SA-TIED
Southern Africa – Towards Inclusive Economic Development

Fiscal sustainability in South Africa
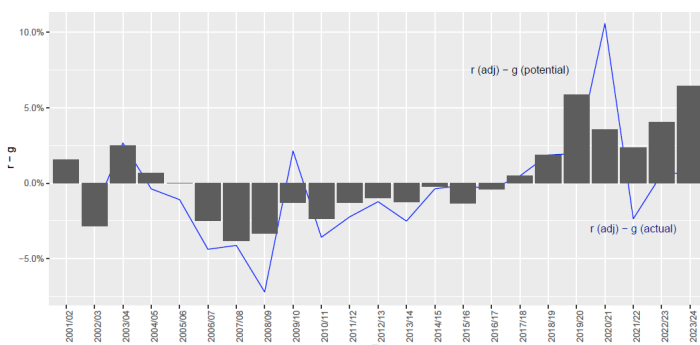## – what to do when fiscal space and economic growth are low

South Africa runs a large, persistent primary fiscal deficit and the interest rate on government debt, *r*, is greater than the economic growth rate, *g* (see Figure 1). Mathematically, these conditions mean sovereign debt accumulates without limit. The typical preferred policy approach would be to grow out of the problem. In South Africa, however, the slow pace of economic reforms means that there is a limit on how fast the economy can grow. As such, there are no simple solutions to closing the primary budget deficit and stabilizing debt.

This paper complements and extends a series of papers that evaluate fiscal policy options in the recent South African context. This literature indicates that neither tax increases nor a debt-financed stimulus are likely to deliver the desired outcomes — in part, because of the saturation of the tax base and the lack of credibility to effectively implement fiscal programmes to stimulate growth. For these reasons, the contribution of this research is to propose an 'optimal' fiscal consolidation strategy, through expenditure rules, that has the least impact on economic growth and households.

We use a medium-sized dynamic stochastic general equilibrium model (DSGE) with two policymakers:

1. The first is the fiscal authority which has two discretionary instruments at its disposal to achieve its debt stabilization objective: government consumption expenditure, and government investment expenditure.

FINDINGS

A saturated tax base and a lack of credible commitment means that neither tax increases nor a debt-financed fiscal stimulus are likely to deliver a sustainable fiscal consolidation in South Africa

This research proposes an 'optimal' fiscal consolidation strategy, through consumption and investment expenditure rules, that has the least impact on economic growth and households

Reducing government consumption spending is found to bring the least painful fiscal adjustment

Increasing government investment spending will support an improvement in the fiscal position by being growth-enhancing — especially if targeted toward constraints such as electricity supply

Coordination with monetary policy is not necessary for our 'optimal' fiscal consolidation strategy

2. The second policymaker is the monetary authority, which adjusts the short-term interest rate to target an inflation rate. This allows us to study the interactions between fiscal and monetary policy during a fiscal consolidation.

The political geography of the continent and the tendency of the industry to cluster in a few locations, which in turn develop key agglomeration advantages, mean that many smaller countries would miss out on attracting investments. It will, therefore, be difficult for the automotive sector to drive regional integration independent of a broader integration process that develops RVCs in a range of sectors within the context of a larger common market.

In our model, the policy options are evaluated using historical data, policy reaction functions, and counterfactual analysis with optimal simple rules. Our contribution is to explicitly model the welfare costs of different policy instruments and targets within a loss function to obtain the optimal fiscal policy response in a low-growth and unsustainable debt enviornment.

Figure 1: Interest rate minus economic growth (r - g) using actual and potential growth, 2001/02-2023/24

Note: Figure 1 presents estimates of *r - g* using the adjusted nominal borrowing cost of existing debt (see Appendix A.1 in the main paper for details about the calculation of r^{adj}) and two estimates of *g* (a long-run 'potential' measure from Fedderke and Mengisteab (2017) and the actual annual growth rates). Using the actual growth rate of *g* in 2021/22 and 2022/23 leads to *r < g*, but these are one-off changes to a post-COVID economic recovery and terms of trade shock. The 'potential' or 'trend' growth rate (a measure of the long-run growth capacity of the economy) is more appropriate for long-run fiscal analysis. Source: authors' compilation based on National Treasury data.

Reducing government consumption spending is found to bring the least painful fiscal adjustment — welfare is reduced less compared to other options. The demand implications of a consumption-led fiscal consolidation are offset by lower interest rates. These lower interest rates are as a result of two effects:

1. The fiscal consolidation reduces the risk of a fiscal crisis, and so reduces the sovereign risk premium. This also reduces borrowing costs for the private sector, stimulating investment.

2. The reduction in government spending is deflationary, allowing the South African Reserve Bank space to reduce the policy rate.

This (endogenous) monetary policy response counteracts the negative demand impact of fiscal policy, leaving economic growth (g) almost unaffected and even somewhat improved. With both long-term and short-term rates reduced, the interest rate on government debt (r) adjusts downwards. R thus moves closer to g, and if the approach is pursued in a time-consistent manner, eventually $r < g$ and fiscal sustainability is restored. The effect is likely to be self-reinforcing, in that the reduction in the risk-premium will reduce debt-service costs at the margin, further reducing government spending. In light of these findings, the current fiscal consolidation path to reduce government wages in real terms will restore fiscal sustainability with the least welfare cost.

In contrast, a large reduction in government investment spending reduces aggregate supply. That is, g is reduced taking it further from r and worsening the fiscal position. Indeed, a strategy to reduce government consumption spending and increase government investment spending will support an improvement in the fiscal position by being growth-enhancing. In particular, if this investment spending is focused on the binding constraint — electricity — then growth is likely to rise quite significantly.

There are complementary measures that will assist the consolidation. These include adjusting the national borrowing profile. South Africa has over time extended the average maturity on debt and issued heavily to ensure healthy cash buffers. This action has largely been taken to spread rollover risk. A credible fiscal consolidation strategy would allow for a complementary reduction in average maturities

and precautionary cash holdings, which will support lower rates. In other words, there is an interlinked relationship between fiscal credibility and fiscal outcomes — weak fiscal credibility raises the sovereign risk premium, which, in turn, leads to higher interest costs and worse fiscal outcomes.

We argue that fiscal credibility may partially be restored through adopting a stricter rule (see Figure 2). The current fiscal rule (a nominal non-interest expenditure ceiling) has proven insufficient. A common international approach is to use a real expenditure rule as the fiscal instrument to meet a fiscal target of a stable debt-to-GDP ratio. We show that the Treasury is unlikely to achieve a debt-stablizing fiscal balance within the medium-term expenditure framework. A more realistic and credible instrument would thus be to map a path for real government consumption spending. We also propose simple measures to protect service delivery, particularly expanding existing conditional grants to health and education, while reducing other intergovernmental transfers.

Figure 2: Government Debt
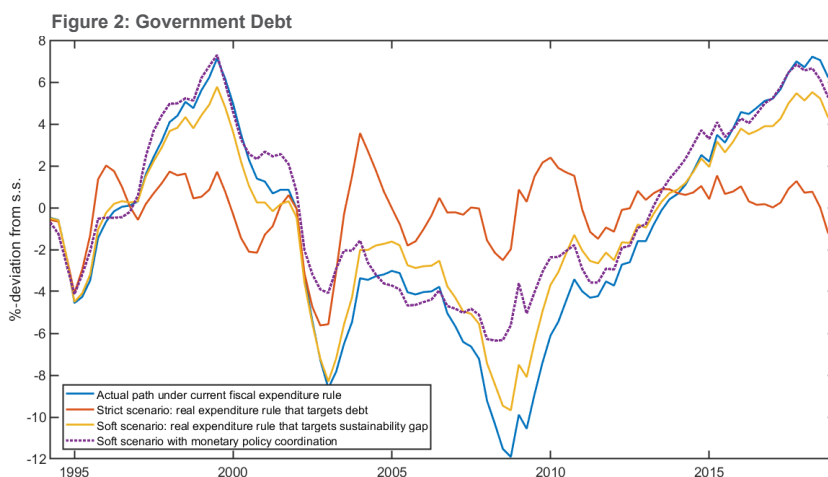
Note: Figure 2 shows actual versus counterfactual paths of government debt, measured as percentage deviations from trend (the steady state). Here, we can observe how the strict fiscal rule (orange line) stabilizes debt significantly more than the soft scenario (yellow line), even under policy coordination (purple dash line). The 'right' approach for fiscal authorities would be to consider a target for fiscal sustainability between these extremes.

IMPLICATIONS

In light of these findings, the current fiscal consolidation path to reduce government wages in real terms will restore fiscal sustainability with the least welfare cost

We discuss complementary measures that will assist the consolidation, such as adjusting the national borrowing profile and proposing simple measures to protect service delivery

The current fiscal rule (a nominal non-interest expenditure ceiling) has proven insufficient

A more realistic and credible instrument to achieve a debt-stablizing fiscal balance, within the medium-term expenditure framework, would be a stricter rule for real government consumption spending