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Poverty-eradicating Job Creation

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INTRODUCTION

"Accelerated delivery" is rapidly becoming the catchword of Thabo Mbeki's presidency. Central to this principle is job creation and the elimination of apartheid's social backlogs. On the periphery, however, is the contradiction between fiscal austerity and the need for public resources to finance social investment. The ANC platform's recognition of the need to revisit GEAR targets opens the door to ironing out inconsistencies that inevitably arise as changing global circumstances play havoc with even the best laid plans.

Apartheid entrenched a racial character to the severe poverty afflicting South Africa. The intentional public skewing of social resources created a morally and politically untenable situation. Yet socio-economic transformation has not been an easy challenge. Five years after democracy's sunrise, the overriding imperatives of poverty eradication and job creation persist like late morning dew. Globalisation and liberalisation constrain the government's tools, and the scarcity of resources hamper conventional approaches.

This paper addresses these issues and lays out a strategy evolving from policy analysis carried out by church councils, labour unions, non-governmental organisations, academics, and research institutes. The framework currently stands constructed in a tentative state, open to the critical scrutiny of interested analysts. The strategy identifies the need for a "big push" promoting social investment in an environment where relative prices of labour and capital are managed towards fostering job creation. The "redistribution" component of GEAR is actively implemented, through expenditure, tax and financial policies. The strategy expands demand in the economy while nurturing the supply response of production over the medium term. The framework stands on five legs:

- The raising of social and money wages through labour policy and social investment while targeting improvements in labour productivity.

- The shifting of relative prices of capital and labour in order to promote employment of additional workers rather than machines and equipment. This may require raising the cost of fixed capital by eliminating capital subsidies, increasing capital taxes, and implementing other policies.

- The financing of additional social expenditure through progressive taxation and judicious borrowing. This will expand labour-absorbing demand in the economy while fostering a more equitable distribution of resources.

- The easing of monetary policy, lowering interest rates, and allowing the rand to weaken, which will have the effect of raising the price of imported capital goods. This encourages the mobilisation of cheaper credit towards working capital, promoting the expansion of finance for job creation.

- The building and energising of a partnership between government and civil society that ensures the productive employment of public resources towards poverty-eradicating job creation.

PRODUCTIVITY GROWTH THROUGH HIGHER SOCIAL AND MONEY WAGES

Wages for many South Africans do not adequately support human development. Money wages are depressed by massive unemployment rates. Fiscal austerity has restrained social wages, slowing delivery of housing, health care, education, and other services. Low money and social wages undermine labour productivity in numerous ways. Inadequate money wages fail to provide proper incentives. Workers cannot easily finance human capital accumulation for themselves and their families. Low incomes undermine public health, with manifold consequences for labour productivity—absenteeism, low morale, poor concentration, and reduced returns to human capital investment because of lower life expectancy.

Studies and reports confirm the low wages paid to the economically marginalised. A forthcoming EPRI submission to the Department of Labour records wages as low as R25 per day for domestic workers in the Western Cape in 1999.[1] A corroborated analysis of provincial disparities suggests that wages are even lower in other provinces. Labour data documents wages as low as R70 per week for a learner sewing machinist in some parts of the country.[2] The widely cited *International Labour Organisation* study of South African labour markets concludes that real wages have largely stagnated over the past several years. While recognising the poor quality of available data, the report documents wide earnings differentials varying by gender, race, educational attainment, and job status. "The differential between chief executives and plant managers was fourth largest out of 30 countries", according to *World Competitiveness Report* data. In terms of value added, chief executives have received very high salaries by international standards.[3]

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[1] Economic Policy Research Institute. 1999. "Minimum wages for domestic workers". A submission to the Department of Labour. Cape Town: Economic Policy Research Institute.
[2] Patel, Ebrahim. 1999. "Journeys into the heart of flexibility." Address at the Annual Labour Law Conference. July 2, 1999. Durban.
[3] Standing, Guy, John Sender and John Weeks, 1996. *Restructuring the Labour Market: the South African Challenge*. An ILO Country Review. Geneva: International Labour Organisation. (The ratio of chief executive salaries to value added per worker was more than twice the level of Korea, Argentina, and Chile, and nearly four times the level in the United States.)

A recent study by a human resources consultancy predicts even further widening in South African earnings gaps.[4]

In a market-oriented economy, public expenditure on social assets finances a social wage, providing the most effective mechanism 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."[5] 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.[6] The graphs below depict the severe inequality between blacks and whites in key areas of health and education during the apartheid era.

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[4] Finance Week, 30 July 1999. "News this Week." Page 7. Citing human resources consultancy FSA Contact.

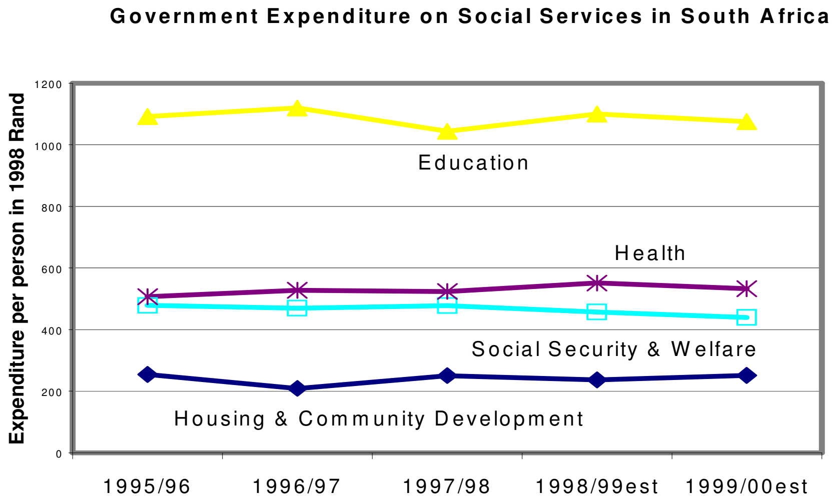
[5] Fallon, P., and L. Pereira de Silva. 1994. *South Africa: Economic Performance and Policies*. Washington, D.C.: The World Bank Southern Africa Department. Page 39.

[6] South African Institute of Race Relations. 1992. *1991/92 Survey*. Johannesburg : South African Institute of Race Relations.

SOCIAL INDICATORS IN SOUTH AFRICA

While the illiteracy rate for whites in 1986 was estimated to be about 3%, the estimated illiteracy rate for blacks stood at 51%. Numerous studies have provided conflicting estimates of literacy rates for racial groups in South Africa, but all of these studies have documented severely unequal illiteracy. This skewed distribution of human capital is reflected in other measures of educational outcomes. For instance, in 1993, matric exemptions were four times more frequent for white pupils than for black pupils. Similar disparities exist in the health sector. The black population has an infant mortality rate four times that of the white population, and whites can expect to live ten years longer than black.

In spite of severe disparities in access to social assets, real per capita social investment has fallen over the past several years. The graph below demonstrates that real per capita public spending on education, welfare, and housing and community development has fallen since 1995. While real per capita health spending has risen about one percent per year, it is projected to fall during the present fiscal year. This fiscal allocation limits resources for redressing apartheid backlogs to those that can be re-allocated from previously advantaged groups—groups that effectively use the legal system to stymie the pace of transformation.



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."[7] 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, 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."[8] Likewise, access to public health care suffers from the scarcity of funding. Health clinics in poor areas are under-staffed and under-resourced.

HIV/AIDS feeds on poverty, engendering an international catastrophe that is particularly devastating for impoverished regions in sub-Saharan Africa. In addition to the enormous human toll, economists estimate that Aids/HIV will reduce South Africa's growth rates by 1-2%, demonstrating the absurdity of policies that aim to trade present poverty for future prosperity. The

[7] Singh, Priscilla. "Education in Crisis—Asmal". *Cape Times*, Wednesday, July 28, 1999. Page 5.
[8] Pretorius, Cornia. " 'Intolerable' school is closed—leaving pupils classless". *Sunday Times*. June 27, 1999. Page 7.

relationship between 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 AIDS.[9]

This strategy for poverty-eradicating job creation proposes that labour policy guarantee a living wage while public expenditure policy ensures adequate social assets to support health, education, and housing services. Social investment should focus on raising labour productivity in a broad sense. The link between higher market and social wages and greater labour productivity must be fully exploited. 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."[10]

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.[11] 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[12] while enhancing the quality and quantity of output.[13] This is particularly important in the area of social capital delivery, where civil servants

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[9] 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."

[10] Southern African Department. 1994. "Reducing Poverty in South Africa: Options for Equitable and Sustainable Growth." Washington, D.C.: World Bank. Page 17.

[11] Akerlof, George A. 1984. "Gift Exchange and Efficiency-Wage Theory: Four Views*". AEA Papers and Proceedings*. Volume 74, Number 2 (May). Pages 79-83.

[12] Burawoy, Michael. 1979. *Manufacturing Consent*. Chicago: University of Chicago Press.

[13] 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.

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. The public sector must take the lead, ensuring at least a living wage for all workers. Government wage policy can emphasise greater increases at lower wage levels. Minimum wages coupled with effective labour protection can extend these benefits to the private sector. Enhanced productivity growth supported by higher social wages will increase the competitiveness of the labour force.

THE CAPITAL/LABOUR TRADE-OFF

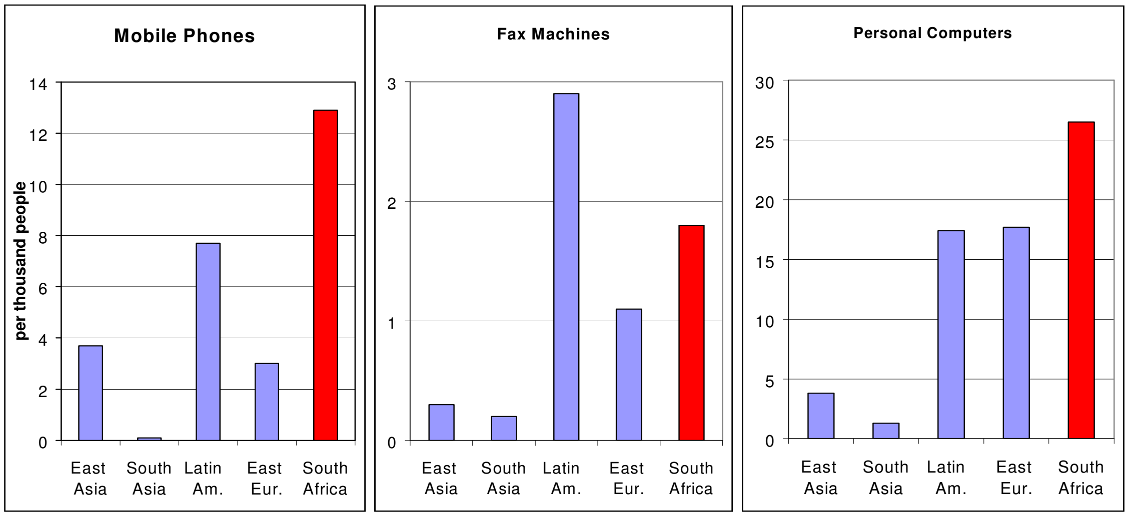
Raising social and money wages raises the cost of labour relative to capital. Although the resulting employment-discouraging effects are offset by improvements in worker productivity, this nevertheless may create some incentives for firms to replace workers through labour-shedding capital investment. 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.[14] 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.

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

[14] *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.

per thousand in Latin America, 4 per thousand in East Asia, and 18 per thousand in Eastern Europe and South Asia.[15]

Private Capital Indicators



South Africa provides a textbook example of inappropriate job-destroying capital-intensive production. 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.[16] One study estimates two million job losses over the past twenty years from inappropriate capital intensity.[17] Statistical analysis links this inappropriate capital and labour use to consistent under-pricing of capital relative to labour.[18] An analysis of private and public capital-to-labour ratios (summarised in the graph below) demonstrates that production in the private

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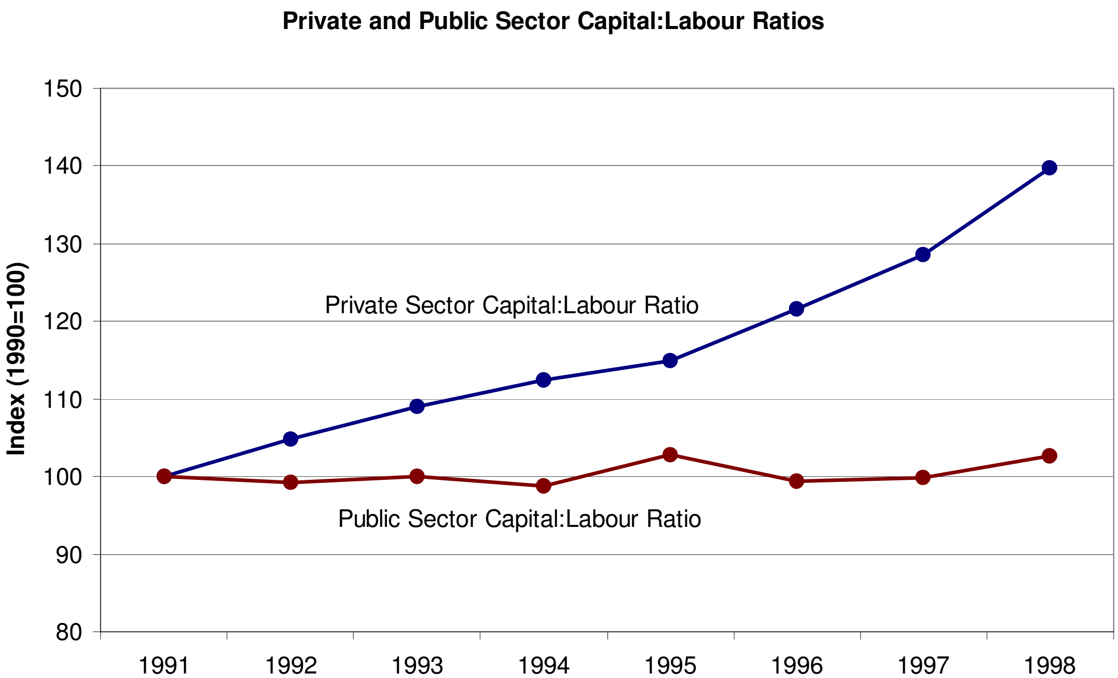
[15] du Toit, J. *The Structure of the South African Economy*. Cape Town: Southern Book Publishers. Page 7 (Source: World Bank).
[16] Fourie, Frederick C v N. 1997. How to think and reason in macroeconomics. Cape Town: Juta. Pages 367-368.
[17] Bowles, Samuel. 1995. "Wages, Aggregate Demand, and Employment 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.
[18] 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.

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.



This strategy for poverty-eradicating job creation 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. Firms that restructure their production processes with the purpose of shedding labour should face the true cost to society of their contribution to increased unemployment. Protective labour legislation alone might be inadequate to achieve this objective, since increased protection for workers might discourage firms from hiring workers in the first place. Shifting production costs to fixed capital discourages firms from substituting machines for workers in order to escape the costs of labour equity.

The cost of capital in South Africa does not reflect the true cost to society of diverting resources to employing machinery and equipment. Enterprises 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 crushes 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. South Africa's competition policy is relatively ineffective. Trade and Industry Minister Alec Erwin, for instance, recently declined to enforce a Competition Board recommendation to stop restrictive practices by direct pharmaceutical distributors because of threatened lawsuits.[19] An effective policy that promotes vigorous competition among South African enterprises is an essential ingredient to poverty-eradicating job creation.

FINANCING TRANSFORMATION—THE ROLE OF TAXES AND BORROWING

The progressive reform of South Africa's tax structure and the judicious use of additional borrowing can finance the transformation process in a manner that stimulates 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 provide additional improvements in social equity. In addition, tax-financed social expenditure and investment-oriented borrowing revitalise demand for goods and services, stimulating job creation in labour-intensive sectors.

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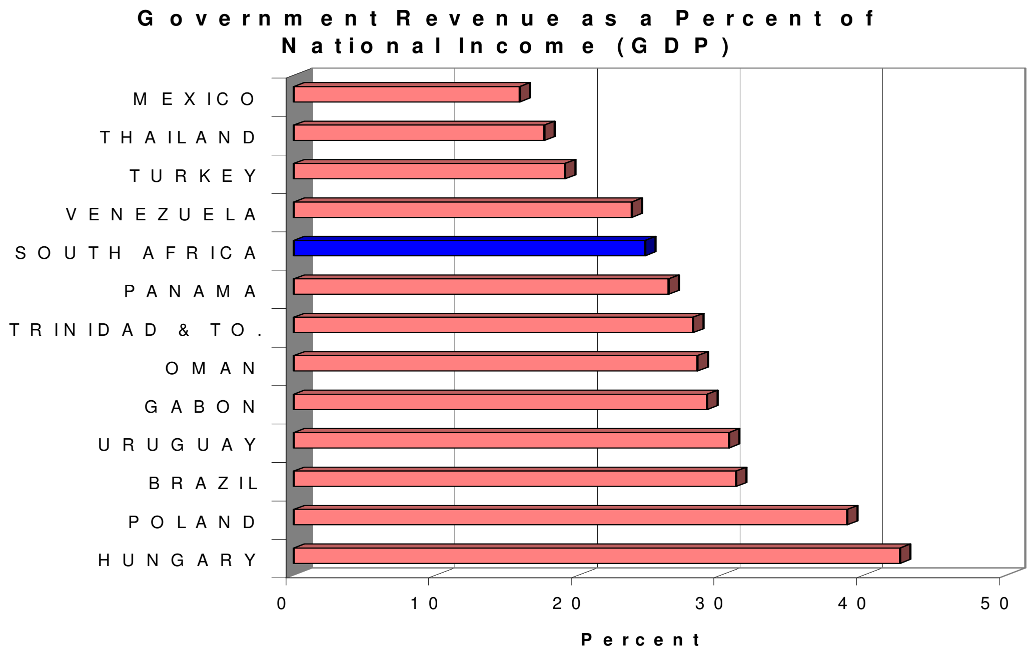
[19] Shevel, Adele. "Erwin won't implement board's ruling." *Business Report*. July 20, 1999. Page 1.

South Africa's tax structure relies heavily on regressive taxes, and 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. For instance, the tax structure is regressive at lower income levels for income taxes, consumption taxes, and all taxes combined.[20] 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.[21]

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



Source: IMF

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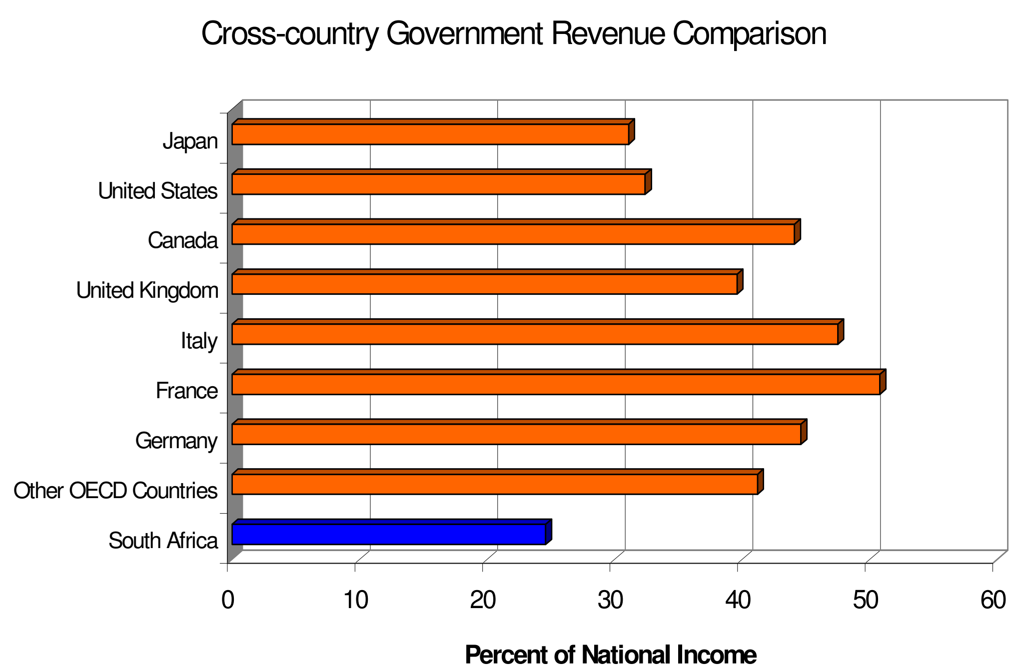
[20] Harber, Richard. 1995. "South Africa's Public Finances". Pretoria: United States Agency for International Development.

[21] 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.

(relative to national income) for countries with per capita incomes within twenty percent of South Africa's level. This documents that South 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 comparison using industrialised countries documents an even greater disparity. The graph below compares South Africa's average tax rate (total tax revenue as a percentage of national income) to those of industrialised countries. South Africa's government revenue (relative to national income) is less than two-thirds the average calculated for industrialised countries. A previous report to ESSET 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, indicating an average tax rate of 32% compared to South Africa's average tax rate of 26%.[22] Econometric studies that control for individual country characteristics have found South Africa's average



SOURCE: OECD, South African Department of Finance

[22] 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.

tax rate to be significantly less than that which would be predicted given the country's economic profile.[23] Furthermore, tax effort analysis suggests that South Africa could mobilise an additional twenty-five billion rand per year without undermining international competitiveness.[24]

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.[25] 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.[26] 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.[27] 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. Additional revenue of approximately eight billion rand per year can be generated by restructuring the Valued Added Tax along progressive lines, primarily by increasing the rate on luxury goods.[28] Increasing excise taxes could generate at least five billion rand per year, through taxes on gambling, an increased fuel levy, and other taxes. Increased revenue in excess of

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[23] 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 Consultancy 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.

[24] Samson, Michael. 1996. "Re-evaluating South Africa's Fiscal Constraints on Transformation." *A Consultancy 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.

[25] 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.

[26] 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.

[27]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.

[28] Macroeconomic Research Group (MERG). 1993. *Making Democracy Work: A Framework for Macroeconomic Policy in South Africa*. Centre for Development Studies: University of Western Cape, Cape Town. Page 35.

requirements for servicing the apartheid debt and funding social investment could finance Value Added Tax relief for the poor, by expanding zero ratings on goods that dominate their consumption baskets.

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.[29] 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.

This strategy for poverty-eradicating job creation proposes that the government finance expansion of social investment through a carefully targeted programme of additional progressive taxation. Key ingredients include an excise tax on luxury goods, a capital gains tax, higher corporate taxes targeting capital-intensive production, and more progressive income taxes on individuals. In order to allow adequate time for effective implementation of the tax reform, an increase in public borrowing will likely prove necessary for the rapid implementation of the strategy.

POVERTY-ERADICATING MONETARY POLICY

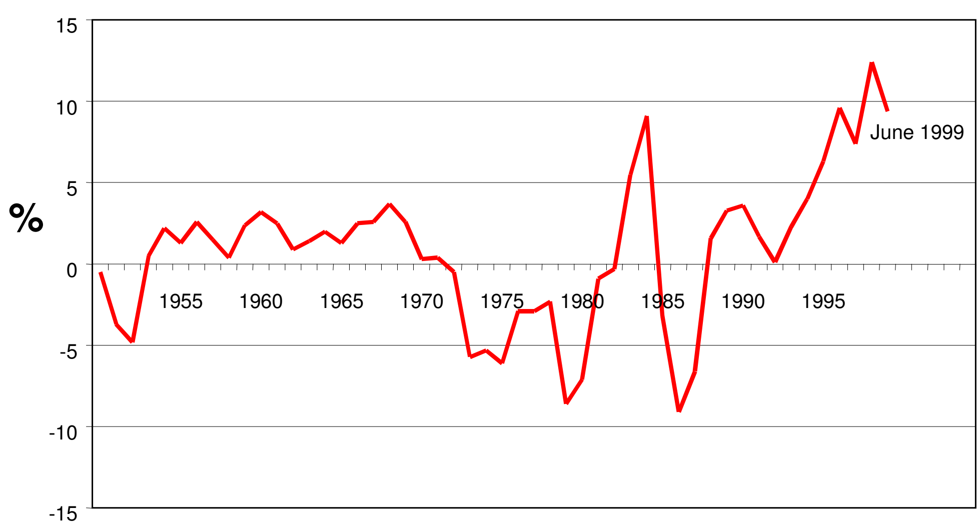
The Reserve Bank has aimed monetary policy since 1989 at the objective of reducing the rate of price inflation. To achieve this, extraordinarily high interest rates have depressed consumer and business demand and inflated the interest costs of servicing the government's debt.[30] The high interest rates have also propped up the external value of the rand, leading to exchange rates in the short run that are probably 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). Thus, high interest rates have increased

[29]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.
[30]Samson, Michael. 1996. "Evaluating the Costs of South Africa's Monetary Policy Alternatives". *A Consultancy Report to COSATU Commissioned by the National Institute for Economic Policy*. Johannesburg: NIEP.

the cost of credit, suppressing job creation, yet also tended to some bias towards capital-intensive production.

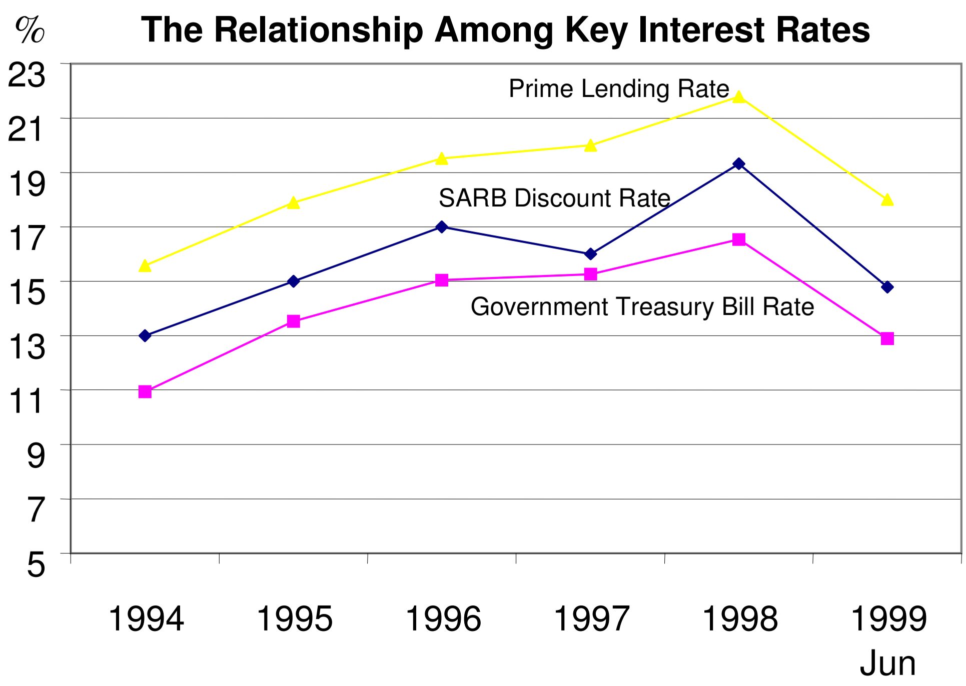
The South African Reserve Bank's monetary policy over the past several years has focused on reducing inflation and stabilising the exchange rate by maintaining some of the highest interest rates in the world. The Reserve Bank initiated a policy of disinflation in 1989 that reduced the rate of inflation from an average of 15% during the 1980s to 7.4% in 1996. The graph below shows that over the past several years the Reserve Bank has raised the key interest rate it controls to the highest levels (in real terms) in the history of South Africa. The cost of this programme in terms of reduced growth, lower national income, and higher unemployment is difficult to measure, in part because of the biased labour statistics maintained by the former apartheid government. Accurate statistics, however, would only confirm the notoriously high level of structural unemployment, which obscures the output/job loss due to restrictive monetary policy. These high interest rates deter investment and undermine prospects for small businesses to survive. They also increase the cost of servicing the public debt, and create a personal debt burden for many

The South African Reserve Bank Discount Rate (Inflation-adjusted)



consumers who rely on credit. A less contractionary monetary policy would not only reduce the interest payments on the public debt but also would allow economic expansion and job creation.

The increasing real interest rates observed since 1994 followed systematic increases in the key interest rate controlled by the Reserve Bank (the "discount rate"), even as the rate of inflation fell. Increasing nominal interest rates and falling inflation together propelled real interest rates higher. A less contractionary monetary policy would require that the Reserve Bank reduce the discount rate. There is a strong link between the "discount rate" and other interest rates in the economy, including the interest rates the government pays on its debt.[31] The graph below demonstrates the strong link between the "discount rate" and the prime lending rate and the interest rate on government debt. Because of the long maturity structure of government debt, the effects of changes in interest rates are not fully realised for twenty years. However, given the current maturity structure, more than half the effects would be realised within ten years. A less contractionary monetary policy might involve moderately higher inflation than would occur if the current regime of high interest rates were kept in place, but a careful approach can minimise adverse consequences.



This poverty-eradicating job creation strategy proposes that the Reserve Bank's policy of disinflation be discontinued, and that an easing of monetary policy allow interest rates to fall while the rand weakens. 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 towards labour-

[31] The Reserve Bank recognises this link. For instance, after the September 1994 increase in the discount rate of one percentage point, the Reserve Bank's December 1994 Quarterly Bulletin noted: "Both short-term and longer-term interest rates and yields reacted immediately to this rise in discount rate and moved sharply upwards" (page 2). For more detail on how the Reserve Bank uses this policy instrument to influence interest rates, see: Nel, H. 1996. "The Term Structure of Interest Rates and Economic Activity in South Africa" in the *South African Journal Of Economics*. 64(3).

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.

THE PARTNERSHIP ROLE OF CIVIL SOCIETY

Much of the debate over macroeconomic strategy focuses on the appropriate division of responsibility between the public and private sectors. Historically, international experience provides many cases of government's failure to intervene appropriately to correct malfunctioning markets. The framework proposed in this document identifies a leading role for government in redressing the social backlogs perpetrated by apartheid. Nevertheless, the strategy recognises that the public bureaucracy alone cannot efficiently employ the necessary resources to rapidly deliver empowering levels of education, public heath, housing and infrastructure, and job creation. A partnership between government and civil society can remedy this, ensuring the efficient allocation of resources towards rapid delivery. South Africa's liberation struggle mobilised churches, labour unions, community groups, non-governmental organisations, political party structures, socially involved businesses, and private individuals. The ongoing process of socio-economic liberation requires the same involvement by civil society.

Non-governmental organisations (NGOs) can play a critical role in mobilising civil society to support poverty-eradicating job creation. The government's "Poverty and Inequality Report" identifies several important roles for NGOs, including reaching the most vulnerable, establishing partnerships with community-based organisations, and overcoming local government capacity constraints.[32] Likewise, churches and religious institutions have a long history in working to eradicate poverty, and they can serve a similar function. In particular, vital institutions in civil society can serve as the voice of the poor, monitoring the effectiveness of public policy and enforcing the effective direction of resources.

A recent UNICEF-sponsored study documents the role of social mobilisation in bringing down the apartheid state, drawing lessons from this experience for ongoing social transformation. "The challenge now facing the emerging democratic state is how to link political transformation to the need

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[32] May, Julian (editor). 1998. *Poverty and Inequality in South Africa (Summary Report).* Durban: Praxis Publishing.

for social transformation with the active participation of the people on the ground." Government partnerships with labour, women, youth, civic, religious, and non-governmental and voluntary organisations are critical, standing as a counter-weight to the business community's "fast tracking" of its new relationship with government. Civil society can work with the Human Rights Commission, the Commission on Gender Equality, and other government institutions to guarantee the attainment of socio-economic rights for the poor. Participatory interaction can inform key aspects of public policy. "Processes designed to develop such partnerships must be inclusive, open and allow for critical debate and reflection on past and present responses if they are to be effective."[33]

PUTTING THE MODEL TOGETHER

The five legs of the framework outlined above stand together to support a unified strategy. Any of the individual components might not work effectively on its own. Increasing wages without shifting relative factor prices or increasing labour productivity may lead to increased unemployment. Relaxing monetary policy and increasing demand in the economy without supporting a positive supply response may lead to an over-heated and inflationary economy. Taxing and borrowing without a focused job creation strategy may lead to an increasingly equitable redistribution of an ever-diminishing pie. Yet growth without poverty eradication may sow the seeds of its own collapse.

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.

[33] Taylor, Viviene. 1997. *Social Mobilisation: Lessons from the Mass Democratic Movement*. A UNICEF-sponsored initiative by the Southern African Development and Policy Research Unit, School of Government, University of the Western Cape.

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. In particular, policies that empower and vitalise the informal sector can substantially support job creation and poverty eradication.

CONCLUSIONS

This document sketches a macroeconomic framework that in whole or in part underlies many policy proposals by churches, labour, and non-governmental organisations. The core of the proposal is the triggering of a "virtuous circle" of growth induced by social investment which then expands the economy's capacity to further human development and promote increasing growth. Greater borrowing and more progressive taxes can finance this initial government intervention, but the resulting growth provides the resource base to further the process of social investment while managing the resulting debt burden. Monetary and industrial policy play important roles in supporting this process, shifting relative prices and providing credit to promote job creation. The feasibility of this approach requires further analysis, but the potential for poverty-eradicating job creation motivates serious examination of this strategy.