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FIXING SOUTH AFRICA'S DEBT

Why Rigid Fiscal Rules are Not the Answer

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SUMMARY OF FINDINGS

- Proponents of fiscal rules say that discretionary fiscal policies lead to unsustainable debt and that such rules enhance credibility.
- However, we argue that South Africa's main issue is not the quantum of its debt, but the cost of that debt. South Africa's debt-to-GDP ratio is in line with similar countries, but its debt service costs are significantly higher.
- The impact of fiscal rules is mixed; where there seems to be an impact, there is no evidence of a causal relationship between fiscal rules and debt outcomes.
- There are more direct ways to tackle the cost of debt other than fiscal rules.
- Despite their popularity, compliance with fiscal rules is weak, and institutions are important to facilitate adherence.
- International cases show that:
  - Fiscal rules encourage 'creative' accounting practices as governments attempt to appear to comply.
  - Growth has been much more effective than fiscal rules in improving debt dynamics.
  - Fiscal rules are no substitute for prudent, long-term, consensus-based budgeting.
  - They limit democratic engagement in fiscal policy.
- In South Africa, imposing a fiscal rule would ignore the political and social realities that put pressure on spending, thereby reducing the quality of fiscal policy.
- It is not clear that such rules can legally override the powers of Parliament.

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KEY LESSONS AND RECOMMENDATIONS

The key lessons for South Africa are that fiscal rules:

- Impose rigidity to fiscal policy and are ill-suited to a world of growing external shocks.
- Cannot be a substitute for budgeting based on negotiation and consensus-building with stakeholders
- May clash with developmental goals.
- May distort spending in unhelpful ways.
- May encourage the use of opaque accounting techniques to comply with numerical limits.
- May fail to place a binding limit on expenditure.
- The influence of the IMF requiring fiscal rules undermines domestic policy sovereignty and closes the space to debate fiscal policy.

We therefore make the following recommendations:

- Build a sustainable fiscal path and political convergence on spending, and associated revenue-raising measures rather than imposing fiscal restraint.
- Use fiscal policy to maximise economic growth and contribute towards structural transformation.
- Use fiscal policy to tackle unemployment, support domestic demand, and expand supply capacity
- Direct adequate spending towards comprehensive social and care services while supporting the social wage.
- Reduce the cost of borrowing through Reserve Bank intervention, targeted capital controls, capital management techniques, and credit allocation policies.
- Use prescribed assets to make available large pools of capital at affordable rates.
- Assess the impact of using the repo rate as the main tool to control inflation and exchange rate as the repo rate affects domestic interest rates, which hikes the cost of borrowing domestically.
- Consider the renegotiation of or cancellation of portions of SOE debt (especially Eskom).
- Take proactive measures to raise revenue by reducing tax breaks for higher-income taxpayers; restoring corporate income tax to 28%, aligning estate duty on large estates with the upper Personal Income Tax brackets, and discontinuing the Employment Tax Incentive.
- Sequence the introduction of a Net Wealth Tax, taxes on the trading of financial assets, and a Resource Rent Tax.

1. INTRODUCTION

CONTEXT

The South African government has been talking about new fiscal rules since at least 2019.[1] In 2020, a Letter of Intent accompanying the IMF Rapid Financing Instrument said "we are open to introducing a debt ceiling in addition to the nominal spending ceiling currently in place".[2] In 2023, South Africa's National Treasury presented to the President its plans to contain debt and ensure fiscal sustainability. A key proposal was the introduction of a new 'budget anchor'. The Treasury argued that "fiscal credibility will require South Africa to adopt fiscal rules," such as a debt ceiling or a primary balance target.[3] In the 2024/25 Budget, Treasury reiterated its commitment to a "binding fiscal anchor", as debt has "failed to stabilise, with a persistent deficit in the primary balance",[4] saying that it would engage in extensive consultation.

The proposal and commitment have been welcomed by the Democratic Alliance (DA), who submitted a Private Member's Bill in 2023,[5] which proposed a debt ceiling, arguing that "Introducing a debt rule would enable a more risk-based fiscal policy and allow for adjustments in spending in line with debt sustainability".[6]

The National Treasury argues that the stress on public finances stems from too much discretion in the use of fiscal policy, which allows too much accommodation of spending demands. The result has been wider and more persistent budget deficits, which have increased debt-to-GDP levels and borrowing costs to unsustainable levels. The higher borrowing costs, so the argument goes, have crowded out private investment, which has contributed to long-term economic stagnation.

The Treasury argues that the debt trajectory can be addressed by "a combination of active debt management strategies and spending restraint that improves the primary fiscal balance".[7] 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".[8] This will contribute, they argue, towards a more sustainable path of public finances.

There are at least three components to this argument:

1. At the heart of South Africa's fiscal woes is too much debt.
2. There is too much debt because political decisions keep getting made to spend in areas that we shouldn't be spending.
3. Such spending decisions can be constrained by the imposition of a binding fiscal anchor.

In the absence of information on the nature of the fiscal anchors being proposed, our initial assessment, explained in this Policy Brief and a previous Discussion Paper entitled *'Are Binding Fiscal Rules the Right Solution for Debt Sustainability in South Africa?'*, is that Treasury's argument is flawed in all its components.

STRUCTURE OF THE POLICY BRIEF

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 outline the problems with fiscal rules. Section 4 draws lessons from the experiences of Brazil and Indonesia. Section 5 focuses on South Africa, its history with fiscal rules, the nature of its debt problem, and whether a fiscal anchor would be successful in solving that problem. Section 6 draws together lessons for South Africa from this analysis, and Section 7 provides recommendations.

2. OVERVIEW OF FISCAL RULES

USE AND DEFINITION OF TERMS

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 'fiscal anchor' and 'fiscal rules' are often used interchangeably, they differ in scope. A fiscal anchor broadly constrains fiscal outcomes or processes to shape expectations about future policy,[9] whereas a fiscal rule imposes a permanent numerical constraint on key fiscal indicators like deficits, borrowing, or debt.[10]

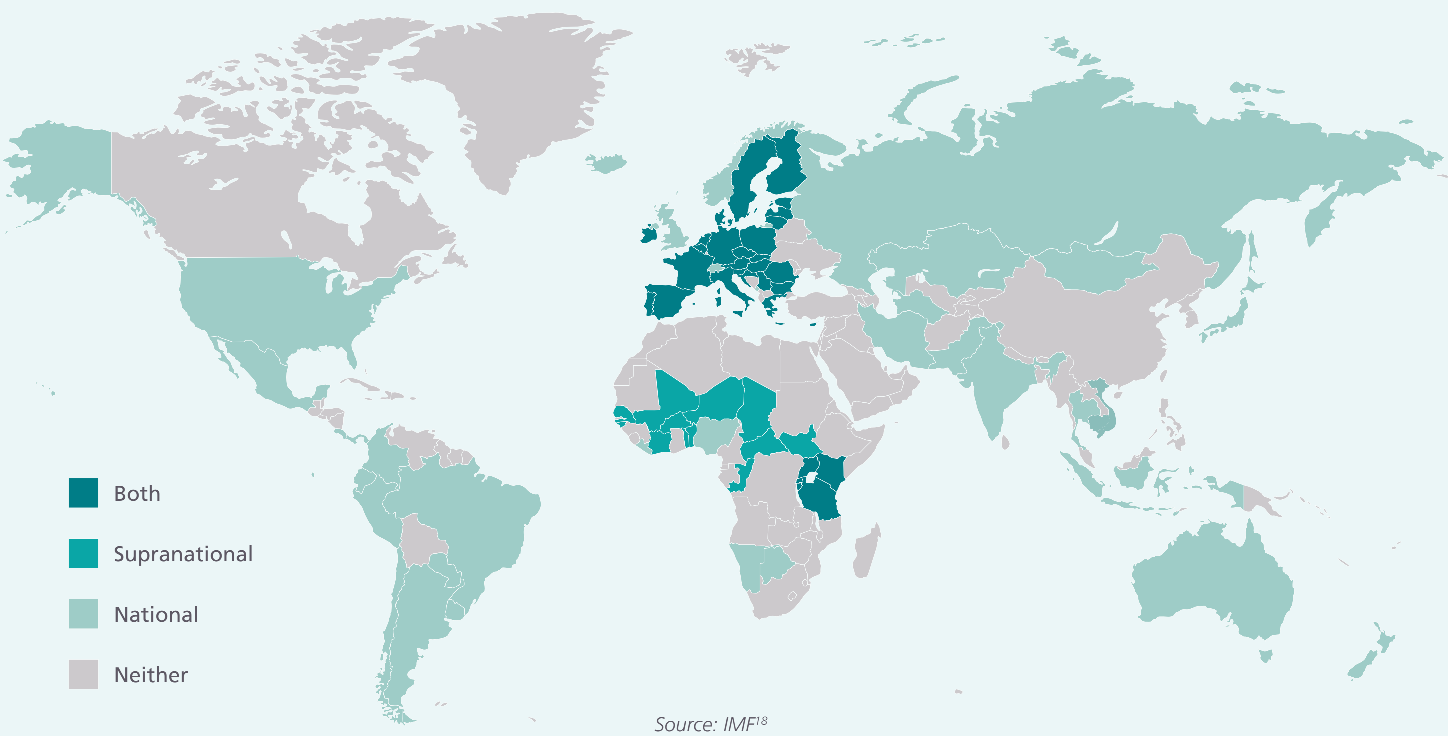
Recent definitions have tended to be more flexible, preferring to use time-bound criteria to define their applicability.[11] Fiscal rules are increasingly used to resist deficit bias — the tendency of governments to accumulate debt over time.[12]

The increase in their use reflects efforts to control debt, spending, and fiscal outcomes while reducing political influence over public expenditure.[13] The goal is to ensure that fiscal fundamentals remain stable and predictable, regardless of the government in power.[14]

INCIDENCE

According to the IMF, by the end of 2021, there were about 105 countries that had adopted at least one fiscal rule (Figure 1).[15] Fiscal rules are fairly common among South Africa's peers (upper-middle income countries)[16] with 29 having adopted one, and 26 African countries (more than half) have at least one fiscal rule.[17]

Figure 1: Countries using fiscal rules worldwide in (1985-2021)



Source: IMF[18]

CATEGORIES AND TYPES

Fiscal rules fall into two categories: those aimed at restricting deficits and debt to ensure fiscal sustainability, and those focused on stabilising macroeconomic fluctuations. This document examines rule-based fiscal anchors, which is what National Treasury is considering.

Four main types of fiscal rules exist: (1) debt rules, (2) budget balance rules, (3) expenditure rules, and (4) revenue rules (see Table 1). These can be combined in different ways based on their objectives, and they vary in legal status, regulation, and duration. Despite differences in design and context, all fiscal rules share a common goal: to confer macroeconomic credibility by removing discretionary intervention.[19]

Table 1: Fiscal rules and the number of countries with them

TYPE	NATURE OF THE RULE	PURPOSE OF THE RULE	NUMBER OF COUNTRIES[20] WITH THE RULE[21]
Debt rule	Sets explicit ceiling for public debt, often expressed as a percentage of GDP, but sometimes in absolute terms.	To limit borrowing. May specify sources, such as central banks.[22]	85
Budget balance rule	Sets a limit on the budget balance - the deficit or surplus.	To requires the government to maintain a particular budget balance.	93
Expenditure rule	Sets limits on government spending. May be total, primary, or current spending, in absolute terms, growth rates, or as a percentage of GDP. The time range typically from three to five years.[23]	To curb spending pressures from recurring budget deficits.	55
Revenue rule	Sets ceiling or floor for tax-to-GDP ratio or total government revenue.	To boost tax revenue, prevent tax burdens, and guide the use of windfall revenue.[24]	17

INSTITUTIONAL FRAMEWORK

Simply having fiscal rules does not guarantee compliance. Institutions responsible for the formulation, execution, and oversight of fiscal policies",[25] and the fiscal framework, are important in facilitating adherence to fiscal rules.

Sub-Saharan African countries have been struggling with enforcing compliance due to weak institutions, with only two countries, by 2020, having some form of fiscal responsibility laws to guide the implementation of fiscal rules.[26] In addition to clear guidelines and laws, there also need 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, tasked with promoting sustainable public finances by assessing fiscal plans, evaluating forecasts, monitoring fiscal rules, and costing government measures.[27] Their number has grown over the last decade, and their mandates have evolved, based on national and regional dynamics.

Fiscal councils vary in structure: some are attached to parliament, others to audit offices, and some operate within the executive. Their role differs accordingly: those linked to parliament focus on oversight, while those in the executive may contribute to policy formulation and analysis. Ultimately, the effectiveness of fiscal rules depends on the institutions in place and their interactions.

ROLE

Fiscal rules are said to support fiscal discipline in three ways. They can:

1. Act as a commitment device that limits the government's use of fiscal discretion.
2. Serve as a signaling device, highlighting government plans and priorities.
3. Serve a political function, helping to facilitate the formation of stable coalitions given the clarity of numerical targets.

3. HOW WELL DO THEY WORK?

THE CLAIMED BENEFITS

Proponents of fiscal rules argue that markets alone cannot restrain wasteful government spending and that discretionary fiscal policies contribute to unsustainable public debt.[28] Rooted in neo-classical economics, this view supports balanced budgets. It says that borrowing for government spending crowds out private investment by reducing available funds and raising interest rates.[29] This can hinder long-term economic growth. However, global evidence has exposed shortcomings in this theory, prompting a shift in approaches to fiscal rules.

Some argue that fiscal rules help governments commit to clear fiscal parameters, enhancing policy credibility and shaping economic expectations.[30] According to this view, "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".[31]

THE PROBLEMS

There are three central problems with fiscal rules:

1. The empirical evidence suggests they have a mixed impact on fiscal performance, and this depends on several contextual factors such as their design, institutional framework, and the economy in general.[32]
2. There is no clear evidence pointing to a causal relationship between fiscal rules and fiscal outcomes.[33] Amongst a range of factors in the economy which influence fiscal outcomes, it is difficult to isolate fiscal rules as the primary reason for outcomes such as reduced debt-service costs and debt levels.
3. They are a very indirect way to lower borrowing costs that ignore a host of other more direct mechanisms, including (1) Reserve Bank intervention, (2) targeted capital controls, (3) capital management techniques, and (4) credit allocation policies. These are taken up again in the recommendations.

In particular, fiscal rules:

- **Limit the ability to respond to shocks:** In addition, 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.[34] 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 temporarily suspended the rules,[35] while others modified the fiscal limit.[36] In an economic downturn, the negative impact of fiscal consolidation on GDP contributes to the worsening of the debt-to-GDP ratio.
- **Constrain 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 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.
- **Have poor rates of compliance:** Compliance with fiscal rules has been poor. In Europe, between 2008 and 2010, 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), 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).
- **Are hard to measure:** 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.[37] For example, with a rule that 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.
- **Are unnecessary:** Some scholars have argued that there is no need for fiscal rules for the government to commit to fiscal discipline; political will is what is more important.[38] Rather than encourage adherence, fiscal rules tend to lead to non-transparent behaviour to bypass them, and this is more likely in an "environment of large deficits and debts, and sustainability concerns" as in South Africa.[39]

"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"

4. INTERNATIONAL CASE-STUDIES

BRAZIL

Background and implementation

Brazil's fiscal rules emerged as a crisis-management tool, imposed by a conservative government and the IMF to address debt problems. Brazil's fiscal vulnerabilities stemmed from reliance on external financing and a volatile currency, which were exposed during the Asian and Russian financial crises (1997–1998).[40] In response, the central bank hiked interest rates to curb capital outflows and stabilise inflation, causing a sharp rise in domestic interest rates. The SELIC rate (equivalent to South Africa's repo rate surged from 25.13% (1996) to 46.26% (1997),[41] and Treasury bill rates rose from 24.5% to 42.32%.[42]

Research by Brazil's National Treasury and the World Bank found that interest rate hikes were a major driver of the spike in debt-to-GDP,[43] compounded by fiscal support for SOEs and sub-national governments. This led to rising debt service costs (from 5% of GDP in 1997 to 12.26% in 2002).[44]

In 1998, Brazil accepted IMF finance,[45] which came with conditions for drastic fiscal adjustments.[46] In 2000, the government enacted the Fiscal Responsibility Law, introducing fiscal rules to entrench these adjustments. This marked Brazil's second fiscal anchor, with two more sets of fiscal rules implemented since (see Table 2).

Table 2: Fiscal anchors in Brazil, 1988-2023

YEAR	RULE	PURPOSE AND FUNCTION
1988	Golden Rule	To safeguard fiscal responsibility and public investment. Restricted new borrowing to finance capital expenditures. 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. 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[47]

The Fiscal Responsibility Law prioritised aligning fiscal targets with national economic policy objectives, rather than the other way around. The annual budget was required to set three-year targets for the primary balance, revenues, expenditures, and public debt, ensuring consistency with economic policy goals.[48] Despite attempts to align the targets with fiscal policy with national economic policy, the impact of numerical limits placed on budgetary aggregates led to negative outcomes as discussed below.

Lessons

We derive four key lessons for South Africa from Brazil's experience with fiscal rules:

1. **The imposition of the fiscal rule led to the use of improper accounting practices,** to allow the government to give the illusion that it was abiding by the fiscal rule. There was widespread creative accounting and budget manipulation by officials and reneging on expenditure items agreed in the budget. agencies like the IMF and Inter-American Development Bank noted systematic misreporting of expenses to comply with fiscal rules.[49] These practices inherently undermine the reasons put forward by mainstream economists in support of fiscal rules as a tool to enhance credibility and transparency.
2. **Sustained economic growth, due to the commodities boom, was necessary to improve debt dynamics.** The period in which the share of expenditure in GDP was largely constant (in the 41%-43% range) coincided with a period of sustained economic growth from the commodities boom. 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.
3. **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 that the government offloaded many of the items that required discretionary spending, through privatisation of SOEs, limiting borrowing

power of sub-national governments, and capping personnel spending at all levels of government.

4. **Fiscal rules limited democratic engagement:** "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."

INDONESIA

Background and implementation

In Indonesia, debt service costs had soared on the back of the Asian financial crisis of 1997-98.[50] 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.[51] 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.[52] 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.

To solidify commitments to fiscal consolidation, in 2004 Indonesia enacted two types of fiscal rules: the Budget Balance Rule and the Debt Rule (State Finance Law No.17/2003, Explanation of Article 12 (3)).[53] The maximum budget deficit is 3% of GDP, meanwhile, the maximum allowed public debt-to-GDP level is 60%.[54]

Lessons

Significantly, many of the lessons from the Brazil experience also come out with Indonesia:

1. **Economic growth appears to be the major explanatory variable for the changes in fiscal aggregates, with no discernible impact of fiscal rules.**
2. **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.
3. **The imposition of fiscal rules highlights the power of organisations such as the IMF in influencing public policy.** 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.

5. SOUTH AFRICA

MIXED RECORD

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: 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 first seven years of its inception, 2012/13 - 2018/19, non-interest spending largely stayed within the three-year projected target set by the expenditure ceiling. Only in 2015/2016 was there an overspend of R19.9 billion. National Treasury believed that "the main budget expenditure ceiling has anchored fiscal policy".[55] This period also coincided with the beginning of intense fiscal consolidation. However, 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% of GDP in 2012/13 to 51.5% by 2018/19, and rising borrowing costs.

For the most recent five years, 2019/20 - 2023/24, the expenditure ceiling has been an ineffective fiscal anchor, with main budget non-interest expenditure significantly exceeding its limit every year. The deviation ballooned from R55bn in 2021/22 to R137bn in 2022/23 and R115bn the following year. 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 were cut by 2.4% in real terms. 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.

THE NATURE OF SOUTH AFRICA'S PROBLEM

The major debt issue South Africa faces is that interest service costs are crowding out other expenditures, because South African government borrowing is expensive — 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.

This idea 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.[56] 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'. Essentially, fiscal space implies a 'maximum' level of debt above which debt service costs are uncontainable.[57]

However, cross-country evidence does not support the existence of a maximum level of debt in two ways:[58]

1. Countries have drastically different borrowing and debt service costs at similar levels of debt. 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%.[59] 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, and the Philippines, as well as the average for all upper-middle income countries.[60]
2. Countries such as Cabo Verde, Guinea-Bissau, Fiji, Spain, and Portugal, with far higher debt levels,[61] have lower debt servicing costs than South Africa (whose interest paid on debt is more than 4.5% of GDP),[62] although this trend is much more common among developed countries.

So rising debt service costs, at any debt level, cannot be explained only by the debt-to-GDP ratio.

Higher nominal interest rates in South Africa are driven by internal and external factors. Domestically, fiscal risks from SOE bailouts, weak economic growth, inconsistent power supply, and social instability have particularly affected medium-to-long-term borrowing. Additionally, borrowing has not been effectively used to expand growth and alleviate unemployment.

Externally, interest rates and inflation in developed economies impact South Africa due to its exposure to global capital markets. Rising interest rates abroad make local bonds less attractive, and the SARB has chosen to increase the repo rate to remain competitive. This, in turn, raises lending rates, strangling local investment.

National Treasury acknowledges that borrowing costs matter and argues that stricter fiscal rules will enhance credibility, mitigate risks, and improve policy predictability, ultimately lowering debt-service costs.

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, 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 such as South Africa that has persistently experienced low growth. 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.

South African experience is that compliance has not been consistent, and has often been enforced through implementing austerity measures. This is in line with international experience. However, in the current South African context, the fiscal rule may be unsuccessful at limiting expenditure (and may ultimately be violated) precisely because it does not take account of the real political economy factors at play in determining spending priorities. For example, National Treasury has deliberately decided not to budget for above-inflation public sector wage increases. In 2015/16 this resulted in breaching the expenditure ceiling. Wage setting is the legitimate outcome of the wage bargaining process, just as political decisions to fund certain spending priorities are the legitimate outcome of political representation and contestation.

Alternatively, adherence to the rule may result in cuts to important social priorities or capital spending:

- In 2024, it resulted in budget shortfalls for education departments across the country.[63] The result has been, variously, cuts in teacher numbers, budget shortfalls, and budget cuts for school nutrition and scholar transport.[64]
- Also, in 2024, 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 it is ideologically opposed.
- It 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.

In short, fiscal rules may reduce the quality of fiscal policy.

A LEGAL ISSUE

And then there is the question of the place of a fiscal rule within South Africa's legal framework. At this stage, we understand the intention is to set legally-binding fiscal rule targets. These are supposed to act as a break on spending. However, the constitutionality of this approach is questionable. 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. But this is not the same as limiting Parliament's powers to appropriate funds. Parliament can pass a budget that requires any given quantum of actual expenditure in any fiscal year. If the fiscal rule prevents borrowing, then National Treasury will need to either find those funds from elsewhere (raise taxes or revenues another way) or break the fiscal rule (that is, break the law). Changing this would likely, therefore, require a constitutional amendment. This requires further legal analysis.

6. LESSONS FOR SOUTH AFRICA

The foregoing analysis allows us to draw a number of lessons for the South African context.

1. **Fiscal rules are ill-suited to a world of growing external shocks**. The rigidity of fiscal rules constrains government efforts to enact counter-cyclical policy and thereby places an undue constraint on fiscal policy.
2. **Fiscal rules may clash with developmental goals.** In Brazil, austerity measures were imposed to abide by the fiscal rule. As the IMF has noted, the rule may distract from the achievement of developmental or welfarist outcomes.[65]
3. **Fiscal rules may distort spending in unhelpful ways.** Fiscal rules intensify contestation over budget priorities, with expenditure items that have political backing receiving priority. This is likely to affect the provincial sphere of government – responsible for crucial social services such as basic education and healthcare – which relies on transfers from the national government.
4. **Fiscal rules do not resolve political contestation and may result in the illegal circumvention of the rule:** Adherence to fiscal rules is sometimes at odds with the political interests of particular groups. Labour, civil society organisations, and other groups may force the government to evade fiscal rules. In the long term, this erodes credibility of the fiscal framework and the budget.
5. **Fiscal rules may encourage the use of opaque accounting techniques to comply with numerical limits.** This limits the transparency and credibility of the budget.
6. **A fiscal rule may fail to place a binding limit on expenditure.** A binding fiscal rule 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.
7. **IMF-backed fiscal rules undermine policy sovereignty.** The influence of the IMF requiring fiscal rules undermines domestic policy sovereignty and closes the space to contest and debate fiscal policy, especially in developing, and upper-middle income countries.

7. RECOMMENDATIONS

1. **Build political convergence on spending:** To address concerns that we are not making the best use of our fiscal resources, establish better vehicles through which the political process of budget contestation can occur so that it channels us towards solutions that better prioritise our public spending. Perhaps a societal 'grand bargain' on the budget is needed, a mechanism through which spending, and associated revenue raising, represent the outcome of collectively agreed prioritisation, rather than centrally-imposed extreme fiscal restraint.
2. **Use the budget as a lever for economic transformation:** Harness the positive potential of the budget rather than seeing it, as Treasury tends to do, as a source of potential economic harm. A robust and collectively-agreed process should investigate the short-, medium, and long-term impact of different spending decisions, through a government-wide spending review. Where benefit is not derived, reduce expenditure, or assist parts of government (for example, municipalities) to spend in a manner that does yield benefit. Where the benefit is most pronounced, increase spending or add new expenditure.
3. **Focus on growth and poverty alleviation:** Fiscal consolidation is a means to an end, not the overriding objective. 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; alleviate destitution and hardship; and 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.
4. **Align fiscal rules with the goals of fiscal policy:** Fiscal anchors do not need to be used to secure austerity. If fiscal rules are paired with revenue-raising measures, it is possible to reduce budget deficits (in absolute terms) while maintaining positive growth in real non-interest spending. However, the tax burden must be on those at the higher end of the wealth and income distribution. Measures should include: a review of tax breaks for high-income individuals and corporations; restoration of the corporate income tax rate to 28%; taxation of wealth, and financial transactions; introduction of a Resource Rent Tax reform of the taxation of dividends and estates;[66] discontinuing the Employment Tax Incentive (ETI) and closure of vehicles for tax evasion.
5. **Lower the cost of borrowing:** 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;[67]
   - prescribed assets to make available large pools of capital at affordable rates;

- a slight shortening of the average maturity of government borrowing; and
- preferential lending, including from international financial institutions (IFIs),[68] where this will not compromise domestic policy space.

6. **Reconsider the sole use of the repo rate to fight inflation:** Monetary policy has a significant impact on borrowing costs. The result of solely using the repo rate to fight inflation and protect the exchange rate is an increase in government bond rates. The South African Reserve Bank may need to explore alternative tools for dealing with the exchange rate and inflation that do not compromise the government's ability to borrow cheaply.
7. **Renegotiate SOE debt and sovereign guarantees:** this should include moving away from generous guarantees for public-private partnership.

ENDNOTES

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