NATIONAL TREASURY RESPONSE TO THE DEBATE ON THE FISCAL RESPONSIBILITY BILL

RESPONSE DOCUMENT| May 2021

Introduction

The National Treasury appreciates the intention of the Fiscal Responsibility Bill. Indeed, over the past twelve years, the debt-to-GDP path has not stabilised and the primary balance has remained in deficit. Stronger steps must be taken to close the fiscal imbalances, but the steps set out in the Bill would not restore the long-term health of the public finances. Instead they would worsen the conduct of fiscal policy thereby deepening the challenges of the public finances.

The National Treasury is prepared to work with Parliament and the Parliamentary Budget Office in order to close the fiscal imbalances.

Figure 1 Real GDP growth outcomes

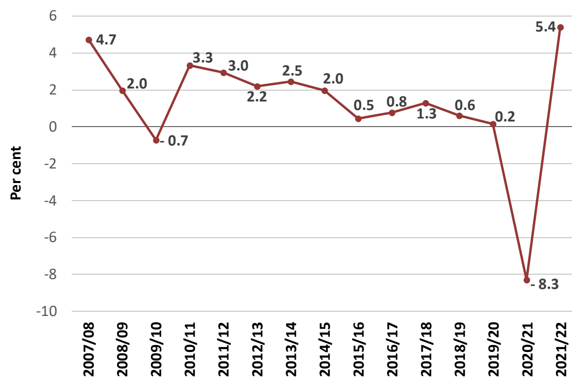


Figure 2 Nominal GDP and gross tax revenue growth

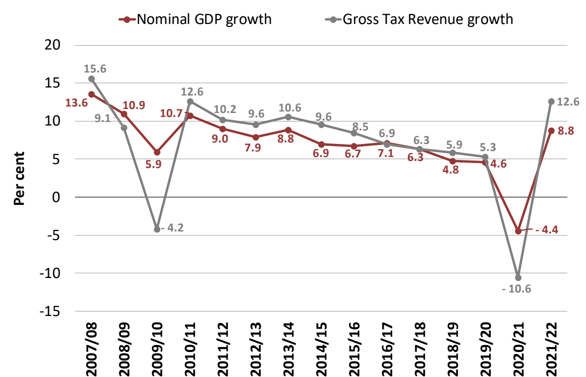


Figure 3 Real main budget non-interest spending growth*

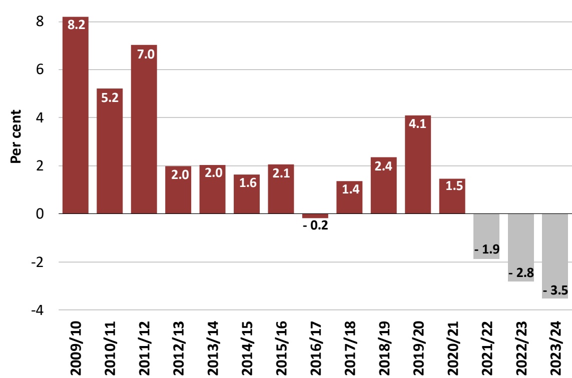
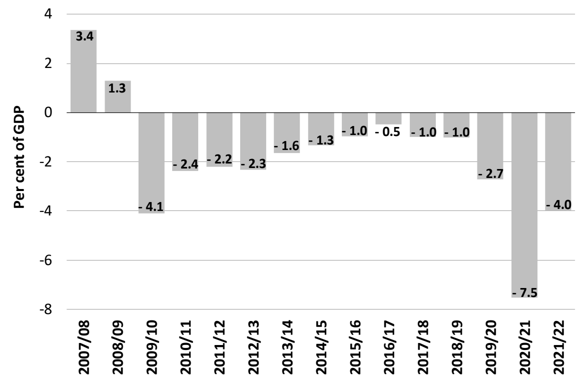


Figure 4 Main budget primary balance



Budget 2021 Priorities

The 2021 Budget sets out a balanced and prudent fiscal strategy in order to stabilise the public finances. The fiscal framework targets a debt stabilising primary balance in 2024/25 with debt as a share of output stabilising in 2025/26. The spending ceiling announced in February 2021 remains a key fiscal anchor.

A less severe revenue shortfall enables government to continue to support the economy and the health sector, while narrowing the deficit more rapidly than projected in the 2020 Medium Term Budget Policy Statement.

The tax revenue shortfall for 2020/21 was R175.5 billion, which is a record. Meanwhile, debt service costs will increase to R269.7 billion in the current financial year, eclipsing total spending on healthcare, and consuming R1 out of every R5 raised in taxes.

Over the medium term, continued expenditure restraint will underpin fiscal sustainability. Efforts to narrow the budget deficit and improve the composition of spending – primarily through restraining wage bill growth – remain on course. Capital spending is the fastest-growing component of non-interest spending.

In terms of the budget, the main budget primary deficit narrows from 6.5 per cent of GDP in 2020/21 to 0.8 per cent of GDP in 2023/24, and gross government debt stabilises at 88.9 per cent of GDP in 2025/26.

Does South Africa suffer from a fiscal credibility problem?

Between 2012/13 to 2019/20, government pursued a 'balanced' fiscal consolidation – controlled real non-interest expenditure growth and tax increases to close the deficit, while limiting the effects of consolidation on service delivery and growth. The debt-to-GDP ratio, however, has consistently been revised upwards on the back of lower-than-projected growth and tax revenue. In each budget, government has responded by reducing the expenditure ceiling and increasing taxes.

Table 1: Main primary deficit forecast and outcomes.

Per cent of GDP	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
Budget 2013	-2.3%	-1.6%	-0.9%				
Budget 2014	-1.8%	-1.7%	-1.2%	-0.3%			
Budget 2015		-1.7%	-1.1%	-0.1%	0.0%		
Budget 2016			-1.1%	-0.2%	0.1%	0.5%	
Budget 2017				-0.5%	-0.1%	0.2%	0.3%
Budget 2018					-1.2%	-0.2%	-0.1%
Budget 2019						-0.8%	-1.0%
Budget 2020							-2.6%
Outcome	**-1.6%**	**-1.3%**	**-1.0%**	**-0.5%**	**-1.0%**	**-1.0%**	**-2.7%**

It should be noted that the expenditure ceiling has remained intact as a key anchor of fiscal policy, despite spending pressures. The expenditure ceiling has created certainty for budget execution and allowed for controlled expenditure growth. Spending has remained within the limits since the introduction of the expenditure ceiling in 2012/13. However, in the 2019

Budget, the expenditure ceiling was breached by R16 billion over the 2019 MTEF. The expenditure ceiling has held, but at levels that generate faster spending growth than GDP growth.

The target of reducing and stabilising debt has been persistently shifted out, largely because of lower-than-expected economic and revenue growth. At the same time, large new spending pressures have emerged from outside of the budget process, mainly from state-owned companies and unaffordable wage settlements. As a result, main budget expenditure has remained relatively high around 30 per cent of GDP and has exceeded this level over the past two fiscal years. This has led to a reconsideration of additional fiscal rules to support credibility.

Does it make sense to implement a fiscal rule?

Fiscal credibility in South Africa is underpinned by a legal framework with strong Treasury control. South Africa has implemented a medium-term expenditure framework that allows for an open and transparent budget framework. In effect, the technical conditions are in place for a fiscal rule to be implemented. However, the proposed rule in the Bill would necessarily mean sacrificing some flexibility in the management of the public finances at least over the medium-term.

National Treasury's view on the specific proposal in the Responsibility Bill

National Treasury's view is that tying policy to the specific range of 50 and 55 per cent of debt-to-GDP will produce significant volatility in fiscal decision-making. This is because small changes to debt projection assumptions can have a very significant impact on the long-run debt outlook (see for example, how much the IMF debt projections can be revised over one year). 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. Unexpected increases in inflation or depreciation of the exchange rate would increase the cost of outstanding inflation-linked or foreign-currency bonds. If the rand were to strengthen, the stock of foreign debt would decline which would imply that higher spending levels would be justified under this rule .

A second concern is that there is no technical justification for many of the provisions in this bill. There is a question as to why net loan debt between 50 and 55 per cent constitutes an optimal debt-to-GDP ratio for South Africa, making the choice of the limit arbitrary. The justification for targeting net loan debt and not gross loan debt is also unclear. It would be easy for future governments to game the rule through a build-up of accruals or other contingent liabilities or by accumulating sufficiently large cash-balances that offset gross loan debt in order to comply with the specific net loan debt provision of this bill. Finally, it is unclear why specifically a ten per cent reduction to compensation of employees (CoE) should be the only mechanism to resolve a breach of the rule and how should this reduction to CoE be achieved. As previously discussed there are many variables influencing the debt stock.

> "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)

If government were to implement this target for the debt-to-GDP ratio it would encourage pro-cyclical fiscal policy stances which would worsen the conduct of fiscal policy. This would be a particular problem when the economy performs well when performance is driven by cyclical factors such as a commodity price boom. In this scenario the debt-to-GDP ratio would automatically improve irrespective of discretionary fiscal policy choices. In this state of the world a future government could make long-term unsustainable fiscal policy choices such as long-term spending commitments without violating the rule. Government could also run deficits without violating the fiscal rule.

South Africa's history with fiscal rules

Over the past 25 years, South Africa has experimented with a catalogue of fiscal rules. We review them briefly in this sub-section.

Long-term deficit target of 3 per cent of GDP

The Growth Employment and Redistribution was a broad macroeconomic strategy document which amongst other things committed to a tighter fiscal stance after a period of debt accumulation. The central fiscal proposal was a commitment to narrow the consolidated budget deficit from 5.1 per cent of GDP in 1996/97 to 3 per cent of GDP in 1999/00 (Department of Finance, 1996b). To achieve this, South Africa's fiscal authorities proposed a reduction of government consumption expenditure as a share of GDP and measures to improve the efficiency of tax collection. A reconfiguration of the public service, reforming the fiscal planning framework and budgetary process, reductions to the level of government debt and dissaving, boosting economic growth, and encouraged public and private sector investment. Government over-performed on this target and exceeded its objectives in each year of the implementation period because of the decline in main budget non-interest spending from 21.8 per cent of GDP in 1996/97 to 19.4 per cent of GDP in 2000/01.

Table 2: Target and actual outcomes during GEAR

Per cent of GDP	1996/97	1997/98	1998/99	1999/00	2000/01
Main budget deficit					
GEAR target	5.1	4.0	3.5	3.0	3.0
Actual outcome*	4.4	3.7	2.2	1.3	1.9
Real government consumption					
GEAR target	19.9	19.5	19.0	18.5	18.1
Actual outcome	19.4	19.1	18.6	18.3	18.1
Real government investment growth					
GEAR target	3.4	2.7	5.4	7.5	16.7
Actual outcome	15.7	3.6	-2.7	-2.5	7.0
Government dissavings					
GEAR target	3.1	2.3	1.7	0.7	0.6
Actual outcome	3.0	1.6	0.3	-0.1	-0.5

**Excluding National Revenue Fund (NRF) receipts and payments*

Source: (National Treasury, 2019) and (South African Reserve Bank, 2019)

The Medium Term Expenditure Framework as a fiscal anchor

South Africa has a credible Medium Term Expenditure Framework (MTEF) that was introduced alongside other fiscal reforms in 1997. The MTEF contains government's three-year forward estimates of the main economic and fiscal variables. These are accompanied by indicative budgets down to the economic and functional budget level. The MTEF is not binding on government, but nevertheless expresses government's policy priorities and commitments. The publication of a Medium-Term Budget Policy Statement enables Parliament and the institutions of civil society to participate meaningfully in the debate. The National Treasury welcomes innovations to enhance the quality of this debate and has over the years introduced innovations such as the publication of a Fiscal Risk Statement, a Long-Term Fiscal Model and a technical annexure in the Medium Term Budget Policy Statement.

The proposed fiscal rule does not address how the medium-term expenditure framework will be strengthened. This is an important consideration because fiscal policy has responsibilities in addition to sustainability. A rule that reduces the planning capacity of departments, provinces and other government agencies would be undesirable. This is because the path of fiscal policy would be unpredictable making it difficult for government to undertake long-term policy commitments.

Debt stabilisation as a fiscal anchor

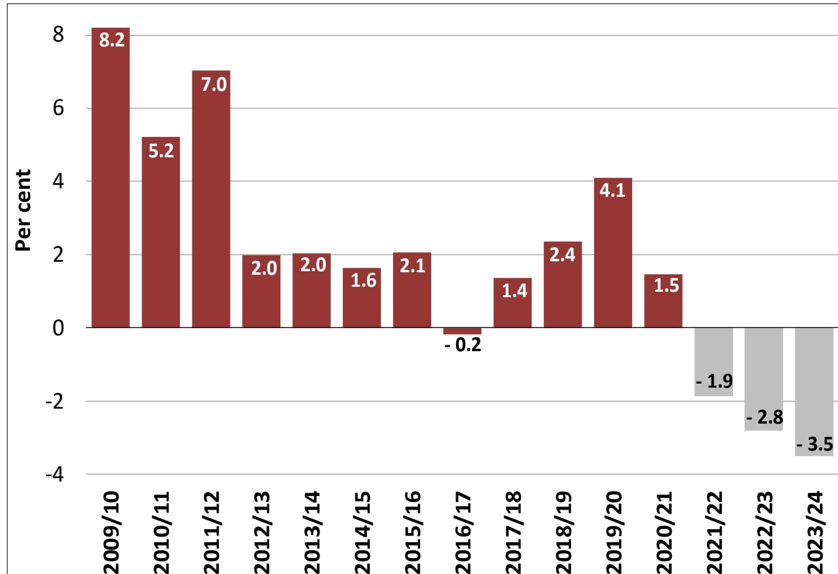
Debt stabilisation is a rolling fiscal target that is delayed (or brought forward) depending on the underlying economic conditions. This has been an explicit fiscal objective for South Africa's fiscal authorities since 2011. While this target has never been achieved it has had a significant influence on the conduct of fiscal policy. Since 2011 the main budget primary deficit has narrowed from 2.9 per cent of GDP to 0.5 per cent of GDP in 2016/17.

The expenditure ceiling

To support the objective of debt stabilisation a ceiling on non-interest expenditure was introduced in the 2012 Budget Review. It sets a maximum level of expenditure to which the government has committed itself. The ceiling is applied to national government departments and excludes spending that is financed from dedicated revenue sources other than the National Revenue Fund. The ceiling has helped to significantly slow the growth of non-interest expenditure as the figure below shows.

A challenge with the implementation of the expenditure ceiling has been that it has not improved the composition of spending and the logic of the ceiling may have helped to worsen the composition of spending. The key issue is that the ceiling did not factor in the negotiations of the public service wage agreements in 2015 and 2018. Retrospective measures were undertaken to ensure that government adheres to the ceiling in particular the introduction of compensation ceilings and early-retirement packages in the 2019 budget. The experience with the expenditure ceiling demonstrates the limitation of rule-linked fiscal policy. The ceiling is simple and transparent and adherence to it is easy to assess, however, because it lacks secondary objectives, in this case, a mechanism to maintain the composition of spending it has not necessarily improved the health of the public finances or supported the service-delivery objectives of fiscal policy.

Figure 6: Real main budget non-interest spending growth*



**Excluding transactions in financial assets and liabilities*

Fiscal rule-of-thumb

A fiscal guideline to set the expenditure ceiling in the outer year of every fiscal framework was introduced in the 2015 MTBPS. Under this fiscal rule of thumb, growth in the expenditure ceiling is linked to the long-run economic growth projections. By linking this rule to potential growth allowed for a properly counter-cyclical fiscal stance. The advantage of the rule of thumb was that over the long-term it allowed for greater predictability and transparency of fiscal policy. This would improve the ability of the rest of government to plan.

There are two drawbacks to the rule, however. The first is that there is uncertainty around South Africa's potential growth estimate. The second issue is that it can only be implemented once the debt-trajectory is stable otherwise government could not adhere to it over the long term.

Other fiscal rules and fiscal institutions to consider

The National Treasury supports measures that will bolster fiscal credibility and budget execution. Two options are possible; the preferred option is steps to re-orient and strengthen institutions that hold government accountable for achieving the fiscal targets in the Budget Review. The second option would be the introduction of more stringent fiscal rules that are consistent with South Africa's fiscal principles of debt sustainability, counter-cyclicality and inter-generational fairness. The rule proposed in this bill uses government expenditure as the sole lever for government to make changes, with potentially undesirable and disproportionate consequences.

Strengthening fiscal institutions is the better option because a public forum would consider and make recommendations on the macroeconomic, budget execution and contingent liability risks to the public finances. Failure to consider these risks would result in frequent breaches of the rule. In the second place, a rule might result in inconsistent fiscal policy. A third challenge is creating political buy-in and accountability for adherence to the rule. For these reasons, it is argued that a more fruitful path is strengthening existing institutions; the Parliamentary Budget Office and the Fiscal and Financial Commission by adding semi-annual assessments of fiscal sustainability to their mandate. In addition, public hearings into the budget could be strengthened through the of a review of official budget forecasts and debt sustainability.

Nevertheless, if fiscal rules are the preferred option of Parliament then it is important to evaluate the universe of rules that exist before adopting the one proposed in this bill. Other fiscal rules that could be considered are:

- A Golden Rule similar to that pursued by the Labour government of the United Kingdom of Great Britain and Northen Ireland between 1997-2007. The rule limits the deficit to financing capital expenditures. The advantage of this rule is that if correctly implemented it will protect the composition of expenditure. It does have its drawbacks since expenditures that improve human capital such as education and healthcare are not protected. In the case of poorly planned capital expenditure programmes such as the Eskom, Department of Water and Sanitation or PRASA investment programmes the rule would imply excessive borrowing on assets with little return. This would pose a risk to debt sustainability.
- A Swiss debt brake could be implemented to ensure that spending is financed from revenue instead of borrowing. How it would work is that fiscal policy would target a structural budget balance. Implemented correctly, the rule keeps expenditure growth in line with trend growth while the economy is booming, therefore producing budgetary surpluses and avoiding fiscal adjustments during downturns. The rule would combine the stabilising properties of an expenditure rule (because of the cyclical adjustment) with the effective debt-controlling properties of a balanced budget rule. The key drawback of the rule is its obvious reliance on the estimate of the economy’s potential level of output, which is unobservable. The calculation of the required cyclical adjustment or revenue estimates is based on assumptions regarding economic conditions and tax bases which if wrong could result in pro-cyclical stances if the underlying assumptions about economic growth are influenced by other factors such as commodities cycles or the financial sector cycles.
- The German debt brake: Under Germany's constitutional Schuldenbremse of 2009, the federal government must cut its structural deficit to 0.35 per cent of GDP. It consists of a structural component that only permits a very low level of structural borrowing – 0.35 per cent of GDP for the federal government and 0 per cent for the states – plus a cyclical component that increases or decreases the leeway for additional borrowing over and above the structural component depending on the current economic situation, and an escape clause for exceptional emergency circumstances.

Table 3: International experiences with debt ceilings

COUNTRY	Current limit	Coverage	Well-Specified Escape Clauses	Outcome
Indonesia (2004)	60%	Central government	No	The country's debt-to-GDP ratio increased from 24.7% to 30% between 2014 and 2018. This is still far from the debt limit.
Armenia (2008)	60%	Central government	No	Prior to 2018, the debt ceiling of 60% was applied together with a debt brake of 50% of GDP. Debt brake is no longer in place because it limited fiscal flexibility.
Botswana (2005)	40%	Central government	No	The government has never breached or even approached its public debt limit set at 40% of GDP.
Ecuador (2010)	40%	General government	No	The debt ceiling was breached in 2016. A new bill now allows for further indebtedness as long as the fiscal consolidation targets are being met.
Jamaica (2014)	100%	Central government	Yes	Following a reform program to stabilise the economy and reduce debt, public debt fell below 100 percent of GDP in 2018/19
Kenya (1997)	45%	Central government	No	Ceiling has been breached since 2016. Debt was 57% in 2018, up from 42.8% in 2008.
Malaysia (1959)	55%	Central government	No	Debt has not breached the ceiling.
Peru (2013)	30%	General government	No	Debt has not breached the ceiling.

Institutional reforms

South Africa's fiscal imbalances are not solely driven by an inability to predict the economic cycle-although this is an important factor. The fiscal rules discussed above are largely designed to deal with deficits driven by pro-cyclical stances. Consideration needs to be given to broader institutional reforms to address the structural factors that drive deficits including the framework to manage contingent liabilities and the setting of wages in the public service. Institutional reform is required to monitor adherence to the rules.

South Africa has a 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 and extensive budget transparency. New reforms and fiscal policy initiatives build on this foundation, such as the introduction of a nominal expenditure ceiling in 2012. Besides the possible implementation of a fiscal rule, other options for institutional reforms, which may be more appropriate, include:

- Additional legal reforms: The fiscal authorities of Brazil and New Zealand responded to the build up of deficits in their public finances by passing Fiscal Responsibility laws. The intention of South Africa's The Money Bills Amendment Procedure and Related Matters Act 9 of 2009 was to give the legislative branch a greater say in the budget process. Amongst other things, it established a Parliamentary Budget Office which has the mandate to provide independent advice to the legislature on the Budget and other Money Bills.
- The Money Bills Amendment Procedure and Related Matters Act of 2009 was amended in 2018. Among other things, the Amendment Act sought to correct the powers and functions of the committees dealing with matters related to the Act; as well as clarify and amend the procedure, resultant reporting and periods involved in the amendment of money Bills and division of revenue Bills and related fiscal instruments. Additional legal reforms in this vein could be proposed to support further fiscal oversight and discipline.

- Refocusing the Financial and Fiscal Commission or Parliamentary Budget Office: Currently, it is the role of the South African Parliament to conduct effective oversight over the utilisation of public resources by the government for policy implementation. The primary function of the PBO, which came into existence in 2013, is to support the implementation of the Money Bills Act by undertaking research and analysis for the four committees on Finance and Appropriations in the National Assembly and National Council of Provinces. The FFC is an advisory body and has the mandate to make recommendations on financial and fiscal matters to parliament, the provincial legislatures, and any other institutions of government when necessary. The FFC is separate from government. Both these institutions will require reforms to introduce the features associated with successful fiscal councils.

The effectiveness of fiscal councils in promoting sound fiscal policies depends less on function and form and more on specific features. According to the IMF, recent international experiences and empirical evidence point to the following lessons on the effectiveness of fiscal councils in promoting sound fiscal policies: fiscal councils can still be effective without fiscal rules; effective fiscal councils must be both legally and operationally independent; direct but disciplined access to the media should be ensured; and fiscal councils must be kept in check (they must publish their assessment methodologies and should be frequently evaluated by external independent peers and the media.)

Conclusion

The National Treasury welcomes proposals to make fiscal policy even more credible. Institutional innovations to strengthen the Medium-Term Expenditure Framework and to enhance the debate on fiscal policy are welcome. The National Treasury also welcomes recommendations to make the fiscal proposals contained in the 2021 Budget more credible

However, it is important to recognise that it is difficult to implement far-reaching fiscal rules because South Africa’s economic growth is persistently weak and the public finances are managing several large risks beyond the control of fiscal authorities. Persistently low economic growth has resulted in revenue shortfalls that have widened over the past four years, and a structural budget deficit has emerged since 2009/10. The quality of public expenditure is often poor and there are significant governance challenges. Growth-enhancing policy initiatives are underway in the telecommunications, electricity and transport sectors. These initiatives will reduce the risk to the public finances and strengthen fiscal policy.

Significant progress in the implementation of economic reforms is needed, otherwise South Africa will continue to be stuck in a cycle of low growth, poor fiscal outcomes, budget constraints and rising debt. Clearly, this requires a fundamental change to underlying economic and social structures.

The National Treasury agrees that governments with low fiscal credibility and high levels of debt have less space to withstand shocks and experiment with significant policy changes. That is why the fiscal targets set out in the 2021 Budget aim to stabilise debt and reduce debt-interest payments as a share of main budget revenue. However, introducing more binding

fiscal targets in the current uncertain environment will be met with scepticism. Despite pursuing credible fiscal stances, the impact of the South African government's fiscal policy on economic growth has been negated by more fundamental macroeconomic trends, including policy uncertainty, contracting investment by the private sector and public corporations and the financial and operational deterioration of the broader public sector.

The proposed fiscal rule would not be effective in countering these trends. Instead it would run the risk of worsening the conduct of fiscal policy by creating incentives to behave in a pro-cyclical manner. This would be particularly true in an economic boom when there is a cyclical upturn in main budget revenue.

In addition, many of the choices made in this bill such as the specific target range and limiting the rules coverage of government's liabilities to only net debt are arbitrary. There is no justification that a range of 50-55 net loan debt as a percentage of GDP is optimal for South Africa.

A single rule as proposed in this bill is insufficient to manage the range of risks to the public finances. A better approach would be a suite of well-designed rules with technical backing and clearly defined escape mechanisms. The provisions contained in this bill are very drastic in the short term and would likely lead to an unprecedented fiscal retrenchment if implemented. At the same time, the immediate implementation date of 2021/22 specified does not seem to show appreciation for the parliamentary process, the complexity of the budget process, including the determination of appropriate fiscal frameworks considering current and projected economic circumstances, political processes and the collective bargaining process, amongst others. For example, the targets set out in GEAR, were implemented over a five-year period.

Any fiscal rule must be backed by decisive action to retain confidence and unlock the impediments to investment. Measures that could restore economic momentum in the short run, neutralise key fiscal risks and win space for easier fiscal adjustments. Government should make progress in strengthening governance in the public sector, stamping out waste and corruption and turning around key state institutions. Objectives that cannot be achieved by a fiscal rule. Government must take the following steps:

- Continuing and supporting the work led by Commissioner Kieswetter of restoring the capability and integrity of the South African Revenue Service.
- Restructuring state-owned companies and the broader public sector by putting in place credible, independent boards, and committing to processes which will allow for greater competition and private sector participation in sectors dominated and held back by excessive state control.
- Announcing a plan to un-burden the state and the fiscus of contingent liabilities that have no clear contribution to the state's developmental agenda.
- Improving the composition and productivity of spending through spending reviews and Zero Based Budgeting.

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