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Basic income support is unavoidable, but making it work requires political courage

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As government gears up to announce its programme for the next year, through the State of the Nation address and the Budget, it seems certain that some form of basic income support will be a central part of its agenda. The lockdown-induced shocks have added to the crisis of structural mass unemployment, and of poverty. There also seems to be broad consensus that basic-income support is an essential part of our social compact. But the fiscal risks it poses to a fragile economy have not diminished, and government faces some hard trade-offs to ensure these risks are minimized and that other social spending is not compromised.

Introduction

A small cash grant to the poorest workers was introduced as an ad-hoc and temporary response to the collapse of employment induced by the Covid lockdowns. The Covid social relief of distress grant (COVID SRD) operates in terms of national disaster regulations, and its financing depends on periodic extensions announced in the national budget. But the success of the grant has underscored a broad consensus in favour of continuation. The first attempt to withdraw it ended in defeat for the treasury in the wake of the organised unrest of last July. Since then, the President has clearly warmed to the idea. The minimum wage helped him forge the coalition of factions that backed him in 2017. Continuing with basic income support may well be necessary to secure his re-election at the 2022 ANC conference, and victory for the ANC in 2024. By then the grant would have been in place for five years, and it does not make sense to think of it as temporary.

The case for income support

This would not be the first time that off-the-cuff responses to temporary crises led to permanent social reforms. It now seems clear that income support for the poorest citizens of working age is a new element of South Africa’s fiscal constitution, a contract on which sustainability of democracy depends. Legislation that defines the beneficiaries and design of the grant will take time to pass. In the meantime, the budget will have to accommodate a structural increase in spending of R50 – R100 billion, or about 1% of

GDP.

It is not unreasonable to assume that mass unemployment will remain a permanent feature of South Africa's economy. This has been the case for the past 25 years and, given the state of politics and the course of technological change, it is hard to see how an effective programme to challenge the structural foundations of inequality and stagnation will emerge. It seems sensible, therefore, to design social policy on the assumption that a large share of workers will remain permanently excluded from formal employment. This is the argument Ferguson (2015) makes for basic income support in southern Africa[1]. As social policy it is a compelling argument. But does it make economic sense?

Basic income for poor workers comes with many economic and social benefits. It should lead to a material extension of economic opportunity for the many, an expansion of human capabilities and a reduction in the daily burden of poverty, hunger, and disease that blights politics and society. There are also cogent arguments (and some evidence) to suggest that cash transfers to working-age adults have positive impacts on labour market participation and employment. Extending the grants system is likely to complement livelihood strategies and activate economic opportunities for poor households. In a context of risky transformations associated with green industrialisation, some form of basic income support may well be a comparatively efficient way to protect the most vulnerable and bring a sense of justice to the transition. It is possible to imagine conditions in which government advances policy across a broad front, acting decisively, dealing with difficult choices, committing to clear and unambiguous policies that ignite economic growth. In such circumstances basic income support could be a positive complement to growth in a virtuous cycle of development. But let's not hold our breath. Policy paralysis is baked deeply into the national condition. On the other hand, we're good at cash transfers and we have a relatively efficient tax system.

A small grant implies a modest weakening of the fiscal position (discussed below), which should be set against its considerable benefits. It doesn't mark a sharp departure from policy, but merely a continuation along the path established after the ANC's 2007 conference. Previous experiences (for instance free university education) offer a clear lesson: we should not leave the design, financing, and institutional framework of policy to chance on the assumption that politicians do not mean to do as they say. It is quite possible to make a difficult situation significantly worse, and so undermine both the potential impact of progressive reforms and the arguments in their favour.

Basic income amid economic stagnation

South Africa's national income has been stagnating for (at least) a decade, and this looks set to continue. High long-term interest rates, low investment, and pedestrian rates of growth are entrenched features of our environment. The claims of true believers that a basic income grant will set in motion a new path of growth and development should be treated with caution.

Demand stimulus may well be required to support recovery from the COVID-19 shock, but it is not the path to sustained growth. Over time, shifting income from the affluent to the poor might generate new investments in retail and expand the scope for production of consumer goods, which may be welcome transformations in economic structure. But South Africa is a society in which the capital stock, when fully utilised, employs a fraction

[1] Ferguson, James. 2015. Give a Man a Fish: Reflections on the New Politics of Distribution. Duke University Press.

of the potential workforce to generate income for a minority of the population. This is offset by fiscal redistributions of income, which are amongst the largest in the developing world, financed by taxes that are far higher than in other countries with a similar level of income.

Economic growth depends not on temporary fiscal multipliers, but on a credible programme to open new channels for transformative investments that enhance productivity, for instance in the form of green industrial transformation. If such a programme can be agreed and executed at scale (a big if) South Africa might experience sustained growth. A condition for success would be macroeconomic policies that constrain consumption so that investments can be financed on a sustainable basis. The extension of income to the poor addresses none of these constraints and could well lead to increased consumption, including of imports, combined with a fall in national savings and investment.

The grant will worsen South Africa's fiscal position, which is already so chronic that it has itself become a central cause of slow growth and economic stagnation. High interest rates on government debt are a hurdle to fixed investment. The incessant rise in debt service costs – now approaching 5% of national income – crowds out social spending out of tax revenue and shifts the profile of public spending in favour of affluent households. The deficit has been entrenched at around 6% of GDP for more than a decade, and there is no clear path to closing it. As these pressures mount, so does the danger of financial and macroeconomic turbulence.

The introduction of a new R50 billion expenditure commitment will aggravate these pressures and weaken the credibility of fiscal policy. Over time, it implies tax increases that will raise the returns required on investment projects. The increased fiscal risks imply higher borrowing costs, which could slow the pace of growth and employment creation. In these circumstances, the Presidential Economic Advisory Council (PEAC) is absolutely correct to advise caution about the fiscal risks. Moreover, the report of the Department of Social Development's (DSD) Expert Panel on Basic Income Support[2] provides no evidence to dispel these concerns (Disclaimer: I was a member of the Panel).

The macroeconomic modelling conducted for the DSD report was not suited to the analysis of macro-fiscal dynamics, and no attempt was made to model the consequences of basic income support for debt sustainability, interest rates, or investment behaviour. The PEAC is also right to caution that the tax modelling in the DSD report is rudimentary. No behavioural responses were modelled on the tax side, and further consideration of the tax policy implications is certainly required before government acts.

However, the more rigorous modelling undertaken by Van Seventer et al. (2021)[3] reached positive conclusions about extending the COVID SRD grant, saying "… even in the most aggressive scenario financed by reduced government savings, the government debt-to-GDP ratio declines, as higher GDP and higher tax collections more than fully offset the increment to government debt." This modelling is based on a social accounting

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[2] van den Heever, Alex, Margaret Chitiga-Mabugu, Stephen Devereux, Murray Leibbrandt, Michael Sachs, Jan van Heerden, and Gemma Wright. 2021. *Expert Panel on Basic Income Support: Report into the Appropriateness and Feasibility of a System of Basic Income Support for South Africa.* International Labour Organisation, Department of Social Development.

[3] van Seventer, Dirk, Channing Arndt, Robert J. Davies, Sherwin Gabriel, Laurence Harris, and Sherman Robinson. 2021. 'Recovering from COVID-1: Economic Scenarios for South Africa'. IFPRI Discussion Paper 02033

matrix (which also underlies the CGE[4] modelling done for the DSD expert panel reports). PEAC correctly points out (and this is acknowledged by the modellers themselves) that such modelling has limitations. Most important for the fiscal discussion is the absence of macro-financial dynamics or interest rate impacts. In a simple Keynesian closed-economy model (which appears to inform most of the noisy condemnations of the PEAC one reads in the popular press) this might not be important. But in the real world of globalized and financialized capitalism such considerations are central for macro policymaking, especially in a small emerging economy with uber-integrated financial markets.

Global conditions currently enable South Africa to sustain its chronic and worsening fiscal position. Rising commodity prices mean corporate tax revenues from mining and finance are temporarily elevated. Easy monetary conditions underpin the flow of portfolio capital in support of the domestic bond market. These factors enable South Africa to continue along a clearly unsustainable path, and the political leadership is determined to make hay while the sun still shines.

It would be foolish to rely on the continuation of these conditions. When times change for the worse tax revenues will fall and interest rates will rise further. Financial markets are aware of these dynamics, and the damage to the credibility of government's fiscal position implied by the additional spending will be anticipated, putting upward pressure on bond yields.

But judgements about fiscal sustainability depend on the overall state of the public finances, not the wisdom of this or that programme. The debt to GDP ratio is rising, interest rates are higher than the rate of economic growth, the extent of fiscal consolidation needed to stabilise it does not look politically feasible, and government lacks a credible strategy to raise the pace of growth. Basic income support will not fundamentally change these conditions.

The grant could have positive multiplier effects on growth during the recovery from Covid and the lockdowns. Adverse macro-financial responses may lead to rising bond yields in the short term, and a fall in savings, investment and growth over time. Government needs to think about how it will limit the potential for these negative outcomes. This means clearly signalling that the new grants will be paid out of new taxes.

New spending means new taxes, not warm feelings

For many years National Treasury has correctly argued that structural increases in spending must be backed by structural increases in taxation. Taxes are not the only means through which government can extract economic value from society on a permanent basis. But taxation is (by far) the most transparent, accountable, progressive, and efficient mechanism. It has also proven to be the only mechanism that is compatible with sustained growth, especially in large social states.

There are several options that now need to be considered. Removing the tax breaks on retirement savings would raise the effective rate of Personal Income Tax for the most affluent. Government can also step harder on the brake of fiscal drag, which distributes the burden onto the middle strata but creates inefficiency and perverse incentives. A better approach would be to raise the rate of value-added tax (VAT). In recognition of the permanence of the grant – and a host of other fiscal pressures - some combination of all

[4] Computable General Equilibrium modelling

these tax measures needs to be placed on the table for discussion as soon as possible.

Tax increases need not be implemented immediately but must be announced far in advance. Delaying tax increases would help reap the multiplier effects of the new spending. But upfront clarity on plans for increased taxation is needed to limit the deterioration in financial conditions which, if left unchecked, could overwhelm any positive multiplier effects. Tax changes of this magnitude also require extensive public deliberation and policy work to ensure effective design and orderly implementation can take place.

The potential upsides of basic income support will depend on design, institutions, and the quality of the social compact that can be negotiated around it. Until now, the President has been warm and fuzzy about the need for basic income support and public employment programmes. He frequently waxes lyrical about social compacting and the need for government to be generous to its people, especially the poor and unemployed. But he has been largely silent on the question of the trade-offs, or the real economic concessions needed to make a social compact work.

Basic income support is not a question of government "being generous". The money will be taken from employed citizens and the affluent, and it is they that the President should be calling upon to be generous, while explaining clearly why he believes it is necessary that they pay higher taxes. Until now, and in stark continuity with his much-maligned predecessor, he appears to believe that these awkward details can be left to Treasury. The trade-offs required to make basic income support sustainable include higher taxes, but also critical compromises on public-sector pay, economic growth, and the transformation of energy supply that the ANC has so far refused to swallow. Basic income support also means sacrificing fiscal space for other progressive social policy interventions, potentially for the next generation, and if not handled carefully could accelerate the deterioration in key government services such as basic education, healthcare, and policing.

An income support grant that reaches poor and unemployed workers can become an effective and prideful part of our fiscal constitution. It will mean sacrifices from the wealthy, but also from those in secure jobs, including public-sector workers and other unionised insiders. And this will take political courage to push through.