Special Interests, Government Expenditure and the Struggle for Optimal Policy in South Africa

(3100 words, excluding title, Bibliography and references)

Introduction

In the 2010 Medium Term Budget Policy Statement (2010, p. 20), Finance Minister Pravin Gordhan announced that the path of fiscal policy from then on will be 'explicitly countercyclical, which means that fiscal consolidation will be phased in without curtailment of core public services'. This took place against a background of ad hoc countercyclical measures aimed at boosting aggregate demand in the wake of the 2008 global financial crisis (Lysenko and Barnard, 2011, p. 20). However, I will present arguments which cast serious doubt as to whether these countercyclical measures were as effective as they could have been. In addition, I will argue that there are political constraints on the South African state's ability to implement countercyclical fiscal policy effectively. The political influence public-sector unions has had (and will continue to have) a diluting effect on the effectiveness of fiscal expansion. By lobbying government, and using both threats and the trading of favours in order to do so, these public-sector unions have been able to adversely influence fiscal policy: bureaucrats have received additional income that may otherwise have been spent on infrastructure projects. Without a significant shift in the nature of the relationship between the state and public-sector unions, any programme of countercyclical fiscal policy will suffer from political constraints on its effectiveness. I therefore argue in favour of removing some of the responsibilities of setting fiscal policy from direct political control. Once the parts of the budget that are most sensitive to political horse-trading are no longer decided upon by those with overwhelmingly political motives, it will become easier for the government to avoid the mistakes of the past and thereby commit to more effective countercyclical fiscal policy in the future.

Why Should Fiscal Policy be Countercyclical?

Discretionary countercyclical fiscal policy refers to the central government deliberately increasing its spending and/or lowering taxes in order to boost aggregate demand during contractions of the economy (Taylor, 2000, p. 26). This is also usually paired with a commitment to reducing spending and/or raising taxes during a boom in order to prevent accelerating inflation (Taylor, 2000, p. 26). The rationale for such a policy usually relies on individuals in the economy disliking unpredictable fluctuations in their consumption opportunities, and hence business cycle fluctuations (a problem which can be especially acute for the poor) (Krussell and Smith, 1999). Hence the goal of discretionary countercyclical fiscal policy as described above is to smooth the business cycle so as to soften the blow of fluctuations in the business cycle. The core of this essay is to show that while such an approach to managing the economy may seem in theory to be quite sensible and straightforward, it runs into serious obstacles in the real world. In what follows, I shall examine the ways in which the countercyclical fiscal policy employed in South Africa from 2008 onwards could have been better, and devote my attention to one of these real-world obstacles: the political environment in which the South African government operates.

South Africa's Fiscal Stimulus: a Mixed Outcome

In order to evaluate the effectiveness of South Africa's recent programme of countercyclical fiscal policy, one must compare it to some reasonable benchmark for success. For us to say where it fell short, we must have some clear idea of what should have been done instead. We may turn to the IMF's programme for fiscal policy in the wake of the Great Recession. Some argue that the composition of fiscal interventions is crucial to how effective they ultimately are (Spilimbergo et al., 2008, p. 4). The corollary of this is that fiscal stimulus that comprises expenditure that does not address directly the underlying causes of the descent into recession will have a much smaller effect on aggregate demand than one that does. Increased expenditure, rather than tax cuts, are therefore recommended as the general tool of stimulus in the recession, since the 'response of the [households and firms] to an increase of their income in current circumstances' is 'highly uncertain' (Spilimbergo et al., 2008, p. 5). Moreover, Spilimbergo et al. (2008) emphasise the importance of prioritising projects such as investment in infrastructure development over increases to the public sector wage bill. This preference is justified with reference to the difficulty of reversing the latter, and its similarity in its effects to government transfers, which are in general less effective at increasing aggregate demand during a downturn. This is due to the larger 'multiplier effects' of infrastructure expenditure, due to positive externalities from improved infrastructure (for example) (Spilimbergo et al, 2008, p. 5), which are in general not brought about by increases in the volume of government transfer payments.

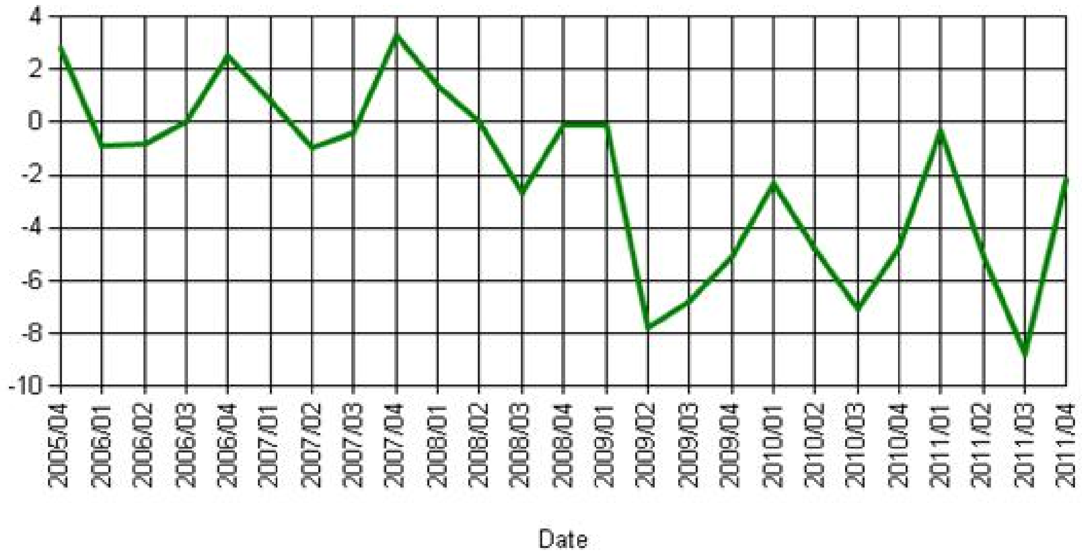

Fig. I: National Government Deficit/Surplus as a Percentage of GDP, 2006-2011 (Source: SARB [www.resbank.co.za])

As can be seen in the graph above, the South African government had already moved into a deficit of 2% of GDP by the third quarter of 2008, just as the worst of the global financial crisis was breaking out. This does not seem to be the result of the government boosting aggregate demand in anticipation of the recession, however, since this brief period of deficit spending is followed by fiscal belt-tightening of an equal size. (This period of fiscal tightening toward the end of 2008 is in fact procyclical, since it amounts to a withdrawal of aggregate demand just as the recession begins to take place). Steeply increasing deficit spending only takes off in 2009: this suggests that there was a clear lag between the recognition of the depth of the crisis that was unfolding and the implementation of fiscal measures to counteract its effects on the South African economy. Based on this, one could criticise the countercyclical measures that were enacted, not necessarily for being inappropriate in principle, but rather for being mistimed: the worst of the initial wave of crisis had started to ebb by the time the more serious efforts at countercyclical deficit spending had got underway.

In the two years following the advent of recession in South Africa in 2008, both the total volume of wages paid out in the public sector and government expenditure on capital projects increased markedly (Lysenko and Barnard, 2011, p. 17). This adheres to the recommendation cited above with respect to the pursuit of stimulus via increased expenditure rather than reducing the burden of taxation. Lysenko and Barnard (2011) argue that one way of making South Africa’s fiscal policy more strongly countercyclical would be to run larger budget surpluses during expansionary phases of the business cycle.

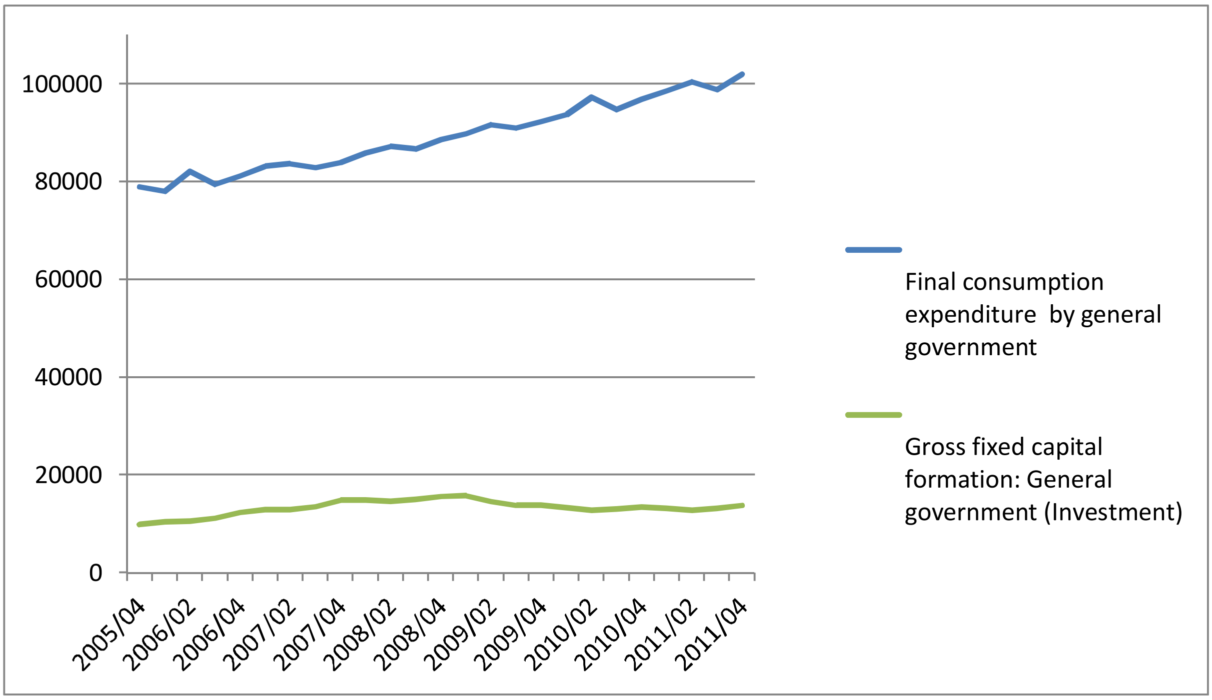

Fig. II: Total Government Consumption and Investment at Constant 2005 Prices, 2006-2011 (Source: SARB [www.resbank.co.za])

A particularly striking feature of Figure II, above, is the relative dynamics of government consumption (purchases of goods and services) as compared with government expenditure on investment. Whereas the former has increased by more than 25% between the end of 2005 and the end of 2011, the latter has barely budged, even stagnated. In fact, the cyclicality of government consumption is much less pronounced than the cyclicality of government expenditure on investment. Although government investment reaches its peak between the end of 2008 and the beginning of 2009, the rate at which public investment increases is far smaller than the rate of increase of public consumption over the same period. Moreover, the increases in public consumption over the period 2008-11 were not noteworthy deviations from the already established trend of ever-greater government consumption expenditure. Hence the picture that is presented is of a government that almost stumbles accidentally into countercyclical fiscal stimulus as a result of trends that were already in place before the beginning of the global financial crisis in 2008. In addition, as Figure III below shows, the proportion of government spending on goods and services that is used up in paying public sector wages has steadily increased over this same period, in lockstep with the overall upward trend of government consumption expenditure. So not only is a relatively large proportion of the increase in government spending due to consumption expenditure that was expected to increase anyway, but a significant slice of that increase comes from a steady increase in public sector wages.

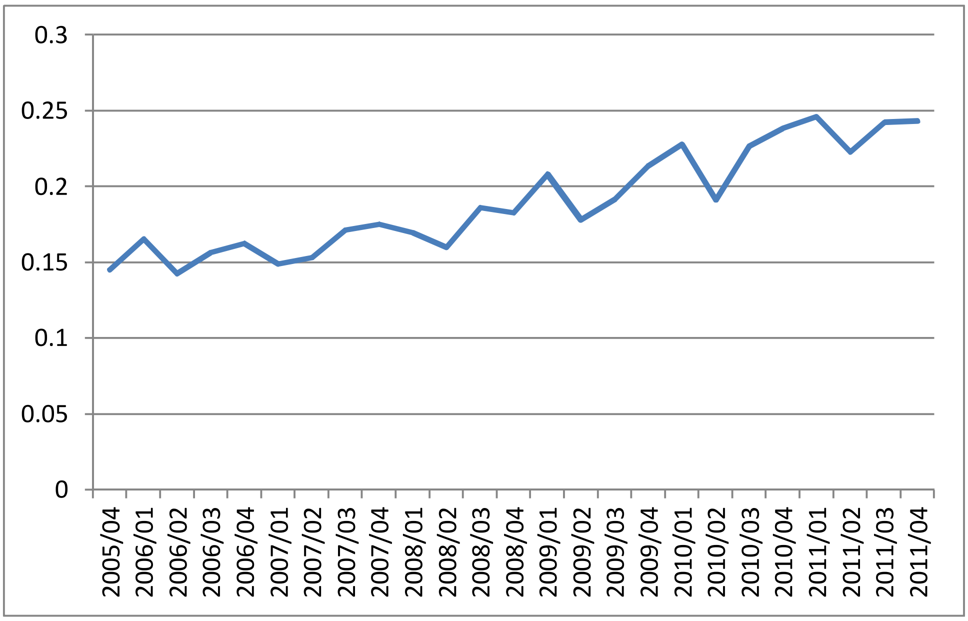

Fig. III: The Public Sector Wage Bill as a Proportion of Government Consumption, 2006-2011 (Source: SARB [www.resbank.co.za])

When compared with the recommendations of the IMF cited above, the analysis above suggests that the South African government's countercyclical fiscal policy could have been improved in some significant respects. The stimulus that was enacted didn't contain as much public investment relative to consumption expenditure as would have been ideal, and much more of the stimulus went to inflating public-sector wages than is theoretically desirable. Consequently, the South African government's fiscal policy in the wake of the 2008 global financial crisis represents a missed opportunity. Although some countercyclical measures that were already scheduled to take place helped to moderate the effects of the crisis, far more could have been done to boost investment spending, which would have been the most effective tool for firing up aggregate demand.

Political Constraints and their Severity

What accounts for this gross imbalance in the way that government spends its revenues? A great deal of insight can be gained by viewing politicians as essentially self-interested, acting as much in their own interest as in the public interest. That is, those who make fiscal policy in the executive branch of government are not necessarily benevolent technocrats who think only of how to make society as a whole better off: in a democracy like South Africa, those in positions of power also have to calculate how to maximise their share of the votes cast in the next election. An important point for the purposes of this essay is that these incentives come into conflict in South Africa in ways that cause fiscal policy to differ significantly from what it would be in the absence of political calculation by economic policymakers. (This is also known as the 'public choice' view (Tullock, 2008)).

Some have argued that politicians 'may prefer to sacrifice necessary spending on infrastructure' in favour of 'more visible forms of spending', since the costs of infrastructure projects are easily perceived, while their benefits are less immediately tangible, thus making them a less attractive tool whereby politicians might seek to increase their chances of re-election (Frant, 1996, p. 373). In this context 'more visible' spending is often transfer spending, since it goes directly to recipients. In order to maximise the payoff that they get from these transfers, politicians are more likely to spend them on (in effect) buying the loyalty of groups that play an important role in getting them re-elected. In particular, South Africa's trade unions are extremely important political allies for the ANC; they are pivotal to efforts at rallying support in advance of elections and are often highly sophisticated and determined lobbyists (Calland, 2006). This has been the case at least since shortly after democratisation; in 1996, teachers' unions had enough bargaining power to extract concessions from provincial governments over higher pay even as these same governments' expenditure outstripped their total revenues (Seekings, 2004). Whatever policy options the South African government has at its disposal, then, are constrained at least in part by the need to appease public sector unions, without whom the proper functioning of government – including fiscal policy – becomes extremely difficult. Public sector unions in South Africa are in a position of particular strength in South Africa: in addition to their political importance, their members are integral to the implementation of government policy. They are therefore in a uniquely strong position to force trade-offs between the optimal implementation of government policy and the satisfaction of their demands.

The steady upward trend in government expenditure on goods and services, relative to government investment (see Figure II, above) becomes relatively less difficult to explain in this light. A government that cannot pursue large infrastructure projects without first satisfying progressively more strident demands for higher wages from public sector unions would be expected to have its wage bill grow faster than its rate of investment. This situation is especially acute in South Africa, where trade unions typically wield a great deal of clout with the tripartite alliance (Calland, 2006).

Possible Objections: On Mandarins and Motivations

It may be argued that the relatively large growth rate and real value of public sector wages are the price of maintaining an efficient state bureaucracy. For example, one might argue that high wages for public servants reduce the likelihood that they will be tempted into receiving bribes or engaging in other forms of corruption. This is buttressed by the example of

Singapore, which pays its public servants real wages that are significantly higher than elsewhere in the world and has a notably clean slate as far as corruption is concerned (Van Rijckeneghem and Weder, 2001, p. 317). However, Van Rijckeneghem and Weder (2001) find that although there is a negative correlation between public-sector wages and corruption, quite hefty increases in the wages of civil servants relative to the average wage are needed in order to produce significant improvements in the overall level of public-sector corruption: one would need, in general, to pay double the average private sector wage before one gets any significant results.

A second counterargument may involve the application of efficiency-wage reasoning to public sector wages; straightforwardly, we should expect to pay civil servants better in order to motivate them to perform their duties well. This, however, ignores the dynamics described above; when pay increases are no longer linked to performance, the power of wages to act as incentives for improvements in that performance is greatly diminished, perhaps even to the point of being negligible.

Overall, it seems that the case for piecing together fiscal stimulus differently in South Africa survives concerns about keeping the public sector honest and efficient. If we are to make fiscal policy work better, we need not be troubled too much by these objections. We may then ask: how can the process of making fiscal policy be made more resistant to political manipulation?

Beyond Politics: How to Improve Fiscal Policy by Changing How It's Made

In Chile since 2002, the government's fiscal stance has been determined by rules that enshrine, among other things, increased spending when output slumps and austerity during booms (Frankel, 2011). Overseeing the implementation of this rule is a collection of authorities on fiscal policy (Du Plessis and Boshoff, 2007, p. 21), whose main duty is to calculate the 'output gap', that is, how far GDP is above or below its estimated long-term trend value. The creation of this committee on fiscal policy was motivated by the well-known problems that commodity-exporting countries have with sticking to countercyclical fiscal policy (in general, most such countries tend not to save enough of the surplus revenue generated for the proverbial rainy season) (Frankel, 2011, p. 8). What I propose is a similar system for another net exporter of commodities: South Africa. Delegating some of the responsibilities of government to less politically motivated experts has the potential to curb the excesses of government and so make future countercyclical fiscal policy more successful.

Specifically, if the government were to adopt a fiscal rule in the mould of Chile's programme, we would be more likely to avoid the bloat in government consumption that has been present over the past few years. A first step would be the creation of an independent panel on business cycles, as proposed by Du Plessis and Boshoff (2007). The role of this panel would be to calculate when the South African economy enters recessions or expansions, and furthermore to estimate the size of current GDP's deviation from its long-term trend level. Such a panel would therefore allow us to obtain data on the business cycle free from political distortions. As things currently stand, there are strong incentives for government to understate the depth of recessions and overstate the size of expansions (Ibid, 2007:20). This gives government leeway to be less committed to countercyclical measures than might otherwise be optimal in a theoretical sense.

The next necessary step would be the adoption of a fiscal rule that is enforced by the pronouncements of the abovementioned committee, similar to the one adopted in Chile. In that country, the government's overall budget balance each year, holding the state of the business cycle constant (the 'structural' budget balance) must be a surplus equivalent to 1% of GDP (Garcia et al., 2005, p. 3). South Africa could adopt this model, though there is no reason for the 1% figure to be cast in stone: the business cycle committee mentioned above would be tasked with deciding on a figure that is appropriate given South Africa's developmental needs. This rule should exempt public investment expenditure from the limits otherwise placed on debt financing, for reasons that will be given below. However, the budget should be allowed to go into surplus or deficit over the business cycle, while keeping the limit on the structural deficit as a way of preventing deficit spending from persisting after a recession ends. Moreover, within this constraint, the government should still have discretion over the composition of spending and taxes, since this part of fiscal policy is overwhelmingly a question of philosophical value-judgements (Du Plessis and Boshoff, 2007). Most policy priorities should still be subject to democratic control, rather than to the whims of philosopher-kings; nonetheless, experts can be useful in informing the limits of sensible government policy.

In allowing fiscal policy to be partially audited by an external body, a significant part of the problem of political interference with the policymaking process would be solved. Politicians' ability to trade favours with public sector unions would be diminished, since they would be able to credibly point out that their hands are tied so far as discretionary spending is concerned. The exemption of investment from the constraint on the structural budget balance would have the likely effect of those in government redirecting their expenditure efforts to relatively less constrained investment, thereby increasing the level of government investment relative to the public sector wage bill (Mintz and Smart, 2006). So the adoption of well-defined constraints for government spending can be used to redirect spending towards more productive uses and curb political interference, while remaining neutral on trickier trade-offs that stray into issues of fairness, desert, and redistribution.

Conclusion

The wasteful and ineffective parts of current fiscal policy in South Africa are not inevitable. Self-interested politicians are using public expenditure as a bargaining chip in their dealings with public-sector unions, reflected in the public-sector wage bloat in the wake of the global recession. The South African government would be well advised to concede some of its power to make fiscal policy to an impartial, external panel of experts: as in Chile, it allows the government to make a credible commitment to less political distortion of its priorities. Africa's fiscal authorities can be made more likely to promote the common good by giving them fewer options. The missed opportunities of the most recent round of fiscal stimulus have indicated what there is to be gained from exercising that much-needed restraint.

Otherwise, political bargaining within the ruling alliance will continue to adversely affect the implementation of fiscal policy in 2012 and beyond.

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