Following the onset of the global economic crisis in 2008, Southern African Customs Union (SACU) member countries experienced a significant growth slowdown and deterioration of their fiscal balances. This deterioration came from two sources. First was a considerable reduction in SACU transfers, which account for a large share of total revenue for Botswana, Lesotho, Namibia, and Swaziland (BLNS), owing, in part, to the global crisis, which reduced the SACU revenue pool, but also to the procyclicality of the revenue-sharing formula, which aggravated the decline (see Chapter 3). Second, there were increased expenditures prior to the crisis. The decline in fiscal balances underscored the need for fiscal consolidation and a new set of institutional reforms to encourage adherence to prudent fiscal policies and reduce the dependence on SACU transfers.

BLNS relied on temporarily high SACU transfers to finance high levels of recurrent expenditure, notably on the wage bill (Figure 4.1). Thus, lower SACU revenues translate into higher fiscal deficits, which are difficult to reduce rapidly given the recurrent nature of many expenditure items.

Aware of the risks, BLNS have already taken significant fiscal adjustment measures. Revenue collection has been improved with the introduction of the value added tax (Swaziland), increased tax rates and duties (Botswana and Swaziland), and continued improvements in revenue administration. In parallel, expenditures were restrained in many countries, with outright cuts in capital spending (Botswana), non-priority spending (Lesotho, Namibia, and Swaziland), wage freezes (Botswana and Swaziland), and further plans to reduce the wage bill (Lesotho and Swaziland). However, despite these measures, primary fiscal balances deteriorated for all countries (except Botswana) during the crisis (i.e. from 2008/09 to 2011/12), with a worsening of primary balances ranging from 5 percent to about 20 percent of GDP. Botswana experienced an improvement of about 6 percent of GDP over the same period, largely because of cuts in capital spending.

This chapter is partly based on Basdevant and others (2011).

\footnote{Before the crisis, SACU transfers represented about 25–30 percent of GDP for Lesotho and Swaziland and about 10 percent for Botswana. The large swings in SACU transfers were in contrast to otherwise rather stable fiscal revenue.}
Although SACU transfers to BLNS have increased significantly in the fiscal year that started on April 1, 2012 (FY2012/13), the risk of lower SACU revenue over the medium term remains high, partly reflecting a likely slowdown of the global economy and trade liberalization. Hence, further fiscal adjustment is needed to reduce the dependence on SACU transfers and restore fiscal buffers. The fiscal policy implications for South Africa differ from those for BLNS. South Africa has been primarily affected by a significant contraction in activity, resulting from lower global economic growth. The policy response was to provide fiscal stimulus to the extent that fiscal space was available. Given that customs and excise revenues are a small fraction of South Africa’s revenue collections, a reduction in SACU transfers would not have a very large impact on South African fiscal policy. As a result, the remainder of this chapter will focus exclusively on BLNS.

South African fiscal policy has strong spillover effects on BLNS through the sharing of receipts in the SACU pool. South Africa generates about 90 percent of the revenue of the SACU pool, and under the existing rule, SACU transfers to BLNS are heavily dependent on South Africa’s GDP and import projections. Thus, as described in Chapter 3, revenue received in a given year $T$ are based on GDP and import projections for that year, and an adjustment is made in year $T+2$ to correct for discrepancies between the transfers received (based on projections) and the level corresponding to the actual collections (based on actual numbers). Empirically, this two-year lag has led to procyclical transfers because downward adjustments have usually occurred simultaneously with lower activity

\[\text{Figure 4.1 Public Wage Bill in Sub-Saharan Africa, Average, 2006–10 (Percentage of GDP)}\]

Sources: Country authorities; and IMF staff estimates.

---

The revenue pool consists largely of revenue from customs duties and, to a lesser degree, excise taxes. The pool is managed by South Africa.
in the cycle. This procyclicality has proven to be damaging, especially in light of the global financial crisis, because the sharp contraction in SACU transfers created heightened risks of debt distress.

The crisis also revealed the importance of redefining fiscal coordination in SACU, in the context of the close economic and monetary integration among the members of the Common Monetary Area (CMA). Without greater coordination—as well as greater fiscal discipline at the country level—unsustainable fiscal policies in BLNS could eventually threaten the sustainability of the CMA. Fiscal policy is the main macroeconomic tool with which BLNS can respond to the decline in transfers. Moreover, BLNS also face significant development challenges (e.g., widespread poverty, HIV/AIDS) and high unemployment. As a result, the design of their fiscal adjustment strategies has to focus not only on the immediate goal of rebalancing public finances, but also on restoring external stability and maintaining positive growth prospects. In contrast, South Africa would also need to factor in the potential impact of its policies on BLNS because these policies could create spillover effects for BLNS, the magnitude of which could complicate implementation of sound fiscal policies in BLNS.

This chapter explores these two issues—adjusting to potentially lower SACU transfers and increasing fiscal coordination in the region—by addressing the following questions:

- How could BLNS adjust their fiscal stance given the risk of a large permanent decline in SACU transfers foreseen for the medium term?
- Could the SACU members (excluding Botswana) strengthen their regional fiscal institutions, to support their exchange rate pegs in the context of the CMA and address the challenges raised by the spillover effects of the South African economy on BLNS?

**FISCAL ADJUSTMENT IN BLNS IN RESPONSE TO THE LOSS OF SACU REVENUE**

In addition to defining common rules within SACU, BLNS countries may face the additional challenge of implementing a significant fiscal adjustment, which is discussed in this section.

**Risk of a Decline in SACU Revenue Calls for Continued Fiscal Adjustment**

BLNS face the risk of another economic decline over the medium term related to at least three factors: (1) a further slowdown in global economic activity, which

---

3 The issue of external imbalances is discussed further in Basdevant and others (2011). Given the unprecedented contraction of SACU transfers and competitiveness issues in BLNS, the question of restoring external balances is essential in designing the fiscal adjustment. It reinforces the recommendation for a fiscal adjustment that would restore competitiveness by reducing the public sector wage bill.
would affect the SACU revenue pool; (2) a reduction in the common external tariff rates as a result of trade liberalization; and (3) the creation of the Southern African Development Community (SADC) customs union. Quantifying these risks is beyond the scope of this chapter. However, a worst-case scenario based on a significant decline in global economic activity and steady progress in trade liberalization suggests that SACU transfers to BLNS could decline in the range of 5–15 percent of GDP over the medium term compared with the 2012/13 levels (Table 4.1). These estimated declines are used to derive the adjustment strategy discussed in this section. Although the specific magnitude of each country loss could be relatively lower, the results are nevertheless qualitatively robust. Thus, the policy recommendations would remain broadly the same, even if the size of the needed fiscal adjustment were to be smaller.  

Similarly, lower SACU transfers worsen the external positions of BLNS. Lower SACU transfers are partly compensated for on the external side by lower imports, the development component, not related to imports and particularly significant for Lesotho and Swaziland, makes the loss an acute external balance issue. Accordingly, the ability to use monetary policy actively is limited by the need to defend the pegs.

### Analyzing Design Options for the Fiscal Adjustment in BLNS

A dynamic stochastic general equilibrium model is used to analyze options for BLNS fiscal adjustment (see Basdevant and others, 2011). The general equilibrium structure provides a coherent framework for tracing the macroeconomic effects of fiscal consolidation from the original steady state (the state before a permanent SACU transfer reduction) to a new steady state (the state reached years after such a reduction). Policy choices are predicated on the assumption that the government does not engage in additional borrowing to make up the financing gap. Thus, the only option is to adjust the fiscal stance, either by increasing non-SACU revenue, decreasing spending, or both. The debt pattern is assumed to remain fixed in the model.

---

**TABLE 4.1**

<table>
<thead>
<tr>
<th>SACU Transfers to Botswana, Lesotho, Namibia, and Swaziland, and Simulated Decline (Percentage of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Levels</strong></td>
</tr>
<tr>
<td>2005/6–2011/12</td>
</tr>
<tr>
<td>Botswana 8.4</td>
</tr>
<tr>
<td>Lesotho 28.5</td>
</tr>
<tr>
<td>Namibia 10.9</td>
</tr>
<tr>
<td>Swaziland 24.6</td>
</tr>
</tbody>
</table>

Sources: Country authorities; and IMF staff simulations.  
Note: SACU = Southern African Customs Union.

---

1 The policy response was also analyzed in Mongardini and others (2011).
2 Although lower SACU transfers are partly compensated for on the external side by lower imports, the development component, not related to imports and particularly significant for Lesotho and Swaziland, makes the loss an acute external balance issue.
3 See Wang and others (2007), which discusses the CMA under which Namibia, Lesotho, and Swaziland peg their currency to the rand.
Optimal fiscal adjustment strategies are based on multiple instruments because the composition of the adjustment is relevant to minimize the impact on growth. Five strategies were modeled: (1) increasing the consumption tax rate and cutting government consumption, (2) increasing the labor tax rate and cutting government consumption, (3) increasing both the labor and consumption tax rates, (4) drawing on the sovereign wealth fund for Botswana and increasing the consumption tax rate, and (5) cutting government consumption and investment. Multiple-instrument strategies are critical to securing broad political consensus on the reform, especially if otherwise only a specific segment of the population (e.g., workers in the case of a labor tax increase) were to carry the burden of the adjustment. Given the large potential decline in transfers, a fiscal consolidation strategy that involves only one fiscal instrument, such as only increasing the consumption tax rate or only cutting government consumption, may not be sufficient to close the budget gap. For example, an adjustment of labor taxes in Swaziland would require more than tripling the effective tax rate, from about 20 percent to 70 percent; the labor tax would have to be raised in Namibia by more than 10 percentage points (see Basdevant and others, 2011).

A combination of government consumption cuts and consumption tax increases appears to have the greatest impact on growth for all BLNS except Lesotho (Figure 4.2). Lesotho’s best option appears to be consumption and labor taxes. Cutting consumption (by lowering demand) puts downward pressure on wages, thus improving price competitiveness and growth prospects for the traded-goods sector. Lesotho is a different case, for which the best strategy would at first appear to combine a labor tax increase with a consumption tax increase. This result comes from the large absorption of nontraded sector output by the public sector, in combination with the relatively smaller size of the country’s traded-goods sector. However, this policy would have to be implemented through improvements in revenue collection and reductions of tax exemptions, instead of increasing tax rates (the value added tax rate is about 15 percent for goods and services, which is relatively high compared with the SACU region). Lesotho’s unique situation also is a result of the very large size of the government in the economy (government spending represented about two-thirds of GDP in 2009/10). From this perspective, although simulations of government spending cuts highlight how such cuts could lead to a significant contraction of the nontraded sector, the large size of the government would still underscore the need to implement spending cuts. These cuts could also help further strengthen a relatively weak external position.

In contrast, the negative impact on productivity of lower public investment makes policies based on this instrument clearly second best. Figure 4.2 shows that the GDP responses to public investment cuts range from 2 percentage points

---

[7] See Basdevant and others (2011) for a more detailed analysis, especially on the underlying assumptions of the model and simulations.

[8] The effective tax rate would increase by about 3–4 percentage points across countries, to a maximum of 7 percentage points (Swaziland).

[9] Tax adjustments may need to be coordinated within SACU.
below the steady state (Lesotho, Namibia) to 4–5 percentage points below (Botswana, Swaziland). Lower public investment propagates through the rest of the economy by lowering the productivity of private investment. Even with a companion instrument, the strong negative impact of cuts to investment remains dominant. The simulation, therefore, has strong policy implications: to alter the

---

10 This result is robust to alternative simulations involving public investment cuts (see Basdevant and others, 2011, for details).
negative impact of fiscal consolidation on growth, investment spending must be protected. However, the recommendation would only apply to investment spending that effectively contributes to enhancing the productivity of the whole economy. Ranking investment projects by both their costs and their benefits is essential. Cutting *prestige* investment spending would, in reality, be more like cutting government consumption rather than truly cutting investment. In addition, even potentially useful investment could become ineffective by, for example, overpricing by suppliers, execution delays, or lack of complementary investments.

![Figure 4.3: Current Account Balance Response to Different Policy Instruments](image-url)

**Figure 4.3** Current Account Balance Response to Different Policy Instruments (Deviation from steady state, in percentage points of GDP)

Source: IMF staff estimates and projections.

Note: The current account balance is proxied by the sum of the trade balance and transfers from the Southern African Customs Union (SACU), the other items of the balance of payment, with the exception of the reserves at the central bank, being held constant vis-à-vis the steady state. Also, x-axes show the number of years after the initial loss of SACU revenue.
Botswana’s sovereign wealth fund (SWF; the Pula Fund) could also be used to ease the adjustment, but it has to be combined with other instruments. The effects of this dual instrument mainly come from the accompanying instrument (in this case, a consumption tax), which adjusts to make up for the SACU transfer reduction. Despite this caveat, the use of an SWF can indeed provide some relief in the adjustment effort. However, two hurdles must be overcome: (1) the drawdown of the SWF raises net government debt, potentially creating debt vulnerability even with no change in gross debt, and (2) use of the resources of an SWF is better suited to a temporary shock—use of the SWF cannot be sustained to respond to a permanent shock. Overall, the use of an SWF would not have a significantly different impact on growth than using the consumption tax alone—even for Botswana, whose SWF is large.

External imbalances are effectively reduced by the fiscal consolidation, mirroring the contraction of domestic absorption (Figure 4.3). By reducing government imbalances, the fiscal consolidation has a strong negative impact on domestic absorption. Overall, the immediate deterioration of the current account balance following the sharp drop in SACU transfers (Figure 4.3) is fairly limited. This result reflects the strong fiscal response, the contraction in domestic demand, and improvements in competitiveness. For most countries, with the notable exception of Lesotho, all fiscal consolidation strategies perform equally well over the medium term. After a short-lived deterioration in the current account balance, it takes about one to two years, on average, to reach a level similar to that in effect before the drop in SACU transfers. It comes as no surprise that the adjustment is much slower when the SWF is used in Botswana, because the demand adjustment takes place more gradually.

Lesotho brings a different perspective to the fiscal consolidation. The best strategy for minimizing the growth impact, namely, taxing consumption and labor income, is actually less efficient in improving Lesotho’s current account balance (by about ¼ percent of GDP). Again, this anomaly occurs because of the relatively lower weight of the external sector in Lesotho and the relatively higher weight of the government sector.

**FISCAL COORDINATION WITHIN SACU: COULD FISCAL RULES BE APPROPRIATE?**

Devising a regional approach to fiscal prudence is appropriate for SACU, particularly in light of expected greater economic integration. As shown in this section, both SACU-level and national-level fiscal rules (Box 4.1) would assist in tackling the heavy dependence on SACU transfers and deficit biases in BLNS. Fiscal rules would also help to anchor the strong fiscal adjustment already undertaken by BLNS to preserve fiscal sustainability.

It is in South Africa’s interests to take into account its spillover effects on BLNS because fiscal imbalances in BLNS are, in the end, contingent liabilities for South Africa. Because of the CMA and the prospects of further regional financial
BOX 4.1

**Fiscal Rules: Rationale, Benefits, and Costs**

Numerical fiscal rules seek to address recurrent deficit bias, eventually improving the credibility of fiscal policies. A fiscal rule is a permanent constraint on fiscal policy, usually defined by numerical objectives or procedures for budget elaboration and implementation (Kopits and Symansky, 1998; IMF, 2005, 2009). The rule is permanent because it responds to a risk of deficit bias, that is, the implementation of policies that are either suboptimal (a deficit higher than its optimal level) or a threat to fiscal sustainability. Credible rules can lead to higher welfare than can discretionary policies (Barro and Gordon, 1983; Drazen, 2000), as well as to lower risk premiums (Hallerberg and Wolff, 2006).

Procedural issues need to be addressed first, so that numerical rules can be fully effective (Milesi-Ferretti, 1997). For example, without transparency in public accounting, “creative” accounting rules could be used to hide a missed deficit target. Improvements in procedural rules would typically cover (1) strengthening the position of the Minister of Finance, (2) limiting the scope of amendments to the budget during discussions in parliament, and (3) enforcing hard budget constraints during the implementation phase. Fiscal transparency would also be essential to ensuring strong political and social support for the rules.

To avoid being too rigid, numerical rules need to leave space for flexibility. Similar to rules for monetary policy, fiscal rules could provide a tolerance band for countercyclical policies and escape clauses, so as to temporarily suspend the application of the rules during exceptional circumstances. Rules can also create incentives for nontransparent behaviors, leading to superficial compliance. In addition, the authorities may use legislative changes to alter rules to ensure formal compliance. These potential hurdles underline the need for institution building, when necessary, and development of a strong consensus on the rules.

As discussed in IMF (2009) and Debrun and Kumar (2007), successful implementation of fiscal rules is generally preceded by a period of fiscal consolidation. Although the introduction of fiscal rules is usually concurrent with improved fiscal performance, the causality is not clearly established (IMF, 2005; Guichard and others, 2007). International evidence suggests that the key to successful fiscal policy lies in factors that change the political climate in favor of fiscal sustainability. A cross-country statistical analysis undertaken by IMF staff finds the intensity of national fiscal rules to be positively associated with the extent to which fiscal targets were met (IMF, 2005, 2009, 2010). In addition, fiscal councils and peer-monitoring processes can enhance accountability in implementing fiscal rules or adjustment plans.

Broad support and a legal foundation (not just political commitment) facilitate the implementation of fiscal rules. Policymakers will suffer the costs of non-enforcement of fiscal rules, either by loss of reputation for ruling parties or through legal sanctions that require specific actions. Law-based rules typically carry penalties for noncompliance. Commitments made to the public coupled with external monitoring raise general public awareness of deviations from the rule, creating reputational risks for the government.

integration, South Africa is de facto the lender of last resort for BLNS. Greater financial integration of the SACU region could facilitate access to financing by BLNS through South Africa’s bond markets. Government securities denominated in rand would offer lower premiums because the currency risk for investors would
Designing Fiscal Policies within the Southern African Customs Union

disappear, although the sovereign risk would remain. A perception of sustainability,\textsuperscript{11} whether deserved or not, might also be created for the smaller SACU countries, which could translate into continued access to finance even under unsustainable policies. This type of risk occurred in recent years in the euro area, which led to debt accumulation beyond a sustainable level in some countries.

**Regional Integration Challenges Suggest Redefining the Revenue-Sharing Formula**

Although South Africa’s fiscal policies are sound, they do not account for potential spillover effects on BLNS. South Africa enjoys a significant degree of economic stability, and does not face specific vulnerabilities to either its public or external debt (IMF, 2011a).\textsuperscript{12} In particular, under the current revenue-sharing formula, SACU transfers are heavily dependent on South Africa’s projected GDP and imports. Forecasting errors have a limited impact on South Africa, but they induce large swings of revenue for BLNS, which are further aggravated by the procyclicality of the formula.

**SACU Numerical Rule**

A new revenue-sharing formula for the SACU pool could be adopted, with the objective of making the transfers more stable and predictable. Chapter 3 of this volume offers a wide range of options. Two characteristics would be essential for that rule to be sustainable and accepted: simplicity and transparency. Simplicity would suggest that redistribution should occur using an easily understood concept, for example, “pay-as-you-go,” in which revenue collected is redistributed at the time it is received.

**SACU Procedural Rule**

A buffer, such as a stabilization fund, could be established for the SACU region as a whole (see Chapter 3). For example, transferring only the structural component of the SACU revenue pool would ensure lower volatility while enforcing countercyclical fiscal policies on all SACU countries, including South Africa. This could also apply to the developmental component of the current SACU revenue-sharing formula.

Addressing the volatility of SACU transfers is only one element of fostering fiscal sustainability. Two complementary sets of rules, explored in the next two sections, could also be considered: procedural rules, notably in BLNS, to strengthen the budget process, and numerical rules to foster fiscal responsibility over the medium term.

**Defining Procedural Rules to Prevent the Recurrence of Sustainability Concerns in BLNS**

The global financial crisis showed that spending bias can build up rapidly (Table 4.2), which, combined with the decline in SACU transfers, has led to a significant increase

\textsuperscript{11} Or a perceived assurance of bail out from South Africa.

\textsuperscript{12} Its sound fiscal management has also been helped by the adoption of a medium-term budget strategy, which anchors each annual budget into a medium-term perspective.
in the risk of debt distress in BLNS, even though debt ratios were fairly low before the 2008 crisis (Figure 4.4). Although Botswana and Namibia are more resilient in the face of this shock than are Lesotho and Swaziland, all indicate a rapidly growing debt burden.

To complement the fiscal adjustment in BLNS, discussed above, one of the first actions must be to secure broad political and social support for correcting the spending bias to reduce the odds of a recurrence. The crux of the issue is fiscal transparency to build political support for the adjustment process.

**National Procedural Rule 1**

International best practices for fiscal transparency and for communicating to the public the need for an adjustment could be applied. Among other actions, financial accounts and budget execution reports would be published, and an external assessment would be performed (overseen by parliament, and including external audits of public accounts) and publicized. By disclosing budget documents, budget execution, and fiscal risks, governments would then have the tools to convince the public of the implications of the adjustment and could inform the public of their efforts to protect the most vulnerable. Communication campaigns could be organized to inform the public about the scale of the fiscal challenge and explain what can be reasonably achieved through reforms without overburdening taxpayers or unduly curtailing necessary public services. Similarly, communication of the adverse consequences of not making the adjustment would also be essential, particularly if the necessary fiscal adjustments were large. These transparency

<table>
<thead>
<tr>
<th></th>
<th>2008 (Annual growth rate, percent)</th>
<th>2009 (Annual growth rate, percent)</th>
<th>2010 (Annual growth rate, percent)</th>
<th>2008 (Cumulative growth rate, percent)</th>
<th>2009 (Cumulative growth rate, percent)</th>
<th>2010 (Cumulative growth rate, percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Botswana</strong></td>
<td>Expenditure</td>
<td>40.9</td>
<td>9.4</td>
<td>4.3</td>
<td>40.9</td>
<td>54.2</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>20.6</td>
<td>-9.2</td>
<td>14.5</td>
<td>20.6</td>
<td>9.5</td>
</tr>
<tr>
<td><strong>Lesotho</strong></td>
<td>Expenditure</td>
<td>35.6</td>
<td>15.4</td>
<td>1.5</td>
<td>35.6</td>
<td>56.5</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>17.6</td>
<td>10.2</td>
<td>7.0</td>
<td>17.6</td>
<td>29.7</td>
</tr>
<tr>
<td><strong>Namibia</strong></td>
<td>Expenditure</td>
<td>24.7</td>
<td>19.9</td>
<td>17.5</td>
<td>24.7</td>
<td>49.5</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>19.2</td>
<td>6.7</td>
<td>10.1</td>
<td>19.2</td>
<td>27.3</td>
</tr>
<tr>
<td><strong>Swaziland</strong></td>
<td>Expenditure</td>
<td>34.2</td>
<td>24.1</td>
<td>1.4</td>
<td>34.2</td>
<td>66.5</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>12.8</td>
<td>6.7</td>
<td>7.3</td>
<td>12.8</td>
<td>20.3</td>
</tr>
</tbody>
</table>

Sources: Country authorities; and IMF staff estimates.
Note: Growth rates are derived from nominal data.

---

13 Using the IMF templates for debt-sustainability analysis, a simulation exercise was done for each BLNS country. The analysis assumed that expenditure levels, measured as a percentage of GDP, would remain during the medium term similar to the levels of the past few years.

14 Large fiscal adjustments would typically require strong support from all stakeholders (Mauro, 2011).
efforts would need to be complemented by improvements in the quality of public spending, for example, by subjecting investment projects to cost-benefit analyses and publishing both the analyses and project rankings.

To deal with a large fiscal adjustment, and subsequently with the enforcement of a sound fiscal policy, BLNS would need to cast their policies within medium-term frameworks. The objective would be to anchor budgets to medium-term fiscal objectives, such as a debt or deficit target. Such steps would complement existing efforts made to strengthen expenditure controls, like those undertaken by BLNS, as well as tax administration.

**National Procedural Rule 2**

Medium-term expenditure frameworks (MTEFs) need to be adopted—or improved—to anchor the budgeting process to medium-term objectives. First, the
authorities could, within MTEFs, define the pace of the adjustment. Two elements strongly favor a front-loaded adjustment: (1) a front-loaded adjustment will reassure markets and international partners, especially when fiscal sustainability is at risk; and (2) longer fiscal consolidations can increase the probability of halting the adjustment before its completion (von Hagen, Hallett, and Strauch, 2001; and Tsibouris and others, 2006). Second, to be credible, MTEFs would need to leave room for contingency planning. Such space would be particularly relevant in the implementation of the fiscal adjustment plans. For 66 plans reviewed by Mauro (2011), the average discrepancy between the planned and actual improvement in the fiscal balance was about ½ percent of GDP. Contingency measures could also cover positive surprises, such as a higher growth outturn. The discrepancy was not related to the size of the adjustment, but instead to spending cuts that did not materialize. As a result, additional revenue measures were often taken to compensate for the difficulty in implementing spending cuts, thus improving the revenue outturn.

Defining National Numerical Rules

Once procedures and institutional reforms are in place, a set of numerical rules could be adopted (Box 4.2). Instead of having just one numerical rule (say, on the primary deficit), BLNS would benefit from a regional approach to setting rules for fiscal policy. Two national-level numerical rules applied equally to all SACU countries could be considered.

National Numerical Rule 1

A common numerical rule on the debt-to-GDP ratio could be adopted. Although SACU members face very different challenges, for an economic union to be viable, member countries need to be treated equally. Thus, a long-term objective of keeping debt ratios below the same threshold for all countries would achieve the objective of an equal treatment. For example, a threshold for debt to GDP of about 40 to 50 percent would be relevant given that emerging market economies have shown vulnerabilities at debt levels higher than this threshold. It should be noted that Botswana has already adopted a debt ceiling of 40 percent of GDP, which is adequate for an emerging market economy. Namibia also has a debt ceiling of 35 percent in its fiscal policy framework, but this is not subject to legislation.

National Numerical Rule 2

Each member country could adopt a country-specific rule for its deficit to (1) comply with the common debt ceiling for all SACU countries over the medium term, and (2) respond to specific vulnerabilities. For example, South Africa could adopt a

---

15 This is the main reason why large fiscal consolidations, especially in emerging and low-income countries, have tended to be more front-loaded (Tsibouris and others, 2006; and Kumar, Leigh, and Plekhanov, 2007).

16 Contingency measures could also cover positive surprises, such as a higher growth outturn. The discrepancy was not related to the size of the adjustment, but instead to spending cuts that did not materialize. As a result, additional revenue measures were often taken to compensate for the difficulty in implementing spending cuts, thus improving the revenue outturn.
BOX 4.2

General Options for the Design of a Fiscal Rule

Three general types of numerical rules could be considered: debt rules, deficit rules, and expenditure rules. There is a trade-off between rules that preserve a sustainable debt-to-GDP ratio (debt or deficit rules) at the cost of a procyclical policy and rules that leave some room for countercyclical policies (expenditure rules) at the cost of less focus on keeping debt sustainable (Table 4.2.1).

TABLE 4.2.1

<table>
<thead>
<tr>
<th>Performances of Simple Numerical Rules against Key Objectives</th>
<th>Debt ratio ceiling</th>
<th>Overall deficit ceiling</th>
<th>Primary deficit ceiling</th>
<th>Expenditure ceiling</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preserve a sustainable debt ratio</td>
<td>+++</td>
<td>++</td>
<td>+</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Sound deficit level</td>
<td>–</td>
<td>+++</td>
<td>++</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Avoids large adjustments in a single year</td>
<td>–</td>
<td>+</td>
<td>+</td>
<td>+++</td>
<td>–</td>
</tr>
<tr>
<td>Limit procyclicality</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>++</td>
<td>+++</td>
</tr>
<tr>
<td>Target relatively controllable</td>
<td>–</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>+++</td>
</tr>
<tr>
<td>Comprehensive coverage</td>
<td>+++</td>
<td>+++</td>
<td>+++</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: IMF staff.
Note: +++ = very good, ++ = good, + = fair, – = poor.

Numerical rules would typically be simple, flexible, credible, and consistent with the ultimate goals (Kopits and Symansky, 1998). Simplicity facilitates the emergence of broad support and also can facilitate implementation (Debrun, Epstein, and Symansky, 2008). Even if rules generally provide rigidity, they should allow some flexibility. Like rules for monetary policy, fiscal rules could provide a tolerance band for countercyclical policies and escape clauses so that application of the rules could be temporarily suspended in exceptional circumstances.

Defining a rule would typically lead to difficult arbitrage between simplicity and flexibility. For example, a rule could be based on cyclically adjusted variables to leave room for automatic stabilizers to operate. However, this would require identifying the position of the economy in its cycle, which is challenging when data quality is poor or when the economic cycle is not well established. Defining the time horizon over which the target should be met is also crucial in providing flexibility. Enforcing a rule on a year-to-year basis would have the advantage of simplicity; enforcing for a predefined period would give more flexibility, but at the cost of more complex enforcement.

fiscal deficit rule to allow for countercyclical intervention, and the more vulnerable countries of the region (Lesotho, Swaziland) could first consider a deficit rule aimed at preserving debt sustainability. Although the medium-term objective of a common debt ceiling would be desirable, Lesotho and Swaziland would probably need to constrain their deficits—and therefore their debt levels—much more strictly until they address the source of their vulnerabilities. Specifically, their targeted deficit levels could be directly derived from the debt-sustainability analysis.

Additionally, the SACU countries face different levels of access to financing. Although the most advanced (Botswana, Namibia, South Africa) can raise funds
fairly easily, the poorest members (Lesotho, Swaziland) cannot. This rule could be implemented with some flexibility by adopting a ceiling for the primary balance for a certain period, say, three years, and revisiting the value every three years, based on the MTEF and financing conditions. For resource-rich countries the problem can be different. Botswana already has two numerical rules, one capping government expenditure at 40 percent of GDP, the other a “golden rule” in which the ratio of non-investment recurrent expenditure to non-mineral revenue stays below 1, so that mineral revenue is primarily directed toward investment projects. Another option would be to adopt a ceiling on expenditures that would be consistent with the primary balance objective. This option would also help Botswana in the implementation of its fiscal rule, because the cap on expenditure can lead to procyclicality when diamond prices increase (because it induces a higher GDP, thus increasing the maximum level of expenditure). Similarly, a target for non-mineral primary expenditure could also be adopted, or an expenditure rule could be based on real expenditure growth. Adopting an expenditure rule would present significant advantages because it would specifically target the source of the fiscal imbalances, but also, if implemented successfully, it would facilitate countercyclical intervention because automatic stabilizers would come into play on the revenue side (Table 4.3).

Some flexibility could be preserved by allowing the government to react to exceptional events by temporarily suspending fiscal rules. However, this would require two main elements: First, parliament would have to approve the government plan for the temporary suspension—ideally by a supermajority to ensure that the political consensus is solid. Second, the government would have to have a strategy for reinstating these rules, for example, no later than two years after suspension.

### Enforcing Numerical Rules: Lessons from the Euro Area

Notwithstanding the specific design of numerical rules, the euro area experience suggests that without an enforcement mechanism at the national level, numerical rules are not fully effective. In essence, two main enforcement mechanisms would have to be introduced: independent oversight of implementation of the rules, and legal requirements to comply with the rules.

<table>
<thead>
<tr>
<th></th>
<th>Fiscal balance rule</th>
<th>Expenditure rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strengths</td>
<td>Simple and transparent</td>
<td>Allows for (some) countercyclicality</td>
</tr>
<tr>
<td></td>
<td>Consistent with DSA</td>
<td>Can be consistent with the DSA</td>
</tr>
<tr>
<td>Weaknesses</td>
<td>Procyclical</td>
<td>Sensitive to assumptions (e.g., revenue growth)</td>
</tr>
</tbody>
</table>

Source: IMF staff.

Note: DSA = Debt sustainability analysis.

©International Monetary Fund. Not for Redistribution
Constitutional amendments could be adopted by each country to define the general principle of the rules. These amendments could later be complemented by fiscal responsibility laws defining the specific features of the rule, including the quantitative ceilings and penalties for noncompliance. The main advantage of such legal changes is that they would create strong incentives for governments to comply ex ante with the fiscal rule through the legal requirements and prevent backtracking ex post through penalties. In addition, legal constraints could be put on the budget deficit approved by parliament, requiring that the deficit not exceed the boundaries of the rules.

A regional fiscal council at the level of the SACU Secretariat could also allow independent and cross-country scrutiny of the countries’ fiscal policies. The fiscal council would need to be independent of the political sphere. The council could report to the public regularly, perhaps quarterly, on the state of public finances in each SACU member country, based on budget execution reports provided by the SACU ministries of finance. The council would make public any deviation from the rule during the year. A government would then be required to explain to its parliament and other SACU members the reasons for the deviations and to present a plan to correct for them before the end of the fiscal year.

CONCLUSION

Fiscal adjustments for BLNS need to be complemented by key public finance management reforms to ensure the sustainability of the adjustments. Among such measures, the following are critical: identifying contingencies, strengthening medium-term frameworks, and improving tax administration. All these measures require not only a well-designed fiscal consolidation plan but also continued efforts in fiscal transparency to ensure wide ownership of the adjustment plans. Public communication strategies about the specific targets to achieve, both in the short and medium terms, can help engender wide ownership and accountability for the adjustment, particularly if the instruments to achieve these targets are also made public. Committing to well-designed fiscal adjustments while preserving the most-needed spending (education, health, and infrastructure) can help secure broad support for reforms, not only from the population but also from donors.

Fiscal adjustments also need to be embedded within a regional and medium-term framework of fiscal rules. These fiscal rules could effectively ensure that the hard-won fiscal adjustment underway in SACU countries is not reversed. Both strong political ownership and strong enforcement mechanisms would be required. Therefore, rules should be enshrined in law, preferably constitutional amendments, rather than simple political commitments. Adhering to best practices for fiscal transparency would be essential to building consensus on the rules. Finally, the creation of a SACU fiscal council would help to ensure that country and regional surveillance are effective.