Financial and Fiscal Commission Briefing to the Standing and Select Committees on Finance on the 2013 Fiscal Framework and Revenue Proposals

"For an Equitable Sharing of National Revenue."

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List of Acronyms

FFC	Financial and Fiscal Commission
GDP	Gross domestic product
ICS	Improvement of Conditions of Service
MDG	Millennium Development Goals MTBPS
	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDP	National Development Plan
NHI	National Health Insurance
NPOs	Non-profit Organisations
OSD	Occupation Specific Dispensation
PFMA	Public Finance Management Act
SIP	Strategic Integrated Project
VAT	Value Added Tax
WGBI	World Government Bond Index

1. THE CONTEXT: BRIEFING TO PARLIAMENT'S POWERS TO AMEND MONEY BILLS

1.1 A recent achievement by the South African Government has been the development and adoption of a national development plan as the key driver for policy-making The National Development Plan (NDP) served as the starting point for the 2013 National Budget. Its principal objective is to eliminate poverty and reduce inequality by 2030.

1.2 The NDP identifies two clear, time-bound targets for increasing sustainable economic development in South Africa:

(a) To attain a growth rate of gross domestic product (GDP) of 5.4% per annum until 2030

(b) To eliminate poverty defined using the income based measure by 2030

1.3 To achieve increased sustainable economic development, South Africa needs to drive up its performance in relation to two key components: productivity and participation. This growth should also satisfy three desired characteristics – solidarity, cohesion and sustainability. Government has set targets and strategies relating to all these areas in the NDP.

1.4 The motivation for fiscal reforms contained in the 2013 Budget begins to create a fiscal framework which will give the country greater ability to increase sustainable economic development. This Submission presents an assessment on the likelihood of the fiscal framework and revenue proposals contained in the 2013 budget to meet Government objectives. The submission is made in terms of Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009) which requires Parliamentary Committees to consider any recommendations of the Financial and Fiscal Commission (FFC) (hereafter the Commission) when considering Money Bills. It is also made in terms of the FFC Act (1997) as amended which requires the Commission to respond to any requests for recommendations by any organ of state on any financial and fiscal matter.

2. THE 2013 FISCAL FRAMEWORK: MACROECONOMIC OUTLOOK AND SUSTAINABLE ECONOMIC GROWTH

2.1 As noted in the Commission's response to the 2012 Medium Term Budget Policy Statement (MTBPS), the South African economy remains vulnerable to slow global recovery (slowdown in China's economic growth and decreased demand for South African exports by the European Union which is South Africa's largest trading partner) as well as to domestic factors such as the recent labour unrest. Economic growth (in real terms) has decreased from 2.8% in 2010 to 2.5% in 2012. The 2.5% growth recorded for 2012 is disappointing because it is much less than the upwardly revised 3.5% growth rate achieved in 2011. However, the economy still managed to register moderately positive growth for the third year in a row following the 2009 recession. The subdued growth rate perpetuates the trajectory of sub optimal growth. This implies that even though the economy may be performing reasonably and is certainly not collapsing, it is also not performing well enough to make a meaningful dent in the country's high unemployment rate. Furthermore, even though the economy is expected to slowly recover in the medium term, the

economic growth forecasts fall below the 5.4% economic growth cited in the NDP document which is necessary to achieve job-creation and poverty reduction goals of the Government.

2.2 Government tabled a total national budget of R1.2-trillion to be spent between the three spheres for 2013 financial year, growing to R1.3-trillion in 2015/2016. A significant portion of this allocation is spent at national (47.6%) and provincial level (43.5%), while the local government sphere receives 8.9% of this allocation.

2.3 Government believes that the best fiscal structure to achieve this is one that will lead to the creation of a fiscal policy making environment which is best placed to meet the challenges of ensuring:

(a) **Long-term competitiveness** – maximising opportunities to raise productivity, competitiveness and economic growth over the long-term; and

(b) **Responsiveness** – maximising opportunities to respond swiftly and effectively to changes in circumstances.

2.4 A central question relates to the likelihood of the fiscal framework and revenue proposals contained in the 2013 budget to meet these twin objectives. To address this question, the Commission is guided by two key criteria against which the options outlined in the budget are assessed. The two criteria are:

(a) **Enhanced Efficiency** – A fiscal framework that encourages economic efficiency is vital to ensuring that South Africa becomes a richer society and economy. Changes to the fiscal framework should create opportunities for raising efficiency and enhancing South Africa's competitive advantage.

(b) **Sustainability** – Changes to the fiscal framework should show the cost effectiveness of the funding mechanism and at the same time ensure affordability of tax and spending policies both in the short and long-term.

2.5 ENHANCED EFFICIENCY

(a) Public policies have an important role to play in boosting sustainable economic growth. Investments in capital, both physical and human, and research and development are essential drivers of South African productivity, competitiveness and sustainable economic growth.

(b) The establishment of clusters and key sectors is also vital to sustainable economic growth. The Nobel laureate Paul Krugman, in his theory of New Economic Geography[1], has stressed the importance of the growth and development of clusters and key sectors in developing networks, enhancing economies of scale, creating spillovers and ultimately boosting economic growth. Government policy has an important role to play in ensuring that regions and countries are well placed to take advantage of such opportunities.

[1] Krugman P., 1991, "Increasing Returns and Economic Geography", *Journal of Political Economy*, Vol. 99, pp. 483 – 499.

(c) Under the **current framework**, Government has in place most of the key elements of supply-side economic policy, including education, skills and infrastructure, which are believed to be important determinants of competitiveness and long-term economic growth. In addition to education and infrastructure policies, other important economic policy levers with a bearing on economic growth rate include: (a) energy policy, (b) competition policy, (c) trade policy, (d) economic regulation of utilities (e.g. telecommunications, broadcasting and energy), (e) financial services and regulation of financial markets, (f) consumer protection and product and trading standards; and (g) policies affecting the labour market, including employment law and immigration. These are significant responsibilities which have a considerable bearing on the performance and the growth potential of the economy. Decisions in these areas by Government can also have important consequences for fiscal policy, at both a national level and in provinces and municipalities. For example, decisions on labour market policy, and particularly on immigration, can have an important influence on demand for public services and the size of the tax base. The challenge across the board is in the implementation of the policies in order to achieve the relevant objectives and address priorities of government.

(d) Table 1 reports changes to the 2013/14 financial year, comparing MTBPS 2012 and Budget 2013. Welcome developments include significant upward revisions of science and technology by 12.4%. South Africa needs to improve the pipeline for developing infrastructure skills. Despite limited fiscal space, it is noteworthy that annual average growth of health and social protection and employment and social security all show increases. Expenditure in this area, especially for social security, provides an important buffer during cyclical downturns.

Table 1: Expenditure Component Revisions (Functional Classification)

	2013/14 Figures		
R'billions	**2012 MTBPS**	**Budget 2013**	**% Change**
General public services	56.0	56.7	1.3%
Defence, public order and safety and state security	151.7	153.7	1.3%
Transport, energy and communication	91.5	88.6	-3.2%
Economic services	48.1	48.0	-0.3%
Local government, housing and community amenities	132.5	132.1	-0.3%
Health and social protection	267.8	268.5	0.3%
Education and related functions	234.0	232.5	-0.6%
Employment and social security	48.6	49.2	1.2%
Science and technology	14.5	16.3	12.4%

Source: MTBPS (2012); Budget Review (2013); Commission Calculations

(e) The following expenditure areas were revised downwards: economic infrastructure, economic services, local government, housing and community amenities and education and related functions The Commission notes the significant downward revision of economic infrastructure by 3.3%, a spending area that can have substantial economic benefits. Although this is due to factors such as

underspending and reallocation of resources to higher spending areas, this could possibly compromise Government's outcome of raising output and achieving productivity gains.

(f) Overall the Commission supports the main themes in the 2013 Budget on exercising fiscal prudence and actively managing the sustainability of the fiscal framework despite the constrained resource envelope due to worse than expected economic conditions. The Commission is of the view that, given the prevailing economic climate, growth and employment in South Africa can only be achieved through a combination of fiscal consolidation and investment in future growth. In line with the NDP, the Commission supports the proposals to enhance the developmental impact of public spending and fight against corruption. Already a number of policies have been put in place such as the Special Economic Zones, Manufacturing Bonus Scheme and the cushioning of social services. However, while Provincial Governments have significant levers to shape spending programmes, for example, on education and skills, there is a need to enhance their abilities to shape the establishment of clusters and key sectors, levers that are seen as vital to sustainable economic development (a provincial function).

2.6 SUSTAINABILITY

(a) ***Sustainability** – Changes to the fiscal framework should show the cost effectiveness of the funding mechanism and at the same time ensure sustainability of spending levels both in the short and long-term.* There are three critical elements to be considered in relation to sustainability, (i) macroeconomic stability, (ii) budgetary stability; and (iii) affordability. Each of these is discussed in turn.

(b) *Macroeconomic stability:* The ability to respond flexibly to changing economic needs and circumstances is important in determining the ability of a country to stabilise its economy in the short-term as well as protecting long-term sustainability. This is especially important during periods of economic uncertainty. The ability to respond swiftly and decisively to short-term economic pressures and challenges is vital to minimise negative shocks to growth, jobs and investment, and enable a stronger, faster recovery.

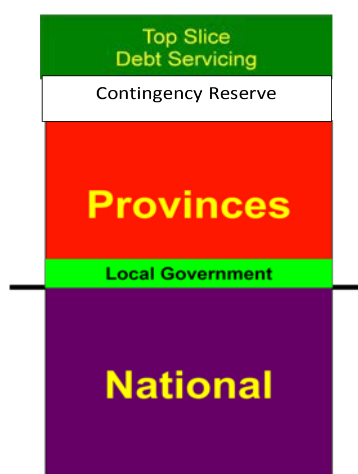
- The origins of the current international economic difficulties lie in the collapse of the market for US sub-prime mortgage debt from mid-2007. On the foot of this, the outlook for the global economy – and for South Africa's main export markets in particular – deteriorated at a very rapid pace. Consequently South Africa experienced its first recession in 19 years in 2009. In line with the Commission's recommendations then, the Government made a commitment to cushion the poor by maintaining the social safety net.

- The worsening in the economic environment has had significant negative consequences for the public finances. General Government deficit of -5.2% of GDP is expected for 2013. This represents deterioration from the small surplus recorded in years up to 2007. While increases in global crisis-related spending have had a

negative impact, the large deficits this year and the last are mainly the results of sluggish performance of tax revenues. Fluctuations in the economic cycle can have a significant impact on the fiscal position in any given period. In principle, the structural budget balance – the headline figure adjusted for the impact of the economic cycle – provides a more meaningful benchmark for assessing fiscal developments. In practice, however, there are considerable uncertainties attached to estimates of the structural position, especially in a South African context. Notwithstanding these uncertainties, evidence suggests that Government is committed to countercyclical fiscal policy and the fiscal guidelines, with plans to reprioritise the budget while also maintaining the social net. It is now also generally accepted that without prudent fiscal and macroeconomic policies, the effects of the 2008/09 crisis on the South African economy could have been a lot worse. Hence, Government must be commended for its role in this respect and encouraged to continue the good work.

(c) *Budgetary Stability:* Through the Equitable Share Formulae, Conditional Grants and the setting of three-year spending plans, the **current framework** provides predictability for the decentralised budget. The total appropriated expenditure for a given financial year comprises all government revenues, including revenues generated from taxation and debt incurred. This revenue supports all government expenditure and ultimately informs the division of revenue among the three spheres of government. However, prior to the division of revenue process, funds are "top sliced" from total government revenues to pay for the costs of government debt and to support a contingency reserve (see Figure 1). The contingency reserve aims to protect the country in instances of unforeseen or unavoidable expenditures or to support Government policy decisions that may arise during the financial year. Once these two expenditure items are accounted for, the remaining funds are available for the division of revenue process.

Figure 1: Vertical division of revenue



Source: Commission.

- Deteriorating external economic conditions, exacerbated by internal strife in the labour markets, resulted in a downward revision of core spending by R10.4-billion over the MTEF. Table 2 compares the MTEF estimates in the 2013 Budget with estimates in the 2012 MTBPS. The fiscal framework for the whole of government is revised upwards by R27 billion over the MTEF. In the 2012 MTBPS average annual real growth in total MTEF allocations was projected to be 2.44%. Growth in the total MTEF allocation is slower in Budget 2013 (2.20%). Government is expected to spend R3.07 trillion over the 2013 MTEF period, with the national sphere making up 47% of total allocations followed by provincial government at 44%. Local allocations remain the lowest, at R277.7 billion, but are expected to grow faster than the other spheres, by 4.3% in real terms per annum over the MTEF period.

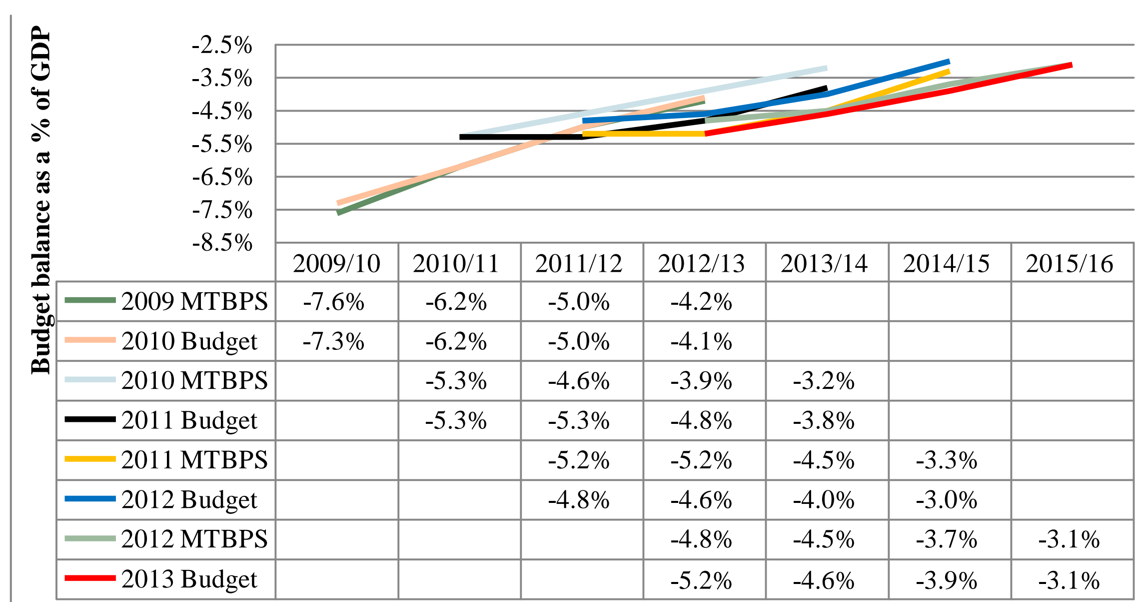
Table 2: Medium Term Expenditure Framework Division of Revenue

Division of Revenue	**Total 2013/14-2015/16 (R'billions)**		**Real Average Annual Growth Rate**	
	2013 Budget	**2012 MTBPS**	**2013 Budget**	**2012 MTBPS**
National Allocations	1 463.7	1 438.4	2.30%	2.49%
Provincial Allocations	1 330.3	1 343.3	1.90%	1.90%
Equitable Share	1 081.2	1 071.4	1.50%	1.63%
Conditional Grants	249.1	272.0	3.60%	2.99%
Local Allocations	277.7	276.8	4.30%	4.99%
TOTAL	3 071.7	3 058.5	2.20%	2.44%

Source: 2012 MTBPS, 2013 Budget, Commission's calculations.

- Against the backdrop of slower than anticipated economic growth, a subsequent decline in revenue collection and a widening of the deficit, budget stability that characterised South African budgetary stability should no longer be taken for granted. To illustrate this point, prevailing economic conditions have meant that Government's approach to moderated expenditure thus far has not seen a significant improvement in the budget balance. Figure 2 shows the results of a comparison of the budget deficit forecasts from 2010, 2011, 2012 and 2013 MTBPS reports and budgets.
- Compared to the 2010 Budget (light orange line) which indicated a fast pace to closing the budget deficit, Budgets 2011 (black line) and 2012 (blue line) indicated gradual declines in the first year of the MTEF followed by a more aggressive approach in the outer years of the medium term. Budget 2013 (dark orange line), indicates a reversal of the 2011 and 2012 trends. From an aggressive approach in the first two years of the MTEF, we see a slow down by year 3. In its response to the 2012 MTBPS, the Commission noted that the slowing down of fiscal consolidation since 2009 meant that South Africa would be unlikely to achieve -3% budget balance as a percentage of GDP over the medium term. Whether the planned moderation of growth in government expenditure as outlined in Budget 2013 will counteract the lower than expected revenue collection to result in the medium-term budget balance breaching the 3% to GDP level by 2015/16 remains to be seen.

Figure 2: Medium-Term Budget Deficit Projections



	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
2009 MTBPS	-7.6%	-6.2%	-5.0%	-4.2%			
2010 Budget	-7.3%	-6.2%	-5.0%	-4.1%			
2010 MTBPS		-5.3%	-4.6%	-3.9%	-3.2%		
2011 Budget		-5.3%	-5.3%	-4.8%	-3.8%		
2011 MTBPS			-5.2%	-5.2%	-4.5%	-3.3%	
2012 Budget			-4.8%	-4.6%	-4.0%	-3.0%	
2012 MTBPS				-4.8%	-4.5%	-3.7%	-3.1%
2013 Budget				-5.2%	-4.6%	-3.9%	-3.1%

Source: MTBPS (2009, 2010, 2011, 2012); Budget Review (2010, 2011, 2012, 2013).

- A critical pillar of the NDP is development of a society with zero tolerance for corruption. Corruption can prevent the equitable allocation of goods and services amongst spheres of government and eventually citizens. In 2012 Budget, a number of measures were put in place to improve financial management and to root out

corruption in the public sector - these included cooperation with other bodies that deal with corruption, supply-chain management measures, capacity building programme for public sector financial management, strengthening of existing controls and increased allocations to the Office of Public Protector. Ensuring that moderated expenditure does not negatively affect service delivery will be crucial. Also, there are a number of bodies that deal with corruption in South Africa and their effectiveness in the fight against corruption can be increased greatly not only through cooperation and through increased resources that are available to them, but also by holding those guilty of corruption accountable by following through with the punishment prescribed by the laws against corruption (Municipal Finance Management Act, Public Finance Management Act (PFMA), Protected Disclosures Act, Public Service Act, Prevention and Combating of Corrupt Activities Act, etc.). The Commission is working on some of these issues in collaboration with the Public Service Commission. The two Commissions are due to conclude a Memorandum of Understanding in April 2013 that will be used to steer this work

- In the interest of budgetary stability, the Commission believes that South Africa should continue on the path of gradual fiscal consolidation. Decelerating global economic growth presents substantial uncertainties and downside risks to the South African economy. This further indicates the need to rebuild fiscal buffers, which helped to moderate the effects of the 2008/09 recession and provided Government with the necessary fiscal space to act in a countercyclical manner. The Commission also notes that the demands on the South African budget are already significant (for example, spending on the public sector wage bill and on the social wage) and in some instances are unpredictable (for example, financial support to state-owned enterprises). Therefore, achieving a growth-friendly fiscal consolidation will involve some difficult choices in the future. As noted in the Commission's past recommendations, a successful fiscal consolidation requires deciding which components of the budget need to be consolidated and the pace at which to achieve fiscal consolidation.

(d) *Affordability:* Although South Africa has put in substantial effort aimed towards reducing poverty and inequality since 1994, there are many studies that show that inequality has risen while poverty has fallen marginally since 2000. Disappointment with upward trends in inequality amidst positive economic growth, heightened especially by the 2009 global financial crisis have all led to renewed interest in the relationship between macro (growth) and micro (poverty and distribution) issues. Increasingly Government economic programs and policies are, with stronger emphasis than before, aiming at the dual objective of accelerating growth and fighting poverty and unequal access to opportunities. Ambitious social reforms are being proposed to tackle poverty, growth and inequality problems. Big ticket project items are in **Job Creation** (including Manufacturing Competitiveness Enhancement Programme, the Jobs Fund, a Youth Subsidy, the Community Works and Expanded Public Works Programmes and the investment infrastructure programme

(including Strategic Integrated Projects (SIPs)), **Education** (increase in funding to cover wage settlement costs but also to improve the delivery of school infrastructure and quality of education for learners from poor backgrounds), Health (health infrastructure and hospital revitalisation, National Health Insurance (NHI) and nursing colleges and schools) and Social development (strengthen selected child welfare programmes, improve the South African Social Security Agency's infrastructure and systems, employ additional social workers and funding non-profit organisations (NPOs)). The NHI promises to be the largest reform undertaken in the health sector since the end of apartheid. The Commission is still waiting for details on the financing model that government is working on.

- Any re-designed fiscal framework needs to be affordable. The relative fiscal strength of a country raises important considerations as to the best design of policy making and fiscal framework. On the one hand, increases in government expenditure can benefit the economy by affecting the level of income and its distribution. This can influence people's wages and returns to capital thereby affecting saving and investment, thus potentially boosting economic growth. However, increased spending, ceteris paribus, will translate into a greater debt, which might not be sustainable in the long run. Indeed, if the government increases its spending, it might need to either reduce them in the future or increase taxes in order to get back to its original debt-to-GDP ratio. Long-term economic development cannot be achieved on a sustainable basis without taking this into account.

- The Commission fully endorses Government's ongoing efforts in developing a long-term fiscal report that assesses the sustainability of spending options in light of demographic and economic projections[2]. Analysis of trends over the next 15-25 years shows that current fiscal policy mix is sustainable, though vulnerable to shrinking fiscal space. Resource pressures on basic education sector and social grants on the fiscus are expected to decline over the next decade. These insights are corroborated by recent simulations by the Commission that focussed on the intertemporal impact of increased current and investment spending[3]. Results show that an expansive fiscal policy would have short run positive impact on GDP but would translate into a greater debt to GDP ratio. Financing increased spending through taxation, direct or indirect, would mitigate this impact but would also have negative short run impact on macroeconomic variables. Increased investment spending would improve long run GDP, under any financing scheme, and would decrease debt-to-GDP ratio as well as deficit-to-GDP ratio. These conclusions are driven by the positive impact infrastructure has on total factor productivity. Without this feature, increased public investment would have almost no impact on the South African economy.

[2] It should be noted that the Government has already published some fiscal guidelines (countercyclicality, debt sustainability and intergenerational equity) as well as agreed with the Commission that, given the uncertainty of economic projections, a low, medium and a high-economic growth scenario should be reported.

[3] This is based on work reported in Mabugu, R., Robichaud, V., Maisonnave, H., and Chitiga, M., (2013) "Impact of Fiscal Policy in an Intertemporal CGE Model for South Africa", *Economic Modelling*, **31**: 775-782, Elsevier B.V. Publishers.

- It is important to point out that in these exercises, macro policies are calibrated to accelerate growth, enhance human development, reduce poverty, inequality and stabilize the economy using the state of the art technologies. Despite this sophistication, we still do not know many things. Importantly, much of the macroeconomic policy calibration and analysis assumes that policies are gender neutral – they are actually gender blind. Apart from the basic principle of promoting equality among citizens, gender equality can benefit the economy through efficiency gains. From the *efficiency* consideration, what is important is the social rate of return of investment in women, and in cases, this can be greater than the corresponding rate for men. Another way to look at the issue is through the "Capability Approach". Capabilities earn freedoms. They can also enhance productivity and maximize outputs. In order to show that much more work needs to be done and information needs to be gathered. Ritualistic preparation of gender Budgets will not service the purpose. Much more research has to go into the area of unravelling gender dimension in various macro policies, incidence of tax and benefits; and simply collecting the required volume of information. The effort should begin at the local level.

3. Sovereign Debt Downgrades and Public Debt

3.1 The current economic deficit represents the single biggest strategic risk facing South Africa. This followed a period of sustained economic growth which provided for a more ambitious and expansive fiscal policy not seen for many years. This fiscal downturn means that a prolonged period of consolidation in public expenditure will lead to difficult choices. In trying to balance the competing needs of fiscal sustainability and promoting growth, Budget 2013 has not drastically changed the composition of spending relative to the 2012 MTBPS. Within the confines of lower growth in expenditure, government has reprioritised resources so as to ensure that growth friendly expenditure despite being somewhat lower[4], is maintained. Moderate increases are planned with respect to the public sector wage bill (growth is projected at a real annual average rate of 1.3%). Given the widening of the deficit, there is a reversal of the 2012 MTEF trend of moderate decreases in state debt costs. This item becomes the fastest growing expenditure component over the 2013 MTEF period. There are two critical challenges that arise from this in relation to sustainability, (i) sovereign debt downgrades; and (iii) public debt stabilization. Each of these is discussed in turn.

3.2 Sovereign Debt Downgrades

(a) South Africa's sovereign debt was once again down-graded by Moody's rating agency[5], including debt issued by five metropolitan municipalities as well as Eskom[6]. Sovereign downgrades raise borrowing costs and debt service costs for governments and are also used as an indication of

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4 Investment in infrastructure declines from R844.5 billion over the 2012 MTEF to R827.1 billion over the 2013 MTEF

5 Moody's Investor Services and Standard and Poor downgraded South Africa's sovereign credit rating in 2012. Fitch followed suite in 2013.

6 Given that South African government guarantees Eskom's debt, sovereign downgrading feeds directly into Eskom's rating. This implies higher costs of financing future expansion projects, which may be financed through higher electricity costs. This is also true in the case of the five metropolitan areas, with Moody's also citing large infrastructure requirements as a reason for the downgrades.

investors' confidence in the ability of governments to repay their debt. The reasons used to justify the recent downgrade ranged from increased levels of indebtedness by South African government to socioeconomic- and political factors (such as labour unrest, sluggish economic growth, lack of competitiveness, high labour costs and political instability). The Commission has noted in its 2012 response to the Fiscal Framework and Revenue Proposals that it does not necessarily agree that sovereign debt downgrades are warranted for South Africa. The Commission believes that there are some key factors that the rating agencies are not assigning enough weight to these, including South Africa's sovereign debt still being in a healthy position, with very little exposure to foreign debt and with average maturity of debt being quite high. Furthermore, the South African government has made a commitment to countercyclical fiscal policy and fiscal guidelines, with plans to reprioritise the budget while also maintaining the social net. There are no indications that government could abandon this fiscal policy stance, and therefore uncertainty is not a medium term policy issue in South Africa. It is now also generally accepted that without prudent fiscal and macroeconomic policies, the effects of the 2008/09 crisis on South African economy could have been a lot worse. Hence, the role of fiscal policy cannot be underestimated when considering sovereign debt issues. However, keeping that being said, greater strides on the issues of composition of expenditure (i.e. investment in infrastructure), eradication of wasteful expenditure and public sector wage bill can greatly increase the credibility of South African fiscal policy, which will bode well for future outlook on sovereign debt. Government therefore needs support from all sectors.

(b) The impact on the economy and how the fiscal policy stance outlined in the 2013 budget is likely to affect future decisions on riskiness of South Africa's sovereign debt. South Africa's placement on a negative outlook by the rating agencies could discourage investors because they anticipate future downgrades. However, a positive development in this regard is that South Africa has joined the Citigroup's World Government Bond Index (WGBI) which is likely to boost investment flows and reduce borrowing costs for South Africa. This, together with continued prudent fiscal policy actions, warrants for a more positive outlook for South African sovereign debt.

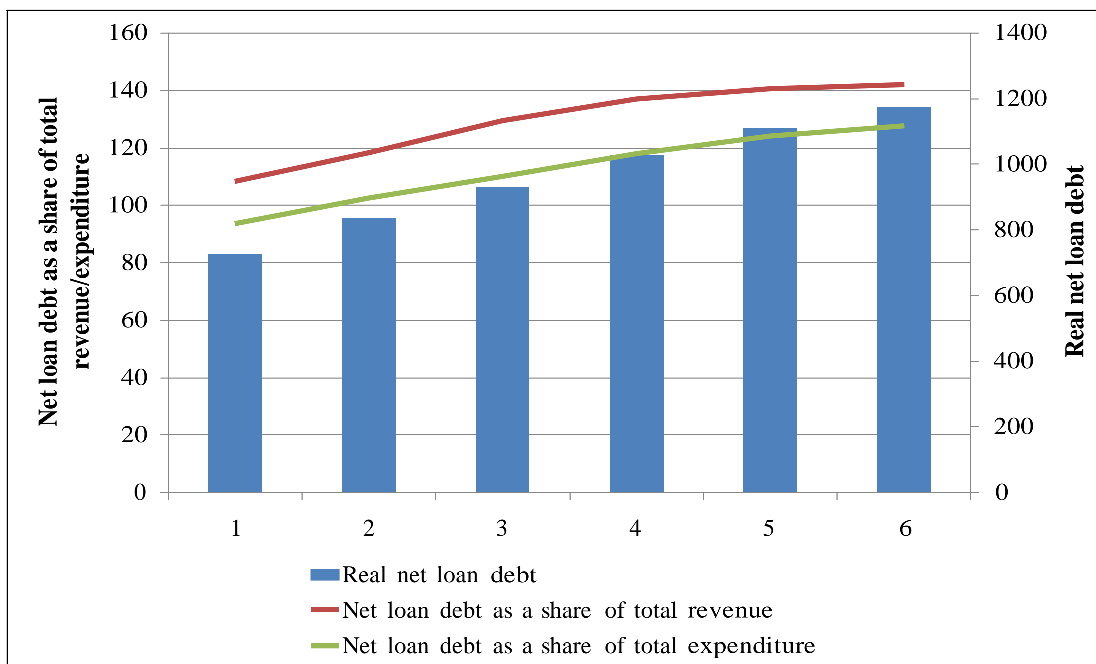
(c) It should also be noted that the reputation of rating agencies has been questioned ever since the 2008 crisis. Many believe that the ratings agencies had a very serious role in the crisis due to their overly optimistic ratings prior to 2008 which were quickly downgraded with the advent of the crisis, thus exacerbating the severity of the crisis. Furthermore, there are conflict of interest issues with the rating agencies charging fees to firms and governments whose debt they rate, thus possibly awarding good grades to debt even in there are reasons to doubt the safety of that debt. More recently, the US government is suing Standard & Poor's for an unwarranted debt downgrade, while Moody's and Fitch rating agencies have been excluded from this lawsuit (because they did not downgrade US debt). This illustrates the current scepticism that surrounds rating agencies, with calls to regulate these agencies by tightening accountability mechanisms, as well as monitoring their performance and accuracy of ratings. It must be accepted though that in lending to South Africa, investors will have regard to the state of our economy and public

finances as well as the structural issues surrounding the country's labour markets. Consequently, for so long as South Africa relies on debt markets for funding, South Africa must be alert to the needs of those investors. Greater strides on the issues of composition of expenditure (i.e. investment in infrastructure), eradication of wasteful expenditure and public sector wage bill can greatly increase the credibility of South African fiscal policy, which will bode well for future outlook on sovereign debt and the economy.

3.3 PUBLIC DEBT

(a) State debt increases over the medium term (absolute terms, percentage of total expenditure, and percentage of total revenue) (see Figure 3). Increasing state debt burden (state debt as percentage of total revenue) implies that expenditure increases are being financed by debt.

Figure 3: State debt: share of total expenditure and revenue

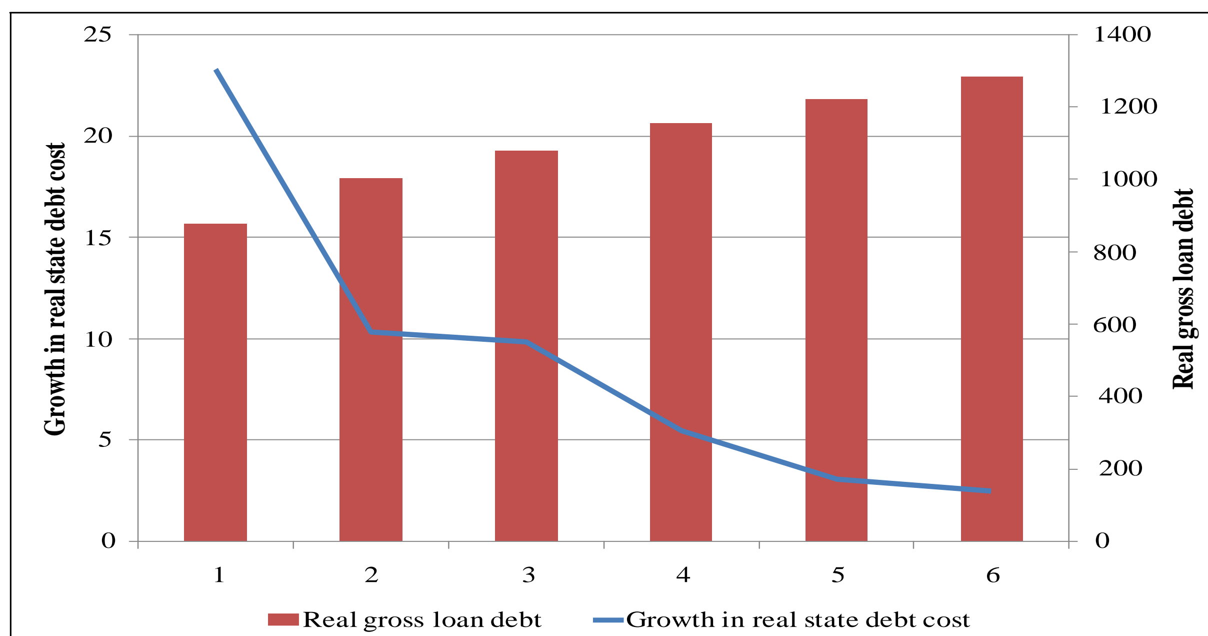


Source: Commission’s calculations.

(b) As Figure 4 shows, the real gross loan debt is increasing while real state debt costs are decreasing, reflecting Government’s debt restructuring efforts through the switch programme[7] that was announced during the 2012 Budget.

[7] Switch programme entails the exchange of near-maturing bonds for longer dated debt in order for the Government to manage redemptions.

Figure 4: Gross loan debt and growth in real state debt cost



Source: Commission's calculations.

(c) The Commission noted in its response to the 2012 MTBPS that while the switch programme reduces the current debt burden and limits the consolidation measures that are imposed on South African citizens (which is necessary in order for government to have the necessary resources to stimulate the economy and maintain the social net), sluggish economic growth may put pressure on Government to extend its switching programme. Refinancing near-dated debt with longer term maturity bonds is likely to put pressure on bond yields as investors will likely seek to be compensated for increased risks associated with deteriorating economic conditions and a wide budget deficit. Hence, although South African bonds are currently still over-subscribed, extending the duration of public debt combined with higher yields could result in increased costs for Government in the future. This is further exacerbated by the recent downgrading of South Africa's sovereign credit rating which may also negatively affect the longer term prospects of debt sustainability in South Africa as it is likely to result in higher costs of borrowing due to negative investor perception.

4. Revenue Estimates and Tax Proposals

4.1 Tax Estimates

(a) Total tax revenue estimates for 2012/13 is R16.3 billion lower than the 2012 Budget estimates and R11.3 billion lower than the 2012 MTBPS estimate. The primary reason for these revised downward estimates is the weaker than expected economic growth. The only tax instruments that are revised upward are VAT, secondary tax on companies, excise duties and taxes on international trade and transactions. The impact of lower economic activity is evident on the core direct taxes of government although most taxes increase in absolute terms in 2012/13 from the 2011/12 outcome,

with revised total tax revenues 9.1% higher than the 2011/12 outcome. Table 3 compares the 2011/12 Budget outcomes with the revised 2012 MTBPS and 2013 Budget 2012/13 estimates for selected taxes. Deteriorating economic activity from 2012 to 2013 results in constant downward revisions to major tax revenue instruments and total tax revenues. However, most tax sources increase from 2011/12 outcomes.

Table 3: Revenue Source Revisions and Growth

R'million	**2011/12 Estimate**	**2012 MTBPS Estimate**	**2013 Budget Revised Estimate**	**% Change 2011/12 to 2013 Revised Budget Estimate**	**% Change 2012 MTBPS to 2013 Revised Budget Estimate**
Persons and Individuals	250 400	282 000	274 020	9%	-3%
Companies	151 627	166 100	156 350	3%	-6%
Value-added Tax	191 020	212 000	217 000	14%	2%
Secondary Tax on Companies/Dividend	21 965	18 800	21 000	-4%	12%
Specific Excise Duties	25 411	28 500	28 360	12%	0%
Fuel Levy	36 602	41 000	40 500	11%	-1%
Customs Duties	34 198	38 000	37 640	10%	-1%

Source: MTBPS (2012); Budget Review (2013); Commission Calculations.

(b) In achieving its goal of fiscal consolidation, government should be commended in striving for fiscal consolidation through the expenditure side and not by raising taxes on the revenue side. Given the current depressed economic conditions, it is important that contractionary fiscal policy in the form of tax increases is not adopted as these would not support growth, particularly in the short term. However, the continued buoyancy of tax revenues at current tax rates remain a concern if economic growth remain at lower than expected levels. Hence the call for a major tax reform during the course of the year by Government is welcome.

4.2 PROPOSED TAX STRUCTURE

(a) The 2013 Budget proposes income tax relief to individuals to the amount of R7 billion. This also includes increases to the medical tax credits. Income tax relief, particularly to low income earners, should be commended given the tight fiscal environment.

(b) Relief is also offered to small business and social-impact businesses by increasing the turnover threshold from R14 million to R20 million. The Commission supports such initiatives to promote the establishments of small and socially oriented businesses as a way of supporting greater economic growth and indirect social assistance to communities.

(c) Tax breaks to small business supports Government's efforts to promote employment. The Commission also notes Government's efforts to support youth employment through employment tax incentives.

(d) In terms of indirect taxes, Government is proposing a comprehensive Carbon tax to mitigate the impacts of climate change and encourage low pollution and energy efficient behavioural change to come into effect in 2015/16. The consideration of phasing-out the electricity levy is also a welcomed development given the general price inelasticity of electricity demand in South Africa. The intent of reducing carbon emissions and promoting the use of renewable energy sources could be better achieved through a comprehensive Carbon tax system. It will be important for the revenues from this source to be ring fenced and earmarked for a worthy cause such as youth unemployment or poverty reduction.

(e) The General Fuel Levy increases by 22.5 cents per litre. A portion (approximately 23%) of the General Fuel Levy is shared with metropolitan municipalities. The current state of this sharing arrangement is of huge concern to the Commission in terms of its implementation and sustainability. The allocation mechanism and agreed to principles underpinning the distribution of this portion of the General Fuel Levy to metros are changing every year based on metros effectively "negotiating" to protect their allocations. Whereas in 2009 it was agreed that fuel sales will be the basis for allocations and such allocations will be accepted (be it increasing or decreasing), these principles have largely been abandoned subsequently. In addition, given weaker economic activity, revenue from the General Fuel Levy is not expected to be as buoyant as before. Therefore, the Commission recommends a review of this revenue sharing arrangement.

(f) The Commission welcomes Government's efforts to broaden the tax base of VAT. This includes the proposal of having suppliers of digital products to register as VAT vendors and reviewing VAT implication for financial services. As this tax is a regressive tax, increasing the VAT rate in the current environment would not support the principles of equity and protecting the poor within the tax structure. Consequently, increasing the tax base of this tax instrument can ensure increased revenues without direct negative impacts on equity. These developments are in line with current Commission research exploring methods to increase the tax base to support fiscal consolidation.

5. How Can South Africa's Fiscal Framework be Improved?

5.1 Long-term Fiscal Reporting

(a) In 2010 and 2011, the Commission proposed the following:

i. A "multi-pronged" strategy to take long-term fiscal concerns into account in the short- to medium-term planning. The tenets of this include a budget process and framework that recognises more clearly the long-term fiscal risks and builds on existing work, strengthened analytic approaches and a blend of aggregate fiscal rules.

ii. The political economy challenge of dealing with long-term fiscal policy issues requires provocation of public debate on long-term fiscal challenges – implied intergenerational tradeoffs, degree of risk aversion, etc.

iii. Pertaining to fairness, Government should be required to publish analysis of the distributional impact of new policies. Requiring such analysis as a rule on all new policy would be welcome, as would a requirement to publish assessments of the inter-generational or long-term impact of policies whose effects vary over time and/or generations.

(b) The Commission fully endorses Government's ongoing efforts in developing a long-term fiscal report that assesses the sustainability of spending options in light of demographic and economic projections and looks forward to publication of the report during the course of the year. The Commission recommends that Government further enhance long term reporting by including a gender dimension. Much more work needs to be done and information needs to be gathered in that respect.

5.2 TOWARDS CONSOLIDATED FISCAL REPORTING

(a) The national fiscal framework has evolved over time to capture various components of national and to larger extent of provincial government. While local government is also an important pillar of this framework a significant proportion of its contribution to public expenditure, particularly on infrastructure, from own revenue is absent in the national fiscal framework.

(b) For completeness future fiscal framework should attempt to integrate consolidated local government budget

5.3 NDP AND BUDGET PROCESS INTEGRATION

(a) Government has made commendable efforts to integrate the NDP and the 2013 Budget process. The Commission seeks to contribute to on-going efforts towards the implementation of this integration.

(b) Within the context of this Submission, an important imperative is that South Africa already has multiple planning functions, instruments and procedures that it has developed which are well integrated with the current budget process. These planning functions, instruments and other processes of policy analysis and review that are integrated with MTEF, program budgets, and performance evaluations. The MTEF already has significant practical influence on resource allocation. There is therefore a strong case for refocusing and streamlining the new NDP planning process on the evaluation of high-level strategic issues, with a medium- to long-term time horizon, and monitoring progress in achieving the NDP and other priorities such as the millennium development goals (MDGs). At the same time, the MTEF could be further enhanced as the core instrument of medium-term policy-making while the NDP becomes the core instrument referred

to in setting priorities for economic development and resource allocation across all the spheres of Government.

(c) It is important that an effective mechanism for coordinating the budget process and the annual, medium term and long term planning processes across spheres of governments and sectors continue to be developed. The MTEF can create a useful bridge between planning and budgeting, but it needs to evolve from simple macro-fiscal framework into comprehensive processes that, in effect, are driven and give effect to the NDP. The flexibility of the MTEF makes it potentially most effective than traditional sectoral plans in giving effect to this.

5.4 TAX REFORM (AND DEBT REFORM)

(a) Government should be commended in striving for fiscal consolidation through the expenditure side and not by raising taxes on the revenue side. Given the current depressed economic conditions, it is important that contractionary fiscal policy in the form of tax increases is not adopted as these would not support growth in a recessionary environment, particularly in the short term. However, the continued buoyancy of tax revenues at current tax rates remains a concern if economic growth remains at lower than expected levels.

(b) The Commission notes and welcomes the announcement by Government of its intention to evaluate the current tax system in terms of its ability to support economic growth and long term policy objectives later in the year. This measured approach is especially admirable given the pressing macroeconomic conditions and revenue shortfalls that would have made tax hikes an obvious choice.

(c) The Commission will engage in this process in line with the Commission's mandate. At this stage the Commission recommends that Government widen the evaluation to also include other important non tax revenue sources particularly ascertaining the optimal level of national debt to enhance further our fiscal frameworks.

6. CONCLUSION

6.1 This Submission has explored the options for reform and reviewed them against a number of key criteria to see how effective each option would be in achieving the aim of increasing sustainable economic growth and enable South Africa as a whole to realise its full potential as outlined in the National Development Plan. It has outlined the case for improving the current fiscal arrangements and the options for reform. It has made recommendations/suggestions on how South Africa can craft the fiscal framework and revenue proposals to ensure they can enhance the country's long-term competitiveness and ability to respond swiftly and decisively to short-term economic pressures.

6.2 The Commission is of the view that:

(a) A credible commitment to fiscal consolidation (within the framework of fiscal guidelines) is necessary to ease the frequency of sovereign debt downgrades as Government demonstrates its ability to control spending pressures.

(b) Government's plans to intensify efforts to carry out expenditure reviews aimed at increasing efficiency of spending and combating waste should be supported. In particular, in-house reviews should be complemented by independent expenditure reviews.

(c) Government's plans in 2013 Budget to intensify efforts to combat waste, inefficiency and corruption particularly the move to establish a Chief Procurement Office in the National Treasury and the alignment of the PFMA with the Public Service Act should be supported.

(d) Plans to evaluate the tax system later in the year should be supported. The evaluation should not just be confined to the issues of tax reform but should also include wider evaluation of all potential sources of Government finance including the optimal level of debt and borrowing policies with a view to putting forward borrowing policies that can enhance South Africa's long-term competitiveness and ability to respond swiftly and decisively to short-term economic pressures.

(e) For completeness, the Government's long term fiscal report should attempt to integrate consolidated gender analysis. There is a growing awareness that *gender inequality is inefficient* to development. Empirical literature draws attention to these efficiency dimensions of integrating gender perspective into macroeconomic policies.

For and on behalf of the Financial and Fiscal Commission

Mr. Bongani Khumalo
Acting Chairperson/CEO
5 March 2013