://www.resbank.co.za/Research/Statistics/Pages/Statistics-Home.aspx Accessed 17 May 2012

Aside from contribution to reduction in unemployment through targeting GDP growth, the government has a more direct means of reducing unemployment – simply employing more public servants. This approach conforms to a theory of the lesser known work on employment of financial economist Hyman Minsky. Minsky conceptualises the state as an 'employer of last resort', an idea analogous to the 'lender of last resort' function of the central bank (Wray, 1998:1). In this way the state can act as an employment buffer against the business cycle, with labourers returning to the private sector during upswings (Wray, 1998:2). Although Wray (1998) develops the thesis that the employer of last resort idea would lead to 0% unemployment in developed nations, he later concedes that in developing nations would not eradicate structural unemployment, but rather achieve a lower and smooth 'natural' rate of structural unemployment (Wray, 2007:37). Figure 5 uses an index of public service figures and shows that the South African government did indeed increase their employment rate in the years following the crisis, an act which prevented even more severe unemployment and helped to stabilise the rate of unemployment in 2010-2011. This effect was not large enough to achieve Minsky's aim of lower overall unemployment, a fact which raises doubts as to practical possibilities of the theory in South Africa. Rankin and Roberts (2011:129) consider unemployment to be a structural issue, implying that it is somewhat beyond the direct control of fiscal and monetary authorities. Structural barriers identified in the South African labour market range from changes in production technology, tight labour regulation, rigidity caused by labour unions, skills shortages and barriers that prevent the emergence of small business. Clearly the path to long-run reduction of unemployment lies in resolving some of the most severe of these rigidities (Rankin and Roberts, 2011:129). Levinsohn (2008:9) suggests as an alternative that a wage subsidy be implemented in which the state subsidises private employment creation. Such a suggestion has, however, met with considerable opposition from trade union federation COSATU (Times Live, 2012:1).

Overall, countercyclical policy has been successful in pulling growth rates back into positive territory while at the same time managing to slow job losses. However, growth is now stagnating and no gains have been made in recapturing lost employment. The recession has hit South Africa’s two key real variables hard of growth acceleration and unemployment hard, and the fiscus has only been able to do no more than soften the blow.

3. PUBLIC SERVICE AND THE DEVELOPMENTAL STATE

3.1. Theory of the Developmental State

South Africa has for some time identified itself as a developmental state (New Growth Path, 2011:2). Evans (2010:37) conceives a developmental state as a country in which a strong institutional infrastructure directs the process of economic growth to achieve the goal of improving the living standards of its citizens. Three separate development models have come to prominence in the last half a decade. The “new growth theory”, developed by economists such as Romer and Lucas builds on the standard neoclassical model, which focused on productivity growth through capital deepening. The new growth model adds human capital development as a primary source of growth. The institutional approach, typified by the work of Rodrik (2006:2) focuses on the necessity of strong institutions that can foster fertile conditions for productive investment and successful market coordination. The capabilities approach pioneered by Amartya Sen emphasizes that GDP per capita is not an end in itself but rather a proxy for wellbeing. Policies aimed at development should ensure that the type of GDP growth achieved will be simultaneous with broader human development measures. The common thread in all three of these theories is the importance of state capacity in ensuring that economic development is achieved. A crucial component of state capacity is a strong public service capable of directing the powerful interests of capital and labour towards developmental goals. To Evans (2010:45) the state is central to development. This view has been reinforced by recent attempts by the South African government to take a more active role in directing South Africa's growth. The New Growth Path (2011:7) places the state at the centre of job creation. In the short run the state will create jobs directly, and in the medium and long run the state will encourage labour-absorbing activities. The problem that the developing state faces is how to improve state capacity. Two key methods are an efficient public service and infrastructural improvements.

3.2. Public Service and Infrastructure Development

The public service has two functions in context of the developmental state. The first function, as the name suggests, is to provide primary services to citizens of the nation. These services directly raise quality of living for citizens. The second role of the public service is to foster the institutions that are necessary for economic development.

Fakir (2007:1) identifies some of the ways in which the state provides primary services by “regulating, administering, executing, mediating, investing and delivering the constructions, operations, maintenance and servicing of service delivery infrastructure”. The state has a constitutional mandate to uphold socio-economic rights through effective service delivery (Republic of South Africa, s25;26). Clearly on this primary count the questions of infrastructure development and the public service development are connected. In a classic chicken and egg situation, one cannot appear before the other. National budgeting must therefore achieve a delicate balance between the two. For instance, Von Holdt and Maserumule (2004:1), in their critical case study of service delivery in the Chris Hani Baragwanath hospital, identify two crucial failures. The first is an under-investment in critical investemtn per bed. The second is a lack of human capital. Administrators of the hospital are incapable of ensuring the discipline of public servants’ managerial skills. There is also an inefficient, decentralized chain of authority. These failures are all interrelated, showing a duel dependence of effective service delivery on human and physical capital.

With respect to the goal of long term development, it is not any easier to separate public service and infrastructural development priorities. In his analysis of the newly industrialized countries of East Asia, Evans (2010:43) argues that an effective public service is a prior condition to infrastructural and industrial development. The rapid growth of the Asian Tigers was attributed to a public bureaucracy that was recruited based on meritocracy, where state employees could expect long term remuneration comparable with the private sector. Evans provides cross-sectional data that strongly correlates a well-compensated public service with higher state capacity and resultant economic growth. For long term growth then, successful state investments depend on the ability of the public service to identify and execute investments effective and efficiently. The state should therefore attract a high quality of employee and actively build capacity to lay the foundation for long term growth.

Another key for analysing the interaction between public employment and increased capacity is to consider which creates more sustainable sources of employment in the long run. Infrastructure programmes have the potential create unemployment through building, utilising and servicing the infrastructure and stimulating economic activity through increased capacity. For instance, Field (2002:1399) contends that the economic prosperity enjoyed by the USA in the 1950s and 1960s was due to infrastructure development public works programmes during the 1930 depression. However, such projects focusing on the supply side of the aggregate economy generally have long time horizons. The average time span from inception actually beginning a public works programme is three years, and the projects themselves range to twenty year plans (National Treasury, 2012:94). Public works programmes are an important path to long-run growth, but will not provide jobs or service delivery in the short-term. Worryingly, McCord concludes that public works programmes completed between 1994 and 2003 had only limited success in job creation and service delivery (McCord, 2003:35). This is why, as the analysis above has shown, the public sector is seen as an unemployment buffer in the short run (Wray, 1998:3).

3.3. Balancing Expenditures

The analysis so far has revealed that it may be in the long-run developmental interest of the nation to attract a high quality public service with a high wage bill. On the other hand, infrastructural development is crucial for service delivery and capacity-based growth. The question to be answered it whether the balance between these two components of spending is optimal.

Figure 6 compares state employment with compensation of employees. The grey line, measured against the right-hand axis, is an index of employment in the public sector with the year 2000 set to 100. The dark line measures total compensation to employees divided by this index. The trend in both lines is clear. The government has employed more workers and increased their individual compensation over the years 2000-2011. The data therefore reflects the consequences of creating direct employment whilst trying to attract a higher quality of public servant.

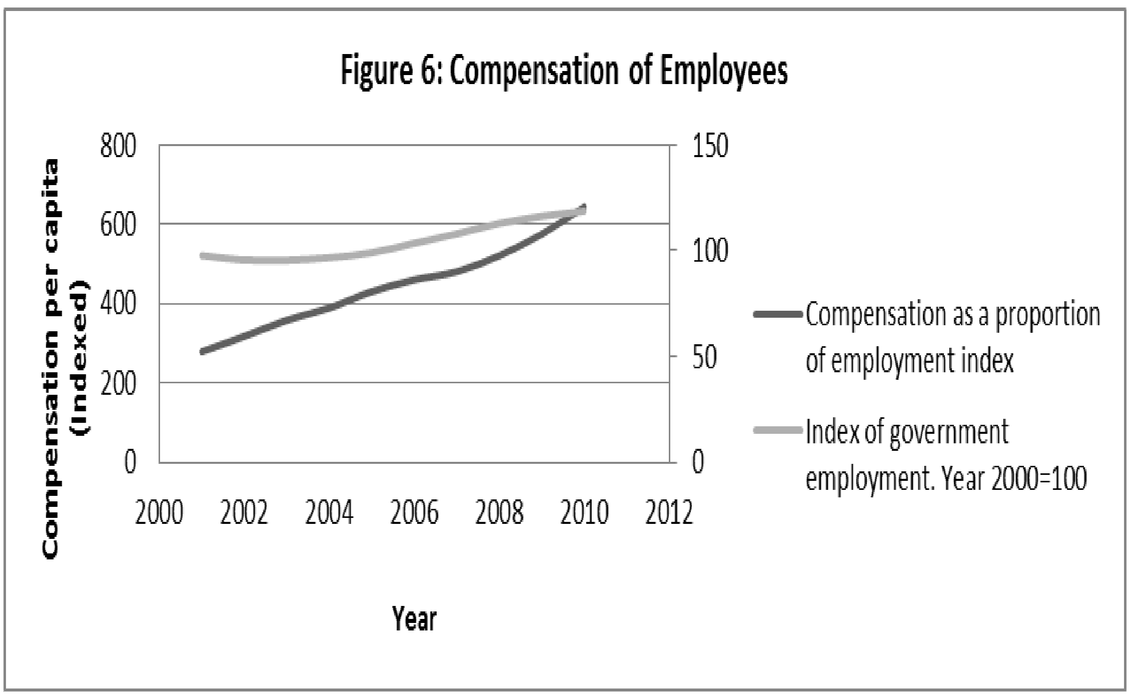
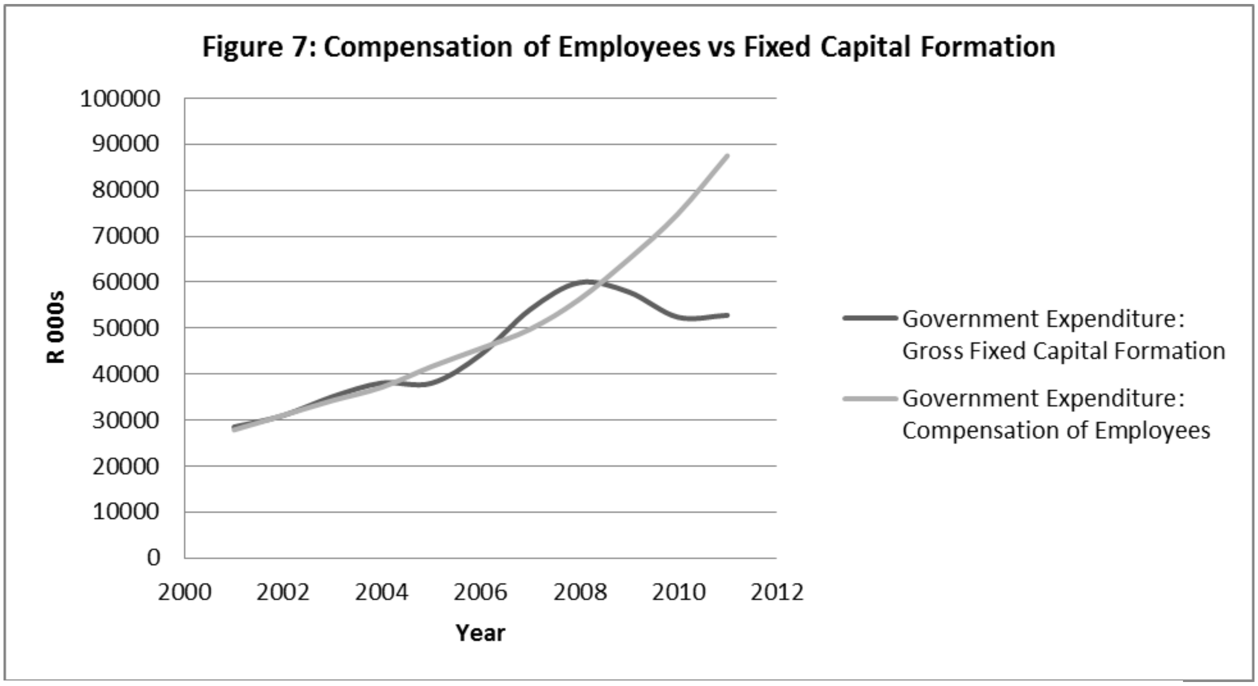


Figure 6: Compensation of Employees

Source: SOUTH AFRICAN RESERVE BANK: *Time Series Query* [Online]. Available: http://www.resbank.co.za/Research/Statistics/Pages/Statistics-Home.aspx Accessed 17 May 2012



Source: SOUTH AFRICAN RESERVE BANK: *Time Series Query* [Online]. Available: http://www.resbank.co.za/Research/Statistics/Pages/Statistics-Home.aspx Accessed 17 May 2012

Figure 7 compares public spending on fixed capital formation and compensation of employees. After 2008 spending on public infrastructure actually decreased after a sustained upward trend. The acceleration in spending after 2004 would in part reflect outlays on the 2012 FIFA world cup. Nevertheless, it is clear that the rapidly rising wage bill has bitten into the state's ability to spend on infrastructure. If this trend continues, the state will be substituting short term employment for long-term growth to an unsustainable degree. While a high quality of public servant is important, infrastructure spending should not be overly restrained, since it is the other major determinant of long-run development.

While raising wages to attract high quality public servants is a legitimate strategy for improved state capacity in a developmental state, this approach clearly has limits. Figures 6 and 7 demonstrate that these limits may well have been reached. A continuation of steep upward trend in the wage bill will crowd out other government expenditure plans, and has already taken its toll on infrastructure development.

3.4. Solutions and constraints

In agreement with Pravin Gordahn's (2012:4) statement that the public wage bill can and should be brought under control without adversely affecting public service delivery, this essay suggests that the government seek alternate ways to improve state capacity. Evans (2010:43) indicates that a strong *esprit do corps* was an important factor in attracting and developing the public bureaucracy of the Asian Tigers. Francois' (1999:295) contends that public servants also respond to what he terms "Public Service Motivation (PSM)". Simply put, if the state as an employer can motivate an ethic of contribution to society among employees, efficiency will rise without additional financial incentive. Francois presents a formal of partial equilibrium in the firm and with respect to individual preference ordered through time and finds that the PSM effect is strongest when other incentive schemes are reduced. Mangaliso (2001:24) suggests that a management strategy focused on the philosophy of ubuntu would be an ideal way to create a uniquely productive African workforce. All of these measures would allow for increased public infrastructure spending grow the proportion of the budget spent on public investments.

It is also recommended that the state focus to a larger extent on skills investment in its employees. Von Holdt and Maserumule (2004:20), show that service delivery in the South African health sector could be vastly improved with better technical management skills. Similarly, Hausmann (2008:6) argues that a key constraint to South African growth is the skills shortage. Improving skills in the public sector would increase capacity while also addressing this broader problem.

Attempts to reduce the public wage bill have been criticised both in academic circles and in society. Academics appeal to studies such as that of Hacke and Sahay (1996:755), who found that a decrease in the public wage bill fails to balance the budget due to efficiency deterioration within the public service. Interest groups in society, particularly organised labour, have their own objection to wage-bill austerity. South Africa has a proud tradition of legitimate civil disobedience which today manifests as world-leading strike levels. This trend is evident in the public sector, where in the 2011 'strike season' municipal workers, teachers unions and two other public worker's unions took to the streets to demand higher wages (WSWS, 2011:1). Congress of South African Trade Unions (COSATU) leader Patrick Craven claimed that COSATU was "obviously opposed to it [wage bill reductions]" (Donnelly, 2012:1). The same article highlights tension between COSATU and the State over the consultation process over public wage austerity. Clearly there are several powerful conflicting interests in the size of public wages, with the taxpayer stuck between labour and the government. The recent clash between COSATU and the DA over a proposed youth wage subsidy shows that South Africa's culture of striking is going nowhere (Du Plooy, 2012:1). Despite its economic importance, a decrease in the wage bill will be difficult due to the competing interest of different sections of society.

2012 is an important year for the ANC. The leadership of the party for the next five years will be decided at the Mangaung conference in December (Du Plessis, 2012:1). It is quite conceivable that a determined effort to reduce public wages could cause some actors to lose political capital, since many in the ANC NEC are government employees. This will present a significant challenge to those attempting to reign in the wage bill as wages may become a tool for political manoeuvre.

4. CONCLUSION

Allocating the national budget in South Africa presents the finance ministry with several balancing challenges. South Africa's status as developmental state dictates certain necessary conditions for growth. The public service must be strong and efficient, capable not only of delivering basic services, but also of planning and actualising a path for long term prosperity. This places demands on the treasury to attract highly skilled labour into the state. At the same time, effective service delivery requires infrastructural development, and the economy will not find a path to sustainable growth unless the businesses and individuals have access to an effective public infrastructure such as transport and power utilities. This places a burden on the state to engage in large-scale infrastructure development programmes. Both the wage bill and infrastructure projects are not easily reversible commitments. They require careful proportional allocations to prevent one crowding out the other.

In the contractionary environment after the 2008 crisis the government was forced to respond by moving into a deficit. While this action was successful when measured by GDP, structural unemployment has increased since 2008, with the massive job losses of 2009 not reversed. More importantly, the countercyclical spending was mostly through the public wage bill, with no expansion of infrastructure outlays. This essay has found that the increase in the wage bill is large enough to 'crowd out' infrastructure investment, an action that if not successfully reversed will be detrimental to long term growth. It has been suggested that while holding the wage bill steady, infrastructure outlays be increased. Increased public service quality can be built through skills investments and improved motivational conditions. Given the power of labour in the public sector this will be very difficult, and is likely to meet with opposition in the form of strikes in 2012. The ANC election conference later in the year will also mean that an iron fist will be needed to prevent public wages being used as a political tool.

5. LIST OF REFERENCES

DONNELLY, L. (2012). *Battle Looms over Stand on Public Sector Wages* [Online]. Mail and Guardian Online. Available: http://mg.co.za/article/2012-02-24-battle-looms-over-stand-on-public-sector-wages [Accessed 17 May 2012].

DU PLESSIS, C. (2012). *ANC Battle Begins* [Online]. Available: http://www.news24.com/SouthAfrica/Politics/ANC-battle-begins-20120610-2 [Accessed 24 May 2012].

DU PLOOI, J. (2012). *DA, COSATU Violence Not The Answer* [Online]. Times Live. Available: http://www.timeslive.co.za/ilive/2012/05/16/da-cosatu-violence-not-the-answer-ilive [Accessed 17 May 2012].

EVANS, P. (2010). Constructing a Democratic Developmental State in South Africa. *HSRC Press: Cape Town.*

FAKIR, E. (2007). *Public Service in a Democratic Developmental State.* Centre for Policy Studies. Johannesburg, South Africa.

FRANCOIS, P. (2000). 'Public Service Motivation' As An Argument For Government Provision. *Journal of Public Economics.* 78: 275-299.

FIELD, A. (2002). *The Most Technologically Progressive Decade of the Century.* Department of Economics: Santa Clara University.

FROYAN, R. (2009). *Macroeconomics: Theory and Policies.* New Jersey: Pearson.

GORDHAN, P. (2012). *Budget Speech.* National Treasury, Pretoria.

HAQUE, N and SAHAY, R. (1996). Do Government Wage Cuts Close Budget Deficits? Costs of Corruption. *Staff Papers – IMF.* 43 (4): 754-778.

HAUSMANN, R. (2008). *Final Recommendations of the International Panel on ASGISA.* Centre for International Development. Harvard University, Cambridge USA.

HBS SOUTHERN AFRICA (2009). *Perspectives: Political Analysis and Commentary from Southern Africa.* HBS Southern Africa. Cape Town. 3.09.

KATZ, L. (1986). Efficiency Wage Theories: A Partial Evaluation.*NBER Macroeconomics Annual*. 1: 235-290.

KRIESLER, P and LAVOIE, M. (2007). The new consensus on monetary policy and its post-Keynesian critique. *Review of Political Economy* 19(3): 387–404.

LEVINSOHN, J. (2008): *Two Policies to Alleviate Unemployment in South Africa.* Centre for International Development. Harvard University, Cambridge USA.

MANGALISO, M. (2001). *Building Competitive Advantage from Ubuntu.* Academy of Management Executive. 15 (3): 23:34.

MANUEL, T. (2009). *Budget Speech.* Pretoria: National Treasury.

MCCORD, A. (2003). An overview of the Performance and potential of public works programmes in South Africa. *Centre of Social Science Research.* Working Paper No. 49.

NATIONAL TREASURY (2012). *Budget Review.* Pretoria: National Treasury.

NEW GROWTH PATH (2011). *New Growth Path: The Framework* [Online]. Available: http://www.info.gov.za/view/DownloadFileAction?id=135748 [Accessed 01 June 2012].

OCRAN, M. (2011). Fiscal Policy and Economic Growth in South Africa. *Journal of Economic Studies.* 38 (5): 604-618.

RANKIN, N and ROBERTS, G. (2011). Youth Unemployment, Firm Size and Reservation Wages in South Africa. *South African Journal of Economics.* 79 (2): 128-145.

REPUBLIC OF SOUTH AFRICA (1996). *Constitution of the Republic of South Africa No. 108 of 1996.* Statutes of the Republic of South Africa – Constitutional Law.

RODRIK, D., 2006. *Understanding South Africa's Economics Troubles.* Centre for International Development. Harvard University, Cambridge USA.

SOUTH AFRICAN RESERVE BANK (2010). *Quarterly Bulletin.* Pretoria: South African Reserve Bank.

SOUTH AFRICAN RESERVE BANK (2012). *Historical Macroeconomic Time Series Information* [Online]. Available: http://www.resbank.co.za/Research/Statistics/Pages/OnlineDownloadFacility.aspx [Accessed 16 May 2012].

TIMES LIVE, (2012). *DA lays Charges Against Cosatu* [Online]. Available: http://www.timeslive.co.za/politics/2012/05/16/da-lays-charges-against-cosatu. [Accessed 17 May 2012].

VON HOLDT, K and MASERUMELE, B. (2004). *After Apartheid: Decay or Reconstruction? Transition in a Public Hospital* [Online]. Available: http://uscdn.creamermedia.co.za/assets/articles/attachments/01413_baragwanath.pdf [Accessed: 26 May 2012].

WORRAL, D. (2009). *Countercyclical Policy: What it is, and what are its Limitations.* Central Bank of Barbados, Jamaica.

WRAY, R. (1998). *Government as Employer of Last Resort: Full Employment without Inflation.* Working Paper. Levy Economics Institute.

WRAY, R. (2007). *Employer of Last Resort Programme: Could it Work for Developing Countries?* Economic and Labour Market Papers. Employment and Analysis Research Unit.

WSWS (2012). *Record Level Strikes in South Africa* [Online]. World Socialist Web Site. Available: http://www.wsws.org/articles/2011/aug2011/safr-a01.shtml [Accessed 17 May 2012].