


Fiscal sustainability and the South African transformation challenge

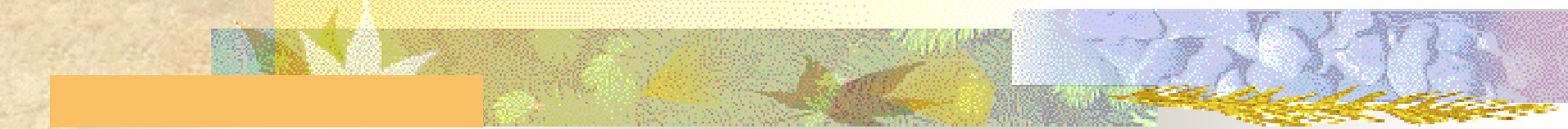


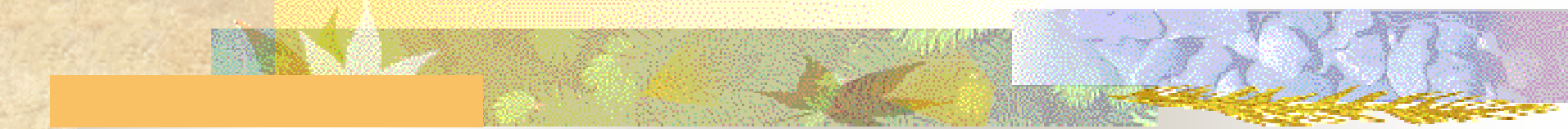
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- A sustainable fiscal policy: Stable public debt/GDP ratio
 - Neoclassical prescription: Sufficiently sized primary surplus and no dissaving
 - IMF, international investors and sovereign credit rating agencies
 - SA government reduced deficit and stabilise the debt/GDP ratio.

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- Conservative fiscal policy to integrate the ‘new’ SA into global economy
 - Many countries face similar ‘fiscal transformation’ challenge
 - SA government faces second transformation challenge
 - Aim of second transformation is sustainable development: “...development that meets the needs of the present without compromising the ability of future generations to meet their own needs” (Brundtland Commission 1987)

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- Claims of development on fiscus conflict with the canons of conservative fiscal policy required by international investors
 - Fiscal policy: Sustainable according to the neoclassical definition, but not politically sustainable
 - Legitimacy lost due to the non-delivery and the persistence of development discrepancies
 - Fine balance
 - Two transformation processes not independent. The ‘either-or’ approach to prudent fiscal policy versus the necessary development spending is false and may be resolved.



Overview

1. *Theoretical background: Neoclassical theory on fiscal sustainability*
2. *The developmental challenges facing South Africa*
3. *The policy quest for fiscal sustainability and sustainable development*
4. *The tension between fiscal sustainability and sustainable development – A sterile debate*
5. *The ‘twin sustainability’ predicament: Not an either/or choice*
6. *Human capital investment for human development and economic growth*
7. *Financing human capital creation: The developing country dilemma*
8. *Conclusion*



1. Theoretical background: Neoclassical theory on fiscal sustainability

$$\Delta D_t/Y_t \equiv (r_{gt} - g_t)D_{t-1}/Y_t + B_t/Y_t + R_{gt}/Y_t$$

If $r > g \rightarrow B$ must be primary surplus $(-)$ on average for $\Delta D_{gt}/Y_t = 0$

If $r < g \rightarrow B$ may be primary deficit $(+)$ on average for $\Delta D_{gt}/Y_t = 0$



2. The developmental challenges facing South Africa

- Nominal GDP: R 1.2 trillion in 2003 (150 billion Euro at exchange rate of Euro1 = R8).
- Real economic growth sluggish from the late 1970 onwards.
 - Signs of improvement
- Population growth rate of 2.2% for 1996-2001 (population: 40 million)
- Real GDP per capita (1995 prices) for 2003: R 14 601 (or roughly Euro 1825).
- Real GDP (1995 prices) in 1971 was R 14 686 per capita.

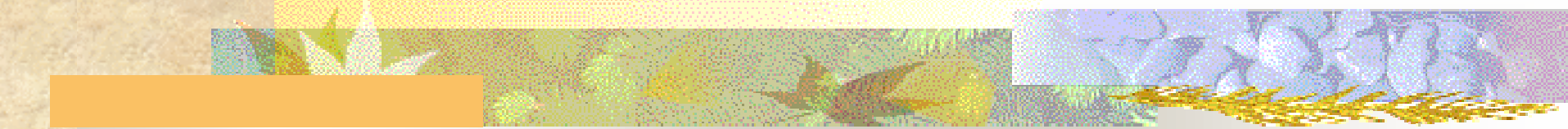
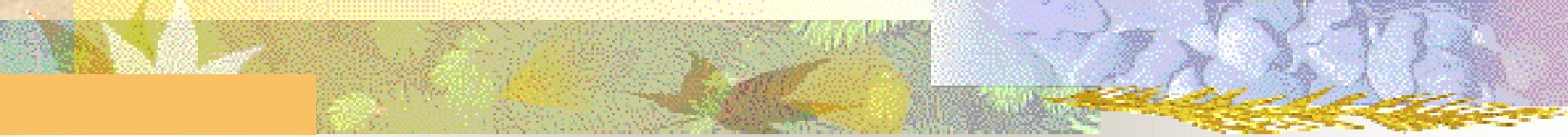
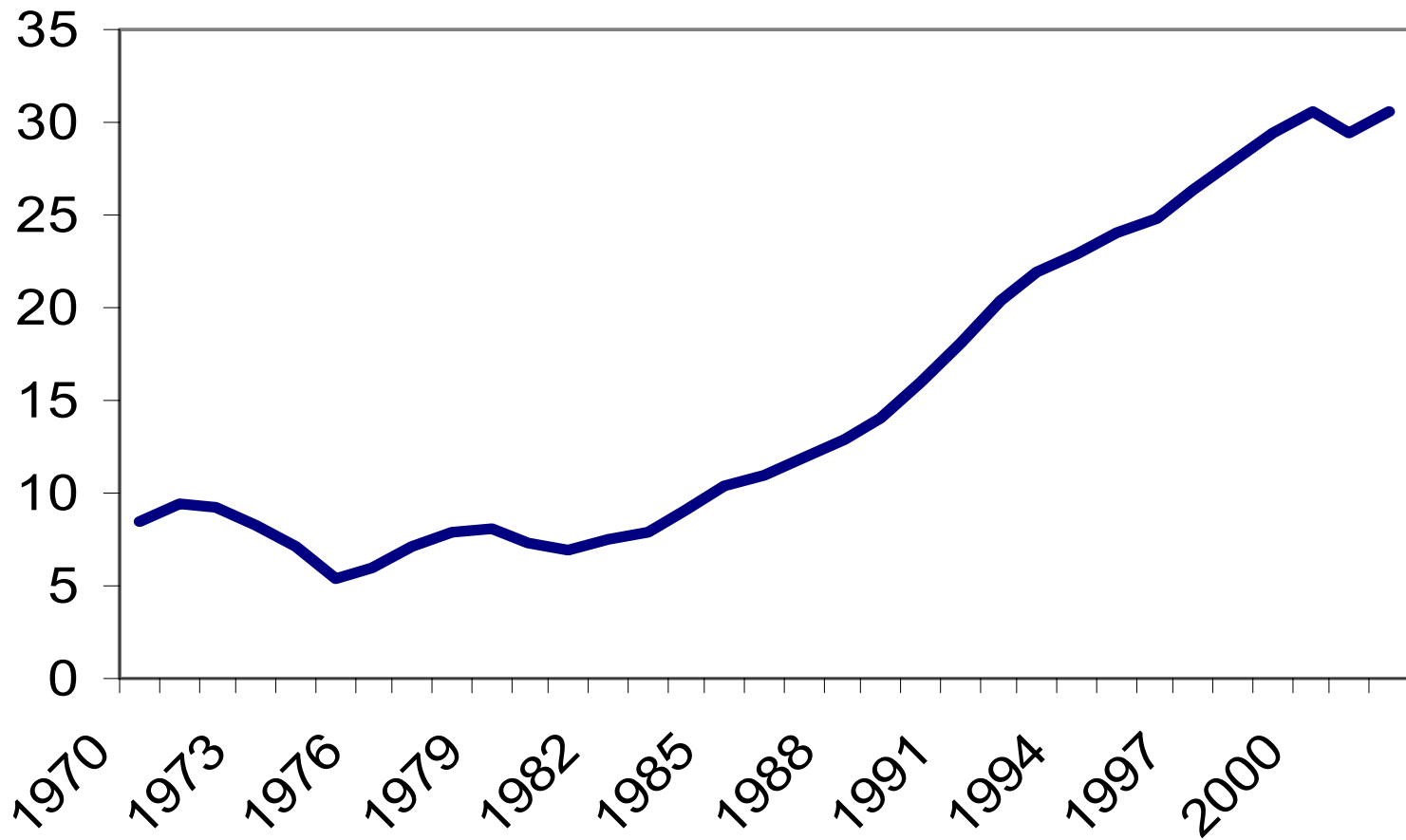


Table 1 – Growth in real GDP (five year averages)

1960-64	6.3%
1965-69	5.3%
1970-74	4.4%
1975-79	2.1%
1980-84	3.0%
1985-89	1.5%
1990-94	0.2%
1995-99	2.6%
2000-03	2.9%

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- National unemployment rose from below 10% in mid-1980s to over 30% currently (other sources put the rate at over 40%). It is still increasing.
 - Gini-coefficient: 0.59 for 1995.
 - South Africa one of the worst income distributions in the world.
 - USA: 0.38; Netherlands: 0.27; Philippines: 0.45; India: 0.42; Brazil 0.59
 - The poorest 60% earns less than 20% of total income,
 - The richest 20% earns more than 60% of total income.

Unemployment rate



— Unemployment rate



3. The policy quest for fiscal sustainability and sustainable development

- Two key economic policy developments in post-apartheid South Africa:
 - Reconstruction and Development Programme (RDP) (1994)
 - Growth, Employment and Redistribution plan (GEAR) (1996)

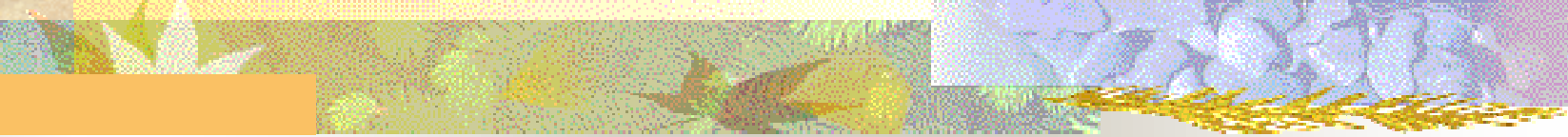


- RDP:

- Improvement of service delivery
- Creation of an enabling environment for human development
- Foster sustainable human development through increased government social spending and infrastructure

- GEAR:

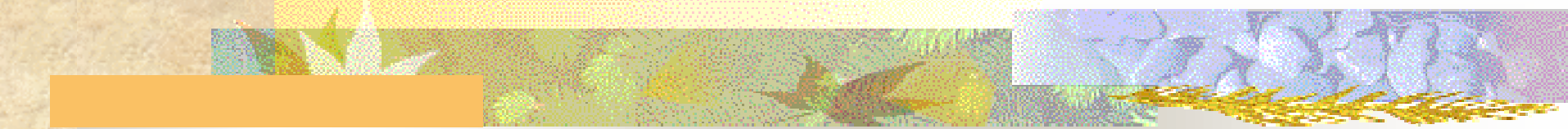
- Neoclassical macroeconomic stabilisation policy (Washington Consensus)
- Ensure fiscal sustainability and elimination of dissaving to release more resources for public and private investment. (Higher investment would lead to higher national income)


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- Succeeded in decreasing deficit; however, investment still low
 - Reduced the public debt/GDP ratio to <math><40\%</math> (Maastricht criteria: <math><60\%</math>)
 - Stabilisation of the debt/GDP ratio prevented further increases in the claim of interest payments on the public purse and left more scope for discretionary public spending

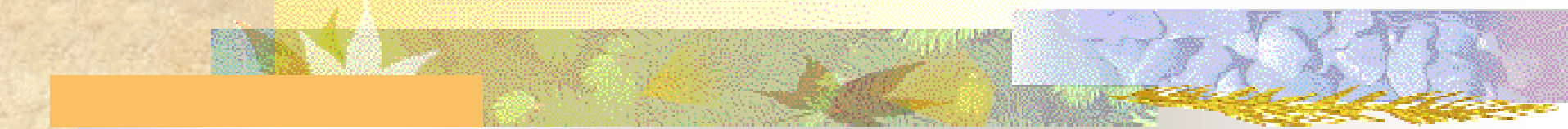


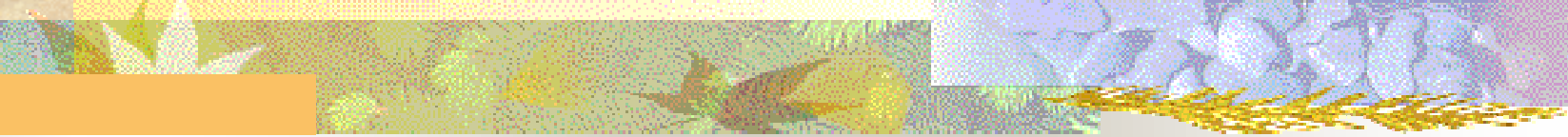
4. Tension between fiscal sustainability and sustainable development – A sterile debate

- The main participants in policy debate are ANC-led government, the business sector and the labour unions
- Differences relate to divergent views about GEAR
 - Government and business support the ideas underlying GEAR
 - Broad labour-community-NGO group (Cosatu, the SACP, the South African Council of Churches (SACC) and South African National Non-Governmental Organisation Coalition (SANGOCO)) oppose it

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- Government and business:
 - Economic growth eradicates past injustices
 - Benefits of additional growth distributed in equitable manner
 - GEAR underpinned RDP
 - Sustainable fiscal policy with zero dissaving a precondition for investment and growth
 - Growth precondition for (the financing of) sustainable development.
 - Government giving primacy to fiscal sustainability relative to development.

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- Cosatu:
 - Strong (socialist) belief in larger role for the ‘developmental state’
 - Favours an activist fiscal and monetary policy
 - The market scepticism of Cosatu is not entirely without foundation
 - Apartheid regime instrument in the hands of business: Apartheid is reduced to a form of capitalism – ‘apartheid capitalism’
 - Concerning GEAR: Decrease in the budget deficit dampens growth and GDP
 - Cutbacks in government expenditure: cannot address social backlogs sufficiently

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- Cosatu argues for abandonment of the conservative fiscal policy
 - Cosatu wants policy that focuses primarily on development and social spending and less narrowly on fiscal discipline.
 - It argues that “... higher social spending ... is a necessary precondition for development and rapid economic growth”
 - Higher investment and growth will allow government to foot the bill for the development expenditure incurred earlier, readily repaying built-up debt.


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- The government view proclaims a causality from disciplined fiscal policy to economic growth and then to development.
 - Cosatu and its allies argue that the causality runs in the opposite direction: growth will follow development, which may follow an increase in expenditure and the debt burden

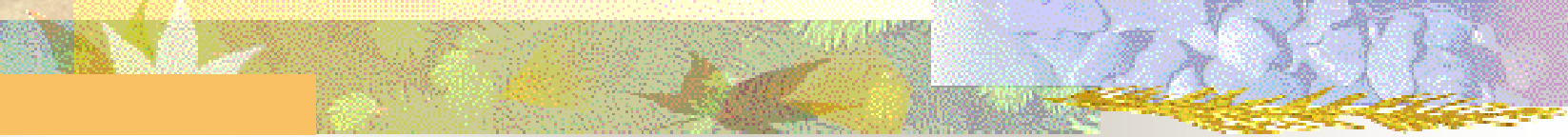


5. The ‘twin sustainability’ predicament:

Not an either/or choice

- South African economy faces two transformation processes: globalise successfully and achieve sustainable development.
- The country appears to face a genuine dilemma, need to ensure **fiscal sustainability** and **sustainable development**
- ‘Twin sustainabilities’ predicament

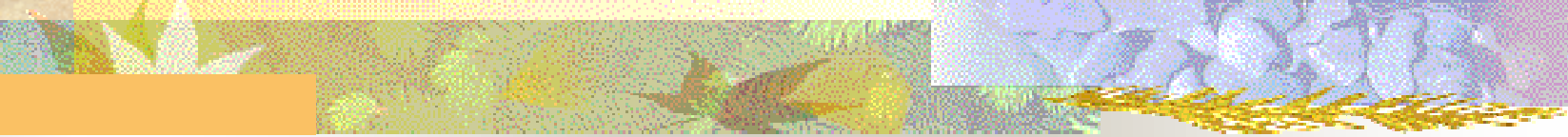
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- Relates to relationship between growth and (human) development
 - Economic growth prerequisite for sustained improvement in human wellbeing
 - Reverse link: human development contributes significantly to economic growth
 - Human development such as education yields visible economic return
 - Why mainstream theory denotes it as human capital investment
 - This suggests that good human development is essential for good economic growth


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- Complex interaction between economic growth and human development
 - Giving priority to either fiscal sustainability or sustainable development (to the neglect of the other): deliver no success in growth or development
 - Need policy approach that allows government to address social needs in a developmentally and fiscally sustainable manner
 - Key element is human capital creation to improve economic growth



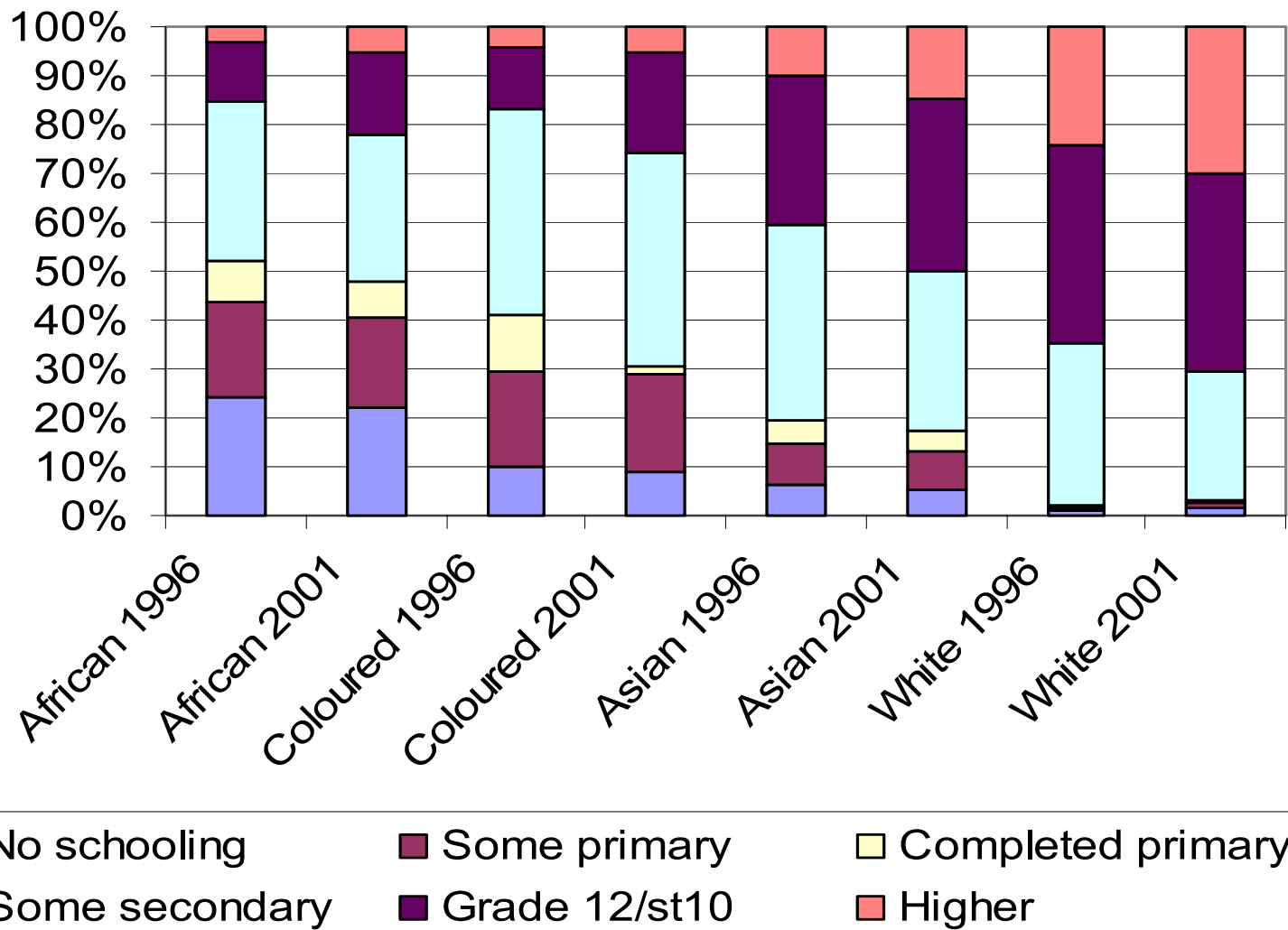
6. Human capital investment for human dev. and econ. growth

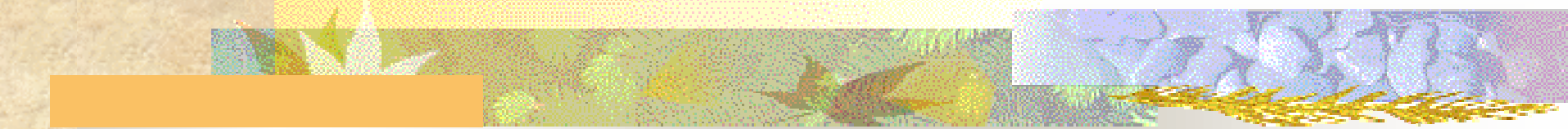
- Human capital development generates economic growth, which provides resources to finance further human development
 - It also is human development
- Higher economic growth: easier for government to run a sustainable fiscal policy.
- Allow SA government to escape the ‘either-or’ choice between a prudent fiscal policy and human development

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- Hartog (2001[1999]) defines human capital as the knowledge, skills, competence and other attributes embodied in individuals that are relevant to economic activity.
 - More than just education, also includes healthcare spending and any other form of expenditure that increases the productivity of individuals.
 - Rate of return to human capital investment between 5 per cent and 15 per cent
 - For SA Chaimberlain and Van der Berg (2002) reports rates of return of up to 6.5% (depending on race group, quality of education and level of school)

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- South Africa: Significant shortage of human capital.
 - Whiteford and Van Seventer project an increasing demand in the formal sector of the economy for skilled labour and a decreasing demand for unskilled labour.
 - Unskilled labour increasingly shifted to the informal sector of the economy or to the unemployed.
 - New growth theories: Higher levels of human capital contribute to a higher economic growth rate

Graph 1: Highest level of education by population group, 20 years and older






7. Financing human capital investment: A developing country dilemma


- The consideration of (human capital) projects can occur on at least three levels:
 - The broader social benefit relative to cost
 - In narrower sense only consider the future extra income to be earned by beneficiaries of the project relative to cost
 - In still narrower budgetary and government net worth context, consider future tax revenue flowing from a project as a return relative to cost for government

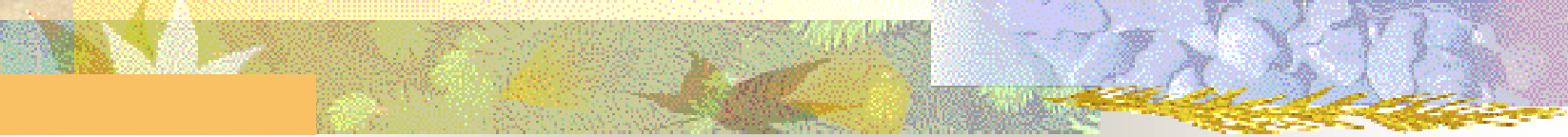


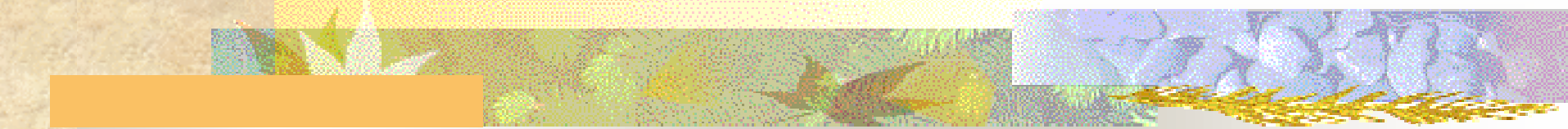
■ Three questions:

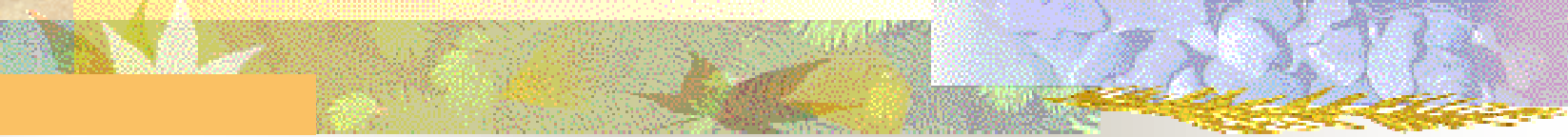
- How does one measure the value of human capital?
- How much should government spend on human capital creation?
- How should government finance the investment?

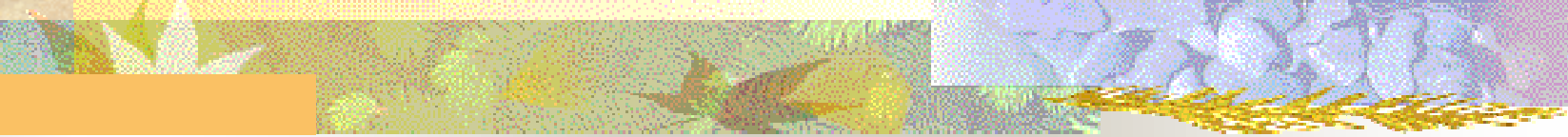
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- The first two can be answered like any such question relating to investment: by considering the return of the investment project relative to its cost:
 - Expenditure on human capital raises the individual income
 - From additional income government probably will receive tax revenue (without the need to increase the tax rate)
 - This represents the 'return' on its investment in human capital.

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- Net value of an investment in human capital (as with any other investment project) is measured by its net present value.
 - Net present value of human capital equals the present value of the future stream of (additional) tax revenue minus the (present value of) expenditure needed to create that stream of tax revenue
 - In a net worth sense government may spend resources on a project to create human capital if its net present value exceeds (or equals) zero

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- Improvements in the quality of education and healthcare topical in SA where government spends between 5 and 7 % of GDP on education throughout 1990s and early years of the new millennium
 - Noted that absolute monetary value of 1% of GDP spend in medium income country is quite different from high income country
 - Average per capita income in high income countries in 1995: \$24 930
 - In middle income countries: \$2 390

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- Can government use debt finance or should it use taxes to finance the investment?
 - Borrowing may cause the debt/GDP ratio to increase.
 - As long as the project has a zero or positive net present value, the net worth of government will not deteriorate.
 - An additional asset on the asset side of the balance sheet of government accompanies the additional debt on the liability side of the balance sheet.
 - The additional asset is the the discounted value of future tax revenue that government will collect out of the additional income that its expenditure generates

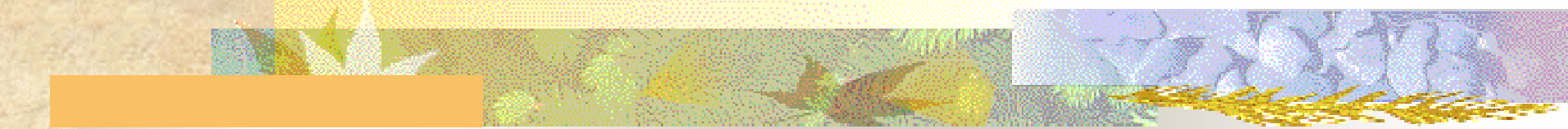
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- Why would a government want to use debt instead of tax finance?
 - If sufficient domestic pool of resources exist – usually income – government can tap it through taxing it or borrowing from it
 - Developing countries: Income base often insufficient to finance expenditure on human capital *via* either debt or taxes.
 - Need to turn international to obtain the necessary resources. Since it cannot tax foreign income, foreign borrowing is the only option

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- The above has at least two far-reaching implications:
 - Higher public debt/GDP ratios in developing countries
 - Reclassification of human capital expenditure:
From current to capital
 - Nordhaus (1996): ‘Our tools for measuring savings are stone-age definitions in the information age’



8. Conclusion

- Conservative policy not enough for robust growth and sustainable development in South Africa
- Insufficient resources. The resources available for human development must grow, which requires a higher economic growth rate
- Higher growth will allow more human development and make it easier for government to maintain a sustainable fiscal policy
- This, in turn, is a prerequisite to integrate the economy into the global economy

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- Better management of existing resources to get better rate of return on human capital
 - Human capital investment to improve the economic growth rate
 - Improvements in education and health levels ensure a better quality of lives for recipients
 - This represents progress in human development independent of its future rate of return
 - Implications of human capital concept for labour, government and investors