



# ARE BINDING FISCAL RULES THE RIGHT SOLUTION FOR DEBT SUSTAINABILITY IN SOUTH AFRICA?

October 2024

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## Recommended citation

Mncube, Z., Mduyana, L., and Isaacs, G. 2024. Are Binding Fiscal Rules the Right Solution for Debt Sustainability in South Africa?. Institute for Economic Justice, Discussion Paper.

## Acknowledgements

We would like to express our sincere gratitude to everyone who contributed to the development of the discussion paper.

We would like to thank all partners who attended and contributed to our dialogue on fiscal rules. Their invaluable insights and provocations were constructive during the writing process.

Finally, we would like to also extend a special thank you to Dr Seeraj Mohamed and Advocate Ben Cronin for their comments and guidance on the first draft of the paper. Their feedback has greatly enhanced our analysis and intervention in the debate on the proposal for fiscal rules in South Africa.

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## Executive Summary

The Discussion Paper engages debates regarding National Treasury's proposal for a new fiscal rule to complement the existing nominal expenditure ceiling. This proposal has been made to gear the fiscal framework towards the objective of debt reduction. The argument for the proposed fiscal rule is that the government has taken on borrowing and increased spending without clear guidelines and limits. In turn, this has led to wider and more persistent budget deficits, which have increased debt-to-GDP levels and borrowing costs to unsustainable levels. Consequently, the higher borrowing costs have crowded out private investment, and have contributed to long-term economic stagnation in South Africa. Therefore, a fiscal rule is needed to arrest increasing debt levels and debt service costs and chart a path to sustainable public finances.

We suggest the National Treasury approach will not meaningfully contribute towards the stabilisation of public finances and carries significant risks.

Prioritisation of a fiscal rule misdiagnoses the key issue facing debt management in South Africa. Whilst South Africa's debt trajectory is concerning, it is the cost of debt rather than the quantum of debt that should be of primary concern. Tackling debt service costs requires more direct mechanisms.

It is also unclear that fiscal rules are well suited in the South African context. If effective, fiscal rules risk reinforcing across-the-board budget cuts, or cuts to areas of expenditure where resistance will be weakest, rather than sparking rational processes of budget prioritisation. Fiscal rules also threaten to close the space for democratic participation and negotiation. We also raise concerns over whether fiscal rules, in South African current constitutional framework can legally place restrictions on Parliament's appropriation of expenditure.

South Africa's own experience with the expenditure ceiling and international evidence reviewed shows they fiscal rules tend to (1) limit government's flexibility to use fiscal policy in times of crisis, (2) encourage creative accounting practices in order for the government to give the illusion that it is abiding by the fiscal rule, and (3) worsen austerity measures, hamstringing government spending, and distort government spending. The case studies also highlight the limited power of fiscal rules to reduce borrowing costs and the centrality of positive growth conditions. In the end, when adherence to numerical targets clashes with other political or economic interests this often results in a breach of the rules and the erosion of the credibility of the budget.

If National Treasury wants to achieve a more sustainable fiscal path it needs to build political convergence behind such. This requires mechanisms through which spending, and associated revenue raising, represents the outcome of collectively-agreed prioritisation rather than centrally-imposed extreme fiscal restraint. This requires embracing the positive-potential of the budget. Fiscal policy should aim to, at least: maximise economic growth and support domestic demand; reduce unemployment; contribute towards structural transformation and the expansion of supply capacity; ameliorate against destitution and hardship; and provide for comprehensive social and care services, while supporting the

social wage. With this in mind, a government-wide spending review is required, resulting in a combination of reducing ineffective expenditure, strengthening the capacity of departments to spend effectively, and increasing existing effective spending, or adding of additional effective expenditure. This must be accompanied by an assessment of ways to raise additional revenue progressively and directly tackle the high cost of borrowing through the prudent use of: capital management techniques; capital allocation tools; central bank intervention; prescribed assets; and preferential lending.

Ultimately, the only credible way to restore the health of public finances is through economic expansion and the budget must be coherently harnessed towards this objective.

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## 1. Introduction

Ahead of the Medium-Term Budget Policy Statement in 2023, South Africa's National Treasury presented its plans to contain debt and ensure fiscal sustainability for the country to the President. One of the key proposals was the introduction of a new 'budget anchor'. The National Treasury argued that "fiscal credibility will require South Africa to adopt fiscal rules," such as a debt ceiling or a primary balance target.<sup>1</sup> The proposal of an additional fiscal anchor dates back to at least 2019.<sup>2</sup> An important commitment to these rules was made in 2020, in a Letter of Intent accompanying the IMF Rapid Financing Instrument, where the Minister of Finance said "we are open to introducing a debt ceiling in addition to the nominal spending ceiling currently in place".<sup>3</sup>

In the 2024/25 Budget, National Treasury further committed to considering a fiscal anchor. In this regard, the Budget Review stated that "to chart a sustainable long-term path for the public finances, the government will, after extensive consultation, propose a binding fiscal anchor. This will secure the benefits of fiscal consolidation and ensure that permanent fiscal imbalances do not reappear in a way that requires painful future adjustments."<sup>4</sup> The proposal and commitment have been welcomed by the Democratic Alliance (DA), who in April 2023 submitted a Responsibility Spending Private Member's Bill.<sup>5</sup> The DA's Bill also proposed a debt ceiling, arguing that South Africa's reliance on an expenditure rule without a debt rule has limited the government's ability to contain spending. They argued that "Introducing a debt rule would enable a more risk-based fiscal policy and allow for adjustments in spending in line with debt sustainability".<sup>6</sup>

National Treasury indicated that it will undertake an extensive consultation on its proposal for a fiscal anchor. This comes as debt has, according to National Treasury "failed to stabilise, with a persistent deficit in the primary balance".<sup>7</sup>

Against this backdrop, it is important to unpack National Treasury's proposals, review the theory underpinning fiscal rules, critically examine their efficacy based on preliminary international evidence, draw lessons for South Africa, and propose policy recommendations, including recommendations beyond fiscal anchors. As the National Treasury continues to consult different stakeholders, we hope the evidence reviewed here will provide a knowledge base for civil society and other progressive actors.

The National Treasury, in our current understanding, is arguing that the stress on public finances stems from too much discretion in the use of fiscal policy. This means that decisions about spending and borrowing have been taken without clear rules or guidelines, giving the government too much room to accommodate spending demands. This, Treasury argues, has led to wider and persistent budget deficits, which have increased debt-to-GDP levels and borrowing costs to unsustainable levels. Consequently, the higher borrowing costs have crowded out private investment, which they argue has contributed to long-term economic stagnation in South Africa. In turn, National Treasury argues that South Africa's debt trajectory can be addressed by "a combination of active debt management strategies and spending restraint that improves the primary fiscal balance".<sup>8</sup> One of these strategies is introducing a binding fiscal rule to "target a debt objective and complement the existing primary expenditure ceiling, thus adapting the fiscal framework to the now critical debt

reduction objective”.<sup>9</sup> According to the National Treasury this will contribute towards a more sustainable path of public finances.

There are at least three components to this argument. First, that at the heart of South Africa’s fiscal woes is too much debt. Second, that too much debt is taken on because political decisions keep getting made to spend in areas that we shouldn’t be. Third, that such spending decisions can be constrained by the imposition of a binding fiscal anchor. Because we do not have clear information on the nature of the fiscal anchors being proposed by National Treasury we can present only a provisional assessment here. Nevertheless, our initial assessment is that Treasury’s argument is flawed in all its components.

We start, in Section 2, by presenting an overview of fiscal rules and where they have been adopted in the world. Section 2 also discusses the theoretical framework for fiscal rules and the key arguments in support of their adoption. Following this, in Section 3, we critically assess Treasury’s diagnosis of the debt issue. We argue that the focus on the quantum of debt is misplaced, and that an additional fiscal rule (by itself) will not address debt levels in the long run. Instead, the focus should be on more direct measures to reduce the cost of debt and on new targets that can unlock growth and structural transformation for the economy. In Sections 4 and 5 we highlight the political and economic risks that are likely to limit the efficacy of a fiscal rule, including through reviewing South Africa’s history with its current expenditure ceiling, political economy dynamics, and legal framework. Section 6 discusses two international case studies of fiscal rules using the experiences of Brazil and Indonesia to draw lessons for South Africa. These lessons are given in Section 7, followed by a proposed way forward in Section 8.

## 2. Overview of fiscal rules

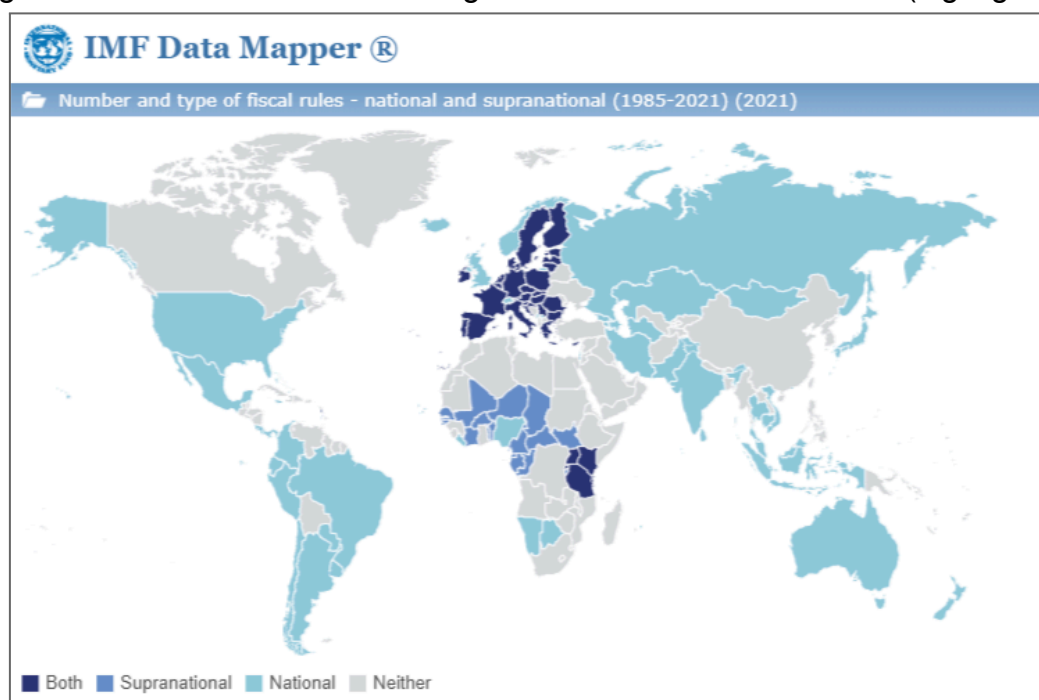
The use of fiscal rules has expanded in different waves over the last four decades to respond to, and manage different crises leading to different definitions and categories of rules used worldwide. Although the terms ‘fiscal anchor’ and ‘fiscal rules’ are often used interchangeably, a fiscal anchor broadly refers to a “constraint on fiscal outcomes or processes that is intended to influence public expectations about the future course of fiscal policy”.<sup>10</sup> On the other hand, a ‘fiscal rule’ is a permanent constraint on fiscal policy, expressed by a summary indicator of fiscal performance, such as the government budget deficit, levels of borrowing, or debt.<sup>11</sup> In this sense, a fiscal anchor provides a guide for fiscal policy, while a fiscal rule sets a numerical target that limits a particular budgetary aggregate.<sup>12</sup>

Sebrits and Calitz (2023) note that recent definitions have tended to be more flexible, preferring to use time-bound adjectives to define their applicability.<sup>13</sup> For instance, another definition notes that a fiscal rule “imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates”.<sup>14</sup> Brenck and Marques (2010) argue that the growing use of fiscal rules represents a move against the deficit bias - which is the purported tendency of governments to allow for deficits and rising debt levels over time.<sup>15</sup> Therefore, the rise in the use of fiscal rules can be seen as an attempt to control debt levels, government spending, and fiscal outcomes, and to reduce the political influence on public

expenditure.<sup>16</sup> Their goal is to ensure that “fundamentals will remain predictable and robust regardless of the government in charge”.<sup>17</sup>

The IMF reveals that by the end of 2021, there were about 105 countries that had adopted at least one fiscal rule (Figure 1).<sup>18</sup> The use of fiscal rules is fairly common among South Africa’s peers, which are upper-middle income countries<sup>19</sup> with 29 upper-middle income countries having adopted a fiscal rule. Moreover, 26 African countries were assessed by the IMF study to have at least one fiscal rule.<sup>20</sup> This means that at least half of the countries on the African continent deploy a fiscal rule as part of their public finance management.<sup>21</sup>

Figure 1: Number of countries using fiscal rules worldwide in 2021 (highlighted)



Source: IMF<sup>22</sup>

## 2.1. Types of fiscal rules

Fiscal rules can be further divided into two categories, (i) fiscal rules that primarily aim at restricting deficits and debt to guarantee fiscal sustainability, and (ii) fiscal rules that primarily aim at stabilising macroeconomic fluctuations. In this document we focus on fiscal rules or rule-based fiscal anchors since this is the type of anchor, we currently understand, National Treasury is looking to implement.<sup>23</sup> Within the first category, four main types of fiscal rules can be identified. These are, (1) debt rules, (2) budget balance rules, (3) expenditure rules, and (4) revenue rules (See Table 1). These can be combined in various ways depending on their aims. Furthermore, they can also differ in their legal status, extent of regulation, and duration over which they are in place. While rules may differ in design and the context they arise in, “all these rules share at least one feature in common: they seek to confer credibility to the conduct of macroeconomic policies by removing discretionary intervention”.<sup>24</sup>

Table 1: Fiscal Rules and the share of countries with the rules

Type	Nature of the rule	Purpose of the rule	Share of countries <sup>25</sup> with the rule <sup>26</sup>
<b>Debt rule</b>	Set an explicit ceiling for public debt, often expressed as a percentage of the GDP but may also be expressed in absolute terms.	The rules limit borrowing. This may specify certain sources such as central banks. <sup>27</sup>	Adopted by 85 countries
<b>Budget balance rules</b>	Set a limit on the budget balance - the gap between government spending and revenue (that is, deficit or surplus).	The rule requires the government to maintain a particular position, not exceed a deficit limit, or target a certain surplus level.	Adopted by 93 countries
<b>Expenditure rules</b>	Set limits on government spending. This may be total, primary, or current spending in absolute terms, real spending growth rates, or spending as a percentage of GDP. The time ranges for the rules are often between three to five years. <sup>28</sup>	The rules are aimed at curbing spending pressures that result from recurring budget deficits.	Adopted by 55 countries
<b>Revenue rules</b>	Set ceilings or floors on the tax-to-GDP ratio or the total government revenue.	These rules are aimed at boosting tax revenue, preventing tax burdens, and guiding the use of windfall revenue. <sup>29</sup>	Adopted by 17 Countries

## 2.2. Accompanying institutions: the role of fiscal councils

Simply having fiscal rules does not guarantee compliance. Institutions and the fiscal framework are important in facilitating adherence to fiscal rules. Institutions can be defined as “the set of requirements, processes and entities responsible for the formulation, execution and oversight of fiscal policies”.<sup>30</sup> Sub-Saharan African countries have been struggling with enforcing compliance due to weak institutions. By 2020, only two countries had some form of fiscal responsibility laws to guide the implementation of fiscal rules.<sup>31</sup> In addition to clear guidelines and laws, there also needs to be transparent and inclusive bodies to manage the implementation of fiscal rules. Fiscal councils have played a role in ensuring adherence to fiscal rules.

The IMF defines fiscal councils as “nonpartisan public entities with a statutory or executive mandate aimed at promoting sustainable public finances through assessing fiscal plans and performance, evaluating macroeconomic and budgetary forecasts, monitoring the implementation of fiscal rules, and costing of government measures”.<sup>32</sup> The number of fiscal councils has increased over the last decade and their mandate has evolved depending on country or regional dynamics. In some cases fiscal councils are attached to parliament while in others they are independent bodies attached to audit offices and in some cases they form part of the executive. This has implications on their role. While the overriding role of fiscal council is to ensure public finances are aligned to current fiscal rules, a fiscal council attached to parliament plays more of an oversight role than one that is in the executive which may also contribute to formulation of policies and the analysis thereof. The ‘success’ of fiscal rules will depend on the institutions in place and their interaction.

## 2.3. The theoretical framework

Fiscal rules are said to support fiscal discipline in three ways. Firstly, rules can act as a commitment device that limits the government’s use of fiscal discretion. Secondly, they can serve as a signalling device, highlighting government plans and priorities. Lastly, they can serve a political function, helping to facilitate the formation of stable coalitions given the clarity of numerical targets.

Proponents of fiscal rules argue that the market alone is too weak to control wasteful governments and that discretionary fiscal policymaking contributes to unsustainable public debt.<sup>33</sup> This is grounded in neo-classical economic thinking that advocates for a balanced budget. According to this line of thinking, financing government spending (which is seen as consumptive) with borrowing will lead to crowding out of private investments.<sup>34</sup> This is based on the assumption that there is a limited pool of funds available to finance private and public investment and public borrowing to finance deficits crowds out private borrowing and/or lead to a rise in interest rates which in turn negatively impacts private investment, and therefore long-term economic growth. However, global experience and evidence indicates the shortcomings of this theory, which has shifted the approach to fiscal rules as will be discussed below.

In line with rational expectations assumptions, some argue that fiscal rules allow governments to commit to particular fiscal policy parameters and that this enhances the effectiveness of policies and influences the expectations of economic agents.<sup>35</sup> According to

these expectation-based arguments for fiscal rules, “it is in the interest of well-intentioned fiscal authorities to voluntarily adopt and comply with rules because doing so would enhance the credibility and effectiveness of their actions”.<sup>36</sup>

### 3. Diagnosis of the problem: is too much debt the issue?

With this understanding in mind, we turn to unpicking the diagnostic premise of National Treasury’s argument in favour of a fiscal anchor: that South Africa is carrying too high a quantum of debt.

The idea that South Africa is carrying too high a quantum of debt is problematic as it is rooted in the flawed concept of fiscal space. National Treasury has referred to ‘growing’ or ‘creating’ fiscal space on multiple occasions, in one instance saying, “Over time, as the debt burden decreases, maintaining this critical benchmark [primary budget surplus] will create fiscal space”.<sup>37</sup> The IMF conceives of fiscal space as the difference between a country’s current public debt level (that is, debt-to-GDP) and the ‘debt limit’. This debt limit is thought of as the debt-to-GDP point above which addressing rising debt service costs will require extraordinarily large primary surplus or a debt default.<sup>38</sup> Essentially, fiscal space implies a ‘maximum’ level of debt above which debt service costs are uncontrollable.

However, cross-country evidence does not support the existence of a maximum level of debt in two ways.<sup>39</sup> First it shows that at similar levels of debt, it is possible for countries to have drastically different borrowing and debt service costs. South Africa’s debt-to-GDP ratio, at 73.9% in 2023/24, is in line with the emerging market and middle-income country average of 73.1%.<sup>40</sup> However, South Africa’s cost of borrowing (real interest rate) and debt service costs (measured as interest paid on debt as a share of GDP) are considerably higher than its peers such as Albania, Thailand, the Philippines as well as the average for all upper-middle income countries.<sup>41</sup> Second, it shows how countries such as Cabo Verde, Guinea-Bissau, Fiji, Spain, and Portugal with far higher debt levels,<sup>42</sup> have comparatively lower debt servicing costs than South Africa (whose interest paid on debt is more than 4.5% of GDP),<sup>43</sup> although this trend is much more common among developed countries. Nevertheless, cross-country evidence indicates that rising debt service costs, at any debt level, cannot solely lie on or be explained by the debt-to-GDP ratio.

The major debt issue South Africa faces is, therefore, that interest service costs are crowding out other expenditures because South African government borrowing is expensive, that is, the government faces high interest rates. Consequently, we believe that National Treasury places undue emphasis on the size of public debt, which cannot be considered outside the context of, and is arguably secondary to, the issue of interest rates. Further, we do not believe the imposition of a binding fiscal rule will sufficiently address this. Rather, it continues a trend of narrowly identifying the debt-to-GDP ratio as the major issue. Therefore, even if implemented successfully, a fiscal rule may not necessarily lead to reduction in debt levels and the cost of borrowing unless it is accompanied by other measures. This position is supported by the experiences of Indonesia and Brazil, which we will go into detail in a later section.

Among the key factors contributing to higher nominal interest rates are internal factors such as growing fiscal risks related to state-owned company bailouts, weakening domestic growth prospects, inconsistent power supply, and social instability, and these have particularly affected medium-to-long-term borrowing.<sup>44</sup> In addition, borrowing has not been sufficiently used to expand growth and alleviate unemployment. Some of the main external factors impacting the cost of government debt are interest rates and inflation in developed countries which impact South Africa due to its exposure to global capital markets and the inflation targeting framework by the SARB. The increase in interest rates in developed economies has made local bonds relatively less attractive and in turn the SARB has chosen to compete by increasing the repo rate, which through driving a higher prime lending rate, has strangled local investment.<sup>45</sup>

In fairness to National Treasury they do consider the cost of borrowing and draw a link between fiscal rules and this cost. A key argument put forward by the National Treasury for supporting the implementation of more stringent fiscal rules<sup>46</sup> is that this will lead to increased credibility, risk mitigation, and enhanced policy predictability, which, it is argued, will lead to lower debt-service costs. Two problems arise here. First, the empirical evidence suggests fiscal rules have a mixed impact on fiscal performance, and this depends on a number of contextual factors such as their design, institutional framework, and the economy in general.<sup>47</sup> In addition, there is no clear evidence pointing to the causal effect of fiscal rules and fiscal outcomes.<sup>48</sup> A range of factors are present in the economy and these influence fiscal outcomes, making it difficult to isolate fiscal rules as the primary reason for outcomes such as reduced debt-service costs and debt levels. Second, this is a very indirect way to lower borrowing costs that ignore a host of other more direct mechanisms, including through Reserve Bank intervention, (2) targeted capital controls, (3) capital management techniques, and (4) credit allocation policies. These are taken up again in the final section.

#### 4. Unpacking the ‘solution’: would a fiscal rule curtail discretionary spending?

Even if we were to accept a lower debt-to-GDP ratio as a legitimate target of fiscal management, which over the medium-term, is something worth aiming to achieve, it is not certain that the implementation of a fiscal rule is the most appropriate means to achieving this. This is especially important in an economy that has persistently experienced low growth such as South Africa. The imposition of a fiscal rule will hamstring much needed expenditure in key social and economic sectors which will worsen, rather than improve, the debt-to-GDP ratio. Below, we discuss South Africa’s history with the expenditure ceiling. The experience highlights that compliance has not been consistent, and has often been enforced through implementing austerity measures. Notably, this is not isolated to South Africa. In general, international experience below highlights that compliance is weak due to various factors. Below we argue that the introduction of a binding fiscal rule ignores the political economy of spending and borrowing in South Africa and that without taking this context, the rule will fail to achieve its intended objectives.

##### 4.1. South Africa’s mixed record with fiscal rules

South Africa has had some experience with fiscal rules with varying degrees of implementation. Most recently, in 2012, National Treasury introduced a nominal expenditure

ceiling. This fiscal rule sets an annual maximum level of main budget nominal non-interest spending over a four or five-year period. This implied that any additional spending demands within departments would have to be fulfilled through reallocations. In the following tables, we assess how well the expenditure ceiling fared in controlling spending across different three-year periods.

In the first seven years of its inception, 2012/13 - 2018/19, non-interest spending largely stayed within the three-year projected target as set out by the expenditure ceiling. We see this in table 3, which shows planned and actual main budget non-interest spending over three year periods, where actual spending exceeds planned spending once (in 2015/16). National Treasury was of the view that “Since 2012, despite considerable spending pressures, the main budget expenditure ceiling has anchored fiscal policy”.<sup>49</sup> This period also coincides with the beginning of intense fiscal consolidation. While the expenditure ceiling facilitated austerity, adherence does not appear to have significantly contained South Africa’s growing debt levels which moved from 41.1% in 2012/13 to 51.5% by 2018/19, and rising borrowing costs.

Table 3: Main budget non-interest expenditure (in millions of rands): 2012/13 - 2017/18

	2012/13	2013/14	2014/15
<b>Budget Review 2012 target</b>	879977.4	953023.6	1030539.3
Outcome	877374.5	946573.9	1017101.7
Deviation	2602.9	6449.7	13437.6
	2015/16	2016/17	2017/18
<b>Budget Review 2015 target</b>	1095904	1168973	1267486
Outcome	1115827.3	1158893.4	1242295.3
Deviation	-19923.3	10079.6	25190.7

For the most recent six years, 2019/20 - 2023/24 (Table 4), the expenditure ceiling has been an ineffective fiscal anchor, with main budget non-interest expenditure significantly exceeding its limit every year. The deviation between planned and actual spending widened considerably in 2022/23 and 2023/24. At the same time severe austerity since the inception of the expenditure ceiling contributed in part to low growth, and decreasing levels of service delivery. For instance, in 2021, social grants received below inflation increases. This meant they were cut by 2.4% in real terms. Moreover, proposals from the 2021 Budget meant that spending per person fell from over R27 000 in 2011/12 to below R25 000 in 2023/24.<sup>50</sup>

Table 4: Main budget non-interest expenditure (in millions of rands): 2018/19 - 2023/24

	2018/19	2019/20	2020/21
<b>Budget Review 2018 target</b>	1332076.2	1434907.1	1543592.8

Outcome	1324756.1	1486232.8	1556420.1
Deviation	7320.1	-51325.7	-12827.3
	<b>2021/22</b>	<b>2022/23</b>	<b>2023/24</b>
<b>Budget Review 2021 target</b>	1564511.1	1562820.7	1572454.6
Outcome	1619208.3	1700697.7	1688080.7
Deviation	-54697.2	-137877	-115626.1

Given the deviations in the estimates and outcomes, some have argued that the budget has slowly lost its credibility as a reliable estimate for government spending. While the deviations are linked to external shocks, such as the Covid-19 pandemic, floods, and load shedding, they are also as a result of policy incoherence, National Treasury's fiscal consolidation, and the refusal to budget for wage bill increases and other social priorities. This is picked up further below.

#### 4.2. In general compliance is poor

South Africa is not an outlier when it comes to poor compliance with fiscal rules. Despite the prevalence of fiscal rules, compliance with them has been poor. In Europe, only 3 of the 27 EU member states never breached either the budget balance or public debt rules of the Stability and Growth Pact (SGP) from 2008 to 2010, while 16 violated one or both rules in all three years and a further 6 in two years (Calmfors and Wren-Lewis 2011: 654). In Africa, there was a 54% compliance rate for 20 African countries from 1997 to 2016 (Nandelenga and Ellyne, 2020). In Latin America and the Caribbean: 14 countries achieved a compliance rate of only 63% from 2000 to 2020 (Ulloa-Suárez, 2023) whilst globally, a sample of 90 countries breached their budget balance rules and public debt rules 42% and 50% of the time from 2004 to 2021 (Davoodi et al. 2020: 19).

There are also often difficulties in ascertaining the efficacy of fiscal rules because of the inability to isolate the effects of fiscal anchors on fiscal outcomes. A fiscal outcome may be due to other factors, some of which may not be easy to observe.<sup>51</sup> For example, the deficit rule targets budget deficits as a share of GDP. A sudden, unexpected rise in GDP may lead to improvements in the budget balance share of GDP and an achievement of the rule, without any deliberate government actions to change spending or revenue. Efficacy of fiscal rules may also be impacted by other factors such as the institutional context, government in charge, and how the rules are enforced in practice. In this regard it is important to take these factors into account in evaluating country experiences with fiscal rules.

#### 4.3. The political economy of spending and borrowing decisions in South Africa

The proposal for a fiscal rule needs to be assessed not just on its technical merits but also its political feasibility. The current trend of the failure to adhere to the expenditure ceiling, and political contestations on the budget, may hinder its efficacy and these need to be considered in the proposal of a fiscal rule in South Africa.

In the current South African context, the fiscal rule may be unsuccessful at limiting expenditure (and ultimately violated) precisely because it does not take account of the real political economy factors at play in determining spending priorities. Take for instance National Treasury's previous deliberate decisions not to budget for above inflation public sector wage increases. In 2015/16 this resulted in breaching the expenditure ceiling (Table 3). In 2024, this had far more dire consequences resulting in budget shortfalls for education departments across the country. The Minister of Education in Western Cape stated that "despite implementing a drastic R2.5 billion budget cut, including on administration, curriculum and infrastructure" the province still faces "a R3.8 billion budget shortfall over the next three years".<sup>52</sup> The MEC stated that this issue is not isolated to Western Cape, with Kwa-Zulu Natal reporting that it cannot afford 11,092 of its teacher posts and faces a budget shortfall of R4bn in 2024.<sup>53</sup> In Gauteng, the MEC announced that the province would be cutting its budget for school nutrition and scholar transport to save more than 3,000 teaching jobs amid a R4.5 billion budget reduction.<sup>54</sup> On top of these cuts, the National Treasury failed to adequately budget for the continuation of the SRD grant, a part of South Africa's social grant system to which National Treasury is ideologically opposed.

In these and other similar instances, the National Treasury may have thought it was strategically tying the hands of those involved in debating these issues politically - how could public servants demand, and the Department of Public Service and Administration agree to, wage increases that couldn't be accommodated in the budget? This is naive and misguided (not to mention anti-democratic). Wage setting is the legitimate outcome of wage bargaining process, just as political decisions to fund certain spending priorities is the legitimate outcome of political representation and contestation.

National Treasury has to accept that the budget must, and should, accommodate for this, and that this political process cannot realistically be constrained by a technocratic rule. Fiscal rules will also need to have political buy-in from various stakeholders such as those at the National Economic Development and Labour Council (Nedlac) or the ANC's alliance partners. This may not be easy given that COSATU has already made a submission in parliament criticising the Fiscal Responsibility Bill and the impacts of fiscal rules.

Rather, if National Treasury is concerned, as we are, that we are not making the best use of our fiscal resources - that these are sometimes wasted, that there are things we are spending on that we shouldn't be, and that there are things we aren't spending on that we should be - then the appropriate intervention is to establish better vehicles through the which the political process of budget contestation can occur such that it channels us towards solutions that better prioritise our public spending. Perhaps a societal 'grand bargain' on the budget is needed - one in which all political constituencies would win some of their demands and lose others and together chart a more sustainable fiscal path. But this will not be achieved through implementing a fiscal rule.

#### 4.4. A debt rule may not actually place a legal restriction on spending

In the context of South Africa's constitutional framework, a debt rule may not in fact, actually legally contain expenditure. At this stage, we understand National Treasury's intent is to set legally-binding fiscal rule targets, for instance, that debt-to-GDP cannot exceed stipulated

percentages in forthcoming years. This is supposed to act as a break on spending - if we cannot generate the necessary funds then we will not be able to spend. Legally speaking, we understand the constitutionality of this approach to be in question. While Parliament may conceivably be able, through an Act of Parliament, to restrict National Treasury's administrative power to issue debt, for example, by limiting it to a certain percentage of borrowing each year, this is not the same as limiting Parliament's powers to appropriate funds.

So let us say that debt-to-GDP is set at 70% in 2026/27. This does not legally prevent Parliament from passing a budget that requires any given quantum of actual expenditure in 2026/27 fiscal year. If commensurate amounts cannot be raised through borrowing because of the fiscal rule, then National Treasury will need to either find those funds from elsewhere (that is, raise taxes or revenues another way) or break the fiscal rule (that is, breaking the law). Put another way, it is our current understanding that the South African constitutional framework does not actually allow for passing laws that would restrict Parliament from being able to exercise one of its discretionary powers - that of appropriating funds. Changing this would likely, therefore, require contemplating a constitutional amendment. This requires further legal analysis.

## 5. Unintended consequences

In addition to raising questions about the efficacy of fiscal rules it is important to note that fiscal rules have also given rise to a series of unintended, and perverse, consequences.

### 5.1. Inappropriate budget cuts

The first of these, building off our discussion of the political economy of spending decisions, is that such rules can give rise to inappropriate budget cuts. Indeed, after the the DA proposed a Fiscal Responsibility Bill in Parliament in 2021,<sup>55</sup> National Treasury acknowledged that the existing expenditure ceiling may have worsened the composition of spending by not accounting for public sector wage negotiations in 2015 and in 2018. In those instances, and subsequently, fiscal consolidation has led to either across-the-board, indiscriminate cuts or squeezed expenditure priorities that may not have political backing, such as nutritional meals for schools or the provision of school transport. Fiscal rules may therefore reduce the quality of fiscal policy given that they are not prescriptive on the composition of fiscal adjustment and this may result in cuts to important social priorities or capital spending.

Rather than foster a collective and rational conversation on the best utilisation of our scarce fiscal resources - in which all options are on the table - the imposition of a more stringent fiscal rule in South Africa is likely to see the universal squeezing of non-wage expenditure in a manner that does not take sufficient account of which spending is best placed to advance economic development and rights realisation. This may result in a short-term focus on adherence to the fiscal rule at the expense of long-term growth, equity, and development considerations.

## 5.2. Limiting our ability to respond to crisis and subsequently breaking the law

Second, fiscal rules may constrain fiscal policy in responding to external shocks, which require government intervention, by inhibiting counter-cyclical spending in times of economic downturns.<sup>56</sup> For instance, following the Global Financial Crisis, the shock to GDP, revenue, and expenditure meant that many governments could not comply with fiscal rules and the fiscal consolidation that was imposed by them. Some countries<sup>57</sup> resorted to temporarily suspending the fiscal rules, while others modified the fiscal limit.<sup>58</sup> The crisis revealed the rigidity of fiscal rules and their self-defeating nature in economic downturns. The latter was evident with the negative impact of fiscal consolidation on GDP which contributed to the worsening of the debt-to-GDP ratio.

Some scholars have argued that there is no need for fiscal rules in order for the government to commit to fiscal discipline, but rather, political will is what is more important.<sup>59</sup> Such criticisms argue that rather than encourage adherence, fiscal rules tend to lead to non-transparent behaviour to bypass the rules and this is more likely in an “environment of large deficits and debts, and sustainability concerns” as is the case in South Africa.<sup>60</sup> This floating of the fiscal rules comes across strongly in our case study of Brazil below.

## 5.3. Limiting democratic engagement

The successful implementation of a fiscal rule may also close important space for democratic contestation. The Brazilian experience, unpacked further below, shows that “in hurriedly adapting its rule-based fiscal policy to international technical standards, the PT government might have also increased the barriers to redistributive growth by reducing fiscal policy—and the public debates over its purpose—to the need to tame instabilities through automatic stabilizers.” This has meant the space to contest and debate the role of fiscal policy and its role in redistribution was closed by the need to adhere to fiscal rules. In South Africa, despite the budget process being celebrated for its transparency, we have already observed the budget making process being closed to a few technocrats with a limited role by CSOs, and other key stakeholders. The introduction of fiscal rules will further entrench this division and centre the need to adhere to technical rules over socio-political considerations.

## 6. International case-studies

We turn to international case studies to get a detailed account of the success and failures of fiscal rules. Beyond looking at compliance rates as we have done above, we want to understand what economic and political factors accounted for the compliance or non-compliance with the fiscal rules. This can help us estimate the likelihood for success of fiscal rules in South Africa. In addition, even where compliance was achieved, we want to know the political, administrative, and economic costs that came with that compliance. Furthermore, we want to be able to draw a causal link between fiscal rules and changes in the cost of borrowing and debt levels. Through this, we can be able to weigh the costs of undertaking fiscal rules with the gains to see whether this measure could be a net positive for South Africa. This requires a detailed examination of countries that have employed these measures. We do this through the case studies of Brazil and Indonesia. These countries are selected as they are in the same income group as South Africa, have a similar exposure to

international economic conditions as a result of liberalised trade and financial markets, and have had a sufficiently long history with fiscal rules such that the effects can be evaluated.

In this section we look 1) at the context for the rule, 2) compliance with the rule, and lastly a cursory evaluation of 3) whether implementation of the rule had any sizable or noticeable effect on the cost of borrowing and the debt-to-GDP ratio. We acknowledge that in regards to the third question, detailed econometric analyses are required to properly isolate the effect of the fiscal rule from other factors. Moreover, it is however important to stress that this exercise does not constitute a comprehensive assessment of fiscal rules.

That is because the proper context in which we must critically evaluate fiscal rules is the potential impact fiscal rules have on the ability of fiscal policy to drive state-led economic development. Hence, the key question we must ask, from an empirical point of view, is whether the implementation of fiscal rules in other countries around the world facilitated the necessary stability in public finances to enable fiscal policy to be an effective tool for economic growth and development? This question allows us to evaluate not only if fiscal rules were able to bring about fiscal sustainability – reduction in sovereign credit risk – but if they allow the government to use fiscal policy in response to crises,<sup>61</sup> for redistribution, and for the provision of essential public goods and services (including education, healthcare, electricity, water and other basic physical infrastructure). We tackle the latter question – the impact of fiscal rules on the role and use of fiscal policy – in a follow up report.

## 6.1. Brazil

### 6.1.1. Background and the implementation of fiscal rules

Fiscal rules in Brazil emerged as a crisis-management tool imposed by a conservative government and the IMF in a package aimed at alleviating debt problems. Brazil's public debt problems were rooted in the country's reliance on external financing and its volatile currency. This vulnerability was exposed amid the Asian and Russian financial crises in 1997 and 1998, respectively.<sup>62</sup> These crises led the central bank to hike domestic interest rates as a way of discouraging capital outflows while stabilising inflation to moderate levels. The period between 1997 and 2000 saw a surge in domestic interest rates. For instance the SELIC rate (the benchmark central bank rate, equivalent to repo rate in South Africa) increased from 25.13% in November 1996 to 46.26% in November 1997,<sup>63</sup> while the nominal interest rate on Brazil's Treasury bills jumped from 24.5% in November 1996 to 42.32% in November 1997.<sup>64</sup>

Research by Brazil's National Treasury and the World Bank found that the central bank move to hike interest rates was one of the main causes of a rapid spike in the debt-to-GDP ratio.<sup>65</sup> These rate hikes, alongside fiscal support for ailing state-owned enterprises (SOEs) and sub-national governments, led to a large increase in debt service costs. The rise in debt service costs can be observed in the interest paid on public debt as a share of GDP, which spiked from 5% in 1997 to 12.26% by 2002.<sup>66</sup>

In 1998, Brazil's government took finance from the IMF as part of a programme to alleviate pressure on their fiscus.<sup>67</sup> As outlined in the 'Memorandum of Economic Policies' of the

Letter of Intent, the IMF programme was carried out on the condition that the government commits to drastic fiscal adjustments (at both federal and state level). These fiscal adjustments would then be entrenched through fiscal rules, which the government promised to put into law.<sup>68</sup> In 2000, the government put in place the Fiscal Responsibility Law, a set of public finance reforms which included fiscal rules. At that point, it was the second instance of fiscal anchors, and there have been two other sets of fiscal rules implemented since. We summarise these fiscal anchors in Table 2.

Table 2: History of Fiscal Anchors in Brazil (1988 - 2023)

Year	Rule	Purpose
1988	Golden Rule	Adopted to safeguard fiscal responsibility and public investment.  Restricts new borrowing to finance capital expenditures, to limit (current) fiscal deficits and reduce public debt, while allowing flexibility to tackle large infrastructure investment needs. The rule applies to each level of government.
2000	Fiscal Responsibility Rule	Consolidated various norms intended to promote fiscal transparency, limit deficit biases, improve budget planning, and define control mechanisms at all levels of government.
2016	Federal Spending Ceiling	Introduced in the wake of the 2015–16 fiscal crisis to address procyclicality and reverse the secular rise in the federal spending ratio. The rule limited federal primary spending growth to inflation for 20 years, with a possible revision after 10 years.
2023	Sustainable Fiscal Regime	Restricts spending growth below revenue growth to guide fiscal consolidation

Source: IMF e-Library, Volume 2023: Issue 289<sup>69</sup>

The Fiscal Responsibility Law strongly emphasised that fiscal targets must abide by or be consistent with the objectives of national economic policy and not the other way around. First, the Law says that the annual budget must set three-year targets for the primary balance, revenues and expenditure, and for public debt, accompanied by “evidencing their consistency with the national economic policy premises and objectives”.<sup>70</sup> Second, this law imposed a limit on personnel spending at the federal level stipulating that it cannot be in excess of 50% of net current revenues,<sup>71</sup> while the limit was set at 60% of net current revenues for both the state and municipal levels.<sup>72</sup> The Law also required that as the Annual Budgetary Law (the budget to start the fiscal year) is tabled, the President must set a multi-year debt ceiling (as a proportion of revenue) for all levels of government, alongside a demonstration that the debt ceilings are consistent with the objectives of fiscal policy. The limits on public debt and revisions thereof are subject to the approval of the Federal Senate and National Congress.<sup>73</sup>

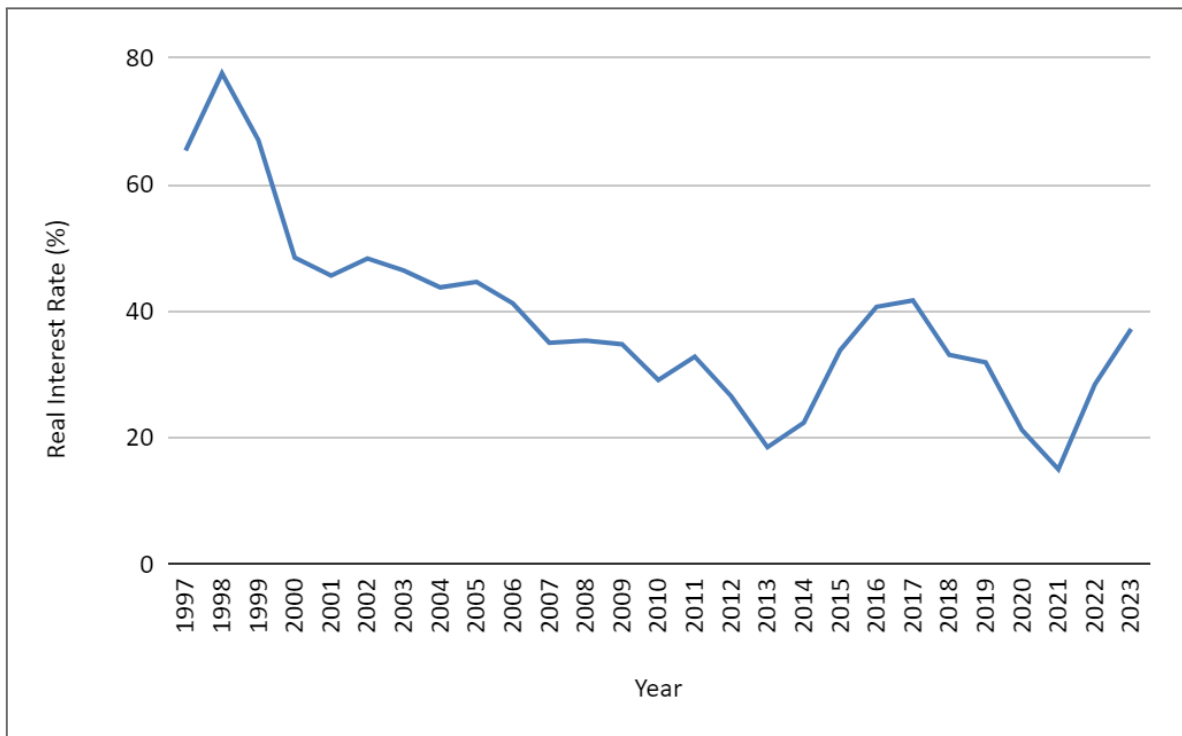
### 6.1.2. Compliance with, and efficacy of, the fiscal rule

The achievement of headline target fiscal aggregates masked dubious accounting practices used by bureaucrats and state officials to adhere to the rule and the renegeing on expenditure items that were agreed-upon in the budget. Since the Law was instated, Brazil managed to contain personnel spending within the threshold at all levels of government<sup>74</sup> while annual primary surplus targets were not only met but were surpassed on many occasions.<sup>75</sup> The IMF and the Inter-American Development Bank noted the extensive, government-wide use of ‘creative accounting’, which came in the form of systematic improper recording of personnel expenses and negative balances, all for the purpose of meeting fiscal rules.<sup>76</sup> The use of creative accounting worsened as economic growth subsided and therefore reduced fiscal space after the Global Financial Crisis.<sup>77</sup> The Inter-American Development Bank highlights that during the 2000s in Brazil, the achievement of higher-than-expected primary surpluses involved “systematically denying expenditures that have been approved in the budgetary process and that have important constituencies”.<sup>78</sup> Importantly, these events led credence to the critique that fiscal rule incentivises a bypassing of rules. In a sense, the fiscal rule becomes an end in itself and no longer functions to enhance transparency and credibility of fiscal policy, nullifying its purpose and potentially creating more risks for the fiscus.

Not only was the rule poorly applied, but it did not on its own improve debt dynamics in Brazil. Rather, this was the result of measures taken to reduce the frequency and size of non-budgeted (discretionary) spending and the cost of debt, combined with economic growth resulting from a global commodities boom. The reduction of the borrowing powers of sub-national governments ensured that these would remain solvent, making bailouts (and therefore additional, often unplanned spending) from the federal government less frequent.<sup>79</sup> As noted by Brazil’s National Treasury, this component of the Fiscal Responsibility Law contributed significantly to the achievement of primary surpluses.<sup>80</sup> Moreover, the wide-scale privatisation of public banks, which required substantial bailouts following the financial crises reduced pressures on the fiscus.<sup>81</sup> Coinciding with this consolidation of the fiscus, the Brazilian economy, whose exports have a high share of primary products, benefited greatly from a commodities boom that started around 2004.

Prior to the commodity boom-induced economic growth, there were no noticeable improvements in the cost of borrowing, despite implementation and compliance with the Fiscal Responsibility Law. In spite of the government primary surpluses and implementation of other tenets of the Fiscal Responsibility Law, credit ratings by agencies Moody’s and Standard and Poor oscillated between positive and negative outlook between 2000 and 2003.<sup>82</sup> As we can see in Figure 2, the 10-year real interest rate on government bonds only saw a marginal dip from 48.5% to 46.44% between 2000 and 2003. This period also coincided with inconsistent growth, which was below 1.5% in 2001 and 2003, and above 3% in 2000 and 2003 (as seen in Figure 3).

Figure 2: Real interest rate on 10-year government bond in Brazil, 1997-2023

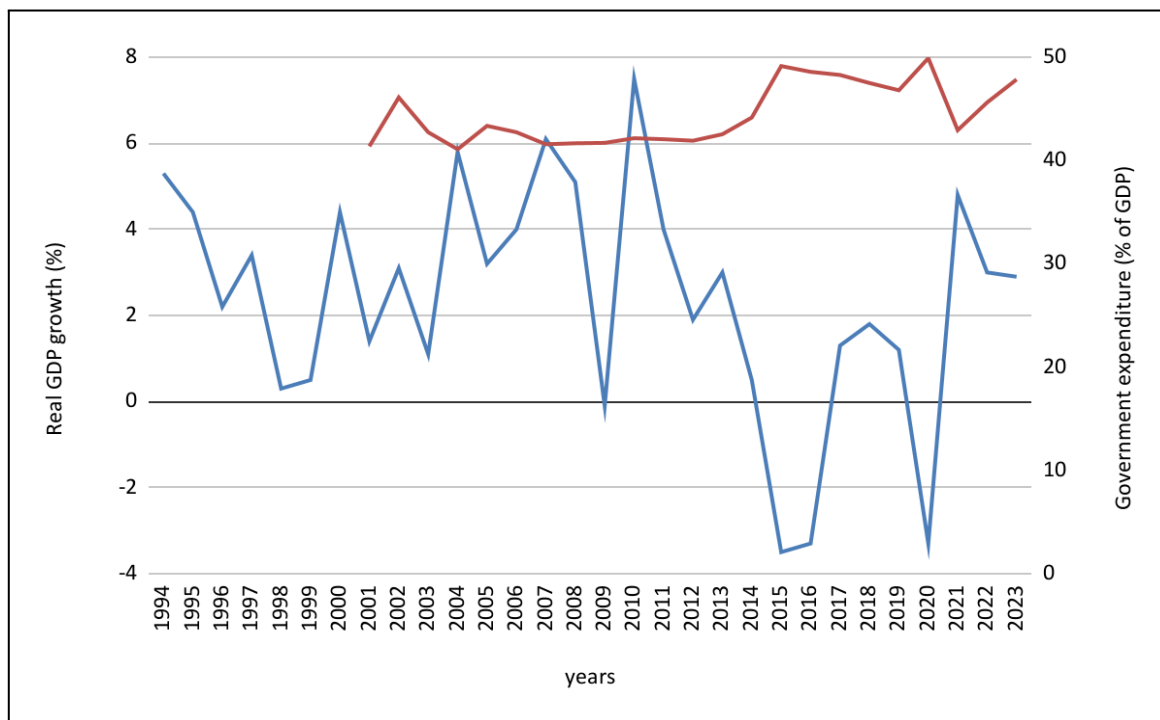


Source: World Bank<sup>83</sup>

By contrast, with the start of commodities boom fueled growth in 2004, Brazil saw a year-on-year maintenance or improvement in its domestic and foreign currency Standard and Poor and Moody’s credit rating until 2013.<sup>84</sup> This period saw a resurgence of economic growth in Brazil, which averaged 4.84% in the period 2004 to 2008 and 4.1% amid recovery from the Global Financial Crisis in 2008 to 2013.<sup>85</sup> As expected, with an improvement in credit ratings, Brazil also saw a consistent tumble in the real interest rate on government bonds, starting from 2004 at 43.78% to 18.5% in 2013.<sup>86</sup> Overall, we observe that economic growth was a big factor explaining the evolution of the cost of borrowing prior to, and after, the institution of fiscal rules. The effectiveness of the fiscal rule in restoring fiscal sustainability was highly dependent on the externally-imposed commodities boom, an enabling macroeconomic environment, and reforms designed to limit discretionary spending.

The use of revenue-raising measures and redistributive programmes assisted the Brazilian government to play an active role in reducing poverty and expanding welfare. Even as Brazil underwent fiscal consolidation in 1999 as part of the IMF programme, the government undertook to increase taxation on enterprise income, simplified the tax system through a single VAT system, and increased taxation on financial transactions.<sup>87</sup> Increased domestic resource mobilisation, as well as economic growth as a result of the commodities boom also aided the government to increase expenditure while achieving surpluses that were in line with the annual target, per the fiscal rule. The increase in the size of government spending during the commodities boom period can be seen in Figure 3 which shows real GDP growth (left y-axis, blue line) and expenditure (right y-axis, red line). Between 2003 and 2013, the share of expenditure in GDP was largely constant, hovering in the 41%-43% range. With positive output growth, this implies year-on-year increase in government spending.

Figure 3: Real GDP growth and government expenditure share of GDP in Brazil, 1994 - 2023



Sources: IMF (real GDP growth)<sup>88</sup>; (government expenditure share of GDP)<sup>89</sup>

In 2017, Brazil had its first fiscal deficit since the inception of Lula’s Workers Party. By 2017, there were three different rules in place - the Fiscal Responsibility Law, the Golden Rule and an expenditure ceiling. These rules contradicted each other and each had different objectives.<sup>90</sup> The shifting economic and political dynamics impacted the long-term implementation of the rules and the role of fiscal policy. Fiscal policy shifted from supporting growth in expenditure to advancing austerity, reversing the impact of progressive programmes such as improved access to cash transfers through the Bolsa Familia, and the minimum wage policy which enabled the increase of labour share and household consumption.<sup>91</sup>

### 6.1.3. Lessons from Brazil

We derive three key lessons for South Africa from Brazil’s experience with fiscal rules.

First, the imposition of the fiscal rule led to the use of improper accounting practices in order for the government to give the illusion that it was abiding by the fiscal rule. However, these practices inherently undermine the reasons put forward by mainstream economists in support of fiscal rules as a tool to enhance credibility and transparency.

Second, sustained economic growth, due to the commodities boom, was necessary to improve debt dynamics, including a falling debt-to-GDP ratio and lower borrowing costs in the long run. However it is not clear that fiscal rules – by themselves – led to lower borrowing costs and fiscal stability. Instead, as the commodity boom waned, the fiscal rules entrenched austerity measures at the expense of key social services.

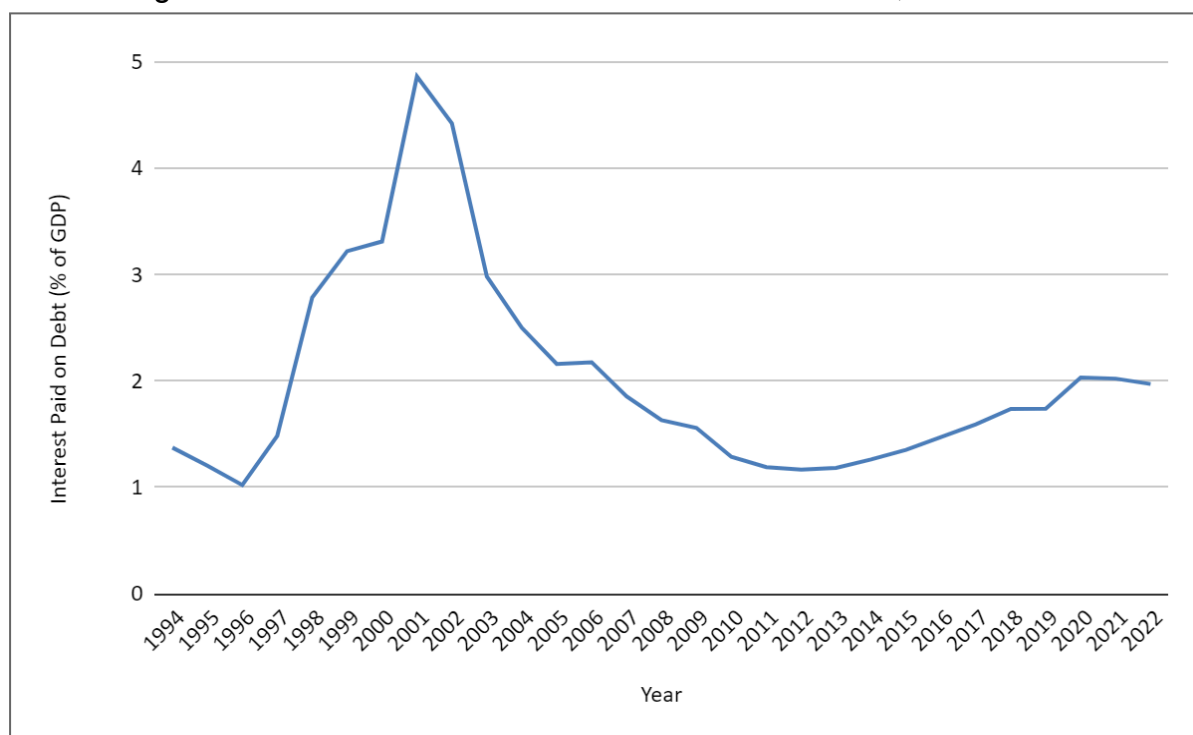
Third, fiscal rules are not a substitute for prudent, long-term budgeting which requires a consensus among key stakeholders. Part of the reason the fiscal rule became credible was because the Brazilian government offloaded many of the items which required discretionary spending, through privatisation of SOEs and limiting borrowing power of sub-national governments, and capping personnel spending at all levels of government. For South Africa, the cases for large-scale privatisation and the capping of personnel spending are significantly weakened by the likely negative effects on the welfare of the majority of the population. Regardless, for any fiscal rule to be credible, it will be crucial for National Treasury to come to long-term strategies and agreements with stakeholders such as public sector unions, government departments, and the public at large.

## 6.2. Indonesia

### 6.2.1. Background and the implementation of fiscal rules

In Indonesia, the institution of additional fiscal anchors also emerged as a means to control rising debt service costs which had soared on the back of the Asian financial crisis of 1997-98.<sup>92</sup> The root of Indonesia's crisis was its dependence on external financing, a condition made possible due to the central bank policy of high interest rates employed to stabilise the Indonesian currency amid capital outflows.<sup>93</sup> In tandem with this high interest rate policy, debt accumulation accelerated due to the fiscal support provided to recapitalise banks in the aftermath of the Asian financial crisis.<sup>94</sup> As we can see in Figure 4, these events prompted an uptick in debt service costs, which reflected a rapid increase in the interest paid on debt as a share of GDP around 1997. Amid difficulty in servicing its debts, Indonesia's government turned to the IMF. The IMF offered support finance on condition of the maintenance of restrictive fiscal and monetary policy. The fiscal component of this deal was institutionalised through an additional set of fiscal rules.

Figure 4: Interest Paid as a share of GDP in Indonesia, 1994 - 2022



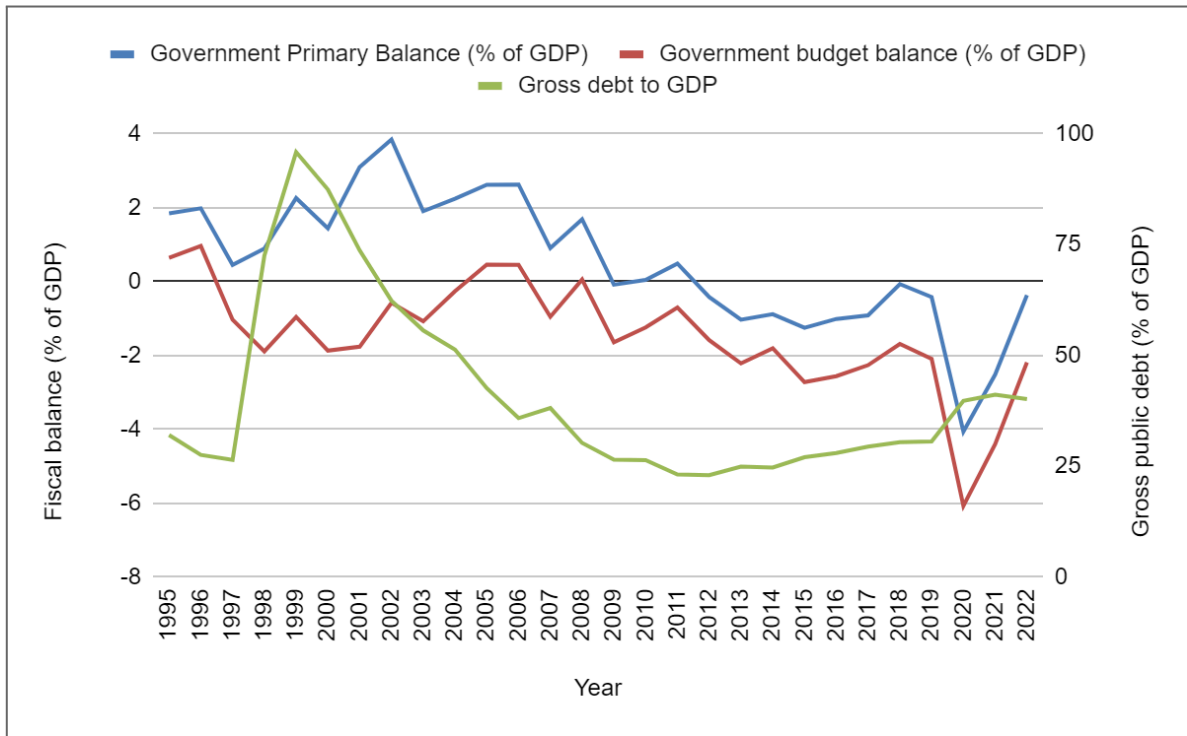
Source: IMF<sup>95</sup>

To solidify commitments to fiscal consolidation, Indonesia enacted two types of fiscal rules in 2004. These were, the Budget Balance Rule and the Debt Rule (State Finance Law No.17/2003, Explanation of Article 12 (3)).<sup>96</sup> The maximum budget deficit is 3% of GDP, meanwhile the maximum allowed public debt-to-GDP level is 60%.<sup>97</sup>

### 6.2.2. Compliance with, and efficacy of, the 2004 fiscal rules

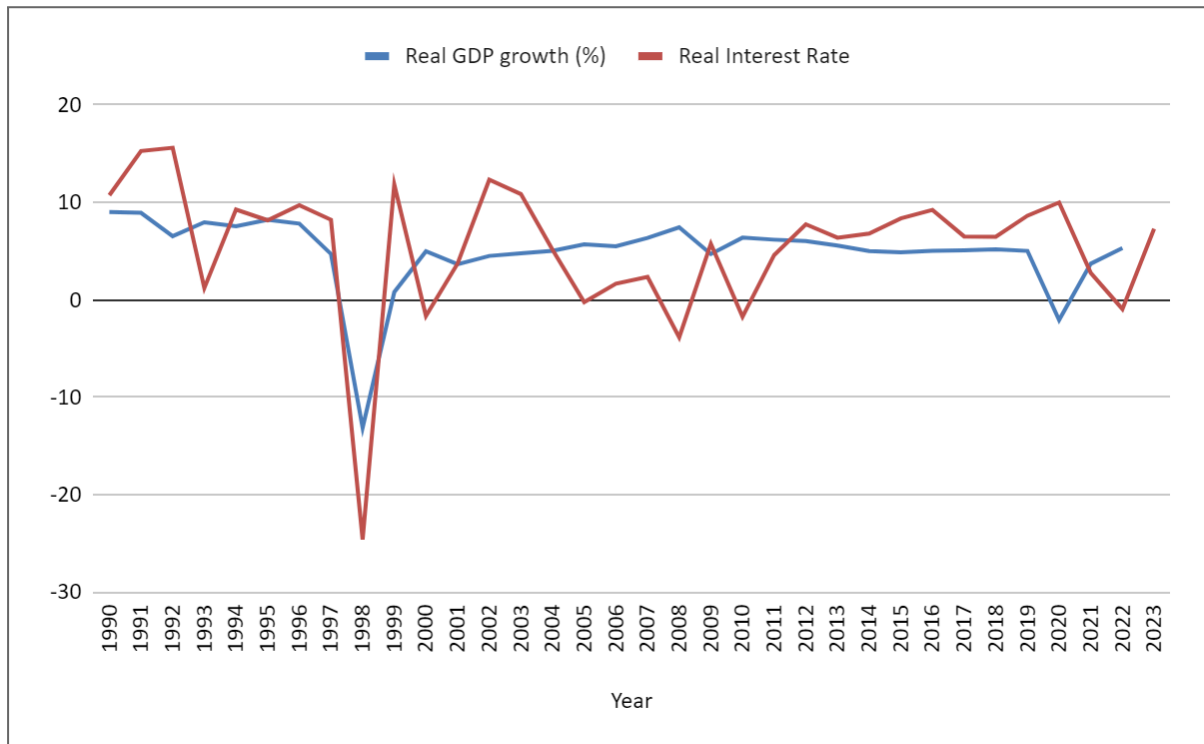
The recovery of economic growth, rather than the implementation of fiscal rules, appears to be the major factor explaining the stabilisation of fiscal aggregates in Indonesia. Some have argued that fiscal rules have helped Indonesia build a solid record of fiscal management and won investment grade ratings from agencies.<sup>98</sup> However, this is not supported by the evidence. First, Francis observes that the Indonesian government had followed a conservative fiscal stance even before the crisis of 1997, recording fiscal surpluses in the period 1990-1996.<sup>99</sup> Second, in Figure 5, we observe that while debt and fiscal balances were within their threshold, they did not have any noticeable improvement following the implementation of the fiscal rule. In fact, debt-to-GDP had been declining since 2000, whereas primary and budget balances actually declined further as a share of GDP. On the other hand, the achievement of positive balances and debt reduction coincided with the resurgence of economic growth in 2000, which we can see in Figure 6, following the financial crisis induced downturns in 1998 and 1999. In sum, the restoration of fiscal aggregates was likely the result of the continuation of a conservative fiscal stance which had provided surpluses before the financial crises, and the recovery in economic growth.

Figure 5: Government primary and budget balance and public debt as a share of GDP in Indonesia, 1995 - 2022



Sources: IMF (primary balance);<sup>100</sup>(budget balance);<sup>101</sup> (debt to GDP)<sup>102</sup>

Figure 6: Real GDP growth and Real interest rate on 10-year Government Bond, Indonesia 1990 - 2023



Sources: IMF,<sup>103</sup> World Bank<sup>104</sup>

Fiscal rules also appear to be an insignificant factor in explaining the decline in the cost of debt. First, we note that even as fiscal aggregates improved in the period preceding the fiscal rule, 2000 to 2003, there was no impact on real interest rates on government debt, which still hovered above 10% in 2002 and 2003. One counter-argument is that the decrease in the cost of debt as a result of improved fiscal balances happens with a lag. However, the onset of the global commodities boom from 2004 appears to be the likely explanation for stabilisation in the borrowing rate. This is because the commodities boom anchored economic growth. This improved the fiscal outlook as economic growth allowed for greater revenues, which, within the government's already conservative fiscal stance, meant higher fiscal balances. Nevertheless, since 2012, the primary balance has been deteriorating, reaching its trough in 2020, amid the economic downturn brought about by Covid-19, with the Indonesian government scrapping the 3% of GDP budget deficit limit for the years 2020 to 2022.<sup>105</sup>

### 6.2.3. Lessons from Indonesia

Significantly, many of the lessons from the Brazil experience also come out with Indonesia. First, economic growth appears to be the major explanatory variable for the changes in fiscal aggregates, with no discernable impact of fiscal rules. Second, the main factor behind the reduction in discretionary spending was the policy certainty provided by privatisation of SOEs, which had required bailouts from the government.

Lastly, fiscal rules may not be necessary to undertake a programme of debt reduction and positive fiscal balances. Instead, the imposition of fiscal rules highlights the power of organisations such as the IMF in influencing public policy. This is because it was only through taking up the IMF programme that Indonesia had to implement fiscal rules, even though their pre-crisis experience showed the government was more than capable of maintaining stable public finances.

## 7. Ten lessons for South Africa

The use of fiscal rules has grown over the last decade. Such rules have emerged in different contexts as a solution to address increasing debt, guide the actions of policy makers, and to ensure credibility of fiscal policy. From the preceding discussion we extract the following lessons to inform the debate moving forward.

1. **Fiscal rules are ill-suited to a world of growing external shocks.** While fiscal rules have been introduced following times of crisis, the experiences of Brazil and Indonesia highlight how they are also vulnerable to external and internal shocks. Overall, we observe that the rigidity of fiscal rules constrain government efforts to enact counter-cyclical policy and thereby place a constraint on fiscal policy. This has often led to breaches of the fiscal rules in place. In the context of increasing economic and climate shocks the appropriateness of fiscal rules is questionable.
2. **Fiscal rules may clash with developmental goals.** In Brazil, the limits placed upon by the fiscal rules clashed with the need for social support once economic growth weakened. Austerity measures were imposed to abide by the numerical limits placed

by the fiscal rule. Therefore, a significant yet unintended consequence of binding fiscal rules is that the adherence to the rule may distract from the achievement of developmental or welfarist outcomes. The IMF also notes this effect as one of the potential drawbacks of using fiscal rules.<sup>106</sup>

3. **Fiscal rules may distort spending in unhelpful ways.** With the need to adhere to fiscal rules, contestation over budget priorities will intensify, with expenditure items that have political backing receiving priority whilst those with politically weak backing will be sacrificed in order to comply with the fiscal rules. In South Africa, the provincial sphere of government – which is tasked with administering crucial social services such as basic education and healthcare – has relatively little revenue-raising power and relies on transfers from the national government to undertake its duties. Where these departments receive allocations that are far below requirement, they are likely to cut on ‘low hanging fruit’, that is, expenditure items that do not have an organised, politically powerful constituency such as school meals and transport for children.
4. **Monetary policy has a significant impact on borrowing costs.** There is a need to consider central bank policy as one of the tools to address high debt service costs. Due to the fragility of the Indonesian and Brazilian local currencies, and the countries’ reliance on foreign financing, monetary policy was highly restrictive. This however meant that domestic borrowing rates, including on government bonds, were pushed up. Fiscal adjustment was then the main way used to reduce debt service costs. This means it is necessary to question the wisdom of solely using the repo rate to fight inflation and protect the exchange rate. Specifically, it means the South African Reserve Bank may need to explore alternative tools of dealing with the exchange rate and inflation, that do not comprise the government’s ability to borrow cheaply.
5. **Economic growth remains key.** Even in cases where there is compliance with the fiscal rules, borrowing costs, and the debt levels are also dependent on the growth path of the economy. It is clear that high levels of growth may support adherence to fiscal rules and the use of fiscal policy to support redistributive policies, while in times of low growth compliance to the rules may hinge on implementing creative accounting or austerity measures. The current low growth path of the South African economy, as well as the experiences with the expenditure ceiling make the proposal for a binding fiscal rule unviable.
6. **Flexibility of fiscal rules must align with the goals of fiscal policy.** The Brazilian experience also suggests that while fiscal anchors are typically put in place to secure austerity, this need not be the case. Specifically, if the implementation of fiscal rules – in order to better align expenditure to revenue – is paired with revenue raising measures, it is possible to reduce budget deficits (in absolute terms) while maintaining positive growth in real non-interest spending. But, in a population where the majority have very little to no excess income, revenue-raising through direct taxes must be progressive - the burden must be on those at the higher end of the wealth and income distribution. The government still has room to boost tax revenue in a

growth-neutral or growth-positive manner by increasing the progressivity of the tax system.

7. **Fiscal rules do not resolve political contestation and may result in the illegal circumvention of the rule:** As noted above, and in the case of Brazil and South Africa, adherence to fiscal rules is sometimes at odds with the political interests of particular groups. Labour, civil society organisations and other groups may make claims for their interests in the budget process which, depending on their relative social power, may force the government to relax fiscal rules. In the long term this erodes credibility of the fiscal framework and the budget.
8. **Fiscal rules may encourage the use of opaque accounting techniques to comply with numerical limits.** Implementing a fiscal rule, especially one which will require rapid fiscal consolidation, is likely to cause departments to fail in carrying out their mandates or to use creative accounting methods. This will limit the transparency and credibility of the budget.
9. **Given South Africa's legal framework it is unclear whether a fiscal rule will, in fact, place a binding limit on expenditure.** A binding fiscal rule may be able to set a limit on debt-to-GDP levels, however, constitutionally, this may not in fact restrict the quantum of funds that Parliament is able to appropriate. Changing this would likely, therefore, require contemplating a constitutional amendment.
10. **IMF backed fiscal rules undermine policy sovereignty.** As noted, both South Africa and Brazil agreed to consider the introduction of binding fiscal rules to facilitate fiscal adjustments in their Letters of Intent sent to the IMF, prior to the approval of financial support. In this sense, fiscal rules have been adopted with the influence of the IMF in exchange for financial support. Therefore their adoption has resulted from, in part, the political influence of the IMF. This undermines domestic policy sovereignty and closes the space to contest and debate fiscal policy, especially in developing, and upper-middle income countries.

## 8. A way forward

Given the preceding analysis, in the contemporary South African context we are doubtful that a fiscal rule offers a meaningful way of improving budgetary processes and fiscal outcomes. This does not mean that no action is required, quite the opposite. Here we provide a provisional framework for considering improved processes, targets, and tools.

If National Treasury wants to achieve a more sustainable fiscal path it needs to build political convergence behind such. This requires mechanisms through which spending, and associated revenue raising, represents the outcome of collectively-agreed prioritisation rather than centrally-imposed extreme fiscal restraint.

The starting point for this has to be a new approach to fiscal policy by National Treasury. Bizarrely, National Treasury seems to have got caught up in a policy approach that views the budget as a source of potential economic harm rather than as a lever for economic

transformation. Under their current approach, budget policy seems geared towards limiting the harm it can do, rather than harnessing its positive potential. National Treasury needs to reclaim the budget as one of our most powerful tools for remaking our society and economy. On this basis, a robust and collectively-agreed process should investigate where we derive most 'bang for our buck'. The short, medium, and long-term impact of different spending decisions should be assessed through a government-wide spending review. Where benefit is not derived it should be possible to reduce expenditure, or arms of government (for example, municipalities) should be given assistance to spend in a manner that does yield benefit. Where benefit is most pronounced it should be possible to increase spending or add new expenditure.

This needs to be accompanied by new targets for fiscal policy. Fiscal consolidation should never be the overriding objective. Fiscal consolidation, like fiscal expansion, are a means to an end. Fiscal policy should aim to, at least: maximise economic growth and support domestic demand; reduce unemployment; contribute towards structural transformation and the expansion of supply capacity; ameliorate against destitution and hardship; provide for comprehensive social and care services while supporting the social wage. In the long term, such a shift will spur growth, alleviate debt levels, and improve tax revenue.

Such a process must include interrogation of ways to progressively raise additional revenue. Tax breaks for high-income individuals and corporations must be reviewed; restoring the corporate income tax rate to 28% explored; taxing wealth, financial transactions, and reforming the taxation of dividends and estate duty modelled;<sup>107</sup> and vehicles for tax evasion closed.

At the same time, debt needs to be tackled through mechanisms to directly lower the cost of borrowing, and, where possible, limit borrowing needs. This should include, at least, the prudent use of: capital management techniques to stabilise short-term, speculative capital flows and provide room to reduce interest rates; capital allocation tools to steer credit to productive sectors of the economy at affordable rates, including through Reserve Bank lending; central bank intervention in the primary market to purchase government bonds;<sup>108</sup> prescribed assets to make available large pools of capital at affordable rates; slightly shortening the average maturity of government borrowing; and preferential lending, including from international financial institutions (IFIs)<sup>109</sup> where this will not compromise domestic policy space. SOE debt and sovereign guarantees require particular attention, with the need to renegotiate some of this debt (Eskom's in particular), while moving away from generous guarantees for public-private partnerships.

Ultimately, the only credible way to restore the health of public finances is through economic growth. The current fiscal framework is misplaced in narrowly focusing on debt reduction. Rather than alleviate debt and debt service costs, the proposal for a fiscal rule, in the context of poor economic growth, risks undermining the quality of fiscal policy, exacerbating budget cuts, and closing the space democratic participation and negotiation of the budget process. It is for this reason that fiscal policy needs new targets, such as alleviating unemployment and fostering structural transformation, alongside coherent processes for negotiating budget repriorisations, not technocratic quick-fixes that impose fiscal straight-jackets.

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