A CASE OF POLARIZATION PARALYSIS: the debate surrounding a growth strategy for South Africa

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SUMMARY

- *The paper is concerned with two questions:*

    1. *What influences came to shape the proposals contained in the GEAR growth strategy?*

    2. *How coherent is GEAR as a growth strategy given the most recent evidence on growth from the theoretical and empirical literature on growth?*

- *The answer to the first question rests on the observation that there are two tendencies contained within the GEAR strategy:*

    1. *The first is "neo-liberal", emphasising openness of the economy, reliance on and liberalisation of markets, and monetary and fiscal policy discipline.*

    2. *The second makes concessions to organised labour, and compromises the flexibility of the labour market.*

    The implication drawn is that GEAR is the outcome of pressure from two distinct lobby groups, business and organised labour. While the document emphasises the neo-liberal dimension, the existence of the alternative component within GEAR will give the government some room for flexibility in altering its policy orientation in the approach to the next election.

- *GEAR represents a coherent growth strategy. Empirical and theoretical evidence suggests that openness, macro policy restraint, and efficient markets are indeed favourable to growth.*

- *GEAR is only a partial growth strategy however: the important dimension of human capital, theoretically emphasised and empirically supported by new growth theory is largely absent, or at best of secondary importance to the growth strategy and the South African debate. Given South Africa's human capital characteristics, this represents a serious omission.*

- *In terms of compliance to the policy thus far, results are mixed:*

    1. *On openness: Good progress has been made with respect to trade liberalisation. More progress is required on exchange control liberalisation.*

    2. *Market liberalisation: Some progress has been made on privatisation, though the overall process remains dogged by uncertainty. Labour market flexibility has continued to decline (through the Labour Relations, and Conditions of Employment Acts).*

    3. *Macroeconomic Policy: has been exemplary, except for some difficulty at the level of provincial budgetary control.*

    4. *On education policy is unclear, and lacks direction. It remains vital that human capital be incorporated as a central component of a growth strategy.*

    Policy thus continues to be shaped by the interplay of forces between organised labour and business. The approaching election in 1999 may make the balance of forces between the two interest groupings unstable.

- *Emphasis on human capital formation represents one avenue of resolving the polarisation between labour and business.*

- **1.0 Introduction**

This paper addresses two questions. The first is an assessment of the crucial thematic concerns of the *Growth, Employment and Redistribution* (GEAR) policy document that currently informs economic policy in South Africa. The second is to assess the coherence of GEAR as a growth strategy in terms of recent developments in our theoretical and empirical understanding of growth.

The answer to the first question will conform closely to what might be termed the now conventional understanding of the tension ANC policy formulation finds itself in. The suggestion will be that GEAR contains two tendencies: the first is the development of a growth strategy based on macroeconomic demand-side policy restraint, market orientation, and increased openness of the economy; the second is an attempt to satisfy its political constituency in the tripartite alliance which incorporates COSATU. The two elements do not sit very comfortably with one another. Nevertheless, the suggestion will be that GEAR contains elements of both, reflecting the need to reassure investors on the one hand, and a political constituency on the other. An important question for a full understanding of the process of policy formation in South Africa will be to establish which of the two elements of GEAR comes to predominate in the approach to the 1999 election.

The assessment of GEAR as a growth strategy will place emphasis on some elements that have not received strong attention in the debate surrounding a growth strategy for South Africa. GEAR will be seen to have identified a number of factors important as determinants of sound long run economic performance. Moreover, while there are some lacuna present in the proposals it advances, in general the strategy is sound and consonant with international evidence and best practice on growth strategies. Yet given that it was clearly informed by modern evidence on growth, it is startling that the factor which can be argued to constitute the very foundation of modern growth theory is effectively sidelined not only in GEAR, but in the wider debate on growth in South Africa also. Investment in human capital and above all improvement in the quality of human capital is vital to long run growth prospects. Yet South Africa's policy record in this vital dimension is patchy at best, without showing signs of rapid improvement. The assessment provided of GEAR is thus as an *incomplete* growth strategy, though (subject to some qualification) sound in most of those proposals it actively pursues.

The debate on GEAR has been very polarized, with attacks on, and defensive sorties mounted on behalf of its so-called "neo-liberal" orientation. In this opposition the important structural foundation of growth in human capital has simply been lost – to the detriment of both labour and business.

2.0 A Brief Summarizing Characterization of GEAR

The conventional characterization of GEAR has come to label the proposals as "neo-liberal" in character. By this is meant that the strategy for growth proposed carries three distinguishing features:

- reliance on market mechanisms rather than government intervention and regulation in the growth process wherever possible
- maintenance of fiscal and monetary policy restraint
- that the economy be opened up to international competitive forces

In broad terms this characterization is only partially accurate. While a subsequent section will provide a more detailed analysis of key elements of GEAR, the strategy rests on a number of distinct proposals which do not all sit equally comfortably with the so-called "neo-liberal" characterization:

1. Fiscal reform aimed at reducing the size of the government deficit, lowering inflationary pressure and reducing the crowd-out of private sector investment expenditure.
2. Monetary policy aimed at the stabilization of the real effective exchange rate, and price stability.
3. A process of tariff reduction and gradual relaxation of exchange controls.
4. A restructuring of state assets, embracing the development of guidelines for the governance, regulation and financing of public corporations, the sale of non-strategic assets, and the creation of public-private sector partnerships.
5. Industrial policy which provides tax-incentives to labour absorbing investment, a strengthening of competition policy, and the development of an industrial cluster support program.

At first sight the proposals appear to conform to the broad characteristics of the "neo-liberal" framework. Fiscal and monetary policies both emphasize restraint, and the maintenance of stable macroeconomic conditions. Trade policy appears to be opening up the economy to increased foreign competition. The restructuring of state assets includes a privatization component, and industrial policy identifies the need to strengthen the efficient functioning of markets through competition policy, emphasizing recognition of the importance of market mechanisms.

Yet we can note a number of important modifications to this characterization. An examination of the detail of the proposals suggests that the proposed opening of the economy relies primarily on tariff reduction, and relatively little on the relaxation of exchange controls. It will be argued below that this represents a crucial limitation to the strategy, which is likely to prove damaging to its long run success[1]. Secondly, proposals outlining the program for the restructuring of state assets are distinguished by their vagueness, privatization constituting only one of the three components, with the remaining two leaving considerable scope for less reliance on market mechanisms than the "neo-liberal" label suggests. Governance, financing and regulation of public corporations, and reliance on public-private sector partnerships are not yet a convincing embrace of the market. Industrial policy similarly carries with it the potential for a more strongly interventionist stance than the apparent "neo-liberal" orientation would imply.

Most significant of all, however, is the position GEAR adopts on the labour market. Again at first sight the proposals appear to conform to the "neo-liberal" format, with emphasis placed on the need for labour market flexibility, wage restraint (such that wage increases lag productivity increases), a lowering of indirect wage costs, and the need for job creation. Cast in such terms the labour market proposals contained within GEAR conform to the neo-liberal characterization associated with GEAR. Closer examination renders the neo-liberal characterization of the labour market proposals less convincing, however. GEAR actively embraces the Labour Relations Act (which came into effect in November 1996, after the publication of GEAR), which introduces a single industrial relations system for all employees, promotes collective bargaining on an industry-wide basis, and introduces workplace forums[2]. The net effect is what GEAR terms "regulated flexibility", with the objective of extending the protection and stability claimed to be the outcome of the Labour Relations Act to all employees in the labour market, though at the discretion of the Minister of Labour.

While it may be the case that the Minister will exercise discretion with due circumspection, this approach at the very least introduces very considerable additional transactions costs for any firm which has to apply to the Ministry of Labour, wait for all relevant representation to have been made, and for the Minister to reach a decision. Certainly it falls outside the scope of what would conventionally be understood as a reliance on free and flexible labour markets, as does the continued reliance on minimum wage policy, collective bargaining and the arbitrary relaxation of minimum wage agreements in the case of young workers.

The GEAR proposals are thus characterized by a fundamental tension. Proposals on demand-side policy conduct, and for the most part the proposals on the openness of the economy can be said to be "neo-liberal" in outlook. However, while providing rhetorical acknowledgement to the need for market flexibility, concrete proposals on labour markets do not provide for increased labour market flexibility. In this respect, therefore, the proposals can hardly be said to chart a "neo-liberal" trajectory.

The issue here is not whether the "neo-liberal" approach is desirable or otherwise – though this question will be addressed in a subsequent section of this paper. Rather the suggestion here is that the debate surrounding a growth strategy in South Africa has come to be characterized by a considerable degree of polarization between the three broad interest groupings party to the debate: labour, business and government. Organized labour pursues a vigorous campaign against what it beleives to be the iniquities of development strategies that rely on markets, openness, and reduced government intervention. Above all it views with unmitigated hostility the growth strategy proposed by "big business" in the *Growth for All* (GFA) document issued by the South Africa Foundation. GFA in turn

[1] We should immediately note that the Reserve Bank has subsequently begun to address this question. We will pursue more recent developments surrounding openness in a later subsection.
[2] Subsequent draft legislation, in the form of the *Conditions of Employment Bill*, confirms the incomplete commitment of government to labour market flexibility. Again, we return to this question in a subsequent subsection.

is pessimistic about the possibilities for job creation, sustainable long run growth, and improved equity in society in the presence of what it views as an excessively rigid labour market, and harmful government intervention in too many markets.

This has left the government facing a dilemma. A vital political constituency and the business sector crucial to the long run growth prospects of South Africa have come to assume strongly confrontational policy positions on the question of growth. This has left government bobbing about in the middle of the debate, attempting to please both parties; in the interests of its political constituency on the one hand, and the need for increased investor confidence on the other. The brief outline above suggests that GEAR, despite the now frequent and conventional characterization of its proposals as firmly in the GFA camp, does contain elements designed to please both competing interest groups.

In effect, while in broad terms the characterization of GEAR as "neo-liberal" captures an important orientation implicit within the development strategy underlying GEAR, there are countervailing tensions within the document. Moreover, this fundamental tension reflects the competing development strategies pursued by the two key interest groupings party to the debate on growth in South Africa: labour on the one hand, and business on the other.

The discussion will proceed by pointing to some of the reasons for the polarization surrounding the GEAR document. The approach will be historical, examining the debate leading up to the publication of GEAR. This will be followed by a more detailed examination of the GEAR proposals in terms of new growth theory and empirical findings on the long run determinants of growth. Finally, the paper concludes with an examination of subsequent policy initiatives, and their coherence with the GEAR framework.

3.0 A Chronology of the Debate surrounding a Growth Strategy for South Africa

The economic policy orientation of the ANC has shown a steady shift throughout the 1990's. The first complete ANC policy position on economic policy is contained in the *Reconstruction and Development Policy* (RDP) proposals published prior to the 1994 elections. Subsequent modifications emerge in the RDP White Paper of September 1994, the draft *National Growth and Development Strategy* (NGDS) of February 1996, and finally the GEAR proposals of June 1996. The evolution of the policy position of the ANC was further influenced by what might be termed external "shocks" and their reception, in the form of the Macroeconomic Research Group's (MERG) proposals, the *Growth for All* (GFA) document of the South Africa Foundation published in February 1996, the *Social Equity and Job Creation* (SEJC) response to GFA by organized labour, and the sharp Rand devaluation of March-April 1996.

None of these interventions can be examined in any great detail at this juncture. But a brief characterization is useful in understanding the influences that came to shape the GEAR proposals. The RDP represents a popularization of the MERG proposals advanced in 1993. The RDP contained five core proposals:

1. Meeting basic needs, through job creation, housing, water and welfare provision, improved sanitation, health and transport services, land reform etc. The objective of such basic needs provision is not only improved welfare of the populace. Instead, basic needs provision was seen as growth enhancing through an expansion of domestic demand for both producer and consumer goods through the redistributive component inherent in basic needs provision providing the section of the population with the highest propensity toward expenditure with additional resources to undertake such additional expenditure. It is this component of the RDP which manifests the strongest influence of the earlier MERG proposals.
2. Development of human resources, through investment in appropriate education and training.
3. Building the economy through a lowering of distortions and barriers to growth.
4. Democratization of the state and society.
5. Implementing the RDP proposals through the development of state capacity and policy coordination.

Most telling in these proposals is the strong attention paid to demand-side stimulus to the economy, and the relatively scant emphasis placed on supply-side measures. Moreover, all proposals while long on rhetoric are short on detailed implementation proposals, a lack that became apparent in the difficulties

encountered in attempts at implementation of the policy[3]. While more detailed supporting argument was advanced in the MERG proposals for a high wage and redistributive development strategy to stimulate the demand-side of the economy, the need for more detailed implementation proposals for the RDP resulted in the RDP White Paper of September 1994. Some attention was given to the role of different levels of government in the RDP, an economic framework of implementation, the financing of the proposals, and the reorganization of the planning framework. Significantly for present purposes, the White Paper shows the first signs of an awareness of constraints imposed by economic realities on RDP objectives. In particular, the imperative for fiscal and monetary discipline, and through the need for a restructuring of the public sector the possibility of privatization receive active consideration for the first time by the ANC. Focus and debate on the possibility of privatization within the ANC in government strengthened during 1995[4].

The publication of the South Africa Foundation's GFA in February 1996 represents the next major intervention in the policy debate. The proposals in summary were for:

1. A solid institutional framework in the form of a sound legal system which guaranteed property rights, and a police force and justice system competent to control crime.
2. A sound macroeconomic policy environment, ensuring low inflationary pressure through control of the money supply, low fiscal deficits to minimize crowd out of private sector investment and lower inflationary pressures, and maintaining a positive real interest rate.
3. Efficient provision of government services by a smaller civil service, emphasizing investment in education and health, and in order to free resources for private sector investment.
4. Promotion of efficient markets, through the furtherance of market competition, private ownership, and above all a flexible labour market.
5. Outward orientation of the economy through export-promotion and the encouragement of overseas competition, a lowering of trade barriers, focus on non-traditional export markets, and the maintenance of an appropriately valued currency.

The GFA proposals represented a major advance in the debate. Their detail and their reflection of elements of the theoretical and empirical literature surrounding the new growth theory brought greater depth to bear on the relevant issues. Perhaps most important of all, in contrast to the RDP proposals, emphasis is shifted from a demand-side focus to a supply-side focus, as is appropriate for a growth strategy. Publication of the GFA proposals coincided with the issuing of the draft National Growth and Development Strategy by government, which represented a further shift from demand-side driven RDP proposals, and above all further embraced the need for fiscal and monetary discipline.

Reaction to the GFA document was far from measured, including calls in parliament for the authors of the document to be dismissed from their private sector appointments. The identification of macroeconomic demand side policy restraint, reliance on markets, privatization and labour market flexibility, resulted in a range of strong attacks on the document, particularly from organized labour. Central to the attack on GFA was the rejection of a two-tier labour market proposed in GFA by both the ANC and COSATU, on the grounds that the two-tier labour market system would be prejudicial to black labour, relegating it to a cheap labour market system[5]. Strong resistance is also voiced against the privatization proposals contained in GFA by organized labour, though the ANC in government has a more ambiguous response. COSATU dismisses the GFA document in its entirety as "neo-liberal" and as inimical to South Africa's interests:

> Behind the gloss lies the oft-repeated programmes of economic deregulation. lower tariffs, privatisation, weaker trade unions, lower corporate taxes, reduced labour standards and financial market liberalisation (SEJC p8.)

In some quarters (though not in an immediate sense from organized labour) there is opposition to the possibility of a Rand devaluation in the pursuit of an export drive and enhanced international competitiveness on the grounds of inflationary impacts and the low price elasticity of South African exports.

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[3] By way of example see the reports in *Finance Week*, 17-23/8/1995, and the *Financial Mail*, 1/9/1995.
[4] See for instance the discussion in the *Financial Mail*, 15/9/1995.

[5] See the *Financial Mail* of March 15, 1996.

Labour's opposition to GFA lead to COSATU's publication of a growth strategy of its own in the SEJC document. It replaces the five "pillars" of GFA with six "pillars" of its own:

1. Job creation, to be based on public works and mass housing programs; "modernization of the industrial base", through a reduction of imports and increasing exports, and opposing the lifting of exchange controls; job sharing; "pragmatic" trade and industrial policies, with tariff reductions only at the rate prescribed by GATT, retraining schemes for workers, and reviewing the GEIS subsidy scheme; expanding domestic demand and promoting local purchasing policies; training the workforce; increasing productivity; creating jobs in labour intensive processes; stopping retrenchments in the economy by raising the costs of retrenchments to employers; land reform and the promotion of small farmers; stimulating economic activity by a less restrictive monetary policy.
2. Redistributive fiscal policy, by redirecting expenditure to the poor (improving delivery of the RDP proposals); increasing the progressive nature of taxation; raising corporate taxation; reducing VAT; raising the marginal tax on the wealthy and introducing a capital gains and luxury goods tax; encouraging savings through provident funds.
3. Strengthening anti-trust initiatives.
4. Increasing the income and quality of life of workers, through an increase of worker's rights under the centralized bargaining system; investing in training and human resources development; using public procurement to promote worker's rights; reducing the pay differential between top management and the shop floor; centralizing the labour market; legislating for paid six month maternity and child care leave; introduction of a 40 hour week. The central motivation for the proposals appears to be an efficiency wage argument, in which higher wages would be more than compensated for in productivity increases.
5. Promotion of industrial democracy, through requiring the workplace forums of the Labour Relations Act to be trade unions based; decreasing managerial prerogatives through legislation; assigning workers 50% of seats on company boards; assigning workers representation on mutual insurance companies.
6. Promoting international worker's rights.

The proposals clearly run counter to the "neo-liberal" mix labour criticized in the GFA document. Yet despite rhetorical calls for a return to RDP style of intervention, and the retention of a number of the programs identified with the RDP, the proposals do represent a shift in the debate. While there continues to be an emphasis on some demand-driven growth, particularly under the Job Creation and Fiscal Policy rubrics, there is increased focus on the supply side of the economy. In these terms the GFA was therefore successful in fundamentally shifting the parameters of the debate in South Africa. However, the approach adopted by SEJC toward the supply side is diametrically opposed to that which emerged from GFA. Instead of openness of the economy, making markets more competitive, and promoting small, efficient government, government intervention in the economy is strengthened, the labour market is to be more rather than less regulated, and openness of the economy is strongly opposed. On the other hand, the shift to supply side considerations in the SEJC document leads to a strong identification of a number of themes central to the new growth literature and that have received too little attention in the South African debate. Most notable of these is the emphasis placed on market failures in the provision of education, training, and technological innovation, all of which are central in determining the long run growth potential of the economy. While GFA did identify the importance of these dimensions, they received relatively little weight in its presentation, and above all in the implementation proposals advanced by the GFA document[6]. In essence the reason for this appears to have been that investment in human resources was seen to follow as a *consequence* of the realization of a higher growth path, and the greater availability of resources which would follow from higher growth. SEJC in effect raises the legitimate question of whether this represents the appropriate sequencing, and whether investment in human capital may not represent a precondition of higher growth. This will be a theme to which the discussion below will return.

Given the direct challenge that SEJC represented to GFA on demand-side issues, on the labour market the openness of the economy, and the implications it carries for the curtailment of the independence of business, the reaction of business forums to the SEJC proposals was predictably negative. Particularly the SEJC proposals governing the labour market were rejected, and continue to occupy negotiations

[6] For instance, in the diagrammatic representation of the 5 pillars of development advanced by GFA, human capital does not feature at all.

between labour, business and government. More interesting was government's skeptical reaction to the SEJC proposals. The cleft between the Tripartite Alliance partners became most apparent on privatization, with COSATU rejecting the prospects, and government in the form of Mandela (no less) embracing the prospect – a far cry from his attempts to convince the international business community of the merits of nationalization[7]. The rift between government and labour persisted beyond the publication of the SEJC proposals. On the publication of GEAR in June 1996, commentators close to labour went so far as to suggest GEAR to be a wholesale capitulation to the World Bank and IMF, domestic conglomerates and as a panic response to the sharp Rand devaluation of March-April 1996[8].

The tensions present in the public debate surrounding a growth policy in South Africa were not without resonance in the ANC itself. A number of accounts of the discussions within the ANC are available. On one plausible speculative account, discussions within the Cabinet during the course of 1995 on the RDP had led to the emergence of a number of core ministries and associated ministers concerned with the development of a coherent economic policy. Crucial to the discussions were Deputy President Thabo Mbeki, Finance Minister Trevor Manuel, Minster of Trade and Industry Alec Erwin, and a number of advisors: Moss Goasheng, economic advisor to the deputy president, Maria Ramos, Director General of the Department of Finance, and Ketso Kodaan. Tito Mboweni, Minister of Labour was also involved with the discussions. In early 1996 meetings were held to finalize a discussion document. Meetings were led by the Department of Finance, but additional important players were the Departments of Labour, of Public Enterprises, while the Reserve Bank and representatives of the World Bank also contributed.

On this account, it appears that immediately prior to the sharp Rand devaluation of March-April 1996, the Finance Committee of the ANC rejected a set of draft proposals largely along the lines of the later GEAR document. The dramatic developments on foreign exchange markets of March 1996, in part indicating a loss of international confidence in the domestic economy, led to the adoption of proposals on demand side policy restraint, and openness of the economy in relatively uncompromised form for the final GEAR proposals. By contrast, labour market policy proved the subject of relatively intense horse-trading. Labour market proposals included in GEAR represented a late compromise, designed to satisfy the Department of Labour and to avoid alienating COSATU. The contributions of Alec Erwin and Jay Naidoo were seen as crucial in dampening and moderating labour demands in the negotiating process. The relatively narrow participation in the formulation of the growth strategy further insulated it from populist pressure.

The GEAR proposals when finally published, were clearly not the product of consensus within the ANC alliance. Thabo Mbeki, Trevor Manuel and Alec Erwin presented the proposals to the Alliance as a fait accompli, and as non-negotiable. This strengthens the view that the proposals were the product of negotiations amongst core ministries, and that the negotiations leading to the formulation of GEAR were effectively insulated in some measure from more populist pressures within the ANC alliance. The strong negative reaction from segments of the ANC alliance, and the need for a strong defence of the proposals, perhaps most notably by Mbeki in the *State and Social Transformation* address to the Alliance of November 1996.

The GEAR proposals thus represent a balancing act on the part of government, between political constituency demands on the one hand, particularly from organized labour, and the need to promote investor confidence in the markets on the other. While market pressures, culminating in the strong loss of investor confidence in March 1996, were pushing the ANC in the direction of a "neo-liberal" growth strategy, the demands of its political constituency pulled back the ANC from full-scale liberalization of labour markets.

There thus does appear to be truth in the suggestion that the broad direction of development in the ANC's economic thinking has been away from the demand-driven RDP-proposals, to the active incorporation of supply-side measures, culminating in GEAR. Yet the outline of GEAR provided by the preceding section suggests that care needs to be exercised before applying such a characterization too wholeheartedly. It was pointed out that GEAR did not fully embrace labour market flexibility, despite rhetoric to the contrary. Moreover, government intervention, remains a feature of the GEAR

[7] See the *Financial Mail* of June 7 1996.
[8] See the National Institute for Economic Policy, *From the RDP to GEAR: the gradual embracing of neo-liberalism in economic policy*, August 14 1996.

proposals, with privatization playing a relatively low-key role in the proposals. Perhaps a more useful characterization of the policy proposals in GEAR is as caught in the tension between the representations of labour in SEJC and the representations of business in GFA. Of the need to satisfy a political constituency on the one hand, and the need to generate investor confidence on the other. The GFA document was successful in focusing the debate on supply-side questions important to growth. But the debate continues to span a wide range of positions, from the liberalizing, open and non-interventionist stance of GFA on the one hand, to the strongly interventionist and closed position of labour on the other, with the GEAR strategy located somewhere in between. The range of policy proposals is outlined in Table 1, which emphasizes the range of policy positions spanned by the three crucial policy proposals, and the differing emphases or orientations of the three documents.

TABLE 1: Crucial Policy Proposals on Growth by the Three Key Players

GFA: Strong Supply Side Focus			
• Labour Market Flexibility: purest form • Openness: most complete • Small, efficient government • Competitive Markets: most insistent • Sound Legal Framework: only proponent	• Fiscal and Monetary Discipline • Privatization • Some attention paid to investment in human capital: education & health	• Labour absorption – through supply-side measures liberalizing labour markets	
	GEAR: Supply Side Focus		
	• Fiscal and Monetary Discipline • Some indication of privatization • Some attention paid to openness • Some attention paid to investment in human capital	• Limited labour market flexibility • Considerable scope for government intervention • Limited reduction in government size • Labour absorption through demand and supply side policy measures	
			SEJC: Demand & Supply Side Focus
	• Considerable investment in human capital	• Openness only under duress (GATT) • Labour absorption through demand & supply side policy measures, with reliance on the demand side.	• Increased government intervention • Reliance on demand-side expansion of output • Increased and pervasive labour market intervention • Opposition to privatization • Opposition to reduction of budget deficit

4.0 An Evaluation of the GEAR proposals as a Strategy for Economic Growth

The crucial question here is whether the strategy proposed under GEAR is coherent in terms of our theoretical and empirical understanding of the determinants of economic growth. As the preceding discussion indicates, the debate surrounding a growth strategy in South Africa has centred on the impact of a number of crucial macroeconomic and institutional characteristics of the economy. The issues of contention identified are:

- The impact of the openness of the economy.
- The impact of labour market flexibility.
- The impact of a reliance of a market economy, as opposed to a heavily regulated economy.
- The impact of monetary and fiscal policy restraint.

In the second subsection which follows below, we examine the international evidence on these questions, in order to provide some clarity on which of the contending positions adopted on these issues can lay strongest claim to being correct. Some considerable evidence has accumulated on these questions, stretching beyond the limited country by country and anecdotal evidence that both sides to the debate have advanced at this stage.

The third subsection in the discussion that follows will identify some important considerations that have occupied growth theorists, and which have perhaps received insufficient attention in the debate in South Africa. The strong polarization surrounding the issues examined in the second subsection below, may well have been the cause of this lack of focus to the debate. It will be argued below that (a.) the evidence gives some indication as to the appropriate stance to be adopted by policy makers on the issues of controversy, and (b.) that the interests of the competing parties to the debate might well have found a means of being reconciled precisely in the important evidence ignored by the debate on growth in South Africa. In effect there is ground for considerably more consensus on the central elements of a growth strategy for South Africa than appears to be feasible given the state of the current debate.

Before turning to these questions of central interest to the present paper, we first address the role of investment expenditure in the growth process. Investment expenditure, its impact on growth, and the means of stimulating investment expenditure divides commentators on South Africa's growth strategy. On the one hand, investment has been portrayed as best driven by the private sector, responding to market liberalization, an open economy and a flexible labour market. On the other investment has been seen as requiring strong stimulus from the fiscus and monetary policy, and as best thriving under regulated markets. Given the central role of investment expenditure to the growth process, such questions are central to South Africa's growth strategy, and require attention before we continue.

4.1 The Role of Investment Expenditure

Investment expenditure can be argued to lie at the heart of traditional growth theory. Long run equilibrium output in the economy is seen as growing due to growing factor inputs combined in order to produce output by means of the technology of production the economy has access to. To the extent that the technology of production is fixed, and the growth rate of the labour force is determined by demographic factors, the single most relevant variable for consideration for the economist remains the rate of change of the capital stock of the economy over time: net investment.

Empirical studies have confirmed the importance of investment in the determination of the growth performance of a wide range of countries. Figure 1 presents a simple cross-plot of the average ratio of total investment expenditure (private & public) to GDP against the average real per capita growth rate in GDP over the 1960-85 period, for a sample of 114 countries[9]. The relationship between investment and growth is strongly positive, confirmed by a correlation coefficient of +0.55 statistically significant at less than the 1% level. Moreover, Asian Tiger economies are confirmed as having the high investment rates one might expect, while African economies which make up the bulk of developing countries with poor (often negative) growth rates over the 1960-85 period are shown to have very low investment rates.

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[9] The data set is drawn from Fedderke and Klitgaard (1996, 1997). The sample of 114 countries is relatively comprehensive, comprising most of the independent nations of the world. A number of unusually small nations are excluded from the analysis. Their inclusion does not substantially affect the results presented.

Clearly such evidence is simplistic, and merely a first indication of the nature of the relationship between investment and growth. However, the literature on empirical evidence on the growth performance of countries provides ample support for a consistent link between investment expenditure and the growth rate in total factor productivity. Levine and Renelt (1992) note that while most explanatory variables of economic growth in cross sectional empirical studies prove to generate very unstable results when subjected to sensitivity analysis, the investment rate of the economy constitutes an exception[10]. More controversially, De Long and Summers (1991, 1993), continuing the work of Jorgenson (1988), argue that growth accounting exercises which have shown only modest returns to capital accumulation have been conducted at inappropriate levels of aggregation. Explicit recognition of investment in *equipment* rather than total capital accumulation shows strong explanatory power for economic growth[11].

Yet this evidence raises a number of important questions. Given the emphasis placed on the relative importance of public and private sector investment to economic growth in the debate in South Africa, the most obvious question here must be which of the two has generated the most favourable growth returns from cross national experience. The World Bank's pooled data set for 57 developing countries, covering the period 1960-90 contains disaggregated data for gross private, fixed private and public sector investment expenditure, each expressed as a ratio of GDP. Table 2 below reports correlation coefficients for all three ratios with:

- *growth* in real per capita GDP as well as
- the *level* of real per capita GDP,

computed both for the data expressed in annual terms, and for three year averages, the latter in order to remove noise introduced by cyclical variations due to business cycle rather than long run growth related changes. The evidence carries clear implications. First, regardless of whether the annual or three year averaged data is employed, the strongest positive correlation with growth emerges from the ratio of gross private investment to GDP, followed by the ratio of fixed private fixed investment to GDP. The correlation of the ratio of public investment to GDP with growth trails by some considerable margin. The implication is that if there are to be positive returns in terms of growth from any form of investment, the strongest returns are likely to come from gross private investment, and certainly from private sector investment rather than public sector investment. Where public sector investment does crowd out private sector investment, therefore, this may carry potentially damaging consequences for long run growth performance.

The second point which emerges from Table 2, is that even for the developing countries which constitute the sample from which the evidence is drawn, public sector investment as a proportion of GDP rises as the level of real per capita GDP increases[12].

None of this is to say that public sector investment is not of some benefit for the growth performance of a country, though the caveat concerning the potential crowd-out effects of public sector investment should be noted. A number of growth models point to the need for a possible coordinated "big push" in investment to break a low equilibrium poverty trap, which can only be provided by the public sector[13]. But the relevant argument applies only at very low levels of per capita capital stock, a condition South Africa simply does not satisfy by international standards. Moreover, consider the cross-plot of the ratio of gross real public investment to real GDP against average real per capita income growth in Figure 2. The evidence suggests that there may well be a positive association between public sector investment expenditure as a proportion of GDP and long run growth, but only in the range from 2 - 4% of GDP. Beyond that the association is, if anything, negative. It is also worth noting that the Asian Tigers, over the 1970-85 period considered, and counter to frequent claims, did not have unusually high ratios of public sector investment to GDP by wider international standards.

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[10] See also the discussion in Fischer (1993). Fedderke and Klitgaard (1997) shows a strong positive impact from the ratio of gross domestic investment to GDP on growth, even when controlling for a range of additional potential determinants of growth.

[11] Though see Auerbach, Hassett and Oliner (1994), and Blomstr'm, Lipsey and Zejan (1993) on some dissenting views.

[12] This is consistent with the Wagner hypothesis, which treats public goods as luxury goods. An income elasticity of demand in excess of unity implies rising demand for public good provision with rising per capita income. By implication, public sector investment may thus well be the consequence rather than the progenitor of growth.

[13] See Romer (1990), Grossman and Helpman (1990) and the discussion in Fischer (1993).

TABLE 2: Correlation between the level and growth in real per capita GDP and investment rates

	Level of Real Per Capita GDP (Annual)	Growth in Real Per Capita GDP (Annual)	Level of Real Per Capita GDP (3 year avg.)	Growth in Real Per Capita GDP (3 year avg.)
Ratio of Gross Private Investment to GDP	0.13	0.41	0.19	0.52
Ratio of Fixed Private Investment to GDP	0.30	0.22	0.39	0.31
Ratio of Public Investment to GDP	0.11	0.08	0.13	0.09

Moreover, for some cross-sectional country studies[14] the implication is that the impact of public sector investment expenditure on the long run growth performance of the economy depends significantly on the *form* the public sector investment takes. Thus Easterly and Rebelo (1993) for instance find that the share of public investment in transport and communications is significantly, positively and robustly correlated with growth. The implication is the rather obvious one that public investment can be growth enhancing, if it is productively allocated, and perhaps that infrastructural development may be one form that such public investment expenditure can take. Nevertheless the preceding cross country evidence on the poor returns attaching to public sector relative to private sector investment rates should alert us to the fact that *finding* the public sector investment projects with strong positive social returns is not necessarily an easy task.

The implications of this evidence for South Africa are not entirely reassuring. Figure 3 shows public, private and well as total investment expenditure as a proportion of GDP. The collapse of the total investment rate for South Africa (GDF/EGDP), which declined sharply from the early to mid 1980's, has not yet returned to its earlier levels, though since 1992 the trend has been steadily upwards. It is the private sector investment rate (GDFIPS/EGDP) which has driven this recovery, reaching much the same heights as were realized in the early 1980's. On the other hand, public authority and public corporation investment expenditure as a proportion of GDP (GDFIPA/EGDP and GDFIPC/EGDP respectively) have continued the decline begun during the 1980's. While there is positive news from private sector investment expenditure, therefore, the same is not true of public sector investment expenditure. Of course, the projected increase in public sector investment expenditure identified by GEAR would not yet be reflected in the data running through the end of 1996. However there has been little indication on the part of government as to what precisely the source of the projected increase in public sector investment expenditure might be, and no announcements of major investment expenditure projects have thus far been forthcoming from government. Evidence from the investment data is thus mixed: good news from private sector investment expenditure, and rather more gloomy news from public sector investment expenditure.

Importantly, further good news emerges in connection with foreign direct investment in South Africa. While not yet at the absolute level that is desirable, the trend has been steadily upward and accelerating since the political transition of 1994. Table 3 illustrates. Internationally the experience has been that international capital flows are led by short term capital flows of the sort South Africa has been experiencing in substantial volume on its bond and equity markets. Not only does this have a positive impact on the cost of investing domestically, but long term direct investment is also frequently seen to follow short term capital inflows with a lag. In the case of South Africa the rising inflow of foreign direct investment may well reflect a perception that the credibility of the macroeconomic policy stance adopted by GEAR is strengthening as the government shows continued adherence to the macroeconomic discipline projected in the GEAR policy proposal. Certainly the budget of 1997/8 showed no signs of an impending change in the government's policy stance, with respect to its commitment to reducing the budget deficit.

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[14] See Rao (1953).

Table 3: Foreign Direct Investment

Year	Foreign Direct Investment (Millions of US $'s)
1994	4921
1995	5494
1996	7835
1997	9923

Source: *Finance* Week 31/7-6/8/1997:pp20-1

The importance attached to investment expenditure in part stems from abstracting away the potential impact of technological progress. Indeed, the new growth literature typified by Romer (1986) and Lucas (1988) emphasizes that the positive impact of investment expenditure on growth may be an expression not only of the direct expansion of the productive capacity of the economy that investment in capital equipment generates, but that there may exist strong positive externalities that attach to investment expenditure. In effect, investment expenditure allows agents engaged in production processes to "learn" to do their tasks better than before – they learn by doing, realizing higher productivity than prior to the investment. This leads to the immediate conclusion that investment alone is unlikely to facilitate a complete explanation of economic growth. Additional factors are likely to be important, and indeed, in the following two subsections we address some of the more important determinants identified in the literature.

4.2 The Bones of Contention

The issues of contention in the debate on a growth strategy in South Africa have been:

- The impact of the openness of the economy.
- The reliance on market mechanisms, including labour market flexibility, and reducing government regulation of the economy.
- The impact of monetary and fiscal policy restraint.

We turn now to each of these in turn in order to examine wider international evidence on their impact.

4.2.1 Openness of the Economy

Evidence on the impact of the openness of the economy is now fairly unambiguous[15]. The consensus is increasingly that greater openness favours long run growth. Consider the plot of the average growth in real per capita GDP from 1960-85 against the World Bank index of trade liberalization (high is good) averaged over the 1960-85 period, contained in Figure 4[16]. The positive association, while obtained from a small sample unambiguously favours increased trade liberalization, confirmed by a correlation coefficient of 0.73 significant at the 1% level.

Of course such a small sample can be misleading. However, the work of Sachs and Warner (1995) extends the results to a sample of countries which ranges from 79 to 117 countries[17]. On the estimates reported Sachs and Warner suggest that countries that were OPEN on their measure which emphasizes low tariffs and low quantitative restrictions on trade, on average grew faster by two whole percentage points over the 1970-89 period, even after controlling for the impact of education, government consumption expenditure, the level and instability of political rights, price distortions in investment goods, investment rates and population density[18]. This is a staggeringly large impact, and even if

[15] Sachs and Warner (1995) provide an in-depth review and analysis.
[16] Unfortunately data are available for only 19 countries. South Africa is not contained in the sample.
[17] As is conventional, a number of small and oil producing nations are excluded from some regression equations.
[18] See Sachs and Warner (1995 Table 11).

considerably biased in magnitude suggests that South Africa with its relatively high tariff barriers and import quotas over the 1960-89 period missed substantial growth opportunities[19].

The evidence does carry the implication that GEAR proposals favouring increased openness in the South African economy are desirable. In particular the phasing out of quantitative restrictions and the lowering of tariff barriers at a rate faster than required by GATT as proposed by the GEAR document are to be welcomed. GEAR represents on balance a code of good conduct on the part of the ANC government, designed to create an environment favourable to both domestic and foreign investment. As we have seen in the preceding section, private sector and foreign direct investment have been seen to respond to the favourable environment.

On the other hand, GEAR while being committed to the liberalization of exchange control, makes only relatively limited allowance for such liberalization. Proposals published in GEAR included:

- that relaxation proceed in a gradual and prudent manner
- that foreign investors be allowed increased access to domestic credit markets, such that a non-resident owned entity can borrow 100% of shareholder equity
- that institutional investors (effectively insurance companies) be allowed to transfer 10% instead of 5% of total assets offshore[20]
- that corporations can offset the cost of imports against export-proceeds if the offset occurs within 30 days
- that existing exchange control limits be adjusted, and administrative exchange reform be undertaken

June 1997 saw the introduction of the 10% asset limit for institutional investors and the adjustment of exchange control limits for private domestic residents. While a step in the right direction, the move does not extend far enough (10% of total assets hardly represents a high proportion), and until the exchange control regime is considerably more liberalized, exchange controls are likely to continue to represent a serious barrier to growth prospects[21].

The problem here lies not with the fact that foreign investors' access is constrained, but that domestic economic agents, particular institutional economic agents are so constrained, and substantially so. The most serious consequence of this is that the positive benefits of macroeconomic policy restraint may come to be lost. Despite the potentially favourable investor climate created by openness and macroeconomic discipline, the difficulty for foreign investors is always that circumstances that are favourable today may no longer be so tomorrow. Governments that implement one policy environment, have the power to change that environment, particularly when as in the case of the ANC, they are subject to populist pressure – witness for instance the rhetoric emerging from the 6'th Annual COSATU Conference. One of the principal tools governments have of limiting the negative impact of such uncertainty is to submit themselves to an environment that contains credible threats if they should break their code of good conduct. Only where the government stands to lose more from abandoning good conduct than it stands to gain, are its policy positions likely to be credible to investors. Where a significant proportion of the agents who would be negatively affected by a departure from good conduct by the government are powerless to escape once desirable macroeconomic policies are abrogated, the credible threat posed to governments is reduced concomitantly. This is precisely the negative consequence of maintaining exchange controls for domestic residents. Foreign investors may withdraw should the government's policy stance worsen, but domestic residents (particularly institutional domestic residents) cannot. As a consequence the negative consequences for the

[19] Jan Willem Gunning in a plenary session of the Economics Society of South Africa Conference of 1997, reviewing explanations of Africa's disastrous economic performance, while agreeing on the importance of openness, suggested that the appropriate order of magnitude may be in the region of 0.5-1%. Even so the impact remains substantial. See also Collier and Gunning (1997).

[20] To this was added that institutional investors be allowed foreign exchange transfers of 3% of net inflows of funds they experienced in 1995, subject to the 10% of total assets restriction. Given the introduction of the 10% rule in June 1997, the proposal loses its relevance, and was clearly intended as a bridging mechanism.

[21] Chris Stals, Governor of the Reserve Bank, has indicated that additional relaxation of exchange controls is likely to follow during the course of 1998. Depending on the scale of such relaxation, the move is to be welcomed.

government, the punishment or credible threat it exposes itself to should it reverse its good macroeconomic policy conduct, would be diminished. The result is simply that foreign investors will view any potential investment prospects as subject to considerably more uncertainty, hence in less favourable light, than they would in the presence of a stronger credible threat which would be provided by improving the openness of exchange control regulation in South Africa.

Despite the desirable policy stance adopted by the government on demand side policy, and its partial embrace of openness in the economy, the continued limited exchange control liberalization therefore remains a barrier to the realization of the full benefits of the growth strategy adopted in GEAR. At the very least, where the central bank does not believe itself to be in a position of relaxing remaining exchange controls immediately, a transparent and therefore public, clear phased program associated with a time table of phased withdrawal of remaining exchange controls would be the next best alternative, and must be strongly recommended.

The implication for the debate on a growth strategy in South Africa is thus twofold:

- **First, the empirical evidence on growth at present favours the "neo-liberal" option of reliance on an open economy with few trade barriers over the alternative of pursuing policies that require protection of domestic industry. To the extent that GEAR embodies such "neo-liberal" tendencies, therefore, it receives support from international evidence.**

- **Second, the suggestion has been that while trade has indeed been liberalized in South Africa, and that GEAR actively pursues a reduction of trade barriers, the same cannot yet be said of South Africa's capital markets. Exchange controls, despite the relaxation of June 1997, continue to be prevalent, with damaging consequences for the credibility of the otherwise disciplined macroeconomic policy stance of the ANC government.**

While a step in the right direction, GEAR could be strengthened. South Africa could do better than it currently is in terms of the openness criteria by embracing more open capital markets.

4.2.2 The Role of Markets and Labour Market Flexibility

On the role of markets, and the role of government in markets the evidence is a little more difficult to interpret, for the simple reason that markets cover a very wide range of activity, and government intervention in them varies widely in intensity. As a consequence quantitative measures of market freedom are aggregative, and hence do not necessarily provide clear evidence. Nevertheless a number of different measures of market freedoms are available, and can be assessed for their association with the growth performance of countries.

The growth literature often asserts the importance of clearly defined and enforceable property rights to the long run growth performance of countries[22]. Empirical evidence supports the hypothesis, as illustrated in Figure 5. Figure 5 depicts the association between average 1960-85 growth, and a measure of property rights[23]. The plot shows a positive association between greater definition and enforceability of property rights and long run average growth. The positive association is evident from the rank correlation[24] between the property rights measure and long run growth of 0.44, significant at the 1% level.

Property rights while important to the functioning of markets, do not yet capture to what extent an economy in fact does rely on the presence and functioning of markets. The legal enabling of markets that property rights represent, must be given practical expression in the ongoing exchange which is the essence of the market mechanism. We therefore examine a measure of the aggregate "market orientation" of an economy in all markets collectively, on a scale of 1 (low) to 3 (high), and examine the association with the average growth in real per capita GDP from 1960 to 1985. Figure 6 illustrates

[22] By way of limited example see Scully (1988), Knack and Keefer (1995).

[23] The measure is an ordinal scale, and reflects the legal recognition of the right to own property, the protection of intellectual property rights, enforceability of property rights, any restrictions on the selling and exchange of property, and the freedom to structure property holdings amongst agents in accordance with preference.

[24] Rank correlations are employed where variables are ordinal rather than cardinal.

the evidence. Two points which emerge are that there is indeed evidence of a positive association between growth and greater reliance on markets, confirmed by the rank correlation for the 86 countries in the sample of 0.38, significant at the 1% level. However, it also emerges from the evidence that the growth performance of countries at any one level of reliance on market mechanisms overlaps substantially with that of countries at other levels. Thus the growth performance of the Congo and Tanzania, both ranked lowest in the degree of reliance on market mechanisms, exceeds that of Switzerland and New Zealand at the highest level of market orientation[25]. It also shows that high growth rates are attainable even without a full-blown reliance on market mechanisms - witness Korea, Malaysia and Thailand. Singapore on the other hand, at similar levels of development to Korea and Malaysia, appears to have fared better still, and relied more heavily on markets.

The existence and reliance on markets still allows for a substantial level of intervention in such markets by government. An additional question is thus to what extent *flexible* markets are important for growth performance. The difficulty here lies in just how to measure the flexibility of market mechanisms, bearing in mind the high level of aggregation such a measure would entail across an entire economy. One suggestion provided by Gwartney, Lawson and Block (1996), is to incorporate into a measure of market freedoms not only formal property rights, but any evidence of price distortions, and strong evidence of the presence of mechanisms likely to lead to market distortions. In particular the measure proposed incorporates:

- protection of money as a store of value and medium of exchange[26]
- government restrictions on production and consumption decisions[27]
- discriminatory taxation[28]
- restraints on international exchange[29]

A difficulty with such an aggregate measure is its composite nature, so that it is difficult to determine which elements of the mix determine the results one obtains. Nevertheless, the evidence once again favours a positive association between the composite market freedom or flexibility measure and average long run growth over the 1960-85 period, as illustrated in Figure 7. The rank correlation between the two variables is 0.22, significant at the 5% level.

More disaggregated measures of the impact of market inefficiencies reinforce the point that efficiently functioning markets free of distortions are desirable. An additional means of obtaining an indication of the prevalence of market inefficiencies is to measure the distortions that attach to a crucial price in the economy. One such crucial price is the wage rate in the labour market; another is the exchange rate. A conventional proxy for market distortions employed by the growth literature has been the black market foreign exchange rate premium over the official exchange rate. Figure 8 illustrates the presence of a negative association between the black market exchange rate premium and long run growth[30], confirming the suggestion that countries with less efficient markets (more distorted markets) have a higher probability of realizing low than high growth rates.

[25] It should be noted that this might be driven by what is termed the convergence phenomenon. Traditional growth theory predicts that less developed countries *should* grow faster than developed countries, in effect because the marginal product of capital at low levels of per capita capital stock exceeds that at high capital labour ratios.

[26] The measure is influenced by (a.) the strength of the inflationary impact of the money supply growth rate; (b.) the variability of the inflation rate, and (c.) the freedom of domestic residents to own foreign currency bank accounts both domestically and abroad.

[27] The measure is influenced by (a.) government consumption expenditure as a proportion of GDP; (b.) the role and presence of state corporations; (c.) the strength of price controls; (d.) freedom of the private sector to compete in all markets; (e.) equality of citizens under the law, and access to a non-discriminatory judiciary; (f.) freedom from government regulation, and negative real interest rates.

[28] The measure is influenced by (a.) transfers and subsidies as a proportion of GDP; (b.) the top marginal tax rate, and the income threshold at which it applies; (c.) use of conscription for the military.

[29] The measure is influenced by (a.) taxation of trade; (b.) divergence between the official and black market exchange rate; (c.) divergence between actual and potential trade; (d.) restrictions on capital market transactions.

[30] Some care is required in interpretation of this data, since it is characterized by the presence of strong outliers. Uganda and Ghana are clearly atypical in the magnitude of the black market exchange rate premium. However, elimination of the two countries from the sample only changes the bivariate regression coefficient from –0.38 to –0.34, without affecting its significance. The presence of outliers is thus not particularly damaging in the present context.

For South Africa the evidence on the impact of market distortions is not reassuring. Figure 7 employed the composite Gwartney-Lawson-Black measure for market efficiency for 1975. In the same measure constructed for 1996 South Africa ranks 56'th out of 103 countries, compared with Hong Kong (1'st), Singapore (2'nd), Malaysia and Thailand (jointly 6'th), South Korea (12'th), Taiwan (15'th). What is more, increasingly it is not only the Tigers that are doing considerably better than South Africa. Latin American and Caribbean countries also are increasingly creating environments favourable to investment, with Costa Rica (joint 12'th), Panama (joint 15'th), Guatemala (17'th), Bolivia (18'th), Jamaica (21'st) being only a few of the many countries doing considerably better than South Africa.

For the South African labour market indications are similarly unencouraging. The concern here is not so much with the absolute level of labour costs. High labour costs that reflect a high demand for labour input, or a high marginal product of labour, need not be a problem for an economy. Rather, what is at issue here is the degree of inflexibility of labour markets in South Africa. Obtaining a quantitative measure for the degree of labour market inflexibility is not easy. One possibility is to use the ratio of average manufacturing sector wages against national per capita income. While a premium if any of manufacturing wages over national per capita income may reflect a superior average level of human capital embodied in manufacturing sector workers, the premium that prevails in South Africa is instructive. Figure 9 plots the ratio of the average manufacturing sector wage rate to per capita GDP, against the level of per capita GDP in 1975 for the countries for which the relevant data is available. The ratio of manufacturing wages to per capita GDP for South Africa is not the highest in the world. But only nine countries have ratios that are higher: Uganda, Ecuador, Nicaragua, Cameroon, Senegal and Indonesia. More tellingly, for countries at a similar level of development in 1975, viz. Argentina and Singapore, the South African manufacturing wage rate premium was approximately eight times and two times greater respectively. None of the Asian Tiger economies have premiums that even remotely approach those of South Africa. Whatever the reason for the high premium in South Africa, it cannot be argued to be healthy for employment creation prospects in the manufacturing sector, and any investment that is likely to take place is likely to continue to be capital rather than labour intensive. The suspicion must also be that the South African labour market in the manufacturing sector is not functioning efficiently. Economic agents who do not have access to employment in the manufacturing sector may well be facing significant barriers to entry into the labour market at present. In effect, the suggestion is that the labour market is subject to insider-outsider rigidities inimical to the efficient functioning of the manufacturing sector.

The Labour Relations and Conditions of Employment Acts similarly are difficult to reconcile with the aim of increasing labour market flexibility. Industry-wide bargaining, a single industrial relations system for the entire labour market, shorter working weeks, paid maternity leave approaching first world standards, raising the costs of dismissal, take little cognizance of the strongly segmented nature of the South African labour market. Even with the promise of selective and discriminating application of the provisions of the acts, such measures increase the rigidity, and certainly raise transaction costs of acting within the labour markets. On the other hand, the provisions of the two labour acts are not entirely undesirable. The bargaining structures intruded into the labour market appear to be resolving disputes somewhat more rapidly than in the past, and given the clear bargaining structures dispute resolution appears to be subject to somewhat less uncertainty than in the past.

The main implications of the evidence of the present section are thus:

- **In favour of the neo-liberal policy stance. Greater reliance on markets, more efficient and freer markets, and fewer market distortions are seen to be positively associated with growth on the basis of international cross-country evidence.**

- **GEAR has been accused of excessive reliance on markets, and of being inimical to the long run interests of workers in labour markets. It is difficult to reconcile such attacks on GEAR with the evidence here presented – better markets are associated with superior long run economic performance. Moreover, the implication of the most recent data on South Africa suggests that it still lags behind, and by some considerable margin, nations who are direct competitors for foreign direct investment. Indeed, the opening section of this paper noted that the GEAR proposals contain little by way of concrete suggestions on improvements to market mechanisms in South Africa.**

- **More significantly still – the opening section of this paper suggested that GEAR contained proposals that perpetuated rigidities in the labour market. Developments subsequent to GEAR's publication, culminating in the Conditions of Employment Bill currently being tabled, reinforce the impression that the Ministry of Labour is at odds with the prerequisites of GEAR and the successful attainment of a higher growth path for South Africa.**

- **While with the partial privatization of Telkom, the privatization process has begun, it is as yet unclear as to how it is to proceed, at what pace, and according to what principles. The strength of government's commitment, especially in the face of significant labour opposition in the run up to an election remains to be seen.**

It thus seems as if the sectional interests of one section of the labour force is continuing to exert an influence on government policy in a direction not necessarily most likely to be favourable to economic growth.

4.2.3 The Role of Demand Side Policy Measures

The issue here is primarily the question of which demand-side policy stance is best suited to the promotion of long run growth in the economy. Perhaps rather surprisingly, given the immediacy of the question, evidence on this relationship is rather new, though at this stage relatively unambiguous in its implications.

Before moving to the question of the appropriate monetary and fiscal policy stance, however, I wish to address very briefly a question that has lurked in the background of the growth debate in South Africa, and which has occupied applied growth theorists for some years: the appropriate size of the government sector for growth purposes. For some authors the answer is unambiguous: higher levels of government consumption expenditure are associated with lower growth rates in per capita GDP, due to the distortionary effects of government consumption expenditure in the economy. Symptomatic of this stance is Barro (1991), for whom government consumption expenditure consistently returns a negative and significant coefficient in the analysis of cross sectional data, even when controlling for a wide range of additional explanatory variables of economic growth. However, subsequent studies have shown the cross sectional results to be inconclusive (by way of example see Levine and Renelt 1992 and Slemrod 1995), given to considerable instability and unclear as to the appropriate direction of causality. In terms of the present state of the debate in the growth literature, the evidence is thus still inconclusive as to the precise impact of the size of the government sector on economic growth.

This still leaves a number of additional dimensions of demand-side policy's impact on growth to be determined. In terms of the debate on an appropriate growth strategy for South Africa the central questions may be identified as:

- The impact of *taxation*
- The impact of *inflation*
- The impact of macroeconomic *instability*
- The impact of the government *deficit*
- The impact of the exchange rate

All of these topics have increasingly been topics of examination in the growth literature, and empirical evidence on all has begun to accumulate. The implication of the evidence is that while in broad terms the "neo-liberal" emphasis on macroeconomic stability finds support, there are a number of important qualifications to be noted, just as was the case with the impact of government consumption expenditure.

For inflation, the evidence points to the presence of a negative impact of inflation on growth performance. Numerous studies on both cross sectional and panel data confirm the finding, as for instance do Fischer (1991, 1993), Grier and Tullock (1989), Kormendi and Meguire (1984, 1985) and Gomme (1993). Ghura (1995) finds that the impact of inflation is strongly adverse in Sub-Saharan Africa, while Grier and Tullock (1989) find the negative impact of inflation restricted to Africa. Moreover, a number of studies report a negative impact not only of the level of inflation on growth, but also a significant negative impact associated with *variability* of the inflation rate, taken to be a proxy of

macroeconomic instability as a whole. Fischer (1991, 1993) and Kormendi and Meguire (1984, 1985) make the point[31].

The impact of the government deficit is somewhat more ambiguous. Nelson and Singh (1994) distinguish between the experience of less developed countries in the 1970's and their experience in the 1980's. While in the former the impact of government deficits could be shown to be negatively associated with the growth rate of countries, for the 1980's government deficits were no longer significantly associated with growth rates. On the other hand, some studies have argued for a clear and unambiguous association between government deficits and economic growth, notably Fischer (1991, 1993), and Grier and Tullock (1989). Nelson and Singh (1994) also point to the possibility of an ambiguous relationship between growth and the size of the government sector (as measured by the total revenue – both tax and nontax - absorbed by government). Again, while for the 1970's a negative association exists between these variables for less developed countries, for the 1980's a negative relationship persists only for the class of countries in the very lowest income category, not for middle income countries.

The impact of alternative tax regimes is more difficult to identify, given the complexity of tax incidence on an economy, and the strong differences in the nature of the tax revenues that governments rely on at different levels of development[32]. Work has been primarily theoretical rather than empirical. Modification of endogenous growth models to incorporate tax and its welfare effects explicitly, has pointed to the possibility that inappropriate taxation policy can not only shut down the growth process, but can result in development traps, particularly for small open economies faced with mobile capital. To quote Easterly and Rebelo:

> Growth models….feature simple channels that link certain taxes to the rate of growth. Increases in income taxes, for example, lower the net rate of return to private investment, making investment activities less attractive and lowering the rate of growth. It is hard to think of an influence on the private real rate of return and on the growth rate that is more direct than that of income taxes. If these do not affect the rate of growth, what does? (1993:418)

While in general the track record of the ANC government has been very sound in terms of their management of macroeconomic policy, taxation represents the one area where the policy environment is not favourable. Table 4 is sourced from Sachs (1996), and compares South Africa's tax structures with that of a number of competitors, particularly Asian Tigers with sound growth performance. It is notable that particularly in terms of corporate taxation tax rates in South Africa are high relative to competitor nations. In terms of the disincentive effects that taxation represents for private investment expenditure, this represents a significant disincentive to investment, and above all foreign direct investment. Lowering such tax rates might well boost private domestic investment expenditure to even higher levels, and above all might help to further attract foreign direct investment.

The net implication of the evidence at the present moment is thus in broad terms favourable to the "neo-liberal" stance emphasizing macroeconomic discipline and stability, but it is at present difficult to argue conclusively that the case has been proved empirically without any shadow of a doubt. The optimal size of the government sector and government deficit cannot be fixed with any great deal of determinacy.

In terms of South Africa's performance in macroeconomic policy dimensions since the publication of GEAR, the assessment has to be generally favourable, at least in terms of macroeconomic discipline and stability. Inflation has been on a steady downward trend, the government has emphasized the need to reduce the government deficit, and the 1997/8 budget did not present any evidence of breaking the mould. Two countervailing elements, however are first a tendency for local government to run relatively substantial deficits relative to income[33], and second a tax regime which could be argued to be out of kilter with the remaining policy stance. Moreover, the government's strategy for reducing the deficit relied on a reduction in the size of the civil service. Projected decreases in the number of civil servants were to have been in the region of 100000. Actual reductions have been only 15000.

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[31] The argument extends readily to the volatility of the environment of the economy in general – such as climatic conditions, international commodities prices, and so on. See also the discussion in Collier and Gunning (1997).

[32] At low levels of development, governments rely primarily on tax revenue collected on international trade. With development income tax as a proportion of total tax revenue tends to grow.

[33] See for instance provincial government deficits on education, *Finance Week*, 14-20/8/97.

Reductions in expenditure on the wage bill were to have been in the region of R11 billion; actual reductions have been only R1.3 billion.

Despite the preceding comments on the appropriate macroeconomic policy stance, we end the section with a sobering statistic for any understanding of the impact of the macroeconomic environment on long run growth. A study by Easterly, Kremer, Pritchett and Summers (1993), notes that the variability of the growth performance of countries across decades is very high. The correlation coefficient of the inter-decade growth performance of countries lies between 0.1 and 0.3. By contrast, country characteristics such as the macroeconomic policy environment of the sort overviewed in the present section tend to be very consistent across decades. Correlation coefficients range between 0.6 to 0.9. The implication is worrying: the growth performance of countries may have more to do with dumb luck than might be comfortable to acknowledge for most policy advisers, and most economists.

4.2.4 A Brief Reconsideration of the Investment Question

The present subsection began by indicating the crucial importance of the proportion of GDP allocated to investment expenditure to long run growth performance. While we noted some characteristics of the South African experience, and some differences that attach to public and private sector investment expenditure the question of what might determine the investment rate of a country was left aside. An adequate exposition of the current understanding of this question in the economic literature is beyond the scope of this study. However, it is worth noting that a few of the factors that have been identified in theoretical and empirical work as important to the determination of growth have been:

- the openness of the economy (as defined in the discussion above)
- the efficiency of markets, and the prevalence of distortions in the price signals markets transmit
- the tax regime maintained by a government, and its impact on rates of return to investors
- non-inflationary macroeconomic policy, with lower money supply growth rates, and controlled government budget deficits
- stability of the macroeconomic environment – extending beyond the maintenance of stable inflation rates, to the foreign exchange rate environment, the consistency of the policy orientation maintained by governments, to the level of risk associated with the nature and stability of the political rights environment and the associated property rights structure maintained by government

Investment expenditure by definition raises questions of intertemporal optimization, since capital equipment is durable in character, and generates costs and returns over sometimes extensive time horizons. The implication is immediately that uncertainty, the nature of the policy environment and even more significantly its *credibility*, the impact and persistence of macroeconomic shocks come to be of primary importance in the determination of investment expenditure.

The implication of the preceding synoptic view is that the factors the discussion identified as being of importance to growth *directly* may also exercise an *indirect* effect on economic growth via their impact on the investment rate of the economy.

4.3 The Missed Opportunities

The preceding sections have identified a number of factors that appear to be potentially important determinants of the long run growth performance of countries. But it would be simplistic to suggest that the factors discussed above are the only ones that matter to the growth performance of countries. It is thus hardly surprising that the growth literature has been preoccupied with extending the analysis of growth to many factors beyond those discussed in section 4.2. Some of these include:

- the impact of the degree of development of financial markets of an economy
- the impact of technological change
- the impact of the rate of technological diffusion from the industrialized to the industrializing world
- the impact of demographic characteristics of countries, and their response to economic growth
- the impact of the nature of institutional factors, such as property rights, political rights, political stability, social capital, and the efficiency of social institutions on the growth path of the economy[34]
- the impact of microeconomic agency structures in households, firms and government on the growth path of the economy

[34] For an overview of the relevant literature see Fedderke (1997). For detailed statistical analysis see Fedderke and Klitgaard (1996,1997).

The list is readily extended. The issues that have occupied centre-stage in the South African growth debate determined our focus in section 4.2. What is surprising is not that the debate in South Africa is selective – but the nature of the selectivity.

The "new" or "endogenous" growth literature of the 1980's and 1990's has been concerned with an explicit modelling of the source of technological change and its impact on economic growth. The fundamental characteristic of endogenous growth models is that the technology of production comes to manifest increasing returns to scale[35] and economies grow without bound. Catch-up for poor economies thus becomes harder since all economies expand indefinitely instead of converging on a common conditional equilibrium growth path, leaving poorer economies perpetually lagging behind. While diverse approaches have emerged by now, an early and seminal contribution by Paul Romer (1986) models technological change as a positive externality of production, such that learning-by-doing has a knowledge spill-over effect (see also Lucas 1988). With this approach technology is viewed as a pure public good, such that the marginal return from innovation is not internalisable by the innovator. The consequence is that markets are likely to underinvest in capital, in the sense that the private marginal rate of return to investment is less than the social marginal rate of return to investment (since the investor does not obtain the benefit of the externality generated by knowledge spill-overs). The appropriate policy response is to subsidise physical capital to realise the full social returns.

While knowledge spill-over models generate the unbounded growth characteristic of new growth theory, the threat is that where knowledge has even limited private good characteristics the unbounded growth result on which the explanation of non-convergence rests also stands to be lost. Romer (1990) extends the analysis by allowing knowledge to have both private and public good characteristics, while again generating endogenous and unbounded growth[36]. The result is a more "realistic" depiction of the economy in a two-sector model, with an explicit knowledge-producing sector, which generates the technology of production employed in production. While having private good characteristics, knowledge is now a mixed good, and continues to have positive externalities. Again therefore private markets underinvest in capital, but now human capital rather than physical capital, and the appropriate policy response is a subsidy on human rather than physical capital[37]. The point has in fact been recognised in growth theory for some time:

> If innovations produce externalities, because they show the way to imitators, then education – by its stimulation of innovation – also yields externalities. Hence the way of viewing the role of education in economic growth….seems to indicate another possible source of a divergence between the private and social rate of return to education (Nelson and Phelps 1966:75)

It is these insights which have formed the springboard from which new work on growth has developed. The emphasis is on the role of knowledge, and of human capital in the growth process. In effect education, training, R&D are all placed in the forefront, and are identified as potential ***preconditions*** of high growth rates, though their importance lies in providing long run structural determinants of the growth path of the economy.

Yet the surprising feature of the growth debate in South Africa is that mention of the human capital dimension of growth is virtually entirely absent. Admittedly, GFA, GEAR and SEJC all mention the importance of education and training to sustainable growth. But in GEAR and GFA investment in human resources follows from the additional revenues the state collects once higher private sector investment expenditure has taken off. In effect, investment in human capital is seen as a *consequence* of higher growth, rather than as the precondition for higher growth emphasised by the new growth literature. Fiscal and monetary discipline in the intervening period constrain the state from using investment in human capital to move onto a higher growth path. Only SEJC identifies investment in human resources as a prime means of generating higher growth rates in the economy, but even then primarily as a means of defending the need for a more redistributive orientation of the fiscus, and to query the need for fiscal and monetary discipline as envisaged by GEAR.

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[35] A doubling (n-tupling) of inputs more than doubles (n-tuples) output.

[36] Further useful surveys and assessments are provided by Arrow (1994), Romer (1993, 1994), Dasgupta and Stiglitz (1988), Mankiw (1995), Solow (1994), Srinivasan and Raut (1992), Verspagen (1992).

[37] Such as a tax exemption on donations provided to educational institutions. However the Katz commission on tax reform gives little evidence of considering whether the educational system could be more actively supported by a restructured tax system.

Ironically, however, all parties to the debate stand to gain from a far more serious engagement of the question of how best to develop human capital in the economy. The empirical evidence that has emerged is now too numerous to review fully. Every empirical growth study now includes the human capital dimension as a starting point together with investment rates in physical capital – only in South Africa education seems to have slipped from the growth agenda, into a niche of its own seemingly unrelated to the long run health of the economy[38].

Nor does the empirical evidence leave much to the imagination. Measurement of human capital is not easy, since it is both the quantity and the quality of the human capital that counts. Standard education measures tend to be based on the number of people to have emerged from the educational system, without any means of establishing the quality of the education that they have received. But consider Figures 10 and 11. Figure 10 shows the plot of the primary school enrolment rate in 1960 against the subsequent average growth performance of countries, demonstrating the positive correlation confirmed by a significant correlation coefficient of 0.52 for the 114 countries in sample. Figure 11 plots the infant mortality rate in 1965 as a proxy for the health of the population, and hence the labour force, against the subsequent average growth rate for a sample of 113 countries. The negative association is again clear from the plot, and is confirmed by a significant correlation coefficient of –0.49. Prima facie evidence thus certainly supports the new growth theory in its assertion of a positive link between the quality and quantity of human capital and economic growth.

Of course, bivariate associations may be misleading. But the tenure of the findings above are extended to a wide range of empirical findings in the literature. For instance, Mankiw, Weil and Romer (1992) report that on the basis of their findings the elasticity of output with respect to human capital is of the same order as the responsiveness of output to increases in physical capital. More tellingly still, Hanushek and Kim (1995) in a recent study published as a working paper by the NBER, emphasise that it is not only the quantity, but also the quality of human capital which is crucial for the long run growth of an economy[39]:

> A single conclusion emerges from the various analytical specifications of how quality of the labour force affects growth: Quality has a consistent, stable, and strong influence on economic growth. Across a wide variety of specifications which include many of the measures employed in past work, the impact of quality indicates that one standard deviation in mathematics and science **skills translates into one percentage point in average annual real growth**. This growth effect is larger than would be obtained from over eight years in average schooling (Hanushek and Kim, 1995:34)

The impact is of staggering proportions – not as large as that attributed by Sachs and Warner (1995) to openness of the economy, but recall that the latter has on subsequent findings been scaled down somewhat. The quality, as well as the quantity of education matters to the long run growth of the economy.

The point also emerges clearly from more micro-based studies. On the basis of a detailed sectoral study of the US experience, Caballero and Jaffe (1993) conclude that technology is subject to constant "creative destruction" of the sort Schumpeter identified as being of the essence to economic progress under "capitalist" economic systems. More specifically, they estimate:

- That a firm that does not successfully invest in R&D (i.e. that does not invent) sees its value decline by on average 4% per annum[40]
- While ideas diffuse quite rapidly, the annual rate of depreciation of ideas (i.e. the rate at which knowledge or technology becomes obsolete) has been high in the twentieth century, and rising. While the rate of depreciation was estimated to be 3% at the beginning of the century, it was as high as 10-12% by 1990.

The implication is clear: survival for firms in an international environment requires innovation, and investment in the human capital at their disposal. The requirement is for investment in innovation and human capital, and under the rising rate of depreciation of technology in technology also.

A slightly different mode of analysis has placed a questioning of the implicit public good aspect of technology in the core theory of economic growth at the centre of its analysis. The argument is that

[38] The *Financial Mail* leader of 8/12/95 is symptomatic in its categorical separation of growth questions form questions related to education.

[39] They employ reported test scores in international mathematics and science tests for school children as the indicator of quality.

[40] Of course, the rate of depreciation varies strongly by sector – for the drug industry the rate of depreciation is as high as 25% when it is not innovative.

technology is not freely available to all countries, and that technological progress is thus likely to have a differentiated impact on alternative countries, depending on their inherent capacity to absorb any advances in technology. Particular emphasis has been placed on the necessary "capacities" societies must develop in order to use the most advanced technology (which are widely defined to embrace features such as human capital, appropriate financial, commercial and market institutions, amongst others), and the required features of the markets in which countries compete for the technological advances to be apposite (typically that the markets be large enough to be able to take full advantage of economies of scale)[41]. Again, the implication of such studies is that the development of the appropriate capacities, and amongst these particularly the human capital on which the society can draw, must be developed as fully as possible if a country is to stand an appreciable chance of being internationally competitive.

It is worth noting that the implication of such studies is that economies need to develop the capacity to absorb new technology. To be able to do so would require not only investment in primary and secondary education. Given the increasingly knowledge-intensive nature of technology, the requirement might well increasingly be that investment in tertiary education also be such as to expand the technology-absorbing capacity of the economy.

Given this evidence, a number of immediate consequences emerge for the debate on growth in South Africa:

- **The first is that human capital, and improvements in the quality of human capital deserve a much more central place in the debate than has hitherto been the case. Moreover, education and health should bee seen as more than long-run concerns, to be attended to once a range of other more pressing issues have been attended to. Rather, they may well be at least one *sine qua non* for South Africa to realize a transition to a higher growth path than it currently enjoys.**

- **The matter is pressing in South Africa. Not necessarily as a matter of greater expenditure on education and health (South Africa already spends a high proportion of its GDP on education), but perhaps as a matter of restructuring the expenditure in order to ensure that the education and health system offer better quality than they did under apartheid governments.**

- **On a number of fronts the evidence is not reassuring for South Africa. Consider Figure 12, showing the number of apprenticeship contracts registered in South Africa over time. Since the peak reached in the early 1970's, even in the presence of a growing population, the absolute number of apprenticeship contracts issued has been on a steady decline. Investment in at least this important form of human capital is simply not healthy. Consider also the non-white pupils to teacher ratio for South Africa, shown in Figure 13. While improving since the early 1970's, the ratio at close to 40:1 is still high. While some evidence shows that pupil-teacher ratios are of little importance to educational quality (see the discussion in Hanushek and Kim 1995), Deaton and Case[42] present compelling evidence that in South Africa the ratios in black schooling have been and continue to be such as to present substantial quality constraints for pupils in the system. At the very least, the issue requires urgent attention in order to both monitor and where necessary improve the quality of the investment in human capital in black (indeed all) schooling. The tertiary educational sector in South Africa is under increasing pressure. Consider the aggregate student-lecturer ratio for universities. Since the early 1980's the rise has been sharp and sustained, reflecting increasing pressure on the resources of the sector. That such increases are conducive to improvements in the quality of the human capital generated by the system is difficult to imagine.**

- **Worrying evidence on South Africa's standing in terms of its human capital is easy to multiply: South African businesses on average invest only 1% of their payroll in training; on a recent international comparison on the maths and science scores which underlay the Hanushek and Kim study, South Africa ranked last out of those countries surveyed; similarly in terms of the latest World Competitiveness Report, South Africa ranks 41'st out of 41 countries surveyed in**

[41] See the discussion in Abramovitz (1986, 1993), Ames and Rosenberg (1963), Fagerberg (1988, 1994), Nelson and Wright (1992), Olson (1988), though Grilliches (1994) strikes a sceptical note.
[42] Early results reported in the Research Seminar Series of the Department of Economics at the University of the Witwatersrand.

terms of human development; in a 1995 survey 34% of 1000 organisations surveyed were unable to find the skilled or managerial staff they sought. The list is long and readily extendable. It suggests that the issue is not only serious and pressing, but that it might deserve a much more central role in the discussion of an appropriate growth strategy for South Africa.

- **Given that on some estimates 50% of the population may be illiterate, and yet that the economy experiences a skills constraint at a 3% growth rate[43], the policy needs of South Africa are relatively unique. The need is not only for an expansion of basic literacy and primary education, though that need is enormously pressing. The need is for a simultaneous expansion of both basic primary and secondary education, as well as an expansion of the sorts of skills generated by the tertiary educational sector - while at all times bearing in mind the importance of the quality of the education that is offered.**

- **Given the centrality of investment in human capital to growth prospects, the lack of integration of economic and education policy is disappointing. A salient example is the lack of attention paid by the Katz commission to the possibility of special tax concessions to the educational sector, in line with those to be found in countries such as the USA. This suggests a lack of appreciation for the strong economic justification for policy encouragement of investment in the human capital producing sector of the economy.**

How the issues raised by the above points are to be usefully addressed in detail cannot be resolved at this juncture. They are vexing and difficult problems. Nevertheless for both extremes in the polarization that has emerged between proponents of "neo-liberalism" on the one hand and the proponents of the regulation of markets, emphasis on human capital should be of immediate and abiding interest. For the "neo-liberals", improved productivity of the workforce is of immediate importance to the competitiveness of South African companies in world markets. Moreover, given the high expenditure on education at present, the focus should initially be on the need for restructuring in the educational sector, not for greater expenditure, thus posing little or no threat to the need for fiscal and monetary discipline. Similarly, investment in the human capital of the currently disadvantaged sectors of society represents perhaps the single most effective means of bringing about sustainable and real redistribution of wealth in South Africa. To opponents of the "neo-liberal" strategy that is believed to be embodied in GEAR, greater emphasis on the lacuna in the current debate on growth in South Africa, might offer more realistic long hope than any immediate increase in state expenditure or inflationary expansion of the money supply.

5.0 The Aftermath of GEAR and a Prognosis for the Future

The success of the ANC government in adhering to the GEAR proposals has been touched on a number of times in the course of the discussion thus far. However, a brief synopsis of developments since the publication of GEAR is useful. Since GEAR was published in mid-1996, the number of subsequent relevant developments is not large. Nevertheless a picture of the patterns of likely future developments is beginning to emerge.

Important developments thus far have been:

1. On the promotion of investment expenditure:
    - Public sector investment expenditure has remained disappointing
    - Private sector investment expenditure has remained strong, and has shown an improving trend
    - Foreign investment expenditure has shown signs of strengthening.

    Developments have thus been mixed, with all forms of private sector investment appearing positive, while public sector investment performance still requires serious attention.
2. On the opening of the economy:
    - Trade liberalisation has been exemplary.
    - Liberalisation of exchange controls has been partial. Additional liberalisation is projected for 1998, and is to be welcomed. Additional transparency on the process of liberalisation would be desirable, however.

    Developments have thus been generally positive, though improvement in the speed with which exchange controls are to be lifted might be desirable.

[43] See the *Financial Mail* 8/12/1995.

3. Market liberalisation:
    - Developments in labour markets have been disappointing. The Labour Relations Act, and Conditions of Employment Act have increased rather than decreased labour market rigidity. Given the segmented nature of the South African labour market such rigidity is unlikely to have a positive impact on employment, and hence long run redistribution in the economy. On the positive side, the introduction of bargaining systems in the labour market has reduced uncertainty in dispute resolution.
    - On privatisation only the high-profile partial sale of Telkom has emerged. Further developments in terms of privatisation at present are subject to some degree of uncertainty, and the extent of the government's commitment to a programme of privatisation is subject to some doubt.

    In terms of market liberalisation developments in the aftermath of GEAR have been the most disappointing, and in the case of labour markets have been in directions contradictory to those outlined in the GEAR document.
4. Demand-side macroeconomic policy restraint:
    - Fiscal policy restraint has been somewhat mixed. While the projected budget deficit of the 1997/8 financial year continues to suggest increased government discipline in terms of expenditure, doubts as to whether the target will be met is legitimate. While the deficit is projected at 4% of GDP, market expectations range from 4.5 - 6% of GDP. In part this can be attributed to teething problems related to the control of expenditure at the level of provincial government. The Department of Finance is in the process of examining the provincial budgetary process and its control, suggesting that in future the problems may be less severe. Developments in terms of fiscal policy are thus cautiously optimistic, and the publication of the *Medium Term Expenditure Framework* in November 1997 reaffirmed the government's commitment to fiscal discipline. Coupled with the apparent containment of populist pressure during the 1997 ANC conference, this suggests that fiscal policy restraint will continue to remain a central feature of the government's macroeconomic strategy in the foreseeable future.
    - Monetary policy conduct has been the single most impressive feature of macroeconomic policy since 1994. Strong real interest rates have been successful in not only sharply containing inflationary pressure in the domestic economy, but monetary discipline has served to stabilise the Rand. Despite recent upheavals in financial markets due to developments in the Far East, the Rand has been insulated from instability to a far greater degree than the currency of other emerging markets.

    Demand side policy developments have thus been generally positive, and in line with the GEAR proposals. The *Medium Term Expenditure Framework* and continued emphasis on the reduction of inflationary pressures suggest that demand side policy restraint continues to be a central platform of the government's macroeconomic policy.
5. Investment in human capital:
    - Has not been integrated into the general growth strategy.
    - Certainly awareness of the importance of human capital to long run growth does not appear to be informing the debate on economic growth in South Africa.

    Developments have thus been poor in terms of growth objectives.

The evidence of developments after the publication of GEAR suggests that the components of the strategy the government is most committed to are demand side policy restraint, and the pursuit of increased openness of the economy. While some constituency pressure is likely to be placed on the ANC to relax particularly fiscal policy restraint, international financial markets place strong constraints on the government in satisfying such demands. However, constituency pressures cannot be ignored, and developments already begun in terms of labour market legislation are likely to be a continued feature of the South African macroeconomic environment for the foreseeable future. Given the constraints on the *level* of government expenditure, moreover, it is likely that low levels of public investment expenditure will continue in an attempt to satisfy demands for public consumption expenditure within tightly constrained budgets.

6.0 Conclusions

Almost inevitably with a major policy position adopted by a government, the picture that has emerged surrounding GEAR as a growth strategy is one of conflicting tensions within it, and of differing degrees of success in implementation.

The argument here presented has been that while GEAR can in broad terms be accepted as what is termed a "neo-liberal" growth strategy, there are countervailing tendencies, which emphasize government intervention in markets, and which does not fully embrace the need of liberalizing the labour market. The suggestion was that this tension was the result of the divergent favoured policy orientations of business and labour (as exemplified in *Growth for All and Social Equity and Job Creation*), and the government's desire to maintain investor confidence on the one hand, and satisfy a political constituency on the other.

We noted that the GEAR policy's objective of attaining an open economy, of efficient markets, and of a disciplined macroeconomic demand-side policy stance is supported by the empirical evidence that is available on the basis of current research on growth. A major weakness of the strategy has been the absence of any attempt to actively incorporate a strategy of investment in human capital as a central component of the attempt to improve South Africa's international competitiveness.

In terms of the success in the implementation of the elements of the GEAR strategy, success has been mixed:

- With respect to investment in human capital, given the lack of emphasis placed on this contributing factor to growth, developments are far from reassuring. It does not appear as if government has thought actively about the requirements of a reform of the education system. The activity of the Ministry of Education does not appear to be well coordinated even with the requirements of fiscal discipline actively pursued by GEAR[44], let alone that a clear program of the requirements of increasing both the quantity and quality of human capital has been identified.

- Improved openness of the economy does appear to have been actively pursued by government. Trade protection has decreased, and exchange controls have been relaxed. However, government should be encouraged to proceed with the liberalization of exchange control more proactively.

- While government has undertaken the high-profile partial privatization of Telkom, it is unclear how the privatization program is to proceed.

- The labour market gives further grave cause for concern. The Labour Relations Act implemented concurrently with GEAR, and the elements of the Basic Conditions of Employment Act which have thus far been tabled, do not in general support the impression that the government is seriously pursuing a liberalization of the labour market.

- The 1997/8 budget confirms the government's commitment to fiscal discipline, while monetary policy certainly continues to be strongly anti-inflationary. while there is some doubt concerning the degree to which civil service restructuring is proceeding in order to aid the objective of deficit reduction, in general the demand-side policy discipline emphasized by GEAR appears to be holding.

The evidence on the extent to which the central principles of GEAR are being adhered to is thus mixed. On macro-policy discipline the track record is good, on openness and market liberalization mixed to poor in the case of the labour market, and on investment in human capital the record is simply not present as part of a coordinated growth strategy. The fundamental tension between two interest groupings, business and labour, tugging the government toward two alternative policy directions thus continues to be present to date. If this pattern persists, the crucial question will be which bias will gain in strength as the 1999 election approaches: the temptation for the government, and a new President seeking endorsement will be powerfully in the direction of populism. Yet at present, the resistance of the ANC to already prevalent populist pressure is impressive, and despite the mixed track record noted above, policy developments have tended to favour the "neo-liberal" over the "labourist" tendency.

[44] Witness the provincial government budget deficits on education.

Perhaps the irony of the situation is that the polarization of the debate need not have been as dramatic as it is at present. If human capital had been placed at the core of all growth proposals, it could have united the interests of the various parties to the debate: labour because of the redistributive and improved wage earnings implications of improved human capital; business because of the unit cost implications of improved human capital. The polarization to the debate on growth represents a missed opportunity, which we should strive to recoup.

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