MINISTRY OF FINANCE
REPUBLIC OF SOUTH AFRICA

LONGER TERM FISCAL POLICY ISSUES IN SOUTH AFRICA

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South Africa has earned an enviable reputation for sound fiscal management and a progressive opening up of its financial markets, within a prudent regulatory regime.

We have brought our budget deficit below 3 per cent of GDP, we have inflation now comfortably within our target range of 3 to 6 per cent, we have kept our balance of payments current account within moderate limits, we have seen capital market interest rates fall to their lowest levels in some 25 years.

We have achieved moderate growth of the economy, and there is encouraging evidence of an acceleration in the pace of job creation.

The fiscal and budgetary reforms of the past decade have built a firm foundation for the years that lie ahead. But in the life of a finance ministry there is no reasonable prospect of a gentle rocking chair retirement: the challenges of the decade ahead are formidable, and in some ways more complex, than the path we have traveled already.

A decade ago, and in 1996 when the Growth, Employment and Redistribution macroeconomic strategy was formulated, it was clear what had to be done macroeconomically. We had to stabilize the fiscal balances, we had to dismantle the exchange controls and trade barriers of an over-protected siege economy, we had to steady the inflation trajectory, we had to redirect public spending towards investment in skills and redressing the distortions of racially skewed social services, we had to reverse the decline in infrastructure investment. There were varying opinions on the details of the macroeconomic framework and of course there were those who regarded the whole strategy as distastefully Washingtonian. But in retrospect these were the right things to do: and by 2001 we were able to adopt an expansionary and pro-growth fiscal stance, in a context of renewed business confidence, a declining debt-GDP ratio, moderate inflation and a healthy balance of payments.

As I have intimated, a finance minister’s life is never boring. By the end of 2001 a speculative attack on the rand made all these happy circumstances seem irrelevant. But we survived that, conducted an inquiry into the causes and consequences, and today I don’t mind saying that a little less market confidence in the rand might be welcome relief. But the interior calculus in the minds of currency traders and hedge fund treasuries is about as comprehensible, I have come to believe, as the Book of Job. Which was, as you know, the original dismal science.

Let me return to my brief, which is fiscal policy.

The fiscal challenge over the past ten years has been pretty straightforward in its key dimensions – develop a medium term framework, strengthen revenue administration, modernize the tax structure, adapt policy-consistent planning and budgeting systems, stabilize the fiscal balances, deepen the debt markets, invest in growth and development.

For the decade ahead, the foundations will remain in place – an open economy, competitive markets, a sustainable deficit, a broad-based tax structure, spending plans informed by transparent social and economic policies. But nobody actually lives in the metaphorical foundations. The habitable structure is what counts, even if the foundations need reinforcement from time to time. The construction project now under way involves design and engineering challenges of considerable complexity, adapting the institutions and culture of government activities, addressing qualitative as much as quantitative dimensions, and yielding returns progressively over many years to come.

I'd like to comment on five aspects. This strays a bit off my prescribed topic, but the curious reality is that if we are to think intelligently about fiscal policy over the next 10 years, we have to think about several important things other than fiscal policy.

First, there is the challenge of reconstructing the urban landscape. Why begin here? Because I'm really still, in my dreams and in my nightmares, a Cape Flats housing activist. And because the dynamics of urban conglomeration, how cities evolve over time, is hugely important for both the efficiency and competitiveness of economies and the quality and character of ordinary people's lives.

Let's try to visualize the landscape of the cities in which our children and our grandchildren will live and work and play. What do we need to do to realize the vision of our dreams and not our nightmares?

We have to build transport networks that are safe and convenient and efficient. (A starting point is to try to ensure that people can leave home in the mornings and get to their places of work before the following day.) We have to arrest the decay of inner cities and accommodate more diverse kinds of trade and commerce. We have to promote job creation near the places where people live. We have to extend access to water, sanitation and affordable electricity, and give greater momentum to both the pace and quality of housing construction.

These are challenges of every city in the world, and over the past decade we have steadily stepped up the flow of resources to support municipal infrastructure investment and services. Progress in building houses, connecting water pipes, installing electricity and improving roads and sewerage systems has kept ahead of a comparatively rapid growth in household formation, but the quality of the newly constructed urban landscape remains bleak, even by Job's standards.

Let's be clear about the vision. There are still 2,8 million households, about a quarter of the population, who live in settlements designed to repress rather than promote the spirit of commerce and community. The *cordon sanitaire* still separates town and township, the off ramps from the freeway to the township are few so that they can be guarded by casspirs, the corridors and greenbelts for trade and recreation are stunted and barren. This all has to change. And it will change, partly because the dynamics of the modern city are irrepressible, but also because our urban planning is now strongly focused on reintegrating the city, and investing in interconnected landscapes.

There are immense investments required to make an integrated urban landscape a reality. There are public infrastructure requirements, but there is also a large opportunity for private investment in housing improvements, commercial and office space, industrial and recreational facilities. This is what the Financial Sector Charter refers to as "transformational infrastructure" – investment that changes the quality of ordinary people's lives. For municipalities, the regulatory environment has to be reformed in important respects, and there are still planning gaps. You can't expect private investors to make transformational investments if they don't yet know where the high street is. But the reconstruction of our cities is a joint responsibility, and the role of private finance is recognized in our new Municipal Finance Management Act. So my first suggestion on the longer term outlook for our public finances is that the structure of both public and private investment in the infrastructure of our cities will deepen considerably over the years ahead.

Having talked about the cities, we have to consider also the rural landscape. It is a mistake to think that development policies are either focused on promoting urban growth or on agriculture and the rural poor. Productivity of the rural landscape is in fact closely bound up with the efficiency and the economic needs – food, resources, recreation – of the city. The challenge of redressing a distorted and fragmented landscape is even more stark in the rural heartland.

We are steadily addressing a portfolio of some 75 000 land restitution claims, and as indicated in last month's Medium Term Budget Policy Statement there will be a significant step up in budget allocations for this programme next year. A new conditional grant to provinces has been introduced to strengthen agricultural support to emerging farmers, so that as the longer term land reform programme gathers momentum it will be complemented by appropriate interventions to maintain farm output and improve productivity. The Land Bank is increasingly active in extending credit to black farmers and supporting a more diverse client base.

Again, there are transport and market access issues to address. There are important shifts in priority of our agricultural research and advocacy programmes, new alignments in support services, reforms of the management and pricing of water and irrigation systems, and ongoing challenges in promoting food safety and quality assurance, managing pests and disease risks and promoting access to international agricultural markets.

South African farmers have adapted to significant reductions in trade protection, dismantling of collective marketing arrangements and phasing down of government subsidies. Agricultural output has remained buoyant and aggregate food security is not at risk. These strengths have to be preserved, while the rural landscape undergoes transformation of ownership and tenancy rights, improved protection of labour and promotion of opportunities for smaller scale farming units.

There are several broad fiscal implications. Land redistribution will continue to be a significant budget commitment for many years, but as we move beyond the restitution phase the fiscal contribution will increasingly need to be complemented by self-financing arrangements, while remaining within realistic limits in the inherently risk-prone agricultural debt environment. Technical support will be a continuing government priority, but the bureaucracy does not have an obvious comparative advantage here and so the contributions of education institutions, farmer organizations and specialized media and advocacy initiatives are perhaps more critical.

Again, I believe that the years ahead will see significant shifts in the balance and depth of both public and private sector financing of rural and agricultural development. Farming today is a comparatively capital-intensive industry – measured in terms of value-added, more capital intensive than either manufacturing or construction. But it is also a source of livelihood of proportionately large numbers of people, and agricultural productivity influences trends in food prices, which in turn influence everybody's cost of living. Creating healthy structures in land and farming debt markets, supported by appropriate risk-mitigation, need not loom large in the overall public finances, but it will be an important, growth- and equity-enhancing, area of reform.

Thirdly, a few remarks on financing infrastructure investment and restructuring of state-owned enterprises.

Our expectation is that general government fixed capital formation will grow by about 7 per cent a year in real terms over the next three years, while investment by public corporations, which expanded by 19 per cent last year and 21 per cent in the first half of this year, will continue to increase strongly. Having spent about R38 billion on freight rail infrastructure, rolling stock and ports over the past decade, Transnet expects to invest more than R40 billion over the next five years. Large port projects currently under way include the R921 million conversion of Durban Pier 1 to a container terminal, expansion and refurbishment of the iron ore terminal at Saldanha and the Richard Bay coal terminal, and the new R3,2 billion Port of Ngqura. A R4,9 billion renewal and replating of some 24 000 freight wagons is in progress.

Eskom has begun its recommissioning of mothballed coal-fired power plants, and will continue its expansion and strengthening of transmission networks. Supported by relatively strong balance sheets, Eskom and the major players in the telecommunications industry should not have difficulty financing their required investments. The position of Transnet is less satisfactory, and so its investment programme will in part depend on restructuring to focus on core freight and port activities.

Drawing in part on experience gained in financing and managing the international partnership through which the Lesotho Highlands Water Project was completed, several important investments in water resource infrastructure over the next few years will be undertaken as ring-fenced self-financing projects. The first of these, involving a new dam on the Berg River, will bring a much-needed supplement to the Western Cape water supply system. Design work is near completion for major water projects in the Mpumalanga and Limpopo provinces.

The fiscal implication is that over the decade ahead the public sector borrowing requirement will widen somewhat, while the more narrowly focused main budget deficit remains around or below 3 per cent of GDP. For the next three years, we anticipate a widening of public sector borrowing from under 1 per cent of GDP in 2002 to 4,6 per cent in 2007, and interest on public debt will stabilize at about 4,5 per cent of GDP.

The acceleration in infrastructure investment cannot entirely be financed through debt. This is of course why the profitability and balance sheets of public enterprises are so important, but it is also why we have put considerable effort into developing a robust programme of public private partnerships, which bring private equity and non-recourse debt finance into selected areas of public infrastructure financing. Treasury projections indicate an increase in capital spending through public-private partnerships from about R2 billion last year to about R5,3 billion in 2007/08.

Public sector investment will make up a rising share of total expenditure in the economy, contributing in turn to improved growth and broadening economic participation. This is part of what we have to achieve in order to see continued robust growth in private business investment, which has expanded at over 5 per cent a year since 2000.

For the public finances, over the next decade, a substantial expansion in capital formation is a requirement for more rapid growth and development, and will in turn require innovative and well-considered financing strategies.

Fourthly, let’s reflect on the challenge of deepening social security and income protection.

We are currently stepping up our expenditure on social security, partly to meet continued growth in numbers of child support, disability grant and foster care grant beneficiaries. These social assistance programmes, amounting to some 4,5 per cent of GDP – represent one of the largest non-contributory income redistribution programmes amongst developed or developing countries.

Over the longer term, we need to give careful consideration to the evolution of the social assurance system. Many countries have chosen to finance collective pension arrangements, health care, disability and unemployment benefits through payroll taxes or social security contributions, variously imposed on employees, employers or both. These taxes raise the costs of employment, but on the other hand they contribute to stabilizing labour market participation. The benefit systems rely on centralized administration, which may be cost-effective but tends to inhibit innovation. In general, the social security system gives fiscal expression to a nation's sense of solidarity, provides an important vehicle for both saving and financing income security, promotes social stability and mitigates several categories of household risk.

In last month's Medium Term Budget Policy Statement, we emphasized the critical importance in public policy of getting the sequencing right: targeted incentives and public works programmes play a role in promoting investment and job creation in the short term, while investment in major transport infrastructure, spatial development reforms and an effective competition policy are key long term requirements; investment in education and training is similarly about long term productivity and human development. Reform of the retirement funding environment, improved compensation for work-related injuries or death, reform of the structure of compensation for victims of road accidents, financing unemployment benefits and further evolution of the health insurance environment are separate, but related, elements of our social security reform challenge. Getting these reforms right, and implementing reform initiatives in the right order and within an appropriate and affordable financing framework, are formidable tasks.

You will forgive me for not rehearsing the full set of options and alternative sequencing arrangements. There are aspects of our longer term fiscal policy trajectory on which even the National Treasury has an incomplete view.

But I know you will agree with me that the initiative taken by our major banks, in keeping with a core Financial Sector Charter commitment, to make banking affordable and accessible to all South Africans, has quite rightly been prioritized as one of the first steps on the road to broadening and deepening income security to all. By extending basic banking facilities to all, opportunities are broadened and costs are reduced for so many other kinds of income support and social assurance arrangements.

And more generally, I welcome this crystallization of a private business response to a public interest purpose. There will be varying roles for the public and private sectors in different parts of the social security system, and we need to concentrate efforts on finding the best possible combinations of resources, capacity, service delivery and cost-recovery.

Lastly, let me try to characterize the fiscal outlook in broad terms.

I have put the focus on the long run trajectory of social and economic development. The budget numbers and the monthly price trends and trade statistics fuel the decisions of market participants for whom 45 minutes is a trading horizon and the long term ends on Friday afternoon. But social progress has to be measured decade by decade, generation by generation. And it is because of its contribution to progress over this time line that we chose, a decade ago, to put our fiscal policy stance and budget framework on a sound and sustainable platform.

There have been broadly three phases in the evolution of our public finances.

- During 1994 to 1996, following a period of recession and a rapid rise in the budget deficit, Government's Reconstruction and Development Programme was phased into departmental plans and budgets, and a comprehensive reprioritisation of public expenditure was undertaken. The new Constitutional order and its fiscal and financial institutions took shape. The average budget deficit stood an 4,7 per cent and government debt was approaching 50 per cent of GDP.

- A period of fiscal consolidation from 1997 to 2000 saw the introduction of medium term expenditure planning, the drafting of the Public Finance Management Act, a strong focus on increasing transparency and accountability in the public finances, substantial investment in tax reform and revenue administration capacity and deliberate coordination of fiscal and monetary policy – leading to the adoption of an explicit inflation target. The budget deficit declined to 2,5 per cent of GDP, public debt began to fall relative to GDP and average borrowing costs fell sharply.

- From 2001, a more expansionary fiscal stance has been adopted. Against the background of much improved fiscal management and the declining relative burden of debt service costs, both tax relief and an acceleration in public expenditure have contributed to strengthening the momentum of economic growth and social investment.

In the Medium Term Budget Policy Statement, setting out the strategic framework for the 2005 Budget, we highlight the following priorities:

- Accelerating the pace of growth of the economy, and in particular the rate of investment in productive capacity
- Promoting opportunities for participation of marginalized communities in economic activity, and improving the quality of livelihoods of the poor
- Maintenance of a progressive social security net, alongside investment in community services and human development
- Improving the capacity and effectiveness of the state, including combating crime and promoting service-oriented public administration
- Regional and international partnerships for growth and development.

All of these broad strategic policy challenges involve important kinds of cooperation and partnership between the public and private sectors. It is the combination of targeted public spending and expanding market-based opportunities that opens real opportunities for accelerating the pace of social and economic development in the decade ahead. Our Financial Sector Charter provides a framework within which substantial capital resources of the banking sector and other financial institutions will be mobilized in pursuit of public policy purposes. I believe the defining characteristic of the further construction of our financial architecture over the decade ahead will be the quality of partnership, the underlying relations of trust, that we forge in this joint project.