EDWARD OSBORN — IN MY OPINION

SQUARING THE FISCAL CIRCLE

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For all its ingenuity, the Recommendations Report of the Financial & Fiscal Commission is unrealistic in its vertical allocations between national and provincial governments. In focusing exclusively on the percentage share of revenue to the two tiers of government, the commission has overlooked two fundamental factors.

First, the increasing pre-emptive bite of the interest bill into revenues as the Budget deficit ratios are reduced. Second, if the deficit ratios are to be reduced, as is government's avowed intention, the growth of functional expenditures (noninterest expenditures) must be significantly less than the growth of expected revenues. The commission recognises the parameters of the challenge — systematic reduction of the Budget deficit and the limitation of revenue to 25% of GDP — but does not allow for the implications.

A high real interest rate and the public debt liability are at the heart of the problem. In the Budget estimates for 1996-1997, the interest bill alone represents 19,33% of total expenditure. Of this, conceptually, 16,59% will be matched by borrowing equal to the deficit; the remaining 2,74% will be a first charge on revenue.

As the deficit reduces but the interest bill remains high, there will be a greater erosion of revenue from interest costs.

The permissible rate of growth of functional expenditures has to be sufficiently below expected revenue growth to reduce the deficit ratio. Thus, with real revenue growth of 3%, a zero real growth of functional expenditures will ensure the deficit ratio will decline to zero by 2002-2003. A 1% growth of functional expenditures will reduce the deficit to zero by 2004-2005. A slow reduction will occur with a 2% growth in functional expenditures. But there will be none at all with 3% growth.

The market yield on loans is put at 14%. The deficit reductions will be progressively slower with higher market yields.

The graph shows allocations of total expenditures to the target year of 2002-2003 chosen by the commission. Total functional expenditures of government and the allocation to the provinces are increased by 1% a year, for a constant market yield of 15%.

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Though the deficit is declining, there is still no relief on the interest bill from earlier debt. Also growing is the share of total expenditures going to provinces. Thus the share remaining for national government is squeezed, and squeezed beyond the point supposed by the commission.

The commission grandly states that the squeeze on national government will have to be met by reordering priorities. But this will probably be unreasonable. Both national and provincial governments must bear the necessary adjustments.

What is left for functional expenditures of national government, should a growth commitment be made to provinces, will depend on market yields on borrowing and growth limits on noninterest expenditures.

Thus the share of total Budget expenditures left for departments of national government will be forced down from 37,31% to, say, 33,01% by the year-end, should the overall growth of noninterest expenditures be kept at 1%. If the overall growth is 3%, it could be as low as 31,65%.

Any higher rate of growth in provincial allocations will be entirely at the expense of national government. For example, a 4% growth for the provinces, as recommended by the commission, would squeeze the national functional share down to 26,26% from 37,31% initially (assuming 2% overall growth and 15% yield). This denotes severe negative growth for the functions at the national level.

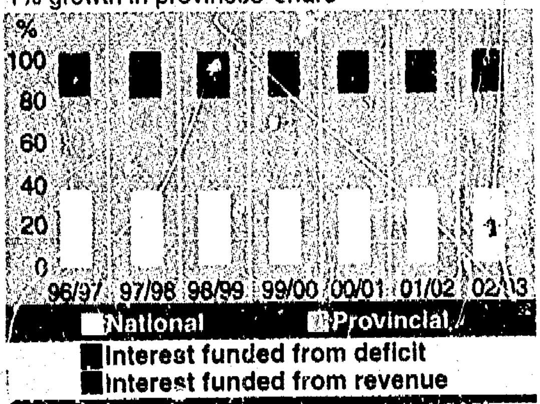
The base year estimates are unrealistically favourable. Economic growth this year has slowed, the bond market has not been as benign as expected and the collapse of the rand has increased currency redemption losses on foreign loans this year. Incidentally, the 1996-1997 Budget provides for 2,07% of total expenditures for such losses, which would effectively reduce national functional allocations to 35,24%.

Finally, given this revised view of vertical allocations, there is no place for the commission's concept of tax room: up to 7% of personal income tax is eventually to be allocated to provinces.

The commission's proposal is advanced to make the provinces more accountable. This is spurious. In any case, the provinces' tax share of personal income tax will be as much a redistribution from the centre, namely the SA Revenue Service, as funding from the Finance Ministry. Whatever tax allocation is made would be taken into account in the Finance Ministry's payout. ■

EXPENDITURE ALLOCATION

15% yield
1% growth in total noninterest expenditure
1% growth in provinces' share



PERCENTAGE SHARE OF TOTAL EXPENDITURE

WITH PROVINCES GROWING AT 2% PER ANNUM AND WITH A MARKET YIELD OF 15%

	96/97	97/98	98/99	99/00	00/01	01/02	02/03
Provinces	43,36	44,23	45,11	46,01	46,93	47,87	48,84
National at ...							
zero growth ..	37,31	35,97	35,01	34,30	33,84	33,67	33,83
1% growth ..	37,31	36,07	35,14	34,36	33,73	33,28	33,01
2% growth ..	37,31	36,17	35,26	34,42	33,64	32,93	32,29
3% growth ..	37,31	36,27	35,39	34,48	33,56	32,61	31.65