Media Release

2010 MEDIUM TERM BUDGET POLICY STATEMENT

28 October 2010

Financial and Fiscal Commission
Montrose Place (2nd Floor), Bekker Street,
Waterfall Park, Vorna Valley, Midrand,
Private Bag X69, Halfway House 1685
www.ffc.co.za
Tel: +27 11 207 2332
Fax: +27 388 3965

For an Equitable Sharing of National Revenue

[**28 October 2010**] Since mid-2008, the Government has utilised the fiscal and monetary space gained through previous prudence in its macro economic policy stance to support economic recovery following the financial crisis of 2007. The repo rate has steadily decreased from 12% in 2008 to a current level of 6%, while the budget deficit has increased from a small surplus of 0.9% to a projected deficit of 7.3% of Gross Domestic Product (GDP) during the same period. Latest economic growth figures are positive (3.2% during the second quarter of 2010) indicating that South African economy is indeed in the recovery phase. Economic forecasts by institutions such as the International Monetary Fund and the South African Reserve Bank also forecast positive economic growth of around 3% for 2010 overall, with the output gap closing around 2014 in line with the "moderate recession impact scenario" projections the Financial and Fiscal Commission (FFC) presented in its Submission for the 2011 Division of Revenue.

However, the following factors may pose a threat to the recovery pace/path of South African economy:

- Interruptions in global recovery may affect South African economy – specifically, major trading partners' slow recovery may impact sectoral composition of economic growth. Given that the major contributors to the latest economic growth figures are reported to be a) manufacturing, b) wholesale, retail, motor trade and accommodation, and c) finance, real estate and business services (the first two especially are important South African exports to the European Union), these are the likely sectors to suffer due to their vulnerability to international price movements (these are also the largest industries in the second quarter of 2010; cf. STATSSA).

- Exchange rate volatility (which has been increasing over the last couple of years) might potentially harm the demand for South African exports.

- Though South Africa is quite diversified in terms of the sectoral contributions to economic growth, human resource needs and labour markets remain serious constraints across the different sectors of the economy (cf. United Nations report on Africa). There is also a problem of skills mismatch that needs correction.

- Access to budget deficit financing might be constrained by the international demand on capital markets driven, in particular, by economies that were severely affected by the sovereign debt crisis.

- Projections show a persistent budget deficit over the medium term. As noted in FFC's response to the 2009 Medium Term Budget Policy Statement, the main drivers of the budget deficit remain continued increases in infrastructure investment, expansion of the social safety net and wage bill costs (larger than anticipated).

From the outset, the government's main task would be to rein in the fiscal deficit which hit a new millennium record in 2009 as an aftermath of the global economic crisis. Recent research at the FFC suggests that a gradual consolidation process seems to be the best policy option. The recent public sector strike and carry through of Occupation Specific Dispensation pose a major risk to this consolidation although it is still expected that the budget outturn will be down slightly on the 6.2% of GDP originally budgeted for due to higher than anticipated revenue collection (improved revenue collection efficiency on

VAT and international trade as well as other taxes due to the increased economic activity following successful hosting of the World Cup).

There can be little dispute that what the country needs at this stage is a faster and more inclusive growth through a multidimensional approach. This growth imperative requires a rapid boost in economic growth that bolsters employment. From a fiscus perspective, the main concern is that although South Africa has very high spending on social services (South Africa spends as much as a first world country), their productivity, impact and social returns remain below expectation. As noted in the FFC's 2011 Division of Revenue recommendations, distribution of social expenditure needs to be rethought. While social grants expenditure do seem to have been well targeted and reduced poverty, increased access in other social services needs to be accompanied by quality improvements that have been sub-optimal. As well government would need to accelerate the speed of undertaking already approved infrastructural investment projects and increase maintenance and rehabilitation spending.

In its Submission for the 2011 Division of Revenue, the FFC cautioned against implementing large and expensive new government programmes in the face of fiscal consolidation. However, there are two major developments in terms of government priorities that cannot be ignored in this area, namely a push toward attainment of Millennium Development Goals (maternal and child health, job creation and income inequality), and the National Health Insurance scheme that has come to the fore of the policy decisions and is being investigated by government. There is a need to boldly address the specifics of how government intends to proceed with these quite quickly in order to limit the potentially unwelcome uncertainty regarding the ability of government to finance such programmes in the face of consolidation efforts. From the FFC's perspective, the first step should be to establish exactly how much is required to finance these mega programmes. The second step would then be to have consensus on ways of raising the required financing in as least costly a manner as possible to the economy. The third and final step would then be to work out effective delivery models. This last exercise should address in quite some detail the impacts of the programmes and the delivery models on intergovernmental fiscal relations. It is quite clear that these programmes have cross-cutting implications for the three spheres of government and issues of powers and functions will have to be clarified. A question that can be asked is what from the Commission's view are some of the options for addressing these twin policy imperatives? Government could at one extreme rely entirely on reprioritisation and spending cuts or at the other on tax increases.

Ongoing work by the FFC on expenditure cuts and consolidation tentatively suggests that irrespective of the outcome of the spending cuts and prioritisation exercise, fiscal consolidation would require tax increases; unwelcome though they may be. Just how big the tax increases should be is a matter of dispute.

Government has several choices in raising these revenues, namely (a) higher income tax, (b) higher VAT, (c) new carbon tax, (d) Tobin tax and (e) windfall taxes.

It is clear that the implementation of such large and complex interventions affects national, provincial and municipal levels of government and would require massive coordination of these various spheres in their approach to the development and

implementation to avoid waste, ineffectiveness and duplication which will make it unnecessarily costly for the tax payer. These arrangements should thus be worked out and announced upfront.

In terms of the division of revenue the Commission made recommendations on the review of the Provincial Equitable Share formula following a more detailed set of recommendations on a review of the intergovernmental fiscal relations system that were submitted in 2009 for the 2010 Division of Revenue. Government at the time, however, indicated that they would be considered for the 2011 Division of Revenue. The Commission is aware that government has indeed been reviewing the formula and is thus awaiting a formal response on the outcome and how its recommendations have been addressed.

It is important in the context of the Division of Revenue, to note that revenue collection exceeded expectation in the last year but it is also important that in view of the gloomy outlook painted in the Commission's projections over the MTEF and the fragile recovery from the global economic crisis, the over run does not mean that the good days are back again! The need for fiscal consolidation is still imperative and therefore there should not be high expectations of more resources going to the 2011/12 resource envelope. The Commission is of the view that government should continue to emphasise the need to increase the efficiency of spending across all spheres and improve the quality of services.

With respect to local government, the Commission also made specific recommendations on the review of the local government equitable share formula and also on revenue improvement strategies in municipalities. The Commission is aware that government commenced with a review of the formula in 2009 and is awaiting a formal response in this regard on how its recommendations have been taken into account. The Commission is of the view that government should be wary of the growing destabilizing impact of administered prices on sub-national government finances. As part of its research, the Commission will be addressing this issue in detail in it its forthcoming submission on the division of revenue.

In conclusion the Commission will be making a full submission on specific issues addressed in the recently tabled Medium

Term Budget Policy Statement, in the context of these observations for tabling to Parliament early next week.

Enquiries
Bongani Khumalo
Acting Chairperson/CE
Financial and Fiscal Commission
Telephone: 011 207 2325
Mobile: 082 904 0811
Email: bonganik@ffc.co.za
Website: ffc.co.za