GROWTH, EMPLOYMENT AND REDISTRIBUTION
A MACROECONOMIC STRATEGY

Table of Contents

Published by the Department of Finance, Republic of South Africa, Private Bag X115, Pretoria 0001, fax number (012) 323 3262.

Acknowledgements

The Minister of Finance, Trevor Manuel, the Deputy Finance Minister, Gill Marcus and the Acting Director General, Maria Ramos, wish to acknowledge the contribution of the technical team comprising the following individuals:

Andre Roux, coordinator (Development Bank of Southern Africa)
Iraj Abedian, coordinator (University of Cape Town)
Andrew Donaldson (Department of Finance)
Brian Khan (University of Cape Town)
Ben Smit (University of Stellendbosch)
Daleen Smal (South African Reserve Bank)
Alan Hirsch (Department of Trade and Industry)
Guy Mhone (Department of Labour)
Ernie van der Merwe (South African Reserve Bank)
Ian Goldin (Development Bank of Southern Africa)
Stephen Gelb (University of Durban-Westville)
Dirk van Seventer (Development Bank of Southern Africa)
Servaas van der Berg (University of Stellendbosch)
Luiz Pereira da Silva (World Bank)
Richard Ketley (World Bank)

1. INTRODUCTION

1.1 A Long-run vision

As South Africa moves toward the next century, we seek:

- a competitive fast-growing economy which creates sufficient jobs for all workseekers;
- a redistribution of income and opportunities in favour of the poor;
- a society in which sound health, education and other services are available to all; and
- an environment in which homes are secure and places of work are productive.

A strategy for rebuilding and restructuring the economy is set out in this document, in keeping with the goals set in the Reconstruction and Development Programme. In the context of this integrated economic strategy, we can successfully confront the related challenges of meeting basic needs, developing human resources, increasing participation in the democratic institutions of civil society and implementing the RDP in all its facets.

1.2 Recent Economic Developments

Against the background of a successful democratic transition, the stagnation that characterised the 1980s has come to an end. Considerable progress has since been made in:

- securing a return to a long-term growth trend in excess of population growth;
- reducing the budget deficit, reforming the tax system and reprioritising public expenditure;
- bringing down inflation and easing the balance of payments constraint;
- opening the economy to international competition and securing access to new markets;
- integrating the civil service and transforming public sector institutions; and
- establishing policy frameworks for delivery of social services.

Notwithstanding these achievements, it has become increasingly evident that job creation, which is a primary source of income redistribution, remains inadequate. It is widely recognised that the present growth trajectory of about 3 percent per annum:

- fails to reverse the unemployment crisis in the labour market;
- provides inadequate resources for the necessary expansion in social service delivery; and
- yields insufficient progress toward an equitable distribution of income and wealth.

Recent exchange rate developments reinforce these conclusions. In February 1996 a depreciation, which was largely a purchasing power parity correction, occurred. However, the subsequent movements in the foreign exchange market reflected more fundamental economic uncertainties. The depreciation presents both an opportunity and a threat. An uncoordinated response, embroiled in conflict, will cause further crisis and contraction. Linked to an integrated economic strategy, on the other hand, it provides a springboard for enhanced economic activity.

1.3 Points of Departure

Sustained growth on a higher plane requires a transformation towards a competitive outward-oriented economy.

The strategy developed below attains a growth rate of 6 percent per annum and job creation of 400 000 per annum by the year 2000, concentrating capacity building on meeting the demands of international competitiveness. Several inter-related developments are called for:

- accelerated growth of non-gold exports;
- a brisk expansion in private sector capital formation;
- an acceleration in public sector investment;
- an improvement in the employment intensity of investment and output growth; and
- an increase in infrastructural development and service delivery making intensive use of labour-based techniques.

The expansion envisaged in the above aggregates is substantial and entails a major transformation in the environment and behaviour of both the private and the public sectors. This must include:

- a competitive platform for a powerful expansion by the tradable goods sector;
- a stable environment for confidence and a profitable surge in private investment;
- a restructured public sector to increase the efficiency of both capital expenditure and service delivery;
- new sectoral and regional emphases in industrial and infrastructural development;
- greater labour market flexibility; and
- enhanced human resource development.

Accompanying the macroeconomic strategy set out below, several appendices provide details and explanatory memoranda. Other coordinated policy programmes, such as the recently announced National Crime Prevention Strategy, complement this framework. Taken together, the Government's approach to development and growth builds a bridge between the present constrained environment and sustainable expansion within an increasingly competitive international context.

1.4 An Integrated Strategy

The core elements of the integrated strategy are:

- a renewed focus on budget reform to strengthen the redistributive thrust of expenditure;
- a faster fiscal deficit reduction programme to contain debt service obligations, counter inflation and free resources for investment;
- an exchange rate policy to keep the real effective rate stable at a competitive level;
- consistent monetary policy to prevent a resurgence of inflation;
- a further step in the gradual relaxation of exchange controls;
- a reduction in tariffs to contain input prices and facilitate industrial restructuring, compensating partially for the exchange rate depreciation;
- tax incentives to stimulate new investment in competitive and labour absorbing projects;
- speeding up the restructuring of state assets to optimise investment resources;
- an expansionary infrastructure programme to address service deficiencies and backlogs;
- an appropriately structured flexibility within the collective bargaining system;
- a strengthened levy system to fund training on a scale commensurate with needs;
- an expansion of trade and investment flows in Southern Africa; and
- a commitment to the implementation of stable and coordinated policies.

It is Government's conviction that we have to mobilise all our energy in a new burst of economic activity. This will need to break current constraints and catapult the economy to the higher levels of growth, development and employment needed to provide a better life for all South Africans. We are confident that our social partners will join us in the combined efforts needed to achieve this goal.

2. CRITICAL CONSIDERATIONS: A FRAMEWORK FOR GROWTH

2.1 Present economic trends

The trends established over the past two years suggest that the economy is on track for continued, if somewhat slower, growth in exports and investment. Policies are in place to bring the fiscal deficit down steadily and to keep inflation in check. Under these circumstances, detailed simulations, based on diverse econometric models, reach a common conclusion: growth of at best 3 percent per annum can be expected on average over the next few years. Although this represents a considerable improvement on past performance, it is not a development path which meets the goals South Africans have set for themselves.

Firstly, in the context of 3 percent growth, and without significant improvements in labour absorption coefficients, it is doubtful whether annual job creation much in excess of 100 000 would be possible over the next five years. The unemployment rate would then rise by some 5 percent to about 37 percent in 2000. This estimate takes into account about 20 000 additional jobs created per annum in response to various employment-intensive public expenditure programmes such as land reform, low-cost housing, community water and municipal infrastructure.

Secondly, the scope for increased public spending on social services would be severely limited. Medium term fiscal projections incorporating a 3 percent growth scenario, a gradual deficit reduction, the recent public sector wage settlement, and severe cuts (15 percent) in real spending in several government functions, indicate that there would be sufficient resources to increase real aggregate spending on social and community services by at most 3 percent per annum, which is barely above the population growth rate. The additional funding available would not cover 15 percent of current medium term departmental expansion plans.

Thirdly, the balance of payments remains a structural barrier to accelerated growth. The economy is dependent on imported capital and intermediate goods and, as in the past, the cyclical upswing brings a deterioration in the current account. Whereas this constraint has been eased through capital inflows since the elections in 1994, the lack of sustained long term capital inflows has made the balance of payments and the economy too reliant on short term reversible flows and consequently high interest rates.

The recent exchange rate instability presents a further complication. There is a danger of a further capital outflow and a balance of payments crisis. In this scenario growth would be abruptly curtailed and structural adjustment under terms set by international agencies would be unavoidable. Leaving aside this risk, growth forecasts have already been revised downwards by most professional analysts. It is recognised that the burden of the adjustment in the short term will fall on monetary policy and that an economic contraction to reduce import demand is likely.

What options are open to government? An expansionary fiscal strategy could be considered. However, even under the most favourable circumstances, this would only give a short term boost to growth since it would reproduce the historical pattern of cyclical growth and decline. Increased growth above 3 percent would be choked off by a rising current account deficit, upward pressure on real wages and curtailment of investment plans. Higher fiscal deficits would also lead to higher inflation and higher interest rates, exacerbating the burden of interest payments on the fiscus. More importantly, in the present climate of instability a fiscal expansion would precipitate a balance of payments crisis. Without attention to more deep-rooted reforms, there is no possibility of sustainable accelerated growth.

Base Scenario Projections: 1996-2000						
Model characteristics	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
Fiscal deficit (% of GDP) (fiscal year)	5,1	4,5	4,0	3,5	3,0	4,0
Real government consumption (% of GDP)	19,8	19,5	19,1	18,6	18,1	19,0
Average tariff (% of imports)	10,0	9,0	9,0	8,0	8,0	8,8
Average real wage growth, private sector	0,8	1,5	1,7	1,3	1,4	1,4
Average real wage growth, government sector	4,8	0,4	0,4	0,3	0,0	1,2
Real effective exchange rate (% change)	-9,6	0,7	0,1	0,1	0,0	-1,8
Real bank rate	7,0	6,0	5,0	4,5	3,7	5,2
Real government investment growth	2,6	2,4	2,2	2,2	2,4	2,4
Real parastatal investment growth	3,0	2,5	2,5	2,5	3,0	2,7
Real private investment growth	6,3	4,2	4,4	5,8	7,1	5,6
Real non-gold export growth	9,6	7,5	6,4	5,5	5,3	6,9
Results	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
GDP growth	3,3	2,0	2,5	2,9	3,3	2,8
Inflation (CPI)	8,4	10,9	9,6	9,3	9,1	9,5
Employment growth (non-agricultural formal)	0,9	1,0	0,8	0,9	1,3	1,0
New jobs per year ('000s)	97	101	84	103	134	104
Current account deficit (% of GDP)	1,8	1,3	1,1	1,1	1,6	1,4
Real export growth, manufacturing	12,5	10,4	7,5	6,6	5,4	8,5
Gross private savings (% of GDP)	20,5	20,7	20,8	20,8	20,6	20,7
Government dissavings (% of GDP)	3,1	2,6	2,0	1,4	0,9	2,0

2.2 Elements of a Medium Term Strategy

An integrated medium term strategy is presented below which provides a broad bridge between the present constrained economic environment and an improved growth and employment performance in the period up to 2000, while strengthening the competitive capacity of the economy in the long term. The core elements of this integrated package are:

- an acceleration of the fiscal reform process, including a tighter short term fiscal stance to counter inflation, an appropriate medium-term deficit target to eliminate government dissaving, further revision of the tax structure, and a range of budgetary restructuring initiatives to sharpen the redistributive thrust of expenditure and contain costs;
- a further step in the gradual relaxation of exchange controls, the maintenance of monetary policies consistent with continued inflation reduction and exchange rate management to stabilise the real effective exchange rate at a competitive level;
- a consolidation of trade and industrial policy reforms, incorporating a further lowering of tariffs to compensate for the real depreciation, the introduction of tax incentives for a fixed period to stimulate investment, a campaign to boost small and medium firm development, a strengthening of competition policy and the development of industrial cluster support programmes, amongst other initiatives;
- the implementation of the public sector asset restructuring programme, including guidelines for the governance, regulation and financing of public corporations, and leading off with the sale of

non-strategic assets and the creation of public-private partnerships in transport and telecommunications;

- an expansionary public infrastructure investment programme to provide for more adequate and efficient economic infrastructure services in support of industrial and regional development and to address major backlogs in the provision of municipal and rural services;
- a structured flexibility within the collective bargaining system to support a competitive and more labour-intensive growth path, including greater sensitivity in wage determination to varying capital intensity, skills, regional circumstances and firm size; reduced minimum wage schedules for young trainees, reducing indirect wage costs; and increasing the incentives for more shifts, job sharing and greater employment flexibility; and
- a social agreement to facilitate wage and price moderation, underpin accelerated investment and employment and enhance public service delivery.

The measures outlined above are mutually supportive and constitute an integrated strategy to enhance economic growth and employment creation. It is Government's conviction that they will establish a stable and competitive environment for significantly improved export and investment growth.

2.3 Accelerated Growth

The recent depreciation of the rand represents one element in the improved competitiveness which the economy must achieve for higher growth to be sustained. Although higher import prices will impact negatively on importing firms in the short term, the advantages of a lower rand for producers of traded goods for both export and domestic markets represent a crucial window of opportunity over the next few years. It is Government's intention to utilise this opportunity to the fullest. This requires several further adjustments to avoid erosion of the improved trading outlook by macroeconomic imbalances.

In brief, government consumption expenditure should be cut back, private and public sector wage increases kept in check, tariff reform accelerated to compensate for the depreciation and domestic savings performance improved. These measures will counteract the inflationary impact of the exchange rate adjustment, permit fiscal deficit targets to be reached, establish a climate for continued investor confidence and facilitate the financing of both private sector investment and accelerated development expenditure.

Drawing on several models of the South African economy, the effects of an integrated economic reform strategy on growth and employment prospects have been tested. Results, bearing in mind the inevitable uncertainties of economic projections, are as follows.

The package will establish a stable platform for a powerful expansionary thrust, with non-gold export growth rising to 10 percent per annum over the period. Against the background of this expansion and supported by the proposed investment incentives, as well as the integrity of the package as a whole, private sector investment can be expected to continue its strong upward momentum, averaging some 12 percent growth between 1995 and 2000. Accelerating public sector investment growth, driven by public corporations and local authorities, programmed to reach growth rates of up to 10 percent per annum by 1998, will complement the demand stimulus of stronger non-gold exports and private investment performance. In the aggregate, these developments are expected to provide sufficient impetus for GDP growth to climb to the targeted 6 percent by the year 2000.

The danger of an increase in the rate of inflation, reinforced by a wage-price spiral, is a constant threat to the expansion anticipated by the strategy. To contain inflationary pressures requires concerted implementation of complementary stabilisation measures: accelerated tariff liberalisation, sharper deficit reduction, tight monetary policy, and above all, productivity linked wage increases. Taken together, these measures would hold the inflation rate below the 10 percent barrier throughout the period, and preserve the competitive advantage of the depreciation.

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

Employment projections are sensitive to assumptions regarding real wage growth, easier access to formal job opportunities and accelerated programmes of small business and small farmer support. A favourable employment response to accelerating growth, reinforced by effective public sector programmes, would see job creation rise to 400 000 per annum by the year 2000. The unemployment rate would then begin to show a visible decline.

There are, in sum, several inter-related aspects of the growth strategy. Departing from the past depreciation of the exchange rate which provides a competitive advantage to exporters, the expected economic expansion will be strengthened if the real value of the currency remains at a stable level. Inflation will not erode competitiveness for the following reasons:

- deficit reduction releases the pressure of the fiscus on the capital market; it also facilitates the accelerated flow of domestic resources into industrial investment and contributes to the overall financial stability of the economy; and
- accelerated tariff reduction compensates for the depreciation and provides an additional buffer against inflation; it also holds imported input prices down and preserves the momentum of restructuring at the firm level.

In addition to maintaining financial stability, job creation is enhanced:

- supply-side industrial measures which replace the general export incentive scheme contribute to industrial competitiveness, investment and job creation;
- public investment to upgrade sustainable economic and municipal infrastructure crowds in private investment and boosts short-term economic performance, while laying the infrastructural foundations for long-term productivity growth;
- wage moderation increases labour demand while lowering inflationary pressures; and
- greater flexibility in the labour market regulatory framework facilitates employment creation while extending basic rights to a broader pool of the work force.

Responsible monetary policies anchor the competitiveness and stability of the economy in regard to both the domestic value of the rand and its foreign purchasing power and encourage domestic saving and investment. Finally, the fiscal containment in the package reduces the burden placed on monetary policy.

The policy package is also consistent with long-run sustainable growth on a higher plane:

- tax reforms are aimed at international competitiveness and minimising the distorting effects of taxation on economic behaviour, while preserving the fundamental progressiveness of the overall tax structure;

- trade and industrial policies aim to promote an outward-oriented industrial economy, integrated into the regional and global environment and fully responsive to market trends and opportunities;
- public sector reforms, comprising asset restructuring, budgetary reprioritisation and improved service delivery, underpin social and infrastructural development in both urban and rural areas and contribute to the redistribution of opportunities and income; and
- employment and training policies enhance the growth potential of industry, extend job opportunities to the unemployed and contribute over time to the redistribution of income.

While recognising that policy-making must remain sensitive to changing circumstances, there is an urgent need to establish firm foundations for this approach to growth and employment creation in the South African economy. The Government’s proposals for such a framework are set out in more detail below.

Integrated Scenario Projections: 1996-2000

Model characteristics	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
Fiscal deficit (% of GDP) (fiscal year)	5,1	4,0	3,5	3,0	3,0	3,7
Real government consumption (% of GDP)	19,9	19,5	19,0	18,5	18,1	19,0
Average tariff (% of imports)	10,0	8,0	7,0	7,0	6,0	7,6
Average real wage growth, private sector	-0,5	1,0	1,0	1,0	1,0	0,8
Average real wage growth, government sector	4,4	0,7	0,4	0,8	0,4	1,3
Real effective exchange rate (% change)	-8,5	-0,3	0,0	0,0	0,0	-1,8
Real bank rate	7,0	5,0	4,0	3,0	3,0	4,4
Real government investment growth	3,4	2,7	5,4	7,5	16,7	7,1
Real parastatal investment growth	3,0	5,0	10,0	10,0	10,0	7,6
Real private sector investment growth	9,3	9,1	9,3	13,9	17,0	11,7
Real non-gold export growth	9,1	8,0	7,0	7,8	10,2	8,4
Additional foreign direct investment (US$ m)	155	365	504	716	804	509
Results	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
GDP growth	3,5	2,9	3,8	4,9	6,1	4,2
Inflation (CPI)	8,0	9,7	8,1	7,7	7,6	8,2
Employment growth (non-agricultural formal)	1,3	3,0	2,7	3,5	4,3	2,9
New jobs per year (‘000s)	126	252	246	320	409	270
Current account deficit (% of GDP)	2,2	2,0	2,2	2,5	3,1	2,4
Real export growth, manufacturing	10,3	12,2	8,3	10,5	12,8	10,8
Gross private savings (% of GDP)	20,5	21,0	21,2	21,5	21,9	21,2
Government dissavings (% of GDP)	3,1	2,3	1,7	0,7	0,6	1,9

3. FISCAL POLICY

3.1 Recent fiscal trends

In response to the unsustainable fiscal situation that had developed by 1992/93, when the overall deficit reached 7,9 percent of GDP, fiscal policy has been informed by the following goals:

- to cut the overall budget deficit and the level of government dissaving;

- to avoid permanent increases in the overall tax burden;
- to reduce consumption expenditure by general government relative to GDP; and
- to strengthen the general government contribution to gross domestic fixed investment.

Although government dissaving has not yet been eliminated, progress has been made in this respect. The cash-flow adjusted exchequer deficit was reduced to an estimated 5,4 percent in 1995/96. Consolidated general government tax revenue has increased from 25,6 percent to 26,8 percent of GDP between 1992/93 and 1994/95, but still somewhat below the 1989/90 level of 27,1 percent. At the same time, significant shifts in the allocation of expenditure have been effected in accordance with reconstruction and development priorities.

3.2 A tighter fiscal stance

To remove the domestic savings constraint and benefit from the expansionary impact of the stronger investment and export performance which is envisaged in this strategy, a tighter fiscal policy is necessary. In this way, inflationary pressures will be kept in check and domestic resources will be released for financing capital formation. A lowering of the fiscal deficit target from 4,5 percent of GDP to 4,0 percent in the 1997/98 fiscal year is therefore proposed. Two further reductions of 0,5 percent of GDP in each of the subsequent years would bring the deficit to a satisfactory long term target of 3,0 percent of GDP in fiscal 1999/00. This, together with the envisaged strengthening of government investment spending, would eliminate government dissaving, currently at 2,5 percent of GDP.

In order to achieve the new fiscal targets in the 1997/98 budget, the Minister of Finance has initiated a thorough audit of government expenditure, including RDP allocations, to identify those areas in which budgetary cuts can be made without detracting from the priorities and commitments of the Government.

3.3 Public service restructuring

The process of administrative restructuring of the public service provided for in the Constitution gathered pace in 1995. With the first phase of the process involving the integration of the public service at national and provincial levels nearing completion, attention is shifting to the longer-term issue of creating a more cost-effective service.

A major step was taken in early 1996 with the devolution to line departments of all career related personnel functions. The restructured Public Service Commission will retain a research and monitoring role, while the Department of Public Service and Administration will be responsible for broad human resource policy, conditions of service and labour relations.

Careful management of the overall government wage bill is central to the fiscal strategy. In implementing the three-year public service salary adjustment and right-sizing programme, affordability considerations, maintenance of public services and macroeconomic consistency are paramount. Agreement has been reached on the principles of broad-banding and occupational classification.

In order to effect a right-sizing of certain parts of the public service, a voluntary severance package has been introduced. This will be implemented with considerable circumspection in order to limit both the resulting loss of skilled personnel and associated costs to the fiscus.

Successful implementation of the agreement would lead to a real increase in the government wage bill of approximately 2 percent per annum over the next five years. This, together with strict containment of spending on other goods and services and current transfers, implies a roughly constant level of real recurrent government expenditure and a reduction of 3 percentage points in this aggregate relative to GDP by the year 2000. This would allow an increase in discretionary RDP-related spending on projects of a capital nature of about 8 percent per year, compared with little more than 2 percent per year in real terms in the absence of accelerated growth. This represents substantial room for manoeuvre in the developmental dimensions of the budget.

3.4 Budgetary reform

The budget is the primary vehicle through which access to social services is assured. Nearly half of all government spending is devoted to education, health, welfare, housing and related services. Strengthening of the redistributive thrust of these expenditures remains a fundamental objective of economic policy. Reprioritisation within the health and education budgets, a municipal infrastructure programme, restructuring of the welfare system, land reform and a review of training and small business support policies are amongst the initiatives which aim to address the claims of the poor to a fair package of basic needs. These adjustments are being accompanied by the elimination or scaling down of activities which cannot be provided to all or which could be undertaken effectively by the private sector.

Government recognises the importance of a longer-term fiscal planning framework alongside the annual budgetary process. A multi-year fiscal model has recently been developed which will be updated annually to provide greater clarity regarding public expenditure trends and priorities. It is envisaged that a draft medium-term expenditure model will be available to assist in the preparation of the next budget.

Several budgetary reforms are presently under consideration, including the earlier presentation of budgets to Parliament, the possibility of a switch to an accrual accounting system, a revised basis for reporting assets and liabilities, a restructuring of the accountability of the various departments and a transformation of the structure of inter-governmental financial relations.

3.5 Revenue issues

International experience confirms that it is on the expenditure side that the fiscus is most effectively able to contribute to redistribution. It is nonetheless important that the incidence of taxation should remain progressive, while at the same time impacting across a broad base so as to avoid excessive rates. Several further steps in the overhaul of the tax structure including the rewriting of the Income Tax Act will be undertaken. A new dispensation for the taxation of retirement funds, higher rates of excise on tobacco products and improved tax collection will lead to increased revenue on the current income base. This will be partially offset by adjustments to the personal income tax structure with a view to correcting for fiscal drag and reducing the distorting impact of excessive rates of tax.

Recognising the importance of effective tax administration, the new SA Revenue Service has embarked on the upgrading of its revenue and customs and excise offices, including personnel training and modernisation of information systems. This will, in due course, contribute to improved collections and greater fairness of the tax system.

The improvement in economic growth, together with improved tax administration, should lead to a strong increase in tax revenue relative to GDP. This will create considerable scope to effect further reductions in the rates of personal and corporate taxation, while maintaining a ratio of tax to GDP of about 25 percent.

In addition, the Department of Finance is reviewing the existing arrangements for the financing of government debt and the management of outstanding debt. The outcome of this process will be the establishment of a fully-fledged Debt Management Office leading to savings on the interest bill in the medium-term. A first step has been taken in this regard with the review of cash management within the public sector.

4 MONETARY AND EXCHANGE RATE POLICY

4.1 Monetary policy and inflation

The main objective of monetary policy will continue to be the maintenance of financial stability and the reduction of the inflation rate. Positive real interest rates are a minimum condition for overall financial stability. Low inflation is an important requirement for higher economic growth, the creation of employment opportunities and a more equitable distribution of income.

Inflation reduction has been facilitated by other developments. Trade liberalisation has contributed significantly to the containment of domestic prices, while more moderate wage-setting and improved industrial relations have also played a role in holding cost increases in check.

Monetary policy will also aim to maintain real interest rates at positive levels to encourage savings and investment. However current levels of interest rates are bound to have negative effects on economic growth. High interest rates hamper the development of the small business sector which is dependent on bank credit and put home ownership out of reach of more people. It is not possible, however, for the Reserve Bank alone to lower interest rates if conditions are not appropriate. Lowering the Bank rate could lead to higher credit demand, higher inflation, and as inflationary expectations take hold, higher long term interest rates. In addition, such a policy would lead to declining capital inflows, capital flight and higher imports, which all add up to a balance of payments crisis.

What is required are the conditions for lower (but positive) real interest rates. The strategy outlined in this document aims to bring about these conditions. These include sustained lower rates of inflation; a reduction in government dissaving which will reduce pressures on the capital markets; and the attraction of long term capital inflows, particularly direct investment flows, which will make the capital account less dependent on short term capital inflows which are attracted by high real interest rates; the commitment to a stable real exchange rate and higher growth will also reduce the risk premium facing foreign capital inflows and this would then allow for lower real interest rates.

By combating domestic inflation the monetary authorities will also contribute to stabilising the external value of the rand. Over the long run, low domestic inflation is a prerequisite for greater stability in the average value of the rand against a basket of currencies of major trading partners.

4.2 Exchange rate policy

Since mid-February the foreign exchange market has been subjected to intense speculative pressure, causing a substantial real depreciation of the rand. This development to some extent reflects that the rand had become somewhat overvalued in response to a temporary capital surge, but was also the result of increased concerns regarding policy trends and economic prospects. The movements of the exchange rate signal some uncertainty in financial markets and call for careful policy responses.

In order to maintain the current competitive advantage created by the depreciation of the rand in the first four months of 1996, the objective is to keep the real effective exchange rate of the rand at a competitive level. Although short-term fluctuations may at times be unavoidable, monetary and other policy measures will be geared towards the attainment of long-term real effective exchange rate stability. This will provide the stable environment needed for a concerted expansion of export industries.

Although the exchange rate is primarily market determined, its value at any moment cannot be considered a true reflection of the underlying value of the rand while exchange controls exist. The

Government has stated repeatedly that it is committed to phasing out controls in a prudent manner. In line with this commitment, the financial rand was abolished in 1995.

In view of the many inherent disadvantages of exchange control, such as the distortion of the price mechanism, the problems encountered in the application of monetary policy, the detrimental effects on inward foreign investment and the large administrative costs, all remaining exchange controls will be dismantled as soon as circumstances are favourable. The gradual approach to the abolition of exchange control is designed to allow the economy to adjust more smoothly to the removal of controls that have been in place for a considerable period.

The current round of exchange control liberalisation is designed as a balanced package which will enhance economic activity. The new measures include the following:

- Policies directed specifically at foreign investors include the relaxation of access to domestic credit. Although a measure of capitalisation from foreign funding is still required, the new regulations will allow for local borrowing capability to be enhanced by doubling the current borrowing limit. In terms of the new regulations, a wholly non-resident owned entity is able to borrow 100 percent of shareholders' equity.

- Institutional investors, namely insurance companies, pension funds and unit trusts, may currently obtain foreign assets by way of asset swaps for up to 5 percent of their total assets, subject to the stipulations of the legal framework within which they operate. This limit will now be increased to 10 percent.

- Institutional investors will also be allowed foreign currency transfers during 1996 of up to 3 percent of the net inflow of funds during the 1995 calendar year. Approval for such transfers will be subject to the overall limit of 10 percent set out above.

- Corporate entities who operate in the export field and also import goods from abroad, will be allowed to offset the cost of imports against the proceeds of exports, provided the set-off takes place within a period of 30 days.

- Adjustments to existing exchange control limits and measures designed to effect administrative exchange reform are included in the package.

5 TRADE, INDUSTRIAL AND SMALL ENTERPRISE POLICIES

5.1 Recent policy developments

The unreliability of raw material exports in the 1980s persuaded policy-makers that the central thrust of trade and industrial policy had to be the pursuit of employment creating international competitiveness. This entails a shift away from demand-side interventions, such as tariffs and subsidies, which raised prices received by producers, to supply-side measures designed to lower unit costs and expedite progress up the value chain.

While long-term survival strategies have had to be developed for certain sensitive sectors, general progress towards an outward-oriented stance is reflected in a number of achievements:

- replacement of former quantitative restrictions with tariffs;
- rationalisation of the tariff structure by almost halving the number of tariff lines;
- abolition of import surcharges, completed in October 1995;

- phasing down of tariffs, begun in 1995, by on average one-third over five years; and
- phasing out of the general export incentive scheme, to be completed by the end of 1997.

Another critical policy thrust has been the expansion of market access through preferential trade arrangements with industrial countries and pursuit of regional economic integration. In the area of concessionary industrial finance, several schemes have been introduced by the Industrial Development Corporation (IDC) and the Regional Industrial Development Programme (RIDP) has been expanded to include a simplified scheme applicable to smaller enterprises.

The impact of trade restructuring is not easily measured. Many firms have been under intense pressure, compounded by the real appreciation of the exchange rate in 1995. Nevertheless, exports and employment in manufacturing have increased, taking advantage of the international cyclical upswing. The most positive sign, also evident in sectors sensitive to the lowering of trade barriers, has been the significant increase in new foreign and domestic fixed investment in the manufacturing sector.

5.2 Compensating tariff reductions

Based on the foundations which have been laid over the past two years, trade and industrial policies will seek to enhance the competitive capacity and employment absorption of manufacturing, alongside continued promotion of tourism as an export sector and appropriate growth-oriented policies in other sectors.

As a result of the real depreciation, a compensating lowering of tariffs is desirable, within the context of an orderly implementation of agreed tariff realignments. The mid-1996 real effective exchange rate is some 12 percent below the January value, which should permit a significant acceleration of the tariff reductions to which South Africa is committed in terms of World Trade Organisation agreements. These reforms will be structured to lower prices for industrial inputs and low-income households, to avoid job losses in sensitive sectors, and to remove price distortions in domestic markets. The overall effect will be to minimise the negative effects of the depreciation on consumer prices and maximise the positive effects on industrial production. It will also encourage additional investment and job creation in competitive sectors, including priority industries.

5.3 Industrial support measures

Industrial innovation support programmes will be enhanced. This includes the incentive provided in terms of the Special Programme for Industrial Innovation, which has had some positive impact on domestic innovation, as well as the matching grants under the Technology and Human Resources For Industry Programme, designed to strengthen the relationship between educational institutions and industry. The technology transfer programme of the Department of Trade and Industry, which serves to police and advise on licensing and royalty agreements, will be converted into an agency dedicated to facilitating access by firms to needed technologies.

Several programmes have already been introduced to promote productivity, such as the IDC's Multi Shift and World Player schemes. A major investigation is now being undertaken under the auspices of NEDLAC to develop a programme to encourage the adoption of best practice work organisation.

To stimulate competitive and labour absorbing industrial development, an accelerated depreciation scheme will be introduced for all new investments in manufacturing. The tax allowance programme will apply to qualifying plant and equipment which is acquired and brought into use for the first time during the period 1 July 1996 to 31 September 1999. In addition, the current Regional Industrial Development Programme will be replaced by a tax holiday available to completely new pre-approved projects initiated during a window of three years, beginning in the last quarter of 1996. Approved projects will get tax exemptions for a period of time determined by three factors: regional location, job creation, and priority industries. The tax holiday, of a maximum of six years, will come into effect as soon as the project becomes liable for tax, and may not be used beyond the tenth year after the initial investment is undertaken.

Closely related are the twelve industrial priority industry investigations as well as the regional industrial locations studies. These major initiatives are intended to identify mechanisms to enhance the competitiveness of selected industrial sub-sectors. While the clusters may be eligible for the proposed tax holiday, specific interventions will also be considered where necessary. These studies involve constant interaction with both owners and workers.

The review of competition policy which is presently under way will be reflected in strengthened new legislation. The main objectives of competition policy are to encourage competition among firms, protect consumers and downstream firms from restrictive practices, and to open up new opportunities for investment.

Ongoing efforts to improve the access of South African firms to foreign markets will concentrate on exploring special arrangements with major trading blocs and continuing participation in the multilateral World Trade Organisation process, as well as other initiatives such as the Cairns Group. A further key element of the strategy is the gradual integration of the economies of Southern Africa through the trade and investment protocols of SADC.

The reform of the system of industrial finance is well advanced. The IDC will continue to provide loan finance, equity, and credit guarantee facilities, and will adapt its programmes to satisfy new needs. The institutional capacity to support small business is also largely in place. The various regional development corporations, however, still need to be integrated more fully into the new investment promotion effort. Other support institutions such as the Board of Tariffs and Trade, the Competition Board, the South African Bureau of Standards, and the National Productivity Institute are also receiving attention to meet the challenge of global competition and employment creation.

5.4 Small and medium-sized enterprise development

The promotion of small, medium and micro enterprises (SMMEs) is a key element in the Government's strategy for employment creation and income generation. Due to obstacles of the past, the SMME sector is severely under-developed. A major effort will be made to operationalise and implement the policies outlined in the White Paper on small business promotion. The relevant legislation is under consideration and various programmes and institutions have been established to give effect to the strategy, including:

- the Small Business Centre attached to the Department of Trade and Industry;
- Ntsika Enterprise Promotion Agency to provide non-financial assistance;
- Khula Enterprise Finance Limited for wholesale loans;
- Khula Credit Guarantee Limited for loan guarantees;
- a pre-shipment export finance guarantee facility to expand access to working capital; and
- the Competitiveness Fund for consultancy advice on technology and marketing.

The Simplified Regional Industrial Development programme will be continued in a modified form as a grant programme tailored to the needs of small and medium-sized firms.

6 SOCIAL AND SECTORAL POLICIES

The past two years have witnessed an energetic review of social and sectoral policies in keeping with RDP objectives. Public policies which affect women have come under scrutiny, programmes of action for children have been developed and a strategy for the disabled has been put forward. Land reform, agricultural development, protection of the environment, programmes in arts and culture, technology enhancement, crime prevention, national defence, urban infrastructure and housing, water and sanitation and primary health services are just some of the areas in which detailed analysis and extensive public discussion have led to major policy revision.

This focus of this document is the overall macroeconomic environment. Social and sectoral policy development cannot be outlined comprehensively here, but a few key linkages between growth, redistribution and new policy directions are highlighted below.

6.1 Education

Progress in education shows up consistently in comparative studies as a key determinant of long-run economic performance and income redistribution. Sustained improvements in the quality of public schooling available to the poor and greater equity in the flow of students through secondary and tertiary education are central to the Government's approach. Despite near-universal enrolment in primary education, only some 40 per cent of children currently complete secondary schooling successfully. Inadequate pass rates in science and mathematics are cause for concern.

Reform initiatives under way, aimed at qualitative improvements in the educational system, include restructuring and decentralising of school governance and management, overhauling school curricula, establishing a national qualifications framework, addressing the culture of learning in schools, building and refurbishment of classrooms, rationalising and renewing teacher education, enhancing educational administration, and expanding further education. Suitable norms, together with quality enhancing rewards, are under review. With spending on education at nearly 7 percent of GDP there is a need to contain expenditure through reductions in subsidisation of the more expensive parts of the system and greater private sector involvement in higher education. This will concentrate public resources on enhancing the educational opportunities of historically disadvantaged communities.

6.2 Health and welfare services

The systematic restructuring of health services, with a strong emphasis on universal and free access to comprehensive primary care, represents a clear commitment to improving the health conditions of the poor. Within the public health system resources are shifting from tertiary services in metropolitan areas towards overcoming the inadequacies of hospitals and clinics in rural areas and townships.

Partnerships between the state and voluntary organisations centred on developmental welfare services will focus attention on the vulnerable, especially in under-serviced areas, while freeing resources from expensive institutionally-based services. By far the greater part of welfare spending is devoted to social grants, which assist some 3 million elderly or disabled persons or needy children. These transfers play a vital role in poverty alleviation, especially in rural areas. Affordable alternatives to support families and children in need are being investigated.

6.3 Housing, land reform and infrastructure

The implementation of the housing and infrastructure programmes has been slow, with continuous refinements to the policy framework. Since late 1995, an acceleration in housing delivery has been evident. A continuation of this trend will see the provision of housing and related services on a substantial scale. This will have several beneficial distributional effects. Construction is largely labour intensive and provides jobs and training, while improvements in housing and infrastructure enhance the productivity of labour and the quality of urban life.

Improved water and sanitation is typically the first priority of rural communities. Some 500 projects costing R1,5 billion have been committed. Rapid progress with the supply of potable water to the 12 million people without adequate access will be a major contribution to poverty relief. These initiatives have been complemented by new policies regarding sanitation systems.

The land reform programme, combining asset redistribution with enhancement of tenure has an important role in improving the long-term prospects for employment and income generation in the rural economy. Progress has been made to finalising procedures for the rapid release of land and the introduction of a settlement grant. Complementary initiatives include emergent farmer support programmes. As these gain momentum, emphasis will shift to marketing support, appropriate technological interventions and streamlined extension services. Over time, agricultural development associated with land reform will play a key role in improving the distribution of income and economic activity.

7 PUBLIC INVESTMENT AND ASSET RESTRUCTURING

7.1 Investment in infrastructure

Investment in social and economic infrastructure will play an important role in increasing the productivity of labour and business and thus the achievement of higher growth rates. The National Infrastructure Investment Report indicated that South Africa currently faces a backlog in infrastructure of at least R170 billion, and that innovative financing strategies and careful prioritisation will be needed if sufficient progress is to be made.

This strategy envisages a substantial acceleration in government investment spending, together with improved maintenance and operation of public assets. Higher growth is clearly critical in this regard, as is a thorough restructuring of the responsibilities of relevant public corporations, development finance institutions and local and provincial authorities.

Public infrastructure needs include domestic and industrial grid electricity and other energy projects; domestic, industrial and agricultural water supplies; sanitation, wastewater and stormwater; roads, railways, airports, harbours and pipelines; telecommunications and postal services; urban housing-related infrastructure; rural development; and hospitals, clinics and educational facilities. Progress in all these areas adds to the quality of life in communities, while simultaneously building productive economic capacity. The provision of basic household infrastructure, in particular, is a relatively low cost and effective form of public intervention in favour of the poor and consistent with the reduction of income inequalities.

Four basic sources of finance are potentially available: fiscal transfers, concessional finance from multilateral institutions and other international sources, development finance channeled through development finance institutions, and loans raised on commercial terms. The nature of projects, including cost recovery potential and the risks involved, determine the appropriate funding mix.

Recognising the limited capacity of the fiscus, Government is committed to the application of public-private sector partnerships based on cost recovery pricing where this can practically and fairly be effected.

7.2 Corporate governance and asset restructuring

Government has prepared a protocol on corporate governance of all state entities, which includes the following elements:

- formulation of dividend policies, together with clear indications of the objectives and performance appraisal norms for all agencies;
- a revised policy regarding government guarantees;
- appropriate regulatory policies, aimed at ensuring that pricing policies are fair and fully recover operating costs, while also promoting competition or protecting consumers against monopolistic practices; and
- a programme of asset restructuring with respect to the ownership and governance of state entities.

Within the context of government policy and in accordance with the procedures agreed in the National Framework Agreement with organised labour, the process of restructuring state assets is now proceeding. Detailed sectoral consultation, planning and preparation are taking place. The telecommunications sector plans to complete negotiations by September 1996 with a view to finding a strategic equity partner for Telkom and addressing other restructuring issues in this sector. A similar process will unfold in the course of this financial year in other sectors, including minerals and energy, agriculture, forestry and water, leisure and transport. Six significant regional radio stations have been put out to tender for outright sale.

The nature of restructuring, as outlined in the framework agreement, may involve the total sale of the asset, a partial sale to strategic equity partners or the sale of the asset with government retaining a strategic interest. Work is in progress to address the outstanding issues on the restructuring of the remaining state enterprises. Specific policy issues and further elaboration will be dealt with by the responsible Ministers.

8 EMPLOYMENT, WAGES AND TRAINING

8.1 Present trends in the labour market

South Africa’s labour market is extremely fragmented. Employment growth in the formal sector of the economy has stagnated over the past decade and private sector employment has fallen. It is apparent that unregulated low wage employment has increased significantly since the 1970s, now accounting for an estimated one-third of all job opportunities. In addition, a large pool of unemployed men and women, who earn no income or derive sporadic earnings from informal self-employment, make up about a third of the potential labour force.

Irregular, sub-contracted, out-sourced or part-time employment on semi-formal contractual terms is becoming the preferred source of labour for many employers. This is resulting in a growing gap between the wages and benefits in the regulated and unregulated parts of the labour market. Where regulations raise the costs of job creation, employers turn to unregulated forms of employment.

The major development in the primary segment of the labour market over the past two years has been the new Labour Relations Act. This has four key features. It establishes a single industrial relations system for all employees, promotes collective bargaining by providing certain organisational rights for trade unions, establishes new procedures and institutions for resolution of disputes and provides for workplace forums to facilitate a shift from conflictual employer-employee relations towards joint problem-solving with employee participation. The reduced incidence of industrial unrest in recent years attests to the considerable progress made in this regard.

Present trends in the economy lead to employment growth of 100 000 to 130 000 per year, with unemployment rising to 37 percent by the year 2000 and an increased casualisation of the labour force. On this trajectory, poorly rewarded employment in survival activities grows nearly twice as fast as formal sector job opportunities. Weakening employment opportunities for the poor imply that income distribution is likely to worsen, impacting particularly severely on the rural poor, young work-seekers and those without education or skills.

8.2 Labour market reform challenges

The fragmented character of the South African labour market, conflictual labour relations and poor productivity have tended to undermine competitiveness and hence investment. Appropriate balances have to be struck in the labour market in respect of job creation, between regions and sectors and between maintaining existing jobs, protecting those in employment, and creating opportunities for new entrants. In a context of approximately 33 percent unemployment, the challenges are immense.

Government has a responsibility for ensuring that labour market rules are fair and that there are appropriate mechanisms for dispute resolution. Government is also an important employer and the main investor in human resource development in the economy. It influences, through its industrial and other policies, the sectoral growth trend of the economy. Accelerated job creation and improved productivity are direct or indirect goals of a wide range of government policies and programmes, some of which are noted elsewhere in this document.

In this integrated macroeconomic strategy, employment growth accelerates, reaching 409 000 jobs annually in the year 2000 and reversing the upward tendency in the unemployment rate. Over the next five years some 833 000 more jobs are created in the higher growth strategy than would otherwise be possible.

In this strategy there are two broad thrusts relating to labour market policy. The first is the pursuit of regulated flexibility aimed in part at extending the protection and stability afforded by this regulatory framework to an increased numbers of workers. The second is the promotion of continued productivity improvements aimed at bolstering the development of skills across the full spectrum of the workforce in both the formal and non-formal sectors. These points of departure are the basis of Government’s labour market policies and will be further elaborated in response to the report of the Comprehensive Labour Market Commission.

The Government will pursue a policy of regulated flexibility in managing the labour market. This entails the regulation of the labour market in a manner that allows for flexible collective bargaining structures, variable application of employment standards and voice regulation.

The appropriate determination of wages is a critical component of the medium term macroeconomic strategy. It is a precondition for sustaining the competitive advantage of the currency depreciation, and it is the key to ensuring the maintenance of industrial competitiveness in the longer term. A sudden upsurge in nominal wage demands would either unleash a wage-price spiral that would soon erode any semblance of a real depreciation or force a severe tightening of monetary policy leading to higher interest rates and economic contraction. It is therefore important that wage and salary increases do not exceed average productivity growth.

Analysis of employment prospects indicates that accelerated job creation can be achieved in broadly three ways. Growth itself could account for about one-third of the increased job creation envisaged under an integrated strategy, some of which would be in informal or other unregulated activities. Government programmes can add a further quarter of the new jobs, mainly through accelerated labour-based infrastructural development and maintenance of public works in urban and rural areas. Some 30 percent of the increased employment, however, and more than half of the new formal private sector opportunities, will have to arise from institutional reforms in the labour market, employment enhancing policy shifts and private sector wage moderation. Stronger growth of more labour-intensive components of industry, facilitated by shifts in industrial policy, is vital. It is these reforms that are needed to bring about the increased responsiveness of labour demand to output growth, and are the essential ingredients of a sustainable, labour-absorbing growth path.

Furthermore, the general direction of economic policy is towards greater openness and competitiveness. The economy will thus become increasingly subject to global forces. The challenge then facing labour market policy is to promote dynamic efficiency, skill enhancement and the expansion of reasonably remunerated employment – while at the same time supporting a labour-intensive growth path which generates jobs for the unemployed, many of whom are unskilled and have never had previous employment. The Government intends to promote collective bargaining while simultaneously pursuing an appropriate balance between productivity enhancement and employment creation.

8.3 A more flexible labour market

Government recognises that industrial agreements which reach across diverse firms, sectors or regions should be sufficiently flexible to avoid job losses and should be extended to non-parties only when this can reasonably be assured. The Minister of Labour's discretion to extend or not to extend agreements should be broadened to permit the Minister to bring labour market considerations into play. Wage agreements must be sensitive to regional labour market conditions, the diversity of skills levels in firms of varying size, location or capital intensity and the need to foster training opportunities for new entrants to the labour market.

Other labour market policies should be negotiated by labour, business and government constituencies at appropriate levels in terms of a national framework. Reforms consistent with accelerated access of new entrants to employment and training opportunities might include less onerous minimum wage schedules for young trainees, lower indirect wage costs (through a more cost-effective provision of retirement, medical, unemployment and accident benefits), increased incentives for more shifts, job sharing and other measures to support greater employment flexibility. Variations on norms set through collective bargaining must be an integral aspect of a system of regulated flexibility building on the safeguarding of employment standards and worker's rights implicit in existing policies.

The determination of minimum wages remains, in certain sectors of the economy, to protect the vulnerable and the weak. The approach will not be to set one minimum wage across the whole economy but to determine appropriate standards by sector and area. The determination of these minimum wages must follow proper hearings, investigations and consideration of relevant economic conditions, the potential for employment creation and the alleviation of poverty.

The Department of Labour will encourage, through the mechanisms provided in the Labour Relations, Act, the rationalisation of collective bargaining arrangements to meet the challenges of the new economic environment while recognising the diversity of the domestic labour market.

8.4 Enhancing productivity

Government also recognises that job creation and improved living standards require a substantially increased commitment by the business sector to industrial investment and productivity-enhancing training. Accelerated investment is a principal thrust of this strategy, and must be promoted across a broad sectoral front, including export-oriented manufacturing and agro-industrial projects, tourism-related industries and improved transport and communication services, and with a particular focus on smaller firms. In many sectors, there is scope for both increased employment and training of the unskilled and improved productivity at higher skill levels.

International indicators show that South African investment in human resource development is inadequate. An enhancement of the level and effectiveness of training across all employment sectors is central to this growth strategy. Training underpins productivity improvement by enhancing human capability – across all labour market segments and product lines – to exploit technological flexibility and add value on competitive terms. Regulated flexibility of the labour market, discussed above, must permit employees to increase their productivity over time. Improved management training, modernisation of work practices, appropriate job grading and better utilisation of working time are also key aspects of enhanced efficiency.

A refocusing of curricula and the organisation of formal learning is currently in progress under the auspices of the education authorities. Coordination of standards and quality assurance will be the responsibility of the newly established South African Qualifications Authority.

The Department of Labour has embarked on the development of a new human resource development strategy, in partnership with all major stakeholders, which is planned to culminate in new legislation in 1997. Central to this strategy is a new financing mechanism and governance framework which aims to increase the aggregate level of effective investment in training. Towards this end the government is investigating the feasibility of introducing a mandatory levy on payroll. The matter is currently under negotiation with the social partners represented in NEDLAC. The strategy includes the following:

- establishment of a tripartite national coordinating council, responsible for giving strategic direction to human resource development and for building an energetic coherent national system;
- restructuring of industry training boards to facilitate best practice training, under industrial management;
- strengthening of the levy-based industrial training financing mechanism;
- appropriately focused funding of training for emergent enterprises and the unemployed;
- an overhaul of the guidance, training, placement and labour market information services of the Department; and
- development of an information and planning capacity to support the national training strategy.

In addition, there will be deliberate campaigns to enrich human resource development programmes within government departments and agencies, aimed at effective service delivery. Management training initiatives are already underway in several key departments.

Government recognises that it has an important role to play in financing education and training activities aimed at the unemployed and the small business sector and in enhancing the quality of technical and vocational education and training. Sustained improvements in the quality of general schooling are also largely the responsibility of the fiscus. Industrial training must remain mainly the responsibility of employers. Government seeks to facilitate the development of financing mechanisms that will enjoy broad support from both the business sector and organised labour.

9 TOWARDS A NATIONAL SOCIAL AGREEMENT

A strong tradition of collective bargaining characterises the South African industrial and social environment. Sectoral and regional agreements are likely to contribute to structuring future growth and development. There is an important role also for a broad national agreement, to create an environment for rapid growth, a brisk investment trend and accelerated delivery of public services based on equity and universal access. The challenge facing the government and its social partners is to ensure that a national agreement underpins rapid growth, job creation, and development.

The immediate objective of the agreement would be to ensure that the recent depreciation of the currency does not translate into a vicious circle of wage and price increases leading to instability in the financial markets and a decline in competitive advantage. For this reason it is important that wage and salary increases do not rise more than productivity growth. It is equally important that price restraint should be maintained, facilitated through an effective competition policy and continued trade liberalisation.

In the longer term, a broad social agreement might address a wider range of issues related to economic restructuring, income distribution and social policies. Orderly collective bargaining between organised labour and employers must remain the foundation of industrial relations.

For its part, the government commits itself to an accelerated increase in its contribution to social and community living standards. Most of the policy frameworks and institutional systems are now in place to ensure the following:

- the delivery of housing and related services;
- steady improvement in the quality of education;
- universal access to primary health care;
- access to land and agricultural support for emergent farmers;
- electrification of all urban areas and an increasing number of rural communities;
- reliable water supplies and appropriate sanitation infrastructure;
- improved postal and telecommunications services; and
- a broad social security net, comprising social grants and targeted welfare services.

Equally important, the government will provide a combination of real exchange rate management and tax incentives aimed at encouraging private sector investment. For workers, this will give certainty that wage moderation will contribute towards growth, job creation and social benefits. For the business sector, this strategy creates an environment in which investments can be made confidently, competitiveness is enhanced and public policies are clear.

10 POLICY COORDINATION

As a result of political stability and sound policies, economic growth has revived, bringing to an end the stagnation that characterised the 1980s. Our strategy will build firmly on the foundations established since 1994, leading to accelerated growth, increased job creation and a significantly improved distribution of income and opportunities.

The higher growth path depends in part on attracting foreign direct investment, but also requires a higher domestic saving effort. Greater industrial competitiveness, a tighter fiscal stance, moderation of wage increases, accelerated public investment, efficient service delivery and a major expansion of private investment are integral aspects of the strategy. An exchange rate policy consistent with improved international competitiveness, responsible monetary policies and targeted industrial incentives characterise the new policy environment.

A strong export performance underpins the macroeconomic sustainability of the growth path. Private sector employment creation is reinforced by small business promotion, land reform and emergent farmer support, greater labour market flexibility and labour-based public sector infrastructural development projects.

Accelerated economic growth associated with stronger employment creation is the key to continued progress towards an equitable distribution of income and improved standards of living for all. Employment creation provides a powerful vehicle for redistribution, supported by government housing, water supply and sanitation, health, education, welfare and social security services.

Success in a more open and complex economic environment requires consistent and integrated policies. Timing, sequencing, and packaging of reforms are important, as is the clear commitment of social partners to an agreed policy framework. World competitiveness nowadays depends as much on comparative advantage in the public policy arena as it relies on technology, human resources and physical capital.

Government has a clear policy coordination role. There are trade-offs amongst policy options and competing claims by different interest groups which need to be nationally resolved. Whilst institutions have been developed to aid this process, and Government is committed to an open and consultative approach, the ultimate responsibilities for a credible and coherent policy framework lies with Government. As a first step in this process, Government calls for a clear commitment by both business and labour to the broad principles set out in this document.

Within Government, especially in the fields of monetary, fiscal, trade, industrial and labour policies, there is also a critical need for coordination. Inconsistent approaches in any of these areas have the potential to destabilise the credibility of the overall macroeconomic framework. Effective coordination of economic policy at Cabinet level has accordingly been given the highest priority by Government, together with supporting arrangements within key administrations and between Government, the Reserve Bank, the business sector, organised labour and other key constituencies. The strategy set out in this document seeks to remove uncertainty, give clear direction to the economic course on which South Africa is headed, and invite Government's social partners to join in the building of a competitive fast-growing economy.

ACKNOWLEDGEMENTS

The assistance of the Development Bank of Southern Africa and Applied Marketing Communications with the production of this document is gratefully acknowledged.

GROWTH, EMPLOYMENT AND REDISTRIBUTION

A Macro-Economic Strategy
(Appendices)

GROWTH, EMPLOYMENT AND REDISTRIBUTION
A MACROECONOMIC STRATEGY

List of Appendices

Published by the Department of Finance, Republic of South Africa, Private Bag X115, Pretoria 0001, fax number (012) 323 3262.

Acknowledgements

The Minister of Finance, Trevor Manuel, the Deputy Finance Minister, Gill Marcus and the Acting Director General, Maria Ramos, wish to acknowledge the contribution of the technical team comprising the following individuals:

Andre Roux, coordinator (Development Bank of Southern Africa)
Iraj Abedian, coordinator (University of Cape Town)
Andrew Donaldson (Department of Finance)
Brian Khan (University of Cape Town)
Ben Smit (University of Stellendbosch)
Daleen Smal (South African Reserve Bank)
Alan Hirsch (Department of Trade and Industry)
Guy Mhone (Department of Labour)
Ernie van der Merwe (South African Reserve Bank)
Ian Goldin (Development Bank of Southern Africa)
Stephen Gelb (University of Durban-Westville)
Dirk van Seventer (Development Bank of Southern Africa)
Servaas van der Berg (University of Stellendbosch)
Luiz Pereira da Silva (World Bank)
Richard Ketley (World Bank)

APPENDIX 1

A REVIEW OF ECONOMIC DEVELOPMENTS SINCE 1994

Recent Macroeconomic Performance

The growth performance of the South African economy has improved considerably over the past two years. Following three years of economic decline, real gross domestic product rose by 1,3 percent in 1993, 2,7 percent in 1994 and 3,3 percent in 1995. This stronger growth occurred in all secondary and tertiary sectors, although agriculture and mining experienced declines in 1995.

A marked increase in real fixed investment has been a welcome feature of the upswing. Private consumption expenditure also firmed as incomes rose and consumer confidence improved. In contrast, real government consumption expenditure, which increased sharply until 1994, levelled off in 1995. Export volumes stagnated in 1994 and then rose by an impressive 8 percent in 1995, while real imports have increased at an annual rate of 16 percent since 1993.

Inflation in 1995 declined to levels last seen in the early 1970s. The annual rate of increase in consumer prices has been below 10 percent for three years. Positive real interest rates and containment of money supply growth have been important factors in combating inflation.

Formal sector employment has responded sluggishly to the economic recovery. Formal non-agricultural employment declined throughout the period 1989 to 1994 and appears to have increased by little more than 50 000 during 1995. However, employment in unregulated sectors of the labour market appears to be on an upward trend.

The post-election period has seen considerable movement in the balance of payments. A net capital inflow amounting to R31 billion was recorded between mid-1994 and the end of 1995. The bulk of this inflow has been portfolio investment, which is comparatively mobile and sensitive to shifts in market perceptions. The balance on current account moved into deficit over this period as imports, particularly capital goods, rose strongly.

Since mid-February the foreign exchange market has been subjected to intense speculative pressure, causing a substantial real depreciation of the rand. This development to some extent reflects that the rand had become somewhat overvalued in response to a temporary capital surge, but was also the result of increased uncertainty regarding policy trends and economic prospects.

Fiscal Policy

In response to the unsustainable fiscal situation that had developed by 1992/93, when the overall deficit reached 9,0 percent of GDP, fiscal policy has been informed by the following goals:

- to cut the overall budget deficit and the level of government dissaving;
- to avoid permanent increases in the overall tax burden;
- to reduce general government consumption expenditure relative to GDP; and
- to strengthen the general government contribution to gross domestic fixed investment.

Although government dissaving has not yet been eliminated, progress has been made in this respect. The cash-flow adjusted exchequer deficit was reduced to an estimated 5,4 percent in 1995/96.

Consolidated general government tax revenue has increased from 25,6 percent to 26,8 percent of GDP between 1992/93 and 1994/95, but still somewhat below the 1989/90 level of 27,1 percent. At the same time, significant shifts in the allocation of expenditure have been effected in accordance with reconstruction and development priorities.

The improved discipline in fiscal policy has contributed to greater financial stability and lower inflation. It has also enhanced local and international business confidence, contributing to capital inflows and investment. A gradual approach to deficit reduction has been necessary to prevent disruptions in the provision of essential public services, but has also had the advantage of avoiding a major contraction in aggregate demand.

It is widely acknowledged that the overall tax burden is high and that personal income tax rates, in particular, lead to excessive distortions in business and household behaviour. A range of tax reforms have been implemented over the past two years.

Tax issues and fiscal relations between the different tiers of government are subjects of major investigations, finalisation of which should lead to greater fiscal certainty and business confidence. The ongoing reform of the budgetary process introduced by the Department of State Expenditure will contribute to more effective planning and expenditure management.

Inflation and Monetary Policy

The basic objective of monetary policy has been to protect the value of the rand. The Reserve Bank operates within a framework in which effective control over the money supply serves as an intermediate objective. Annual guidelines for growth in broadly defined monetary aggregates are set, aimed at reducing the inflation rate.

Following a period of negative real interest rates in 1986/87, monetary policy has been kept relatively tight. A consistent anti-inflationary stance was maintained throughout the 1989-1993 cyclical downturn, bringing broad money supply growth down from 28 percent to single-digit levels. The lower rates of increase in monetary aggregates, with sustained surpluses on the current account, enabled nominal interest rates to decline. The Bank rate was reduced in steps from a maximum of 18 percent in 1989 to a low point of 12 percent in late 1993.

The acceleration in money supply and credit growth in 1994 called for tighter policies to prevent a resurgence of inflation. In September 1994 the Bank rate was raised by 1 percent, followed by three further increases of the same order to bring the rate to 16 percent by April 1996.

Inflation reduction has been facilitated by other developments. Trade liberalisation has contributed significantly to the containment of domestic prices, while more moderate wage-setting and improved industrial relations have also played a role in holding cost increases in check.

The consistent application of monetary policy and the maintenance of positive real interest rates over the past few years have not only brought inflation down to single-digit levels, but have also, with the exception of recent developments, reduced the volatility of a number of financial variables including interest rates. This has facilitated business planning and reduced the intensity of cyclical movements in the economy.

Exchange Rate Developments

The current approach to exchange rate policy reflects the view that the exchange rate of the rand is best protected through consistent application of anti-inflation policies as this brings stability to the average value of the rand against the currencies of trading partners.

The monetary authorities have not attempted to fix a specific exchange rate of the rand. Because the variables which impact on the balance of payments are continuously in flux, the rate must be flexible. The Reserve Bank can to some extent smooth erratic movements in the exchange rate, but it cannot override fundamental market perceptions. Nevertheless, an unsustainable appreciation can be countered by appropriately relaxing exchange controls and accelerating the Reserve Bank's withdrawal from the forward exchange market.

Although the exchange rate is primarily market determined, its value at any moment cannot be considered a true reflection of the underlying value of the rand while exchange controls exist. The government has stated repeatedly that it is committed to phasing out controls in a prudent manner. In line with this commitment, the financial rand was abolished in 1995.

To maintain orderly conditions in the foreign exchange market, it is necessary to retain an adequate stock of foreign exchange reserves. Large capital inflows since mid-1994 enabled the Bank to increase the net gold and other foreign reserves by R9,1 billion during 1995, thus countering somewhat the tendency of the rand to appreciate in real terms.

In view of shortcomings in the forward exchange market, the Reserve Bank has been an active market-maker. While this has led to a large imbalance in the forward book, considerable progress has been made since 1994 in reducing the Bank’s exposure. The combination of more market-related forward rates, interest rates and spot exchange rates has encouraged private parties to develop the forward cover market. This remains true although the Reserve Bank's involvement in that market has increased again since the depreciation of the rand.

Trade and Industrial Policies

The unreliability of raw materials exports in the 1980s persuaded policy-makers that the central thrust of trade and industrial policy had to be the pursuit of employment-creating international competitiveness. This entails a shift away from demand-side interventions, such as tariffs and subsidies, which raised prices received by producers, to supply-side measures designed to lower unit costs and expedite progress up the value chain.

While long-term survival strategies have had to be developed for certain sensitive sectors, general progress towards an outward-oriented stance is reflected in a number of achievements:

- substitution of former quantitative restrictions with tariffs;
- rationalisation of the tariff structure by almost halving the number of tariff lines;
- abolition of import surcharges, completed in October 1995;
- phasing down of tariffs, begun in 1995, by on average one-third over five years; and
- phasing out of the general export incentive scheme, to be completed by the end of 1997.

Another critical policy thrust has been the expansion of market access through preferential trade arrangements with industrial countries and pursuit of regional economic integration. The following developments deserve specific mention:

- the signing of the Marrakesh Agreement has secured membership of the World Trade Organisation and continued “most favoured nation” access to member country markets;
- the granting of Generalised System of Preferences status by various developed countries (the USA, the European Union, Japan, Canada, Norway and Hungary) has brought preferential access to their markets; and
- the signing of bilateral trade treaties with several African countries and rapidly growing trade with neighbours has seen exports from within the Southern African Customs Union area to the rest of the Southern African region quadruple.

In the area of concessionary industrial finance, several schemes have been introduced by the Industrial Development Corporation (IDC), to meet strategic industrial objectives, including:

- the JOBS scheme for small enterprises satisfying certain employment criteria;
- the LIFE scheme for ventures which satisfy certain export performance criteria; and
- the Multi-Shift scheme for existing concerns which introduce an additional shift.

Although the Regional Industrial Development Programme (RIDP) is under review, it was expanded in 1993 to include a simplified scheme applicable to smaller enterprises. The phasing in of supply-side support measures has begun recently, with the introduction of the IDC’s World Player scheme for the modernisation of plant and equipment in sensitive industries facing a significant decline in protection. The development of a full package of supply-side measures is the central focus of medium-term industrial and trade strategy.

The impact of trade restructuring is not easily measured. Many firms have been under intense pressure, compounded by the real appreciation of the exchange rate in 1995, and will require additional investment incentives to meet international competition. Nevertheless, manufacturing employment and exports have increased, taking advantage of the international cyclical upswing. The most positive sign, also evident in sectors sensitive to the lowering of trade barriers, has been the significant increase in new foreign and domestic fixed investment in the manufacturing sector.

Employment and Labour Trends

South Africa’s labour market is extremely fragmented. Employment growth in the formal sectors of the economy has stagnated over the past decade and private sector employment has fallen. It is apparent that unregulated low wage employment has increased significantly since the 1970s, now accounting for perhaps a third of all job opportunities. In addition, a large pool of unemployed men and women who earn no income or derive sporadic earnings from informal self-employment make up about a third of the potential labour force.

Irregular, sub-contracted, out-sourced or part-time employment on semi-formal contractual terms is becoming the preferred source of labour for many employers. This is resulting in a growing gap between the wages and benefits in the regulated and unregulated parts of the labour market. Where regulations raise the costs of job creation, employers turn to unregulated forms of employment.

The following additional features of the labour market may be noted:

- spatial imbalances between supply and demand for labour;

- inordinate distances between places of residence and work;
- poor integration of education and training into job entry and career planning; and
- diversity in technology, skills and productivity across regions and sectors.

The major development in the primary segment of the labour market over the past two years has been the new Labour Relations Act. This has four key features. It establishes a single industrial relations system for all employees, promotes collective bargaining by providing certain organisational rights for trade unions, establishes new procedures and institutions for resolution of disputes and provides for workplace forums to facilitate a shift from conflictual employer-employee relations towards joint problem-solving with employee participation. The reduced incidence of industrial unrest in recent years attests to the considerable progress made in this regard.

What are the implications of labour market trends for income distribution? Over the past two decades, black wage income in the non-primary sectors of the economy has increased by 4,5 percent per year in real terms, mainly due to rising average wages. Though many households have been lifted above the poverty line, the trend is shifting in favour of higher income classes, where education, training and experience contribute to sustained improvements in productivity. Employment growth has contributed just 1,2 percent per year to the increase in black wage income over the past twenty years, and has been virtually zero over the past decade. The slow pace of regulated formal employment growth has resulted in limited benefits of growth reaching the poor. Though the unemployed are in some cases attached to households where other members have access to productive employment, in many of the poorest households the main breadwinner cannot find a job. Whereas the average household received R1 360 per month from wages in 1993, the poorest fifth received R47 per month from regular employment, mainly because so few of their work-seekers had jobs.

Restructuring the Public Sector

The process of administrative restructuring of the public service provided for in the Constitution gathered pace in 1995. With the first phase of the process, involving the integration of the public service at national and provincial levels, nearing completion, attention is shifting to the longer-term issue of creating a more cost-effective service.

A major step was taken in early 1996 with the devolution to line departments of all career-related personnel functions. The restructured Public Service Commission will retain a research and monitoring role, while the Department of the Public Service and Administration will be responsible for broad human resource policy, conditions of service and labour relations.

Agreement was recently reached on a three-year conditions of service adjustment package. Inter-related elements include the right-sizing of the public service, a voluntary severance package and simplification of occupational remuneration schedules. Substantial improvements in wages in 1996 are envisaged for certain categories of civil servants, redressing imbalances within the service and relative to the private sector. Improvements in subsequent years will depend on the overall reduction in personnel and affordability considerations.

Government has initiated a review of state assets, with a view to restructuring their ownership and governance. An agreement has been signed with organised labour which sets guidelines for further consultation. A process of enhancing the governance of public enterprises is under way, with the first step covering policy regarding dividend payments to the fiscus. Revised conditions for sovereign guarantees have also been issued which reduce fiscal exposure and extend the discipline of the market to public sector institutions.

Progress has been made over the past year regarding the restructuring of development finance institutions. A strong emphasis has been placed on ensuring financial sustainability. It is envisaged that grant components of project finance should be channeled through the fiscus in a transparent manner and that loan terms should be market-related.

Social Policy

The past two years have witnessed an energetic revision of social policies. Although implementation of these initiatives has been uneven, policy development is now sufficiently advanced to expect significant delivery across a broad front in the coming years. A few key linkages between growth and redistribution and new policy directions are highlighted below.

Progress in **education** shows up consistently in comparative studies as a key determinant of long-run economic performance and income redistribution. Sustained improvements in the quality of public schooling available to the poor and greater equity in the flow of students through secondary and tertiary education are central to the Government's approach. Despite near-universal enrolment in primary education, only some 40 per cent of children currently complete secondary schooling successfully. Inadequate pass rates in science and mathematics are a cause for concern.

Reform initiatives underway aimed at qualitative improvements in the educational system include restructuring and decentralising of school governance and management, overhauling school curricula, establishing a national qualifications framework, addressing the culture of learning in schools, building and refurbishment of classrooms, rationalising and renewing teacher education, enhancing educational administration, and expanding further education. Suitable norms, together with quality enhancing rewards, are under review. With spending on education at nearly 7 percent of GDP there is a need to contain expenditure through reductions in subsidisation of more expensive parts of the system and greater private sector involvement in higher education. This will concentrate public resources on enhancing the educational opportunities of historically disadvantaged communities.

The systematic restructuring of **health** services, with strong emphasis on universal and free access to comprehensive primary care, represents a clear commitment to improving the health conditions of the poor. Within the public health system resources are shifting from tertiary services in metropolitan areas towards overcoming the inadequacies of hospitals and clinics in rural areas and townships.

Partnerships between the state and voluntary organisations centred on developmental **welfare** services will focus attention on the vulnerable, especially in under-serviced areas, while freeing resources from expensive institutionally based services. By far the greater part of welfare spending is devoted to social grants, which assist some 3 million elderly or disabled persons or needy children. These transfers play a vital role in poverty alleviation, especially in rural areas. Affordable alternatives to support families and children in need are being investigated.

Although the implementation of the **housing** and infrastructure programmes have been slow, there have been continuous refinements to the policy framework. Since late 1995, a marked acceleration in housing delivery has been evident. A continuation of this trend will see the provision of housing and related services on a substantial scale in subsequent years. This will have several beneficial distributional effects. Construction is largely labour intensive and provides jobs and training, while improvements in housing and infrastructure enhance the productivity of labour and the quality of urban life.

Improved **water and sanitation** is typically the first priority of rural communities. Some 500 projects costing R1,5 billion have been committed. Rapid progress with the supply of potable water to the 12 million people without adequate access will be a major contribution to poverty relief. These initiatives have been complemented by new policies regarding sanitation systems.

Enhanced **crime prevention** has been identified as one of the key pillars on which growth and development rests. The national crime prevention strategy, which will involve considerable coordination with other departments and includes several projects, such as community policing stations, will have a strong redistributive thrust, as the poor are hardest hit by violent and property-related crimes. The emphasis on community policing in the new approach recognises the crucial link between crime prevention and development at the local level.

The **land reform** programme, combining asset redistribution with enhancement of tenure, has an important role in improving the long-term prospects for employment and income generation in the rural economy. Progress has been made with finalising procedures for the rapid release of land and the introduction of a settlement grant. Complementary initiatives include emergent farmer support programmes. As these gain momentum, emphasis will shift to marketing support, appropriate technological interventions and streamlined extension services.

Growth, Employment and Redistribution: A Summary

As a result of political stability and sound policies, economic growth has revived, bringing to an end the stagnation that characterised the 1980s. Most commentators are confident of a return to a growth trend somewhat in excess of population growth, ensuring a gradual improvement in living standards. The higher growth path is linked to an improved balance of payments situation, which eases the major constraint on medium term economic growth. The last few years have also witnessed success in the fight against inflation as a result of effective monetary policies and more moderate wage settlements.

With regard to the challenge around redistribution, the past years have seen the introduction and extension of policies aimed at more equity in access to social services. These have important redistributive effects, and in the case of education and training, land reform and urban development, will also have favourable consequences for economic growth in the longer term. There has been some redistribution of wage income over the past two decades, partly as a result of union pressure. A continuation and possible acceleration of this process has been made possible by increases in productivity. Improvements in education, skills, labour effort and management are now crucial for wage increases and are increasingly being addressed in industrial negotiations.

Higher economic growth has not yet been translated into significant employment creation. This is to some extent to be expected, as many firms began the upswing with substantial unused capacity and economic restructuring aimed at improved international competitiveness has required cost reductions, including some shedding of labour. However, in the absence of rapid employment growth, unemployment has increased, so that the distribution of income exhibits an increasing dichotomy between those inside the formal economy and those on its edges. Accelerated economic growth associated with stronger employment creation is the key to continued progress towards an equitable distribution of income and improved standards of living for all.

APPENDIX 2

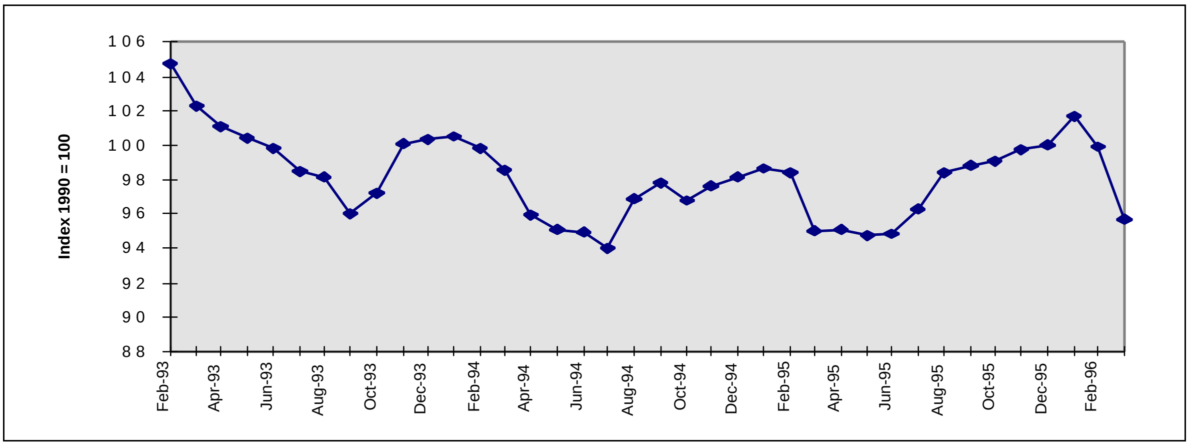
AN INTERPRETATION OF THE RECENT DEPRECIATION

Since mid-February the foreign exchange market has been the focus of intense speculative pressure, leading to a significant real depreciation of the rand. These developments were to some extent the result of unfounded rumours and increased uncertainty over the direction of Government economic policy, but also reflected the fact that the exchange rate had become overvalued and that an adjustment was overdue.

The table and graph below place the depreciation in perspective. The February adjustment appears to have been a purchasing power parity correction which brought the real exchange rate back to its 1994 level. It is also clear that this level is not as low as those that prevailed in 1985.

Real Effective Exchange Rate

1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	Jan96	Feb96	Mar96
108,5	83,7	86,5	100,3	95,8	95,4	100,0	103,0	104,8	100,2	97,2	97,5	101,7	99,9	95,7



During 1995 South Africa experienced a falling rate of inflation, which, coupled with continuing tight monetary policy, resulted in real interest rates that were high by international standards (8 percent vs 2 percent). These high rates helped to attract a net capital inflow in excess of R30bn. This inflow dominated the growing current account deficit, thus placing upward pressure on the nominal exchange rate. The Reserve Bank responded by preventing the nominal appreciation. In the course of 1995, gross reserves increased from R11 to R16 billion and net reserves from R6 to R16 billion.

The stable nominal exchange rate meant that the real rate was appreciating over this period. Such a strong rand did not, however, reflect the underlying fundamentals as the economic recovery was not sufficiently strong to justify a real appreciation and an inflation differential still persisted between South Africa and its major trading partners.

Market participants, lulled into accepting that the nominal rate would remain stable, maintained uncovered positions in the belief that the real interest rate differential would be enough to compensate holders of rand assets for any expected depreciation. The markets also displayed a false sense of complacency about the stability of the foreign exchange market. The fact that the rand market is relatively thin and therefore subject to a high degree of volatility appears to have been ignored. Moreover, the financial rand, which previously insulated the commercial rand from such volatile capital movements, no longer existed. This underlying reality was hidden during 1995 since it is relatively easy to contain fluctuations in the exchange rate when upward pressure on the currency coincides with the need to accumulate foreign reserves.

The February depreciation was finally triggered by unsubstantiated rumours concerning President Mandela's health and possible exchange control relaxation, as well as a rise in US bond rates. During the subsequent two weeks intervention in the spot market amounted to just over R1 billion. The Reserve Bank's efforts were, however, concentrated in the forward market where the oversold position increased by R5 billion. Although this eased the pressure on the spot market and the reserve position, it could create a fiscal burden in future.

The depreciation in April, which resulted in a further decline of the real exchange rate of approximately 9 percent, can be attributed to the following:

- rumours of Minister Liebenberg's resignation;
- rumours of an impending removal of exchange controls;
- perceptions of divergent views between business and labour; and
- perceptions of policy indecision within government.

The initial policy reaction to the April crisis included further intervention on the spot and forward markets as well as an increase in the Bank rate by one percentage point. Although the interest rate increase was not a welcome development from a growth perspective, it had the effect of assisting in stabilising the foreign exchange market.

How the exchange rate crisis is managed from here onwards is critical to South Africa's economic fortunes. The commercial banks have already reacted by increasing their lending rates by a further one percentage point. This will clearly have a more depressing effect on growth and employment in the remainder of 1996 and beyond. In the absence of a clear and credible macroeconomic policy framework the currency weakness will continue with further financial market reactions, raising the spectre of a fully-fledged recession with inflation accelerating and escalated capital flight.

However, the depreciation of the Rand also represents a significant window of opportunity. The integrated strategy is designed to take advantage of the implied shift in the prices of tradables and non-tradables, and to lay the basis for an export-led revival of the economy. But this will only occur if the depreciation is not dissipated through increased wages and prices and if it is supported by appropriate monetary, fiscal and trade policies - in short the integrated macroeconomic policy package.

APPENDIX 3

THE MACROECONOMIC OUTLOOK OF CURRENT POLICIES

In this appendix results are reported of simulation exercises based on current fiscal and sectoral policies utilising inputs from four macroeconomic models of the economy. The projections described here are derived from an adaptation of the Reserve Bank's econometric model, but are broadly consistent with results obtained using models of the Development Bank of Southern Africa, the Bureau for Economic Research and the World Bank.

Model characteristics

1. The base scenario assumes a decline of almost 10 percent in the real effective exchange rate in 1996. This implies a partial reversal of the exchange rate movements which have occurred in April 1996, with the rate averaging about R4,30 to the US$ during 1996. For the rest of the period 1996-2000 an almost constant real exchange rate is assumed.

2. The main fiscal assumptions in the base model are:
   - a reduction in the budget deficit to 3 percent of GDP by the 2000/01 fiscal year, broadly consistent with current fiscal targets;
   - a decline in real government consumption expenditure as a proportion of GDP to about 18 percent in the year 2000;
   - a decline in tariff revenue relative to dutiable imports from 10 percent to 8 percent, broadly in keeping with the present commitments to the World Trade Organisation;
   - an average increase in the government real wage of about 1 percent per year, based on the agreement reached in the Central Bargaining Chamber and projected inflation;
   - average real increases in general government investment and capital formation by public corporations of between 2 percent and 3 percent per year.

3. Real interest rates remain positive through the simulation period, but fall somewhat with a projected lower inflation environment in the second half of the period.

4. Modest increases in real wages in the private sector are anticipated throughout 1996-2000, associated with productivity improvements and relative stability in labour relations.

Key results

1. As is widely expected, GDP growth reaches a cyclical peak in 1996 of about 3,3 percent and then falls somewhat before recovering to about 3 percent again in 1999 and 2000. Growth is mainly the result of steady increases in fixed investment and manufactured exports.

2. The current account of the balance of payments remains in deficit throughout, but improves to around 1 percent of GDP as a result of relatively weak growth. Without any gains in competitiveness, substantial foreign direct investments are not likely and the current account deficit is financed largely by public borrowing.

3. Government consumption expenditure in the year 2000 is about 2 percent higher than in 1996 in real terms.

4. Inflation rises to nearly 11 percent in 1997 as a result of the exchange rate depreciation and falls slowly thereafter, consistent with adherence to fiscal and monetary policy guidelines.

5. Private saving remains fairly stable, averaging just under 21 percent of GDP, while government dissaving falls to below 1 percent of GDP in 2000.

6. With an estimated output elasticity of 0,4, formal non-agricultural employment growth averages 1 percent per year. Allowing for somewhat faster growth of informal and semi-formal employment (elasticity = 0,7), which accounts for 50 percent of total employment, annual employment creation averages 100 000 between 1996 and 2000 and unemployment rises from 35 percent to 38 percent. Nearly two-thirds of new jobs are non-formal.

In sum, the base scenario represents a stable macroeconomic trajectory in the presence of adherence to deficit reduction guidelines, but export and output growth are insufficient to reverse the worsening unemployment trend. The base model assumes that the deficit reduction programme will be adhered to, and envisages a reduction in real government consumption expenditure relative to GDP. The resulting reduction in government borrowing for consumption purposes represents an enhancement of the capacity of the domestic economy to finance private sector investment and somewhat improves long-run growth potential.

Base Scenario Projections: 1996-2000

Model characteristics	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
Fiscal deficit (% of GDP) (fiscal year)	5,1	4,5	4,0	3,5	3,0	4,0
Real government consumption (% of GDP)	19,8	19,5	19,1	18,6	18,1	19,0
Average tariff (% of imports)	10,0	9,0	9,0	8,0	8,0	8,8
Average real wage growth, private sector	0,8	1,5	1,7	1,3	1,4	1,4
Average real wage growth, government sector	4,8	0,4	0,4	0,3	0,0	1,2
Real effective exchange rate (% change)	-9,6	0,7	0,1	0,1	0,0	-1,8
Real bank rate	7,0	6,0	5,0	4,5	3,7	5,2
Real government investment growth	2,6	2,4	2,2	2,2	2,4	2,4
Real parastatal investment growth	3,0	2,5	2,5	2,5	3,0	2,7
Real private investment growth	6,3	4,2	4,4	5,8	7,1	5,6
Real non-gold export growth	9,6	7,5	6,4	5,5	5,3	6,9
Results	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
GDP growth	3,3	2,0	2,5	2,9	3,3	2,8
Inflation (CPI)	8,4	10,9	9,6	9,3	9,1	9,5
Employment growth (non-agricultural formal)	0,9	1,0	0,8	0,9	1,3	1,0
New jobs per year ('000s)	97	101	84	103	134	104
Current account deficit (% of GDP)	1,8	1,3	1,1	1,1	1,6	1,4
Real export growth, manufacturing	12,5	10,4	7,5	6,6	5,4	8,5
Gross private savings (% of GDP)	20,5	20,7	20,8	20,8	20,6	20,7
Government dissavings (% of GDP)	3,1	2,6	2,0	1,4	0,9	2,0

APPENDIX 4

THE MACROECONOMIC OUTLOOK OF THE INTEGRATED STRATEGY

The simulation results reported here introduce several policy adjustments to the base scenario sketched above, illustrating the possible macroeconomic consequences of the proposed integrated strategy. The key growth drivers, namely the investment and export projections, were tested for feasibility and consistency on all the models and subjected to econometric analysis. There is a strong redistributive thrust to the policy shifts envisaged which is not reflected here due to the macroeconomic nature of the modelling framework.

Model characteristics

1. A real effective exchange rate depreciation of 8,5 percent, averaging R4,25 to the US$ for the full 1996 calendar year, and maintenance of this real rate over the 1996-2000 period.

2. A tighter fiscal stance, reducing the deficit to 4 percent of GDP in 1997/98, falling to 3 percent by 1999/00, resulting in the virtual elimination of government dissaving by 2000.

3. Accelerated tariff reform, bringing forward by two years the scheduled adjustments on clothing, textiles and vehicles and reducing all other lines by 5 percentage points on average in 1997. This improves competitiveness and dampens inflation.

4. A reduction in the average annual increase in the private formal sector real wage from 1,4 percent to 0,7 percent, brought about by wage moderation within the collective bargaining system and sectoral shifts in favour of more labour-intensive industry.

5. Strong increases in investment by public authorities and public corporations, accelerating in real terms to 17 percent and 10 percent, respectively, between 1999 and 2000.

6. Additional growth in real non-gold exports, particularly manufacturing, rising to over 10 percent per annum in 2000, driven by improved competitiveness.

7. Additional foreign direct investment averaging US$509 million over the period, induced by the more favourable investment environment.

Key Results

1. GDP growth improves markedly relative to the base scenario, increasing to just over 6 percent in 2000 and averaging 4,2 percent over the period. Much of this expansion is associated with manufacturing export growth averaging over 10 percent per year accompanied by increased public and private sector investment activity.

2. Gross private savings rises somewhat as a percentage of GDP, due to fiscal discipline, increasing the availability of domestic financing for the accelerated investment.

3. Inflation is lower due to the tight fiscal and monetary stance and the containment of wage increases.

4. The current account deficit increases due to the higher growth, partly financed by foreign direct investment inflows.

5. Employment creation in the formal sector increases from 1,0 percent to 2,9 percent on average per year, brought about in part by an increase in the employment elasticity relative to output growth. Reinforced by increased non-formal employment induced by income growth, job creation increases to an average of some 270 000 per year and just over 400 000 in the year 2000.

The main strength of the integrated strategy lies, however, in the growth prospects after 2000. Annual GDP growth averaging 5 percent or higher, fuelled by strong private sector capital formation, export growth and improvements in labour productivity, leads to employment growth of some 500 000 annually, increasingly dominated by higher formal sector wage growth.

Integrated Scenario Projections: 1996-2000

Model characteristics	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
Fiscal deficit (% of GDP) (fiscal year)	5,1	4,0	3,5	3,0	3,0	3,7
Real government consumption (% of GDP)	19,9	19,5	19,0	18,5	18,1	19,0
Average tariff (% of imports)	10,0	8,0	7,0	7,0	6,0	7,6
Average real wage growth, private sector	-0,5	1,0	1,0	1,0	1,0	0,8
Average real wage growth, government sector	4,4	0,7	0,4	0,8	0,4	1,3
Real effective exchange rate (% change)	-8,5	-0,3	0,0	0,0	0,0	-1,8
Real bank rate	7,0	5,0	4,0	3,0	3,0	4,4
Real government investment growth	3,4	2,7	5,4	7,5	16,7	7,1
Real parastatal investment growth	3,0	5,0	10,0	10,0	10,0	7,6
Real private sector investment growth	9,3	9,1	9,3	13,9	17,0	11,7
Real non-gold export growth	9,1	8,0	7,0	7,8	10,2	8,4
Additional foreign direct investment (US$ m)	155	365	504	716	804	509
Results	**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
GDP growth	3,5	2,9	3,8	4,9	6,1	4,2
Inflation (CPI)	8,0	9,7	8,1	7,7	7,6	8,2
Employment growth (non-agricultural formal)	1,3	3,0	2,7	3,5	4,3	2,9
New jobs per year ('000s)	126	252	246	320	409	270
Current account deficit (% of GDP)	2,2	2,0	2,2	2,5	3,1	2,4
Real export growth, manufacturing	10,3	12,2	8,3	10,5	12,8	10,8
Gross private savings (% of GDP)	20,5	21,0	21,2	21,5	21,9	21,2
Government dissavings (% of GDP)	3,1	2,3	1,7	0,7	0,6	1,9

APPENDIX 5

THE MACROECONOMIC IMPLICATIONS OF A FISCAL EXPANSION

As part of the analysis of the strategic options for South Africa, the possibility of utilising a fiscal expansion as the primary basis for a growth strategy was explored. Such a strategy would normally be aimed at stimulating aggregate demand with the aid of large-scale increases in government spending. The evident attraction of this option lies in the fact that it complements the urgent need for accelerated provision of services and infrastructure.

An area of concern immediately arises. The experience of the past two years casts doubt on the capacity of the public sector to absorb significant additional resources and on the prospects for reprioritisation in the absence of budget compression. A fiscal expansion may therefore exacerbate the unacceptable level of wastage in the public sector inherited from the past.

To investigate the macroeconomic feasibility of a public expenditure driven growth strategy, the effects of an increase of 10 percent per annum in real general government expenditure and in parastatal fixed investment for the period 1997 to 2000 were simulated on the econometric model of the Reserve Bank, and compared to the baseline growth scenario.

The results of the simulations are reported in the table below. Increased spending drives up interest rates which crowds out private investment. The growth rate, after an initial surge therefore declines and falls below the baseline. There is an improvement in employment as a result of government employment growth, however real wages are eroded by inflation. A growing proportion of the increased expenditure goes towards debt servicing. The major problem areas are a current account deficit that increases to well over 4 percent of GDP, a fiscal deficit which rises to 16 percent of GDP and an inflation rate that reaches 15 percent in the year 2000.

Results from two growth scenarios		**1996**	**1997**	**1998**	**1999**	**2000**	**Average**
GDP growth	Baseline	3,3	2,0	2,5	2,9	3,3	2,8
	Alternative	3,3	4,2	2,8	2,9	2,9	3,2
Inflation	Baseline	8,4	10,9	9,6	9,3	9,1	9,5
	Alternative	8,4	11,1	12,1	13,4	14,8	12,0
Current account deficit (% of GDP)	Baseline	1,8	1,3	1,1	1,1	1,6	1,4
	Alternative	1,8	3,4	3,6	3,9	4,4	3,4
Government deficit (% of GDP)	Baseline	5,1	4,5	4,0	3,5	3,0	4,0
	Alternative	5,1	7,0	9,4	12,5	16,2	10,0
Employment growth	Baseline	0,9	1,0	0,8	0,9	1,3	1,0
	Alternative	0,9	3,1	2,2	2,6	2,8	2,4

Furthermore, it should be noted that these models do not provide for realistic expectations. Modern financial markets are aware of the fact that unsustainable increases in government expenditure cause balance of payments and debt servicing problems. These expectation effects, given South Africa's relatively large public debt and limited foreign reserves, would precipitate capital flight at an early stage of the expansion. The outcome would be further currency instability and a possible monetisation of the budget deficit.

These conclusions are not surprising. The case for a public expenditure driven growth strategy rests on a version of the Keynesian model developed for a closed economy with constant prices prevalent in the 1950s and 1960s. In a modern open economy with mobile capital it is not possible to expand government expenditure without a deterioration in the budget and foreign balances and an increased exposure to a loss of confidence.

This analysis is confirmed by international experience. During the 1970s and 1980s several South American countries opted for growth and redistribution strategies characterised by large-scale government spending. The effects in all of these cases were similar: an initial period of sharp increases in output and employment, followed by severe macroeconomic bottlenecks in the forms of balance of payments crises, massive currency deprecation, large government deficits, high inflation and sharply declining real wages and growth rates.

In conclusion, large-scale increases in government spending as a macroeconomic strategy will create major macroeconomic imbalances in the form of high inflation, serious balance of payments difficulties and poor long term growth and employment prospects. This does not imply that increases in government spending aimed at addressing backlogs should not be considered under current circumstances - the macroeconomic strategy presented in this document does in fact provide for substantial spending in this respect. It does suggest, however, that increased government spending of the magnitudes required for it to serve as the foundation of growth is likely to defeat the very purposes of the strategy.

APPENDIX 6

A REVIEW OF RECENT FISCAL DEVELOPMENTS

Since 1993, the main goal of fiscal policy has been to achieve an annual reduction in the budget deficit of about 0,5 percent of GDP, together with a reduction in government consumption expenditure and avoidance of permanent increases in the tax burden. It is also envisaged that there should be an increase in public sector investment spending.

The table below indicates that the budget deficit represented 7,9 percent of GDP in 1992/93, and is budgeted to be 5,1 percent in 1996/97. For the general government as a whole and measured on a national accounts basis, current dissaving peaked at 5,9 percent of GDP in 1993 and fell to an estimated 4,0 percent in 1995. Although these trends represent a significant reduction in the public sector borrowing requirement, this has partly been the result of lags in spending and a robust recovery of revenue during the economic upswing. The underlying fiscal stance has probably remained fairly stable. Given the rising trend of debt service payments, however, the underlying deficit remains a cause for concern.

The actual spending outcome in recent years has been lower than budgeted mainly due to greater end-of-year rollovers, which can to a large extent be carried forward. Some rollovers reflect accrued commitments, including substantial unspent RDP funds. Accelerated delivery and tighter budgetary allocations must in due course lead to a reversal of the trend.

The conventional deficit excludes extraordinary transfers to offset liabilities incurred over a longer period by the government pension fund on early retirement benefits and by the Reserve Bank on the foreign exchange forward book. There are several further aspects to note:

- Debt cost is recorded on a cash flow basis and does not include provision for the discount at which stock is issued, estimated at about 0,5 percent of GDP.
- Inflation-adjusted accounting, incorporating the decrease in the real value of the debt associated with inflation, would reduce debt service charges by about 4 percent of GDP.
- Annual contributions to the government pension fund to improve the pension funding level over-state the level of remuneration by about 0,2 percent of GDP.

Non-interest current expenditure on the national budget has fallen from 25,5 percent of GDP to an estimated 22,3 percent in 1996/97, although outlays in the earlier years included some once-off expenditures. Increases in expenditure associated with the democratic transition were matched by a temporary tax surcharge on income which took effect in 1994/95 and 1995/96. Expenditure containment has been most effective in respect of transfers to local authorities and to businesses, partially offset by an increase in transfers to households (mainly social grants). As remuneration comprises nearly three-quarters of government consumption expenditure, containment of public sector employment growth and/or real wages are key elements in managing the consumption spending aggregate in future.

Although capital expenditure on the national budget has been increasing, actual spending has lagged, largely due to unspent RDP funds. Local authorities have also had some difficulty in maintaining capital expenditure. For the public sector as a whole, this has been compensated for by a stronger recovery in investment by public corporations. The considerable work on programme design done since 1993 will shortly be reflected in increased capital spending.

The higher tax-GDP ratio in 1994 and 1995 reflects, in addition to the cyclical upswing, the effect of the transition levy, phased out with effect from the 1996/97 year. Sales of oil reserves have also contributed to revenue in recent years. Tax reforms since 1993 include:

- consolidation and simplification of the personal income tax schedules;
- reduction in average income tax rates while raising the maximum marginal rate to 45 percent;
- elimination of discrimination between men and women in the tax code;
- lowering of the corporate tax rate to 35 percent; and the secondary tax on companies to 12,5 percent;
- abolition of import surcharges;
- withdrawal of the non-resident shareholders' tax;
- reduction of the marketable securities tax and stamp duty from 1 percent to 0,5 percent;
- increase in the rate of estate duty and donations tax from 15 percent to 25 percent;
- increases in excise duties, including significantly higher duties on tobacco products;
- extension of VAT to certain financial services and abolition of the financial services levy;
- introduction of a 17 percent tax on the gross interest and net rental income of retirement funds.

The combined effect of recent tax reforms has probably been roughly neutral with respect to the overall burden. Several measures have had a favourable impact on the distortionary effects of the tax system, while the overall tax incidence has remained progressive. However, annual adjustments to the personal tax schedule have not fully compensated for the effects of inflation. There has been a strong focus on improving the capacity of the tax authorities and an important step was the establishment of a more independent revenue service.

Total government debt at the end of 1995 amounted to 57 percent of GDP. Foreign debt is less than 5 percent of the total, although a proportion of domestic debt is also held by non-residents. The debt-GDP ratio has risen markedly in recent years, reflecting historically high budget deficits, lower inflation, high real interest rates and the issue of stock to cover liabilities of the former regional governments, forward cover losses of the Reserve Bank, accelerated pre-funding of pensions and provision for early retirement of civil servants. Improved debt management has been identified as a priority of the Department of Finance.

National Budget Estimates (% of GDP)	**1992/93**	**1993/94**	**1994/95**	**1995/96**	**1996/97**
Tax revenue	23,2	23,8	24,7	24,7	25,1
Non-tax revenue	0,6	0,7	0,4	0,6	0,3
Other receipts	0,4	0,4	0,0	0,3	0,4
Total revenue	24,2	24,8	25,2	25,6	25,8
State debt cost	4,9	5,3	5,4	5,8	6,1
Current expenditure	25,5	23,7	23,5	22,7	22,3
Capital expenditure	1,7	2,0	1,9	2,5	2,5
Extraordinary transfers	0,0	3,8	0,0	0,6	0,0
Total expenditure	32,1	34,7	30,8	31,7	31,0
Budget deficit (excl extraordinary transfers)	7,9	6,1	5,6	5,5	5,1

APPENDIX 7

THE REPRIORITISATION OF EXPENDITURE AND THE RDP FUND

A commitment to maintain fiscal discipline while effecting a reorganisation of expenditure in line with the objectives of the reconstruction and development programme has been a cornerstone of fiscal policy since 1994. To achieve this the government established the RDP Fund as a dedicated financing channel to prioritise key developmental projects.

Until its abolition, the RDP fund was a budget allocation scheduled to increase by R2,5 billion per year. In their first year projects appeared directly on the RDP fund vote, thereafter they were assumed under the relevant departmental vote.

RDP Allocations (R million)	**1994/95**	**1995/96**	**1996/97**
Urban infrastructure and development	841	1722	1999
Rural infrastructure and development	116	898	1387
Health services	971	1887	1760
Education	100	511	1000
Protection services	12	284	390
Other	783	285	964
Total allocation	2823	5587	7500
Roll-over of unspent allocations	1947	4245	4643

The bulk of RDP funds have been allocated to social spending. In the area of urban development, the focus has been mainly on infrastructure and to a lesser extent housing, while rural development spending largely concentrated on land reform and water supply. Spending on health has been either in the form of bridging finance to provinces or in support of the primary health care initiative. The contribution to the education budget has been relatively modest, although R1 billion was set aside in the 1996/7 allocation for school building. The “other” category comprises a range of projects, often with a capacity building emphasis.

At a time of very tight budget constraints a significant increase in social infrastructure spending was achieved through the mechanism of the RDP Fund. It is indeed doubtful whether a switch in spending of this order would have been possible in its absence. The RDP Fund has now been abolished in recognition of the ability of the normal budget process to allocate resources to priority areas.

The extent of reprioritisation of the overall budget is shown in the table below which presents figures for the consolidated national and provincial budgets. The most notable change has been the decline in defence expenditure. However, the spending trends in other components of protection services has limited the scale of the relative reduction in spending within the overall function. The continued increase in the proportion of the budget allocated to interest payments, which has been compounded by falling inflation and high real interest rates, has reduced the amount available to other functions. Despite this, there has been an increase in the budget share allocated to social services. The increase in the social services allocation reflects the increase in spending on infrastructure, housing and welfare, and will increasingly come to reflect the impact of new education and health policies. The decline in economic spending has been achieved by a reduction in spending on transport, agriculture and export promotion.

Functional Allocation of Consolidated Budget	**1993/94**	**1994/95**	**1995/96**
General Government	7,5	8,9	7,0
Protection Services	17,6	18,3	16,8
Defence	8,1	8,7	7,6
Police, Prisons & Justice	8,7	9,5	9,2
Social Services	44,1	44,1	46,0
Education	21,1	21,3	21,3
Health	10,6	10,5	10,0
Welfare	8,2	9,2	9,7
Housing	1,2	1,1	1,9
Other Social	2,5	1,5	2,8
Economic Services	13,9	12,0	11,4
Interest	16,9	16,8	18,8
Total	100%	100%	100,0%

Economic Allocation of Consolidated Budget	**1993/94**	**1994/95**	**1995/96**
Current	92,3	92,3	91,7
Wages	36,3	38,1	36,1
Interest	16,9	16,8	18,8
Capital	7,7	7,7	8,3
Total	100%	100%	100%

APPENDIX 8

MANAGING THE PUBLIC SECTOR WAGE BILL

Fiscal discipline is synonymous with the proper management of wages and salaries within the public service, since remuneration comprises almost 50 percent of the non-interest budget. However, containment of the wage bill without maintaining adequate conditions of service for civil servants reduces the overall efficiency of government and is in the end counter productive. The Government's approach to restructuring the public service is aimed at:

- achieving equity and efficiency within the service;
- repositioning various skill categories higher up the salary scale;
- achieving parity between conditions of service in the public and private sector;
- simplifying the complicated grading system and the rigid occupational classification;
- increasing departmental autonomy in the determination of the personnel structure.

During 1996/97 the restructuring package will cost the exchequer an additional R7,4 billion, increased to R8,5 billion with savings to be implemented from July 1996. This will be financed with R6,5 billion set aside under the improvement of conditions of service vote, a supplementary appropriation of R950 million, R550 million of projected savings on the wage bill and R450 million from reduced contributions to the pension fund. The settlement takes the total wage bill from R56,7 billion in 1995/96 to R64,1 billion in 1996/97. For each of the subsequent two years the wage bill will increase by an amount of R6,5 billion, thus raising the wage bill to R70,6 billion in 1997/98 and to R77,1 billion in 1998/99. The real increment in the wage bill will be 3 percent in 1996/97 and 0,5 percent in 1997/98, and it will decline in the following year.

The restructuring agreement provides for utilising any savings that result from the right sizing of the civil service to fund additional salary increases, although the overall increase in the wage bill must remain within the limits set out above. Right sizing will involve the reallocation of resources currently budgeted against unfilled posts, the elimination of posts that are no longer required and the removal of supernumerary officials. It is estimated that there are around 135 000 unfilled posts, of which 50 000 can be immediately eliminated resulting in a saving of R2 billion. The estimated 25 000 supernumerary officials in the provinces due to the incorporation of previous administrations will be offered severance packages. The defence force is scheduled to reduce its staff complement by up to 40 000.

The granting of severance packages is at the discretion of director generals in affected departments. Severance packages will be self financing through the application of savings from unfilled posts, the utilisation of accumulated rollovers, and other savings at the departmental level. The Departments of State Expenditure, Finance and Public Service will carefully monitor expenditure to ensure that the right sizing does not place any additional burden on the budget. Further right sizing is anticipated in 1997/98 and 1998/99 as departmental managers review their organisational structures.

APPENDIX 9

THE OUTLOOK FOR FISCAL POLICY

The fiscal component of the integrated package is a more rapid reduction in the budget deficit towards the targeted 3 percent of GDP. The intention is to reduce the deficit to 4 percent in the 1997/8 fiscal year, and thereafter at 0,5 percentage points per annum. In this appendix the expenditure implications of this fiscal strategy are analysed with the aid of the Medium Term Expenditure Model of the Department of Finance.

The results of two sets of expenditure projections are reported below, corresponding to the macroeconomic scenarios described earlier. In the modest-growth baseline projection the deficit declines to 4,5 percent of GDP in 1996/7 and at 0,5 percent in the subsequent years. The available resources for government expenditure increase at a slow 1 percent per annum from R161 billion to R167 billion in fiscal 2000/1. The faster deficit reduction associated with the integrated strategy places tighter limits on expenditure in 1997/8. However, the additional resources generated by the improved growth performance more than compensate from 1998/9 onwards, with expenditure over the period as a whole, increasing by an average of 2,3 percent per annum.

The cumulative additional resources available for public expenditure with 1995/6 expenditure as base of the integrated strategy amount to R42 billion. A continuation of current policies, on the other hand, would release a total R26 billion in additional government funds.

	1996/7	**1997/8**	**1998/9**	**1999/0**	**2000/1**
Baseline					
Growth rate	3,3	2,0	2,5	2,9	3,3
Deficit as % of GDP	5,1	4,5	4,0	3,5	3,0
Resource envelope (1995 millions)	161 111	161 173	162 503	164 438	166 995
Integrated					
Growth rate	3,5	2,9	3,8	4,9	6,1
Deficit as % of GDP	5,1	4,0	3,5	3,0	3,0
Resource envelope (1995 millions)	161 423	160 248	163 574	168 691	178 981

In order to determine the implications for line departments, a set of medium term expenditure projections broken down by economic category were generated. The results are summarised in the table below.

Cumulative additional expenditure 1996/7-2000/1	**Baseline**	**Integrated**
Remuneration (R billion - 1995 prices)	13 475	17 678
Goods and services	1 125	4 761
Current transfers	-21 125	-21 125
Capital expenditure	9 145	21 773
Interest	23 260	18 490
Total additional resources	**25 880**	**41 577**

The remuneration items in each projection incorporate the effects of the recent agreement on public sector restructuring in term of which the nominal wage bill for 1996/7 and the subsequent two fiscal years has been fixed. Due to the lower inflation envisaged under the integrated package the real cost of remuneration will be higher than in the baseline. The differential is, however, compensated for by the lower anticipated debt servicing costs. The larger deficit and higher real interest rates incorporated in the baseline projections will mean that some 84 percent of the cumulative additional resources available for public expenditure will have to be spent on interest payments alone. This contrasts with a corresponding figure of 43 percent associated with the integrated strategy.

In both sets of medium term expenditure projections assumptions were made to effect a switch in expenditure from current transfers to capital expenditure. In each case significant spending cuts were assumed in respect of transfers to businesses (GEIS, agricultural subsidies, etc), extra budgetary accounts, local authorities, and to a lesser extent, households. In the baseline this would provide capital resources incrementing at approximately R1 billion per annum. In the integrated case, capital expenditure would be able to rise by R2,5 billion per year, sufficient to fund substantial housing, land reform and infrastructural development programmes.

The critical challenge facing fiscal policy is to ensure that the deficit target for the current financial year is not exceeded and to effect sufficient cuts in real spending in the short term to achieve a 4 percent deficit in 1997/8. To this end the Department of Finance has launched an audit of various expenditure programmes, beginning with those funded through the RDP Fund, to identify possible savings.

APPENDIX 10

THE EFFECTS OF RECENT TRADE LIBERALISATION

After a decade of gradually moving away from import-substitution policies, a far reaching programme of liberalisation was launched in 1995 aimed at increasing competitiveness. The key proposals were contained in an offer to GATT effective from January 1995 replacing all quantitative import controls on agricultural and industrial products with ad valorem tariffs, simplifying and rationalising industrial ad valorem tariffs and proposing a phased reduction of tariffs over periods varying between 5 and 8 years. This appendix considers the empirical evidence of the effect of the tariff reductions implemented thus far. The main concern is that subsectors with the largest tariff reductions would have faced the most competition leading to lower output and employment.

Changes in Tariffs, Output & Employment - 94-95	**Employment**	**Output**	**Exports**	**Imports**	**Tariff change**[1]
Food	-1.5	0.0	25.8	26.1	15.4
Beverages	-5.8	5.7	-11.8	22.2	64.3
Leather Products	3.6	7.0	15.0	10.2	-78.7
Wood Products	-5.1	4.8	-16.2	18.2	-20.0
Paper Products	4.8	10.9	71.0	35.7	-40.0
Printing and Publishing	2.1	-3.9	12.1	12.5	-81.8
Glass Products	-3.9	6.6	-14.5	26.8	-52.9
Other Non-Metallic Mineral Products	-7.1	9.1	29.0	37.8	-50.0
Iron and Basic Steel	0.8	14.0	22.9	28.6	-72.7
Non-Ferrous Metal	-3.4	17.9	119.3	122.9	-16.7
Metal Products	-2.2	5.4	55.1	29.8	-56.3
Machinery	13.1	12.5	66.8	22.5	-77.8
Electrical Machinery	-3.0	23.4	58.7	32.3	-58.8
Motor Vehicles	9.4	15.8	19.1	41.0	-62.5
Other Transport Equipment	-4.9	-14.2	..	..	0.0
Other Industries	-3.5	-11.7	-6.7	-18.6	-12.5
Tobacco	-6.7	-2.3	69.8	-8.1	110.0
Textiles	-7.6	12.0	16.5	15.8	-7.9
Clothing	9.9	14.1	18.0	-8.7	-4.0
Footwear	7.6	5.7	2.6	40.6	20.0
Furniture	6.3	8.5	39.2	37.6	-40.0
Chemical Products	-1.4	6.4	43.7	28.5	-36.4
Rubber Products	7.6	8.6	58.3	31.3	-71.0
Plastic Products	14.6	10.2	49.7	28.4	-81.0
Total Manufacturing	**1.1**	**7.4**	**33.7**	**27.5**	**-5.6**

1. Change in tariffs between 1990 and 1995. It should be noted that clothing and textile tariffs were increased in many cases in 1992.

At the sectoral level the evidence is mixed. Among the sectors that faced the largest declines in nominal protection, some increased both output and employment, while others showed the opposite trend. However, these sectors are also not the major employers in manufacturing. The five sectors that faced the largest tariff reductions in 1995 account for only 17 percent of total manufacturing employment.

An analysis of trends among major employers - food, clothing, motor vehicles, electrical machinery and metal products - showed that restructuring need not be contractionary. Despite tariff cuts, a range of firms managed to expand output and employment.

The recovery has undoubtedly eased the potentially negative effects of liberalisation. Between 1994 and 1995 manufacturing output grew by 7,4 percent in real terms, while exports increased rapidly in almost all sectors despite a real appreciation of the currency. These trends have been accompanied by substantial private investment in manufacturing.

Firm-level responses to the pressures entailed by liberalisation are diverse. There is evidence of production processes being reorganised through the introduction of additional shifts, the consolidation of production lines and the alteration of product mixes. Increasing numbers of firms are seeking foreign linkages to acquire technology. In labour-intensive industries firms may resort to sub-contracting to increase flexibility and reduce adjustment costs.

Organised labour may experience the adjustment costs differently. Union employment is typically concentrated in larger traditional firms which may encounter higher adjustment costs, while union membership cannot be extended to new market entrants immediately. In fact, it is doubtful whether the data summarised above captures adequately the changes in employment over recent years.

In summary, preliminary indications are that the aggregate costs of trade liberalisation have been kept low, partly as a result of the economic recovery and a resurgence in exports. The recent depreciation of the rand should shift relative prices in favour of exporters. The integrated strategy is designed to maintain these benefits and limit their erosion through inflation.

APPENDIX 11

MEMORANDUM ON TAX INCENTIVES FOR INVESTMENT

It is proposed that an accelerated depreciation tax allowance scheme to enable existing manufacturing entities to expand in response to the challenge of globalisation, and a tax holiday scheme aimed at new projects in key regions and industries, designed to favour labour absorbing manufacturing activities, should be introduced.

Accelerated depreciation tax allowance

The standard tax allowance for investment in manufacturing plant and equipment at present allows for depreciation at 20 percent per annum over five years. On buildings in the manufacturing sector, the allowance is five percent per year over 20 years.

For a limited fixed period, depreciation allowances in respect of plant and machinery used in a manufacturing process will be allowed at 33,3 percent per year over three years and in respect of new buildings for manufacturing purposes at 10 percent per annum over a ten year period.

The foregoing accelerated depreciation provisions will only apply in respect of new and unused qualifying plant and equipment which is both acquired and brought into use for the first time during the period 1 July 1996 to 31 September 1999.

Details will be made available by the Commissioner for Inland Revenue.

Tax holiday

A tax holiday scheme is to be introduced to contribute to the achievement of South Africa's industrial development goals. It is structured as follows.

Projects which meet certain basic conditions will be awarded a tax holiday, the duration of which will depend on three criteria. The basic qualifying conditions, which will include a sufficient level of domestic value added in a manufacturing process (determined relative to sub-sectoral industrial averages) and evidence of a commitment to key economic goals including human resource development, foreign exchange conservation, and environmental responsibility, are not intended to be unduly restrictive.

The key criteria relate to labour absorption, regional location, and industrial priority. For each of the criteria satisfied a project will be awarded a cumulative two year holiday, up to a maximum of six years.

- Labour absorption will be determined by reference to the proportion of value added devoted to wages and salaries.

- Regional priorities will be determined according to an assessment of regional potential for industrial development and regional need. Qualifying locations, which may be defined as manufacturing development corridors or manufacturing development zones, will be designated by the Minister of Trade and Industry after discussions with provincial governments and taking into account the re-evaluation of the Regional Industrial Development Programme that is to be completed in the near future.

- Priority industries will be defined by the Minister of Trade and Industry in the following categories: labour intensive industries, critical industries with strong economic linkages, sensitive industries affected by tariff reform, and future industries defined in terms of their potential to secure a larger share of global consumer expenditure.

Only new entities will qualify. Regulations defining value added requirements, labour coefficients, development corridors and zones, and priority industries will be released in due course. The tax holiday scheme will be introduced in the last quarter of 1996 and the window for entry into the tax holiday scheme will extend for a three year period. The tax holiday will come into affect after the entity becomes liable for tax, after taking into account the accelerated depreciation allowances referred to above. However, all incentives granted under the tax holiday programme will expire in the tenth financial year after the project has been approved.

The tax holiday scheme will be managed by a board, which will operate according to clear and transparent regulations issued by the Minister of Trade and Industry.

APPENDIX 12

FOREIGN DIRECT INVESTMENT

Increased openness to international trade and capital flows is one of the hallmarks of the more rapidly growing developing economies world-wide. Foreign direct investment plays an important part in encouraging growth in several ways:

- modern technology is frequently transferred through investment flows;
- skills, management expertise and high level training accompany international investment projects;
- access to international sources of finance is enhanced; and
- access to global markets is facilitated.

Following the debt problems experienced in the early 1980s by many countries which had borrowed excessively and faced severe adjustment problems when interest rates increased and international trade slowed, the advantages of foreign direct investment are now widely appreciated. While short-term capital and portfolio flows can meet balance of payments capital account financing requirements under certain circumstances, the risks associated with depending on internationally mobile loan financing are considerable. On the one hand, changed expectations which lead to capital outflows can precipitate serious balance of payments difficulties. On the other, excessive capital inflows associated, for example, with high interest rates and a strong growth performance, can put undue upward pressure on the currency and interfere with domestic financial management. International experience favours foreign direct investment as a more stable source of international finance and as a crucial element in a more outward-oriented growth strategy.

Accelerated investment in the South African economy requires international capital inflows to complement domestic savings and finance the increased imports of capital and intermediate goods which accompany faster growth. The growth model described in appendix 4 suggests that the current account deficit in a period of high growth might reach some 3 percent of GDP, or perhaps US$5-6 billion. The strategy implies that perhaps 15 percent of the foreign savings required would be in the form of direct investment, mainly in export-oriented manufacturing.

Since the 1994 elections, South Africa has received net capital inflows of some R30bn. Most of the investment has taken the form of portfolio flows, which can be quickly reversed as has occurred in recent months. There has been little direct foreign investment. Redressing this imbalance requires attention to the fundamental determinants of international investment decisions and the underlying macroeconomic expectations which may be relevant. These might include:

- political and economic stability, including macroeconomic stability and clarity about economic policy;
- sustained high rates of economic growth;
- labour market stability and flexibility;
- investment incentives;
- the tariff regime;
- protection of property rights; and
- various determinants of expected investment returns.

Macroeconomic and other policies which aim to deal with these factors in the context of an export-oriented strategy can be expected in due course to lead to stronger foreign direct investment flows. International evidence suggests that growth itself is a powerful stimulus of foreign investment. The sustainability of the growth path can be weakened by excessive reliance on foreign capital, however. Higher flows of foreign direct investment are more likely in the presence of a strong domestic savings performance, underpinning prospects for longer term industrial expansion.

Several developments are needed for South Africa to attract a more substantial volume of foreign direct investment:

- an overall macroeconomic environment conducive to growth and an expanding domestic and regional market;
- removal of exchange controls;
- improved domestic savings and steady reductions in the fiscal deficit;
- a tax regime favourable to foreign investment;
- restructuring of state assets so as to create opportunities for equity investment in public corporations by foreign partners;
- improved labour market flexibility and increased training for a more skilled workforce; and
- reduced crime and improved social stability.

APPENDIX 13

AN ANALYSIS OF LABOUR MARKET TRENDS

Recent trends in the labour market are discussed below. The analysis is based on the *standardised employment series (SES)*, which remains the most satisfactory index of long term trends, although it is no longer fully compatible with available survey evidence.

Employment by Sector (‘000s)	**1950**	**1960**	**1970**	**1980**	**1990**	**1994**
Agriculture, forestry, fishing	1018	1033	1076	1010	892	861
Mining, quarrying	488	601	657	769	758	614
Manufacturing	510	642	1083	1460	1517	1476
Electricity, gas & water	24	33	46	79	91	71
Construction	94	123	322	399	468	413
Trade, catering & accommodation	364	513	737	944	1017	925
Transport, storage & communication	248	315	361	502	439	340
Financial and business services	57	120	190	292	448	469
Community & personal services	75	133	182	262	319	318
Government services	268	443	629	976	1325	1463
Domestic services	641	695	882	868	794	767
TOTAL	3787	4651	6165	7561	8068	7717
Growth per annum		2.1%	2.9%	2.1%	0.7%	-1.1%
Non-agriculture-domestic private sector	1860	2480	3578	4707	5057	4626
Growth per annum		2.9%	3.7%	2.8%	0.7%	-0.9%

These estimates indicate that commercial agricultural employment has been in decline since the 1970s. Employment in mining peaked in the mid-1980s at just over 800 000 and has since fallen to little more than 600 000. The contraction in these sectors, and the apparent decline in domestic service, are structural trends which will not be reversed by growth alone.

Manufacturing employment has remained at about 1,5 million since 1980, while employment in construction, electricity and transport has fallen significantly since its 1984 peak. Employment in trade reached just over 1 million in 1990 and has since fallen by 9 percent. The only sectors to record growth through the 1980s and early 1990s have been finance (up by 60 percent since 1980), private services (up 21 percent) and government (up 68 percent). Overall employment growth has fallen from 2,3 percent per year between 1950 and 1980 to just 0,7 percent a year between 1980 and 1990 and -1,1 percent annually since 1990.

Informal and unregulated employment has increased over the past two decades, accounting for perhaps 2 million people[1]. Open unemployment has nonetheless increased from an estimated 19,6 percent of the

[1] In the absence of reliable evidence on the growth of informal and semi-formal employment, the total employment figures reported here take the 1994 estimates of the official October Household Survey as point of departure, and the difference between the 1994 SES figure and the OHS formal employment aggregate as a measure of unregulated employment. The emergence of this category of employment, outside of the SES estimates, is taken to be almost entirely a feature of the post-1980 period.

labour force in 1980 to nearly one-third in the mid-1990s. Survey evidence indicates, furthermore, that another 2-4 million people, mainly in rural areas, are "discouraged" work-seekers who would be in the labour market were there realistic prospects of employment.

Employment and Unemployment ('000s)	**1980**	**1994**	**Growth 80-94**
Estimated labour force	10258	14297	2,4%
Standardised employment series	7561	7717	1,5%
Semi-formal unregulated employment	23	349	21,5%
Informal sector activities	662	1575	6,4%
Total	8246	9641	1,1%
Open unemployment	2012	4656	6,2%
Percentage of labour force	19,6%	32,6%	

The main source of the decline in employment growth has been the secular deterioration in output growth of the economy. The elasticity of formal non-agricultural employment with respect to output growth has been comparatively high: output growth of 6,2 percent in the 1960s was associated with employment growth of 3,7 percent, while output grew at 3,5 percent in the 1970s and employment at 2,8 percent. The unemployment trend has been exacerbated, however, by a more recent decline in labour-output ratios. In agriculture, mining, and domestic service the downward trend in employment seems firmly established. During the course of the 1980s, the responsiveness of employment in several other sectors of the economy to output growth appears to have weakened. Sectoral trends between 1985 and 1994 are illustrated below.

Sectoral Output & Employment Growth	**Employment**		**Value added**	
	('000s) 1985	growth 1985-94	(Rm) 1985	growth 1985-94
Agriculture, forestry, fishing	921	-0.7%	10907	2.4%
Mining, quarrying	790	-2.5%	26130	-0.9%
Manufacturing	1484	-0.1%	58872	0.2%
Electricity, gas & water	94	-2.8%	9143	2.7%
Construction	461	-1.1%	8875	-2.0%
Trade, catering & accommodation	961	-0.4%	35599	0.5%
Transport, storage & communication	518	-4.1%	16977	1.4%
Financial and business services	386	2.0%	32441	1.5%
Community & personal services	277	1.4%	4037	1.7%
Non-agriculture-domestic private sector	4971	-0.7%	184825	0.5%

The links between real wage increases, output growth and employment over the past decade are complex. A simple logarithmic regression of non-agricultural formal private sector employment on the corresponding output and real wage series yields an output elasticity of 0,7 and a wage elasticity of -1,2, broadly consistent with international comparable evidence. Account should also be taken, however, of the effect of the price of capital and technology choice on employment.

Several general structural features of the domestic labour market can be noted:

- Alongside the regulated market, a complex unregulated market exists which has grown in importance. There are in reality no sharp lines between market segments: wage levels and working conditions vary along a continuum. Sub-contracting, substitution of casual for formal employment and considerable flexibility in the structure and organisation of smaller enterprises are important features of recent trends.
- Within the unionised sector, remuneration typically includes a growing non-wage element, which has contributed significantly to the overall rise in the costs of labour. Although the magnitude of wage effects on employment are subject to considerable uncertainty, it is likely that wage-bargaining in unionised sectors has contributed somewhat to the slowdown in employment creation and to a rising gap between remuneration in unionised and unregulated segments of the labour market.
- Apartheid-based migrant labour flows have evolved into more complex rural-urban linkages, both between urban and rural households or household members and involving longer term migration. The pace of urbanisation has been slower than observers were predicting a decade ago, which is consistent with the slow rate of formal job creation.
- Government has contributed disproportionately to employment creation over the past decade and public sector job creation has somewhat exceeded the average growth of the labour force since the early 1980s.
- As has occurred elsewhere, services have become increasingly important sources of employment, and indeed provide the only sector outside of government in which employment growth has continued during the 1990s.

Account must also be taken of global economic forces:

- Relative wages now play a major role in an international division of labour in which low wage products are almost exclusively produced in the developing world;
- International trade between developed and developing countries places downward pressure on unskilled wages and upward pressure on skilled wages;
- Greater labour market flexibility has emerged in many countries, improving prospects of the unemployed finding work but widening the wage distribution.

As South Africa proceeds with trade liberalisation and adapts to international competition, downward pressure will be placed on unskilled wages. If this is not accommodated by the labour market, then unemployment will rise and irregular, insecure forms of employment will increase. Employment of skilled workers and their wages are, by contrast, likely to rise as skills are in relatively short supply.

Institutions of collective bargaining are important vehicles for securing a stable and sufficiently flexible employment trajectory. Progress has been made in this regard, and there has been a marked reduction in the incidence of industrial unrest or of confrontational relations between business and labour. The collective bargaining system will need to strike an appropriate balance between regulating job security, working conditions and promoting training and productivity enhancement strategies, while at the same time ensuring labour market flexibility, especially at the lower end of the wage distribution.

In the context of a broader strategy aimed at accelerating growth, labour market measures which facilitate job creation for unskilled and semi-skilled work-seekers are needed to enhance the labour absorption associated with economic expansion.

APPENDIX 14

THE PROSPECTS FOR GOVERNMENT EMPLOYMENT

Some 1,5 million people are employed by general government, comprising national and provincial departments (1 162 000 employees), statutory bodies (70 000) and local authorities (260 000). Over the past decade, employment by general government departments and agencies has increased by nearly 20 percent, offsetting somewhat the decline in private sector employment over this period. However, the trend in more recent years has been more stable, with increases in education and police compensated for by declines in defence and local services.

The trend in real wages over this period is also of interest. Over the whole public sector, remuneration per worker increased by about 10 percent in real terms between 1986 and 1995, driven partly by improvements in wages at lower skill levels and partly by the sectoral shift in favour of educators and other higher-earning occupational groups. Average remuneration in the private sector increased by roughly the same margin over the period.

The police force currently numbers just under 145 000. Given the severity of the crime problem and the need to expand policing in under-serviced areas, there is a compelling case for some expansion in police services. Correctional services employ nearly 30 000 people at present, and some increase in staffing of prisons may be needed. The National Defence Force employs 120 000 people, and envisages a phased reduction in this number. Overall, total employment in the protection sector should remain fairly stable over the period to the year 2000, with increases in police personnel offset by reductions in defence.

National and Provincial Government Employment	Employment	Percentage
Protection services	277 500	23,9
Health services	210 500	18,1
Education	429 300	36,9
Other services	244 900	21,1
Total	1 162 200	100%

The emerging primary health care strategy of the national health authorities envisages fairly rapid expansion of employment of health personnel in primary care facilities. Curtailment of growth and possible reductions in staff allocations to the hospital sector are implied by the proposed reorientation of health services. Growth in health services employment of 1 to 2 percent annually over the next five years should be possible, and would permit progress with the extension of the primary health network, while retaining appropriate personnel levels in hospitals.

Although there may be some scope for rationalisation of educational administration, total employment in this sector will need to grow in response to anticipated enrolment growth of 3 percent per annum. Increased employment of educators in public schools might feasibly be held to under 2 percent per year, while college and higher education expansion is likely to require a somewhat higher growth rate. Innovative financing arrangements and containment of real salary increases will be necessary if these growth targets are to be achieved.

Other government functions account for some 240 000 public service jobs. Organisational restructuring might permit cutbacks of perhaps 20-30 000 employees. Sustained employment reduction cannot be expected, however, unless accompanied by explicit decisions to terminate programmes, close regional offices, or devolve activities to the private sector. It must also be emphasised that in several crucial areas of general administration, serious personnel shortages have been reported.

Employment by local authorities has fallen over recent years. This trend should now be reversed, as consolidated authorities take responsibility for revised jurisdictions, municipal infrastructural development gets under way and service delivery is improved. The ongoing maintenance and service provision associated with improved services under local jurisdiction should be expected to lead to growth of between 50 000 and 100 000 jobs by the year 2000.

The main area for increasing employment is as a result of the expanded capital spending in the fields of agriculture and land reform, urban infrastructure and housing, social infrastructure construction and road construction and maintenance. It is estimated that capital spending of approximately R1 billion is needed in these areas for every 20 000 jobs, although the employment impact of these programmes will depend crucially on the extent to which labour intensive construction techniques are adopted. In the improved fiscal context of accelerated growth, and provided expenditure on current transfers and the normal government wage bill is contained, it would be possible to increase capital spending by an average of R2,5 billion per annum. A programme aimed at 250 000 jobs by 2000 would then be a realistic, if daunting target.

There are also compelling grounds for expanding the existing provision for special employment initiatives, while paying close attention to long term benefits and effective programme management. Rural land improvement and municipal infrastructure development are possible clusters of such activities. Government cannot undertake to absorb all potential work seekers through such projects, but can nonetheless provide jobs and limiting training opportunities to a significant proportion of the unemployed poor through well designed and carefully managed public works projects.

To conclude, in view of the need to contain public sector remuneration in GDP and the fact that the public sector restructuring process involves a realignment of salaries and wages in several occupational groups, careful management of the size of the public service is crucial. Although the scope for reductions in the size of the public service is uncertain, right-sizing initiatives should have the effect of reversing the growth in administrative personnel. There is more scope for increased employment at local government level associated with social and infrastructural development projects. These initiatives will include activities in which significant numbers of unskilled and semi-skilled workers could be employed, bringing down somewhat the average wage of total public sector employment. Government funded capital projects are an important source of demand for labour in the present context of widespread unemployment, and should be targeted at the end of the market where employment needs are greatest.

APPENDIX 15

THE PROSPECTS FOR EMPLOYMENT CREATION

A balance needs to be struck between encouraging high productivity employment and the expansion of lower wage jobs in order to reduce unemployment. As is illustrated below, sufficient job creation to reverse the deteriorating unemployment trend can be achieved if appropriate labour market reforms and public sector development initiatives are adopted.

A simple model of the determinants of sectoral employment trends is used below to compute future employment on the basis of projections regarding sectoral output growth and real wage movements. There are unavoidable judgement calls to be made in specifying the relevant elasticities to apply in an exercise of this nature, but it has been possible to utilise a range of evidence regarding the main assumptions.

The model takes as point of departure an employment structure based on the 1994 October Household Survey and Standardised Employment Series. The labour force is estimated to grow at 2,5 percent per annum initially, declining marginally thereafter.

The results of two employment projections are reported below, broadly consistent with macroeconomic scenarios described elsewhere. Higher economic growth in the integrated strategy contributes to a stronger employment performance. However, the model also incorporates changed assumptions about wage trends and the responsiveness of employment to output growth, consistent with the industrial and trade policy proposals of the integrated strategy, a more flexible labour market and a stronger emphasis on labour-based development projects in public sector spending.

Unemployment is projected to increase from 33,5 percent in 1995 to 37,8 percent in 2000 in the base run, in which GDP growth averages some 2,8 percent. The annual increase in job opportunities rises from 97 000 in 1996 to 134 000. Unemployment rises to 46 percent by the year 2020.

Unemployment in the integrated strategy reaches 34,3 percent in 1996 and then falls to 32,7 percent in 2000. By the year 2020, unemployment will have fallen to an estimated 8 percent. By 2000, new job creation has reached 409 000 per annum and is particularly strong in the manufacturing, construction, trade and private services, with important contributions from the public service, government administered development projects and the unregulated sectors of the economy. The increase of 833 000 new jobs created relative to the base run can be decomposed as follows:

Sources of increased employment in the integrated strategy	**Formal sector**	**Non-formal**[1]	**Total**
Higher output growth	189 000	119 000	307 000
Increased government induced employment	195 000	7 000	202 000
Improved output elasticities and wage moderation	229 000	8 000	238 000
Interaction of growth and policy shifts	79 000	7 000	87 000
Total	692 000	141 000	833 000

1. Domestic service, semi-formal contractual employment and informal sector activities.

Close to 30 percent of the increase in employment in the integrated strategy arise from changes in the flexibility of labour markets and employment-enhancing shifts in other policies. Institutional and microeconomic reforms are the key to reversing the structural barriers to labour absorption in the economy.

Also evident in the sectoral trends is the critical role of growth in trade and services in ensuring a reversal of the unemployment trend. The primary sectors contribute little to employment growth. Manufacturing and construction are important growth sectors, but it is in trade and services such as tourism that there are the most favourable responses of employment to output growth. It is clear, furthermore, that labour-based development projects, which would mainly be the responsibility of local authorities, have a significant contribution to make to employment creation.

Base run assumptions

Non-primary formal private sector employment is assumed to respond to the real wage trend by a factor of 0,4 after a lag of one year, implying that a 1 percent rise in the real wage lowers employment by 0,4 percent. A smaller wage effect is assumed for mining and none for agriculture.

The secular declines in agricultural and mining employment are projected to continue at 1 percent and 2 percent per year respectively, which is somewhat slower than in recent years, while the employment elasticities with respect to output in both sectors are taken to be 0,2. The output elasticities in the manufacturing and transport sectors are set at 0,35, in construction and electricity at 0,5 and in trade and private services at 0,75.

Regular government service employment is kept constant in the first year and rises 10 000 per year thereafter. Labour-based projects as part of RDP development strategies add a further 25 000 jobs on average per year.

The model incorporates a positive response in the semi-formal and informal sectors to growth and to increases in formal sector real wages, reflecting the apparent trend towards casualisation in certain sectors. Urban contractual employment increases in response to growth with an elasticity of 0,8, and in response to formal private sector real wages with a positive elasticity of 0,3. The broader informal sector responds to GDP growth with an elasticity of 0,6 and to the private real wage trend with an elasticity of 0,1.

Integrated strategy

The integrated strategy model retains the same wage elasticity assumptions as the base run, but the lower private sector real wage trend in this strategy reduces the negative impact on formal employment. Stronger output growth improves formal, semi-formal and informal employment. In addition, the model allows for substantial increases in the responsiveness of employment to output growth from 1987 onwards due to greater labour market flexibility and to support measures for more labour-intensive sectors.

The secular declines in agriculture and mining are reduced to 0,5 percent and 1 percent respectively, while the output elasticities rise to 0,4. Output elasticities of 0,65 are assumed in manufacturing, electricity, construction and transport sectors and 0,85 in trade and private services.

In these projections, public service employment grows by 10 000 in 1996, rising gradually to 30 000 per year in 2000. Development projects administered by public authorities account for 25 000 additional jobs per year.

	Employment 1995	**Employment Projections - 2000**			
		Base Run		**Integrated Strategy**	
	(000's)	(000's)	growth	(000's)	growth
Labour force	**14 658**	**16 487**	**2,4%**	**16 487**	**2,4%**
Unemployment rate	33,5%	37,8%		32,6%	
Agriculture	850	827	-0,5%	867	0,4%
Mining	596	534	-2,2%	571	-0,8%
Manufacturing	1 492	1 555	0,8%	1 719	2,9%
Electricity, water	72	75	0,9%	80	2,3%
Construction	413	410	-0,2%	506	4,1%
Trade	953	1 034	1,6%	1 111	3,1%
Transport	343	351	0,5%	383	2,3%
Other services	798	877	1,9%	923	2,9%
Government service	1 463	1 503	0,5%	1 568	1,4%
Development projects	20	120	-----	250	-----
Domestic service	773	801	0,7%	852	1,9%
Semi-formal	360	411	2,7%	431	3,7%
Informal sector	1 609	1 762	1,8%	1 833	2,6%
Total employment	**9 742**	**10 261**	**1,2%**	**11 094**	**2,7%**

APPENDIX 16

DETAILS OF THE ECONOMETRIC MODELS

The quantitative assessment of the various policy proposals presented in the document was predominantly derived by means of simulations with several econometric models of the South African economy. The models concerned are the macro-econometric models of the SA Reserve Bank, the World Bank and the Bureau for Economic Research and the CGE models of the Development Bank of Southern Africa and the World Bank. Various cross-checks were performed on the different models in order to limit the effects of specific model design features or of specific parameter estimates on the simulation results. For purposes of consistency the final results were derived from a single model. The Reserve Bank model was selected for this purpose, but the results are broadly consistent with results obtained using all the other models. A brief description of the different models is presented below.

The SA Reserve Bank Model: The SARB model is based on the standard income-expenditure framework. It incorporates specific supply-side elements. These consist of an input-output conversion matrix, in which final demand components are transformed into value-added inputs per productive sector, and of a Cobb-Douglas production function which generates a measure of potential output and of the output gap. The latter feeds into imports, investment and into prices via a price expectation term in the determination of wages. The model also includes a monetary sector which determines interest rates and the money supply. The real Bank rate is treated as an exogenous policy variable.

The World Bank Econometric Model: The World Bank econometric model follows the income expenditure format. However, it has a number of unusual features. Firstly, by incorporating an explicit production function (a two-level nested CES with three factors of production) the model allows for switching between a demand constraint and a supply constraint. Secondly, it distinguishes between skilled and unskilled labour and provides for supply constraints in the skilled market. Thirdly, the model tracks the impact of changes in the distribution of factor incomes.

The Bureau for Economic Research Model: The BER model is similarly based on the income-expenditure approach and also deals with the impact of supply-side factors. As in the case of the SARB model, the supply-element is derived from a production function-determined potential output gap which affects prices, imports and investment. In addition, the BER model includes a policy reaction function for the Bank rate and an endogenous treatment of the R/$ exchange rate.

The Development Bank of Southern Africa Model: The DBSA model differs from the econometric models described above in that it is essentially a dynamic computable general equilibrium model resting on a social accounting matrix and various real-financial interactions. The model does, however, incorporate conventional macro-economic relationships.

The World Bank CGE Model: The World Bank CGE model is a fairly standard computable general equilibrium model with profit-maximising producers, utility-maximising consumers and flexible prices that clear all markets except the market for unskilled labour. The model is highly disaggregated with 94 productive sectors, 13 labour skill categories and 24 household types.