PIMS

BUDGET PAPER 5

The 2009 Medium-Term Budget Policy Statement: Have We Found New Balance?

The PIMS Budget Papers provide analysis of significant, topical budgeting questions to promote wide-ranging, informed debate on the best uses of public resources in South Africa.

The series covers:

- fiscal policy,
- the budget system,
- good fiscal governance,
- issues of political economy,
- the performance of key institutions,
- the impact of the budget on poorer households.

Comments or questions can be sent to Len Verwey, 021 467 7630, lverwey@idasa.org.za

idasa
AN AFRICAN DEMOCRACY INSTITUTE

PIMS Budget Paper 5

The 2009 Medium-Term Budget Policy Statement: Have We Found New Balance?

by Len Verwey, Thembinkosi Dlamini, Saranne Durham and Musa Zamisa

2009

Contents

Page

1. Introduction

Pravin Gordhan became South Africa's new Minister of Finance under difficult circumstances. Although it appears as though the global economy may be moving out of recession, and that South Africa will soon follow, economic headlines leading up to the October 27 MTBPS speech focused on the ballooning budget deficit, the poor performance of tax revenue which is one reason for it, and on what seem to be continuing tussles within government over who should be running the economy.

It was therefore not surprising that the Minister did his best to calm the waters, to insist that in fact everything was under control. The credibility of these assurances, and the degree of fiscal risk South Africa takes on board over the coming medium-term, should inform our discussions going forward, as well as Parliament's deliberations on the budget.

The basic story is a commitment on government's part not to cut spending over the coming medium-term, even though tax revenue will only recover slowly from its slump. In fact, tax revenue looks likely to recover more slowly than the growth rate, in part because South Africa's over-indebted households will not be spending as much for quite some time as they did in the boom years. Thus, we not only get the 7.6% budget deficit which is estimated for the current fiscal year, but deficits of 6.2%, 5% and 4.2% in the following years. Large deficits mean more debt, and the 2009 MTBPS estimates debt stock at 41% of GDP by 2013. This is large by recent South African standards, but not particularly large within the current crisis-response paradigm.

The MTBPS did not contain big surprises as far as allocations are concerned: government priorities remain social spending, infrastructural expansion (much of it led by the state-owned enterprises), as well as job creation. Whilst all South Africans would agree on the importance of these, job creation in particular requires establishing a more inclusive and competitive economy. This will not happen overnight and cannot happen solely through the agency of government.

As expected, the Minister emphasised that government would try to save some money and reduce corruption. There was also a surprising degree of emphasis on improving tax compliance, suggesting that SARS may believe tax evasion has increased in the current harsher economic environment. Emphasising these points is clearly necessary for a government that will not be able to increase its spending much over the next three years but has to get the most value possible out of every allocated rand. It is a welcome

emphasis and Parliament, the media and NGOs need to contribute to what may be called 'value for money' oversight.

It remains to be seen, though, whether government's growth and tax predictions have come through these turbulent times with credibility fully intact. The issue here is less the economics of the budget and more its role in enhancing fiscal predictability and transparency. The 7.6% deficit which seems likely for the current year stems from a significant underestimation of growth, accompanied by a very significant spending increase from 2008/09 to 2009/10. That increase in spending was warranted, and remains warranted, not only because curtailing infrastructure plans would have been foolish, but also because increased spending, combined with relaxing monetary policy, is the right way for government to soften the recessionary shock.

But clearly February 2009's budget was far too optimistic in its assumptions for 2009/10 growth and tax performance, and therefore underestimated the likely deficit. Then, Trevor Manuel said the economy would grow by 1.4% over the 2009/10 fiscal year. This at a time when the economy had already been contracting for a quarter and was busy contracting at an annualised rate of 6%. Pravin Gordhan now had to take the stage and revise that growth down to -1.6% for the same fiscal year. This kind of divergence exposes how little we understand about the nature of our economy's adjustments when it comes under strain, understandable perhaps given the complexity of the variables involved. .

Over the next three years, while growth is expected to recover slowly and tax revenue even slower, government will keep spending. It does not have a choice, given the poverty, the inequality, and the unemployment that mar our democracy. When the books are closed on the 2009/10 fiscal year, government spending will have made up about 35% of GDP. Although this ratio will go down over the medium-term, it will not go down below 30% again in the foreseeable future. The MTBPS also makes it clear that, three years from now, South Africa is likely to be significantly more indebted than it has been in some time. These figures point to obvious risks as far as the sustainability of public finances is concerned, but no clear debt trap or other alarmist scenario awaits us. However, what is required, now more than ever, is value for money. The social and economic stakes may well continue going up under Minister Gordhan's financial leadership, and effective and broad oversight of public finances must now take centre stage in our conversations about how to get from a Finance Minister's speech to a South Africa that fully meets the aspirations of the Constitution.

The MTBPS is an opportunity for discussion and debate on the broad direction of fiscal policy, allocation priorities and government performance in spending those allocations. To contribute to this debate, and to provide some further background to the relevant issues in anticipation of the February 2010 budget, this Idasa paper looks in more detail at a number of issues.

2. Fiscal Policy in the 2009 MTBPS

The 2009 MTBPS needs to be assessed against the backdrop of the continuing recession in the South African economy. The contraction of the South African economy in the first half of the 2009/10 fiscal year has meant reduced tax revenue and almost certainly a much larger budget deficit (7.6% of GDP as opposed to 3.8% of GDP) than proposed in February. Both the 2008 MTBPS and the February 2009 budget were too optimistic in their assumptions regarding the rate of economic recovery and the tax revenue which would be available for 2009/10 and onward.

The 7.6% deficit is larger than South Africans have become accustomed to, though it is not so anomalous in the current global environment, which has seen most G-20 economies embark on deficit spending and interest rate cuts to soften the impact of the recession. Whilst tax revenues have been weaker than anticipated, spending has been roughly maintained in line with the February proposals. With government spending maintained even as the overall economy has contracted, government's share of GDP rises to about 35% in 2009/10, and remains appreciably above 33% over the medium-term period to the end of 2013.

The MTBPS proposes significant deficits over the medium-term, rather than an abrupt return to a pre-crisis deficit paradigm: 6.2%, 5% and 4.2% are proposed from 2010/11 to 2012/13. These deficits are needed less to finance further substantial real increases in spending, and more to ensure maintaining, in real terms, the levels of government spending which were established in the 2008/09 and 2009/10 budgets. These levels include a higher degree of infrastructural spending but also reflect the impact of public sector wage settlements. In the 2009 Adjustments Budget, about R12 billion of the additional R14 billion allocated went to cover such wage agreements.

It is noteworthy that the MTBPS forecasts growth to pick up fairly soon, and is probably realistic in this regard, but it is anticipated that tax revenue

will be slow to recover, as a result of high indebtedness going into the crisis. Table 1 compares the growth forecast of the National Treasury for the 2010 calender year with that of a number of other institutions.

Table 1: Real GDP Growth Forecast, 2010	
Institution	Forecast
ABSA	2.3%
Rand Merchant Bank	2.5%
Investec	1.5%
Nedbank	2.0%
Bureau for Economic Research	2.7%
International Monetary Fund	1.7%
National Treasury	1.5%

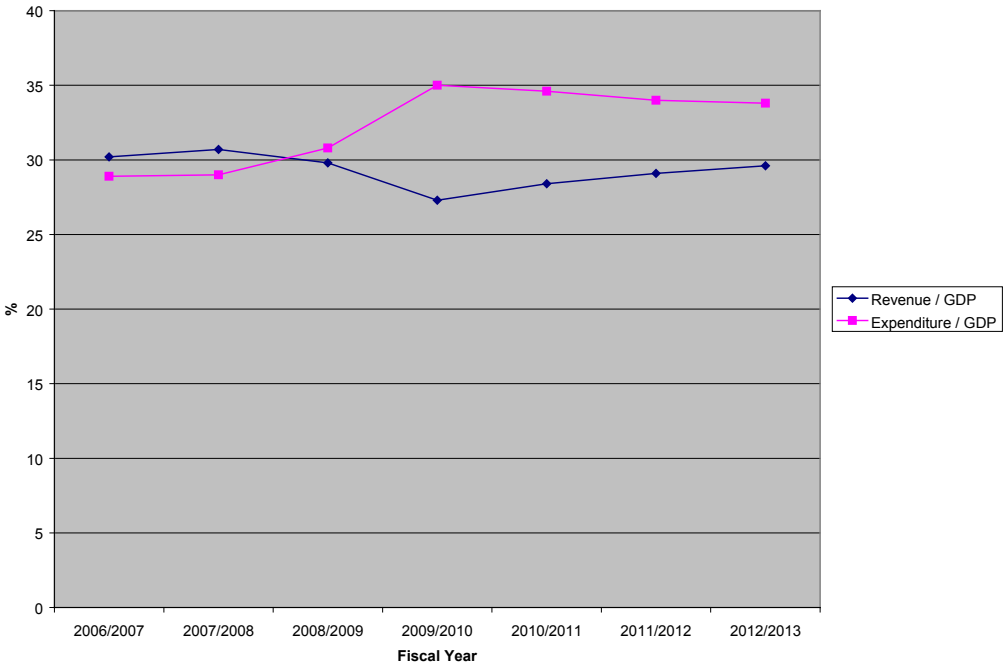
Although the real GDP growth forecast for the 2010/11 fiscal year is 2%, tax financing will continue to be sizeably supplemented by loan financing. Another way of expressing this is to note that the gap in the ratios of spending and tax to GDP which opened up in 2009/10 will be narrowed but not closed in the foreseeable future, as Figure 1 on page 8 shows.

It is not surprising, then, that the Minister of Finance in his speech placed significant emphasis on the need to improve tax compliance, broaden the tax base, and introduce new taxes, though it does suggest the potential precariousness of the current situation and the change in the risk-profile of South African public finances. The MTBPS document further expresses it as follows: "stabilisation of debt-service costs as a percentage of GDP will require continued improvement in the fiscal balance beyond the forecast period. Combined with the stabilisation in expenditure growth, other means of increasing budget revenue will need to be considered. These include broadening the tax base, improving tax compliance and the introduction of new taxes." (National Treasury 2009: 46).

Poor tax collection in 2009/10 and the anticipated sluggish rate of tax revenue recovery must be partly attributed to high levels of household debt at the time the crisis commenced. Households had to sharply curtail expenditure as their circumstances changed, and indeed it is VAT collection which was underestimated to the largest extent in the February budget: the 2009 MTBPS estimates a VAT shortfall of R 30.8 billion, or 18.2% for 2009/10. High indebtedness means that rising incomes in the

future will only partly go towards increased consumption, with debt servicing taking up the rest.

Figure 1: Expenditure and Revenue as Share of GDP over MTBPS Period



Source: MTBPS 2009, The National Treasury: Page 36, Table 3.1.
Own visual representation

It is worth asking whether the 2009 MTBPS risks placing South African public finances on an excessively risky course over the next three years, notwithstanding the global paradigm shift towards more interventionary fiscal policy and looser monetary policy. Should proposed deficits be moderated more quickly and a more moderate debt stock position be aimed at over the medium-term? There is no easy answer, but there are some general remarks that can be made in this regard.

South Africa's response remains consistent with that of other G-20 countries, and envisaged levels of indebtedness are not in excess of that of the majority of these countries. In this sense, then, there is no need for alarmist thinking. On the other hand, the social and economic return on this lending will go a long way towards determining the kind of economy and

society we have three years from now. If wage increases in the public sector do not elicit improvements in service delivery, and if infrastructural spending does not actually remove the well-documented constraints to growth, then we may find that our wealth and income have not grown as much as needed to service the greater debt we have. Under such circumstances the debt stock could cast a larger shadow over the ability of the budget to alleviate poverty and contribute to decent job creation.

3. Aspects of Government Performance

Both government and non-government stakeholders have emphasised the importance of value for money in the changed circumstances of the medium-term. Enhancing value for money includes weeding out corruption, eliminating waste and ensuring a resolutely goal-driven orientation throughout government as well as amongst those tasked with oversight of its finances and operations. As Idasa noted in response to the February 2009 budget: "At the crux of the current debate over economic policy are the critical questions of whether government has effectively used public funds to achieve poverty alleviation, increase income and deliver basic services."

Performance assessment is to some degree developed in the Public Finance Management Act (PFMA) and the Municipal Finance Management Act (MFMA), and the establishment of the Ministry for Performance Monitoring and Evaluation followed by the publication of a Green Paper on government performance has revived the call for a performance-oriented public sector. The role of Parliament in overseeing performance is also strengthened by the additional budgetary authority bestowed by the Money Bills Amendment Procedure and Related Matters Act. An overview of recent performance suggests that great gains can be made through improved oversight and accountability, but that much needs to be done.

Education spending by government has consistently averaged above 5% of GDP, which compares favourably with world averages. As shown in Table 2 on page 10, provincial spending on education has since 2002/2003 ranged above 40% of provincial budgets.

Table 2: Education as Share of Provincial Budgets						
Percentage of Provincial Budget	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	44.7	45.7	45.6	44.7	44.7	40.8
Source: 2006 and 2009 Provincial Budget and Expenditure Reviews. Available at: www.treasury.gov.za						

Access to education has broadened, both at the lower and upper level, with the adoption of compulsory education for children up to the age of 15 years and the introduction of FET institutions in 1998, with the FET said to be: "increasingly seen as an alternative to other schooling" and playing a "critical role in vocational skills development" (Towards a 15 Year Review, 2008: 76). However, as noted by many commentators, the performance of the South African education system still falls short of providing the most essential skills required by the economy, and this occurs almost irrespectively of the considerable financial resources allocated to education. Similarly, although the health function accounts for the largest part of government spending after education, the quality of outcomes and the impact on the health of South Africans remains an area of concern. In this regard, government's recent Provincial Budget and Expenditure Review notes what it terms "reversal of progress" in indicators such as life expectancy, maternal and child mortality, and other health-related Millennium Goals.

Access to water and sanitation for South Africans has increased considerably, with the number of households with access to sanitation increasing from 49.9% in 1993/94 to 77.1% in 2008/09, while households using a bucket system declined from 609 675 to 9 044 in the same period. The percentage of households with access to water infrastructure above or equal to the RDP standard increased from 61.7% in 1994 to 91.8% in 2009 (Development Indicators, 2009: 32).

However, the quality and reliability of water remains a challenge. In fact, South Africa has already missed its 2008 target of making safe drinking water accessible to all (FFC, 2009: 97). The FFC further attributes the challenges facing the water and sanitation sector to the collapse of infrastructure and maintenance programmes which are largely attributed to the loss of skilled and experienced personnel, particularly engineers and technicians. The failure by the South African education system to meet the growing demand for scarce skills in areas such as science, engineering and technology is also a major culprit.

These and similar challenges suggest that there is much to be done to enhance budgetary impact on the wellbeing of South Africans. The MTBPS, of course, simply provides an indication of the resource allocations and assumptions regarding the economy within which these challenges need to be addressed. The next section looks in a bit more detail at the role that the MTBPS has played in South African fiscal governance.

4. The MTBPS, Participation and Credibility

Budget reform in post-apartheid South Africa was premised on the need to improve fiscal sustainability, foster the alignment of public spending with national priorities and maximise available resources for attaining these priorities. Democratic South Africa also required a budget system that instilled stakeholder confidence and was characterised by transparency, accountability and participation.

A medium-term budget policy statement can assist in achieving these goals as its sketching out of medium-term parameters provides an indication of government's assumptions and intentions, which should improve both planning and budgeting within line-departments as well as overall budget coordination, and contribute to the quality of engagement with the budget from civil society and legislatures. The latter should in turn strengthen oversight and hence budgetary efficiency and effectiveness. In this section we look briefly at two aspects of the MTBPS from a good fiscal governance perspective, namely the extent to which it has fostered participation in budgeting and, secondly, the more technical question of its credibility in the light of recent growth and tax revenue forecasts and estimates

Although the MTBPS has been effective in coordinating medium-term budgeting within government, it has not functioned particularly effectively in promoting participation. At least three reasons for these can be cited, though it is more difficult to measure the impact of each.

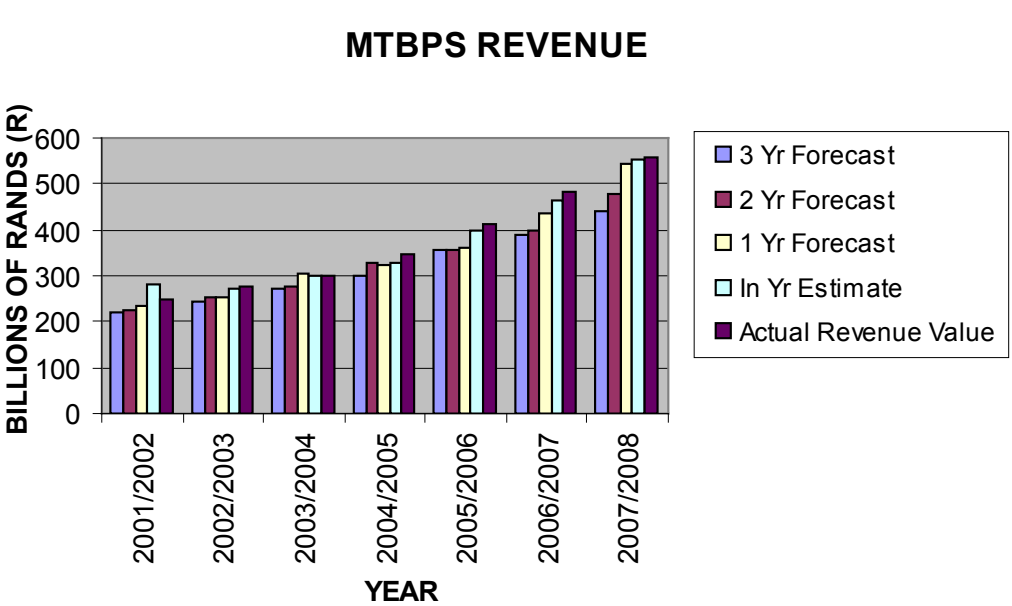
Firstly, the capacity of civil society as well as legislatures in South Africa to engage substantively and rigorously with public finances remains weak. This is clearly not the fault of the fiscal authorities, but it does hamper both the allocative efficiency of the budget and its degree of social ownership. Participation is not merely a democratic "add-on" to a process which is in fact completed elsewhere, but a necessary means of ensuring that spending reflects preferences and that citizens see the budget as "theirs".

A second reason why the MTBPS may not have fostered participation in the past is that is has provided broad indications of changing priorities, but not draft allocations. The 2009 MTBPS provides more detail in this regard and, it is hoped, will make a positive contribution.

Finally, until recently the constitutionally-required legislation setting out the procedure for Parliament to amend the budget had not been enacted. In one sense, therefore, submissions made to Parliamentary Committees lacked real force, as recommendations made by civil society could not be adopted by the committees in their engagement with the budget. The 2009 Money Bills Amendment Procedure and Related Matters Act provides Parliament with strong powers to amend the budget, and should therefore also have a positive impact on participation. From a broad fiscal governance perspective, the aim is not to have a proliferation of amendments simply because an Act now exists which allows them, nor should the risks of amendment from an under-capacitated Parliament be underestimated. But the fact that legislation grants Parliament amendment authority as a final recourse should result in more weight being accorded to its deliberations on the budget and its oversight hearings. This is a positive development, particularly given the increased emphasis on value for money by government.

The MTBPS sketches out medium-term budget figures and predicts economic performance. The budget figures it sketches out will be regarded as credible only if its forecasts of variables such as economic growth are themselves regarded as credible. Since the MTBPS looks forward by three years, it is useful to test the accuracy of forecasts made at different times for the same year, from those made closer to the time (including in-year forecasts) to those made three years beforehand. Thus, for example, it is useful to compare forecasts from 2006/07, 2007/08, 2008/09 and 2009/10 for real GDP growth in 2009/10 and trace government's changing conception of economic developments and assess these against what actually happened.

As regards firstly the forecasting of tax revenue since 2001/02, these have not always been particularly accurate. Typically, and not surprisingly, the most accurate revenue forecasts are the in-year ones, that is, the estimates of tax revenue halfway through the year in question. However, more surprisingly, forecasts made two and three years before the outcome are consistently more accurate than the forecast made one year before. Furthermore, only the two-year forecast and in-year estimates are more accurate than a no-change simple or naïve extrapolation forecast.

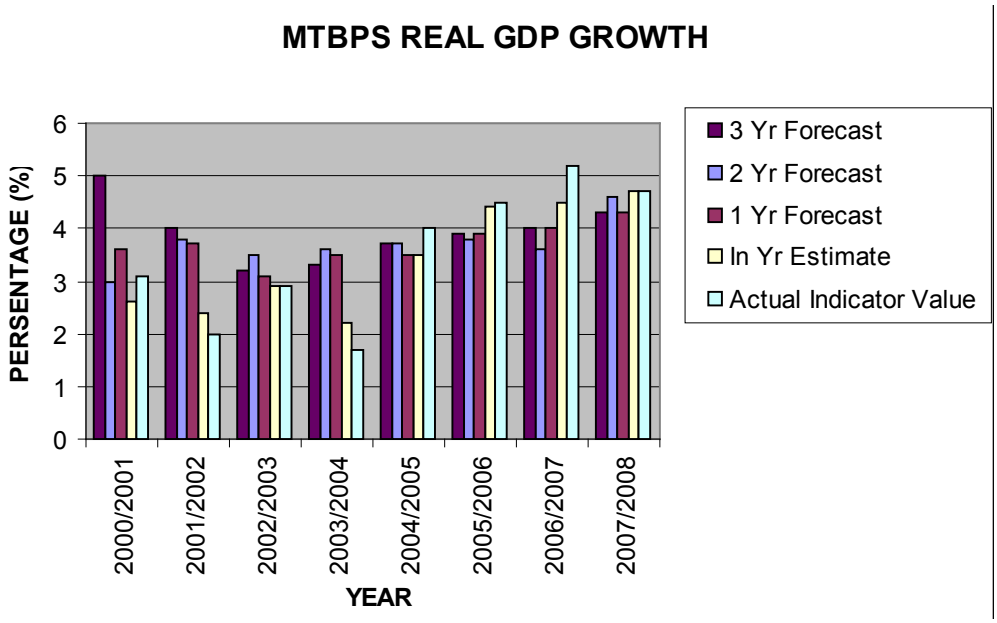


In most instances since 2001/2002, Treasury has been forecasting conservatively with actual revenue being nominally greater than forecasts and estimates. This confirms the preference for caution which has characterised tax forecasts, and which has often led to revenue over-runs. Given the preference for caution-related underforecasting to date, the large revenue shortfall which is likely for 2009/10 appears particularly anomalous.

As regards the forecasting of real GDP growth, the most accurate forecasts have again, and not surprisingly, been the in-year ones (see graph on page 14).

For the 2000/2001 to 2003/2004 forecasts there seems to have been be a trend towards over-confidence when forecasting GDP growth. Subsequently, the trend becomes more conservative and, typically, real GDP growth has been higher than its preceding forecasts. Again, as with tax revenue, this suggests the cautious approach which provided the Minister of Finance with additional room to manoeuver each February.

The 2009/10 budget was therefore quite a divergence, in the sense that it represents by far the most significant instance of growth and tax revenue underestimation we have yet experienced. Both growth and tax responsiveness to growth were underestimated in what were probably unique circumstances. It is essential that the MTBPS growth and tax revenue forecasts for the medium-term do not turn out to be equally optimistic, both for the sake of fiscal sustainability and the credibility of the MTBPS.



5. Conclusion

It is a truism that budgeting is something of a balancing act, that it is about trade-offs and difficult choices. In South Africa, with its social challenges and the tensions over economic policy within the Tripartite Alliance, budgeting is perhaps especially marked by strong engagement. Both the initial period of what was sometimes called fiscal consolidation, from about 1996 to about 2001, and the subsequent glory years, which ended in 2008, were defined by a degree of budgetary caution which the Left tended to regard as excessive. Budget surpluses in a number of recent fiscal years, for example, were a particular bone of contention.

The financial and economic crisis and the South African recession, in a post-Polokwane political environment, have done much to change that, as globally even conservative fiscal authorities have adopted strong counter-cyclical fiscal policy. This is and was the correct policy option for South Africa too, but it remains to be seen whether the scope of increase was optimal and whether, indeed, a successful balance has been achieved in a difficult situation.

The emphasis by the Minister of Finance and others on improved oversight to ensure value for money is welcome, and Parliament and civil society will have important roles to play in this regard. They can also help foster social ownership of the budget, which in turn has a significant role

to play in enhancing budgetary impact. Broader, stronger and more rigorous stakeholder engagement may well tip the scales in favour of all South Africans.

References

Financial and Fiscal Commission, "Submission for the Division for the Division of Revenue 2010/11". Available at: www.ffc.co.za.

National Treasury, 2009, "Medium-Term Budget Policy Statement". Available at www.finance.gov.za

National Treasury, 2006a. "Provincial Budget and Expenditure Review 2002/03 – 2008/09". Available at: http://www.treasury.gov.za

National Treasury, 2006b. "Provincial Budget and Expenditure Review 2005/06 – 2011/12". Available at: http://www.treasury.gov.za

Presidency, 2008. "Development Indicators, 2009". Available at: http://www.info.gov.za/view/DownloadFileAction?id=85218

Presidency, 2008. "Towards a Fifteen-Year Review". Available at: http://www.info.gov.za/view/DownloadFileAction?id=89475