

# *Disciplined Fiscal Policy: Does such exist in South Africa? Why not and what can be done?*

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**Word count: 3733 (Excl. references)**

## **1. INTRODUCTION**

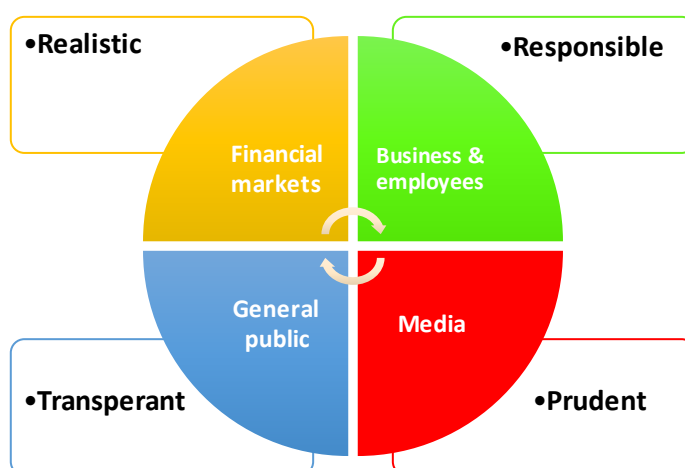
The 2008 Global Financial Crisis (GFC) left the majority of nations (e.g. United Kingdom, United States, South Africa) in miserable financial and economic shape (Blinder, 2014). Although progress has been made, their development routes are still faced with a plethora of bottlenecks that impede growth. Because of this, the co-ordination between monetary policy and fiscal policy has gained popularity, as they have the potential to address some of the overarching issues created by the 2008 GFC. Even worse, the global economy has become somewhat complex, requiring nations to make tough political choices that would ensure fiscal sustainability while taking government debt into account. This process or idea is known as fiscal credibility, often called disciplined fiscal policy. Like trust, fiscal credibility is hard to build, easy to lose and once lost, quite impossible to regain (Clark, 2011). It thus becomes necessary for policy makers to formulate and implement policies that ensure sustained fiscal discipline.

Against this backdrop, this essay aims to innovatively assess the current stance of fiscal credibility in South Africa (SA) thereby generating robust thoughts as to how it can be strengthened if not restored. The rest of the paper is broken as follows: Section 2 provides a simple framework of fiscal credibility while section 3 offers an overview of trends in fiscal credibility components in relation to SA. Section 4 is a brief discussion of various measures that can be taken by the ministry of finance to restore fiscal credibility in SA. Section 5 details the effects of fiscal credibility on monetary policy and the economy at large while Section 6 concludes the essay.

## 2. A SIMPLIFIED FRAMEWORK OF DISCIPLINED FISCAL POLICY

This section provides a simple framework of credible fiscal policy. The framework in figure 1 is in the form of values and role players involved in credible fiscal policy. Firstly, the figure illustrates that the government should consult financial markets as they possess information necessary to make informed decisions when borrowing. Because governments often run deficits, information on the cost of borrowing either internally or externally becomes of paramount importance (Schick, 2003). Secondly, it is illustrated in figure 1 that taxes are charged and collected from employees and businesses. Following this, it becomes necessary for both employees and businesses to be consulted as they influence economic activity.

**Figure 1: Values and Role players involved in credible fiscal policy**



**Source: Clark (2011)**

Even more, figure 1 captures public opinion (media), as it can translate into political instability as well as economic uncertainty, consequently declines in investor confidence. Governments therefore should seek approval from the media because the media is crucial in shaping public opinion. Lastly, it is illustrated in figure 1 that elected bodies and the general public must be consulted. The government must carefully explain why action is necessary, the nature of the actions being considered, and how such actions affect them. “Furthermore, the public must be convinced that actions are necessary, that they are equitable and that they will lead to long-term benefits, even though there may be short-term pain” (Clark, 2011: 3). Now that the parties have been identified, a probing question would be “what do these parties consider (criteria) in concluding that fiscal policy is

credible”? Although economic wisdom relies heavily on assumptions, the real world is based on reality. Thus, fiscal policy should be realistic and achievable. A realistic fiscal policy is one that is accommodative, balanced, sustainable and achievable (Schick, 2003). Moreover, it should be able to accommodate as well as address real world issues using both short-run and long-run tools. Secondly, fiscal policy must be responsible, in that, the government should be dedicated towards the establishment and maintenance of sustainable medium term or long term fiscal framework (Pakkies, 2016).

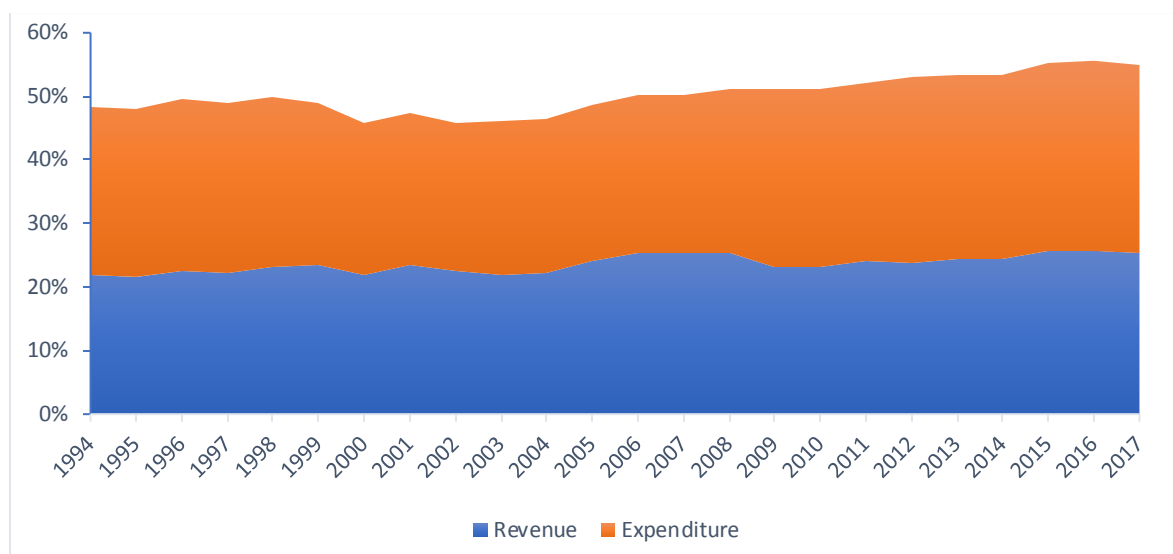
In addition, the implementation of macroeconomic policies that yield constant if not increasing returns should be at the forefront. Thirdly, for fiscal policy to be credible it must be prudent by allowing a reasonable amount of insurance to hedge against economic defaults and forecasting errors (National Treasury Policy Document, 2011). Lastly, because of the role and involvement of key groups, fiscal policy should be transparent. The general public needs to know what the government intends to do, how they intend to do it and how this will affect their overall wellbeing.

### **3. TRENDS IN FISCAL CREDIBILITY COMPONENTS**

In simple terms, fiscal policy involves decisions about government spending and revenue. Hence, this section highlights trends in government spending and revenue. It is worth noting that government spending in general is often more than revenue, and because of this, governments incur deficits and are thus forced to borrow either domestically or abroad. Trends in government debt are thus included in this discussion.

#### **3.1. Revenue and Expenditure**

Figure 2 below illustrates trends in government revenue and expenditure in SA. Unfortunately, the revenue gap in SA for the 2017 fiscal year amounted to R48, 2 billion, higher than the 2016 revenue shortfall of R30, 8 billion (Budget Review, 2018). Several issues owing to tax under collections have been identified, which include, but not limited to: tax evasion and avoidance in response to tax hikes, corruption, estimation errors and efficiency challenges in the tax administration (Khumalo, 2017). Even more, citizens see no importance of paying tax in a country faced by extreme corruption and poor service delivery. SA's tax morality remains questioned and this threatens the future of tax collections (Marelize, 2018).

**Figure 2: Revenue and Expenditure trends (%GDP)**

**Source: South African Reserve Bank (SARB) Database (2018)**

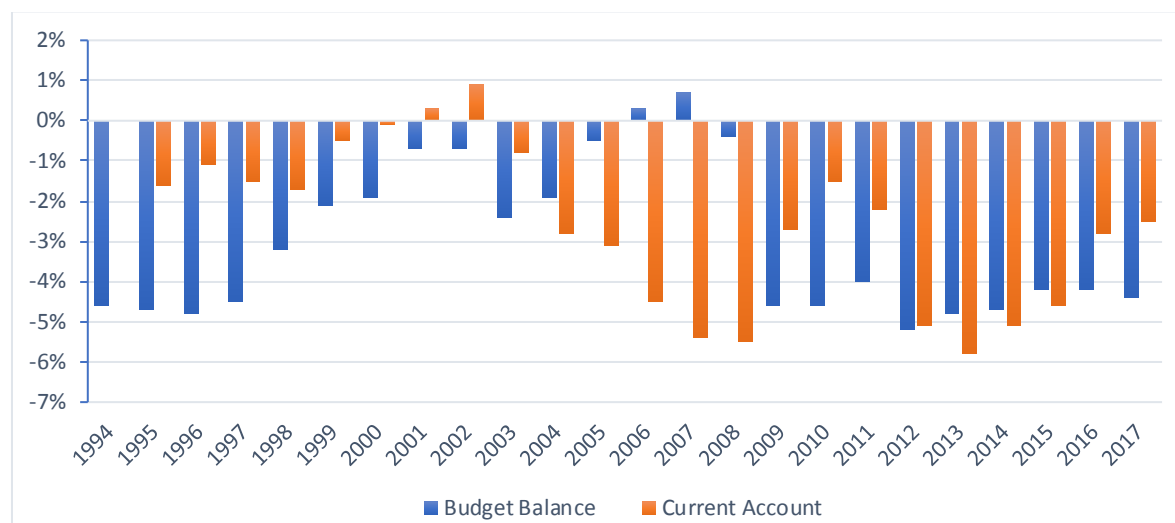
From figure 2 above, it is undoubtedly clear that expenditures have been in excess of revenues. That is, the government is spending more than what it generates and this is likely to result in budget deficits. Even worse, expenditures seem to be on the rise while revenues are declining, exacerbating the budget deficit. For example, the public-sector wage bill as a percentage of total government spending rose from 32.9% in 2016 to 35% in 2017 (Mahlakoana, 2018). In addition, real per capita spending has tripled from R1, 703 to R7, 959 between 1960 and 2007 (Alm and Embaye, 2011). During the same period, real per capita Gross Domestic Product (GDP) rose from R15, 938 to R25, 414. Notably, the South African Revenue Services (SARS) has implemented tax awareness campaigns in hopes of restoring tax morality and compliance (SARS, 2018). Given such efforts, tax administration costs and revenue gaps are expected to fall.

### **3.2. Budget and Trade Balances**

Figure 3 illustrates trends in budget and current account balances in SA. It is apparent from figure 3 that the government has been incurring budget and current account deficits post-apartheid era and even after two decades, much of these remains in place. However, the government took several measures in the 2018 budget to narrow the budget shortfall, which included a mixture of tax proposals and expenditure cuts. These measures are an epitome of fiscal credibility as they involve tough decision making in an overheated economy. Nonetheless, figure 3 shows that the budget deficit as a ratio of GDP narrowed

from -4.6% in 1994 to -0.4% in 2008 (Budget Review, 2018). Unfortunately, due to the short recession in 2009, the budget deficit made a downturn, hitting a record high of -4.8% in 2013 (Department of Information and Research (DIR) Report, 2017). Nonetheless, the budget deficit is projected to narrow down to -3.8% in 2018/19 due to renewed focus (Fin24 Newsletter, 2018).

**Figure 3: Budgetary and Current Account trends (%GDP)**



**Source: SARB Database (2018)**

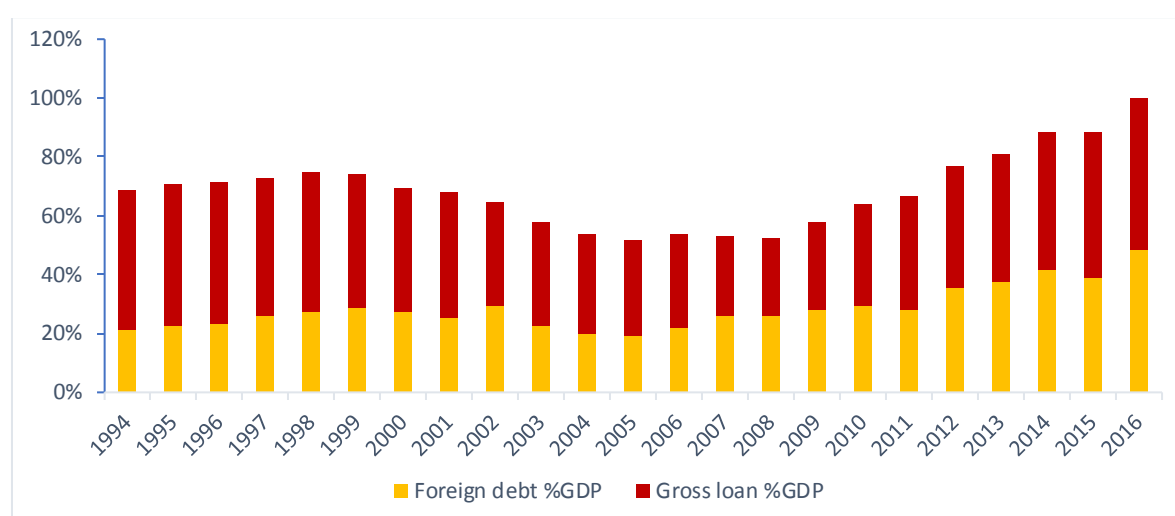
As can be seen in figure 3, the current account balance has been negative for most years. By 2014, the current account deficit as a ratio of GDP reached -5.8%, before improving to -2.5% in 2017 (SARB Quarterly Bulletin, 2018). These improvements are a result of rising commodity prices, enhancements in agricultural productivity and various trade agreements sealed by the government. Although SA incurred a trade surplus in the second quarter of 2017, the surplus was outweighed by the widening shortfall of the service, income and current transfer account (SARB Quarterly Bulletin, 2017). In addition, primary goods prices remain relatively low to manufactured goods prices and because a huge proportion of SA exports are primary goods, this has adversely affected the trade balance, consequently the current account.

### **3.3. National Government Debt**

It has been a decade since the occurrence of the 2008 GFC yet, even today, nations are still grappling with the bottlenecks created by the financial turmoil. Apart from shrinking growth, raising poverty and unemployment rates, the 2008 GFC brought about large government debt positions that are more harmful than crowding out (Mhlaba and Phiri,

2017). To foster development projects and spur growth, governments had no choice but to borrow extensively from international financial institutions such as the World Bank (WB) and International Monetary Fund (IMF). SA in particular, has relied heavily on borrowing to finance its projects and revenue shortfalls. Debt repayments on the one hand, have been constrained and threatened by widening revenue gaps and budget deficits (Baaziz, Guesmi and Hellen, 2015). Debt is detrimental to growth because money that could have been used to finance domestic projects is consumed by debt service costs (Eberhardt, 2015). Figure 4 below illustrates trends in government debt.

**Figure 4: Government debt trends in SA**



**Source: SARB Database (2018)**

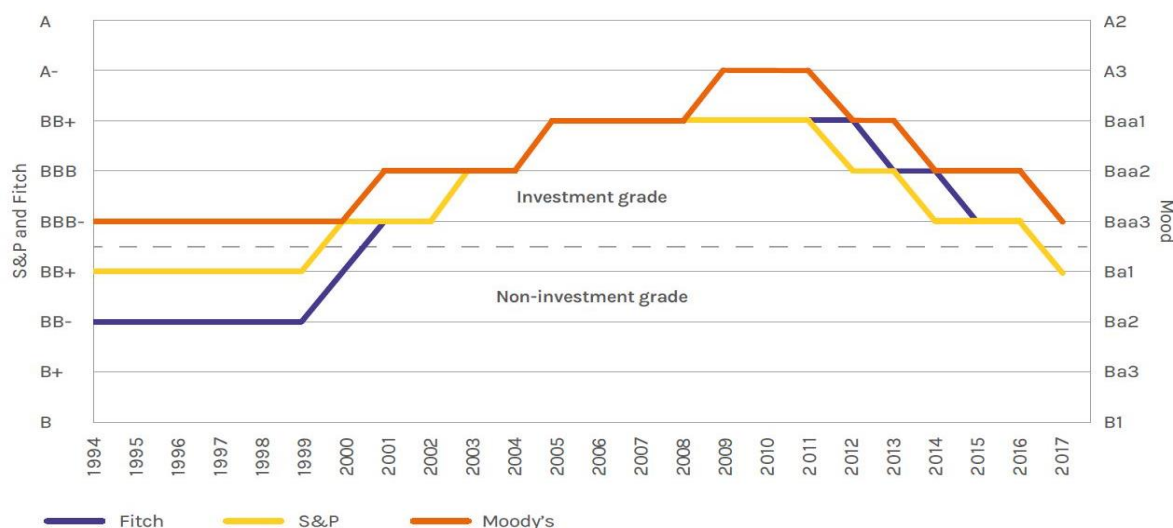
From figure 4, it is clear given the upward trend that the government has been borrowing extensively from international financial institutions. Debt to GDP, post-apartheid and pre-financial crisis, stabilised gradually, hitting a record low of 27.1% in 2008 (DIR Report, 2017). However, this came to an end when the financial sector collapsed following the fall of Lehman Brothers (Srivastava, 2016). To this end, Debt to GDP has been on the rise, hitting a record high of 53% in 2017 (SARB Quarterly Bulletin, 2017). A logical explanation to this is that: the government took numerous steps to shield and spur economic activity following the 2008 GFC and 2009 recession. Borrowing from international institutions was one of the steps that had to be taken.

### **3.4. Credit Ratings**

Figure 5 below shows SA's credit rating history as rated by globally recognised rating agencies such as Fitch, Moody's and Standard & Poor (S&P). SA has been downgraded

numerous times to “junk” status by Fitch and S&P (Donnelly, 2016). “The downgrading of the country’s international credit rating to junk status has profound long term economic and political effects” (Heystek, 2017:1). The aftermath of a downgrade includes: exchange rate depreciation, high inflation, capital flight, increased public borrowing costs and high interest rates, consequently, economic downfall (Donnelly, 2016). In addition, a downgrade results in policy shifts, which may undermine fiscal and economic growth. As apparent from figure 5, the year 2017 marked SA’s major downgrade by two of the three global rating agencies, Fitch and S&P, to the sub-investment grade of BB- on political and institutional uncertainty (PSG Wealth Report, 2017).

**Figure 5: South African Sovereign Bond Credit Ratings**



**Source: J.C. Rathbone Associates Ltd White Paper (2017)**

A major consequence of the 2017 downgrade was the decline in bond prices which resulted in higher interest rates given the inverse relationship between bond yields and prices (J.C. Rathbone Associates Ltd White Paper, 2017). Following the 2017 announcement, the R186 10-year government bond surged by 5 basis points (Stafford, 2017). As bond yields surge, public borrowing costs rise. The rise in borrowing costs has serious implications on infrastructure and other development projects. These events adversely affect fiscal credibility through sudden policy changes.

#### **4. MEASURES FOR RESTORING FISCAL CREDIBILITY**

The primary objective of this essay is to devise strategies that government can execute to restore fiscal credibility and such strategies are explained below in detail.

#### **4.1. Resolving State-Owned Enterprises Crisis**

From an economics point of view, it's clear that State-Owned-Enterprises (SOEs) are caught up in a pickle. SOEs used to be drivers of growth in the public sector until they befriended bailouts, costing the Treasury significant amounts (Zietsman, 2016). It is worth noting however, that it all starts with governance. Much of the difference between successful and failed SOEs lies in poor or incompetent governance. To move towards a more successful public sector, good governance needs to be in place. In addition, financial reforms in the form of auditing of SOEs statements and operations by both internal and external auditors (to avoid biasness) should take place. Hence, good governance and financial audit are re-requisites for the success level of SOEs in SA (Smith and Osborne, 2018). If such is achieved, potential investors and the general public will gain trust in the government's policies, fiscal policy being one of them.

#### **4.2. Reducing Political and Policy Uncertainty**

Political and policy uncertainty weaken the exchange rate and drive away potential investors (Heystek, 2017). Lack of potential investors is associated with few business start-ups and expansions, few jobs created and, consequently poverty. When citizens are unemployed and nutritionally deprived, they lose hope in the government. In extreme cases, some engage in criminal activities which further drives away potential investors. To avoid policy uncertainty, the government should inform the public in time about its plans and goals, how it plans to execute them and how this will impact on the economy. However, informing the public about plans and goals is necessary but not sufficient to gain trust.

For the public to believe in the government and its plans, the government should stick to its plans and only plans that are aimed at improving the overall wellbeing of citizens. In addition, information on government operations needs to be readily and easily available and accessible to the public. There should be a fair play in politics and everyone should be treated and given equal opportunities to avoid political instability. A favourable economic climate that is embodied with optimism towards the implementation and achievement of government policies and goals is necessary for attracting private investment (Bhatti, Ali, Nasir and Iqbal, 2008).



#### **4.3. Strengthening Policy Coordination**

“Macroeconomic policy plays a crucial role in providing sustainable and credible economic stability, thus creating the environment for rapid economic growth” (Rakic and Radenovic, 2013: 103). Because both monetary and fiscal policies are aimed at achieving key macroeconomic objectives, coordination between the two policies becomes necessary to avoid conflicts. For example, during periods of high inflation (above 6%), a mixture of interest rate hikes (by monetary authorities) and tax cuts (by ministry of finance) would have a lesser effect in curbing inflation. Hence, the monetary authorities’ goal of curbing inflation would be undermined by the actions of the ministry of finance. Notably, the relationship between monetary and fiscal policies lies in budget deficits and debt accumulation. Thus, it becomes necessary for monetary and fiscal authorities to communicate their actions to each other. The policy coordination has to be supported by concrete institutional and operating arrangements like monetary and fiscal coordination board (Hanif and Arby, 2014). Similar to Monetary Policy Committee (MPC) meetings, such a coordination board could meet on a semi-annual basis to discuss the targets and actions of each. This would benefit fiscal credibility by sending correct signals to the general public.

#### **4.4. Subduing Corruption**

Thriftless public expenditure and lower state revenue collection result in excessive fiscal deficits and considerable debt accumulation (Kaufman, 2010; Madlopha, 2018). This is extremely prevalent in SA where levels of corruption are very high, resulting in concurrent budget and trade deficits. The fiscal and economic costs of corruption (i.e. lower investment rates, poor services delivery, tax under collection etc), as stressed by various academics (i.e. Madlopha and Masuku, 2018) through the Nedbank and Old Mutual Budget Speech Competition, cannot at any stage, be undermined. This has demoralised not only the ordinary public servants but the general public at large. Thus, to fight corruption and improve the fiscal stance of the public sector, law enforcement coupled with penalties and fiscal decentralization should take place (Masuku, 2018). In addition, the government should work on reducing fruitless and wasteful expenditure, thereby redirecting the funds towards projects that will bring meaningful change to society. This will restore hope; stabilise the fiscus, thereby making the government credible.

#### **4.5. Improving Efficiency of the Tax System**

Apart from raising taxes, which often hurt the poor and de-incentivise the labour force, the government can focus on improving its tax collection mechanisms as tax administration costs remain high. Seemingly, certain individuals are insufficiently educated and thus lack understanding of tax regulations and often make unintentional mistakes in compliance process (Tax Administration, 2015). Thus, the government should put forward programmes that are aimed at promoting tax literacy amongst less educated citizens. Another probing question is: Which benefits do tax payers derive from paying tax in a country faced by poor service delivery and extreme corruption? Addressing issues of corruption and poor service delivery thus becomes necessary to serve an impetus for tax payers to settle their taxes. In addition, tax payers need to be constantly reminded and convinced that paying tax benefits the whole society, more especially in redistributing income. As more citizens voluntarily settle their taxes, tax administration costs arising from audit and enforced collection fall. Consequently, revenue gaps will decrease and budget deficits will remain reasonably lower. Lower budget deficits imply less borrowing by the government, which translate into credible fiscal policy through signalling.

#### **4.6. Stabilising Government Debt**

Through the introduction of expenditure ceilings and tax hikes, the government will somehow manage to stabilise debt to 56.2% of GDP in 2022 (Budget review, 2018). Furthermore, the proposed tax reforms of raising Value Added Tax (VAT) by one percentage points will generate additional revenues for government, thereby reducing the revenue shortfall, consequently the budget deficit. As the fiscal balance improves, people's trust in government will rise. As the former Minister of Finance (Malusi Gigaba) stated in the 2018 Budget, to stabilise debt even further, the government should be aimed at promoting higher GDP growth, a narrower deficit, a stronger currency and lower borrowing rates (Budget Review, 2018). A stronger currency requires political stability while a narrower deficit entails fiscal consolidation. Fiscal consolidation hurts the economy in the short run but is necessary to maintain an investment grade credit rating (Mohr, 2017). In addition, the government should adopt more hands on approaches to debt management, thereby devising an optimal debt management strategy. Through these measures, government debt will stabilise, leading to a more positive outlook.

#### **4.7. Enhancing the Accuracy of Fiscal Projections**

“The accuracy and impartiality of the forecasts used to set the annual national budget have important implications for the credibility of a country’s fiscal policy” (Calitz, Siebrits and Stuart, 2016: 1). Notably, forecasting imprecisions have two adverse effects: firstly, they undermine government credibility, thereby reducing the effectiveness of fiscal policy. Secondly, manifestations of “budgetary opacity” are a result of imprecisions in fiscal forecasting. SA, like many other countries, has been faced with problems of forecasting errors or missing targets. For example, SA’s economy has been growing far slower than Treasury projections. In 2012, Treasury forecasted real GDP growth for the 2014 fiscal year to be 4.25% (National Treasury, 2014). However, a year later this forecast was revised to 3.5%. Moreover, in the 2014 Budget it predicted it would be 2.7%. Surprisingly, the actual figure for real GDP growth for 2014 was 1.5% (Kahn, 2017).

Issues of forecasting imprecisions can be linked to fiscal problems such as persistent deficits and excessive debt burdens due to revenue shortfalls. To address issues of forecasting, the government should consider the international approach of introducing fiscal councils and flexible fiscal rules (Calitz *et al*, 2016). In addition, the government and fiscal councils should focus more on addressing the root causes, which include, amongst others, unrealistic assumptions in forecasting and unforeseen events such as protests and political tensions. Forecasting methods should be reviewed to identify methods that are most accurate. Even more, the coordination between Treasury forecasts and independent institutions forecasts should not be undermined.

#### **5. THE EFFECTS OF RENEWED FISCAL CREDIBILITY ON MONETARY POLICY AND THE ECONOMY**

Fiscal credibility remains of paramount importance as it affects monetary policy conduct and the economy in numerous ways. For example, it affects monetary policy conduct through the price stabilization in the inflation targeting framework (Kuncoro, 2015). This can happen either through the aggregate demand channel or indirect taxes. Notably, inflation expectations are also induced by agents’ expectations of public debt (Montes, Oliveira and Nicolay, 2017). Interestingly, several studies (i.e. Mendonça and Auel, 2016) found that high credibility has the potential to enhance public debt management. Even more, other studies

(i.e. Silva and Mendonça, 2016) have empirically investigated the relationship between fiscal credibility and inflation. Surprisingly, they found that the fiscal balance matters for the success of inflation targeting. The fiscal balance puts pressure on inflation due to the risk of using expansionary monetary policy to finance the public debt. Nonetheless, the measures proposed in this essay, such as stabilising government debt and improving efficiency of the tax system, will benefit inflation targeting through price stabilization. Even more, subdued corruption and proper functioning of SOEs will benefit job creation and growth since funds that were consumed by corruption and SOEs bailouts will now be channelled towards development projects. Reductions in political and policy uncertainty will benefit the economy through openness to trade and attracting private investment. Eminently, endeavours of the new African National Congress (ANC) pioneers to root out corruption and lift the weakened economy may mean the country can divert future downgrades (Monteiro and Amin, 2018).

## **6. CONCLUSION**

In conclusion, the primary objective of this essay was to formulate measures that can strengthen if not restore fiscal credibility in SA. Some of the factors hindering fiscal credibility, which include, amongst others: poor performance of SOEs, policy and political uncertainty, revenue under collection and fiscal projection errors, have been identified and thoroughly discussed. The proposed measures, which include, but not limited to: resolving SOEs crisis through good governance and financial practices, stabilising debt through hands on approaches, enhancing efficiency of the tax system, minimising political and policy uncertainty and better policy coordination, have the potential to restore fiscal credibility in SA. However, the successful implementation of these measures depends on the willingness and commitments by government. As Blanchard (2009: 632) states, “the efficacy of policy is linked to its credibility, that is, the degree to which people and markets believe that a policy announcement will actually be implemented and followed through”.

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