Thematic Focus and Research Projects: Submission for 2015/16 Division of Revenue

Research and Recommendations Programme[1]

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1. Theme and Rationale

The research theme for the 2015/16 Annual Submission for the Division of Revenue is:

"Balancing fiscal sustainability with socio-economic impact"

This theme is consistent with FFC's Research Strategy and Government's flagship publication *National Development Plan: Vision for 2030* (launched in August 2012) which has a distinct focus on inequalities, poverty and financing. The National Development Plan (NDP) Vision 2030 sets as its principal objective the *elimination* of poverty and *reduction* of inequality by 2030. Work carried out to operationalise the theme therefore contributes to on-going efforts by FFC towards the implementation of the National Development Plan Vision 2030 of South Africa by addressing the potential national and subnational specific impacts of various components of fiscal leadership and how the government could craft together intergovernmental fiscal relations and transfers in order to promote shared prosperity and fiscal sustainability.

Developed economies have seen their public debt to GDP ratios increasing massively in recent years in the wake of the global financial crisis. That compelled many governments to bail out their financial institutions by using taxpayers' money to do so and in so doing to increase their public debt levels enormously. The principal manner in which they have managed this debt has been by driving long-term interest rates down to undreamed of levels through quantitative easing, i.e. getting their central banks to purchase government bonds back from financial institutions in such a way as to inject cash back into these financial institutions, with the hope that these institutions would then on lend this money to the economy. In this way, the intention has been to boost real economic activity. The process has only been partially successful. The real economies of the advanced countries have only responded modestly to these cash injections. Instead, much of the newfound cash has gone into investments in financial assets, including equities, commodities, emerging market bank deposits and the further purchase of government bonds. We are yet to see the full effects from a longer-term point of view of this distortion of global interest rates. However, for the present, these policies have succeeded in reducing the costs of servicing government debt in advanced economies and in this way have helped to prevent them from defaulting. Having said that, it has been a close shave in the case of the few European economies.

Whilst the average level of government debt to GDP in these advanced economies has risen to somewhere between 80% and 100%, South Africa seems extremely well placed in comparison, with a public debt to GDP ratio of no more than 40% at present. However, the difference is that whereas long-term interest rates in most advanced economies are below 5%, in South Africa's case they are closer to 7%. Therefore, the debt servicing burden of South Africa's government is not proportionately that much lower than it is in advanced economies. At the same time, the downward trend in long-term interest rates in advanced economies has also been accompanied by a decline in long-term interest rates in South Africa, as the wall of liquidity generated by quantitative easing has come to be invested, amongst a whole variety of emerging market alternatives, also into South African government bonds, precisely because of the attractions of being able to get 7% return as opposed to 2% in advanced economies. In turn, these capital inflows have played an important role in limiting the extent of the Rand's depreciation and the inflationary impact that a bigger depreciation would have had in the face of an enormous current-account deficit, of 6% of GDP. Typically, portfolio inflows into South African bonds have been averaging around R100bn per annum, which is about half the value of the current account deficit (the difference between imports and exports of goods and services), of about R200bn.

The problem which has attracted attention about the fiscal situation domestically has been not its absolute level, but its direction. During the period prior to 2008, the policy of Growth Employment and Redistribution (GEAR) had as one of its important tenets the need to reduce South Africa's government indebtedness by running a tight ship on fiscal discipline. The policy succeeded in the sense that the public debt to GDP ratio fell enormously from close to 50% of GDP at the time of the arrival of democracy in 1994 (following enormous excessive expenditure by the National Party to finance its homelands projects down to 22% of GDP by 2007/08). However, since then the ratio has risen quite sharply to close to 40% of GDP. This has raised alarm bells that, should this trend continue, then before too long South Africa might end up the same way as the advanced economies. They have now been obliged to follow fairly severe fiscal austerity in order to rein in their public debts and this is depressing their growth rates. Were South Africa to allow its public debt to rise commensurately, it's government to would be obliged to cut back on expenditure and raise taxes, which would also have a depressing impact on economic growth.

The most obvious manner in which South Africa could improve its fiscal situation is if the economy could grow faster. This would help generate higher growth in tax revenue and in this way, budget deficits could decline a lot faster and public debt begin to reduce accordingly. Indeed, to some extent the National Treasury has incorporated such a scenario into its three-year medium-term expenditure framework. GDP growth is projected to accelerate from a forecast level of 2.7% for this year, to over 3% for 2014 and over 4% for 2015. In this way, the government has managed to budget for a reduction in the budget deficit as a percent of GDP from 5.2% in 2012/13, to just 3.1% in 2015/16. This enables the public debt to GDP ratio to top out at around 45% in

2016/2017. There are two obvious challenges in this regard. Firstly, is the economy actually going to accelerate its growth in such a way as to enable these optimistic projections to be achieved. In this regard, the government is dependent not only on addressing domestic structural impediments to economic growth, but also on the performance of the international economy, given the high correlation between the growth of South Africa's economy and that of the world. Should the world's leading countries not be able to extricate themselves from the low growth environment of the past year driven by the need to observe fiscal austerity in the face of huge public debt levels, South Africa's own economic growth will suffer. The hoped-for reduction in budget deficits and public debt will then be harder to achieve. Secondly, incorporated into these forecasts is the budgeted assumption that growth in the public sector wage bill, which as mentioned above was 8.3% per annum in the last three years, will decline to just 1.3% per annum over the next three years. In this regard, the government rests its assumption on the fact that it has a three year public sector wage agreement with public sector unions in place, to grant increases of 1% above the CPI inflation rate plus a further 0.3% per annum for notch increases. Cynics will argue that a wage agreement of this ilk with trade unions was not honoured in the mining industry last year and that therefore there is no guarantee that the same will not prevail in the public sector. On a more optimistic note, were the country to succeed in implementing the National Development Plan, which has been officially endorsed by government and the ANC and DA, there is reason to believe that the country's sustainable growth rate would rise sufficiently in a manner that enables the country's public debt to GDP ratio eventually to decline on the back of enhanced tax revenues. Included in the NDP as strategies to improve sustainable economic growth are an increase in the focus on education and skills development, a less adversarial relationship between business and organised labour, more focus on improving small business development of entrepreneurship, increased infrastructural investment, greater cooperation between public and private sectors, improved capacity of the public sector to implement projects and strategies to reduce corruption.

The purpose of the 2015/16 Annual Submission is to refresh our analysis of the causes and dimensions of inequality and to explore alternative approaches to tackling the issue. While demands for the pace of socio-economic change have intensified, at the same time prospects for future fiscal space for South Africa over the near and medium term have deteriorated markedly, as a result of both international factors as well as the domestic incidents discussed above. These tradeoffs and tensions between fiscal policy and developmental demands suggest **twin cliffs, namely a fiscal cliff and a socio-economic development deficit cliff** South Africa has to negotiate. Projects will consider the relationship between poverty, inequality and growth. They will analyse the dynamics of poverty and the barriers to social mobility. The submission will also examine what can be done about inequality. It will compare the strengths and weaknesses of social grants with policies to increase people’s capabilities, such as education and health services. Papers will explore measures to move people from welfare into work, along with wider policies to redistribute income, change social structures and relationships, and tackle the fiscal funding arrangements that perpetuate unequal outcomes, such as inadequate and unfair education and health financing. So far, the debate over the fiscal cliff has largely focused on its potential impact on the national budget and economy. But the fiscal cliff also would affect the **provinces and municipalities**. The general economic slowdown that would result from all of the changes occurring at once would significantly affect provincial and local economic activity and therefore indirectly affect subnational budgets.

2. 2013/14 New Research Projects

Table 1. Project descriptions

Project title	Description
1. “Experience with Equitable Sharing for Progressive Realisation of Access to Basic Services and Poverty Reduction in South Africa”	In South Africa, the key problem facing public finance practitioners and policy makers in the face of disparities defined by high levels of poverty, inequality and unemployment is how to reconcile the progressive provision of constitutionally mandated basic services (CMBS) against the limits of macroeconomic constraints. The study will review, evaluate and analyse the effectiveness of revenue sharing instruments to address disparities and poverty. The study will examine the possibility of accounting for disparities in budget allocations as required by the Constitution such that poverty and inequality that differentiate sub-regions from each other may be addressed without compromising the macroeconomic balance. Fieldwork for collection of data and information will include interviews and consultations with national and provincial policy-makers and government officials involved with intergovernmental fiscal relations practices.
2. “The Challenge of Mineral Wealth: Using Resource Endowments to Foster Sustainable Development”	South Africa has a long mining history. Before and during colonial times gold mining was a particularly important economic activity. Today the country remains a very significant global provider of minerals. Many new investments have taken place and there are a considerable number of operations at various stages of development. There is no shortage of promising prospecting opportunities, so the availability of suitable ore bodies is unlikely to constrain this recent mining boom. How has the resurge in the mining sector impinged on the economic performance of the country and on the living standards of its people? To answer these and related questions the study examines the performance of the sector with respect to macroeconomic management and economic and social contributions at the national, regional and local level. The study triangulates the local level perspective with the macroeconomic and national effects to identify where the major challenges lie in delivering larger benefits to the South African

population. It highlights various institutional and governance problems, including for example in public financial management. The study hypothesis is that if these challenges could be overcome, larger socio-economic benefits could be delivered, social tensions mitigated, and operational risks reduced.

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3. “The Impact of Government Spending Shocks on Employment in South Africa”

The usefulness of fiscal policy as a short-run stabilisation tool has received increased attention since the recent global economic crisis, particularly with the monetary policies of many countries being constrained by zero bound interest rates and thus having limited scope to stimulate their ailing economies. South African government has been pursuing a countercyclical fiscal policy for some time now, but a question that has not yet been addressed in the literature is whether or not the countercyclical policy has had any tangible effects required to reach favourable macroeconomic outcomes (as those set out in the New Growth Path (NGP) document as well as the National Planning Commission's (NPC) vision for 2030). These outcomes are centred on employment creation, and although all economic players have a role in this goal, it is important to ascertain the role of fiscal policy (and government expenditure, in particular) in the employment-creation process. With the above in mind, this project aims to empirically assess the impact of government spending on private spending, unemployment and employment in South Africa. Specifically, the paper aims to provide answers to these questions: (i) does government spending stimulate or crowd out private activity in South Africa; (ii) does government spending result in a reduction in unemployment in South Africa; and (iii) does government spending result in an increase in employment in South Africa and if so, how is this rise in employment distributed between the public and private sectors. Hence the project takes a closer look at the different channels of the fiscal transmission mechanism in South Africa in order to see whether or not government spending has been able to stimulate economic activity and employment in particular. The methodology employs

	quarterly macroeconomic data in a vector autoregression (VAR) set-up.
4. “Fiscal Policy and Sovereign Risk in South Africa”	Recent increases in sovereign debt downgrades for South Africa have been attributed to a number of factors ranging from poor economic growth prospects to labour unrest to fears that fiscal policy is increasingly becoming unsustainable. To date, the importance of fiscal policy in sovereign risk management has not been investigated in South African context. This project investigates the reaction of interest rates to fiscal policy changes. The project distinguishes between the effects of fiscal policy on the expected short-term future interest rates and the effects of fiscal policy on the risk premium. The principal aim is to see whether or not there are any fiscal circumstances under which the expectations about future short-term interest rates and risk premium react favourably, ceteris paribus. Quarterly data on fiscal variables and interest rates is used in a structural vector autoregression (SVAR) set-up which will enable the proper specification of the underlying relationships between the variables as well as for the identification of the relevant fiscal shocks.
5."Identifying the Funding Constraints in Municipal Capital Investments "	The specific objectives of this research are to (a) explore the current funding needs for municipal economic and social infrastructure, (b) understand the current constraints in the current municipal own revenue instruments that supports the financing of capital expenditure, (c) review the grant framework of local government that supports the financing of municipal infrastructure and (d) identify and propose additional funding streams to support municipal capital expenditures. The study will be based primarily on quantitative analysis in the form of descriptive statistics, financial analysis and possible econometric analysis.
6."The Impact of the Demarcation of Municipal Boundaries on the Fiscal Base and Fiscal Sustainability of Municipalities"	Municipal demarcations should ideally result in viable and sustainable municipalities. As many municipalities lack a sound revenue base to sustain their activities, some rigorous scrutiny is required of the demarcation criteria and the impact of the demarcations on the transfer systems, fiscal sustainability and

	fiscal base of municipalities. The proposed research project will seek to establish the impact of demarcations on the fiscal viability of municipalities; Quantify the impact/cost of demarcations on the intergovernmental transfer system and on the fiscal sustainability of municipalities. The project will be done by FFC and MDB.
7."Household Vulnerability to Climate Change Disasters: An Application of the Household Vulnerability Index (HVI)"	The main aim of this study is to determine which households are vulnerable to disasters (climate change- disasters), food and water security; using the household vulnerability index; so as to provide basis for strategic interventions for targeted beneficiaries. The specific objectives are to use the HVI tool to evaluate the vulnerability of rural households to natural disasters associated with climate change. The gender dimensions of household vulnerability will also be considered.
8."Costing of basic services in the local government sector"	One major weakness that was noted in the new LES formula review process was the absence of an objective and robust costing framework for some of the basic services. The new LES formula is vulnerable to criticism on this. The aim of this project is to provide a robust costing mechanism for basic services.
9."A Review of Regulatory Framework for Tariff Setting in the Local Government"	A review of the tariff setting regulatory framework in the local government sector and among utilities that supply services to the sector, is necessary and urgent. This is done with a view to making tariff setting transparent, cost reflective, cost effective, equitable and ensuring sustainable service provision
10."Understanding the Demand for Housing in South Africa"	This models the demand for housing in South Africa. The study seeks to (a) evaluate the need for shelter in South Africa, (b) understand the housing demand ladder and how it changes over time and housing location issues, (c) assess implications of housing needs for human settlements planning; and (d) recommend how the current funding could be reviewed to respond to housing demand. In order to situate housing need in the subsidy income bands, the study develops a GIS-based concept map of the spatial distribution of subsidy housing demand for South Africa. A survey will be undertaken using a standardized

	questionnaire with a sample of 300 to 600 cases. Such a survey may be done on a national basis, or may concentrate on selected key locations in one or two of the five main national migration corridors which link South Africa's rural source areas to metro urban migration destinations.
11."Perfomance Impact of PES at Lowest Institutional Level of Service Delivery"	This project aims firstly to rejuvenate research interest on PES related issues and secondly to provide an impact and performance analyses of PES on the lowest most grant recipient (i.e. schools, hospitals) using spatially disaggregated information such as Annual National Assessments (ANA), school funding allocations according to norms and standards, hospital budgets etc. The fundamental objective is to isolate districts or regions where poor performance is concentrated with a view that PES is transformed to take into account regional peculiarities, or specific regional interventions be introduced.
12."Implications of Overlapping Intergovernmental Fiscal Transfers within the Social Sectors"	Horizontal and vertical disintegration between levels of government throws the system of fiscal transfers into disarray often resulting in detrimental duplications and inefficiencies. More often these inefficiencies are not accounted for within the various accounting and auditing frameworks since expenditure on duplicate programs by two spheres is not necessarily classified as irregular. This project goes beyond just describing and identifying fragmentations in the fiscal transfers but also establish implications which in most likelihood are not always instant but rather long term in nature.
13."Public Sector Health Care Health Financing: Is it Under-Funded?"	The South African health system is inequitable, with the privileged few having disproportionate access to the health care services. There is need to have a health care that is financed in an equitable and sustainable manner. The National Health Insurance (NHI) proposes health care reforms to address this. It is envisaged NHI would be able to finance and cover the whole population provided there is an overhaul in the health care system through the establishment of the National Health Insurance Fund. The National Health Insurance grant was introduced in 2012, followed by the piloting programme (2012) to test the readiness of the NHI in district and

	central hospitals. This study seeks to answer questions the following questions; is the current financing mechanism of the public health adequate? What are the reasons for non performance of the National Health Insurance grant in the piloting phase? And lastly, what are the alternatives to public sector financing?
14."An evaluation of how budgetary resources for exclusive national functions are distributed amongst regions"	The purpose of this study will be to assess whether exclusive national functions which are regionally deconcentrated have been able to achieve increased provincial redistribution of budgetary resources and access to services. The study in particular will focus on exclusive functions of national government and will be done in phases. In the 2013/14 research cycle, the study will focus on Police Services, Defence and Justice. The study will address the following questions: 1. How is the budget allocated from exclusive national functions to the regions? 2. What is the criteria for the distribution of the budgetary resources to the regions? 3. To what extent is the budget equitably distributed between the regions?
15."The Functional and Fiscal Assessment of Urban Food Security"	The hypothesis of this study is that the intergovernmental institutional and funding arrangements of IFSS fail to address the rising problem of urban food insecurity sustainably: a problem compounded by migratory patterns and an evident drop in the purchasing power of poor urban households since 2008. The study seeks to (a) investigate the extent of food insecurity in South Africa, specifically in urban areas?, (b) assess the effectiveness of the intergovernmental institutional and funding arrangements in addressing urban food security, placing particular focus on the CASP programme and the provincial equitable share, (c) evaluate various long term scenarios of food insecurity in South Africa in terms of their intergovernmental impact and (d) explore the potential of possible intergovernmental fiscal implications of policy interventions as well as the limitations of these interventions to address sustainable food security issues in urban areas in South Africa.