

## GAMBLING ON INVESTMENT: COMPETING ECONOMIC STRATEGIES IN SOUTH AFRICA<sup>1</sup>

Nicoli Natrass

During his opening speech to parliament on 9 February 1996, President Mandela pointed to South Africa's slow economic growth, rising unemployment and persistent poverty. He then called on the public and private sectors to develop and implement a 'national vision to lift us out of this quagmire'.<sup>2</sup>

This set the scene for a year which turned out to be rich in contrasting economic visions and growth strategies. By mid-year, all the so-called 'social-partners' (business, labour and the government) had put their economic policy cards on the table. In February 1996, the South African Foundation (SAF) - an organisation of top South African companies - presented 'Growth for All' (SAF, 1996) to President Mandela and distributed copies around the country.

The Nedlac Labour Caucus, ie COSATU, FEDSAL and NACTU, responded a couple of months later with 'Social Equity and Job Creation' (LABOUR, 1996).<sup>3</sup> Some of LABOUR's implicit views on macroeconomic policy were supported in a subsequent ILO Review of the South African labour market (Standing et al, 1996). The government completed the picture in June by publishing the 'Growth, Employment and Redistribution' (GEAR) macroeconomic framework (GEAR, 1996).<sup>4</sup>

The various documents cover a broad range of policies with differing emphases on technical, economic, institutional and political arguments. All of the strategies stress the importance of productivity growth, and all see a role for some government intervention in the supply-side of the economy (such as training, the provision of economic services, etc).

It is not the aim of this article to provide a detailed description of the different proposed policies.<sup>5</sup> The purpose here is to indicate how the moral claims of the contending positions are rooted in contrasting approaches to the labour market, and how the coherence of each growth strategy depends on different views towards fiscal policy and the determinants of investment.

Although there are important differences between the four visions for growth and development, they can be categorised into two broad stables: SAF/GEAR versus LABOUR/ILO.

### **The SAF/GEAR Argument**

The rather polemical SAF argument and the shorter, more technical GEAR presentation, occupy the right wing of the spectrum. Despite differences relating to infrastructural investment,<sup>6</sup> labour market policy, welfare spending, etc, both stress the need for economic policy consistency, market-oriented growth strategies, fiscal discipline and investor confidence. Although the intellectual roots of this argument lie within neoclassical economic growth theory, the SAF/GEAR vision moves beyond this by including a Keynesian concern for investor confidence, and through positing an active and redistributive role for the state. The SAF/GEAR vision sees the world economy as an integrated capitalist system where market forces reign supreme, punishing countries which do not obey the unwritten code of 'sound' fiscal, monetary and labour-market policies. Both documents stress the need for privatisation in order to reduce debt and to signal government's clear commitment to market-oriented policies. SAF and GEAR recognise that some government policies promote redistribution (such as land reform and the provision of basic social services). However, both regard job creation through greater labour-market flexibility as the most sustainable and effective means of lowering inequality. Herein lies the moral claim (most bluntly made by the SAF) that lower wages are good for the poor.

### **The Labour Market**

Job creation in the SAF/GEAR framework is supported in two major ways: by creating an 'investment-friendly' policy environment to provide a basis for output and employment expansion; and by making the labour market more 'flexible' so as to facilitate the expansion of lower-wage employment.

The SAF/GEAR approach attributes unemployment (cited in both documents as being in excess of 30 percent), in large part to the inability of wages to adjust downwards to 'clear' the labour market. The SAF's notorious suggestion for a 'two-tier' labour market differentiates between those already in employment (who will remain subject to existing labour regulations) and new recruits (who will become employed under a more flexible set of regulations). The SAF believes that by removing or limiting institutional distortions<sup>7</sup> which supposedly act to buoy up wages especially for unskilled workers, employment will expand.

The SAF suggests:

eliminating extensions of industrial council agreements to non-parties<sup>7</sup>; maintaining only those minimum labour standards (eg health and safety regulations) that do not hurt the poor and the unemployed; avoiding implementing minimum-wage regulations which threaten jobs; and making the second (or free-entry) tier more flexible through legislative changes aimed at encouraging new jobs, new investment, and the employment of youths (1996b:17).

The proposed legislative changes for workers in the second tier (ie new recruits) include: no automatic rights to severance pay, no statutory procedural obligation prior to retrenchment, the right to fire second-tier workers for engaging in unprocedural strike action, and the exemption of second-tier workers from minimum-standards legislation (1996a:103).

GEAR also supports greater 'labour-market flexibility', but adopts a less extreme position. Rather than scrapping the extension of collective bargaining agreements to non-parties, GEAR argues for greater ministerial prerogative in the decision to extend. This is consistent with the recommendations of the recent Presidential Labour Market Commission (Labour Market Commission, 1996). GEAR avoids the 'two-tier' discourse and talks instead about promoting 'regulated flexibility' - ie greater wage variation within the existing wage-determination system.<sup>8</sup> The only suggestion made by GEAR to differentiate between workers in the same firm relates to the possibility of including a 'less onerous wage schedule for young trainees' (GEAR, 1996:18).

According to the SAF, South African wages are high relative to productivity (1996:89). A more flexible labour market (which allows for the downward adjustment of lower-skilled wages) is thus argued to lower unit-labour costs and improve competitiveness.

But the benefits of lower wages do not accrue only to capitalists. In an attempt to capture the moral high-ground, the SAF argues that a more flexible labour market will benefit the poor by encouraging the expansion of relatively low-paid wage employment. Given South Africa's high unemployment rate, the SAF suggests that such job creation will also narrow inequality.

There is some supportive evidence that inequality is driven to a significant extent by the gap between those without jobs and those in wage employment. Work done by Borat, Woolard and Leibbrandt (1995) on the SALDRU data set, for example, shows that wage income inequality accounts for 73.5 percent of total inequality. Of this wage inequality, 46 percent is because one in three South African households have no wage income whatsoever, while the remaining 54

percent is due to the inequality within wage earning households (Bhorat and Leibbrandt, 1996:154).

Under these conditions, employment expansion should lower inequality. Simulations on the same (SALDRU) data by Hertz (1995) indicate that a 10 percent increase in real household income accruing entirely to currently poor households via new low-wage jobs, results in over one-third of poor households rising above the poverty line. Adopting a similar methodology, the SAF estimates that 1.5 million new low-wage jobs (paying R700 a month) could lift 4.5 million out of poverty.

It is a moot point, however, whether a more flexible labour market will indeed result in a significant expansion of low-wage unskilled employment. The SAF argument ultimately rests on a belief that South Africa's labour market institutions are responsible for higher than market clearing wages for unskilled workers, and that wage-employment elasticities are large. According to the ILO Review, there is no convincing evidence for either of these propositions (Standing et al, 1996).

Furthermore, even if significant low-wage employment did come about as a result of labour-market reforms, it is unclear what the final impact on inequality will be. If the wages of already employed workers remain the same, then as Hertz has shown, the impact on inequality will be dramatic. But if greater labour-market flexibility undermines existing wages, then the eventual impact on inequality is uncertain. More research is required to resolve this issue.

### **The Need for 'Decisive' State Action**

Anticipating resistance to its policies, the SAF warns that the government will have to act 'firmly' and not shy away from taking the necessary 'harsh' and 'painful' decisions, which are supposedly in the interests of the unemployed poor. Indeed, the metaphor of no gain without pain applies to the entire SAF reform package:

Reform programmes are painful, particularly in the first couple of years. While the costs of reform can be considerable, the alternatives to it in the long term (sluggish growth, unemployment, poverty, crime) are far worse. Government needs to be decisive about reform, over-riding opposition from those who will suffer short-term losses, while providing a social safety net to ease the transitional costs to society (SAF, 1996b:20).

In short, the SAF's ideal state is both strong and small: it must be strong enough to combat crime and resist being captured by sectional interests; and small enough to avoid crowding out private investment. Governments should avoid

running large deficits, and should intervene as little as possible in the productive sphere of the economy.

Whilst sharing some of these assumptions, GEAR attempts to tread a more conciliatory path between 'decisive' action and consultation:

Government has a clear policy co-ordination role. There are trade offs amongst policy options and competing claims by different interest groups which need to be nationally resolved. Whilst institutions have been developed to aid this process, and Government is committed to an open and consultative approach, the ultimate responsibilities for a credible and coherent policy framework lies with government (GEAR, 1996:21).

In short, GEAR supports corporatist negotiations between organised interest groups but makes it quite clear that economic policy is the job of government - and not substantially the stuff of negotiations in NEDLAC. The social partners are called upon to 'ensure that a national agreement underpins rapid growth, job creation, and development' (GEAR, 1996:20). This means in the short term buying into the government's macroeconomic framework and taking steps to ensure that 'the recent depreciation of the currency does not translate into a vicious circle of wage and price increases leading to instability in the financial markets and a decline in competitive advantage' (GEAR, 1996:20).

In other words, rather than achieving favourable macroeconomic conditions by limiting the power of organised labour, GEAR attempts to harness the trade union movement to an incomes policy involving price and wage restraint. Price restraint, it is argued, will be achieved through an effective competitions policy and continued trade liberalisation. Wage restraint is assumed to result from labour market reforms and from commitments by organised business and labour to keep wage growth in line with productivity.

Whether organised labour will trade wage restraint for increased government spending on the 'social wage' (ie health, housing, etc) remains to be seen. How such a bargain could be enforced within the current system of wage bargaining at plant and industry level is another matter altogether.

### **Economic Logic**

The SAF/GEAR vision for growth and development boils down to the following economic logic. Introduce a set of orthodox, outward-oriented, investor-friendly stabilisation and adjustment policies; make the labour market more flexible, cut government-consumption spending, and boost investment by the government and the parastatals. This will send positive signals to the market

and thus will boost investor confidence. Private investment will rise as business confidence increases, and as exports rise.

Once investment occurs, a rapid expansion in output and employment will soon follow. As more currently unemployed people obtain jobs (even at relatively low wages), the economy-wide income distribution will narrow.

We thus get the result that promoting the interests of capital (in the sense of creating an 'investor friendly' environment) is necessary for growth, and ultimately also good for the poor and unemployed - and hence will promote equity in the longer run.

### **The LABOUR/ILO Review Argument**

LABOUR and the ILO Review reject the above depiction of the relationship between investment, growth, labour-market institutions and equality. Although there are important differences<sup>9</sup> between the ILO Review and the LABOUR documents, their views on macroeconomics are sufficiently similar to classify them into the same (left-of-centre) macroeconomic stable. They argue that high levels of inequality undermine growth, and that reducing inequality should be a precondition for - rather than merely an outcome of - economic growth. By arguing that poverty should be addressed (at least in part) through improving the wages of low-paid workers, the LABOUR/ILO position turns the SAF/GEAR moral argument on its head.

### **The Labour Market**

Both the ILO Review and LABOUR reject the SAF/GEAR claim that increased wage flexibility (which will widen the wage distribution for employed workers) is the root to job creation and a more egalitarian income distribution. LABOUR, in particular, casts angry aspersions on this idea:

It is telling that the business community, represented by the South Africa Foundation, has launched a well financed and well publicised campaign to cling onto their wealth. They do so by creating a range of red herrings such as the allegedly 'inflexible' labour market and the alleged 'labour elite'. In so doing, they seek to let poor people pay for growth and development, whilst keeping the wealth and power of the privileged intact (1996:5).

LABOUR opts instead for protecting existing labour standards and for promoting equity within the ranks of employed people. LABOUR insists that the existing framework for collective bargaining should not be tampered with and that the government should support policies designed to narrow wage

distribution. LABOUR document takes particular exception to the SAF's suggestion that the interests of the employed and unemployed are somehow different and opposed. LABOUR argues that employed workers support the unemployed directly through household transfers, and indirectly by providing demand for goods and services produced in the informal sector. The analysis ignores the fact that 53 percent of the unemployed live in households without a wage earner,<sup>10</sup> and provides no estimate of the effect of wages on informal activity.

The ILO Review adopts a more equivocal position and questions the evidence used by SAF in support of its labour market analysis. The Review suggests that South African statistics over-estimate the unemployment rate, and that South Africa's unemployment rate is probably closer to 20 than 30 percent.<sup>11</sup> Furthermore, they argue that South Africa's official statistics are unreliable and probably underestimate employment.<sup>12</sup> This, together with doubts they raise about the empirical techniques used by those suggesting a trade-off between wages and employment, lead them to conclude that 'available studies have not demonstrated that either real wages have been rigid, or that they have had a strong negative effect on employment' (1996:195). They do, however, warn that this does not imply that 'minimum wages and protection of employment security have a positive impact on employment' either (1996:195).

As regards the claimed link between unemployment and poverty, the ILO Review suggests that poor rural households and farmworkers may have been undersampled by the SALDRU survey (Standing et al, 1996:226-40). If so, then work on the SALDRU income data (such as that of Borhat et al cited above) showing unemployment to be a major cause of inequality, may not reflect reality. However, until Standing et al produce alternative estimates which are at least as rigorous as those based on the available data, these claims remain simple assertions.

### **A Wide-Ranging Role for the State**

LABOUR presents 6 pillars to promote social equity:

- 1) job creation (public works, mass-housing programme, job sharing, increased domestic demand, pragmatic trade policies, land reform etc);
- 2) redistributive fiscal policy;
- 3) proposals to break up economic concentration;
- 4) measures to promote workers rights (including a 40 hour week);
- 5) industrial democracy (strengthen shop steward structures, reduce managerial prerogative, etc); and
- 6) promote equity and development globally.

Rather than introducing policies to attract capital into the country, the LABOUR document proposes various measures (eg preventing offshore movements of assets, increased taxation of the wealthy, higher corporate taxes, prescribed assets, etc) which would certainly not fall under the SAF/GEAR definition of investor-friendly!

This, however, is of no consequence for growth in the LABOUR economic vision because investment is seen as being in large part driven by the expansion of demand<sup>13</sup> rather than through sending investor friendly signals encoded in so-called sound economic policy stances. It is also assumed that government spending on infrastructure and the like will 'crowd in' rather than 'crowd out' private investment.

The ILO Review agrees, arguing that 'investment is primarily determined by profitability of investment and the complementarity between investment by the state and the private sector' (1996:30).

LABOUR calls on the government to adopt a more interventionist stance (along the line of the South East Asian developmental states) and to promote redistribution actively through the budget. This, coupled with wage policies to support the incomes of workers, is argued to boost productivity and output.

The ILO Review supports LABOUR's claims about the growth-enhancing effects of greater economic democracy: 'Flexibility should not be a euphemism for more labour market insecurity or be synonymous with a weakening of protective regulations. Sensible regulations can provide a framework within which disruptive socio-economic conflict can be reduced or avoided while promoting dynamic efficiency, allocative efficiency and x-efficiency' (Standing et al, Executive Summary, p.1).

LABOUR takes the argument further and stresses the beneficial effects of increased demand (from higher wages, redistribution through the state, mass-housing provision, etc) on economic growth. In Keynesian fashion, an expansionary policy stance pays for itself through increased output and taxation.

### **Economic Logic**

This boils down to the following economic logic. Promote the interests of workers, pursue training and other supply-side policies, and redistribute actively through the state. This will improve productivity and expand domestic demand - and thereby induce an expansion in output. Investment will rise in response, thus adding further to the growth of output and employment.

We thus get the result that promoting the interests of labour, addressing income inequality directly, and limiting the power of capital is good for equity, demand, employment and output - and hence is ultimately also good for investment.



### **Gambling on the Investment Wild Card**

There is a certain logic to both the SAF/GEAR and the LABOUR/ILO economic positions. However, in the final analysis success in each case depends on how investors are assumed to respond. This is a subject about which the economics profession knows very little (see Chirinko, 1993). As Eisner puts it, 'estimation of investment functions is a tricky and difficult business and the best posture for any of us in that game is one of humility' (quoted in Chirinko, 1993).

Yet both sides in the South African debate choose to gamble hugely on the investment wild card. Unlike the standard neoclassical growth models, SAF/GEAR do not assume that investment will automatically absorb savings. Instead, they adopt a Keynesian concern for investor confidence - but link such confidence to successful adjustment policies. However, in contrast to standard Keynesian wisdom, the SAF/GEAR vision assumes that investors will respond appreciatively to restrictive fiscal policy despite its deflationary effects.

By contrast, in the LABOUR/ILO world investors are assumed to throw their weight behind a more expansionary policy irrespective of the debt situation, labour market dynamics and inflationary prospects. In so doing, the LABOUR/ILO vision adopts a Keynesian concern for boosting demand, but attaches no importance to investor confidence, ie to the 'animal spirits' which Keynes believed drove investment. Investment is simply assumed to be unproblematically induced by expanding markets.

### **SAF/GEAR on Investment, Fiscal Policy and Growth**

According to SAF and GEAR, there are simply no alternatives to their orthodox economic stabilisation and adjustment policies. GEAR starts off by explicitly ruling out an expansionary fiscal policy as a means of lifting the economy onto a higher growth path on the grounds that 'even under the most favourable circumstances, this would only give a short-term boost to growth since it would reproduce the historical pattern of cyclical growth and decline' (1996:3). GEAR argues that higher fiscal deficits would:

lead to higher inflation and higher interest rates, exacerbating the burden of interest payments on the fiscus. More importantly, in the present climate of instability a fiscal expansion would precipitate a balance of payments crisis. Without attention to more deep-rooted reforms, there is no possibility of sustained accelerated growth (1996:3).

In the statistical appendix, GEAR claims that the projections, whilst based on an 'adaptation of the Reserve Bank's econometric model', are 'broadly

consistent with results obtained using models of the Development Bank of Southern Africa, the Bureau for Economic Research and the World Bank' (GEAR, appendix:10). In this way, fiscal expansion is ruled out as unsustainable. SAF takes the limitations imposed on national economic policy choices by the international environment one step further:

Each country's monetary stability, tax rates, levels of services like telecommunications, and, above all, the skills, energy and wages of its workers, affect whether its firms will prosper or dwindle in the global environment.

This is why investors are so preoccupied with economic policy. If policy is right, firms have a better chance of success and higher profits; wrong policies raise the chance of their failing. The increasingly free movement of money across political borders has magnified the link between economic policies and investment. If policies are appropriate, the enormous capital resources of the industrialised world become available; if policies are wrong, even a country's own citizens will hesitate to invest ... With the right policies South Africa can grow much faster than would otherwise have been possible, but with the wrong policies it will be punished harshly and quickly (SAF, 1996b:1-2).

SAF's language is unequivocal: there is only one 'right' set of policies (crime prevention, competitive markets, labour-market flexibility, efficient government, outward orientation and sound macroeconomic policies) to encourage investor confidence and hence create a suitable basis for growth. 'Wrong' policies (such as LABOUR's) will incur the wrath of international markets and the ultimate destruction of economic growth. Capital is all-powerful; national policy must pay obeisance or pay the cost.

According to the SAF, 'the orthodox view is now that a budget deficit averaging more than one or two percent of GDP over the business cycle is evidence of policy failure' (1996:11). The SAF warns that unless South Africa's deficit is reduced sharply (by 1.5 percent points a year), South African economic policies will lack credibility in the eyes of investors, and a real danger exists that South Africa may slide into a debt trap during the next recession. The SAF recommends slashing government spending rather than raising taxation in order to achieve this reduction. The SAF suggests keeping education, health and housing spending constant in real terms, whilst reducing welfare spending, eroding the real value of pensions, cutting child benefits, eliminating various subsidies (such as that on transport), and increasing the police budget. Proceeds from privatisation are to go to reducing the debt.

GEAR is less extreme, suggesting a lowering of the deficit to 4.0 percent in 1997/8, and subsequently by half a percentage point a year to reach 'a satisfactory long term target of 3.0 percent of GDP in fiscal 1999/2000' (GEAR, 1996:8). However, GEAR has little to say about how this reduction will take place: 'In order to achieve the new fiscal targets in the 1997/98 budget, the Minister of Finance has initiated a thorough audit of government expenditure, including RDP allocations, to identify those areas in which budgetary cuts can be made without detracting from the priorities and commitments of the Government' (GEAR, 1996:8). This is a surprisingly limp statement given the emphasis placed by GEAR on sending credible fiscal policy signals to investors.<sup>14</sup>

A reduced budget deficit (as part of a consistent economic policy package including trade liberalisation and privatisation) is assumed in the SAF/GEAR model to have beneficial effects through freeing up savings for private investment, and by sending a positive 'signal' to investors about the soundness of the government's fiscal policy. While it is indeed likely that reduced government debt will lower interest rates,<sup>15</sup> the assumed beneficial effects of restrictive fiscal policy on investment are tenuous. This is a serious problem given that the very logic of GEAR's projected effects of economic policy reform depends on a very favourable investment response to tight fiscal policy.

As a result of the reduction in government consumption expenditure relative to GDP, and the reversal of government dissaving, gross domestic saving is expected to rise from 18 percent to 22 percent of GDP. This represents an important basis for the sustainability of the long-run growth path. Gross domestic investment is expected to increase from 20 percent to nearly 26 percent of GDP in the year 2000. This requires capital inflows equivalent to almost 4 percent of GDP. The integrity of the growth strategy is therefore dependent on maintaining a favourable investment climate, in order to attract foreign investment (GEAR, 1996:5-6).

This, however, is a questionable story even in terms of GEAR's own projections. As can be seen from Table 1 below, there is no difference between average government consumption as a percentage of the GDP in GEAR's Base Scenario (BS) projection, ie assuming no change in government policy, and that for the Integrated Scenario (IS) projection, ie assuming new policies. Likewise, the projected difference in government dissavings is a mere average 0.1 percentage point of GDP between the two scenarios. Although the lower real bank rate in the IS projection (presumably brought about by the reduction in government debt) is no doubt responsible for higher investment in the model, the

major forces behind economic growth appear to be increased government and parastatal investment, and increased exports.

However, given that the real effective exchange rate is the same for each scenario, it is unclear how or why exports rise so fortuitously in the IS projection. Furthermore, in light of the fact that the current account deficit (as a percentage of GDP) grows steadily in the IS projection (as imports rise faster than exports), one can only but conclude that the immediate effect on demand of external trade is negative. Thus, while export expansion lays the basis for sustainable growth, the external sector as a whole withdraws rather than injects demand into the economy.

**Table 1. Some of the Key Integrated Scenario Projections**

	Integrated Scenario Projections 1996-2000					ISP (Av)	BSP* (Av)
	1996	1997	1998	1999	2000		
Deficit/GDP	5.1	4.0	3.5	3.0	3.0	3.0	4.0
Real government consumption (% of GDP)	19.1	19.5	19.0	18.5	18.1	19.0	19.0
Av. real wage growth (private sector)	0.5	1.0	1.0	1.0	1.0	0.8	1.4
Real government investment growth	3.4	2.7	5.4	7.5	16.7	7.1	2.4
Real parastatal investment growth	3.0	5.0	10.0	10.0	10.0	7.6	2.7
Real private investment growth	9.3	9.1	9.3	13.9	17.0	11.7	5.6
Real Bank Rate	7.0	5.0	4.0	3.0	3.0	4.4	5.2
Real non-gold export growth	9.1	8.0	7.0	7.8	10.2	8.4	6.9
Real export growth (manufacturing)	10.3	12.2	8.3	10.5	12.8	10.8	8.5
Real effective exchange rate (% change)	-8.5	-0.3	0.0	0.0	0.0	-1.8	-1.8
Current account deficit (% of GDP)	2.2	2.0	2.2	2.5	3.1	2.4	1.4
GDP growth	3.5	2.9	3.8	4.9	6.1	4.2	2.8
Non agricultural formal employment growth	1.3	3.0	2.7	3.5	4.3	2.9	1.0
Government dissavings (% of GDP)	3.1	2.3	1.7	0.7	0.6	1.9	2.0

Source: GEAR, 1996.

- \* This is the average for the period 1996-2000 assuming no change in government policy. It is GEAR's Base Scenario Projection.

This implies that the integrity of the GEAR model depends almost entirely on a wild guess as to how much investment is likely to be induced (from domestic and foreign sources) as a result of the implementation of the government's new macroeconomic strategy.<sup>16</sup> Rather than responding to an increase in demand, private investment expands autonomously at 11.7 percent pa, and thereby acts as a demand stimulus. And, despite the decline in interest rates, capital is assumed to flow into the country on the strength of increased investor confidence.

Thus, while most econometric estimations include a powerful effect of demand on investment (as pointed out by the ILO and LABOUR), the GEAR model assumes the reverse. A massive, assumed autonomous increase in investment (complete to a decimal place) is at the heart of the growth strategy.

GEAR has been portrayed as a 'technical' document drawing on the major South African macroeconomic models for inspiration and for testing the integrity of the various policy options. But this is a very slippery process. Macroeconomic models can be useful in showing how different fiscal policy stances are likely to affect the economy - assuming that all other parameters remain unchanged. Thus GEAR's rejection of a fiscal stimulus in the absence of other complementary economic policies is probably borne out by such macroeconomic modelling.

However, once the very parameters in a model (such as the response of investment to an increase in output) are changed *by assumption*, then the integrity of the projection becomes extremely questionable. For example, one of the models which GEAR supposedly consulted - namely Gibson and van Seventer's Development Bank model - shows that a contractionary fiscal policy could actually dampen the recovery in private sector investment: 'If the goal is to reduce the public sector borrowing requirement as a share of GDP, the result must be a fall in income, output and employment, all other things equal' (Gibson and van Seventer, 1995:21). The ILO Review makes a similar point: 'deficit reduction as an ex ante policy constraint results in slower growth and greater difficulty in reducing the deficit' (1996:33).

Echoing the concerns of LABOUR and the ILO, Gibson and van Seventer write:

The critical element necessary to motivate private investment, whether domestic or foreign, is markets. Ultimately it is the ability to sell what is produced that guides the investment decision, not available savings, either private or government. Fiscal policy which increasingly withdraws demand and shrinks markets will lead to a contraction in the level of economic activity.

... To quantify this conclusion, define a 'unit of fiscal discipline'

as a one percent reduction in the deficit before borrowing. Over the next five years, one unit will reduce the average growth rate by about 1.5 percent for each year (Press Briefing, 15 June 1995).

This result comes from the very model GEAR claims to have used in its projections. For GEAR to have reversed this above conclusion so spectacularly, much tampering must have been done to the investment-response function when the Reserve Bank model was conveniently 'adapted'.<sup>17</sup> The same applies to GEAR's projected increase in employment. Assumptions were clearly made about how the various policy reforms would affect the average capital labour ratio. These (rather unrealistic) assumptions were then summarily plugged into the model.<sup>18</sup>

There are, in short, so many 'shift parameters' in GEAR's integrated scenario projection that its 'technical' status is severely compromised. The growth and employment outcomes are in large part the product of a set of optimistic guesses about the likely effects of the economic policy package.<sup>19</sup>

### **LABOUR/ILO: Closed Economy Keynesianism?**

LABOUR and the ILO are probably on good grounds when they argue that fiscal austerity is not a growth strategy. To bet everything on investors responding positively to 'sound' economic policies, even as the economy contracts, is a risky strategy indeed.

But is the alternative proposal any better? Whilst SAF/GEAR may have exaggerated the omnipotence of international capital, the LABOUR document errs by ignoring the potential for capital flight and the limitations globalisation places on domestic economic policy choices. Although LABOUR accepts some need for 'fiscal discipline' and, hence, recommends matching increased government expenditure with taxation, there is no recognition of the potentially adverse effects of higher corporate taxation on investment. There is also something anachronistic in LABOUR's harking back to the hey days of developmental state intervention. Yes, such policies worked in the 1960s. But that was then, and this is now. It is unclear what kinds of state intervention are needed to support economic growth in the 1990s. To some extent, today's policy makers are forced into 'shift parameter' type guesstimates in order to try and understand how economies might operate in rapidly changing economic circumstances.

The ILO Review's suggestion that the South African government borrow up to 5 percent of GDP and pursue more expansionary monetary and fiscal policies, appears less realistic than the LABOUR's proposals. It does not consider potentially adverse effects on investment, and the proposal appears not to have

considered seriously the adverse effects of such policies on the balance of payments or inflation.<sup>20</sup>

South Africa is a small open economy attempting to compete in an increasingly competitive and globalised world economy. While international capital flows may not yet hold the key to a country's economic life or death, policy makers ignore this power at their peril.

The SAF's claim that foreign investors regard a deficit of over 2 percent of GDP as evidence of policy failure is probably exaggerated. As the ILO Review puts it, "There is no golden rule for assessing whether a budget deficit of x percent is or is not excessive, just as there is no reason to presume that public expenditure "crowds out" private investment rather than "crowds in" such investment" (1996:30).

Yet it is probably fair to say that investors will wonder about the sustainability of any macroeconomic strategy based on comparatively high deficit to GDP ratios. If investors fear that fiscal policy is heading for a debt trap, then capital will flow elsewhere. It is not good enough simply to assume that investment will follow growth no matter how that growth is generated in the short-term. And if one adds to the policy pot the punitive measures the LABOUR has in mind for the owners of capital, the chances of attracting capital appear even slimmer.

### Conclusion

These are difficult and risky times for South African economic policy makers. There are no clear and obvious lessons to be learned from economic history (although LABOUR and the SAF both try and do so by selecting successful cases of state-led development and structural adjustment respectively). And even if one could draw firm policy conclusions from the past, it is unclear to what extent, and how, they should be adapted to suit today's increasingly globalised economic environment.

Anyone peddling the perfect economic policy package for South Africa should thus be greeted with the kind of scepticism investors are already showing. GEAR's belief that the model's assumptions about private investment will become a self-fulfilling prophesy is particularly strange in this regard. Radical policy changes, be they along the lines of SAF/GEAR or LABOUR/ILO, are on weaker foundations than their proponents would have us believe. They are rooted in ideological assumptions and guesses about the functioning of the labour market and the determinants of investment. They are essentially grand socio-economic experiments, and should not be dressed up in fancy, supposedly technical, but ultimately suspect projections.

Cabral's warning to 'Tell no lies and claim no easy victories' is particularly relevant in today's economic policy debate. GEAR should simply have outlined South Africa's economic constraints and challenges, argued why specific proposed policy changes were likely to bring about a more stable, growth-oriented, investor-friendly environment, and stated that *if* investment responded positively, *then* sustainable improvements in living standards might be possible. A more humble approach, coupled with greater clarity regarding how the deficit is to be cut, would have been more credible.

## NOTES

1. I would like to thank Iraj Abedian, Sean Archer, Terence Moll, Jeremy Seekings, Nick Segal, Chris Sellars, Guy Standing and an anonymous referee for their useful comments. The errors of interpretation remain mine.
2. Nelson Mandela's opening speech to Parliament, 9/1/96.
3. An earlier version of LABOUR's macroeconomic reasoning can be found in MERG (1993). NB, the LABOUR document is often referred to as a COSATU document.
4. An earlier version of this kind of economic reasoning can be found in the old South African government's Normative Economic Model of 1993 - although GEAR's language and concerns are more social democratic.
5. A useful summary of the SAF, LABOUR and GEAR policies can be found in the Special Supplement to the Weekly Mail (July 19, 1996). For partisan critiques of the SAF argument and supportive arguments in favour of LABOUR, see Baskin (1996) and Adelzadeh (1996).
6. GEAR believes that greater state spending on infrastructure will be growth enhancing. SAF, however, is sceptical.
7. The SAF argument draws on Moll (1996). See also Natrass and Seekings (1996). According to the Labour Relations Act, wage agreements between unions representing 50 percent or more of the workers in an industry, and employers employing 50 percent or more of workers, can be extended to firms not party to the agreement. In this way, parties to the bargain can set minimum wages for the entire industry. It has been argued that this extension mechanism harms small business and biases the growth path in a capital-intensive direction.
8. According to GEAR, wage agreements must be 'sensitive to regional labour-market conditions, the diversity of skills levels in firms of varying size, location or capital intensity and the need to foster training opportunities for new entrants to the labour market' (GEAR, 1996:18).
9. The ILO Review has much less faith than the LABOUR document in legislative intervention in the labour market. Whilst supporting labour standards, collective bargaining etc, the ILO Review places much greater emphasis on 'voice regulation' and on including the unemployed and marginalised in social accord processes.
10. This was calculated from the SALDRU data set for the Labour Market Commission.
11. The ILO Review has a problem with the way unemployment is defined, and with the way data is gathered on unemployment. See Standing et al (1996, chapter 4), and Natrass and Seekings (1996) for a discussion of these issues.



12. The Review provides sixteen reasons why official statistics probably underestimate employment (1996:67-71).
13. There is empirical evidence for this claim. According to Chirinko, 'regarding empirical determination, it appears that investment is most sensitive to quantity variables (output and sales) with price variables having only modest effects' (1993:1883). Terence Moll, however, argues that most evidence linking investment to demand is for advanced capitalist countries where increases in demand are regarded as sustainable by investors. While this is probably the case, there is some evidence that investment has been positively related to demand in South Africa (Natrass 1990). Whether this will remain true in the 1990s is unclear.
14. According to Iraj Abedian, the Ministry of Finance was not able to be more concrete without falling foul of South Africa's budget process.
15. If the authorities reduce debt (by buying government stock from the public), then the money supply will increase and interest rates will fall. This appears to be the mechanism operating in the GEAR model. To the extent that the lower interest rate will increase the expected return on investment projects, this can be expected to translate into higher fixed investment.
16. The National Institute for Economic Policy estimates that 93 percent of the stimulus must come from private investment in the GEAR model (NIEP, 1996:6).
17. It is interesting to note that when Gibson and van Seventer attempted to model the results of a 'neoliberal' policy stance not all that dissimilar to the government's, they reasoned that the investment function would shift up by only 1.5 percent (1996:14). GEAR boosts this estimate tenfold.
18. I am grateful to Trevor Bell for pointing out the problems with GEAR's employment projections.
19. Chris Sellars has pointed out to me that this method of estimating investment so as to generate desired output and employment results is (ironically) similar to that used by MERG (1993).
20. The ILO recommends a 'prudently expansionary' fiscal policy, an accommodating monetary policy which targets the real interest rate to equal the growth rate, and moderate and periodic real devaluations (1996:46). Such policies, it is argued, will 'yield a growth rate of near 5 percent, inflation of 10 percent or less, a sustainable balance of payments, and a modest growth in real wages' (1996:46). It is difficult imagining what open-economy model of the South African economy could generate such results. The ILO appears to have taken inadequate account of the inflationary effects of devaluation, has assumed that a devaluation will immediately result in an improvement in the current account of the balance of payments, and has ignored the impact of capital flight if real interest rates are cut dramatically.

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