FINANCIAL AND FISCAL COMMISSION

Briefing to the Standing and Select Committees on Finance on the Fiscal Frameworks and Revenue Proposals

1 March 2011

For an Equitable Sharing of National Revenue

Overview

- Review of 2011 Fiscal Frameworks
- Macroeconomic Outlook and Long-Term Fiscal Risks Confronting SA
- Revenue Estimates and Tax Proposals
- How Can SA's Fiscal Framework be Improved?
- Conclusion

REVIEW OF 2011 FISCAL FRAMEWORKS

- Key recommendations of the Commission for 2011
  - Fiscal consolidation
    - Cushioning the vulnerable and laying the foundations for growth
- Total national budget of R889-billion to be spent between the three spheres for 2011 financial year
  - National government (47%), provincial government (44.3%), local government (8.7%)
    - Allocations to provinces revised upwards with an additional R30.1-billion to PES and R10.1-billion to the conditional grant
    - Local government receives additional R1.2-billion to LES, R3.7-billion to conditional grants and R300-million for general fuel levy
- Fiscal framework releases R94.1 billion relative to baseline over the MTEF
  - Focus: job creation, skills development and infrastructure

MACRO OUTLOOK AND LONG TERM FISCAL RISKS CONFRONTING SA

- SA steadily moving out of the recession
  - In line with the Commission's moderate impact of the recession scenario
    - Fiscal and monetary accommodation
    - Growth projections lowered (IMF, SARB): 3.4% for 2011 (below 6.5% average for developing countries)
  - Commission's projections: GDP does not recover to BAU by even 2015
  - Mining and quarrying, manufacturing: biggest contributors to overall real economic growth and recovery in 2011
    - Industries that comprise the majority of SA's exports
    - Exchange rate is extremely important to the SA economy:
    - Important that Government and SARB continue to moderate the effect of capital flows on the exchange rate

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MACRO OUTLOOK AND LT FISCAL RISKS CONFRONTING SA (CONT.)

- Government has put economic growth at the centre of job creation
  - NGP, R9-billion jobs fund, R10-billion allocation by the IDC and up to R20-billion tax breaks
- However, “higher, inclusive growth, and above all sustained” needs to be accompanied by improvements in skills and education
  - SA faces enormous pressure to upgrade human capital skills
  - Suffers from competitive disadvantage in terms of quality of its human capital, investment in R&D, and ICT penetration
  - SA will need to increase investments and quality of spending in education and bolster spending on R&D
  - These supply-side factors constitute most pressing key long term challenges confronting SA

Macro Outlook and LT Fiscal Risks Confronting SA (cont.)

- Although Government has made some progress in achieving the MDGs, gaps remain
  - Modelling at the Commission shows that if the economic conditions do not change, there will be progress in achieving some MDGs but this progress will not be sufficient to achieve all
  - For example government should be able to achieve MDG 1, but not MDGs 4 and 5 (even when GDP growth of 4.5% is assumed) by 2014
  - Further scenarios conducted to investigate the impact on public spending to achieve the MDGs, separately and simultaneously
    - If the health MDGs are targeted alone, health spending increases from 3.1% of GDP to 5.1% of GDP

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MACRO OUTLOOK AND LT FISCAL RISKS CONFRONTING SA (CONT.)

- Important development: NHI allocated R8 billion
  - Well known that full programme will cost a lot more; poses a fiscal risk
- The Commission recently made long term budget projections under 3 scenarios that reflected different assumptions about future policies for revenues and spending that mimic introduction of NHI
  - Business as usual (BAU) scenario is assumed to follow a steady state path in which all variables are constant per effective labour unit
  - Scenario 1: no imposition of any constraint on the debt to GDP ratio
  - Scenario 2: Any increase in public spending would need to be financed though increased taxes on household income

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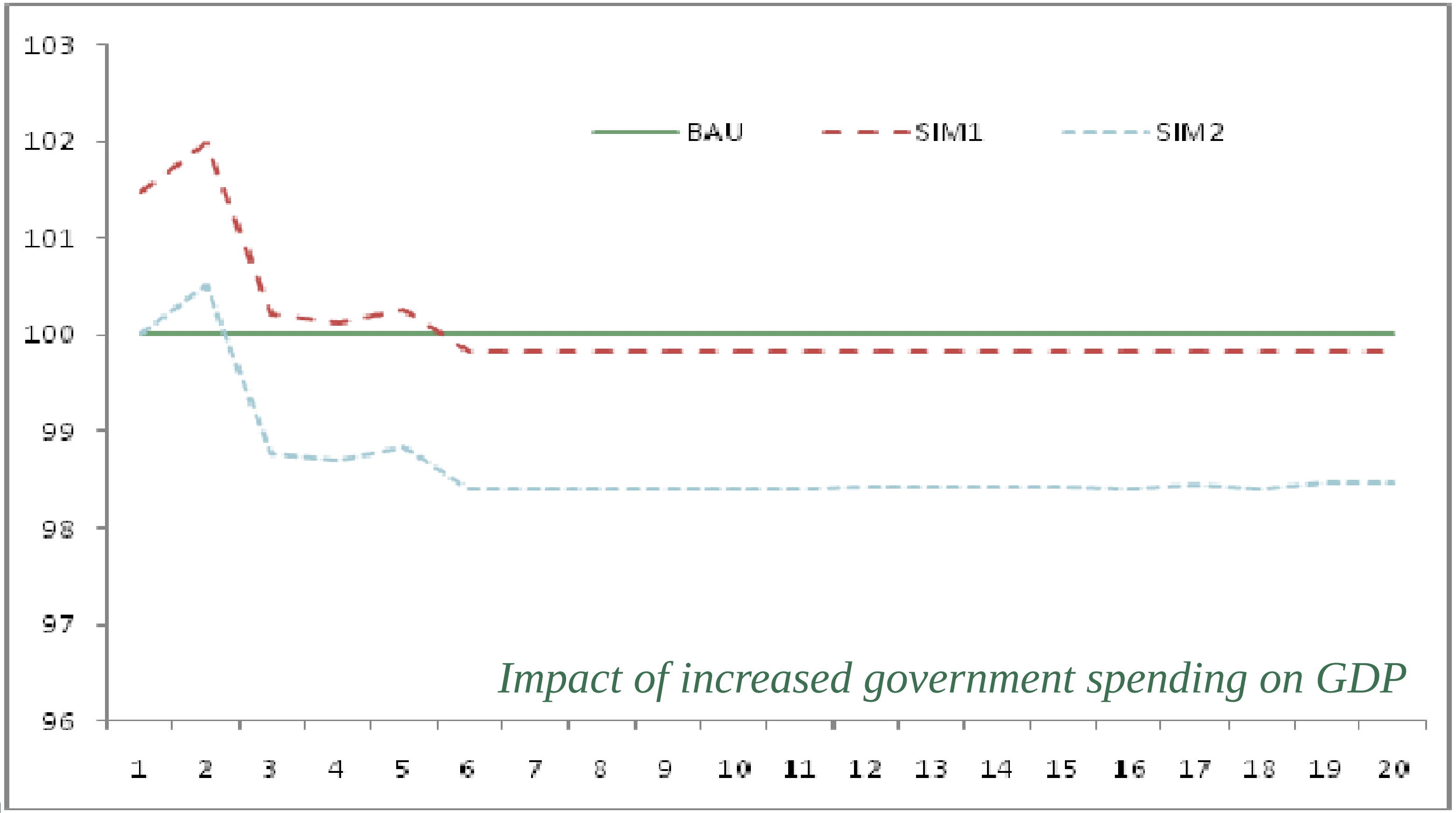
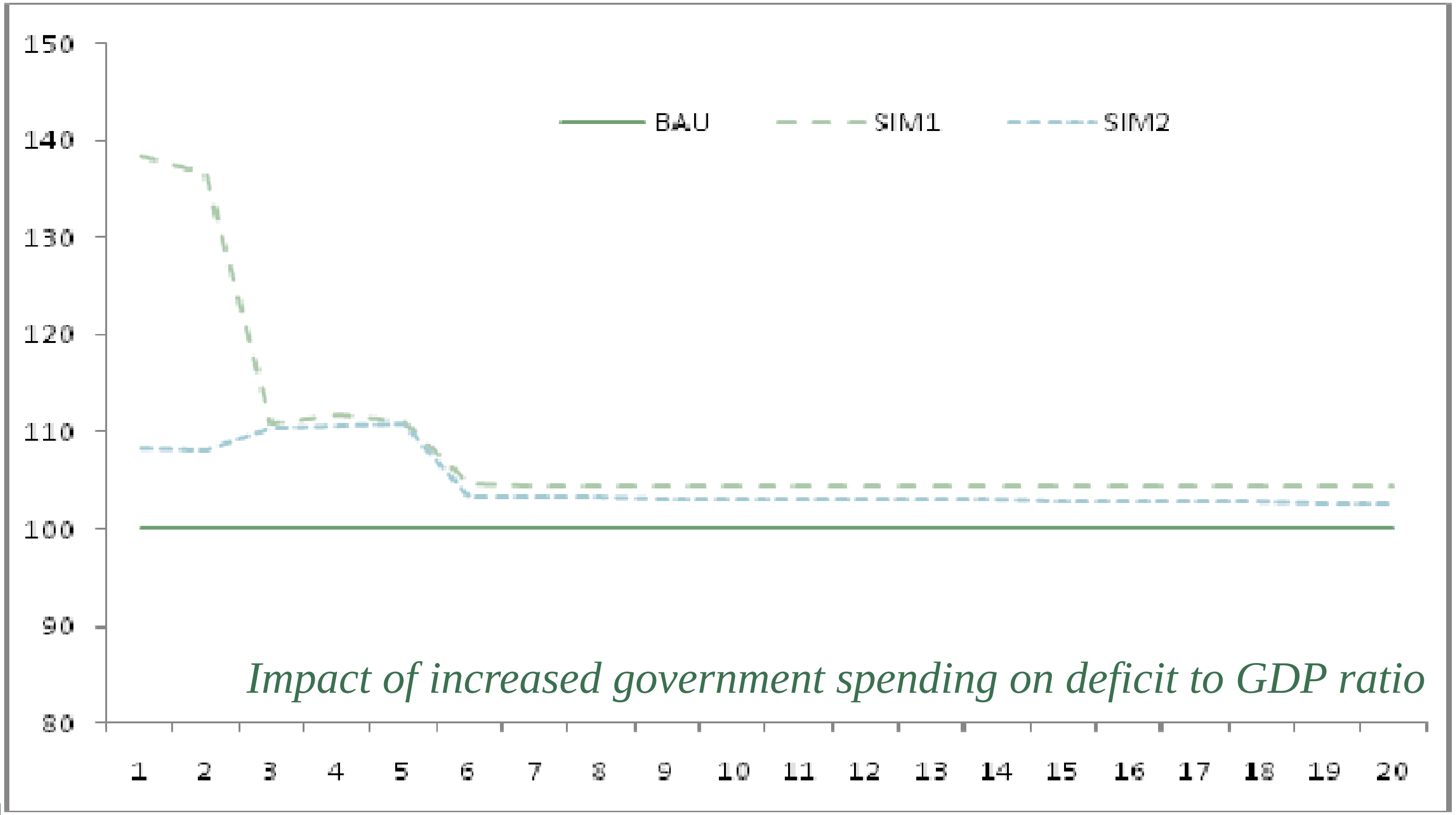
MACRO OUTLOOK AND LT FISCAL RISKS CONFRONTING SA (CONT.)



Impact of increased government spending on GDP

Macro Outlook and LT Fiscal Risks Confronting SA (cont.)



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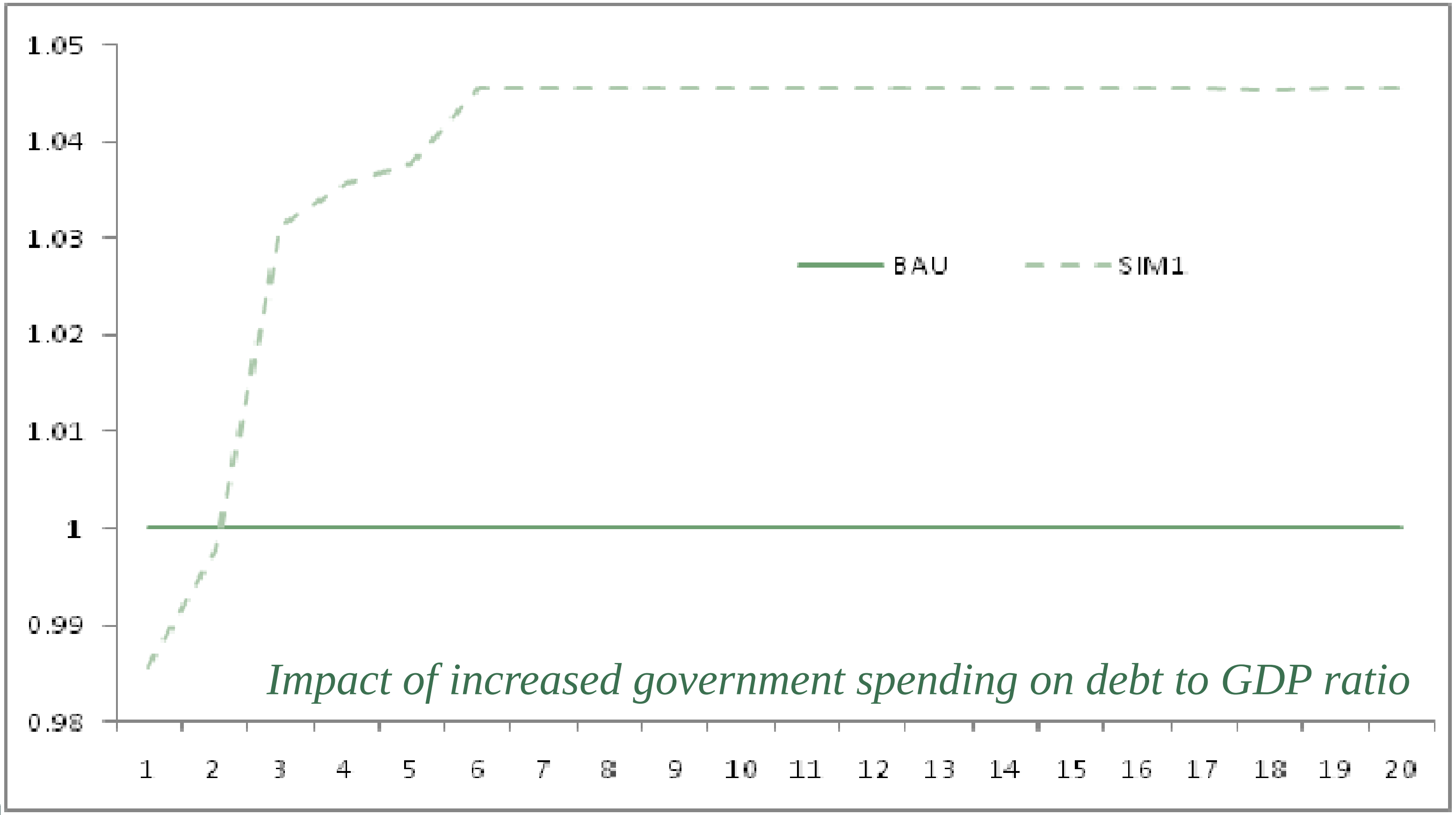
MACRO OUTLOOK AND LT FISCAL RISKS CONFRONTING SA (CONT.)



MACRO OUTLOOK AND LONG TERM FISCAL RISKS CONFRONTING SA (CONT.)

- Other risks:
  - Commodity Prices
    - Research carried out by the Commission suggests that oil price increases would reduce GDP by between 2.2% and 2.5% in the long-term (20 year cycle)
    - Impact on government deficit varies widely among the scenarios, ranging from a worsening of 12% to 22% in the floating prices and the fixed price scenarios, respectively
  - Debt Service Costs
    - It is necessary for government to borrow in order to pursue countercyclical policies and ensure sufficient service delivery – exposure to foreign exchange risk must be considered
  - Rising personnel costs
    - Personnel costs still rising as percentage of government spending
  - Contingency reserve for inevitable surprise factors

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Revenue Estimates and Tax Proposals (cont.)

- Proposed tax structure designed to support economic growth and the Commission welcomes that
  - International evidence
- Other commentary by the Commission
  - Fuel levy increase
    - Reasonable, but continued increases approached with caution
  - 'Sin' taxes
    - Possible negative tax returns
  - Environmental levy
    - Potentially negative effects

HOW CAN SA FISCAL FRAMEWORK BE IMPROVED?

- Government has proposed guidelines for fiscal sustainability:
  - Annual target for the structural budget balance
  - Making explicit the costs of existing and new programmes requiring long term expenditure commitment
  - Setting out a timeline to bring the budget back on target following large fiscal shocks
- The Commission is of the view that indeed fiscal rules can be used as a mechanism for achieving these goals
  - However there needs to be careful considerations of the objectives and at what sphere of government these will have to be applied
- SA has come a long way in operating some sort of fiscal rules that are implemented through constitutional amendments, statutory provisions or policy guidelines
  - Variety of enforcement mechanisms exist to enforce these

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How Can SA Fiscal Framework be Improved? (cont.)

- A key issue: whether and how to strengthen fiscal rules in SA?
  - Commission's analysis suggests that subnational government's fiscal policy has been disciplined without necessarily being rules-based
- More nuanced view of the appropriate role of fiscal rules at national and subnational government needs to recognize that a sophisticated IG system is in place and look at how to improve an existing and functioning system
- Possible option for fiscal rules: target a balanced budget or surplus over the cycle without any limits
  - Allows for the operation of automatic stabilisers and also for discretionary countercyclical action
  - In addition, limits on the government wage bill need to be imposed
  - If an expenditure rule is to be proposed, then limiting capital expenditure (which is thought to contribute to long-run growth) not an option

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How Can SA Fiscal Framework be Improved? (cont.)

- Commission's research on public expenditure finds some evidence that expenditure on defence, health and transport seems to be contributing positively to economic growth in SA
  - These expenditures have been given priority in the 2011/12 budget
- There is a need for Parliament to obtain greater clarity on the risks to which the public sector is exposed
  - Entails clarifying potential costs of different risk factors
- The political economy challenge of dealing with long-term fiscal policy issues need provocation of public debate
  - Pre-announcement of alternative ways of financing NHI and guidelines for fiscal sustainability by Government – steps in this direction
- Government should be required to publish analysis of the distributional impact of new policies
- A requirement to evaluate regularly the impact of policies (where not prohibitively costly) would strengthen the frameworks

CONCLUSION

- 2011 Budget contrasts conflicting objectives between job creation and fiscal consolidation
  – Will SA achieve higher growth through its fiscal stance?
- 2011 fiscal frameworks noteworthy in one major respect – explicit recognition of need to take account of long term issues in budget
  – Critical that such a perspective is shared both by executive and legislative branches
- SA needs to take account of potential long term structural developments and risks
- A multi-pronged approach necessary to deal with issues of long run nature
  – Strengthened policy analysis, reforms of budget process, sustained fiscal consolidation, sectoral policy reforms
  – SA fiscal frameworks acknowledged as the most transparent of 94 countries - the Commission commends the Government for this achievement

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THANK YOU.

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