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SOUTH AFRICA

INSIGHT

The BIG picture - contextualising its impact

Given the lack of details and consensus within the government on a basic income grant (BIG), we provide a broad framework for contextualising any future decisions on such a policy. We simulate the impact of a BIG on key variables of the South African economy. The transmission mechanism through which the income grant affects the economy and local capital markets is largely dependent on how the grant is funded, while the size of transmissions into the economy would depend on how large the BIG is.

Ultimately, financial sustainability is key

There would be many considerations for the size of a BIG and each of these considerations would have its own valid merits. On a multi-year view, however, only one consideration matters – its impact on growth and by extension its affordability. As a result, we analyse the impact it may have on the economy through the lens of capital markets and financial sustainability rather than argue whether it should or should not be implemented.

Furthermore, there still appear to be a lack of consensus within the government on whether a BIG should be implemented or not, never mind the details of what this BIG would look like. As a result, we keep our analyses and assumptions generic, given the lack of detail on such a policy. However, this does provide a broad framework for contextualising any future decisions on a BIG.

Sizing the BIG

We work with a total annual cost of the grant to the fiscus of R160bn per year in real terms. This would broadly equate to a monthly grant of R350 per person for every South African over the age of 18. We use R350 because it is the size in the current Covid-19 Social Relief and Distress grant, which is pegged at R350 (or R4,200 p.a.). Should a BIG be implemented, it seems like a natural starting point, in our view.

In practice, the less people excluded from a grant, the smaller the administrative burden and the smaller the possibility of fraud. As a result, in our analysis, we include the whole population above 18. Naturally, a higher monthly grant per person would increase the cost of a BIG, while more exclusion criteria on who is eligible may in turn reduce the cost of such a programme.

It is also useful to mention other levels that have been suggested for a BIG as some argue that R350 per month is too low. For example, the Institute for Economic Justice (IEJ) suggests the government should rather consider the Food Poverty Line of R585 per month. This is the minimum level for a person to meet their basic food needs every month. The EIJ also suggests the lower and upper bound of the poverty line, which they put at R840 and R1,268, respectively. Lastly, there is also the minimum wage of R3,500 per month that may be suggested by some as a relevant level for a BIG. However, ultimately, a BIG must be funded in a sustainable manner otherwise everybody, including BIG recipients, are likely to be worse off.

Three avenues to fund a BIG

A BIG can be funded in one of three ways or a combination thereof. We analyse the impact of each funding mechanism separately, as this, in our view, provides a good framework to judge the impact of such a policy in the absence of any details.

Firstly, a BIG can be funded in a deficit-neutral manner via an increase in taxes (Scenario 1 or S1). One of the aims of a BIG would be to reduce inequality and poverty and as such, taxes on capital and wealth tend to be the suggested sources of funding rather than labour income and consumption.

Secondly, a BIG can be funded in a deficit-neutral manner via a reallocation of existing government expenditure (Scenario 2 or S2). Reallocating existing expenditure tends to be politically difficult and often one would expect either a pro-rata reduction in allocations across budget items or e.g. a cut in capital expenditure. In South Africa's case, a pro-rata cut would be difficult because a large part of the government expenditure is the wage bill, which, as we have recently seen with the public sector wage negotiations, is extremely difficult to reign in, never mind cut. However, some

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reallocation may be possible in other areas, including existing social support measures in favour of a BIG.

Lastly, a BIG can be funded in a non-deficit-neutral manner via additional borrowing (Scenario 3 or S3).

Three funding mechanisms, three outcomes

We simulate each three of these hypothetical scenarios. Under all three scenarios in our simulation, the BIG is spent on non-durable goods (80%), such as food, and semi-durable goods (20%), such as clothes. Furthermore, in our analysis, the source of funds for the BIG depends on the funding mechanism under the specific scenario.

In Scenario 1, the BIG is funded via an increase in taxes and we assume that 65% of the tax is raised via a wealth tax on individuals and 35% via corporate income and related taxes.

In Scenario 2, we assume the BIG is funded via a general cut or reprioritisation in government expenditure.

In Scenario 3, the BIG is funded via an increase in government expenditure via an expansion of the government deficit.

Exhibit 1 provides a summary of the results from our analysis and contains the average change in each variable over a five-year period. While we highlighted in red areas of concern under each scenario, averages do hide details and as a result we provide more information on each scenario below.

Exhibit 1: Average annual change over five years

Average annual change over five years	Scenario 1	Scenario 2	Scenario 3
BIG as a % of GDP	5.1%	5.1%	5.1%
Change in GDP	0.4	1.1	2.5
GFCF by the private sector	-3.9	2.2	0.6
Headline CPI	0.0	0.3	0.4
Government budget balance as % of GDP (negative number implies a wider deficit)	2.2	0.6	-5.5
Nominal 10-year government bond yield	-1.0	-0.3	2.6
Real 10-year government bond yield	-1.0	-0.2	2.5

Source: Nedbank CIB Markets Research

Scenario 1 provides the lowest growth over the forecast period and skews the economy (even more) away from investment towards consumption

Marginally higher growth but less investment

This scenario results in the lowest increase in annual growth of 0.4% over a five-year period (Exhibit 2). The growth is almost exclusively driven by a rise in consumption expenditure on non-durable and semi-durable goods as future demand is pulled forward.

At the same time, there is a sharp decline in gross fixed capital formation induced by the increase in taxes on corporate profits and savings via the wealth tax on individuals (Exhibit 3). A reduction in savings and profits results in a decline in investment by the private sector.

Worthnoting, the real 10-year bond yield declines marginally under this scenario (Exhibit 7). This is largely because the government deficit as a percent of GDP is less negative than before driven to a large extent by the higher growth.

Risks to Scenario 1 is the cyclicality of the funding base, which could shrink fast, and the reinforcement of consumption at the expense of investment.

Our analysis suggests the net result is likely to be an economy that is marginally larger in size than before but is ultimately more skewed towards consumption rather than production. This, in our view, is a red flag, which makes this approach on a multi-year view questionable.

Furthermore, the funding mechanism (corporate profits and wealth) is not fixed but rather cyclical in nature and the tax base can shift location. We do not model this explicitly but if the user cost of capital in South Africa, which includes not only the tax rate but also cost of funding and country risk premia, rises significantly relative to other locations, it is likely that capital will shift accordingly. These attributes of the tax base could lead to long periods of underfunding and an explicit default by the government to other funding scenarios.

Scenario 2 provides a positive multiplier with a rise in investment and consumption in a sustainable manner

Strong growth with both consumption and investment seeing a rise, while real yields drop

Scenario 2 results in a rise in average growth of 1.1% over a five-year period (Exhibit 2). This comes from a positive multiplier effect as expenditure shifts from the government that has a very low multiplier to households.

The higher growth results in the government budget deficit as a percent of GDP being smaller than before (Exhibit 4), which in turn results in lower government bond yields. The stronger growth and lower government bond yields result in a positive impulse on gross fixed capital formation (Exhibit 3).

Risks to Scenario 2 would be largely political with the reprioritisation of government expenditure leaving other areas unfunded

From an economic perspective, the headline numbers suggest little downside to Scenario 2. However, the reprioritisation of expenditure may leave areas, such as education, health and security, underfunded by an even larger margin, especially if revenue collection disappoints due to e.g. a decline in commodity prices. There is also the risk that capital expenditure is being cut to fund the BIG. That said capital expenditure is already a very small portion of the overall budget in any event.

Worthnoting, higher growth implies a natural rise in spending power of the government, which ultimately may see some of the initial expenditure cuts being reversed in the future.

Scenario 3 creates a large credit impulse with an unsustainable rise in government debt that ultimately drains growth

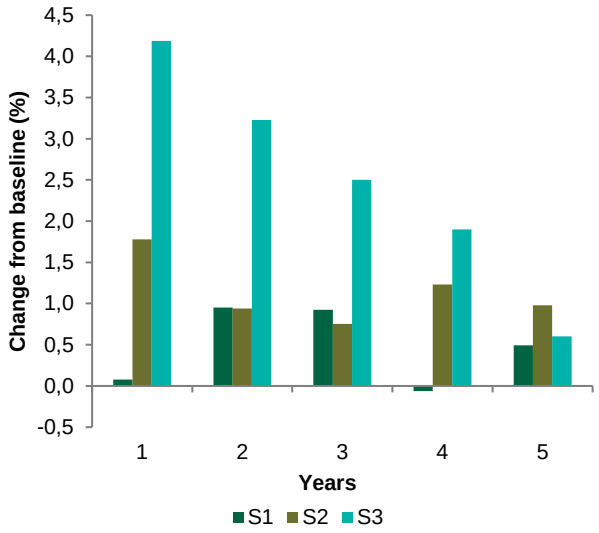
Rising debt and higher real yields

Initially, the additional government borrowing creates a strong credit impulse, which drives growth higher (Exhibit 2). The unsustainability of this strategy is immediately apparent from Exhibit 2, where in year 1, GDP rises by only 4.1% despite government borrowing 5.1% of GDP. Furthermore, this growth fades fast as the government deficit expands at an unsustainable pace (Exhibit 4), and real yields increase because of the government's growing debt burden. At the same time, the investment growth drops to almost zero (Exhibit 3), being held up only by the positive but slowing growth.

Risks to scenario 3 is a huge run-up of debt that will become unsustainable within the forecast period

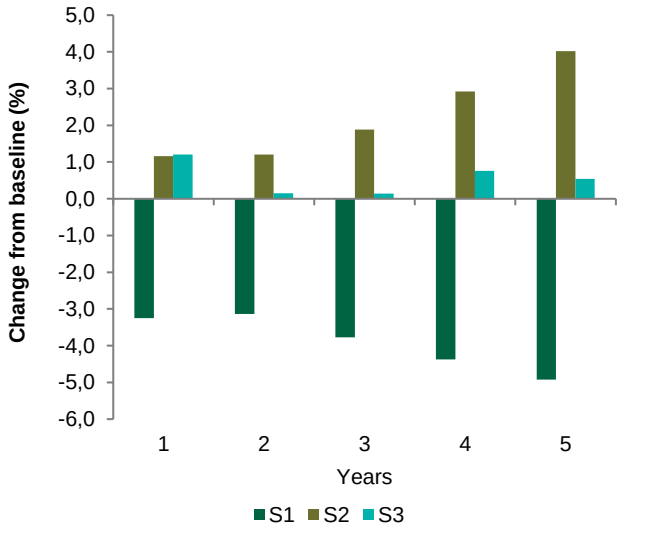
The rise in government debt because of the sizeable increase in the government deficit will become unsustainable within the forecast period, which ultimately will render a BIG unaffordable in any event.

Exhibit 2: GDP growth under the three funding scenarios



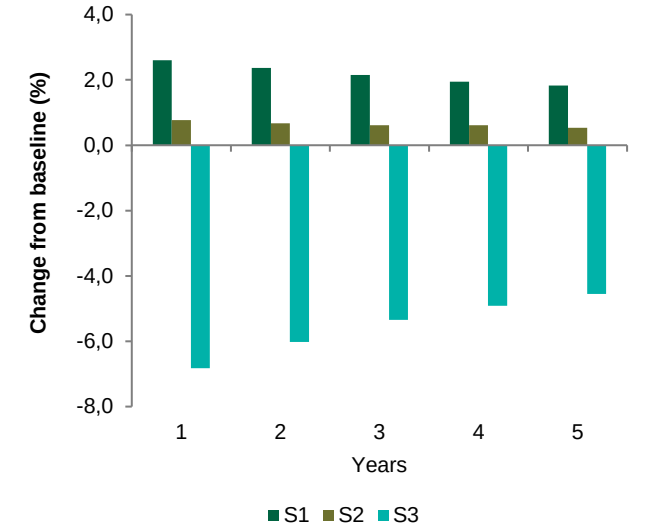
Source: Nedbank CIB Markets Research

Exhibit 3: GFCF under the three funding scenarios



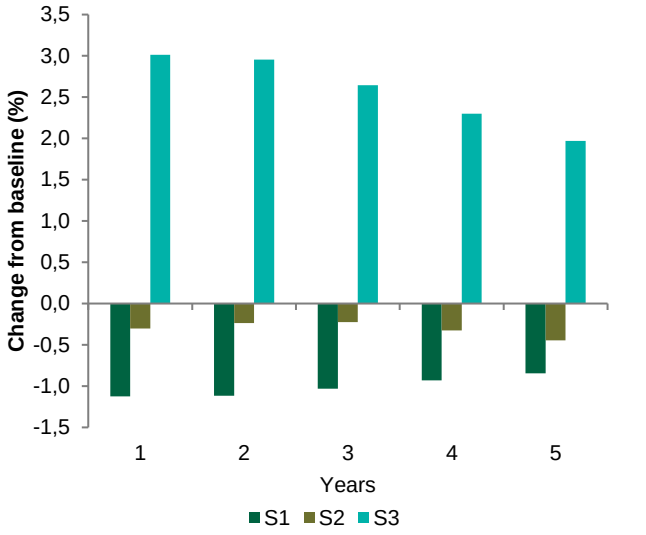
Source: Nedbank CIB Markets Research

Exhibit 4: Government budget balance under the three funding scenarios



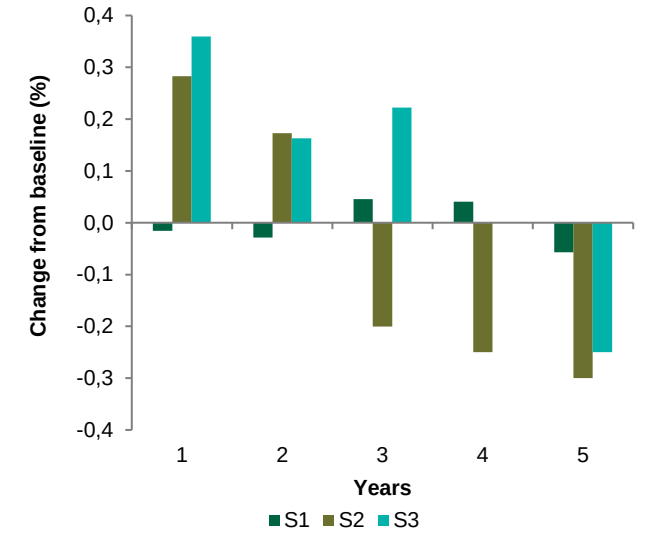
Source: Nedbank CIB Markets Research

Exhibit 5: Nominal 10-year government bond yield under the three funding scenarios



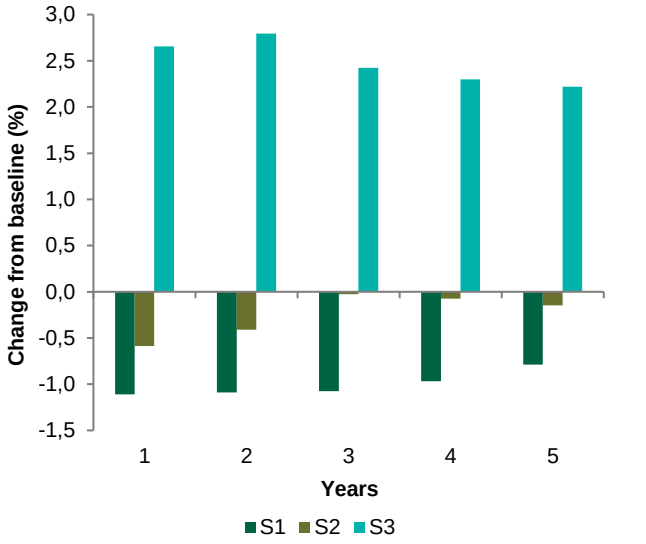
Source: Nedbank CIB Markets Research

Exhibit 6: Headline CPI under the three funding scenarios



Source: Nedbank CIB Markets Research

Exhibit 7: Real 10-year government bond yield under the three funding scenarios



Source: Nedbank CIB Markets Research

Ultimately, only the reprioritisation of the current expenditure results in a sustainable BIG

Our results suggest the only sustainable way to fund a BIG that may also result in generic growth and a rise in investment within the economy is via the reprioritisation of current expenditure.

While funding a BIG via an increase in taxes may result in marginally higher growth, our analysis suggests that this growth comes at the expense of fixed investment. Furthermore, the tax base is cyclical and the risk that it shrinks is extremely large, in our view, ultimately making the BIG unaffordable.

Lastly, funding a BIG via debt may induce a short-term credit impulse that drives growth higher. However, debt will be accumulated at such a fast pace that any benefit will permanently disappear within our forecast period.