CHAPTER 2: FISCAL RULES FOR SOUTH AFRICA

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2.1 Introduction

Over the last few years, internationally, public finance has been characterised by rising deficits and public debt. In a bid to achieve the goal of sustainable public finances (as well as to reduce debt to sustainable levels), many countries have adopted some form of fiscal rule (or a combination of fiscal rules). 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 rules can provide a useful framework for fiscal policy and can ultimately contribute to macroeconomic stability and economic growth. Furthermore, to enhance their effectiveness, the rules need to be well-designed at both national and sub-national level, which has implications for the intergovernmental fiscal relations (IGFR). For South Africa (as well as for many other countries emerging from the crisis), the question becomes whether or not the government has been fiscally prudent (and pursued stable public finances). And if the answer is in the negative, what type of fiscal rules should be followed to entrench the current efforts of fiscal consolidation. Also important is the question of whether or not the South African government is expected to have stable and sustainable public finances.[11] In order to achieve the goals of fiscal sustainability and stability, the government should pursue two broad strategies:

- Fiscal discipline based on fiscal frameworks that are focused on credible and transparent strategies (i.e. the focus is on proper/effective fiscal institutions);[12] and
- The adoption of a fiscal rule to entrench fiscal prudence.

As in the case with most other countries, South Africa needs to take account of potential long-term structural development and risks. Many of these risks have fiscal dimensions, and so the fundamental uncertainties need to be dealt with. Dealing with long-term issues requires a multi-pronged approach that involves strong policy analysis, budget process reform, sustained fiscal consolidation and sectoral policy reforms. This chapter assesses the need for stronger national fiscal frameworks and independent fiscal institutions as a way of strengthening South African fiscal rules.

2.2 What Are Fiscal Rules?

Fiscal rules are defined as permanent constraints on fiscal policy through simple numerical limits on budgetary aggregates (IMF, 2009). In order for fiscal rules to guide fiscal policy, a fiscal indicator (instrument) is needed to create a rule that is relatively simple and which can be easily monitored and communicated to the public. Fiscal rules are generally adopted with the aim of achieving fiscal (debt) sustainability, yet these rules can have different roles, such as stabilising the economy and limiting (expanding) government size.[13] The different rules can be summarised as (IMF, 2009):

- Budget balance rules, which can be based on the overall balance, structural balance or cyclically adjusted balance (CAB).[14]
- Debt rules, which generally target a certain level of debt-to-GDP ratio and are most effective in achieving the goal of debt convergence.

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9 Financial and Fiscal Commission.

10 Financial and Fiscal Commission.

11 It is reported that the US public debt-to-GDP is expected to double by 2018, whereas UK is facing many years of budget deficits and a rising debt burden.

12 Countries like Australia, New Zealand and Canada all reduced their debt-to-GDP ratios without strictly enforced fiscal rules. Generally, countries are more likely to reduce their debt burdens during times of strong economic growth (e.g. Spain and UK).

13 Fiscal rules also need to be growth oriented.

14 It should be noted that the CAB is most linked to the debt sustainability goal (IMF, 2009).

- Expenditure rules, which, for example, permanently limit total, primary or current spending (i.e. spending of the ordinary state budget plus spending of the public investment budget) in relation to GDP.

- Revenue rules, which aim to boost revenue and/or prevent tax burden (by, for example, restricting the debt-to-GDP ratio).

In addition, a distinction must be made between hard rules and broader rules (Emmerson *et al*., 2004). Hard rules can result in an accumulation of tax reserves as safety margins, which can reduce welfare. Broader rules, on the other hand, specify a central target with an acceptable range. A summary of the trade-offs involved with fiscal rules is provided by Kilpatrick (2001):

- Transparency vs. rigidity: the higher the transparency, the less the need for a rigid rule. The assumption here is that, if fiscal authorities behave in a transparent, credible manner, a fiscal rule can allow for some cyclical variation in spending and some flexibility in the budget planning process.

- Rigidity vs. tax/revenue smoothing: the more rigid the rule, the less the government can smooth tax/revenue. A rigid rule implies a lower possibility that fiscal policy can adapt to changing economic conditions.

Box 2.1 A Brief Background to Fiscal Policy in South Africa

Since the Franzen (1969), Margo (1986) and Katz (1995) Commissions, South Africa's fiscal and finance policies have become more transparent and efficient. Over the last two decades, various tax reforms and expenditure decisions have improved the effectiveness of fiscal policy. In addition, the income tax system has become more progressive in an attempt to reduce income inequality.

Public spending has focused on education and health, which are necessary driving forces behind economic growth. With a greater focus on countercyclical fiscal policy, the government was able to reduce debt levels from around 50% of GDP in the 1990s to around 20% of GDP just prior to the 2008 financial crisis. South Africa also recorded budget surpluses, which helped minimise the impact of the financial crisis on the domestic economy. In addition, most of South Africa's debt is denominated in local currency, which reduces exchange rate and foreign risks of meeting its debt repayments.

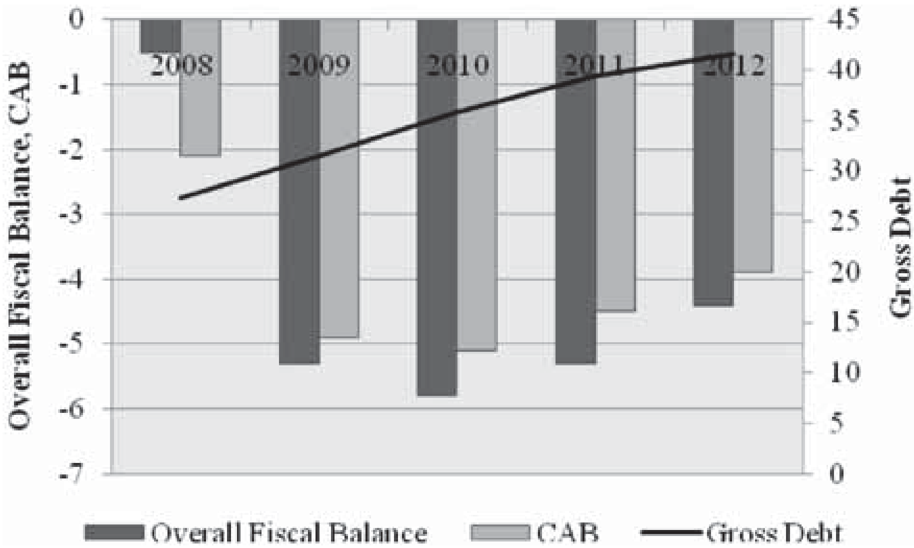
2.2.1 Cyclically adjusted budget balance (CAB)

During a recession/slowdown phase of the economic cycle, government finances usually worsen, as tax revenues slow down and social payments rise. The cyclically adjusted budget balance (CAB) or structurally-adjusted budget balance (SBB)[15] seeks to make an adjustment for the effects of the economic cycle and thus provide a more accurate representation of the budget. The CAB takes out the effect of economic swings that are above or below the natural rate of economic growth. In essence, it is the balance that accords with the long-run natural economic growth rate of the country. A CAB rule generally requires a constant numerical target, and movements in the CAB can be seen as discretionary fiscal expansion.

In South Africa, the CAB was introduced in the 2007 Medium-Term Budget Policy Statement and is currently reported regularly with the estimates of the structural revenue and expenditure. For an example, see the Budget Review (National Treasury, 2010: Chapter 4, Figure 4.8). More recently, the International Monetary Fund (IMF) has started publishing similar figures in their Fiscal Monitor Updates (IMF, 2011). Figure 2.1 contains information on the actual budget balance, the CAB and gross debt as a percentage of GDP. The CAB measure shows a deficit of less than 4% by the end of the forecast period. Interpreting the forecasts, government's commitment to control its spending can be considered successful, and tax revenues are expected to grow as the South African economy further recovers from the recession.

15 Technically speaking there is a small difference between the CAB and SBB. Jacobsen (2002) defines CAB as the total balance less the cyclically neutral balance, whereas the SBB is the cyclical effect of the budget plus a benchmark balance. In policy analysis, CAB figures are used to construct indicators of the SBB and the discretionary element of fiscal policy (Brunila *et al*., 1999), so the two are closely linked. Hein and Truger (2008) define the difference simply as SBB being the CAB in relation to potential GDP.

Figure 2.1 South African fiscal indicators (% of GDP)



Source: IMF (2011)

Some rules may be more suitable for national levels, while others are more suitable for the sub-national levels (Kennedy and Robbins, 2001). In fact, some studies argue that fiscal rules are more suited to sub-national governments than to national governments (Corsetti and Roubini, 1996; Bayoumi and Eichengreen, 1995).

2.2.2 Sub-national fiscal rules

Since fiscal discipline is greater at national level, fiscal rules at this level are generally found to be more effective than those implemented at the local government level (IMF, 2009). Some reasons for the inefficiency of fiscal rules at sub-national level are: limited authority and dependence on central government transfers, which creates situations of moral hazard; spillovers from higher spending jurisdictions; and differences in the timing and size of economic cycles across sub-national government that may spur procyclical behaviour, when countercyclical fiscal policy is desirable. Countercyclical fiscal policy aids the government by acting as a stabiliser; in other words, spending occurs during downturns and saving during upturns in the business cycle. However, sub-national fiscal rules should optimally be introduced simultaneously at all levels of government, which is hardly ever the case. Internationally, fiscal rules have either been first introduced at national level and then at sub-national level (e.g. Argentina) or the other way around (e.g. Canada).

Before a sub-national fiscal rule is introduced, some elements need to be in place. First, fiscal legislation needs to be imposed at corresponding government level(s) so that policymakers can be held accountable (Kopits, 2001). In South Africa, the Public Finance Management Act (PFMA of 1999) and Municipal Finance Management Act (MFMA of 2003) cover this aspect. Secondly, the underlying vertical (regional) imbalances need to be offset by a sufficient mechanism of intergovernmental compensation transfers (Kopits, 2001), such as the equitable share mechanism in South Africa. While the national government raises the bulk of aggregate revenues, its expenditure responsibilities are much lower, which means a mismatch between raised revenues and expenditure responsibilities. A converse mismatch exists at the provincial and local government level. This vertical mismatch is known as vertical fiscal imbalance (pre-transfer fiscal deficit). There are also horizontal imbalances, as the revenue-raising capacity of sub-national governments varies, and different regions may face different cost and demand pressures when they attempt to meet their assigned expenditure responsibilities.

The gap between revenue and spending in sub-national jurisdictions is met through intergovernmental transfers (grants and revenue sharing), borrowing by governments in deficit, or a combination of the two. While the equitable share transfers may appear to be free of rules, it is important to note that many institutional and legal arrangements are in place for the use of these transfers. In terms of the Intergovernmental Fiscal Relations Act (IGFRA of 1997) the Minister of Finance has a legal obligation to convene the Budget Council twice a year and the Budget Forum once a year. The Council and the Forum may be convened in order to solve any disputes, in line with the scheme provided for in the IGFRA of 2005. Reporting requirements are also governed by the PFMA and MFMA as well as the Appropriation Act, which regulates the conditional allocation of national revenue directly. Local governments in South Africa are required to enact balanced budgets. Therefore, strictly speaking, the equitable share is supposed to be used to deliver on constitutional mandates. Where a province (or a municipality) fails to deliver on these mandates, the national government (or a province) can intervene through Sections 100 and 154 of the

Constitution. It is the responsibility of national departments to implement 'emergency' measures to bring provincial spending and revenue into balance.

Some provinces (notably Gauteng and KZN) are once again over-spending (particularly on hospitals and health professionals), but only time will tell whether Section 100 interventions will be made. This raises an interesting politico-economic point about the government's goal of fiscal consolidation and rules. Some forces within the government would like to increase spending countercyclically and encourage employment, while others emphasise savings and deficit reduction; it is clearly a matter of balancing the trade-offs. It goes without saying that budget and/or debt rules should be viewed as complementary rather than substitutes for the equitable share mechanism. There are two general approaches to fiscal responsibility at sub-national level: sub-national autonomy and a coordinated approach (Shah, 1994; Kopits, 2001). In the autonomous approach, the sub-national government seeks to gain credibility for its own fiscal policy, while in the coordinated approach all sub-national governments are subject to uniform rules in order to establish credibility for overall macroeconomic policy. In the latter case, a free-rider problem could arise, so penalties for non-compliance need to be introduced at the sub-national level as well. Flexibility is also an important consideration; for example mechanisms need to be put in place to correct unanticipated deviations from target (unless these stem from cyclical fluctuations). In addition, revenue shortfalls and over-expenditure need to be met with automatic measures.

The purpose of fiscal rules is to bind government to responsible behaviour, which may not always be in its short-term interests.[16] In addition, fiscal rules can address the problem of time inconsistency (Gutiérrez and Revilla, 2010), where the government's favoured choice (action) changes over time. In other words, fiscal rules increase the political cost of breaking past commitments and foster credibility because the government adopts rules, sets targets and adheres to them. Fiscal rules can be part of a broader legal framework (statutory requirement) making them more difficult to reverse. Policy rules (guidelines) that are not legislated do not impose binding constraints on government (Kennedy and Robbins, 2001). In South Africa, fiscal responsibility laws are outlined in the PFMA and the MFMA as well as in different sections of the Constitution.[17] The advantage is that such legislation limits the government from selectively focusing on policy that would reflect in its favour. However, more stringent frameworks for accountability, monitoring and enforcement need to be put in place, together with clear penalties for non-compliance (such as administrative sanctions, financial penalties and/or loss of reputation).

2.3 Why Fiscal Rules?

One of the main problems with completely discretionary fiscal policy is that the government's record of fiscal policy cannot really be assessed without firm guidelines (Emmerson *et al*., 2004). In addition, a number of factors 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. As mentioned in the previous section, the usual motivation for fiscal rules is that they create a de-politicised policy framework (i.e. they correct the government's short-sightedness that results 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 (for example in EU countries), it is difficult to isolate the direction of causality and the effect. In other words, the introduction of rules might make government more responsible, but responsible governments are also more likely to make rules. Internationally, fiscal rules have been found to foster consolidation efforts (for example IMF, 2010a). A major disadvantage of fiscal rules is that they constrain discretion when discretion is needed and may force fiscal policy to be procyclical when it needs to be countercyclical (Kennedy and Robbins, 2001; IMF, 2009).[18] In addition, fiscal rules, especially expenditure rules, may result in capital spending cuts that could harm long-term economic growth. Kennedy and Robbins (2001) cite the following reasons for adopting fiscal rules:

- Fiscal rules ensure macroeconomic stability through the promotion of countercyclical fiscal policy.
- Fiscal rules enhance the credibility of governments' fiscal policy and aid in eliminating deficits.
- Fiscal rules ensure the long-term sustainability of fiscal policy.

The timing of implementing fiscal rules is a major consideration, as it is vital to implement rules at the correct time.

16 Kennedy and Robbins (2001) argue that what underlies fiscal rules is a sense that present (future) governments may not be able to implement optimal fiscal policy measures without external pressure.

17 It should be noted that New Zealand was the forerunner in the fiscal responsibility legislation with the introduction of the Fiscal Responsibility Act in 1994 (Emmerson *et al*., 2004).

18 In the South African context, the general opinion is that fiscal policy needs to be more countercyclical so as to maintain low future capital costs and inflation, support a more competitive exchange rate, reduce debt service costs and provide fiscal space (Loewald, 2010).

Box 2.2 Brief History and Evolution of Fiscal Rules

Fiscal rules have a long history (Kopits, 2001; Kennedy and Robbins, 2001; IMF, 2009). Since the 1990s, an increasing number of countries have adopted fiscal rules (to eliminate deficits and ensure the stability of public finances), with the sharpest increases being those of emerging and low-income countries. Another recent trend is that countries have moved away from a single fiscal rule to a combination of rules that focus on debt sustainability. Generally, the result was that a number of countries adopted a budget balance rule combined with a debt rule (expenditure rules have been used to curtail the size of government). In addition, custom-made rules are sometimes deemed necessary because of differences in institutional capacity and exposure to external shocks. Finally, rules based on the CAB have been getting more popular in recent years. For a more detailed report on recent trends in international fiscal rules please refer to IMF (2009).

2.3.1 Preconditions that need to be in place for fiscal rules to be effective

First of all, adequate public finance management systems need to be in place. Adequate data also needs to be available, which is generally the case for South Africa. In addition, the National Treasury needs to have a good track record in technical forecasting capacity because budgetary aggregates need to be predictable with a certain degree of accuracy, so as to avoid the risk of large fluctuations from the announced fiscal policy stance which would undermine a rule's credibility (Emmerson *et al*., 2004; Favero and Massimiliano, 2005). Budget reporting systems need to be extensive, and fiscal data should be publicly released, which is the case for South Africa at the national level. However, this could prove problematic at provincial and particularly municipal levels, if fiscal rules are introduced for sub-national governments in South Africa. Political commitment is also key, as without it, fiscal rules are unlikely to be sustained and may even harm the credibility of fiscal policy.

Furthermore, for a fiscal rule to operate optimally requires the following (IMF, 2010b):

- An unambiguous and stable link between the numerical target and the ultimate goal. Fiscal rule methods, linkages and outcomes must be clearly announced in advance. In addition, a clear reaction function must be formulated; one that explains how government will respond to failures to meet the rules.
- Sufficient flexibility to be able to respond to shocks: specifying a clear reaction function does not mean that government must always follow the rule. However, when it does not, the government must have a good reason and explain why.
- A clear institutional mechanism to map deviations from numerical targets and take corrective action. In addition, a decision needs to be made about how the rule will be judged (i.e. retrospective or prospective).

Box 2.3 Forecasting Performance of National Treasury

National Treasury should publish (or provide an indication of) past forecast errors for fiscal aggregates (Emmerson *et al*., 2004). The idea is to publish data series of forecasting errors (i.e. comparing the initial forecast with the final outcome, preferably adjusted for subsequent policy changes), as this information will provide an indication of the degree of uncertainty surrounding current forecasts (and also indicate the probability distribution within which these forecasts should be based). Variables that can be considered include public sector net borrowing, public sector net debt, current budget balance, current receipts, current spending and public sector net investment (Favero and Massimiliano, 2005).

Regular summaries about the size and variability of the forecasting errors could be summarised, and the National Treasury could use this information to indicate and quantify the uncertainty surrounding the current set of fiscal forecasts (graphical representation can take the form of fan charts). This will also make communication to the public easier, in the sense that government will be able to determine and communicate the probability of breaking the rule and plan accordingly. Furthermore, fan chart representation (for example) can make the public more aware that outcomes do not necessarily align with the forecasts (Emmerson *et al*., 2004).

2.4 Fiscal Variables and the South African Economy

There is a considerable quantity of literature on the influence of fiscal variables (expenditure on government programmes and taxes) on the economy.

2.4.1 Effect of fiscal variables on economic growth in South Africa

Most fiscal variables related to economic growth are reported in the form of tax and/or revenue elasticities. Although these elasticities are difficult to obtain and strictly speaking are meant for closed economies, they offer a useful indication of the effect of fiscal policy on economic growth. Simply defined, elasticities are measures of the responsiveness of a variable to a change in another variable. For South Africa, a number of studies have estimated tax elasticities (albeit using different methods and sample periods). In addition, the Fiscal and Financial Commission (the Commission) has estimated revenue elasticities for different components of public expenditure. Tables 2.1 and 2.2 provide summaries of these estimated elasticities.

Table 2.1 Summary of tax elasticities for South Africa

Study → Tax ↓	Swanepoel and Schoeman (2002)	IMF (2006)	Du Plessis and Boshoff (2007)	Jooste (2009)
Personal income tax	-	1.43	-	0.84
Corporate income tax	-	2.52	-	1.79
Value added tax	-	0.99	1.14	1.01
Income and profit	1.04	-	1.05	-
Goods and services	1.24	-	-	-

Source: Jooste and Naraidoo (2010)

Table 2.1 shows the responses of taxes to the economic cycle, which has important implications for calculating the CAB. Most countries assume that taxes respond in a one-to-one relationship with the cycle. However, recent studies, such as Wolswijk (2007) and Jooste and Naraidoo (2010), show that taxes respond asymmetrically to the economic cycle. Thus, depending on the elasticity, significantly different CAB outcomes may be obtained. There is an obvious trade-off between technical sophistication and a communicable method of calculating the CAB. While technical rigour may improve the 'exact' outcome of the CAB, it is not as transparent as a communicable method and may be subject to manipulation. In contrast, whereas a communicable method is transparent, it is sometimes off the mark.

Table 2.2 Summary of revenue elasticities for South Africa

Expenditure Category	Elasticity Estimate
Agriculture, forestry and fishing	2.41
Defence	0.22
Education	1.51
Fuel and energy	0.61
Health	1.87
Housing and community amenities	0.37
Mining, manufacturing and construction	-1.86
Public order and safety	-1.38
Recreation, culture and religion	-0.25
Social protection	0.39

Source: FFC calculations

Table 2.2 shows the responses of economic growth to changes in public expenditure components. Positive elasticities larger than 1 are considered conducive to economic growth (i.e. a 1% increase in government spending leads to more than a 1% increase in economic growth, all other things being constant). Therefore, agriculture, education and health are the key contributors to economic growth in South Africa. Negative elasticities can indicate a reverse causality, i.e. from growth to expenditure.

2.4.2 Effect of fiscal variables on local government economic activity

According to Tiebout (1956) in an efficient federal system, many local governments and people are able to choose their preferred service-tax package. All else being equal, service responsibilities are assigned to small local governments. The resulting limits (perceived or real) seriously reduce the fiscal autonomy of sub-national governments, enabling a stronger, but more distant, national government to impose its will on local voters. Public choice theory shows that combining uncompetitive market structure and self-interest can have unwelcome effects on tax and expenditure outcomes. At any sphere of government, perfectly rational, self-interested officials tend to raise taxes and spend more than the median voter would prefer. Using their monopolistic position to decide how much to tax and what levels of public service to provide, public officials can obtain 'rents' and will find it in their interest to expand the role and size of provincial and local governments – referred to as a 'leviathan'. Therefore, public choice theorists argue for the use of fiscal rules (in the form of stringent limits on taxation and spending) as a means of controlling the ambition and fiscal excess of the 'leviathan' or public officials (Brennan and Buchanan, 2000).

From a quantitative viewpoint, Tiebout's theorem implies that decentralised government would lead to increases in public tax-spending combinations that are efficient in the sense that they are proportional to the increase in the median voter's income – with identical effects on local government expenditure (Wyckoff, 1988; Turnbull, 1992). However, a number of empirical studies find that available data consistently rejects the median-voter model prediction of equivalence (for example Gramlich, 1977; Fisher, 1982; and Hamilton, 1983), leading to an empirical phenomenon that has come to be known as the 'flypaper effect'. The flypaper effect explains the observed tendency for local government authorities to spend intergovernmental grant transfers rather than pass on such transfers to constituents/residents through, for example, tax cuts.

There is no consensus about the cause of the flypaper effect, which is considered by some to represent a kind of illusion on the part of voters, and by others to be a mis-measurement of some kind. Estimates of the flypaper effect vary widely. In the United States, a typical estimate finds that $1 of aid has the same impact as $3 of income. Downes and Figlio (2007) surveyed empirical literature on the impact of state-level tax and expenditure limits on primary and secondary education performance and conclude that small spending reductions (due to tax and expenditure limits) can cause disproportionately large, presumably unintended, negative effects on student achievement. They also report evidence that suggests teacher wage contracts may shift the greatest impact of tax and expenditure limitations to students and new teachers, away from teachers with long tenure.

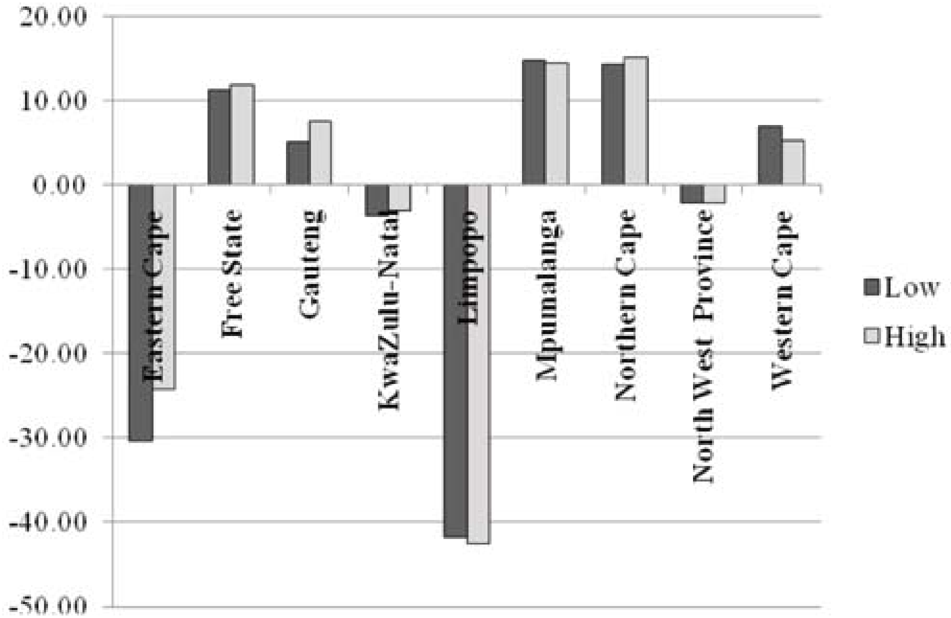
A study on the multiple dimensions of the intention and implementation of fiscal rules for sub-central governments in the Organisation for Economic Cooperation and Development (OECD), finds that fiscal rules are generally designed to control the size of the public sector and to prevent large increases in debt or public spending (Sutherland *et al*., 2005). Instead of directly restraining sub-central government spending, most OECD governments use rules limiting tax autonomy and restricting the amount of borrowing to control the outstanding debt of sub-central governments. The study finds that fiscal rules generate side effects and trade-offs that create inefficiencies in public finance and short-change critical public services. In particular the study found that constraints associated with balanced-budgets rules might create incentives to spend unnecessarily near the end of a budget cycle, and that tax and expenditure limits can distort public spending patterns. When applying across-the-board tax and expenditure limits, law-makers may find that they cannot prevent other policymakers from funding public programmes and services. Such across-the-board limits force policymakers to allocate funds for programmes and services in inefficient ways (Sutherland *et al*., 2005).

In the context of the South African local government grant process, using the flypaper effect hypothesis, Amusa *et al*. (2008) offer empirical evidence of the concept of fiscal illusion. The study used an empirical framework that has its foundations in the median voter model developed in the article by Wyckoff (1988, 1991) and adapted in Heyndels and Smolders (1994). Their results suggest the absence of a flypaper effect on municipal expenditures from intergovernmental transfers. In other words, fiscal rules implemented through conditions on various grants have not had unduly discernible negative effects on local government. Two major implications of these findings for fiscal rules would be the need to (i) improve the overall administrative, institutional and financial capacity of municipalities (in particular enhancing the ability and innovation of municipalities to spend effectively their grant allocations) and (ii) further understand the potential effects that current reform proposals could have on the fiscal autonomy and revenue-raising capacity of municipalities.

2.4.3 Effect of fiscal variables on provincial government economic activity

At provincial level in South Africa, empirical evidence is scant owing mainly to data deficiencies (such as interregional mobility and expenditure profiles). Furthermore, many complex responses, which arise from the interaction of the different spheres of government, are difficult to capture effectively. Using a multiple provincial/regional computable general equilibrium model, recent work by the Commission provides a picture of how altering existing fiscal rules affect efficiency and equity goals in South Africa. The model is the first of its kind for South Africa and accounts for three spheres of government: national, provincial and local governments. Each government sphere spends on providing public services, subsidising the national economy (activities and products) and transferring revenues to other governments and institutions. Fiscal rules are loosely embodied in the conditions and restrictions associated with intergovernmental fiscal transfers discussed earlier. Therefore, a reduction of intergovernmental transfers with tax compensation is interpreted as a loosening of fiscal rules. A loosening of fiscal rules is found to have heterogeneous effects on households' well-being, which is measured by changes in the equivalent variation of initial consumption expenses. The nationwide welfare does not change significantly (0.6% in both scenarios), but its distributional effect among regions is important (Figure 2.2).

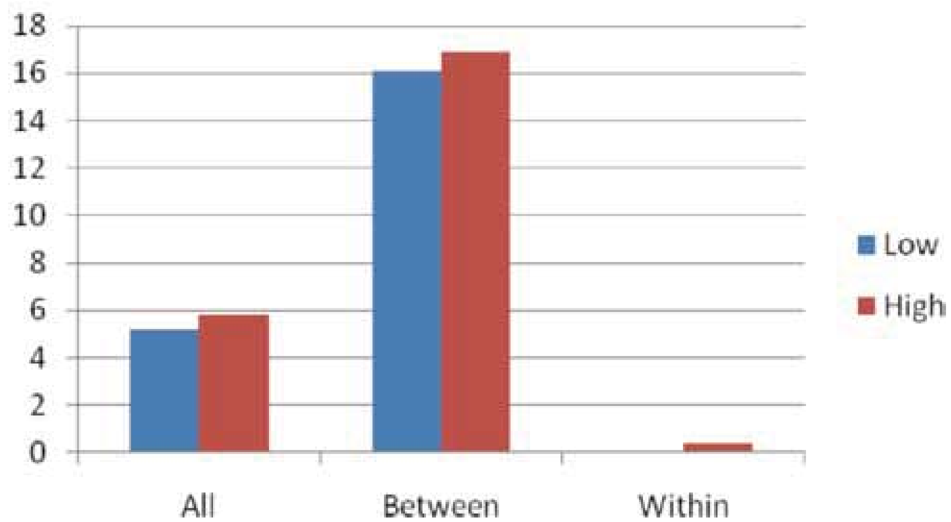
Figure 2.2 Equivalent variation of initial consumption expenses (%)



Source: FFC calculations

The overall regional disparity increases by 5–6% when Theil indices are used to measure regional disparities within and between regions. (Figure 2.3 is essentially imputed to the increase in disparities between regions.)

Figure 2.3 Variation in Theil indices (%)



Source: FFC calculations

The results are varied but pertinent for the use of fiscal rules. Firstly, sub-national governments play a key role in successful fiscal consolidation, which supports the argument that understanding sub-national government behaviour is important in overall macroeconomic stabilisation. Grant allocations provide a mechanism whereby national government retains considerable effective control over aggregate sub-national government expenditures. Secondly, cuts in grants can play an important role in fiscal consolidation.

However, the findings demonstrate that the interregional equity effects are significant, although the overall impact is less important. Concerns about intra-generational equity appear to be well justified, if deficit reduction is implemented through cuts in social assistance or less regressive taxes. A programme of fiscal consolidation could easily conflict with ambitious (re)distributive objectives, not least from a South African welfare state perspective. Thirdly, cuts in grants can be offset by increases in compensatory taxation. However, after an episodic cut in grants, an increase in sub-national taxation results in falling household gross income and widening income disparity.

2.5 Design, Timing and Implementation of Fiscal Rules

The implementation of fiscal rules would require the government to publish in advance these key pieces of information: how the rules will be met, what happens if the rules are not met or are not on course to be met (i.e. corrective action and penalties), and the time frames for when the targets will be reached (Emmerson *et al.*, 2004). In terms of the design of fiscal rules, two requirements need to be satisfied:

i. The rule must deliver the required adjustment and put debt on a sustainable path.

ii. The rule has to have a certain degree of built-in flexibility in order to deal with shocks.

Head of Hungarian Fiscal Council, George Kopits (2001), claims that a fiscal framework should have the following main features:

- A numerical policy rule.
- A set of 'procedural' rules.
- Monitoring by an independent, authoritative body.
- Full and clear public accounts (including future costs).

Other issues to consider include:

- Coverage of rules.
- Whether or not rules should respond to past deviations.
- Effective monitoring and evaluation.

In addition, when choosing the fiscal instrument, the following need to be considered (IMF, 2009):

- The instrument has to be closely linked to the ultimate objective of fiscal policy.
- The instrument must be controllable.
- The instrument must be transparent and easy to monitor – commentators must be able to audit fiscal policy, which means that fiscal authorities need to publish as much data and information as possible.[19]

The budget balance-to-GDP ratio generally fulfills the above requirements and thus makes a good instrument. However, constraining the debt ratio is more difficult because of the lags that are involved before any budgetary slippages can be detected and because debt is more volatile. Generally, if debt is targeted, it is targeted together with a budget balance. In addition, targeting revenue is tricky because it is not linked directly to debt ratio unless the expenditure side is considered. A growth-based balance rule (an augmented one) performs well in a low-growth environment (however, the price is the reduced countercyclicality).

In terms of the implementation, the following are important points (Anderson and Minarik, 2006; IMF, 2009):

- Before a rule is introduced, countries need to make an effort at fiscal consolidation and macroeconomic stability, which is likely to make the rule more credible.
- Speed of adjustment is also an issue, as the rule might require an excessive speed of adjustment, or not mandate enough adjustment as is needed/feasible/optimal.

19 Although it is understandable that government would want/need to withhold some information to manage expectations. In South Africa, fiscal authorities publish budget documentation that is consistent with the IMF's *Revised Code of Good Practices on Fiscal Transparency.* South Africa is currently considered one of the most transparent fiscal authorities in the world (out of a sample of 94 countries). It publishes information on forthcoming policies and policies under consideration, provides consistent data and presents estimates of the budgetary aggregates over the medium term.

- Fiscal rules should not be introduced in a markedly uncertain macroeconomic environment.

The main points to keep in mind are that the cost (of breaking the rule) needs to be higher than the benefit, and while fiscal rules can anchor medium-term expectations, they are not ideal when dealing with extreme shocks.

Box 2.4 The Case for an Independent Fiscal Agency in South Africa?

National Treasury faces a clear conflict of interest in acting as judge and jury on its performance. Despite their similarities, fiscal policy and monetary policy are very different. The argument for an independent fiscal agency centres on bolstering trust (especially in countries where it is hard to promise fiscal credibility), by putting fiscal policy on the same footing as monetary policy. In other words, budgetary decisions are outsourced to independent councils with a mandate to preserve fiscal solvency (Daban, 2011; Debrun *et al*., 2009; Kennedy and Robbins, 2001). The problem is that, whereas monetary policy has one instrument, fiscal policy has many. However, a number of countries have opted for this approach: Chile (independent expert panels), Netherlands (Central Planning Bureau), Hungary (Fiscal Council), Sweden (Fiscal Policy Council), and the USA (Congressional Budget Office). A less extreme case of independent guidance of fiscal policy is technocratic (econocratic) governance of fiscal rules, where technical experts exercise a certain degree of control over decision-making. For example, in Sweden, a fiscal council monitors compliance with the budget-balance target (consistent with a chosen debt burden), leaving politicians to make tax and spending decisions within those limits. Fiscal institutions such as the Financial and Fiscal Commission (the Commission) play a complementary role to effective fiscal rules. Their role is limited, as it has no executive power, although the advisory role may be its strength. When multiple agencies have executive authority over fiscal rules, often the tendency is not to take responsibility and shift blame to the other for non-compliance/enforcement. In this regard, the Commission must continue to rely on influence and the requirement to respond to its recommendations in Parliament. The Commission can still have a beneficial effect through its work on improving the level of public debate and, in the future, producing reliable fiscal variable forecasts (e.g. debt).

2.6 International Experience

Internationally, combining budget balance and expenditure rules has been particularly effective, even more so when the countries have wide coverage and strong monitoring. The following are some examples of international experience with fiscal rules.

UK and Australia: Neither country's framework has legislated numerical targets. Instead, the emphasis is on requiring government to set its fiscal str*ategy and ta*rgets out clearly. Australia's reduction in debt is mainly due to privatisation proceeds, and the current objective is to balance the budget over the economic cycle by running short-term surpluses and (as a supplementary objective) to improve its net worth.

Japan: The country has had some form of fiscal rules since 1947. However, since 1997, its rules address the deficit as well as ensure that the sum of national and local government debt does not exceed 3% of GDP. In addition, deficit financing bonds need to be reduced every year, and numerical limits are set on expenditures.

New Zealand: The Fiscal Responsibility Act places more emphasis on transparency than on numerical targets. The government set some targets for fiscally prudent levels of debt. Temporary departures are allowed as long as government specifies reasons for doing so (and also when it plans to return to the principles). In general, improved fiscal performance in New Zealand can be attributed to fiscal rules plus improved reporting requirements, better economic conditions and political commitment.

Canada: The country set limits on programme spending (overspending is permitted in one year if offset in the following two years, and unspent amounts can be allocated to the subsequent fiscal year). The government has also introduced a number of non-legislated rules that contribute to better federal finances (two-year rolling deficit targets with an ultimate goal of a balanced budget; credible short-term fiscal targets combined with commitment).

Chile: Often cited as a success story of fiscal rules' implementation, the country introduced a new fiscal framework in 2001 (codified in the Fiscal Responsibility Law). The target is a structural fiscal surplus, and an expert committee determines the cyclical stance. Between 2004 and 2008 the country had a cumulative surplus of 28.5% of GDP. In 2009, real public spending grew by 14.5% despite a 28.5% fall in fiscal revenue (implying a fiscal deficit of 4%).

Box 2.5 Debt Brake Fiscal Rule

In Sweden, the 'debt brake' rule was approved by referendum as a flexible instrument for limiting public debt (Brandner *et al*., 2005). The aim was to establish a long-term countercyclical policy and to prevent the accumulation of permanent structural deficits. The model also accounts for the 'time-lag' problem (i.e. recognition and decision lags of fiscal policy) that is normally associated with discretionary fiscal policy, which aims to smooth the business cycle. Discretionary fiscal policy is still allowed to stimulate the economy when the 'debt brake' rule is found to be lacking. The rule is characterised by an expenditure rule (with a binding clause), consideration of exceptional circumstances (to aid flexibility), introduction of a stabilisation account (i.e. an analytical instrument used to distinguish between estimated and actual budgets over the medium term), and stipulations for the use of extraordinary revenue (Brandner *et al*., 2005).

2.7 Recommendations

South Africa has come a long way in operating fiscal rules, which are implemented through constitutional amendments, statutory provisions or policy guidelines and enforced through a variety of mechanisms. When rules are violated, sub-national governments may be subject to administrative sanctions, financial penalties, or a loss of prestige and reputation. For instance, when sub-national governments fail to adhere to such rules, 'peer pressure' is available in the form of recommendations by the Commission to restore fiscal discipline. In some instances, local-level authorities have been removed from office for violating fiscal rules. Furthermore, a constitutional provision, which allows Parliament to adjust the budget proposed by government, has proven to act as if allocations are indeed rules.

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. The entrenched recognition and clear demonstration of fiscal prudence by South African authorities permeates through to sub-national government. A key issue that arises in the context of South Africa is whether and how to strengthen fiscal rules.

This preliminary and tentative analysis suggests that sub-national government fiscal policy has been disciplined without necessarily being rules-based in the conventional sense. Furthermore, the emerging empirical evidence appears to reject the notion of the flypaper effect, suggesting that rules embedded in intergovernmental transfers to local governments have not had discernible perverse effects. For the provincial government, rules embedded in intergovernmental transfers appear to have delivered government's equity goal, while the efficiency objective has largely not materialised. In view of these considerations, a more nuanced view is needed of the appropriate role of fiscal rules at national and sub-national government level, which recognises that a sophisticated intergovernmental system is in place and looks at how to improve an existing and functioning system.

Therefore, the first aspect should be to recognise the existence of fiscal rules that are working reasonably well. The second aspect is that National Treasury is certainly conflicted by acting as both judge and jury on its performance. This calls for a separation of function and, in this regard, the Swedish model of an independent fiscal policy council is a good guide and needs to be considered.

On the basis of these considerations, a possible option for fiscal rules would be to target a balanced budget or surplus over the cycle, without any limits, which would allow for automatic stabilisers to operate and also for discretionary countercyclical action. In addition, limits need to be imposed on the government wage bill. Generally, if an expenditure rule is to be proposed, then limiting capital expenditure (which is thought to contribute to long-run growth) is not an option. However, transparent, unambiguous and operationally sensible definitions of capital expenditure are needed (so that the focus is on productive capital expenditure).

To use the example of Australia and New Zealand, as is generally the case for macroeconomic policy in South Africa. These two countries have strengthened their fiscal frameworks without having to announce numerical fiscal targets. The establishment of a South African Fiscal Policy Council appears plausible. Such an institution would be given executive powers, assess cyclical position and fiscal risk distribution, recommend appropriate cyclical policies, monitor compliance with fiscal rules, evaluate debt management strategy, and monitor transparency of fiscal data and research on South African fiscal policy. Issues that need to be considered include:

- Establishing accountability lines (to Parliament or Executive) and who reviews this Council.

- Public sector pay and its potential destabilising effect on budget. For example, would there be political/civil buy-in if such a Council pronounces on annual wage adjustments? While the recently created National Planning Commission and/or Monitoring and Evaluation Departments in the Presidency may play this role, the conflict issue would not be entirely eliminated, as the Council would need to be depoliticised or at least be independent.

Fiscal institutions such as the Commission should continue to play a complementary role, in particular ensuring compliance to IGFR through its periodic advisories.

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