

**FISCAL POLICY IMPLICATIONS FOR INFLATION
TARGETING IN A GLOBALISED ECONOMY:
*THE CASE OF SOUTH AFRICA***

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I am grateful for the useful comments and insight on the text by Stan du Plessis. The opinions and remaining errors in the paper are entirely my responsibility

ABSTRACT

Policymakers internationally have responded to the financial crises of the last decade with a series of structural reforms to enhance the efficiency and robustness of policy. These reforms occur against the backdrop of an increasingly integrated global economic order. Adoption of inflation targeting has been part of these reforms and is an approach to monetary policy that aims at making the objective of monetary policy clear and the pursuit thereof, credible. The adoption of fiscal policies that constrain the proclivity of the fiscus to spend beyond their revenue potential and enhance reductions in budget deficits is consistent with this development in central banking. The proposed paper analyses the rationale for reforming fiscal institutions by adopting fiscal policy rules in an endeavour to make the stance of macroeconomic policy consistent. The paper identifies structural and institutional inconsistencies affecting the design and implementation of monetary and fiscal policies. A set of coherent fiscal policy reforms in the form of the adoption of fiscal policy rules and institutions are suggested and their chronological sequencing is emphasised. For South Africa it provides germane historical, theoretical and empirical issues for consideration.

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1.0 INTRODUCTION

Recent years have seen macroeconomists in various institutions such as government, think tanks, academia, and financial establishments endeavour to develop and understand models of growth and development. These models have focused on a number of components, including macroeconomic policy options, policy consistency and establishment of appropriate institutions. Variables considered in this respect include among others, inflation and interest rates for monetary policy, government debt and the fiscal position, the level and currency composition of foreign debt, the domestic financial sector, the level of international reserves, political stability, and the exchange rate.

The financial crises in the last decade have added another angle to the analysis of the world economic system. The absence of obvious economic links between affected countries during these episodes and the increasing importance of financial markets has concentrated efforts on finding economic elucidations for the crises. Policymakers have responded to the financial crises with a series of structural reforms to enhance the efficiency and robustness of policy. These reforms occur against a backdrop of an increasingly integrated global economic order.

In the context of globalisation, for the policy reform process to be effective, it is crucial that it is designed and implemented within the framework of a minimum of fundamental market institutions. The necessary institutions for this process include such components as functioning property rights, contract enforcement and supportive legal institutions. These institutions must be complemented by an adequate degree of articulation of key sectoral activities such as those in the financial and social sectors. In the absence or malfunctioning of these enabling conditions, any market-based economic policy cannot be expected to operate efficiently, as the policy transmission mechanisms that are intended to create the structure of incentives are blocked or perverted (Prabowo, 2002).

Following the political change in 1994, South Africa was faced with a challenge of developing an appropriate growth oriented policy regime encompassing a consistent set of fiscal, monetary and exchange rate policies, and their related institutional framework. Macroeconomic policy is but only one element in the set of government institutions that constitute the macroeconomic framework (Calitz, 2002).

The fact that macroeconomic equilibrium is the end result of a complex process of interactions between the economic environment, the policy regime, and the structure and capacity of institutions, raised the challenge for the new government in its designing, implementing and achieving the overall objectives of the macroeconomic strategy of growth, employment and redistribution (GEAR). And here lies the challenge for policy in South Africa.

This paper attempts to contribute to the above analysis by providing a critical appraisal of relevant approaches to macroeconomic policy design. To this end, the paper is organised as follows: Section 2, provides a brief theoretical underpinning of existing views on macroeconomic policy consistency. Section 3, proceeds to provide an analysis of the

consistency of the macroeconomic policy framework in South Africa, while at the same time examining trends in policy and analysing supporting evidence. Following this, Section 4, provides a brief theoretical overview of policy rules while Section 5, specifically discusses the development of fiscal policy rules. Section 6 of the paper then considers the appropriateness of adopting fiscal policy rules in South Africa and their institutionalisation. Section 7, then follows by analysing the challenges facing the adoption of these rules. The final section then provides a summary and concludes.

2.0 CONSISTENCY OF MACROECONOMIC POLICY

The goal of macroeconomic policy is to maintain an internal and external balance of the macroeconomic system through a combination of monetary, fiscal and exchange rate policies utilising appropriate institutional mechanisms. The macroeconomic policy mix is divided into two broad categories; namely, monetary policy and fiscal policy. In order to create an enabling environment for sustained growth, a country's policy mix should provide a stable, consistent and predictable financial system. To achieve these objectives there is a pressing need for the coordination of monetary and fiscal policy so as to make them internally consistent with each other. The consistency is necessary as the viability of either set of policies depends on the sustainability of the other (Laurens and de la Piedra, 1998).

In the above scenario macroeconomic crises can arise for several reasons, including the existence of an inconsistent or incompatible policy regime or weaknesses in institutional capacity. The relationship between monetary and fiscal policy comes into play with regard to how the government budget deficit is financed and how monetary policy complements the financing of the deficits. This interplay can be better understood from equation 1, adopted from Laurens and de la Piedra (1998: 10) showing the relationship between the government budget deficit and fiscal and monetary policy. Equation 1, is a simplified version of the economic relationships existing between fiscal and monetary policy. For a more advanced expositions of this refer to Auerbach and Hassett (2002), Buiter and Grafe (2002), Benigno and Woodford (2003) and Lambertini and Rovelli, (2003). For purposes of this paper we analyse the following relationship:

$$D_t = (B_t - B_{t-1}) + (M_t - M_{t-1}) \quad (1)$$

Where:

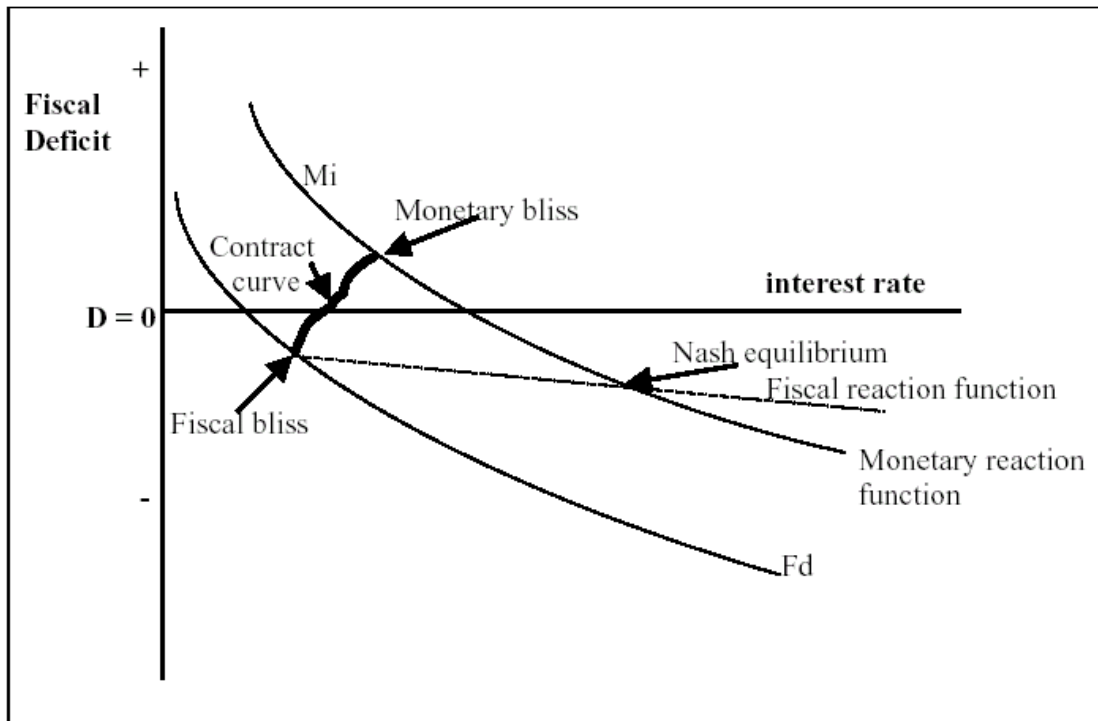
- D_t = Government Budget Deficit
- $(B_t - B_{t-1})$ = Net domestic and foreign Government bonds and;
- $(M_t - M_{t-1})$ = Change in monetary base due central bank credit to Government

Laurens and de la Piedra (1998) give three possible outcomes from the above relationship. Firstly, when there is monetary dominance, monetary authorities will employ market operations affecting $(M_t - M_{t-1})$ to determine the monetary base without consideration of the

financing needs of government. This would then result in either government arbitrarily reducing its deficit or relying on foreign borrowing or placing the debt on the domestic market with the consequent rise of interest bill pushing the fiscus into more debt. Secondly, the alternative is if fiscal policy is dominant using $(B_t - B_{t-1})$, the CB will then have to provide credit to government and if this exceeds the demand for real base money, inflation and depletion of international reserves would ensure. And lastly, if the two policies are implemented independently, the economy would produce a sub-optimal outcome with dual existence of high interest rates and high deficits. Consequently when foreign financing runs out, government will turn to domestic market and thereby drive interest rates higher and create a worse deficit position.

Diagrammatically the policy options are shown by figure 1, from Hall et al., in Ardy (2000). The diagram depicts monetary and fiscal policy game reaction functions in a fiscal deficit interest rate space.

FIGURE 1.



Source: Hall *et al.*, 1999: 8-12

In the diagram M_i represents monetary policy interest rate trajectory for every level of deficit to maintain price stability, while F_d shows the deficit the fiscus will set for given levels of interest rates to maximise their objective functions (Ardy, 2000). Monetary policy prefers a higher interest rate for given deficit while for the same deficit government would prefer a lower interest rate. In the policy game, the Nash equilibrium will be determined by the nature of decision making between the two authorities. If decisions are made independently, then the non-cooperative solution for monetary policy is to stick to M_i for a given deficit

while for the fiscus to operate along F_d for given interest rate levels. With a dominant monetary policy the fiscus will realize that raising the deficit will in turn affect interest rates therefore their reaction function will be less steep than the F_d line. This will result in a non-cooperative Nash equilibrium with the two reaction functions intersecting at a point that will exhibit a higher deficit and a higher interest rate than are desired by either authority (Ardy, 2000).

Subsequently, to get an optimal solution in the policy game the cooperative, Nash equilibrium will occur when there is policy coordination between the monetary and fiscal authorities. This solution in the diagram will be represented by the heavy dark curve between the points of monetary bliss and fiscal bliss. The contract curve is optimal for the economy and represents a compromise between the preferences of the two authorities.

The cooperative solution discussed above can be achieved by using either of two methods, they may decide to have extensive contact between the two authorities or they may opt to institutionalise the coordination by adopting policy rules. Whichever modality is adopted, it has to adhere to some elementary standards of coordination for it to be effective. The important elements of this coordination involve jointly setting the macroeconomic objectives of both the monetary and fiscal authorities.

Furthermore, separately and jointly the various components of macroeconomic policy should be sustainable, credible, and take cognisance of the different decision, implementation and impact time frames for monetary and fiscal policy (Laurens and de la Piedra, 1998). This is so under the realization that while monetary decisions can be undertaken virtually instantaneously, fiscal policy actions have to go through a political process. This creates a lag and may even result in decisions different from the government's initial intentions or end with no action at all. Policy is also conducted in an uncertain world and this may call for rapid action and the decision may have to be reversed when the previous forecasts turn out to be wrong and the fiscus is ill equipped to operationalise this. (Wyplosz, 2002).

The consequent coordination should ensure for example, that in the short run government's debt management operations must be consistent with the interest rate target of the monetary authorities whilst ensuring that in the long run, policy co-ordination realizes a stable economic environment and lower output volatility. This stable economic environment can only be attained by a macroeconomic policy mix that guarantees a stable financial environment free from fiscus.

3.0 POLICY DEVELOPMENTS IN SOUTH AFRICA

Following the political change, government has drafted and adopted a strong commitment to an outward orientated macroeconomic strategy for growth, employment and redistribution (GEAR). The document was published in 1996 and endorsed by the Minister of Finance. It provides a framework within which the government aims to rebuild and restructure the economy in keeping with the goals set in the Reconstruction and Development Programme (RDP). The GEAR document highlights the major

macroeconomic objectives of government and the strategies with which these are to be achieved. We will analyse the contents of this document in an endeavour to evaluate the consistency of the country's policy objectives. We will restrict the analysis of the country's policy changes to the period after 1994 as major structural changes occurred at that point, and will only refer to previous periods when a historical background is necessary.

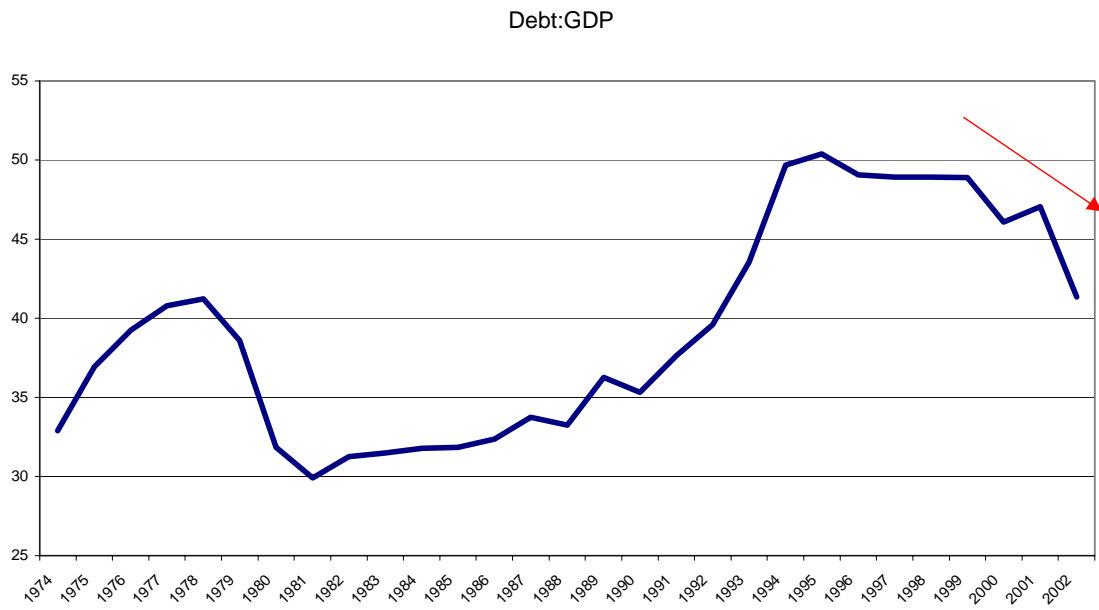
3.1 South African Policy Progression

An important component of the developments in South Africa was the adoption of the final Constitution in 1996, which catered for a market based economic system and binds future governments to implement policies that guarantee a market based economy and discourage policy inconsistency (Calitz, 2002). The constitution further made the South African Reserve Bank (SARB), instrument independent in meeting the objective of protecting the value of the currency in order to enhance balanced and sustained growth of the economy. This was consistent with the adopted GEAR.

In the year 2001, through the Budget Speech government decided to adopt an inflation targeting policy framework. To this end an inflation target range of 3 to 6 per cent for the year 2002 was set. This meant that the monetary policy started to target inflation directly instead of employing the previously eclectic monetary policy approach with intermediate objectives (Mboweni, 2000). As a new approach to monetary policy, government was of the view of taking advantage of some benefits that are consistent with such a policy approach. These advantages included enhancing the coordination of different components macroeconomic policy, improving the SARBs transparency, accountability and credibility vis-à-vis the objective and implementation of monetary policy. Further, inflation targeting is a forward looking framework of monetary policy that makes the stance of the central bank clear and consistent over time so as to improve planning in the private and public sectors. It thus aims at containing inflation in the pursuit of the broader economic objective of high economic growth and employment creation (Mboweni, 2000). The provision of an anchor for monetary policy would then make the policy approach credible, accountable and consistent in the planning horizons of economic agents. For further expositions on this approach to monetary policy refer to SARB quarterly bulletins (2000 – 2003), Bernanke and Mishkin (1997), du Plessis (2002). This paper focuses on the fiscus' input to policy achieving the above outputs.

In contributing to maintaining balanced and sustained growth, the fiscus has utilised its policy instruments to bring down government debt. To contain deficits the treasury has employed the mid-term expenditure framework and annual budgets as the instruments for coordination of fiscal policy. Though the implementation of fiscal policy has been discretionary, the fiscus has managed to reduce the debt levels since GEAR came into effect. This success maybe attributed the fact that the medium term expenditure framework has served as a constraint on the discretion. Figure 2, below shows the trend of debt to GDP. As can be seen from the graph, the fiscus since the implementation of GEAR has managed to reduce the debt burden that had been on the rise since the early 1980s. To date government is still in making progress in reducing the burden of its outstanding debt.

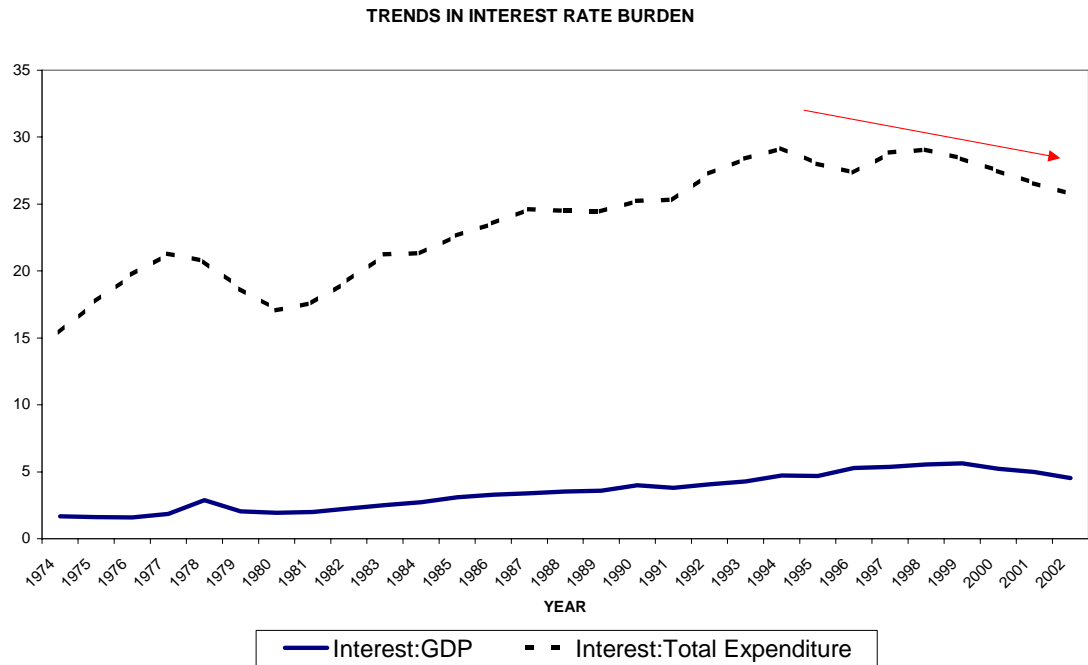
FIGURE 2



SOURCE: Data from SARB quarterly bulleting

Consistent with this trend has been a lowering of government's interest rate burden, implying that the fiscus has more resources to channel to other priorities including expenditure on potentially growth enhancing projects. Figure 3, shows the reduction in interest rate burden, firstly as a ratio of GDP and secondly as a ratio of total government expenditure.

FIGURE 3



SOURCE: Data from SARB quarterly bulleting.

In the above instance, budgetary discipline has implied the need to halt the continuous rise in government debt, as was the case during the 1980s. For South Africa, discipline has additionally meant reducing the debt to more acceptable levels. The determination of acceptable levels of a deficit is dependent on the level of economic activities and social commitments a government has made and hence it differs from one economy to the other. The reduction of the debt to an acceptable level cannot be achieved in a single year as government has expenditure obligations it cannot negate. Thus meeting this objective is a challenge fiscal policy can only meet in the long run. While aiming at this, in the short run fiscal policy should contribute to output and inflation stabilization by balancing the budget over the cycle (Wyplosz, 2002).

The debate on policy credibility relies heavily on how economic agents perceive fiscal policy actions. With regards to fiscal policy rules and the Ricardian equivalence, temporary tax measures are taken to be ineffective, as economic agents adjust their saving behaviour in accordance with the fiscal policy direction. On the other hand, permanent fiscal measures are of limited credibility as agents who realize the long run trade off for government financing equally discount them. In addition, if agents perceive the debt path to be unsustainable, restrictive fiscal policies can exert an expansionary effect especially when they are taken as stabilizing an explosive public debt (Wyplosz, 2002).

As Wyplosz (2002) further puts it, fiscal policy frameworks have to meet complex explicit and implicit objectives over time. The effectiveness of fiscal policy in meeting these objectives can be improved by increasing the visibility of implicit commitments and by eliminating the possibility of creative accounting. The heavy reliance of the process on

political procedures further complicates the credibility of the fiscus due to varying points of view to be considered. Policy co-ordination in this stance may adopt rules in these circumstances to improve the credibility of policy in the face of the credibility shortcomings of committing to implicit objectives.

3.2 Policy inconsistencies

While implementing inflation targeting monetary framework, the South African macroeconomic policy stance may suffers from lack of credibility to economic agents. The credibility shortfalls can stems from the policy design not taking explicit cognisance of the need for overall coordination of policy. The lack of explicit emphasis on co-ordination is analysed in terms of potential inconsistencies in the policy matrix. In recent literature focus has paid attention to credibility as a chief goal of policy co-ordination in policy design (Agénor and Montiel, 1998: 450).

Adopting an approach by Agénor and Montiel, (1999) we analyse some possible sources of inconsistency in South Africa's policy stance. To make a policy stance credible, there is need to make the entire policy package internally and externally consistent with other components of government policies. Thus for the country's anti-inflation program to succeed it requires appropriate fiscal reform which will ensure that policies are internally consistent. The reform in this area can take the form of adoption of fiscal policy rules while ensuring economic agents' expectations are formed on the basis of a consistent fiscal policy reaction function (Agénor and Montiel, 1999: 488-489).

Another problem that arises in the policy mix is the existence of time inconsistency. Time inconsistency in policy transpires when there is a possibility of a short run trade-off between various macroeconomic policy goals and output, but no long run trade-off. If economic agents realise that the fiscus values both of these goals, then they will not expect government to credibly commit to the long run goal in the face of the short-run trade-off. For fiscal policy specifically for the South African case, it can be an approach to reduce the debt burden through inflation (Agénor and Montiel, 1999: 489). This can clearly be inconsistent with inflation targeting. Thus government's credibility can be undermined as economic agents realise the trade-off and that the government has the incentive and the discretion to take advantage of the trade-off.

The effects of external and internal shocks also pose a problem for policy credibility. In the increasingly globalising economies, such shocks can have devastating consequences. The Asian crisis is a case in point. The impact of such shocks on discretionary policy may result in the policies being abandoned where as with rules a directional reaction function of fiscal policy will be anticipated. The way out of this is to have policy reaction functions that can be used as instruments and are consistent over time, and employment of fiscal policy rules can be such an instrument. Government's commitment, when only provided through rhetoric can further enhance policy credibility problems. This can occur when there is political uncertainty caused by a weak governing coalition or the existence of strong pressure groups (Agénor and Montiel, 1999: 492-493):

In assessing the credibility of South Africa's inflation targeting, a study of inflation targeting in emerging market economies ranked South Africa 14th out of 18 countries (Carare and

Stone 2003, in du Plessis, 2003). This ranking may be indicative of the country not having reached the level of credibility of other emerging markets like Korea or Thailand. Further employing a forward looking modality and an analysis of a wide range of macroeconomic variables and paying attention to policy consistency Carare and Stone's' sovereign credit rating, ranks the SARB's commitment below median of inflation targeting emerging market economies. Though this ranking has showed some measure of improvement, the internal policy mix still suffers from consistency and credibility shortcomings arising from the lack of an explicit coordination mechanism. Another nail into the credibility of the policy mix is exhibited by the survey of inflation expectations by the Bureau of Economic Research (BER) at the University of Stellenbosch, which has consistently recorded higher than targeted inflation levels. The survey shows forecasted inflation levels by different economic agents in the financial, business and labour sectors of the economy (BER, 2003). The lack of convergence between the forecasts and the target shows a lack of credibility of the target and may explain it never being met.

In trying to address some of these concerns the fiscus has utilised the Mid-Term Expenditure Framework and annual budget to show government commitment to meet set objectives and control the deficit. This has produced a reduced government deficit over the last few years but suffers from a lack of credibility due to its discretionary process. As Calitz (2002: 101) puts it, the country has had a lack of coordination within government for the implementation of policies. By implication, this calls for analysis of the possibility for institutional policy reform with the goal of improving the credibility of the overall policy mix.

4.0 THEORETICAL OVERVIEW OF POLICY RULES

An introduction to policy rules is usefully considered with reference to monetary policy but of relevance to all policy rules by utilising the definition by John Taylor (2000: 3), he defines policy rules as "a contingency plan that specifies as clearly as possible the circumstances under which a Central Bank should change the instruments of monetary policy". This definition implies that for a policy rule to be a credible rule, it must be used and its use be expected to continue in the future. With regards to the adoption of rules, neoclassical synthesis macroeconomic analysis suggest that the target for policy can be both nominal and real variables, whereas the classical or new classical macroeconomic paradigms support the neo-classical conclusion in the short-run, they conclude that in the long-run only nominal variables can be affected by monetary policy. The new Keynesians are in agreement with the neo-classical synthesis (Gerrald B, 1996). Thus for monetary policy there are three components to consider. These components include the objective, strategy and the institutional structure for implementing the policy framework. Thus the choice of rules and variables to employ presents a clear area for consideration of policy reform.

Whereas central bankers generally support making low and stable inflation the principal target of monetary policy, they require independent powers to determine when to effect changes in the monetary aggregate that is supposed to influence prices (Mishkin 1999). However, whether the objectives of monetary policy are to achieve economic stability, presupposes that the link between quantity of money and the target variable is predictable. If the link is not direct, but is through a proximate monetary aggregate, then the issue becomes

sequential, in the sense that the central bank has to predict the link between the proximate target and the ultimate target. Thus irrespective of what school of thought one uses, once the objectives of monetary policy are identified, the real work is to operationalise monetary policy. As much as monetary policy has continued to provide a framework for free market economies fiscal policy has started to progress in the same direction with a lag but recognizing the importance of institutions backed by a precise mandate. The approach to monetary policy has recently evolved and has started to pay greater attention to establishing institutions and delegated the implementation of policy to them. Thus appointed Monetary Policy Committees (MPCs), are assigned a clear tasks of maintaining price stability, and enhancing the credibility of the policy regime (Wyplosz, (2002).

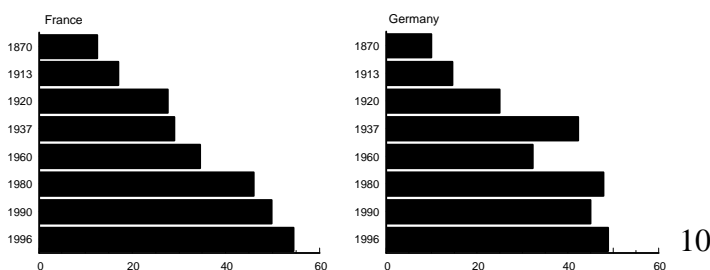
5.0 DEVELOPMENT OF FISCAL POLICY RULES

There are many definitions for fiscal policy rules, but for the purposes of this paper, we will define fiscal policy rules simply as a set of statutory or constitutional restrictions on fiscal policy that put a limit on some fiscal indicator such as the budgetary balance, debt, spending, or taxation (Kennedy and Robbins, 2001). In contributing to financial stability in an economy, fiscal policy can be employed as a macroeconomic instrument ensuring that the deficits are balanced over the cycle while functioning as a counter-cyclical instrument. As policy rules are sometimes perceived as being rigid, an increasingly important approach has been to build institutions that create appropriate incentives for policy makers to better optimize fiscal policy objective functions (Wyplosz, 2002)

The use of fiscal policy rules and their supportive institutional arrangements, are increasingly receiving attention in public finance and macroeconomics. This trend has greatly been encouraged by the realisation in many economies that discretionary demand management has delivered increased government expenditure that have not been consistent with revenue potential (Kopits, 2001). Public choice economists have analysed the problem of the size of the government on empirical as well as theoretical grounds (Sharipova, 2001).

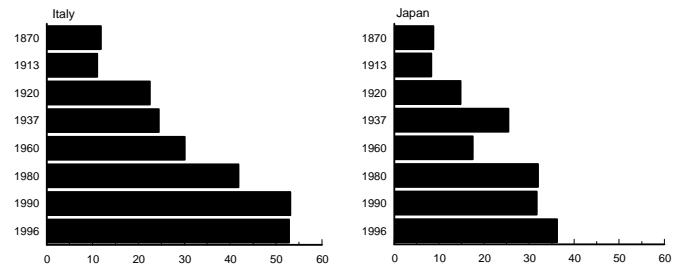
During the last few decades the phenomenon of public expenditure growth has occurred widely, apparently irrespective of the nature of either the political or economic systems concerned. In a study by Seeber and Dockel (1978), quoted by Black et al., (1999), high-income elasticities were found for a majority of government expenditure in many countries implying increasing expenditure with GDP (Black et al., 1999). South Africa has not been an exception to this trend. The trend only changed during the last two decades that have seen some developed countries reduce their share of government expenditure. The two diagrams below from the IMF (quoted in Agénor, 2000) depict this trend.

Figure 3.3a
Industrial Countries: Government Spending, 1870-1996
(In percent of GDP)



Source: International Monetary Fund.

Figure 3.3b
Industrial Countries: Government Spending, 1870-1996
(In percent of GDP)



Source: International Monetary Fund.

5.1 Advantages Of Fiscal Policy Rules

In theory, discretionary policy can achieve the same outcomes as fiscal rules, and should in fact be superior because it allows greater flexibility. However the practical experience with fiscal policy has been more sobering, with policy makers finding it difficult to use the policy to its calculated effect on account of the long and variable lags of fiscal policy, which led to overshooting and or delays in policy adjustments (Friedman, M 1968).

The major problem with discretionary fiscal policy derives from government's commitment problem. The problem is more visible with the modern approach to macroeconomics that stresses the importance of forward-looking behaviour and rational expectations of economic agents. Thus fiscal policy rules may be used to address government's inclination to adopt a short time horizon, resulting in socially suboptimal policy choices over time.

The argument is that discretionary fiscal policy distorts the long run relationship between the policy maker and economic agents. This distortion is caused by the inability of discretionary fiscal policy to commit to a pre-announced policy path in multi-period scenarios. At period t , the chosen policy path is optimal given the domestic and international economic conditions. But in period $t + 1$, when or if some variables have changed or ceased to exist the re-optimisation of fiscal policy will suggest a change of policy stance from that adopted in period t . Under discretionary fiscal policy it will be rational for government to abandon its earlier commitment for the re-optimised scenario. Since decision makers with rational expectations know this, the government's initial commitment will lack credibility, too. Thus governments with discretion suffer from a credibility problem.

Credibility can be achieved in this case by the use of rules that will commit fiscal policy to the obligations it made in period t . Further, present or future governments, for any number of reasons, may fail to implement optimal fiscal policy measures due internal or external pressure².

To avoid discretionary distortions another advantage of fiscal policy rules is that they specify the earlier mentioned contingent plan that specifies clearly and consistently the adjustment mechanisms of the policy framework over a long time horizon. Due to some of the above-mentioned potential distortions that fiscal authority can cause in an economy, fiscal rules may be viewed as the best alternative for a benevolent social planner (Kennedy and Robbins, 2001).

In the modern approach to fiscal policy, attention to fiscal policy rules has been further motivated by the success of monetary policy rules in macroeconomics. Just as in monetary

² Additionally, after allowing for forward looking expectations, policy design can only be invariant to policy changes if the policy itself is based on rules that clearly stipulate how future policy adjustments will be modelled (du Plessis, 2003).

policy, fiscal policy rules are being considered and introduced in an effort to constrain ad hoc counter cyclical actions which have not had great success in lowering output volatility and have lead to long run costs of excessive debts (Romer, 1999).

A further advantage of rules is that they make the objectives of fiscal policy clear and consistent and thereby facilitates planning in the private and public sectors. The rules are also expected to assist in formalising a co-ordinated approach to contain excessive debts in the pursuit of the broader economic objective of sustainable economic growth. By being transparent and informing economic agent of the goal variables and relative weights used, rules provide a forward-looking framework which private agents could incorporate in their decisions, especially in the formation of expectation (du Plessis 2003). They also assist in focusing the role of fiscal policy and enhancing the accountability of the fiscus to the public and contributing to the credibility of the overall policy mix.

In practice, fiscal rules have been adopted for a variety of reasons, significant among these have been macroeconomic stability, as in the case of post-war Japan; enhancing the credibility of the government's fiscal policy stance and aiding in deficit elimination, as in some Canadian provinces; to ensure long-term sustainability of fiscal policy, as in New Zealand; and to minimize negative externalities within an international arrangement, as in the European Economic and Monetary Union (Kennedy and Robbins, 2001). The major instrument for the implementation of these fiscal policy rules is through the budget process and for several developed and developing countries, this is being implemented in the context of a medium term expenditure framework.

5.2 Budget Process

As alluded to above budgeting in most of developed and developing countries have recently started using medium term macroeconomic frameworks, from within which the annual budgets are developed. As Kopits explains, this framework strengthens the use of rules, as it is able to signal to economic agents the adjustments that are required to adhere to the rule over time (Kopits, 2001). In the case of South Africa, the budget process already uses a medium term expenditure framework. Therefore a further move towards adopting rules may only require that the budgeting process enhance the use of the already existing automatic stabilisers that ensure elements of unforeseen circumstances are corrected in the process and this should be communicated to the public

5.3 Transparency criteria

Policy makers gain the flexibility to respond to unforeseen circumstances by deviating from the policy rule, only when the policy rule is credible in the long run. As long as the rule retains its credibility the government need not engage in creative accounting to appear consistent with the rule at all times. On the contrary, the credibility of the rule allows the government to explain why specific circumstances have made it desirable to deviate from the rule, and how the government intends to return to the rule. That is to say, a credible rule guides policy under "normal circumstances" and also defines the discretion exercised in

exceptional circumstances. Part of the process of achieving credibility is to consistently deliver the targets set in medium term expenditure framework and for the institution to be transparent in its setting and achieving goals, objectives, instruments and targets. Transparency can only be achieved by having consistent reporting mechanisms that are comprehensive and timely (Kopits, 2001). These are the components which institutionalisation of fiscal policy, with the use of rules, can deliver.

5.4 Penalty for non Compliance

A principal-agent framework is often used to describe the various components of rule-like policy. First, policy objectives have to be defined and a procedure developed for the systematic pursuit thereof. But an important subsequent step is to define a monitoring and penalty mechanism that will encourage implementation of the rule. The adoption of policy rules will require appropriate institutions for monitoring policy makers as a part of the overall macroeconomic policy. Where rules have been established, there has been the need to also put in place penalties for non-compliance by the authorities. These can be the termination of contracts of the implementing individuals. A penalty for non-compliance can also be loss of credibility which means that economic agents will not believe the rules will be adhered to and thus their expectations become self-fulfilling as the government reacts to the expectations of economic agents ex-post and thereby rendering the rule inadequate.

It should be understood that fiscal discipline is not guaranteed, even in the presence of the most effective fiscal rules, for these to deliver results the country needs political commitment to ensure that the rules are not to be circumvented. The imposition of a fiscal rule may then denote a simple trade-off between window-dressing through creative accounting and real fiscal adjustment (Kennedy and Robbins, 2001).

TABLE 1

Total Government Structural Balance

% of GDP

	1995	1996	1997	1998	1999	change from 1995 to 1999
Countries with legislated fiscal rules						
United States	-3.0	-2.3	-1.1	0.0	0.7	3.7
Germany	-2.7	-2.4	-1.6	-1.2	-0.5	2.2
France	-4.6	-2.8	-1.7	-1.8	-1.3	3.3
Italy	-7.2	-6.5	-2.0	-2.0	-0.8	6.4
New Zealand	2.5	2.4	1.7	2.5	0.7	-1.8
Sweden	-6.9	-1.9	-0.5	2.9	2.1	9.0
EU-11 weighted average	-4.1	-3.0	-1.4	-1.3	-0.6	3.5
Countries without legislated fiscal rules						
Canada	-4.4	-1.6	1.0	0.9	2.3	6.7
Japan	-3.1	-4.4	-3.6	-4.2	-6.0	-2.9
United Kingdom*	-5.0	-3.8	-2.1	0.2	1.1	6.1
Australia*	-3.5	-2.0	-0.4	0.3	1.6	5.1

Source: OECD Economic Outlook, December 2000.

* Note that the United Kingdom and Australia have legislated fiscal frameworks with non-legislated numerical rules. (Adopted from Kennedy and Robbins, 2001)

Several developed economies have implemented fiscal policy rules with a high degree of success in limiting the fiscal deficit. Table 1, shows the evolution of structural balances relative to GDP for a number of developed countries from 1995 to 1999. The table indicates that most countries with fiscal policy rules improved their fiscal position during this period. A notable exception to this is New Zealand, which had already attained a fiscal surplus in 1995. It is interesting to note that both countries with fiscal policy rules and those without had improved balance positions (Kennedy and Robbins, 2001). Japan is also the exception here as it was engaged in deficit spending in an effort to combat a major economic downturn. United Kingdom and Australia, though not having numeric legislation on deficits, have legislated frameworks that make them similar to rules and may account for their exhibited success. Further, their having explicit monetary policy rules which may necessitate rule like fiscal policy. This shows that having legislated fiscal rules is not a necessary condition for successful fiscal policy but is a modality that has made fiscal policy predictable. Predictability of fiscal policy feeds into economic agents' expectations and thereby facilitates monetary policy by lowering inflation expectations in the economy.

6.0 ADOPTION OF FISCAL POLICY RULES IN SOUTH AFRICA RECOMMENDATIONS

6.1 Objectives

The major objective for adopting fiscal policy rules in South Africa will be to make budgetary discipline predictable and to establish credibility of the fiscus and their macroeconomic policies. The South African Government has been consistent in reducing their budget deficit but the decisions have been discretionary. Economic agents on the other hand are sceptical about discretionary fiscal decisions and hence a need to adopt fiscal policy rules that can be institutionalised, so as assure market participants of the fiscus reaction function given divergent economic scenarios. The specific objectives are adopted from du Plessis' cited advantages of inflation targeting and applied to fiscal policy rules (du Plessis, 2003). Here the rules will contribute to the co-ordination of fiscal and monetary policy at the macro level and ensure debt sustainability. They will also provide a forward-looking framework for policy and by focussing on the future, the fiscus will be able to avoid the "stop-go" response to present economic circumstance that have been typical of poor discretionary policy (du Plessis 2003, p 29.). In this way policy rules may contribute to expectation formation and stability in the country.

6.2 Preconditions and Time Plan

Due to some peculiarities in the country, several preconditions have to be fulfilled before fiscal policy rules can be objectively implemented. Firstly, the tax structure has to be revised so as to broaden the base and make collection more efficient, this is a process recognised in GEAR and is under implementation. Secondly, the need then arises to appoint or create an independent institution to implement the macroeconomic components of fiscal policy. As the policy framework can be divided between the distributional component and the

macroeconomic component, delegating it to an instrument independent authority can institutionalise the macroeconomic fiscal component of policy. Thirdly, after the appointment of qualified agents to handle the macroeconomic aspects of fiscal policy and required constitutional amendments to give them appropriate power, an all-encompassing education campaign has to be devised and implemented to inform economic agents of the new fiscal stance and government's commitment to it. Lastly, in order to operationalise, these rules South Africa would need to continue its structural reforms to ensure sustainability of the rules and then develop a roadmap of how the rules will be effected over time (Kopits, 2001). The roadmap will be of the form of medium term frameworks that are already being used in the country but structured for implementation in an institutionalised context.

6.3 Operational Mechanism

Since the objective of fiscal policy rules will be to install budgetary discipline, for South Africa this will entail a continuation of the implementation of the multi year frameworks that aim at reducing the debt to sustainable and acceptable levels. Two modalities for sustainability have been suggested. The first modality is one that employs automatic stabilisers to keep the debt/GDP ratio at the set level. The second modality has been the draw down or accumulation of reserves (Kopits, 2001). For an emerging market economy the operational mechanisms can be the achievement of a balanced budget over a cycle. This balance should include debt repayments. Another mechanism can be a commitment to stabilise the debt to GDP ratio over time (Wyplosz, 2002). The challenge will be in defining the appropriate explicit target for debt levels that can be sustainable and lies in establishing supportive institutions for the process. A serious concern about fiscal rules is that they may be overly restrictive and limit a government's ability to engage in legitimate countercyclical fiscal policy when required, thus legislation must be written in such a way that it provides some flexibility to the executing institution, in order to be functional, yet not be so lax as to become a non-binding constraint (Kennedy and Robbins, 2001). The institution will then use instruments provided to it to ensure deficit management is consistent with monetary policy objectives.

6.4 Institutional Arrangements

The enactment of fiscal rules raises a number of issues concerning flexibility, credibility, and transparency. In many of the countries that have introduced policy rules, the function has remained under the treasury. The treasury has mostly been reorganised so as to operationalise the rule. What will be important here will be the appointment of an independent authority like the FPC. This will then involve a delegation by the principal who will entrust an agent to deliver a particular task and in this regard much has been learnt from the experience of central banks. In institutionalizing fiscal policy, the principal still remains the people through elected representatives. The key advantage is that the agent will be given a mandate to exercise judgment depending on the existing conditions in the economy.

As monetary policy has exhibited, institutions that are independent of political pressure better implement policy rules. As fiscal policy is a public good, its implementation cannot

easily be removed from elected representatives. The option is to establish an institution and grant it instrument independence while the goals of fiscal policy remain with elected representatives. Wyplosz (2002) here differentiates two tasks of fiscal policy which are the structural and redistributive tasks and macroeconomic (Wyplosz, 2002). The distributive elements of policy has to remain with parliament but the macroeconomic components of stabilisation and development planning, which involve the budget process, can be delegated to an independent authority. As mentioned earlier, a principal agent relationship can be established where the independent authority can be granted a constitutional mandate and subsequently be able to exercise judgement on debt levels.

As alluded to above, a Fiscal Policy Committee (FPC) operating on the lines of the Monetary Policy Committee (MPC) can be established. The FPC would then consist of a convenient number of appointed persons for a non-renewable tenure. The tenure should not be renewable to ensure that appointed individuals do not make decisions with the aim pleasing the appointing authority so as to be reappointed. Wyplosz (2002) argues that the FPC would have to deliver debt sustainability over an appropriate horizon but have the discretion of annual surplus or deficits as is justified by current analysis. And this decision by force of law would be imposed on government. Here the FPC would have no control over the distributive components of the budget regarding size, tax structure and allocation of spending, while the FPC will check the budget before it is approved (Wyplosz, 2002). Escape clauses would also be set for debt sustainability to cater for exogenous disturbances (i.e. national calamities), but should be so designed as to ensure evoking it is extremely difficult.

Fiscal policy rules in provinces can also be designed in the same manner. Caution should however be taken to ensure that fiscal policy rules are consistent with the overall macroeconomic framework and appropriate mechanisms are put in place to address regional specific shocks. As the introduction of policy rules and FPCs would take time the option would be to form working groups that can have a similar mandate while waiting for the formation of a FPC.

7.0 CHALLENGES OF ADOPTING FISCAL POLICY RULES IN SOUTH AFRICA

Rule like fiscal policy has been attempted by a number of developing countries. These took the form of adoption of the IMF Structural Adjustment Programmes (SAPs) that stipulated explicit fiscal objectives with sanctions of programme cancellation for non-compliance. The programmes that have not been very successful have been attributed to lack of supportive institutions and their not been taken as credible by economic agents (Wyplosz, 2002). For South Africa, the implementation of fiscal policy rules will require the existence of supportive institutional and human capacity, political commitment and public confidence. To this end, the introduction of fiscal policy rules first dictates a continuation of the political commitment to control deficits and the high levels of public debt. This will involve a change from reliance on discretion to having rules that will be implemented by an appropriate institution.

With the establishment of fiscal policy rules to complement inflation targeting, the policy will be in a better position to enhance its credibility. This credibility will ensure that savers and investors factor in low inflation expectations in their decision making process and hence not push the economy to higher inflation levels. Policy rules will, in this way, contribute to changing expectations that are currently cynical due to the fact that the target range for inflation has never been met, and hence agents need to be given a new reason to believe it will be met.

8.0 CONCLUSION

The introduction of fiscal policy rules should be so designed using a specific roadmap for the introduction of the policy rules. This roadmap will include proposed constitutional and legislative amendments and necessary institutional changes for their adoption. These designs should all be done in the context of achieving sustainable debt levels and contributing to economic growth in a globalised environment. They should also then consider how their objectives, operational and institutional mechanisms for policy rules will be sold to economic agents whose expectations will ensure the success of the policy change. The fiscus should also realise that this will be a long process and will be better designed over a long period using medium term frameworks. Credibility will only be achieved by working for it.

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