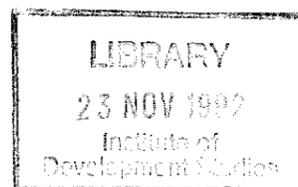


SOME NEW (AND OLD) APPROACHES TO BUDGETARY POLICY: IMPLICATIONS FOR THE SOUTH AFRICAN BUDGET

by

J VAN DER S HEYNS



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 Economic Research Unit
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PREFACE

The work on which this paper is based was undertaken while the writer was on sabbatical in London from November 1985 to May 1986. A research grant from the Human Sciences Research Council enabled him to examine various aspects of fiscal policy, and this occasional paper reproduces, in a revised form, one of the final research reports submitted to the Council in August 1986.

Financial assistance rendered by the Human Sciences Research Council towards the cost of this research is hereby acknowledged. Opinions expressed or conclusions arrived at are those of the author and are not to be regarded as those of the Council.

J. van der S. Heyns
September 1986

1 INTRODUCTION

In South Africa, as elsewhere, the so-called Keynesian revolution of the 1930s led to significant changes in thinking about the economic role of the government budget and public debt. The new attitude towards budget deficits and government borrowing, based on Keynesian principles of short-term demand management, was, inter alia, reflected in a changed framework of budgeting and budgetary presentation in South Africa in the post-1945 period. The process of adjustment of the budget to the new Keynesian vision of how the economy worked, and the role of the budget in it, culminated in the abolition of the so-called dual budgetary system and the introduction of a unitary budget over a decade ago.

Recently, however, there have been signs in South Africa of a revival of interest in some of the longer-term budgetary issues of earlier years. These concerns have already had some effect on the government's approach to the budget and they could become increasingly relevant in years to come.

This paper provides some historical and international perspectives on these latest developments, in the light of recent shifts in emphasis abroad regarding the concept of fiscal discipline and its evaluation, and considers some of its implications for the further evolution of the South African budget.

2 CHANGING ATTITUDES TOWARD BUDGET DEFICITS AND GOVERNMENT BORROWING

Perhaps the most important factor which affected government finances on a virtually world-wide scale in the post-1945 period has been the almost literal 'explosion' of public expenditure which occurred in many countries in the decades that followed the Second World War. While the financing of the rising public spending was facilitated by the high levels of economic growth of the 1960s, serious budgetary imbalances emerged during the 1970s as economic growth rates declined, with both high expenditures and high tax levels coinciding with growing actual and structural public-sector deficits.

However, towards the end of the 1970s a broad consensus began to emerge that the growth of the public sector had been much too fast and unbalanced and not sufficiently under the control of government. Especially among most of the Western industrial nations, and in international organisations such as the IMF and OECD, of which these nations were the principal members, there was broad agreement that the crisis in which budgetary policy found itself could be overcome only by reverting to the recognised principles of public finance and by steadfastly pursuing anti-inflationary policies.

By the turn of the decade, the focus of fiscal policy had, therefore, shifted in favour of budgetary consolidation, i.e., the reduction of deficits by raising taxes or reducing spending. In the OECD, for example, the majority of members considered it necessary during the 1980s to pursue the long-run objective of reducing government deficits to historically more normal levels, in order to control inflation and reduce interest rates. In some countries, the objective of qualitative consolidation, especially the containment of current outlays on income transfers, has also been a high priority. The objective of cutting deficits was generally also associated with the

additional aims of reducing the longer-run share of public spending and taxation in national income, in order to lay the foundations for sustained private-sector recovery in the medium term through reduced public-sector claims on resources.

Classical Views

Several objective factors, including the oil crises of the 1970s, declining growth rates and the acceleration of inflation, contributed to the deterioration in the public financial position of many countries during the 1970s. However, the indifferent and careless attitude towards budget deficits and public debt which has prevailed in the post-1945 years also played an important role. This more relaxed attitude towards borrowing is widely attributed to the abandonment, since the 1930s, of the classical budget-balancing norms of fiscal prudence and responsibility in favour of open-ended Keynesian fiscal activism, focusing on the budget's short-term impact on aggregate demand.

Classical views on public finance and budget deficits were dominated by a concern with the public debt. Classical economists were almost unanimous in condemning budget deficits and the accumulation of government debt. Although it was frequently conceded that deficit financing was permissible in times of war, they were concerned that in peacetime it would lead to irresponsible government and wasteful expenditure. It was feared that the burden of the public debt could become excessive because of the taxation required to service it. Taxes were considered to be harmful because of the burden they imposed on productive activity. In this kind of environment, low expenditure and budget surpluses were the order of the day, except in war-time. In the classical years prudent and responsible financial conduct by the government was thus conceived in basically the same image as that for the family. Frugality was the cardinal virtue, and this norm was given practical shape in the widely shared principle that government budgets should be in balance, if not in surplus, and that

deficits were acceptable only in extraordinary circumstances. Substantial and continuing deficits were interpreted as the mark of folly.

The Keynesian Revolution

The Keynesian revolution of the late 1930s produced a significant change in these traditional attitudes towards fiscal policy and budget deficits. In sharp contrast to pre-Keynesian concerns with the longer-term implications of government borrowing and public debt, Keynesian analysis focused on the short-term link between budget deficits and aggregate demand, with fiscal policy being seen as a means of achieving an appropriate level of real demand, and hence employment, in the short term. This Keynesian vision of how the economy worked was widely shared in the first two decades after 1945.

The notion of an unstable economy whose performance could be improved through the manipulation of government budgets produced a general principle that budgets need not be in balance, indeed that they should not be in balance, as that would mean that the government was not doing its duty. In short, the classical norm of balanced budgets was replaced by the Keynesian norm of unbalanced budgets:

"the Keynesian platform for economic management replaced the old-fashioned belief in a balanced budget with what was viewed as a new and superior principle, that of using the budget - deficits and surpluses - to balance the economy" (Wagner, et al, 1982, p.9).

Under the new fiscal regime, deficits were thus no longer viewed as a sign of irresponsible government action, and the avoidance of budget deficits, along with some effort to reduce the public debt, ceased to be a sine qua non of fiscal behaviour:

"we may now free ourselves from the old and narrow conception of balancing the budget, no matter over what period, and move towards the new and wider conception

of the budget balancing the economy" (Dalton, 1954, p.221).

One country after another therefore discarded the old norms of responsible fiscal conduct in favour of the new doctrine with its emphasis on the functional use of the budget for short-term demand management purposes.⁽¹⁾ In particular, the traditional principles of sound finance, which had held that no borrowing was justified if associated with unproductive investments or current expenditures were accordingly abandoned in favour of activist policies which went far beyond deficits in recession. In many countries deficits were larger than could be reconciled with pure Keynesian principles of smoothing out fluctuations in demand, so that permanent and sustained fiscal deficits became the norm rather than the exception.

The weak link in the Keynesian theory of counter-cyclical policy was, of course, its failure to give adequate recognition to the shortcomings of the political systems within which policy was to function. Deficit financing was actually only the first part of the Keynesian contra-cyclical policy prescription. As developed by the economists who advocated macro-economic planning, fiscal policy should be devoted to smoothing out cycles in private economic activity. Thus Keynesian fiscal policy should be symmetrical, i.e., it would be guided by the same principle during both recession and inflation - deficits would be created during recession and surpluses during inflation. However, over the course of the cycle, the budget could remain in balance.

"The time-honoured norm of budget balance was thus jettisoned, but, in the pure logic of Keynesian policy, there was no one way departure. It might even be said that Keynesian economics did not destroy the principle of a balanced budget, but only lengthened the time-period over which it applied, from a calendar year to the period of a business cycle" (Buchanan, 1978, p.15).

However, Keynesian fiscal policies functioned rather differently when put into practice. The reason, according to Buchanan, was that after the abandonment of classical principles of sound finance, political institutions were no longer constrained as before:

"Anyone, citizens no less than politicians, would typically like to live beyond his means. Individual citizens generally face a personal or household budget constraint which prevents them from acting on this desire, although some counterfeit and others go bankrupt. In the century before the shift in belief wrought by the Keynesian revolution, politicians acted as if they sensed a similar constraint when making the nation's budgetary choices. Contemporary political institutions, however, are constrained differently because of the general belief in the Keynesian vision. This shift in constraints due to the shift in general beliefs alters the character of governmental budgetary policy. While there is little political resistance to budget deficits, there is substantial resistance to budget surpluses. Hence, fiscal policy will tend to be applied asymmetrically: deficits will be created frequently, but surpluses will materialise only rarely. This bias results from the shift in the general, public impression or understanding of the Western economic order, and of the related rules of thumb held generally by the citizenry as to what constitutes prudent, reasonable, or efficacious conduct by government in running its budget" (Buchanan, 1978, p.18).

Although deficits were therefore created during recessions, these were not followed by offsetting surpluses when economic activity improved. There was, moreover, little political opposition to non-recessionary deficits. Buchanan wrote that:

"Keynesian economics has turned the politicians loose;

it has destroyed the effective constraint on politicians' ordinary appetites to spend and spend without the apparent necessity to tax" (Buchanan, 1978, p.27).

With respect to this disintegration of the traditional doctrine of balanced budgets, the IMF's de Larosiere noted:

"... the traditional stigma attaching to fiscal deficits and growing public debt gave way to a certain nonchalance and laxity on the part of policy makers. Fiscal deficits no longer required justification, and they did not seem to have undesirable political repercussions, even when they occurred during non-recessionary periods" (de Larosiere, 1984, p.261).

3 FISCAL DISCIPLINE THROUGH CONSTITUTIONAL MEANS

A political bias in favour of higher spending is therefore seen by some as an important cause of the growing public indebtedness of many governments. De Larosiere has, for example, noted that:

"Because the beneficiaries of these (government) services represented large and politically powerful groups, while those who opposed them were less numerous and less concentrated, the political process generally favoured their expansion. If the cost of these services had been totally covered by ordinary revenue, we would have witnessed a process of income redistribution in favor of lower-income users of these services, without fiscal deficits. However, while the electorate pushed for higher spending, it was far less supportive of the tax increases that would have been needed to finance that spending. As time passed, and in spite of substantial tax increases in all industrial countries, the gap between government spending and revenue grew, contributing eventually to higher public debt burdens" (de Larosiere, 1984, p.261).

In the United States a presumption that the country's current budgetary procedures are incapable of overcoming the procedural bias in favour of ever greater levels of federal expenditure and persistent deficits is behind the numerous proposals that would limit the growth of federal spending or revenues, prohibit federal deficits, or both. In 1982 the United States Congress was considering over 100 such proposals. Some were in the form of amendments in the constitution, while others were in the form of legislation.

In the United States especially, there is therefore a strong lobby, led by public-choice economists, in favour of some sort of constitutional amendment to restore discipline and responsibility to the budgetary process.⁽²⁾ The issues around the possible

imposition of constitutional fiscal constraints on the United States government have been explored at a number of conferences, and a substantial body of literature exists on the subject.⁽³⁾ Notable public figures who are supporters of a constitutional amendment include, inter alia, Nobel Prize winner Milton Friedman⁽⁴⁾ and the former chairman of the Federal Reserve Board, Arthur Burns. President Reagan is said also to be an enthusiastic supporter of the principle of imposing a constitutional constraint on the United States government.

To date, over 30 state legislatures have petitioned the United States Congress for a convention to amend the constitution. Congressional hearings have been held (United States, 1981), and in 1982 the Congressional Budget Office (CBO) published a comprehensive study of current budgetary procedures and the proposals before Congress (United States, 1982).

Public and congressional debate over more than a decade, on this latter issue, culminated in the passing in December 1985 of the so-called Gramm-Rudman-Hollings budget balancing law (The Balanced Budget and Emergency Deficit Control Act of 1985).⁽⁵⁾ The countering of the built-in bias in the United States budgetary process in favour of government spending and budget deficits is seen as an important rationale for the enactment of this legislation. For example, the United States budget for the fiscal year 1987 noted that:

"The American political system faces a great test. At present, the benefits of government programs tend to be concentrated on particular fiscal constituencies which lobby to defend their benefits, while the costs of such programs are spread over the population at large. The Balanced Budget and Emergency Deficit Control Act of 1985, better known as the Gramm-Rudman-Hollings amendment (GRH), was designed to cut through this Gordian knot and return the budget to balance by 1991" (United States, 1986a, p.2-3).

Some of the provisions of this Act have already been challenged in court as unconstitutional (United States, 1986b). However, by passing this law, Congress bound itself to five years of forced deficit reductions, with the goal of balancing the budget by October 1990. The Federal deficit is to be eliminated using conventional legislative means or, failing that, through automatic spending cuts.

But there seems to be limited support outside the United States for a constitutional approach to the problem of maintaining fiscal discipline, the main argument being that budgetary decisions, i.e., the allocation of resources, distribution of income and issues of stabilisation (such as the choice between inflation and unemployment), are political issues and that governments are unlikely to restrict their political freedom in that regard. The support that exists for a constitutional budgetary constraint in the United States is considered to be a result of the country's peculiar system of Congressional decision-making. In the United Kingdom, for example, there is very limited support for the concept of a constitutional limitation on deficits or spending, there being, of course, no written constitution.⁽⁶⁾

Legislative constraints on government borrowing for purposes of financing consumption exist in West Germany, Japan and Switzerland (Chouraqui and Price, 1983, p.34). In West Germany the constitutional constraint on the financing of current expenditures from loans was imposed in terms of the Growth and Stability Act of 1967. This Act heralded the beginning of the Keynesian era in Germany. However, it failed to have the desired effect and has not prevented the authorities from running budget deficits in excess of their own capital expenditure, often through redefinitions of expenditures and other forms of window-dressing.

4 SOME RECENT DEVELOPMENTS

Most of the major industrialised countries remain resolutely committed to a continuation of the policies of budget consolidation and fiscal restraint of the early 1980s. However, there is, as we have noted, little support for a return to the rigid budget-balancing rules of fiscal restraint which exerted such a dominant influence on public finance in the pre-Keynesian years. On the other hand, the former concerns over longer-term fiscal issues, on which most attention was focused before Keynes, have once more become an important part of discussion of fiscal policy (de Larosiere, 1984; and Odling-smee, 1985). It is, in addition, increasingly recognised that these longer-term considerations need be dealt with in a budgetary framework which has a medium-term orientation. This section briefly reviews recent developments in two related areas: (1) the important role that the public debt has once more assumed in the analysis and evaluation of fiscal policy, and (2) recent interest in the United Kingdom in the public sector's net worth as a guide to fiscal policy.

Public Debt Issues

In recent years increasing attention has been devoted to the public debt and the burden of debt service costs. The rapid growth in public debt levels relative to GNP since the early 1970s has caused concern in many countries. Both the IMF and the OECD have recently exhorted member countries to reduce the ratio of debt to national income. Public debt developments in member countries and the debt service burden now also feature regularly in OECD reviews.⁽⁷⁾ The public debt in a medium-term context and its implications for fiscal policy were also the subject of a recent OECD working paper (Chouraqui, Jones and Montador, 1986).

The growing importance of public debt as a component of fiscal analysis is further demonstrated by the fact that a recent United

Kingdom Green Paper on public expenditure devoted an entirely new section to the issue of public debt interest (United Kingdom, 1984). In the Netherlands, the role of the public debt as a determinant of the optimal budget deficit is dealt with in a recent report by the Sociaal-Economische Raad (The Netherlands, 1985). The exceptional rise in the United States public debt which is held by the public, and the increase in interest costs in the budget, were also highlighted recently by a special study of these issues undertaken by the Congressional Budget Office (United States, 1984).

A high level of public debt in relation to GNP can adversely affect economic performance in several ways: (1) a reluctance on the part of financial markets to absorb disproportionate amounts of government debt into private portfolios will tend to be reflected in upward pressure on interest rates; (2) high levels of government debt are often associated with fears of future inflation (in case of monetisation) and/or high taxes; (3) the growth of the nation's capital stock may be lower if private-sector savings have been channelled into government securities rather than productive investment; and (4) an increasing government debt burden will cause a reduction in the future flexibility of fiscal policy.⁽⁸⁾

However, according to the OECD, no obvious policy rule for the ideal level of public debt appears applicable to all countries. The appropriate level of debt and the rate of adjustment towards that level will depend on many factors.⁽⁹⁾ However, while present debt/GNP ratios are generally within the range of historical experience, the current pattern of continued increases in these ratios during a period of economic expansion is considered to be unusual (Chouraqui, Jones and Montador, 1986).

Another important aspect is the relation between public debt accumulation and the size of structural budget deficits. It might first be noted that rising debt interest payments have

contributed to the emergence of structural budget deficits in many countries. In some cases, structural budgets, excluding debt interest, are even in approximate balance.⁽¹⁰⁾ The increasing importance of the public debt in fiscal-policy analysis has also given rise to a need to construct a structural budget measure which is consistent with trends in government debt accumulation. The point is that a permanently balanced structural budget (based on peak output) may still be adding to 'structural' debt and portfolio problems because of the cumulation of 'cyclical' budget deficits. To make structural budget estimates consistent with longer-run government debt accumulation, potential output needs therefore to be defined not as peak output but as the mid-cycle average (Muller and Price, 1984).

The rise of the public debt in many countries and a fear of the increased debt burden have thus resulted in more attention being given to so-called fiscal or debt calculus which runs in terms of budget deficits, the interest rates and the growth rate of the economy.⁽¹¹⁾ More particularly, the adverse consequences of a rising debt/GNP ratio for future budgetary policy could act as a severe constraint on budgetary policy and are presently being seen as a possible constraint on the fiscal expansion of some Western economies. Marris, for example, argues that whilst there has been a remarkable improvement in the fiscal calculus of Japan, Germany and the United Kingdom since 1978-80, the position of the United States has deteriorated badly since 1981, and that the United States will be getting very close to a so-called 'danger zone' by 1990 (Marris, 1985, pp.180-189).

Whether or not the public debt calculus imposes a constraint on fiscal expansion in the United Kingdom is currently the subject of considerable debate in that country in the context of the observed need to reduce the exceptionally high level of unemployment. Whilst Congdon (1985a, 1985b, 1985c) takes the view that the United Kingdom is already in the so-called debt

trap, Layard (1985), Charter for Jobs (1985), Dornbusch (1985), Davies (1985) and Davies and Layard (1985) argue that the government should expand its borrowing in order to reduce the high level of unemployment. Budd, Dicks and Keating (1985) accept that there is an optimal debt/GNP ratio, but do not venture to determine it.

The public debt/GNP ratio has also been discussed in the United Kingdom as a possible target of British financial policy. It is especially popular amongst London's financial fraternity⁽¹²⁾ and, in a recent speech, Mr Roy Hattersley, the Deputy Leader of the Labour Party and shadow Chancellor of the Exchequer, also foreshadowed the use of the ratio as a possible target for financial policy and as an instrument of fiscal discipline by a future Labour government (Hattersley, 1985).

Public-sector Net Worth as a Policy Guide

In the United Kingdom in particular the focus of attention has recently shifted to some extent from simplistic measures of fiscal stance, such as the Public Sector Borrowing Requirement (PSBR) or debt/GNP ratios, in favour of a fuller assessment of the effect of budgetary actions on the public sector's net worth, emphasising the longer rather than the shorter term (Buiter, 1983; Buiter, 1985; Chouraqui, Jones and Montador, 1986; Hills 1984a, 1984b; and The Economist, 1985). The concentration by the United Kingdom government's monetary and fiscal strategy (in terms of the well-known Medium-term Financial Strategy, or MTFS) on a single number, i.e., the PSBR, has attracted a great deal of criticism ever since its adoption in 1980, not least because of the way in which public sector asset sales as well as the current high revenues from North Sea oil have affected the PSBR and been used to justify tax reductions.

The PSBR is, on the one hand, regarded as inappropriate as a measure of the impact of the government on financial markets and economic activity, because: (1) it disregards the demand impact

of the effect of inflation on the value of existing debt; (2) it does not take into account what is happening to public-sector financial assets; and (3) it assumes that, whereas sales of gilts have an impact on financial markets, sales of shares in a public corporation do not. From the point of view of notions of fiscal prudence and responsibility to those who live now or in the future, the PSBR is regarded as equally misleading, because: (1) it fails to show the effect of inflation on the outstanding public debt (the net outstanding debt may thus fall although there might be continuous new nominal borrowing; (2) a reduced PSBR does not mean that larger net assets are being passed on to future generations if such reduced levels of borrowing are made possible by asset sales; and (3) if one is concerned with the future one should be concerned not only with financial liabilities but also with capital works and other productive assets.

A particular bone of contention in the United Kingdom at present is the budgetary treatment of public sector asset sales, i.e., the proceeds of the privatisation of large public undertakings such as British Telecom. In the MTFs, such sales are treated as a reduction of the PSBR rather than as a means to finance it (as alternative to public debt sales). The use by the present Conservative government of public-sector asset sales to make room in the budget for tax reduction in terms of the MTFs has prompted a former Prime Minister, Lord Stockton, to refer scathingly to the government's actions as that of "selling the family silver". It is contended that a prudent budgetary policy demanded that the process of such sales of public assets not be used to justify a reduction in current taxation, which benefits present taxpayers, but to reduce the public debt instead, and that exclusive focus on the size of the PSBR therefore fails to take into account the fact that the composition as well as the level of the PSBR is important.

A single number like the PSBR is considered to be unable to sum up or reflect adequately such a wide array of fiscal concerns as those mentioned above; hence the interest in the presentation of changes in public-sector assets and liabilities as a guide to public-sector borrowing decisions. The empirical results of work done by the Institute for Fiscal Studies on public sector balance sheet accounting was recently published in London (Hills 1984a, 1984b; and Institute for Fiscal Studies 1984), and comprehensive balance sheet accounting for the government was also recently discussed in articles by Buiters (1983, 1985). Buiters writes of Hill's work:

"While one can quarrel with each and every one of Hill's figures, the need to go through an exercise of this kind in order to evaluate the feasibility and consistency of public sector fiscal-financial-monetary plans is beyond doubt" (Buiters, 1985, p.35).

The appropriate long-term stance of fiscal policy in the context of the maintenance of the public sector's net worth was also discussed recently in an important article by two UK Treasury economists (Odling-smee and Riley, 1985). This article attracted a great deal of attention in the United Kingdom because of its apparent critical stance towards the concept of the PSBR as a guide to borrowing policy. The Economist (1985) observed that Odling-smee and Riley's views "show that the arguments over fiscal policy are moving on to new ground".

Martin (1985) wrote that Odling-smee and Riley's new framework - that is, in the medium to long term, government debt should move so as to maintain the 'net worth' of the public sector - represents a "significant shift of emphasis". He further spells out three possible consequences of such a shift: (1) it will hasten the day when PSBR discussion and presentation will differentiate much more clearly between current and capital account transactions; (2) it will set a baseline for the PSBR target roughly equal to levels of public-sector investment, net

of depreciation; and (3) public-sector asset sales, if correctly valued, would not be used to finance tax cuts.

Walters (1985), on the other hand, recognises the need to take a longer-run view of current budgetary decisions but is sceptical of the practicability of balance sheet accounting. He says:

"Although one might admit these criticisms of the use of the current deficit or PSBR, no one could conceivably draw up a balance sheet for the public sector that could carry the least bit of conviction" (p.155).

The Treasury and Civil Service Committee (United Kingdom, 1985) has also questioned the Chancellor of the Exchequer about the policy implications of Odling-smee and Riley's article. The Chancellor responded by saying:

"Theirs is an interesting conceptual approach but of no practical significance whatsoever" (p.ix).

However, since the article in question was prompted by a desire on the part of the authors to examine what the optimal level of the PSBR might be in the long term, once the medium-term objectives of the government regarding inflation (in terms of the MTFS) have been achieved, these issues remain very relevant despite the Chancellor's denial.

Finally, the British Labour Party has also expressed considerable interest in the concept of balance sheet accounting for the public sector. Mr Roy Hattersley set out his party's approach as follows:

"My approach to public finance will revolve around two sets of published figures. First, a public sector balance sheet will be published which will show the implication of public expenditure and borrowing decisions for public sector liabilities and public sector assets both real and financial. Second, discipline towards borrowing will be carried out with

reference to the general government debt-output ratio. Within the Treasury our fiscal stance will be set with reference to a third set of figures - the general government financial deficit. Inflation-adjusted and cyclically-adjusted versions of the general government financial deficit will also need to inform our policy. Inflation-adjusted figures are necessary in order to take account of the possible demand effects of a decline in the real value of government debt due to inflation. Cyclically-adjusted figures are needed in order to help distinguish the appropriate level of discretionary demand stimulation from the operation of built-in stabilisers. The general government financial deficit will not be targeted. However, it will be taken into account when setting the pre-announced guidelines embodied in the public sector balance sheet and the ratio of general government debt to GDP" (Hattersley, 1985).

**5 SOME GENERAL COMMENTS ON FISCAL DISCIPLINE
AND RESPONSIBILITY IN SOUTH AFRICA**

The so-called Keynesian revolution of the 1930s also led to significant changes in thinking about the economic role of the budget and the public debt in South Africa. This revolution in fiscal thinking was, inter alia, reflected in a changed style of budgetary practice and presentation after 1945.

The Dual Budgetary System

The so-called divided or dual budgetary system, which existed in South Africa from 1910 until its demise in the 1970s, reflected the earlier, pre-Keynesian attitudes towards the budget and public debt. In terms of this system, the central government's financial and budgetary accounts were divided into a so-called Revenue Account and a Loan Account (the smaller Bantu Education and South West Africa Accounts are not considered here). In general, the government's current expenditures were brought to account in the Revenue Account and financed from taxation and other current revenues, whilst capital expenditures and lending, i.e., permanent or recoverable expenditures, were brought to account in the Loan Account and financed from borrowing.

Until at least the early post-1945 years this dual budgetary system, founded therefore on the nature of government spending, provided a necessary and adequate framework for the conduct of what were then considered to be sound financial policies. These were based on the principle, accepted at an early stage in the development of public finance in South Africa, that responsible fiscal conduct demanded that at least current expenditure should be financed by current revenues, but that capital expenditure, i.e., productive outlays, could be financed from borrowing. In these early years the distinction between current and capital expenditure was therefore of vital interest.

However, since the 1950s there had been a gradual blurring of the distinction between the Revenue and Loan Accounts. This reflected, at least in part, the fact that the distinction between current and capital expenditure had become blurred and was fraught with definitional problems. But the breakdown of the division also resulted from a weakening post-war resolve on the part of policy makers in South Africa to maintain the earlier dictums of sound finance against the onslaught of the new principle of functional finance with its emphasis on short-term demand management. The final step on the road to a new style of budgetary presentation, based on the new Keynesian vision of the economy, was taken when, following the recommendations of the Franzsen Commission in 1970, the distinction between the Revenue and Loan Accounts, and hence the underlying distinction between the central government's capital and current expenditures as a rationale for financial decisions, was formally abandoned in 1976 in favour of a so-called unitary or undivided budgetary presentation, setting out total government spending, total revenues, and the overall deficit (surplus) and its financing.

Apart from the obvious administrative advantages which must have flowed from such a unification of the accounts, the introduction of a unitary budget served a twofold purpose: (1) to underline the importance of the concept of a consolidated budget deficit and the need to finance it in a non-inflationary way; and (2) to promote the idea that the choice between taxation and borrowing should be based on so-called 'economic factors' such as the state of economy, conditions in the money and capital markets, the state of the balance of payments, etc., rather than on the type of expenditure to be undertaken. The eclipse of the longer-term dimensions of budgetary policy, which attracted so much attention in former times, by shorter-term issues was thus completed when the first of the so-called unitary budgets was introduced in Parliament in March 1976.

The Keynesian revolution and its corollary—the eventual collapse of the dual budgetary system — therefore changed the fiscal constitution of South Africa in an important respect. This is that there were no longer considered to be any apparent traditional or constitutional constraints on the conduct of government finance or on the size and stability of government deficits. In other words, as elsewhere, the government assumed complete freedom to unbalance the overall budget on the basis of accepted Keynesian (demand management) principles. In short, by the 1970s the creation of open-ended budget deficits and borrowing, no longer related to or evaluated with reference to the government's assets or investments, had become normal and acceptable fiscal behaviour in South Africa in the interest of pursuing the macro-economic objectives of stability and growth.

As the old budgetary system gradually disintegrated over the years and was replaced by a more modern (Keynesian) system of accounting and presentation, the earlier (classical) pre-occupation with principles of sound government finance and the longer-term implications of fiscal policy, e.g., the burden of the public debt, debt servicing costs and inter-generational equity, inevitably also faded in the public mind, and the visible signs of the older order likewise disappeared. For example, references to the burden of the public debt and the old rules of fiscal responsibility, which were still quite common in earlier post-War years, disappeared almost completely from Parliamentary debates during the 1970s. Moreover, the 'old fashioned' budgetary distinction between current and capital expenditure, which dominated budgetary policy in South Africa for so long, was dropped in favour of a new, low-profiled, classification of expenditure (to be voted) into: current expenditure, capital expenditure and transfers. As the transfers component cut across the former division of outlays between the Revenue Account and the Loan Account, the new classification was not even comparable with the old. In addition, 'to be voted' expenditure excluded the so-called Statutory Appropriations, rendering the

classifications incomplete.

Although a much more detailed 'Keynesian' economic and functional classification of government expenditure (not easily reconcilable with the aforementioned classification contained in the **Estimate of Expenditure**) was indeed supplied, the relevant table was relegated to a rather obscure part of the annual budget format, i.e., the statistical appendix. One could perhaps argue about the importance of these classifications in the budget's presentation since 1976, but there is no doubt that they have not played an important part in the determination of the government's fiscal stance since then. During the 1970s a familiar sign of the old order, i.e., the traditional annual statement by the Auditor-General on the so-called productive nature of the total outstanding public debt, also disappeared from the government's audited accounts.

Since the demise of the dual budgetary system in the 1970s, the annual budget document has accordingly provided few if any longer-term perspectives on the government's annual budgetary stance, and little to aid those who continued to look at the budget through classical eyes.

The Maintenance of Discipline

In such a Keynesian fiscal regime, under which short-term demand considerations reign supreme, much depends on the government's own sense of responsibility to conduct budgetary policy in a disciplined and restrained manner. In the years of fixed exchange rates, a loss of exchange reserves could still act as a kind of brake on government fiscal behaviour. However, few countries today welcome the kind of budgetary or other disciplines imposed by the IMF as a quid pro quo for the granting of credit facilities (as witness the experiences of the United Kingdom, Portugal, Mexico and South Africa in recent years).

Nonetheless, the avoidance of serious fiscal imbalances is particularly difficult when a government is subject to very strong political, economic and social pressures to increase spending, and in South Africa the importance of government spending as a potential source of fiscal imbalance is likely to grow as existing services are extended to more people or as demands for some kind of welfare system increases against a background of continued high spending on national defence, black education and housing. Over the last few years the public finances in South Africa have often been characterised by critics as undisciplined in view of: (1) the apparent unrestrained growth of especially government current spending; (2) the resultant relatively high tax burden on especially the middle- and high-income groups of the population; and (3) the apparent inability of government even to maintain budgetary discipline, as a consequence of which considerable overspending on budget forecasts frequently occurs.

Some steps have already been taken in recent years to counteract undesirable tendencies in the public finances.⁽¹³⁾ These include the following :

- (1) The introduction during the late 1970s and early 1980s of a system of budgeting by objectives in all government departments. According to an announcement in the 1986 budget, the system will now be "taken a step further".
- (2) The establishment in 1976 of an interdepartmental priorities committee under the chairmanship of the Director-General of the Department of Finance, with the aim of securing improved control over the capital spending of the public sector in the light of available resources.
- (3) The abolition of the dual budgetary system in 1976. It is ironic, in the light of the theme of this section, that it was actually one of the purposes of the introduction of a

unitary budget in 1976 to enhance the objective of greater discipline over government outlays, by focusing attention on the financial constraints on government spending - a task for which the former divided framework was considered to be not well suited.

- (4) In the 1986 budget the Minister of Finance announced a twofold approach to the containment of government spending. The new approach included: (a) the regular evaluation of public-sector capital spending; and (b) the control of current spending by the appointment of "a small, highly specialised task group" to critically evaluate various aspects of current spending and devise control systems, e.g., zero-based budgeting, etc.
- (5) The government has in recent years embarked on a (very cautious) programme of privatisation and deregulation of the economy.

In addition, various steps were announced in the 1984 and 1985 budgets to improve budgetary discipline, i.e., the control of government's outlays over the course of the forecast year. These included measures to achieve a better spread of outlays over the twelve months of the budget year.

On the tax side, a number of structural improvements have been effected over the past decade, notably various adjustments to reduce the incidence of bracket creep due to inflation, the broadening of the tax base by the introduction of first the old sales duties and later the General Sales Tax, and the achievement of a better balance between direct and indirect taxes. In 1984 the government also appointed the Margo Commission of Enquiry into the Tax Structure of South Africa. The Commission is expected to present its final report to the government in late 1986.

New Emphases

Although observable trends in the government's financial position in terms of deficit and debt to GDP ratios, etc., have not yet reached the critical levels that they have at times reached in some other countries, there have been indications recently that some of the issues on which attention was focused in earlier years are once again regarded as legitimate areas of concern in discussion of fiscal policy in South Africa. Refer, for example, to the recent expression of concern by various individuals in the financial press about, inter alia, (1) the role of government interest payments as a cause of growing current expenditure; (2) the burden on future taxpayers of the rising debt interest payments; and (3) the financing of general government current expenditure from borrowing, i.e., government dissaving.

The government has responded to the current revival of concern about these longer-term budgetary issues in various ways. Firstly, it was a stated aim of the 1985 budget that 'current' expenditure would not again be financed by borrowed funds, as had happened in 1983 and 1984 (it should be noted that the Finance Minister's concern in this latter regard seemed to centre more on the effect of government dissaving on the total volume of saving than on the government's own future financial position).

The 1985 budget also attempted to provide a longer-term orientation by the inclusion of a section on "longer-term fiscal and monetary policy". This section stipulated, inter alia, that "total public sector spending" as a percentage of GDP was to be brought down to its 1981 level by 1990, and the deficit before borrowing of the "government sector" would not in future years exceed 3 per cent of GDP, barring highly unusual circumstances. In the event, the 1985 budget provided for a deficit before borrowing on the State Revenue Account alone of about 2,2 per cent of GDP. There was, however, no indication of how much this desirable deficit was expected to contribute towards keeping the deficit before borrowing of the "government sector" as a whole

within the 3 per cent of GDP limit. The 1986 budget likewise failed to throw any light on this puzzle.

In a further development the 1986 budget, however, effectively pushed into the background again, if not actually abandoned, the Finance Minister's previously declared medium-term objective of reducing public-sector spending as a percentage of GDP to its 1981 level, by declaring that it "will be more difficult to realise, at any rate in the following few years". With respect to the financing of current expenditure, the 1986 budget also declared that "as a further discipline the government's total borrowing requirement has been kept below the total intended capital spending for 1986-87". However, there was no statistical backup to substantiate this statement. At the same time, the budget actually also questioned the appropriateness of the usual national accounting distinction between capital and current expenditure. The question is: why does the government accept a discipline on itself which is based on arguably inapplicable national accounting concepts?

It is also worth mentioning that the 1985 budget for the first time gave a breakdown of the total of transfer payments into capital and current outlays. As this move will make it easier for the budget user to estimate the government's total capital expenditure, it could perhaps be seen as a further indication of the government's willingness to recognise any renewed interest in the structural aspects of the budget deficit and to facilitate its evaluation.

The Need for a New Budgetary Framework

There are several reasons why the South African government could come under growing internal and external pressure to devote more concentrated attention than before to issues such as: (1) the composition of government expenditure and deficits in relation to its financing, (2) the burden of debt-servicing costs and its role as both a cause and consequence of budget deficits, (3) the

effect of a high debt/GNP ratio on future tax and spending levels and on the future flexibility of budgetary policies, and (4) the budgetary implications of substantial public-sector asset sales. These reasons include, firstly, the virtual inevitability of growing future demands for higher 'current' as well as 'capital' expenditures to deal with the severe social and economic problems facing the country, especially if viewed against the background of its limited resources. There is a distinct possibility that serious difficulties might be experienced in accommodating such demands in a system which is subject to crude constraints on the financing of traditionally defined 'current' expenditure of the type referred to above. Because of these expected pressures on the budget, the government may thus increasingly be forced to rationalize its actions by drawing much more relevant distinctions between really productive and non-productive current and capital expenditure, and to consider the effects of the different kinds of expenditures on its finances in the medium to long term.

Secondly, the proceeds of the sale of public assets as part of the government's programme of privatisation could reach significant levels if the objective of 'rolling back the frontiers of the public sector' is pursued with vigour. In that case, guidelines need to be worked out timeously regarding the budgetary treatment of such proceeds, their proper relationship to movements in the public debt, and their effect on the level and stability of taxes over time. The haphazard treatment of such sales could play havoc with the government's finances because of their irregularity or temporary nature. Lastly, in the light of the aforementioned expected pressure on the budget as well as, for example, the growing current consensus in South Africa in favour of budgetary stimulation of the economy, there is the possibility that budget deficits as a percentage of GDP could reach historically unprecedented levels if taxes are not to be raised any further, with obvious consequences for the future of the public finances in terms of debt-servicing costs, policy

flexibility, etc.

It is important that these and other longer-term aspects of public finance be placed in a medium-term budgetary context in the interest of the consistency, continuity and credibility of policy. This means that the budget should not only provide an appropriate framework for the evaluation of the effects that policy decisions made today will have on the public finances two, three or five years hence, but also facilitate an evaluation of its provisions in the context of any declared medium or longer-term objectives.

Viewed against these fundamentals, the present framework and style of presentation of the South African budget are in reality very poorly adapted to deal with the longer-term questions which have now resumed an important role in discussions of fiscal policy. As we have seen, references in recent budgets to some of these issues have been unsophisticated and superficial. This compares unfavourably with the situation abroad where budgets frequently supply detailed analyses of, for example, issues relating to the public debt and future debt-servicing cost, etc. Recall also the embryonic interest shown especially in the United Kingdom in issues related to the public sector's net worth, considering the possibility that some of these latter issues, which are currently the subject of debate in the United Kingdom, may also become important in South African public finance. The inevitable conclusion must be drawn from all this that the long-maintained one-year perspective of the budget, and its failure to provide any longer-term perspectives on current policies, must be viewed as a serious obstacle in the way of a more effective use of the budget as a guide to responsible fiscal conduct. The style of presentation and the content of the South African budget clearly ought to be overhauled to enable it to throw light on a wider range of issues related to the government's handling of the State's finances than at present.

One particular aspect of considerable importance in this above context is the distinction between the structural and non-structural or cyclical components of the budget and its stance, as measured by the deficit/surplus. As it is the trend of deficits or debt accumulation rather than the annual figures which serve as an indicator of fiscal discipline, a budget needs to distinguish between longer-term trends and purely short-term and reversible departures from the trend. The reason is that a short-term departure from a norm may not give cause for concern or have undesirably expectational consequences if it is expected to be merely temporary and will soon be reversed. For example, temporary increases in the budget deficit or temporary loan-financing of 'current expenditure' when the economy is weak may to some extent be made up when the economy is strong, and may thus be quite acceptable in a medium-term context. On the other hand, unchanged or increased actual budget deficits can effectively disguise the extent to which governments are exercising restraint. Thus, in the context of recent policies of budget consolidation, intentions of fiscal restraint in, for example, OECD countries have frequently been frustrated by the effect of automatic fiscal stabilisers on actual budget deficits, with the resultant continuation of high actual deficits and the continued growth of public debt. According to the OECD, automatic stabilisers have been significant factors where a deterioration of actual budget deficits occurred in the economy of a number of countries.

These various considerations make it crucial to draw a clear distinction between purely cyclical elements of the budget and debt accumulation, on the one hand, and the structural components of deficits which are likely to remain even if the economy is operating at a satisfactory level, on the other. In this latter respect, the concept of the cyclically-adjusted (structural) budget deficit, designed to distinguish between discretionary action (which includes inflation-induced fiscal drag) and the effects which are defined in terms of the automatic budgetary

reaction to shortfalls from high-employment GDP, has been the object of considerable interest (Price and Muller, 1984; and Muller and Price, 1984).

Against this background, the South African authorities' neglect of the distinction between structural and cyclical components of the budget in the presentation of their policies, and their consequent failure to supply a much needed medium-term perspective - as opposed to the present purely short-term perspective - on the budget deficit and debt accumulation, seem bound to create additional uncertainty in the public's mind about the government's policy directions and to undermine the public's confidence in the government's ability and willingness to conduct the public finances in a disciplined and responsible manner.

Fiscal discipline and its evaluation, especially in the context of the recent shifts in emphasis referred to in this paper, are further undermined by the South African budget's well-known lack of comprehensiveness. To describe the present budget as a unitary or undivided one is in reality a misnomer in view of the existence of a substantial, but unquantifiable, volume of extra-budgetary or off-budget activity. As a result of this extra-budgetary activity, the budget itself may present an incomplete and distorted picture of the central government's financial position. However, it is currently an impossible task, given the paucity of data, to estimate the expected amount of expenditures, revenues or overall deficit of the central government as a whole, or to measure the change in the public debt in the hands of the private sector for a particular year. Consequently, the preparation of a consolidated budget for the central government sector as a whole, and the development of clearly defined and operational concepts for such a budget, must be seen as an essential first step in the direction of a more effective budgetary framework for policy design and evaluation.

Finally, given the aforementioned recent revival of interest in

the distinction between capital and current expenditure, the fact that the South African tax system is presently, and will probably continue in future, to be heavily burdened with a substantial volume of indirect subsidies (tax subsidies or tax expenditures) is highly relevant. In other words, if the distinction between current and capital expenditure is at all relevant as a guide to fiscal policy, such 'off-budget' income transfers cannot be ignored. The identification and quantification of all indirect or tax expenditure programmes in the personal and corporate income tax systems, in particular, would thus seem to be essential for purposes of a proper evaluation of the composition of government outlays, and should form part of any comprehensive design to maintain a disciplined approach to South Africa's public finances.

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3. See Moore and Penner (1980); Buchanan and Wagner (1978); Institute for Contemporary Studies (1982); Harriss (1985); Niskanen (1973); and Sommers (1984).
4. See Milton and Rose Friedman (1984).
5. See United States (1985).
6. For a view in favour of a constitutional fiscal limitation in the United Kingdom, see Burton (1978, 1985).
7. See, for example, OECD *Economic Outlook No.36*, December 1984, pp.32-33, and OECD *Economic Outlook No.37*, June 1985, pp.6-8.
8. Refer OECD *Economic Outlook No.37*, June 1985, p.6.
9. See OECD *Economic Outlook No.37*, June 1985.
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