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Op-ed

Contractionary fiscal consolidation versus expansionary stimulus
Implications for growth, employment and debt
By Daryl Swanepoel

The South African economy is in a precarious position, which, simply put, threatens its ability to provide the necessary growth required to fund the economic and social needs of the country. This, in turn, is crucial to provide social justice, stability and cohesion.

Treasury's chosen fiscal course is one of fiscal consolidation, aimed at reducing, what they have identified as too high a debt burden for the state coffers to finance. And of course, there is truth in this. But with fiscal consolidation comes a cutting of public services, and infrastructure development. And if there is minimal infrastructure development, the economy will not expand.

For example, the mining industry have a market for, and are capable of producing, at least 20 percent more ore than what they are currently exporting. But they cannot get it onto the ships because of the collapsing rail networks and inadequate port facilities. In similar vein the agricultural sector can export some 7,5% more produce, but insufficient cold storage facilities at the ports negate this opportunity. Economic infrastructure refurbishment and expansion is necessary to grow the export market, associated jobs and improve the countries balance of payment. Not to mention the concomitant increase in tax revenue.

Therefore, the question needs to be asked: Is fiscal consolidation the right path for the current economic environment we find ourselves in. The answer: Yes and no. In reaching this conclusion we need to weigh up the two approaches to debt.

Austerity is a form of voluntary deflation in which the economy adjusts through the reduction of wages, prices, and public spending to restore competitiveness, which is (supposedly) best achieved by cutting the state's budget, debts, and deficits. Its adherents believe that it will inspire business confidence since the government will either be crowding-out the market for investment by amassing available capital through the issuance of debt, or adding to the nation's already considerable debt that they regard as too large and unsustainable in the long term.

Other economists suggest that evidence and results from the 1939 Great Depression and the 2008 great financial crisis demonstrate that fiscal stimulus is the most effective way of cutting deficits, to resist recession and to combine deficit reduction with rapid growth. In addressing the economic woes of 1939, President Roosevelt said that "as desirable as a balanced budget might be, the needs of recovery come first". Similarly, from the mid-1940s to the mid-1960s the public debt to GDP ratio was considerably larger in Britain than it has been at any since the 2008 financial crisis, with high growth rates. Britain was also establishing its welfare state at the time, developing a foothold for the welfare

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state in Europe, and then globally. Its debt to GDP ratio in 1948 was more than 200 per cent, more than double what it has been over the last two decades.

There is a general prevailing narrative that South Africa's debt ratio to GDP is too high. It currently stands at 70.1%. By international standards the average South Africa's debt level is not particularly onerous. The other plus in the case of South Africa is that most of our debt is rand-denominated; which shields government from some volatility in debt costs due to fluctuations in the exchange rate. The world average is 97%; advanced economies 120%, emerging markets 66%, upper income higher than 66%, Asia 73% and Latin America 72%. But the interest rate on our debt is high, at eight to nine percent.

By comparison, developing countries' average debt cost on external borrowing is three times higher than that of developed countries. In the low interest environment of the last decade, developed countries borrowed at an interest cost of an average of one percent. This article acknowledges that the interest differentiation does confine the extent to which South Africa can extend its public debt, but there is scope.

The appropriate policy mixes, contextual to our situation, should be implemented so that our economic turnaround can occur in the short term and be sustainable. This article argues for less severe budget cuts within a more gradual, realistic, less procyclical framework and more longer-term fiscal recalibration than the current Treasury one, which is too ambitious in its outlook. Given the current dismal global economic scenario (likely to continue into the medium term), fiscal consolidation is not economically and politically attainable in a low growth, high interest rate, higher inflation environment.

A more realistic fiscal approach should result in a more gradual rise in the primary surplus in the years ahead, rather than a short, sharp shock approach that will dump the economy into a recession with all it negative attributes.

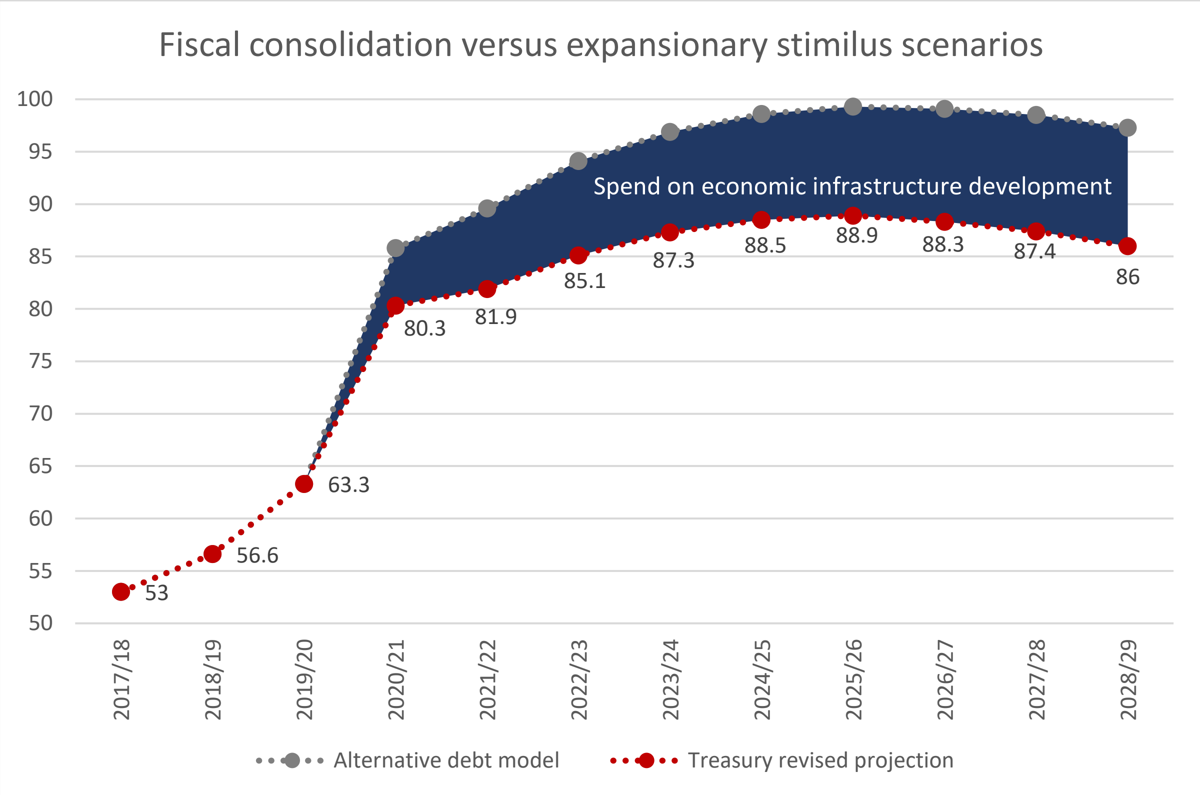
Fiscal consolidation has costs attached to it, such as a reduction in government personnel, less funds for public services and infrastructure maintenance and development. A recent Financial Times editorial captured the sentiment by suggesting that "Rigidly sticking to fiscal orthodoxies in a crisis is not always wise, as much as it needs to be balanced with boldness". So, on the no side of the answer, it is argued that fiscal consolidation will stifle longer-term economic growth.

However, and crucially important, this expanded fiscal space generated by less severe budget cuts, must be spent on economic infrastructure development and job enhancing projects and programmes and not on consumption. It would not be wise to crowd out spending on infrastructure that is needed to underpin the productive sectors of the economy. Economic infrastructure development will undoubtedly lead to higher economic growth and a bigger market, with an accompanying increase in tax revenues and more social and political stability; a win-win situation in South Africa.

Whereas Treasury envisages public debt to peak at around 89% in 2025/26, by being slightly more flexible by allowing an incremental rise, it will free up considerable fiscal space to fund economic infrastructure development. This is also motivated by the critique of a group of economists from Amherst-Massachusetts who disproved the Carmen Reinhart and Kenneth Rogoff paper *Growth in time of Debt,* which was seized upon by many finance ministers in the developed world to justify spending cuts and sharply lowering government debt. They established that "policy makers cannot defend austerity measures on the grounds that public debt levels greater than 90% of GDP will consistently produce sharp declines in economic growth".

On the yes side of the answer: Wasteful expenditure and unnecessary perks should be ruthlessly erased from budgets; SOEs should be radically restructured and better governed, underpinned by the necessary structural reforms of our economy. There are enough areas to cut in government spending with the amount of waste and inefficiencies that is prevalent.

In short, it is about understanding that there is both good and bad debt. Bad debt is consumption debt, it does not spur economic expansion to the same extent as investment debt (good debt). This article concludes that the twin reforms of austerity related to consumption spending and debt expansion to accelerate economic infrastructure development will enable both growth and future tax revenue enlargement that is capable of servicing the newly acquired debt and future public spending expansion.



Source: Treasury projection: http://www.treasury.gov.za/documents/national%20budget/2021/review/FullBR.pdf (grey line); illustrative alternative debt model : Inclusive Society Institute (red line)

Daryl Swanepoel is the Chief Executive Officer of the Inclusive Society Institute. This article draws from the Institute's soon to be published occasional paper 'Contractionary fiscal consolidation versus expansionary fiscal stimulus in the context of the South Africa budget'.