Financial and Fiscal Commission Briefing on the 2011 Fiscal Frameworks and Revenue Proposals

For an Equitable Sharing of National Revenue

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1. The Context: Briefing to Parliament's Powers to Amend Money Bills

1.1 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. It is also made in terms of the FFC Act which requires the Commission to respond to any requests for recommendations by any organ of state on any financial and fiscal matters.

1.2 The Commission's Submission has five sections. The second section gives a brief description of the fiscal framework for 2011. The third section looks at the macroeconomic outlook and long term fiscal risks. Section 4 discusses tax revenue estimates and 2011 tax proposals while section 5 raises what the Commission considers as important issues in relation to future fiscal frameworks. The final section contains the conclusions.

2. Review of 2011 Fiscal Frameworks

2.1 Government tabled a total national budget of R889-billion to be spent between the three spheres for 2011 financial year, growing to R1.1-trillion in 2013/2014. A significant portion of this allocation is spent at national level (47%) and provincial level (44.3%), while the local government receives 8.7% of this allocation.

2.2 This year's fiscal framework sees expenditure rise by R94.1-billion relative to baseline over the medium term expenditure framework (MTEF). A total of R150-billion goes towards job creation and skills development programmes and R800-billion to infrastructure investment.

2.3 The allocations to provinces have been revised upwards with an additional R30.1-billion to the Provincial Equitable Share (PES) and R10.1-billion to conditional grants over the Medium Term Expenditure Framework (MTEF). Local government receives an additional R1.2-billion to its equitable share, R3.7-billion to conditional grants and R300-million for general fuel levy (to cater for the introduction of two new metros (Buffalo City and Mangaung)).

3. Macroeconomic Outlook and Long-Term Fiscal Risks Confronting South Africa

3.1 South Africa is steadily moving out of the recession with the domestic demand being supported by automatic stabilisers and monetary accommodation, increased public investment, as well as greater social support. Economic growth (in real terms) has increased from -1.7% in 2009 to 2.8% in 2010 which is reflective of the ongoing economic recovery. However, the International Monetary Fund (IMF) lowered its projection for South African economic growth in 2011 by 0.1% to 3.4% (World Economic Outlook, January 2011), citing slower pace of recovery due to lower world trade and high (chronic) unemployment rate. Similarly, South African Reserve Bank (SARB) has adjusted its growth forecast downwards to 3.4%, which is well below the expected 6.5% average growth rate for developing countries. During 2010, SARB reduced the repo rate three times to 5.5% in an attempt to boost consumer spending and aid economic recovery in South Africa. Manufacturing, as well as mining and quarrying were the biggest contributors to economic growth in the last quarter of 2010 (Statistics South Africa, 2011). In real terms, and relative to size of the industry, mining and quarrying as well as manufacturing were also the biggest contributors to the overall economic growth in 2010, and these are the industries that comprise the majority of South Africa's exports. Exchange rate is thus extremely important to the South African economy and the Commission welcomes attempts by the government and SARB to moderate the effect of capital flows on the exchange rate. These include the accumulation of foreign reserves as well as the increase in prudential limits for the South African investor community (i.e. easing of the exchange controls have already contributed to a depreciation of the Rand – some 10% as mentioned in Minister of Finance's speech).

3.2 The Commission's economic outlook last year based on a dynamic computable general equilibrium model projected that GDP would fall in 2008 and 2009 and then increase again from 2010 although 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. As was expected, South Africa

has maintained moderate positive economic growth through to the fourth quarter of 2010 in line with the Commission's projection. This growth, marginally higher than the Commission projection has been driven by (a) stronger than expected global economic recovery, (b) ongoing lagged benefits of a 6 ½% decline in short-term interest rates between December 2008 and the present and (c) substantial decline in inflation and consequent increase in disposable income.

3.3 South African government recognises the importance of economic growth in job creation as well as the contribution of different sectors to economic growth. This is made clear with the announcement of the New Growth Path (which is the main focus of this year's budget), State of the Nation announcement of R9-billion jobs fund, a R10-billion allocation by the Industrial Development Corporation (IDC) and up to R20-billion tax breaks to promote investment in the manufacturing sector.

3.4 However, high economic growth ("higher, inclusive growth, and above all sustained", as Minister of Finance put it) needs to be accompanied by improvements in skills and education. South Africa faces enormous pressure to upgrade human capital skills. It suffers from competitive disadvantage in terms of quality of its human capital, its investment in research and development (R&D), and information and communication technology (ICT) penetration. The country will need to increase investments and quality of spending in education and bolster spending on R&D. These supply-side factors constitute most pressing key long-term challenges confronting South Africa and necessitate consideration of long-term fiscal risk.

3.5 The South African government adopted the United Nations Millennium Declaration alongside other countries as an unprecedented declaration of solidarity to rid the world of poverty. This declaration is encapsulated in the Millennium Development Goals (MDGs). The South African government did not only embrace the MDGs, but set policies in place to increase economic growth and employment, focusing on redistribution and thereby reducing poverty and inequality. Key policies implemented since the abolishment of apartheid include the Reconstruction and Development Program (RDP), the Growth, Employment, and Redistribution (GEAR) strategy, the Accelerated and Shared Growth Initiative for South Africa (AsgiSA), and recently the New Growth Path. Although South Africa has made progress in achieving the MDGs, some gaps remain. Using a dynamic, computable general equilibrium to analyse the budgetary efforts required to achieve the MDGs, simulations carried out by the Commission show that if the economic conditions (including external

conditions and policies) do not change, there will be progress in achieving some MDGs but this progress will not be sufficient to achieve them all. South Africa should be able to achieve MDG 1 (eradicate extreme poverty and hunger[1]), but not any of the other MDGs (even when higher GDP growth numbers of 4.5% per annum are assumed) unless more efforts are made to reach these MDGs. Further scenarios were conducted to investigate the impact on public spending in order to achieve the MDGs, separately and simultaneously (excluding MDG 1). If the health MDGs (MDG 4: reduce child mortality, and MDG 5: improve maternal health) are targeted alone, health spending increases from 3.1% of GDP to 5.1% of GDP, and stays at 5.1% of GDP even when all the MDGs are met simultaneously. Water and sanitation spending increases from very low numbers in the base year to 2.3% of GDP and stays at this level even when all targets are met. Under higher growth scenarios the cost of achieving the MDGs is somewhat lower.

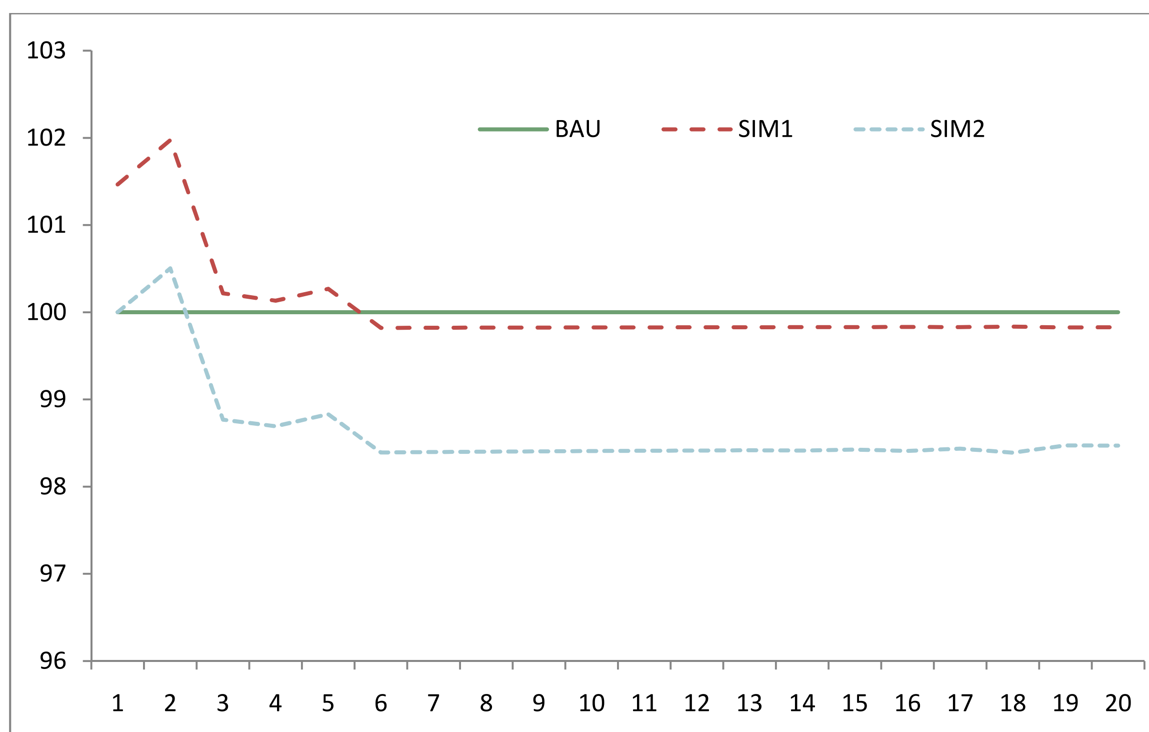
3.6 This year's budget sets aside some R8-billion in allocations for specific health service interventions that are meant to lay the foundation for the National Health Insurance (NHI). It is well known that the full programme will cost a lot more and hence poses a fiscal risk[2]. The Commission has recently made long-term budget projections under three scenarios that reflected different assumptions about future policies for revenues and spending that mimic introduction of NHI. The business as usual (BAU) scenario is assumed to follow a steady state path in which all variables are constant per effective labour unit. To reflect policies that could be implemented to achieve the NHI, an increase in public spending of 10% for the two first periods and of 2% for the three following years is made. In a first simulation, there is no imposition of any constraint on the debt to GDP ratio whereas we assumed, in the second scenario, that any increase in public spending would need to be financed though increased taxes on household income.

3.7 During the years of increased spending, and without any constraints on the debt level, South Africa would experience greater GDP than what would have otherwise been the case (Figure 1). This result confirms that the policy would indeed boost GDP in the short run. However, the opposite happens once the government goes back to its initial spending levels. This outcome results from the crowding out effect public spending would have on private investment. Indeed, the greater the public deficit, the less

[1] For more information on the MDGs, see www.undp.org/mdg/goals.
[2] NHI is expected to cost R128-billion in the first year, increasing to R325-billion by 2025.

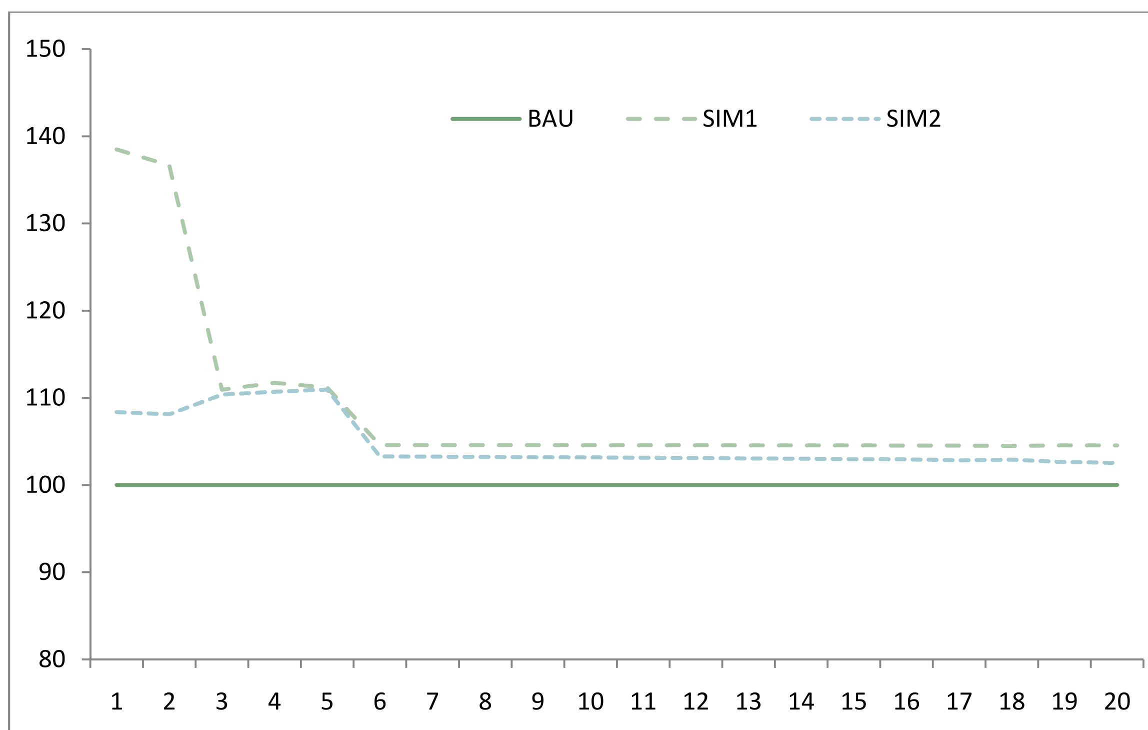
savings there are to finance other investments, which leads to a smaller productive capacity in the future, and thus, to a smaller GDP. Figure 2 shows the evolution of the public deficit to GDP index (BAU = 100). It can be seen that the index increases sharply during the first five years but also for the following periods. In fact, by borrowing more during the first years, the government increases its interest payments for all future periods, which exacerbates the crowding out effect. Figure 3 shows that under such a scenario, the debt to GDP ratio would be 5% greater than its BAU levels.

Figure 1. Impact of Increased Government Spending on GDP



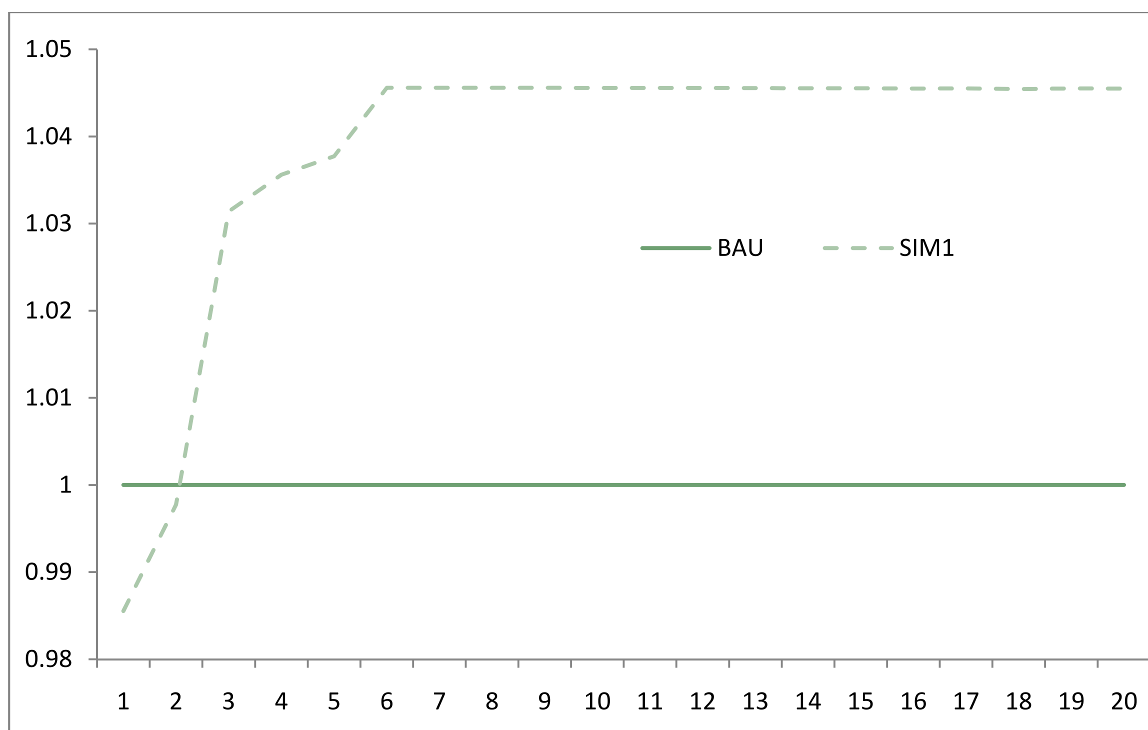
Source: FFC 2011

Figure 2. Impact of Increased Government Spending on Deficit to GDP Ratio



Source: FFC 2011

Figure 3. Impact of Increased Government Spending on Debt to GDP Ratio



Source: FFC 2011

3.8 When government cannot increase its debt to GDP ratio beyond its BAU level, in other words NHI would be financed though increased taxes, it is not surprising to see that the public deficit would not increase as much as it did under the first scenario (see Figure 2). However, the positive impact on GDP is not significant as it was in the first case. Increased taxes on households' income would have a negative impact on their consumption and saving levels, and thus on GDP. Figure 1 shows that, in the long run, greater public spending financed through increased taxes would translate into a loss of GDP close to 2%, although a small positive impact is observed in the shorter run. This year's budget has allocated R8-billion to lay the foundations for the NHI that is being implemented as part of the Department of Health's ten-point plan for improving outcomes. According to the 2011 Budget Review, over the medium to long term, the revenue requirements of the NHI system will require upward adjustments in the tax structure. Increases in VAT, payroll taxes and surcharge on the personal income tax base are financing options under consideration. The Commission's research discussed above indicates that GDP growth is lower when utilising taxation compared to utilising borrowing. In particular, private consumption spending is lower when using tax sources, but the largest impact is on private investment which declines pointing to domestic crowding out. This compromises future growth.

3.9 Another important fiscal risk that South Africa faces is that associated with adaptation to global climate change. Most Global Climate Change Models (GCMs) project a temperature increase for South Africa by 2100 (SIAM Model). While the global damage cost of a tonne of carbon-dioxide is estimated to be "only" approximately $5[3], the broader, negative, societal impact of coal, coal mining and electricity generation is very high. Examples indicating costs of up to R15-billion per year (extrapolated to R18-billion per year in 2008) in mortality, morbidity and climate change associated with coal-fired electricity generation[4]. These external effects are not reflected in the price of either coal or electricity. Neither is the cost to reduce atmospheric carbon (e.g. recent estimates for Carbon Capture and Storage are as high as R600 per tonne of carbon-dioxide). Climate change will also be reflected in increased frequency and intensity of extreme weather events, reduced precipitation in

[3] Tol, R.S.J. (2005). "The marginal damage costs of carbon dioxide emissions: an assessment of the uncertainties." *Energy Policy* 33: 2064-2074.

[4] Blignaut, J.N. and Zunckel, M., 2004. *Cost of a decline in air quality*. In Blignaut, J.N. and De Wit, M.P. (Eds). Sustainable options. Cape Town: Juta.
Spalding-Fecher, R. and Matibe, D.K. 2003. Electricity and externalities in South Africa. *Energy Policy*, 31(8): 721-734.

many regions and an increased probability of flooding episodes with accumulated precipitation in heavy rainy periods. On the agricultural sector front, there are likely to be net adverse effects emanating from negative impact of temperature change and from pressures on available water supply. There will be differential impacts across regions, with shifting to different crops in different zones. For the Coastal zones, there will likely be an increase in sea level, necessitating the need for protective actions to minimize impact, particularly in regions of high development and high population density. While there are no estimates available of impact on insurance or tourism sectors, urban centres, or soil and land resources, these costs are likely to rise. These contingencies are generally not factored in the fiscal framework proposed (note that change in the structure of the electricity tariff will have an environmental consequence, but not replacing the need to consider things like an input (e.g. coal) tax purely from an environmental vantage point separately such as put forward by the National Treasury's "Environmental Fiscal Reform" policy document as well as global action but the risk is not entirely eliminated).

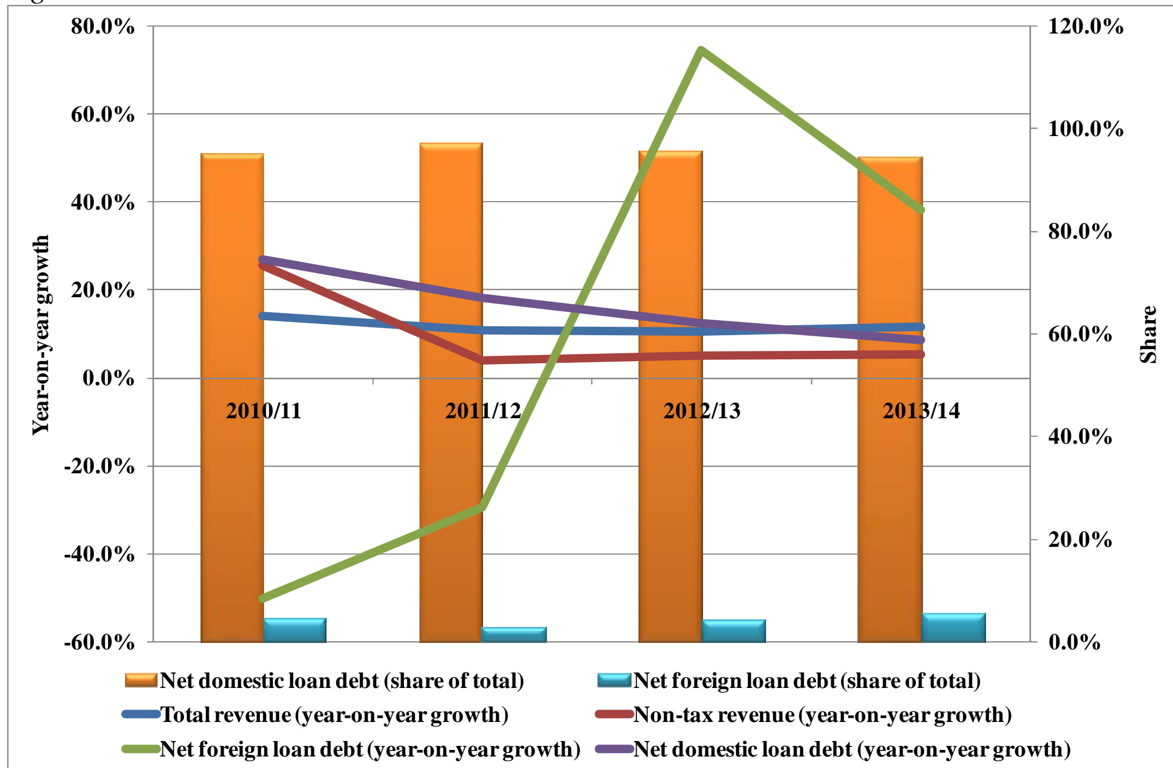
3.10 Commodity prices are expected to continue to be high during 2011. While the country would be expected to benefit from high prices on platinum and gold, oil price increases pose significant economic and fiscal risks. During the last years, the oil market has witnessed substantial price volatility as well as historically high prices for crude oil and the major light products. In July 2008, oil price struck an all time record high above $144 a barrel, seven times higher than when it was at $19.70 a barrel in December 2001. In recent weeks, political developments in North Africa have resulted in the oil price rising again to over $100 a barrel. Analysts have pointed out that higher oil prices are inevitable and it is unlikely that prices will be reduced in the long term without major discoveries of sufficient sources of oil or alternative energy sources. The oil price therefore poses significant risks to government fiscal frameworks that need to be accounted for. Government management of higher oil prices will have significant repercussions on the economy in terms of income distribution and poverty reduction. In addition, higher oil prices will lower oil consumption in favour of other sources of energy such as coal, which are known to be more damaging for the environment. Using an energy-focused computable general equilibrium model linked to a micro-simulation household model of South Africa, research carried out by the Commission suggests that oil price increases would reduce gross domestic product by between 2.2% and 2.5% depending on the magnitude of the increase assumed. The

impact on government deficit varies widely among the scenarios, ranging from a worsening of 12% to 22% in the floating prices and the fixed price scenarios, respectively. Poverty headcount ratio increases and the poorest households are most adversely affected by the increase of oil prices. Employment and wages drop. Thus, the Commission concludes that oil prices do pose a substantial risk to the current fiscal position.

3.11 In his speech, the Minister of Finance mentioned that debt service costs are the fastest rising component of government expenditure in South Africa. The budget balance is expected to gradually decrease from 5.8% of GDP in 2010 to 5.3% in 2011. However, the debt figures are expected to rise in the same period from 30.8% to 34.3% of GDP, respectively (Budget Review, 2011[5]). As mentioned in the Commission's response to the MTBPS, the source of funds used to finance the deficit need to be closely examined (see Figure 4 below). Non-tax revenue includes mineral and petroleum royalties, mining leases and departmental revenue. The revenue components as well as the net domestic loan debt growth rates level off, whereas the net foreign debt growth rate increases sharply. It is true that the share of net foreign debt to total debt remains constant at approximately 5%, but there still is cause for concern around the sharp increase in foreign indebtedness. Figure 5 below shows that state debt increases no matter how one looks at it – that is, in absolute terms, as a percentage of total expenditure, or as a percentage of total revenue. State debt as a percentage of total revenue can loosely be interpreted as the debt service ratio, which is increasing steadily pointing towards an increase in the state debt burden. This implies that expenditure increases are increasingly being financed by debt. While it is in part necessary for government to borrow in order to pursue countercyclical policies and ensure sufficient service delivery, exposure to foreign exchange risk is cause for concern. In addition, borrowing should only be spent on capital financing exercises (golden rule). In last year's submission, the Commission also noted that 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 would make the determination of rules particularly difficult.

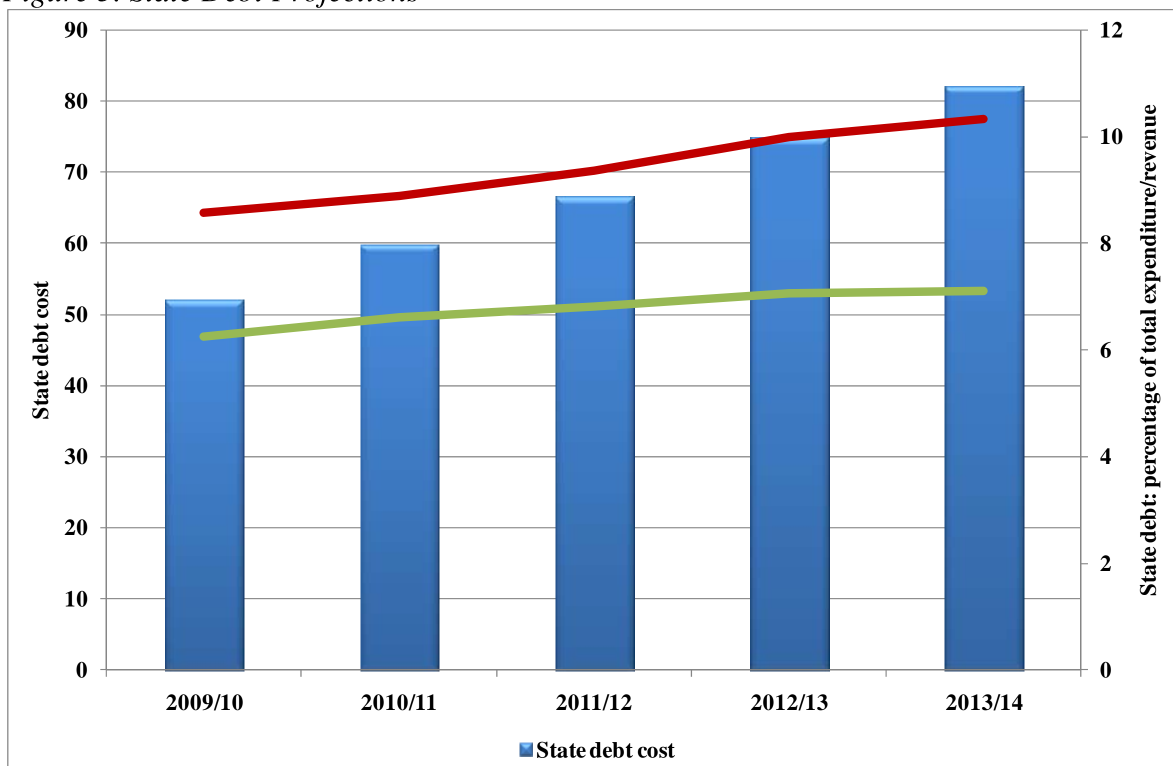
[5] IMF Fiscal Monitor, January 2011 reports slightly higher figures, but a resulting increase nonetheless.

Figure 4. Loan Debt and Revenue



Source: National Treasury (2011), Commissions' own calculations.

Figure 5. State Debt Projections



Source: National Treasury (2011), Commissions' own calculations.

3.12 Closely linked to the issue of debt are rising personnel costs. The present fiscal position, while sound, is still imbalanced in terms of the share of wages and salaries and hence too reliant on one-off measures such as the results of wage bargaining. On political economy grounds, it is hard to change these commitments now but they do pose significant fiscal risks going forward.

3.13 There are a number of contingent risks associated with commitments on public private partnerships (PPPs in transport, water, energy, education, correctional services, defence, and hospital sector). These are akin to debt, but not reflected in the Budget Review although some information pertaining to PPPs appears in the Estimates of National Expenditure.

3.14 Finally, there are also "inevitable surprise" factors, that is, shocks that are difficult to predict for which fiscal leeway is required. The contingency reserve "top slice" amount that South Africa routinely sets aside should be commended and further strengthened.

3.15 Therefore, there are many issues that pose fiscal risks for South Africa. These range from explicit, legislated, commitments, to implicit fiscal commitments flowing from perceived role of government (e.g. Government backup for NHI, dealing with effects of sea level rise, sectoral adjustments in agriculture, flooding, etc.). The question is whether or not South Africa should tighten the fiscal policy framework further to take account of these long-term issues.

4. Revenue Estimates and Tax Proposals

4.1 Tax revenue has recovered in 2010/11 and is 12% higher than last year. The revised tax revenue estimates for 2010/11 are up R73.5-billion compared to 2009/10 and R24.35-billion above the 2010 budget estimate. However, tax revenues are R7-billion below the 2010 Medium Term Budget Policy Statement (MTBPS) estimate.

4.2 Tax revenue growth is driven by value added tax and custom duty revenues which display strong growth. There is modest growth in personal income tax revenues while corporate income tax revenue is lagging.

4.3 Government has proposed introduction of a third rebate for taxpayers that are 75 years and older, tax on gambling winnings, conversion of medical tax deductions to tax

credits, increases in the monetary thresholds relating to the exclusion from capital gains. Government is also exploring options to fund increased spending on the health system and considering tax incentivised savings accounts (first time home deposits and for higher education). On business taxes, the new dividends tax will be introduced on 1 April 2012. In addition, a youth employment tax credit is proposed as well as an extension of the date of the learnership/skills development tax incentive. The incentive regime to facilitate equity investments in small and medium size companies and junior mining companies (venture capital company) will be reviewed. Indirect tax proposals include increase in fuel taxes, electricity environment levy, alcohol and tobacco taxes and air passenger departure tax.

4.4 The proposed tax structure in this year's budget is designed to support economic growth and the Commission welcomes that. International evidence suggests that corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and consumption taxes. Generally, growth-oriented tax reform measures involve tax base broadening. The rest of the Commission's commentary on the specific tax proposals are as follows:

a. *Fuel levy increase:* Previous work carried out by the Commission on fuel taxes found out that the welfare effects of increasing the fuel levy 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. A fuel levy increase 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.

b. *'Sin' taxes:* As pointed out last year, 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.

c. *Potential tax options for funding NHI:* As discussed above, research carried out by the Commission so far suggests that GDP growth is lower when utilising taxation, private consumption spending is lower and private investment declines. The Commission will continue its work and also respond to the proposals presented by the Minister.

d. *Environmental Levy:* The Commission welcomes the idea of an environmental levy to encourage desirable behavioural change. The proposed levy potentially results in actions towards cutting down of environmentally damaging expenditures. The levy however has potential to negatively impact on poverty and income distribution. The Commission awaits further details on how such negative consequences of the levy would be addressed.

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

5.1 What a country should do to respond to the risks identified in the sections above is not easy at all. This is because we are dealing with problems for which there are fundamental uncertainties. Policy responses will imply significant short-run costs to taxpayers with uncertain scale of actions required and uncertain benefits to future generations (e.g. climate change). There is a need to decide how much risk aversion is acceptable in judging sustainability of policies and what probability of long-term fiscal sustainability is desirable. In addition, the losses if action not taken need to be considered. The answer will depend on social time preference rates (intergenerational welfare choices and associated difficulties of defining generations).

5.2 Government has proposed guidelines for fiscal sustainability in the 2011 budget aimed at protecting fiscal gains for future generations. It proposes that government (a) adopts an annual target for the structural budget balance, (b) make explicit the costs of existing and new programmes requiring a long term expenditure commitment and (c) set out a timeline to bring the budget back on target following large fiscal shocks.

5.3 In last year's submission, the Commission proposed a "multi-pronged" strategy to take long-term fiscal concerns into account in the short to medium-term. The tenets of this include a budget process and framework more clearly recognizing long-term fiscal risks that builds on existing work, strengthened analytic approaches and a blend of aggregate fiscal rules. It noted that the important issue is really not in the minor differences between its projections and the National Treasury's, 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, and 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.

5.4 The Commission is of the view that indeed fiscal rules can be used as a mechanism for achieving fiscal sustainability.

a. South Africa has come a long way in operating some sort of fiscal rules that are implemented through constitutional amendments, statutory provisions or policy guidelines. A variety of enforcement mechanisms exist to enforce these. For example, when rules are violated, sub-central governments may be subject to administrative sanctions, financial penalties, or a loss of prestige and reputation. In addition, "peer pressure" in the form of recommendations by the Financial and Fiscal Commission (FFC) to restore fiscal discipline when subnational governments fail to adhere to such rules is available. There have been instances where local level authorities are removed from office for violating fiscal rules. Furthermore, a constitutional provision allowing the parliament to adjust the budget proposed by government has proved 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. Thus, there is entrenched recognition and clear demonstration of fiscal prudence by South African authorities permeating through subnational government.

b. A key issue that arises in the context of South Africa is whether and how to strengthen fiscal rules. The Commission's analysis, though preliminary and tentative, suggests that subnational government's 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, it appears that rules embedded in intergovernmental transfers have delivered government's equity goal while the efficiency objective has largely not materialized.
c. In view of the above considerations, a more nuanced view of the appropriate role of fiscal rules at national and subnational government needs to recognize that a sophisticated intergovernmental system is in place and furthermore look at how to improve an existing and functioning system. Thus, the starting point should be recognition of the existence of some sort of fiscal rules that largely are working reasonably well.
d. As is common in other countries pursuing fiscal rules, government is certainly conflicted when it comes to acting as both judge and jury on its performance. This calls for a separation of function. The Swedish model in this regard of setting up an independent fiscal policy council is a good guide and needs to be considered. Based on these considerations, a possible option for fiscal rules would be to target a balanced budget or surplus over the cycle without any limits which allows for the operation of automatic stabilisers and also for discretionary countercyclical action. In addition, limits on the government wage bill need to be imposed. 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). If we use the example of Australia and New Zealand, which generally is the case when macroeconomic policy is concerned in South Africa, these two countries have strengthened their fiscal frameworks without having to announce numerical fiscal targets. When it comes to the second aspect, the set up 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, monitor transparency of fiscal data and conduct research on South African fiscal policy.

e. When it comes to fiscal rules, there are a number of issues to ponder over, including (a) establishing its accountability lines (whether to Parliament or Executive) and who reviews this Council, and (b) issue of public sector pay and if there will potential destabilising effect on budget – will there be political/civil buy in for such a Council when it pronounces on annual wage adjustments, for example? While the role may be played by the recently created National Planning Commission and/or Monitoring and Evaluation Departments in the Presidency, this would not eliminate the conflict issue entirely as the Council would need to be depoliticised or at least be independent. Fiscal institutions such as the FFC should continue to play a complementary to effective rules, and in particular to compliance as pertaining to intergovernmental fiscal relations through its periodic advisories.

f. However, as noted in the Commission's 2010 submission, it is in favour of the proposal by government 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 (PFMA) and the Municipal Finance Management Act (MFMA) are a step in that direction, particularly by adding a rule for public investment, or to allow policy makers to borrow for public investment.

g. The Commission is looking forward to contributing to the debates surrounding this topic.

5.5 Spending is directed towards core social priorities and economic infrastructure. The Commission's research on public expenditure finds some evidence that expenditure on defence, health and transport seems to be contributing positively to economic growth in South Africa. It should be noted that these expenditures have been given priority in the 2011/12 budget. In addition, given that the recently announced New Growth Path has included infrastructure investment and maintenance as well as National Health Insurance (NHI) on its list of key focus areas, it is encouraging that

the analysis finds these components of expenditure to be growth-promoting. The estimated elasticities for health are particularly impressive, indicating that health in particular seems to be an important driver of growth in South Africa. Similarly, backlogs in education, particularly those pertaining to infrastructure and teachers (i.e. performance and quality issues), pose an enormous challenge for the government over the coming years.

5.6 There is a need for Parliament to obtain greater clarity on the risks to which the public sector is exposed. This entails clarifying potential costs of different risk factors (e.g. climate change).

5.7 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. Pre-announcement of alternative ways of financing NHI and guidelines for fiscal sustainability by Government in the 2011 budget, for example, are a big positive step in this direction.

5.8 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.

5.9 In the interest of efficiency, a requirement to evaluate regularly the impact of policies – where not prohibitively costly – would strengthen the fiscal frameworks in South Africa.

6. Conclusion

Overall, this year's budget contrasts the conflicting objectives between job creation and fiscal consolidation. However, the question becomes will South Africa achieve higher growth through its fiscal stance? The budget acknowledges that debt service costs are rising faster than any category of spending, yet the Government has failed to reduce the budget in the coming year. It is important to point out that this year's fiscal frameworks are noteworthy in one major respect, reflecting explicit recognition by the Executive of the need to take account of long-term issues in budget formulation. It is critical that such a perspective is shared both

by executive and legislative branches. As with most other emerging countries, South Africa needs to take account of potential long-term structural developments and risks. There are *fiscal* dimensions to many of these risks and these dimensions involve dealing with problems for which there are fundamental uncertainties. A multi-pronged approach is necessary to deal with issues of a long-run nature, one that involves strengthened policy analysis, reforms of the budget process, sustained fiscal consolidation, as well as sectoral policy reforms. It should be noted that in 2011 South African fiscal frameworks was acknowledged as the most transparent of 94 countries surveyed when it comes to making information public. The Commission commends the Government for this achievement.

For and on behalf of the Financial and Fiscal Commission

Mr Bongani Khumalo
Acting Chairperson/CE
March 03 2011