

SHOULD SOUTH AFRICA ADOPT NUMERICAL FISCAL RULES?¹

F.K. SIEBRITS AND E. CALITZ²

INSTITUTIONAL ISSUES NOW LOOM large in the theory and practice of macroeconomic policymaking. South Africa has recently adopted two institutional innovations in monetary policy, namely inflation targeting and constitutional protection of the independence of the central bank. The South Africa fiscal authorities have implemented multi-year expenditure planning, but numerical fiscal rules do not seem to be on the agenda yet. However, the growing popularity of such rules in other countries suggests that they will eventually come under consideration in South Africa as well.

The purpose of this article is to stimulate debate on the potential of numerical fiscal rules at the national-government level in South Africa.³ In section 1, we introduce the rules-versus-discretion debate and summarise the practical shortcomings of discretionary regimes. Section 2 outlines

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² Senior Lecturer in the Department of Economics at the University of South Africa, and Executive Director: Finance and Professor of Economics at the University of Stellenbosch, respectively.

³ The use of fiscal rules at lower levels of government is an important topic in its own right, but space limitations prevent us from addressing it in this article. Kopits (2001:12-14) provides a useful introduction to the issues.

options for reforms. In section 3, we draw on theory and case studies to compare the effectiveness of numerical fiscal rules and the accountability-enhancing fiscal reforms that are being implemented in South Africa. Against this background, we offer an answer to the question whether or not South Africa should adopt numerical fiscal rules in section 4. Our major conclusion is that the adoption of numerical rules is more likely to do harm than to improve fiscal policymaking in South Africa.

1. DISCRETIONARY FISCAL REGIMES

Macroeconomists have long debated the relative merits of rules-based and discretionary policy regimes.⁴ According to Blinder (1987:399-401), the positions of participants in this debate are closely linked to their views about two sets of issues. The first is the adjustment properties of the economy, especially whether or not it can return to equilibrium speedily and at low cost after experiencing a shock. The second is the effectiveness of macroeconomic policy, which depends upon policymakers' knowledge or understanding of the working of the economy, their ability to influence the macroeconomy and their motives. Table 1 links different permutations of views on these issues to positions in the rules-versus-discretion debate.

Table 1. The Choice between Discretion and Rules

Policy	Effective	Ineffective
Economy		
Self-adjusting	?	Rules
Not self-adjusting	Discretion	?

Source: Adapted from Blinder (1987:400)

Discretion would be preferable to rules if the economy is characterised by rigidities that prevent aggregate demand and output from returning to their full-employment levels after an

⁴ The controversy is often traced back to an article (Simons, 1936) published in the same year as John Maynard Keynes's *The general theory of employment, interest and money* – the book that launched modern macroeconomics.

adverse shock, and if macroeconomic policies can effectively stabilise the economy. The latter condition requires that policymakers are sufficiently benevolent to prefer economically sound policies over politically expedient ones, know enough about the working of the economy to quickly and optimally respond to shocks, and have policy instruments at their disposal that can steer the economy back towards full employment quickly and at low cost. By contrast, there is a compelling case for rules when the economy quickly adjusts to adverse shocks and if macroeconomic policy is largely ineffective at stabilising the level of economic activity. Neither discretion nor rules has a clear-cut advantage in the environments represented by the upper left-hand quadrant in Table 1 (a highly self-regulating economy and highly effective macroeconomic policy) and the lower right-hand quadrant (an economy that adjusts sluggishly to shocks and ineffective macroeconomic policy).

Keynesian macroeconomics emphasised the sluggishness of market adjustment to shocks and the stabilising properties of active anti-cyclical fiscal policies (*cf.* Argy, 1988:147-148). For much of the 20th century, the prominence of the Keynesian-neoclassical synthesis in macroeconomics promoted the view that fiscal policymaking occurs in the environment represented by the lower left-hand quadrant in Table 1. Discretion was therefore the norm in fiscal policymaking.

With the passage of time, however, it became clear that technical and political factors often distort the operation of discretionary fiscal regimes. Keynesian anti-cyclical fiscal policies proved to be ineffective because of the long lags of fiscal policy (Friedman, 1948) and the small size of fiscal multipliers (Hemming, Kell and Mahfouz, 2002).⁵ Economists

⁵ Friedman, and many other writers, emphasised the long inside lag of fiscal policy, especially the delays associated with taking and implementing policy decisions. More recently, however, Blanchard and Perotti (2002) have found that the outside or impact lag of fiscal policy in the US is as long and uncertain as that of monetary policy.

from the public-choice school have led the way in showing how representative democracy creates incentives for politically expedient fiscal policies that result in political business cycles (Drazen, 2001), continuous growth in the size of the public sector (Borcherding, 1977) and excessive fiscal deficits (Buchanan and Wagner, 1977).⁶

Taken together, these considerations have given rise to the perception that fiscal policy is ineffective at stabilising the economy, perhaps to the point of causing more instead of less volatility. The vast majority of academic economists now believe that fiscal policy should have its main countercyclical impact through the automatic fiscal stabilisers - such as progressive income tax systems and unemployment benefit programmes - and that activist policies should be avoided (cf. Eichenbaum, 1997; Taylor, 2000).⁷ This development, together with mounting concern about public-sector growth and large budget deficits, have led a growing number of countries to adopt fiscal reforms to improve the working of discretionary regimes, or to replace them altogether.

⁶ Alesina and Perotti (1995) provide a useful survey of political explanations of "deficit bias" in fiscal policy.

⁷ As Eichenbaum (1997:236) puts it: "In sharp contrast to the views that prevailed in the early 1960s, there is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible. Practical debates about stabilization policy revolve almost exclusively around monetary policy." Among academic economists, only some Keynesians (*e.g.* Arestis and Sawyer, 2003) retain faith in the stabilising ability of fiscal policy. In policymaking circles, however, the situation is less clear-cut. Keynesian policies are seldom preached, but surprisingly often practiced – the fiscal policies of the Bush administration and the refusal of some European countries to adhere to the Stability and Growth Pact rules (*cf.* section 3(a)) being obvious examples. Ambiguity in policymakers' attitudes towards anti-cyclical fiscal policies may well impact powerfully on the political feasibility of fiscal rules and governments' commitment to them.

2. ALTERNATIVES TO FISCAL DISCRETION

Attempts to solve the problems of discretionary fiscal regimes have taken one of three forms: the adoption of numerical fiscal rules, transparency-enhancing measures aimed at making fiscal policymakers more accountable, and reform of the procedures for formulating and implementing budgets (Hemming and Kell, 2001:2-3).⁸ Budget-process reforms have revolved around steps to strengthen the policymaking powers of the treasury minister and department *vis-à-vis* the spending ministers and departments and those of the executive branch of government *vis-à-vis* the legislative branch. Such reforms therefore affect decision-making processes within a given (discretionary or rules-based) regime. The relationship between decision-making processes and fiscal regimes is in itself an interesting topic for research. The purpose of this article, however, is to discuss the relative merits of discretionary and rules-based fiscal regimes in the South African context. We therefore do not give further attention to budget-process reforms.

(a) Numerical Fiscal Rules

We follow Kopits and Symansky (1998:2) in defining a fiscal rule as “... a permanent restraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance.” The adjective “permanent” indicates that the constraint was at the time of its adoption intended to apply to successive governments, even if it was subsequently abandoned or suspended. This definition implies that fiscal targets pursued over pre-announced periods (such as those in macroeconomic stabilisation and structural adjustment programmes) are not fiscal rules.⁹

⁸ Wyplosz (2002) has suggested a fourth option, namely depoliticising the macroeconomic dimension of fiscal policymaking by delegating it to an independent fiscal-policy committee. This idea may yet have its day, but to the best of our knowledge it is not under serious consideration anywhere yet.

⁹ This element of Kopits and Symansky’s definition is controversial.

The case for numerical fiscal rules is simple and persuasive. Its point of departure is that discretion is the ideal breeding-ground for the fiscal problems outlined in section 1. Rules can prevent these problems and improve the effectiveness of fiscal policymaking, so the argument goes, by restraining fiscal authorities' scope for straying from sound policies. Aspects of this argument are discussed in more detail in section 3 of this article.

Rules-based fiscal regimes have been around for a long time (*cf.* Kopits, 2001:4-6). It is fair to say, however, that such regimes have never been as popular as they are right now. Table 2 shows that the majority of industrial countries now use numerical fiscal rules, and that rules are also growing in popularity in Latin America and elsewhere in the developing world.

The most popular numerical rules are the following:

- *Expenditure-limiting rules* cap the level of or growth in total government expenditure or specific categories of government spending. Such rules are in force in Argentina, Brazil, Canada, Peru, Sweden and the United States, among others.
- *Current-balance rules* stipulate that current government spending should not exceed current government revenue or, what amounts to the same thing, that governments may not borrow to finance current expenditure. This so-called "golden rule" of fiscal policy applies in Brazil and the United Kingdom.
- *Overall-balance rules* limit the extent of the budget deficit or prescribe budget surpluses. Rules of this nature apply in countries such as Argentina, Chile, India and Peru, as well as in the European Union.
- *Public debt rules* prohibit borrowing from certain sources (typically the central bank) or limit the extent of the public debt. Such rules are used in the CFA franc zone, the European Union, India, Indonesia and the United Kingdom, among others.

Hemming and Kell (2001), for example, adopt a broader definition of fiscal rules that includes some non-permanent targets.

Table 2. Examples of Fiscal Rules at the National-Government Level

Country/Area	Rule(s)
Argentina	Limit on deficit-to-GDP ratio on an annual basis
	Limit on primary expenditure
Brazil	Current balance
	Limit on wage bill
Canada	Limit on programme expenditure, except major self-financing programmes
	Overall or current balance
CFA franc zone	Central-bank borrowing limited to 20% of previous year's revenue
Chile	Structural surplus of 1% of GDP on an annual basis
European Union	Limit on deficit-to-GDP ratio on an annual basis (3%), with medium-term position close to balance or in surplus
	Limit on gross government debt as a percentage of GDP on an annual basis (60%)
India	Limit on deficit-to-GDP ratio (2%)
	Limit on total liabilities as a percentage of GDP (50%)
New Zealand	Annual operating surpluses to achieve a prudent debt level
Peru	Limit on deficit-to-GDP ratio on an annual basis
	Limit on primary expenditure
Sweden	Nominal expenditure limits on a three-year rolling basis
United States	Limit on discretionary expenditure

Sources: Kennedy & Robbins (2001); Kopits & Symansky (1998); Kopits (2001); Perry (2002)

(b) Accountability-Enhancing Transparency

Kopits and Craig (1998) define fiscal transparency as being open to the public about the structure and functions of government, fiscal-policy intentions, the public-sector accounts and fiscal projections. Advocates of transparency argue that it improves fiscal policymaking by making the fiscal authorities more accountable. As Hemming and Kell (2001:3) put it:

Such openness is essential if discipline is to be imposed on governments by making policymakers accountable for the design and implementation of fiscal policy. Transparency should then lead to better, more credible policies, a less uncertain policy environment, an earlier and smoother fiscal policy response to emerging economic problems, and ultimately to improved economic performance.

Australia, New Zealand and the United Kingdom are widely credited with having pioneered the adoption of transparency-enhancing measures aimed at making fiscal policymakers more accountable.¹⁰ The fiscal frameworks of these countries do not

¹⁰ The reforms adopted by these countries have been the starting-point for

prescribe specified numerical targets, but require the fiscal authorities to regularly disclose their fiscal objectives (which may or may not take the form of quantitative targets) (*cf.* Hemming and Kell, 2001:436-437). New Zealand's Fiscal Responsibility Act of 1994 requires that the government should in each budget set out its strategic priorities for that year and the next three years, as well as its long-term fiscal policy objectives. It further stipulates that the government should achieve an unspecified "prudent" level of public debt. In Australia, the 1998 Charter of Budget Honesty requires the government to set out its medium-term fiscal strategy and short-term fiscal objectives and targets in each budget. Also in 1998, the United Kingdom adopted legislation that requires the government to table in Parliament a code for fiscal stability. This code should outline a strategy to meet fiscal-policy principles such as transparency, stability, responsibility, fairness and efficiency.

Each of these countries has supplemented their broad fiscal frameworks by also adopting numerical targets in separate legislation. The New Zealand government has set itself the targets of reducing gross and net government debt to below 30 per cent and 20 per cent of GDP respectively (Kennedy and Robbins, 2001:9). Moreover, the 2000 Budget Policy Statement stipulated that an operating surplus should be maintained over the course of the economic cycle. Australia's 2000 Budget Strategy and Outlook Report announced the aim of maintaining budget balance, also over the course of the cycle. The current UK government has chosen a fiscal code guided by two numerical rules: the current balance rule (or "golden rule") and

research that has led to the publication of the International Monetary Fund's *Code of Good Practices on Fiscal Transparency*. First published in 1998 and revised in 2001, the *Code* revolves around four principles: clarity of roles and responsibilities in the fiscal arena; public availability of all relevant fiscal information; openness in budget preparation, execution and reporting; and assuring the integrity of fiscal information. See also Kopits and Craig (1998).

a public debt rule. The latter stipulates that net public sector debt should be held at a stable and prudent level, which is currently defined as 40 per cent of GDP.

3. ACCOUNTABILITY OR NUMERICAL RULES?

It is widely believed that policymakers face a trade-off between flexibility and credibility when choosing among fiscal regimes. Discretionary regimes are associated with more policymaking flexibility, and rules-based regimes with the credibility benefits that follow from pre-commitment to certain policies (Kopits and Symansky, 1998:19). In this section, we use this trade-off as a framework for discussing the choice between accountability-enhancing transparency (which represents an intermediate position on the discretion-rules spectrum) and numerical fiscal rules.

(a) Can Numerical Rules Bind Policymakers?

In section 2(a), we indicated that the case for rules hinges on the claim that they can effectively bind governments to sound policies. There is much scepticism about the ability of numerical rules (or, for that matter, any other type of rule) to do this. In practice, governments find it relatively easy to circumvent, ignore, suspend or abandon fiscal rules (Kopits and Symansky, 1998:12; Kopits, 2001:7). Many examples can be cited to underscore the validity of this observation.

Circumvention and outright inobservance eroded the intent of the dual-budgeting system that was in force in South Africa from 1910 to 1976. This system was designed to give effect to the golden rule of fiscal policy (*i.e.* the current-balance rule), the idea being that the government's current spending should be financed from tax and other current revenues *via* the Revenue Account and its capital expenditure and lending by borrowing *via* the Loan Account (*cf.* Heyns, 1991). According to Heyns (1991:387), the authorities occasionally resorted to creative accounting by recording certain current outlays (that belonged in the Revenue Account) in the Loan Account. The distinction

between the two accounts blurred from 1953 onwards, when surpluses on the Revenue Account were from time to time transferred to the Loan Account. Some Budgets explicitly broke the “golden rule” by providing for Revenue Account surpluses to finance deficits on the Loan Account (Heyns, 1991:387).

Circumvention also led to the failure of the Balanced Budget and Emergency Deficit Control Act (better known as the Gramm-Rudman-Hollings legislation) in the United States (*cf.* Kennedy and Robbins, 2001:5). Introduced in 1985, this Act set targets to reduce the *projected* budget deficit to zero by 1991, which was later extended to 1993¹¹. The authorities abused the fact that the Act did not apply to the *actual* budget deficit by using highly optimistic economic and fiscal forecasts. This enabled them to generate projections that met the targets, but the actual deficits consistently exceeded the limits. In addition to creative accounting and manipulating forecasts, governments can also circumvent fiscal rules by introducing vagueness in policy statements, by exploiting ambiguities in the institutional coverage of rules and by misrepresenting the extent and timing of future fiscal obligations (Kopits and Symansky, 1998:18).

A well-known example of an ignored rule is Article 81 of the Italian Constitution, which stipulates that no new taxes or expenditures may be introduced through the annual budget law, and that any legislation on new or increased spending items must indicate how they are to be financed (Kopits, 2001:7). In Japan, the government has since 1975 issued bonds to finance a range of spending categories, thus ignoring legislation dating from 1947 that limits bond issuance to the financing of public works (Kennedy and Robbins, 2001:8).

The fiscal rules of the Maastricht Treaty have also been

¹¹ Strictly speaking, the Gramm-Rudman-Hollings legislation therefore did not constitute a rule, which we defined in section 1 as a *permanent* restraint on fiscal policy. We refer to its failure here to emphasise the relative ease with which any numerical policy benchmark can be circumvented, even in sophisticated economies.

beset by compliance problems. The Treaty, which came into effect in 1993, stipulated as conditions for entry into the European Economic and Monetary Union (EMU) that the overall fiscal balances and gross government debt ratios of Euroland countries should not exceed 3 per cent of GDP and 60 per cent of GDP respectively. Both rules were later included in the Stability and Growth Pact (SGP) agreed upon by Euroland countries in 1997, despite the fact that the debt rule was not enforced in the run-up to the establishment of the EMU (Buiter, 2003: 85-86). For purposes of the SGP, the fiscal-balance rule of the Maastricht Treaty was amended to include the provision that the medium-term fiscal position of EMU countries should be close to balance or in surplus.

Empirical evidence suggests that the Maastricht Treaty/SGP fiscal-balance rule contributed to reductions and convergence in budget deficits from 1993 to 1999, but this was followed by “adjustment fatigue” (a slight increase, on average, in the budget deficits of EMU members) from 1999 to 2002 (*cf.* Fatás and Mihov, 2003:120-124). It appears as if a strong economic upswing and the carrots and sticks of the Maastricht convergence criteria drove the initial reductions in budget deficits. Countries apparently did not have a strong incentive to further reduce their budget deficits after they had met these criteria, and several of them experienced a widening of deficits and increased policy volatility when Euroland went into recession. Portugal breached the limit in 2001 and responded to heavy European Union (EU) pressure by sharply cutting government spending, *inter alia*. The economy subsequently fell into deep recession, with tax revenues plummeting and the budget deficit growing to a projected 5 per cent of GDP in 2003. By the end of 2003, recession-hit France and Germany had been in breach of the deficit limit for the third year running, yet refused to implement the remedial measures recommended by the European Commission. The rules of the SGP stipulated that both countries should be fined heavily, but on 25 November

2003 the majority of the EU finance ministers voted not to impose fines. This step effectively suspended the SGP.

More examples can be given, but we rest our case. The adoption of fiscal rules does not necessarily improve fiscal outcomes - what really matters for outcomes is the strength of a government's commitment to fiscal discipline.¹² A rapidly growing economy also makes it much easier to practice fiscal discipline. We are not aware of compelling evidence of the ability of numerical (or other) fiscal rules to substitute for government commitment by thwarting the implementation of irresponsible policies. Where governments are bent on profligate policies, rules can do little more than highlight policy slippage.

There are two main reasons why rules cannot bind governments to sound fiscal policies. First and foremost, all rules are subject to sovereign political authority. The sanctions for non-compliance with fiscal rules suggested in the literature, such as reprimands by the courts and financial penalties on the responsible elected or appointed officials (Kopits, 2001:16), are too weak to deter sovereign governments that choose to ignore the wealth of empirical evidence of the benefits of fiscal discipline. The second reason is that policymakers have only

¹² It appears as if the debate about the underlying determinants of the success of International Monetary Fund stabilisation and adjustment programmes is pointing in the same direction. The traditional carrots-and-sticks approach of lending conditionalities has had a high rate of failure. Ivanova, Mayer, Mourmouras and Anayiotos (2003), for example, found that 70 per cent of the 170 Fund-supported programmes approved between 1992 and 1998 experienced interruptions, while 44 per cent were not completed. The Fund is increasingly emphasising the importance for the success of its programmes of "country ownership", which is defined as "... the assumption of responsibility for an agreed program of policies, by officials in a borrowing country who have the responsibility of carrying out these policies, based on an understanding that the program is achievable and is in the country's own interest" (International Monetary Fund, 2001:6). The notion of country ownership seems closely related to what we call "government commitment".

limited control over fiscal outcomes. As we indicated earlier, numerical fiscal rules typically establish upper limits for the ratios of key fiscal aggregates to GDP. The values of such ratios are strongly affected by factors beyond the immediate control of governments, including GDP shocks (which impact upon the denominator and the tax revenue component of the numerator) and legal restrictions on the scope for changing tax rates and the level of government spending in the short run.¹³

As will become apparent in the next two parts of this section, the inability of numerical rules to bind governments has important implications for the fiscal-regime choice.

(b) Transparency, Rules and the Credibility of Fiscal Policy

The rational-expectations revolution in macroeconomics has changed the mainstream view of the nature of stabilisation policy from that of a control-theory problem to a game-theoretic problem (Eichenbaum, 1997:236). In game-theoretic approaches, announced policies affect the behaviour of rational private agents in the desired manner only if such policies are deemed credible, that is, if agents believe that they will be carried out (Drazen, 2000:166). The literature often frames the credibility issue in terms of the time consistency problem first analysed by Kydland and Prescott (1977). This problem may be summarised as follows. Unless there are substantial costs associated with deviating from an announced plan, the *ex post* optimal policy can differ from the *ex ante* optimal one: policymakers are often tempted to announce a policy, wait for private agents to align their behaviour with the announcement, and then take a different course.¹⁴ But rational private agents

¹³ We will return to the impact of such restrictions on the scope for changing fiscal policy in the short run in section 3(c).

¹⁴ The problem is often explained with the aid of the following example. Policymakers could coax the private sector into negotiating moderate wage settlements by announcing their intention to reduce inflation. Once the private sector has responded in this way, however, the government would be tempted to renege on the announced policy in an attempt to exploit the

understand these temptations and in such cases will not regard the optimal policy as credible. The essence of the time-consistency problem therefore is that optimal policies often lose their effectiveness because they lack credibility. This problem has focused the attention of macroeconomists on the design of institutional mechanisms by means of which policymakers can credibly commit themselves to the optimal policies. As we pointed out in section 2(b), rules - especially numerical rules - are widely regarded as effective commitment mechanisms.

We accept the notion that the reactions of economic agents to fiscal policies are influenced by the credibility of such policies. However, it is far from clear to us that rules-based policy frameworks necessarily make fiscal policies more credible than discretionary ones. The view that the credibility of fiscal policies is boosted by the adoption of rules rests on the belief that such rules can effectively “bind” policymakers to sound policies. In section 3(a) we showed that this belief is erroneous: policymakers have limited control over fiscal outcomes and, more importantly, there are no effective mechanisms to force sovereign governments to adhere to fiscal rules. If private economic agents were as rational as modern macroeconomic theory suggests, they would surely recognise the fragility of rules and not regard rules-based commitments as credible.

Furthermore, committing to a rule is not the only mechanism for establishing policy credibility. Credibility can also be achieved independently of the nature of the regime by consistently applying sound policies and in this way establishing a reputation for fiscal prudence (Barro and Gordon, 1983b; Drazen, 2000:166-215). The current popularity of rules belies the fact that the academic debate about the relative merits of rules-based commitments and reputations as mechanisms for achieving policy credibility is far from settled. We briefly refer to two recent contributions that confirm the viability of the

short-term trade-off between inflation and unemployment (Barro and Gordon, 1983a).

reputation option. In the context of monetary policy, a survey conducted by Blinder (1999) showed that central bankers and American academic macroeconomists regard reputation-related factors (a track record for honesty and inflation aversion) and transparency as significantly more important determinants of the credibility of policymakers than the existence or otherwise of rules. Furthermore, Cowen, Glazer and Zajc (2000) have argued on theoretical grounds that the policies of discretionary regimes are more credible than those of rules-bound governments in situations where the durability of rules is in doubt. The gist of their argument is that the existence of rules prevents governments from demonstrating their underlying preference for sound policies; rational economic actors therefore cannot trust governments not to break the rules in future. By contrast, governments who use their discretionary powers responsibly clearly signal their commitment to macroeconomic prudence, thus establishing a reputation for sound policymaking that renders their policies credible. This argument seems to imply that rules-based regimes cannot be credible unless underpinned by a pre-existing reputation for responsible policymaking. Kopits (2001:19), who generally supports the adoption of fiscal rules, has acknowledged the merits of the reputation option for establishing policy credibility by stating that "... governments with a strong reputation of fiscal prudence do not need to be constrained by rules".

In sum: the pro-rules literature exaggerates the credibility benefits of switching from discretionary and transparency-based regimes to numerical and other fiscal rules, largely because of its excessive faith in the constraining effect of policy rules.

(c) Transparency, Rules and Flexibility in Fiscal Policymaking

Numerical rules intentionally limit the degree of flexibility enjoyed by fiscal policymakers. Transparency-based frameworks are also less flexible than discretionary ones. The extent to which transparency-based frameworks constrain policymakers depends on their specification and interpretation. As we

indicated in section 2(b), the frameworks of Australia, New Zealand and the United Kingdom do not prescribe the adoption of binding targets. By voluntarily adopting such targets, however, these countries have significantly reduced the degree of flexibility enjoyed by their fiscal policymakers. Their regimes nonetheless remain more flexible than rules-based ones, because the targets can be changed from time to time (*e.g.* at the conclusion of medium-term budget cycles).

It cannot be denied that anti-cyclical fiscal policy has a poor track record and that discretion facilitates public-sector growth and “deficit bias” in fiscal policy. But, as we argued in section 3(a), we strongly believe that the only lasting solution to these problems is a consistent commitment to fiscal discipline. Merely restricting the flexibility of policymakers by adopting numerical fiscal rules cannot substitute for such commitments.

Moreover, we believe that there are at least two reasons why governments who are committed to fiscal discipline should not adopt numerical rules either. The first is that it tends to be very difficult materially to change the fiscal stance between budgets. The scope for doing so depends on factors such as the procedural details of the budget process, legislative restrictions on the scope for changing tax rates, the contractual nature of certain outlays, *et cetera*. These are the very factors that make the inside lag of fiscal policy so long. In South Africa, for example, the budget is usually approved by Parliament about four months after its initial presentation by the Minister of Finance. The difficulty of reducing government spending in the short term is illustrated by the fact that almost 50 per cent of the total expenditure of the consolidated general government in 2002/03 consisted of the wage bill (the extent of which is influenced strongly by labour laws and multi-year remuneration agreements between government and labour unions) and debt service obligations. Government procurement programmes are also contract-bound and cannot be suspended easily and without cost. In addition, the government has to honour social

expenditures and some subsidies and transfer payments, for example social pensions and various industrial and trade-related incentive schemes.

Governments that are not burdened by numerical rules need not respond actively to small or transitory increases in budget deficits or public indebtedness caused by, for example, negative GDP shocks. By limiting the range of allowable fiscal outcomes, however, rules basically force policymakers to react to the threat of overruns in order to maintain their own credibility and that of the rules-based regime. But policy lags will bedevil activism to comply with numerical rules in exactly the same manner as they bedevil activism of the anti-cyclical variety. In order to avoid the perils of activism, governments deprived of the flexibility to respond passively to short-term fluctuations in fiscal outcomes may well take recourse to ultra-conservative forecasting and budgeting techniques that result in excessively contractionary fiscal outcomes, or to undesirable forms of tax increases and expenditure cuts. It has been noted, for example, that governments often reduce growth-promoting public investment to avoid transgressing deficit-limiting rules (Kopits and Symansky, 1998:12).

In principle, it is possible to make numerical rules more flexible by adding escape clauses or by prescribing that the target should be met by the average value of the relevant fiscal aggregate over the length of a full business cycle. But these “solutions” to the flexibility problems are far from satisfactory. Cyclical adjustment of fiscal aggregates is, as Hemming and Kell (2001:10) emphasise, “... a technical, and highly imperfect exercise”. It is also a moot point whether or not it would indeed remove the contractionary bias likely to characterise rules-based fiscal policymaking. Hemming and Kell (2001:10) explain:

If a rule is to apply on average over the cycle, it is necessary to define the cycle for the purpose of applying the rule, and then when designing fiscal policy a view has to be formed on the cyclical position of the economy. While the latter can be done to an approximate degree, the risk is that as the end of the cycle approaches the focus will be on predicting where the end

may be, and making corrections to fiscal policy to meet a rule, rather than on tailoring fiscal policy to macroeconomic requirements.

Moreover, escape clauses and cyclical adjustment of fiscal aggregates increase the complexity of rules. This reduces the credibility of rules-based regimes by making rules less understandable to politicians and the public, hampering verification of compliance, and creating opportunities for circumvention. Compare, for example, the United Kingdom's cyclically adjusted golden rule, which stipulates that, over the economic cycle, the government may borrow for investment purposes only and not to fund current outlays, with the Stability and Growth Pact (SGP) rule that limits the fiscal deficit of Euroland countries to 3 per cent of GDP on an annual basis. The UK rule is more flexible than the SGP one, but also much more difficult to interpret and verify. The permanent-balance rule proposed by Buiter and Grafe starkly illustrates just how much complexity is required (*i.e.* how much credibility has to be sacrificed) to obtain a truly flexible numerical rule (*cf.* Buiter, 2003:86; Buti, Eijffinger and Franco, 2003:106). This tax-smoothing rule requires that the inflation-and-real-growth-adjusted permanent government balance should be in balance or surplus, where the permanent budget balance is defined as the difference between the constant long-run average future values of tax revenue and government expenditure. The permanent-balance rule has excellent flexibility properties, but clearly scores poorly on simplicity, enforceability and, hence, overall credibility.

The second flexibility-based argument against rules-based fiscal regimes derives from longer-term considerations. Numerical fiscal rules prescribe upper limits for the levels of aggregates such as the budget deficit, tax burden, government expenditure and public indebtedness, usually as percentages of GDP. While it may make sense to set such limits as short or medium-term policy targets to redress fiscal imbalances, neither economic theory nor experience provides a basis for adopting

them for long periods that transcend business cycles and structural economic changes. The optimal levels of fiscal aggregates - especially indicators of the size of the public sector - differ from country to country and from period to period during any specific country's development. They cannot, and should not, be prejudged and fixed by means of numerical fiscal rules (Buiter, 2003:89-90).

Numerical rules cannot constrain the flexibility of governments that are too myopic or capricious to appreciate the benefits of fiscal discipline. Governments that are serious about using numerical rules as a commitment device, however, will find that they complicate the macroeconomic and structural management of the economy. Transparency-based regimes can yield the same credibility benefits while preserving the policymaking flexibility that is essential for the short-term and long-term management of economies.

(d) Transparency, Rules and Market Discipline

The financial markets have become a powerful restraint on the *de facto* policy independence of fiscal policymakers.¹⁵ These institutions exercise what Lane (1993) has called “market discipline” over fiscal policymakers, punishing profligacy by suspending lending, withdrawing capital and increasing risk premiums.¹⁶

On the whole, the influence of market discipline on fiscal policymaking is benign – indeed, it may well be a more effective force for the maintenance of fiscal discipline than numerical

¹⁵ Calitz (2003:22) juxtaposes *de facto* policy independence with *de jure* policy independence. Governments enjoy *de jure* independence when they can make policy decisions without the permission of or compulsory consultation with foreign parties.

¹⁶ Empirical work by Mosley (2000) has confirmed that international financial markets exert a strong disciplining influence on the macroeconomic policies of industrial countries. If anything, this influence is likely to be stronger in emerging-market economies (such as South Africa), where default risk is perceived to be higher than in industrial countries.

fiscal rules *per se*. In some respects, though, market discipline is problematic. Mosley (2000:747-749) found that the disciplining influence of financial markets is narrow in the sense that fund managers tend to focus on a small set of macroeconomic indicators, mainly the extent of budget balances and the public debt. We believe that such an unsophisticated approach to the assessment of fiscal policy exposes countries to a high risk of unnecessary or excessive "punishment" by markets. Moreover, governments could become excessively concerned with gaining or maintaining the confidence of markets, and allow their macroeconomic policy decisions to be dictated by the short-term oriented preferences of market participants (*cf.* Mukand, 1999).

Rules-based fiscal regimes emphasise a small number of summary indicators of fiscal policy, thus fostering the tendency of market participants to judge fiscal policy on a too narrow basis. Transparency-based regimes, on the other hand, can strengthen the effectiveness of market discipline by ensuring that the bigger picture receives due emphasis.

4. FISCAL REGIMES IN SOUTH AFRICA

(a) The Past and the Present

From 1910 until 1976, South Africa used a dual-budgeting system that was designed to give effect to the golden rule of fiscal policy (*i.e.* the current-balance rule). The idea was to finance the government's current spending from tax and other current revenues *via* the Revenue Account and its capital expenditure and lending by borrowing *via* the Loan Account (*cf.* Heyns, 1991). As we indicated in section 3(a), circumvention and inobservance gradually eroded the intent of the dual-budget system. The dual-budget system (and, *ipso facto*, the application of the golden rule) was abolished in 1976 after the Franszen Commission had recommended that the South African fiscal authorities should adopt a more explicit Keynesian focus.

South Africa has not used numerical fiscal rules since 1976.

The authorities' approach to the macroeconomic role of fiscal policy has changed in line with the international shift outlined in section 1: active anti-cyclical fiscal policy was abandoned towards the end of the 1970s in favour of a longer-term fiscal orientation (Calitz and Siebrits, 2003). Thereafter, taxation and government expenditure no longer were used actively or deliberately to stimulate economic growth in times of recession, nor to dampen demand during boom times. The implied thinking was that the best contribution that the fiscal authorities could make to macroeconomic stability was to stabilise its own finances.

In giving effect to the more structural approach to fiscal policy, the authorities from time to time adopted annual or medium-term fiscal targets. These targets, however, never achieved the status of formal numerical rules. From 1985 until the mid-1990s, fiscal policy in South Africa was guided by a 3 per cent deficit guideline. This guideline had no theoretical basis and proved ineffective when the budget deficit rose sharply during the early 1990s. In 1995, the post-apartheid government embarked on a fiscal adjustment effort that contributed to a reduction in the general government deficit from 9,1 per cent in 1993/94 to 1,5 per cent in 2000/01.¹⁷ This effort was guided by the goals of the Growth, Employment and Redistribution (GEAR) strategy.¹⁸ The GEAR goals were pursued in a flexible manner, as was seen most clearly when the timeframe for reaching the 3 per cent deficit target was extended by one year when the 1997/98 currency crisis precipitated an economic downswing. With the exception of a central-bank borrowing rule and

¹⁷ This adjustment effort is discussed in more detail in Calitz and Siebrits (2003) and Siebrits and Calitz (2003a).

¹⁸ The fiscal goals of GEAR included a step-wise reduction in the budget deficit to 3 per cent of GDP, maintenance of the tax burden imposed by the national government at 25 per cent of GDP, the reduction of general government consumption expenditure as a percentage of GDP and the gradual elimination of dissaving by the general government (Department of Finance, 1996:7-10).

constitutional restrictions in the intergovernmental fiscal system, there were no permanent restrictions on fiscal policymaking during the adjustment.¹⁹

From 1998 onwards, the South African government adopted various measures to make fiscal policymaking in South Africa more transparent. The overarching framework for this endeavour is the Public Finance Management Act (PFMA) of 1999. The Act does not put limits on the absolute or relative values of fiscal aggregates, that is, does not prescribe numerical fiscal rules. Instead, it aims to address the accountability dimension of fiscal transparency by emphasising regular financial reporting, sound internal expenditure controls, independent audit and supervision of control systems, improved accounting standards and training of financial managers, and greater emphasis on outputs and performance monitoring. Article 28 of the Act stipulates that all national and provincial budgets must contain multi-year projections of revenues and expenditures, with the national budget also outlining the macroeconomic projections on which the estimates are based. This provision compels the South African fiscal authorities to annually disclose their longer-term objectives and views about future trends in fiscal policy.

Effect was given to Article 28 of the PFMA by the introduction of the Medium-Term Expenditure Framework (MTEF) in 1998/99. The MTEF consists of three-year rolling budgets for the national and provincial governments, accompanied by detailed explanations of the broader fiscal and macroeconomic policy stance. The broad fiscal framework currently in force in South Africa is therefore reminiscent of those used in Australia, New Zealand and the United Kingdom. In contrast to these countries, however, South Africa has not adopted separate legislation specifying binding annual or medium-term fiscal targets.

¹⁹ Section 13(f) of the South African Reserve Bank Act of 1989 (as amended) prohibits lending to the South African government.

Both regimes that have been used since 1994 (target-guided discretion from 1994 to 1998 and transparency-based discretion since then) have worked well. In line with our argument about the real determinants of fiscal-policy choices (*cf.* section 3(a)), we believe the successful completion of the fiscal adjustment effort in 2001 and the maintenance of fiscal discipline thereafter were made possible first and foremost by the fiscal authorities' strong commitment to fiscal prudence. However, the flexibility of these regimes proved useful in a turbulent milieu marked by, *inter alia*, political democratisation, strong popular pressure for more expansionary policies, and three currency crises (1996, 1997/98 and 2001). And their discretionary nature was not a drawback from a credibility point of view. The authorities have earned considerable credibility for themselves and the regime, having established an enviable reputation for maintaining fiscal discipline. This is evident from South Africa's relatively good international credit ratings, which have improved consistently since the first official ratings were conducted in 1994 (*cf.* National Treasury, 2002:99).

(b) The Future: Should South Africa Adopt Numerical Fiscal Rules?

We see no compelling reason why South Africa should adopt numerical fiscal rules. Rules are unlikely to add credibility benefits over and above those already enjoyed by policymakers and the transparency-based regime, especially if it is taken into account that rules *per se* cannot constrain future generations of policymakers. Moreover, the adoption of numerical rules will rob policymakers of valuable flexibility that they have so far used wisely. The present transparency-based regime seems to offer the best of both worlds: the (overrated?) commitment benefits of rules and the flexibility advantages of discretionary regimes. In our view, it would make more sense to seek to make this regime more effective by continuing to implement appropriate transparency-enhancing reforms than to go down the slippery road of numerical rules.

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