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Chapter 1

SOUTH AFRICA'S TRANSITION TO A CONSOLIDATED BUDGET AND FISCAL GUIDELINES

1.1 Introduction

South Africa, along with most of the world, faces tough decisions regarding the size of the budget deficit and how to reduce it. This chapter examines some of the issues related to the current fiscal policy context in South Africa. In Section 1.2, fiscal policy is decomposed into relevant components to see which of them can help achieve the three key objectives of fiscal consolidation[1]: closing the output gap,[2] reducing output volatility[3] and managing government debt. The analysis presented in Section 1.2 shows that extreme views such as leaving the fiscal deficit unchanged or decreasing it rapidly should be ignored and that a gradual (consistent) response is the optimal response to fiscal consolidation in South Africa. In addition, Section 1.3 of this chapter argues that proper implementation of fiscal guidelines/rules[4] could contribute to and complement the existing fiscal policies. This would not only ensure that fiscal policy remains sustainable, but also allow for proper counter-cyclical fiscal policy that has maximum spending impact during recessions and contributes to savings during expansions (which 'crowds in' or encourages investment). Given that the South African Government is intent on continuing its policy of fiscal stability and consolidation (as well as possibly implementing fiscal guidelines to strengthen its fiscal frameworks in the future) any expenditure and taxation decisions need to be carefully balanced in order to achieve its social objectives. Section 1.4 presents evidence of linkages between fiscal policy and economic growth in South Africa from a national, provincial and municipal perspective. Lastly, Section 1.5 outlines the recommendations derived from this chapter.

1.2 Fiscal Consolidation in South Africa

The 2008/09 global financial crisis put pressure on the fiscal balances of most economies. The limited scope (ability) of monetary policy to stimulate economies in recession meant that fiscal deficits (and hence public debt) had to increase. South Africa's small budget surplus in 2008/09 was used to prevent the contagion effects of the financial crisis. Gross domestic product (GDP) growth became negative in the final quarter of 2008 and peaked in the second quarter of 2009 at -7.43% (SARB, 2010). However, positive growth was registered in the latter half of 2009 and peaked at 4.56% in 2010Q1 (SARB, 2010). Even when considering the uncertainty around economic recovery, policymakers' focus shifted to fiscal sustainability. In South Africa, debt is projected to reach a maximum of 44% in 2015/16 according to the Budget Review (National Treasury, 2010a,b). Given the sovereign debt crisis in the euro area peripheries, it comes as no surprise that austerity measures are called for, which implies immediate changes in the budget in the form of (for example) cuts in expenditure and/or widening of the tax base. For this purpose, it is important to distinguish between transitory and permanent influences on the budget, as incorrect diagnoses can lead to fiscal over- or under-adjustment. In addition to the composition of fiscal consolidation, timing considerations are also important – for example, a premature and untimely fiscal exit[5] may harm growth and ultimately lessen fiscal effectiveness.

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1 Fiscal consolidation refers to government policies aimed at reducing government deficits and debt accumulation.

2 Output gap is defined as the difference between actual and potential output (GDP). Essentially, output gap measures actual output against what it should be if the economy were using its resources efficiently.

3 Output volatility refers to the pace at which output (GDP) moves higher and lower. A number of studies have shown that output volatility impedes economic growth and welfare and increases poverty (cf. Ramey and Ramey, 1994).

4 For the purposes of this chapter, the terms "fiscal rule" and "fiscal guideline" are synonymous and are used interchangeably.

5 The term "fiscal exit" refers to the shift in the role of fiscal policy from supporting demand (by, for example, increasing expenditure) to reducing the budget deficit.

1.2.1 Background

Fiscal consolidation is generally defined in terms of policies aimed at reducing government deficits and debt accumulation. Siebrits and Calitz (2004), Ajam and Aron (2007) and Du Plessis and Boshoff (2007) note that there are sound reforms behind fiscal consolidation in South Africa, one of the main being the Public Finance Management Act (PFMA) of 1999, which calls for sound expenditure controls and a system of supervision, among other things. They further refer to discretionary fiscal policy in South Africa post-1997 as "transparency-based discretion", which amounts to fiscal authorities reporting cyclical, structural and off-the-line budget items. Other fiscal reforms contributing to fiscal consolidation in South Africa are related to the budget procedure, as well as tax reform and revenue collection.

South Africa has a good track of fiscal prudence (OECD, 2010). Since the 2008/09 economic recession, the budget framework has balanced the need for short-term stimulus with the long-term goal of fiscal sustainability (National Treasury, 2010a). Public debt has increased significantly to ensure that spending on social services does not decline despite a decline in tax revenue brought on by the recession. In addition, the government has made a commitment to reducing the deficit in order to bring the budget back into a sustainable position. However, the latest budget has posted bigger deficits over the next three years than previously expected, largely in a bid to support the job-creation efforts set out in the New Growth Path (NGP) (National Treasury, 2011). Despite this, the government is adamant about staying on course with its policy of fiscal stability and consolidation, which is also borne out by recent efforts to create stronger fiscal institutions to aid government policies by implementing fiscal guidelines. The following section examines the effects of various paths of fiscal consolidation on debt sustainability and output in South Africa.

1.2.2 Paths (Strategies) for South Africa

Figure 1 shows the possible scenarios for different fiscal consolidation strategies for South Africa. The top left panel of the figure shows the possible fiscal consolidation paths, which can be defined as follows:

- Path 1 (solid line): the ratio of budget balance to potential output remains unchanged over the medium term (i.e. 2010Q1–2012Q1 Medium-Term Expenditure Framework, MTEF).
- Path 2 (dotted line): the ratio of budget balance to potential output decreases by 0.4 percentage points every quarter over the medium term.
- Path 3 (dashed line): the ratio of budget balance to potential output decreases by 0.6 percentage points every quarter over the medium term.
- Path 4 (dot-dashed line): the ratio of budget balance to potential output decreases by one percentage point every quarter over the medium term.

The top right and two bottom panels show how different macroeconomic variables (i.e. public debt, output gap and output volatility) respond to the different consolidation paths as set out in the four points above. The patterns used in these graphs correspond to the patterns that are assigned to the four consolidation paths above. Thus, for example, the dashed line in the bottom left panel illustrates the output gap trajectory over the medium term that is associated with consolidation strategy under Path 3 (i.e. when the ratio of budget balance to potential output decreases by 0.6 percentage points every quarter).

In this analysis, fiscal shocks (i.e. decreases in the ratio of budget balance to potential output) are treated as exogenous (i.e. in control of fiscal authorities) and take various paths that are plausible. As mentioned above, Path 1 keeps the budget deficit at a constant level through the MTEF. From the bottom left panel, it can be seen that the output gap associated with Path 1 (solid line) closes very quickly (i.e. moves quickly towards 0). However, the shape of the output gap is curved, implying that keeping the budget deficit relatively high might result in a lower output in the future. This is most likely due to the feedback effects of debt, interest rates and inflation on economic growth. The top right panel shows that debt associated with Path 1 increases in a linear fashion above 50% in 2011, which poses a potential risk for future fiscal policy in South Africa. Taking the other extreme of reducing the deficit very quickly (Path 4, and to some extent Path 3) does not ensure a closing output gap even though debt levels decline to very low levels over the medium term (dashed and dot-dashed lines in the four panels of Figure 1). This implies that fiscal multipliers are negligible and ineffective in addressing poverty issues or averting a recession.

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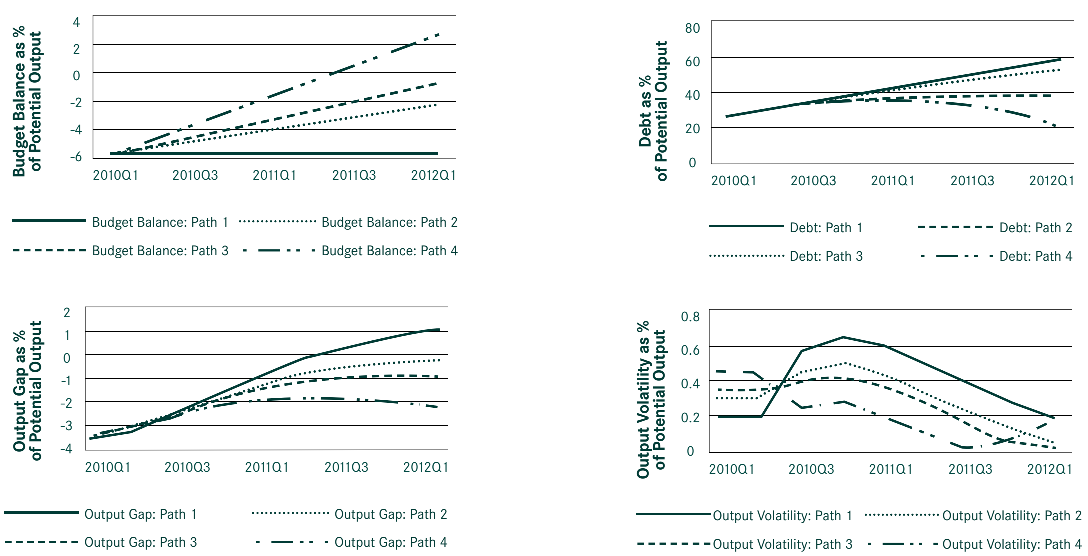
Choosing a fiscal deficit reduction in the fashion of Path 2 (dotted line) seems to be a plausible policy option. Under this scenario the output gap closes towards the beginning of 2012, and debt levels stabilise around the same period, which means that the deficit should be reduced in line with output gap movements. Under the Path 2 scenario the concerns of public finances are balanced in terms of social outcomes as well as in terms of output volatility (which decreases at a reasonable rate throughout the forecasting period: see the dotted line in the bottom right panel of Figure 1).

Figure 1. The effects of different fiscal consolidation paths on public debt, output gap and output volatility



Along with most of the world, South Africa faces tough decisions regarding the size of the deficit and how to reduce it. This analysis shows that extreme views, such as leaving the fiscal deficit unchanged (Path 1) or decreasing it rapidly (Path 4), should be ignored. A negative output gap will persist even when closing the deficit at a faster rate (i.e. faster than the rate at which the output gap closes), as it limits the impact of fiscal multipliers (which will result in a slower closing of the output gap). Conversely, if the deficit is kept at the current level, or decreased at a very slow rate, the result will be higher debt levels and hence higher debt service costs. Over the long run, its contribution to the output gap also becomes negative. These findings therefore suggest that a gradual response is the optimal response to fiscal consolidation in South Africa.

With the above in mind, proper implementation of fiscal guidelines/rules can only contribute to and complement the existing fiscal policies. This would not only ensure that fiscal policy remains sustainable, but also allow for proper counter-cyclical fiscal policy that has maximum spending impact during recessions and contributes to savings during expansions (which 'crowds in' investment). However, the difficulty of implementing such rules lies not in the rules themselves but in the numerical targets set out by these rules. Section 1.3 below looks at the issues around fiscal guidelines, with a particular focus on the South African context.

1.3 Usefulness of Fiscal Rules (Guidelines) for South African Fiscal Policy

Over the last few years, internationally, public finance has been characterised by rising deficits and public debt. In a bid to achieve the goal of sustainable public finances (as well as the reduction of debt to sustainable levels), many countries have adopted some form (or combination) of fiscal rules/guidelines. Generally, a government with a strong reputation for fiscal prudence does not need to be constrained by rules, but when this is not the case, international evidence shows that fiscal rules can provide a useful framework for fiscal policy and ultimately contribute to macroeconomic stability and economic growth.

Furthermore, in order to enhance their effectiveness, the rules need to be well-designed at both the national and sub-national levels, which has implications for intergovernmental fiscal relations (IGFR). For South Africa (as well as for many other countries emerging from the crisis), the question becomes whether or not the government has been fiscally prudent (and pursued stable public finances) and if the answer is in the negative, what type of fiscal rules should be followed to entrench the current efforts of fiscal consolidation. In addition, the question of whether or not South African government is expected to have stable and sustainable public finances is also important.[6] Simply put, the choice is between the following two broad strategies:

- Fiscal discipline based on fiscal frameworks that are focused on credible and transparent strategies (i.e. the focus is on proper/effective fiscal institutions)[7], or
- The adoption of a fiscal rule to entrench fiscal prudence.

In response to a request from Parliament, the National Treasury prepared a draft of fiscal guidelines for discussion (National Treasury, 2011). These guidelines propose the adoption of an annual target for the budget balance, among other things, and are based on the principles of countercyclicality,[8] long-term debt sustainability and intergenerational equity. As is the case with most other countries, South Africa needs to take account of potential long-term structural developments and risks. There are *fiscal* dimensions to many of these risks and problems for which there are fundamental uncertainties that need to be dealt with. In this case, a multi-pronged approach is necessary to deal with issues of a long-run nature, involving strengthened policy analysis, reforms of the budget process, sustained fiscal consolidation and sectoral policy reforms. In this section, the focus is on exploring the potential to strengthen South African fiscal rules by assessing the need for stronger national fiscal frameworks and independent fiscal institutions.

1.3.1 What are Fiscal Rules?

Fiscal rules are defined as permanent constraints on fiscal policy through simple numerical limits on budgetary aggregates (IMF, 2009). In order for fiscal rules to guide fiscal policy, a fiscal indicator (instrument) is needed to create a rule that is relatively simple and can be easily monitored and communicated to the public. Fiscal rules are generally adopted with the aim of achieving fiscal (debt) sustainability, yet these rules can have different roles, such as stabilising the economy and limiting (or expanding) government size.[9] The different rules can be summarised as (Kopits, 2001; Kennedy and Robbins, 2001; IMF, 2009):[10]

- Budget balance rules, which can be based on the overall balance, structural balance or cyclically adjusted balance (CAB).[11]
- Debt rules, which generally target a certain level of debt-to-GDP ratio and are most effective in achieving the goal of debt convergence.[12]
- Expenditure rules, which, for example, permanently limit total, primary or current spending (i.e. spending of the ordinary state budget plus spending of the public investment budget) in relation to GDP.
- Revenue rules, which aim to boost revenue and/or prevent tax burden (by, for example, restricting the debt-to-GDP ratio).

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6 It is reported, for example, that the USA public debt-to-GDP is expected to double by 2018, whereas the UK is facing many years of budget deficits and a rising debt burden.

7 Countries like Australia, New Zealand and Canada have all reduced their debt to GDP ratios without strictly enforced fiscal rules. Generally, countries are more likely to reduce their debt burdens during times of strong economic growth (e.g. Spain and the UK).

8 As defined in Swanepoel and Schoeman (2003:803), countercyclical fiscal policy requires government deficit and debt to increase during recessions and decrease during booms.

9 Fiscal rules also need to be growth oriented.

10 Fiscal rules have a long history. An increasing number of countries have adopted fiscal rules since the 1990s (to eliminate deficits and ensure the stability of public finances), with the sharpest increases being those of emerging and low-income countries. Another recent trend in fiscal rules is that countries have moved away from a single rule to a combination of rules that focuses on debt sustainability. Generally, this has resulted in a number of countries adopting a budget balance rule combined with a debt rule (expenditure rules have been used to curtail the size of government). In addition, custom-made rules are sometimes also deemed necessary because of differences in institutional capacity and exposure to external shocks. Finally, rules based on the CAB have become more popular in recent years. For a more detailed report on recent trends in international fiscal rules please refer to IMF (2009).

11 It should be noted that the CAB is linked mainly to the debt sustainability goal (IMF, 2009). Generally, during a recession/slowdown phase of the economic cycle, government finances worsen due to tax revenues slowing down and social payments rising. The CAB seeks to make an adjustment for the effects of the economic cycle and thus provide a more accurate representation of the budget. It is thus a measure of the balance that takes out the effect of economic swings that are above or below the natural rate of economic growth. In essence, the CAB is the balance that is in accordance with the long-run natural economic growth rate of the country. A CAB rule generally requires that the its numerical target is constant, and movements in the CAB can be seen discretionary fiscal expansion. For South Africa, the CAB was introduced in the 2007 Medium-Term Budget Policy Statement (MTBPS) and currently the CAB is reported regularly together with the estimates of the structural revenue and structural expenditure. See for example Chapter 4, Figure 4.8, in the Budget Review (National Treasury, 2010a).

12 Debt convergence refers to the ratio of debt to GDP converging to a certain level (or a steady state) through the actions of fiscal authorities (i.e. the implication is that government is keeping public debt under control and that public debt is not exploding).

In addition to the above, a distinction must be made between hard rules and broader rules (Emmerson *et al.*, 2004). Hard rules can result in an accumulation of tax reserves as safety margins, which can reduce welfare. Broader rules, on the other hand, specify a central target with an acceptable range. A summary of the trade-offs involved in fiscal rules is provided by Kilpatrick (2001):

- Transparency vs rigidity: the higher the transparency the less need for a rule to be rigid. The assumption here is that if fiscal authorities behave in a transparent, credible manner, a fiscal rule can allow for some cyclical variation in spending and give some flexibility in the budget planning process.

- Rigidity vs. tax/revenue smoothing: the more rigid the rule, the less able is the government to smooth tax/revenue. A rigid rule implies a lower possibility for fiscal policy to adapt to changing economic conditions.

Flexibility of fiscal policy is an important economic mechanism that can counter an expected or an unexpected shock through changes in public deficits, which are in turn managed through smoothing of tax/revenue. The need for tax/revenue smoothing is created by shocks in the benefits of public spending created by events such as the 2008/09 economic crisis. Some rules may be more suitable for national levels while others are more suitable for the sub-national levels (Kennedy and Robbins, 2001). In fact, some studies argue that fiscal rules are more suited to sub-national than national governments (Bayoumi and Eichengreen, 1995; Corsetti and Roubini, 1996; Alesina and Bayoumi, 1996).[13] Section 1.3.4 contains a more comprehensive discussion on sub-national fiscal rules.

The purpose of fiscal rules is to bind government to responsible behaviour, which may not always be in its short-term interests.[14] In addition, fiscal rules can address the problem of time inconsistency (cf. Gutiérrez and Revilla, 2010), where the government's favoured choice (action) changes over time (i.e. fiscal rules increase the political cost of breaking past commitments and foster credibility because the government would adopt rules, set targets and adhere to them). Fiscal rules can be part of a broader legal framework (statutory requirement), making them more difficult to reverse. Policy rules (guidelines) that are not legislated do not impose binding constraints on government (Kennedy and Robbins, 2001). In South Africa, fiscal responsibility laws are outlined in the PFMA and Municipal Finance Management Act (MFMA) as well as in various sections of the Constitution (see Section 1.3.4 below).[15] The general advantage of such legislation is that it limits the government's ability to focus selectively on policy that would reflect it favourably. However, more stringent frameworks for accountability, monitoring and enforcement need to be put in place, together with clear penalties for non-compliance (such as administrative sanctions, financial penalties and/or loss of reputation).

1.3.2 Reasons for Implementation of Fiscal Rules

One of the main problems with completely discretionary fiscal policy is that the government's record of fiscal policy cannot really be assessed without firm guidelines (Emmerson *et al.*, 2004). In addition, a fair number of factors lie outside the government's control, such as the position in the economic cycle, shocks to the international economy and levels of debt and deficit from previous years. As mentioned in the previous section, generally the motivation for fiscal rules is that they create a depoliticised policy framework (i.e. they correct the government's short-sightedness resulting from electoral prospects). In addition, fiscal rules have been known to contain the size of government and promote intergenerational equity. Although fiscal rules have been associated with improved fiscal performance (for example in EU countries), it is difficult to isolate the direction of causality and the effect – i.e. the introduction of rules might make government more responsible, but responsible governments are also more likely to make rules. When it comes to fiscal rules fostering consolidation efforts, international evidence has been favourable (see for example IMF, 2010). A major disadvantage of fiscal rules is that they constrain discretion when discretion is needed and may force fiscal policy to be procyclical when it needs to be countercyclical (Kennedy and Robbins, 2001; IMF, 2009).[16] In addition, fiscal rules, and expenditure rules in particular, may result in capital spending cuts, which could harm long-term economic growth. Kennedy and Robbins (2001) cite the following reasons for adopting fiscal rules:

13 For example, Alesina and Bayoumi (1996) find that the stringency of a national fiscal rule does not affect output variability, which implies that the state's role in stabilising output is not important. They conclude that if this is the case, balanced budget rules may not be suitable for national government and are thus more suitable for sub-national government instead.

14 Kennedy and Robbins (2001) argue that what underlies fiscal rules is a sense that present (or future) governments may not be able to implement optimal fiscal policy measures without external pressure.

15 It should be noted that New Zealand was the forerunner in the fiscal responsibility legislation with the introduction of the Fiscal Responsibility Act in 1994 (Emmerson et al., 2004).

16 In the South African context, there is a general opinion that fiscal policy needs to be more countercyclical so as to maintain low future capital costs and inflation, support a more competitive exchange rate, reduce debt service costs and provide fiscal space (Loewald, 2010).

- Fiscal rules ensure macroeconomic stability through the promotion of countercyclical fiscal policy.
- Fiscal rules enhance the credibility of governments' fiscal policy and aid in deficit elimination.
- Fiscal rules ensure the long-term sustainability of fiscal policy.

The timing of the implementation of fiscal rules is a major consideration, as it is vital to implement rules at the correct time.

1.3.3 Fiscal Rules: Further Considerations

(a) What are some of the preconditions that need to be in place for fiscal rules to be effective?

First of all, adequate public finance management systems need to be in place. Adequate data also need to be available, which generally is the case for South Africa. In addition, the government needs to have a good track record in technical forecasting capacity because budgetary aggregates need to be predictable with a certain degree of accuracy to avoid the risk of large fluctuations from the announced fiscal policy stance, which would undermine a rule's credibility (cf. Emmerson et al. 2004; Favero and Massimiliano, 2005).[17] Budget reporting systems need to be extensive, and fiscal data should be publicly released, which is the case for South Africa at the national level. However, this could prove problematic at provincial and particularly municipal levels, if fiscal rules are to be introduced to sub-national governments in South Africa. Political commitment is also key because without this fiscal rules are unlikely to be sustained and may even harm the credibility of fiscal policy.

Furthermore, the following are needed for a fiscal rule to operate optimally (IMF, 2010):

- An unambiguous and stable link between the numerical target and the ultimate goal. Fiscal rule methods, linkages and outcomes must be clearly announced in advance. In addition, a clear reaction function must be formulated – one that explains how government will respond to failures to meet the rules.
- Sufficient flexibility to be able to respond to shocks. Specifying a clear reaction function does not mean that government must always follow the rule. However, when it does not, the government must have a good reason and provide a clear explanation why.
- A clear institutional mechanism to map deviations from numerical targets and take corrective action. In addition, a decision must be made as to how the rule will be judged (i.e. retrospectively or prospectively).

(b) Design, timing and implementation of fiscal rules

Implementation of fiscal rules would necessitate that government publishes in advance three key pieces of information: how the rules will be met, what happens if the rules are not met or are not on course to be met (i.e. corrective action and penalties), and the time frames for when the targets will be reached (Emmerson et al., 2004).

In terms of the design of fiscal rules, two requirements need to be satisfied:

- First, the rule must deliver the required adjustment and put debt on a sustainable path.
- Second, the rule has to have a certain degree of flexibility built into it in order to deal with shocks.

A fiscal framework should have the following main features (Kopits, 2001):

17 National Treasuries should publish (or provide an indication) of past forecast errors for fiscal aggregates (Emmerson et al., 2004). The idea is to publish data series of forecasting errors (i.e. comparing the initial forecast with the final outcome, preferably adjusted for subsequent policy changes), as this information will indicate the degree of uncertainty surrounding current forecasts (and also indicate the probability distribution within which these forecasts should be based). Variables that can be considered include public sector net borrowing, public sector net debt, current budget balance, current receipts, current spending and public sector net investment (Favero and Massimiliano, 2005). Regular summaries of the size and variability of the forecasting errors could be summarised and the National Treasury could use this information to indicate and quantify the uncertainty surrounding the current set of fiscal forecasts (graphical representation can take the form of fan charts). This will also make communication to the public easier in the sense that government will be able to determine and communicate the probability of breaking the rule and plan accordingly. Furthermore, fan chart representation (for example) can make the public more aware that outcomes do not necessarily lie in line with the forecasts (Emmerson et al., 2004).

- A numerical policy rule.
- A set of "procedural" rules.
- Monitoring by an independent, authoritative body.
- Full and clear public accounts (including future costs).

Other issues to consider include:

- Coverage of rules.
- Whether or not the rules should respond to past deviations.
- Effective monitoring and evaluation.

In addition, considerations when choosing the fiscal instrument include (cf. IMF, 2009):

- The instrument must be closely linked to the ultimate objective of fiscal policy.
- The instrument must be controllable.
- The instrument must be transparent and easy to monitor – commentators must be able to audit fiscal policy, and so the fiscal authorities need to publish as much data and information as possible.[18]

The budget balance to GDP ratio generally fulfils the above requirements and thus makes a good instrument. Constraining the debt ratio, on the other hand, is more difficult because of the lags that are involved before any budgetary slippages can be detected and also because debt is more volatile. Generally, if debt is targeted, it is targeted together with a budget balance. In addition, targeting revenue is also tricky because it is not linked directly to debt ratio unless the expenditure side is considered. A growth-based balance rule (an augmented one) performs well in a low-growth environment (however, the price is the reduced countercyclicality).

In terms of the implementation, the following are important points (Anderson and Minarik, 2006; IMF, 2009):

- Before a rule is introduced, countries need to make an effort at fiscal consolidation and macroeconomic stability, which is likely to make the rule more credible.
- Speed of adjustment is also an issue, as the rule might require an excessive speed of adjustment, or it might not mandate as much adjustment as is needed/feasible/optimal.
- Fiscal rules should not be introduced in a markedly uncertain macroeconomic environment.

The main points to keep in mind are that the cost of breaking the rule needs to be higher than the benefit of doing so, and while fiscal rules can anchor medium-term expectations, they are not ideal when dealing with extreme shocks.

1.3.4 Sub-national Fiscal Rules

Generally, since fiscal discipline is greater at the national level, fiscal rules at this level are found to be more effective than those implemented at the local government level (IMF, 2009). Other reasons for inefficiency of fiscal rules at the sub-national level are: limited authority and dependence on central government transfers, which creates situations of moral hazard; spillovers from higher spending jurisdictions; and differences in the timing and size of economic cycles across sub-national government that may spur procyclical behaviour. It should be noted that countercyclical fiscal policy is desirable as it aids

18 Although it is understandable that governments would want/need to withhold some information to manage expectations. In South Africa, fiscal authorities publish budget documentation that is consistent with the IMF's "Revised Code of Good Practices on Fiscal Transparency" and is currently considered one of the most transparent fiscal authorities in the world (out of a sample of 94 countries considered). It publishes information on forthcoming policies as well as policies under consideration, provides consistent data and presents estimates of the budgetary aggregates over the medium term.

the government by acting as a stabiliser – i.e. spending during downturns and saving during upturns in the business cycle. However, if sub-national fiscal rules are introduced, it is optimal for these rules to be simultaneously introduced at all levels of government. However, this is rarely the case: internationally, fiscal rules have either been first introduced at the national level and then at the sub-national level (e.g. Argentina) or the other way around (e.g. Canada).

What are some of the elements that need to be in place before a sub-national fiscal rule is introduced? Firstly, fiscal legislation needs to be imposed at corresponding government level(s) to provide a means for accountability for policymakers (Kopits, 2001). In South Africa, this aspect is covered by the PFMA of 1999 and MFMA of 2003 legislations. Secondly, the underlying vertical (regional) imbalances need to be offset by a sufficient mechanism of intergovernmental compensation transfers (cf. Kopits, 2001), such as the equitable share mechanism in South Africa. While the national government raises the bulk of aggregate revenues, its expenditure responsibilities are much lower, which means a mismatch between revenues raised and expenditure responsibilities. A converse mismatch exists at the provincial and local government level. This vertical mismatch is known as a vertical fiscal imbalance (pre-transfer fiscal deficit).

There are also horizontal imbalances since the revenue-raising capacity of sub-national governments varies and because different regions may face different cost and demand pressures as they attempt to meet their assigned expenditure responsibilities. The gap between revenue and spending in sub-national jurisdictions is met through intergovernmental transfers (grants and revenue sharing), borrowing by governments in deficit, or a combination of the two. While the equitable share transfers may appear to be free of rules, it is important to note that many institutional and legal arrangements are in place for the use of these transfers. In terms of the Intergovernmental Fiscal Relations Act (IGFRA) of 1997, the Minister of Finance has a legal obligation to convene the Budget Council twice a year and the Budget Forum once a year. The Council and the Forum may be convened in order to solve any disputes, in line with the scheme provided for in the IGRFA of 2005.

The PFMA and MFMA also govern reporting requirements as well as the Appropriation Act, which regulates the conditional allocation of national revenue directly. Local governments in South Africa are required to enact balanced budgets. Therefore, strictly speaking, the equitable share is supposed to be used by recipient sectors to deliver on constitutional mandates. Where a province (or a municipality) fails to deliver on these mandates, the national government (or a province) can intervene through Sections 100 and 139 of the Constitution. It is the responsibility of national departments to implement "emergency" Section 100 (of the Constitution) measures to bring provincial spending and revenue into balance. Such intervention has happened before and is currently in place in the Eastern Cape education department.

It goes without saying that budget and/or debt rules should be viewed as complementary rather than substitutes for the equitable share mechanism. There are two general approaches to fiscal responsibility at the sub-national level: sub-national autonomy and a coordinated approach (Shah, 1994; Kopits, 2001). In the autonomous approach, the sub-national government seeks to gain credibility for its own fiscal policy, while in the coordinated approach all sub-national governments are subject to uniform rules in order to establish credibility for overall macroeconomic policy.

In the latter case, a free rider problem could arise, so penalties for non-compliance need to be introduced at the sub-national level as well. Flexibility is also an important consideration at the sub-national level. For example, mechanisms must be put in place to correct unanticipated deviations from target (unless these stem from cyclical fluctuations). In addition, revenue shortfalls and over-expenditure need to be met with automatic measures.

1.3.5 International Experience and Lessons for South Africa

In addressing fiscal challenges, South Africa can draw on experience from other countries. Internationally, combining budget balance and expenditure rules has been particularly effective, and even more so when the countries had wide coverage and strong monitoring.

The following are some examples of international experience with fiscal rules.

UK and Australia: Neither framework has legislated numerical targets. Instead, emphasis is placed on requiring government to set out its fiscal strategy and targets clearly. Australia's reduction in debt is mainly due to privatisation proceeds, and the current objective is to balance the budget over the economic cycle by running short-term surpluses and aiming to improve its net worth as a supplementary objective.

Japan: This country has had some or other form of fiscal rules since 1947. However, since 1997 it has had rules to address the deficit as well as ensuring that the sum of national and local government debt does not exceed 3% of GDP. In addition, deficit financing bonds need to be reduced every year and numerical limits are set on expenditures.

New Zealand: Here the Fiscal Responsibility Act places more emphasis on transparency than on numerical targets. The government did set some targets for fiscally prudent levels of debt. Temporary departures are allowed as long as the government specifies reasons for doing so (and also when it plans to return to the principles). In general, improved fiscal performance in New Zealand can be attributed to fiscal rules plus improved reporting requirements, better economic conditions and political commitment.

Canada: This country set limits on programme spending (overspending is permitted in one year if offset in the following two years, and unspent amounts can be allocated to the subsequent fiscal year). The government has also introduced a number of non-legislated rules that have contributed to better federal finances (two-year rolling deficit targets with an ultimate goal of a balanced budget and credible short-term fiscal targets combined with commitment).

Chile: Often cited as a success story in the implementation of fiscal rules, the country introduced a new fiscal framework in 2001 (codified in the Fiscal Responsibility Law). The target is a structural fiscal surplus, and the cyclical stance is determined by an expert committee. Between 2004 and 2008 the country had a cumulative surplus of 28.5% of GDP. In 2009, there was 14.5% real growth in public spending despite a 28.5% fall in fiscal revenue (implying a fiscal deficit of 4%).

South Africa has come a long way in operating some sort of fiscal rules that are implemented through constitutional amendments, statutory provisions or policy guidelines. A variety of enforcement mechanisms exist to enforce these. When rules are violated, sub-central governments may be subject to administrative sanctions, financial penalties, or a loss of prestige and reputation. For instance, "peer pressure", in the form of recommendations by the Commission to restore fiscal discipline when sub-national governments fail to adhere to such rules, is available.

There have been instances where local level authorities have been removed from office for violating fiscal rules. Furthermore, a constitutional provision allowing Parliament to adjust the budget proposed by government has proven to act as if allocations are indeed rules. The government's medium-term horizon for fiscal policy, which has given fiscal policy some discipline without making it rules-based, has also proved useful because markets could easily detect any deviation from medium-term targets. The entrenched recognition and clear demonstration of fiscal prudence by South African authorities permeates through to sub-national government. A key issue that arises in the context of South Africa is whether and how to strengthen fiscal rules.

Thus, the first aspect should be to recognise the existence of some sort of fiscal rules that by and large are working reasonably well. The second aspect is that the National Treasury is certainly conflicted, as it acts as both judge and jury on its performance. This calls for a separation of function and, in this regard, the Swedish model of an independent fiscal policy council is a good guide and needs to be considered.

On the basis of these considerations, a possible option for fiscal rules would be to target a balanced budget or surplus over the cycle, without any limits, which would allow for the operation of automatic stabilisers and also for discretionary countercyclical action. In addition, limits need to be imposed on the government wage bill. Generally, if an expenditure rule is to be proposed, then limiting capital expenditure (which is thought to contribute to long-term growth) is not an option. However, transparent, unambiguous and operationally sensible definitions of capital expenditure are needed (so that the focus is on productive capital expenditure).

1.4 Link between Fiscal Variables and Economic Growth in South Africa

The question of whether or not fiscal policy stimulates growth has obvious important implications for the South African economy. Given that the South African Government is intent on continuing its policy of fiscal stability and consolidation (as well as possibly implementing fiscal guidelines to strengthen its fiscal frameworks in the future), any expenditure and taxation decisions need to be carefully balanced in order to achieve its social objectives. Unfortunately, the question of whether or not fiscal variables have a positive effect on economic growth has no simple answer. One viewpoint holds that government involvement in economic activity is fundamental for achieving economic growth; another argues that government operations are inherently bureaucratic and inefficient and hence suppress rather than promote economic growth. In an attempt to shed some light on this issue, this section presents various evidence of linkages between fiscal policy and economic growth in South Africa from national, provincial and municipal perspectives.

1.4.1 National Level

There is a considerable quantity of literature on the influence of fiscal variables (expenditure on government programmes and taxes) on economic growth, most of which are reported in the form of tax and/or revenue elasticities.

Though difficult to obtain, and while strictly speaking these elasticities are meant for closed economies, they offer a useful indication of the effect of fiscal policy on economic growth. Simply defined, elasticities are measures of responsiveness of a variable to a change in another variable.

For South Africa, a number of studies have estimated tax elasticities (albeit using different methods and sample periods). In addition, the Commission has estimated revenue elasticities for different components of public expenditure. Tables 1 and 2 provide summaries of these estimated elasticities.

Table 1. Summary of tax elasticities for South Africa

Study Tax ↓	Swanepoel and Schoeman (2002)	IMF (2006)	Du Plessis and Boshoff (2007)	Jooste (2009)
Personal income tax	-	1.43	-	0.84
Corporate income tax	-	2.52	-	1.79
Value added tax	-	0.99	1.14	1.01
Income and profit	1.04	-	1.05	-
Goods and services	1.24	-	-	-

Source: Jooste and Naraidoo (2010)

Table 1 shows the responses of taxes to the economic cycle, which has important implications for calculating the CAB. Most countries assume that taxes respond in a one-to-one relationship with the cycle. However, recent studies such as Wolswijk (2007) and Jooste and Naraidoo (2010) show that taxes respond asymmetrically to the economic cycle. Thus, significantly different CAB outcomes may be obtained, depending on the elasticity.

There is an obvious trade-off between technical sophistication and a communicable method of calculating the CAB. While technical rigour might provide a more "exact" outcome of the CAB, it is not as transparent as a communicable method and may be subject to manipulation. And whereas a communicable method is transparent, it can sometimes be off the mark.

Table 2. Summary of revenue elasticities for South Africa

Expenditure Category	Elasticity estimate
Agriculture, forestry and fishing	2.41
Defence	0.22
Education	1.51
Fuel and energy	0.61
Health	1.87
Housing and community amenities	0.37
Mining, manufacturing and construction	-1.86
Public order and safety	-1.38
Recreation, culture and religion	-0.25
Social protection	0.39

Source: FFC calculations

Table 2 shows the responses of economic growth to changes in public expenditure components. Positive elasticities larger than 1 are considered conducive to economic growth (i.e. a 1% increase in government spending leads to more than a 1% increase in economic growth, all other things being constant), making agriculture, education and health the key contributors to economic growth in South Africa. Negative elasticities can indicate a reverse causality, i.e. from growth to expenditure.

1.4.2 Sub-national Level

Empirical evidence at the provincial level for South Africa is scant, mainly because of data deficiencies (for example in the case of interregional mobility and expenditure profiles). Furthermore, many complex responses arise from the interaction of the different sectors of government and to capture these effectively is difficult. Using a multiple provincial/regional computable general equilibrium (CGE) model, a recent study by the Commission provides a picture of how South Africa's efficiency and equity goals are affected by altering existing fiscal rules. Fiscal rules here are loosely embodied in the conditions and restrictions associated with intergovernmental fiscal transfers discussed earlier. A reduction of intergovernmental transfers with tax compensation is therefore interpreted as a loosening of fiscal rules. This loosening is found to have heterogeneous effects on households' well-being, which is measured by changes in the equivalent variation of initial con-

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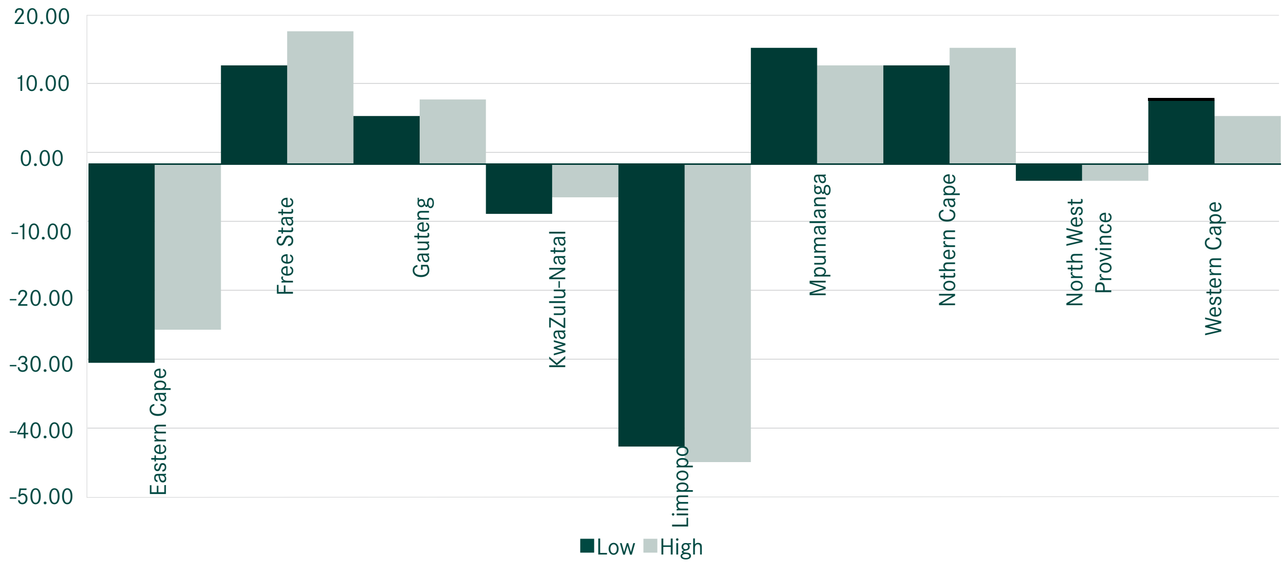
sumption expenses.[19] The nation-wide welfare does not change significantly (0.6% in both scenarios), but its distributional effect among provinces is important (see Figure 2).

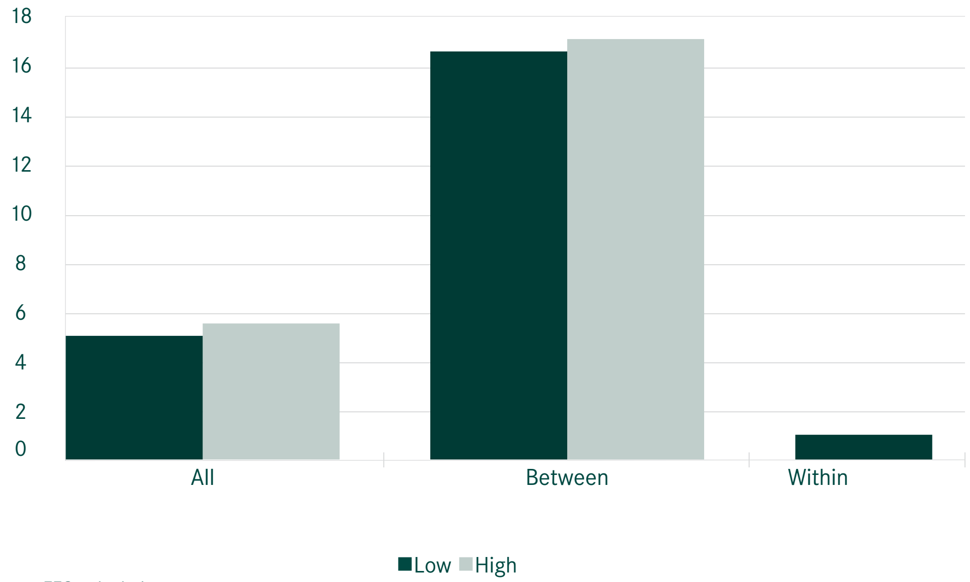
Figure 2. Equivalent variation of initial consumption expenses (%)



Source: Own calculations

Theil indices are used in the study to measure regional disparities, in particular within and between regions.[20] The overall regional disparity increases by 5 to 6% (Figure 3 is essentially imputed to the increase in disparities between regions).

Figure 3. Variation in Theil indices (%)



Source: FFC calculations

These results are varied but pertinent for the use of fiscal rules. The first general point is that sub-national governments play a key role in successful fiscal consolidation. This provides support for the argument that understanding sub-national govern-

19 This is the change in consumer income that results in a change in well-being that is equivalent to a change in well-being resulting from a price change. It can be positive or negative.

20 The Theil index is part of a larger family of measures referred to as the General Entropy class and is a statistic used to measure economic inequality. While less commonly used than the Gini coefficient, an appealing feature of the Theil index compared with the Gini coefficient is that it is additive across different sub-groups or regions in the country, which explains why it is used here.

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ment behaviour is important for overall macroeconomic stabilisation. Grant allocations provide a mechanism whereby the national government retains considerable effective control over aggregate sub-national government expenditures.[21]

The second general point is that cuts in grants can play an important role in fiscal consolidation. However, the results demonstrate that there are significant interregional equity effects although the overall impact is less important. Such concerns about intragenerational equity appear to be well justified if deficit reduction is implemented through cuts in social assistance or a reduction in regressive taxes. Not least from a South African welfare state perspective, a programme of fiscal consolidation could easily conflict with ambitious (re)distributive objectives. The third general point is that cuts in grants can be offset by increases in compensatory taxation. However, the increase in sub-national taxation following an episodic cut in grants is that households' gross incomes fall and income disparity widens.

1.5 Recommendations

With respect to South Africa's transition to a consolidated budget and fiscal guidelines, it is recommended that:

- Over the medium term, government should continue with a gradual programme of fiscal consolidation that entails reducing moderately but consistently the budget deficit. Such efforts to preserve fiscal sustainability must be sustained in the future, even with the addition of longer-term programmes such as the New Growth Path and proposals for National Health Insurance.

- Recent government proposals on fiscal guidelines in South Africa should be supported. The Commission is of the view that proper implementation of fiscal rules (guidelines) can contribute to and complement existing fiscal policies in South Africa. However, even though international experience with fiscal guidelines has shown that such measures can further strengthen the current countercyclical policy and contribute towards fiscal sustainability, there is no "one size fits all" formula when it comes to the institutional arrangements, design and the implementation of such guidelines. The government should thus focus on these aspects of fiscal guidelines in the short to medium term. The Commission will continue to investigate the implementation implications of introducing fiscal rules in South Africa.

21 In the context of the South African local government grant process, Amusa et al. (2008) offer empirical evidence on the concept of fiscal illusion, using the flypaper effect hypothesis. The flypaper effect refers to the observed tendency of local government authorities to spend intergovernmental grant transfers rather than pass them on to constituents through, for example, tax cuts. The empirical framework used in this study has its foundations in the median voter model developed in the article by Wyckoff (1991) and adapted by Heyndels and Smolders (1994). Amusa et al results suggest the absence of a flypaper effect on municipal expenditures from intergovernmental transfers. In other words, fiscal rules implemented through conditions on various grants have not had unduly discernible negative effects on local government. Two major implications of these findings for fiscal rules would be the need to (i) improve the overall administrative, institutional and financial capacity of municipalities (in particular making them more innovative and effective in spending their grant allocations) and (ii) further understand the effects that current reform proposals could have on the fiscal autonomy and revenue-raising capacity of municipalities.