# CHAPTER 1
# INTRODUCTION AND BACKGROUND

## 1.1 INTRODUCTION

Apart from contributing to a more efficient allocation of resources and a fair income redistribution, fiscal policy also pursues the objective of stabilising economic activity. The stabilisation function of fiscal policy is seen as beneficial both from a microeconomic (to smooth taxes and consumption over time) and a macroeconomic view (to avoid excessive output and employment variability and boom-bust fluctuations). High macroeconomic volatility is particularly harmful to the poor as they are unable to adapt their skills to downturns in labour markets and have less assets and access to credit to facilitate consumption smoothing. Thus, there may be irreversible losses in nutrition and educational levels should no appropriate safety nets be provided (Perry 2003:4).

Stimulatory monetary and fiscal policies played an important role during the world economic slowdown of the past two years as reflected in low interest rates and widening public deficits in many countries. Stabilisation could result from discretionary policy-making, when governments actively decide to adjust spending or change revenue flows in response to changes in economic activity. By contrast, government revenue and expenditure patterns can also adjust automatically in response to macroeconomic fluctuations (without any deliberate government action) in such a way that the business cycle is smoothed. Thus, the inherently procyclical nature of many revenue sources and the countercyclical behaviour of some expenditure components act as automatic fiscal stabilisers.

In assessing and formulating fiscal policy, actual budget balances need to be corrected for the effects of the business cycle in order to analyse the underlying or structural budgetary positions, the fiscal stance and the demand impact of fiscal policy. Weak fiscal policy could sometimes be masked temporarily by a strong revival in the economy, whereas during a recession, conversely, a strong fiscal stance on fiscal policy could be undervalued due to a cyclical downturn. The influence of cyclical fluctuations in economic activity on the budget balance therefore needs to be examined if fiscal developments are to be monitored accurately.

The discussion of automatic fiscal stabilisers has become more immanent since the introduction of the Maastricht criteria and the Stability and Convergence Programs in the eighties and nineties. Automatic fiscal stabilisers have long been suggested to be an effective instrument for overcoming the problems of discretionary policy. Its potential to be used as powerful countercyclical weapons is being recognised by many countries and international organisations.

This study addresses the government's stabilisation goal, with particular reference to the role and impact of automatic fiscal stabilisers. The aim of this study is to evaluate the role of automatic fiscal stabilisers in the South African economy and to quantify the cyclically adjusted budget balance as an alternative fiscal indicator that could contribute to more effective fiscal policy in South Africa. In a broader context, the study also highlights the macroeconomic stabilisation potential of automatic fiscal stabilisers in the New Partnership for Africa's Development (NEPAD) Program.

## 1.2 STATEMENT OF THE RESEARCH PROBLEM

This study reviews the stance of fiscal stabilisation policy in South Africa, considering the extent of its use, its successes and failures, and the extent to which alternative fiscal policies have been implemented. One key problem for an empirical analysis of fiscal policy is to separate the impact of discretionary policy actions from the aggregate data available. The main methodological problem is that budget variables not only change in reaction to discretionary policy, but also because of automatic stabilisers built into the tax and welfare system of the economy. Thus, the main aim of this study is to identify, analyse and document the types, size, role and impact of such automatic stabilisers in South Africa. The potential and significance of automatic fiscal stabilisers as stabilisation instrument is highlighted, together with some guidelines to indicate how they should be implemented and managed. The business cycle effects of both discretionary fiscal policy and automatic fiscal stabilisers are analysed during the period 1970 to 2000 and the cyclically adjusted budget balance of the consolidated general government is estimated as an alternative fiscal indicator that could contribute to more effective fiscal policy and fiscal analysis. The usefulness of alternative indicators, such as the cyclically adjusted budget balance, is also highlighted in Jacobs (2002), who argues that South Africa should move away from using just the conventional budget balance as fiscal indicator.

## 1.3 RESEARCH METHODOLOGY

The study is predominately a literature study that draws upon econometric techniques in order to determine the significance of automatic fiscal stabilisers and fiscal stabilisation in general in South Africa. Standard norms and criteria to evaluate automatic fiscal stabilisers are presented, analysed and documented. Conclusions are drawn and results are derived by means of econometric techniques as well as from graphic illustrations and tables. With the objective of basing the analysis on sound economic and statistical theory, the study starts with an overview of the literature underlying automatic fiscal stabilisers. Thereafter, the most useful techniques identified are used to cyclically adjust the fiscal scenario. The results for South Africa were then compared with other developing countries. Finally, the stabilisation role of government under the New Partnership for Africa's Development (NEPAD) is assessed.

The main focus is on the macroeconomic stabilisation functions of government - the use of taxing, spending and other policies to affect the overall level of unemployment and the price level in the economy. Certain normative aspects are also highlighted in view of the moralistic issues involved in judging the outcome of government taxing and spending activities and the levels thereof. The study therefore explains both positive and normative aspects of fiscal stabilisation.

## 1.4 OUTLINE OF THE STUDY

The study consists of eight chapters supported by a number of graphs and tables. The introductory chapter describes the background and objective of the study, the statement of the research problem, the research methodology and the outline of the study. Chapter 2 describes the theoretical literature on the effectiveness of fiscal policy. The chapter differentiates between discretionary and non-discretionary policies, describes the usefulness of budget rules and discusses the linkages between monetary policy and fiscal policy.

In Chapter 3 automatic fiscal stabilisers are defined, the various types of automatic fiscal stabilisers described, their role and effectiveness analysed and the main determinants regarding their size documented. The main advantages and disadvantages of automatic fiscal stabilisers are evaluated together with a discussion of the various ways in which they could be measured. Chapter 3 also provides some international empirical evidence of the usefulness of automatic fiscal stabilisers, highlights some supply-side considerations that are often neglected, addresses the question whether the level of government at which fiscal stabilisation occurs has any effect on its net impact and reviews the main aspects regarding cyclically adjusted budget balances.

Chapter 4 analyses the South African business cycle and the main features and trends in the South African government finances. It also peruses the fiscal policy objectives pursued in South Africa during the period 1970 to 2000, as these aspects impacted directly on the size of automatic fiscal stabilisers. In the chapter the course, strength and duration of the South African business cycle are illustrated, with an outline of the reasoning behind its performance over the years. Some insight into the magnitude and composition of government revenue and expenditures is provided, together with a comparison between South African government finances and some developing countries.

In Chapter 5 the relevance of tax revenue as an automatic fiscal stabiliser in South Africa is investigated through an empirical analysis of its role and impact since the 1970s. In the chapter estimates are provided of the sensitivity of tax revenue flows with respect to output. The cyclical and structural components of tax revenue are estimated and compared with tendencies in other developing countries.

The role and impact of the South African Unemployment Insurance Fund as an automatic fiscal stabiliser is investigated in Chapter 6. Firstly, the main features of the South African Unemployment Insurance Fund are outlined. Thereafter, the stabilising properties of various expenditure categories are evaluated and the impact of the new Unemployment Insurance legislation on the stabilising role of the Unemployment Insurance Fund is discussed. Finally, these results are compared to similar tendencies in other developing countries.

Chapter 7 really contains the heart of the research results with the quantification of a cyclically adjusted budget balance as an alternative fiscal indicator for South Africa that can contribute to more effective fiscal policy implementation and analysis. Moreover, the results obtained from Chapters 5 and 6 are used to analyse the total impact of automatic fiscal stabilisers and discretionary fiscal policy on the South African economy. In the chapter the fiscal stance in relation to cyclical conditions is examined in an attempt to find an answer to the question whether the policy mix is appropriate to provide conditions conducive for economic growth and macroeconomic stability. In addition, the effectiveness of automatic fiscal stabilisers at lower levels of government in South Africa is investigated together with an evaluation of the role of fiscal policy under the New Partnership for Africa's Development (NEPAD).

Finally, Chapter 8 concludes and puts some suggestions forward for future research.