Public Debt and State Credibility in South Africa

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Abstract

It has been characteristic of the many waves of decolonization and national independence that they are followed by a process of extensive borrowing in order to fuel economic growth and development. In 1994 the new South African government bucked this trend. It had inherited an economy in disarray and the new political elites decided first to stabilize the economy and reduce public debt via the adoption of an austere fiscal programme. Why did they make this choice and how has it shaped democratic South Africa? What does this experience tell us about the relationship between representative democracy, public debt and state credibility? In answering these two questions this paper provides an explanation for this path-determining choice of fiscal austerity, arguing that it has backfired; and submits that the orthodox argument regarding the relationship between representative democracy and public debt does not hold in the case of South Africa.

Keywords*: South Africa; public debt; representative democracy; constitution; state credibility*

[1] The authors would like to thank the participants of the Cambridge Mellon Sawyer Conference on Public Debt, Corpus Christi College, Cambridge, September 2007, and the University of KwaZulu-Natal Politics Seminar, August 2008, for helpful suggestions on earlier versions of this paper. None of them, however, are responsible for any of the errors that may remain. Lawrence Hamilton would also like to thank Ayesha Omar for research assistance and the South African National Research Foundation, the University of Johannesburg and Clare Hall, University of Cambridge, for their institutional support.

Introduction

It is characteristic of the many waves of decolonization and national independence that they are followed by a process of extensive borrowing in order to fuel economic growth and development. In 1994 the new South African government bucked this trend. It had inherited an economy in disarray and the new political elites had before them three possible options. First, they could default on Apartheid debt. Second, they could refinance existing debt with more debt from international institutions to address the urgent issues of income redistribution and economic transformation. Third, they could stabilize the economy and reduce public debt via the adoption of an austere fiscal programme. They chose the third option. Why did they make this decision and how has it shaped the political and economic development of democratic South Africa?

In this paper we argue that the choice was made in order to gain greater policy independence from creditors and portray an image of sound fiscal management to potential international investors. In accordance with the predominant economic orthodoxy regarding representative democracy, public debt and state credibility, the new South African elite assumed that a combination of secure institutions of representative democracy and 'prudent' fiscal management would enhance the state's credibility and thus make it less expensive for them to finance the transformation of South Africa's economy. However, the consequences of the decision were quite the opposite. The South African government's austere response to debt made its bonds more attractive. It has therefore become more, not less, dependent on the constraints of creditors, that is, more subject to investor scrutiny and sentiment. And, yet, the brutal irony is that, in the eyes of investors, South Africa still lacks creditworthiness and remains a relatively risky place in which to invest, and thus, relative to other young representative democracies, the servicing of South Africa's public debt remains expensive.

The orthodox argument regarding public debt and representative democracy holds that representative democracy is a necessary (and in some instances even a sufficient) condition for credibility, that is, that its institution reduces uncertainty and thus increases the value of a state's bonds, which means it becomes less expensive for a government to finance its activities (North and Weingast 1989; MacDonald 2006; *cf* Stasavage 2003). The experience in South Africa undermines this received theoretical opinion. Although the dawn of democracy in South Africa enabled the consolidation of representative government and ensured against violent, political upheaval, the associated negotiated settlement between old and new political and economic elites (formally codified in the constitution of 1996) left the interests of the main economic elite without clear, formal political representation in parliament. The previously disenfranchised majority is now represented in the new parliament by means of the ANC's electoral dominance. The interests of the old economic elite, whose continued support and presence as creditors is vital for economic stability, are still represented by the small number of relatively homogeneous economic agents at the helm of South Africa's economy. Aware that they were unlikely to have their interests represented in parliament, they ensured that the constitution of 1996 secured these interests in its vaunted bill of rights, a set of rules for South Africa's nascent representative democracy that safeguards universal suffrage without seriously jeopardizing the economic power of national creditors. However, despite these constitutional safeguards, the fact that the economic elite, which is only partly in the process of being transformed by the Black Economic Empowerment (BEE) initiative, is not directly represented in parliament is the main determinant for South Africa's relatively poor credibility. South Africa's inability to gain the levels of creditworthiness that ought to have been the result of constituting representative democracy is explained by one of the main consequences of the negotiated settlement: the fact that the economic elite does not enjoy formal, political representation and thus does not control a 'veto point'. In other words, it does not have strict veto power over political decision-making.[2] International investors also thereby lack a 'veto point', as the domestic economic elite represent their interests (in the third sense discussed below, at p.7), and thus they deem South Africa a risky place in which to invest.

Our argument regarding representative democracy, public debt and state credibility in South Africa highlights the fact that understanding the dynamics of public debt is vital for

[2] 'A 'veto point' is a political institution, the holder of which, as specified by a country's constitution, has the power to block a proposed change in policy. For more on 'veto points' and 'veto players', see Tsebelis 2002 and Stasavage 2003.

an understanding of representation and *vice versa*. All governments need creditors, even under conditions of austerity, and so creditors are in a privileged position as regards the formation of fiscal policy. They retain the power to discipline government by dint of the fact that the state cannot function without their credit. If their interests are accorded formal, political representation, they control a veto point; if not, their country will be deemed less creditworthy than those that do, which in itself provides a strong incentive for the formal political representation of their interests. This suggests that at the very least the orthodox argument must be augmented. The weakest form of our argument here is therefore that both representative democracy and the formal, political representation of a state's national creditors together constitute necessary conditions for credibility. The stronger version of our argument requires that we discard the orthodox position entirely: it is that the main necessary condition for state credibility is the formal, political representation of its national creditors, irrespective of the exact form of its regime. Within modern representative democracies the clamour is no longer 'no taxation without representation'; rather the reality is 'no credit without representation'.

Representation in South Africa

Contemporary representative democracies have evolved from a political system that was conceived by its founders in opposition to democracy or government by the people. What we now call representative democracy has its origins in ideas and institutions that developed in the wake of the English, American and French revolutions. In very different if more or less contemporary contexts (the defence of the American Constitution and the French revolution), James Madison and Emmanuel Siéyès played a crucial role in establishing our modern conceptions and institutions of political and economic representation, and both of them conceived of representative government as quite distinct from democracy. Madison often contrasted the 'democracy' of the city-states of Antiquity, where 'a small number of citizens… assemble and administer the government in person', with the modern republic based on representation. Madison argued that representation was not an approximation of government by the people made necessary by the size and complexity of large modern states. He saw it as an essentially different and superior system that would enhance good judgment in politics and overcome the danger of faction in politics (Federalist 10, in Hamilton, Madison, Jay 2003; Manin 1997: 2). Similarly, in *Qu'est-ce que le Tiers-Etat?*, Siéyès consistently stressed the 'huge difference' between democracy, in which citizens make the laws themselves, and the representative system of government, in which they entrust the exercise of their power to elected representatives.[3] He defended representative government because he thought it most appropriate to the condition of modern 'commercial societies' in which individuals were chiefly occupied in economic production and exchange (Siéyès 2003: xv, 92-162).

Representative democracy has certainly seen changes over the past two hundred years, for example, the extension of voting rights and the establishment of universal suffrage (Rosanvallon 1992). Certain central elements, however, have not been affected by these developments. These include the fact that: those who govern are appointed by election at regular intervals; the decision-making of the representatives is independent from the wishes of the electorate; those who are governed may give free expression of their opinions without fear of sanction from those who govern; and public decisions undergo trial of debate (Manin 1997: 3, 6).

But Siéyès theory of representation went more emphatically beyond established usage by referring to something systematic in any durable and extensive modern human association: the division of labour and its link to increased specialisation and representation. This was based on a concept of representation that was both more systematic and more general in it applicability than anything to be found in the ideas of Madison and company. He made a distinction between two kinds of representation in modern commercial societies that both belonged to a single system. The one kind of representation was to be found in all the nonpolitical activities of everyday life. For, example, he argued that the person who makes my shoes is my representative. He is representing me in utilizing a capacity common to both us to carry out a vital function (or means) to satisfy a need of mine. Moreover, in utilizing a representative for my capacity

[3] See Siéyès 2003; Manin 1997, p.3 fn 3. Also the kind of constitution that Siéyès thought suitable for a free state was quite similar to the kind of 'not-quite republican, but not-quite royal constitution' that the Federalists advocated for the United States of America (Sonenscher 2003, p xv).

to make my own shoes, I am reducing the amount of effort involved in meeting my need to protect my feet and thus freeing myself up to undertake other activities. Siéyès thought that this division of labour and associated plurality of representation would increase the enjoyment of people's lives and was a necessary component for the development of the arts and the sciences and thus all durable human association (Sonenscher 2003: xv).

The other kind of representation was the kind to be found in political society – my member of parliament is my representative, or so we assume. As Hobbes, Siéyès and others have pointed out, members of parliament may in fact represent the state rather any particular citizen thereof. If either of these two replaced the other, Siéyès argued, the representative system would collapse. According to Siéyès, both kinds of representation have their origins in human needs and the means that humans used to meet these needs. Both meet the same purpose: anyone acting as somebody's representative meets a particular need for them and thus enables the person to do something else. Just as my representative, specialist shoe-maker frees me up to do other things, so does my representative, professional politician. But they are also fundamentally different. The kind of representation found in daily life is essentially plural while that of political life, essentially singular. The former was associated with the means individuals use to meet their individual needs. The latter was made up of the means individuals use to meet their common needs.

Thus, in contrast to those who maintain that political representatives represent the individual interests of particular citizens, Siéyès maintained that government made of political representatives represented the nation's common interests, not its members' several interests. Most commentators assume that this equates to a choice between representatives doing what their constituents want and doing what they, the representatives, think is best (Pitkin 1989: 142). But this is too simplistic. Representatives could represent the interests of members without necessarily doing what the members want, and yet not have to revert to a notion of 'common interest: the representatives could do what they think is in the best interests of the members, which may *not* be what the members in fact want, and yet still successfully represent the individual interests of the members and *not* the common interest (Geuss 1981 and Hamilton 2003).

Whether political representatives represent individual member's interests or common interests, which Hannah Pitkin calls the 'mandate-independence controversy' (1967, 1989:142), and thus what exactly is meant by representation, depends upon a number of factors that turn out to be vitally important for understanding the argument of this paper. The history of the concept of representation is full of a variety of conceptions of representation drawn not only from politics, but also from law, economics, literature and the theatre. These are concerned with how we represent individuals, groups, the state and, increasingly, non-governmental structures and organisations.

As regards individuals, there are three ways people have thought about representation that complicate the distinction between 'mandate' and 'independence': a) as a principal-agent relation, where one person (the *principal*) appoints another (the *agent*) to perform some action or function on their behalf; b) the idea of representatives as trustees, in which as owners of the trust for its duration, trustees act independently, but in the interest of their beneficiaries; c) representation as identification, in which, unlike in the cases of the former two, no conscious decision to *appoint* a representative is needed, but there remains a sense in which the representative promotes my interests – this occurs when an individual identifies with the actions of another person in a way that gives that individual a stake in the other's actions (Vieira and Runciman 2008: 66-81).

Groups can be represented in similar sorts of ways, despite some complications regarding whether groups can be conceived as principals at all (Vieira and Runciman 2008: 84-119). Underlying representation as identification in all cases is the idea that someone who resembles me or my group in important respects will act as I or my group would act and therefore promote my or my group's interests automatically. As will become evident in what follows, it is this kind of representation that plays a vital role in our argument: the market, or more exactly, (potential) creditors respond to whether or not their interests will be defended within the formal structures of a state's representative democracy, and their interests can either be defended by representatives from parties that enjoy the support of (potential) creditors or by representatives with whom they identify, but who may not formally represent creditor interests. In both cases, the creditors can only be sure that their interests are being accorded *political* representation if their agents or the representative with whom they identify are members of the formal institutions of political representation.

As has already been highlighted, besides representing individuals and groups in different sorts of ways, political representatives also represent the state. States, like other forms of association, depend upon representation in order to function at all, but to function as states they depend upon a wider claim to legitimacy than other kinds of association: a distinctive claim to represent all their citizens. Despite the fact that the history of representation shows that there is nothing inherently democratic about the idea of representation, in our democratic age, we assume that to be legitimate political representation must be democratic.

The question of debt, democracy and representation in South Africa provides a unique lens through which to view the tensions within and amongst the various forms of representation at play within and beyond modern, complex nation-states. In particular it focuses our attention on the potential contradiction that exists between representing the state (and thus all its citizens) and representing the interests of creditors. South Africa's history and current political and economic conditions makes this is a very real contradiction that requires urgent attention. This theoretical introduction is important for the purposes of this paper because it identifies why we must take seriously Siéyès's account of representation in general, as well as his distinction between everyday, commercial representation and political representation. Here, when we use expressions such as 'informal' or 'economic' representation, we mean something like Siéyès's 'commercial representation', either in the form of principal-agent representation or representation as identification, as specified; and when we talk about 'formal' or 'political' representation we mean representation as found within the political structures of South Africa's representative democracy, in particular parliament, which, again, can take either the form of principal-agent representation or representation as identification.

The transition in South Africa is characterized by the establishment of the formal structure of genuine representative democracy as well as new informal kinds of representation. The formal structure is the set of rules codified within the final political constitution of 1996 and the related institutions of the legislature and the executive. Parallel to the debate around the creation of a new constitution (about which more below), there was a semi-formal debate or forum in which national economic power and the new political elite defined an economic constitution that would characterize the new South Africa. This forum generated a form of representation of the main economic powers and interests in South Africa. Given the transformation in political power, it was clear to most of those involved in these processes that the interests of the existing economic elite, at least initially, would not be represented in parliament. The bargaining process that ultimately gave rise to the constitution of 1996 provided the opportunity for these powers and groups to safeguard their interests. The subsequent relationship between economic and political power is bolstered further by means of an informal agreement between these parties. The constitution of 1996 provides a legal safeguard for their more general interests, but it did not ensure that the main economic powers could retain effective control over the economy.

The behind-the-scenes agreements, assurances and concessions that occurred during this period provided the necessary means to ensure that monetary and fiscal policy would not undermine the interests of those who had the means and potential to continue to act as creditors for the South African state. The quick and sorry demise of the ANC's Make Democracy Work policy is a case in point. It was an attempt to turn the general promises of the Freedom Charter – for housing and health care – into practical policies. But it never saw the light of day; it was dropped as part of the horse-trading that constituted the negotiations between the representatives of the old economic elite and the new political elite. Some have argued that the ANC leadership was simply outmanoeuvred in these negotiations (Klein 2007: 200-206; Gumede 2005), which may, in part, be true, but even as they do so they provide evidence for the ANC's active involvement in this process. Take, for example, the central role played by the likes of Thabo Mbeki, who himself made several key revisions to the ANC's economic programme to address the concerns of top business people and industrialists, such as Harry Oppenheimer (Gumede 2005: 33, 39 690).[4]

In terms of representation, the main economic agents – the top business people and industrialists – essentially act as informal representatives of existing and potential national creditors (and owners of capital more generally). In other words, those individuals who have the means to purchase South African government bonds *identify* with the main economy agents and thus feel that their interests are being represented by them. What is peculiar in the case of South Africa is not the presence of this kind of representation, but the fact that this group of representatives is homogeneous in the sense that it was not and did not expect to be represented within the democratically elected ruling elite. It may have courted and been courted by these political representatives, but it could not assume that its interests would find secure political representation within the institutions of democratic South Africa. The power of these economic agents operates as purely economic power. It is not represented formally within the existing political institutions and by means of political representation. It is therefore a constraint on political power rather than part and parcel of the structure of political representation.

Constituting Representative Government

The initial outcome of the development of these new forms and dynamics of formal and informal representation is the fact that the Mandela government initially retained National Party (NP) appointees at the South African Reserve Bank and the National Treasury. Nelson Mandela's first treasury minister was Keys, who was appointed by De Klerk, and who subsequently left after four months for personal reasons, and his second treasury minister was a professional banker by the name of Liebenberg. This retention of

[4] For more on the motivations behind the shift in economic policy of the ANC towards an orthodox fiscal and monetary management, see Habib and Padayachee (2000).

extant personnel and the subsequent appointment were important indicators of the desire by the ANC to stress continuity and stability.

They focused on continuity as opposed to radical transformation for two related reasons. First, they felt the need to retain the confidence of existing domestic white business people and prospective international investors. In other words, this imperative has its source in their desire to keep their side of the bargain or contract as regards fiscal policy and the continuity of the economic order. The final and formal version of this contract is the 1996 Constitution, the lauded legal document that was the result of approximately five years of negotiation. These formal negotiations began on the 20 December 1991 within a series of meetings that were to become known as the Convention for a Democratic South Africa (Codesa). Second, their emphasis on continuity can also be explained by the fact that the ANC government inherited an economy in complete disarray. The levels of fiscal mismanagement of the Apartheid regime from 1980 until 1994 were staggering. While GDP had grown at an average of 3.3% between 1970 and 1979, and 2.2% between 1980 and 1989, it grew at a paltry 0.2% between 1990 and 1994. Inflation had risen at an average of 14.6% between 1980 and 1989, and interest on public debt amounted to the largest budget item during this period.[5] The ANC government took the prudent step of attempting to stabilize the ship of state first before embarking on any expansive and directly transformative policies. They decided to transform the treasury prior to flooding it with lavish borrowings.

Figure 1 illustrates the dynamic of total government debt in South Africa from 1970 to 2005 as percentage of GDP. From the data is clear that the most significant accumulation of debt happened at the end of the Apartheid period.

[5] Budget Review 2000, at www.treasury.gov.za

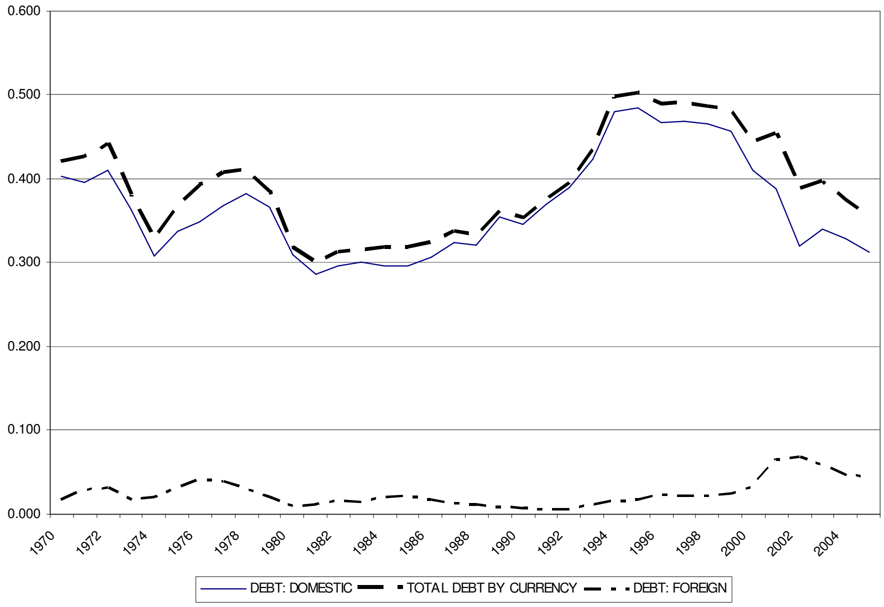
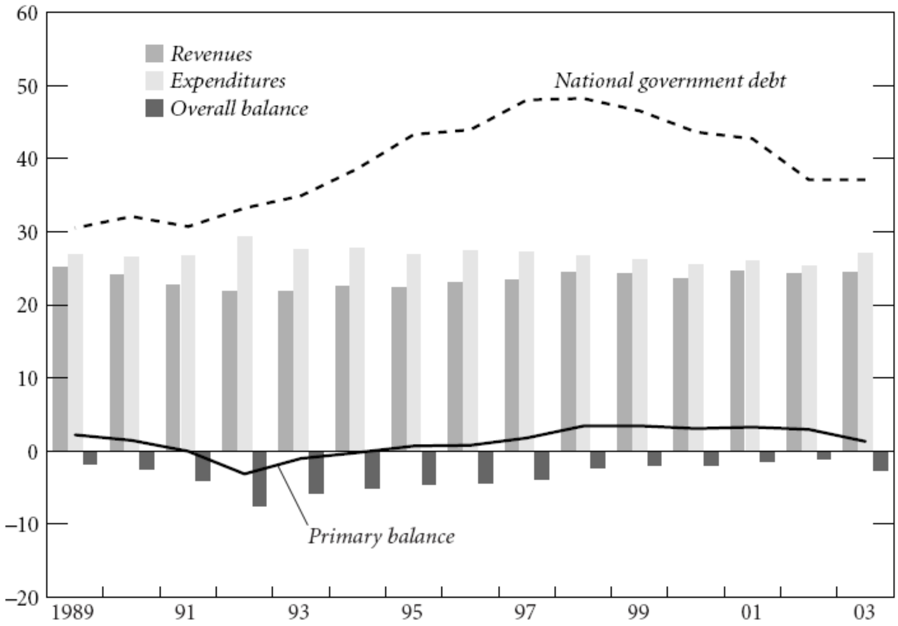


Figure 1
Debt Dynamics in South Africa: 1970-2005
(Source: International Financial Statistics)

Nevertheless the explosion of debt at the beginning of the 1990s has its origin in the crisis and economic policy response of the Apartheid government in the 1980s. As can be seen from Figures 2 and 3, from the beginning of the 1980s any attempt to stabilize expenditure as percentage of GDP had been abandoned and from 1989 revenues had fallen dramatically, creating the significant explosion of debt that the country experienced in the following years.

Figure 2
Revenues and expenditure dynamics in South Africa, 1970 to 2005



Source: National Treasury.

Figure 3
Fiscal Indicators in South Africa 1989 – 2003

It is also noticeable how, in the last 14 years, the effort to put public finance under control is the main driving force of Treasury policies, starting with the first annual budget of the new democratic government: note the marked dip in expenditure in 1994 (especially clear in Figure 2).

Things began to change in 1996, at least as regards personnel. Trevor Manuel, the first black Finance Minister was appointed. His first period ran for the remaining three years of the Mandela government, 1996-1999, and he was in charge until the 2009 elections. The market was initially hostile to his appointment as a consequence of racist assumptions regarding his competence as well as fears that he might begin to embark on a process of nationalization of large enterprise. In fact, on 14 June 1996, soon after his appointment, he proposed quite the opposite in the form of a new macroeconomic policy, the Growth, Employment and Redistribution (GEAR) strategy (Lodge 2002: 26). This strategy adds another vote to the ‘Washington Consensus’ in that it focuses on privatization, government ‘right-sizing’, the creation of incentives for Foreign Direct Investment (FDI) such as tariff reduction, the reduction of the fiscal deficit (which in 1994 had reached 9% of GDP), and productivity-linked wage rates (Lodge 2002: 25;

Davis 2003). Needless to say, very soon after his first budget speech, these events allayed most of the market's fears.[6]

In other words, this part of the rationale for the choice of option three has to do with the sentiments and goals of a new regime and how these are linked to the history of debt in South Africa.[7] The new regime inherits from the Apartheid regime a series of problems that are the consequence of two related legacies of Apartheid: irresponsible borrowing and an over-dependence on national capital. The new political elite were intent on reversing both of these trends. They wanted to create a fiscal environment characterized by responsible borrowing that would simultaneously make South Africa attractive in the eyes of international investors – both in the sense of FDI and enhancing the creditworthiness of South African state bonds – and allow them to gain independence from national capital. Their response was an austere fiscal policy and a concomitant drop in capital expenditure and taxation, which only now is beginning to be reversed.

Coupled with this desire to gain autonomy from national capital is the hope that they could also, as a consequence, insure against dependence upon international financial institutions. Many of the new political leaders had (often in exile) experienced decolonization in the rest of Africa and the subsequent condition of severe indebtedness of many independent African states. They had also experienced the fate of populist policies and economic instability in many Latin America countries in the 1970s, 1980s and 1990s as debt crisis followed debt crisis. And, finally, they also observed first hand the collapse of big-bang transformation policies in the former eastern block. The issue of debt and a cautious approach to transformation became central to any planning of public policies for growth and development. Thus although this is a story that has very specific South African characteristics, its origin can in part be traced back to the experiences and failures of development policies around the world in the decades before 1994. Thus the overriding motivation behind the new political leaders' choice of option three was their

[6] It is ironic that the market reacted with equal nervousness when Minister Manuel announced his resignation in September 2008, at the time of President Thabo Mbeki's recall by the ANC. This episode is analysed in more detail below.
[7] See Minister Manuel's 2007 budget speech at www.treasury.gov.za.

desire to properly harness and retain the sovereignty of the South African state, in other words, to wrench power from national creditors and avoid a loss of autonomy to international creditors and financial institutions. This claim has been given extra credence by the new governor of the Reserve Bank, Gill Marcus, who as then chair of Parliament's finance committee played a central role in stabilising the debt-ridden economy the ANC government inherited. At the time it was she that convinced her party comrades that they did not have a 'blank slate' and that if South Africa's 'huge debt' and 'massive tax shortfall' were not addressed 'it [South Africa] was likely to land up in the hands of the IMF … [and] we certainly had not worked this hard for our liberation to hand it over to the IMF' (Green 2009)**.** Under these conditions and given the state of the economy at the time, even with the advantage of hindsight selecting option three seems like a prudent choice.

Understood in these terms it is easy to see a parallel between these choices and those finally made within the constitutional process that took place within Codesa. The formal process of negotiation over the substance of the Constitution, initially called the Multi-Party Negotiating Process, began on 1 April 1993 at the World Trade Centre, Kempton Park and ended with the ratification of the Constitution on 10 December 1996 at Sharpeville (Davenport and Saunders 2000: 559-572; Spitz and Chaskalson 2000: xiii). Despite evident disagreement and fraught negotiations over whether the constitution should include a bill of rights, and whether that should itself include a right to property,[8] the final outcome was a very progressive document founded on human rights and in particular the right to property. In the final document there is some qualification of the right to property understood in terms of imperatives in line with the 'national interest', but these are to cover the need for land reform.[9] For obvious reasons, the fact that the right to private property is listed within the Bill of Rights was enough to satisfy the owners of capital. Thus the form of the final constitution of 1996 is very much determined by the perceived need to safeguard the interests (property) of the capital-owning class; without this safeguard this class and the old elite under which it had

[8] For more on these matters, see Du Plessis (1994), van der Walt 1996, Spitz and Chaskalson (2000) and Hamilton (2003).
[9] For more on how this has affected delivery on land reform see Hamilton (2003: 173-84) and Hamilton (2006).

flourished would not have leant their support to the new political elite. Given the fact that the outgoing elite were unlikely to be represented within the incoming majority ANC government, the constitution offered them the main means of safeguarding their interests.

This is clearly evident with regard to the right to property. Although the constitution provides a comprehensive list of individual entitlements or rights that the framers determined would be necessary for transformation, the ability to actualize these rights depends upon resources and their distribution. For example, in order for a new citizen without property to make proper use of these enshrined rights, in particular the right to property, they must first acquire property. The constitution stipulates a right of access to property, but this is weak in the face of a similarly enshrined right to property (both in clause 25 of the Bill of Rights) as well as a well-entrenched property-owning status quo. The only realistic means by which a new citizen without property can acquire property is if fiscal policy ensures the redistribution of property. However, if the nation's debt and wealth are concentrated within the small group of property-owners whose interests are likely to be directly affected by this kind of policy, as is the case in South Africa, they are likely to make use of their unique position of power to hinder the process of property redistribution. As a consequence of what this entails, they will therefore act in a manner counter to transformation and the general actualization of rights: they own the debt and ensure that fiscal policy follows an equilibrium path, which they themselves define. In other words, so long as they retain the debt they retain the power to discipline government by dint of the fact that the state cannot function without their credit. All governments need creditors, even under conditions of austerity, and so creditors are in a privileged position as regards the formation of fiscal policy. Therefore in a national context, the only way to transform under these conditions is either to default on debt; expropriate property and distribute; or gain a modicum of independence from national lenders by reducing indebtedness. The South African government chose the last, most conservative option, with the goal of eventually placing sovereignty in the hands of all of the citizenry. But in doing so it surrendered the only effective means of enabling the rest of society to actualize their rights, for without redistribution they remain in a condition in which they are lacking the resources to do so. The hope is that the process of ‘transformation through austerity’ would generate, ‘in the end’, sufficient growth to eliminate any distributional constraint. But this depends on two unstable variables – growth and continued economic sovereignty.

The alternative options of reneging on apartheid debt and accessing aggressively international official financial institutions to finance economic and social reform were not considered feasible. The choice of cautious reform is actually quite unique in the context of dramatic political and economic regime change. At least since the French Revolution, history is replete with examples of shock therapies, often involving reneging on debt, radical land reform, nationalization (or privatization) of natural resources, in general radical and fast changes in economic and political institutions. In the case of South Africa, a shock therapy would have been to disregard the constraints imposed by the economic constituency and promote economic equality through nationalization, land reform and debt cancellation. The price would probably have been economic isolation and stagnation for a considerable period of time, although tempered by odious debt considerations and international goodwill following the end of Apartheid. The choice of option three, in contrast, constituted a decision in favour of stability, internationalization and delegation of economic oversight to a yet to be transformed economic elite. It also ensures, at least until this elite is completely transformed, that the representatives of creditors are unlikely also to be represented in the formal structures and institutions of government; in other words, it ensures that they do not acquire a power of veto over government policy, unless of course they are given access via other means, such as the electoral success of a party that does formally represent their interests.

Consolidating Representative Government: Increased Credibility?

The choice made in 1994 saw economic discipline as a way to consolidate representative democracy. In doing so South Africa has structured its economy in a manner that gives rise to an increase in its creditworthiness. One of the main indicators of accountability and credibility for financial investors is the existence of consolidated institutions of representative democracy.

Two important things follow from this state of affairs. First, the South African government has managed to acquire the kind of independence in its policy-making it was seeking: 'The managers of public finance do not need to serve other masters than those to whom they profess loyalty' (Lodge 2002: 25). Therefore, spending in service delivery to the general population, education, housing and social protection has increased exponentially. However, second, the internationalization of the economy produced by the increase of creditworthiness has the consequence that the actions and decisions of the South African government are now regulated and disciplined to a much greater extent by the interests and sentiments of international market participants. The state has no sovereign relation to these investors and most are, obviously, not citizens and are therefore not represented formally within any of the institutions that constitute representative democracy in South Africa. They are not even part of the informal national economic forum that produced the economic constitution post 1994. The only relation that exists is through markets and the sentiments and moods that affect these markets. This was not what was intended. The programme of austerity was chosen specifically as the best means of securing greater independence for the new South African government, but the result is in fact increased interdependence on the conditions of other emerging markets and the sentiments of international investors.

The measure that best maps the historical events that we have described is derived from the analysis of the fluctuations of the yield curve on Government bonds.[10] Put simply, the idea is that a change in political or economic expectations will have an effect on the evaluation of the same asset at different dates of maturity. If the market expects a political crisis, long-term investment will be more risky relative to short-term investment, thus affecting the relative returns. Using this property of the yield curve of Government debt, we estimate a measure based on the deviation of the yield curve from the long-term equilibrium relationship and we call it a time varying risk premium. In figure 4, the solid line is the time varying risk measure on South African government bonds from 1981 to 2007, while the dotted line is the underlying short run fluctuations from which this

[10] See Fedderke and Pillay (2007) for technical details. Essentially the measure extracts a risk measure from the co-integrating relationship between yields at different maturity. The time varying risk premium is chosen for its ability to match historical events as in figure 4.

measure is derived through a process of filtering. The solid line is derived using a Hodrick–Prescott filter on the residuals of the co-integrating relationships between 3 months, 3 years and 10 years government bond yields. The vertical lines represent historical events that help to evaluate the ability of this risk measure to capture real market response to events. So, for example, the tricameral referendum of 1983 seemed to be a period of relatively good evaluation by the creditors of the prospect of the country. This impression was very rapidly reversed with the dramatic increase in political conflict in the second half of the 1980s and with the debt standstill in 1985. The legalization of the ANC seems to have been another moment of relative optimism, followed by the uncertainty of the pre-election period. After the election, and especially with the introduction of GEAR in 1996, we observe a process of stabilization of expectations with a series of fluctuations in correspondence with international economic uncertainty.

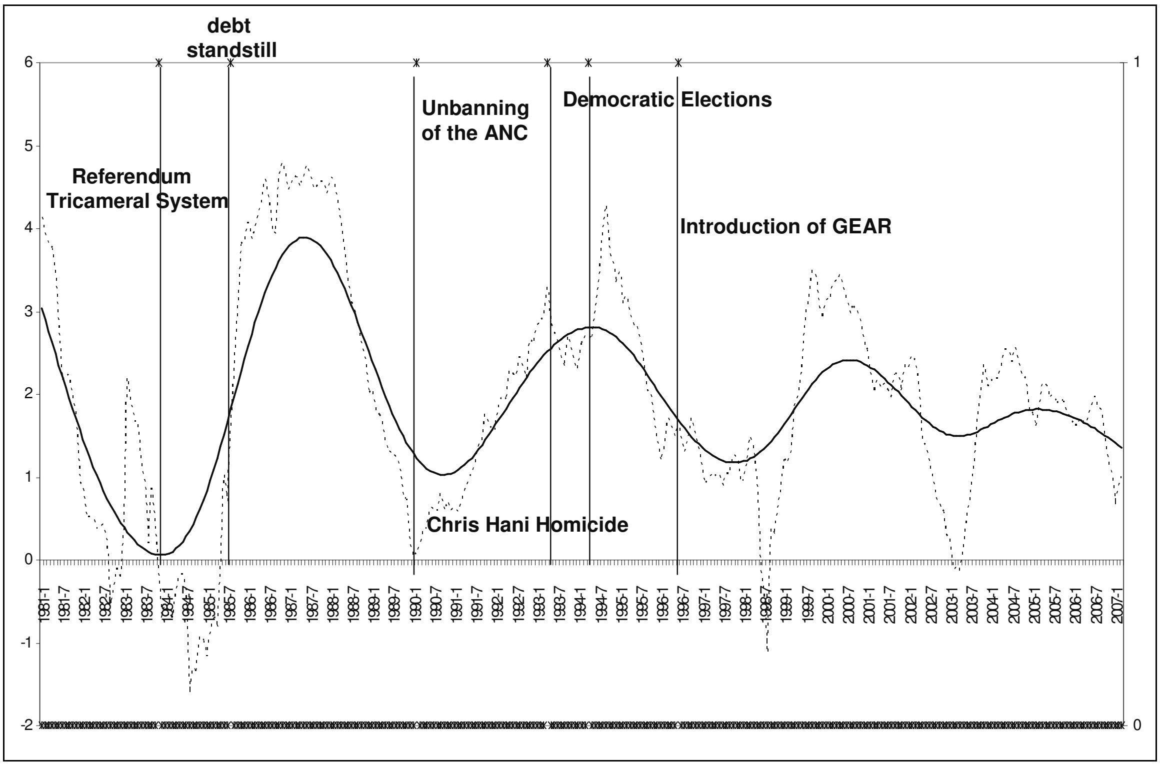


Figure 4
South Africa 1981-2007 – Estimates of Risk vs Historical Events

We submit that this measure captures quite well past political and economic uncertainty. If this is the case, how do we evaluate the volatility and overall risk? The most important thing to note is that even following political stabilization, the country is still evaluated with a degree of suspicion by international markets. Although the average fluctuation seems to be reducing, especially after the second election in 1999, it is still substantially different from any concept of an equilibrium relationship. The mean risk today is still very similar to the mean risk prior to 1994.

A useful comparison is the one between our market measure of risk and political risk measures that we find in the literature. These political risk measures, like the Polity index, the Fedderke, De Kadt and Luiz (FKL) index (2001), or the World Bank political stability index tend to focus on institutional stability and political conflict. As can be seen in Figure 5 below, the FKL index corresponds with the market index of risk we calculated for the last ten years of Apartheid. However, with the advent of democracy and the peaceful transition institutional risk and market risk diverge considerably. While all the indices show a market increase in institutional quality and political stability after the introduction of democracy, the market still attaches a significant risk premium to South African debt.

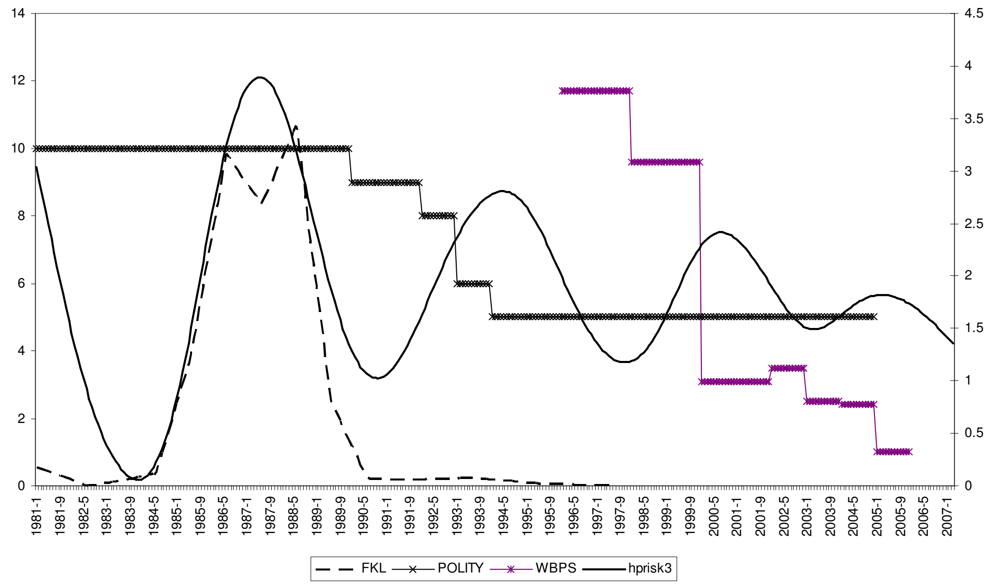


Figure 5
Market Risk vs Institutional Risk (indexes rescaled for comparison)

Thus institutional quality tells us little about the way a country is seen by international creditors. Even the financial market 'rating' is not enough. A more directed measure of the market sentiment towards the country still shows a certain degree of caution and a significant degree of uncertainty about the country. The presence of residual uncertainty is also evident if we analyse a composite political risk index provided by the PRS group, from 1984 to 2008.

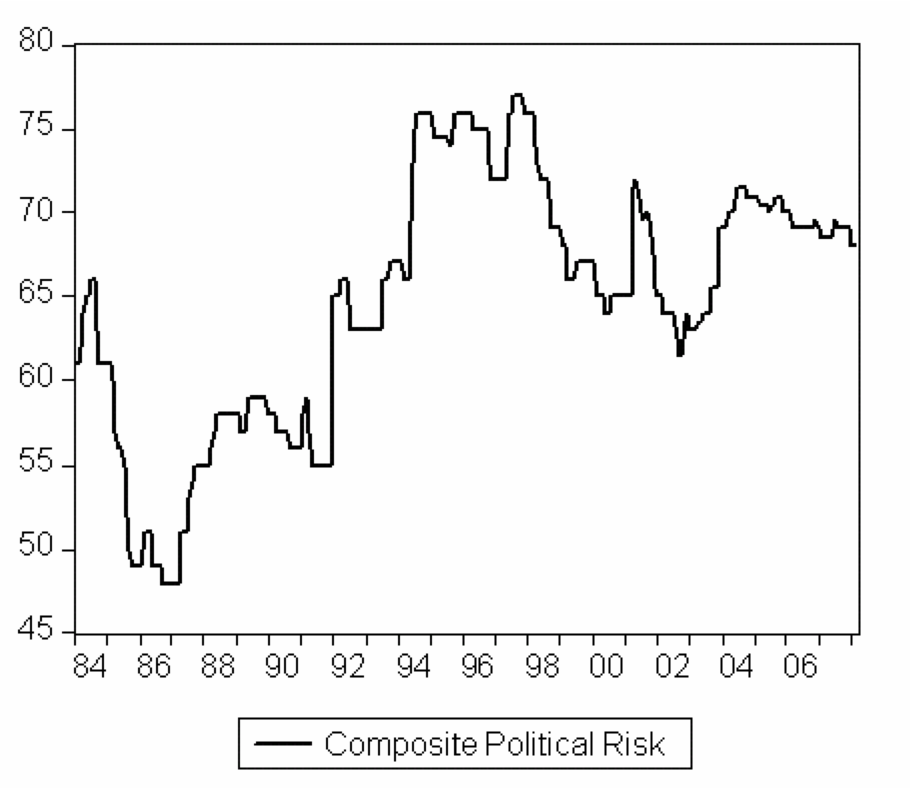


Figure 6:
Market Political Risk Analysis – PRS Data

After a golden age of political goodwill from 1994 to 1998, market participants show a persistence uncertainty about the political risk implied by social and economic indicators forming the underlying structure of the index. A principal component analysis of the underlying indices shows that, while market participants recognize the stability of formal democratic institutions (which drives the first principal component of the indexes), much less progress is recognized in the fields of institutional efficiency and socio-economic transformation.

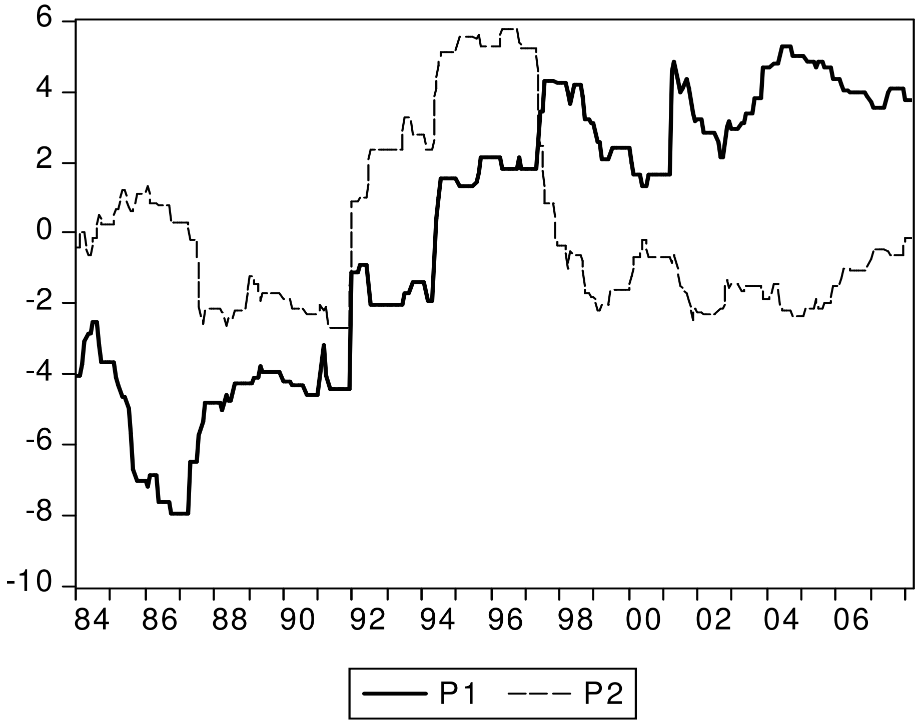


Figure 7
Principal Component Analysis of Political Country Risk by PRS Group

Why is this important? This is important because it suggests that the government is subjected to a high degree of scrutiny by the markets. And, moreover, any significant change in policies must be, as it were, 'contracted' with the market for it to be feasible, i.e. to ensure against any negative repercussions on the credibility of the country. Independence of political power from national capital may have been achieved through fiscal discipline and economic stability, but the sovereign power required to achieve the constitutional goals is still, and is likely to continue to be, constrained by international market sentiment and approval.

An example of how prices constitute a form of judgment on government policy was the reaction of markets to Finance Minister Trevor Manuel resignation following the 'recall' of President Thabo Mbeki by the ruling ANC party. The news provoked a strong market reaction, with 4% losses on the stock exchange, 5% devaluation of the currency and a loss of 20 basis points on government bonds. The resignation was immediately explained as a formal requirement and that Trevor Manuel was still available to serve in the new government. But the message coming from the market was clear: whatever the political instability coming from inside the ANC, the economic constitutions guaranteed by the economic policy framework established by Mr Manuel and the then reserve bank governor, Mr Mboweni, should be protected carefully, as a condition for economic stability.

Two important and related conclusions follow from this. The first is that the ANC government's intention to achieve greater independence from national and international investors had the unintended consequence of making it more, not less, dependent on the constraints of creditors, even if the identity of those creditors has, to a certain degree, changed. Its austere and prudent response to debt made its debt more attractive and thus more subject to investor scrutiny and sentiment. If anything, it now has less, not more sovereign independence with regard to it policy choices. Second, these developments have only further undermined an important condition for creditworthiness: that the interests of creditors are represented in the formal structures of representative government. Despite BEE, this is still very much not the case in South Africa. We submit that, more than any other factor, it is this that explains the continued lack of credibility of South Africa, that is, it is this inability to complete the representative circle that explains why South Africa is still deemed a relatively risky place in which to invest.

Concluding Remarks on State Credibility

In this paper we have provided an explanation for the ANC's decision to adopt an austere fiscal policy following liberation from Apartheid. We have shown why this decision was made and how it has backfired: in particular, despite making all the right moves in terms of the economic orthodoxy of the age, the South African state still lacks the credibility needed for relatively cheap debt servicing and economic transformation. By way of conclusion, we submit that this is because the orthodox arguments regarding the causal relationship between representative democracy, public debt and state credibility are fundamentally flawed, at least in the case of South Africa, but potentially in all contexts.

State credibility is best defined as the perceived likelihood that a current or future government will honour debt contracts (Stasavage 2003: 23). Increased state credibility is associated with a significant drop in the premia states have to pay to service their debts; in other words, as credibility increases, so the cost to a state of its debt decreases.

The received opinion on public debt and state credibility is that representative democracies are much better suited to public borrowing than autocracies or other forms of political regime because they display greater commitment to debt repayment, or, in other words, are less likely to default on debt (Macdonald 2002: 6). This is the case, various economists and political scientists have argued, for a number of possible reasons. 1) In democracies, as long as the state borrows from its citizens, 'there is no divergence of interest between borrower and lenders, for the two are one and the same' (Macdonald 2002: 7). 2) Limited or 'Mixed' government creates the constitutional checks and balances necessary to ensure commitment (Montesquieu 1989; Hamilton, Madison and Jay 2003; North and Weingast 1989). 3) Representative democracies normally delegate management of government debt to an independent agency, like a central bank, which increases commitment by making it more costly for a government to default on its debts: since government revenue is channelled through the bank, any decision to default would quickly lead to a halt in payments from bank to government (Weingast 1997). 4) Credible commitment in democracies is the result of the concomitant growth and significance of parties and party government, which generate compromises and concessions that lead to moderate policies and thus a reduction in the possibility for default (Schattschneider 1942). 5) Representative democracies support the free movement of capital and are therefore also more wary of taxing it heavily to avoid capital flight. This may be equally true with regard to taxes on capital and for default, which may be seen as one-off tax on holders of government bonds (Stasavage 2003: 21; and Lindblom 1982).

Our evidence as regards the recent history of South Africa casts doubt on all of these arguments. The first argument given by Macdonald seems to rest on a naïve notion of democracy because even if all creditors were citizens, in representative democracies it is highly unlikely that there will be *no* divergence of interest between borrowers and lenders, or rulers and ruled. In any case, this assumption clearly does not fit in the case of South Africa. Second, the case of South Africa makes it clear that constituting representative democracy, including all the necessary checks and balances, is not sufficient to ensure credibility. South Africa remains a risky place in which to invest, despite its consolidation of representative democracy and adoption of prudent fiscal management even beyond that expected by the IMF. Nor do the third and fifth reasons hold much water under South African conditions, for while, like other representative democracies, the South African government does delegate some of its fiscal management to its central bank it still maintains strict exchange control and therefore bucks the alleged trend that representative democracies support capital mobility. Finally, the fourth reason depends upon a strict condition that does not obtain in all representative democracies and is clearly not the case in South Africa – that there must be conflict over multiple issues and where the dividing lines in each conflict do not coincide. As is well known, the dividing lines in South African society are still very much determined by race and the liberation struggle, vary little in nature and significance across all areas of conflict.

Rather, as we and others suggest, the more likely reason that representative democracies normally bring about an increase in a state's credibility is that the have tended to provide the representatives of the creditor class with a veto point in parliament. This is not the case yet in South Africa and so it lacks credibility. International creditor interests are represented (through identification) by an economic elite that does not enjoy formal representation in parliament and therefore both international and national creditors do no control a veto point. Thus the case of South Africa supports this broader theoretical claim regarding representative democracies. Whether it supports the strong version of our claim – that the necessary condition for a state's credibility is the formal, political representation of its national creditors, irrespective of the exact form of its regime – is up for debate. This more demanding theoretical question could only properly be answered by means of a comparison of various examples of public debt management, representation and state credibility.

By way of gentle hint, though, the stronger of our claims is supported by the example normally used to defend at least claims (3) and (4) outlined above: the dramatic changes that took place in English government finance after the Glorious Revolution of 1688. Before 1688 default on loans had always been a possibility, and thus the Crown had been unable to gain access to credit on anything less than exorbitant rates of interest. After the revolution, Parliament gained substantial prerogatives in the area of public finance and the Bank of England was created and the Crown found it was able to borrow at much lower rates of interest. By contrast, during the 18th Century the French monarchy was never able to reduce the high interest it had to keep paying to its creditors (North and Weingast 1989; Weingast 1997). In fact, it took over thirty years after 1688 before the British government could borrow as cheaply as could the government of Holland, which was universally recognized at the time for its creditworthiness. There was volatility in interest rates, sometimes reaching levels as high as those that had prevailed before 1688, and periodic runs on Bank of England shares until at least 1714 (Stasavage 2003: 5-6). Stasavage argues convincingly that, more than any other factor, trends in interest rates on UK government debt after 1688 vary according to which party was in power, the Whigs or the Tories. When the Whigs were in power interest rates tended to be lower and Bank of England share prices higher, and the converse in both cases when the Tories were in power.[11] And this is explained by the fact that government creditors were active members of the Whig party, whereas the Tory party was more closely aligned with landed interests 'who chafed at the tax payments necessary to repay public debt on schedule' (Stasavage 2003: 6). And, it is also worth remembering something much of the literature on public debt and state credibility seems to have overlooked: the governments of both Holland and the UK for most of the 18th century were far from what, much later, became known as 'representative democracies', in fact the term had yet to be coined (Manin 1997; Dunn 2006). In other words, whether or not they could borrow cheaply had nothing to do with their status or otherwise as 'representative democracies'.

It follows from our argument regarding South Africa's continued lack of credibility despite constituting representative democracy, supported as it is by Stasavage's

[11] The Bank of England share price suffered a precipitous crash after a Tory electoral victory in 1710.

interpretation of UK debt management in the 18th century, that a state's credibility depends not so much on the specific form of its regime, but on whether or not the representatives of its government's creditors enjoy a veto point in parliament, that is, whether or not they have the power in parliament to veto a decision to default on debt. When they do, a state's credibility rises and interest on its debt decreases; and when they don't, the converse occurs, and therefore debt servicing remains relatively expensive.

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