

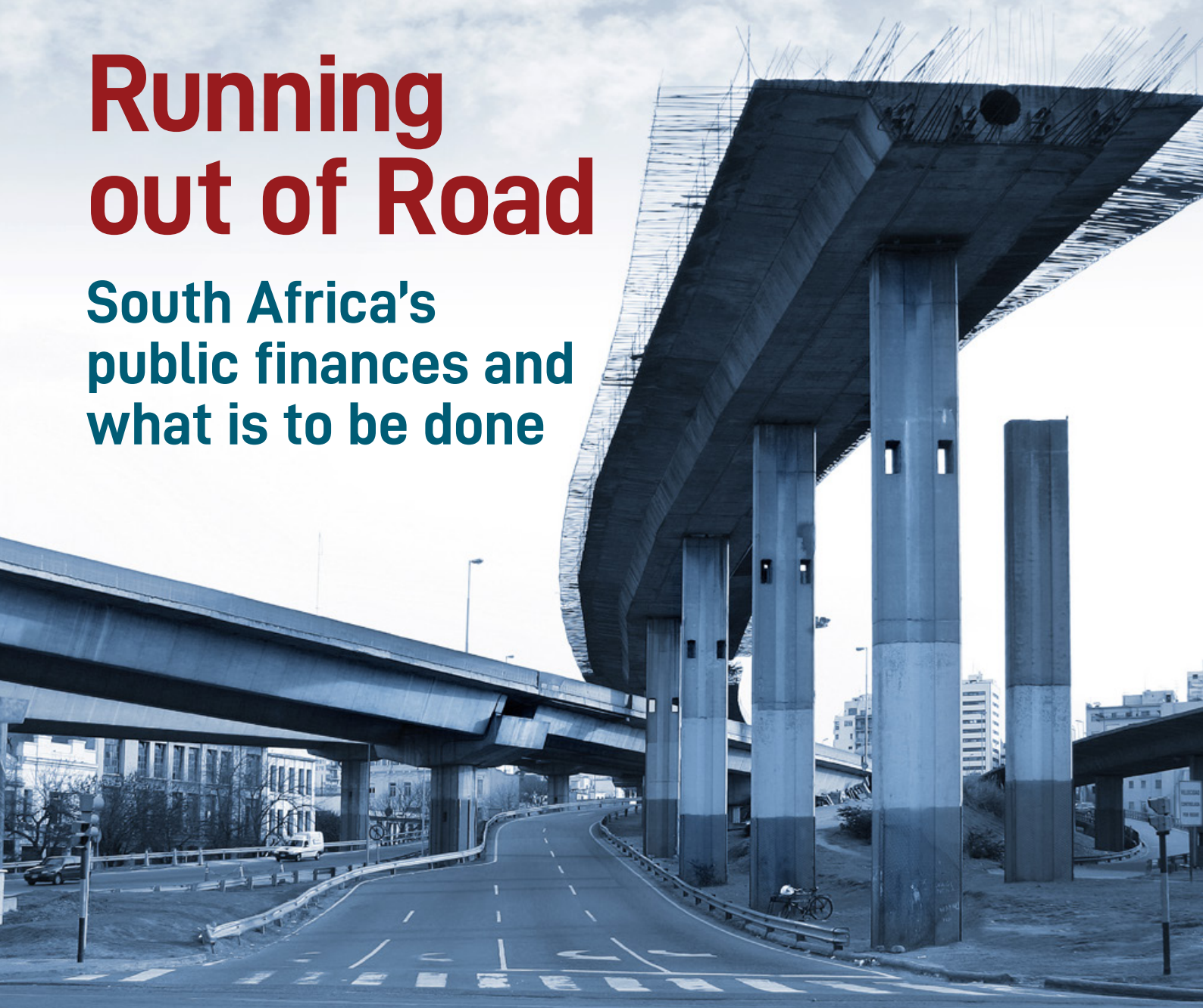


GROWTH AGENDA

Priorities for mass employment and inclusion

Running out of Road

South Africa's public finances and what is to be done



CENTRE FOR
DEVELOPMENT
AND ENTERPRISE

August 2019

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Series Editor: Ann Bernstein

This report was prepared by CDE after extensive consultation with a wide range of economists from across the private sector. Input from all participants is gratefully acknowledged. Errors and omissions are CDE's responsibility.

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Running out of Road

South Africa's public finances and what is to be done

Introduction

The two most important facts about the South African economy over the past decade are that growth has been exceptionally disappointing and this has been accompanied by a vast build-up of public sector debt. The two trends are linked: slow growth drove the rise in debt, which has now reached a point at which its weight is slowing growth.

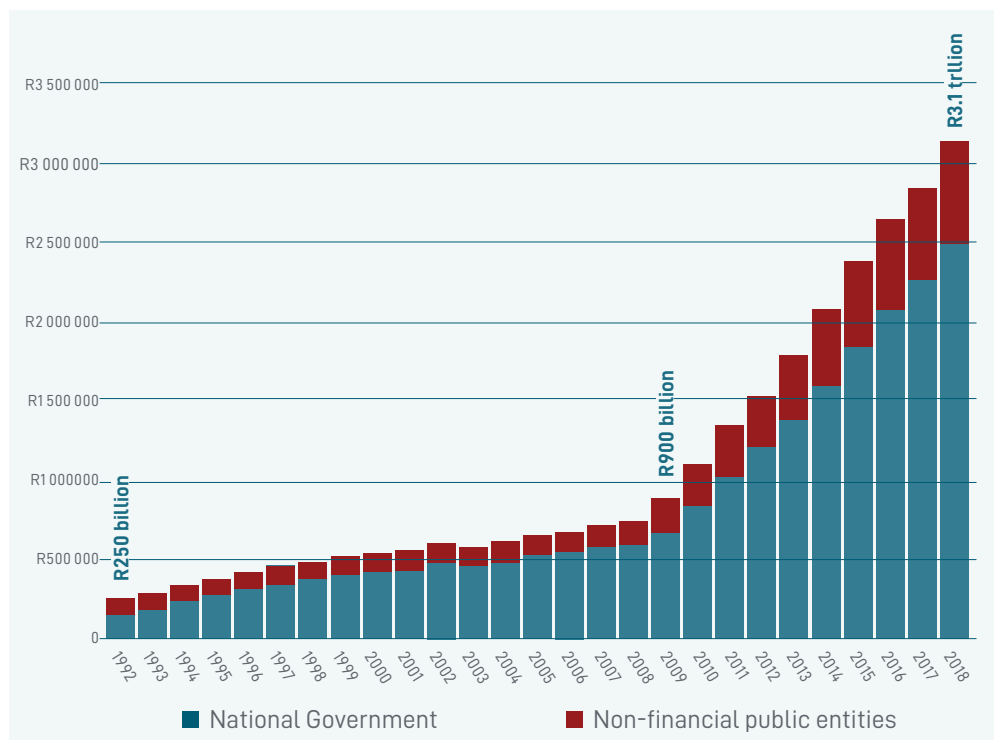
This report, drafted after considerable interaction with some of the country's leading economists, describes the trajectory of government's debt explosion, explains its causes, and sets out what we have to do to get out of this trap. It shows that the fiscal crisis has been driven by slow growth, and that growth needs to be accelerated to end it, but it shows also that unless we deal with the fiscal crisis, growth will not accelerate.

Why is there a crisis in our public finances?

South Africa's government and its state-owned companies (SOCs) have outstanding debts of over R3 trillion, a figure that is almost four times higher than it was in 2008 and 15 times higher than in 1992. Expressed as a percentage of GDP, debt now exceeds 60 per cent, a return to the highest levels recorded at the end of apartheid. Critically, it shows little sign of slowing its upward trajectory.

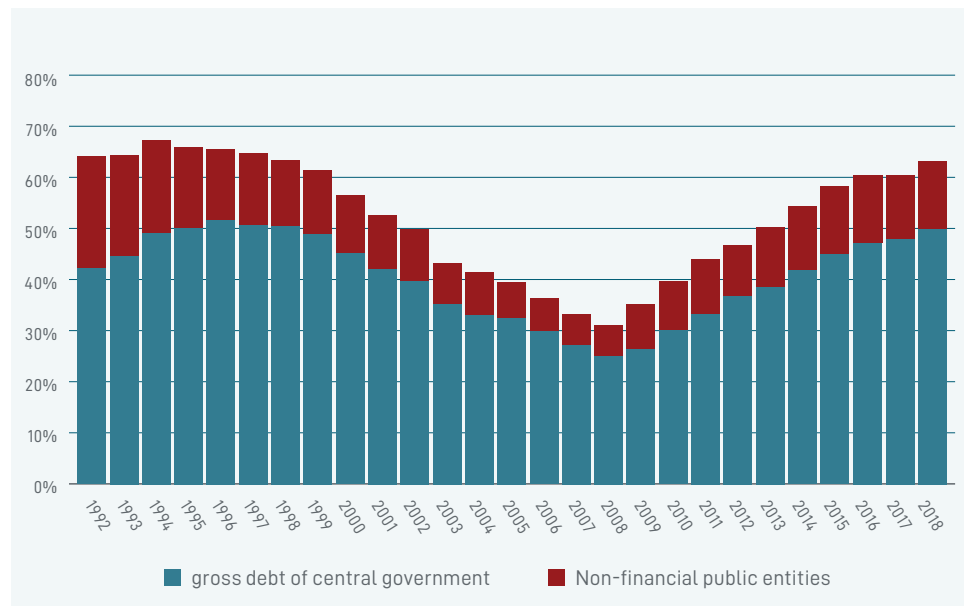
“South Africa's government and its state-owned companies (SOCs) have outstanding debts of over R3 trillion.”

Figure 1: Public sector gross debt (1992 to 2018)



Source: SARB database

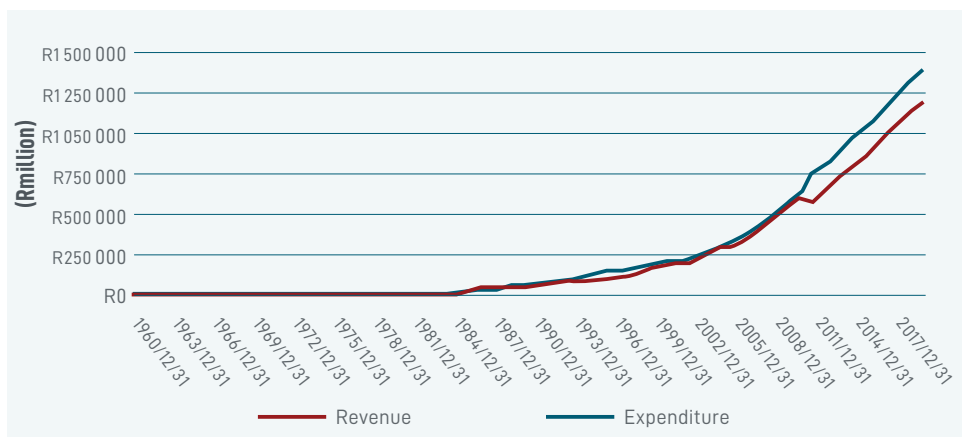
Figure 2: Public sector gross debt as a % of GDP (1992 to 2018)



Source: SARB database

The main reason for the debt explosion is that, in the immediate aftermath of the global financial crisis in 2008, a large gap opened up between government spending and the taxes that it collects. This gap has not been closed in the intervening years (Figure 3).

Figure 3: Revenues and expenditure of national government



Source: Qantec data

It would have been inappropriate to cut spending at the time of the global recession (when the collapse in growth meant that tax collection fell). And there was a strong argument for a temporary increase in spending to help the economy recover. However, the actual policies adopted were all built on the idea that the economy (and, therefore, tax collection) would quickly

“In the aftermath of the global financial crisis of 2008, a large gap opened up between government spending and the taxes it collects.”

return to the rapid growth that had characterised the five years before the crisis. These policies – which included an increase to the size of government and an increase in remuneration for public servants – have permanent effects on spending levels. Had they been accompanied by a return to rapid growth, they would not have led to the explosion of debt. But growth has never returned to the levels achieved in the five years before the global financial crisis, and, as a result, public spending continues to be far greater than tax revenues. Since 2009, the two fastest growing expenditure items in the budget have been debt service costs and public sector payrolls, both of which have grown much faster than the economy.

Nor does it seem that this pattern will change any time soon: in the 2019 budget, government announced spending plans that imply borrowings by it and the SOCs that will average nearly R350 billion a year for the three fiscal years between 2019/20 and 2021/22. In the seven years between 2015/16 and 2021/22, the public sector is expected to borrow R2.2 trillion rand. Overall total borrowing over the period will average just under R1 billion a day, every day over seven years.

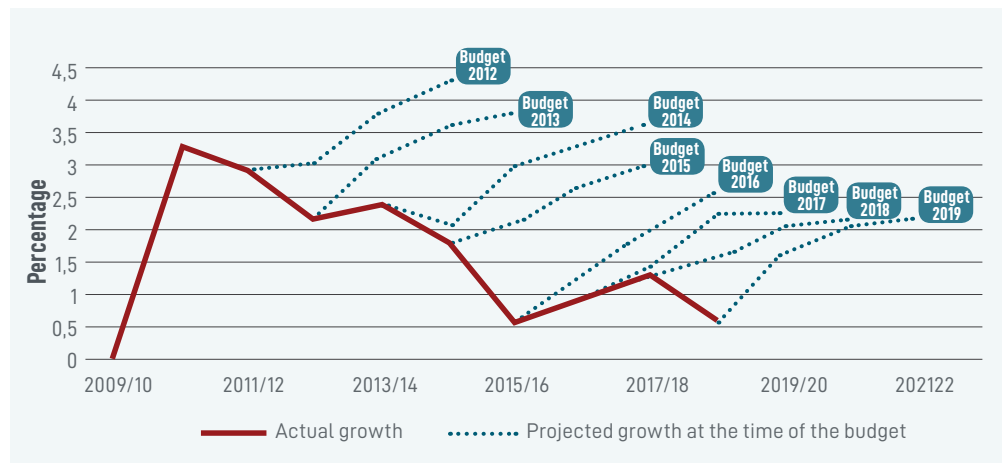
What does the debt explosion have to do with economic growth?

Decisions about how much money government will spend are based in large measure on expectations about how fast the economy will grow: the faster it is expected to grow (both in the short and long term), the more taxes government can expect to collect, and the more government can afford to spend. This means that if actual growth is persistently below what government expects, its spending plans are going to be higher than taxes for a long period of time, and it is going to have to borrow more and more money.

This is exactly what has happened in South Africa in the last decade, where spending plans have been based on growth expectations that have failed to materialise and have led to ever more borrowing. This is reflected in figure 4 which shows the growth estimates for each of the next two years that Treasury has used when compiling budgets since 2012. As is apparent, actual growth has been consistently lower than what was anticipated. The result is that all of those budgets have been premised on growth predictions that have failed to materialise.

“Government spending plans imply borrowings will average nearly R350 billion a year for the three fiscal years between 2019/20 and 2021/22.”

Figure 4: Actual growth (blue line) compared to budget projections



Source: Annual budget documentation, various years

The importance of growth to the trajectory of the ratio of debt to GDP can be demonstrated by using a counterfactual: if over the past decade growth had been 1 percentage point higher than it was every year, and if this had generated a plausible increase in tax revenues, the combined effect of a larger economy and less borrowing would be that government debt would be 44 per cent of GDP and falling rather than 63 per cent of GDP and rising.

If this is true of the past decade, it is also true of the next one. The obvious implication is that ensuring faster economic growth, so long as this is neither driven nor accompanied by more public spending, is a first order priority for the sustainability of our public finances.

Why does public sector debt matter?

Governments borrow money all the time, and the ratio of South Africa's public sector debt to GDP is actually lower than that of many other countries. What is out of line with global norms is how steep the rise of the debt ratio has been. But why does this matter at all? And what are the consequences for the economy?

The main consequence of borrowing money is that it has to be repaid. This is all well and good if the use to which the borrowed money is put increases a country's capacity to repay it. When this is not the case, however, higher levels of debt mean that its repayment imposes a burden on the economy, with tax-payers having to finance debt repayment. If debt increases faster than the economy grows, then a larger and larger share of tax-payers' incomes must be devoted to servicing it. This reduces the funding available for everything else and transfers more and more real resources from tax-payers to lenders.

“Debt, when it gets sufficiently large and/or when it is rising sufficiently quickly, creates a range of risks for the economy.”

The second consequence of debt is that when it gets sufficiently large and/or when it is rising sufficiently quickly, it creates a range of risks for the economy, and, in doing so, makes it less likely that firms and households will do the kinds of things that they need to do in order to ensure faster growth.

The main reason for this is that when government borrows as much as ours is doing, interest rates rise. The result is that firms and households spend a larger proportion of their incomes paying back loans and become more and more reluctant to borrow more money. The rise in interest rates is partly a result of the laws of supply and demand: higher levels of public borrowing mean that the price of borrowed funds will rise. But interest rates rise not just because of the increase in demand to borrow savings; they rise also because high ratios of debt to GDP mean that the risk that government will be unable to repay loans is also rising. The more government borrows, the less creditworthy it seems, and the less creditworthy it seems, the more onerous the terms under which it borrows.

Higher debt levels raise the risk of rare but very serious outcomes: rapidly increasing inflation, currency depreciation, a credit crunch, sustained periods of negative growth. High and rising levels of debt also increase the possibility of government having to raise taxes at some point in the future in order to meet its obligations. All of these risks raise interest rates and make firms and households less willing to invest because the future is less certain.

This is the nub: when debt levels are high and/or when they are rising, the increased costs of borrowing combined with the increased risk of bad outcomes means that there is less investment. Less investment now means less growth later, so high levels of debt can reduce an economy's growth for some time.

South Africa largely borrows in its own currency and this means that some of the worst outcomes that other developing countries with large and rapidly rising debts have experienced, are less likely to happen here (see box on page 8: Could South Africa default?). Even so, South Africa still faces serious consequences.

Higher debt that leads to slower growth and rising debt service costs imply declining living standards. There is already less money for infrastructure, which is one reason (there are others) that our public transport systems are collapsing; there is less money for road maintenance, so our roads are getting worse; critical infrastructure – electricity (of course), but water too – has deteriorated markedly, and the vastness of our debt and the associated cost of capital make it very hard to envisage financing the investment that we need. We will be able to build fewer houses, hospitals and universities. And, given the nature of our social and political dynamics, it is not hard to envisage rising

“South Africa may not be facing a fiscal cliff, exactly, but we are in a swamp from which we will struggle to emerge.”

crime and conflict as a result. South Africa may not be facing a fiscal cliff, exactly, but we are in a swamp from which we will struggle to emerge.

Could South Africa default?

As a general rule, countries that borrow in their own currencies cannot default because, if push ever came to shove, they could always print the cash needed to pay off creditors. Doing so would spark an inflationary episode, which is a form of soft default in that creditors are paid back in currency that is worth less than they expected it to be worth, but it is not, technically speaking, a default.

The fact that a soft default of this kind is even possible makes lending to governments risky and, in the absence of some guarantee that debts will not be paid off with worthless paper, no such lending would happen. This is why the independence of central banks, tasked with maintaining the value of the currency (and investing in a reputation for commitment to this goal), is so central to sustainable economic growth. Without such a credible reputation, interest rates would be much higher. And this, ultimately, is why recent debate about the independence of the Reserve Bank is so damaging: by undermining confidence in the future value of the rand, it raises the costs that everyone has to pay when they borrow money.

“The independence of the SARB is central to sustainable economic growth.”

What are South Africa's options?

South Africa's public finances are increasingly precarious, its macroeconomic fundamentals are increasingly unsound, and the path we are on is increasingly unsustainable. All of us are already bearing the costs and, as growth declines, so too do our prospects of resolving the many social and economic challenges that we confront. This is a crisis by any definition, one that will shape the policy agenda for years and even decades to come. What can be done?

Only a limited number of variables determine whether a country's debt is going to grow explosively or stabilise, and the relevant equation predicts that a country's debt ratio will worsen (or improve) at a rate determined by:

- The larger (or smaller) the size of the existing stock of debt as a percentage of GDP;
- The extent to which a country's borrowings exceed (or are smaller than) its debt service costs (i.e. whether the country is borrowing more than it is paying off or is paying off more than it is borrowing); and
- The extent to which the interest rate exceeds (or is lower than) the rate of economic growth.

None of these variables is entirely under the control of the fiscal authorities. Economic growth is determined by a wide range of factors, few of which can be directly manipulated by government; the interest rate on government bonds is set in the market and the value of the stock of existing debt is the outcome of past choices that cannot be undone in the present. What, then, are the options for putting debt on a more sustainable trajectory?

Could South Africa inflate its way out of trouble?

Inflation increases nominal GDP and it is one way that societies have reduced the burden of accumulated debt: as current prices rise, the ratio of debt to GDP falls as does the real cost of servicing it. But seeking to engineer a temporary increase in inflation to ease the burden of outstanding debt would be exceptionally reckless and, ultimately, self-defeating in a society in which many core costs are indexed to inflation. Most important, an inflationary episode would be extremely costly because it would permanently raise the cost of capital in South Africa as lenders price in the risk of further inflation, anticipated and unanticipated. Worse, inflation would also deepen poverty and inequality because the poor are much less able to protect themselves from its consequences than are the better-off.

The less said about inflation as a "solution", then, the better.

Can South Africa begin paying off the debt?

If inflating the debt burden away is a wholly undesirable approach to improving long-run debt sustainability, policy-makers are left with stimulating growth (see below) and closing the primary deficit (i.e. the gap between non-interest spending and taxes). This is what is meant by the term "fiscal consolidation", and it can be done by some combination of raising taxes and reducing spending.

In the short term, fiscal consolidation tends to slow growth, though there is some evidence that raising taxes slows growth more than expenditure cuts do. This effect means that, at least in the short run, consolidation needs to anticipate its effect on short-term growth and what that might mean for tax collection. In South Africa, fiscal consolidation must also take account of what is happening in the SOCs: to the extent that these continue to run large deficits of their own, government has to make larger adjustments to its spending and tax plans than would be the case if the SOCs were profitable.

Having said that, the primary deficit, while significant, is not so large that it is hard to imagine its being reversed: it was R42.3 billion (or 0.8 per cent of GDP) in 2018/19, an amount that could have been eliminated with relatively small adjustments to spending and taxation.

"Inflation would deepen poverty and inequality because the poor are much less able to protect themselves."

Should taxes be raised?

There has been some attempt at fiscal consolidation over the past few years, driven, primarily, by attempts to increase tax revenues through higher taxes, including, most controversially, an increase in the VAT rate. At the same time a range of administered prices, especially electricity tariffs, have risen rapidly. It is clear, in other words, that government has sought to close the gap between spending and revenue by raising the latter. It is also clear that this has not worked.

One reason for this is that growth has consistently disappointed, leaving government with less revenue than expected. It also appears that tax collection has become much less efficient than it once was. The combined result is that, over the last four financial years, government has taken in a total of R150 billion less tax than it expected to collect, making it very unlikely that the primary deficit can be closed through higher taxes, and almost certainly not without a significant impact on growth.

Could government reduce spending?

If government can't increase taxes, then the only way to close the deficit is to spend less. But reducing spending is politically difficult because the pain of cuts either falls on politically powerful constituencies and/or impacts on service delivery.

One worry about cutting spending is that it will slow growth. This may well be true in the short-term, but because the build-up of debt and the unsustainability of the existing trajectory has become a drag on growth, fiscal consolidation has become necessary for long-term growth. Besides, given the well-known problems of corruption and inefficient spending, it seems possible that smartly targeted spending cuts would not harm growth and may improve the quality of public spending. This is easier said than done, however, particularly in light of the fact that the inflation of supply costs to government is often both the unintended effect of corruption as well as an all-but-explicit goal of policies aimed at economic transformation. So, if targeting cuts in this way proves impossible, or if the vested interests linked to corruption and tenderpreneurship prove impossible to push back, the burden of spending cuts will likely fall on the public sector's compensation budget, which accounts for about 35 per cent of public spending. Here, the clear priority must be the excessively rapid increase in public servants' average remuneration, which has increased at around 11 per cent per annum for the last decade, a rate far in excess of inflation and economic growth.

If fiscal consolidation is difficult, what other options are there?

Fiscal consolidation undertaken thus far has not been able to close the primary deficit and will only be possible if bolder decisions are taken. But even if the

“Government has sought to close the gap between spending and revenue by raising the taxes.”

primary deficit is closed, unless growth accelerates (thus generating higher tax collections), we will struggle to bring down the ratio of debt to GDP. Here, too, of course, the challenges are numerous and large because the reasons why growth has disappointed are many and deep. Apart from the increasing precariousness of our public finances, these include:

- Declining quality in governance;
- The increasingly fraught and mistrustful tone of national politics and the unwillingness of many political actors to embrace reform;
- Hard constraints on growth like the scarcity of skills, and the scarcity and costliness of electricity; and
- A weakening and more uncertain international economy.

Not all of this can be fixed by government in the short term, but progress on a broad range of fronts is possible and needed to give us any chance of faster growth.

What must be done? Recommendations for action

Putting South Africa's public finances on a more sustainable footing is not possible without faster growth, but it is not possible for growth to accelerate unless control is imposed on the explosive trajectory of South Africa's debt. What needs to be done to achieve more sustainable public finances and more rapid growth.

1. Strengthen institutions critical to growth and good governance

Rapid growth is not possible without the institutions necessary to foster and protect markets that are deep, broad and efficient. The most important of these are secure property rights and the rule of law, but important also are the systems needed to ensure efficient trade and commerce: sound banks, a stable currency, effective courts, efficient procedures for the registration of businesses and the conduct of cross-border trade. In the absence of these, there is no prospect of rapid and inclusive growth.

Many of these performed admirably during the malign tenure of the former president, and after a decade of deprecation, the last 18 months have seen some improvements in the quality of governance with the removal of Jacob Zuma from the presidency, the institution of credible judicial enquiries into state capture and the appointment of better boards at the SOCs. Progress has been made, but much more is needed.

There have also, however, been some developments that threaten to weaken some institutions. Of these, three are most important:

- The fraught debate over land reform,
- The questions that have been raised about the independence of the Reserve Bank, and
- The possible introduction of prescribed assets.

“Putting South Africa's public finances on a more sustainable footing is not possible without faster growth.”

In addition to these three issues, the fast-tracking of a model of NHI that is unworkable and in the face of evidence about its poor performance in the pilot sites, has now generated high levels of uncertainty among members of the medical profession and the communities they serve. Confidence in government's ability to pull this off and build a healthcare industry that works is low, and the painful, costly disruption of the industry is considered likely by many. This seems a terrible risk to run in the circumstances.

The political dynamics that have led to these populist initiatives are not hard to understand. However, the calls that have been made are largely wrong-headed, and implementation of the proposed policies has the very real potential to slow economic growth for a substantial period of time as well as to reduce tax revenue.

It is critical that the real risks to growth are recognised and taken seriously in the resolution of the policy debates that have opened up on these issues.

In this regard, it is worth making special mention of the Reserve Bank, the credibility and competence of which is critical for sustained growth. If doubts emerge about its continued ability to regulate the banking sector sensibly and to avoid catastrophic decisions relating to the management of the currency, South Africa's capacity to borrow will weaken further, rates will rise and growth will slow even more. And that is the best case scenario.

2. Fix our public finances

The build-up of public debt has slowed growth by directly raising the cost of capital and by increasing the risk of very bad outcomes. In slowing growth, public finances have increased the degree to which their trajectory is unsustainable, and unless determined efforts at fiscal consolidation are implemented now, the likelihood of an acceleration in growth is greatly diminished.

As noted above, fiscal consolidation requires either higher taxes or lower spending. There are good reasons to think that this should be weighted to expenditure reductions rather than tax increases.

In seeking to reduce spending, immediate attention needs to be placed on reducing waste, corruption and inefficiency in public spending, the cost of which, it is increasingly clear, is very large. Doing so will be difficult, however, so more attention will have to be paid to big ticket items – the compensation budget in particular. Here, the obvious problem is not the size of the public service (which has, in any case, been shrinking), but the rate of increase of public servants' remuneration.

**“There is no
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In this context, it seems beyond obvious, but it is still a point worth making: there is no fiscal space for new spending programmes. We cannot afford what we already do; there is no room to increase the list, whether for new, smart cities, NHI or the recruitment of substantial numbers of additional police officers. Our current situation requires a tough choice of priorities for expenditure and ferocious determination to stick to these.

Fiscal consolidation from this point on needs to be driven by expenditure reductions. However, this does not mean that there is no need to think about the structure of South Africa's taxes. These are dominated by direct taxes (such as personal and corporate income taxes) which can distort incentives and generate tax avoidance strategies, reduce economic efficiency and slow growth. Changing this would be hard, because raising indirect taxes such as VAT and fuel taxes, is politically difficult. Nevertheless, the benefits of increased efficiency and reduced avoidance would be real. So too would be the benefits of getting SARS back to its efficient best while ensuring that tax-payers pay what is owed, and the users of public services and clients of the SOCs do the same.

3. Fixing the SOCs

Getting people to pay for the services they consume would help fix the SOCs, but it is not going to be nearly enough. Unless greater control is obtained over the SOCs' finances, they will undo any progress that is made on the main budget.

Considerably more urgency is needed to get these entities functioning on much more commercially sustainable terms (something that has been woefully absent despite the announcement of innumerable turnaround strategies). Absent these actions the task will only get harder and we will continue to do for all the SOCs what Finance Minister Tito Mboweni lamented we do for SAA : pour in bailout money to the same effect of pouring water into a sieve. In this regard, it is critical that the boards and managements of the SOCs are staffed by people of high integrity and with the right mix of skill and experience. Critical (and difficult) as this is, getting all this right will not be sufficient.

Improving the performance of the SOCs is not a question of financial engineering alone. Many, Eskom in particular, face deep operational challenges, seemingly unable to deliver on their core mandates at anything like the level of efficiency and reliability that any firm that faced the possibility of competition would have to achieve if it were to stand any chance of staying in business. This is critically important, for it suggests that South Africa could be delivering the goods and services currently provided by SOCs much more efficiently.

“Unless greater control is obtained over SOC's finances, they will undo any progress that is made on the budget.”

“Government has been unduly reluctant to allow any SOC to fail.”

There are hundreds of SOCs and public entities in the public sector. The largest ones – Eskom, Transnet, SAA and the SABC – present the biggest challenges to the fiscus. Each also operates in a market that is hopelessly distorted by their highly-subsidised presence. Undoubtedly, these markets could provide goods and services at lower costs to firms and consumers as a result of a combination of their restructuring and the liberalisation of the markets in which they operate.

Increasing competition in these sectors might make it harder for some SOCs to resolve their financial difficulties, but it would make South Africans better off. Most importantly, it would create the basis for increased competitiveness elsewhere in the economy and, therefore, faster growth. This runs counter to the instincts of many in government, but it is, nevertheless, essential.

More generally, the absence of accountability for SOCs' performance seems to be a significant source of the challenges faced by the sector: budget constraints simply do not appear to be sufficiently hard, leading to all kinds of inefficiency, a complete failure to plan properly, and, in the worst cases, abuse and corruption. One reason for this is that government has been unduly reluctant to allow any SOC to fail. Government will have to allow at least some SOCs to fail, if only to draw a line in the sand.

A final comment on the SOCs relates to prescribed assets, an idea that some in the ruling party have mooted as a mechanism for financing the SOCs by forcing pension and retirement funds to allocate resources to them. This is an exceptionally bad idea: compelling voluntary savings intended to finance retirement to be allocated to assets that promise lower or more risky returns would damage the credibility and efficiency of South Africa's capital markets. This will have enormous repercussions for long-term growth and, crucially, to future pressures on the fiscus.

4. A growth-focused policy agenda

The economy is over-regulated and until this failing is addressed, growth will always disappoint. The key reforms we need include:

- *A different attitude to business and the role of competitive markets from government*

The degree to which policy-makers have expressed scepticism to the point of hostility about the motives, commitment and patriotism of business is a key factor in our disappointing growth. It has heightened uncertainty about the future, reducing the appetites for risk and willingness to invest. While an improved attitude to business and the power of competitive markets will not on its own change all of this, it is necessary if investment rates are to begin to rise again.

“Labour market reform is critical to making growth more inclusive.”

- *Addressing the skills constraint*
South Africa's economic prospects require significant progress on the different components of our skills crisis. We need urgently to fix our schools, vocational education system and universities, but these reforms will take time to impact on the workforce. In the meantime, we need to tap into the global skills pool more effectively through immigration reform. This is important: it would allow South African businesses to attract essential skills, it could drive entrepreneurship, investment and capacity for the economy and our key educational and health institutions, and it would also send the right kind of signal about the direction of future policy reforms and our openness to the global economy.
- *Providing reliable and affordable energy*
Rapidly growing, industrialising countries need significant quantities of reliable, affordable, and environmentally sustainable energy. Without this resource, it is not possible to build a prosperous economy.
- *Labour market reforms*
Labour market reform, while helpful for growth, is critical to making growth more inclusive. Although there is a strong argument for deeper reforms, the minimum needed are reforms that would exempt smaller and new, young firms from some of the more onerous requirements of the various laws and regulations that structure employment norms and wage-setting. There is also an exceptionally strong case for an export processing zone that focuses on labour-intensive manufacturing activities.
- *Regulatory reform*
The regulation of economic and commercial activity in South Africa is far more onerous and intrusive than conducive for growth. A deep, no-holds-barred review of how sensible and justifiable are all the regulations with which business must comply is long overdue.
- *Faster urbanisation and better-managed cities*
Well-managed urbanisation is a key foundation for more rapid economic growth. At the moment, South Africa's policy is ambivalent at best, and existing support for effective urban development – notably grants from the fiscus to support RDP housing and public transport – is riddled with contradictions. Much more could be done to support expanding cities, which should be a key component of any serious growth strategy.

Concluding remarks

South Africa is in a profound and deepening economic crisis. Growth has disappointed for ten years, and yet, as the exceptionally poor growth figures for the first quarter of 2019 show, it still has the capacity to surprise on the downside. For the most part, the build-up of debt (which has doubled

as a proportion of GDP in ten years) is a consequence of the growth slowdown and the failure of fiscal policy to adapt to the reality of much slower economic growth.

Increasingly, however, the debt explosion has become a cause of slower growth, as firms, households and investors come to realise the risk posed by the deepening unsustainability of our public finances. If we add to this the apparent unwillingness or inability to act with urgency on the deepening operational and financial crises at Eskom and other SOCs, as well as the destructive "debate" about the role of the Reserve Bank, and it is hard to avoid despair about whether government and the ruling party recognise the extent of the challenge the country faces.

Responding to these mounting challenges is going to require action – much of it urgent – on a range of fronts. Urgent action must include reining in spending, improving tax collections, fixing failing SOCs and re thinking the sector as a whole, and implementing growth-enhancing reforms.

It is far from clear that government fully grasps the depth of the changes required and how much leadership it will take from the President to get this done. While there have been some good signs in some areas (notably in relation to the exposure of state capture), there has also been a woeful lack of leadership in others. This will not do for very much longer.

"It does not appear that government and the ruling party recognise the extent of the challenge the country faces."

This report is based on a longer publication, **Running out of Road: South Africa's public finances and what is to be done** which is available on CDE's website, www.cde.org.za. See the website for other publications in the **Growth Agenda** series.



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