

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

25 February 2010



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## **1. *The context: Briefing to Parliament's powers to amend money bills***

This 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 (hereafter the Commission) during their deliberations on Money Bills.

The Commission's Submission is structured in four distinct but intertwined areas. The first section gives a brief description of the fiscal framework and how it has evolved since inception. The second section looks at the economic outlook and suggests areas for further enhancement. Section 3 looks at specific revenue and tax proposals in the 2010 budget. Section 4 raises what the Commission considers as important issues pertaining to consolidating transparency and addressing contingent liabilities.

It is important to point out that 2010 Appropriation Bill is the first ever of its kind and as such this submission to the Committees has not benefited from any previous experience gained by the Commission. The submission should therefore be viewed as the beginning of a learning experience not only for the executive and legislature, but also for the Commission and indeed all stakeholders in helping with the implementation of this very important legislative mandate.

## ***2. Review of basic fiscal framework principles***

1. The South African constitution is the supreme law upon which the underpinnings of the fiscal framework are enshrined. Various chapters of the constitution set out the legal framework for the collection and estimation of revenue, expenditure, borrowing and contingency reserves within the prevailing macroeconomic fundamentals.
2. The Money Bills Amendment Procedure and Related Matters Act defines the fiscal framework for a specific financial year that gives effect to the national executive's macro-economic policy to include:
  - a. Estimates of all revenue, budgetary and extra-budgetary specified separately, expected to be raised during that financial year;
  - b. Estimates of all revenue, budgetary and extra-budgetary specified separately, for that financial year;
  - c. Estimates of borrowing for that financial year;
  - d. Estimates of interest and debt servicing charges; and
  - e. An indication of the contingency reserve necessary for an appropriate response to emergencies or other temporary needs, and other factors based on similar objective criteria.
3. The national fiscal framework, as defined above, can be specified for a single financial year. With the acceptance of the Medium Term Expenditure Framework (MTEF) process by cabinet in 1998, the national fiscal framework now forms part of the rolling three year budgeting cycle. In addition to the current financial year, a three year forward estimate of the fiscal framework is also tabled so as to improve fiscal planning over the medium term.
4. The MTEF set out to improve the allocation of resources to priority services, enable spending agencies to plan ahead with certainty, provide a framework within which policy proposals are assessed, improve transparency, reduce roll over's and demonstrate how fiscal targets will be met. The ultimate aim of

these reforms has been to deliver a more stable environment in which firms and households could plan and make decisions with confidence.

5. . The fiscal framework complements the monetary policy framework of inflation targeting that is run by the (independent) Reserve Bank. Both frameworks sought to reconcile commitment to medium term objectives with the need for short term flexibility through the principle of constrained discretion. While the monetary policy framework is reliant on interest rate adjustments, fiscal policy has three fiscal targets as follows:
  - a. Taxation raising, spending and borrowing for each organ of the public sector consistent with the underlying macroeconomic conditions. Within this broad objective, government further aims to achieve fiscal sustainability, that is, ability to finance a given level of expenditure for an extended period of time and without shifting the burden to future generation and stifling future economic growth prospects.
  - b. Allocation of expenditure across different spheres of government that matches the distribution of functions and their relative priority, as well as across and within various sectors.
  - c. Within each sphere of government, utilise resources in a manner that minimise costs and maximise delivery of services. This encompasses both fiscal discipline (staying within budget constraints and not underspending) as well as eliminating unproductive, wasteful and fruitless expenditures (increasing operational efficiency).
6. Upon the end of a period of fiscal consolidation associated with Growth, Employment and Redistribution (GEAR) policy, government adopted discretionary stimulus fiscal policy as opposed to revenue, debt and deficit restraining fiscal rules. The post fiscal consolidation period, that is the period between 2002/03 and 2008/09, was somewhat conducive to expansionary fiscal policy due to buoyant economic conditions. As a result, the budget deficit averaged 0,6 percent of Gross Domestic Product (GDP) while revenue averaged around 30 percent of GDP. This healthy fiscal situation has over time lessened the need to impose explicit tighter fiscal rules or targets on the fiscal framework.

7. For the 2010 MTEF, government has set itself an implicit and maximum budget deficit of 7,3 percent of GDP. The increased government borrowing requirement is necessary in part as a counter cyclical instrument and also to fulfil government commitment to services delivery. Some countries tend to employ the golden rule that over the economic cycle, government only borrows to invest in capital and not to fund current spending (current consumption)
8. The current political nature of the vertical division of revenue makes it difficult to determine with certainty the expenditure items to which the debt finance is apportioned. This makes the determination of rules rather difficult. However, in future government may wish to make explicit fiscal rules in order to ensure time-consistency of policy and reduce political rent-seeking. Fiscal rules should apply to all policy areas which may affect future resources. Both the Public Finance Management Act and the Municipal Finance Management Act are a step in that direction, particularly by adding a rule for public investment, or to allow policy makers to borrow for public investment.

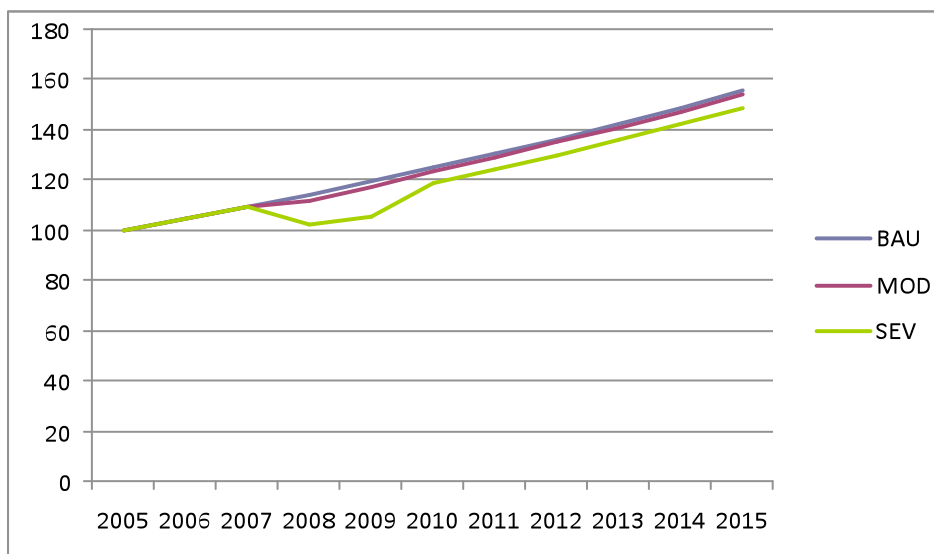
### ***3. Responding to exceptional circumstances – the macroeconomic outlook underlying 2010 Budget***

1. As set out in the 2010 Budget Speech of the Minister of Finance Pravin Gordhan, a major economic shock that has hit the economy has been the global recession. That shock has brought out the point that economic prospects are subject to exceptional uncertainty.
2. The Financial and Fiscal Commission's economic outlook based on a dynamic computable general equilibrium model suggests that the world economic crisis produces a huge drop in GDP (Figure 1). For both assumptions made about the severity of the scenario (mild and severe), GDP falls in 2008 and 2009 and then increases again, but it does not return to its business as usual (BAU) value even by 2015. In other words, without positive shocks or deliberate and successful interventions that stimulate the economy and

counteract the negative impact of the world economic crisis, GDP will not recover to what it would have been in the absence of the crisis, that is, the BAU scenario.

3. Government is somewhat more optimistic regarding South Africa's GDP growth performance, in the near future. National Treasury forecasts that GDP will contract by 1.9% in 2009, where after growth will start to pick up. Growth of 1.5% was forecast for 2010 rising to 3.2% by 2012 in the most recent issue of the Medium Term Budget Policy Statement (MTBPS) (National Treasury, 2009). The 2010 Budget is even more optimistic. Based on the belief of a pick up in growth in China, government's growth expectation for 2010 is now 2.3 per cent, rising to 3.6 per cent by 2012.

**Figure 1: Evolution of Real GDP in BAU, Moderate and Severe scenarios**



4. In these circumstances, the role of the fiscal framework is to ensure fiscal policy has the flexibility to respond appropriately, while remaining committed to clear, transparent long term goals. So, to achieve its objectives as outlined in the 2010 Budget, the government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.
5. Irrespective of minor differences in projections between the Financial and Fiscal Commission and government, it is clear that South Africa entered into

an economic downturn, with the first recession in over 17 years. This will no doubt have persistent implications for the public finances. To this end, government has developed a substantial fiscal stimulus package, supported by a big budget deficit.

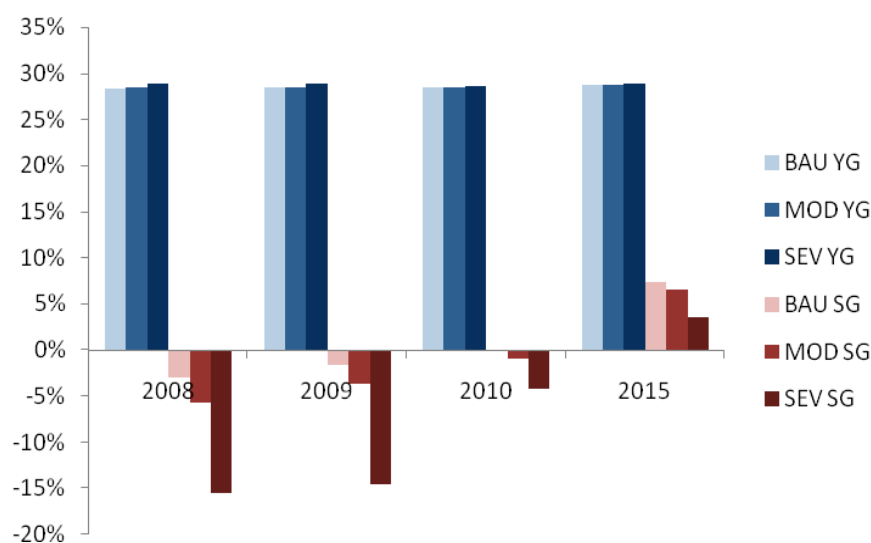
6. The Commission agrees with this fiscal policy stance at this point in time. However, an important issue is really not in the minor differences between our projections but rather on whether the country should explicitly adopt a temporary operating rule such as measures to improve cyclically adjusted current budget each year once the economy emerges from the downturn so that it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full. This could be formalised in some kind of a fiscal pact or stability pact. For instance the pact will clearly establish the level of debt and what the debt can or cannot finance, possibly guarantee a move towards current budget surplus (cyclically adjusted). The point is that a successive government will have to agree to cutting debt incurred by the previous government.
7. The Commission has raised already in its response on the Division of Revenue Bill the point that national government's net loan debt is to rise sharply from R526 billion at end-2008-09 to R1,3-trillion in 2012-13. Consolidated government debt service costs are to rise from 2,4 percent of GDP, or R57,6 billion, in 2009-10 to 3,2 percent, or R104 billion, in 2012-13 (see Business Day of 19 February 2010). The public sector wage bill had almost doubled in five years. This scenario might imply that significant amounts of the debt service cost increases are driven by personnel expenditure. If this is indeed the case, it would be important that this development is reversed as soon as possible. Large amounts of debt that are driven by current consumption as opposed to the financing of capital assets are known to ultimately compromise economic growth and destabilise the domestic financial system. Setting clearly fiscal rules pertaining to debt in a crisis would be one way of increasing transparency in this way.



#### 4. Revenue estimates and tax proposals

1. With a recession of the magnitude just witnessed, government revenue is expected to decrease. Indeed, based on the modelling exercise of the Financial and Fiscal Commission mentioned above, direct taxes are decreasing (as a share of households and firm income), and taxes on products are also decreasing for most sectors (due to the decreases in imports and production). Half of government income comes from direct taxes and around a third from indirect taxes on products. Thus one can expect its revenue to decrease. Figure 2 represents the variations of the share of government income in GDP as well as government savings as a percentage of GDP for the BAU anticipated by the Commission.

**Figure 2: Revenue/GDP and Savings /GDP for government<sup>1</sup>**



2. The 2010 Revenue Estimates tabled by government does acknowledge these depressive effects of the recession on government revenue. The expectation now is that government will raise R69 billion less in tax this year than was budgeted for. Consolidated revenue will be R658 billion in 2009/10, which is

<sup>1</sup> We compute here, Government income / Gross Domestic Product (YG/GDP) as well as Government Savings/ Gross Domestic Product (SG/GDP). BAU refers to the situation without crisis (Business As Usual), MOD and SEV respectively refer to Moderate scenario and severe scenario.

R32 billion less than in the past fiscal year with the drop coming from Value-added tax (R22 billion less than the February budget estimate and 5.1 per cent lower than last year), Corporate income tax (R30 billion less than expected, and over 20 per cent less than the amount we collected in 2008/09), Customs duties (R6 billion below target) and personal income tax (R4 billion lower and secondary tax on companies R3 billion less). The Commission did raise this possibility of larger than anticipated revenue shortfalls in its commentary on the 2009 MTBPS that it tabled to Parliament in October 2009. The Commission is happy that Government has revised its projections downward in line with its 2009 predictions and this downward revision brings in more credibility to the forecasts.

3. A related question that the Commission feels the Standing and Select Committees on Finance should be concerned about is the evolution of the budget deficit. According to our modelling scenarios up to 2015 and shown in Figure 2, in the absence of a globally induced recession the government income/GDP would have stayed around 28 percent. This share increases in the recession scenarios due to the huge drop of GDP. Because our modelling assumptions were based on the actual revealed policy stance of government that transfers national government makes to other agents are fixed, this leads to a sharp decrease in its savings (government's expenditure is fixed as well as transfers) or more conventionally an increase in the budget deficit presently observed. As shown in Figure 2 therefore, savings over GDP of about 3 percent of GDP in 2008 would have decreased to reach a small surplus in 2015 had there been no shock. Note that in the base year, the deficit is quite low, and then there is a decrease in prices in the absence of a globally induced recession (as the economy is becoming more and more efficient through time). It is therefore easy to understand why government savings become positive in the long run. With the crisis of course, we do not observe the same pattern in the short run. Indeed, the deficit reaches 15 percent of GDP in 2008 and 2009 in the severe scenario, and around 5 percent for the moderate scenario. In the long run, the situation improves

somewhat, but remains far below what it would have been had there been no global crisis.

- a. With subnational government spending slower to decelerate than revenue, deficits at all levels of government are expected to widen significantly. Fiscal policy responses to the dilemma of deficit financing include raising tax revenue, reducing or deferring expenditure and improving spending efficiencies.
  - b. In order to stabilize their fiscal environment, the subnational governments will need to undertake a combination of these three responses over the coming three years.
4. Government's preferred method of achieving higher revenues spelt out in the 2010 Budget is through base broadening, closing loopholes and improving tax compliance. Additional environmental taxes will be explored both to raise more revenue and to meet environmental objectives. Government could also raise taxes in the future to fund public spending commitments. Government therefore makes the following revenue proposals:
- Personal Income Tax relief for individuals valued at R6.5 billion
  - Discontinuation of the SITE system
  - Increase in fuel taxes of 25.5 cents per litre
  - A carbon emissions tax on new vehicles
  - An increase in taxation on smoking (a packet of 20 cigarettes will cost R1.24 more)
  - An increase in taxation on alcohol consumption (a 750ml bottle of wine will cost R0.12 more, a 750ml bottle of spirits will cost R2.22 more while a can of beer will cost R0.07 more).
5. The Commission views these proposed measures as credible given the environment in which the country finds itself in. It is sensible to postpone any major tax reform exercise to a period when the economic environment is stable. The rest of the Commission's commentary on the tax proposals are as follows:

- a. *Tax Relief on individuals* – In times of low economic activity, tax cuts are an important fiscal instrument to curb the impacts of a recession and increase aggregate demand in an economy. With consumption spending being one of the economic variables most impacted by the recession, increasing an individual or household's disposable income will ensure increased buying power and demand in the economy. An important attractive feature of the proposal is that most of the tax relief is provided to lower income tax payers, thereby enhancing the progressivity of the tax regime. Having said that, there is an issue of bracket creep that has not been explicitly explained in the received documentation. The Commission would wish to advise the Committees to seek clarification on whether bracket creep due to inflation may actually outweigh the direct effects of the relief offered. Some estimates quoted in a recent issue of the Star newspaper claim that this phenomenon may have the effect of increasing individuals' tax bill by R22 billion compared to the R6.5 billion relief that was granted. This would reverse the intended effects of the tax relief policy. More generally, government needs to explain explicitly how the issue of bracket creep has been attended to if at all.
- b. *Fuel levy increase* – The proposal is to raise fuel taxes by 25.5 cents per litre. In the Commission's previous work on fuel taxes published in the South African Journal of Economic and Management Sciences recently, an assessment of the economic effects of a hypothetical fuel levy increase was explored. The welfare effects of increasing the fuel levy by 10 per cent are negative but very small. Similarly, the marginal excess burdens for efficiency and equity (poverty) are quite low, suggesting much smaller impacts of the intervention on both economic activity and equity. Furthermore, a fiscal policy reform that raises fuel levy by 10 per cent is progressive as it has stronger negative effects on higher income households than the lower income households. On the basis of this, it is the Commission's view that the proposed measure is reasonable. However, continued increases in the

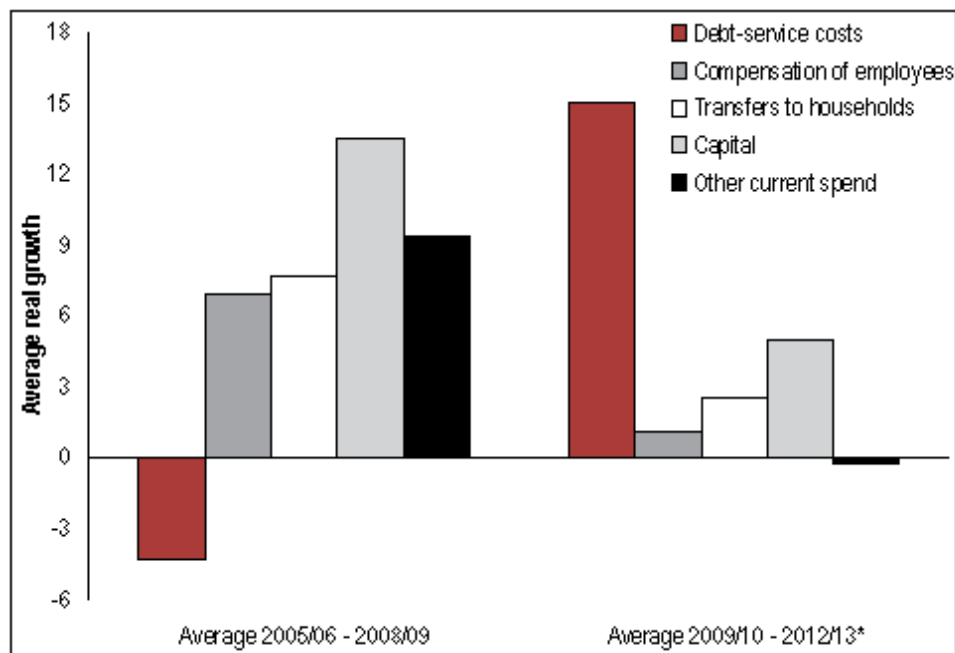
fuel levy need to be heeded with caution, given the large increases in the tax in last year's budget as well as South Africa's high dependence on oil.

- c. *'Sin' taxes* – The proposal to raise revenue through increasing sin taxes should generally be supported as sin taxes are an important revenue source for national government and an instrument of improving social living standards and curb the negative social impacts of alcohol and cigarette abuse. However, government needs to review the potency of the tax instrument to achieve the latter goal. Alcohol and cigarettes are addictive goods. Government should not run the risk of over increasing taxes on these goods to such an extent that it impacts negatively on household expenditure and promote instances where individuals spend most of their disposable incomes on these goods due to addiction. There would thus be negative social returns to the tax as household expenditure on food and other necessities are sacrificed. A further more subtle issue is the differential treatment of the alcoholic beverages that can have distortionary effects on the system and the fiscal framework needs to clarify that. In particular the Committees may wish to request further explanation of why the alcoholic beverages are treated differently when the idea is to discourage this harmful consumption? Is it the policy to encourage wine consumption at the expense of spirits and beers for example? Or put more forcefully is it government policy to prefer jobs in wine industries over those generated in beer and whisky industries/breweries? The simple point is that differential taxation can have distortionary effects that need to be anticipated and explained clearly to the public.
- d. *Carbon dioxide tax on new vehicles* – The proposed carbon dioxide emissions tax on new vehicles is welcome as it is meant to alter behaviour of individuals towards cutting down of environmentally damaging expenditures.

- e. *Mineral Royalties* - The introduction of mining royalties, which is considered a non tax revenue source, was postponed by a year due to the recession to lessen the burden on the mining sector. The royalty is to be imposed on disposal of or exported minerals on 1 March 2010. The Commission feels that this could be too soon for the imposition of the royalty given the fact that the mining sector and domestic imports were severely impacted on by the global recession and the fall in commodity prices.
  - f. *Further research on broader environmental tax reforms* – The Commission welcomes the stance of further research on a broader environmental tax reform. The Commission feels that introducing broad sweeping environmental taxes in the midst or aftermath of a recession would have sent wrong signals that government’s intentions are revenue raising when infact the idea is to encourage desirable behavioural change. The Commission is also carrying out work on environmental fiscal reform for the next research cycle.
  - g. *Local Business Tax as replacement for RSC Levy*: The Commission is aware that SALGA has been doing some work on this as a potential revenue source and will be making it’s recommendations in terms of the Municipal Fiscal Powers and Functions Act provisions
6. While the Commission agrees with this broad stance of tax policy proposed by government, we think the bigger and more important question that needs to be clarified is the need for there to be consistency with long-run fiscal objectives: Spending increases and tax cuts in the face of a recession lead to budget deficits in the short term as we have seen. Because government debt tends to “crowd out” capital, higher deficits, if persistent, slow economic growth in the long term. Given the large projected fiscal imbalance in the medium and long run under the Commission’s two scenarios above, new fiscal actions will need to be spelt out that best meet the country’s long-run fiscal needs if our present actions are to avoid enlarging the long term fiscal gap. To achieve that goal, near-term increases in government spending or reductions in taxes would need to be followed by offsetting reductions in

spending (which have not been spelt out and seems unlikely given political pressures not to do so) or increases in taxes after the economy recovers (which again have not been spelt out except that government reserves the right to increase taxes in the future).

7. A related and perhaps more important point pertains to the fiscal risk perceived or real related to personnel expenditure and transfers to households. These have increased considerably in recent years (7 percent and 8 percent in real terms respectively from 2005/06 – 2008/09). Over the next few years, that is, 2009/10 – 2012/13 growths in these items is expected to decline to approximately 1.5 percent for personnel costs and approximately 3 percent for transfers to households in real terms in order to account for increased debt payments, which is predicted to increase by approximately 15 percent in real terms. There are concerns over these predictions as personnel expenditure and social grants are fiscally rigid expenditure items. With increased volatility on the revenue collection side, this could exacerbate perceptions of increased fiscal risk, which could also impact on the country's credit rating. Government has already taken some hard choices (e.g. the coverage of social grants versus the level of entitlement), but will have to also balance expansion of the public service including addressing the high vacancy rates with wage increase expectations.



\* 2009/10 – 2012/13 are based on forecasts.

## ***5. Further issues on fiscal frameworks, transparency and contingent liabilities***

1. The exceptional uncertainty at present underlines the importance of providing the public with key information on the fiscal position. Underlying assumptions should be set out in detail and subjected to audit, in particular those that make up for the fiscal forecast. This will enhance further the credibility of revenue forecasts used for equitable distribution among the three spheres of government.
2. In line with international best practice it may be important to explore the establishment of an independent office along the lines suggested by the Commission in its submission on the Division of Revenue Bill for 2007.
3. The fiscal situation in South Africa, especially for provincial and local governments, is very weak. Stimulus money from the national fiscus, prevented massive public employee layoffs this year, but given the current state of revenue projections sketched above, it is highly questionable whether additional funds will be forthcoming soon. Given the slow state of



the economic recovery and the inherent lag in provincial and local government tax revenue growth, many provinces and local governments will eventually be forced to enact large cuts in public spending. Unfortunately, public education and health are likely to be hit very hard. It is here that the Commission wishes to ensure that cuts will be limited to non-core areas, and done in a reasonable way so that basic service delivery is not compromised, nor the progressive realisation of socio-economic rights.

4. Looking at the non financial sector public enterprises, we note that there is increased funding for parastatals. The public sector borrowing requirement rises cumulatively over the three years by R331 billion compared with what was budgeted for in February or a large R1.11 trillion over the next four years. The substantially bigger borrowing requirement is partly linked to large infrastructure investment projects that would be key for long term growth and well being of future generations. However, the Commission is increasingly concerned about contingent liabilities associated with increased guarantees to parastatals as well as increased levels of concessionary finance in the industrial policy strategy. These contingent liabilities might become an actual liability and a loss and depend on something in the future, which may be beyond government's control. These should therefore be monitored carefully.
5. Finally and related to this, the recapitalisation of the Development Bank of Southern Africa (DBSA) (allowing an increase in its callable capital) is a significant development as it constitutes the first recapitalisation in over a decade). This raises significant issues in terms of the current focus on DBSA lending (largely on highly creditworthy municipalities). The issue is whether it has exhausted its current lending capacity and the impacts of the recapitalisation on the overall debt market. This may have the unintended consequence of squeezing out private lenders or actually growing the size of lending to municipalities. The Commission would wish to point out these risks involved, as well as the need for clear policy objectives to be transmitted to the DBSA.