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The Budget: both the fiscal stance and 'structural stance' are sound

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Many economists have argued that the government's fiscal stance in the recent budget is verging on the risky. This article argues that the fiscal stance is both correct and prudent. In addition, the article puts the budget in a broader developmental context, highlighting its contribution to long-term growth and development and to tackling poverty and inequality.

Introduction

That the Budget presented by Finance Minister Pravin Gordhan on February 27 was a difficult balancing act is unquestionable. On the one hand, slow domestic growth and low levels of private investment as well as weak global growth, especially amongst South Africa's major trading partners, put revenue under pressure. On the other hand, the Minister has been under pressure from bond markets and ratings agencies to reduce the budget deficit by reducing government expenditure. In the light of these pressures and constraints, I believe that the fiscal stance in the Budget was both correct and prudent.

Beyond its macroeconomic, fiscal stance a national budget is also a tool of microeconomic and structural reform. The budget helps shape the distribution of income in society, it allocates resources for key priorities and can contribute towards the better utilisation of resources in both the public and private sectors. The 2013 Budget continues to prioritise the social wage as the main instrument in the war on poverty as well as in building the capabilities that will drive longer-term growth and productivity – amongst which are education, infrastructure and a diversified industrial capacity.

Growth and cyclical strategies

The budget covers a single year in detail – or possibly, three years at a stretch. However the Budget should also contribute towards a longer-term growth strategy, which is informed by the National Development Plan. The strategy is to invest in our human and physical capital, to lower the cost of living for the poor, to improve competitiveness, to raise exports and to form a collaborative partnership with the private sector and labour for investment, employment and growth. Within this context, macroeconomic policy should create a strong foundation for growth through taking a future orientation. Microeconomic reforms should address the distribution of rents in the economy, create incentives for productivity growth and reduce inequality in society.

Most economists from across the spectrum support the policy of counter-cyclical fiscal policy. This means that when times are good, government should reduce debt through smaller budget deficits – and in bad times, it should increase spending to help support the economy. During the good years in South Africa between 2001 and 2008, government steadily reduced the level of public debt by running either smaller budget deficits, or even surpluses. The debt-to-GDP ratio fell from over 50% in the mid-1990s to a low of 22% in 2007/08. In an upswing period that lasted several years, government was able to pursue a counter-cyclical policy, creating the fiscal space to respond to a future downturn (which occurred from 2008 onwards). Today, five years into a major global economic slowdown, our debt-to-GDP ratio is still below 40% and is projected to peak at only about 45% in 2017.

The global recession did come – with a vengeance. The world is experiencing its slowest period of growth in 80 years. South Africa too is experiencing a long and unprecedented slowdown. The mechanics of the downturn is that demand growth slows as a result of several factors such as lower household consumption, lower private investment and slower export growth – and these often reinforce each other. Slower household consumption reduces corporate investment. During a period of slower growth, households pay off debt and corporations either reduce their debt or hold cash because the returns on cash are better than on other investment opportunities.

Under these circumstances, the correct policy stance is to maintain government spending and to borrow to finance the growing deficit that results from the revenue shortfall due to slow growth. This is exactly what government has done.

Nevertheless, it is true that counter-cyclical fiscal policy comes under strain when the period of slow growth is prolonged. There are limits to government's ability to borrow (to support demand). These restrictions are mainly determined by the willingness of private and corporate investors who buy government debt to do so (and thus finance government debt) at a reasonable price. This price of debt – the cost of debt to government – will rise when other investments are available that yield better returns to investors than government debt. When that happens, government had better reduce its borrowings because debt service costs may rise quickly.

As yet, all the signals from the bond market, the financial markets and the real economy suggest that this is not the case. Inflation is not a major threat, bond yields are still low by historical standards and government is able to finance its deficit with ease. By all standard economic measures, the South African government deficit is not crowding out private investment.

The alternative would be to reduce government spending. This would have had the effect of reducing consumption growth. We can have endless debates about the efficiency (or lack thereof) of public spending. However, the economics are quite straightforward: lower government spending will further depress the economy in the short term. The evidence from abroad regarding Greece, Spain and the UK reinforces this argument. Government could also raise taxes to reduce the deficit. This would reduce private investment. While there may be arguments for higher taxes, it is not sensible to raise taxes when the economy is weak.

Those who advocate austerity in a crisis – the 'austerians' – argue that if government reduced its deficit, it would send a signal of confidence to the private sector, which would kick-start spending and stimulate the economy. This is wishful thinking. There is not a single country in which this is happening.

Long-term social and structural considerations

At least part of the problem in South Africa is that investors are concerned about the economic policy trajectory and the capacity of government to manage the long-term social strains in society. It may be said that South Africa has deep structural weaknesses in areas ranging from education to spatial patterns and the labour market. Government must deal with these structural challenges by means of a long-term reform programme. The National Development Plan sets out how these structural challenges can be overcome in order to reduce poverty and inequality.

Government has already tried to provide greater certainty to investors on major policy issues (such as nationalisation), but it is accepted that more can be done. At the same time it can be said that government and the private sector have a long way to go to repair their relationship with each other, which is presently characterised by a high degree of mistrust and sometimes misunderstanding. However, the simple economic truth is that, even if government were to do these good things (and it should), it will not change the short-term growth outlook which drives much of corporate investment decision-making.

A budget has an impact on the distribution of resources in an economy. In this regard, the Budget continues to strike a balance between broadening the social wage – which is well targeted to help the poor – and investing in the capabilities required to support longer-term growth and create employment. These capabilities include the education and health systems as well as economic and social infrastructure.

New in the Budget is a focus on city planning, creating infrastructure for municipal transport and managing the transition to a low-carbon future. The procurement reforms announced in the Budget focus on value for money, reducing wastage and tackling corruption. It should, however, be recognised that a budget is a weak instrument for improving efficiency in the public service. A much broader set of instruments and approaches is required, including giving citizens a greater voice in determining how public institutions, such as schools, are managed.

Conclusion

The government's budgetary stance is a balanced package which aims to continue the pursuit of sound fiscal policy (counter-cyclical fiscal policy that supports demand), to continue broadening the social wage to help fight poverty and inequality, to deal with inefficiencies in public spending, to take steps to assure investors of the long-term policy trajectory and repair the relationship with the private sector. We need all segments of society to help fight corruption and hold government institutions accountable. We also need private investment to take advantage of opportunities, both locally and on the African continent.

Economists call for sound economic policy. Sound policy is based on good theory and the best available evidence. The balance of current budgetary policies pursued by government is informed by both sound economic theory and the best international evidence.