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Macroeconomic Options for Job Creation and Social Development

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INTRODUCTION

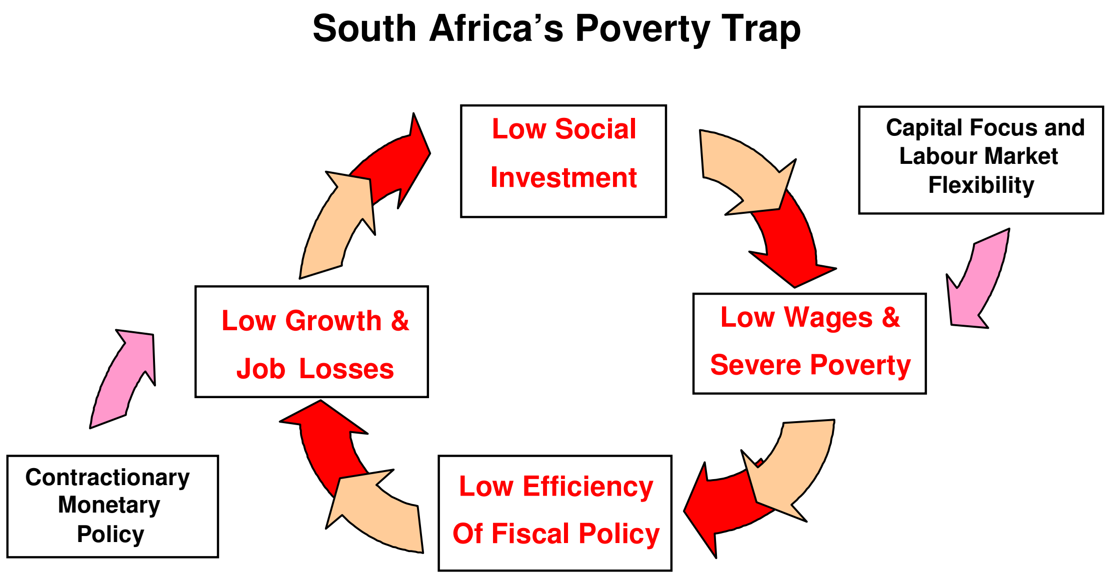
This research paper evaluates the government's current macro-economic strategy and identifies policy reforms aimed at job creation, social development, redistribution, and poverty reduction. The primary scope of the evaluation focuses on the government's budget and its impact on social objectives, but the analysis also integrates related dimensions of other economic policies (i.e. monetary, labour, industrial, etc.) The proposed policy reforms constitute a framework for fiscal policy interwoven with other important dimensions of economic strategy supporting a feasible and sustainable macro-economic strategy.

The research paper consists of two parts: (1) an evaluation of the government's macro-economic policy and outcomes, and (2) an integrated set of policy reforms that support job creation and social development. The first part can be further divided into a detailed examination of fiscal policy and a contextual analysis of related economic policies. The second part consists of a conceptual framework unifying the policy options as well as specific recommendations.

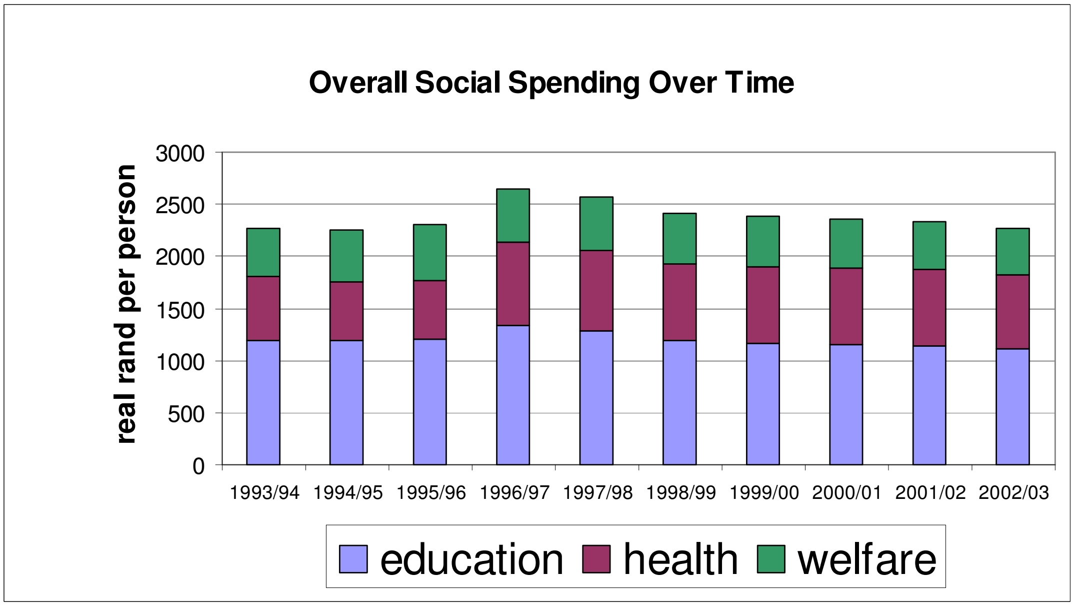
AN EVALUATION OF THE GOVERNMENT'S MACRO-ECONOMIC STRATEGY

The fundamental basis for evaluating a macro-economic strategy is its achievement of critical policy objectives. In South Africa, this involves an assessment of the policy impact on job creation, poverty reduction, redistribution, social delivery and economic growth. South Africa's macro-economic strategy since 1996 has failed to increase formal sector job creation or adequately address the severe poverty afflicting the country. From 1996 to 1999, the government's macro-economic strategy projected the creation of 944,000 jobs. Instead, 460,000 jobs were lost. This trend is continuing according to the South African Reserve Bank, "regularly surveyed *formal non-agricultural employment* declined by an estimated 162,000 workers or 3.3 per cent in the year to March 2000." (SARB 2000).

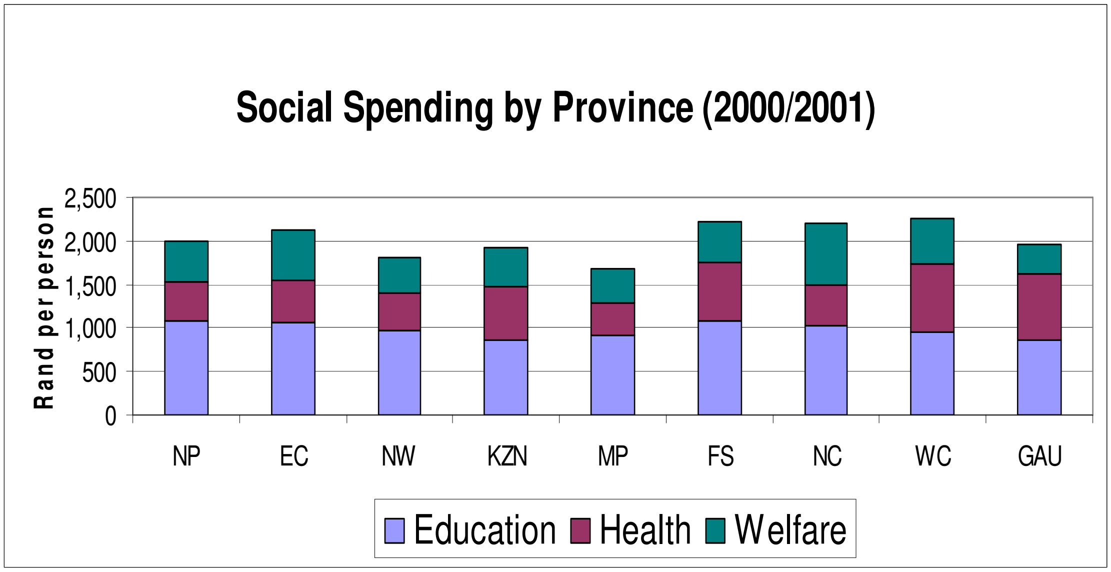
A central feature of South Africa's poverty trap is the skewed and falling levels of social investment. Since 1996, real per capita expenditure on productive investments in education, health, and welfare has fallen each year. This has undermined productivity growth, underpinning a low wage labour market characterised not only by severe unemployment but also a large number of the working poor. The most recent Reserve Bank report documents a steady decline in total labour compensation, even while profits are rising. (SARB September 2000) Attempts to undermine the bargaining position of workers in an already flexible labour market reinforce the poverty trap. Poverty in turn erodes the efficiency of fiscal policy. The following diagram illustrates the circular nature of this poverty trap.



South Africa's falling levels of social investment spending (on a real per capita basis) are documented in the graph below (based on calculations on data provided in the Medium Term Budget Policy Statement). Productive spending on health, education, and welfare peaked in the 1996/97 fiscal year, and then began to fall steadily. By the 2002/03 fiscal year, spending will fall below apartheid-era levels.



This falling level of social investment coincides with a skewed allocation of spending across provinces. The graph below depicts the provinces arranged from poorest to wealthiest as measured by per capita income, with the respective levels of per capita social spending plotted. This shows that some of the poorest provinces have the lowest levels of per capita social investment. The Northern Province is the poorest province, yet per capita social spending is lower than that for the Western Cape, the Northern Cape, and the Free State. The three provinces with the lowest per capita social investment levels—Mpumalanga, the North West, and KwaZulu-Natal—all have per capita incomes well below the national average.



"There is a very strong correlation between level of education and standard of living: the poverty rate among people with no education is 69%, compared with 54% among people with primary education, 24% among those with secondary education, and 3% among those with tertiary education. There is also a correlation between poverty and ill-health…" (PIR, 1998) This suggests that addressing the skewed allocation of social capital may yield important benefits in terms of effective redistribution and reduced poverty. The following sections examine the specific sectors of social investment.

SOCIAL INVESTMENT IN EDUCATION

Every province except the Free State indicates a decline in per capita education expenditure over the five-year period from 1998/99 to 2002/03, according to Medium Term

Budget Policy Statement (MTBPS) estimates. The two provinces with the lowest matric pass rates in 1999 are experiencing some of the largest cuts in per capita spending on education over the five year time period. The Northern Province, with the nation's lowest matric pass rate in 1999 (38%), faces a reduction in per capita education expenditure from 1998/99 to 2002/03 of 11%. The Northern Province, with the nation's second lowest matric pass rate in 1999 (40%), faces a reduction in per capita education expenditure from 1998/99 to 2002/03 of 9%. The national average reduction in per capita expenditure over this time period is 7%. The table below documents the evolution of real per capita expenditure in education across South Africa's nine provinces, based on calculations on data provided in the Medium Term Budget Policy Statement (MTBPS).

	1998/99	1999/00	2000/01	2001/02	2002/03
Eastern Cape	1118	1080	1086	1048	1017
Free State	1061	1079	1119	1123	1101
Gauteng	877	850	856	844	830
KwaZulu-Natal	904	860	895	901	884
Mpumalanga	993	984	943	935	899
Northern Cape	1128	1077	1084	1070	1053
Northern Province	1238	1154	1130	1121	1105
North West	1016	1006	995	908	938
Western Cape	1035	967	959	937	913

SOCIAL INVESTMENT IN PUBLIC HEALTH

The table below shows the time path of real per capita health expenditure for each of South Africa's nine provinces. Every province except the North West suffers a decline in per capita health expenditure over the five-year period from 1998/99 to 2002/03.

	1998/99	1999/00	2000/01	2001/02	2002/03
Eastern Cape	516	563	497	501	486
Free State	686	622	666	651	639
Gauteng	795	756	766	766	755
KwaZulu-Natal	618	602	627	608	592
Mpumalanga	400	402	385	377	371
Northern Cape	496	516	481	475	462
Northern Province	439	445	442	425	414
North West	428	410	440	448	444
Western Cape	820	788	800	789	738

The disparities in public health spending per capita are more extreme than in education. Health public expenditure per capita in the Western Cape is more than twice that in Mpumalanga. The inequalities are even starker when analysed in terms of the populations of the provinces without access to medical aid. The disparities persist even when controlling for conditional grants.

SOCIAL INVESTMENT IN WELFARE

The table below documents the evolution of per capita welfare expenditure across South Africa's nine provinces. Every province suffers a decline in per capita welfare expenditure over the five-year period from 1998/99 to 2002/03.

	1998/99	1999/00	2000/01	2001/02	2002/03
Eastern Cape	617	609	616	569	541
Free State	470	450	459	442	415
Gauteng	333	327	329	323	318
KwaZulu-Natal	505	478	446	444	419
Mpumalanga	411	405	394	384	375
Northern Cape	855	829	720	690	659
Northern Province	434	457	465	429	417
North West	413	416	417	391	376
Western Cape	599	557	533	504	489

Like health expenditure, welfare spending exhibits a skewed allocation across provinces, reflecting in part "historical differences in access to grants." (Intergovernmental Fiscal Review, 2000). In the Northern Cape and Western Cape, about 80% and 60% of the respective populations of disabled people receive disability grants. Less than 20% of disabled people in Mpumalanga, the Northern Province, and the North West receive the grants. Old age grants, however, have a more progressive incidence. Nevertheless, fiscal austerity and the failure to index grants to the inflation rate undermine the social and productivity benefits of an appropriate social security system.

OTHER DIMENSIONS OF MACRO-ECONOMIC POLICY

Fiscal policy has interacted with monetary, labour and industrial policy in contributing to the perpetuation of South Africa's poverty trap. Monetary policy has focused exclusively on financial stability, ignoring its constitutional role in supporting sustaining economic growth and development. Labour and industrial policy have missed important opportunities to shift the productive sector onto a labour-demanding growth path.

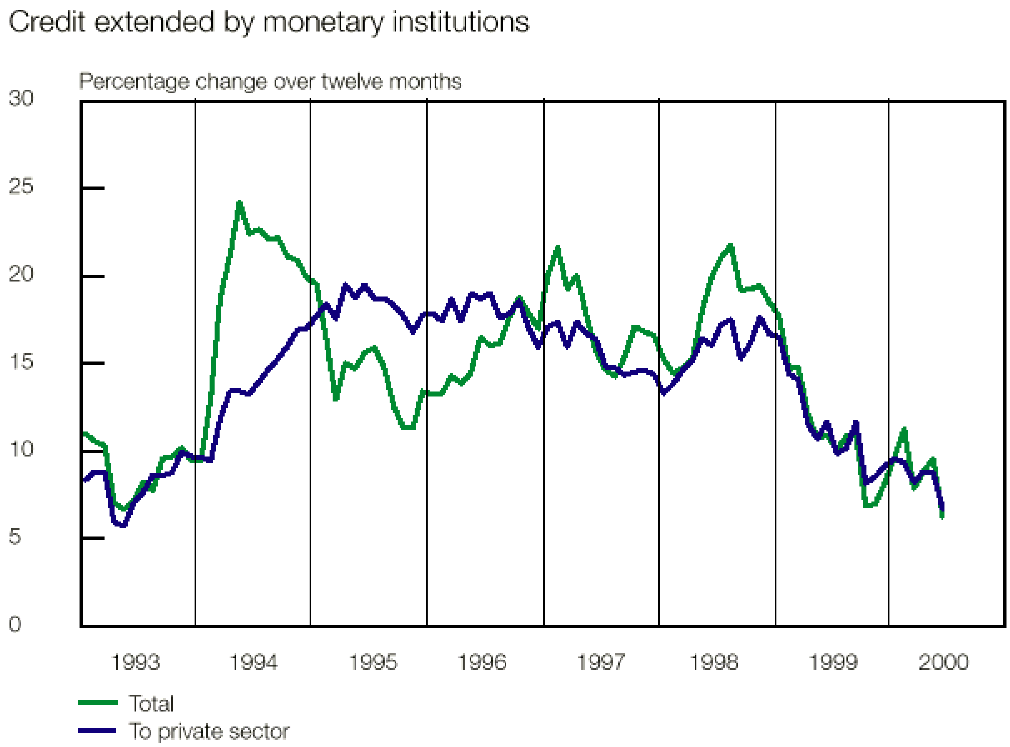
MONETARY POLICY

Monetary policy has focused on reducing inflation, employing extraordinarily high real interest rates that have artificially supported the rand. The Reserve Bank has oriented monetary policy since 1989 around the objective of reducing the rate of price inflation, occasionally expending public resources to support the external value of the rand. To achieve this, extraordinarily high interest rates have depressed consumer and business demand and inflated the interest costs of servicing the government's debt.[1] The high interest rates have tended to support the external value of the rand, leading to exchange rates in the short run that are somewhat stronger than they would otherwise be. Stronger exchange rates lead to lower costs for imported capital goods (as well as capital complements such as imported energy products). High interest rates have increased the cost of credit, suppressing job creation while tending to some bias towards capital-intensive production.

The disinflationary monetary policy has imposed severe costs on the productive economy. An analysis of the cost of disinflation quantified the high costs in terms of reduced growth and lower employment resulting from the high real interest rates characterising the South African economy since 1989.[2] Particularly since 1998, these policies have substantially deterred credit extension to the private sector, as depicted in the graph below. Even the Reserve Bank has recognised—in an understated way—that "there is good reason to believe that the very high levels of interest rates in 1998 could have weakened the appetite for bank credit of private economic agents." (SARB AER 2000, p.56) Likewise, Trevor Manuel has acknowledged this link: "Maintaining the value of the rand in support of sustainable economic growth is the constitutional responsibility of the South African Reserve Bank. Its main instrument in executing this responsibility is the level of interest rates and rising inflation is consequently accompanied by higher interest rates. We know that high

[1]Samson, Michael. 1996. "Evaluating the Costs of South Africa's Monetary Policy Alternatives". *National Institute for Economic Policy*. Johannesburg: NIEP.
[2]Ibid.

interest rates impose a heavy burden on families and small businesses." (Budget Speech 2000) Real interest rates over the past five years have been the highest in South Africa's history, depressing consumer demand as well as productive job-creating investment by firms. An appropriate monetary policy should balance the financial stability concerns with the developmental objectives of the nation, thus sustaining the value of the rand *in support of sustainable economic growth*. Financial stability is a means to an end—sustainable growth that supports job creation and social development. Excessive emphasis on the means—the stability intermediary—may prove counter-productive, undermining the fundamental developmental objective.

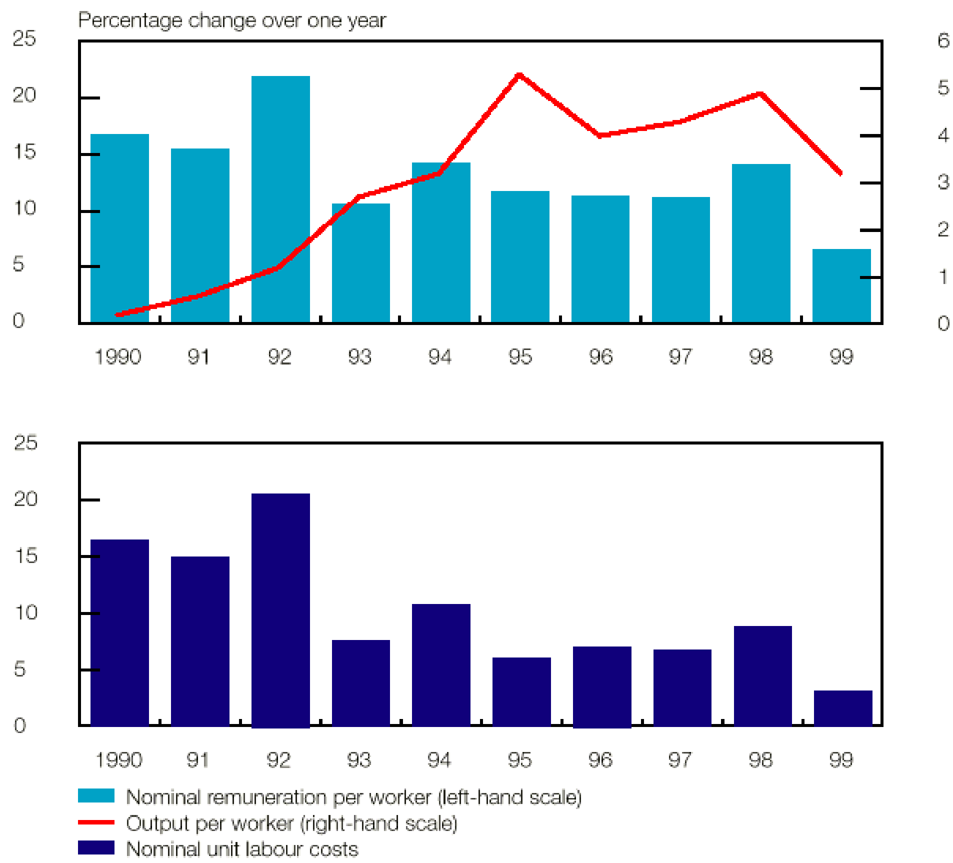


SOURCE: SOUTH AFRICAN RESERVE BANK

LABOUR POLICY

An analysis of wages, productivity and unit labour costs (see the graph below) does not support the argument that labour market distortions are responsible for the destruction of jobs over the past four years. Wage increases have fallen dramatically since 1994, even as worker productivity has risen. The result has been a substantial drop in unit labour costs–which actually fell in real terms in 1999 and through the first quarter of 2000.

Non-agricultural remuneration, labour productivity and unit labour costs



Over the past five years, South African labour policy entrenched important gains for workers. In other areas, however, progress in promoting a living wage has slowed. South Africa's economy demonstrates a causal link from higher wages to productivity growth. A Dresdner Bank study of South African manufacturing sectors found evidence of a positive efficiency wage effect in many industries.[3] This is consistent with international experience in many low wage developing countries.[4]

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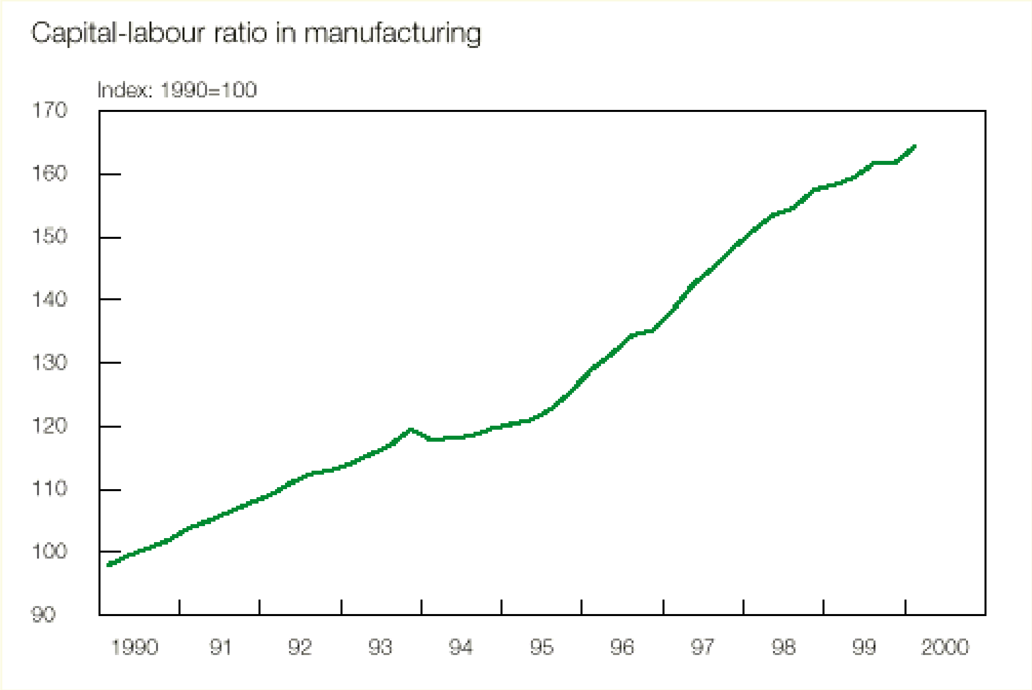
[3] Piazolo, M. and M. Wurth. 1995. "Productivity in the South African Manufacturing Industry: A Cointegration Approach." *South Africa Journal of Economics*. Volume 63, Number 2. Pages 173-196.

[4] A recent World Bank study finds "significant efficiency wage effects" using firm-level data from Mexico (Maloney and Ribeiro 1999). Another World Bank study using an endogenous growth framework for Guatemala found similar results (Sakellariou 1995). Likewise, a study of Zimbabwean firm level data is consistent with positive efficiency wage effects (Valenchik 1997). Similarly, a study

INDUSTRIAL POLICY

Industrial policy in South Africa is still in formative stages. The increasing capital-to-labour ratio demonstrates the need for a focused industrial policy that promotes labour-demanding growth. While statistics on investment in South Africa indicate low levels of capital utilisation, public policy has historically encouraged relatively capital-intensive production rather than job-creating growth. The Katz Commission interim report, for instance, identifies tax distortions that have lowered the user cost of capital and made labour relatively more expensive. These include skewed depreciation rules, investment allowances, payroll levies, and registration fees.[5] The absence of significant capital taxes supports the relative attractiveness of capital over labour, particularly since the weight of the tax structure falls on labour income and consumption. Stringent monetary policy that maintains the value of the rand also tends to keep the price of imported capital equipment from rising.



SOURCE: SOUTH AFRICAN RESERVE BANK

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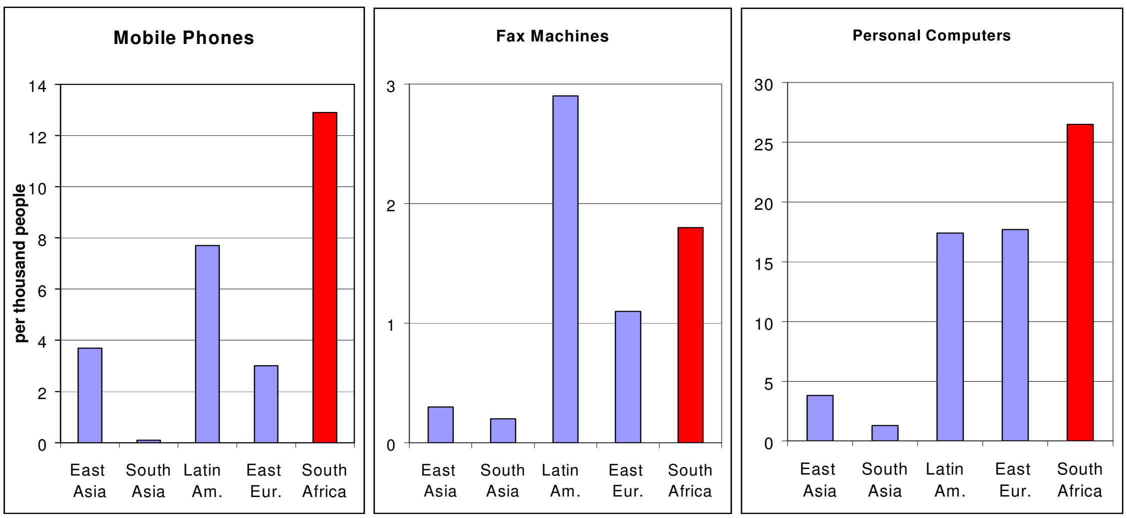
of the cement industry in Turkey finds that higher wages improve productivity by increasing technical efficiency (Saygili 1998).

[5] *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*. 1994. (Chaired by M. M. Katz.) Pretoria: Republic of South Africa Government Printer. Pages 254-255.

Furthermore, the allocation of fixed capital is skewed within the economy. Certain industries are characterised by abundant labour-saving capital, while others—particularly in the informal sector—lack adequate capital to effectively employ labour. Gross domestic fixed investment in the public sector has plummeted since 1975, while private sector investment has grown in step with economic performance. Certain measures of private capital utilisation indicate relative abundance. As depicted in the graphs below, South Africa has 27 computers for every thousand people, compared to 17 per thousand in Latin America, 4 per thousand in East Asia, and 18 per thousand in Eastern Europe and South Asia.[6]

Private Capital Indicators



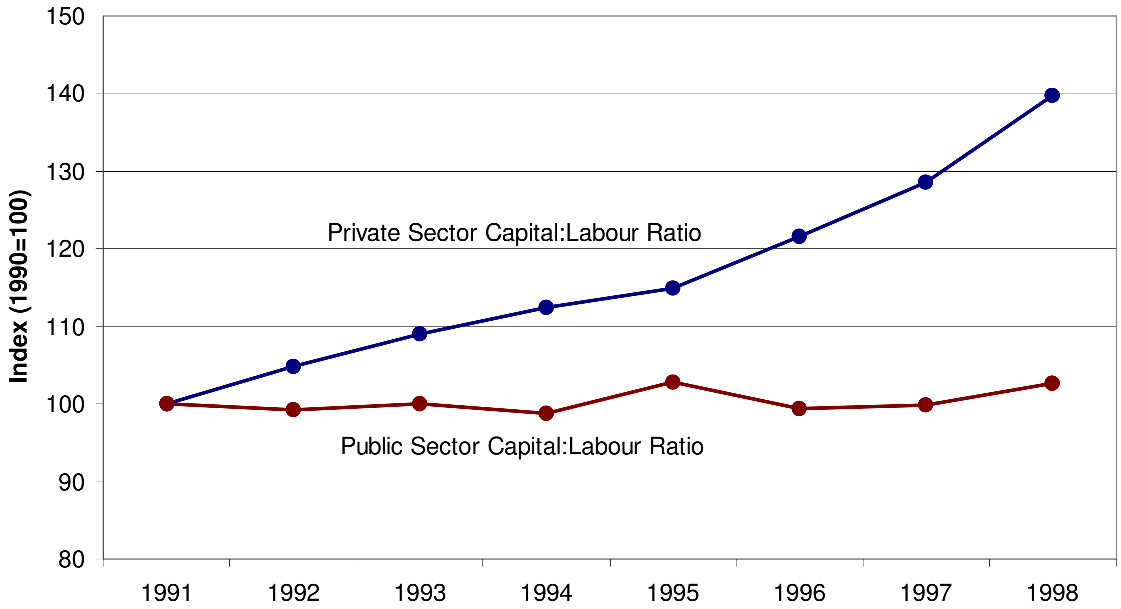
South Africa provides a textbook example of capital-intensive production that does not necessarily support job creation. Fourie's textbook, for instance, characterises South Africa's pattern of capital and labour use as typical of industrialised economies with far lower unemployment rates. He identifies numerous possible causes, among them tax distortions, unqualified admiration of inappropriate technology from industrialised countries, scarcity of skilled workers, imported consumer preferences that skew demand towards capital-intensive goods, and anti-competitive behaviour by large South African conglomerates that undermine smaller labour-intensive enterprises.[7] One study estimates two million job losses over the

[6] du Toit, J. *The Structure of the South African Economy*. Cape Town: Southern Book Publishers. Page 7 (Source: World Bank).

[7] Fourie, Frederick C v N. 1997. How to think and reason in macroeconomics. Cape Town: Juta. Pages 367-368.

past twenty years from inappropriate capital intensity.[8] Statistical analysis links th inappropriate capital and labour use to consistent under-pricing of capital relative to labour.[9] An analysis of private and public capital-to-labour ratios (summarised in the graph below) demonstrates that production in the private sector has shown a steady increase in the capital-intensity of production, and this choice of capital over labour has accelerated beginning in 1996. Meanwhile, the public sector has maintained a fairly constant proportion of labour and capital employment.

Private and Public Sector Capital:Labour Ratios



SOURCE: RESERVE BANK OF SOUTH AFRICA

MACRO-ECONOMIC STRATEGY OPTIONS

Tightened fiscal austerity or increased labour market flexibility will not break South Africa's poverty trap. Policies that increase poverty intensify the trap, creating costs with long-term impacts. This research paper identifies policy options that can support the breaking of the poverty trap through co-ordinated social investment combined with pro-poor and pro-worker industrial and labour policies. A key issue questioned by the analysis is the presumption of a necessary trade-off between higher wages and more employment.

[8] Bowles, Samuel. 1995. "Wages, Aggregate Demand, and Employment in an Open Economy: An Empirical Investigation". In *Macroeconomic Policy after the conservative era: Studies in investment, savings, and finance*. Edited by Gerald A. Epstein and Herbert M. Gintis. Cambridge: Cambridge University Press. Pages 143-171.

[9] Van Seventer, D. E. N. and van Niekerk, F. D. 1991. "An evaluation of the price structure in South Africa. *South African Journal of Economics*. Volume 59, Number 1. Pages 45-57.

THE ANALYTICAL MODEL

The proposed strategy is based on a macro-economic model that analyses the link between job creation and growth, as well as incorporating an appropriate role for technology, wages, and fiscal policy. The micro-foundations are based on analysing the behaviour of productive enterprises whose output (and hence the economy's income) depends on factor inputs (labour and capital) and the respective measures of their productivity. The model incorporates a fiscal budget constraint linking taxes, government expenditure, and public borrowing. The model is different from many macro-economic models in that productivity depends explicitly on wages and social infrastructure investment—wages, at least over a certain range, can increase both labour and capital productivity. Social infrastructure investment, largely a public good, is also productive for both labour and capital. Wages also have a public good character—higher wages lead to higher remittances—inter- and intra-family, with diffuse productivity benefits. Higher wages reduce poverty and contribute to social cohesion. The technical details of the model are described in more detail in a recent paper published by the Economic Policy Research Institute (Samson 2000).

A key feature of the model is the relationship between job creation and investment, productivity, and wages. As in most macro-economic models, capital investment and improved capital productivity both increase the rate of job creation. Increased labour productivity, however, can be either job-creating or job-destroying. The impact of increased labour productivity on employment depends on two characteristics of the economy: (1) the degree of substitutability between labour and capital in the production processes, and (2) the relative shares of capital and labour in national income. If labour and capital are not very substitutable, and capital's share of income is high, then labour productivity growth is more likely to be job destroying. The reason is that increased labour productivity provides employers with an economic choice: (1) to take advantage of the resulting increased profitability by employing more labour and substantially increasing national income, or (2) to take advantage of increased productivity by maintaining existing production levels but employing fewer workers. If capital were relatively cheap and abundant, the first choice would generally dominate. Under conditions of scarce and expensive capital, however, the first choice is more likely to be chosen by employers if workers can effectively economise on capital—that is, if more workers can substitute for capital in the production process.

Economic growth can generate more employment and higher wages if it stems from higher labour productivity combined with an improved capacity for workers to substitute for capital in the production process. Social investment can satisfy both of these requirements. Social investment has important productivity-improving effects on both capital and labour, and it supports the enhancement of technology choice that allows the substitution of workers for capital.

This link between social investment and job creation can be supported through an appropriate fiscal policy. For any given overarching fiscal policy framework, low levels of social infrastructure investment require relatively low levels of taxation and borrowing. Efficiently allocated scarce social investment, however, is likely to have very large positive effects on the economy's output. The economic growth costs of higher taxes are likely to be small if tax rates are relatively low. The net effects from tax-financed social investment under these conditions include increased growth and more rapid job creation.

Low wages may reinforce the poverty trap. Low levels of social capital constrain labour productivity, keeping wages down. And low wages themselves reinforce low productivity. In a country with a high degree of unemployment, this becomes self-reinforcing. Wages take on a public good character—since the society's social safety net (a public good) is largely financed by inter- and intra-family remittances from the working poor. This interferes with the efficiency effects of higher wages—the productivity benefits of higher wages are not entirely appropriated by the wage-increasing firm.

Under these conditions, an economy may have two problems:

(1) Individual firm profit-maximising behaviour may not move the economy from the initial point, even if a higher point is associated with higher profits for the economy as a whole.

(2) If the fiscal policy framework is too austere, the trade-off between wages and national income is weak, since social investment complements wages in production. If the level of social infrastructure investment is too low, or the dead-weight loss of financing taxation too great, then growth will respond relatively weakly to wage increases.

POLICY IMPLICATIONS

What are the policy implications of this analysis:

(1) It is possible to have both increased employment and higher wages—if the substitutability of labour for capital can be improved. This must go hand-in-hand with increased labour productivity.

--to the extent that tax incentives are used to promote industrial policy, they will be most effective if they provide wage subsidies rather than capital subsidies.

--promoting capital investment is not unambiguously positive for employment growth—evaluating programmes to promote investment should involve the assessment of their impact on technology, as reflected by the capital-to-labour ratio.

--policy should focus as much as possible on fostering a labour force that can economise on capital inputs.

(2) One way to do this is through higher levels of social infrastructure investment

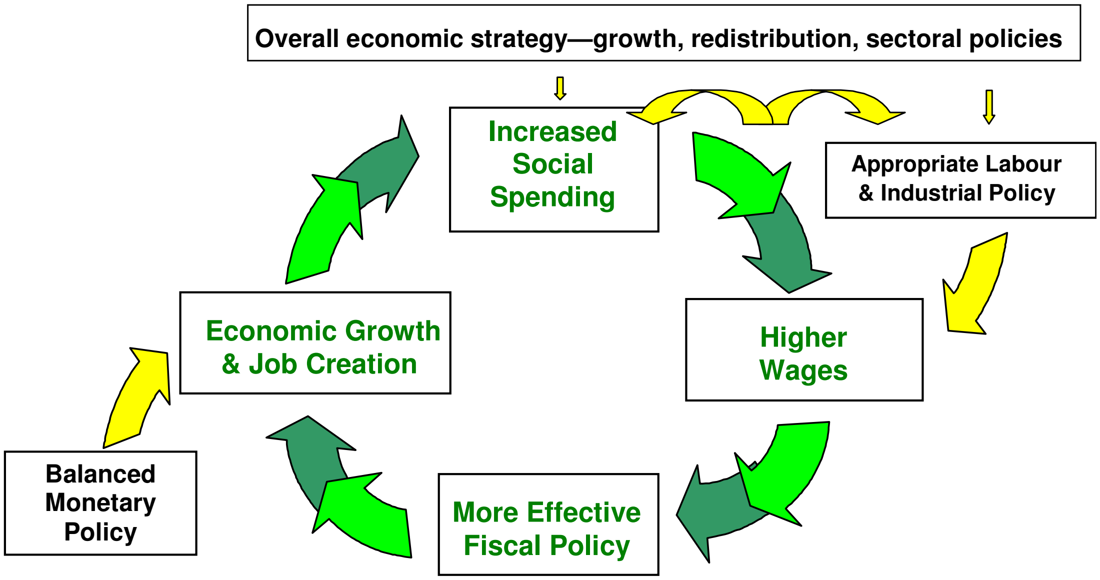
--social capital in South Africa remains highly skewed, and delivery has been constrained in part by fiscal austerity. Given historical inertia that impedes the reallocation of resources to the poorest groups—where the long run marginal productivity is likely to be highest—higher levels of expenditure may be necessary. This can be financed out of more progressive taxation or greater borrowing, where there is substantial untapped capacity.

--greater levels of social investment will improve labour productivity, but more importantly, it can make labour more substitutable for capital. Modern labour-intensive techniques require a high morale, reliable workforce. If health conditions are poor, absenteeism will be higher. If there's no reliable and safe mass transit system, tardiness will undermine productivity not only of the tardy employees, but also of the entire co-ordinated production process. Information-intensive capital-saving innovations require a skilled well-educated workforce—social infrastructure investment supports this.

(3) Finally, this framework does not suggest that lower wages for the poorest workers are likely to have positive employment effects. On the contrary, improved wage co-ordination, coupled with growth and employment-enhancing industrial and fiscal policy, is necessary.

The analysis suggests that a strategy of improved productivity coupled with increased substitutability of labour for capital can promote both higher wages and more employment. Wage co-ordination for the lowest paid workers may be necessary, and a key ingredient in this strategy is improved delivery of social infrastructure investment. This policy framework can be illustrated with the following diagram.

An Alternative Macroeconomic Strategy



The diagram depicts the reinforcing nature of the component macro-economic policies. Increased social investment combined with appropriate labour and industrial policies support higher wages, fostering a more stable and productive workforce, supporting job creation and reduced poverty. This bolsters the effectiveness of fiscal policy, since efficient social delivery produces a greater growth effect if the economy can break out of the poverty trap. Expanding access to education is not as efficient if households lack the resources to provide learners with adequate nutrition. Expanding access to electricity fails to yield optimal results if households lack the capacity to pay the associated service charges. With higher social wages and less severe poverty, fiscal policy has a stronger effect promoting economic growth and job creation. An appropriately balanced developmental monetary policy can reinforce these effects. Higher rates of economic growth can in turn expand the fiscal resource base, supporting even greater levels of social delivery, and the entire 'virtuous circle' is accelerated.

THE ROLE OF APPROPRIATE LABOUR POLICY

The public guarantee of a living wage for workers supports the process of productivity growth. The economics principle of the "efficiency wage" identifies how higher money wages foster greater productivity.[10] Higher wages promote job stability, low turnover rates, efficient skill acquisition, positive employee morale, and worker loyalty, all of which lead to greater labour productivity. Wages perceived as equitable support worker self-management, providing an invaluable substitute for burdensome supervisory oversight[11] while enhancing the quality and quantity of output.[12] This is particularly important in the area of social capital delivery, where civil servants are largely responsible. If public policy reduces the real wages paid to social workers, teachers, and health providers, the quality of social investment is likely to decline. Enhanced productivity growth supported by higher social wages will increase the competitiveness of the labour force.

INDUSTRIAL POLICY THAT MANAGES THE CAPITAL-LABOUR TRADE-OFF

This strategy proposes that the government implement policies that eliminate distortions favouring the use of capital at the expense of labour, thus shifting incentives towards more rapid job creation. The cost of capital in South Africa does not reflect the true cost to society of diverting resources to employing machinery and equipment. Enterprises

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[10] Akerlof, George A. 1984. "Gift Exchange and Efficiency-Wage Theory: Four Views". *AEA Papers and Proceedings*. Volume 74, Number 2 (May). Pages 79-83.
[11] Burawoy, Michael. 1979. *Manufacturing Consent*. Chicago: University of Chicago Press.
[12] Adams, J. Stacy. 1965. "Inequity in Social Exchange" in L. Berkowitz, ed. *Advances in Social Psychology*, Volume 2. New York: Academic Press. Pages 267-299. Also: Richard T. Mowday. 1979. "Equity Theory Predictions of Behavior in Organizations," in Richard M. Steers and Lyman W. Porter, eds., *Motivations and Work Behavior*, New York: McGraw Hill. Pages 124-146.

lay off workers and replace them with automated machinery based on expected cost-benefit analysis that assesses the relative costs to the firm. The additional costs to society of increasing unemployment do not enter the calculation—yet they are substantial, in terms of social safety net costs (both public and private) as well as increased crime and social unrest.

Eliminating distortions that subsidise the cost of fixed capital constitutes an essential ingredient to poverty-eradicating job creation, redressing the market failure resulting from decades of capital subsidies. Higher wages tend to make capital expenditures relatively more attractive, reducing the employment of workers. While higher labour productivity will tend to offset this, it may be insufficient. Policies that result in an increased cost of capital can effectively shift factor demand towards job creation. These policies can include higher taxes on capital and profits, reduced subsidies, as well as a weaker rand (discussed below). These policies also have ancillary benefits—the capital taxes and resources freed from eliminating capital subsidies can support social investment objectives. The weaker rand goes hand-in-hand with lower interest rates, broadly supporting the objectives of poverty-eradicating job creation.

Effective competition policy that restricts monopolistic and collusive business practices promotes expansion of output at lower prices, thus creating jobs while stemming inflationary pressure. The failure of effective competition policy biases the economy towards excess capacity to protect monopoly and oligopoly, contributing to employment-depressing capital intensity. In 1999, for example, Trade and Industry Minister Alec Erwin declined to enforce a Competition Board recommendation to stop restrictive practices by pharmaceutical distributors because of threatened lawsuits.[13]

DEVELOPMENTAL MONETARY POLICY

South Africa's developmental objectives are not consistent with the high interest rates required to reduce inflation below its current moderate levels. An easing of monetary policy would allow interest rates to fall while and the rand to weaken. Lower interest rates will provide cheaper credit, particularly for small and medium enterprises that do not have access to substantial supplies of retained earnings. These small and medium enterprises are prime candidates for job-creating growth. Policy can be managed to direct credit

[13] Shevel, Adele. "Erwin won't implement board's ruling." *Business Report*. July 20, 1999. Page 1.

towards labour-intensive small and medium enterprises. At the same time, the weaker rand will increase the cost of imported capital goods, further shifting relative prices towards promoting job creation. An added benefit of lower interest rates is lower debt servicing costs for the government, bolstering fiscal resources for social delivery. In addition, the possibility should be explored of expanding credit effectively to survivalist and informal enterprises, combined with the necessary logistical and infrastructure support that fosters their success in expanding labour-intensive production.

MODEL SIMULATIONS

This model provides insight into the impact of a social investment strategy on economic growth and public finances. For comparison purposes, the baseline scenario was drawn from the 2000 Medium Term Budget Policy Statement (National Treasury, 2000), with public debt figures estimated based on the 2000 Budget Review (since the Medium Term Budget Policy Statement did not explicitly project debt figures). The table below summarises some of the key characteristics of the government's macro-economic strategy through the 2003/04 fiscal year. Government revenue and expenditure as well as the fiscal deficit (calculated as a percentage of GDP) fall steadily over the medium term. Growth is projected to increase rapidly in the next fiscal year—to 3.7% real GDP growth compared to 2.6% projected for 2000/01, and then to fall moderately for the following two years. As a result of lower deficits and more rapid growth, government debt as a percentage of national income (GDP) falls rapidly.

baseline scenario	2000/01	2001/02	2002/03	2003/04
government revenue (% of GDP)	23.8	23.8	23.7	23.6
government expenditure (% of GDP)	26.4	26.3	25.9	25.7
fiscal deficit (% of GDP)	2.6	2.5	2.3	2.1
public debt (% of GDP)	45.8	44.2	42.1	41.1
real GDP growth rate	2.6	3.7	3.5	3.3

SCENARIO 1) GRADUAL EXPANSION IN SOCIAL INVESTMENT

Three scenarios are explored. The first is a gradual fiscal expansion financing a social investment programme. In 2001/02, the fiscal deficit is raised to 3% of GDP, and taxes are increased by an amount equivalent to one percentage point of baseline GDP. In 2002/03, the fiscal deficit is maintained at 3% of GDP, and taxes are increased by an amount equivalent to two percentage points of baseline GDP. Finally, in 2003/04, the fiscal deficit is again maintained at 3% of GDP, and taxes are increased by an amount equivalent to three percentage points of baseline GDP. The resulting resources from greater borrowing and higher taxes are channelled into productive social investment expenditure. The results of these policies are summarised in the table below.

gradual expansion	2000/01	2001/02	2002/03	2003/04
government revenue (% of GDP)	23.8	24.6	25.2	25.7
government expenditure (% of GDP)	26.4	27.6	28.3	28.7
fiscal deficit (% of GDP)	2.6	3.0	3.0	3.0
public debt (% of GDP)	45.8	44.4	42.2	40.7
real GDP growth rate	2.6	4.3	4.7	4.9
additional social investment (R billions)	---	14.2	30.2	45.7

The real growth rate increases substantially, yielding significant increases in job creation because of the labour-intensive nature of the expansion. The initial expansion in growth is a combination of a demand stimulus and an increase in productive capacity as social investment bolsters labour and capital productivity. The longer-term results reflect more fully the positive effects of social investment on expanded economic capacity. The real growth rate rises to 4.9% over the three-year horizon instead of fluctuating at lower levels. In spite of the higher levels of borrowing, the public debt (measured relative to national income) falls more rapidly than in the baseline scenario, since the growth rate of the economy is significantly higher. In 2003/04, public debt amounts to only 40.7% of GDP, rather than 41.1% in the baseline scenario. The increase in available resources to finance social investment rises gradually, from R14.2 billion in 2001/02 to R45.7 billion in 2003/04. This gradual expansion is designed to accommodate a measured development in the public sector's capacity to efficiently deliver social investment.

SCENARIO 2) MODERATE EXPANSION IN SOCIAL INVESTMENT

The second scenario illustrates the results of a moderate expansion in social investment financed by a temporary increase in borrowing and a gradual increase in taxation. In 2001/02, the fiscal deficit is raised to 4% of GDP, and taxes are increased by an amount equivalent to one percentage point of baseline GDP. In 2002/03, the fiscal deficit is reduced to 3.5% of GDP, and taxes are increased by an amount equivalent to two percentage points of baseline GDP. Finally, in 2003/04, the fiscal deficit is reduced again to the 3% of GDP target, and taxes are increased by an amount equivalent to three percentage points of baseline GDP. As in the first scenario, the resulting resources from greater borrowing and higher taxes are channelled into productive social investment expenditure. The results of these policies are summarised in the table below.

moderate expansion	2000/01	2001/02	2002/03	2003/04
government revenue (% of GDP)	23.8	24.4	24.9	25.5
government expenditure (% of GDP)	26.4	28.5	28.4	28.4
fiscal deficit (% of GDP)	2.6	4.0	3.5	3.0
public debt (% of GDP)	45.8	45.2	42.2	40.3
real GDP growth rate	2.6	5.1	5.0	4.9
additional social investment (R billions)	---	24.9	35.5	45.7

The real growth rate increases more rapidly, yielding greater increases in job creation because of the labour-intensive nature of the expansion. Again, the initial expansion in growth is a combination of a demand stimulus and an increase in productive capacity as social investment bolsters labour and capital productivity. The real growth rate rises immediately to 5.1%, falling slightly in the second and third years. In spite of the higher levels of borrowing, the public debt (measured relative to national income) falls more rapidly than in either the baseline scenario or the gradual expansion scenario, since the growth rate of the economy is substantially higher. In 2003/04, public debt amounts to only 40.3% of GDP, rather than 41.1% in the baseline scenario. The increase in available resources to finance social investment rises more rapidly in the first year and more gradually thereafter, from R24.9 billion in 2001/02 to R45.7 billion in 2003/04. This more rapid initial expansion is designed to support more effective development of the public sector's capacity to efficiently deliver social investment.

SCENARIO 3) RAPID EXPANSION IN SOCIAL INVESTMENT

The third scenario illustrates the results of a more rapid expansion in social investment financed by a temporary increase in borrowing and a more rapid increase in taxation. In 2001/02, the fiscal deficit is raised to 4% of GDP, and taxes are increased by an amount equivalent to two percentage points of baseline GDP. In 2002/03, the fiscal deficit is reduced to 3.5% of GDP, and taxes are increased by an amount equivalent to three percentage points of baseline GDP. Finally, in 2003/04, the fiscal deficit is reduced again to the 3% of GDP target, and taxes are increased by an amount equivalent to four percentage points of baseline GDP. As in the preceding scenarios, the resulting resources from greater borrowing and higher taxes are channelled into productive social investment expenditure. The results of these policies are summarised in the table below.

rapid expansion	2000/01	2001/02	2002/03	2003/04
government revenue (% of GDP)	23.8	25.4	25.8	26.2
government expenditure (% of GDP)	26.4	29.4	29.2	29.2
fiscal deficit (% of GDP)	2.6	4.0	3.5	3.0
public debt (% of GDP)	45.8	45.0	42.0	40.0
real GDP growth rate	2.6	5.4	5.3	5.3
additional social investment (R billions)	---	34.7	46.2	58.3

The real growth rate increases even more rapidly, again yielding greater increases in job creation because of the labour-intensive nature of the expansion. The initial expansion in growth again is a combination of a demand stimulus and an increase in productive capacity as social investment bolsters labour and capital productivity. The real growth rate rises immediately to 5.4%, falling slightly in the second year and stabilising. In spite of the higher levels of borrowing, the public debt (measured relative to national income) falls more rapidly than in either the baseline scenario or both of the preceding scenarios. In 2003/04, public debt amounts to only 40% of GDP, rather than 41.1% in the baseline scenario. The increase in available resources to finance social investment rises much more rapidly in the first year and continues to rise substantially thereafter, from R34.7 billion in 2001/02 to R58.3 in 2003/04. This more rapid initial expansion is designed to support much more effective development of the public sector's capacity to efficiently deliver social investment.

TAX REVENUE

The scenarios described above depend on the progressive reform of South Africa's tax structure and the judicious use of additional borrowing, which can finance South Africa's transformation process in a manner that stimulates and sustains higher levels of economic activity. While the main redistributive effects of this strategy result from government expenditure and industrial and labour policy, progressive taxation that shifts the tax burden onto wealthier groups can support substantial improvements in social equity, not only by financing social delivery but also by progressively shifting the distribution of after-tax income. In addition, tax-financed social expenditure and investment-oriented borrowing revitalise demand for goods and services, stimulating job creation in labour-intensive sectors.

South Africa's tax structure relies heavily on regressive taxes, and currently fails to employ progressive taxes such as effective estate tax and capital gains taxes. Studies of the South African tax system document the extent to which lower and middle income groups bear a disproportionate share of the tax burden.[14] From 1994 to 1996, South Africa derived more than a quarter of its tax revenue from the Value Added Tax (VAT), yet the poorest fifth of the population spend 61% of their consumption expenditure on goods subject to VAT, while the wealthiest fifth of the population spend only 43% of their consumption expenditure these types of goods. The Katz Commission report, recognising the "huge disparity of incomes and assets between the various groups in South Africa", argues for the need for greater reliance on wealth taxes.[15]

The graph on the next page compares South Africa's tax revenue (as a percentage of national income) to government receipts of OECD countries during the past decade, demonstrating no evidence that South Africa's tax burden is unusually high.[16] The average OECD country's ratio of revenue to national income is 42.3%, compared to a ratio of 24.7% for South Africa. The relevance of an OECD comparison is supported by the argument that

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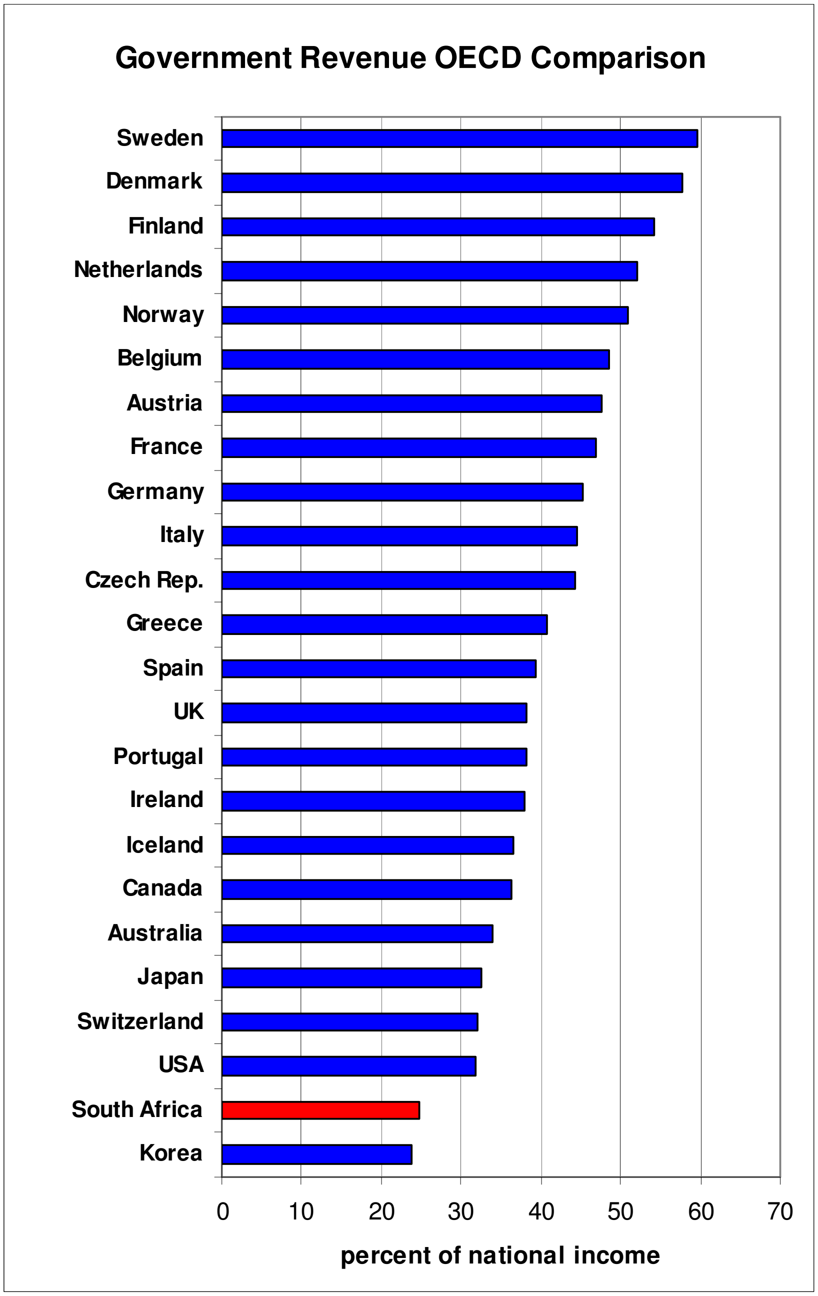
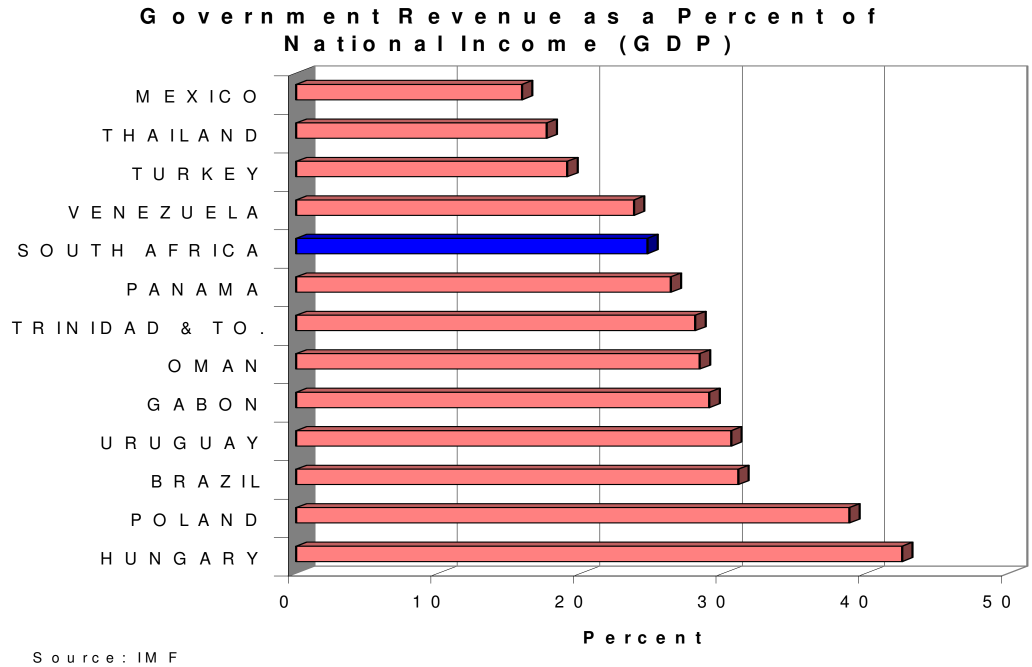
[14] Harber, Richard. 1995. "South Africa's Public Finances". Pretoria: United States Agency for International Development.
[15] Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa. 1995. (Chaired by M. M. Katz.) Pretoria: Republic of South Africa Government Printer. Page 50.
[16] The comparison includes data for all countries listed in the OECD 1999 yearbook, averaging all data for the 1990s. South Africa's data covers the timeframe comparable with the OECD sample, with data drawn from the 2000 Budget Review.

unduly high tax rates will induce immigration out of South Africa, and the overwhelming majority of immigration from South Africa is to OECD countries.



Furthermore, South Africa's government revenue (relative to national income) is significantly less than that of other countries with comparable income levels. The graph below shows average government revenue (relative to national income) for countries with per capita incomes within twenty percent of South Africa's level. This documents that Sou Africa's government revenue (as a percentage of national income) is about four percentage points lower than the average for countries with similar income levels. A previous ESSET research paper supported a similar conclusion, comparing South Africa's tax ratio with those of countries with similar income levels. The ten countries with per capita incomes closest to South Africa were analysed—their average tax rate was six percentage points higher than that for South Africa.[17] Econometric studies that control for individual country characteristics have found South Africa's average tax rate to be significantly less than that which would be predicted given the country's economic profile.[18] Furthermore, tax effort analysis suggests that South Africa could mobilise up to an additional twenty-five billion rand per year without undermining international competitiveness.[19]



[17] Samson, Michael, Kenneth Mac Quene, Ingrid van Niekerk, and Thami Ngqungwana. 1997. "South Africa's Apartheid Debt." *A Public Policy Study for ESSET*. Johannesburg: ESSET.
[18] Harber, Richard. 1995. "South Africa's Public Finances". Pretoria: United States Agency for International Development. Also, Michael Samson. 1996. "Re-evaluating South Africa's Fiscal Constraints on Transformation." *A Report to NEDLAC Commissioned by the Economic Policy Research Institute*. Cape Town: EPRI. Also, Michael Samson, Kenneth Mac Quene, Ingrid van Niekerk, and Thami Ngqungwana. 1997. "South Africa's Apartheid Debt." *A Public Policy Study for ESSET*. Johannesburg: ESSET.
[19] Samson, Michael. 1996. "Re-evaluating South Africa's Fiscal Constraints on Transformation." *A Report to NEDLAC Commissioned by the Economic Policy Research Institute*. Cape Town: EPRI. Also, Harber, Richard. 1995. "South Africa's Public Finances". Pretoria: United States Agency for International Development.

The revenue potential from a more equitable tax system requires detailed investigation. Preliminary analysis indicates that a capital gains tax can increase total revenue by five to ten billion rand, including both direct capital gains taxes plus indirect revenue effects resulting from eliminating inefficient tax arbitrage.[20] The Katz Commission suggests that the revenue from improved tax compliance may generate at least five billion rand, while other estimates place the figure as high as fifteen billion rand.[21] The Katz Commission notes that some countries have generated between 1% and 1.5% of total tax revenue from inheritance taxes and estate duties, which in South Africa's case is equivalent to approximately two billion rand.[22] Historical and international comparisons of income tax yields suggest that South Africa could generate higher revenue from increased reliance on corporate taxes and a more progressive tax structure, but the main effect of income tax restructuring is to reduce the burden on lower and middle income groups. Restructuring the Valued Added Tax along progressive lines, primarily by increasing the rate on luxury goods can generate additional revenue of approximately eight billion rand per year. Increasing excise taxes could generate at least five billion rand per year, through taxes on gambling, an increased fuel levy, and other taxes.

In the 1999/00 fiscal year, relatively progressive direct taxes accounted for 59.1% of total tax revenue, while regressive indirect taxes provided 40.9% of the total. The new tax proposals are projected to reduce the progressive direct tax component to 57.6% and raise the regressive indirect tax component to 42.4%. (Budget Review 2000, p. 101). In addition, the proposed tax reforms reduce the progressivity of the income tax. Individuals with income over R150,000 per year are projected to receive 21.3% of the income tax relief. (Budget Review 2000, p.82).

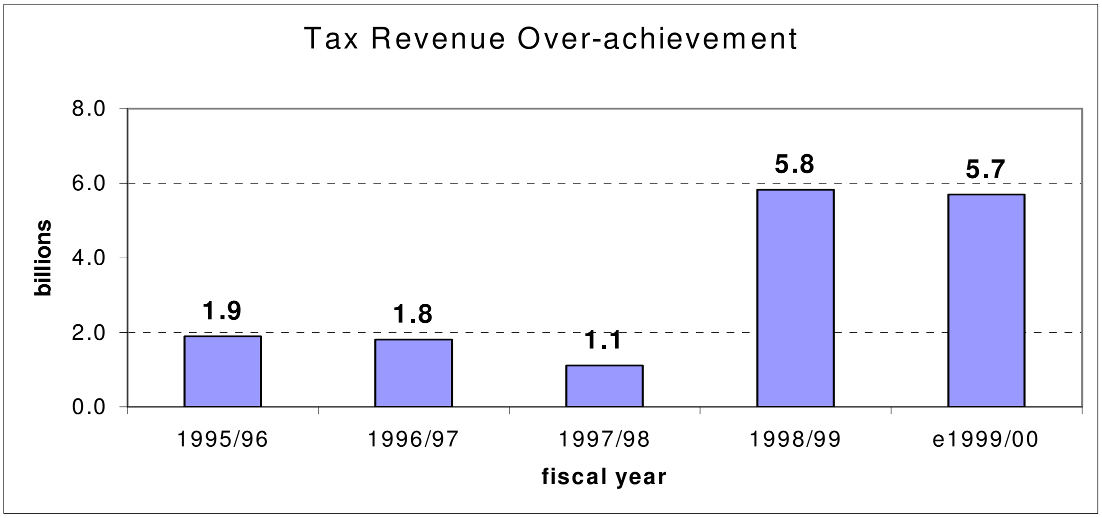
South Africa's relatively low level of taxation has been consistent with an over-achievement of revenue targets. Improvements in tax administration and efficiency have enabled the South African Revenue Service (SARS) to raise tax collections more rapidly than predicted. With tax rates well below revenue-inefficient levels, increased collection

[20] The absence of a capital gains tax creates incentives for wealthy individuals to create schemes that convert other forms of income into artificial capital gains. This is both economically inefficient and costly in terms of foregone tax revenue.

[21] Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa. 1994. (Chaired by M. M. Katz.) Pretoria: Republic of South Africa Government Printer. . Also, Harber, Richard. 1995. "South Africa's Public Finances". Pretoria: United States Agency for International Development.

[22] Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa. 1995. (Chaired by M. M. Katz.) Pretoria: Republic of South Africa Government Printer. Page 54.

effort productively yields abundant returns. Over the past five years, South Africa has consistently over-achieved its budgeted tax revenue targets—in the past two years by nearly six billion rand annually. Given this experience, the high degree of efficient capacity in the Department of Finance, the existing backlog of uncollected taxes, and South Africa's relatively low tax ratio, expectations are likely to persist that SARS will continue to over-achieve budgeted revenue targets.



While progressive tax reform is a more sustainable source of finance for social transformation over the long term, over the immediate horizon, judicious borrowing can support the process of transformation. The upward revisions in national income figures reinforce South Africa's attractive public debt position, which is compared to other countries in the graph on the following page. South Africa has very little foreign public debt, and its domestic public indebtedness is low by international standards.[23] A "big push" in social investment is likely to increase demand in the short run above and beyond what the domestic economy can supply, but medium term economic growth will bolster the country's capacity to service a higher debt level. Judicious borrowing can also support the country's transformation programme while an appropriate tax structure is implemented.

[23]Samson, Michael, Kenneth Mac Quene, Ingrid van Niekerk, and Thami Ngqungwana. 1997. "South Africa's Apartheid Debt." *A Public Policy Study for ESSET*. Johannesburg: ESSET.

GOVERNMENT EXPENDITURE

In spite of severe fiscal constraints, many government departments have successfully achieved important social delivery goals over the past five years. Nevertheless, effective redistribution and social development have lagged the demands of transformation.

SOCIAL INVESTMENT

Government expenditure on social services such as health, education, housing, and community infrastructure constitutes productive social investment and promotes long term productivity growth. This public expenditure finances a social wage, providing one of the most effective mechanisms supporting poverty eradication and welfare-enhancing redistribution. South Africa's apartheid legacy skewed the distribution of social assets. A World Bank report noted that social indicators (such as life expectancy and infant mortality) for the white population are comparable to industrialised countries while those for the black majority are close to those of poorer surrounding countries. The study described two South Africas: "A First-World society for whites and a Third-World society for blacks."[24] The report documented the skewed provision of social infrastructure: South Africa's predominantly white cities compare to the top countries in the world for *per capita* expenditure on urban services. For instance, in historically white areas of Gauteng, *per capita* expenditure on residential infrastructure was about US$550, compared to US$225 in Stockholm, US$270 in Munich, and US$340 in Melbourne. Yet for the majority of the black urban population who live in informal settlements, services are poor even by the standards of low-income countries.

These disparities have had devastating effects on the health and education of the majority of the population. As late as the 1989/90 fiscal year, for instance, South Africa's *per capita* expenditure on education was more than four times higher for the white population than for the black population. In 1994, nearly all teachers in white schools were formally qualified, while less than two-thirds of the teachers in black schools had formal qualifications. Historically, disparities were much worse. In 1970, for instance, *per student* spending on education was more than *thirteen* times higher for white students than for black students.[25]

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[24] Fallon, P., and L. Pereira de Silva. 1994. *South Africa: Economic Performance and Policies*. Washington, D.C.: The World Bank Southern Africa Department. Page 39.
[25] South African Institute of Race Relations. 1992. *1991/92 Survey*. Johannesburg : South African Institute of Race Relations.

A United Nations report documents the extent to which inadequate early childhood nutrition contributes to long-term health and education problems, leading to lower productivity through poorer health and higher absenteeism.[26] In addition, conditions resulting from childhood deprivation lead to long term strains on the nation's health and education systems, draining resources that could efficiently target other social priorities. Recently the Education Minister Kader Asmal characterised South Africa's educational system as a national emergency: "Large parts of our system are seriously dysfunctional and it will not be an exaggeration to say that there is a crisis at each level of the (education) system."[27] While inadequate funding for public education is not the only cause of this crisis, budget constraints have driven teacher retrenchments, increased school fees, delays in implementing outcome-based education, persistent inequalities, and inadequate upgrading of sub-standard schools. In June 1999, the Masedi School in the Northern Province was permanently closed, deemed "unsuitable for human habitation" by the Transitional Local Council. The school had one working toilet for 503 pupils and ten teachers, and three classes were held outside under trees because of the lack of classrooms. According to Northern Province MEC Edgar Mushwana, "the department couldn't do anything about the problems last year because the budget had been set and no extra money had been available."[28] Likewise, access to public health care suffers from the scarcity of funding. Health clinics in poor areas are frequently under-staffed and under-resourced.

A 1994 World Bank report identifies how "investment in health and education can unleash a virtuous circle of developmental synergies. Education has direct and beneficial effects on earnings, farm productivity and fertility. Educating females could well yield a higher rate of return than any investment in the developing world. … Better health contributes to improved education and to more rapid and equitable growth."[29]

HIV/AIDS feeds on the vulnerability stemming from severe poverty, engendering an international catastrophe that is particularly devastating for impoverished regions. In addition to the enormous human toll, economists estimate that HIV/AIDS will reduce South Africa's growth rates by 1-2%, demonstrating the inconsistency of policies that aim to trade present

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[26] James, Philip. 2000. Report of the Commission on the Nutrition Challenges of the 21st Century. New York: United Nations.
[27] Singh, Priscilla. "Education in Crisis—Asmal". *Cape Times*, Wednesday, July 28, 1999. Page 5.
[28] Pretorius, Cornia. " 'Intolerable' school is closed—leaving pupils classless". *Sunday Times*. June 27, 1999. Page 7.
[29] Southern African Department. 1994. "Reducing Poverty in South Africa: Options for Equitable and Sustainable Growth." Washington, D.C.: World Bank. Page 17.

poverty for future prosperity. The relationship between HIV/AIDS and poverty ensures that the failure to invest in poverty eradication now may render futile attempts to sustain growth in the future. The fact that the poor pay many times the price paid by the relatively wealthy for the same life assurance coverage due to their higher risk assessment provides stark documentation of the link between poverty and HIV/AIDS.[30] Poverty-linked HIV/AIDS also creates a cataclysmic burden on health resources, and truncates the productivity of human capital prematurely through the death of its victims. The World Bank has documented the extent to which HIV/AIDS will undermine economic growth, further exacerbating the social crisis.[31]

THE BASIC INCOME GRANT

A comprehensive social security system complements a strategy of direct social investment in health, education, housing, and community infrastructure. The lack of sufficient delivery capacity within the public service to adequately deliver the required levels of social investment suggest the positive developmental role of a basic income grant for all South Africans. Research suggests that a basic income grant is affordable and supportive of developmental objectives.[32] The pro-growth dimensions of a basic income grant that support its role as productive social investment stem from at least seven transmission mechanisms:

1) MANAGING RISK FACED BY THE POOR AND VULNERABLE

A basic income grant provides a guaranteed safety net that may encourage low-income individuals to undertake risky yet high return investments in education, training, job search, and other income-generating activities. A basic income grant stimulates overall economic activity, reducing the risk that the poor lose the jobs they have or fail to find employment if they are unemployed. The grants mitigate risk by providing the security of a

[30] Cameron, Jackie. "Assurers make poor pay more for AIDS cover". *Saturday Argus Personal Finance*. June 26, 1999. Page 1. "Liberty Life chief actuary Dave Nohr said a 30-year old male non-smoker who earned less than R36 000 a year would pay about R96 for R100 000 worth of cover, while a man with a similar profile but an annual salary of R200 000 would pay about R26 a month for the same life cover…. Momentum Life chief actuary Nicolaas Kruger said: "AIDS/HIV is very linked to income levels, but it's not such a big issue for us because we target middle and upper income groups."

[31] Piot, Peter. 1999. Presentation to the May Meeting of African Ministers of Finance and Ministers of Economic Development hosted by the Economic Commission for Africa—Addis Ababa. 7 May 1999.

[32] Michael Samson et al. 2000. "The Macro-economic Implications of Poverty-reducing Income Transfers" Cape Town: Economic Policy Research Institute.

guaranteed minimal level of income, enabling a poor person to more securely send children to school, confident that the resulting marginal loss in income will not mean the difference between perishing and survival. Low income domestic and farm workers can give up their R400 per month jobs and undertake riskier yet more remunerative self-employment, or acquire human capital in order find higher wage employment. The mere costs of job search—with its risky outcomes—can lock low-income workers into poverty traps. Basic income grants provide an elastic safety net, enabling vulnerable individuals who fall into adversity to bounce back into more sustaining livelihoods. Finally, basic income grants provide a coping mechanism for the least fortunate, supporting a minimal level of subsistence for society's most marginalised.

2) IMPROVING THE CAPACITY OF THE UNEMPLOYED TO FIND JOBS

The basic income grant will raise living standards, supporting the capacity of unemployed job seekers to find work. Conventional economic theory argues that basic income grants to the unemployed will tend to undermine their willingness to work, as additional income reduces the "opportunity cost" of not working. In the absence of basic income grants, the alternative to working may be unacceptable living standards. Basic income grants make the alternative living standards more tolerable. Empirical evidence from South Africa's *1997 October Household Survey* as well as from the SALDRU/World Bank living standards survey does not support this premise. Statistical analysis by the Economic Policy Research Institute indicates that higher living standards are correlated with more extensive and more intensive job search efforts as well as higher rates of finding employment, even when controlling for the effect of remuneration on consumption.

The samples of individuals in Gauteng, KwaZulu-Natal, and the Western Cape who expressed an interest in employment in October 1997 (active and passive job seekers) were divided into five quintiles based on per capita household consumption in September 1997. Then the rates at which job seekers in each quintile found jobs in October 1997 were calculated. The analysis demonstrated that higher prior living standards are correlated with higher job-finding rates. One interpretation of this statistical result is that individuals who can better afford leisure nevertheless choose to find jobs and/or are apparently better able to secure employment. The analysis does not support the conventional argument that basic income grants will lead to reductions in labour supply.

3) INCREASING JOB OPPORTUNITIES FOR THE UNEMPLOYED

Basic income grants to the poor act as a wage subsidy, allowing wage increases to more efficiently raise the productivity of workers. Currently, the imperative of providing remittances to family members, friends, and other individuals in need reduces the remaining wage available to sustain the worker's productivity. Wage increases are in part "taxed" by associated increases in remittances, since the working poor provide the primary social safety net for the very poor. As a result, the "efficiency wage" effect is diluted—wage increases do not lead to as powerful a productivity-enhancing effect as they would if the remittance pressures were reduced. This tends to create a low wage trap, as higher wages provide a public good, and market failure ensures that this "good" is insufficiently provided.

A model developed by the Economic Policy Research Institute demonstrated how providing basic income grants to the poor could lead to increased employment, even benefiting those who do not receive a net income transfer. Basic income grants reduce poverty, mitigating the demands on workers for remittances. This allows workers to channel more of their wages to productivity-enhancing consumption and human capital investment, increasing firm competitiveness and thus raising production and creating jobs.

Empirical evidence in South Africa and in other countries supports this hypothesis. The 1996 ILO study of the South African labour market documents how the tendency for large family remittances to flow from urban to rural areas places South African firms at a structural disadvantage, resulting in reduced employment. A large body of cross-country evidence documents the substantial role remittances from the working poor play in creating a social safety net for the very poor. Empirical and theoretical analysis supports the applicability of the "efficiency wage" hypothesis. Wage increases that support nutrition, health, better housing, education, and other social and private assets significantly increase worker productivity.

4) SOCIAL INVESTMENT

Basic income grants to the poor increase the efficiency of social investment, promoting long term productivity growth. In this context, basic income grants cannot be analysed as unproductive consumption expenditure, but rather must be viewed as a critical component of social investment, which complements the development of other social assets.

5) A SOCIAL STAKE

The basic income grant provides a social stake for the economically disenfranchised, promoting social cohesiveness and investor confidence. Poverty creates vulnerability to crime, and victimisation in turn erodes human and social capital and undermines access to employment. Theoretical economic and empirical cross-country evidence demonstrates that income grants yield social benefits that increase private investment and stimulate economic growth. Investing in basic income grants will likely yield substantial social returns, redressing the turmoil associated with South Africa's apartheid legacy and promoting social cohesion and stability. These dividends will support continued productive investment and economic expansion.

6) FISCAL STIMULUS

Basic income grants to the poor stimulate aggregate spending, leading to increased economic activity which promotes economic growth. An analysis of South Africa's productive capacity does not support the contention that basic income grants to the poor might be inflationary or unsustainable. Since 1995, utilisation of productive capacity has fallen approximately five percent. The substantial increase in economic activity generated by basic income grants will tend to increase capacity utilisation. This spending will provide a demand-side stimulus that increases the demand for labour, promoting increased employment.

7) FOSTERING JOB-CREATING SPENDING

Redistributing income to lower income individuals is likely to stimulate job creation, particularly if appropriate policies are implemented to enable the unemployed to undertake productive activities that meet the resulting increased economic demand. Effective micro-credit policies combined with logistical support for entrepreneurs can effectively maximise the resulting job creation.

CONCLUSIONS

The leading policy in this framework is a rapid expansion of social investment that increases overall economic activity while reinforcing the capacity of the economy to supply goods and services. The structure of the public investment spending will target labour-intensive sectors of the economy—primary health care, education, and low cost housing. Improved equity will be nurtured through labour policies that support greater rights and higher money wages. The greater labour costs are offset by the implicit subsidy provided by higher social wages as well as the resulting improvements in labour productivity. The strategy further promotes job creation by raising the relative cost of capital, shifting resources to labour and consequently mobilising resources for financing the social investment. More progressive taxation and judicious borrowing will also finance the costs of the transformation programme while further stimulating demand and nurturing labour-intensive enterprises. Vital institutions in civil society play a critical role in ensuring the efficient allocation of resources.

Monetary, industrial, and sectoral policies play important roles in supporting this strategy. Lower interest rates serve manifold purposes. First, they reduce the cost of credit, stimulating economic activity in the economy. Second, with accommodating industrial policies, less expensive credit can effectively support labour-intensive enterprises. Third, falling interest rates remove undue support for the rand exchange rate, eliminating implicit subsidies on imported capital goods. The combined effect shifts investment towards job-creating enterprises. In addition, the lower interest rates reduce the government's debt service burden, freeing resources for additional social investment. Effective industrial policy can support this process, redressing the inertial effects resulting from decades of severe unemployment.

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