The new fiscal guidelines and a “rule-of-thumb”

National Treasury proposals in the 2015 MTBPS

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Outline

- A short review of fiscal performance and outcomes
- A short review of fiscal institutions
- Proposals in the 2015 MTBPS
  - Stabilising debt
  - "Rule of thumb" for expenditure growth
  - Capital project appraisal
  - Reporting on fiscal risks
  - Strengthening transparency and public participation

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Introduction

The increasing role of social spending in our lives has been linked to three other great social transformations: the transition to fuller democracy, the demographic transition towards fewer births and longer life, and the onset of sustained economic growth.

Peter Lindert
Growing Public: Social Spending and
Economic Growth since the Eighteenth Century (2004)

… a per capita output growth rate on the order of 1 percent is … much more rapid than most people think… A society that grows at 1 percent per year, as the most advanced societies have done since the turn of the nineteenth century, is a society that undergoes deep and permanent change.

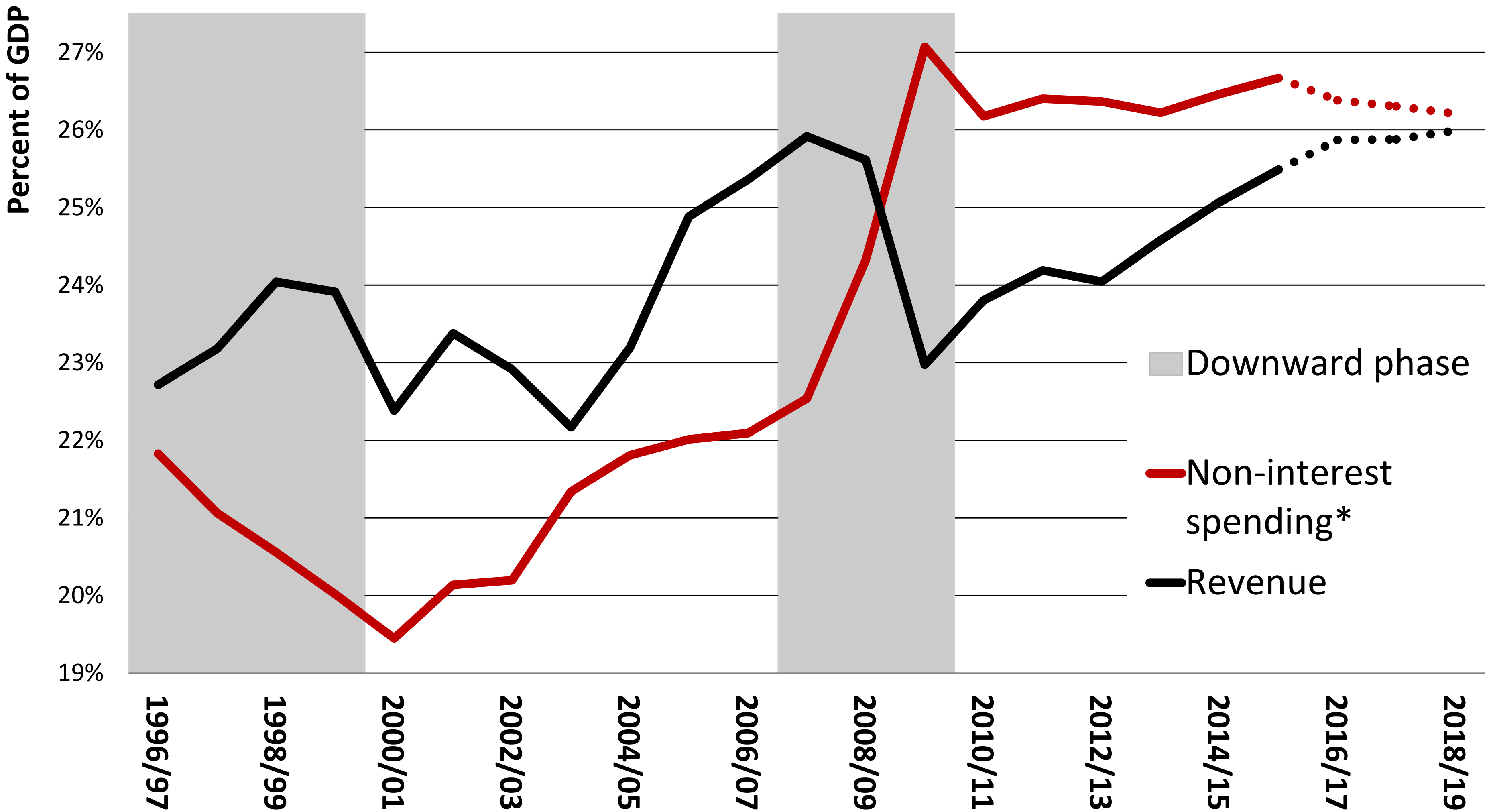
Thomas Piketty
Capital in the Twenty First Century (2014)

The state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of each of these rights

The Constitution

FISCAL PERFORMANCE AND OUTCOMES

20 years of fiscal policy in South Africa

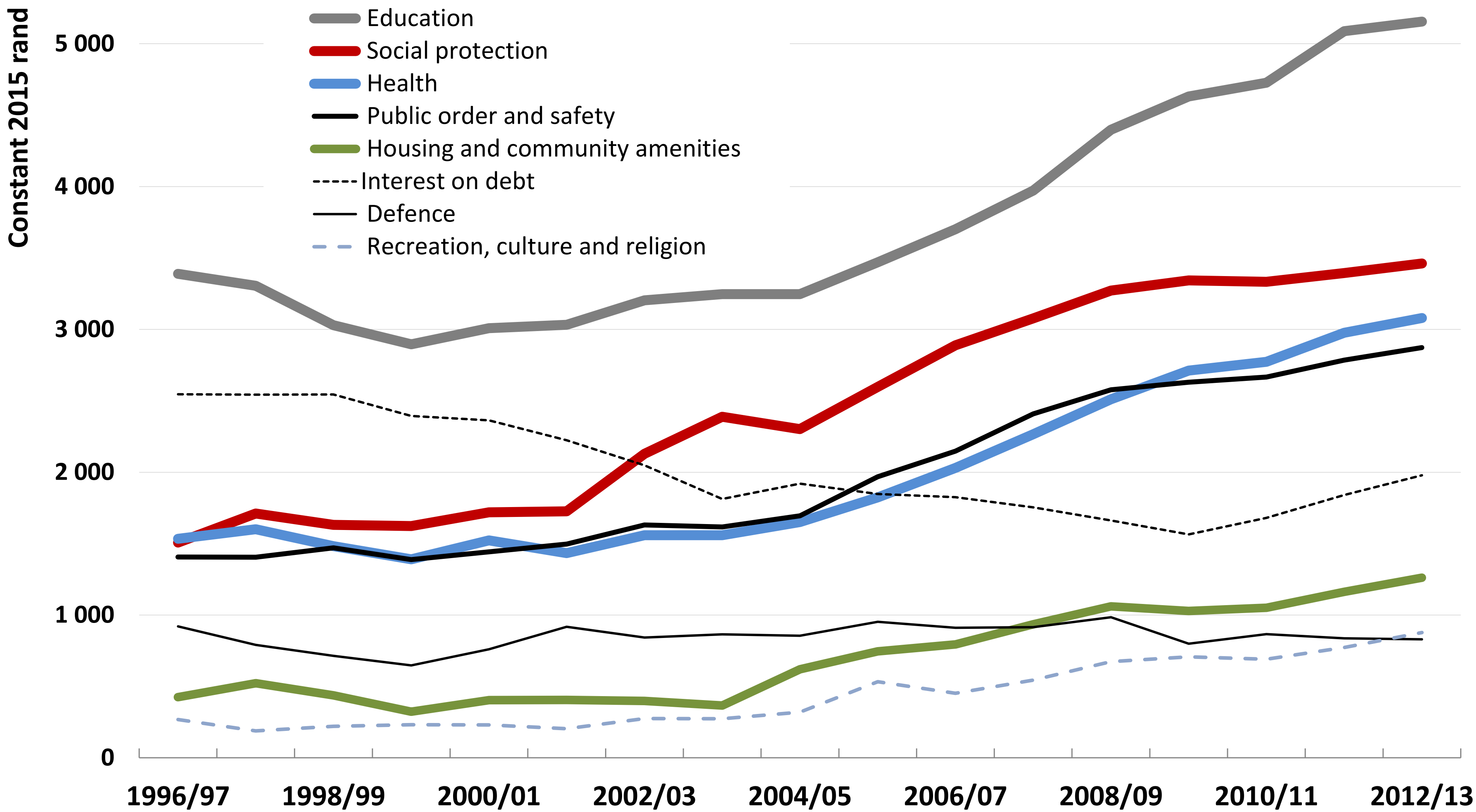


MAIN BUDGET NON-INTEREST EXPENDITURE AND REVENUE AS A SHARE OF GDP

* Non interest spending excluding payments for financial assets, Eskom capitalisations and similar once-off transactions

Source: National Treasury and Reserve Bank

Public spending doubled in real terms in the last decade
leading to substantial real increases in spending per person



REAL GOVERNMENT SPENDING PER CAPITA

Source data: General government spending (Reserve Bank), Consumer Price Inflation and population (StatsSA)

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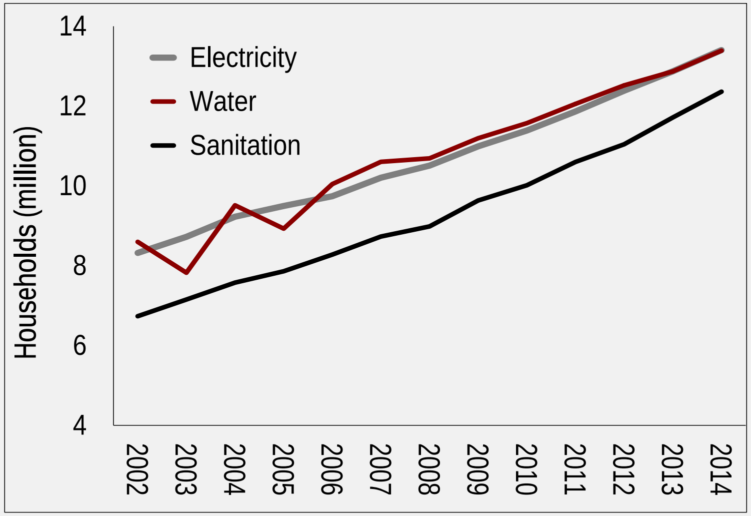
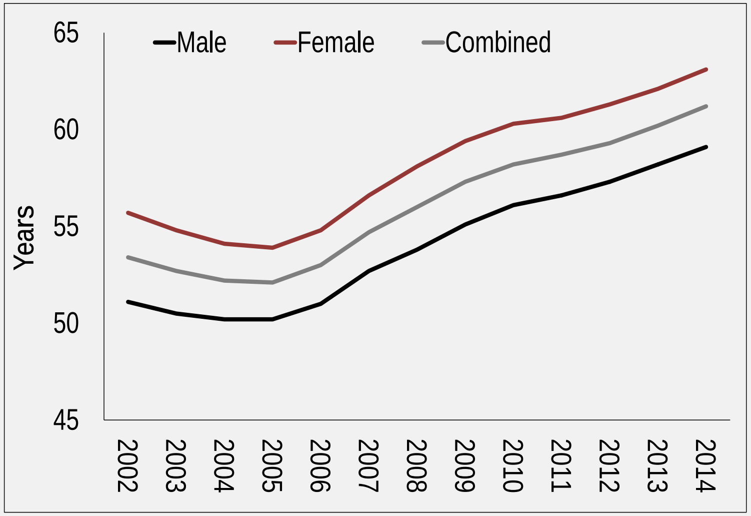
Supporting sustained social progress
achievements made possible through allocation of public funds

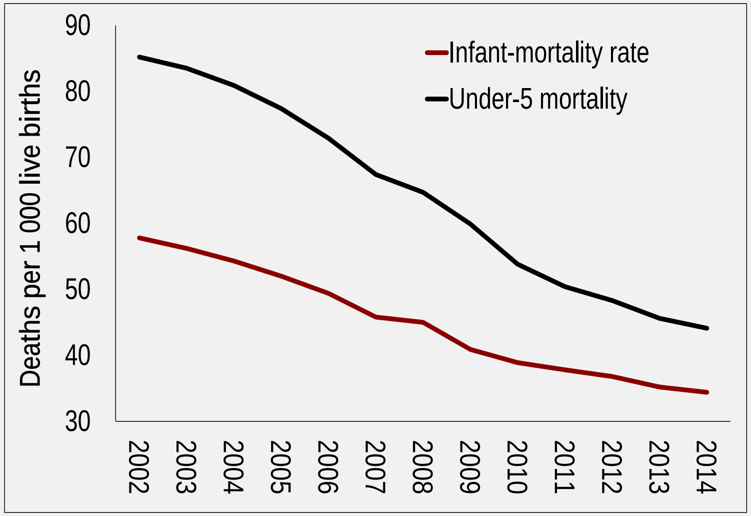
Access to basic services



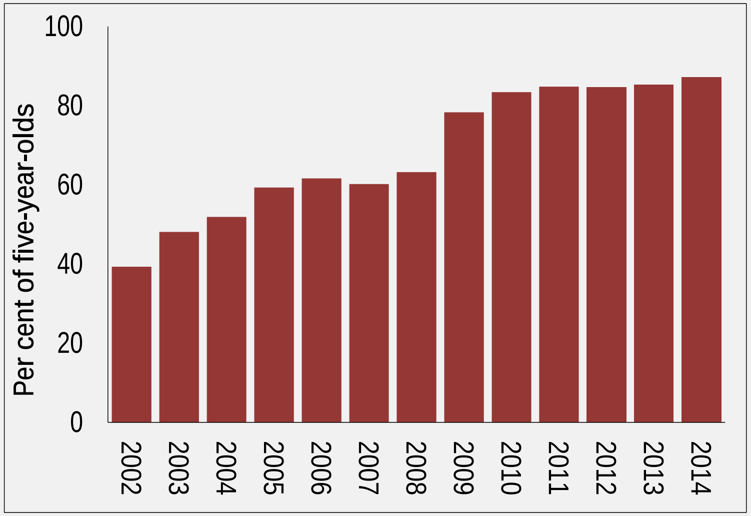
Life expectancy



Infant mortality



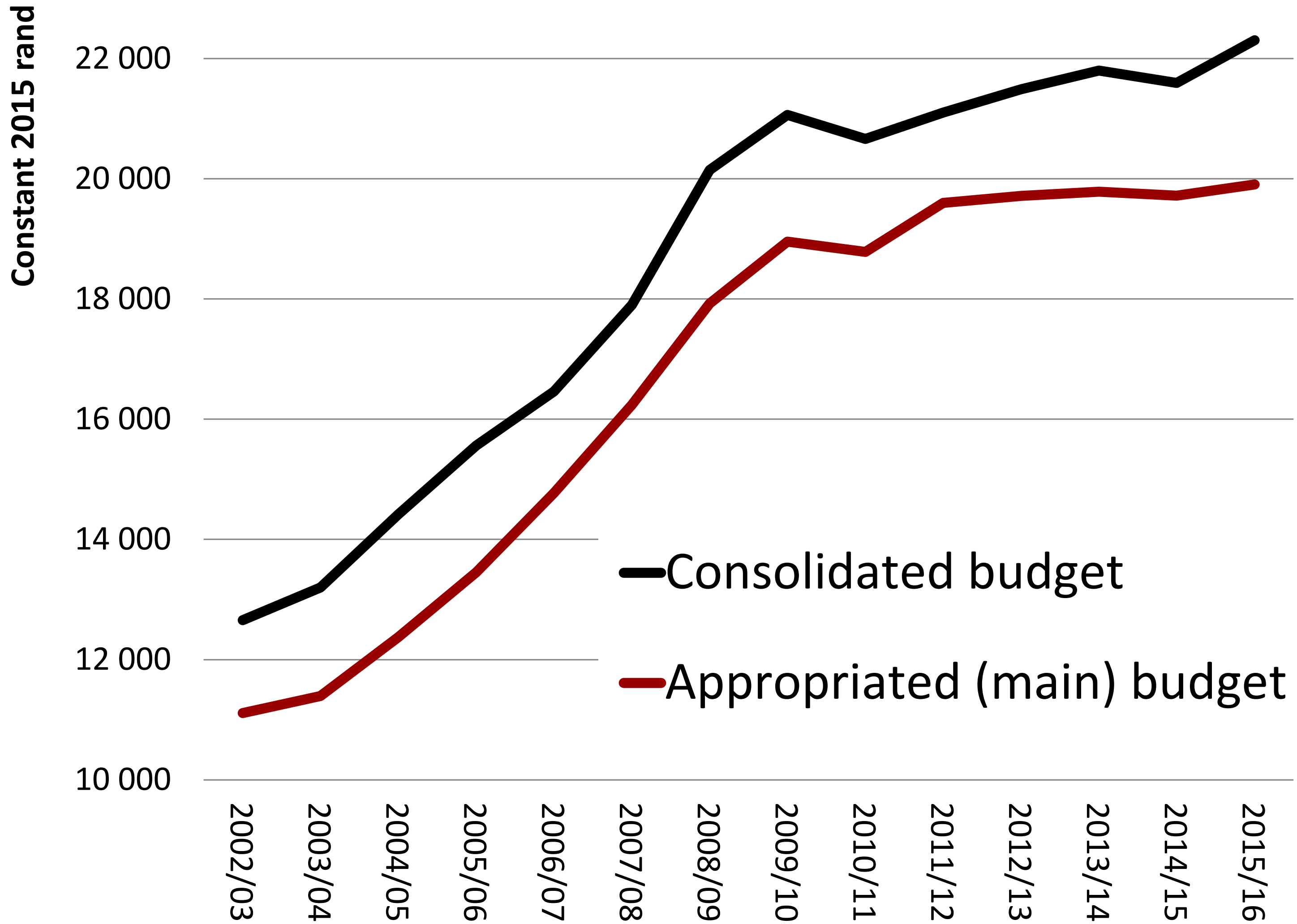
Early childhood development enrolment



Source: Development Indicators, 2014; Department of Planning, Monitoring and Evaluation

Gains in per capita spending have been sustained

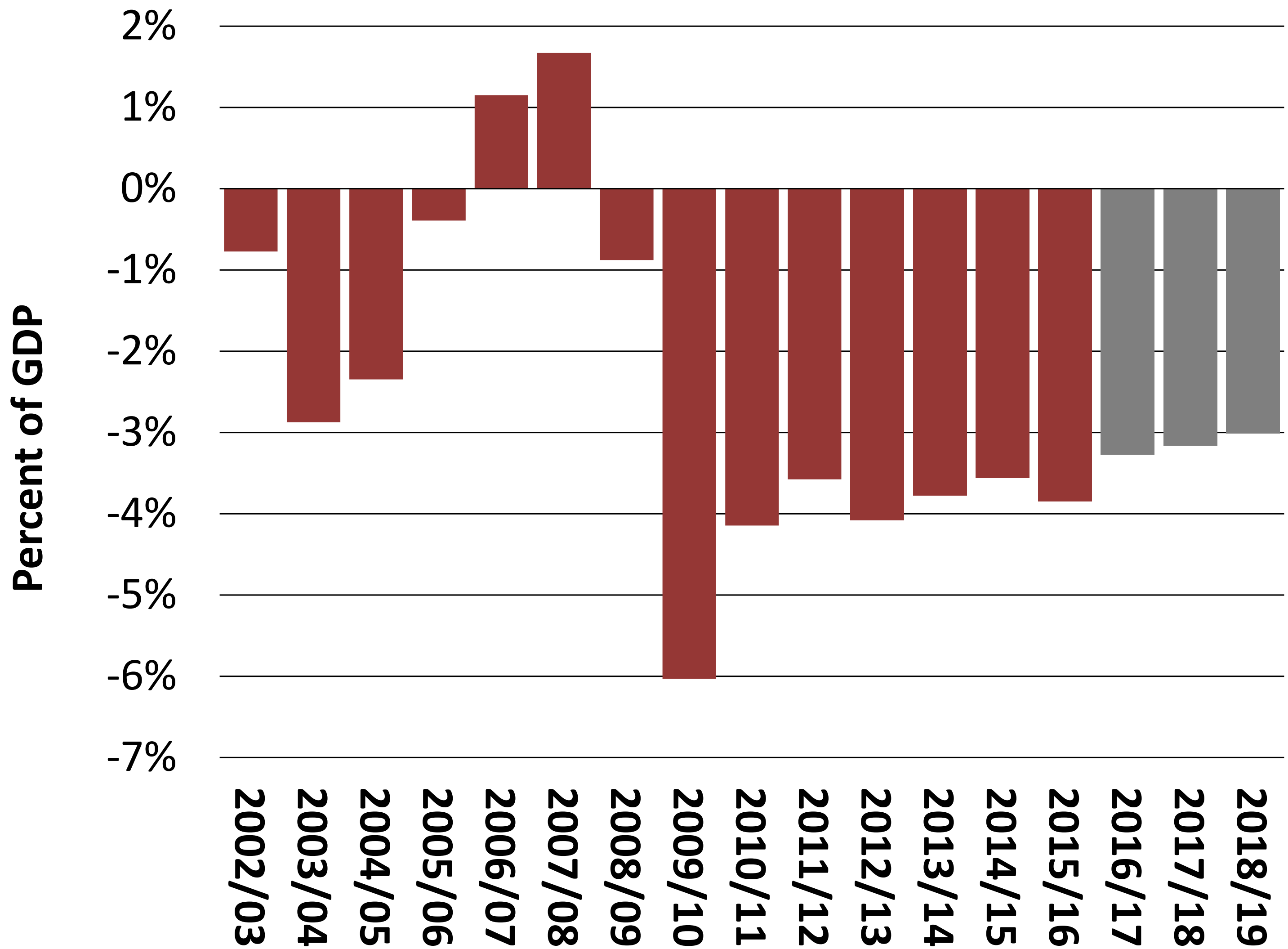
but are threatened unless fiscal sustainability is restored



REAL NON-INTEREST SPENDING PER CAPITA

Source data: Budget data on non-interest spending excluding payments for financial assets, Eskom capitalisation and similar once-off transactions (National Treasury)
Consumer price inflation and population (StatsSA)

A structural deficit has now become entrenched …



CONSOLIDATED BUDGET BALANCE

SOURCE DATA: NATIONAL TREASURY

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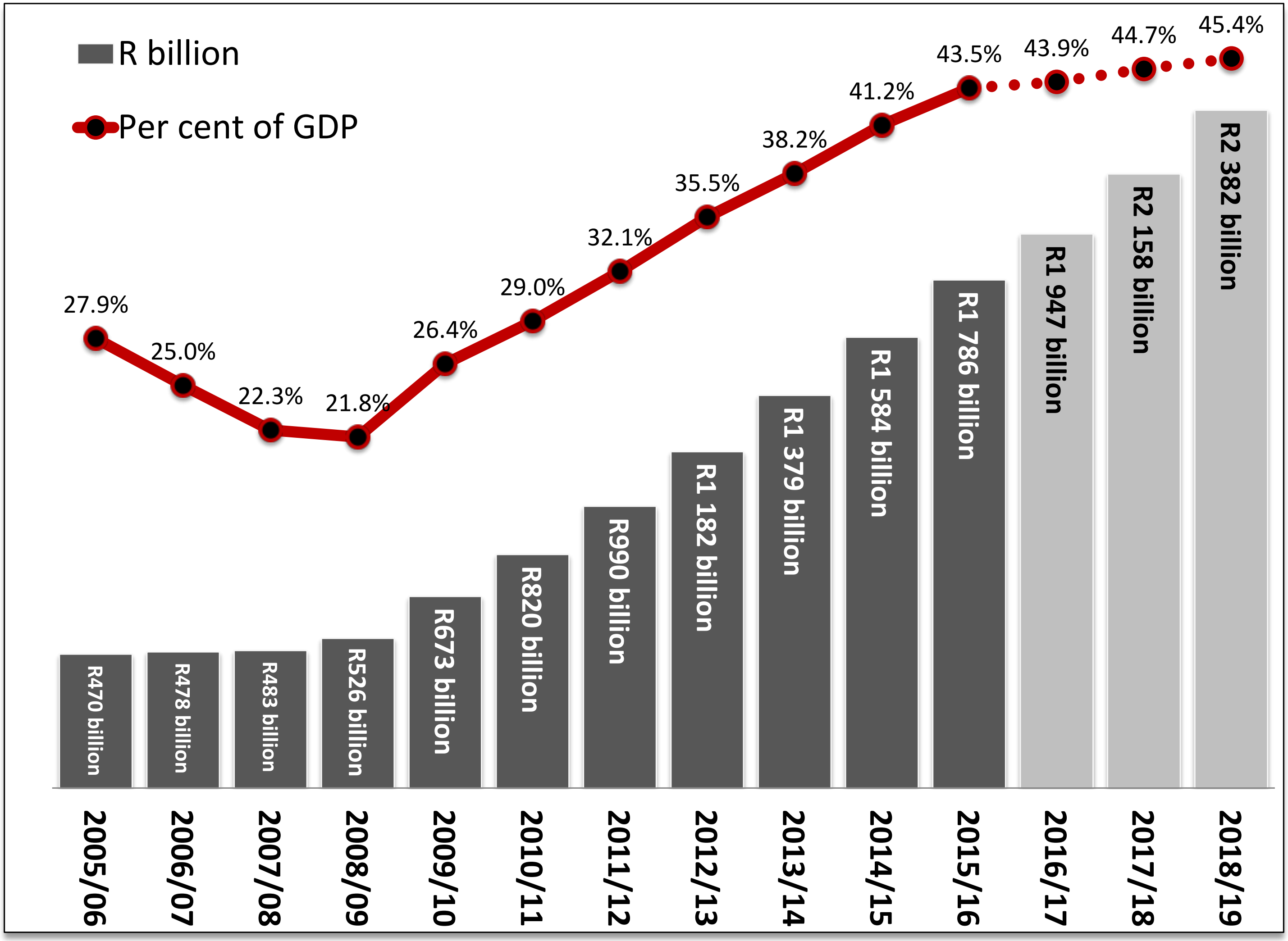
… and government debt has not yet stabilised …



GOVERNMENT DEBT

Government debt net of cash balances as a percent of GDP and in nominal terms

SOURCE DATA: NATIONAL TREASURY

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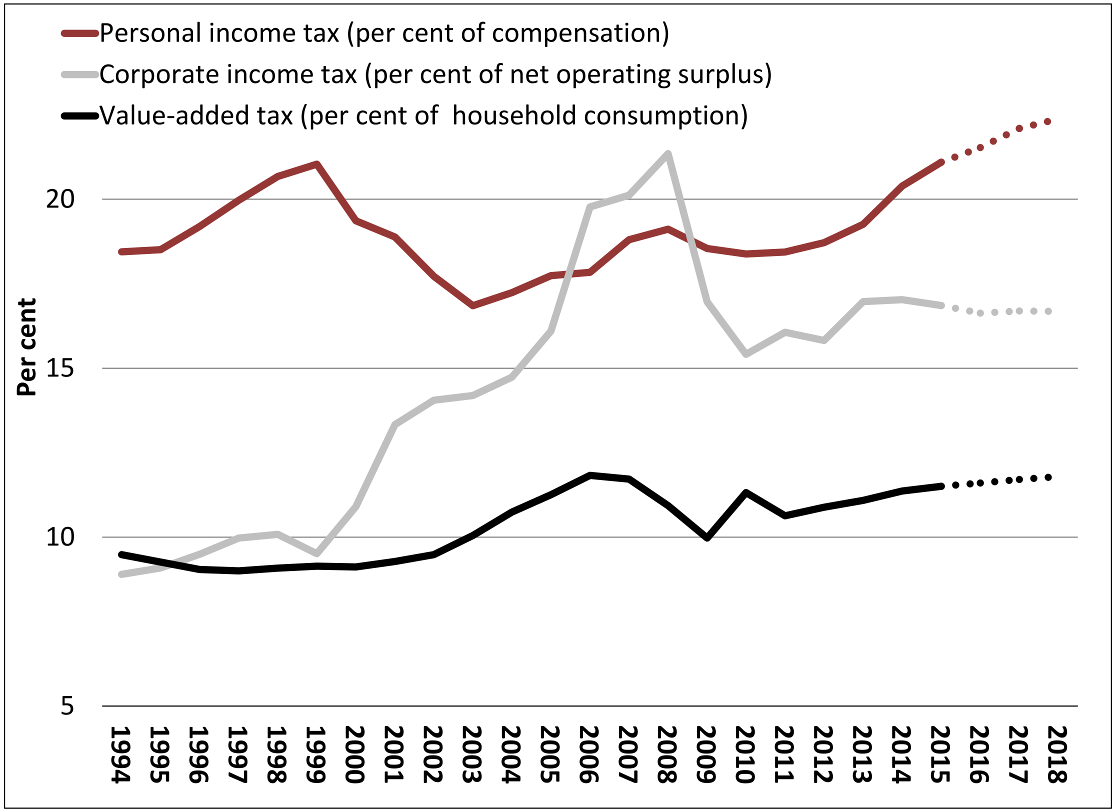
… despite an apparent structural improvement in revenue

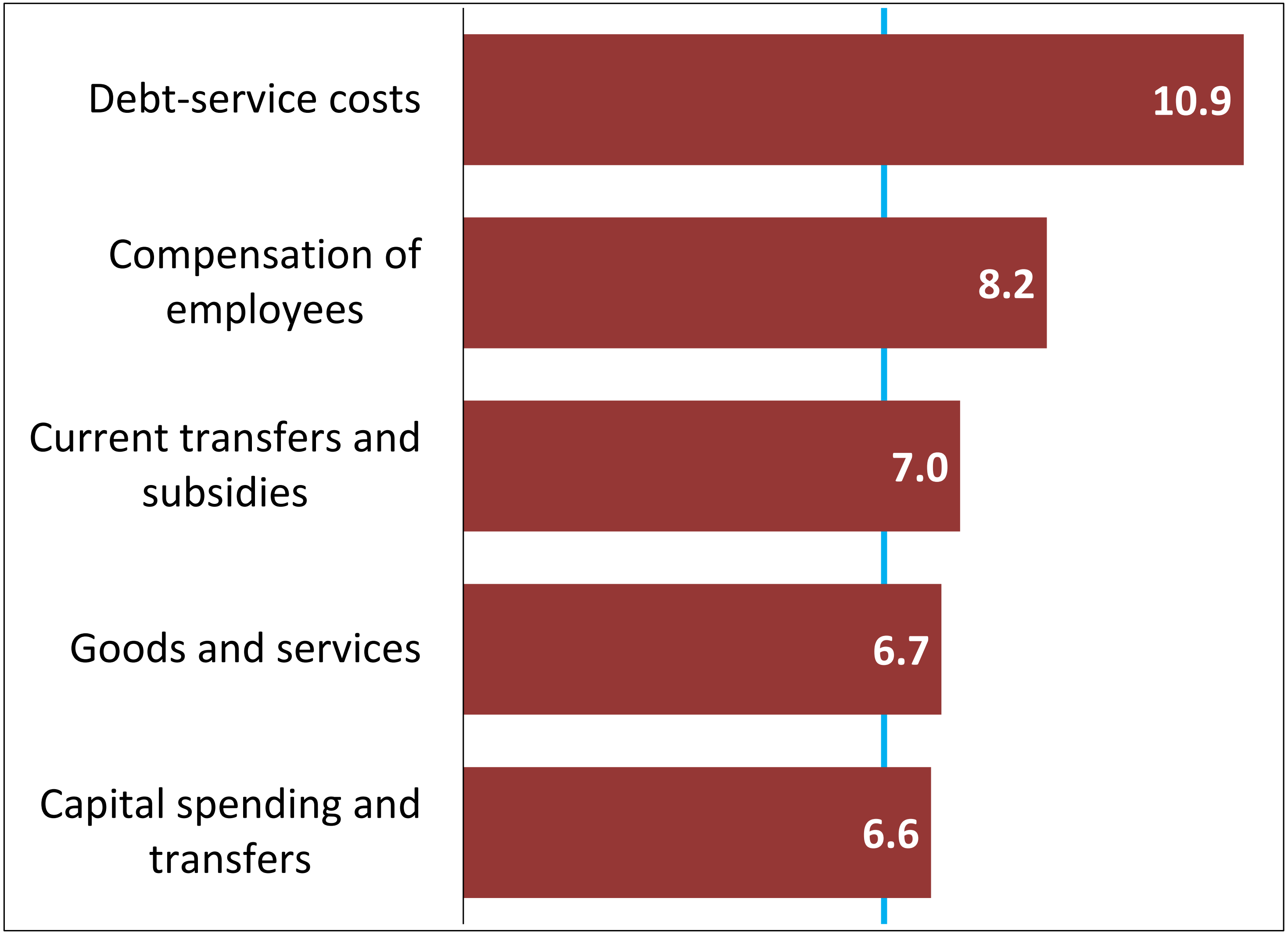
- Despite weak economic growth over the past five years, revenue collection has consistently outpaced economic expansion.
- It is not yet clear whether this is due to permeant or temporary factors, although both are likely to have played a role. PIT in particular has remained very buoyant.
- Factors could include:
  - Tax policy changes (i.e. increased rates)
  - Improved tax collection
  - High wage growth, especially at the upper end of the distribution
  - Structural shifts towards services sectors
  - Cyclical impact of SACU revenues



EFFECTIVE TAX RATES

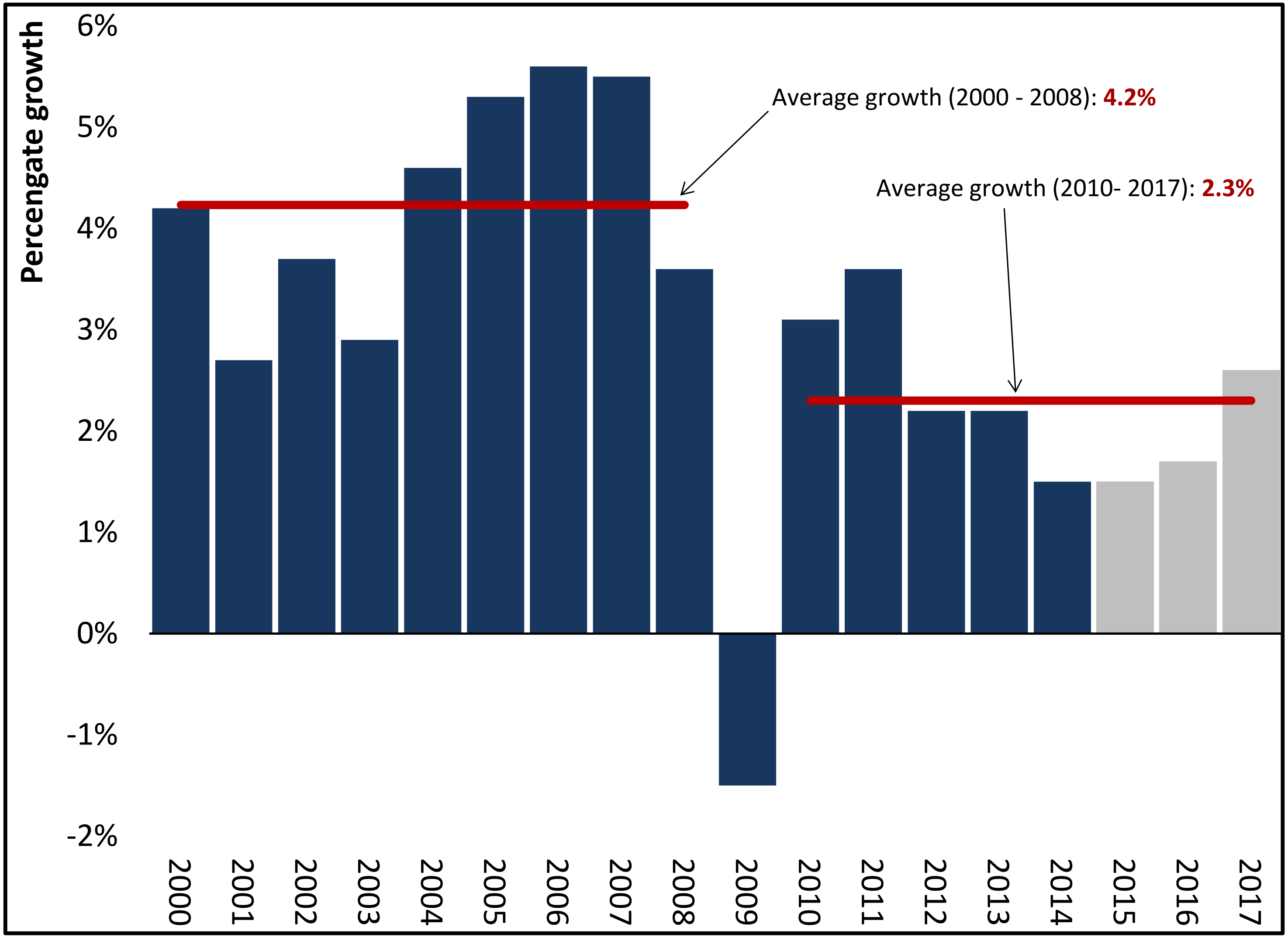
Source data: National Treasury

Interest on debt and compensation are crowding out other types of spending



GROWTH OF SPENDING BY ECONOMIC TYPE
annual average nominal growth rate, 2015/16-2018/19
Source Data: National Treasury

Doubts about the long run growth path are increasing …

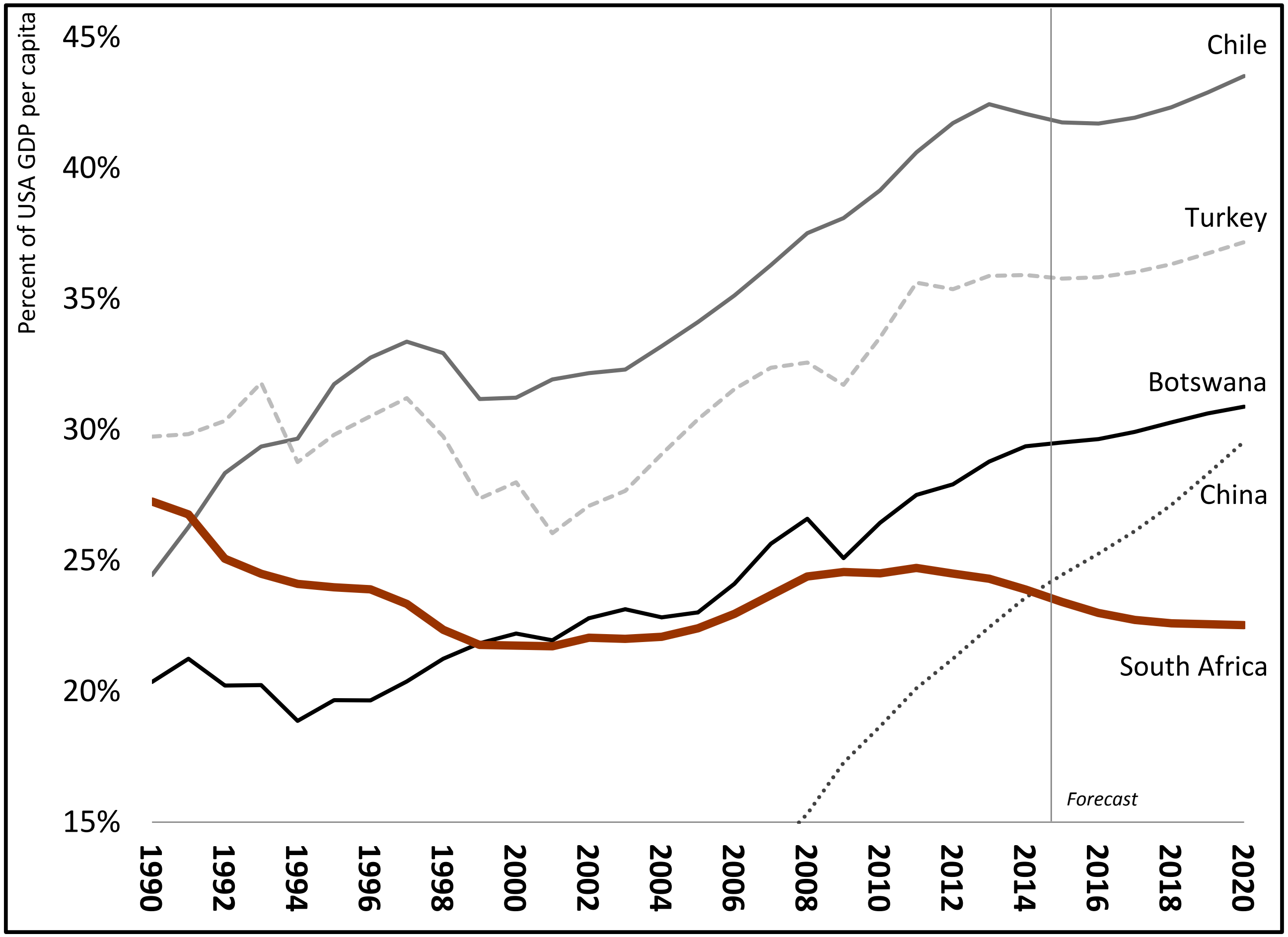


REAL GDP GROWTH

Source data: Reserve Bank and National Treasury

… and average income is already stagnating

- Several other small open economies (Botswana, Turkey, Chile) have made progress in narrowing the gap in per capita income with the USA but South Africa is falling behind



AVERAGE INCOME RELATIVE TO USA

GDP per capita as a share of USA GDP per capita at PPP exchange rates

Source data: IMF World Economic Outlook

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Social gains cannot be taken for granted and new policy priorities will require difficult choices

- The medium-term framework sustains social gains in a weak economic environment.
- The current level of spending is sustainable if economic growth returns to its historic average.
- However, if 2 per cent growth is a ‘new normal’ a stable debt path will be difficult to sustain in the long run with current levels of expenditure, even if no new policy initiates are taken.
- Several new policy initiatives are under consideration, including:
  - An expansion of post-school education and training. Achieving the NDP targets and providing free tertiary education for the poorest would add 2 per cent of GDP to public spending
  - National health insurance would raise government spending by approximately 2.5 - 3 per cent of GDP
- Rising debt means increased dependence on private capital. Many countries have experienced set-backs where well-functioning social programmes had to be reined in or reversed as a result of fiscal crises.

Room for additional taxation is limited

- Additional taxes will be needed to fund government’s ambitious policy agenda, but should be approached with caution given weak economic conditions
- The design and structure of tax arrangements must take account of the relationship between taxation and economic growth in the short and long run
- In South Africa, taxes on personal incomes and profits are already in line with OECD countries. Taxes on consumption remain much lower than global averages
- Countries with larger, more generous public expenditures often favour a mix of taxes that promotes growth, savings and investment
- The progressivity of the whole fiscal system is more important than the progressivity of individual taxes
- Raising taxation through fiscal drag tends to be regressive and inefficient
- Initiatives are under way to combat base erosion, profit shifting and the misuse of transfer pricing.
- The question of increased taxation is as much political as it is economic. Improving the quality of public expenditure and the credibility of the budget process are important elements of any tax debate.

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FISCAL INSTITUTIONS

A solid foundation of strong fiscal institutions

- South Africa has solid foundation of fiscal institutions built over the last 20 years
- Critical reforms have included:
  - The creation of a unitary fiscal system
  - A medium term budget framework
  - Extensive budget transparency
- New reforms and fiscal policy initiatives build on this foundation.

A unitary fiscal system

- Integrating and consolidating the budgets of racially-fragmented institutions, nominally independent states and self governing territories.
- The Constitution:
  - All money received by national government must be paid into a National Revenue Fund, except money reasonably excluded by an Act of Parliament
  - All government budgets and budgetary processes must promote transparency, accountability and the effective financial management of the economy, debt and the public sector.
  - National legislation must establish a national treasury, empowered to enforce compliance with accounting practices, expenditure classifications and uniform treasury norms and standards.
  - Loans and guarantees by subnational government are limited and subject to national legislation.
- Since 2002, the budget has been presented in consolidated terms, reflecting the spending by public entities, social funds and provincial governments that is not voted by Parliament or financed from National Revenue Fund.
- While fiscal unity has served South Africa well, debates continue about:
  - The extent of decentralisation in the inter-governmental fiscal system
  - Decentralised authority over procurement
  - Imbalances arising from earmarked taxation

Medium-term budget framework

- The medium-term budget system was introduced from 1997, with three components:
  - The October Medium Term Budget Policy Statement (MTBPS) sets out the goals of policy, forecasts the economic environment and projects the fiscal framework over the next three years
  - The February Budget specifies a Medium Term Expenditure Framework (MTEF), including headline expenditure, departmental allocations.
  - The Division of Revenue, showing how resources are shared between national, provincial and local government.
- The medium-term framework created a more predictable, open and transparent budget process.
- The tabling of the MTBPS in October, provides an opportunity for Parliament to discuss and shape government's approach to the Budget.
- Parliament is empowered to amend the fiscal framework or change appropriations.

Extensive budget transparency

- South Africa ranked third out of 102 countries in the 2015 release of the Open Budget Index by the International Budget Partnership.
- The survey measures the quality of:
  - Budget transparency,
  - Public participation in the budget process and
  - Institutional oversight.
- South Africa was one of only four countries that performed solidly across all three categories.
- It was in the top five on measures of transparency and oversight by the legislature and audit institutions, but came out sixth for public participation.
- In recent years, the National Treasury has worked to improve public dialogue with citizens on the budget process, making regular presentations at universities and civil society forums.

Fiscal guidelines were proposed in 2011

National Treasury proposes fiscal guidelines for South Africa

'Nothing is free, absolutely nothing ... it is paid for from revenue collected from those who pay taxes.' – President Jacob Zuma

The current debt crisis in several European countries, which has tested the durability of the currency union, is a stark reminder that fiscal mismanagement can make social programmes unaffordable. During 2010, Parliament asked the National Treasury to investigate how government could sustainably afford its expenditure over the long term. In response, the National Treasury is proposing guidelines for sustainable management of the public finances. The guidelines are informed by three principles:

- Countercyclicality: The budget balance should be set to counteract variations in the business cycle.
- Long-term debt sustainability: Spending levels must ensure that debt and interest costs do not rise indefinitely.
- Inter-generational equity: The long-term costs of spending programmes should be considered.

Developing fiscal policy based on these principles will strengthen parliamentary oversight of the budget process, encourage greater transparency and enhance public accountability. It will also facilitate sustainable progress on the New Growth Path by encouraging investment, a more stable economy and higher growth. To give effect to these principles, the National Treasury proposes that government:

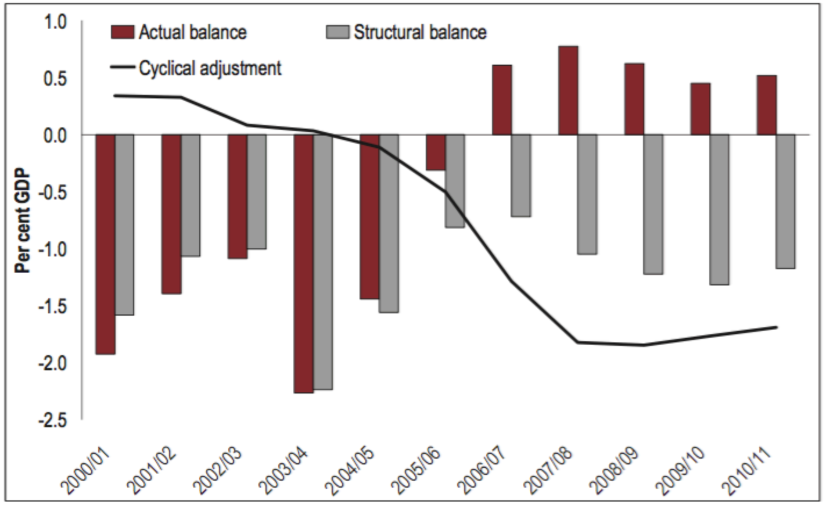
- Adopt an annual target for the structural budget balance consistent with long-term growth, the desired level of public debt and inter-generational considerations.
- Make explicit the costs of existing and new programmes that require a long-term commitment.
- Set out a timeline to bring the budget back on target following large fiscal shocks.

Extract from the 2011 budget review, p50

A “structural balance” rule has not gained traction

- South Africa has reported a structural balance since 2007 but it has not gained traction as a key fiscal policy metric.
- It remains of interest to academic economists and multilateral institutions but public discourse, policy-makers and bond markets continue to focus on directly observable fiscal measures such as the primary balance, or debt.
- Several factors weaken the appeal of the structural balance as a fiscal policy target:
  - It is complicated and difficult to communicate
  - It depends on “unobservable” assumptions, which can be controversial
  - In a medium-term framework there is often little difference between estimates of the actual and structural balance in the outer year projections.

Figure 3.2 Main budget and structural budget balances, 2000/01 – 2010/11



Despite an anticipated moderation in the pace of global growth, commodity prices are expected to remain high, resulting in the economy continuing to operate with a significant positive cyclical component. After adjusting the budget framework for estimates of cyclical revenue, the structural budget balance is broadly stable at a deficit averaging 1.2 per cent of GDP over the next three years. This illustrates the strength of the government finances and the ability of the fiscus to sustainably finance the current level of expenditure should the economic cycle reverse.

Extract from the 2008 budget review, p47

A nominal expenditure ceiling was introduced in 2012

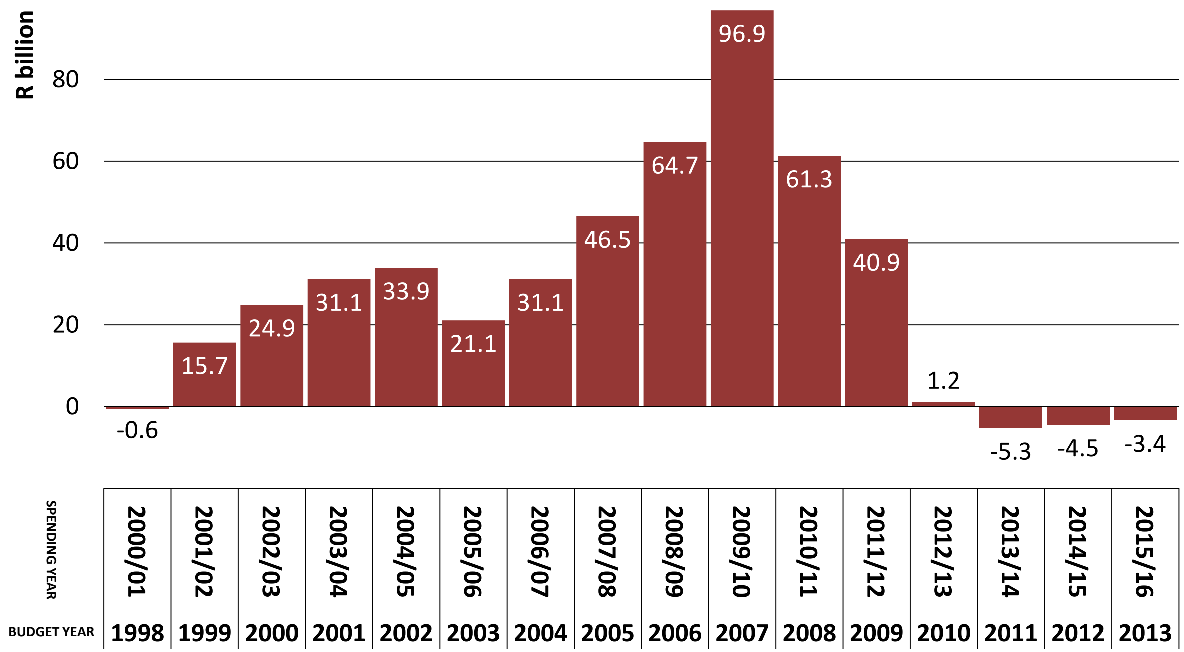
- MTEF projections facilitate discussion of an expenditure path, they did not constitute a binding medium-term target. As Schick points out:

  "Many countries that claim to have an MTEF have treated outer-year constraints as floors for future spending, not as ceilings, which defeats their purpose and can adversely affect the government's fiscal positions…

  When a medium-term constraint is soft, spending units regard the amounts specified for future years as minima and use the budget process to wrest more money from the government…

  To counter this tendency it is necessary for governments to adopt fiscal rules that harden the MTEF constraint so that it is treated as a ceiling rather than a floor."

- From 2012 government announced it would treat the MTEF estimate of main budget non-interest expenditure as a ceiling.



Difference between third-year forward estimate and expenditure outcome
Main budget expenditure

Pros and cons of the MTEF expenditure ceiling

- The expenditure ceiling approach has been important in creating certainty about fiscal policy and the path of expenditure
- It builds on existing well-established budget institutions (i.e. the MTEF)
- It is clear and easily communicated and doesn't require complicated calculations or depend unobservable variables
- It targets the most immediate fiscal policy lever: non-interest spending paid out of the National Revenue Fund
- Creates an unambiguous path of resources available to departments, thereby supporting the planning process behind the MTEF

- However, since it is set in nominal terms, changes in inflation result in shifts in real growth rates.
- Government has not specified the basis on which the ceiling is set in the outer year of each framework and how this relates to broader fiscal policy objectives

FISCAL PROPOSALS IN THE 2015 MTBPS

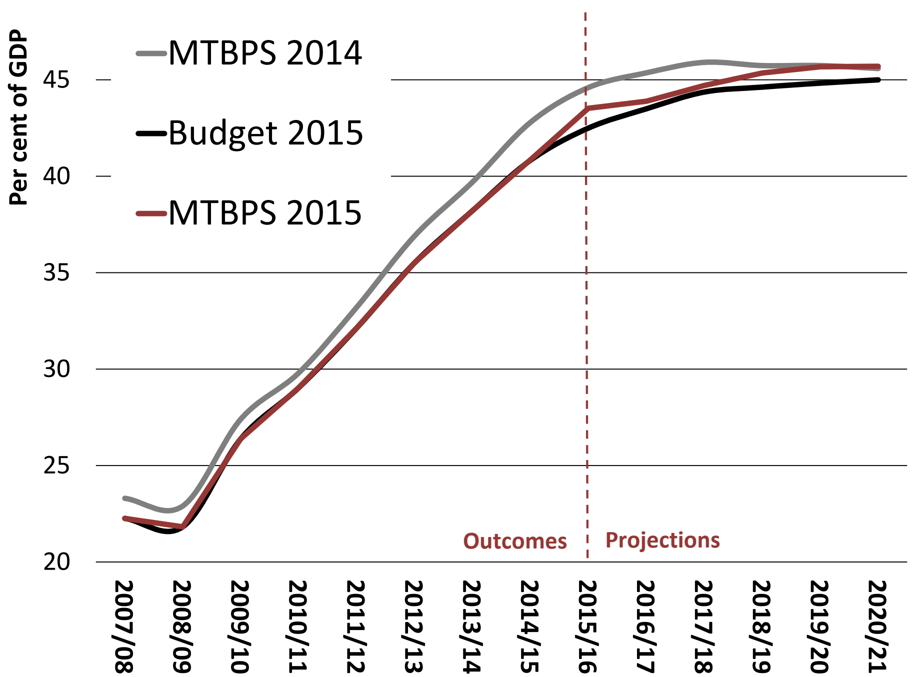
Fiscal policy proposals in the 2015 MTBPS

1. A clear medium term objective: stabilise the debt-to-GDP ratio
2. A long-term "rule of thumb" for setting the path of expenditure growth
3. Clear criteria for deviations from the expenditure ceiling ('escape clauses')
4. A programme to improve capital project appraisal
5. Stronger reporting on fiscal risks and contingent liabilities
6. A programme to strengthen transparency and public participation

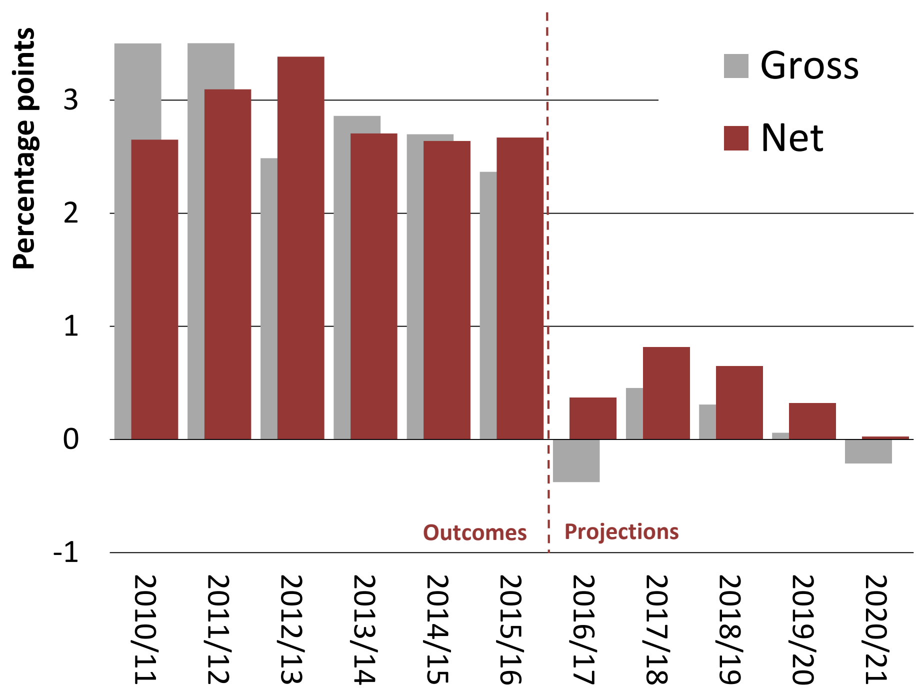
Stabilising the debt-to-GDP ratio

- Government's core medium-term fiscal objective is to stabilise the debt-to-GDP ratio.
- Downward revisions to GDP, shortfalls in revenue and the weaker exchange rate have led to an upward revision of the debt-to-GDP ratio.
- But the trajectory continues to stabilise.

Government debt-to-GDP ratio (net of cash balances)



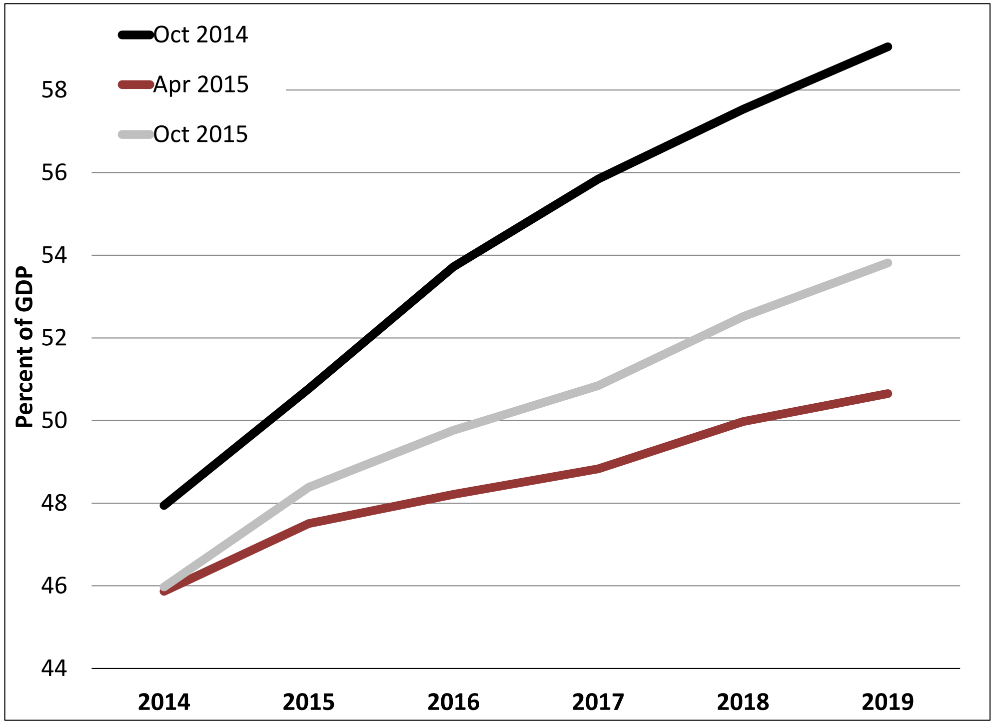
Change in debt-to-GDP ratio (percentage points)



Why not target a debt ceiling?

- "What constitutes a safe level of debt … is, needless to say, very difficult to pin down precisely in practice and can never be established through some mechanical rule or threshold" (Ostry et al, 2015)
- Projections of debt are very sensitive to assumptions about future rates of economic growth, interest rates, exchange rates and the long-term path of the deficit.
- Once debt stabilisation is effective, several factors must be taken into account in thinking about the path of debt.
  - Rebuilding fiscal space to manage risk
  - The deadweight burden of inherited debt stock on economic growth
  - Financing infrastructure investments, where social returns exceed borrowing costs.

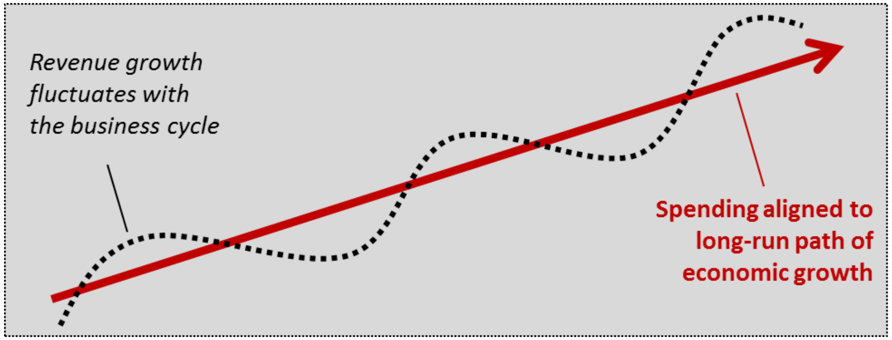
IMF projections of SA's debt to GDP ratio



IMF World Economic Outlooks (October 2014, April 2015 and October 2015)

An expenditure "rule of thumb"

- The expenditure ceiling binds government to nominal limit on expenditure growth over three years. But on what basis is the level of expenditure chosen in the outer year?
- The MTBPS proposes a *rule of thumb:*
  - The long-term path of economic growth guides the choice of spending envelope in the outer year.
  - This implies that spending remains stable as a share of GDP over the long term



  - Where growth is temporarily elevated (depressed), spending would decline (increase) slightly as a share of GDP
- Gauging long term path of economic growth is not straightforward
  - Over the last 20 years, real growth has averaged 3 per cent; the IMF projects growth of 2.6 per cent in 2020; SARB's estimate of potential growth is 2.1 per cent
  - The MTBPS proposes real spending growth of 2.5 per cent in the new outer year
- The MTBPS proposes a guideline: *not* a numerical rule
- Should institutions that build consensus on an estimate of long-term growth be considered (e.g. a Parliamentary hearing or a Chilean style expert committee)?

The expenditure ceiling can be changed in two circumstances

- **Structural improvements to revenue**
  - The guideline implies that spending would remain stable as a share of GDP
  - Several policy proposals set out in the National Development Plan imply an increase in spending as a share of GDP
  - The guideline does not preclude spending increases, but a permanent increase in revenues – for instance through changes to tax policy – would be needed to trigger concomitant adjustments to the spending limit
- **Large inflation shock**
  - Nominal fiscal limits have the advantage that they can be easily understood, but unanticipated inflation could erode the real value of planned spending.
  - Government would consider adjusting the ceiling if annual inflation were to depart significantly from the 3-6 per cent target band.
  - There is little risk of such an outcome given robust inflation targeting.

Reforms to capital budgeting

- In principle, borrowing to fund investments that generate a social rate of return that is higher than the interest rate should not be unduly constrained by the fiscal guideline.
- However, governments' capacity to appraise, select, plan and build capital projects needs to be strengthened.
- While coordination has improved, further work is required to develop institutions with the authority to deliver technically sound cost-benefit analyses, enabling government to choose projects and assess their social returns
- The development of a strong capital project planning and appraisal system should enable government to adjust spending plans where good projects have been identified
- Such adjustments could be activated by special legislation that empowers government to implement large projects within specified parameters, and authorises expenditure commitments beyond the annual appropriation, or even beyond the MTEF.

Key features of effective public infrastructure management systems

- Investment guidance, project development and preliminary screening
- Formal project appraisal
- Independent review of appraisal
- Project selection and budgeting
- Project implementation
- Project adjustment
- Facility operation
- Basic completion review and evaluation

Stronger risk analysis

- National Treasury is developing a risks framework informed by international best practice and historical drivers of fiscal slippage in South Africa
- An internal fiscal risks committee has been established with a mandate to ensure the risk framework is integrated into the budgeting process.
- A stronger approach to disclosing information on contingent liabilities and guarantees is being developed.
- A fiscal risk report will be published next year.

Risk framework

Examples of issues under consideration

	Examples of issues under consideration
A. Macroeconomic and revenue risks	▪ Gross financing requirement and sensitivity analysis ▪ Reconciliation of Nominal GDP estimates to outcomes
B. Medium-term Expenditure pressures	▪ Wage-bill impact on fiscus ▪ Impact of inflation on expenditure plans ▪ Public entity spending forecast errors
C. Contingent and accrual liabilities	▪ Direct fiscal exposure to SOEs through guarantees ▪ Implicit fiscal exposure to financial sector
D. Consolidated public sector balance sheet	▪ National and provincial government finances ▪ Funding status of social security funds and GEPF
E. Long-term fiscal outlook	▪ Long term spending pressures arising from demographic change ▪ Long-term debt projections and fiscal sustainability ▪ Local government infrastructure and maintenance backlogs

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Deepening transparency and participation

- In recent years, the National Treasury has worked to improve public dialogue with citizens on the budget process, making regular presentations at universities and civil society forums.
- The executive, Parliament and audit institutions all need to consider how to deepen citizen engagement on the public finances.
- Additional steps to strengthen budget transparency are being taken:
  - For the first time, key assumptions underlying the macroeconomic and revenue forecasts presented in the fiscal framework are published in the MTBPS
  - National Treasury is working with civil society organisations to make budget data more accessible and understandable to citizens through an internet portal.
- To support the fiscal guideline, institutions that generate a transparent, widely-discussed estimates of potential output and realistic medium-term growth forecasts need consideration.
- The *#FeesMustFall* campaign has ignited public dialogue on budget issues. How should government build on this energy to encourage greater budget participation?

Thank you

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- Ostry, J., Ghosh, A., and R. Espinoza. *When Should Public Debt be Reduced*, IMF Staff Discussion Note, SDN/15/10, June 2015
- Schick, A. *Post-crisis fiscal rules: Stabilising public finance while responding to economic aftershocks*. OECD Journal on Budgeting, Volume 2010/2, 2010