

**EPRI Policy Report #31**



*Research Review on*  
**SOCIAL SECURITY REFORM  
AND THE  
BASIC INCOME GRANT  
FOR SOUTH AFRICA**

*Commissioned by the*  
**International Labour Organisation (ILO)**

*And Produced by the*  
**Economic Policy Research Institute (EPRI)**



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Policy  
Research  
Institute**

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**Social Security Reform and the**  
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21 January 2002

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# TABLE OF CONTENTS

EXECUTIVE SUMMARY.....	1
1. INTRODUCTION.....	5
2. SOUTH AFRICA'S SOCIAL SECURITY SYSTEM.....	5
2.1 AN OVERVIEW OF THE SOCIAL SECURITY SYSTEM.....	5
2.2 HOUSEHOLD STRUCTURE AND SOCIAL SECURITY.....	7
2.3 THE HOUSEHOLD STRUCTURE AND POVERTY.....	7
2.4 THE IMPACT OF THE SOCIAL SECURITY SYSTEM.....	8
2.5 CONCLUSIONS.....	9
3. SOCIAL SECURITY TAKE-UP AND MEANS TESTS.....	10
3.1 AN ASSESSMENT OF THE POTENTIAL OF FULL TAKE-UP.....	10
4. SOCIAL IMPACT OF THE BASIC INCOME GRANT.....	13
4.1 INTRODUCTION.....	13
4.2 THE IMPACT OF A BASIC INCOME GRANT.....	15
4.3 CONCLUSIONS.....	16
5. ECONOMIC IMPACT OF A BASIC INCOME GRANT.....	17
5.1 SOCIAL CAPITAL.....	17
5.1.1 Malnutrition and Health.....	17
5.1.2 Education.....	19
5.1.3 Poverty, Inequality and Social Instability: Growth Implications.....	20
5.2 LABOUR MARKET EFFECTS.....	21
5.2.1 Raising labour supply.....	21
5.2.2 Labour demand.....	22
5.3 MACRO-ECONOMIC EFFECTS.....	24
5.3.1 The level of aggregate demand.....	25
5.3.2 The composition of aggregate demand.....	26
6. THE AFFORDABILITY OF A BASIC INCOME GRANT.....	26
7. CONCLUSIONS.....	32
REFERENCES.....	33

# **EXECUTIVE SUMMARY**

## **INTRODUCTION**

Severe poverty and high unemployment in South Africa threaten social stability and long term growth prospects, underscoring the compelling need for social security reform. Recent research, particularly that commissioned by the Committee of Enquiry for Comprehensive Social Security, raises the question of whether a basic income grant could serve as an instrumental tool for raising living standards and improving the efficiency of social delivery. This paper reviews and summarises several recent research papers focusing on social security reform in South Africa, with an emphasis on the proposal for a basic income grant.

## **SOUTH AFRICA'S SOCIAL SECURITY SYSTEM**

The social security system in South Africa targets poverty rooted in the legacy of apartheid. Low incomes compound poor access to health care, education, housing, and social infrastructure. The severity of South Africa's poverty persists in spite of existing social security programmes—most of the poor live in households that receive no social security benefits at all, and the rest remain poor in spite of the benefits they receive. Nevertheless, South Africa's social security grants make a significant impact, reducing the average poverty gap by approximately 23%.

The relatively low percentage obscures a diverse set of impacts. The State Old Age Pension reduces the poverty gap for pensioners by 94%. Poor households that include pensioners are on average significantly less poor than poor households without pensioners. For the average poor household without a pension-eligible member, however, social security's impact is almost negligible. For households with only children and working age adults, for instance, the social security system reduces the poverty gap by only 8.4%, compared to 46.1% for similar households that include a pensioner. South Africa's social safety net has a very loose weave.

## **THE MEANS TEST AND SOCIAL SECURITY TAKE-UP**

Means testing distinguishes the basic income grant from other forms of social security. The application of the means test and other eligibility criteria influences the rate of take-up of existing programmes. One of the major causes of the social security system's inability to secure adequate social protection is the low rate of take-up of these programmes. Recent analysis documents that only an estimated 43% of eligible individuals actually succeed in receiving the grants for which they are qualified. The take-up rate is relatively high for the State Old Age Pensions—approximately 85%. For the Child Support Grant, however, the

take-up rate is very low—approximately 20%—with negative consequences for the effectiveness of the social security system. The low take-up rate is in part a consequence of system failure. Extremely poor individuals are likely to fail in large numbers to qualify for a grant with a complicated and expensive means test and application process. Social security reform that fails to address the structural problem of low take-up is unlikely to yield substantial social benefits.

## **THE SOCIAL IMPACT OF A BASIC INCOME GRANT**

The coverage gaps within South Africa's social security system combined with the structurally low rate of take-up of the Child Support Grant underscore the need for comprehensive reform. The nature of structural unemployment in the face of a changing global economy that marginalises unskilled workers expands the necessary scope of a social safety net. Not only do children, retirees and the disabled need social protection—millions of potential workers are vulnerable to unemployment and the resulting impoverishment.

The nature of an income transfer has important implications for its socio-economic benefits. A universal grant, provided as an entitlement and without a means test, will more readily reach the poorest population. Also, by removing the stigma that labels the recipient as “poor”, the grant bolsters economic support without draining psychological resources. The universal nature of the grant addresses critical structural problems with social security take-up that undermine the effectiveness of the current system. Dispensing with the means test lowers the cost of accessing the grant to both the government and the beneficiaries. Providing the grant as a fundamental right reduces arbitrary discretion, minimising opportunities for corruption.

The basic income grant enables the social security system to reduce the poverty gap by three-quarters, compared to one-quarter without the grant. No other social security reform can provide the effective breadth of coverage demonstrated by the basic income grant.

## **ECONOMIC GROWTH AND SOCIAL DEVELOPMENT**

The basic income grant potentially supports economic growth and job creation through at least three transmission mechanisms. First, the income transfers may promote the accumulation of human and social capital. The interactions are mutually re-inforcing. Both nutrition and education support health, and health raises not only the absorption of learning but also the total return to education by extending lifespan. The expectation alone of imminent improvements in these social spheres may improve social stability.

Second, theoretical and empirical evidence indicates that the basic income grant may positively influence both the supply and demand sides of the labour market. Closely linked to the optimal management of social risk, the labour supply transmission mechanism operates through the effect that higher living standards

exert on the capacity of unemployed job seekers to find work. Likewise, a basic income grant has the potential to increase the demand by employers for workers through its direct and indirect effects on productivity. Directly, a basic income grant supports the accumulation of human capital by a worker, and it supports the worker's productivity-bolstering consumption. Better nutrition, health care, housing and transportation all support the increased productivity of the worker. Indirectly, the basic income grant supports higher worker productivity by reducing the informal "tax" on workers that results from the combination of severe poverty and a remittance-oriented private social safety net.

While the implementation of a basic income grant will partially reduce the need for the private social support network, it will release significant resources to wage earners to bolster their own productivity-improving consumption. The interaction of this effect and the tax effect discussed above creates a type of effective wage subsidy: as employers increase the wages of workers, more of the wage increase goes to the employee's own consumption. This magnifies the increase in labour productivity, increasing the profits of the business enterprise and potentially increasing employment.

Third, two macro-economic transmission mechanisms exist by which the basic income grant may stimulate economic growth. First, the basic income grant will bolster the overall level of aggregate demand in the economy. Second, the grant has the potential to shift the composition of spending towards labour-absorbing sectors of the economy.

## **THE FISCAL IMPACT**

The size of the basic income grant, together with the demographic assumptions and the extent of existing social security programmes, determines the gross cost of the income transfers associated with the basic income grant. Assuming a basic income grant of a hundred rand per month, the gross cost of the income transfers would be R43.8 billion. Out of the R43.8 billion gross cost of the basic income grant, people in the top three quintiles of the population receive R22.2 billion. Adjusting income tax rates and thresholds recuperates the basic income grant from middle and upper income earners. The value-added tax, in turn, recuperates a significant portion of the expenditure associated with the net transfers. Micro-simulations of various tax adjustment options yield an average recuperation of R16.7 billion through the income tax, and R3.3 billion through the value added tax. This results in a net cost of the basic income grant transfers of R23.9 billion.

The economic growth resulting from social security reform has two effects on the fiscal impact of the basic income grant. First, it raises overall national income, and thus supports the capacity of the economy to support fiscal expenditure. Second, by concentrating growth on lower income individuals, recipients of the basic income grant gradually move to income levels in which their

net transfer is reduced. This lowers the overall net cost of the basic income grant transfers over time.

Just as the basic income grant has a positive impact on economic growth, it also supports more efficient social services. Higher living standards raise the efficiency of the educational system, reducing the repeat rate and thus economising on educational resources. Improved nutrition raises lifetime health levels, reducing the strain on the public health system. The medium-to-long term impact of the basic income grant is likely to reduce the cost pressure on several social sectors, resulting in a reduction in the net fiscal impact of the grant.

The basic income grant represents a substantial commitment of fiscal resources. However, a well-managed programme is affordable and consistent with fiscal responsibility. South Africa's tax structure has the potential to finance the entire cost of the programme without recourse to deficit spending. The long-term growth implications of the developmental impact further support macroeconomic stability and fiscal affordability.

## **CONCLUSIONS**

The evidence reviewed and summarised in this report supports the conclusion that the basic income grant is feasible, affordable, and supportive of poverty reduction, economic growth and job creation. A universal basic income grant has the potential to fortify the ability of the poor to manage risk while directly improving their livelihoods. In addition, the grant can improve the efficiency of social capital and societal cohesiveness while stimulating overall economic activity. These factors may increase both the supply and demand for labour, increasing employment and economic growth and thus sustaining a dynamic growth process. Complementary public policy that supports job creation and socio-economic development can reinforce the process by which redistribution generates growth that in turn sustains further broad-based improvements in living standards.

# 1. INTRODUCTION

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The combination of severe poverty and high unemployment in South Africa raises the question of whether a basic income grant could serve as an instrumental tool for raising living standards and improving the efficiency of social delivery. The long-term nature of many job creation strategies suggests the need for immediate measures that address the severe poverty afflicting the nation. A basic income grant offers the potential to resolve the counter-productive predicament of extending infra-structural investment in basic services (water, sanitation, electricity, and communications) to households that lack the income to finance usage charges. Likewise, the favourable investment returns of early intervention in nutrition development with respect to lifetime health and education outcomes demonstrate the need to analyse income transfers within the context of a social investment.

## 2. SOUTH AFRICA'S SOCIAL SECURITY SYSTEM

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South Africa's social security system aims to address a state of poverty rooted in apartheid's legacy. Low or non-existent incomes compound poor access to health care, education, housing, and social infrastructure. This section reviews research that assesses the state of poverty and the impact of the social security system in South Africa using a household-level micro-simulation model.<sup>1</sup>

### 2.1 AN OVERVIEW OF THE SOCIAL SECURITY SYSTEM

In April 2001 an estimated 3.5 million South Africans received a social security grant<sup>2</sup>. The State Old Age Pension (SOAP) is the largest social assistance programme with about 1.9 million beneficiaries. The important redistributive impact of this programme has been recognised by government,

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<sup>1</sup>This section draws heavily on Samson et al (2001a). See also Haarmann and Haarmann (1998) and Haarmann (2000).

<sup>2</sup>Payment Extraction Report for Pay Period April 2001, SOCPEN system—Department of Social Development, 5 April 2001. The figure counts beneficiaries for the Child Support

labour and academia.<sup>3</sup> The disability grant is the second largest programme in rand terms, but smaller than the Child Support Grant (CSG) in terms of beneficiaries. Disability Grant beneficiaries numbered 643,107 in April 2001. Eligibility for the grant is determined based on a medical diagnosis assessing the degree of disability, along with a means test.

The introduction of the Child Support Grant represents one of the most important reforms introduced by the government since the transition to democracy. In April 2001, 800,476 caregivers received grants with an estimated value of 120 million rand. The distinctive feature of the programme is the concept of 'follow the child', meaning that the benefit is independent of the child's family structure. This grant was introduced in April 1998, paying R100 per month per child for children under the age of seven. The declared goal then was to reach 3 million children within the next five years. At the same time, the phasing-out of the State Maintenance Grant (SMG) with about 350,000 beneficiaries started. The Department decided to phase out the grant over a period of 3 years. In April 2001, the CSG benefit was raised to R110, with a commitment to adjusting it for inflation in subsequent years.<sup>4</sup>

Other programmes include the Foster Care Grant (FCG), which provides benefits for families that have adopted a child, and the Care Dependency Grant (CDG), which supports parents taking care of a disabled child at home. At the age of 18, the disabled individual can apply for a Disability Grant. In terms of numbers of beneficiaries, the SOAP, the DG and the CSG are the largest social security programmes.

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Grant as the actual number of grant recipients, not the number of children. In March 2001, there were 842,892 beneficiaries, receiving grants for 1,084,659 children.

<sup>3</sup>Finance Minister Trevor Manuel acknowledged the State Old Age Pension system as one of government's most important poverty alleviation programmes (Budget Speech 1997/98), a fact which is similarly recognised in the White Paper (1997): "The number of elderly South African beneficiaries has stabilised, with fairly good coverage (80%), but there are still particular pockets where many eligible people do not get a grant. The impact of a grant income on household income for people in poverty is dramatic. The majority of people in poverty who are not white live in three-generation households, and the grant is typically turned over for general family use. In 1993, there were 7,7 million people in households that received a state grant. For black South Africans, each pensioner's income helped five other people in the household." See also COSATU (1996), Ardington & Lund (1995), and Haarmann (2000).

<sup>4</sup> Finance Minister Trevor Manuel, Budget Speech 2001.

## **2.2 HOUSEHOLD STRUCTURE AND SOCIAL SECURITY**

In March 2001 South Africa had a population of approximately 45 million people. This compares to the Statistics South Africa estimate of 43 million people in October 1999. The typical South African lives in a household with six members.

- Most pensioners (84%) live in households with non-pensioners, so it is likely that old age pensions are likely to support the living standards beyond their immediate beneficiaries.
- Nevertheless, most adults (81%) and children (76%) live in households with no pensioners, so they are less likely to benefit from the grants paid to pensioners. It becomes clear that while pension money often benefits poor children, pensions are not good at targeting them.
- Over four million working age adults live in households with no pensioners or children. The poor in these households are excluded from a social security system that protects children and pensioners.
- Most South Africans live in large households (more than 6 people). Since larger households tend to be poorer, a fixed grant to each household will not be efficient in targeting the poor--larger per capita benefits will accrue to less poor households.

## **2.3 THE HOUSEHOLD STRUCTURE AND POVERTY**

Poor households are large and crowded. Nearly thirty percent of South Africans live in the poorest household consumption quintile--more than twice as many people as in the wealthiest quintile. Half of the adults of pensionable age who live alone are in the wealthiest quintile--only a tenth are in the poorest quintile. The very poor (bottom quintile) in "three-generation" households are twenty-three times more numerous than the wealthy (top quintile) in these households. Likewise, the very poor in "skip generation" households number thirty-four times the number of the wealthy in these households. On the other hand, a wealthy individual (top quintile) is ten times more likely to live in a

household consisting only of working age adults than is a very poor person (bottom quintile).

Analysis of household survey data provides a picture of the demographics of the people living in the 40% of households with the lowest per capita consumption. 53% of South Africans live in these poorest households, including 60% of the nation's children. Poor households are more likely to be made up of pensioners living with children and working age adults. Eight people live in the average poor household, compared to six in the average household for the nation as a whole. (The average household in the poorest quintile is more than twice as large as the average household in the wealthiest quintile.)

## **2.4 THE IMPACT OF THE SOCIAL SECURITY SYSTEM**

This section compares a scenario without any social security assistance with a scenario modelled on the current level of take-up of existing social security grants. It provides an assessment of the social implications of the current system.

In the absence of social assistance transfers, 58% of South African households would fall below the subsistence line of R401 per adult equivalent. Households with both children and adults of pensionable age are the most vulnerable. 91.4% of households with children and adults in pensionable age ("skip" households) and 81.9% of households with children, working age adults, and adults in pensionable age ("three generation" households) would fall below the subsistence line without the current social security system. 87.6% of child-headed households would be similarly poor. These households are disproportionately black and rural-- 81.9% of "skip" households, 65.6% of "three-generation" households, and 93.7% of child-headed households are rural, and nearly all are black. Households with only working age adults, on the other hand, are disproportionately urban (70.8%) and significantly less vulnerable--only 23.1% would fall below the subsistence line in the absence of existing social assistance transfers. 26.4% of South Africa's households are headed by women.

The household micro-simulation model provides an assessment of the social implications of the current delivery of social security benefits, based on data available for March 2001. Approximately half of the people in the bottom two quintiles live in households that receive no social security benefits. Out of a projected 23,840,471 people in the bottom two quintiles, the simulation model estimates that 11,840,597 individuals (49.7%) live in households who receive no

social assistance. The average per capita social assistance transfer is R42, of which two-thirds (R28) is distributed through the State Old Age Pension (SOAP). The disability grant accounts for approximately twenty percent (R9), and the Child Support Grant only about ten percent (R4). Existing social security programs reduce the average poverty gap by 22.9%, but leave 13,063,820 in destitution (with income levels less than half the poverty line).

The simulation estimates that 3,643,244 individuals are currently receiving social security—more than half of these (1,898,312) receiving the State Old Age Pension. The estimated number of Child Support Grant beneficiaries is 1,096,759, while 648,172 people receive the Disability Grant. The total value of transfers is R18.1 billion, of which R11.6 billion is distributed to individuals living in the bottom two quintiles. Approximately sixty percent of the benefits are transferred to rural recipients, consistent with the strong rural bias to South African poverty.

## **2.5 CONCLUSIONS**

This section describes and quantifies the severe nature of poverty in South Africa, highlighting the predicament facing the nation's twenty-three million poor people. This problem has not responded adequately to existing social security programmes—most of the poor live in households that receive no social security benefits at all, and the rest remain poor in spite of the benefits they receive. Nevertheless, South Africa's social security grants make a significant impact, reducing the average poverty gap by approximately 23%.

The relatively low percentage belies important variances. The State Old Age Pension reduces the poverty gap for pensioners by 94%. Poor households that include pensioners are on average significantly less poor than households without pensioners. Social security reduces the average poverty gap for "skip generation" households by 62.4%, and for three-generation households by 46.1%. For the average poor household without a pension-eligible member, however, social security's impact is almost negligible. For households with only children and working age adults, the average poverty gap reduction is only 8.4%, and for households comprised only of working age adults, the reduction is only 7.6%. South Africa's social safety net has a very loose weave.

### **3. SOCIAL SECURITY TAKE-UP AND MEANS TESTS**

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The means test distinguishes the basic income grant from other forms of social security. The application of the means test and other eligibility criteria influences the rate of take-up of existing programmes. This section reviews studies of the current take-up of South Africa's social security programmes. The impact of the means test on take-up is explored, with a particular focus on the Child Support Grant. An example of the implications of the means test and take-up rates is reviewed based on a simulation exercise involving the extension of the CSG to age eighteen.<sup>5</sup>

#### **3.1 AN ASSESSMENT OF THE POTENTIAL OF FULL TAKE-UP**

In order to quantify take-up rates, it is necessary to estimate the full number of individuals eligible for the existing social security programmes. The scenario discussed in this section is based on micro-simulations run with the assumption that all beneficiaries received the entire set of benefits to which they were entitled, based on detailed household characteristics. The full take-up simulation provides the baseline scenario for the subsequent analysis.

Even with full take-up of all social security programmes, nearly five million people living in the bottom two quintiles live in households that received no benefits at all. Approximately eighty-four percent (4.1 million) of these people are children or adults who live with children. The remainder (806 thousand people) consists of adults who live in households with only working age adults. Ninety percent of those poor households (bottom two quintiles) made up only of working age adults would fail to receive social security benefits.

The existing social security system has the capacity to close 36.6% of the poverty gap if all benefits are distributed to everyone entitled. The closing of the gap, however, is not evenly distributed across household types. Households containing only working age adults have on average only 10.9% of the poverty gap closed, while the entire poverty gap for households containing only adults in pensionable age would be closed. Households containing only children and working age adults have an average of only 22.4% of the poverty gap closed, while "skip generation" households have an average of 80.3% of the poverty gap closed. 60.4% of the poverty gap for three-generation households is closed.

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<sup>5</sup> For further discussion of these issues, see Samson et al (2001b), Haarmann and Haarmann (1998) and Haarmann (2000).

With full take-up, the average per capita transfer rises to R62, with most of the increase relative to current take-up associated with the Child Support Grant. The average per capita transfer distributed through the CSG rises from R4 to R19. The average per capita SOAP transfer rises from R28 to R33, and the Disability Grant from R9 to R10.<sup>6</sup> As a result, the relative shares of the programmes change. Most of the benefit of the existing social security system with full take-up still comes from the State Old Age Pension (SOAP)—but it falls to approximately sixty percent of the per capita social assistance transfer, while the share attributable to the CSG rises to a third (from ten percent).

More than eight million people are eligible for South Africa's social security programmes, of which over five million are children. With full take-up, South Africa would spend R26.5 billion rand on the transfer payments--R14.8 billion for the SOAP, R7.2 billion for the CSG, and R4.5 billion on the disability grant (DG). Approximately 83% of the grants would go to households that include children, and nearly half the transfers would be paid to "three generation" households.

The distribution of the grants is progressive--the potential value of grants to the poorest quintile would be 30% greater than the amount provided to the next poorest quintile, and about eight times the value of transfers to the wealthiest quintile. In the wealthiest quintile, seventy percent of the transfers would go to households without children, compared to eight percent in the poorest quintile. Nearly two-thirds of the transfers would be paid to rural households.

Even with full take-up of all grants, over half the population remains below the subsistence line. With full take-up of all social security programmes, 21,955,935 people fall below the poverty line, while 20,768,683 are above. In particular, a large group of the poor are concentrated in the low tail of the distribution. This group is particularly difficult to target with means tested programmes.

Comparing the current take-up scenario with the full take-up scenario provides measures of rates of take-up. The table below compares the actual and predicted numbers of beneficiaries with the estimates of eligible beneficiaries based on the full take-up scenario. The actual numbers of beneficiaries are

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<sup>6</sup> Micro-simulations of the SOAP and CSG are relatively robust because all of the information required for determining grant eligibility can be captured using household surveys. This is not true, however, for the Disability Grant. As a result, somewhat arbitrary assumptions need to be made to model incomplete take-up when eligibility criteria—such as the results of medical tests—are not supported by data in household surveys. This study assumes a conservatively high take-up rate of 90%.

provided by the Department of Social Welfare's SOCPEN system for March and April 2001. The approximate take-up rate is the same using the actual and predicted numbers of beneficiaries. The estimated take-up rate for the Child Support Grant is approximately 20%, while the estimated take-up rate for the State Old Age Pension is 85%.

**Table 1: Take-up Rates for South Africa's Major Social Security Programmes**

Social security programme	Actual No. of Beneficiaries	Predicted No. of Beneficiaries	Eligible No. of Beneficiaries	Take-up rate
State Old Age Pension	1,905,263	1,898,312	2,237,196	85%
Child Support Grant	1,084,659	1,096,759	5,460,659	20%
Disability Grant	643,107	648,172	718,050	90%
<b>TOTAL</b>	<b>3,633,029</b>	<b>3,643,243</b>	<b>8,415,905</b>	<b>43%</b>

Full take-up of existing social security benefits moves an estimated 843,164 people out of poverty, and increases the average poverty gap reduction from 22.9 to 36.6 percent. However, these benefits are unlikely to be realised with the current structure of the social security system. Means tests, rigid eligibility criteria, and the high relative cost of applying for social security all contribute to low take-up rates. The following section assesses the impact of the means test on take-up rates, and the resulting social consequences.

One of the major causes of the social security system's inability to secure social protection is the low rate of take-up of existing programmes. Only an estimated 43% of eligible individuals actually succeed in receiving the grants for which they qualify. The take-up rate is relatively high for the State Old Age Pensions—approximately 85%. For the Child Support Grant, however, the take-up rate is very low—approximately 20%—with negative consequences for the effectiveness of the social security system. The low take-up rate is in part a consequence of system failure. Extremely poor individuals are likely to fail in large numbers to qualify for a grant with a complicated and expensive means test and application process. Social security reform that fails to address the structural problem of low take-up is unlikely to yield substantial social benefits.

Even if it were possible to reach full take-up of the existing social security system, the cost of additional grants would require approximately eight billion rand, excluding the administrative costs. Because achieving incremental increases in take-up becomes more expensive as the take-up rate rises, the additional administrative expenses are likely to be high. Reaching out to the very

poor with a cumbersome means test is an expensive proposition. The high cost of fully implementing the existing system—with its documented gaps in coverage—is another motivation for exploring alternative options that can more cost effectively deliver comprehensive social security.

## **4. SOCIAL IMPACT OF THE BASIC INCOME GRANT**

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### **4.1 INTRODUCTION**

The coverage gaps within South Africa’s social security system combined with the structurally low rate of take-up of the Child Support Grant underscore the need for comprehensive reform. The nature of structural unemployment in the face of a changing global economy that marginalises unskilled workers expands the necessary scope of a social safety net. Not only do children, retirees and the disabled need social protection—millions of potential workers are vulnerable to unemployment and the resulting impoverishment.

This section assesses the potential of the basic income grant to address the severe poverty characterising the South African society. The nature of an income transfer has important implications for its socio-economic benefits. A universal grant, provided as an entitlement and without a means test, will more readily reach the poorest population. Also, by removing the stigma that labels the recipient as “poor”, the grant bolsters economic support without draining psychological resources.

This social policy option is defined as “a general social assistance grant for all South Africans.”<sup>7</sup> The following discussion identifies the concrete characteristics of this option. In practice the grant would be calculated on a per person basis and paid out to the primary caregiver in the household. For instance, a basic income grant of R100 would mean that a single person living alone receives R100 per month. A household with 6 people (the average for the South African population)<sup>8</sup> receives R600 a month, which would be paid to the person primarily responsible for childcare. The working assumption in this modelling is that there is no overlap between different grants. (Alternative assumptions can be

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<sup>7</sup> This is based on the terms of reference of the project commissioned by the Committee of Enquiry for Comprehensive Social Security. For a more detailed discussion of the social impact of a basic income grant in South Africa, see Samson et al (2001c), Haarmann and Haarmann (1998) and Haarmann (2000).

<sup>8</sup> See Haarmann (2000).

readily modelled.) A basic income grant serves as a social entitlement for all South Africans. Such an entitlement supports the right to social security as entrenched in the South African constitution [27(1)(c); (2)] while furthering the vision of a comprehensive social security system as identified in the White Paper for Social Welfare.

The Basic Income Grant has no means test and therefore avoids many of the disincentives to work inherent in other social assistance systems. This stands in stark contrast to what is sometimes referred to as a 'dole system', which employs conventional means tests to target the unemployed, the unemployable or the very poor. Such 'dole systems' are often associated with significant negative incentives and stigma.

The targeting of the poor within the context of a basic income grant depends on the tax system. The South African Revenue Service is one of the most capable arms of government, reflecting a transformation process that has supported consistent over-achievement of revenue targets over the past five years. Appropriate tax reform linked to the basic income grant can achieve very effective redistribution. Several financing mechanisms have been proposed. COSATU has proposed recuperating the amount of the grant from middle-income earners while implementing a 'solidarity tax' for high-income earners, and other proposals have focused on alternative tax mechanisms.<sup>9</sup>

One of the major advantages of a universal grant that uses the tax system instead of a means test is the reduced danger of corruption, as the payment is an entitlement and is not dependent on officials with the discretion to decide who receives it. The implementation of a basic income grant also develops administrative economies of scale that generate spill-over benefits for the payment of other social grants, the development of the financial system, and the collection of taxes.

The structure of the basic income grant is important. Paying a fixed grant per household or calculating the benefit on a per person basis yields very different social impacts. A basic income grant, which is calculated on a per person basis, favours larger households that on average are poorer than smaller ones. Pooling of income leads to economic efficiencies and a more equitable intra-household

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<sup>9</sup> COSATU (1998); Hazelhurst (2000); Samson, Babson, Mac Quene, van Niekerk (2000).

distribution of income, which contributes to the empowerment of women and younger people in the family.<sup>10</sup>

## **4.2 THE IMPACT OF A BASIC INCOME GRANT**

Much of the research in South Africa on a basic income grant has analysed a benchmark scenario of the implementation of a basic income grant of R100 per month for all South Africans. This section summarises the results of recent findings.<sup>11</sup>

A basic income grant enables the social security system to reduce the poverty gap by 73.7%, compared to 22.9% without the grant. With full take-up, the number of poor South Africans excluded from the social security system is reduced to zero. The dispersion among household types in the closing of the poverty gap is substantially reduced. The household type with the least reduction in the poverty gap is the household with only working age adults--the poverty gap is closed by 56.7%, compared to only 7.6% with the current system. For households with children but no pensioners, the poverty gap is closed by two-thirds, and for households with children and pensioners, the gap is closed even more successfully. For “skip generation” households, 95% of the poverty gap is closed, for “three-generation” households, 85% of the poverty gap is closed. The gap between the average per capita transfers for households with children and no pensioners versus households with children and pensioners falls substantially.

The variance in average per capita social security transfers across household types narrows significantly. Under the existing system, poor households with just children and working age adults receive per capita transfers averaging R14, while poor pensioner households receive an average of R523, a ratio of 37 to one. With the basic income grant, poor households with just children and working age adults receive per capita transfers averaging R109, while poor pensioner households receive an average of R568, a ratio of only five to one.

Likewise, disparities among households with children narrow also. Under the existing system, a poor child fortunate enough to live with a pensioner grandparent benefits from an average per capita transfer as high as R154 (“skip generation” households), or R84 (“three generation” households). Children without pensioners in the household receive less than a tenth the transfer for “skip

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<sup>10</sup> Haarmann and Haarmann (1998).

<sup>11</sup> Samson et al (2001c).

generation” households (R14). With a basic income grant, the child living with a pensioner grandparent benefits from an average per capita transfer of R250 (“skip generation” households), or R178 (“three generation” households). Children without pensioners in the household receive a little less than half the per capita transfer for “skip generation” households (R109).

Most of the benefits (53%) are distributed to rural households, reflecting the spatial character of South African poverty. Two-thirds of the transfers to three-generation and “skip generation” households are to rural recipients, reflecting the household structure’s role in coping with rural poverty.

The incidence of extreme poverty is nearly completely eliminated. The closing of the poverty gap improves to 74%. On a headcount basis, approximately 6.3 million are moved out of poverty. The number of destitute individuals (measured using half the poverty line) falls by 10.2 million people. Most of the remaining poor individuals are clustered fairly close to the poverty line, so that broad-based growth would demonstrate substantial success in moving additional numbers of people out of poverty.

### **4.3 CONCLUSIONS**

Recent research provides strong evidence of the capacity of a basic income grant to address some of the major shortcomings of the existing social security system. First, the universal nature of the grant addresses critical structural problems with social security take-up that undermine the effectiveness of the current system. Dispensing with the means test lowers the cost of accessing the grant to both the government and the beneficiaries. Providing the grant as a fundamental right reduces arbitrary discretion, minimising opportunities for corruption. Furthermore, the broad coverage that universal access provides fills the gaps of the existing system. The basic income grant enables the social security system to reduce the poverty gap for all groups by at least fifty percent—compared to a reduction as little as eight percent for households with just working age adults (or children and working age adults) under the current social security system. No other social security reform can provide the effective breadth of coverage demonstrated by the basic income grant.

## **5. ECONOMIC IMPACT OF A BASIC INCOME GRANT**

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This section examines the transmission mechanisms through which the basic income grant may potentially support economic growth and job creation. This review assesses three major areas. First, it examines the linkages between the grant and the accumulation of social capital. Second, the report analyses the potential impact of the grant on the labour market. Third, the study evaluates the macro-economic consequences of the grant, assessing the impact on the level and composition of aggregate demand.<sup>12</sup>

### **5.1 SOCIAL CAPITAL**

The preceding section documents the substantial positive social impact of the basic income grant in terms of reducing poverty and raising living standards. This section discusses an extensive body of research that supports the link between these results and consequent social capital development. Several transmission mechanisms are important: nutrition and health, education, and social stability. While these are addressed distinctly in the following discussion, the important linkages and complementarities are highlighted. Both nutrition and education support health, and health raises not only the absorption of learning but also the total return to education by extending lifespan. The expectation alone of imminent improvements in these social spheres can improve social stability. The recently Cabinet-approved human resource strategy recognises that poverty and inequality limit “the ability of individuals, households and the government to finance the enhancement of skills, education and training that are critical prerequisites for improved participation in the labour market, and therefore, improved income.”<sup>13</sup> In this way poverty reinforces a trap that keeps living standards low and growth prospects dim.

#### **5.1.1 Malnutrition and Health**

One major transmission mechanism is the maintenance of proper nutrition supported by accessible social security. A recent United Nations report documents the extent to which inadequate early childhood nutrition contributes to long-term health and education problems, leading in turn to lower productivity

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<sup>12</sup> For a more detailed analysis, see Samson et al (2001d).

<sup>13</sup> Human Resource Development Strategy for South Africa (2001).

through poorer health and higher absenteeism.<sup>14</sup> In addition, conditions resulting from childhood deprivation lead to long term strains on the nation's health and education systems, draining resources that could efficiently target other social priorities. Childhood malnutrition often leads to "severe and costly physical and psychological complications in adulthood."<sup>15</sup> The transmission mechanisms of early deprivation are manifold. For instance, the associated childhood stress leads to reduced life expectancy.<sup>16</sup> Early malnutrition reduces the capacity of the immune system to protect health.<sup>17</sup> Studies in South Africa find a strong link between poverty and low birth weight.<sup>18</sup> The long-term consequences include higher risks of heart disease, strokes, hypertension and diabetes.<sup>19</sup> The inertial effects are long lasting--the negative consequences of pre-natal malnutrition can be passed on to the next generation. Women who themselves suffered from pre-natal malnutrition are more likely to give birth to low birthweight babies--even if they have proper nutrition during their own pregnancies.<sup>20</sup>

According to the 1999 October Household Survey, children in a quarter of the poorest households (household consumption less than R800 per month) experience hunger because of insufficient resources to buy food. A report issued by the South African Human Rights Commission identified fourteen million South Africans as vulnerable to food insecurity, with two-and-a-half million South Africans malnourished.<sup>21</sup> "One in four children under the age of six years (some 1.5 million) are stunted due to chronic malnutrition."<sup>22</sup>

"Integrated programs in early child development can do much to prevent malnutrition, stunted cognitive development, and insufficient preparation for school... Such programs can improve primary and even secondary school performance, increase children's prospects for higher productivity and future income, and reduce the probability that they will become burdens on public health and social service budgets."<sup>23</sup> Social security reform provides the income security that effectively reduces the incidence of malnutrition. International studies

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14 Philip (2000).

15 Henry and Ulijaszek (1996).

16 Barker (1996).

17 Chandra (1975), Miler (1982).

18 Cameron (1996).

19 Barker (1996).

20 Lumey (1992).

21 Mgijima (1999).

22 Mgijima (1999).

23 Young (1996).

demonstrate that poor families allocate more than half of additional income to increased food consumption.<sup>24</sup> The resulting improvements in health and nutrition directly improve not only the well being but also the productivity of the very poor. International studies document the positive impact of improved nutrition on productivity and earnings.<sup>25</sup> A study in Colombia found that social interventions supporting improved health and nutrition raised lifetime earnings by factors between 2.5 and 8.9.<sup>26</sup> A study in Chile that tracked children over time found that preventing malnutrition yielded productivity returns six to eight times the cost of the social investment.<sup>27</sup>

### **5.1.2 Education**

The October Household Survey also provides evidence of the important linkages between social security transfers and educational attainment. Econometric tests document a strong impact of income grants (as measured by the State Old Age Pension in three-generation households) on school attendance. Pensions exert a significant and positive effect on the likelihood that a school-age child will attend school, this effect is stronger among the poorer segments of the population.

In theory, receiving an income grant affects school enrolment in two ways. First, to the extent that there are financial barriers to school attendance – purchasing school supplies, uniforms, tuition, transportation, etc. – the boost in disposable income provided by the grant could help pay the otherwise unaffordable costs of attending school. Second, a grant potentially reduces the opportunity cost of school attendance. With a grant in hand, a family might be more able to forgo a child's contribution to household income (or food production in the case of subsistence farmers) in favour of making a long-term investment in education.

The evidence supports this theory. The poorer the household, the stronger the impact of a grant in terms of promoting school attendance. Furthermore, the impact is greater for girls than for boys. In poor households, defined as those households falling into the lower quarter of all households in a

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<sup>24</sup> Strauss and Thomas (1995). See also Bouis and Haddad (1992).

<sup>25</sup> Ranis and Stewart (2000), Cornia and Stewart (1995), Strauss (1986), Immink and Viteri (1981), and Wolgemuth (1982).

<sup>26</sup> Selowsky (1981).

<sup>27</sup> Selowsky and Taylor (1973).

given province ranked by expenditure per capita, school-age boys are 3 percent more likely to attend school full time if the household receives a pension benefit. The effect is even more pronounced for girls: girls who live in pensioner households are 7 percent more likely to be enrolled full time in school than are their peers who live in households without a pension. In general, a five hundred rand increase in income transfers to a poor household of five would increase the probability of attending school by an estimated 2 percent for a school-age boy and 5 percent for a girl.<sup>28</sup>

Not only does increasing school attendance among poor children add to human capital, improving future productivity and prospects for economic growth; it also can have an important long-term effect on stemming the spread of HIV/AIDS. Indeed, the World Bank notes that increasing education, and in particular the education of women, is one of the most effective ways to combat the spread of HIV/AIDS.

Numerous international studies corroborate these findings. The positive link between improved household incomes and improved educational attainment by children is rigorously documented.<sup>29</sup> The strong result for girls in South Africa's case is particularly important. A recent study by Ranis and Stewart found that the most consistent predictor of successful human development was improved female education, particularly through the consequent improvements in infant survival and child nutrition.<sup>30</sup> Education also improves economic performance not only through improved labour productivity but also through improvement capital productivity. A more educated workforce is more likely to innovate, raising capital productivity.<sup>31</sup>

### **5.1.3 Poverty, Inequality and Social Instability: Growth Implications**

The basic income grant provides a social stake for the economically disenfranchised, promoting social cohesiveness and investor confidence. "Research conducted in working class townships around Durban revealed a link between...violence and the erosive effects of apartheid and poverty...."<sup>32</sup>

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<sup>28</sup> For a more detailed analysis, see Samson et al (2001e).

<sup>29</sup> Alderman (1996), Behrman and Wolf (1987a,b), Birdsall (1985), Deolalikar (1993) and King and Lillard (1987).

<sup>30</sup> Ranis and Stewart (2000).

<sup>31</sup> Lucas (1988).

<sup>32</sup> Louw and Shaw (1997).

Poverty creates vulnerability to crime, and victimisation in turn erodes human and social capital and undermines access to employment.<sup>33</sup> “The shock of being victimised by crime makes the poor more vulnerable.... In some cases, heightened vulnerability may force victims to resort to criminal activity as a means of survival...”<sup>34</sup> Theoretical economic and empirical cross-country evidence demonstrates that income transfers yield social benefits that increase private investment and stimulate economic growth.<sup>35</sup>

A recent World Bank report argues that “the foregone cost of not accounting for the poor may compromise economic growth in the long-run. In order to survive, the poor may... resort to criminal or marginalised activities.... Moreover, denying the poor access to economic and educational opportunities accentuates inequality—an outcome likely to retard economic growth.”<sup>36</sup> An extensive literature documents the link between severe inequality and poor rates of economic growth. Cross-country empirical evidence includes econometric studies, which find a negative effect of inequality on economic growth.<sup>37</sup> These findings are supported by methodological studies.<sup>38</sup>

## **5.2 LABOUR MARKET EFFECTS**

Theoretical and empirical evidence demonstrates that the basic income grant positively influences both the supply and demand sides of the labour market.

### **5.2.1 Raising labour supply**

Closely linked to the optimal management of social risk, the labour supply transmission mechanism operates through the effect that higher living standards exert on the capacity of unemployed job seekers to find work. The conventional wisdom stemming from economic theory argues that income transfers to the unemployed will tend to undermine their willingness to supply labour to the market, as additional income reduces the “opportunity cost” of not working. In the absence of income transfers, the alternative to working may be unacceptable living standards. Income transfers make the alternative living standards more tolerable. Empirical evidence from South Africa’s 1997 October Household

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<sup>33</sup> Moser, Holland, and Adam (1996).

<sup>34</sup> Louw and Shaw (1997).

<sup>35</sup> Cashin (1995).

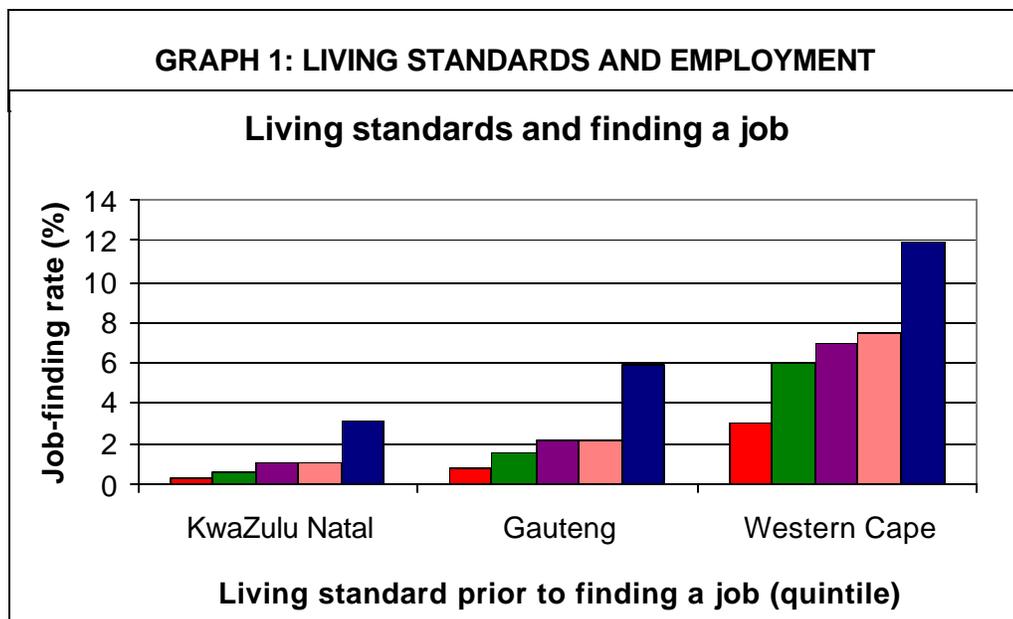
<sup>36</sup> Subbarao, Bonnerjee, Braithwaite (1997).

<sup>37</sup> Alesina and Rodrik (1994), Persson and Tabellini (1994).

<sup>38</sup> Perotti (1992, 1994, 1996), Lipton (1995).

Survey contradicts this neo-classical economic theory, suggesting that higher living standards may be associated with higher rates of finding employment, even when controlling for the effect of remuneration on consumption.

The graph below demonstrates the link between prior living standards and the rate at which individuals wanting employment found jobs. The population of individuals in Gauteng, KwaZulu-Natal, and the Western Cape who expressed an interest in employment in October 1997 was divided into five quintiles based on per capita household consumption in September 1997. Then the rates at which job seekers in each quintile found jobs in October 1997 were calculated. The graph below maps the job-finding rates across quintiles for the three provinces, demonstrating that higher prior living standards are linked to higher job-finding rates. Individuals who can better afford leisure nevertheless choose to find jobs and are apparently better able to secure employment. The data raises questions about the applicability to poor households in South Africa of the conventional argument that income transfers will lead to reductions in labour supply.



### 5.2.2 Labour demand

Income transfers to the poor act as a wage subsidy, allowing wage increases to more efficiently raise the productivity of workers. Currently, the imperative of providing remittances to family members, friends, and other individuals in need reduces the remaining wage available to sustain the worker's productivity. Wage increases are in part "taxed" by associated increases in remittances, since the working poor provide the primary social safety net for the

ultra-poor. As a result, the “efficiency wage” effect is diluted—wage increases do not lead to as powerful a productivity-enhancing effect as they would if the remittance pressures were reduced. This tends to create a low wage trap, as higher wages provide a public good, and market failure ensures that this “good” is insufficiently provided.

A theoretical model of firm behaviour reflecting these conditions demonstrates that providing income transfers to the poor leads to increased employment, even benefiting those who do not receive a net income transfer.<sup>39</sup> Income transfers reduce poverty, mitigating the demands on workers for remittances. This allows workers to channel more of their wages to productivity-enhancing consumption and human capital investment, increasing firm competitiveness and thus raising production and the demand for labour.

Empirical evidence in South Africa and in other countries supports this hypothesis. An ILO study documents how the tendency for large family remittances to flow from urban to rural areas places South African firms at a structural disadvantage, resulting in reduced employment.<sup>40</sup> A large body of cross-country evidence documents the substantial role remittances from the working poor play in creating a social safety net for the very poor.

Empirical and theoretical analysis supports the applicability of the “efficiency wage” hypothesis to South Africa. Higher wages increase productivity in several ways: (1) higher wages improve equity, reducing social tension and economising on capital inputs through fuller utilisation—fewer strikes, more opportunities for extra shifts, etc. (2) Higher wages support improvements in health and education, contributing to higher labour productivity and the generation of capital-saving innovations, as discussed in the previous section under “Social capital”. (3) The improved distributional effects of higher wages increase expected returns to capital by reducing political risk.<sup>41</sup> A Dresdner Bank study of South African manufacturing sectors found evidence of a positive efficiency wage effect in many industries.<sup>42</sup> This is consistent with international experience in many low wage developing countries.<sup>43</sup>

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<sup>39</sup> See Appendix II in Samson et al (2001d).

<sup>40</sup> Standing, Sender, and Weeks (1996).

<sup>41</sup> “Hochtief, the multi-national German construction company, may have broken off talks with Murray and Roberts, the engineering and construction group, earlier this year as a result of fears arising from the Zimbabwe crisis.... This is one of the first concrete examples of a large investment decision that was directly affected by the events in the neighbouring country.” (Business Report, September 10, 2000, page 1.)

<sup>42</sup> Piazzolo and Wurth (1995).

<sup>43</sup> A recent World Bank study finds “significant efficiency wage effects” using firm-level data from Mexico (Maloney and Ribeiro 1999). Another World Bank study using an

A basic income grant has the potential to increase the demand by employers for workers through its direct and indirect effects on productivity. Directly, a basic income grant supports the accumulation of human capital by a worker, and it supports the worker's productivity-bolstering consumption. Better nutrition, health care, housing and transportation all support the increased productivity of the worker. Indirectly, the basic income grant supports higher worker productivity by reducing the informal "tax" on workers that results from the combination of severe poverty and a remittance-oriented social safety net. The graph below, estimated from SALDRU data, documents the extent to which remittances impose a burden on wage earners. The percentage of a household's resources allocated to remittances rises steeply as per capita income increases. On average, remitting households earning R2600 pay nearly 17% of their income in remittances to family members, friends, and others in need who live outside the household.

A study of the interaction between public and private transfers in South Africa finds that a government grant of a hundred rand provided to a household receiving private transfers led to a reduction of twenty to forty rand in remittances to that household.<sup>44</sup> This suggests two important implications: (1) the implementation of the basic income grant will not erase the private social support network, (2) a basic income grant will release substantial resources to wage-earners to bolster their own productivity-improving consumption. The interaction of this effect and the tax effect discussed above has a further important implication. With a basic income grant in place, as employers increase the wages of workers, more of the wage increase goes to the employee's own consumption. This magnifies the increase in labour productivity, increasing the profits of the business enterprise and potentially increasing employment.

### **5.3 MACRO-ECONOMIC EFFECTS**

There are two types of macro-economic transmission mechanisms by which the basic income grant can stimulate economic growth. First, the basic income grant will bolster the overall level of aggregate demand in the economy. Second, the grant has the potential to shift the composition of spending towards labour-absorbing sectors of the economy.

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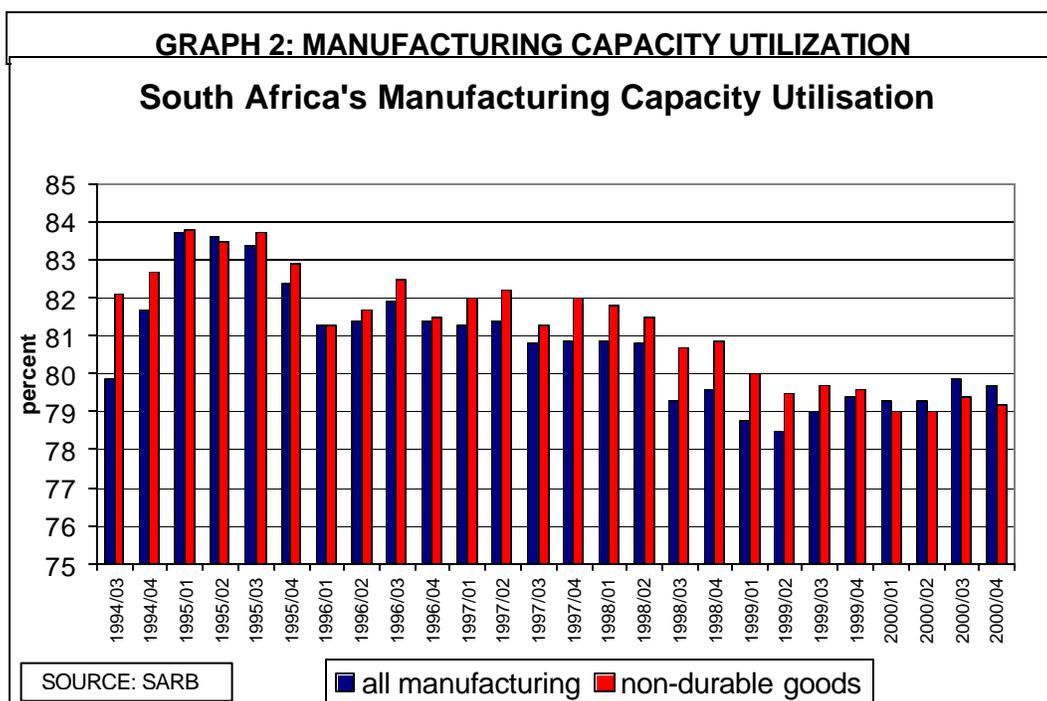
endogenous growth framework for Guatemala found similar results (Sakellariou 1995). Likewise, a study of Zimbabwean firm level data is consistent with positive efficiency wage effects (Valenchik 1997). Similarly, a study of the cement industry in Turkey finds that higher wages improve productivity by increasing technical efficiency (Saygili 1998).

<sup>44</sup> Jensen (1996).

### 5.3.1 The level of aggregate demand

A basic income grant, by shifting resources from savings to consumption, stimulates the overall level of economic activity. Given the high rate of unemployment and large levels of excess capacity, the growth effects of this stimulus are likely to be substantial.

Income transfers to the poor stimulate aggregate spending, leading to increased economic activity which promotes economic growth. An analysis of South Africa's productive capacity does not support the contention that income transfers to the poor might be inflationary or unsustainable. Since 1995, utilisation of productive capacity in manufacturing has fallen approximately five percent, as demonstrated in the graph below. The substantial increase in economic activity generated by income transfers will tend to increase capacity utilisation, probably more with non-durable manufacturing than with durable goods. This spending will provide a demand-side stimulus that increases the demand for labour, promoting increased employment. The government's new human resource strategy identifies how poverty and inequality undermine the generation of "increased aggregate demand for goods and services, therefore limiting economic growth."<sup>45</sup>



<sup>45</sup> Human Resource Development Strategy for South Africa (2001).

### **5.3.2 The composition of aggregate demand**

The spending of the lower income groups tends to concentrate on labour-absorbing sectors of the economy. Income transfers to the poor shift aggregate demand towards labour-intensive job-creating industries, because it increases the consumption of the poor, the composition of which is relatively labour-intensive. Relatively affluent consumers spend a relatively large share of expenditure on capital-intensive and import-intensive goods, creating a bias against labour-intensive production in the country. The largest components of South African imports (excluding capital goods) include appliances, electronics, automobiles, jewellery, and other goods consumed disproportionately by the relatively affluent. Redistributing income to lower income individuals is likely to stimulate job creation, particularly if appropriate policies are implemented to enable the unemployed to undertake productive activities that meet the resulting increased economic demand. Effective micro-credit policies combined with logistical support for entrepreneurs can effectively maximise the resulting job creation.

The basic income grant may support economic growth and job creation in three major ways. First, it may support both increased labour supply and demand, raising employment levels and supporting economic growth. Second, it may promote the accumulation of social capital, which raises the productivity of labour and capital and fuels economic growth and job creation. Third, at a macro-economic level, it raises the level of aggregate demand while shifting the composition of demand in a way that potentially promotes higher rates of growth and employment.

## **6. THE AFFORDABILITY OF A BASIC INCOME GRANT**

Substantial research has evaluated the potential fiscal impact of a basic income grant under alternative financing and implementation scenarios. Recognising that the fiscal costs of the basic income grant are substantial, this section focuses on the question of affordability. The magnitude of the fiscal impact depends on several factors:

- the size of the grant,
- the associated adjustments to the income tax structure,
- the growth effects resulting from the improved living standards,
- the impact of the grant on other government expenditures,
- the take-up rates for the grant.

The size of the basic income grant, together with the demographic assumptions and the extent of existing social security programmes, determines the gross cost of the income transfers associated with the basic income grant. The micro-simulations of the South African economy indicate a total population in March 2001 of 44.9 million people, of which 8.4 million people are eligible for existing social security programmes. Assuming a basic income grant of a hundred rand per month, the gross cost of the income transfers would be R43.8 billion.<sup>46</sup>

Out of the R43.8 billion gross cost of the basic income grant, people in the top three quintiles of the population receive R22.2 billion. Adjustments to the income tax structure can recuperate most of these transfers without significantly affecting the vertical equity of the net tax burden. Adjusting the tax rates and income thresholds at lower income levels gradually recuperates the basic income grant from middle and upper income earners. The value-added tax, in turn, recuperates a significant portion of the expenditure associated with the net transfers. Micro-simulations of various tax adjustment options yield an average recuperation of R16.7 billion through the income tax, and R3.3 billion through the value added tax. This results in a net cost of the basic income grant transfers of R23.9 billion.

The basic income grant is likely to promote economic growth through a number of important transmission mechanisms that are discussed in the previous section. Growth has two effects on the fiscal impact of the basic income grant. First, it raises overall national income, and thus supports the capacity of the economy to support fiscal expenditure. Second, by concentrating growth on lower income individuals, recipients of the basic income grant gradually move to income levels in which their net transfer is reduced. This lowers the overall net cost of the basic income grant transfers over time.

Just as the basic income grant has a positive impact on economic growth, it also supports more efficient social services. As discussed in the preceding section, higher living standards raise the efficiency of the educational system, reducing the repeat rate and thus economising on educational resources. Improved nutrition raises lifetime health levels, reducing the strain on the public

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<sup>46</sup> Samson et al (2001f).

health system. The medium-to-long term impact of the basic income grant is likely to reduce the cost pressure on several social sectors, resulting in a reduction in the net fiscal impact of the grant.

The take-up rates of the grant determine the dynamic impact of the programme. Historically, planning of social security programmes in South Africa has over-estimated the take-up rates. Take-up rates are largely a function of administrative capacity and political will. Aggressive outreach campaigns can substantially improve take-up rates, particularly when co-ordinated with aggressive improvements in bureaucratic capacity.

The graph on the next page compares South Africa's tax revenue to government receipts of OECD countries during the past decade, demonstrating that South Africa's tax structure is not unduly burdensome.<sup>47</sup> The average OECD country's ratio of revenue to national income is 42.3%, compared to a ratio of 24.7% for South Africa. The relevance of an OECD comparison is supported by the argument that unduly high tax rates will induce immigration out of South Africa, and the overwhelming majority of immigration from South Africa is to OECD countries. The relevance is reinforced by the comparability of South Africa's financial system--a key determinant of taxable capacity--to those in industrialised countries.

Studies of the South African tax system document the extent to which lower and middle income groups bear a disproportionate share of the tax burden.<sup>48</sup> From 1994 to 1996, South Africa derived more than a quarter of its tax revenue from the Value Added Tax (VAT), yet the poorest fifth of the population spend 61% of their consumption expenditure on goods subject to VAT, while the wealthiest fifth of the population spend only 43% of their consumption expenditure on these types of goods. The Katz Commission report, recognising the "huge disparity of incomes and assets between the various groups in South Africa", argues for the need for greater reliance on wealth taxes.<sup>49</sup>

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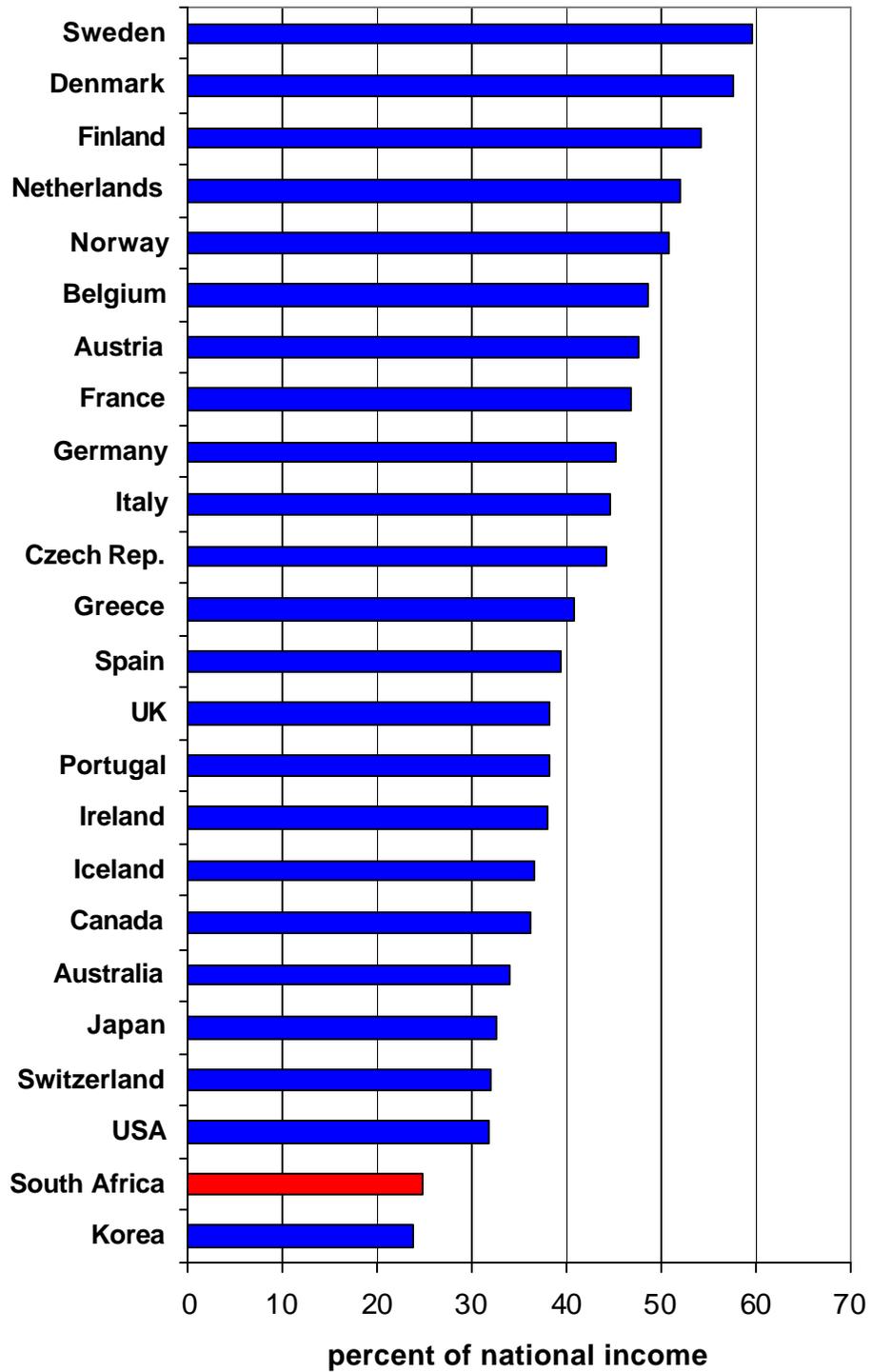
<sup>47</sup> The comparison includes data for all countries listed in the OECD 1999 yearbook, averaging all data for the 1990s. South Africa's data covers the timeframe comparable with the OECD sample, with data drawn from the 2000 Budget Review.

<sup>48</sup> Harber (1995).

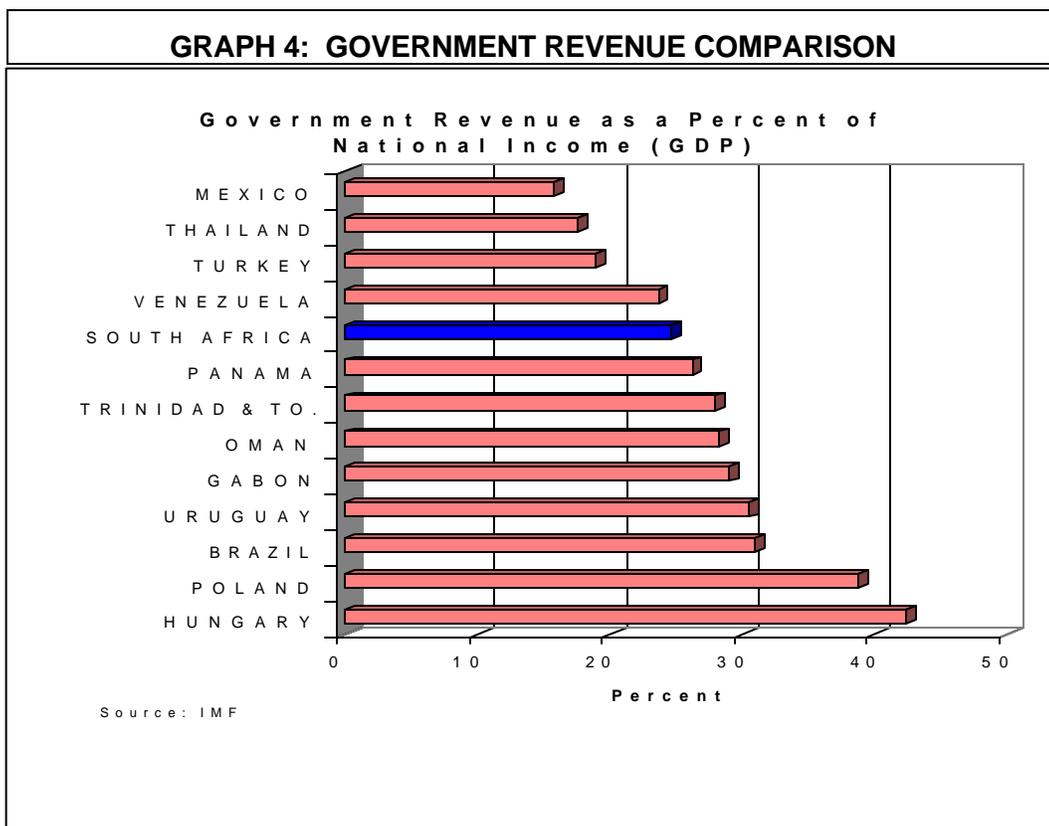
<sup>49</sup> Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995).

**GRAPH 3: GOVERNMENT REVENUE OECD COMPARISON**

**Government Revenue OECD Comparison**



Furthermore, studies document that South Africa's government revenue (relative to national income) is significantly less than that of other countries with comparable income levels. The graph below, from a study by EPRI, shows average government revenue (relative to national income) for countries with per capita incomes within twenty percent of South Africa's level. This indicates that South Africa's government revenue (as a percentage of national income) is about four percentage points lower than the average for countries with similar income levels.



A previous research paper supported a similar conclusion, comparing South Africa's tax ratio with those of countries with similar income levels. The ten countries with per capita incomes closest to South Africa were analysed—their average tax rate was six percentage points higher than that for South Africa.<sup>50</sup> Econometric studies that control for individual country characteristics have found

<sup>50</sup> Samson, Mac Quene, Van Niekerk, Ngqungwana (1997).

South Africa's average tax rate to be significantly less than that which would be predicted given the country's economic profile.<sup>51</sup> Furthermore, tax effort analysis suggests that South Africa could mobilise up to an additional twenty-five billion rand per year without undermining international competitiveness.<sup>52</sup>

The revenue potential from a more equitable tax system requires detailed investigation. Preliminary analysis indicates that a capital gains tax can increase total revenue by five to ten billion rand, including both direct capital gains taxes plus indirect revenue effects resulting from eliminating inefficient tax arbitrage.<sup>53</sup> The Katz Commission suggests that the revenue from improved tax compliance may generate at least five billion rand, while other estimates place the figure as high as fifteen billion rand.<sup>54</sup> The Katz Commission notes that some countries have generated between 1% and 1.5% of total tax revenue from inheritance taxes and estate duties, which in South Africa's case is more than two billion rand.<sup>55</sup>

Historical and international comparisons of income tax yields suggest that South Africa could generate higher revenue from increased reliance on corporate taxes and a more progressive tax structure. Restructuring the Valued Added Tax along progressive lines, primarily by increasing the rate on luxury goods can generate additional revenue of several billion rand per year.

South Africa's relatively low level of taxation has been consistent with an over-achievement of revenue targets. Improvements in tax administration and efficiency have enabled the South African Revenue Service (SARS) to raise tax collections more rapidly than predicted. With tax rates well below revenue-inefficient levels, increased collection effort productively yields abundant returns. Over the past six years, South Africa has consistently over-achieved its budgeted tax revenue targets. Given this experience, the high degree of efficient capacity in the Department of Finance, the existing backlog of uncollected taxes, and

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<sup>51</sup> Harber (1995); Samson (1996); Samson, Mac Quene, Van Niekerk, and Ngqungwana (1997).

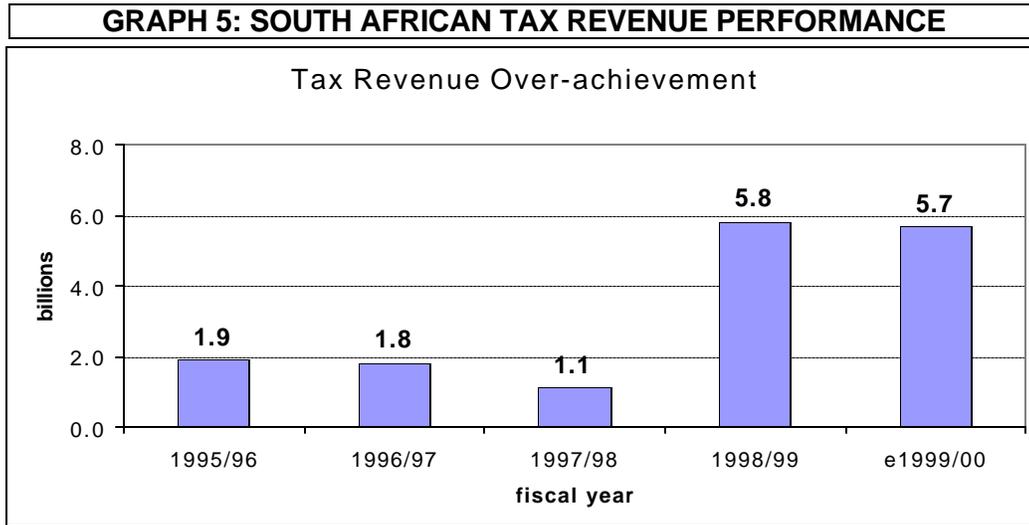
<sup>52</sup> Samson (1996), Harber (1995).

<sup>53</sup> The absence of a capital gains tax has created incentives for wealthy individuals to create schemes that convert other forms of income into artificial capital gains. This is both economically inefficient and costly in terms of foregone tax revenue. The recent capital gains tax legislation will begin to address this problem.

<sup>54</sup> Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1994), Harber (1995).

<sup>55</sup> Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995).

South Africa's relatively low tax ratio, expectations are likely to persist that SARS will continue to over-achieve budgeted revenue targets.



The basic income grant represents a substantial commitment of fiscal resources. However, a well-managed programme is affordable and consistent with fiscal responsibility. South Africa's tax structure has the potential to finance the entire cost of the programme without recourse to deficit spending. The long-term growth implications of the developmental impact further support macroeconomic stability and fiscal affordability.

## 7. CONCLUSIONS

The research reviewed in this report supports the conclusion that the basic income grant is feasible, affordable, and supportive of poverty reduction, economic growth and job creation. Income grants have the potential to fortify the ability of the poor to manage risk while directly improving their livelihoods. In addition, income transfers can improve the efficiency of social capital and cohesiveness while stimulating overall economic activity. These factors may increase both the supply and demand for labour, increasing employment and economic growth and thus sustaining a dynamic growth process. Complementary public policy that supports job creation and socio-economic development can reinforce the process by which redistribution generates growth that in turn sustains further broad-based improvements in living standards.

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