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A F R I C A N S T U D I E S I N S T I T U T E

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Title: An Evaluation of the IMF Mission Document on Economic Policies for a New South Africa.*

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1. Introduction:

In January 1992, an IMF occasional paper entitled "Economic Policies for a New South Africa " (IMF 1992) was issued. As stated in the Preface, the study was intended as a contribution to the debate regarding the appropriate economic policies to be pursued in a new South Africa. The authors of the study have drawn heavily on the work of the IMF 1991 Article IV Consultation Mission to South Africa, but insist that the opinions expressed in the paper are their own, rather than those of the South African authorities or of the IMF. Nevertheless, the central message is in total conformity with the broad economic philosophy of the Fund. The purpose of this paper is to criticize the policy emphasis and major conclusions of the IMF occasional paper and, by so doing, to add a new perspective to the dialogue concerning an economic policy agenda for South Africa's transition to democracy.

2. A Summary of the IMF Occasional Paper

The authors begin with an overview of the principal issues confronting a new South Africa. The focus of these are the redistributive and growth policies that will be needed, the budget options available to affect such policies and the opportunities for outward-looking policies that would result from the eventual elimination of trade and financial sanctions. While acknowledging the vast disparity in income distribution along racial lines, the authors classify the decade of the 1980's as one in which the reduction in economic growth resulted in an arresting of earlier trends toward a more equal distribution of income and, relatedly, in a sharp rise in formal sector unemployment to a level of over 40 per cent. The main conclusion, according to the authors, is that "poverty in South Africa is so severe that redistributive policies, which alone will not be adequate to counter it, must be supported by policies designed to place the economy on a higher growth path. Only then could the economy be expected to generate the resources necessary to satisfy the needs of the least privileged sectors of society on an sustained basis." (p.1)

In Chapter II, the study reproduces some of the estimates of the profile of poverty that suggest a reversal of previous trends towards a narrowing of gaps between racial incomes. Chapter III argues that improvements in the non-white share of total income could be attributed to a narrowing in the "wedge" between white and non-white wages for jobs in similar skill categories. Based on this finding, the study suggests that future improvements in income distribution be related to improved productivity and better training and employment opportunities, rather than to the further compression of the "wedge" between wages for different racial groups. In Chapter IV, which deals with a medium-term economic scenario, the study argues that in order to attain the requisite increases in the economic growth rate to reduce the level of unemployment, increased investment would need to be supported by a major savings effort (particularly in public savings). A related and controversial policy proposal is that real wage growth must be contained, if employment growth is to rise sufficiently to begin alleviating the existing severe unemployment problem (p. 13). The budgetary policy conclusions are that efforts at redressing social backlogs will require a reorientation of spending priorities, and should not be funded through deficit financing.

Chapters V and VI, in turn, deal with trends in budgetary expenditure and taxation. The broad conclusion of the authors is that, with regard to expenditures, attempts at racial equalisation will have to be extremely limited, while increasing the "already high" tax burden for the white community would result in disincentives and should be avoided.

Chapter VII deals with external policy issues and examines the scope for shifts towards more liberal trade and payment policies as international sanctions are lifted.

This paper will examine several of the more contentious arguments embodied in the IMF paper. The discussion will focus on the internal economy, in particular on the IMF's recommendations regarding:

a) the levels of taxation
b) public and private sector Savings and Investment
and
c) the level of real wages.

3. Tax Rates:

Using various comparative measures both nationally (by source and race) and internationally (in terms of tax ratios to G.D.P.) the IMF argues that present tax rates in South Africa are relatively high (p. 26). In typical supply-side, neo-classical tradition, the authors of the study conclude that an increase in either personal, company or even certain indirect taxes would impose substantial costs on the society through the diminution of effort or motivation for earning income. However attempts at comparing tax rates across countries are widely acknowledged to be fraught with

difficulties. Measures which assess the tax burden by looking at either the source of such taxation (by companies and individuals) or at the ratio of tax revenue to GDP, tend either to overstate or understate the real burden imposed by either direct or indirect taxes. For these reasons, Tait et al (1979) argue that the notion of taxable capacity replace the tax ratio-given the limitations of the latter concept. Tanzi (1989) shows how the notion of the taxation level in various countries changes dramatically over short periods in response to macroeconomic policies - particularly, exchange rate, import substitution, trade liberalisation, inflation and financial policies.

The crudeness of the concept of comparative tax ratios is particularly pertinent in a South African context. Given a country in which recorded unemployment is extremely high and the majority of the working population earn incomes which fall below the minimum taxable level, the contribution of company tax will obviously appear relatively high.

Secondly, while tax rates may appear to be burdensome for individuals or corporations at the upper end of the income spectrum, such estimates do not take into account the large number of direct nor indirect subsidies to the business sector, which should be deducted from tax contributions. Nor do these estimates take into account the extent of tax evasion, tax avoidance or undeclared profits which completely escape the net of taxation.

A related argument can be applied to indirect taxes. Unless both supply and demand are inelastic with respect to price, excess "burdens" of taxation affect not only production but demand or consumption choices as well. A generally-levied indirect tax (such as the General Sales Tax or Value Added Tax) because of its price-escalating effect could reduce consumption of certain commodities and hence reduce the amount of revenue collected - thus misleadingly suggesting that, on a comparative basis, the proportion raised by indirect means is low, in relation to other countries. In a country where income levels for the vast majority of the population are verging on the subsistence level, such considerations are highly relevant. The uproar following the introduction of an equal VAT level on all commodities in South Africa, towards the end of 1991 was not just a political ploy. It reflected concerns about the effects of increased prices on the consumption patterns of lower income groups.

Despite the IMF's unwarranted conclusion that taxation burden is high, there is considerable scope in South Africa for raising tax revenues. Firstly, as far as direct taxes are concerned, methods of combatting tax evasion/avoidance can be introduced and strengthened. The introduction of a capital gains tax (particularly on highly speculative stock exchange activities), increased inheritance taxes and a tax on houses exceeding a specified size or exchange value, could easily be implemented. With regard to indirect taxes,

a graduated VAT system, allowing zero rating for certain basic wage goods and much higher rating for certain non essentials and luxury consumer durables, could also be introduced. A more imaginative tax system could raise tax revenue considerably, without adversely affecting effort, or unduly disturbing the balance between direct and indirect taxes, or corporate and individual contributions.

In conclusion, as far as this discussion is concerned, the alleged constraints on increasing tax revenue, as well as the limited possibility of redistributive expenditures are based on a rather static perception of the state of the economy. The authors fail to take into account the prospects of enhanced economic growth contributing substantially to increased revenue over a longer time period.

4. Personal Saving

While the link between Savings and Investment represents the core of neo-classical growth theory, their interaction within developing countries and, in particular, a country such as South Africa, in the process of dramatic reconstruction, is a lot more complex than this theory suggests. Levels of domestic savings have been unacceptably

low during the 1980's. Certainly as far as public savings are concerned, a reallocation of existing budgetary expenditures by the State could generate substantial increases in savings which could be utilized for more productive purposes than at present. As far as a "crowding-out" effect is concerned, it cannot be assumed that there is competition for such saving between public and private sectors. A contraction in public sector expenditures is not necessarily a condition for encouraging more saving by the private sector. In fact, valid arguments exist indicating that the reverse effect may predominate. Frequently, a complementary relationship can be found whereby public investment can promote increased private investment-by direct subcontracting and/or securing an enabling demand environment that is secure and stable. The mere creation of financial savings in the private sector does not necessarily guarantee that they will be converted into real productive investment.

While a moderately positive real and stable interest rate frequently represents a precondition for increased generation of personal savings, experience in South Africa as well as other developing countries has shown that this is not necessarily the most effective instrument to encourage increases in the levels of Saving and Investment. In South Africa, for example, there have been periods in the 'seventies and early 'eighties when real interest rates were

negative and personal savings were high. In contrast, after the De Kock Commission proposals were introduced and interest rates became unfrozen, real interest rates reached historically high levels, while savings levels dropped substantially.

In analysing the above, one has to take into account a unique structural factor imposed on South Africa in the form of the 1985 debt standstill and its subsequent effect on savings and investment trends. The austerity measures induced as a result of the debt standstill brought into play a set of factors that call into question some of the predictions and policy prescriptions of conventional macroeconomic theory. Efforts by the monetary and fiscal authorities to introduce austerity and increase the general level of domestic savings backfired. A parallel decline in output and per capita consumption, with a consequent adverse impact on living conditions - led to a DECLINE IN THE COEFFICIENT OF SAVING. The policy measures required in such circumstances involve moderating consumption so as to ensure an increase in production that would push saving to higher levels, instead of having negative growth rates in both output and consumption - a situation that drastically reduces savings and penalizes investment. In analysing the reaction of Latin American countries to the debt crises of the 1980's, Eyzaguire (1989) poses this dilemma in an interesting way.

"In the search for an expansionary policy for promoting savings, it is essential to introduce the distinction between ex ante saving and ex post saving. If we try to moderate consumption in order to absorb, without detriment to investment, the turnaround in the transfer of resources, the result will be an expansion of ex ante saving. However, if the adjustment effort leads to a decline in investment, ex post saving may remain unchanged-in other words, the austerity will be useless. On the other hand, if the initial moderation of consumption is accompanied by a stable level of investment, ex post saving will rise." (p.32, 33)

Clearly, what has happened in South Africa is a typical Keynesian scenario. A scarcity of investment has produced a recessionary adjustment, and the potential excess of saving has disappeared as real incomes have fallen. This above scenario could be classified as a "paradox of austerity" rather than a "paradox of thrift." The crisis provoked by a decline in saving seems to have resulted in a situation normally typical of an excess of saving. An obvious solution to this impasse would be a substantial increase in State productive investment expenditure. Such State involvement could be complementary to private sector investment and would serve as a vehicle for channeling unproductive private savings. To summarise, increases in saving in both the state and private sector cannot be expected to arise through a non-interventionist policy stance. Urgent State-induced direction is a necessity in present circumstances.

3. Real Wage Growth.

Perhaps the most contentious policy conclusion in the IMF document - that real wage growth should be "contained" - follows from an entirely orthodox approach to the issue of labour markets and wages which argues that such markets be treated like any other market.

Empirical grounds apart, there is a theoretically plausible counterargument to the effect that rising real wages could constitute an integral part of a growth process in South Africa. The notion that real wages "have grown too rapidly" in South Africa during recent times is certainly not borne out empirically. In another paper, this author has shown, for example, that in the manufacturing sector, real wages have shown hardly any tendency to increase. throughout the 'eighties (Zarenda 1992.)

The ILO has argued that such real wage increases as did occur , were a result of union pressure as well as a reduction in racial wage differentials from 90% to 14%. If the latter argument is correct, the mere fact that a racial wage differential still persists, particularly at the skilled labour level, begs the question as to why there have not been increases in employment of blacks, if their wage rates are still lower for similar categories of work.

Clearly, the level and rate of growth of employment in South Africa, as elsewhere, are influenced by factors other than the level of real wages.

Furthermore, by treating labour in a similar way to any other commodity, certain 'social' concerns regarding labour are disregarded. Standing (1992) lists these as

a) the need to protect those in low-paid, low productivity jobs from poverty,
b) the need to protect vulnerable groups from wage discrimination,
c) the desirability of reducing wage differentials and
d) the need to ensure productivity-enhancing stability and predictability of earnings.

The conventional rationale underlying the IMF argument is that a minimum wage structure and rising real wages cause unemployment and sluggish labour mobility, partly by pricing goods produced by low productivity workers out of the domestic market and, furthermore, rendering exports less competitive in international markets. This logic is fallacious. It neglects the fact that wages rates have other functions than merely indicating the 'competitive' price for labour. Low wages, in fact, encourage low productivity and if ever there was empirical validity to this, South Africa has provided it during much of the post-World War II period. In addition, one can argue that

minimum wages can pressurise firms to find ways of raising productivity, whether by technological change or through the provision of training and acquisition of skills which would go some way to ensuring that the labour supply would become more stable (Standing p. 24). Additional substantive arguments are provided by Sengenberger (1992). He argues that if a firm is allowed or encouraged to compete through lower wages and other means of reducing labour costs, that firm is not only discouraged from investing in human resource development, but, in addition, the incentives to seek more dynamic paths to competitiveness - such as process innovation, product innovation or diversification - are also removed. Equally importantly, 'wages' have a role in securing optimum effort from workers in those enterprises and jobs requiring a lot of commitment and stability. Furthermore, neo-classical theory's prediction that lower wages lead to more employment because of the downward - sloping demand for labour is unconvincing not only in South Africa, but for other African countries as well (Vandemoortele 1992). Despite dramatic falls in real wages there are no signs of renewed employment growth over the past 20 years throughout much of the continent. On the contrary, recorded levels of employment are stagnating. In many countries (South Africa included) the crude neoclassical argument that real wages and employment are directly and inversely related has certainly been rejected by events of the last decade. Evidence further suggests that the reverse causality has applied in countries on the

Asian continent, where both real wages and the numbers employed have continued to increase over long periods of time. The evidence suggests that the Keynesian conclusion, that the level of employment is determined by aggregate demand, rather than by wage rates, is more applicable. It may therefore be concluded that minimum wages which permit a decent living standard and rising real wage growth can influence the level of demand substantially and indirectly exert a positive influence on the supply side as well. This latter influence could arise as a result of the work force having improved access to a whole variety of wage goods - food, health, housing etc. - all of which would improve the quality of the labour force. Such positive effects of the increase of wages as a share of national income, should be investigated in a comprehensive study of the ramifications of implementing a minimum national wage, as well as rising real wages as part of an income-redistributive policy package. There certainly may be perturbing negative side effects in implementing such a policy. Issues that must be addressed should include:

a) what the basis of such a minimum wage determination should be?
b) whether cost-raising effects and increased unemployment could nullify the intention of improving income distribution?
c) what the impact of such a policy may have on the balance of payments?

and

d) what the financial implications are of implementing such a strategy in those countries having a large public service?

But there may be several persuasive counterarguments to justify the introduction of a minimum wage, given the current economic climate in South Africa. Reference has already been made above to the possibility that the introduction of a minimum and rising real wage policy could substantially boost the effective demand for goods and services and possibly alleviate unemployment, rather than simply transferring purchasing power from one section of the population to another. As regards the supply side, apart from a possible increase in productivity of workers as a result of improved access to food, housing and health, higher wages could induce management to increase the efficiency of the labour force through increased training, supervision and willingness, on the part of the labour force, to work. While there exists the theoretical danger of substitution of capital for labour in the event of wage escalation, as long as such substitution remains imperfect and the scope for such substitution is confined to the long run, larger capital and managerial inputs could have the effect of enhancing labour productivity and increasing output growth. To assign the entire blame for poor productivity in South Africa to the labour force is erroneous. The managers and owners of enterprises should bear their share of responsibility. It may be that in relation to labour, management is overpaid and that harder and more productive work on the part of management could represent part of the solution.

The above suggestions are merely tentative and indicative of the complexity of the present situation in South Africa. Hopefully, these will arouse debate and a more level-headed approach to the solution of economic problems in South Africa. "Quick- fix" mechanistic solutions as advocated by the IMF occasional paper do not make a serious contribution to the debate. The rigid adherence to deterministic, neo-classical behavioural assumptions concerning such variables as Taxation, State Expenditure, Savings, Investment and Wages, which characterizes much of the orthodoxy of the major international institutions, needs to be challenged in societies undergoing dynamic transition.

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