DOI: 10.1111/saje.12370

SPECIAL ISSUE ARTICLE

A supply-side alternative for SRD grants in South Africa

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Abstract

During a lively debate between Haroon Bhorat and Michael Sachs at the University of Pretoria recently, Bhorat pleaded for supply-side measures to alleviate poverty in South Africa, rather than demand-side measures. (The debate took place during a session at the Faculty of Economic and Management Sciences' Inaugural Research Day on 8 September, 2023).Bhorat claimed that the SRD grants could not secure a solution to unemployment in a sustainable manner. In this paper, we use the UPGEM Computable General Equilibrium (CGE) model of the University of Pretoria to test the performance of wage subsidies in South Africa, in comparison to the Social Relief of Distress (SRD) grants of the same expenditure magnitude, and report on the differences between the two policy measures in terms of (i) unemployment alleviation, (ii) poverty alleviation and (iii) economic impact in general.

KEYWORDS

CGE modelling, inequality alleviation, social grants, wage subsidy

JEL CLASSIFICATION

C68, H53, H55, I31, J33

1 | INTRODUCTION

During 2021, an expert panel was established as part of an International Labour Organisation (ILO) initiative together with the Department of Social Development (DSD) to examine the salience and feasibility of a Basic Income Grant (BIG) option for South Africa. The membership of the panel changed somewhat during 2022, but the work continued for another year. The 2021 panel conducted a

[1] This was an informal discussion during a session conducted by Nicola Viegi, called 'Narratives in Economic Policy' during the Faculty of Economic and Management Sciences' Inaugural Research Day on 8 September, 2023.

comprehensive review of evidence on the BIG in South Africa, identified BIG policy options and conducted economic appraisals of the options for South Africa, while comparing different financing methods of different sizes of BIGs (van den Heever et al., 2021). The 2022 panel focused more on the COVID-19 SRD grants and its sustainability while marginally touching on the idea of a wage subsidy as a complementary scheme to the SRD grant system (van den Heever et al., 2022).

The DSD is fully committed to the continuation of BIGs, and very much in favour of increasing the sizes of the grants, which is a typical demand-side policy measure.

The Department of Labour (DoL), however, has implemented a youth wage subsidy scheme to reduce youth unemployment by providing a subsidy to firms, which covers part of their employment costs. The targeted population is recent school leavers. This is clearly a supply-side policy measure.

In this paper, we compare the economic impacts of a BIG scheme with a wage subsidy scheme of the same gross amount spent by the South African government using the UPGEM regional Computable General Equilibrium (CGE) model of the University of Pretoria.[2] The literature on both policy measures is large, including studies that focus on South Africa. However, studies that compare the two policy measures are very scarce.

Jeremy Seekings is one of the authors who has published widely on a BIG for South Africa, with various co-authors (see Matisonn & Seekings, 2003; Nattrass & Seekings, 2002; Seekings & Matisonn, 2012), and he also co-authored a book on the labour market (Nattrass & Seekings, 2019), but he did not compare the two schemes and also did not use a CGE model in his analysis.

Lawrence Edwards and Karl Pauw are two authors who published widely on a wage subsidy scheme for South Africa (see Burns et al., 2010, 2013; Pauw & Edwards, 2006).

We could find only two articles actually comparing a BIG scheme and a wage subsidy scheme. The first was Van der Veen (2004), and the second was the said Pauw and Edwards paper (Pauw & Edwards, 2006). Van der Veen uses a theoretical model and extends the theory of linear optimal taxation, which studies the impact of redistribution when productivities are unequal, preferences for income and leisure are diverse, and income is taxed proportionally. Adding the instrument of the wage subsidy alters the incentive structure and thereby allows for different optimal tax rates associated with different possible mixes of basic income and wage subsidy levels.

Pauw & Edwards (2006) mostly focus on the modelling of a wage subsidy scheme using a national CGE model of South Africa. They discuss the wage subsidy scheme in detail from a theoretical and empirical point of view and only compare it with a BIG in a small section of the paper, concluding that the wage subsidy scheme is much better for job creation, but that the BIG is better for poverty alleviation.

This paper takes a completely different approach than Van der Veen (2004). His paper uses a theoretical maximin model, and it is not empirical at all. The Pauw and Edwards paper (Pauw & Edwards, 2006) also uses CGE, but it differs much from this paper. They compare the effectiveness of a wage subsidy scheme applied to different industries, while we target specific occupational groups in all industries, which is in line with the current policy design in South Africa. We also cover the basic income grant in more detail using real 2021 data on the distribution among income groups.

1.1 | Social grants in South Africa

South Africa has a social grants system comprising child grants for children below the age of 18, old age grants for persons over the age of 60 and disability grants, as part of its social expenditure budget, which takes up a large proportion of total government expenditure,[3] and a significant proportion of GDP. According to a recent World Bank report South Africa spends 4.6% of GDP on social assistance,

[2]The model is fully described here: HORRIDGE, M. (2012). The TERM model and its database. In G. Wittwer (Ed.), Economic modeling of water (Global Issues in Water Policy, Vol. 3). Springer. https://doi.org/10.1007/978-94-007-2876-9_2

[3]Social development as functional expenditure item in the 2023/2024 National Budget comprises 16.8% of the main budget non-interest expenditure (National Treasury, 2023).

compared to the other four BRICS countries spending between 1% and 1.5% of GDP (World Bank, 2023). Only one country in Africa spends a higher percentage of GDP on social assistance, namely, Lesotho (United Nations Development Programme [UNDP], 2019).

One big problem with the current system in South Africa is that the age group 18–59 is excluded from the general social grants system, unless they are classified as disabled. (There is temporary support for the group in the form of the COVID-19 Social Relief of Distress grant, or COVID-SRD grant, implemented during the recent COVID pandemic.) Support does exist for persons in this age group in the form of unemployment insurance, but there is no support for an unemployed person aged 18–59. However, this paper does not focus on contributory social security schemes such as the unemployment insurance fund (UIF), but rather on non-contributory schemes where the entitlement is entirely based on need, with the source of revenue derived from general taxes.

The 2022 Panel focused specifically on the SRD grants and not only argued for its continuation, but for real incremental increases in the value of the grants over time (van den Heever et al., 2022).

1.2 | Wage subsidies in South Africa

According to the latest available data, the unemployment rate reached 32.6%, with the youth unemployment rate (15–34 years) standing at 45.3% (StatsSA, 2023). Aiming to address this problem by reducing the cost of employment, the South African government implemented the Employment Tax Incentive (ETI) to encourage hiring and reduce barriers to employment, particularly for those with less work experience.

This government policy was introduced in 2014[4] and operates as a mechanism that provides tax relief to companies that hire young workers in the formal sector, specifically those aged between 18 and 29 and earning monthly wages below R6 500 (SARS, 2022). The underlying rationale is that by hiring young people more affordable for businesses, it could stimulate employment in this demographic, while addressing high youth unemployment rates. Furthermore, firms can complement the ETI with other existing programmes with similar objectives such as learning agreements.

The ETI is structured in such a way that companies receive monthly tax allowances for each eligible young employee, and its initial values were increased as of 2022. The allowance is time limited and is calculated differently across predefined monthly remuneration categories, with a maximum allowance of R1 500 per month for the first year and R750 per month for the second year of employment (equivalent to a wage subsidy of 23% in the first year and 11.5% in the second for the highest wage level). Through this policy, the government aims to provide employees and companies with an initial adjustment period in which young workers can gain skills and work experience, with the expectation that, at the end of the subsidy, they will be better positioned to remain in employment without the need for additional support.

The evaluation of the ETI policy effects has undergone various analyses coming up to very different conclusions. These analyses can be categorised into two groups according to their approach: Those comparing eligible individuals (young workers) and non-eligible workers for ETI did not reveal statistically significant employment increases attributable to the ETI. (Ebrahim & Pirttilä, 2022; Ranchhod & Finn, 2016). On the other hand, those examining differences among firms rather than individuals observed no aggregate effect on youth employment but positive effects on smaller firms (Ebrahim, 2021; Makgetla, 2016) or even negative effects for very large firms (Rankin & Chatterjee, 2016). However, these results should be interpreted with caution, as the employment uptake in ETI-claiming firms might have originated from pre-existing differences between firms rather than the influence of wage subsidies under the ETI. Finally, Bhorat et al. (2020) utilised both individual- and firm-level tax returns, identifying limited employment increases and noting variations based on firm size. The relatively low adoption rate of the ETI among smaller companies raises concerns, as the policy, intended to benefit these companies, might not be widely known or could encounter administrative difficulties in claiming the subsidy.

[4]Has been extended until February 2029.

The current study, which compares the performance of social grants with wage subsidies, aims not only to shed light on outcomes in terms of unemployment reduction but also to assess their impact on poverty alleviation and the broader economic implications. Furthermore, none of the above-mentioned analyses uses a CGE approach, which provides with a comprehensive and systematic understanding of the macroeconomic effects, allowing for a nuanced evaluation of the socio-economic dynamics involved.

In the next section, we introduce the CGE model that was used to run all the simulation, as well as the two scenarios that are modelled.

2 | THE MODEL

2.1 | The core principles of the CGE model used in all the simulations

To model the provision of SRD grants to all qualifying households, as well as the financing of the grants, we used a South African version of the 'TERM'[5] model of Australia (Horridge, 2012). It is a bottom-up multi-regional CGE model that treats each province of South Africa as a separate economy. The model simulates the effects of the grants on the national economy but also on each provincial economy.

We have 30 main industry groups in the model and 30 commodities. Each industry could theoretically produce all the commodities, but we have simplified the model such that each industry mostly produces just one or two commodities. There are four final demanders in each region: households, investors, governments and foreigner buyers, which could be foreign households, investors, industries or governments.

Unlike the Australian version of TERM, we have multiple households in our model, namely, 12 groups distinguished by income: We have the poorest decile split into two ventiles, then the eight next deciles by income and finally the richest decile also split into two ventiles. The model is therefore very well suited to measure changes in the income distribution or poverty levels.

The basic production function for all industry production is the Leontief function, which means that inputs into the production process are used in fixed proportions: If an industry wants to double output, it has to double all inputs, irrespective of input prices. However, industries can choose *where* to buy their intermediate inputs from, according to CES demand functions: Depending on relative prices and the substitutability of the goods from different sources, industries will decide where to source their inputs from.

Transportation cost in the model plays a very important role and is included in the purchaser's price of a commodity. A buyer would therefore rather source from a nearby industry than from one far away. Distances between the capitals of the nine provinces as well as to the different ports of import and export are used to build a gravity mechanism, determining where industries would source their inputs from, or which ports of import and export they will use.

The demand for factors of production also follows the CES functional form: An average level of factors grows proportionally with output, but an industry could substitute labour for capital or vice versa. Labour demand is also modelled using the CES demand functional form: Once the industry has decided about the capital–labour ratio it prefers, different occupational groups—we have 11 in the model—are chosen: Different wage levels play a strong role, as well as the substitutability of one occupation for another.

Export demand is a very simple function of domestic versus foreign prices of commodities: If South Africa's price levels increase relative to world prices, which are exogenous in our model, then the demand for South African commodities decrease. Since South Africa is a small open economy, exports play a very significant role in the model.

Household demand follows the linear expenditure system (LES) format: Households have a subsistence demand for all commodities, which they will buy first, without looking at the price of the goods.

[5]The Enormous Regional Model.

Then they will use the money left over in their budgets to buy 'luxury' components of the same goods. On a national or provincial level, the subsistence demand is only a function of the size of the population, but luxury demand is a function of the disposable incomes of households.

Unlike households, who maximise utility subject to budget constraints, and industries, who minimise costs or maximise profits, given certain quantities to be produced, we do not have a theory of government in the model. We model the government in two possible ways: (i) exogenously, with its behaviour determined by the modeller (from information published by the government itself, such as in the regular medium-term budget information sessions), or (ii) endogenously, and specifically tied to household behaviour. Governments receive direct and indirect tax income, as well as transfers from all the role players in the economy. The indirect taxes could be modelled as GST's or a VAT system, and we use the latter. Individual households as well as companies pay direct income taxes as well, while we also have production taxes and subsidies in the model. The government could borrow and build up debt over time, which needs to be serviced on an annual basis. In our simulation, we keep the annual government budgets balanced: They give grants to all households but need to raise either indirect or direct taxes to finance the grants, or a combination of the two types of taxes.

The general method of performing dynamic simulations with a CGE model is to start with a baseline forecast of the macroeconomy, without any grants given. A second forecast—the policy simulation—is then performed and compared to the baseline. We generally only report the deviations from the baseline that happen as a result of the policy simulation.

2.2 | Assumptions made in the model for the specific SRD grants simulations

2.2.1 | The baseline forecast

The first step in a modelling simulation exercise is to run a baseline forecast. We would typically incorporate macroeconomic forecast data from the National Treasury of South Africa and the World Economic Outlook Database from the International Monetary Fund, among others. Specifically, we adopt forecasts for the GDP expenditure components, employment and population growth. Since the South African economy, just like any other economy in the world, is still recovering from the devastating period since the outbreak of COVID-19, it would be very hard to accurately forecast the baseline economy from 2016 onwards. GDP growth made large zigzag movements, accompanied by similar movements in all the macroeconomic variables.

We therefore adopt the strategy to forecast a 'vanilla' baseline, which assumes a smooth growth path for GDP, followed by similar growth paths for the GDP expenditure components of household consumption, investment expenditure, government expenditure, exports, population growth and employment.

2.2.2 | The policy simulations

We compare two policy simulations here: We use a given total amount of funds[6] to compare the economic impacts in the two scenarios as follows:

i. We use the proportions from the actual 2021 data of SRD grants and give each decile of the households in the model the same proportion of the total grant outlay in 2022, as they received in 2021.[7]

[6]We worked with an amount of R50bn per annum, which is the number we received from the microsimulation modelling team, which was part of both expert panels: It is the net cost (gross cost less VAT recovery) of a R350 per month for approximately 13 million beneficiaries for our comparison. Since the model is linear, it does not matter how much money is distributed: The Rand amount of grants per Rand collected in taxes will remain the same.

[7]See Table 1.

The outlay is funded by increasing the income tax rate on the top 3 deciles, until the government budget is balanced.

ii. In the second simulation, we let the government give wage subsidies for four occupational groups, to the same total value as the SRD grants in (i), namely, domestic workers, elementary workers, operators and skilled agricultural workers.

We run the two simulations with the same closure (i.e. same list of exogenous variables).

2.2.3 | Modelling mechanisms of the two scenarios

To give the reader a feel for what should happen with each of the compared policy scenarios, we introduce the variables and equations that are directly impacted by the modelling shocks applied (in a CGE model all variables are indirectly affected, but here we show the directly affected variables).

Modelling the SRD grants

Giving the SRD grants to households would increase their disposable income and hence their nominal consumption expenditure. The scheme is funded by increased income taxes paid by rich households, whose disposable income decreases. The net effects are increases in aggregate household expenditure, which stimulates aggregate demand.

Modelling the wage subsidies

Giving wage subsidies to the four said occupational groups would decrease the cost of labour to all firms, since the government pays part of all wages. Firms maximise profits subject to their budget constraints and become able to hire more labour than before, which would stimulate aggregate supply.

3 | MODELLING RESULTS

In this section, we report some of the key results from the modelling exercise. The results are presented under five headings, namely, Poverty and Inequality, GDP, Household Consumption, Sectoral output and Employment.

3.1 | Social outcomes

The per cent changes in household disposable income are given in Figures 1 and 2. It is assumed that the SRD grants are permanent in nature and the graph shows that disposable income of the five poorest deciles increase by between 2% and 7% per annum, while the richest three deciles experience a permanent decrease in disposable income of up to 3%. The increased income levels for the poor leads to decreases poverty in South Africa, while the income distribution is also improving significantly with this scenario.

Wage subsidies as a policy measure does not have the primary goal of improving the income distribution of the country, and it is clear that the spectrum of the changes in disposable income between rich and poor is much smaller than with the SRD grant scenario. However, only the top two deciles do not

TABLE 1 Shares of SRD grants given to the different household groups, by decile.

	D1	D2	D3	D4	D5	D6	D7	D8	D9	D10	Total
% Share	18.0	19.2	16.2	12.7	9.7	6.7	6.5	5.1	3.5	2.6	100

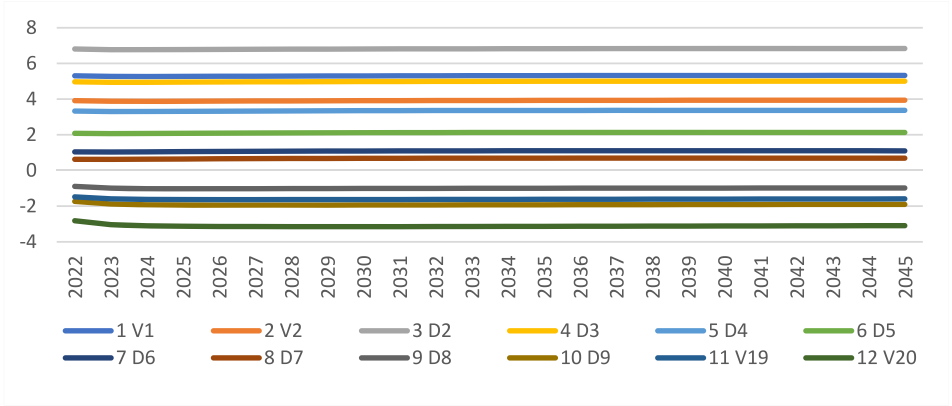

FIGURE 1 Per cent change in household's disposable income (SRD grants). *Source*: CGE model simulation results. [Color figure can be viewed at wileyonlinelibrary.com]

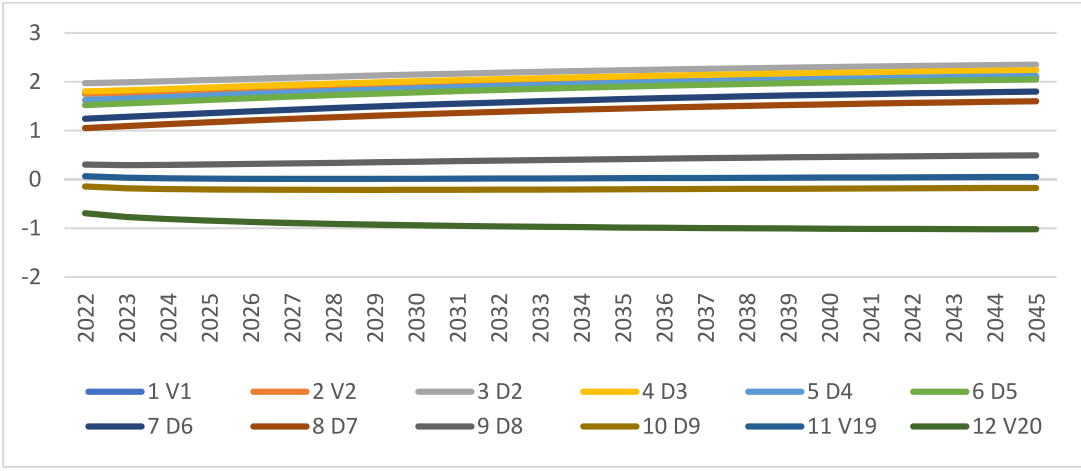

FIGURE 2 Per cent change in household's disposable income (wage subsidies). *Source*: CGE model simulation results. [Color figure can be viewed at wileyonlinelibrary.com]

have increases in disposable income with the wage subsidy scenario, so that this policy measure would also alleviate poverty.

3.2 | Economic outcomes

3.2.1 | National GDP

The per cent change away from the baseline of national gross domestic product (GDP) for the two scenarios are presented in Table 2. The first row shows the changes in GDP resulting from the SRD grants to the value of R50b, while the second row shows the changes in GDP resulting from wage subsidies of the same value.

When social grants are financed with an increase in the income tax rate on high-income earners, GDP moves slightly above the baseline in the short run but ends up below the baseline in the medium and longer term.

TABLE 2 National GDP—per cent change away from the baseline (cumulative).

Scenario	2022	2023	2030	2035	2040
SRD	0.076	0.065	0.004	−0.018	−0.031
Wage subsidy	0.542	0.549	0.607	0.644	0.674

Source: CGE model simulation results.

TABLE 3 National household consumption—per cent change away from the baseline.

Scenario	2022	2023	2030	2035	2040
SRD	0.277	0.215	0.115	0.083	0.063
Wage subsidy	0.568	0.571	0.646	0.695	0.735

Source: CGE model simulation results.

A wage subsidy of the same magnitude as the social grants give positive GDP results. A wage subsidy lowers the hiring cost of firms and therefore their overall costs. Firms in this neoclassical model give all cost savings through to consumers so that overall demand increases for all industry production. Moreover, with lower labour cost, firms hire more labour, and households therefore also have more income to spend and save.

3.2.2 | National household consumption

National household consumption for the different scenarios are presented in Table 3. Household consumption follows similar trends as national GDP: When the grants are funded with income tax increases, household consumption rises to above the baseline in the short and medium term but returns to the baseline in the long run.

When wages are subsidised, household consumption moves beyond the baseline and remains there in the long run.

3.2.3 | National sectoral output

We show the per cent deviation from the baseline in sectoral output for 2030 and 2040 for the two scenarios in Figure 3.

When grants are given to households, and funded by increased income tax on rich households, about two thirds of all industries benefit by producing more than in the baseline. All households receive grants from the government and demand more of all the commodities that they consume. A few rich households pay more income tax, but total household demand increases nationally.

Sectoral output with wage subsidies increases for all industries and improve over time.

It is not a focal point of the paper, but Table 4 shows how sectoral output of our simulations differ between provinces. We took agriculture as an example and see that the SRD grant simulation would increase demand for agricultural goods in all provinces, but the least in Western Cape, while demand in Limpopo Province increases the most. The wage subsidy simulation favours agricultural output the most in Mpumalanga and KZN, while growth in the Limpopo Province in this case is the smallest.

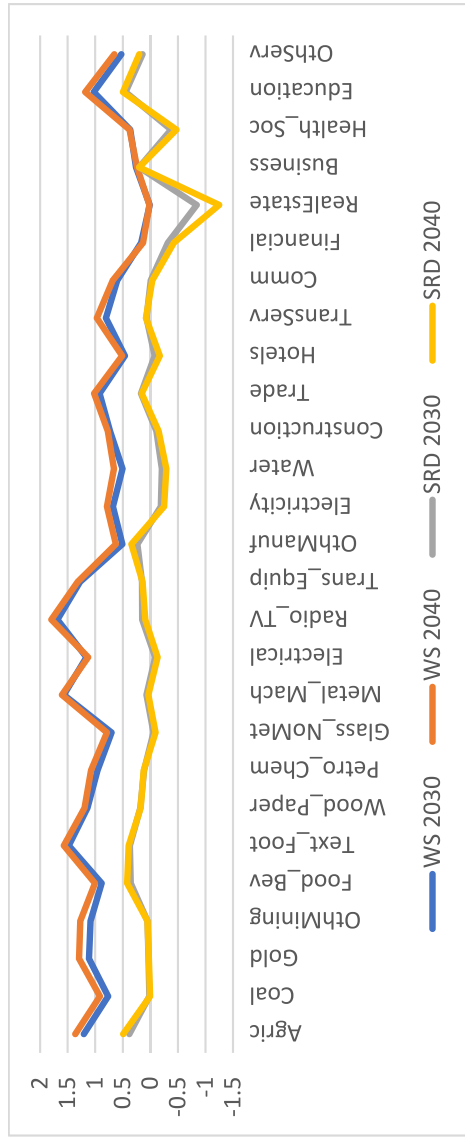

FIGURE 3 Industry output (% change). *Source*: CGE model simulation results. [Color figure can be viewed at wileyonlinelibrary.com]

TABLE 4 Per cent change in agricultural output on provincial level in South Africa.

Simulation	Year	LP	NW	MP	GP	FS	NC	WC	EC	KZN
SRD grants	2023	0.34	0.30	0.24	0.25	0.28	0.26	0.20	0.22	0.22
	2030	0.54	0.46	0.37	0.38	0.43	0.40	0.30	0.35	0.34
	2040	0.72	0.60	0.49	0.49	0.56	0.51	0.37	0.46	0.44
Wage subsidy	2023	1.03	1.06	1.07	1.06	1.06	1.06	1.07	1.06	1.07
	2030	1.13	1.19	1.22	1.21	1.19	1.19	1.22	1.20	1.22
	2040	1.24	1.34	1.39	1.37	1.34	1.33	1.38	1.36	1.39

Source: CGE model simulation results.

TABLE 5 Per cent change in employment rates, relative to the baseline.

	2022	2023	2024	2025	2026	2027	2028	2029	2030	2035	2040	2045
Income tax	0.11	0.09	0.07	0.06	0.04	0.03	0.02	0.01	0.00	−0.01	−0.02	−0.02
Wage sub	1.06	1.03	1.01	0.98	0.96	0.95	0.93	0.92	0.91	0.86	0.83	0.81

Source: CGE model simulation results.

3.2.4 | National employment

In our CGE model, we usually assume that a natural rate of unemployment exists in South Africa and structure the employment function such that employment always returns to the baseline in the long run. For the wage subsidy simulation, however, we needed to change the model closure, such that the 'automatic move back to the baseline' does not hold for four occupational groups so that net positive employment is possible. To be able to compare apples to apples, we apply the same closure to the SRD grants simulation as well. The per cent changes in employment away from the baseline are given in Table 5. Employment increases by 1% above the baseline in the short run and converges to 0.8% above the baseline in the longer run. With the SRD grant simulation, there is very little movement in employment: 0.1% above the baseline in the year of the shock, while employment swiftly goes back to the baseline in the medium term.

4 | CONCLUSION

If the same amount of government funding is spent on wage subsidies than on continued SRD grants, the economic benefits of the wage subsidy scenario outweighs the SRD grant scenario prodigiously. The GDP, employment and industry production are markedly higher in the former scenario than the latter. However, SRD grants have proven to uplift extreme poverty and improve the income distribution during the past decade in South Africa, and the model results confirm that this is a successful policy option to achieve such goals.

The government will always have a difficult normative choice between the two said policy options, but we believe that the wage subsidy scheme could be sustainable in the long run, with acceptable economic returns.

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How to cite this article: Van Heerden, J.H., Horridge, J.M. & Suarez-Cuesta, D. (2024) A supply-side alternative for SRD grants in South Africa. *South African Journal of Economics*, 92(1), 69–79. Available from: https://doi.org/10.1111/saje.12370