

FINANCIAL AND FISCAL COMMISSION  
**POLICY BRIEF**

# Fiscal Guidelines: Does South Africa Really Need Them?

## EXECUTIVE SUMMARY

**This policy brief is a summary of the research that the Commission has worked<sup>1</sup> on and is planning to work on in future. It examines the merits of fiscal guidelines in the South African context.**

**P**ublic finance in most countries has been characterised by rising deficits and public debt over the last few years. In a bid to achieve the goal of sustainable public finances (as well as the convergence of debt to sustainable levels), many countries have adopted some form of a fiscal rule (guideline), or some combination of fiscal rules (guidelines). Generally, a government with a strong reputation of fiscal prudence does not necessarily need to be constrained by rules. However, when this is not the case, international evidence shows that fiscal guidelines can provide a useful framework for fiscal policy and ultimately contribute to macroeconomic stability and economic growth. Furthermore, in order to enhance their effectiveness, fiscal guidelines need to be well-designed at both the national as well as the subnational levels, thus having implications for the intergovernmental fiscal relations (IGFR). In October 2010, Parliament requested for the Commission to comment on fiscal guidelines.



1. Mabugu, R., and Marinkov, M., (2011). "Fiscal rules for South Africa", FFC, Midrand, South Africa.

# STATEMENT OF THE PROBLEM

South Africa's current fiscal environment (as well as for many other countries emerging from the crisis) is characterised by questions of whether or not the government has been fiscally prudent (and pursuing stable and sustainable public finances) as well as what type of fiscal rules (if any) should be pursued to entrench the current efforts of fiscal consolidation. This brief argues that these goals can be achieved through a combination of two broad strategies:

- Fiscal discipline (i.e. management of government budget with a goal of avoiding excessive budget deficits) based on fiscal frameworks that are focused on credible and transparent budget and consolidation strategies.
- The adoption of a fiscal rule(s) to entrench fiscal discipline (the box below gives more details on fiscal guidelines).

As 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 there is a need to deal with problems for which there are fundamental uncertainties. 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 policy brief, the focus is on exploring the potential to strengthen South African fiscal rules through assessing the need for stronger national fiscal frameworks and independent fiscal institutions.

## POLICY OPTIONS

One of the main problems with completely discretionary fiscal policy is that government's record of fiscal policy cannot really be assessed without firm guidelines. In addition, there are quite number of factors that 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. Generally, the motivation for fiscal rules is that they create a depoliticised policy framework (i.e. they correct the governments' 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 (e.g. EU countries), it is difficult to isolate the direction of causality and the effect – i.e. introduction of rules might make government more responsible, but responsible governments are also more likely to make rules. In terms of the fiscal rules fostering consolidation efforts, international evidence has been favourable. A major disadvantage of fiscal rules is that they constrain discretion when discretion is needed and might force fiscal policy to be procyclical when it needs to be countercyclical.

**In addition, fiscal rules, and expenditure rules in particular, may result in capital spending cuts which could harm long-term economic growth. Further reasons for adoption of fiscal rules include:**

- 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 long-term sustainability of fiscal policy.

## BACKGROUND - WHAT ARE FISCAL GUIDELINES?

Fiscal guidelines (rules) are defined as permanent constraints on fiscal policy through simple numerical limits on budgetary aggregates. In order for fiscal rules to guide fiscal policy, a fiscal indicator (instrument) is needed to facilitate a rule that is relatively simple and which can be easily monitored as well as communicated to the public. While generally fiscal rules are adopted with the aim to achieve fiscal sustainability (debt sustainability), these rules can have different roles such as economic stabilisation, growth orientation and/or limiting (expanding) government size. The different rules can be summarised as:

- Budget balance rules which can be based on the overall balance, structural balance or cyclically adjusted balance (CAB).
- Debt rules which generally target a certain level of debt/GDP ratio and are most effective in achieving the goal of debt convergence.
- Expenditure rules which, for example, permanently limit total, primary or current spending in relation to GDP.
- Revenue rules that aim to boost revenue and/or prevent tax burden.



The idea is to strengthen these fiscal frameworks and utilise them as mechanisms to assist national fiscal rules, so as to involve all levels of government in the operation of fiscal guidelines in

## PRE-EXISTING POLICIES

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 and a variety of mechanisms exist to enforce these (some examples include, balanced budget requirement for local governments, (procedural) borrowing rules for provinces, etc.). When rules are violated, sub-national governments may be subject to administrative sanctions, financial penalties, or a loss of prestige and reputation (an example here includes the criteria prescribed in section 138 of the Municipal Finance Management Act of 2003). The government's medium-term horizon for fiscal policy, which gave fiscal policy some discipline without making it rules-based, also proved useful because markets could easily detect any deviation from medium-term targets. Thus, South African authorities are gradually entrenching recognition of fiscal prudence that is permeating through to sub-national government. The focus of policymakers should be on exploring potential to strengthen South African fiscal rules through assessing the need for stronger national fiscal frameworks and independent fiscal institutions. Tentatively, we suggest that a possible option for fiscal rules would be to target a balanced budget or a small surplus (or deficit) over the cycle without any limits which allows for the operation of automatic stabilisers and also for discretionary countercyclical action. In addition, the set up of a South African Fiscal Policy Council appears plausible. Fiscal institutions such as the Financial and Fiscal Commission should continue to play a complementary role to evaluate rules, in particular with regard to compliance issues as pertaining to intergovernmental fiscal relations through its periodic advisories.

## RECOMMENDATIONS

The idea for national fiscal rules (guidelines) in South Africa should be understood in the context of the phrase "prevention rather than cure". South African government is aware of some very real and substantial pressures on the budget such as NHI (National Health Insurance), NGP (New Growth Path) as well as constant wage increase demands. With these in mind, fiscal guidelines are intended to assist the government in maintaining credible expenditure management while still achieving its social objectives. In terms of subnational fiscal rules, the Commission's research surveys some literature and begins exploring the legislative aspects of subnational fiscal guidelines in the South African context (i.e. Public Finance Management Act, Municipal Finance Management Act, equitable share, etc.). With the above in mind, recent government

proposals on fiscal guidelines should be supported. The Commission is of the view that proper implementation of fiscal rules (guidelines) can contribute to and complement existing fiscal policies. 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 institutional arrangements, design and implementation of such guidelines. Government should thus focus on these aspects of fiscal guidelines in the short to medium term. The Commission will continue to investigate implementation implications of introducing fiscal rules in South Africa.



## RECOMMENDED SOURCES

Fiscal guidelines (rules) are internationally growing more popular. South African fiscal authorities have long implemented multi-year expenditure planning and there has been much debate around whether or not fiscal rules should also be implemented in South Africa – even more so recently given the international evidence on usefulness of fiscal rules in managing public finances<sup>2</sup>. In terms of South African literature, papers such as Du Plessis and Boshoff (2007)<sup>3</sup>, Burger and Jimmy (2006)<sup>4</sup>, as well as Siebrits and Calitz (2004)<sup>5</sup> are useful. This year, National Treasury has included a short discussion on fiscal guidelines in the Budget Review (2011). Also, a two page document is available in the public domain dealing with political issues associated with the implementation of fiscal rules in South Africa (source: Fiscal Policy, National Treasury).

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2. International Monetary Fund (IMF). 2009. "Fiscal Rules – Anchoring Expectations for Sustainable Public Finances". Available online: [www.imf.org](http://www.imf.org).
  3. Du Plessis, S. and Boshoff, W. 2007. "A Fiscal Rule to Produce Countercyclical Fiscal Policy in South Africa", University of Stellenbosch Economic Working Paper Series, paper number: 13/07. Available online: [www.sun.ac.za](http://www.sun.ac.za).
  4. Burger, P. and Jimmy, C. 2006. "Should South Africa Have a Fiscal Rule?", *South African Journal of Economics*, 74(4): 642–669.
  5. Siebrits, F.K. and Calitz, E. 2004. "Should South Africa Adopt Numerical Fiscal Rules?", *South African Journal of Economics*, 72(4): 759-783.

Ramos Mabugu ([ramosm@ffc.co.za](mailto:ramosm@ffc.co.za)), Marina Marinkov ([marina@ffc.co.za](mailto:marina@ffc.co.za))

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](http://www.ffc.co.za)  
Tel: +27 11 207 2300  
Fax: +27 86 589 1038

