A quick glance at a modern social democracy's national accounts shows a gradual increase in the public sector's share of the national product. As the governmental sector absorbs a growing segment of the national income, it exercises a growing influence on its economic life. It collects a growing proportion of national income as taxes which it redistributes as social contributions in various forms.

Keeping a Lid on the Public Sector

The experience of all countries shows that the powerful trend of increasing the public sector's share of the national expenditure has given an added strength to inflationary pressures. In most instances, inflation target ceilings have to be set to discipline government spending. The public sector share grows faster than the gross national product. Public sector spending grows faster than private sector spending which, after all, is the original source of all taxable income. The reason is that public spending under electoral pressures can be adapted upwards more easily than downwards. There are more tax beneficiaries than income tax payers.

Direct taxes determine how large a part of the incomes of private persons and businesses is available for consumption and investment. Direct transfer payments, i.e. pensions and social contributions of all kinds amount to very large sums – up to 50 percent of the annual budget. Indirect transfers, eg. interest payments on loans drive expenditure even higher. In addition, the public sector's activities, through its income and expenditure patterns, also have an influence on liquidity and the supply of money. The amount of government borrowing and its cash holdings influence the amount of money and liquid assets available to banks and different spheres of the economy. Central bank action plays a central role in the determination of interest rate levels and the volume of money in circulation.

The economic effects of fiscal policy revolve around the levels of total public sector revenue and expenditure as shown in current and capital budgets. Of importance is the difference between actual and planned totals of income and expenditure, i.e. on budget surpluses and deficits.

Surpluses and Deficits

When is a surplus desirable? At what level is a deficit excessive? The targets of budgetary policy should be set up in the light of a systematic consideration of the state of the economy as a whole. Various aspects of a government's income and expenditure levels have important effects on the national economy: on the demand and supply of goods and services, on income formation (and thus on demand), on liquidity and interest rates (and thus indirectly on both income and demand levels). Budget policy inevitably has either restrictive or expansive effects on an economy through its impact on savings and investment activities. Fiscal policy influences demand levels, incomes and price levels. Sums paid out as subsidies lead to real expenditure. But the income-creating effect of social transfer payments has an income-destroying effect if it is financed by rising taxes. Taxes and expenditure have redistributive effects by reducing disposable incomes for some and increasing them for others. An increase in company tax may cause business investments to be curtailed. The effects of curtailing social transfer payments may depend on the marginal propensities to save and to consume by the social groups affected by these changes.

Increases in various types of expenditure or decreases in various tax levels may have varying marginal effects on the general economic situation. But the formulation of economic policy is not merely concerned with aggregate effects on income, demand and prices. It is also concerned
with policy desires for specific results such as inculcating a desire to “live within your means” as a principle of sound public finances.

The choice of appropriate policy measures ultimately depend on what is considered to be a desirable macro-economic outcome such as the net contribution to the creation of real national income and the avoidance or elimination of factors that stand in the way of such an outcome. In macro-economic terms such an outcome could be measured as improved total factor productivity or any acceptable gauge of increased general economic efficiency that does not involve increased balance sheet debt liabilities for the economy as a whole but adds to the optimal use of productive resources.

The "Fools Gold" of GDP Growth on Credit

High levels of public debt, particularly if the loans have been raised abroad, require high levels of annual interest payments which crowd out other spending priorities. Repayment of such loans requires sending money out of the country. Loans raised locally benefit the local bondholders and redistribute income.

By adding to the national income simply by way of government handouts financed by loans is like chasing “fool’s gold”. Loans are reflected in the balance sheet and have to be serviced and repaid. A large loan account requires to be serviced by annual interest payments as well as staggered repayments of the capital amount. These payments “crowd out” other desired expenditures such as on education, disability care and infrastructure. Chronic deficit budgeting and a rising debt pile could land a country in a debt trap where the debt increases faster than the rate of economic growth and a government has to keep borrowing to service the old existing debt. When a government’s creditors no longer accept a government’s ability to finance interest payments on existing debt through higher taxes, let alone to redeem existing debt, it will not be able to borrow and would be tightly caught in a debt trap.

Because government spending is treated in the national accounts as final outputs, it adds to the money in circulation and hence to an increase in the GDP. But this can be a deceptive benefit because deficit financing creates a debt entry on the country’s balance sheet and may constitute a “deadweight debt” if it does not create any specific asset from which the cost of servicing the debt can be met. It is impossible for a government to finance its debt service without cutting other expenses or raising taxes which distort the incentives or real wealth of taxpayers by more than the amount the government receives. To cover running expenses with loans is not an advisable long-term financing strategy. The government should always generate a useful and positive result with the resources it extracts from the national economy. Policies promising a better future need to be costed and subjected to feasibility and cost-benefit analysis.

Capital and Current Expenditure Budgets

Traditionally governments used capital budget accounts to finance their long-term assets and current budget accounts to finance their operating expenses. The former, capital budget accounts, were usually financed with borrowings whereas current budget accounts were financed essentially out of taxation paid by individuals and companies.

In recent years these budgetary categories were collapsed so that governments no longer use separate capital budgets. It means that on the expenditure side the distinction between expenses of a capital nature on assets that have a continuing value and expenses of a current nature (such as welfare entitlements) can both be funded out of borrowings. That means government debt no longer has a clear-cut relationship to investment in capital assets.
It is now argued by a new generation of economists that all money is “fungible”. However, as a principle of sound financing it is essential to understand the implications of financing your expenditure with borrowed funds! Borrowed funds must be serviced and repaid.

**Cash Accounting versus Accrual Accounting**

Traditionally governments used “cash accounting” rather than the “accrual accounting” used by business enterprises. “Cash accounting” means that expenses are only added in when money is actually paid or received. As a result governments could actually rack up large future obligations far beyond their ability to repay, while their budgets appear to be well balanced. "Accrual accounting" means that any future obligation incurred (a debt or a pension obligation) is counted as an expense. The “cash accounting” approach to public sector accounting led to inadequate funding provisions to cover future funding obligations.

**Towards Economic Efficiency**

Taxes always impose economic costs because it distorts people’s consumption and investment choices. It may also curtail productive people’s incentives to work. Inflation-indexed government expenditures also exacerbate the “inflation ratchet” effect on the proportion of income paid into taxes. The end result is a gradual decline in the after-tax income levels of taxpayers unless they are given inflation-offsetting income rises. But the “inflation ratchet” pushes income earners into ever higher income tax brackets. Increases in tax rates discourage workers and businessmen from producing and investing. You hit the “fast ox” to your own detriment! High marginal tax levels impact upon productive efforts as well as saving and consumption levels.

Progress towards a higher level of economic efficiency would have to include high levels of employment and work participation. It also requires a well functioning competitive price system which creates favourable conditions for the efficient use of productive resources while giving a tolerably accurate expression of the valuations of consumers. Where there are inefficiencies in the price system, eg. in excessive inflationary or deflationary conditions, a market-based price system loses its rationality with the result that the price elasticities of demand and supply decline. Changes in exchange rates as a result of foreign trade fluctuations may also exercise a distorting influence on the operation of the price mechanism. Interferences with the price system – whether public or private – have a considerable influence upon income distribution, price levels, productivity and consumer choice. When governments use price instruments to obtain income redistribution or social policy objectives, they are “intentional distortions” of price relations. This applies to all price fixing for agricultural products, housing facilities, wages, etc. It exerts an influence on the distribution of income, the direction of consumption and thus to a sub-optimal allocation of the society’s productive resources.

**Productivity Growth**

Productivity growth is the most reliable gauge of progress towards a higher level of economic efficiency for society as a whole. It implies increasing the average level of production per capita, generating higher economic growth, expanding employment opportunities, raising competitiveness and curbing inflation. Productivity is measured by the ratio between goods and services produced and the resources used to produce them. It indicates the productive efficiency with which labour, capital, materials, technology and other inputs are combined and used to produce goods and services. The level of productivity is driven by technological progress, practical training, a work culture, non-disruptive labour relations and the level of human dynamism manifested by entrepreneurs, workers, investors, innovators and governments. Efficiency describes a situation where goods and services are produced with the
least possible wastage. Outputs must be maximised with given inputs. Unproductive businesses and societies usually end up as losers.

**Avoiding Market Distortions**

It should be clear that the impact of market distortions, whether by private interests or by government intervention, should be carefully scrutinised. The monetary policy of a government and central bank interventions have serious impacts on money and capital markets. Excessively low interest rates may lead to an imbalance between savings and the investments required for growth.

Ultimately the smooth functioning of a market-based price system is a matter of degree. The more rigid a credit market is or the more monopolistic a product market, the worse the market system functions from the point of view of the most productive allocation of resources to different economic activities. Whenever government-directed determinations of prices (e.g., of wages, retail margins, credit) are made, it takes on the same character as the physical regulation of products and prices. Considerations of profitability are thrust aside in favour of the priorities determined by the regulating authorities while simultaneously price relations are distorted. The central regulation of credit would distort the price system to such an extent that profit calculations become misleading and discouraging to new initiatives. Once price controls are established, additional regulations become necessary to control power concentrations or monopolistic tendencies in production and labour relations.

Whenever control measures are considered necessary in money, credit or commodity markets, the methods or instruments used should be as general as possible. Economic controls and specific interventions should be used for purposes of stabilising general economic development only as a last resort in crisis situations. Too much detailed intervention allows too much room for the exercise of arbitrary decisions and the risk of abuse of power. The operation of the price system which is the driving force of competition, promotes the rational use of productive resources and the sub-division of economic decisions on a decentralised scale. A highly decentralised market economy does not allow for much room for the exercise of private and public monopolistic power and arbitrary decisions in economic life. Competition offers alternatives to consumers and reduces the risk of the abuse of power. The balance between savings and investments, as well as between expansion and contraction in the markets for goods and services, have far-reaching implications for the maintenance of a high level of macro-economic efficiency and a desired rate of economic progress.

**A Sound Growth Strategy**

The essence of a growth strategy is revitalising, activating and improving the productive efficiency of the productive resources of society.

The current distress of the advanced economies was caused by the financial world's excesses which were compounded by policy mistakes. The failure of financial markets was coupled with excessive profligate government deficit spending. Over many decades the governments of the advanced economies have saddled their political economies with unaffordable privileges, bloated bureaucracies, rigid labour relations and unaffordable welfarist benefits. Then dodgy financial innovation outpaced the skill levels of governmental rule making.

A growing economy is a *sine qua non* for the improvement of the quality of the lives of its citizens: it is a requisite for providing the basic goods people strive for to improve their lives – education, health services, housing, security as well as a stable and fair political system. The momentum of growth in a country is reflected in improvements in productivity. Productivity is driven by efficiency: the maximisation of outputs with the available inputs of capital, labour,
technology and management. The ultimate dynamism that drives development is the inventiveness and creativity of people to improve their productivity.

Small businesses are the main drivers of job-creating growth because they are the most mobile, flexible and versatile form of enterprise. The SME sector is the natural home of the entrepreneurial spirit of free enterprise.

Public purse dependency leaves little scope for the productive creativity that generates taxable income. What is needed is not more government and more laws, but less government and less legal and regulatory restraints. The way forward is not more regulation but better regulation – not more government, but better government.

**Economic Imbalances and Harmful Interventions**

It would seem that the one area of economic life where “collective” control in some measure appears to be inevitable, is the total supply of money and central bank credit. It is the most delicate, most difficult and most central task of control. There are no absolute certainties about the “correct” monetary policies (eg. about the correct volume of money in circulation, about interest rate levels, about the volume of savings and investments). There are no certainties about the “correct” economic balance.

In the final analysis, the most important justification for a decentralised market economy is to be found in the realm of politics. Regulations and interventionist economic policies involve a concentration of power that tends to grow of itself. As Lord Acton remarked: “power corrupts and absolute power corrupts absolutely”. Adam Smith observed that power and authority should not be entrusted to a council or senate or whatever and nowhere “... in the hands of a man who has folly and presumption enough to fancy himself fit to exercise it”. A good system requires such arrangements that bad politicians, bad bureaucrats, bad economists and bad business leaders have the least possible chance of doing harm.

* Dr W B Vosloo, PhD, Cornell 1965, is a retired former professor of Political Science and Public Administration, University of Stellenbosch, South Africa (1966-1981) and was Chief Executive of the South African Small Business Development Corporation, Johannesburg (1981-1995). He is now retired and has been living in Wollongong, NSW, since 1998.