

IN THE MEDIA | 17 FEBRUARY 2025

There is no reason not to like fiscal rules

By Roy Havemann, Robert Botha and Claire Bisseker

Fiscal rules are there to promote discipline, ensure that debt can be paid, and enhance a government's credibility. But will a fiscal rule help improve South Africa's fiscal position and, in turn, reduce borrowing costs?

In a recent research note, the Bureau of Economic Research (BER) reviewed the international evidence on fiscal rules. The experience in the 105 countries that have adopted them suggests that strong, well-designed rules can signal a government's commitment to fiscal prudence and are associated with better fiscal performance.

A well-designed fiscal rule could also lower interest rates. The interest rate that South Africa pays on its debt is directly related to whether or not lenders believe we will repay it. If they worry that we won't honour our debts, the interest rate will rise and vice versa.

This is important for the average South Africans given that the rate at which banks borrow is directly linked to government's borrowing rate. If government interest rates fall, so will interest rates across the economy. Furthermore, interest payments are now the government's biggest spending item, exceeding the budgets for education or health. Bringing down interest costs will unlock money for other things.

Of course, poorly designed or inadequately enforced fiscal rules can make the problems worse.

A common criticism is that fiscal rules create "straitjackets" that overly limit government. Indeed, first generation fiscal rules, which were prevalent before the global financial crisis of 2007/2008, were often criticised for being too inflexible to allow treasuries to respond to adverse shocks.

Since then, however, fiscal rules have been adapted to be more flexible - either by adjusting the rule to allow for economic cycles or through the provision of well-defined escape clauses. In the wake of Covid-19, 35% of countries with fiscal rules triggered their escape clauses and 45% revised their fiscal targets.

Political commitment and strong institutional frameworks are needed, however. For instance, in November 2023, the German constitutional court overruled a budget that

was passed in the Bundestag because it breached Germany's fiscal rules. In South Africa, a well-designed rule could leverage off the country's strong institutions.

The case of copper-rich Chile is also instructive. Chile's fiscal position fluctuated wildly due to the cyclical nature of copper prices, so it adopted a fiscal rule based on the principle that "permanent" spending should only follow "permanent" revenues.

Essentially it was a structural fiscal balance rule, whereby the budget balance would be adjusted to account for copper price cycles to ensure the Treasury saved copper windfalls during upswings so it could deploy them during downturns. The aim was to contain fiscal spending and isolate it from political and social pressures. It also helped to smooth out the boom-bust cyclical nature that all commodity-producing nations grapple with, South Africa included.

During the commodity boom in the run up to the global financial crisis, Chile's finance minister Andrés Velasco came under huge pressure to spend more. Fortunately, the country's fiscal rules helped him to stand firm. This ensured that Chile built up fiscal buffers during the good times, giving it enough fiscal space to respond to the financial crisis when it hit.

South Africa was also well positioned when the global financial crisis struck. But this was only because we had built up fiscal buffers under former finance minister Trevor Manuel, who cut back sovereign debt and saved some of the gains from the commodity supercycle – an approach which was politically very unpopular at the time.

In fact, by 2007 South Africa was running a budget surplus and the debt ratio was a mere 27.8% of GDP. Today, our fiscal position couldn't be more different: the country is running a budget deficit of just under 5% of GDP and the debt ratio has risen to almost 75%. A large shock now could tip the country into a sovereign debt crisis.

Given the inexorable build-up of debt, despite South Africa having imposed a soft expenditure rule in 2012, the National Treasury has been pushing the idea of legislating a binding fiscal anchor to restore the country to long-term fiscal sustainability. It undertook to release a discussion document on fiscal rules by the end of March 2025.

If South Africa adopts a fiscal rule it must be enforceable, flexible and simple. It should:

- stabilise and eventually reduce the debt-to-GDP ratio
- target government spending as a share of GDP, emphasising consumption spending like salaries and goods and services, rather than capital expenditure
- have political buy-in
- be overseen independently
- be legally binding and enforceable.

Drawing on international best practice, our proposal is a rule with three components.

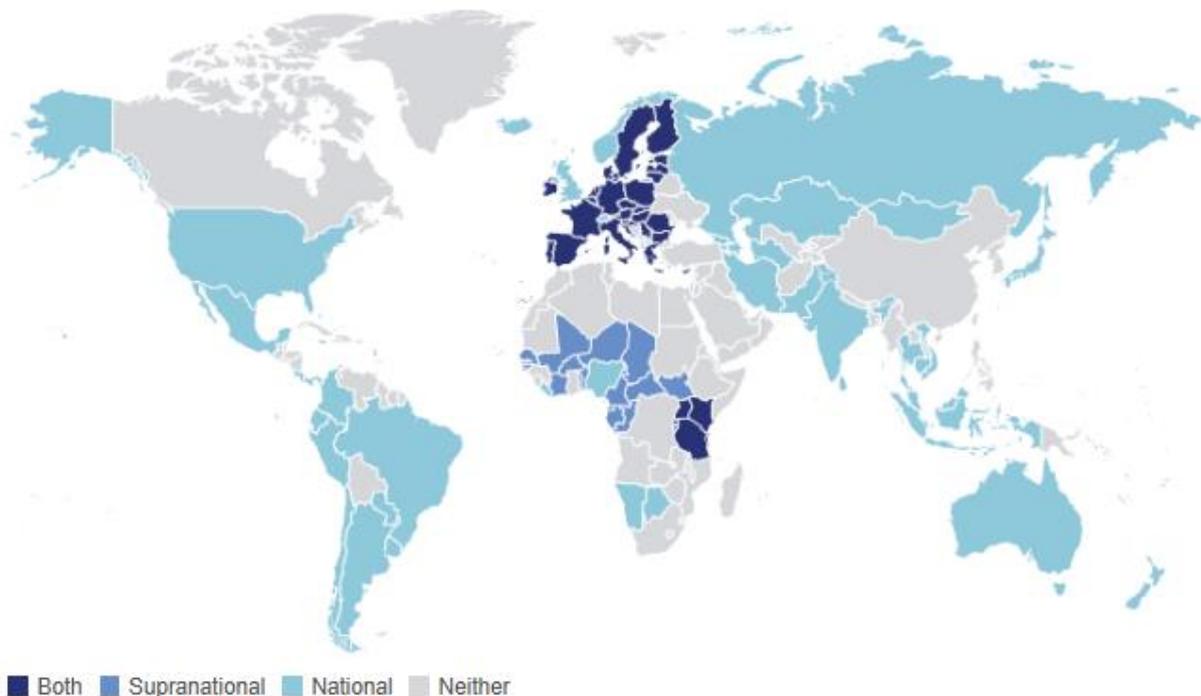
First, it should have an ultimate objective. Experience shows the best ultimate objective is debt stabilisation. If debt is rising without limit, then interest rates tend to start rising quickly. This creates a “debt spiral” as the country borrows more to meet rising interest rates repayments, causing debt to increase even faster.

Second, there should be an intermediary objective to keep the ultimate objective on track. We suggest using the primary balance, which is already the National Treasury’s guiding fiscal metric.

Finally, we propose that the rule target the ratio of current spending to GDP (spending excluding investment) since too often it is easy to meet a fiscal rule by cutting investment spending. This hurts long run growth.

Overall, the Treasury is on the right track in proposing a fiscal rule that could support South Africa getting its finances right. This would be to the benefit of all.

Figure 1: 105 countries have a fiscal rule



Source: IMF Fiscal Rule Dataset (1985-2021)

Note: This article first appeared in the Business Day of 14 January 2025

CONTACT US

Tel: +27 (21) 808 9786

Email: royh@sun.ac.za

Please refer to the glossary on the **BER website** for explanations of technical terms.