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Ref. M2/1/1/3 (2939/10)

Mr MV Sisulu, MP
Speaker of the National Assembly
Parliament of the Republic of South Africa
P O Box 15
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Dear Mr. Sisulu,

REPORT OF STANDING COMMITTEE ON FINANCE ON 2010 REVISED FISCAL FRAMEWORK

The following pertains to the report of the Standing Committee on Finance, submitted in terms of the *Money Bills Amendment Procedures and Related Matters Act, Act 9 of 2009* which was adopted by the National Assembly on 2 November 2010.

Please find attached a response to the Standing Committee's recommendations that the National Treasury should:

(i) Take appropriate steps to accelerate the rate of decline in expenditure;
(ii) Provide the Committee with a detailed report on how government would rebuild the fiscal space;
(iii) Provide the Committee with a detailed report on the impact of a zero rating value added tax (VAT) on books on the fiscal framework; and
(iv) Resolve issues pertaining to the SACU's revenue sharing formula as a matter of urgency.

Kind regards

PRAVIN J GORDHAN
MINISTER OF FINANCE
Date: 28-2-2011

Response to Standing Committee on Finance on the 2010 revised fiscal framework

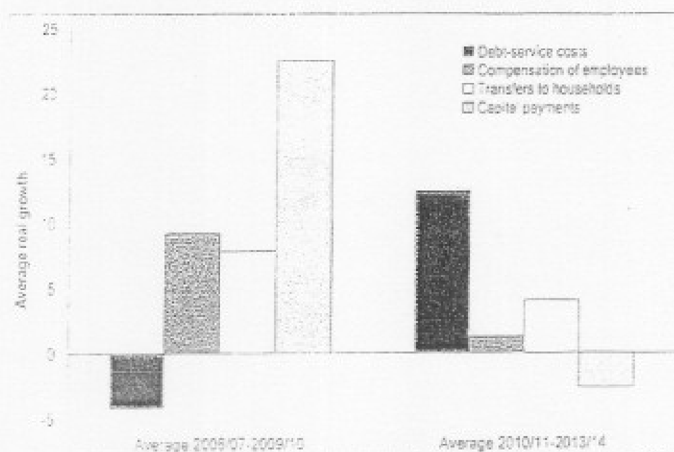
Recommendation 4.1 *"That National Treasury should take appropriate steps to accelerate the rate of decline in expenditure."*

The MTBPS framework includes an improved revenue outlook, lower levels of non-interest expenditure as a proportion of GDP and lower interest costs. All these factors assist in contributing to a faster recovery in the budget balance. In February 2010, the consolidated government balance was expected to move from 6.2 per cent of GDP in 2010/11 to 4.1 per cent in 2012/13. The 2011 MTEF indicates a budget position of 5.3 per cent of GDP in 2010/11, narrowing to 3.9 per cent in 2012/13 and then to 3.2 per cent in 2013/14.

Over the MTEF average real growth in non-interest expenditure is forecast to be 2.7 per cent a year. This is much lower than in previous years. Figure 1 illustrates average real growth in elements of expenditure under this scenario. The figure shows that despite a contraction in the fiscal deficit, most of the growth in expenditure is being driven by interest costs on debt. Further reductions in expenditure would only lead to less money available for essential services.

The measured unwinding of the fiscal deficit laid out in the 2011 fiscal framework means that debt stock and interest costs will stabilise in 2015/16. This rate of recovery is in line with Treasury modelling on the gap between actual GDP and potential GDP. Modelling and forecasting by the National Treasury shows that while South Africa has moved out of recession, the economy is still performing below its long-run level and will continue to do so until about 2014/15. Until this gap between actual and potential closes, the fiscus will continue to support the economic recovery and inclusive growth. The 2011 fiscal framework provides the resources to achieve these outcomes.

Figure 1: Real growth in expenditure, 2006/07 – 2013/14



Recommendation 4.2 *"That National Treasury should provide the committee with a detailed report on how government would rebuild the fiscal space."*

Countercyclical fiscal policy assists in defining a sustainable fiscal path by ensuring that expenditure which seems affordable when the economy is overperforming remains affordable during a recession and by encouraging a growth-friendly environment with low inflation, a low cost of capital and a competitive real exchange rate. In following this fiscal stance, government saves for future economic downturns and thus creates fiscal space. The discussion document to be prepared by National Treasury on fiscal sustainability will provide additional detail on this issue.

Recommendation 4.3 *"That National Treasury should provide the Committee with a detailed report on the impact of a zero rating value added tax on books on the fiscal framework."*

The proposal to zero-rate books is not supported for the following reasons:

- Very few of the benefits will be passed on to consumers in the form of lower prices.
- Of the limited benefits that will be passed on to consumers, most will accrue to middle and upper income households.
- Zero-rating of books will trigger requests for similar relief measures for other "merit" goods and services. This might undermine VAT as an efficient revenue raising instrument.
- Redistribution is better achieved through the expenditure side of the budget and through a progressive personal income tax system.

During the last few years, especially since the zero-rating of illuminating paraffin in 2001, the Minister of Finance has received several requests from the public, certain interest groups and by way of questions in Parliament to abolish VAT on the following goods and services: medicines; medical services; books; electricity; water; red meat; mageu (a maize based soft drink, largely consumed by the poor); security related expenses by private individuals; canned vegetables; and 450 gram household candles (as the South African Candle Manufacturers argued that the zero-rating of illuminating paraffin has impacted negatively on the sales of household candles).

These requests have been turned down so far. However, the request for VAT relief on books and medicine has persisted and this led to the commissioning of an independent study to examine the pros and cons of providing VAT relief on certain merit goods, e.g. books, medicine, etc. This study was completed in 2007. The aim of the study was to determine whether the current VAT concessions should be retained or be abolished and whether the introduction of additional concessions for other merit goods and services should be considered.

Based on the study's results it doubtful whether the zero-rating of books would achieve the desired outcome of more affordable academic books. Also, attempts to restrict a VAT concession to educational publications would be arbitrary and lead to compliance and administration complexities for both the industry and revenue authorities.

It is unlikely that a preferential VAT treatment for books would lead to any substantial price reduction for consumers. The study commission by the National Treasury suggests that consumers would probably

enjoy only around 13 per cent of any VAT concession, whilst 87 per cent of the benefits will accrue to publishers and distributors. Of the limited benefits that will be passed on to consumers most would be enjoyed by the middle and upper income groups.

The relatively low book penetration in South Africa appears to be primarily due to low literacy levels. This problem could be more effectively addressed through enhanced literacy programmes and expenditure programmes to provide a variety of reading books to all public primary and secondary schools, and public libraries.

Recommendation 4.4 *"That National Treasury should resolve issues pertaining to the SACU's revenue-sharing formula as a matter of urgency."*

An international consultancy that specialises in economic policy has been contracted by the SACU Secretariat to formulate proposals pertaining to the review of the SACU Revenue Sharing Formula. A first draft of the report has been circulated to member states, and discussions are on-going amongst officials of member countries on the initial findings and proposals from the consultants. The driving force behind the review is to arrive at a more equitable formula. However, given the uneven sizes of the participating economies, it is expected that SACU member states will be affected differently through a re-design of the Revenue Sharing Formula. Following these discussions at officials' level, it is expected that this matter will be discussed by the Council of Ministers of Finance, after which official negotiations towards a revised SACU Revenue Sharing Formula will commence.