PBO Written response to the joint meeting of the Finance and Appropriations Committees

Questions on the risk premium, cost of financing and debt

The PBO is engaged in ongoing research work on sovereign government debt and will furnish the committee with a brief once it is finalised.

Question 16: The private sector's contribution to GDP has been omitted. The PBO is lamenting support to big corporations, however, nothing has been mentioned about SMMEs

Response: The PBO presentation indicated that the structural reforms proposed by the National Treasury cannot transform the economic structure but rather favour dominant large corporations and financial institutions that focus on high short-term returns rather than long-term productive investment, job creation and economic growth. We further indicated that economic growth and fiscal sustainability may be achieved by building the resilience and productivity of households and businesses, particularly small and medium businesses.

Question 17: Provide in greater detail the specific fiscal and financial risks identified in the medium term and what measures or adjustments can be put in place to mitigate these risks?

Response: Annexure A of the MTBPS provides in greater detail the fiscal and financial risks considered by the National Treasury. The PBO is of the view that the budget ought to also respond to other broader social, economic, environmental and political risks. These include the very high levels of unemployment, poverty and inequality, the insufficient resilience of households to respond to social and political instability, climate change events, the lasting effects of COVID-19 and possible future pandemics, geopolitical conflicts as well as overall economic and financial instability. These risks not only undermine the credibility of the fiscal framework but also threaten democratic institutions. To a large extent, these risks can be mitigated by building household resilience through fiscal expansion on services, grants and infrastructure investment. Spending on households can also boost aggregate demand in the economy.

Question 14: How does fiscal consolidation enable GDP growth?

Answer on fiscal consolidation and GDP growth

Fiscal consolidation does not enable growth. Two prominent arguments based on mainstream macroeconomic theory and empirical analyses became the main selling points for fiscal consolidation and an austerity stance:

- Alberto Alesina's case for "expansionary austerity", and
- Reinhart and Rogoff's empirical work to show that large deficits negatively affect GDP

Alesina's theory of "expansionary austerity:

Alesina and Ardagna (2009) said fiscal consolidation would be expansionary. They argued austerity (or fiscal consolidation) would be more effective if they were in the form of spending cuts rather than increasing taxes. Alesina received much acclaim for his argument that "large, credible and decisive spending cuts" would change expectations of market participants. He asserted that businesses' change of expectations would bring forward investments that were held back by policy uncertainty in the recession. Put simply, the argument in favour of fiscal consolidation here is that if government can reduce the deficit and achieve budget surpluses then they will increase business confidence. Businesses will the feel better about the economy and invest.

Alesina and Ardagna's arguments were backed up by empirical "evidence". They did econometric analysis for a large sample of countries that showed that governments that successfully cut deficits enjoyed reduced debts & higher growth. However, there were serious problems with Alesina's empirical work (which is why we have to be careful of "evidence based arguments":

1. None of the cases of expansionary austerity they examined occurred during recessions
2. They misclassified some periods of fiscal expansion in their econometric analysis as periods of contraction

IMF (2010) noted that classifications of fiscal policy as expansionary and contractionary had very little connection with actual fiscal policy changes. The Washington Post (2013) said that "No advanced economy has proved Alesina correct in the wake of the Great Recession".

The truth is that when their countries and periods they studied are examined there is agreement (including by the IMF who still argues in favour of fiscal consolidation for developing countries) that:

- fiscal consolidation did not deliver higher growth.
- Instead, output contracted more or less exactly in line with the degree of austerity they managed to impose

Reinhart and Rogoff's view that increasing debt levels cause GDP to decline:

The second academic and empirical work that was used to justify fiscal consolidation was from Reinhart and Rogoff (2010). Unfortunately, it had a massive impact beyond academia at the time of the sovereign debt crisis. Unfortunately, this academic study is still referred to by the NT, even though, it has been shown to be deeply flawed and incorrect.

They said that their empirical work showed that once debt to GDP levels go over 90 per cent then they will have a negative impact on GDP. The idea that public debt was bad for GDP was already widespread amongst mainstream economists and in government and business, so Reinhart and Rogoff's results were initially accepted without question. However, when there empirical work was examined by many other authors it was found that:

- Reinhart and Rofoff's results were the consequence of coding errors and omissions and nonstandard weighting of data.
- The 90 per cent drop-off in growth disappeared when errors were corrected, in fact they showed that debt to GDP higher than 90% was associated with growth in GDP not declines.

Other people who examined the data showed that if at all there was a correlation between debt and growth. They argued that it was more likely that episodes of low growth led to higher levels of debt rather than the other way around. This counter argument had been made by opponents of austerity and could have easily been verified by supporters of austerity, such as the NT, but they simply did consider those alternative macroeconomic views that since consolidation constrains growth it is likely that consolidation worsens levels of debt

Crowding out

A view not only in support of fiscal consolidation but against government debt in general is that when the government borrows more money then they crowd our potential private borrowers and this crowding out causes the private sector to have less money for investment. However, it is clear that over the past few decades, as economies and businesses have become increasingly financialised that a very large part of the credit extended to the private sector does not go to increasing investment, particularly productive investment in the real sector of the economy. We have a graph in our MTBPS presentation showing how much higher extension of credit to the private sector has been than investment in South Africa over a number of years.

Many neoclassical, mainstream economists are now agreeing that government spending that increases reduces poverty, inequality and social tensions, productivity and improves infrastructure and other factors that help business can actually improve economic growth. These kinds of investment may generally be seen to 'crowd-in' investment from the private sector – even when government borrows to pay for these investments.

Conclusion

In short, the mainstream theoretical justification for fiscal consolidation, which unfortunately is still used by the NT, is flawed. Fiscal consolidation does not support growth but it does:

- constrains and reduces growth
- reduces government's ability to ensure protection of human rights and
- to address gender and other injustices in society.
- deepens existing schisms and crises and intensifies risks

The NT pushed South Africa onto the fiscal consolidation bandwagon in 2011 after policymakers in developed countries pivoted sharply away from the fiscal stimulus policies they had supported in response to the global financial crisis (GFC) of 2008. Why did they change their policy stance?

- The sharp rise in public debt in much of Europe due to bailouts to private finance
- The rise of US "Tea Party" conservatives after the November 2010 congressional elections
- Reducing the deficit and debt advances long-term goals of reducing the size of the state,
- The stimulus position was replaced, at least among pro-austerity policymakers, with a commitment towards fiscal consolidation and austerity

Question 34: In terms of the special relief fund, what is the PBO's view in terms of sustainability and the plan is pronounced by NT and the Minister? Should the relief be permanent? Where will the money come from? Will this need to be borrowed and if so what happens to South Africa's debt?

The uncertainty associated of not knowing whether the grant will be further extended in March 2024 could lead to high levels of anxiety and potential instability within communities. It must be asked whether we can afford not to spend more to address ongoing risks to livelihoods and the economy at large. Grants have been shown to have made a significant impact on poverty and hunger in South Africa. A study by Kohler and Bhorat (2021) on the fiscal incidence of the COVID-19 SRD grant suggests the grant reduced poverty by 5.3 per cent amongst the poorest households, and household income inequality by 1.3 - 6.3 per cent depending on the measure in 2020.[1]

The PBO remains concerned about proposals put forward to replace the SRD in the future. Robust discussions on social security must continue. The Constitutional mandate is that "everyone has the right to have access to social security, including, if they are unable to support themselves and their dependents". The following questions should be asked taking into consideration the impact of long-term structural unemployment:

- What will happen to the millions who will remain vulnerable to poverty and hunger after 2024?
- What is happening to those who are being excluded from the current grant?
- How much hardship and instability will result from not continuing with the grant or similar social support to adults?
- Have the socioeconomic risks been adequately considered and addressed?
- Beyond cost, on what basis are the caregiver and job-seeker grants better alternatives to UBIG or other forms of grants?
- Has substantive research been conducted on the success and failures of the grants initially proposed?
- What measures need to be in place to progressively realise the Constitutional obligations of the state to provide social security for all?

Question 7: Can SoEs contribute to economic development in South Africa, given their current state? Why do we think that state owned enterprises would be viable and add to the economy considering that they draining the country of money? What about private public partnerships as the current model isn't working? If the PBO thinks the current model is working it, how did the PBO reach this conclusion.

Many State-Owned Enterprises (SOEs) play a vital role in the economy. They need to be considered within a developmental state agenda. It is essential to reverse the decline of SOEs. SOEs continue to face significant challenges in adequately financing their operations and servicing their debts, as well as funding critical infrastructure. Part of the problem has been the inadequate investment from government itself to support the growth of the SOEs since the 1990s. We note in the presentation that the experience of Eskom raises the questions whether

[1] Köhler, T & Bhorat,H. 2021. "Can cash transfers aid labour market recovery? Evidence from South Africa's special COVID-19 grant," Working Papers 202108, University of Cape Town, Development Policy Research Unit.

larger targeted and conditional financial support to Eskom by government several years ago could have prevented prolonged load shedding and the need for the current large debt relief.

The Presidential Review Commission on State Owned Enterprises (PRC), established in 2010 recommended the following:

- developing an overarching long-term strategy for SOEs and enacting a single
- overarching law for their mandate, supervision and operation;
- developing a framework for appointing SOE Boards;
- developing a uniform regulatory framework;
- critically reviewing SOE mandates on a regular basis;
- addressing the procurement process;
- rationalising holdings to focus on strategic SOEs; and
- developing an integrated reporting, monitoring and evaluation capacity for SOEs
- across government

While these recommendations were made in 2010, it is important that government reflect on why over a decade later, SOEs are still facing similar issues.

As highlighted in the PBO presentation, Public Private Partnerships (PPPs) remain a highly contested vehicle for infrastructure financing and delivery. Their high expenses, the rigidity and length of the contracts, the difficulties in attracting enough private investor interest, and the disparate evaluations of their effectiveness, risk transfer, and social impact have all been cited by critics. Evidence suggests that PPPs should be approached cautiously, both in the context of individual projects and as an increasingly integrated pathway to infrastructure or public service delivery. PPPs can become a risk to the fiscus. In an IMF Working paper, they note that

> "Large fiscal costs and fiscal risk have arisen from PPPs in both developing and advanced countries … government bias and possible manipulation of PPPs add an important layer to the common project risks. An inadequate budgetary and/or statistical treatment may allow governments to ignore the impact of PPPs on public debt and deficit. In practice, governments often end up bearing more fiscal costs and risks than expected in the medium and longer term."[2]

In the United Kingdom, there has been a phasing out of PPPs. An official audit of the Private Finance Initiative, conducted in 2018, found that the cost of PPPs was at least 40% more costly than relying on public funding.

[2] Jon, H. and Rial, I. (2016). Regulating Local Government Financing Vehicles and Public-Private Partnerships in China. September 2016. http://www.imf.org/external/pubs/ft/wp/2016/wp16187.pd