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CONSTITUTIONAL ASSEMBLY

THEME COMMITTEE 6.2

FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

SUBMISSIONS

(AS AT 22 MARCH 1995)

VOLUME 10

ORGANISATIONS

SUBMISSIONS - ORGANISATIONS

INDEX

	ORGANISATIONS	EXTRACT/DOCUMENT	PAGE
1.	Africa Christian Action	Printed Extract - 2 paragraphs	1
2.	SBDC (Small Bus Dev Corp)	Document	2-39
3.	Development Bank of Southern Africa	Printed Extract - 6 pages	40-45
4.	Volkstaat Council	Printed Extract - 2 pages	46-47

(Incorporating Salt Shakers)

CONSTITUTIONAL ASSEMBLY

13 FEB 1995

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The Director

9 February 1995

(A) Public Administration

Civil power is vested in and derived from God. Civil officers and their trustees and servants are at all times amenable firstly to God and then to the people. Public servants are agents of the people and their power must be as such.

Taxes are to be levied by civil government in order to be spent on those objects which they properly render. The payment of services rendered should not permit an expenditure of money in excess of such services; such as pensions, special privileges or emoluments. Pensions should be paid by the servant to a fund in the private sector so as to release the tax payer for paying for no service being rendered. Emoluments are any advantage, profit or gain arising from the possession of an office within the civil government. The agent should not gain personally by the agency beyond compensation for service.

Civil offices should not be hereditary.

(B) Finanical Institutions and Public Enterprise

Goverment monopolies must be barred, but not businesses which corner the market absent of fraud or coercion.

The individual must have the right to pursue any lawful vocation as God calls. Civil government may only judge the criminality thereof. It must also not grant any privilege or franchise to any business, occupation or profession and no licencing should be allowed.

Civil government should not carry on any business by establishing its own company or enterprise unless it is undertaking a lawful civil project. It must also be barred from determining the "qualifications" of anyone to pursue any lawful vocation. Qualifications must be left to the private sector and voluntary associations are established for this purpose.

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20 December 1994

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Mr S Nyoka
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Aknowledge receipt.

Dear Mr Nyoka

THE CONSTITUTION MAKING PROCESS : FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

Your letter of 6 December 1994 refers.

Our Managing Director, Dr W B Vosloo, requested me to forward to you our submissions "The Quest for Efficiency and Responsibility in the Generation and Spending of Public Funds" (subject 3.3) and "Comments on the Future of Development Agencies" (subject 3.8).

We trust that these documents will be of assistance in the constitutional making process.

Yours faithfully

J S NIEUWOUDT
Personal Assistant to the Managing Director

2

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THE QUEST FOR EFFICIENCY AND RESPONSIBILITY IN THE GENERATION AND SPENDING OF PUBLIC FUNDS

(DR W B VOSLOO)

CONTENTS

	Page
THE GROWTH OF GOVERNMENT ACTIVITY	
Increasing Need for Public Goods	1
Increasing Demand for Public Programmes	3
Imbalances in Productivity Growth	3
Staying Power of Government Agencies	4
Good and Bad Public Expenditure	4
South African Trends	5
THE RISE OF THE MIXED ECONOMY WELFARE STATE	
The Market Economy Approach	6
The Command Economy Approach	6
The Mixed Economy Approach	7
The Law of Creeping Public Bureaucracy	9
EFFICIENCY IN GOVERNMENT EXPENDITURE	
Public versus Private Provision	10
Allocative Inefficiency	10
Productive Inefficiency	11
South African Trends	12
THE TAX SYSTEM AND THE EFFICIENCY OF THE ECONOMY	
Negative Impact of Taxation	13
Influence of Taxation on Propensity to Save and Invest	13
South African Trends	14
The Tax System and Economic Growth	15
SEEKING ADMINISTRATIVE RESPONSIBILITY	
Examples of Shortcomings	16
Examples of Lack of Responsibility	17
Are Effective Checks and Balances Possible?	21
CONCLUSIONS	22
RECOMMENDATIONS	26

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THE QUEST FOR EFFICIENCY AND RESPONSIBILITY IN THE GENERATION AND SPENDING OF PUBLIC FUNDS

(DR W B VOSLOO)

In every nation, some of the most durable and contentious political issues are the perennial controversies over what functions government should perform and how these tasks should be implemented. In most democratic nations the debate over these perennial issues have revolved around dichotomous positions described as "free enterprise" versus "government intervention", "market economy" versus "command economy", "capitalism" versus "socialism", "democracy" versus "authoritarianism", etc. The underlying issues are what the proper scope of government activity should be, what strategies and policies should be followed and how executive and administrative structures are to be organized financed, staffed and controlled.

In this analysis our focus is turned on "what" issues and "how" issues. The "what" issues deal with the scope of government activity and its implications for the political-economic order. The "how" issues deal with the requirements of efficiency and responsibility on the expenditure and income sides of public finance.

THE GROWTH OF GOVERNMENT ACTIVITY

Although most countries rely on private enterprise to supply most of its needs for products and services, governments everywhere have grown in the size and variety of its activities as reflected in the growing share of public expenditure in the gross domestic product. (See Table 1) But why do government activities grow? Many arguments and theories have been advanced to explain or justify the expansion of government's role and variations in expenditure trends.

Increasing Need for Public Goods

As society develops and grows it becomes more industrialized and urbanized. Its social, commercial and legal relationships become more complex as its capacity to participate in large-scale activities and highly organized modern life expands. Social and economic progress thus causes governments to assume a more prominent role in establishing and running institutions to control this complexity. (See Diagram 1)

It could even be said that there is an inevitability in the expanding relative share of government. This argument was more clearly expounded as a "Law of Ever-Increasing State Activity" by German scholar, Adolph Wagner, in 1883. Upon surveying the expenditure records of several countries in

Western Europe, Wagner set forth his theory that government activity increases faster than the economic output of society. He attributed this "law" to a variety of factors: increasing regulatory services required to control a more specialized and complex society, increasing involvement of government in economic enterprise through the device of the public corporation, increasing needs for economic and social services, such as postal, transport, education, welfare and public health, increasing capacity to produce effectively on a large scale. Thus the "law of ever-increasing state activity" portrays growth in government activity as an inevitable accompaniment of a developing society. (Wagner in Musgrave and Peacock (ed), 1964, p8)

Peacock and Wiseman (1961 have tested Wagner's ideas and claimed that expenditures grow because revenues grow within the framework of a given tax system. As tax rates yield more money as the economy grows, governments somehow spend that income. Furthermore, the cost of providing public services grows with the nation. Because there is a substantial gap between people's desires for expenditures and their tolerance levels of taxation, the pressures of larger budgets are always strong. To the extent that revenues are available, the guardians of the public purse (politicians and bureaucrats) have little power (or incentives?) to refuse requests. Only when action is required to raise tax rates to finances new spending do they tend to say "No!". However, during periods of social disturbance, such as war, famine or some natural disaster, the level for tolerance for taxation is greater and, consequently, government expenditure is able to expand. After the social disturbance, the tolerable rate of taxation does not return to its original level. Public expenditure therefore increases permanently due to the displacement effect. This means that there is inevitably a lot of inherent momentum in existing spending programmes in a growing economy exerting a permanently upward pressure on revenues an expenditures.

This theory seems to fit well with experience in many countries. It is clear that there is a lot of momentum in existing spending programmes. But long-term movements in expenditure levels also result from conscious decisions by politicians and bureaucrats.

Since Peacock and Wiseman's study in 1961, a new phenomenon gained prominence in most economies of the world: high levels of inflation and its impact on the taxable income of individuals in the form of "bracket creep". As a result of inflation, more and more citizens are continually pushed into higher taxable income brackets and in so doing increased the income of the state. Although this phenomenon had a different origin, its impact on government revenue was similar to Peacock and Wiseman's displacement effect.

Increasing Demand for Public Programmes

This theoretical explanation focuses on the growth of public expenditure as a result of the increasing demands made by the voting public on the basis of their perception of their needs or ideological considerations and the willingness of politicians and bureaucrats to oblige. (See Diagram 2) The popular demand for more and better quality "products" form government - schools, roads, hospitals, recreational facilities, provision of social services to the needy (aged, infirm, unemployed, etc.) urban infrastructure, protection of natural resources, subsidies, public safety, etc - is channelled through the political and bureaucratic processes by which government decisions are made. The views of elected representatives are mediated by the decisions of the bureaucrats responsible of policy implementation. Majority rule may lead to an over-provision of public programmes because coalitions form to push expenditure levels higher. The bureaucrats staffing public agencies also play a key role by originating and/or supporting expenditure programmes enhancing their own power, prestige or material interests.

On balance, market failure and distributional concerns are most generally used to explain and /or justify government involvement. The term "compensatory action" has been popularized in designating certain fiscal and monetary policy measures in Keynesian economic doctrine when these measures are used to balance or make up purported failings in the private economy. Subsidies may also have similar effects, but are usually viewed as a means of assisting private producer groups who cannot survive or flourish if left to the choices of the market. Virtually every function assumed by the modern state is rationalised in terms of the growth in public demands.

Imbalances in Productivity Growth

A further set of explanatory theories lies in the role of supply-side factors which emphasize imbalances in productivity growth. Their reasoning typically starts with the assumption that citizens have an array of preferences, most of which can be satisfied in the private economy by goods and services which are produced, priced and distributed there. But there are other kinds of goods for which people have preferences which are not so easily sold and distributed through the market system, because they cannot so easily be priced and sold in separate units eg. highways, sanitation services and national defence. The same applies to other goods and services which will not be produced by private enterprise as a result of high risk or cost eg. irrigation dams, bridges, scientific research etc. These goods and services must be publicly produced and generally made available.

This theoretical model implies that the price of the goods and services provided by the government rises more rapidly than the price of privately produced goods and services. Productivity in the public sector does not improve as much as the economy as a whole. Although the pay of public employees lags at times, in the long run they receive the same amounts and increments (if not more?) as other workers. As a result, and because of the large share of wages in government expenditure, the unit cost of these public services increases steadily, which implies a built-in tendency for public expenditure to grow faster than national income. (Otto Eckstein, 1979,p2)

Staying Power

Herbert Kaufman's research into the "death rate" of government agencies compared to the failure rate of business organisations, indicated that public bureaucrats have a remarkable staying power. His research findings did not indicate that government organisations are "immortal" or that their growth as distinct institutions cannot be stopped. However, he found that they endure a relatively long time - at least much longer than private
organisations that are subject to the discipline of the "bottom line" as imposed by the market mechanism.

Whether or not public agencies manage to outlive their usefulness is difficult to assess in empirical terms because of measurement difficulties. But it is clear that bureaucrats have developed remarkable survival skills, because malfunctioning and mismanagement is difficult to detect and/or expose. As a result they tend to stretch the life span of public agencies or units long after it has become questionable whether such units or organisations continue to serve the public interest. They are often protected by their internal an external clientele groups. This problem is further aggravated by the considerable obstacles standing in the way of the retrenchment or dismissal of unproductive or redundant public employees. (See Kaufman, 1976, pp20-34 and Anderson, 1975 pp104-130)

Good and Bad Public Expenditure

Are there good and bad arguments explaining and justifying the level and composition of public expenditure? Richard Hemming argues that a clear distinction needs to be drawn between normative rules describing the extent to which governments ought to intervene (e.g. as a result of market failure or valid distributional concerns) and scientific explanations of the degree to which they actually do intervene. The distinction between good and bad arguments for
public expenditure is central to assessing the level and composition of public expenditure. The objective should be to distinguish between good and bad expenditures using arguments that derive from a clear view of the justification for government intervention. Hemming claims that there

is little merit in public programmes and high levels of expenditure which are coupled with "..... potentially damaging effects of increased taxation, low public sector productivity, the influence of pressure group politics and the misconceived objectives of public bureaucrats." (Hemming, 1991, p25) Hence, we need to scrutinize with a very sharp eye the quality of activities funded through public expenditure.

South African Trends

In South Africa government expenditure has also increased as a result of a wide range of economic, social and political considerations. Government expenditure at all levels have increased from 16 percent of GDP in 1960 to 32 percent of GDP in 1991. (See Figure 1) Government expenditure by function is set out in Table 2. (See also Figure 2) Government activity has grown faster than any other important index in our national accounting system: the population growth, inflation, the GDP and even private enterprise.

Also in South Africa, government has taken responsibility for the social welfare and health care of society. Today, social welfare and health care cost over R 15,3 billion which is 15 percent of government spending and 5 percent of the expected 1992 GDP.

More people than ever before today receive education. Total annual budgeted expenditure on education now stands at R 19 billion which is 19 percent of government spending and 6 percent of the expected GDP, one of the highest ratings in the world.

The maintenance of internal and external security puts a heavy burden on the modern state. Total spending on these items in South Africa now stands at R 15,3 billion which is 15 percent of government spending and 5 percent of the expected GDP.

General administration expenditure (including salaries, purchases and maintenance not included in the above-mentioned items but excluding interest on government debt) now stands at a budgeted R 37 billion, which is 37 percent of government spending and 11 percent of expected GDP. Figure 3 shows clearly that the growth in the wage bill of the government is a prime reason for the strong growth in government consumption expenditure and general administration expenditure.

THE RISE OF THE MIXED ECONOMY WELFARE STATE

What is the proper scope of government activity? This question has concerned thinkers since ancient times: John Lock, Adam Smith, Edmund Burke, the French Physiocrats, Karl Marx, Harold Laski, Joseph Schumpeter, Carl Friedrich, Ludwig von Mises and Margaret Thatcher. A divergent spectrum of answers has been given.

The Market Economy Approach

On the one end of the spectrum stands the market economy approach with its emphasis on free enterprise, private initiative, entrepreneurship, and efficiency. The government's role is confined to such areas as defence, the administration of justice, enforcing contracts, protecting private property, certain public works, collective goods and services that cannot be provided through the market (e.g. education), extraordinary technological risks (e.g. atomic energy), the management of natural monopolies (e.g. the supply of electricity, telecommunications and mass transportation) or where there is a general presumption in favour of doing things through public sector agencies. In general, however, government action is considered permissible only when the private sector is not suitable. Otherwise, private enterprise, operating in a market economy, is expected to meet most desires of consumers. In most "free enterprise" countries, governments tend to go far beyond the functions which, according to the classical doctrine of "laissez faire", they should perform.

The Command Economy Approach

On the other end of the spectrum stands the command economy approach with its commitment to egalitarianism, welfare services and social security based on government intervention and control. But the command economy approach is to be found in two fundamentally diverging varieties: leftist socialist interventionism and rightist capitalist interventionism.

Socialist interventionism, whether in the centralist Marxism/Leninism or Third World form of "African Socialism" has lost much of its appeal and political momentum since the end of the eighties. Socialism has not lived up to its promises. Marxism/Leninism and Third World Socialism invariably led to totalitarian one-party rule or one-man dictatorships and the violation of human rights. It appeared that egalitarian social engineering can only be achieved by means of an omnipotent totalitarian state. Totalitarianism seems to be an inherent and inevitable mode of socialism. The only functioning democracies in today's world are found in free enterprise countries, while authoritarianism is firmly entrenched in every remaining socialist country. In the communist countries of Eastern Europe technology, innovation and productivity have fallen far behind most free market countries. The egalitarianism which is the moral imperative of socialism, has remained a utopian promise. Third World countries that have turned to socialism (such as

Zambia, Tanzania, Burma and Vietnam) by nationalizing manufacturing, mining and agriculture and have placed their economies under centralized planning, have experienced disastrous results. Productivity plummeted, government management proved to be poor and corrupt while living standards declined. They have been out performed by countries avoiding central planning and relying on private initiative.

Capitalist interventionism has been the strategy in several East Asian countries such as Japan, Taiwan, South Korea, Hong Kong, Singapore and now also amongst the "little tigers" along the Pacific Rim: Thailand, Malaysia and Indonesia. Governments in these countries intervened quite aggressively to alter patterns of trade, industrial output and consumption in ways thought desirable.

It used public enterprises as instruments of a conscious development strategy and protected parts of the economy from import competition. It used rules on inward investment to promote selected industries and heavily subsidized export promotion. The four economic "tigers" of East Asia - South Korea, Taiwan, Singapore and Hong Kong - have achieved the fastest rate of economic growth the post-war world has seen. They have grown much faster than OECD countries.

But there are counter arguments to consider. In scores of developing countries state intervention failed damagingly as a result of bad government, self-serving bureaucracies, corruption and ethnic nepotism. The main reason is that state intervention is an extremely complex task which calls for special skills, flexibility and an enabling political and cultural environment. It also requires strong executive power and less sensitivity to democratic responsiveness on the part of government. It calls for a "benevolent dictatorship" style of government. But how does one keep a dictatorship benevolent? Another nagging problem experienced in all "Pacific Rim" countries is the challenge to prevent special interests from "capturing" interventionist policies for their own benefit and thus creating "crony capitalism".

The Mixed Economy Approach

Between the above-mentioned extreme positions, stands the mixed-economy approach. Most countries in today's world are running a mixed economy that combines free-market features and some government intervention. But sharp questions have to be asked about the nature of the mix - or the direction of the tilt. It is necessary to figure out what governments should do and can do well and what governments should not even try to do. Sharp surveillance must be kept on the quality of government activity: its allocative efficiency as well as its productive efficiency. (See Diagram 3)

It is a truism to state that a society's level of economic development inevitably imposes limits on what government can do in providing public goods and services to the community. The available economic resources is clearly an important limiting factor. The scarcity of economic resources will, of course, be more limiting in many of the less developed countries of the world than in the affluent Western countries. The level of economic development shapes both political systems and policy outcomes. Still, no government has all the resources available to do everything that everyone wants done.

We have become accustomed to the intervention of government in its ascribed role as the main gap-bridger, as redistribution agency as well as provider of public goods, collective goods and social insurance. This form of mixed economy is sometimes described as the "Social Democratic Market Economy Model". This model, which manifests itself in various degrees of state intervention assumes that the state should take the responsibility for maintaining the basic socio-economic fabric of society to the extent that the market fails to provide. But what are the costs and how is it to be financed? What are the pitfalls of intervention? How can unproductive expenditure be avoided?

An important indicator of the cost of governance is the ratio of government expenditures to gross domestic product. Although governments do many things that cannot be measured in money terms, government expenditures are the best available measure of the overall dimensions of government activity. There are few government policies that do not require the expenditure of funds. Therefore budgets represent government policies with price tags attached.

The level of public expenditure clearly has far reaching implications on the macro as well as the micro-economic life of society. It reflects the resources from the economy absorbed by government for the purposes of social security benefits, grants, purchases and salaries of public employees. Does government expenditure yield benefits that are larger than the value of goods and services forgone in the private sector? Figure 4 suggests that there is a positive correlation between low government current income and high real economic growth in society. There is a clearly inverse relationship between the level of government revenue as a percentage of total output and the rate of economic growth: the lower the percentage of total output which government appropriates in the form of income for itself, the higher the rate of real economic growth.

South Africa has regressed from an economic growth rate of more than six percent and a share of government equal to 15 percent of GDP in 1966, to less than 2 percent growth in the economy, whilst government absorbed 25 percent of the GDP in 1990. (See Figure 4 (a)) Mexico, Nieu Zealand and Japan shared the same fate. This negative correlation between economic growth and the share of government in the GDP is true in many countries over long time periods. (See Figure 4 (b)) As soon as the share of government in the GDP changes (shown by the solid line), there is a similar change in economic growth, but in the opposite direction (shown by the broken line).

The Law of Creeping Public Bureaucracy

Today serious questions must be asked about the ability of the state to accomplish its benevolent goals. When you ask the state or government to do something or to intervene, you are in effect asking civil servants to come into action. Hence you are inevitably inviting bureaucracy. Whoever propagates an expanded role for government, whether benevolent or otherwise, calls the Law of Creeping Public Bureaucracy into operation.

All regimes, including the modern constitutional social democracy, are afflicted by the problem of the bureaucratic "administrative state": the displacement of both politics and policies away from elected legislators and executives to what is called the "faceless bureaucrats" of public administration. To passively accept the fact that the area of state action and expenditure will inevitably continue to grow and that public officials will increase in number regardless of any precautions, would be hazardous in the extreme. It would spell grave danger for the future of democracy and for the maintenance of an efficient and responsible system of governance.

EFFICIENCY IN GOVERNMENT EXPENDITURE

There are several aspects of potential inefficiency in public expenditure which could render programmes unproductive:

- inefficiency arising from an inappropriate assignment of activities to the public sector as opposed to the private sector;

- allocative inefficiency manifesting itself as a mix of public programmes that does not meet the very objectives in terms of which government intervention has been initiated and justified;

- productive inefficiency describing a situation where goods and services are not provided by the public sector at a minimum cost i.e. inputs or resources such as staff, material, money and time are not employed to reach public objectives effectively and without waste. (Hemming, et al, 1991, pp26-31)

Public versus Private Provision

Looking first at public versus private provision, the point of departure should be that competitive markets always provide the incentive to seek economic efficiency. The product market guides prices and output. Producers who do not sell what the public wants at a price they are willing to pay, will not make a profit. Producers who do not make a profit will go bankrupt or be taken over. If the distributional outcome is acceptable, there is also social efficiency. But if the distributional outcome is considered unacceptable or unfair (e.g. because of a divergence between private and social costs or benefits), there may be a clear case for government intervention. To the extent that government intervention extends beyond those activities characterized by market failure or unacceptable distributional outcomes, the additional public expenditure that results could be regarded as inefficient or unproductive. The scope for efficiency gains from increased private sector involvement in activities currently undertaken in the
public sector through privatization lies in its potential to enhance allocative efficiency as well as productive efficiency. Privatization tends to reduce inefficiencies caused by political interference, poor quality managerial decision making in the public sector, lack of financial discipline in the style of public sector management and lack of incentives in public sector management to reduce costs and to make rational managerial decisions. Increased exposure to competition is likely to yield the largest gains in economic efficiency. The scope for devolving public sector activities to the private sector can be enlarged through asset sales, joint ventures, contracting out and franchising. (Richard Hemming and Kenneth Miranda, 1991, pp139-144)

Allocative Inefficiency

The most obvious sources of allocative inefficiency are prestige projects that serve no apparent economic or social purpose. Examples are numerous: prestigious airports, misplaced highways, redundant power stations, over ambitious industrial projects, extravagant office development projects, wasteful civil engineering projects and other misallocated "white elephants". Ostentatious expenditure is often found to be largest in countries that can least afford it, and where the opportunity cost in terms of foregone expenditure on essential infrastructure, social services and anti-poverty programmes is therefore higher. Improvements in allocative efficiency require that expenditures be prioritized and some rudimentary form of benefit-cost analysis be done to enable decision-makers to pass judgement on the worth of the expenditure at issue. In principle every expenditure should yield a benefit at least equal to the value of goods or services foregone in the

private sector or should not prevent a more valuable public expenditure in some other field. Thus the benefits of marginal expenditures should exceed opportunity costs both in the public and the private sectors. (Otto Eckstein, 1979, pp18-24)

However, real world situations are much more complex. Benefits and costs are not easily quantified in many fields of government activity. The benefits of defence, police protection or the administration of justice cannot be readily expressed in money terms. Neither does education, housing, slum clearance, highways or recreation facilities yield to reliable measurement and economic analysis. Their benefit is widely diffused and partly non-economic. Competing programmes are often not directly comparable. Hence the setting of normative priorities cannot be avoided.

Moreover, decision-making on budgetary matters takes place in a political environment. It is subject to bargaining and the lobbying of parties and pressure groups as well as vested clientele interests, both inside and outside the government. This process of bargaining and lobbying does not follow logical or rational principles. As a result, public policy becomes a continuation of past government activities with only marginal incremental modifications. (Dye, 1981, pp19-45)

Productive Inefficiency

The efficiency of production has both a technical aspect (the maximization of output with given inputs) and an allocative aspect (whether the input mix reflects opportunity costs). The root causes of productive inefficiency overlap with those that give rise to allocative inefficiency. These include the political and bureaucratic considerations that generate ever-increasing budgets, salary and wage-setting mechanisms that neither reward efficiency nor penalize inefficiency, and a fiscal illusion that leads the public to accept both increases in the number of public programmes and the rising costs of running them. Political manipulation of public agencies lead to ineffective monitoring and control, poorly motivated management and inflexible public sector labour markets. In general, the price of public sector output rises faster than that of private sector output. While wage costs are similar, productivity growth is slower in the public sector, reflecting the low level of competition and the inefficiency of complex bureaucracies. There is therefore a built-in tendency for public expenditure to grow relative to national income without any increase in output.

Because the wage bill of government employees represents a sizable share of government expenditure (refer to Figure 3) the government's wage and employment policy has an important bearing on productive efficiency. The private sector employs labour solely for the purpose of the value of its productive services and the demand for labour services will depend on the cost of labour relative to the value of the output it produces and the cost of other

inputs into the productive process. Public sector employment is not influenced by cost minimization and therefore has a dynamic of its own. Pressures to increase employment emerge that are quite independent of any increase in demand derived from an increase in the demand for public services. Moreover, increasing employment in the public service is also often seen as part of national employment policy. However, in a fully employed economy an increase in public sector employment crowds out private sector employment through its impact on private sector wage rates. (Mackenzie, 1991, pp41-45)

South African Trends

Although the South African economy is nowhere close to being fully employed, the government sector has been a very active creator of "employment" during the last decade. (See Figure 5) Most business sectors, including government businesses were nett losers of employment opportunities in the ten years prior to 1991. Figure 6 indicates that one in four people employed in the formal sector of the economy, is employed by the government. Figure 7 indicates that public authorities have been acting as "market leaders" in real wage packages in the period 1971-1991.

In most countries it is generally conceded that the level of public employment exceeds any reasonable estimate of requirements by a substantial margin. Often public offices are filled with personnel with little to do. Such over-employment is often associated with inadequate levels of expenditure on other current goods and services and an increase in the wage bill as a percentage of government expenditure. (Mackenzie, 1991, pp43-44) In South Africa, the wage bill of government, constituted as much as 61-66% of current expenditure, since 1984.

The realization that resources have been wasted on excess public employment has prompted experiments in many countries, particulary in Africa. The most generally used measures to restrain public sector employment include the following: eliminating ghost workers, firing temporary workers, hiring freezes, partially replacing departing employees, abandonment of the policy of employer-of-the-last-resort for university graduates, voluntary retirement or resignation, early retirement, dismissal coupled with generous severance pay and, last but not least, privatization. The experience with policies to reduce public sector employment points to the conclusion that it is easier to avoid hiring new employees than to reduce existing employees. Employment policy is an area where the dictum that an ounce of prevention is worth a pound of cure, is of particular validity. (Mackenzie, 1991, p45)

THE TAX SYSTEM AND THE EFFICIENCY OF THE ECONOMY

The scope for raising revenue is, in the final analysis, the main determinant of sustainable public expenditure. The magnitude of the revenues raised, affects every important aspect of a country's economy: its stability and its growth performance. The enormous payments extracted by government cannot leave the efficiency of the economy unchanged.

Negative Impact of Taxation

Taxation is by far the most important source of income for the modern state: direct and indirect taxes imposed on individuals and business enterprises. Every tax is composed of a base and of a rate structure applied to that base. This base may be taxed at a flat rate, such as a percentage of value or a fixed amount per unit, or with a more elaborate rate structure, such as the progressive income tax rates. There are many controversial issues involved in the design of a tax system in relation to its fairness, its administrative qualities and the distribution of the tax burden. The most important issue, however, is that it must be designed to minimize any negative impact on the performance of the economy. The tax system affects the efficiency of resource allocation within the economy. People consider taxes in their personal and business decisions. An employee may decide not to do extra work because income tax will take a substantial portion of the additional pay. A business person may pass up the opportunity to make an investment because the prospective return after taxes is not worth the risk. A consumer may buy commodity B rather than A because A is subject to an excise tax and B is not. Perhaps someone may even smoke or drink less because of the very high taxes on tobacco and alcohol. Tax systems are not neutral. (Eckstein, 1979, p71)

The single most important question about the effect of the income tax system on the economy's efficiency, is the impact of high marginal tax rates on people's willingness to put forth their best productive efforts. If a person has to pay in taxes a large proportion, say more than one-half, of his/her income from extra work, that person's incentive will certainly be reduced. These effects are pertinent despite the fact that the supply of effort are not motivated by money income alone. In addition, an immense amount of effort goes into tax avoidance and so the tax base erodes. (Eckstein, 1979, p79)

Influence of Taxation on Propensity to Save and Capital Formation

The retarding effect the tax system exerts on economic growth, is an important question to consider. Every country relies heavily on fixed capital formation for its growth performance - that is, investment in productive assets. The tax system, in turn, affects the incentive to invest (e.g. the profit anticipated), the riskiness of the investment and the volume of saving and hence the supply

of investable funds. Investment projects will not be undertaken by individuals or companies unless their expected return exceeds the cost of capital and compensates for the risk being taken. Inevitably, entrepreneurs or companies will invest less if government takes too large a proportion of the gain. Tax systems invariably do not make adequate provision for comparable treatment of gains and losses. Nor do they encourage the supply of investable funds by way of adequate depreciation allowances, the generation of retained profits and investment credits.

Although business saving is an important source of capital for industrial growth, personal saving also makes an enormous contribution. Rapidly growing enterprises as well as public utilities must look to the capital market for both equity and debt capital. It is personal saving, the saving of households (both voluntary and contractual), that must provide the bulk of long-term funds available in the capital market.

The marginal propensity to save is higher for families with larger incomes. As a whole, lower- and middle-income families do not save a great deal and most of their savings tend to be channelled into home mortgages or into government bonds (through their banks and life insurance companies). Thus, industry depends largely on savings of a relatively small number of upper-income families. A strong progressive income tax falls particularly heavily on this income group and reduces the availability of venture capital. This is a crucial point for the growth of the economy because the private investor's pushed or pulled by the tax structure out of and into certain kinds of investments e.g. government bonds versus stock market. The preoccupation with capital gains rather than dividend income tends to accentuate the speculative elements in the stock market. (Eckstein, 1979,p84)

South African Trends

In South Africa the tax burden on individuals have nearly doubled in recent years, whilst the tax burden on business remained relatively constant. The individual tax burden includes personal income tax and indirect taxes such as Value Added Taxes. (See Figure 8)

Figure 9 shows the percentage of taxpayers in different income categories on the left and the percentage of tax paid, on the right. It is particularly in the higher income categories that the percentage of tax paid by individuals outstrips the percentage of taxpayers in these same categories. This is largely due to the presence of "bracket creep" that was mentioned earlier. Sadly, these individuals with incomes high enough to enable them to save, cannot do so, owing to the increasing tax burden on high income earners. This must of necessity have a negative impact on investment patterns and hence, on economic growth.

But what role does the public sector play in gross domestic fixed investment? In spite of the increasing amounts of money spent by the SA government sector, its investment activity significantly reduced during the last decade. Figure 10 shows that government invested only marginally more in 1992 than in 1960. The private sector's investment consistently increased until 1980. Thereafter it declined as a result of its perception of unattractive business prospects. Another major reason for this phenomenon is that government became a nett dissaver during the 80's. (See Figure 11) In the period after 1983, government dissaved annually, with the exception of 1990. This redirected the available pool of savings money, away from investment into government consumption expenditure. What little savings were left over after government dissaving was financed, largely went into contractual savings (i.e. pension funds and long term insurance). Very little savings was finally left to be invested. (See Figure 12)

The present lack of growth in the economy thus results from too little new investment for a considerable number of years. As is shown in stark reality by Figure 13, government dissaving as well as the outflow of capital absorbed the bulk of available savings in the economy. Consequently a small proportion of savings is channelled into investment.

The underlying problem is to be found in the increasing domination of the South African economy by general government expenditure. Uncontrolled government expenditure, or the lack of fiscal discipline, places an inordinately large burden on monetary policy instruments to maintain financial stability. The inflationary effects of uncontrolled fiscal expenditure is reflected by the need of a compensatory strict monetary policy in the form of high rates of interest.

<u>The Tax System and Economic Growth</u>

There is a close causal relationship between the tax system and the growth of the economy's capacity to produce. More effort means more output, more saving leads to more investment and more productive capacity. Higher taxes constitute a disincentive to the supply of effort and it discourages savings. On the other hand, if higher government spending results in larger fiscal deficits, then the government is forced to turn to deficit financing by way of borrowing from the private sector, money creation and foreign borrowing (if available). Money creation invariably leads to inflation and rising public debt raises the question of sustainability and "crowding out" of private investment. Hence, the pursuit of a fiscal policy that is unsustainable from a macro-economic point of view will result in insolvency and the destruction of the economy's productive capacity.

A former French finance minister, Colbert, once said that the problem of taxation from the point of view of the legislator or the administrator resembles the problem of plucking a goose ..... i.e. getting the largest amount of feathers with the fewest squawks. Perhaps he misunderstood the real

underlying problem from the point of view of the sustainability of tax levels: the goose that lays the golden eggs must be well looked after in order to maintain (or improve) its capacity to produce!

SEEKING ADMINISTRATIVE RESPONSIBILITY

At all levels of government, today's bureaucracy has grown to be tremendously powerful. Bureaucrats draft and interpret laws, make policy, make and enforce decisions, regulate and control in a variety of ways that have a major impact on the lives of citizens. As with any authority, administrative authority can be abused.

The ideal of administrative responsibility implies compliance with a number of basic values and standards of behaviour. Some of these entail responsiveness of government to popular demands and preferences, assurance that government will be administered by laws and not by arbitrary discretionary powers; accountability and answerability to someone or something outside themselves such as public opinion, political parties, elected representatives, courts of law, the "line of command", the community, obligation to behave according to certain ethical norms such as honesty, fairness, prudence and integrity, and obligation to comply with technical norms and standards of competence, efficiency and economy in the use of resources.

Examples of Shortcomings

What are the major shortcomings or pitfalls on the way to responsibility? Examples of abuses are numerous, not only in other parts of the world but also in South Africa:

- dishonesty of public officials in the form of theft, embezzlement, fraud, bribery and corruption;

- unethical behaviour lying in the "grey zone" between what is not strictly criminal and what is certainly not ethically prudent, such as conflict of interest situations, acceptance of benefits ("kickbacks"), nepotism in favour of family, personal friends or political allies, etc;

- overriding the law in the sense of acting without legal authority or in violation of the law including procedural requirements as well as failure to respect legislative intent;

- gross inefficiency in performance as a result of incompetence, wasteful operations and practices, administrative failures, inertia, failure to show initiative.

Examples of Lack of Responsibility

Much criticism has been levelled at government bureaucracy's lack of responsibility in recent years:

1. That bureaucracy has become so overly centralized and huge that it is inefficient, insulated and non-responsive to the needs of the people.

2. That bureaucracy, following an agenda of its own, is only interested in surviving and growing, and resists change to meet contemporary social problems.

3. That the self-propelling bureaucracy has become so large and powerful that it is not answerable to anyone.

4. That the maintenance of legislative, judicial, media and citizen control or surveillance is undermined by the huge amounts of money disbursed in terms of "secret" funds under the cloak of being in the interests of protecting the "safety of the state".

5. That the incidence of the misuse of funds and the abuse of administrative power are far to prevalent.

Even as early as 1787, one of the "Founding Father's" of the American constitution, James Madison, knew that administrative responsibility could not be taken for granted. He knew that external and internal controls are necessary. In Federalist Paper No 51 he wrote: "If men were angels, no government would be necessary. If angels were to govern men neither external nor internal controls on government would be necessary..... A dependence on the people is, no doubt, the primary control on the government, but experience has taught mankind the necessity of auxiliary precautions."

How can responsibility be enhanced, particularly in the field of public finance? This question has generated much debate, controversy and varied solutions. Some solutions refer to external control measures, others rely on the internal aspects of achieving administrative responsibility.

1. **Legislative Oversight**

Legislatures have a vital role in setting the objectives of administration: they pass the laws, approve the budgets, determine the structures of agencies and sometimes prescribe operational detail. They monitor progress and achievements through committee hearings, special investigations, parliamentary questions and debates. Yet we know that legislative attempts at

scrutiny and control are spasmodic and post hoc and only rarely does it assume the initiative in policy-making.

Legislatures have extreme difficulties in exercising an incisive review of appropriations. The use of committees as an investigatory instrument has inherent defects in that it is spotty, transitory and remedial rather than preventive. Legislative control often seems to be of limited effectiveness in technical fields such as defence spending, and where transfer payments are concerned (e.g. for social security benefits and in support vested interests) there is reason to doubt the strength of the legislature's desire to control public spending. The control of the Auditor-General, who is supposed to act as "watchdog" in the field of public spending, scrutiny is occurring only after the money has been spent. There is also reason to doubt the legislature's desire to control public spending on public sector emoluments because political representatives and public officials are basically on the same payroll.

The means to improve legislative control are well known but they fly in the face of vested interests, the weight of tradition and the demands of political survival, political fence-building, bureaucratic obstruction and constituent demands. (Presthus, 1975, pp388-390)

2. Executive Control

It has often been said that we live in an "executive-centred era" in which the effectiveness of government depends substantially upon executive leadership, both in policy formation and in policy execution. Legislation often delegates significant policy making authority to the executive branch, particularly in the areas of foreign policy and security matters. In modern industrial societies, the technicality and complexity of many policy matters and the need for continuing control, have led to the delegation of such discretionary authority, often formally recognised as rule-making power, to the executive branch. The executive branch, in turn, relies heavily on administrative agencies. Consequently these agencies are in effect, as advisors to executive office-bearers, making decisions that have far-reaching consequences.

In a democratic society executives do not operate in a vacuum. Their decisions are influenced by a variety of factors: their value commitments, their political party affiliation, their constituency interests, their perception of the public opinion and the applicable decision rules. The styles of decision making depends on the individuals concerned as well as the political system and political culture within which they operate. In most developing countries strong executive policy-making prevails, whereas in open political systems there are numerous autonomous organised group interests in action: labour, unions, business

organisations, professional associations, environmental groups, sports clubs and civil rights groups. In this environment decision-making involves negotiation, give-and-take, compromise and persuasion. Nevertheless, policy-making and policy execution is in large measure at the mercy of executives and administrators. To rely heavily on executive control is to put the fox in charge of the hen house!

3. Judicial Control

Although legislatures occasionally insulate administrative agencies from judicial review, the courts are in a position to question most administrative decisions in terms of official powers as defined by the law. An injured party can appeal to the courts to seek redress and in this way the courts can exercise surveillance to prevent unfair treatment and the observance of procedural requirements. But there are many limitations to judicial control. The most important point to recognise is that responsibility is always after the fact: that is to say all the courts can do is to alleviate or punish wrongs that have occurred. This deficiency also applies to the office of the Ombudsman as an agent of control. Moreover, courts of law can hardly play any role of significance in the area of exacting responsibility in the area of public finance.

4. Citizen Participation

Generally speaking, citizen participation in policy-making, or in surveillance on public administration, is relatively thin. Many people do not vote, engage in party activity, join pressure groups, or even display much interest in politics. A great many citizens do not avail themselves of their opportunities to influence public affairs because of inertia or indifference.

That does not mean citizens in a democracy have no impact on public affairs. The mere fact that citizens have the right in democratic regimes to elect their representatives, as well as the existence of genuine periodic elections, puts a stamp of approval on citizen participation. Indirectly, therefore the fact of elections enforces on aspirant policy-makers a rule that citizens' wishes do count in policy-making. Citizens have a right to be heard and officials have a duty to listen. Moreover citizens, through their intellectual activities, contribute new ideas and directions to the policy process. (See Anderson, 1975, pp47-48)

In many parts of the world efforts have been made to include citizens, either in their individual capacity or as members of organized interest groups, to participate in the administrative process. The most common form that citizen participation assumes, is the advisory committee or the citizen group acting in a governing capacity in a specific policy area or an area of activity. In most countries, as in South Africa, there are a multitude of advisory committees on the various levels

of government and within units of government. Administrators use these bodies to obtain information, advice, opinions from affected interests and they act as sounding boards for ideas, strategies and viewpoints.

The track records of these institutions are not entirely encouraging. They are often merely used as instruments to pacify dissatisfied groups by way of cooptation, or as a vehicle by which a bureaucracy builds a clientele, or as a method for transferring responsibility elsewhere. At the same time, such committees may be misused by outside interests in instances where the more powerful groups represented on them, may dominate committee deliberations. In such cases these committees provide a distorted view of interest opinion and provide a focus through which strong and strategically placed interests may exert a disproportionate amount of influence.

5. **Media Surveillance and Exposure**

The power to determine what the people will read, see and hear about is vested in today's mass media. The press, television and radio are the major sources of information and the instruments of public opinion formation for the vast majority of people. Particular problems or issues attract the attention of the media, and through their reportage, could either be converted into public agenda items or be given more salience.

The leadership of mass media often claim that they do no more than "mirror" reality. But news people decide what the news will be, how it will be presented and how it will be interpreted. They decide what issues will be given attention and what issues will be ignored. Issues which will receive the greatest attention in the media are also more likely to be viewed by voters as important. As important opinion shapers, the media help structure the political agenda.

Normally television networks and the national press interact with one another. The topics they select for coverage reflect, and often create, newsworthy events, trends or issues worthy of public attention. To capture the attention of readers, viewers or listeners, the media often require drama, action or confrontation. Shocking incidents, dramatic conflict, violence, corruption in government are favourite topics because of popular interest. More complex problems such as inflation, government spending, development strategies must either be simplified, dramatized or ignored.

The media's exposure of scandals, abuse, mismanagement and corruption in government, or what is wrong in our society, can play an important role in producing a reformist and constructive frame of mind. Hence their role in the surveillance of government activity cannot be underestimated. By conducting"investigative reporting" the media can produce a continuous flow of information of what goes wrong in the public sector and thereby can help instill a sense of responsibility in the ranks of public officials and elected office-bearers.

To perform these "watchdog" functions, the media has to be unfettered by the powers that be. It also requires them to be staffed by competent reporters who are able to delve into the large volumes of complex and intricate public reports. To research and establish the levels of expenditure and employment on the various levels of government in the numerous public institutions, requires technical expertise and highly trained and experienced analytical skills. Meeting this requirement is probably the biggest constraint on the effectiveness of the media to act as watchdogs of the public.

6. Inner Checks

By "inner checks" is meant the individual's own sense of responsibility to the public. This can be enhanced by incorporating codes of ethics, professional codes and conceptions of the "public interest" as key elements into the value hierarchy of the public sector. As a result of the frailties of human nature, most observers are highly sceptical about the success potential of "inner checks". Yet it is of critical importance that every effort should be made to influence public sector employees "from within".

Public servants must be sensitized to the true nature of responsible action:

- recognition of an obligation to meet a standard or a need outside of and superior to one's own interests;
- regard for the consequences or outcomes of one's decisions and actions;
- respect for the element of rationalism and prudence; and,
- awareness of a time perspective that transcends the present moment, recognising that the future is as important as the present.

Are Effective Checks and Balances Possible?

Can sufficient checks and balances be introduced to enhance administrative responsibility? No artificial system of organizational or legal safeguards can enforce administrative responsibility or prevent unethical behaviour. The ultimate control is the internalised value system of individual employees. They must themselves be able to discern which actions can be held up to public scrutiny and which cannot.

While there are many competent and dedicated public servants, the number of persons on the government's payroll who are not earning what the taxpayers are paying them is one of the most daunting challenges of the modern state. Most modern democracies tend to overspend, i.e. their expenditure chronically outpaces their income. But it is particularly significant to note that in many countries the emoluments of civil servants and politicians make out around sixty

percent of all government spending. This means that any reliance on the state to perform any task is more likely to increase job opportunities and benefits for civil servants than benefits for the taxpaying public.

In addition, it should be noted that most modern countries have introduced "collective bargaining" practices into the public sector. But they have transferred the practices evolved in the private sector without its concomitant "checks and balances". Hence the beneficiaries of the outcome (i.e. civil servants and politicians) sit on both sides of the bargaining table. The taxpayers real interest is not represented. This problem has taken on gigantic proportions in modern democracies.

The search for administrative responsibility has become a basic concern in modern public life. As pointed out by George A Graham in one of the classic texts called Elements of Public Administration (1946), the essentials of responsibility lies at the roots of civilization and government. It is the derivative of centuries of human experience and a characteristic of both men and institutions. It needs to permeate men and institutions alike if it is to exist at all. "Responsible men create responsible institutions, and responsible institutions develop responsibility in men." (George A Graham, 1946, p501)

CONCLUSIONS

1. Governments everywhere continue to grow in size

Every society develops some form of government to provide selected services to the population. Consequently there are always economic costs associated with government, regardless of the social, economic or political framework within which it operates. Because modern government has a voracious appetite for money, these costs consume a large and growing percentage of the gross domestic product. Hence, the level of government expenditure is a controversial issue in all countries where freedom of speech is allowed. Some argue that government has become too large, provides too many services, employs too many people and therefore urge a reduction in government's role which would reduce costs. Others demand a fuller range of services on grounds of market failure, distributional or redistributional concerns.

2. Government Spending Chronically Outpaces Income

The shortage of funds to meet the costs of government has been the root cause of many difficulties faced by governments and societies since ancient times. The same shortage which exists today can be expected to escalate into the future due to an ever-increasing demand for services, inflation and the competition for resources between pressure groups. With this trend will come a deeper and more intense political controversy.

3. Mixed Economies Require Sharp Surveillance on the Nature of the Mix

In the current world, the controversy surrounding the proper scope of government activity is mainly focused on the debate between proponents of the market economy approach with its emphasis on free enterprise, private initiative, entrepreneurship and efficiency on the one hand, and the command economy approach with its commitment to egalitarianism, welfare services and social security based on government intervention and control. Some interventionists are in favour of a leftist, socialist type of interventionism, whereas others favour a rightist, capitalist type of interventionism. In reality, most countries in today's world are running a mixed economy that combines free-market features and some form of government intervention. In consequence, the most important arguments have to be focused on the nature of the mix. Sharp surveillance must be kept on the quality of government services: its allocative efficiency as well as its productive efficiency.

4. High Levels of Intervention Lead to Declining Economic Growth

In recent years the world has witnessed the dismal failure of all centrally planned socialist economies in contrast to the impressive economic growth performance of Pacific Rim countries that judiciously used government guidance and facilitation to mobilise the creative energies of business entrepreneurship and to utilise the benefits of economic prosperity to improve the quality and scope of government services. But a different picture started to emerge in the traditionally prosperous social-market democracies of the West: the USA, the United Kingdom, Germany, France, the Netherlands and the Scandinavian countries. They are now plagued by economic stagnation and bureaucratic bondage as a result of their tax policies and income-levelling experiments. It appears that forced egalitarianism not only destroys freedom and stifles creativity, but that the cost of a high level of government expenditure results in unacceptably high levels of intervention and taxation which remove incentives to produce and lead to declining rates of economic growth.

5. The Law of Creeping Public Bureaucracy Inevitably Drives Every Society to Higher Levels of Government Activity

Whatever the level of government intervention, there is a price to be paid by society in terms of bearing the tax burden and in terms of keeping in check a self-propelling bureaucracy. There is a LAW OF CREEPING PUBLIC BUREAUCRACY in operation that drives every society to higher levels of government activity absorbing an ever-increasing portion of the gross national product as a result of the permanently upward pressure on revenues an expenditure. This law of creeping public bureaucracy is underpinned by the following mutually reinforcing causal factors:

- As society becomes more complex as a result of economic, social, technological and cultural advancement, governments assume a more prominent role in establishing and running public institutions to control this complexity in response to political and bureaucratic demands.

- Because productivity in the public sector does not increase in step with the private sector, the price of goods and services provided by the government rises more rapidly than the price of privately produced goods and services. In the long run public employees receive the same remuneration and increments as other workers. As a result the unit cost of these public services increases steadily, which implies a built-in tendency for public expenditure to grow faster than national income - and exerting an inflationary cost-push force in the economy.

- Productive inefficiency in the public sector arises out of a variety of causes: ineffective external monitoring and control; poor management practices; employment practices that bear no relationship to the value of labour as a productive resource (eg. cost of labour to the value of its output and the cost of other inputsn the production process); salary and wage-setting mechanisms that bear no relationship to productive output (neither rewards efficiency nor penalises inefficiency); budgetary procedures focusing on activities of government in terms of their costs and inputs totally unrelated to expected results; policy makers generally considering existing expenditure levels on specific items or programmes as a base and thus focusing their attention on a narrow range of increases and decreases in expenditure levels; fragmented and segmented decision-making on budgetary matters between agencies, departments and legislatures (both the income and expenditure side); the range of decisions available to policy-makers on budgetary matters becoming very small as a result of so many "uncontrollable" items carried over from past commitments.

- Ignorance, political apathy as well as a sense of political ineffectuality lead the general public into an illusionary state of mind which causes them to placidly accept increases in the number of public programmes as well as the rising cost of running them, regardless of the level of allocative or productive efficiency involved. This climate of opinion leaves decision-making on public spending and tax levels largely in the hands of political executives and the administrative agencies supporting them.

- Hence, a built-in tendency for public expenditure to grow relative to national income becomes an unchecked, self-generating force with a dynamic and momentum of its own that leads to an inevitability in the expanding share of the state in the economy.

6. <u>High Levels of Public Spending and Taxation "Crowds Out" Private Enterprise and Destroys Productive Capacity</u>

It is now becoming clearer that there is a close causal relationship between the tax system and the growth of an economy's capacity to produce. More effort means more output, more saving leads to more investment and more productive capacity. Higher taxes, on the other hand, constitute a disincentive to the supply of effort and it discourages savings and investment. (See Figures 14 and 15) Hence the pursuit of a fiscal policy that is unsustainable from a macro-economic point of view, results in the destruction of the economy's productive capacity.

A fiscal policy that allows vigorous growth of government expenditure, for whatever reason, "crowds out" the productive private sector from most of the important factor markets. A government that competes against the private sector for funds; skilled and less-skilled labour; consumer goods necessary to conduct business (such as vehicles, office machinery and equipment) reduces the scope and efficiency of the private sector's wealth creating efforts. Such a situation must be avoided at all costs.

There is little merit in public programmes and high levels of public expenditure which are coupled with the potentially damaging effects of increased taxation, low public sector productivity, inappropriate stimulation of pressure group influence and the misconceived objectives of public bureaucrats. Special interests are generally incline to "capture" interventionist policies for their own benefit.

More and more countries are now facing vexing questions about the expanding scope of government activity. How far can the nation's wealth and income be absorbed by government and decided upon by the political process before its production capacity starts to decline? Unless a satisfactory answer is found and proper counter-measures taken, a growing number of countries will face the collapse of its political-economic order.

RECOMMENDATIONS

How can allocative and productive efficiency in the public sector be improved? In the private sector the competitive market process, self-interest and the bottom-line discipline serve to produce rational production decisions and the application of economic criteria. In the public sector special procedural and institutional arrangements have to be introduced to enhance the process of rational choice in order to obtain allocative and productive efficiency. Despite obvious constraints, much can be done by way of improvement.

1. The principle that marginal benefit must exceed marginal cost can be applied in some areas of public decision-making on budgetary matters - mostly where benefits are tangible and measurable. It will focus the attention of decision makers on the margins where the decisions are made. Decisions should not be based on a simplistic consideration of requirements or needs (e.g. x thousand new housing units, classrooms or hospital beds). There is always some cost that the requirement or need is not worth. Economic resources are scarce and tough choices have to be made between competing programmes. Benefits must be balanced against costs at the margin - even where precise measurement of benefit is impossible. If problems are defined in relative rather than absolute terms, they will always outpace capabilities. Not all forces operating in society can be harnessed by government intervention. Some solutions may require policies that are more costly than the problem they purport to solve. The manner in which the costs and benefits of a policy is distributed will have important consequences for the attainment of allocative efficiency.

2. Attention can be given to the rationalization of organizational structures in order to make a single decision unit responsible for a given objective or set of tasks. In that way one authority is confronted with a choice among alternatives that can be used to achieve a particular objective and can rationally seek out the best one. Organizational structures should closely match functionally specific or area specific objectives, in order to allow choices to be made more rationally. Expenditures must be clearly identified with the objectives they are to accomplish and the results to be attained should be evaluated in relation to its costs. This implies that responsibility for the expenditure side and the income side of the budget should not be fragmented.

3. Every activity or unit must be costed, monitored and compared with alternative applications. The ability of units or departments to keep costs down should be rewarded. Decision makers must be under pressure to apply rational and transparent criteria in all areas of activity.

4. Procurement of government stocks, material, equipment and services should leave incentives for efficiency. Competitive bidding after public notice must be used as widely as possible and "cost-plus" contracts should be avoided. Every incentive must be built into the procurement process to keep costs down. Free and open competition is the only safeguard for fairness and moral integrity.

5. The most significant available cost-cutting measure in the public sector is staff reduction. Emoluments make up around 60 percent of all current general government expenditure. Staff reductions will also result in additional savings on office space, general maintenance and other associated expenditure. The use of a task force of business executives of proven accomplishment could assist in identifying priority areas for staff reduction.

6. Because government budgeting lies at the heart of public policy-making every effort should be made to improve fiscal discipline in the budgetary process. This requires a clear distinction of productive expenditure from unproductive expenditure. In this way priority targets can be set in the event of either a need for expenditure cuts or a desire to accommodate new expenditure demands. Outputs must be clearly distinguished from outcomes.

7. Policy and decision makers should pay more attention to policy, programme and procedure evaluation. This means that the impact government activities have on their targets in terms of the goals they are meant to achieve must be continuously evaluated. The impact of an activity refers to all its effects on real-world conditions eg. on the target group or situation, the spillover effects, the present as well as the future, direct costs (resources absorbed) and indirect costs (loss of opportunities to do other things). An important analytical tool could be the introduction of a more rational government accounting system showing a balance sheet of assets and liabilities as well as an accrual-based operating statement of income and expenses - just like those of a private-sector company.

8. Privatization is an important policy measure to transfer activities to the private sector in order to gain allocative efficiency and productive efficiency. Its most notable manifestation is the sale of public enterprises to the private sector. Privatization does not necessarily require total divestiture: franchising, contracting out and leasing are also widespread methods whereby public sector activities are undertaken by the private sector. Privatization is unlikely to result in increased efficiency unless it is accompanied by a dismantling of protective barriers that restrict competition.

9. It is necessary to retain a healthy scepticism about the effectiveness of state intervention. Bad decision-making, bad planning and inefficient production by the government bureaucracy drives out good decision-making, good planning and efficient production by private enterprise. Modern societies and economies are much too complex to permit sosio-economic engineering and master-minded intervention by public bureaucrats. The collapse of the centrally planned economies was the final spectacular demonstration of a phenomenon that was already indisputably clear. For all its weaknesses and needed reforms in South Africa, the free enterprise system holds out the most promising the most creative and dynamic force that the civilization of mankind has ever discovered: the creative power of the free enterprising individual.

10. The rise of open market economies and the advance of pluralist political systems are two important megatrends in today's world. Although these megatrends are not automatic or inevitable, most countries seem to perceive them as winning strategies - albeit with variations in content and sequence. Hence, most countries will, in the foreseeable future, opt for an open free-market economy, dominated by the private sector. A corollary trend in this development process will be the process of democratization as manifested by social diversification, the spread of education and wealth, and demand for effective political participation and the recognition of basic human rights. Development policies should be designed to provide a suitable setting for these two great processes. Countries that fail to facilitate this transition, run the risk of ending up as losers.

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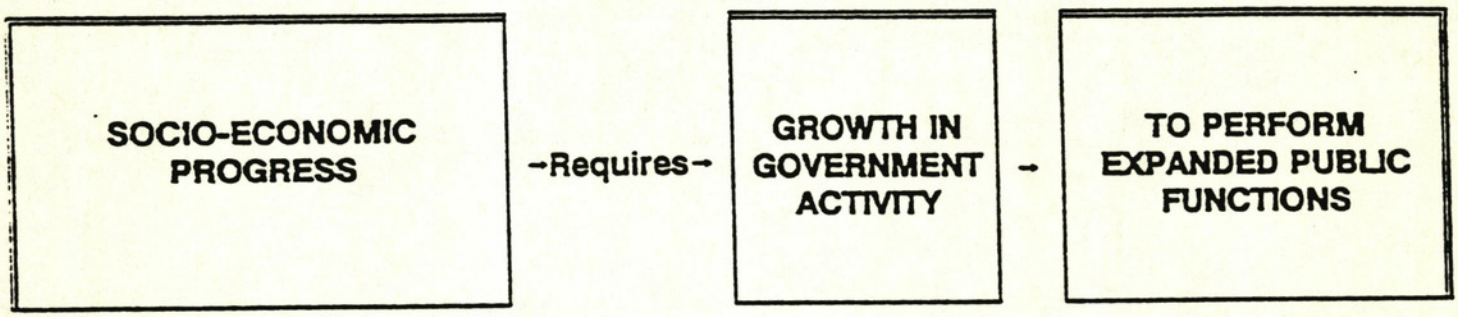
Diagram 1

PUBLIC GOODS AS INCREASING NECESSITIES

IN COMPLEX SOCIETIES



- economic growth
- population growth
- technological development
- urbanization
- social atomization
- economies of scale
- complementarities
- externalities

- law and order
- economic services
- social services
- health and sanitation
- education
- basic infrastructure
- nature conservation

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Diagram 2

PUBLIC DEMANDS AS ROOT CAUSE OF PUBLIC PROGRAMMES

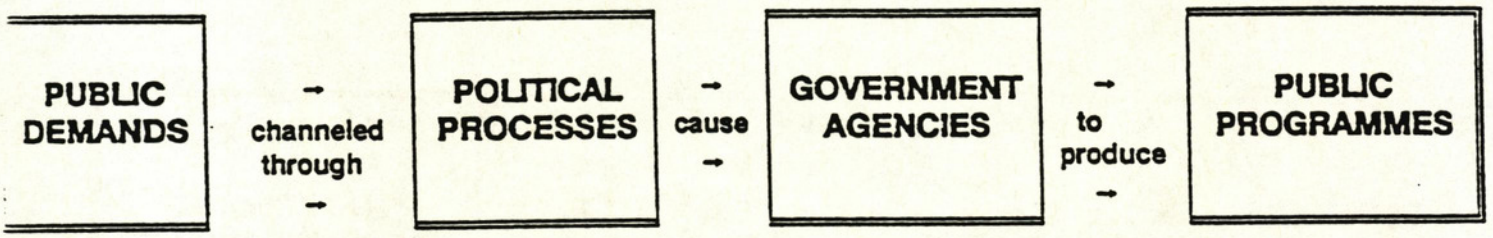

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DIAGRAM 3

CHOICE BETWEEN PUBLIC AND PRIVATE GOODS

Figure 3a

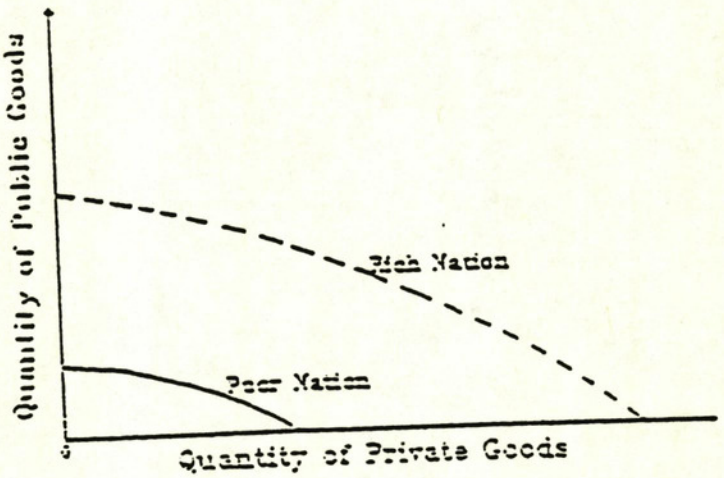
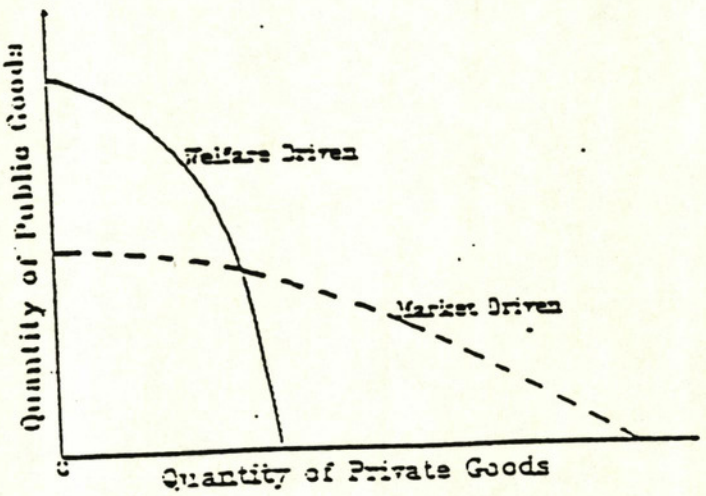


Figure 3b



SSDC: Economic Research

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Table 1

PUBLIC EXPENDITURE AS A PERCENTAGE OF GDP
1972 - 1988

	1972	1975	1980	1985	1988
Industrial Countries	36.7	42.1	46.0	48.3	48.9
Developing Countries	23.8	23.0	30.2	32.7	...
Africa	22.6	25.7	32.6	35.5	36.0'
Asia	27.3	24.8	30.3	29.3	30.0'
Middle East	32.2	30.7	44.6	43.1	44.0'
Western Hemisphere	21.8	24.1	24.6	29.1	30.0

1. General Government (excluding Public Corporations)
2. Estimates

SBDC: Economic Research
Source: IMF Government Finance Statistics Yearbook

Pubexp.cht 21/10/1992

1545

Table 2: FUNCTIONAL CLASSIFICATION OF SOUTH AFRICAN GOVERNMENT EXPENDITURE

(CENTRAL GOVERNMENT EXCLUDING PUBLIC CORPORATIONS)

Percentage of total expenditure

	1982	1985	1987	1989	1991
General Public Services	25.2	28.5	28.2	27.7	29.7
Safety Services[1]	20.8	18.8	18.5	20.0	15.2
Education	18.0	17.4	18.3	18.4	18.9
Welfare Services[2]	21.6	20.0	20.5	19.8	20.0*
Interest	13.6	15.3	13.8	14.9	16.2

Source: SA Reserve Bank

1. Defence and Police
2. Housing, Health and Welfare

* Estimate

SBDC: Economic Research

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39

239

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CONSTITUTIONAL
ASSEMBLY

20 FEB 1995

001621

Mr Snakes Nyoka
Managing Secretary
Theme Committee 6
Constitutional Assembly
P O Box 15
Cape Town
8000

Our ref

Your ref

Date 9 February 1995

Dear Mr Nyoka

SUBMISSION TO THE CONSTITUTIONAL ASSEMBLY : THEME COMMITTEE 6 ON FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

Thank you for the opportunity to provide you with inputs regarding the key issues for which Theme Committee 6 is responsible.

Herewith please find the DBSA submission in this regard. This document provides a development perspective on the areas of responsibility as highlighted in your request and focuses on strategic issues that would need to be addressed as a matter of urgency. Should Theme Committee 6 require further elaboration and detailed technical inputs, we would be available to provide it to you.

Since DBSA has in the past, in many instances (albeit in the old system), acted in the capacity of an intergovernmental development finance institution, I would again like to offer our assistance and experience to support the endeavours of the Constitutional Assembly.

Yours sincerely

G J RICHTER
General Manager : Centre for Policy and Information

DEVELOPMENT BANK OF SOUTHERN AFRICA

SUBMISSION TO

THE CONSTITUTIONAL ASSEMBLY
THEME COMMITTEE 6
ON FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

1. INTRODUCTION

1.1 The past few years have been devoted to mega-constitutional change in South Africa, resulting in the introduction of an Interim Constitution in 1994. The introduction of a process of economic transformation of a society marked by deep diversity has coincided with the implementation of this Constitution. **The final Constitution presents the opportunity to move beyond the 'political' covenant reform of the Interim Constitution to a new foundation for a 'social' contract among all South Africans by recognizing the importance of socio-economic issues in the design of the political system**

1.2 The Interim Constitution *inter alia* defines a way of life and the people comprising the community which is so directed; a form of government; the regime, the public and citizenship; as well as establishing the basis for the authority of the regime and distributing political power. Furthermore, it contains a set of binding and juridically enforceable principles with which all future Constitutions have to comply.

1.3 The form of government is defined by providing a framework for three levels of governments and the basis for its behaviour; providing a framework for, and in some instances the shape, of political institutions and specialized structures of government, e.g. an independent Public Service Commission, Reserve Bank, Auditor-General and Public Protector; as well as formalizing intergovernmental fiscal arrangements both in mechanism, i.e. a Financial and Fiscal Commission, and in criteria to be taken into account for this purpose. This submission will comment on specialized financial structures of government and specifically on the Financial and Fiscal Commission.

2. POINT OF DEPARTURE

2.1 There is a need to recognize the importance of socio-economic issues in the design of the political system.

2.2 The disparate socio-economic situation, interpersonally, and intergeographically, the stage of economic development, and the design and implementation of a reconstruction and development programme, all suggest that South Africa will experience profound structural shifts in the social and economic spheres. In order to accommodate this dynamic socio-economic environment, it is believed that constitutional proposals, specifically on financial and fiscal mechanisms, should not be excessively detailed, but rather outline the broad parameters and principles within which mechanisms and arrangements have to be developed. Therefore, the nature of the Constitution will have to be enabling rather than prescriptive or restrictive.

2.2 It is recognized that the vision, strategies and mechanisms for implementation of a socio-economic reconstruction and development plan should be fully compatible with the Constitution and foster the envisaged development of the nation-state. However, in turn, accomplishing the long-term socio-economic visions of a country, is not only dependent on specific policies and strategies in this regard, but also on enabling political, fiscal and financial, as well as administrative arrangements. It would thus be relevant to identify and strengthen those features of the political, fiscal and financial system as well as administrative arrangements that would have a positive impact on the process and outcomes of reconstruction and development. The people-centred development focus of the RDP as reflected in its six basic principles, i.e. an integrated and sustainable programme, that must be a people-driven process, that provides peace and security for all and builds and integrate the nations, links reconstruction and development and deepens democracy, provides a useful point of departure for shaping constitutional proposals in a way that will reinforce the socio-economic reconstruction and development of South Africa.

3. AUDITOR-GENERAL

3.1 Sections 191-194 of the Constitution provides in considerable detail for the establishment, appointment, independence, impartiality, and effectiveness of a common Auditor-General for the public sector at large, including all levels of government. This section could be shortened and reordered without detracting from the content of the Constitutional provisions. For example, sections 191(3, 8 and 7) deals with the eligibility criteria for an Auditor-General; section 191(5) with a temporary substitute; and sections 191(4, 6, 9 and 11) with terms of office, remuneration and service conditions. Some of these

issues such as those on remuneration and service conditions could even be dealt with statutorily rather than in the constitution.

3.2 A well-functioning national system of financial accountability is essential, but represents only one aspect of accountability and strategic management measures that need to be promoted in South Africa in realizing our visions for reconstruction and development. In the past and irrespective of the level of government, public financial accountability and financial control systems have been artificially divorced from accountability for overall socio-economic performance. However, the systems and mechanisms to promote these as well as strategic management are interdependent. Although constitutionalisation of an elaborate system for financial and socio-economic performance accountability is not desirable, the linkages of the financial accounting system with accountability for socio-economic performance and strategic management need to be recognized in the Constitution. It is, therefore, proposed that section 193 be amended to incorporate the linkages of the financial accounting system with accountability for socio-economic performance and strategic management.

3.3 Furthermore, in view of these interdependencies, whether intergovernmental or on a particular level of government, as well as the need to encourage community participation through political and informal control mechanisms, it could be argued that accountability on the provincial level could be strengthened by the establishment of provincial Auditor-Generals as well. The functions of these could be extended to include overall socio-economic performance assessment of provincial and local authorities. It is proposed that the Constitution be amended to enable the establishment of provincial Auditor-Generals.

4. THE SOUTH AFRICAN RESERVE BANK

4.1 The independence of the Reserve Bank as enabled in the Constitution is supported.

4.2 A Constitutionally independent Reserve Bank, however, supposes strong cooperation and coordination with loci of responsibility for other macroeconomic policies, not only with *the Minister responsible for national financial matters,* section 196(2). The degree of cooperation and coordination between the monetary authorities and other macroeconomic policy decision makers would *inter alia* influence the choice and level of policy instruments for achieving price stability and the appropriate external balances.

4.3 This could be illustrated by the fact that in many other countries, money supply has lost some of its appeal as an anchor for monetary policy purposes, and, in some instances, has been abandoned and replaced by a different basis, e.g. the exchange rate. In a number of countries - for example in the United Kingdom, New Zealand and Canada - the authorities

are now pursuing inflation targets more directly, instead of through an intermediate target such as the money supply. This approach, however, requires a degree of cooperation between government, private businesses, trade unions and the central bank which, in the present phase of socio-political reforms in South Africa, is extremely difficult to obtain. Therefore, the Bank is of the opinion that money supply targeting remains, at least in the present South African context, the most sensible anchor for monetary policy and for guiding the authorities in their decisions in executing their monetary policy responsibilities.

5. THE FINANCIAL AND FISCAL COMMISSION (FFC)

5.1 It is recognized that it is rarely possible to design a multi-governmental constitution in a way that allow for the precise matching of autonomous revenue sources with expenditure responsibilities for each level of government. Even if it could be done initially, the relative shares of different taxes and expenditures are likely to shift over time, thereby creating imbalances and a source of intergovernmental controversy. In South Africa, such a perfect matching of revenue sources and expenditure responsibilities is particularly unfeasible, due to the imbalances in economic activity and the need for interjurisdictional and interpersonal equalization. This makes the constitutionally established FFC (section 198) an immensely important link in the overall operation of the constitutional structure and the relationship between the various tiers of government, particularly regarding advice on a rational, accountable and predictable structure of intergovernmental fiscal relations.

5.2 Sections 200 to 205 can be considerably shortened and refocused in the new Constitution. Except for the composition of the FFC, section 200(1), the focus of the Interim Constitution should shift from an emphasis on structures to ensuring the impartiality, integrity, objectivity and professional competence of the FFC. This could be done through establishing eligibility criteria for members, e.g. those in section 200(3 to 10) as well as through establishing principles for operation. The latter might include e.g. fostering transparency; providing for interaction with communities/parties/institutions, e.g. to present their views; undertaking professional technical analysis; having access to relevant information; fostering the exercise of sound and impartial judgment; ensuring that reporting is done fairly, comprehensively and clearly; and effectively managing its resources.

5.3 Current constitutional proposals regarding its meetings; establishment of committees; cooption of persons by committees; terms of office of members and officials; remuneration and conditions of service of members and other persons; appointment of staff; and other relevant matters, could be allowed for statutorily rather than constitutionally.

5.4 An important element in establishing sound intergovernmental relations is the existence of a framework and criteria for evaluating and deciding on the intergovernmental

allocation of functions. As DBSA subscribes to the principle that *finance should follow expenditure function*, it is proposed that section 199(1 or 2) be amended to include an in-principle statement on such functional criteria that should serve as a framework for the FFC's advice and recommendations regarding the financial and fiscal requirements of the different tiers of government. The details of such a framework and criteria should, however, be dealt with in separate legislation.

5.5 Furthermore, it is proposed that section 199 on objects and functions be extended to provide for the FFC to play a facilitating role regarding inter-governmental fiscal/financial relations. In particular, the FFC should seek to facilitate coordination and cooperation between the different levels of government (vertically) as well as between same-level governments (horizontally). Although the process for this facilitating role need not be constitutionalised, it is important to notice that, for this purpose, close coordination between the FFC, the Public Service Commission, the Commission for Provincial Government, and/or any other institutional mechanism that might impact on intergovernmental finances would be essential.

6. OTHER

DBSA is of the opinion that issues such as the national fund, budget, procurement, special provisions for pensions and income tax of elected representatives and political officers, and provisions on public enterprises should not be constitutionalised.

7. CONCLUSION

7.1 These comments depart from the viewpoint that a constitution should be designed as a foundation for a social contract among citizens, through recognizing the importance of socio-economic issues in the design of the political system. Furthermore, the dynamic South African socio-economic environment requires flexibility and appreciation of the fact that a constitutional text cannot and should not with certainty and precision control every detail of the future.

7.2 The socio-economic realities, the intergovernmental allocation of resources, functions and powers, and the design and implementation of a reconstruction and development plan all require great intergovernmental cooperation, coordination, joint planning and sharing of resources

7.3 While the fiscal relations are to a certain extent constitutionalised, other types of intergovernmental relations will probably be provided for either statutorily or through informal arrangements. As in other federal and regional-type systems, the success of the South

African political dispensation will to a large extent depend on the success of these intergovernmental relations.

7.4 Serious consideration should be given to constitutionalise an advisory commission on intergovernmental relations, in order to analyze, evaluate and improve intergovernmental relations in general. It could have a number of functions, ranging from investigative tasks regarding the functioning of the system to the formulation of policy inputs and arbitration of intergovernmental disputes. The Commission for Provincial Government may well be transformed into a permanent advisory commission focusing on intergovernmental relations in general.

VOLKSTAAT COUNCIL

SUBMISSION TO THEME COMMITTEE 6

THE APPOINTMENT OF FINANCIAL AND FISCAL COMMISSIONS

(Hierdie dokument is ook in Afrikaans beskikbaar)

A. Principles

1. The purpose of such a commission is to establish an expert, unbiased body to furnish fiscal advice to the national and constituent states seeking it.

2. Such a commission may also advise on financial transfers which may prove necessary to enable poor and economically dependent constituent states to survive financially. In this regard, compare, for example, Gauteng and Northern Transvaal.

3. Constituent states may appoint their own commissions and these commissions may liaise and coordinate with the National Commission. Should they prefer, the constituent states may join the National Commission without appointing commissions of their own.

B. PROPOSAL FOR CONSTITUTIONAL WORDING

1. A Financial and Fiscal Commission is hereby established.

2. The objects and functions of this commission will be to appraise itself of all financial and fiscal information relevant to the national government and to those constituent states who requested and authorised the commission to do so and local governments within their borders and, on the basis of such information, to render advice and make recommendations to the relative legislative authorities in terms of the constitution regarding the financial and fiscal requirements of the national and relevant constituent states and local governments including:

   a. financial and fiscal policies;
   b. equitable redistribution of revenue collected at national level;
   c. taxes, levies, imposts and surcharges;
   d. loans; and
   e. all such matters assigned to the commission by the national government or the participating constituent states.

3. The Commission shall consist of:

This is next page

a. a chairperson and deputy chairperson appointed by the President in consultation with the cabinet;

b. a person designated by each participating constituent state by reason of his or her expertise in economics, public finance, public administration, taxation, management or accountancy.

4. Any constituent state will be entitled and authorised to appoint a Financial and Fiscal Commission on ***mutatis mutandis*** the same basis. Such a commission will co-operate and co-ordinate fiscal management.

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