

## CHAPTER 2

### FISCAL STABILISATION POLICY

#### 2.1 INTRODUCTION

During the recent world economic slowdown, great emphasis was put on fiscal policy to stimulate the economy as reflected in generally widening budget deficits, with some governments in the euro area even breaching the 3 per cent deficit limit putting pressure on the credibility of the Stability and Growth Pact. These effects, for example, took place in the form of extended unemployment insurance benefits in the United States and proposed tax cuts in the United States and Germany. The economic policies used by government to smooth the extreme swings of the business cycle are called countercyclical or stabilisation policies. Fiscal policy instruments can contribute to the stabilisation of the economy to the extent that they could stabilise output, income and demand during an economic downturn by maintaining or even increasing government expenditure, or by reducing tax revenue. By the same token, restrictive fiscal policies could moderate activity during periods of strong growth. Macroeconomic policy has a key role in delivering economic stability. Unpredictable fluctuations in output, employment and inflation are disruptive, and can delay the economy's long-term potential growth. By contrast, economic stability helps firms, households and Government to plan effectively for the long term.

The use of fiscal policy as a stabilisation instrument, however, proved to be complicated. There are many factors that contribute to the frequent divergence of fiscal and economic outcomes from government's plans. These factors include, for example, uncertainty regarding the impact of fiscal measures on the economy, uncertainty as to the present and anticipated economic conditions, the lag between fiscal decisions and their implementation, the possibility of conflict between political and fiscal policy objectives and the complexity of intergovernmental financial relations. Moreover, fiscal instruments have behavioural and structural consequences and their use for stabilisation purposes may conflict with other government objectives. The government's budget

serves many purposes besides stabilisation, and much of government spending is committed years or even decades in advance. Expanding or contracting government expenditure rapidly for macroeconomic stabilisation purposes is therefore difficult without either spending wastefully or compromising other fiscal policy objectives. The same applies to taxes. Although taxes are somewhat easier to change, the tax laws could have many different objectives.

Fiscal policy could play an important countercyclical role in a small open economy such as South Africa where external shocks may arise due to its vulnerability to global economic conditions. Fiscal policy could be used as a stabilising instrument of economic activity either through the effects of built-in automatic stabilisers or through discretionary tax and expenditure measures, or through a combination of both. However, the structure of revenue and expenditure of the public sector is crucial in determining the capacity of government to use the budget as an effective macroeconomic policy instrument. The sustainability of public finances and the stabilising role of fiscal policies are closely linked. Persistent deficits undermine the stabilising role of public finances. When countries continuously incur additional liabilities, governments lose the necessary room for manoeuvre to let public finances react appropriately to macroeconomic fluctuations over the business cycle. Countries with unsustainable deficits face unavoidable and disruptive large-scale adjustments in the future.

If one argues that fiscal stabilisation policy is desirable, the question arises as to what policies and instruments will be the most effective and what will the effect of these policies have on other macroeconomic policies and variables. These issues are dealt with in the remaining sections of this chapter. The next section describes the theoretical literature on the effectiveness of fiscal policy. Section 2.3 differentiates between discretionary and non-discretionary policies, while Section 2.4 describes the usefulness of budget rules in stabilisation policy. Finally, the linkages between monetary policy and fiscal policy are discussed in Section 2.5.

## 2.2 THEORETICAL LITERATURE ON THE EFFECTIVENESS OF FISCAL POLICY

According to Fatás and Mihov (2002:6), mainstream macroeconomic theory predicts that fiscal policy is not neutral with respect to output – changes in spending or taxes exert a strong influence on the economy in virtually every macroeconomic model. In the standard Keynesian models, the effect arises from aggregate demand, while in dynamic general equilibrium models of the real business cycle type; output changes because fiscal policy affects the incentives to work and to save.

Hemming, Kell and Hahfouz (2002) highlight the theoretical literature on the demand-side effects, supply-side effects and institutional aspects of fiscal policy. Theoretical literature on the effectiveness of fiscal policy spans the simple Keynesian model, closed and open economy IS-LM models, demand-side models incorporating rational expectations, Ricardian equivalence, interest rate premiums, credibility, uncertainty and supply-side models. The authors argue that literature suggests fiscal multipliers will tend to be positive and possibly be quite large when there is excess capacity, the economy is either closed or open and the exchange rate is fixed. Furthermore, households have limited time horizons or are liquidity constrained, increased government spending does not substitute for private spending, government debt is low and the government does not face financing constraints, and there is an accompanying monetary expansion with limited inflationary consequences. On the other hand, fiscal multipliers are likely to be smaller, and could turn negative when there is crowding out, either directly as government provision substitutes for private provision and through imports or as interest rates rise and a flexible exchange rate appreciates in response to a fiscal expansion. Furthermore, households are Ricardian, in which case a permanent fiscal expansion could reduce consumption, there is a debt sustainability problem and risk premia on interest rates are large. Finally, expansionary fiscal policy increases uncertainty, which leads to more cautious saving and investment decisions by households and firms.

On the demand-side effects of fiscal policy, the Keynesian model assumes price rigidity and excess capacity so that output is determined by aggregate demand. In this model, a fiscal expansion has a multiplier effect on aggregate demand and output, and the Keynesian multiplier exceeds one – it increases with responsiveness of consumption to current income and it is larger for spending increases than for tax cuts. The balanced budget multiplier is exactly one if a spending increase is matched by a tax increase. It can generally be observed that prices are flexible. Fiscal action is therefore relatively less effective at demand management as what the Keynesian model suggests. However, a high degree of price flexibility also mean that fiscal action is less likely to be required as greater wage and price flexibility reduces the importance of stabilisation in the face of demand or supply shocks. Rapidly adjusting prices and wages would reduce the extent to which output and employment respond to, for example, a negative demand shock. Greater flexibility therefore reduces both the effectiveness of fiscal stabilisation and the need for it in the first place.

Extensions of the simplest Keynesian model allow for crowding out through induced changes in interest rates and the exchange rate that is additional to direct crowding out that affects the size of fiscal multipliers but does not change their sign. Private investment depends negatively on interest rates in the standard IS-LM model to the extent that a fiscal expansion paid for by increased borrowing leads to higher interest rates that reduce investment. In the open economy IS-LM (Mundell-Fleming) model, there can also be crowding out through the exchange rate, as higher interest rates attract capital inflows that appreciate the exchange rate, resulting in deterioration in the external current account that could offset the increase in domestic demand deriving from a fiscal expansion. The appropriateness of the IS-LM framework can be questioned in the sense that it assumes prices are fixed and hence ignores the supply-side of the economy. Output is effectively demand-determined. This may still be a reasonable short-term assumption if wages and prices are slow to adjust and movements in aggregate demand are initially caused by movements in output rather than prices. But it is unlikely to be helpful in analysing the longer-term effects and it could be highly misleading were the speed of adjustment of wages and prices to change relative to previous experience.

The non-Keynesian effects of fiscal policy emerge from new classical models, which address well-known shortcomings of the Keynesian approach, and in particular, its lack of microeconomic foundations. Although some variants of the Keynesian approach recognize the role of expectations, they typically rely on adaptive expectations. Rational expectations tend to bring forward adjustments in variables that would occur more progressively with adaptive expectations so that longer-term effects of fiscal policy will matter, even in the short term.

The way in which consumers are perceived to respond to changes in the government's budget balance is therefore a crucial element in fiscal stabilisation policy. The impact of fiscal policy on aggregate demand depends on the marginal propensity to consume and on the foresight on which consumers base their decisions. To a considerable degree households smooth consumption over time due to their expectations of future income. The less liquidity-constrained consumers are, the more feasible is this smoothing. An implication of this forward-looking behaviour is that the responsiveness of consumers to changes in the government's fiscal policy may differ, depending upon whether it reflects a permanent or temporary change. Both the overlapping generations and the Ricardian models attribute considerably greater weight to the longer-term consequences of fiscal policy than to the current changes in fiscal variables. Full Ricardian equivalence is highly unlikely, but as long as there is a degree of consumption smoothing by households, the impact of any discretionary fiscal policy will generally be reduced.

Fiscal policy will therefore be less effective in altering aggregate demand if consumption depends on future as well as on current levels of income (Chouraqi, Hagemann and Sartor 1990:2). A fiscal stimulus to aggregate demand will be offset if consumers reduce or increase current consumption expenditure when they expect to pay higher or lower taxes in the future as a result of government deficits or surpluses today. Friedman's permanent income hypothesis and Modigliani's life-cycle theory of consumption are particularly important in this respect. Friedman argued that welfare maximising individuals formulate their consumption decisions on the basis of what they expect their

permanent income to be. Thus, tax cuts only stimulate consumption expenditure to the extent that higher taxes are not anticipated in the medium term to service future deficits. Hence, a short-term tax cut for cyclical demand management purposes would be unlikely to boost consumption expenditure unless liquidity constraints affect households severely. Similarly, an increase in exhaustive government spending, which can be expected to result in higher taxes in the medium term, will also fail to stimulate aggregate demand. Forward-looking consumers' consumption in the life-cycle theory of saving depends on lifetime wealth expectations. A deficit-financed tax cut will only increase consumption expenditure to the extent that the debt is expected to exist beyond the lifetime of the current generation. Similarly, a debt-financed increase in government spending will only boost aggregate demand to the extent that consumers do not anticipate that the debt will be repaid within their lifetime. The longer the time horizon on the basis of which life-cycle consumers base their decisions, the less likely it is that short-term demand management policies will be effective. Forward looking consumers, who are not liquidity-constrained and can therefore smooth consumption in the face of a change in their income, will generally reduce the stabilising effects of income tax changes.

The focus of the discussion so far has mainly been on the short-term impact of fiscal instruments as this is what is relevant for stabilisation policy. However, unlike monetary policy, it is also important to point out that fiscal policy instruments can have a potentially significant long-run impact (through the long-term impact of debt and the long-run growth rate of the economy) and that different fiscal instruments are likely to have very different effects in the long run as well as in the short run.

### **2.3 DISCRETIONARY VS. NON-DISCRETIONARY POLICY**

The main difference between discretionary and non-discretionary fiscal policy is that non-discretionary fiscal policy does not involve any deliberate government action, while discretionary fiscal policy can be defined as a deliberate attempt by government to obtain a certain objective. Discretionary fiscal policy can therefore be interpreted as changes in fiscal variables due to deliberate government action to obtain a certain objective (for

example to smooth the business cycle), while automatic (or built-in) stabilisers are types of automatic fiscal policies that do not require new legislation, because economic conditions cause government revenue and expenditure to change without any deliberate government action. Governments have the option to either allow these automatic stabilisers to work, to reinforce or to restrain their effect via discretionary budgetary policy. During a recession, governments might prefer not to let the budget deficit deteriorate due to the operation of the automatic stabilisers and will therefore decide to conduct a procyclical budgetary policy, or they might choose to actively undertake a countercyclical budgetary policy that will increase the deficit further.

Many practical economic and political difficulties are encountered in discretionary fiscal stabilisation policy. Political constraints could arise because politicians may find it unpopular to raise taxes and cut government expenditure when the economy becomes overheated. The democratic and political process often implies that it is easier to mobilise support to raise budget deficits than to cut them back or create surpluses. According to the European Central Bank (2002:36), this induces a tendency towards continuous increases in deficits and the tax burden. Furthermore, it is difficult to determine the appropriate size of the annual deficit, while fiscal adjustments and their effects are also subject to variable and unpredictable time lags. As a result, governments' well-intentioned efforts to stabilise the economy often end up destabilising it, "booming the boom" or "depressing the depression". Proper timing of discretionary policy is extremely difficult to achieve, but crucial if it is to assist with economic recovery. Therefore, most economists favour active, discretionary fiscal policy only in response to a major recession.

There is a growing realisation that high budget deficits could directly or indirectly crowd out relatively more productive private sector activity such as investment. Moreover, discretionary policy presents a dilemma when low levels of economic activity coincide with high inflation and balance of payments deficits such as was the case in South Africa during the latter half of the 1970s (Heyns 1999:70). According to the European Commission (1997:109), the efforts to support the economy during downturns in EU

countries have often been made through expenditure commitments that have subsequently proven *de facto* irreversible. This resulted in an upward “ratchet” effect of the size of the public sector in the economy, on both the tax and the expenditure side.

Attempts to stabilise the economy through discretionary fiscal policy therefore encounter some technical problems. The ability to measure and analyse the economy is imperfect; gauging how far the economy is from full employment at any particular point in time is difficult. Furthermore, the amount that output will increase in response to a fiscal expansion is not known exactly, making it difficult to assess how much of a fiscal change is needed to restore full employment. Because macroeconomic policies take time to implement and more time to affect the economy, their optimal use requires knowledge of where the economy will be in six or twelve months from now. However, such knowledge is, at best, very imprecise.

In order to avoid the typical pitfalls of fiscal fine-tuning, the main focus has increasingly been put on the working of automatic fiscal stabilisers to fulfil the stabilisation objective. Many of the objectives that fine-tuning might be designed to achieve can be met with adequately designed automatic stabilisers, though many of the problems that fine-tuning face are also faced by these stabilisers. Discretionary changes in taxes and spending and changes in taxes and spending due to the automatic stabilisers both impact on aggregate demand. However, the automatic stabilisers are more predictable and work quicker than the discretionary ones (Taylor 2000:26).

The duration perspective of stabilisation considers the frequency of business cycles, while the volatility debate focuses only on their amplitude. Diebold and Rudebusch (1992:994) argue that some of the structural changes in an economy cited as possible sources for volatility stabilisation may actually impede duration stabilisation. A countercyclical entitlement program such as unemployment insurance, for example, increases individual unemployment durations by reducing the adverse effect of unemployment on personal income. Although the unemployment insurance program acts as an automatic fiscal stabiliser to the extent that it reduces the severity of contractions



and the variability of fluctuations, it generally does not shorten the duration of contractions or lead to duration stabilisation.

## 2.4 BUDGET RULES

Government could manage public finances by following some rules to guarantee sustainability and which allow automatic stabilisation. According to the European Central Bank's *Monthly Bulletin* (2003:39), growing awareness of the limitations associated with macroeconomic fine-tuning has led to a worldwide trend towards the adoption of more rule-based institutional frameworks. These frameworks could provide authorities with specific mandates, i.e. clearly identified policy objectives, in order to set proper specific targets for decision-making level and ensure predictability of policy. Moreover, these frameworks could provide responsible authorities with guidance on the appropriate setting of their instruments in the face of constantly changing economic conditions in such a way as to keep the path of their action through time as consistent as possible with the long-term attainment of their policy objectives.

Marin (2002) emphasises that there are a number of issues under discussion on rules of fiscal discipline, namely the way in which the rules of budgetary discipline are implemented, the appropriate medium-term targets, the importance of allowing automatic stabilisers to operate symmetrically over the cycle, the allowance of temporary deviations from close to balance positions or from surplus budgetary positions toward deficit positions, the operational assessment of the sustainability of public finances, etc.

The interest in fiscal policy rules stems in part from the deterioration in public finances, which prompted the need to achieve or maintain long-term fiscal sustainability. Kopits and Symansky (1998:2) define a fiscal policy rule, in a macroeconomic context, as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. The rules cover summary fiscal indicators such as the government budget deficit, borrowing, debt, or major components thereof – often expressed as a numerical ceiling or target, as a ratio of gross domestic product. A critical feature of a

fiscal rule is that it is intended for application on a permanent basis by successive governments in a given country, at the national or sub-national levels of government. For a policy rule to be credible, it must involve commitment over a reasonably long period of time. Much like other rule-based policies, a fiscal rule can be defined in terms of the degree of stringency, precision and enforcement of the statutory instrument. There are borderline cases that in principle can be viewed as fiscal rules, such as the provisions for reducing the public debt to GDP ratio to a reference value at a satisfactory pace or to a prudent level while achieving an adequate level of net worth.

Binding fiscal policy rules are likely to influence the level and composition of government expenditure and taxation (Kopits and Symansky 1998:12). Moreover, they have major macroeconomic consequences for inflation, external indebtedness and economic growth. The effect of fiscal rules on output variability is determined by the relative size and persistence of fiscal policy shocks compared with the size of the other underlying shocks, and by their interaction with automatic stabilisers. According to Kopits and Symansky (1998:18), a fiscal policy rule should be well defined in order to avoid ambiguities and ineffective enforcement, adequate with respect to the specified goal, consistent internally as well as with other macroeconomic policies or policy rules, simple to enhance their appeal to the legislature and to the public, flexible to accommodate cyclical fluctuations and exogenous shocks beyond the control of the authorities, enforceable in the given environment, highly transparent and supported by efficient policies.

The rationale for fiscal policy rules rests primarily on the need for macroeconomic stability, support of other financial policies, long-term sustainability of fiscal policy, overall policy credibility and reduction and avoidance of negative spillovers and adverse market reactions (Kopits and Symansky 1998:6). The potential benefits of fiscal rules over discretionary policies ensue from the credibility of lasting commitment to fiscal discipline. Most of these objectives can be met with discretionary fiscal policy measures, but they have proved to be less successful, suggesting that although discretionary policies

may theoretically be superior, well-designed fiscal policy rules may offer a useful second-best solution to counter political pressures on fiscal policy-making.

According to Millar (1997:1), recent research suggests that budget rules are theoretically justified if the social benefits of foregone fiscal stabilisation are outweighed by the benefits of avoiding government debt accumulation, and the potential for reduced risk premiums on government borrowing rates. Empirical evidence confirms that stringent anti-deficit rules improve government finances and reduce borrowing rates more effectively than less stringent rules, although evidence is limited on whether the mere existence of such rules is beneficial. Studies also confirm that deficit-constraining rules reduce fiscal offsets to demand shocks, which may increase output volatility. Properly designed fiscal rules may facilitate the functioning of automatic stabilisers, while at the same time supporting solvency goals and enhancing credibility (Perry 2002:3).

Anti-deficit constraints, however, could compromise the stabilising role of automatic stabilisers, especially for negative demand shocks (*op. cit.*:13). Such constraints could be destabilising if fiscal authorities are forced to adopt restrictive measures to offset revenue shortfalls when negative demand shocks occur, which could amplify the decline in output. Since budget rules do not preclude large surpluses, the response of fiscal authorities would not necessarily be destabilising in the presence of positive demand shocks.

The loss of fiscal stabilisation implied by anti-deficit constraints may not be as large for governments that are already burdened with high levels of debt when the constraint is adopted (*op. cit.*:14). In this context, the potential costs of foregone fiscal stabilisation resulting from anti-deficit constraints may be reduced, at least while government actively attempts to reduce debt to more acceptable levels. However, if anti-deficit constraints are adopted as a preventative measure against excessive debt accumulation and remain in place even when the debt is back to a more acceptable level, the potential costs of foregone fiscal stabilisation may remain a concern in the long term. Anti-deficit and anti-debt constraints could also limit the discretion of policy-makers to adopt optimal policies

in a number of other ways. For instance, anti-deficit rules could prevent policy-makers from making socially optimal public infrastructure investments, the omission of which would be undesirable consequences on the welfare of future generations. To some extent, it may be socially equitable to run deficits to finance such investments, since the cost can be shared amongst the present and future generations that will profit from their existence. Another negative consequence of fiscal rules is that governments could lose the flexibility to use debt to reallocate welfare intertemporally when it is socially equitable to do so (*op. cit.*: 15).

Alternatively, Millar (1997:15) argues that if markets perceive fiscal rules to be effective safeguards against unsustainable fiscal policy, they may lower government borrowing rates by reducing the perceived risk of default on, or monetisation of, government debt. Moreover, rules could prevent miss-timed discretionary fiscal policy (due, for example, to unpredictable policy lags) from being a source of instability. While budget constraints may imply lasting costs in terms of foregone fiscal stabilisation and tax smoothing, these costs may not be as high if the budget constraint is adopted only temporarily, particularly if fiscal policy is already constrained by excessive debt levels.

Finally, Millar (1997:26) argues that there is evidence that the form of a budget constraint matters, in addition to the economic and political context. More stringent constraints with strong enforcement mechanisms enhance the possibility of fiscal discipline. The disciplinary benefits of budget rules should be weighed against the social costs of foregone output stabilisation or tax smoothing.

## **2.5 MONETARY POLICY VS. FISCAL POLICY**

The policy mix could consist of various combinations of expansionary and restrictive policies, with a given fiscal stance being either supportive or non-supportive of monetary policy. Coordinated monetary and fiscal policies are extremely important as uncoordinated policies could potentially slow the economy's long-term growth rate or cause unwanted surges in inflation. Fiscal and monetary policies should therefore be

coordinated to achieve macroeconomic stability objectives. Each set of policies has its own focus, instruments and procedures. In recent years, monetary policy was increasingly focused on controlling inflation, most explicitly so in countries such as South Africa that has adopted inflation targeting. As monetary policy concentrates on bringing and keeping actual inflation close to target, it is less concerned with a stable and small output gap. It could be argued that under these conditions, the management of the output gap and current account balances becomes the responsibility of fiscal policy. However, assigning the task of stabilising output fluctuations to fiscal policy creates theoretical and practical problems, as is indicated in Section 2.3. Theoretically, fiscal policy is rather ineffective in stabilising output for a variety of reasons. Practical problems relate to the fact that fiscal policy instruments are rather inflexible in the short term and can therefore not respond quickly enough to output fluctuations. The literature has therefore in recent years increased the focus on the medium- to long-term issues in fiscal policy, such as the sustainability of the fiscal deficit or government debt. This trend is illustrated, for example, in the European Union where all Member States use long-term projections at some stage of the budgetary process, reflecting a shift in recent years from budgetary procedures that only focussed on short-term targets, to procedures that incorporate more longer-term considerations.

The interactions between monetary and fiscal policies relate to the fact that both types of policies have an impact on key macroeconomic variables, and this in turn creates interdependencies in the pursuit of policy objectives. On the one hand, fiscal policy influences price developments, real interest rates and risk premia as well as aggregate demand and potential output, all variables which need to be systematically taken into account by a monetary policy that focuses on price stability (*European Central Bank Monthly Bulletin* 2003:37). In contrast, monetary policy has an impact on, *inter alia*, short-term interest rates, inflation expectations and the risk premia incorporated in long-term yields. All of these variables affect the economic environment in which fiscal policy operates. Monetary policy is generally more flexible than fiscal policy and, although the economy's response to monetary policy is also subject to variable time lags, it can be changed more rapidly.

According to the *Reserve Bank of New Zealand Bulletin* (1992:224), fiscal policy decisions can affect the appropriate short-term stance of monetary policy either through a direct impact on prices (due to changed taxes or charges), or indirectly by affecting aggregate demand. Central banks must monitor fiscal trends carefully, as fiscal policy outcomes may result in continual increases in public debt to GDP ratios which impact on the inflation outlook. The systematic relationship between fiscal and monetary policy arise from the fact that fiscal expansions tend to lead to more rapid growth in the future, which would be taken into account in setting monetary policy as this has implications for price stability. In addition, government borrowing tends to drive up the equilibrium real interest rate. Thus, fiscal policy affects future output, which has implications for monetary policy.

Fiscal policy therefore affects the economic environment in which monetary policy operates. In order to be effective, central banks also have to adjust to the non-discretionary components of fiscal policy in a systematic way. With strong automatic stabilisers in place, an increase in aggregate demand would have less effect on output and inflation, and would decrease the need for the central bank to respond aggressively. The automatic responses could always be over-ridden by discretionary action, while the predictable fiscal responses of automatic fiscal stabilisers are also likely to facilitate the operation of monetary policy. Automatic fiscal stabilisers could therefore play an important role in complementing countercyclical monetary policy.

Fiscal policy should contribute to maintaining an environment of macroeconomic stability, while monetary policy must continuously monitor the fiscal policy stance in order to be effective. Objectives and instruments must be assigned efficiently and a clear division of responsibilities is needed. An open exchange of views and information between monetary and fiscal authorities could assist the overall outcome if this enhances an understanding of the objectives and strategies to pursue them (Duisenberg 2003). However, active coordination of fiscal and monetary policies is bound to be ineffective, given the inability of both fiscal and monetary policy-makers to fine-tune economic

developments. Moreover, commitments to *ex ante* coordination between fiscal and monetary policies may blur the responsibilities of monetary and fiscal authorities and ultimately reduce the incentives to pursue their respective objectives.

## 2.6 SYNOPSIS

Despite some theoretical concerns regarding the effectiveness and impact of demand management, the fiscal stabilisation goal of government is still being recognised as important given the widening public deficits during the recent world economic slowdown. In the light of the arguments presented in this chapter, there is also little practical doubt that the fiscal system could be used for stabilisation. The economic policies used by government to smooth the extreme swings of the business cycle are called countercyclical or stabilisation policies. Fiscal policy instruments could contribute to the stabilisation of the economy to the extent that they can stabilise output, income and demand during an economic downturn by maintaining or even increasing government expenditure, or by reducing tax revenue. By the same token, they could moderate activity during periods of strong growth. Fiscal policy can be used as a stabilising instrument of economic activity either through the effects of built-in automatic stabilisers or through discretionary tax and expenditure measures, or through a combination of both.

Mainstream macroeconomic theory predicts that fiscal policy is not neutral with respect to output – changes in spending or taxes exert a strong influence on the economy in virtually every macroeconomic model. In the standard Keynesian models, the effect arises from aggregate demand, while in dynamic general equilibrium models of the real business cycle type; output changes because fiscal policy affects the incentives to work and save. Theoretical literature on the effectiveness of fiscal policy spans the simple Keynesian model, closed and open economy IS-LM models, demand-side models incorporating rational expectations, Ricardian equivalence, interest rate premiums, credibility, uncertainty and supply-side models.

Discretionary fiscal policy can be interpreted as changes in fiscal variables due to deliberate government action to obtain a certain objective (for example to smooth the business cycle), while automatic (or built-in) stabilisers are types of automatic fiscal policies that do not require new legislation, because economic conditions cause government revenue and expenditure to change without any deliberate government action. If automatic stabilisers are overridden by discretionary adjustments, their impact will be neutralised. On the other hand, if they are reinforced by discretionary adjustments, the overall fiscal impulse will be stronger.

Discretionary fiscal policy decisions are needed to preserve the sustainability of public finances in the medium term and this serves as a precondition for automatic stabilisers to operate freely. Moreover, discretionary fiscal policies determine the structure of public finances, which in turn affects the functioning of the economy and the features of automatic stabilisers. The impact of fiscal actions for stabilisation purposes depends on country specifics (structure of public finances, extent and nature of shocks, political environment etc.), consumer behaviour, the type of action and their interdependence with other macroeconomic policies and variables. As with monetary policy there are risks in allowing political discretion as these policies might be influenced by the superficial appearance of current events and short-term electoral considerations. In such cases, governments could be over-keen to view poor economic growth as being a consequence of demand problems to be dealt with through demand management, rather than supply problems appropriately handled by means of structural policies.

Many practical economic and political difficulties are encountered in discretionary fiscal stabilisation policy. The combined problems of lags, crowding-out effects, the possibility that some portion of tax cuts could be saved, political constraints, inflexibility and practical problems in measuring and forecasting the state of the economy and determining how much fiscal stimulus is needed at any particular point in time, all present serious challenges for discretionary fiscal policy to have the desired effect on stabilisation. In order to avoid the typical pitfalls of fiscal fine-tuning, the main focus has increasingly been put on the working of automatic fiscal stabilisers to fulfil the



stabilisation objective. Many of the objectives that fine-tuning might be designed to achieve can be met with adequately designed automatic stabilisers, though many of the problems with fine-tuning are also applicable to these stabilisers. Discretionary changes in taxes and spending and changes in taxes and spending due to the automatic stabilisers both impact on aggregate demand. However, the automatic stabilisers are more predictable and work quicker than the discretionary ones.

Growing awareness of the limitations associated with macroeconomic fine-tuning has led to a worldwide trend towards the adoption of more rule-based institutional frameworks. These frameworks could provide authorities with specific mandates, i.e. clearly identified policy objectives, in order to set proper incentives at the decision-making level and ensure predictability of policy. Moreover, these frameworks could provide the responsible authorities with guidance on the appropriate setting of their instruments in the face of constantly changing economic developments, in such a way as to keep the path of their action through time as consistent as possible with the long-term attainment of their policy objective. The disciplinary benefits of budget rules should be weighed against the social costs of foregone output stabilisation or tax smoothing.

In the light of South Africa's historical context, in particular the rapidly rising debt levels and unsustainable deficits during the early 1990s, the country's experience may warrant a greater interest in fiscal policy rules. A fiscal policy rule such as a balanced budget rule can enhance South Africa's credibility due to a lasting commitment to fiscal discipline. However, a balanced budget rule might be too strict (and unwise) for South Africa given its deficit bias and the fact that deficits only recently declined to lower levels. Moreover, further consolidation efforts might compromise the stabilising role of automatic stabilisers and it would make it difficult for South Africa to increase social expenditure and make important public infrastructure investments. The application of fiscal rules and multi-annual targets in budgetary decision-making also touches on the "rules vs. discretion" debate. Coordination problems inherent in budgetary decision-making can be overcome by either the delegation of power to the Minister of Finance or an approach that hinges on pre-established budgetary targets and rules. Although rules seem to be

attractive and straightforward to contain the spending and borrowing bias of profligate governments, it is by no means clear what institutional design and multi-annual budgetary targets are needed for it to be effective. Imposing a tight multi-annual framework may be dysfunctional for the stabilising role of public finances in South Africa to the extent that this should be based on discretionary policy measures. Before an assessment of the feasibility of fiscal rules in South Africa can be made, it is necessary to analyse the choice of budgetary rules and procedures and their impact on the sustainability and stabilising role of public finances.

Since budgetary outcomes are affected by automatic stabilisers, appropriate fiscal policy measures to react to economic shocks, as well as unexpected fiscal changes that regularly occur after major reforms of tax and benefit systems, it is desirable to de-link the impact of automatic stabilisers from targets by using cyclically adjusted budgetary concepts. The cyclical sensitivity of the budget is a key question for both setting targets and analysing automatic stabilisers. Rigid interpretations of targets would force governments to make a trade-off between the size of automatic stabilisers and meeting the targets. Hence, an understanding of the scale of automatic stabilisers and ways of evaluating targets is important when discussing fiscal policy. The effect of the economic cycle on the budget position, therefore, has to be taken into account when assessing compliance with budgetary commitments, and in particular, the adjustment path to a specific target. The appropriate speed of convergence to a desired medium-term target also has important implications. If adjustment is too slow, confidence in attaining a sustainable path may be undermined and the scope for the operation of automatic stabilisers may be too restricted to prevent an excessive deficit. On the other hand, consolidation by definition consists of discretionary measures and attenuates demand, meaning that overly fast consolidation with excessive short-term retrenchment could also risk policy reversal if the political costs of consolidation become too high.

Although monetary and fiscal policies use different policy instruments, they are closely related in terms of certain objectives and their attainment by affecting the levels of output in the economy. Both monetary policy and fiscal policy have an impact on key

macroeconomic variables, and this in turn creates interdependencies in the pursuit of policy objectives. The close relationship between monetary and fiscal policies carries with it the possibility of conflict and sub-optimal policies, should their implementation be at cross-purposes. A coordinated monetary-fiscal policy mix may be mutually reinforcing and therefore more effective. Fiscal policy affects the economic environment in which monetary policy operates. In order to be effective, central banks also have to adjust to the non-discretionary components of fiscal policy in a systematic way. With strong automatic stabilisers in place, an increase in aggregate demand would have less effect on output and inflation, and would decrease the need for the central bank to respond aggressively. The automatic responses could always be overridden by discretionary action, while the predictable fiscal responses from automatic fiscal stabilisers are also likely to facilitate the operation of monetary policy. Automatic fiscal stabilisers could therefore play an important role in complementing countercyclical monetary policy.

It is clear from this chapter that an assessment of the extent of automatic stabilisation is needed before fiscal stabilisation could be accurately formulated and implemented. Thus, the timing and accuracy of discretionary fiscal policy in South Africa could have been adversely influenced due to the absence of any measure of the extent and role of automatic stabilisers in South Africa. The lack of measures of automatic stabilisation and the inadequate adjustment of the budget balance for economic cycles also made it difficult for the central bank to distinguish between the discretionary and non-discretionary components of fiscal policy, limiting its ability to assess fiscal trends and its impact on output and inflation and therefore to determine the appropriate monetary response. The next chapter is the first step in an attempt to shed new light into the dynamics of automatic stabilisation and its implications in the South African context in order to avoid past policy mistakes. However, the introduction of alternative fiscal indicators such as the cyclically adjusted budget balance would also have important implications for the effectiveness of fiscal policy, as it would enhance the foresight on which consumers base their decisions.