ECONOMIC POLICY OPTIONS FOR POST 1994 SOUTH AFRICA

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CHAPTER 1

INTRODUCTION

1.1 PROBLEM SETTING

The South African economy was confronted by many challenges and had to deal with factors other than the problems of normal economic development in past decades. The ideology of *apartheid* forced the South African economy to deal with unique factors in the formulation and implementation of broad macroeconomic policies, mostly designed to support *apartheid*. The system involved the protection of white privilege through racial segregation, the denial of political rights of people of colour, unequal access to economic opportunities and social services such as health care, education and housing, the bantustan policy and job discrimination against the black people of the country (Macroeconomic Research Group -MERG, 1993:3).

In the period 1965 to 1990 the government constantly developed and changed its policies, including macroeconomic policies, to secure the political and economic power of the white minority. These policies manifested in all aspects of economic life, among others:

- Government finances.
- The establishment of state corporations.
- Infrastructure development.
- Foreign exchange and industrial policy.
- Restrictions on the movement and employment conditions of people.
- Ownership of land.
- An ever increasing involvement of the government in all aspects of daily life.

To evaluate the economic effects of macroeconomic policies in support of *apartheid*, an understanding of the nature of the South African economy is needed. A popular perception exists that South Africa is an industrialised country. South Africa is, however, not a rich, developed or industrialised country (McCarthy, 1991:2). Based on the Gross National Product (GNP) per capita and the structure of production, South Africa is considered an upper-middle-income country (International Monetary Fund - IMF, 1992:3). Compared with other African countries, South Africa could be considered economically more advanced, since it has the largest Gross Domestic Product (GDP) on the continent. On the other hand, South Africa's economy in terms of GDP is only about 2% of that of the USA's GDP.

According to McCarthy (1991:2-3), South Africa's economy can be described as a" *mineral-rich, semi-industrialised open economy"*, which refers to the following features:

(i) South Africa is known for its mineral wealth, which includes gold, diamonds, chromium and platinum. Over decades this wealth gave South Africa the means to develop its economy. In this regard, South Africa is fortunate to have such a large mineral base, compared to other African countries, which rely mainly on one or two primary products to acquire foreign exchange and reserves. South Africa however, adds little value to these minerals before exporting them. A logical step would be to develop industries to add value to these minerals.

(ii) Since 1925, South African governments have followed a policy of import substitution in order to develop the manufacturing sector. Protectionist policies were used to discourage imports so that domestic production could replace products that were usually imported. Although this policy succeeded in increasing the contribution of the manufacturing sector, South Africa also developed into one of the most protected countries in the world in terms of international trade. A side-effect of this protection was that it gave rise to monopolistic industries, which find it difficult to compete on the international market.

(iii) The open nature of the economy refers to the large ratio of exports to GDP and the high intensity of imports. During 1988-89, an average of 28% of GDP was exported, while imports on average amounted to 23% of GDP. The openness of the economy, although positive for economic development, also makes the economy more vulnerable to external factors as a result of inconsistent capital flows, exchange rate fluctuations and international competition.

A main characteristic of the South African economy is that it finds itself in a transitional dualistic stage of development. In this context, the economy is divided into a developed sector and an underemployed peasantry in subsistence agriculture. The first sector represents mainly whites, while the second represents mainly blacks. This is a direct result of the *apartheid* policy's aim of securing economic power and control by whites. The dualistic stage of development in the economy has resulted in an uneven income distribution between whites and blacks, which was fuelled by huge wage differences between the races. This situation was one of the contributing factors that gave rise to frustration among black people, and consequently a rise in domestic unrest and violence, especially after mid-1970's. Any economic policy proposal to revitalise the economy will have to address the income disparity between different races for it to succeed.

South Africa experienced rapid economic growth for two decades after the Second World War, which enabled the country to improve the living standards mainly of its white population. During and after the 1970's the economy became bogged down in growth constraints, with the international oil crisis also playing a role. The economy was subsequently unable to improve or even sustain the living standards of the population. The economy was characterised by GDP growth levels below the population growth rate, increasing unemployment levels and declining per capita income. South Africa's GDP per capita has fallen by about 15% since 1975 (Van der Berg, 1991:4). Furthermore, in the period 1975 to 1988, the labour force grew by 3.9 million, while formal employment grew by only 900 000, leaving some three million people to seek a living in the informal sector or subsistence agriculture, or to remain unemployed (Van der Berg, 1991: 4, 5).

The economic situation continued to deteriorate during the 1980's. Three factors played an important role in this regard. Firstly, the "total onslaught" policy and the extraordinary militarisation of the PW Botha era. Vast amounts of money were poured into the defence industry (e.g ammunition manufacturing and aeroplanes) (Jones, 1994:1). This put a tremendous strain on available scarce resources and government finances. Secondly, pressure on government finances was made worse by the manner in which homelands were granted "independence" without any effective control measures over their expenditure. As a result, the South African Government found itself having to contribute billions of rands to subsidise corrupt and ineffective homeland administrations lacking proper accountability. Thirdly, the international sanctions campaign against South Africa intensified in the middle of the 1980's, including trade and financial sanctions, disinvestment and cultural and sport boycotts. It is estimated that the total direct cost of sanctions against South Africa amounted to some R 52 billion in the period 1973 to 1990 (Finansies & Tegniek, 1992:12-13). According to Leape (1991:3), the dominant external factor affecting the South African economy in the period 1985-1990 was a moratorium on the repayment of more than half of South Africa's foreign debt. This resulted in two major growth constraints: the balance of payments and a shortage of capital for investment purposes. As such, *apartheid* and the economic policies designed and implemented by the government in the period 1965 to 1990 in support of *apartheid* led to the stagnation of South Africa's economic growth, resulting in declining living conditions.

The election of a new democratic government in 1994 saw a major change in broad macroeconomic policy with the introduction of its Reconstruction and Development Program (RDP), which was later complimented by the Growth, Employment and Re-distribution Programme (GEAR). The major economic challenges the new government had to address include:

- The inclusion of the entire population in economic activity.
- Putting the economy on a growth path again.
- Correcting the income distribution problem.
- Creating new jobs to alleviate the unemployment problem.
- Correcting the socio-economic problems of education, health and the like.

Many economic policy changes have been introduced regarding fiscal, monetary, and industrial matters. Although the main thrust of the GEAR policy is to stimulate growth and employment mainly through a redistribution program, many implementation problems have been encountered. Some of these problems are inherent in the content of the policy, such as its assumptions and targets, while other problems are experienced with trade unions regarding the perceived negative impact on employment and the gaining of economic power by the majority of people previously excluded from the economy. Despite a general acceptance by the broad public and foreign role players of the GEAR policy, room for improvement and fine tuning still remains. Furthermore, domestic and global economic realities require adjustments to the GEAR policy to align it with changed realities.

1.2 THE AIMS OF THIS STUDY

Seen in the light of the stagnation of the South African economy mainly as a result of the apartheid system, the aims of this study can be summarised as follows:

(i) To describe and determine the impact of the apartheid policy on the formulation and implementation of broad macroeconomic policy in South Africa and the resultant effect it had on economic growth and development, employment and wealth. No attempt will be made to determine apartheid's monetary cost, but rather the effects it had on the economy. This will create a better understanding of its economic impact on and problems caused for South Africa.

(ii) To compare South Africa's development with that of other countries that were more successful, and also those that were not as successful in terms of their economic policies. This is aimed at presenting alternative broad economic policy options for South Africa and to take lessons learned by these countries into consideration.

(iii) To evaluate proposals regarding the direction of those possible future macroeconomic policies for South Africa needed to put the country on a path of sustainable economic growth and development.

The study will show that South Africa could have achieved higher economic growth without economic policies being influenced and dictated by apartheid. Had South Africa followed policies similar to those of East Asian countries, its economic development level could have been on a higher level.

1.3 METHODOLOGY OF THE STUDY

Since the question of apartheid is and was a very emotional issue, the study will not attempt to determine whether apartheid was morally acceptable or not, but will rather analyse the effect it had on economic policy formulation in South Africa and on its people. Furthermore, the study will also not deal with each and every government economic policy decision over the years, but will in some instances refer to those policies which had a visible impact on the course of economic development in South Africa.

As a result of the policy of apartheid, the governments of the day developed and implemented economic policies in line with the principles of apartheid. As such, the government did not always implement those economic policies that would have led to continued and sustainable economic growth and development. Since nobody can say what would have happened to South African history in the period 1960 to 1990 without apartheid, it is assumed that broad economic policy in South Africa would have been developed with the aim of achieving optimum economic growth and development for all people in South Africa.

It should be kept in mind however, that apartheid did not lead to a total economic breakdown, but forced the government to a point where it was necessary to re-evaluate the continuation of the policy. In this regard, even after apartheid, South Africa's economy is still more advanced than that of any African country that was confronted by even fewer problems.

Since it is nearly impossible to calculate the cost of apartheid in monetary terms, the methodology of the study is empirically descriptive. Macroeconomic indicators will be used to support various viewpoints. Important theoretical principles of macroeconomics and the role of the government in the economy are used as points of departure.

Chapter II deals with theoretical aspects of macroeconomics to explain the way in which broad macroeconomic policy is formulated and implemented. It also provides a theoretical basis for the role of government as an economic subject, and provides a rationale or analysis of the expected effects of different economic policy measures.

Chapter III focuses on the economically successful countries of Asia. The aim is to look at the broad economic policies of those countries and their impact. At the end of the chapter specific lessons for South Africa will be highlighted.

Chapter IV deals with the economic failures of the former USSR. Again, lessons for South Africa will be highlighted at the end of the chapter.

Chapter V is a macroeconomic analysis of the South African economy for the period 1965-1990. This will be used to indicate mainly the failure, and to a lesser extent the successes of broad macroeconomic policy in support of apartheid. The chapter also deals with the latest economic policy decisions and proposals of the democratic South African Government, with specific reference to the Growth, Employment and Re-distribution Programme (GEAR).

Chapter VI summaries the conclusions of the study and presents proposals for broad economic policy to stimulate sustainable economic growth and development in South Africa.

CHAPTER 2

MACROECONOMIC THOUGHT AND GOVERNMENT AS AN ECONOMIC SUBJECT

2.1 INTRODUCTION

This chapter deals with macroeconomic theory to highlight the role of government as an economic subject. The actions of each subject in the economy have a certain impact. The aim of this chapter is to use macroeconomic theory as a guide to evaluating different possible outcomes of government economic policies and actions on economic performance. Government policies can be classified on a spectrum ranging from pure capitalist to pure socialist policies or any combination of these. Based on the different forms of the ownership of the factors of production, different coordinating mechanisms and different parameters governments have different roles, functions and responsibilities in the economy which will lead to different economic outcomes.

2.2 BASIC ECONOMIC PROBLEMS AND THE ECONOMIC CYCLE

In a society, certain economic problems exist as a result of the lack of proper allocation of resources and knowledge. There can never be enough resources to address all the economic needs of society. Three basic economic problems exist (Smit, et al, 1996:5):

(a) The scarcity problem

Available resources and means are insufficient to fulfill all needs, since needs are unlimited and continue to expand, whereas resources are finite and scarce. The problem entails trying to satisfy these unlimited demands with limited resources.

(b) Limited resources

These resources include natural resources, labour, capital and entrepreneurship. As needs expand, so does the demand for resources increase, which makes them more scarce and expensive. This problem deals with three essential economic processes, namely the allocation process, the production process and the distribution process. As such, a constant search for answers on how to allocate resources, how and where to produce and how to distribute goods and services, occurs. The search for the solutions to these questions contributed a great deal towards economic and especially technological development.

(c) Unlimited needs

Part of life's cycle is the ever increasing task of satisfying more needs. As needs are fulfilled, new needs arise, creating new demand. For instance, a person who is hungry will be occupied with thoughts of how to satisfy his hunger instead of planning a holiday. If a person's staple food is bread, he will eat bread until such time as he can afford meat, or a meal at a restaurant. Our inherent desire to fulfill our basic needs and improve our economic prosperity means the community's total needs (demand) will exceed its total resources (supply). As a person gets richer, so will his needs increase and variety become more important. According to Maslow's hierarchy of human needs, this expansion of needs will occur as soon as the current need is fulfilled (Figure 2.1).

Figure 2.1: Maslow's hierarchy of human needs

Self-actualization, e.g. self-fulfilment

Ego needs, e.g. prestige, success, self-respect

Social needs, e.g. affection and friendship

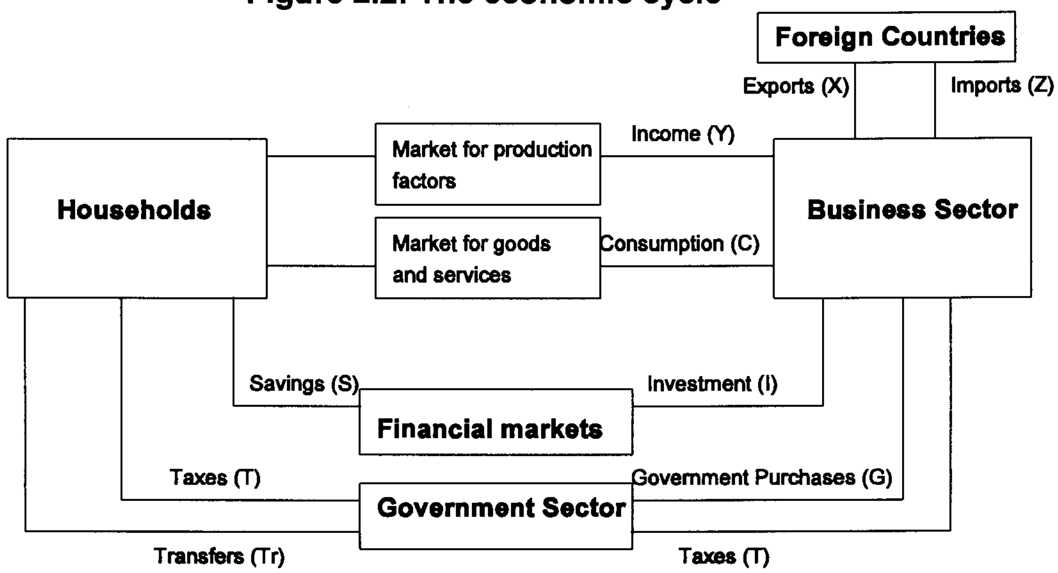
Safety and security needs, e.g. protection, order and stability

Physiological needs, e.g. food, water, air and shelter

Source: Schiffman, et al,1987:83

In seeking to address these basic economic problems, government's role in the economy has become more important over time and has taken on a definite role and character. This is better demonstrated by the economic cycle diagram (Lombard et al, 1987: 282).

Figure 2.2: The economic cycle



The economic cycle consists of four main players, namely households, businesses, the government and the foreign sector (Figure 2.2). Households supply the production factors to business, and then buy consumer goods from them. In the cycle there are two flows, i.e. the flow of goods and the flow of money. Households receive money for their production inputs (salaries), which they spend on goods and services (consumer spending = C). The portion not spent, represents savings (saving = S), which are used by businesses to invest (investment = I). Households are also responsible for paying taxes to the government (tax = T). Businesses do not sell their total production to households. Part of it is retained for stock formation, to serve as intermediate input to other businesses, or for government purchases and exports (X). Exports represent an injection into the economy, since foreigners pay for their imports, which leads to money flowing into the country. Businesses also import those factors/resources that are not locally available (imports = Z). Imports represent a withdrawal of income from the economy since local importers have to pay for their imports. The net effect of exports and imports is X-Z. Government on its part also participates in the economy by levying taxes, transfer payments to the public and investment in infrastructure (governments also participate through state-owned companies, usually in critical sectors such as telecommunication and electricity). Government can withdraw income from the economy or it can increase income in the economic cycle. This function of government forms the main objective of its fiscal policies.

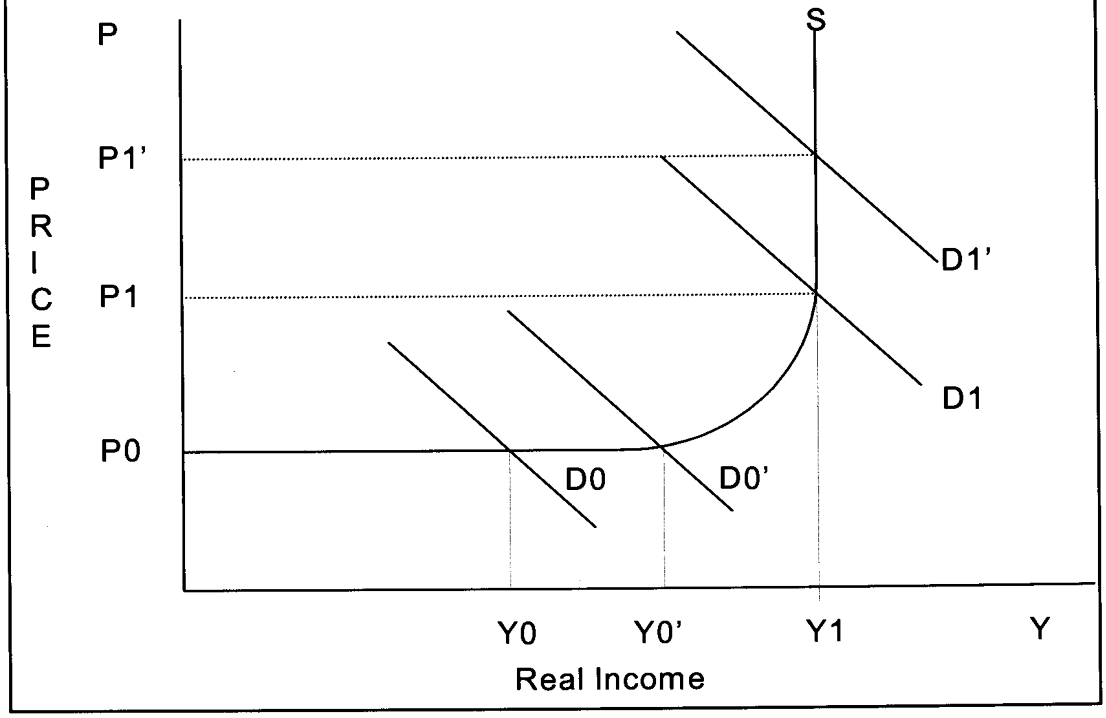
Proceeding from this, the business view of the economy argues that total income must be equal to total expenditure: all money that businesses receive (C, I, G and X), is spent again (Y and Z). The basic measurement of economic activity will thus be Y+Z=C+I+G+X or Y=C+I+G+(X-Z) (Smit, et al, 1996:247). A household's view would be: earnings = payments, thus Y=C+S+T (Smit, et al, 1996:248). As indicated, income equals expenditure for businesses as well as for households. Since a business and a household have the same type of expenditure, the following holds true: C+I+G+X-Z=C+S+T, with C=C for both equations so that I+G+X-Z=S+T. If Z is added to both sides: I+G-X=S+T+Z, the left side represents injections into the economy and the right-hand side represents leakages from the economy. From these equations it is evident that government behaviour and actions do have a direct impact on overall economic performance. By altering its policies, government can improve economic performance. Similarly, if government policies are not suitable or are ill designed, they can have the opposite effect.

2.3 A MACROECONOMIC VIEW

Dernburg defines macroeconomics as *"the study of the behaviour of economic events in the aggregate"* (Dernburg, 1985:3). The aggregates in this field of economic study are the overall rate of unemployment, levels of production and the rate at which they change, and price stability. Thus, macroeconomics is the study of the behaviour of production, employment and prices. Froyen goes further by including interest rates, wage rates and foreign exchange rates (Froyen, 1993:3). Froyen also shows that macroeconomics is the policy-oriented part of economics. It refers to that area of economic life where government can use various macroeconomic tools to alter levels of employment, production, prices and wages.

Different macroeconomic explanations for the mixed economic performance seen over the years have been put forward. In this regard, classicists, Keynesians, monetarists as well as new theories rooted in these schools have all made contributions. These schools contributed to developing the macroeconomic model, which is the unifying principle in macroeconomics. In nearly all cases, major theoretical developments have been absorbed into the model (see, for example, Froyen, 1993). The model is based on aggregate demand and supply (similar to the demand and supply model of a market for a single commodity) (Figure 2.3). Aggregate demand is the end result of all the factors that determine the level of total spending by consumers, government, business and foreign countries. Aggregate demand is influenced by factors such as interest rates, money supply and taxes.

Figure 2.3: Aggregate demand and supply



Aggregate supply is determined by factors such as technology, the supply of capital and labour, pricing decisions by business and inflation expectations. The horizontal part of the supply curve (S) is generally associated with recession or depression, while the vertical segment is generally associated with the classical full employment economy. Equilibrium output and price levels are established where aggregate demand and aggregate supply intersect. If demand (D1) and supply (S) intersect at P1 and Y1, an increase in aggregate demand to D1' will not expand total income, but will only cause inflationary pressure. If aggregate demand (D0) intersects aggregate supply (S) at P0 and Y0, an increase in demand to D0' will increase output and create jobs, without causing inflationary pressure. This is a very simple explanation of the workings of the economy. If other extensions or assumptions are made, the curve might change especially if fiscal and monetary policies are applied to alter demand or supply in the economy. These two instruments are among the most powerful tools available to steer the economy.

2.3.1 Targets of macroeconomics

The three major macroeconomic targets are rapid growth in output (economic growth), full employment and price stability. Economic growth must be the most important target of any country, since growth in output influences all aspects of economic life, such as employment, prices, the ability to increase the standard of living and competitiveness. The reality that economies do not grow at the same rate each year is an important focus point for macro economists. This fluctuation in output pertains to the business cycle.

Economic growth can be defined as an increase in a country's production during a specific period, or as the annual increase in goods and services (Smit, et al, 1996:362). This growth is usually measured in terms of the change in real gross domestic product (GDP). GDP is also used to indicate the level of prosperity of a country by dividing the GDP by the total population (GDP per capita). This is an indication of the level of development of a country and the degree to which the population's needs are satisfied. Although many factors contribute to the change in real GDP, Smit discerns three reasons for economic growth namely, (i) an increase in the supply of capital, as determined by savings and investment, (ii) growth in population to supply labour and increase demand for products, and (iii) technological development and improvements in production factors (Smit, et al 1996:363). Growth in output also refers to changes in productivity, which is the relationship between inputs and outputs. The major sources of economic growth are increases in production factors (labour, natural resources and capital) and technological development.

When rapid growth in output is an objective of a government, it is important to know the potential output levels of the country. The potential output level is determined by starting from the premise that output is a function of long-term growth of supply factors. This level can then be used to measure the relative success or failure of economic output growth.

An increase in economic output, has certain advantages such as an improved standard of living including better education and health services, job creation, social reform, and domestic stability and security. Economic growth also holds certain disadvantages, however, such as increased levels of pollution, environmental degradation and the depletion of natural resources. These disadvantages come at a cost which has hitherto not been included when calculating GDP. The question then is not whether economic growth is desirable or not, but how to deal with the negative effects of this growth.

The target of **full employment** has become one of the most important goals of governments throughout the world. Unemployment can be defined as a situation in which people who seek work cannot find employment at prevailing remuneration rates (Smit, et al, 1996:294). The unemployment rate therefore refers to the number of unemployed persons as a percentage of the total labour force. Three types of unemployment occur, namely frictional, cyclical and structural unemployment. Frictional unemployment refers to those people who choose voluntarily not to work or because they are between jobs. Cyclical unemployment refers to unemployment brought about by a temporary downswing in the economy, a situation where companies lay off employees as a result of a slump in demand for their products. Structural unemployment refers to unemployment as a result of structural problems in the economy. Factors that might cause these problems are technological developments (new processes and materials) and the lack of skilled and trained workers. The sum of frictional and structural unemployment is the so-called natural unemployment rate. A fourth form of unemployment is under-employment, where people are working in the informal sector because they can not find work which pays better in the formal sector.

Price stability is as important as growth in output and full employment. Price changes are measured by a composite price index, which gives one the percentage change in prices over a specific period (the inflation rate). Three causes of inflation can be identified, namely "demand pull", “cost push" and "expectation of future price changes". Unstable and rising prices have a number of negative implications on investment decisions, the value of money, the cost of living and standard of living. Increasing prices also have the ability to erode growth in output, especially in real terms. In this regard, a government can design policies conducive to stable prices using fiscal and monetary policies.

Two other macroeconomic objectives have come to the fore. They are **balance of payment (BoP) equilibrium** and **the equal and fair distribution of economic benefits**. Equilibrium in the balance of payments is important since a continued deficit on the BoP has a negative impact on the value of a currency, which directly influences imports and exports. The growing gap between rich and poor raises the question of an equal and fair distribution of economic benefits to all members of the population. Many governments are seized by this issue. The gap begs the question of whether the economic system of capitalism is sustainable, given the importance and magnitude of this problem.

2.3.2 Central macroeconomic questions

The period since the 1970's has been a challenging one for macro economists, since macroeconomic indicators such as levels of output, unemployment, inflation, interest rates and exchange rates have proven difficult to explain and predict (Froyen, 1993: vii). Questions surrounding increased unemployment despite increases in output, maximum output levels being reached despite their being lower than potential output, and persisting inflation, are being posed. These and other difficulties in the economy have re-focused attention on macroeconomic theories.

2.4 MACROECONOMIC MODELS

Studying economic theories of the past enables an understanding of modern economic problems so as to find solutions for these problems. It also enables a better perspective of the economy, since many modern economic developments have characteristics drawn from various economic schools of thought. In examining historical theories of economics, it is clear that no specific school of thought has all of the right answers to economic problems, changes and development.

The four main schools of economic thought are the Classicists, Keynesians, Monetarists and the New Classicist and New Keynesian directions. In many cases, new schools represent paradigmatic offshoots of older schools due to the latter not being able to explain certain economic problems of that time.

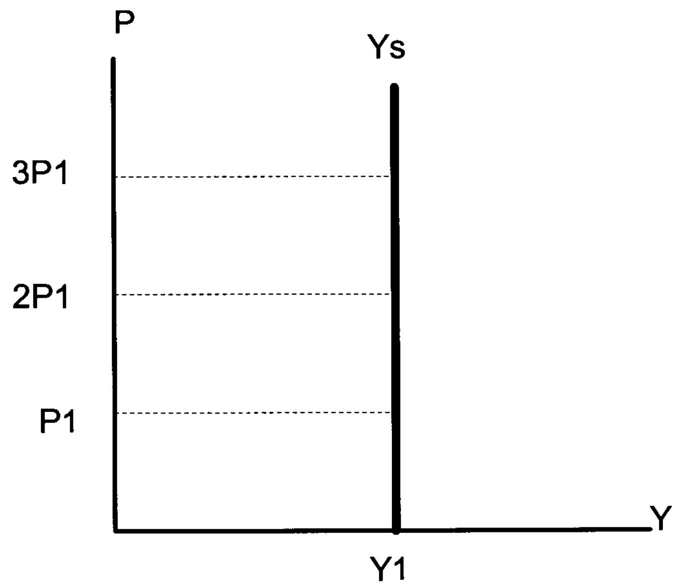
2.4.1 The classical school

The economist John Maynard Keynes classified all economic thinking before 1936 as "*classical economics*". This refers to economic thinking developed by the father of economics, Adam Smith, and his theories on the wealth of nations. Two periods can be distinguished in the development of economic theory before 1930. The first is called the classical period and was dominated by the works of A Smith (1776), D Ricardo (1817) and JS Mill (1848). The second is called the neoclassical period and was dominated by the works of A Marshall (1920) and AC Pigou (1933). These periods focussed mainly on microeconomics (Froyen, 1993:43). Classical thought developed as an attack on the mercantilist economic system of the 1700s. As such, classical theory is based on two premises:

- The role of "real" as opposed to monetary factors in determining real variables such as output, where money's only role in the economy is as a means of exchange.
- The self-adjusting tendencies of the economy when free of government intervention. Government policies to expand demand were considered to be harmful and unnecessary by this school.

The aggregate production function is a central element in the classical model, and represents the relationship between the level of output and the level of factor inputs. It can be presented as: y = F(K, N) where y is real output, K the stock of capital and N the quantity of homogeneous labour. The stock of capital is assumed to be fixed in the short term, while the state of technology and population are also assumed to be constant. As such, output in the short-term varies solely with changes in the labour input. According to the classicists, the demand for labour is Nd = f(W/P), with W as wage and P as profit. This determines that the demand for labour will decrease when wages rise. Similarly, the supply of labour is given as Ns = g(W/P), where the supply of labour will increase with an increase in real wages. The three relationships, together with the equilibrium condition for the labour market of Ns = Nd, determine output, employment and the real wage in the classical system and are referred to as the endogenous variables.

Figure 2.4: Classical supply curve



The vertical classical aggregate supply curve (short-term) reflects the fact that higher price levels require proportionally higher levels of the money wage of labour market equilibrium

(Figure 2.4). The real wage, employment and therefore level of output are the same at P1, 2P1 and 3P1. The nature of this curve implies that output is completely supply-determined. Demand-side factors such as the quantity of money, government spending and the level of demand for investment goods will have no effect on output according to the classical model. Cyclical movements in the economy cannot, however, be explained by the classical model, which gave rise to the Keynesian revolution.

The classical aggregate demand for output in the classical model is implicitly based on the quantity theory of money. To understand the determinants of the price level, it is necessary to analyse the role of money in the economy. As such, the quantity of money determines the level of aggregate demand, which ultimately determines the price level. Characteristics of the classical model are (Smit, et al, 1996:72):

- The government plays a small role in the economy, while free market forces determine production, exchanges and distribution, in effect economic freedom.
- Self interest is the main driving force which maximizes performance.
- A natural harmony of interest exists in a market economy, where the natural order of things plays an important role.
- The wealth of a nation is determined by economic resources (labour, capital, land and entrepreneurial ability) and economic activities such as production, international trade and agriculture.
- Value is determined by production cost.

Despite the shortcomings of the classical system, it did contribute some important economic laws that are still in use today, namely the law of diminishing returns, the notion of consumer sovereignty, the importance of capital accumulation on economic growth and the market as a mechanism for reconciling the interests of individuals with those of society (Smit, et al, 1996:73).

The neoclassical school of thought started out in 1871 as a "marginal school", but later became part of neoclassical economics or microeconomics. It argues that the value of a product is not determined by its production cost, but rather by its usefulness to the consumer, and therefore by the use of a final (marginal) unit of the product. The neoclassical school contributed new mathematical and analytical tools to make economics a more exact social science. Characteristics of the neoclassical school are:

- Rejection of the historical method in favour of an analytical approach.
- Focus on the point of change where decisions are made.

- The individual decision-making process is paramount.
- It assumes pure competition as basis, and later extended it to market analysis beyond pure competition, pure monopoly and duopoly to market structure.
- Marshall synthesised supply and demand into neoclassical economics.
- Economic forces generally tend towards equilibrium.
- It assume that people act rationally in making decisions.
- Minimal governmental intervention in the economy.

2.4.2 Keynesian thought

The apparent failure of the classical equilibrium model to explain economic problems such as rising and persistent unemployment, cyclical movements in output and the depression in the 1930's, led JM Keynes to write his book "*The General Theory of Employment, Interest and Money*", that contained a number of theories related to the business cycle and accompanying sets of policy prescriptions for stabilizing economic activity.

The starting point of Keynes' theory on the high level of unemployment is that it was the result of a deficiency in aggregate demand which was too low because of inadequate investment demand. His theories provided the basis for economic policies to combat unemployment. At the time of the Great Depression, Keynes favoured an increase in government spending through fiscal measures. These theories and policy proposals laid the basis for increased government intervention in the economy, whereby government can influence aggregate demand. According to Keynes, the central problem of the classical model, and also the reason for its failure to provide solutions for unemployment, was its lack of an explicit theory of the aggregate demand for output, and hence, of the role of aggregate demand in determining output and employment (Froyen, 1993:93).

Keynes' theory contains the notion that for output to be at a level of equilibrium, it must be equal to aggregate demand, thus $Y = E$, where Y is equal to total output (GNP) and E is equal to aggregate demand. Aggregate demand consists of three spending components, namely household consumption (C), government (G) and desired business investment demand (I), thus $Y = E = C+G+I$ for a closed economy, and $Y = C+G+I+X-Z$, where X is equal to exports and Z equals imports for an open economy. Characteristics of the Keynesian model are:

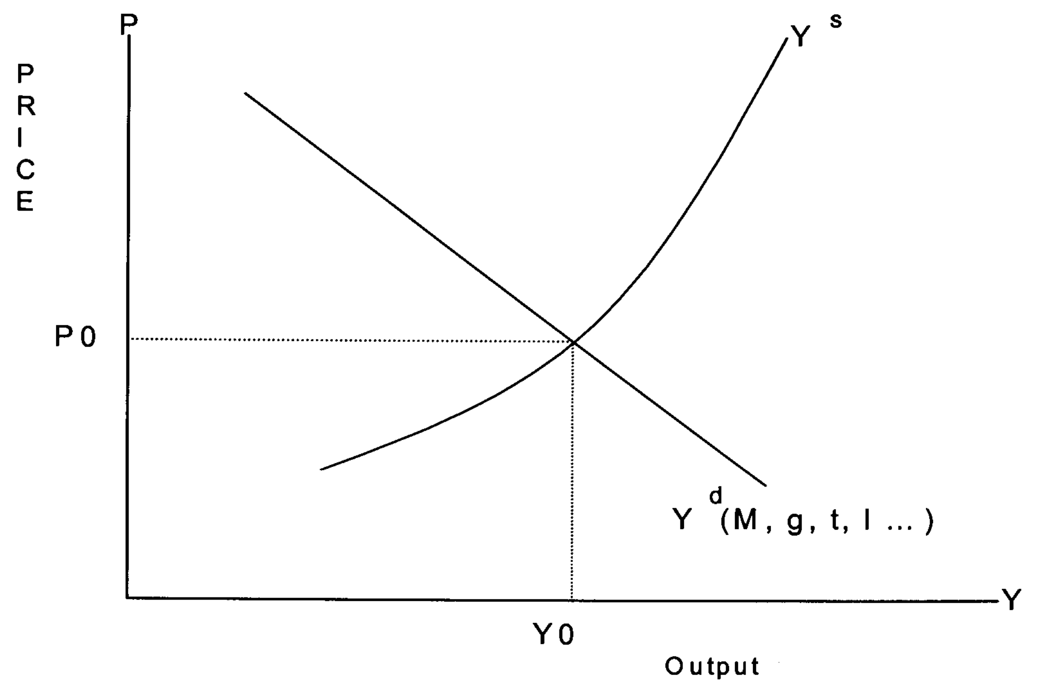
- A macroeconomic approach to the determinants of aggregate consumption, savings, income, output and employment.
- Aggregate demand as an immediate determinant of national income, employment

and output.

- An unstable economy is the result of changes in investment plans that influence national income and output. Equilibrium levels are thus reached by changes in national income and not by changes in interest rates.
- Prices and wages tend to be rigid.
- The model favours government intervention in the economy through fiscal and monetary policy to reach its objectives of full employment, price stability and rapid growth in output (Smit, et al, 1996:83).

The major difference between the Classical and Keynesian theories of aggregate demand is that the Classical school believed that the aggregate demand schedule depends only on the level of the money stock (Mo), while the Keynesian model of aggregate demand also depends on the levels of fiscal variables (go, to), the level of autonomous investment (io), and other variables. The key difference between the classical and Keynesian aggregate supply functions concerns the slope of the function. The Classical aggregate supply function is vertical, which results from the classical assumptions about the labour market, where labour supply and demand are assumed to depend only on the real wage. Because the aggregate supply function is vertical, output and employment are thus determined only by supply: aggregate demand plays no role. In contrast, the Keynesian aggregate supply function slopes upward to the right. The slope would be flatter at levels of output well below full capacity and would become steeper as full capacity output is approached (Figure 2.5). As such, actual output and employment will not be solely determined by supply factors that determine full employment and output.

Figure 2.5: Keynes' aggregate demand and supply



2.4.3 The monetarist counter-revolution

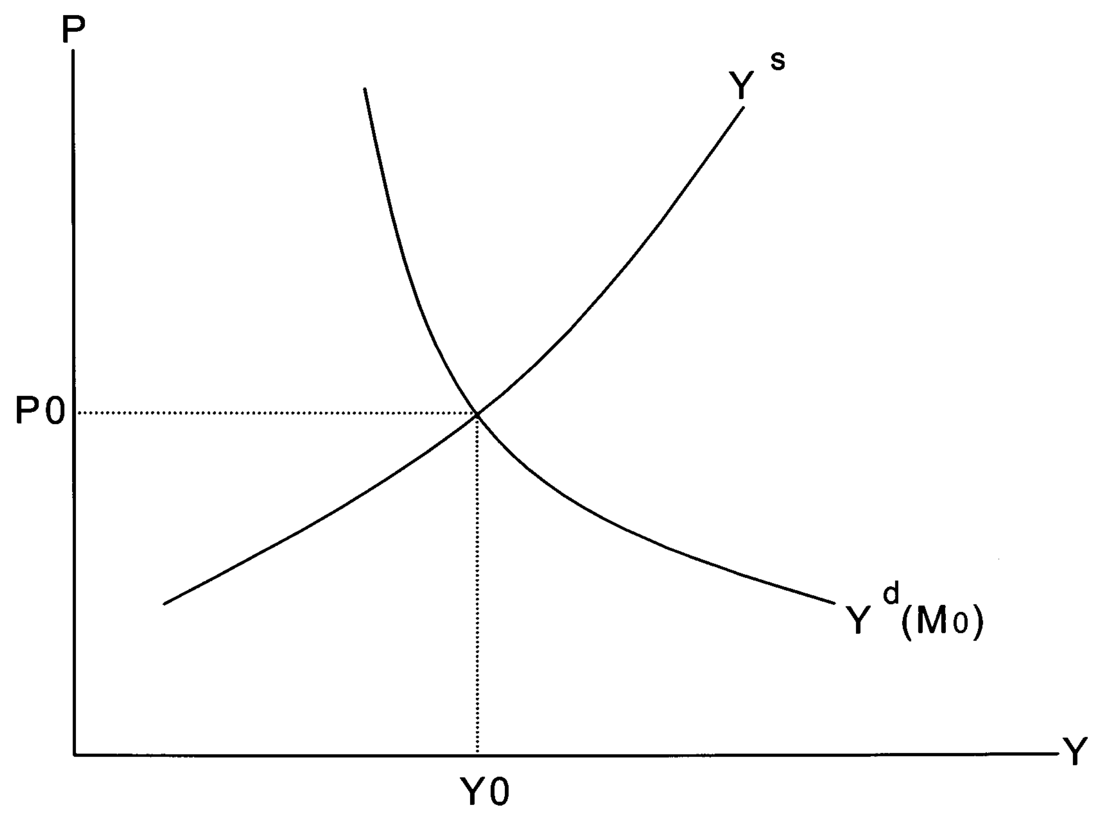
After the Keynesian approach to economics had been well established in the 1950s in response to classical thought, Monetarism began to develop as an attempt to reassert the economic importance of money and therefore of monetary policy. Since early Keynesian thought was also an attack on the quantity theory of money in the classical model, the Monetarist approach was by implication an attack on the Keynesian model where the supply of money received little attention. *The Economist* defined a monetarist as someone "*who thinks it more important to regulate the supply of money in an economy than to influence other economic instruments. This is thought very wicked by those who can't be bothered to find out what it means*" (The Economist, 8 January 1983:4). Milton Friedman was the central figure in the early development of the Monetarist approach, with its departure point of redefining the quantity theory of money as developed by the Classical School. The characteristic Monetarist propositions are:

- The supply of money is the dominant influence on nominal income.
- Money influences the price levels and other nominal magnitudes, implying that over the long-term real variables such as real output are determined by real, not monetary factors.
- The supply of money in the short run does influence real variables, causing cyclical changes in output and employment.
- The private sector is inherently stable and instability in the economy is the result of government policies.
- Fiscal policy is not an effective stabilisation tool, since it has little effect on real or nominal income.
- Stability in the growth of the money supply is crucial for stability in the economy, where the growth rate of money supply is determined by rules rather than by the discretion of policy makers.

An important aspect of the monetarist approach is its view of government as a destabilizing factor in the economy that permits instability in the growth of the money supply, which is the major determinant of the level of economic activity. It also holds that the government can destabilize the economy by interfering with the nominal adjustment mechanism in the private sector (mandatory controls on prices and wages are the most obvious examples). This seems to be similar to the view of the classical model which promotes minimal government intervention in the economy. As such, fiscal options in these circumstances are limited.

In terms of aggregate demand, monetarists believe that changes in the money supply are the major factor causing changes in aggregate demand and nominal income. The demand curve therefore depends only on the quantity of money and is termed by Friedman as an "*exaggeration but one that gives the right flavour*" to monetarist conclusions (Figure 2.6). Monetarists do not, however, deny that there are some non-systematic influences on aggregate demand. In contrast, Keynesian aggregate demand depends not only on money stock, but also on government spending, taxes, investment, etc. As far as aggregate supply is concerned, both Monetarists and Keynesians agree that the aggregate supply curve slopes upward to the right in the short-term. An increase in aggregate demand will therefore increase both output and prices in the short-term, with both schools of thought believing that there is a trade-off between unemployment and inflation in the short-term.

Figure 2.6: Monetarist aggregate demand and supply



2.4.4 New classical economics

The New Classical School developed against the background of the high unemployment and inflation of the 1970's and the accompanying dissatisfaction with the Keynesian model. Both the New Classicists and Monetarists base their theories on aspects of the original classical model, with similar non-interventionist policy conclusions. In an article entitled "*Rules, Discretion, and the Role of the Economic Advisor*", Lucas expressed his agreement with Milton Friedman's proposal for non-interventionist policy rules (Froyen, 1993:313). Lucas was one of the early figures who contributed to the development of the New Classical School.

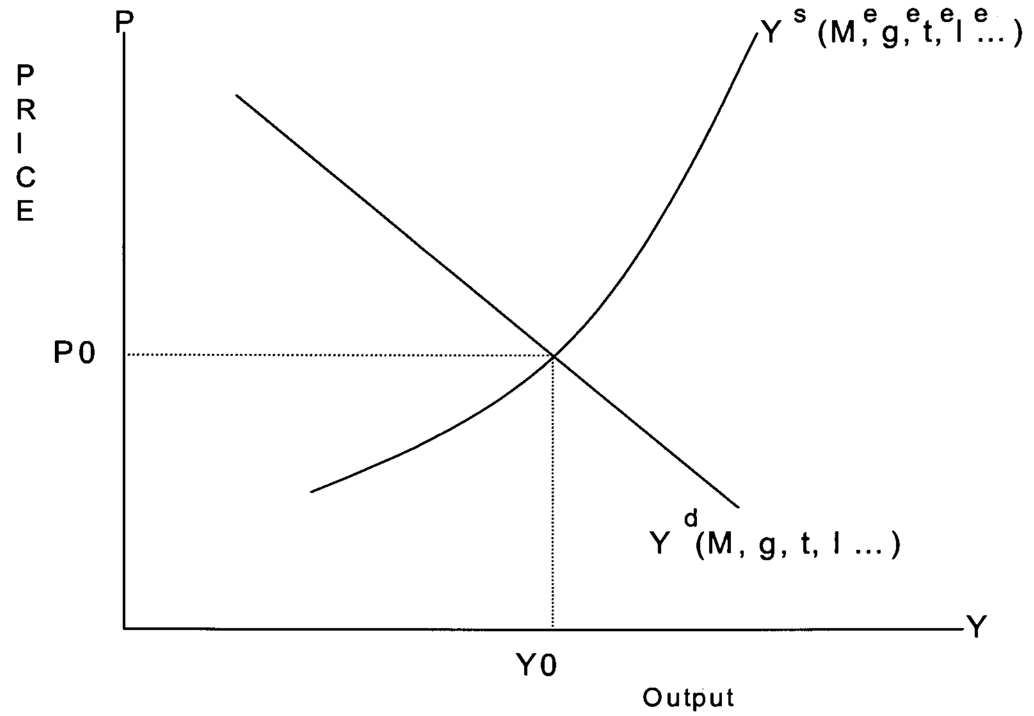
New classical economics was a more fundamental attack on the Keynesian model and highly critical of Keynesian economics as a whole. In their paper "*After Keynesian Macroeconomics*", Lucas and Sargent described the Keynesian theoretical and policy analysis as "*fundamentally flawed, wreckage and of no value*" and suggested a total restructuring of macroeconomics (Froyen,1993:325).

The major criticism on Keynesian theories was:

- The model is based on "*rules of thumb*" such as the consumption and money demand functions, replacing more sound classical functions based on individual optimizing behaviour. They hold that the classical system was more carefully designed, based on a theory of rational choices by individual households and businesses.
- The Keynesian model was made up of ad hoc elements, which were failed attempts at explaining the observed aggregate behaviour of the economy (e.g. the role of expectations). They argued that a subject will form rational expectations, rational in the sense that he or she will use all available information in forming expectations.
- The Keynesian assumption that wages are "sticky". The new classicists argue that markets, including the labour market, "clear" prices including the wage rate.

As such, New Classical Economists argue that macroeconomic models should rectify the failures of the Keynesian model by adhering to the assumption that markets clarify and that agents optimize or act in their own interest. Central to new classical economics is the belief that demand management cannot achieve stabilisation of real variables such as output and employment, since these variables are insensitive to systematic aggregate demand policies in both the short and long term. This implies that systematic fiscal and monetary policy actions that alter aggregate demand will not affect output and employment. This was termed '*the new classical policy ineffectiveness postulate*'. Aggregate supply, according to New Classical economics, depends on the rationally formed expectations of current variables, including monetary and fiscal variables. In this case, the slope of the aggregate supply curve will slope upwards to the right in contrast with the classical vertical supply slope (Figure 2.7). Aggregate demand in this model also depends on variables such as investment, taxes, government spending, etc.

Figure 2.7: New classical aggregate demand and supply

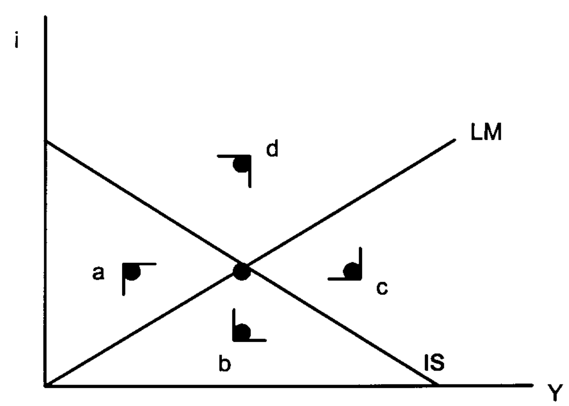


2.4.5 Hicks IS-LM model

To determine the equilibrium level of income and output in the product and monetary market, the IS-LM model can be used. Various theories are used as building blocks in constructing the IS-LM model. The IS-LM model was first introduced by Hicks, and has proved to be the most durable and useful tool for macroeconomic demand analysis (Dernburg, 1985:199). The IS curve represents product market equilibrium, while the LM curve represents monetary equilibrium.

Although the IS curve suggests that various interest rates can be consistent with product market equilibrium, and the LM curve suggests that various interest rates can be consistent with monetary equilibrium, there can only be one interest rate and level of income that is consistent with both for any combination of the IS and LM curves. This level of income and interest rate is determined when the LM curve is superimposed on the IS curve (Figure 2.8).

Figure 2.8: The IS-LM combined



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614311100

By using the IS-LM model, the influence of a number of policy decisions on economic activity can be determined. The slopes of the IS and LM curves will, however, determine the effectiveness of such actions. It is with regard to the slopes of these curves that it is possible to identify the differences between the various schools of thought on the effectiveness of fiscal and monetary policies (Table 2.1).

Table 2.1: Relative monetary and fiscal policy effectiveness and the slopes of the IS/LM curves

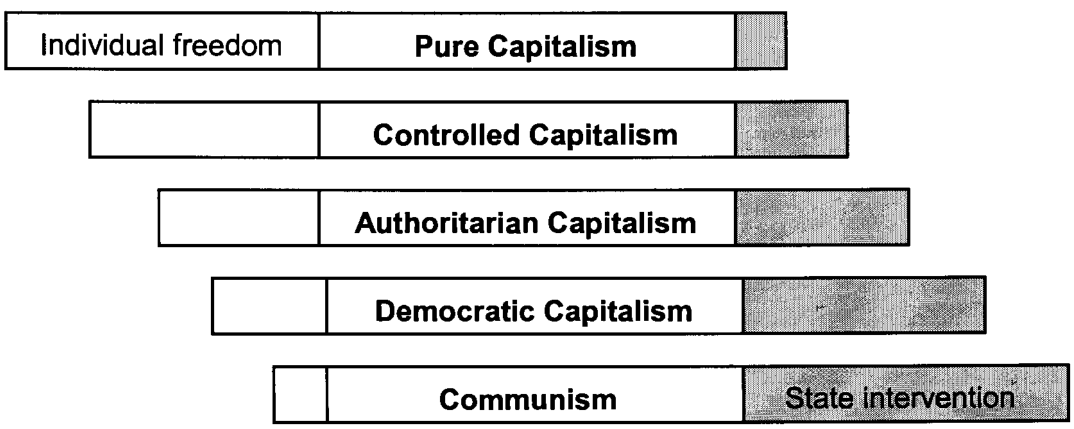
Slope	IS Curve	LM Curve
	Monetary Policy	
Steep	Ineffective	Effective
Flat	Effective	Ineffective
	Fiscal Policy	
Steep	Effective	Ineffective
Flat	Ineffective	Effective

Source: Froyen, 1993:193

2.5 ECONOMIC SYSTEMS

As various economic theories developed, so did different types of economic systems in terms of which societies organised their economic activities. Economic systems are usually indicative of the broad parameters of government policies. The type of system in place in a country will therefore determine the various economic objectives, procedures and policy tools available to maximize wealth creation and the manner in which this wealth is distributed among the population.

Figure 2.9: Spectrum of economic systems



Source: Smit, et al, 1996:16

The extreme economic systems of pure capitalism and communism claim to have as their main goals wealth maximization and an equal and fair distribution of this wealth to the population. As one moves from the top to the bottom, the more limited individual freedoms become and the more state intervention increases (Figure 2.9). There is probably no country in the world with an economic system in place that has all the characteristics of one of these two extreme systems; rather economic systems with a mix of individual freedom and state intervention are found.

2.5.1 Capitalism

Capitalism is a production system in which production factors, namely land, capital, labour and entrepreneurship are privately owned. The state's role in the economic process is minor and there is no central planning (Smit, et al, 1996:17). In the capitalist system the major driving forces are the self interest of individuals, while the market determines the allocation of resources as well as the distribution and prices of all products. The questions *"how, where and for whom"* are therefore determined by the market (demand and supply). As such, individuals have the freedom to make choices on issues such as where to work, where to live, how to spend their money, etc. In a pure capitalist economic system, the government's role will be limited to provide general security, implement laws and regulations to serve as the broad parameters for the functioning of the economic system, and limited social and administrative services. Each economic system has its positive and negative points. Some positive points of capitalism are (Smit, et al, 1996:20):

- It tends to allocate resources better, with better distribution of goods.
- It tends to utilise labour more effectively.
- Individual freedoms.
- It stimulates initiative, which contributes to rapid technological development and thereby improves. overall production.

Some negative points of capitalism are (Smit, et al, 1996:20):

- It results in an unequal distribution of income, which could unsettle the internal socio-political situation in a country.
- It leads to increasing unemployment, since market forces determine the demand for labour as well as the rapid technological advances in production. This goes hand-in-hand with the occurrences of business cycles.
- Investments tend to follow high profit sectors and are not necessarily allocated to production where there is a need (e.g. public infrastructure such as roads and parks).

- It leads to imperfect competition (creation of multi-national companies that sometimes develop into monopolies that can determine production levels and prices).
- Surplus production occurs which sometimes goes to waste (e.g. an apple board will rather dump 20 tons of surplus apples so as to manipulate the price of apples, than give the apples to less privileged people). It is therefore not only the apples that go to waste, but also all the resources involved in growing the apples.

2.5.2 Socialism

"Socialism is an economic system in which the means of production belongs to the state, although limited private ownership is allowed" (Smit, et al, 1996:21). As in capitalism, various degrees of socialism occur. Depending on the degree of socialism, the factors of production belong to the state in areas where the economy is centrally controlled. The state decides what to produce, where to produce, at what price, as well as the distribution process of goods and services. A socialist system falls between a capitalist and a communist system, with characteristics of both.

As a result of the Great Depression in the 1930s, the ability of the market system to regulate itself came into question. This led to governments increasing their involvement in the economy. They believed that this would correct the defects of the market. After more than fifty years, this system also proved to have failed in correcting market defects. For a socialist system to work effectively, government which takes decisions on the economy, should control the economy on the basis of running a business with highly capable people steering this process. Even in countries that view themselves as capitalists, the level of government intervention has increased since the 1930's. These countries also realized in the early 1990's that government's role should decrease. At issue is finding the right balance of government intervention to truly optimize economic activity.

Two types of socialist systems exist, namely authoritarian socialism and democratic socialism. Authoritarian socialism refers to a system where government plays a dominant role in the economy, whereas democratic socialism refers to a system in which the private sector plays the dominant role in the economy. Some positive points of socialism are (Smit, et al, 1996:22):

- Fewer fluctuations in the economy as a result of government intervention.
- The population has a greater sense of security.
- More equal distribution of income among the population.

Some negative points of socialism (Smit, et al, 1996:22):

- Lack of individual freedom. Since everything is provided for by the government, people tend to become more passive and have a lack of motivation. This has a serious effect on productivity levels, and ultimately the competitiveness of businesses in that system.
- Lack of innovative thinking, especially in technologies where it can contribute to increased competition levels.
- The lack of profit as a motive for production leads to inefficient companies that accumulate huge debts, as well as the ineffective allocation of resources.

2.5.3 Communism

"Communism is a production system in which the production practice, land and capital belong to the state. The economy is planned centrally" (Smit, et al 1996:24). Everything in a communist system is owned and controlled by the state, which hold that the private ownership of capital will lead to the exploitation of workers. This system is at the other extreme on the spectrum. In this system, government decides what to produce, how much, where and the distribution of goods and services. The individual's needs and freedom in the economy are thus neglected.

The father of communist ideology was Karl Marx (1818-1883). According to him, all assets within a country should belong to the population as a whole, while each individual participates in the economy to the best of his ability. To this end, the individual would receive goods and services according to his needs. The worker is central to the economy because without the input of the worker, for example, mineral wealth is meaningless. The profits of an entrepreneur are seen as surplus value, with the worker having been exploited to attain this profit. It therefore belongs to the worker. According to Marx, the difference between a worker's wage and the selling price of that product (profit) will eventually lead to the collapse of the capitalist system. Some positive points of communism are (Smit, et al, 1996:26):

- Wealth is distributed more evenly.
- Limited cyclical economic fluctuations since government controls the economy.

Some negative points of communism (Smit, et al, 1996:26):

- Individual freedoms are limited.

- Without a price mechanism it is difficult to determine demand and supply levels.
- Without the profit motive productivity is low and efficiencies in the economy increase.
- Central planning is difficult to implement; it eventually falls victim to its own complexities.

2.5.4 Comparison of economic systems

The differences between the various economic systems are indicated in Table 2.2.

Table 2.2: Differences between economic systems

	CAPITALISM	SOCIALISM	COMMUNISM
Ownership of production factors	Privately owned	State owns basic industries	State
Profit	Basic right	No motivation in state-controlled industries	No motivation
Consumers	Freedom of choice. Standard of living determined by own ability	Freedom of choice, except with regard to products of state industries	No choice. State determines prices and standard of living
Competition	Free competition is supported by legislation	No competition between state industries	No competition
Management	Management decides what and how to produce, based on estimated demand	Management decides in free-market sector. State takes all other decisions	State appoints management to prescribe decision-making
Ownership of land	Private, except for property owned by the state	Mostly owned by the state	State owns land
Capital	From shareholders and private financial institutions	From citizens through savings and from the state	From state by way of tax
Price	Determined by demand and supply	State determines prices in the public sector of the economy	State determines prices
State's role	Limited. Protects consumers	State develops a central economic plan. Individual liberties are allowed within this framework	State plans and implements all economic activities
Labour	Free choice of employment	Free choice of employment, but state planning influences job opportunities	The state is sole employer and therefore determines employment needs

Source: Smit, et al, 1996:28,29

2.6 THE NATURE OF POLITICAL ECONOMY

The parallel existence of and interaction between "state" and "market" in the modern world led to "political economy"; without both state and market there can be no political economy (Gilpin,1987:8). Since the earliest period of civilization, the state has played a role in the economy. Over the years this role has often changed. The development of economics as a science also led to an investigation into the role government could play in improving the performance of the economy. The role of government in the economy decreased during the classical economic period due to this theory.

The inefficiencies of the market in the 1930's saw a change in this tendency, however, when Keynes' work indicated that government could in fact influence the economy through certain policy instruments. Since then government's role in the economy has increased to such an extent that neither the state nor the market can function on its own. According to Gilpin (1987:11), the logic of the market is to locate economic activities where they are most productive and profitable, whereas the logic of the state is to capture and control the process of economic growth and capital accumulation. In this regard the government can make use of economics to protect national interest.

2.7 THE GOVERNMENT AS AN ECONOMIC SUBJECT

According to Lombard et al, the reason the government is studied is because government in a modern society, as a separate economic entity, has the ability to influence the economic process dramatically, and because government decisions evolve in a special manner (Lombard, 1987:101). Much has been written and many theories developed to explain the "why, what and how" of government involvement in the economy.

Two renowned economists of the past had specific thoughts on government involvement in the economy. Firstly Adam Smith, with his "Wealth of Nations", criticized the considerable involvement of the government in the economy at that time. His theories on 'laissez faire' saw government's role and influence decrease over time. According to Smith, government had basically three functions to fulfil. These functions are (i) the protection of the country from foreign invasions, (ii) the development and effective implementation of a legal system and (iii) to provide certain collective services and a public infrastructure. The works of Keynes in the 1930s giving expression to actual of shortcomings in economic processes, led to a strengthening of the role of government in the economy. Since the theories of Keynes included demand side issues, government could influence economic activity by altering its spending and tax policies.

In comparison with other economic subjects, government's approach, responsibilities, functions and decision-making processes in the economy differ substantially from those of households, the business sector and the foreign sector.

2.7.1 Functions of government

The main functions of government can be classified as an order function and a social function. The complexities of modern government intervention in the economy require a much broader classification of its functions. The following functions are identified:

- Maintenance of law and order and national security.
- Stabilisation of economic factors.
- Development of the economic system.
- Economic development.

a. *Maintenance of law and order and national security*

For any society to function properly, it needs to have the assurance that it can do so within a protective framework. This function of government includes the provision of a legal framework, policing, constitutional development, border protection and the protection of national interests. In short, this implies that government is responsible for providing the broad parameters through various rules and regulations so that all participants in an economy can function optimally.

Since no other economic subject can provide these services on a fair and equal basis, such provision is government's most important responsibility. By providing these services, government is in a position to alter individual behaviour through forceful actions. This is one area where government action differs from actions by other economic subjects.

Within the context of national security, especially in the 20th Century, it is government's responsibility to provide the framework for promoting national security. This includes the maintenance of a national defence force, policing and intelligence structures. By determining "what" national security entails and where its parameters lie, government must design objectives, policies and infrastructure to ensure national security. National security is a broad term and includes issues such as national sovereignty, prevention of military action against the country, the protection of strategic industries, resources, information and also the economic ability of a country to sustain and improve its global position. As such, national interest in any country or society represents the collective greater good.

To provide these services certain "withdrawals" from the economy are necessary, such as human resources, materials and money, which influence economic behaviour and processes. The cost of government involvement in this regard is difficult to determine, since the financing of these activities is sometimes shrouded in secrecy. Apart from the nominal cost of this function by government, it is also difficult to determine the contribution of these services to economic growth and development. Despite this it can be assumed that without these services, society and the economy could face serious problems.

b. *Stabilisation of economic factors.*

The ineffectiveness of the market in bringing about economic stabilisation is one of the arguments used to justify government intervention in the economy. The stabilisation function of government in the economy is closely associated with its broad macroeconomic goals of economic growth, full employment, price stability as well as currency stability and balance of payments.

– Economic growth

Growth in economic activity is arguably one of the most important economic goals, especially if that growth exceeds population growth, which implies that the living standards of the population have improved. Government plays an important role in giving effect to the goal of economic growth and must then communicate it, together with its related policies and programmes, to the other participants in the economy. In this regard, government must not only state its policies and programmes, but must also have an indication of "how" these will affect economic growth. Various approaches can be followed such as export promotion, protection of infant industries via subsidies and import measures, and public infrastructure programmes. Since individuals and businesses are primarily concerned with maximizing their personal wealth or profits, and it is government's function to implement policies that will influence their behaviour to such an extent that it contributes to economic growth. Government nonetheless has the responsibility to ensure that its own actions will contribute to economic growth, and that such actions are not counter-productive.

– Full employment

Since the early days of modern civilization the problem of unemployment has existed. This problem can be associated with many socio-economic and socio-political instabilities in many countries. Usually, the government of the day is held responsible for the level of unemployment, which makes it a topic for debate during elections. No theory yet exists which can provide a permanent solution to this problem. With the unemployment levels of the depression years, and in the period after the Second World War, governments were convinced that by increasing their role in the economy, they could address this problem. Initially this approach worked well, but since the 1970's the Keynesian solution for addressing unemployment has not been uniformly successful.

Government has a role to play in addressing the unemployment problem, but the method is at issue. In this regard, government can influence the level of employment directly by following two options. Firstly, government can create jobs through its infrastructure development programmes; secondly, by expanding the public sector. The latter option has, however, proved to be counter-productive, as it increases government's financial burden and uses human resources that could have been better utilised by the private sector. Over the years these approaches have resulted in the accumulation of huge public debt, since the initial rationale for such actions was to create safety nets. The case of Sweden in the 1990's is instructive.

Government can also contribute to increased employment in an indirect manner. This approach requires that government implement actions and policies that will contribute to increased competitiveness in the business sector. This will enable the private sector to increase production and thereby also increase employment. By following this route, the USA has been successful in creating private sector jobs in the 1990's.

– Price stability

Unstable prices as measured by the inflation rate hold numerous negative implications for the economy. Some of these are declining competitiveness, lower purchasing power, faulty predictions, distortions in saving and investment patterns, etc. As such, an ongoing increase in the inflation rate eventually causes money to lose its value as an asset. Any government action in this regard should guard against the danger of using measures that concentrate on the symptoms and not the real causes of inflation (Botha, 1986:48). Since the spiralling inflation of the 1960/70's, governments have designed a number of measures to combat inflation based on fiscal and monetary discipline. On the fiscal side government can restrict its expenditure to ensure that it keeps within budget, while on the monetary side, government can use interest rates to influence the money supply. It is clear that government has a role to play in controlling inflation and ensuring price stability.

c. *Develop the economic system*

Since the economic system that is in place in a country is in many cases based on the ideology followed by its people and government, the government has the function of ensuring that the economic system operates in the correct manner. Whether it is a market system or a centrally-planned system, government is responsible for implementing policies and programs conducive to its goals of economic growth, employment, price stability and economic development.

In a centrally-planned system, government itself is the "market" or at least acts like a market. In this situation government is supposed to "know" its shortcomings, and as a result, correct them. The market economic system also has many "flaws" that sometimes need correction. As such, government will take responsibility for correcting the market. In this regard (Botha, 1986:42-45), government has the following functions:

- Provision of collective goods and services.
- Elimination of external cost and advantages.
- Promoting competitiveness.
- Differentiation of the economic system.
- Improvement of market knowledge.

d. *Economic development*

Economic development is often viewed as synonymous with economic growth. Economic growth is an increase in the goods and services available to the community, while economic development is the improvement of the standard of living of the population as a whole (Smit, et al, 1996:650). Economic development represents the qualitative value added by economics to the standard of living. For economic development to take place, economic growth is necessary.

Economic development is usually measured in terms of GDP per capita. This figure can be seen as representing perfect income distribution, where each member in society receives the same income. To look only at GDP per capita as an indicator of the level of economic development, however, usually gives a distorted picture. Aspects such as literacy rate, life expectancy, access to clean and safe water, etc., are often a better indication of economic development. As far as economic development is concerned, government has a definite function and role to play which touches on its social obligations in terms of providing education and training, health services, and even housing.

The aim of economic development must be to improve the quality of life for all citizens of a country. The Human Development Report of 1991 states that economic development should concern people, the development of people, by people and for people. In this regard the Human Development Report is currently the most comprehensive index for the measurement of economic development. This report makes use of a number of indicators, such as the distribution of income, life expectancy, discrimination against women, etc., to compile an index according to which economic development in different countries is compared.

2.8 CONCLUSION

It is clear given the above theoretical basis that government has a role to play in economics. All schools of economic thought acknowledge the role of government. The extent and depth of this involvement nonetheless varies from one approach to the other and from one economic system to the other. These theories can be used as a valuable guide in designing, evaluating and implementing government economic policies.

The reality of modern economics is that it consists of a complex web of variables, interdependencies and interests, which are dictated by global economic change. This can necessitate government regulatory intervention in the economy where government must contribute in setting the broad parameters for all economic subjects to maximize their potential. Many internal and external factors impact on economic performance, of which government action is but one. Governments of today seem more preoccupied with policies that contribute to economic growth and development. Although politics is still important, economic issues have increased in importance in the last decade as people seek an improved quality of life. In this regard, government is obliged to implement those policy options that will address the basic economic needs of the population.

CHAPTER 3

THE ECONOMIC SYSTEMS OF EAST ASIAN COUNTRIES

3.1 INTRODUCTION

Many of the countries in Asia, such as Malaysia, Singapore, Indonesia and Japan have experienced strong economic growth over the past three decades, leading to a rapid expansion of Asia's role and importance in the world economy (World Bank, 1993:1). What makes the economic growth attained in the Asian region even more spectacular is the fact that this growth could be sustained for many years. By the early 1990's, East Asia looked set to became the world's economic dynamo in the next century (Chau, 1994:2). These successes have contributed to the overall reduction of poverty levels and substantial improvements in living standards. "*The transformation of East Asian countries from being backward and poverty-stricken to an emergent industrialised powerhouse, constitutes one of the most remarkable developments in the postwar history of international development*" (Hussain, 1994:1).

Because of the successes of the Asian region in terms of economic development it is worth taking a closer look at how this was achieved, especially since it is widely acknowledged that Asian governments played a considerable role in achieving this economic success. For the purpose of this study, many of the statements made refer to countries in Asia called the High Performing Asian Economies (HPAE), which include Japan, the Four Tigers (Hong Kong, Taiwan, South Korea and Singapore), the Newly Industrialized Countries (Malaysia, Indonesia and Thailand), and late-comers (People's Republic of China, Vietnam, Sri Lanka, Pakistan and India). *"During the last three decades, East Asia has become the one of the world's most important economic regions"* (Panagariya, 1994:16).

A World Bank study published in 1993 examined 23 Asian economies and reached the conclusion that these 23 countries had achieved higher economic growth than any other region in the world. The economic success of Asian countries is a well documented subject, and as such, literature dealing with this subject tends to commonly refer to the "Asian economic model". Such a single model does not, however, exist, but similar policy elements and development options were followed. The aim of this chapter is to point out the economic successes of the Asian region and to formulate policy lessons that might be of value for South Africa in designing and implementing economic policies.

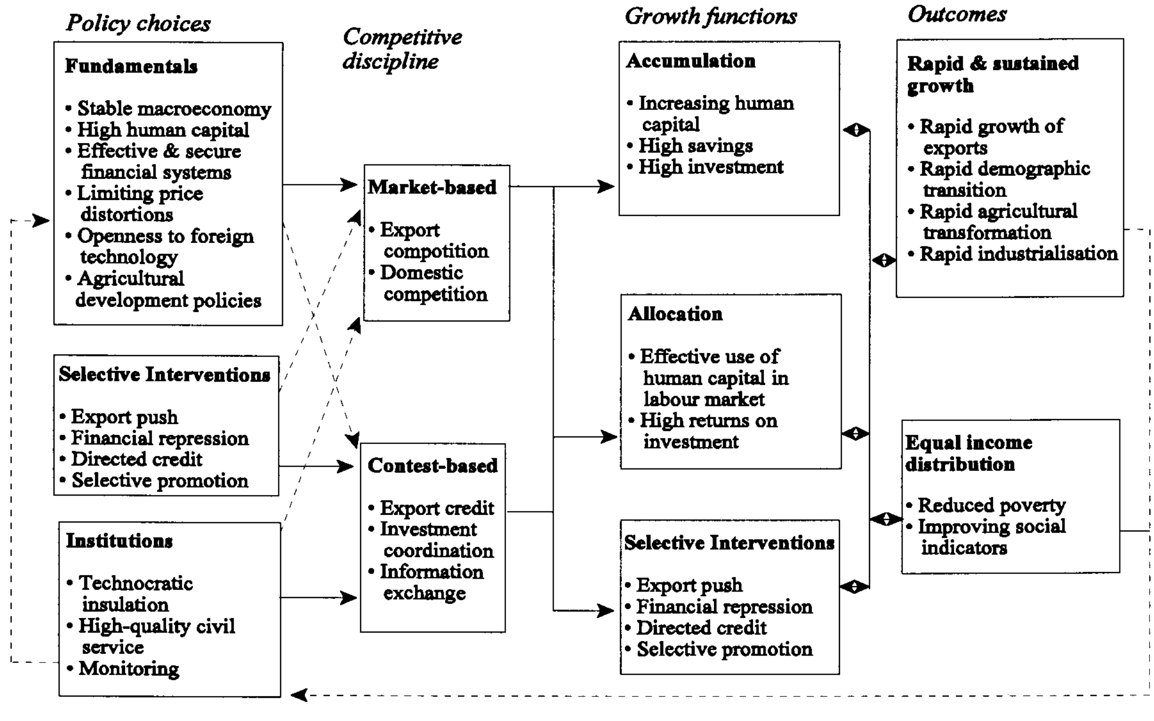
It is important to note that although many of these countries also suffered from the 1997/98 financial crisis, the economic policies followed between 1960 and 1990, and the successes of these policies, are still relevant today. It can be argued that since the financial crisis, many of the successes achieved and policies followed are invalid. The counter argument is that many factors, especially external ones such as the role of international speculators and the impact of globalisation on international financial markets played a role in aggravating the crisis. In some cases though, policy adjustments will have to be implemented to adapt the economic course of these countries. An analysis of the financial crisis nonetheless falls outside the scope of this study.

3.2 THE ECONOMIC SUCCESS OF EAST ASIAN COUNTRIES

3.2.1 A functional approach to understanding growth

In its study "The East Asian Miracle: Economic Growth and Public Policy" the World Bank has developed a framework for the functional approach to growth. This framework links rapid growth to the attainment of three growth functions namely accumulation, efficient allocation and rapid technological advances while maintaining macroeconomic stability. This was achieved by applying various policy combinations of a market-oriented and state-led nature (World Bank, 1993:10). Diagram 3.1 gives a schematic view of the functional approach to understanding East Asia economic success.

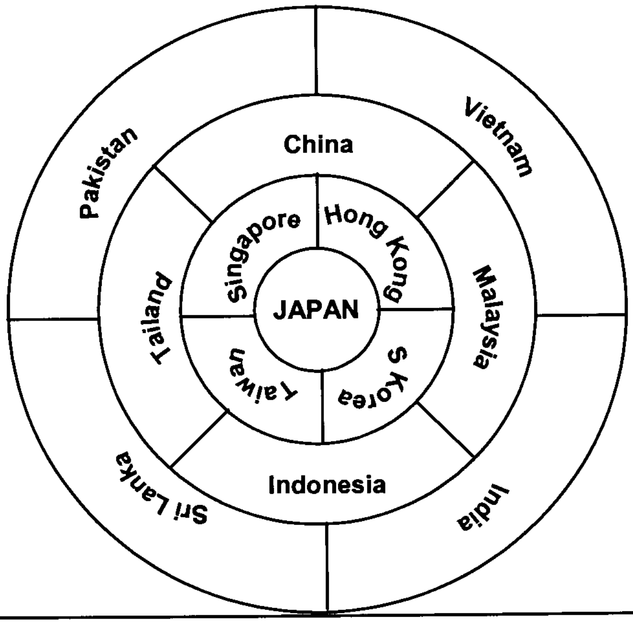
Diagram 3.1: A Functional approach to growth



Source: World Bank, 1993:11

"Outsiders have pondered the success of East Asia - what some call a miracle - with wonder and admiration" (Page, 1994:2). At the heart of this miracle are nine High Performing Asian Economies (HPAE) namely, Japan, the "Four Tigers" - Taiwan, Hong Kong, South Korea and Singapore, the Newly Industrialised Economies (NIE) - Malaysia, Indonesia and Thailand and lately the PRC, Sri Lanka, India, Pakistan and Vietnam as demonstrated Diagram 3.2 (World Bank, 1993:1).

Diagram 3.2: The spill-over effect of economic success of HPAE, starting with Japan



Since 1960 Japan, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia and Thailand have experienced economic growth rates three times faster than South Asia and Latin America. Between 1960 and 1985, Japan, Hong Kong, Korea, Singapore and Taiwan saw their real per capita incomes increase more than four times. (Jaycox, 1994:1). *"East Asia's rates of economic growth are unprecedented in modern history. In the span of a generation, the East Asian economies have moved from among the world's poorest countries to among its most prosperous. Growth in industrial output has occurred in a fraction of the time required for Europe and the United States to achieve similar levels."* (Jaycox, 1994:1).

An important factor, which contributed to the industrialisation of the East Asian NIE's were the favourable economic conditions in the post-war period. This period coincides with Japan's *"Greater East Asian Co-Prosperity Sphere"* and perceived post-war sphere of influence, which encouraged Japanese economic interests in East, including South East Asia, since the late nineteenth century. East Asia became the obvious external market for

Japanese goods as industry became more sophisticated and internationally competitive. After the war, Japanese industrial recovery led to a search for external markets in the region, which was promoted by a wave of post-war decolonisation. This recovery was achieved by taking advantage of the import-substituting industrialisation strategies of most post-colonial regimes in the region, especially from the 1960's (Jomo, 1996:4).

East Asia has a remarkable record of high and sustained economic growth. From 1965 to 1990 the twenty-three economies of East Asia grew faster than all other regions. An indication of the remarkable growth is the average growth of per capita income in the period 1965 -1993. In this regard the growth in HPAE was 5.5% in comparison with the OECD average of 2.3% and Sub-Sahara Africa's 0.2% (see Table 3.1).

Table 3.1: Average growth of GNP per capita - 1965 to 1993 (in percent)	
HPAE's	5.5%
East Asia	5.3%
South Asia	1.8%
Middle East and Mediterranean	1.7%
Sub-Saharan Africa	0.2%
OECD economies	2.3%
Latin America and the Caribbean	1.7%
Source: World Bank, 1993:1	

"Macroeconomic stability combined with human resource development and openness have contributed to the high growth experience" (Panchamukhi, 1996:29). These countries' share in total world trade and GDP more than doubled from 11% in 1970 to 22.7% in 1993 as a result of their outward-orientated economic policies (Wang, 1997:2). Most of these countries also operated within a relatively stable consumer price environment (see Table 3.2).

Table 3.2: Average change in CPI (1961 to 1991)	
HPAE's	7.5%
South Asia	8.0%
SSA	20.0%
Latin America and Caribbean	192.1%
Source: World Bank, 1993:12	

Other factors that also contributed to Asian economic success include (a) hard-working people, (b) low taxes, (c) high savings rates, and (d) minimal government.

(a) ***Hard work:*** The phrase "hard-working Asians" is already a cliché, but not if one considers the hours worked (see Table 3.3). From these figures it is clear that people in Asia did not expect government job creation schemes or social benefits that destroyed jobs in many Western countries. No government tried to limit the hours people could work, the wages they could earn or the hiring of people because they belonged to a favoured ethnic group.

Table 3.3: Comparison of working hours/per year and paid holidays of various countries (1992)

Country	**Working hours/year**	**Paid holidays**
South Korea	2055	26
Thailand	2272	8.8
Hong Kong	2222	12.1
Singapore	2044	17.7
Denmark*	1669	25.0
Germany*	1573	31.2
The Netherlands*	1715	38

Source: ILO, 1994:109
* Deutschland, 2000:25

(b) ***Low taxes:*** Relatively low tax rates were one of the instruments Asian governments used to promote savings and investment. The maximum personal tax rate in Asia tends to be lower than in other parts of the world, and then kick in at higher wage levels than in the industrialised countries (see Table 3.4).

Table 3.4: Comparison of maximum personal tax rates (1994)

	Top tax rate	**Affected income level**
Singapore	30%	$ 259740
Hong Kong	15%	$ 11600
Malaysia	34%	$ 38460
Thailand	37%	$ 159050
New Zealand	33%	$ 18160
Australia	47%	$ 36500
Japan	50%	$ 192300

Source: Asiaweek, 1994:49

(c) ***High savings rates:*** Asian savings rates have been nothing short of phenomenal, helping to power Asia's economic boom (see Table 3.5). High savings allow countries to finance domestic investment in education and infrastructure. Savings rates in Asia have increased more rapidly over past years than in any other region in the world because these countries generally maintained interest rates above the rate of inflation during the 1970's and 1980's. Singapore's savings rate as a percentage of GDP in 1993 was the highest in the world at 47%.

Table 3.5: Asia - savings rate as a percentage of GDP (1993)	
Japan	33%
Thailand	37%
Malaysia	38%
Indonesia	32%
Singapore	47%
South Korea	25%
Hong Kong	32%
Source: Tenold, 1997:7	

(d) ***Minimal government intervention:*** Many academics and journalists studying the Asia economy have tried to discern the role of the governments in contributing to the region's economic success. In most Asian countries government policies contributed to creating the right economic and political climate for the creation of wealth. The main features of the role of government in Asian economies are:

- Many governments established their legitimacy by following the principle of shared growth, promising that all citizens would benefit from economic growth.
- Limited nationalization of corporations.
- Limited state bureaucracies.
- Ensuring a stable, predictable economic environment.
- Actively promoting exports.
- Keeping taxes low.
- Let the free-market forces operate.
- Contributing to creating infrastructure.
- Providing a stable incentive system.

3.2.2 Other common features of the Asian experience

Many of the Asian countries mentioned earlier also share other economic features, making their economic experiences and success distinctly different from other developing countries. These features include inter alia:

- *"More rapid output and productivity growth in agriculture"* (Page, 1994:2).
- A focus on creating effective and secure financial systems. *"Financial sector policies in these economies were designed to encourage savings and channel the funds into activities with high social returns* " (Page, 1994:3).
- Growth rates of manufactured exports were generally higher, which facilitated a rapid absorption of foreign technology.
- *"Earlier and steeper declines in fertility"* - population growth rates declined (Page, 1994:2).
- Rapid technical progress resulting in a high degree of efficiency in the use of inputs. In this regard, some of these countries have more in common with developed than developing countries (Tenold, 1997:4).
- Skilful management and intervention by the authorities resulted in huge increases in human and physical capital accompanied by productivity increases.
- Governments have at various times followed policies such as land reforms, housing schemes, health programmes, and expansion of education so that the majority of citizens share in the benefits of economic growth.
- The ability to alter economic course, which includes the shifting of resources between productive activities. "*All of these countries have successfully undergone several stages of growth, moving from an initial stage which typically involved either land reform or some form of reconstruction following World War II, into labour-intensive import-substitution and then on to more skill- and capital-intensive forms of export manufacturing, and in some cases services catering to international markets; and, in the more advanced of these countries, very high technology production*" (Jaycox, 1994:2).
- Two other unique features of the ESEA experience are worth noting. "*One is the continuous upgrading of manufacturing exports from individual countries in the region as they grow. The other is the transformation of countries from recipients of inward FDI (host countries) to providers of outward FDI (home countries) as they grow*" (Wang,1997:31).

- Over time, almost all Asian governments were engaged in some form of policy intervention such as selective interventions in the repression of interest rates, supplying direct credit, selective industrial promotion, and trade policies to stimulate manufactured exports (Page, 1994:3).
- A generally stable domestic security situation was favourable for economic activity and facilitated the implementation and pursuit of growth-focused policies.
- Governments focused on investing in basic education, especially on science and technology training after schooling (Page,1994:3).
- *"Letting markets work: flexible labour markets. They have focused their efforts on generating jobs, effectively boosting the demand for workers. As a result, employment levels have risen first, followed by market and productivity-driven increases in wage levels"* (Page, 1994:4).

The correct combination of hard work, low taxes, high savings rates and minimal government intervention in the economy are in a nutshell the secret of high and sustained economic growth in most Asian countries during the period 1960 to 1990. Rapid economic growth did not take place simultaneously in all countries. It instead followed a spiral pattern of growth in which there were leading countries, catching-up countries and newcomers. This was attained despite differences in development strategies, history, culture and government (Hussain, 1994:2). These positive developments in Asia were supported by sound macroeconomic policies.

3.3 THE ROLE OF EXPORTS

Many studies have been done on the role of exports in the Asian economic success (e.g. "Trade and Foreign Investment in East and South-East Asia" by Wang, 1997). Exports undoubtedly play an important role in economic development and growth. The question of whether exports generate economic growth or whether economic growth generates export growth nonetheless arises. Since the 1960's, Asia has achieved successes in both these areas with its share in world trade double than what it was in 1965. As a result of the export growth of Asia and the focus of those governments on stimulating exports, the concept of "export oriented industrialization" enjoys wide recognition today and is being followed by many governments implementing economic reforms. Key elements of an export-led strategy include the importation of the best available technology and know-how, competitiveness in international markets and labour specialisation (Hussain, 1994:3).

"Export promotion is defined as public policy measures which actually or potentially enhance exporting activity at a company, industry or national level. The role of export promotion then is the creation of awareness of exporting as a growth and market expansion option; the reduction or removal of barriers to exporting; and the creation of promotion incentives and various forms of assistance to potential and actual exporters" (Van Der Hoff, et al,1991:)

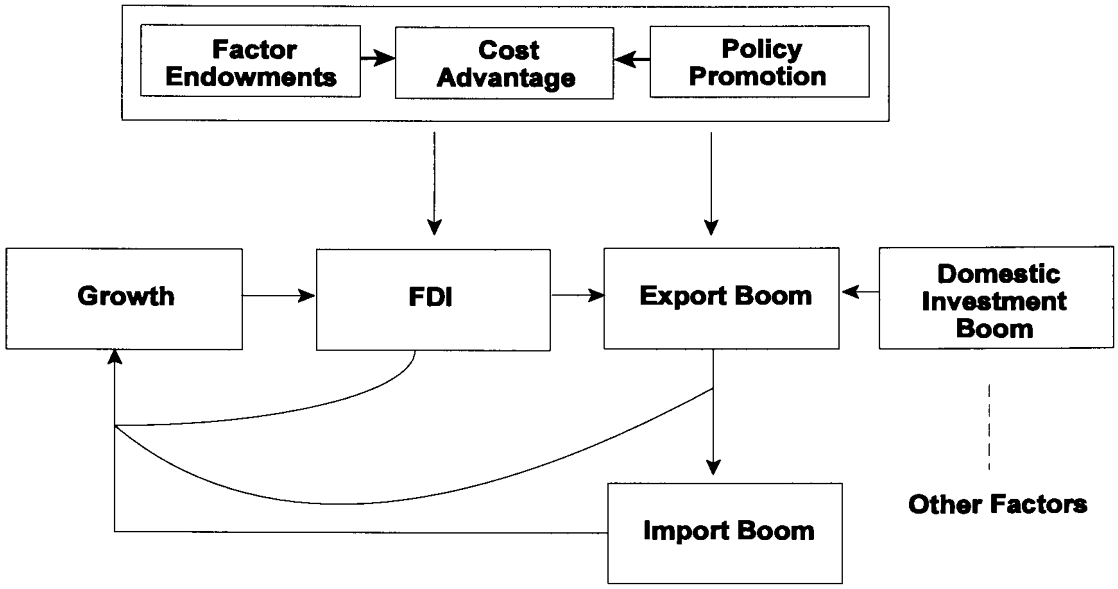
Japan was the first country in the region to introduce policies that stimulated exports, and was soon followed by the four Asian Tigers and later by other Asian countries. These countries believed that in their pursuit of rapid economic growth and industrialization they had to implement export-push policies. This was achieved by introducing specific export targets in exchange for protection in the domestic market, a combination of import-substitution and export-promotion measures. *"Such provision of effective protection conditional on export promotion appears to have been a critical difference between East Asian late industrialisation and other experiences of import-substituting infant industry protection with the infants never really growing up to compete internationally*" (Jomo,1996:16).

As a result, three Asian countries are classified as "super-exporters", characterised by the export of an increasingly sophisticated range of industrial products. In terms of exports as a percentage of domestic output in 1993 these countries (Malaysia 81%, Hong Kong 129%, and Singapore 168%) achieved superior export performances (Wang, 1997:6). Asian exports are also characterised by a large composition of manufactures. *"While these countries mostly exported low value-added labour-intensive manufactures two decades ago, they now export on a large scale high-tech manufactures with high value-added*" (Wang, 1997:31).

3.3.1 The "virtuous growth cycle"

In his study, Wang argues that the *"export booms in East Asia since the 1960s may have been driven by an increase in the profitability of investment, with outward orientation as a consequence of the investment boom rather than its instigator*" (1997:22). In an attempt to explain the relationship between trade, government policies and foreign direct investment (FDI), Wang developed the "Virtuous Growth Cycle" (see Diagram 3.3).

Diagram 3.3: The Virtuous Growth Cycle



Source: Wang, 1997:24

According to this model, it is possible that a combination of increased domestic investment, government policy, factor endowments and other factors will have a positive impact on export growth, which on its part will lead to increased imports. Wang argues further that such expansion of trade, particularly when export manufactures are based on technological know-how could stimulate growth through a number of channels. They are:

- Cross-border spillovers,
- Cross-border imitation (innovating country),
- Cross-border imitation (imitating country),
- Cross-border imitation (global),
- Product market effect,
- Factor market effect (Wang, 1997:25-27).

Wang also makes the following observations regarding the interaction of government policies, FDI, trade and other factors:

- Manufactures' share of exports tends to increase.
- Manufactures export tends to become more sophisticated.
- Countries tend to develop from recipients of FDI to providers of FDI as their export quality improves and there is a shift of production of less sophisticated manufacturing

to even less developed countries.

- As countries move through the "virtuous growth cycle", they also climb a "growth ladder". (Wang, 1997:31).

The prospect of profit from trade with the world, as well as FDI, serve as an important motivator in the process of "ladder climbing". Characteristic of the "growth ladder" process is the exploitation of economies-of-scale and inter-country cost differences, which lead to increased regional integration *"and continue to be the unifying forces that stimulate growth across the region"* (Wang, 1997:32). Wang thus comes to the conclusion that this constant regional economic interaction may be the reason for the cluster of Asian regional economic growth. The interdependence in the Asian region as a result of the export focus of governments has led to functional regional integration, creating vast networks linking regional actors. *"This functional integration can be traced through examining three aspects, namely: intra-industry division of labour, inter-regional trade and inter-regional investment, which tended to interrelate and reinforce each other"* (Hussain, 1994:7).

3.4 THE ROLE OF INDUSTRY

The authorities in East and Southeast Asian countries have played an active role in industrialisation, and a variety of industrial, technology and foreign trade policies were utilised to direct industrial development. A large part of this direct intervention was aimed at increasing the production, and especially the exports of manufactures by focusing on trade policies and directed credit. *"For those who acknowledge their success in terms of industrial policy, North East Asian States have been variously credited with having capacity, coherence and competence, particularly in terms of their ability to successfully coordinate and discipline private firm behaviour and otherwise intervene in market processes without generating serious government failure"* (Jomo, 1996:5).

3.4.1 Lessons from industrial policy in South East Asia

It is widely acknowledged that governments played a role in the regions' industrialisation although variations in the nature and extent of this role exist. (Jomo, 1996:12). Despite the questionable nature of this role, evidence exists that government did make a contribution towards industrialisation.

"The role of governments in promoting industrialisation beyond what would have been possible and likely without intervention is suggested by the contrasts between the late colonial economies of Malaysia and Indonesia and these national economies today. Despite all the flaws and abuses involved, there is now little doubt that the structural transformation and industrialisation of these economies have gone well beyond what would have been achieved by exclusive reliance on market forces and private sector initiatives" (Jomo, 1996:13).

An important starting point for industrialisation is to focus on developing already existing comparative advantages such as cheap labour and national resources, which requires some government support. This holds particularly for strengthening exports by providing support in the form of information, marketing, finances and incentives, rather than by relying on free trade, while an infant industry programme can focus on tariff protection, subsidies, human resource training and other government support. This approach was followed by many Asian countries, resulting in production efficiency, cost competitiveness as well as product quality improvements (Jomo, 1996:14).

Furthermore, Asian governments not only started the industrialisation process, but continued to support it by adapting their role as circumstances changed. This was especially the case in addressing new problems of market and state failure and the changing international arena. "*While State intervention may not necessarily be a superior solution to a market failure, a State failure may be better addressed by different government intervention rather than by relying on the market.*" (Jomo, 1996:16).

The fact that many Asian countries followed similar industrial policies coupled with the existence of growth triangles in the region created a favourable environment for spill-over successes. At the same time, the contribution and importance of social investment in health, transport, education and other areas cannot be underestimated in enhancing labour productivity, a crucial element of successful industrialisation. "*The pattern and pace of regional industrial restructuring in East Asia has not simply been market-driven, but has also been very much affected by home as well as host country industrial policies which have encouraged such industries to relocate abroad, e.g. in South East Asia and China*" (Jomo, 1996:5).

As noted earlier, industrial policy should favour and develop national, especially human resources. Much social investment in areas such as education, housing, transport and health enhances labour productivity and contribute to industrial development by socialising costs and promoting social and political stability. "*Industrial policy has also been poorly conceived when:*

- *Not based on a sound analysis of the market failures it was supposed to overcome.*
- *Not selective in addressing specific market failures and maximising the positive externalities of developing strategic industries.*
- *Ignoring market signals in trying to achieve efficiency.*
- *Underestimating the information requirements necessary for effective interventions.*
- *Overlooking the limited capacities, competencies and capabilities of governments.*
- *Overestimating the human and other resources available to build efficient industries.*
- *Otherwise disregarding efficiency, scale and other considerations*" (Jomo, 1996:18).

Industrial growth in these countries was promoted by the growth of key industries. In this regard governments followed a two-pronged approach by focusing on labour-intensive export manufacturing while not abandoning import-substitution. A key element of the success of industrialisation in Asia was the acquisition of technology and know-how in an attempt to close the technology gap and catch-up with more advanced countries. This was done either through promoting FDI or imports (Hussain, 1994:5).

For industrialisation to be successful, the process must lead to improved productivity and efficiency. Several policies were implemented by Asian countries to achieve this, including absorbing foreign technology (technology transfers in the form of licenses and capital goods imports), promoting specific industries (including import protection and subsidies for capital and other imported inputs), and encouraging export strategies (liberalization of exchange rates and currency devaluation).

"*Manufactured export growth provided a powerful mechanism for technological upgrading. Because world markets for technology are imperfect, firms that export have greater access to technology than those that produce import substitutes or non-traded goods. Exports can confer benefits to the enterprise and spillovers to the rest of the economy that is not reflected in market prices. These information-related spillover effects are an important source of rapid total factor productivity growth*" (Page, 1994:5).

3.4.2 Diverse industrial policies

Industrial policy has been the most controversial aspect of policy in many successful Asian countries; while many observers see it as the *"major reason"* for Asia's success, others describe it as an *"obstacle to growth"* (Leipziger, et al, 1994:7). A common goal of these countries was to promote international competitiveness of targeted industries by focusing on those policies that would alter the industrial structure in the country.

The common feature is that success was based on export development. Governments did not merely provide protection for local industry, but supported differing industries to help them achieve export competitiveness. This approach is based on principles such as guiding and not overriding private companies decisions, using international price signals, and local companies having to achieve specific performance requirements in exchange for government support.

3.5. THE ROLE OF PHYSICAL CAPITAL

"*The dynamic between investments and economic growth operates in two directions; high economic growth makes it possible to increase investments without foregoing consumption, and high investment activities make it possible to achieve higher rates of economic growth*" (Tenold, 1997:6). Asian countries were successful in attracting substantial foreign capital. The importance hereof is that six countries namely the PRC, ROC, South Korea, Singapore, Hong Kong and Malaysia attracted 83% (US$ 111 billion) of total FDI to South East Asia and 42% of all FDI flows to developing countries in the period 1982 to 1992. They also succeeded in accumulating huge foreign reserves. In terms of FDI flows, Japan played an important role in Asia.

An important factor behind the generation of investment in Asian countries was the high level of domestic savings. Asian governments had a direct and indirect influence on the savings rate of the population. Actions taken by the government to support a high propensity to save included creating an economic environment conducive to saving, providing stable interest rates, currency rates and economic growth, and the implementation of favourable tax systems, including tax breaks and depreciation allowances.

Foreign direct investment also made a significant contribution towards capital accumulation in Asia. This is particularly the case since FDI included manufacturing technology knowhow transfers which contribute to improvements in domestic productivity. The combination of these developments resulted in a superior accumulation of capital. Asian countries were also successful in allocating this capital to highly productive industries.

It is widely acknowledged that Chinese business networks in Thailand, Malaysia and Indonesia have played a crucial role in the region's economic success. These networks, based on a high degree of homogeneity, culture, family ties and principles of Eastern philosophy not only stimulated expanded trade relations, but were also conducive to capital flows and investment.

"*Internationally competitive, export-oriented industrial production has generally only developed with State support and other advantages, e.g. 'natural protection' for resource-based industries. This pattern may well reflect rational responses to the investment environment, as shaped by State intervention and prevailing economic and political considerations*" (Jomo, 1996:6).

Labour market conditions, including wage and immigrant labour policies had a profound impact on investment patterns in Asia. These policies were adjusted to deal with new circumstances, problems and opportunities. They included providing finance and support services for small and medium-size exporters, improving trade-related aspects of the civil service, creating an environment favourable to exporters, focusing infrastructure development on areas that encourage exports and aggressively courting export-oriented direct foreign investment. Furthermore, Asian governments implemented particular policies to compensate for their own limited resources by focusing on FDI and the use of external know-how.

The availability of cheap labour, free trade and the absence of capital controls were, however, not a guarantee for the spontaneous development of export-led labour-intensive manufacturing by foreigners (Jomo, 1996:14). Other conditions also prevalent in Asia which created an environment suitable for investment, including incentives such as tax breaks and subsidies on education and training, investment promotion, cultural and linguistic affinities, law and order, provision of infrastructure and primary education (Jomo, 1996:14).

3.6 THE ROLE OF HUMAN CAPITAL

Private initiative, government initiative and FDI in terms of know-how transfers played an important role in stimulating economic development and change in Asian countries. "*The relationship between human capital formation and economic growth is self-enforcing in a similar manner to the virtuous cycle of investments and economic growth*" (Tenold, 1997:12).

Several mechanisms were used to increase the contribution of labour to economic growth. Government policies on increasing the quality of education were particularly successful in raising the skills level of the work force, which made the transition from an agricultural to an industrialised society. "*The ability of these countries to absorb foreign technology and know-how was initially made good by the availability of educated human capital. This ability was sustained, upgraded and staged to the adaptation and internalisation of technology, by further investment in human capital and increased expenditure on research and development*" (Hussain, 1994:6).

Elements of high human capital formation in Asia included their ability to control population growth coupled with reductions in fertility and mortality rates. This enabled governments to increase their education expenditure per pupil more easily than most other developing countries. The focus was placed on basic education, while higher education attracted a smaller share of education expenditure. "*An important fact to note is that their literacy rates and school enrollment ratios were much higher even when their per capita income was much lower than other LDCs as in the 1950s*" (Hussain, 1994:6).

Another feature of human capital was the high degree of on the job training which also contributed to rapid human capital formation. In this regard the private and public sectors complimented each other. Asian countries could afford the movement of labour from low productivity sectors to more productive sectors with this having a positive impact on economic growth. Rapid human capital accumulation on its own will, however, have little impact on growth if it fails to improve total productivity, which is a measure of technical progress and is measured as the residual of growth of output per worker adjusted for the effects of human and physical capital accumulation. In Asia's case, the accumulation did contribute to increased factor productivity, which in turn simulated overall economic growth.

3.7 THE ROLE OF GOVERNMENT

Asian government involvement in the economy has long been debated, particularly with regard to the contribution of this role to economic success. *"The reality is that economic success in Asia appears to be based on intricate interrelationships between state-intervention and market forces"* (Swedish Department of International Development Cooperation, 1992:129). Characteristic of government involvement was its focus on specific issues with clear plans and goals, especially with regard to industrial policy. Bureaucratic organisation was also important since poor planning and organisation would have had a negative effect on policy design, implementation, enforcement, monitoring and ultimately government efficiency. It is important to note that although the starting point for economic development and policies in Asia was based on market principles such as competition, the aim of the market and government was never to promote perfect competition. In this regard, Asian governments were deliberately avoiding excessive competition (Jomo, 1996:18).

A key element of Asian government success was the establishment and maintenance of their legitimacy, a situation where the population believed that government was doing the right thing and thus did not mind fulfilling government demands on them. "*Government legitimacy is a vital ingredient in producing economic results*" (Jaycox, 1994:14). This legitimacy was mainly the result of a government drive to achieve equity through shared economic growth. "*Sustained provision of material welfare and security of the population within the state's domain vastly enhanced the emergence of a more deeply moral sense of legitimacy*" (Jaycox, 1994:14).

Asian government involvement in the economy had both a direct and indirect approach. The direct intervention of governments, for example their involvement in the start-up of new companies in specific sectors lies at the hart of the debate on the extent and effect of direct government intervention in Asian economies. Governments were directly responsible for the establishment and management of infrastructure projects, health and social welfare programmes, education systems and finance and credit systems so as to promote national saving and investment. At the same time government did not build and manage factories; this was left to the private sector, which was better able to produce more effectively than government. Governments did, however, assist these firms to achieve international competitiveness (Jaycox, 1994:3).

Indirectly, governments were responsible for creating an economic environment conducive to economic growth and development. This indirect involvement is usually referred to as "getting the fundamentals right". According to Yanagihara "*The fundamentals comprised of six factors; macroeconomic stability, high human capital investment, effective and secure financial systems, limited price distortions, openness to foreign technology and agricultural development. Macroeconomic management was very good compared to most other developing nations, and the resulting stability led to a framework in which businesses, both foreign and domestic, were willing to invest, thereby laying the foundation for economic growth*" (1994:664).

3.7.1 Macroeconomic policies

Macroeconomic policies implemented by Asian governments greatly differed from macroeconomic policies in other developing countries. According to Tenold (1997:21) sound macroeconomic policies have resulted inter alia in:

- Low single digit inflation rates for most of the period 1986-1990.
- Small fiscal and current account deficits, which have usually been less than half the average of other developing countries.
- High savings and investment rates.
- The creation of a stable environment which facilitated long-term planning.

The following commonalities regarding macroeconomic policies can be identified in Asia:

- *"Prudent fiscal behaviour was aided by legislation that limited the size of public deficits"* (Leipziger, et al, 1994:6).
- A flexible government, which enabled government to rapidly react to destabilising challenges (Tenold, 1997:21).
- When macroeconomic control lapsed, it was swiftly re-established (Leipziger, et al, 1994:6).
- Macroeconomic policy formed an integral part of industrial and export policy, illustrating governments' desire to create a prosperous nation (Tenold, 1997:22-23).
- Other growth-focusing policies were also implemented which included policies on taxation, income redistribution, health, education and foreign trade (Tenold, 1997:23).

Another point of debate regarding Asian government involvement is the absence of political democracy in many of these countries. Countries such as Japan, Malaysia and Indonesia all had the same political party governing for decades without much opposition from other political parties. This was mainly the result of the successes these governments achieved in developing the economy in which the vast majority of the population could share. Tenold even goes so far as to say that: "*It is evident that the lack of political democracy in several of the ESEA-countries has not had an adverse impact on economic growth. Rather, the high degree of political consistency and dedication to growth which was evident in several of the countries in the region may be important factors in explaining their economic success*" (Tenold, 1997:23). Fishlow (1994:1830), states that political freedoms played second priority to economic advancement and developments, which success has contributed to creating conditions for more political openness.

3.7.2 Pragmatic policy making

Government success in Asia was not just built on sound policies, but also the way in which these policies were designed, implemented and monitored. "*The governments in the successful countries maintained objectivity about these policies and reversed them when they failed*" (Leipziger, et al, 1994:8). The following common characteristics of the way in which policy was implemented can be identified:

- Although many governments were authoritarian, they all had a clear economic vision. While authoritarian rule has existed throughout the world, in Asia this type of rule delivered extraordinary economic results.
- Effective bureaucracies were established by recruiting highly trained and competent individuals. Governments would then set up core economic ministries with the aim of focusing on national interests (Leipziger, et al, 1994:9).
- Long-term economic goals were pursued to promote political and economic stability.
- Government actions and policies were constantly subjected to review, thereby promoting accountability, which was enhanced by publicising performance standards.

The combination of macroeconomic, industrial and export policies, coupled with effective procedures and accountability proved able to make a positive contribution towards economic growth and development. "*Here the message is not more government, but better government*" (Leipziger, et al, 1994:6).

3.7.3 The policy approach to understanding the Asian economic success

A 1994 study by Hussain looks at the policies or combination of policies that created the Asian economic miracle. This is done by summarising the views of four schools of thought namely the Neo Classical view, the Revisionist view, the World Bank's Functionalist view and the Strategist view (Hussain, 1994:8).

According to Hussain, the Neo Classical view of the Asian success is based on getting both the "prices and basics" right, which included sound macroeconomic policies and a reliable legal framework. It was also seen as governments' legitimate task to invest in people in terms of health and education which are required for rapid human capital formation (Hussain, 1994:8).

In contrast to this view, the Revisionists argue that the so-called non-interference approach by government is not in line with interventions and policies that Asian governments did follow. According to this view "Asian governments 'led the market' by deliberately 'getting prices wrong' so as to attract investment into industries that would generate the highest growth for the overall economy - the very act that the free-market consistently failed to do" (Hussain, 1994:9).

The World Bank's functional approach explains the success as the rapid growth of three functions, namely technological catching-up, accumulation and efficient allocation, by using combinations of policies (e.g. state-led vs hands-off). This approach focuses more on the practicality of the Asian success than on the theoretical basis (Hussain, 1994:9).

Hussain summarises the fourth approach as the "Communitarian approach". "*It attributes the Asian success story to the communitarian model of capitalism adopted by East Asian countries as opposed to the individualistic model of capitalism adopted by Anglo-Saxon countries. It is argued that the individualistic model of capitalism is based on 'profit maximisation' and consumerism, while the communitarian model is based on 'strategic conquest' and producerism*" (Hussain, 1994:10). This approach refers inter alia to the practice in Asia whereby the acquisition of skills is a joint responsibility of the firm and the individual under the guidance of the government. It is also based on the use of strategic planning and conquest to ensure international competitiveness. This strategic approach is the result of close cooperation between government and business.

3.7.4 Ingredients for rapid economic growth

A study commissioned by the Swedish Department of International Development Cooperation in 1992 summarised a number of factors that contributed to rapid economic growth in East Asian countries (1992:29-30). They are:

Long-term factors

- Political stability and continuity of government.
- A competent, relatively incorrupt and disinterested state bureaucracy.
- A relative equitable distribution of assets and income.

Medium-term factors

- A high level of human resource development.
- Labour mobility and a smooth functioning labour market.
- Gross domestic savings in excess of 30%.
- Reliance on a bank dominated financial system.
- Macroeconomic stability and predictable economic policies.
- Adequate physical infrastructure.
- Moderate / declining fertility rates.

Short-term policy determined factors

- Moderately high positive real interest rates.
- A stable exchange rate regime.
- Low levels of price distortions.
- Export promotion through a free trade regime for exports, and government subsidised export promotion and marketing services.
- Attraction of high levels of foreign direct investments in exporting industries.
- Infant industry protection.
- government intervention through industrial targeting and industrial policies.

3.8 CASE STUDY: MALAYSIAN RECONSTRUCTION AND DEVELOPMENT

The economic situation and realities in Malaysia make it an ideal case with relevance to the South African situation. Ethnic diversity, initial high levels of poverty and abundance of natural resources are just some of the similarities between Malaysia and South Africa. The aim here is to identify those lessons South Africa can learn from the Malaysian experience in achieving successful economic development.

Malaysia's development philosophy can be summarised as a **mixed system** of free enterprise but with active government support and direction, where **government** provides the broad thrusts and sets direction for the whole economy, and ensures the achievement of socio-economic goals, while the **private sector** is free to operate with appropriate policy, institutional and infrastructure support.

After independence in 1959, Malaysia was a largely rural society, with only 27% of the population living in urban areas, while 60% was employed in the agricultural sector. Only 8% of GDP and 5% of exports in 1957 were made up by manufacturing. Since the 1950's and 1960's extensive development policies were formulated and implemented which led to sustainable economic growth in subsequent years. These policies consisted of import substitution (mainly to promote small-scale, family owned industrialisation), export promotion (the establishment of free-trade zones and licensed manufacturing warehouses), policies to attract foreign investors (capital, technology and know-how transfers) and various macroeconomic policies with the main aim of reducing poverty (Tenold, 1994:36).

3.8.1 Reconstruction and development in Malaysia

In Malaysia, the economic neglect of the indigenous people, the Bumiputra, representing 51% of the population, was identified as the major reason for serious ethnic riots in 1969, which resulted in the introduction of a New Economic Policy (NEP) in 1971. The NEP had two main objectives namely to eradicate poverty irrespective of race, and to restructure Malaysian society in order to do away with inter-ethnic economic imbalances. This policy was also conducted within basic political parameters, inter alia the proclamation of the indigenous people's political hegemony while continued Chinese economic dominance was guaranteed, key issues considered vital to the indigenous peoples' interest were non-negotiable; laws were passed to restrict political debate; and the actions of pro-ethnic advocates were limited (Tenold, 1997:36).

Although the development efforts undertaken in line with the NEP resulted in rapid industrialisation and structural transformation, it was felt that more was needed to achieve economic resilience and to gain a foothold in the competitive international market economy. As a result a National Development Policy (NDP) was introduced in 1991 with the following objectives:

- Maintaining a high rate of economic growth.
- Continued efforts at restructuring Malaysian society with an increase in Bumiputra (indigenous) participation in the modern sectors of the economy and the creation of the Bumiputra Commercial and Industrial Community.
- The restructuring of the employment base and labour utilisation of the Bumiputra by increasing their involvement in higher paying jobs and ensuring greater participation in larger companies, especially in leading sectors such as trade and industry.

Apart from the NDP directing Malaysia's development strategy for the ten years from 1991, Prime Minister Mahathir introduced Vision 2020 in 1991, which envisaged a further nation-building strategy that would result in Malaysia being a fully-developed country in all spheres of life, politically, economically and culturally by the year 2020. Malaysia is the only country in the world to set itself the goal of becoming fully industrialised within a specific time frame.

3.8.2 Development planning

As far as Malaysia's development planning is concerned, it can be described as a deliberate comprehensive, time-specific effort, initiated and sustained by the central government for the purpose of creating and maintaining conditions that will accelerate economic growth and social development in the country (Seventh Malaysian Plan, 1996:v, vi and vii). This objective has been realised through the effective implementation of the Malaysian Development Planning System (MDPS) in terms of which Five Year Development Plans, starting in 1956, were introduced. MDPS is designed to co-ordinate and monitor both the functions of planning and implementation of publicly-financed development activities. Each five-year plan serves as a guide for the country's development planning and implementation process for a five year period, as well as offering a framework for coordination of government public expenditure. Each five-year planning process starts with the issuing of a call circular by the Economic Planning Unit (EPU), the main planning agency in Malaysia, situated in the Prime Minister's office, requesting every ministry, state government and district authority to submit reports on progress made in the previous plan; problems that are expected to arise in the next five years; and specific proposals in terms of programmes and projects to overcome the identified problems. The EPU has the following functions:

- To formulate development planning objectives, policies and strategies.
- To prepare long and medium term plans.
- To prepare the development budget.
- To evaluate the achievements of development programmes and projects.
- To advise government on economic issues.
- To initiate necessary economic research.
- To prepare projects for privatisation.
- To coordinate the development of growth triangle projects.
- Serves as the Secretariat to the Foreign Investment Committee.
- To initiate and coordinate assistance from donors and international organisations.
- To manage the "Malaysian Technical Cooperation Programme".

3.8.3 Implementation of development planning

At the federal level, the National Planning Council (NPC) and the Cabinet Committee for Planning chaired by the Prime Minister, are responsible for the highest level of policy making. The NPC formulates and coordinates the country's socio-economic development policies, while the National Development Planning Committee (NDPC) is responsible for the formulation and consideration of development plans, programmes and projects. The Implementation Coordination Unit in the Prime Minister's Office is responsible for ensuring the coordination of development efforts at federal level. State and local development planning structures are based on the same arrangements. State Development Committees (SDC) chaired by Chief Ministers of the respective states, coordinate development implementation and monitor and evaluate programmes at state level.

In addition, the effectiveness of the development strategy is enhanced by the way in which it is planned, namely through two sub-systems, the sectoral planning (vertical planning) system and the inter-sectoral planning system (horizontal planning), used in the identification and formulation of development projects. While the vertical planning process allows for policy directives and guidelines to be filtered downwards, the bottom-up planning approach provides sufficient feedback and opportunities for views and needs from the grassroots to move upwards for consideration. It is this combination of two planning sub-systems which makes the development planning process in Malaysia uniquely effective. There are several instruments of national planning in Malaysia and include: the Long-term Plan, the Five-Year Development Plan and the Mid-Term Review of the Five-Year Plan.

3.8.4 Successes of the Malaysian model

By implementing these development policies the Malaysian economy has achieved major successes:

- Base-line poverty decreased from 49.3% of the population in 1970 to 9.6% in 1995.
- The literacy rate increased from 58% in 1970 to 89.3% in 1995.
- The average annual GDP growth in the period 1971 to 1990 was 6.7%.
- The average income per capita increased from US$ 360 in 1970 to US$ 3908 in 1995.
- Manufacturing's share of exports increased from 11.9% in 1970 to 79.6% in 1995.
- By 1988, manufacturing contributed 24% to GDP.
- Life expectancy by 1988 was 71 years (Tenold, 1997:36).

3.8.5 Malaysian economic lessons for South Africa

Given the experiences of Malaysia regarding economic policy formulation and implementation and the economic success these policies have produced, it is worth drawing some lessons for South Africa, which include:

- Balanced development creates stability.
- Human resource development is necessary for sustainable economic growth.
- Social development and the upgrading of the quality of life should form part of the broad economic development strategy.
- Political and social stability is a key factor for economic development.
- Government has an active role to play, both directly and indirectly. Directly by allocating national resources through a series of public investments; indirectly by intervening in certain sectors of the economy to correct the imperfections of the market.
- Economic development is not just the primary responsibility of the government, but also that of business, labour and the citizens of the nation. As such the government should facilitate this process by creating structures that will ensure that the inputs of all participants are considered and coordinated.
- The most important aspect of successful economic development is that all policies on all levels must be coordinated. There should also be mechanisms to oversee the

implementation and constant monitoring of development strategies.

- The political responsibility for economic development policies lies with the Head of Government of the country, who has the power and authority to obtain cooperation from all structures
- A single structure is necessary where all economic policies on all levels are coordinated, including trade, labour, infrastructure, social upliftment, energy, agriculture, health, education, housing, industry and fiscal and monetary policies.
- Economic development strategies should focus both on the short-to-medium term as well as on the long term, each complementing the other.

For further information regarding the Malaysian Economic Plan see "Seventh Malaysian Plan 1996 - 2000, 1996".

3.9 LESSONS FROM THE ASIAN ECONOMIC EXPERIENCE

A number of lessons can be learned from the Asian experience. Despite the effects of the 1997/98 financial crisis in Asia, many of these lessons are still applicable to developing countries and particularly South Africa. They include:

- The quality of governance will benefit from appropriate institutional capacity building and flexibility in responding to new challenges.
- Regional interconnectedness is important in terms of geography, location, proximity, investment and trade patterns.
- Getting the fundamentals right are important. "*Without high levels of domestic saving, broadly based human capital, good macroeconomic management, and limited price distortions, there would have been no basis for growth and no means by which the gains of rapid productivity change could be realised*" (World Bank, 1993:32).
- Rapid economic growth as experienced by the HPAE's can benefit from careful policy interventions. "*One of the defining characteristics of interventions in the HPAEs is that in general they have been carried out within well defined bounds limiting the implicit or explicit costs*" (World Bank,1993:32).
- Human capital formation is important. "*The message that emerges from successful Asian experiences is that human capital formation in the form of education, training and capacity building should come first. This seems to be the precondition for other measures to be effective and not counterproductive*" (Hussain, 1994:15).

- Economic policy is a continuous process of reform, which includes adapting policy instruments and institutions to achieve the objectives and reducing, modifying, or foregoing policy instruments which succeeded in the past. "*The experience of the HPAEs broadens our understanding of the range of policies that contribute to rapid growth. It also teaches us that willingness to experiment and to adapt policies to changing circumstances is a key element in economic success*" (World Bank, 1993:34).
- Momentum in economic reform programs is important. "*If you moved quickly and widely enough, the cost of reforming one sector of the economy would be met from the benefits of reforming others, that you would retain the initiative and not allow special interests to coalesce and put obstacles in your path and that the burden of the reforms would be shared equitably*" (Absolum, 1996:2).
- Diversification of production will eventually lead to higher exports which will serve as a stimulus for economic growth.
- "*In a market economy, incentives or right prices constitute the conventional variables which are necessary for inducing private investment and ensuring an efficient allocation of resources through the free play of market forces.*" (Hussain, 1994:15).
- The technological gap between developed and developing countries can be narrowed. A precondition is sufficient investment in human capital and expenditure on R&D.
- "*There are also several aspects of government behaviour that are crucial to a successful growth strategy. In this respect, the desire, experience and strength to manage public agencies and organisations and to guide the economy through sound macroeconomic policies are of paramount importance. Furthermore, political stability is obviously essential for any development programme to be effective. It is particularly important for the policies of the government to be credible to domestic and foreign entrepreneurs who are risking their capital and managerial skills in the promotion of the private sector*" (Hussain, 1994:17).
- The principle of shared economic growth for the whole population as a major social goal is important.
- Government and business can work together to create wealth and economic development. "*East Asian leaders built a business-friendly environment, of which a major element was a legal and regulatory structure that was generally hospitable to private investment. But beyond this, these economies have, with varying degrees of success, focussed on enhancing communications between business and*

government" (Page, 1994:5).

- High levels of domestic investment as a result of a high savings rate is a precondition for attracting foreign investors.
- Sound macroeconomic management encourages long-term planning and investment.
- *"Strategies to promote exports and to adapt and improve the technology available in industrial countries have been by far the most generally successful selective approaches used by these economies and hold the greatest promise for other developing economies"* (Page, 1994:5).
- The deregulation of financial markets, floating the exchange rate, removing restrictions on bank competition and abolishing exchange controls could stimulate economic growth.
- Smaller efficient public services can produce the required economic results.
- Macroeconomic policies must be supported by legislation.
- Government should be careful not to spend money it does not have and run up a crippling national debt.
- Government should not get involved in areas of business where the private sector can do better.
- Markets cannot substitute guidance from government implying that: *"market-oriented development and state intervention must be viewed as complementary rather than competing"* (Sharma, 1995:25).
- Always keep comparative advantage in mind when planning economic development programmes.

3.10 CONCLUSION

Despite the many similarities and common features of the Asian economic experience, it is impossible to design a "single Asian model" for economic success. The different experiences of Asia in this regard imply that carbon-copy implementation of these economic policies will not automatically lead to rapid economic growth and development. Country-specific circumstances must dictate what policy options to follow.

The Asian experience has, however, demonstrated the value and contribution of sound economic policy fundamentals to achieving rapid and sustainable economic growth and development. It has also proved that responsible and competent government behaviour can overcome social, political, geo-physical and other obstacles to economic development. As such, it is important that government through its actions and policies create an environment conducive to economic activity. In this regard, good governance is a prerequisite for economic growth in terms of transparency, openness, accountability, predictability and the rule of law, which will lead to social legitimation of the government's efforts.

It is thus important for developing countries such as South Africa to note the lessons from the Asian economic experience in designing and implementing economic policies that lead to accelerated economic growth and development.

"It is now recognised that the East Asian success was accompanied by government intervention in economies far beyond that of the "night watchman" state. A major reason for East Asia's success is that its governments were technically competent and were also capable of gaining the compliance of their societies with development policies" (Jaycox, 1994:i).

CHAPTER 4

THE ECONOMIC SYSTEM OF THE FORMER UNION OF SOVIET SOCIALIST REPUBLICS (USSR)

4.1 INTRODUCTION

The Soviet economic system, which was created over many decades, was one of the purest socialist systems ever created. Many other countries have implemented aspects of the system, with only a few following the principles of socialism to the same extent as the former Union of Soviet Socialist Republics (USSR). In many ways the economic system adopted by the former USSR makes it a truly unique economic system, with many of its features bearing little or no resemblance to a market economic system. For many years the capitalist and socialist systems coexisted in an antagonistic manner: this has changed (Tselichtchev, 1994:1). One of the major aims guiding its creators was the creation of a new social order, one that would lead to improved living conditions for all its people. Since the government played a central role in the USSR economy, it is worthwhile studying the way in which it fulfilled that role. As South Africa is still developing its own economic identity after political transformation, the aim is to identify those factors and policies which contributed to but later destroyed the USSR's economy. The scope of this evaluation will deal with the economic development of the USSR until the beginning of 1990. Although the USSR no longer exists, this study will still refer to the USSR as it existed until its break-up. It should be kept in mind that the political circumstances, realities and considerations that prevailed in the USSR are inseparable from the economy. This is especially true when one looks at the economic policies and decisions taken in support of political and military goals.

The economic situation that led to the October 1917 revolution in Russia and the seizure of power by the Bolsheviks included:

- A predominant peasant population that was land-hungry.
- A high rate of illiteracy.
- An under-developed and war-torn industry.

Although the Bolshevik Party had no formal economic policy, Lenin took his lead from the teachings of Karl Marx. Soon after the assumption of power, many decrees were implemented, nationalizing everything from land, banks, heavy industry, railroads, to the abrogation of Czarist Russia's state debts to foreign governments. These measures followed logically from the classic Marxist ideology that destroyed the old order. The first years of the new order were characterised by a rapid drop in economic activity, transforming the economy into a 'national primitive system' with direct exchange of goods for goods. Over time it became evident that the government would rule by way of issuing decrees. The early days of socialism also established the use of force by the government to coerce people in a certain direction, especially during the period when "surplus value" in the agricultural sector had to be handed over to the government.

The rise of socialism was based on the works of Karl Marx, which did not include a single completed piece of work on the economic system of socialism. His work was driven by an obsession with criticizing the capitalist market, which according to him created "surplus value" (from which the law of surplus value is derived) or profit. This surplus value is created during the production phase in which labour plays a dominant role. Marx also argues that this surplus value and the craving for personal gain, lead to a clash of interests among the capitalists in the market economy, creating chaos in the market. As such, this chaos in market relations eventually results in the increased exploitation of labour.

To solve this problem, Marx states that the economic system should avoid producing surplus value, and the exploitation of persons. To achieve this, the Soviet Government implemented the Marxist instructions that it found practical, which included the planned management of the economy, the restructuring of agriculture and industry, nationalisation of production, planned prices and the distribution of goods and services to people. As such, a system was created that was to produce no surplus value and did not have to consider aspects such as cost, price and profits. The following assumptions were also made:

- The only cost to the economy was that of labour (wages).
- Everything in the country belongs to the people through the state.
- Raw materials available in the country are free.

Every economic system nonetheless needs laws to guide it; Marx never formulated these laws for a socialist economy. Stalin took it upon himself to formulate socialist economic laws of which one is the law of balanced proportional growth. This approach to production *"and the disregard for value categories always led to enormous wastes of materials and manpower. This was felt as early as the 1930*s." (Krylov, 1979:16).

For many years the official Soviet Government viewpoint was that their system was a socialist system because all production means belonged to the people and the bourgeois exploiting class had been liquidated. They were also of the opinion that the Soviet economic system was the first scientifically organized system in the history of mankind since it was controlled by scientifically-based planning and not the chaos of the market. They also believed the system to be characterised by:

- The existence of full harmony of production forces and in industrial relations.
- The absence of economic crises or traumas in the system.
- That the economic system was the most progressive in history.

Krylov, however, describes an opposite view of the Soviet economic system: "*The principles of this system have nothing in common with science in general and with economics in particular. The means of production belong not to the people, but to the elite of the new class. It is a system of both classes and conflicts. These conflicts have many variations. The form and character of production forces do not correspond to the character of industrial relations. The Stalinist economic system, while under the leadership of Stalin himself, can be defined as a Party-police monopolistic voluntarism. Such a definition is based on (1) placing the economy in complete subordination to and at the disposition of the Party elite or Stalin personally, (2) the threat of police terror behind every coercive stimulus for economic activity (the fulfillment of a planned assignment), (3) the existence of a single, nationwide monopolistic authority with the ability to implement monopolistic measures (the turnover tax, for example), and (4) the fact that the economic system was not based on any unified economic theory and was therefore a product of Stalin's will and arbitrary experiments.*" (Krylov, 1979:10).

4.2 ECONOMIC PLANNING IN THE USSR

The basic principle of a socialist economy lies in its goal of social development by maximising the satisfaction of needs. This satisfaction then serves as an indicator of the effectiveness of social productivity. In reality the USSR was following the principle of systematic proportional development that differs from classic social principles. Central to economic planning in the Soviet economy was the law of systematic proportional development; the question was, whether it guided or influenced planning, especially since the State Planning Commission predominately followed the orders of the party leadership.

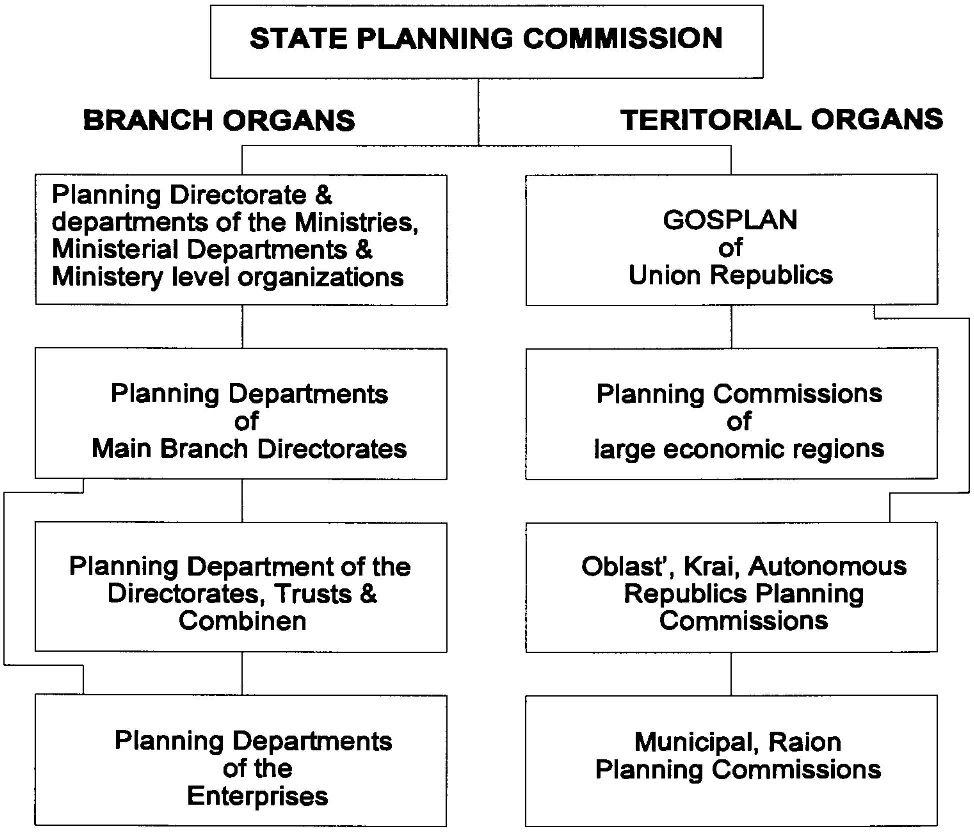
Since national economic planning in itself is a very complex task, even in a market economy, economic planning in the USSR was based on eradicating the imperfections of market mechanisms. Soviet economic planning also had to plan for those actions and issues normally performed automatically by the market. The idea was that the plan should perform these functions better, more scientifically and more purposefully. (Krylov, 1979:37).

The most important aspects of national economic planning in the USSR were as follows:

- Complete centralisation of control along the lines of the "party-spirit" principle.
- It encompassed all economic life.
- Detailed plans were drawn up with specific time frames for completion such as five years, yearly, quarterly and monthly.
- Economic plans were guided by policies, regulations and directives from the Communist Party of the Soviet Union (CPSU) Congress, spelling out the wishes of the Central Party Leadership (this included the identification of goals, structures to perform these goals and the allocation of national resources).
- Economic principles were absolute, making the execution of the plan almost completely uniform (uniformity existed in almost all spheres of economic activity).
- These economic plans were based on decrees with the effect of law. Non-fulfillment was therefore an offence.

The structures to manage the entire economic planning process developed into a very complex system including hundreds of branches, departments, ministries, councils and thousands of people. As time passed, this method of economic planning became more complicated. Diagram 4.1 represents the basic planning organs of the USSR. At the head of the structure was the State Planning Commission, Gosplan, which was established in 1921. Gosplan reported to the USSR Council of Ministers and the Supreme Soviet of the USSR. Two distinct groups existed: the state planning and the branch planning organs. The state planning organisations were structured along territorial lines and included republic Gosplans, regional planning commissions and autonomous raion and municipalities. The branch planning organisations included inter alia departments of ministries, directorates and enterprises. These structures fulfilled many functions including planning, coordination, monitoring and execution. Everything centered around the Economic Plan, serving as a guide to what was to be produced, how much, when, where, by whom, the allocation of national resources as well as funding.

Diagram 4.1 Soviet structures in planning the economy



Source: Krylov, 1979:40

Long-term economic planning in the early years never took place and was considered to be "*economic forecasting, which was rejected as a bourgeois false science*." (Krylov, 1979:41). In later years, however, long-term economic planning was conducted on a fifteen-year basis, which was then broken down into five-year and annual plans. Only the annual plans were considered operational plans since they included complete material balances, with the aim of matching resources with production. The most important section of this plan was the plan for material technical supply. It also stipulated exactly what every person/industry should do. Since the annual plan had specific goals, it became the most important framework guiding economic activity (for a schematic view of how the plan is coordinated see Krylov,1979:53).

Indicators were used as measuring devices for the planning task. These indicators were predominantly cost or physical indicators (e.g. items, area, volume, weight, and length). The most important of these indicators was the output indicator, known as the multiple indicator, moving through the entire economy. Over the years this indicator was changed many times in name and in the way it measured economic activity (e.g. gross output volume, volume of market output and the volume of normative net output). Krylov (1979:42-43) criticises the effectiveness of using the output indicator to stimulate economic growth: "*This indicator has made it possible to use various measures that are economically not expedient but advantageous for creating the illusion of well-being and for exceeding the gross output plan. In conjunction with other conditions this indicator has opened up additional loopholes for disguising and falsifying the actual state of affairs relevant to the fulfillment of economic plans. ... this failing is characteristic of all cost indicators and stems from the Soviet system of price setting in planning*".

4.2.1 Problems associated with the planning structure and process in the USSR

The following problems are associated with the Soviet economic planning process:

- Aganbegian identified a "*basic contradiction in our economic theory and practice." He argues that the central goal of socialism is to satisfy individual and society's needs, but that when it comes to planning and implementation "we are never directly governed by this goal*" (Ekonomizdat, 1968:41).
- For many years economic planning lagged behind the requirements of an increasingly complicated economy.
- Many of the structures and procedures involved in economic planning originated in the 1930's. In later years, these structures found it increasingly difficult to address the economic problems and challenges of the Soviet Union. The introduction of mathematical methods and computers into the planning process was also difficult.
- The planning system became very cumbersome, time consuming and labour intensive. As early as 1963, more than ten million people were already involved in the planning process (Planovoe Khoziaistvo, no8, 1963:49). Since the National Economic Plan had to deal with every aspect of economic life, it became evident that the effectiveness of national economic planning was becoming the most important economic problem.

- The huge apparatus of state planning made coordination difficult, both in the planning and implementation phase. This resulted in an imbalance between production and material-technology supply, as well as production and financing, which caused enormous waste and unused reserves of goods.
- When it came to implementing plans, the responsibility for solving production problems was shifted onto the shoulders of lower-ranking persons, who tended to focus on their immediate concerns.
- Although fifteen-year economic plans were drafted, and broken down to five and annual plans, the constant adjustments and changes to the goals of the annual plans violated the plan's integrity.
- Finally, Krylov made the following critique of the Soviet system: "*the social system lack general principles based on objective economic laws. The system lacks instruments of internal self-regulation and self-adjustment or any sort of automatic system of optimizing economic decisions and actions.*" (Krylov, 1979:32).

4.3 THE SETTING OF PRICES IN THE USSR

A major characteristic of the Soviet economic system was the role of government in arbitrary price setting, with the price policy as the basis for setting prices. The guiding principle here was that the price for the means of production was set lower than cost, while consumer prices were set higher than cost. This was done by using extra-charged coefficients, which were added to cost (e.g. 0.7, 1.0 or 1.2) based on the branch average production cost and applied to all industries/goods in a certain sector. Price setting was done by the same structures responsible for economic planning (see Diagram 4.1).

4.3.1 Problems experienced with the price structure in the USSR

A number of problems were associated with planned prices in the USSR, including:

- Despite various price reforms and attempts to streamline the process, it still took months to set the price for a new product. The number of offices (thirteen to fifteen) involved in price setting greatly contributed to this problem and rendered it ineffective (Krylov,1979:33).
- Domestic prices tended to be much higher than world prices for the same or similar product. In this regard, the free establishment of prices was inhibited by the

difference between domestic and world prices. By 1967, for example, Soviet coal prices were on average 1.5 times higher than world coal prices (Krylov, 1979:32).

- The comparison of wholesale industrial prices was impossible, especially since the turnover tax was based on it. As such, consumers found it extremely difficult to compare prices.
- At one stage prices were set for more than ten million products, with the majority of the price information processed by hand and primitive machines. This was labour consuming and exposed the inflexibility of the system. In later years, the automation (computerization) of the price setting process also proved to be extremely difficult.
- Price setting in the agricultural sector was very difficult. Certain crops had a higher price than others, leading to huge losses to peasants. Many farmers would switch to the crops yielding a higher price; this also holds true in a market system where prices determine profitable crops. This shift to higher priced crops was, however, one of the major factors that contributed to ineffectiveness in the USSR's agricultural sector.
- Prices (tariffs) of transported goods also proved difficult. This was the result of the "free-on-board at receiving station" vs. "free-on-board at shipping station" principle, causing the transportation of the majority of goods to operate at prices set below actual cost (Krylov, 1979:34).
- Price setting was based on Marx's theory of labour value, which argues that value is determined exclusively by labour expenses in production. Anything not produced by labour has no value and therefore cannot be assigned a price. This, as mentioned earlier, left all natural resources in the Soviet Union free, with only the cost of exploiting them to be considered. This led to huge wastage of these resources, one of the factors that contributed to the ineffectiveness of the Soviet economy.
- Planned prices contained less economic information than prices set by the market (e.g. what should be produced, how much, and at what minimum profit). Information contained in the planned prices would often differ from the directives of the National Economic Plan, which caused conflict between government, social groups and private interests. This was the source of many social problems in the USSR, especially because planned prices did not reflect economic realities.
- Finally, Krylov stated that "*this planned price setting procedure is the basic cause of general disproportion in the national economy. These disproportions occur between industry and agriculture, within industry, they occur between groups. At the same time, it is universally recognized that unbalanced development must be eliminated*" (Krylov, 1979:35).

4.4 MANAGEMENT OF THE SOVIET ECONOMY

The management of the Soviet economy was based on the principle of a total subjection of all aspects of the economy to the center, which is then guided by the "party spirit." Each and every economic decision and action is designed to fulfill the main objective of transforming society. Following from the "party spirit" all managers in the economy are chosen and appointed by the Communist Party.

Characteristic of the Soviet management style was that eventually almost all actions had to be carried out under duress, leading to the implementation of administrative methods to ensure compliance with the wishes of the central leadership. Over years this approach proved that instead of acting as an incentive for initiative, it rather killed it. This stemmed mainly from a lack of willingness among lower-ranking officials and individuals to take responsibility for making decisions out of fear for the implications of failure. According to Krylov "*It is precisely this avoidance of responsibility that causes the many stages and the long periods of time required to study and confirm almost every economic decision. This is the source of 'conference sitting', the purpose of which is to convert an individual decision into a collective decision.*" (Krylov, 1979:77-78).

The major problem associated with the Soviet economic management system was that it eventually became so large and unmanageable that effective decision-making was difficult. Added to this were the thousands of bookkeeping forms, indicators and control measures in place to guide decision-making, going through several layers up and down the bureaucratic channel before implementation could take place. As it passed through the system, information had to be reworked at each level, causing the generation of billions of pages of administrative work. As such, the Soviet socialist failure can be described as the failure of millions of Soviet people, since the processes involved implied collective decision making.

An important aspect of the management system was its focus on the operational side of the economy, which was just as complex as the decision-making processes. This operational side of management led to an ever increasing workforce and the creation of new directorates to deal with the burden of paperwork. Coupled with the administrative measures, workers tended to rather play it safe than to take the responsibility for failure, creating a tradition of ineffectiveness and deceleration of scientific-technical progress.

Krylov highlighted the following shortcomings of Soviet economic management:

- It lacked objective means to measure the effectiveness of managers.
- Large scale deception was practiced.
- The system lacked adequate economic legislative regulation (no self-regulation).
- A lack of a clear, strict command chain.
- A lack of effective regulation of economic interrelationships.
- The practice in the USSR as far as economic agreement was concerned usually followed the line of "as far as possible."
- The main obstacles to perfecting management systems lay in the principles, methods and management style that had become tradition (Krylov, 1979:81).

4.5 LABOUR ISSUES IN THE USSR

Labour practices in the USSR were stipulated in the constitution as being "from each according to his ability, to each according to his labour." The argument was that every able body must work; those who do not work were seen as parasites. According to Krylov, "*the Communist Party Leadership is the absolute monopolistic-employer. It sets the amount (intensity) of labour, establishes the hours, wages, and working conditions*." (Krylov, 1979:137). The central leadership was the sole provider of employment and thus had total responsibility for labour conditions.

The Soviet labour market was characterised by two labour methods. Firstly, the so-called volunteer Saturdays. Their main aim was to cultivate a sense of loyalty and belonging among the population. This would be done by working an extra day without any pay, planting trees, doing normal work, and cleaning streets. Secondly, the concept of socialist competition was introduced among individuals, groups and even republics. The aim was to stimulate work performance by fulfilling plans, over fulfilling plans or fulfillment ahead of schedule. A great deal of economic and political significance was attached to socialist competition by the party leadership, since it demonstrated people's full support for the party, socialism and the Soviet Government. This socialist competition did not take place automatically, but was implemented under party, administrative, trade union and plan pressure. These two labour methods were the cause of many discrepancies between the economic plan and the real performance of the economy despite the lack of objective measuring instruments in the economy. It also led to constant changes in labour norms.

The most important norm was the 'rate of output-wage norm', which was determined by the number of outputs or units in a certain time-slot. Norms were set to determine the maximum volume per time unit, which then determined the worker's pay or salary. Compliance with this norm would mean that the worker received the wage/value attached to that work. The labour methods (volunteer Saturdays and socialist competition) would usually raise these norms. Eventually workers would pace themselves, so as to prevent the setting of high norms. These norms also played an important role in national economic planning, especially since labour was the only creator of value, and the only factor determining production cost. A mistake in the calculation of the one would also lead to failure in the other. Wages played an important role in the economic planning process. The central idea of wages was that they should embrace the principle of "equal pay for equal work." Wages were centrally planned for the following reasons:

- National allocation of wages was important for production planning.
- Its important for domestic trade planning.
- It determined the amount of cash in circulation.

Wages consisted of different interconnected elements. The two major parts were a basic, relatively constant portion and a supplementary changing portion (for a schematic outlay of these elements, see Krylov, 1979:150). In the Soviet system a close relationship existed between wages and increased volumes of consumer goods. In this system it was possible to distribute this increase in consumer goods either by stabilising wages and lowering prices or by raising wages and stabilising prices. The Soviet Government followed the latter option because of:

- The propaganda value, where an increase in wages was seen as an improvement in living standards.
- For organisational simplicity, where it was easier to change wages than reset prices.

The wage system had a direct impact on labour productivity which was politically more significant than economically. It was believed that labour productivity was the most important requirement in creating a new social order and that socialist labour productivity would create a higher productivity than capitalist systems. As such, labour productivity was one of the most important economic indicators used in the USSR. The following formula was used to determine Soviet labour productivity:

<u>Gross output in rubles</u> = share of gross output per worker per year (Krylov, 1979:143)
Number of workers

Various methods were used to portray this indicator more favorably, which led to distorted figures and criticism. The following shortcomings can be listed regarding Soviet labour:

- People were forced to work by using administrative measures and economic sanctions on collective farms.
- Management posts were awarded to people in terms of the "party spirit" principle.
- The "scientific" approach in labour was not successful. It led to a totally irrational utilisation of specialists/labour (Krylov, 1979:139).
- The Soviet system constantly lacked skilled labour.
- Low labour productivity was induced by the application of socialist production relationships and the scientific organisation of labour.
- The system induced negative attitudes towards labour and poor labour discipline.
- The wage system led to the creation of gaps in the economy (planned versus. actual performance) which materialised most noticeably in the production of consumer goods. These gaps led to unmet demands from the public giving rise to speculation, problems with the circulation of cash and black market activities.
- The supplemented portion of wages did not provide sufficient incentive for workers to strive for better performance.

4.6 THE MILITARISATION OF THE ECONOMY

A major focus of the Soviet leadership was that the entire socialist / communist system had to be able to defend itself. As such, the defense sector, including production, enjoyed the highest priority when it came to prioritising the allocation of resources. In this regard, the Economic Plan played an important role in the militarisation of the economy, making it impossible to separate the functioning of the economy from national defense. According to Krylov "*the attempt to militarize the entire economy and especially the leading sectors of industry has an all-embracing character. This stems directly from the unity of economic and defense tasks in all national economic plans*" (Krylov, 1979:62).

Although this all-encompassing approach to economics and defense made the USSR a military super-power based on its defense capabilities, it placed a huge burden on the economy and Soviet living standards.

4.7 THE ROLE OF STATISTICS IN THE MANAGEMENT OF THE SOVIET ECONOMY

The use of statistics (accounting or the mathematical measurement of economic activity) plays an important role when government has to take economic decisions. The Soviet Union was long criticised on the way it kept and used these economic indicators. Lenin acknowledged the importance of keeping track of economic developments and formulated the phrase "Socialism is accounting." It was only in Stalin's time that the methodology of accounting economics was developed with the main objective being to measure any deviations from economic plans and not so much to use accounting as a management and decision-making tool. It did not measure socio-economic developments or problems until they had matured. A major flaw in the USSR's statistical methodology was that it was not only designed to account for development, but it was held that the system should also present its findings in a favorable manner. This concept was used extensively to enhance the practice of "catch-up and surpass America."

Krylov has the following criticism of the Soviet statistical system "*The credibility of the Soviet statistical data presents a distinct problem on which the opinions of Economists are sometimes diametrically opposed. The two opposing poles are that everything is correct and that nothing can be trusted because everything is falsified*" (Krylov, 1979:66). Furthermore, statistical data on the economy was rarely published, making it difficult to determine the true nature and problems of the Soviet economy.

National economic accounting consisted of statistical accounting, bookkeeping and operational accounting. Of these, only statistical accounting included the entire economy and was the most important, while bookkeeping focused on sectoral monetary-material values and operational accounting on the direct management of the sectors, forming the basis of the economy's administrative management. Other problems experienced with the Soviet economic accounting system included:

- Measuring national accounts: "*Many of the criticisms of Soviet economic statistics have been directed at its national accounts. The problem most frequently noted is that real growth rates for these accounts are upwardly biased by the failure to account fully for inflation*" (IMF, 1991:137). This study also identified other problems associated with national accounts, which included undocumented changes in methodology and coverage.

- Measuring price indices: Problems associated with this included the availability of information on the retail price index, measurement of this index and that of sample design.
- Keeping track of and measuring data was labour intensive with little automation.
- Measurement was based on the entire economy and not on a sample basis, making it time consuming.
- The process of accounting focused on data processing rather than on data analysis.
- Since the Soviet system was incentive driven to fulfil national economic plans at plant level, a habit of over-exaggeration of performance was established, which led to distortions of real performance.
- Measurement of labour activities was insufficient. No official measurement of unemployment existed to enable comparison with western countries.
- Measurement of data on capital stock and investment was difficult, since concepts such as depreciation and valuation were based on other rules.
- Huge discrepancies in data existed on the sources and use of capital, especially with regard to state enterprises.
- As a result of the Soviet system of value, the measurement of activities and data related to foreign trade and government finances also proved to be difficult, especially when trying to make comparisons with international standards.

For a more information on the Soviet statistical system see IMF, 1991:133-170.

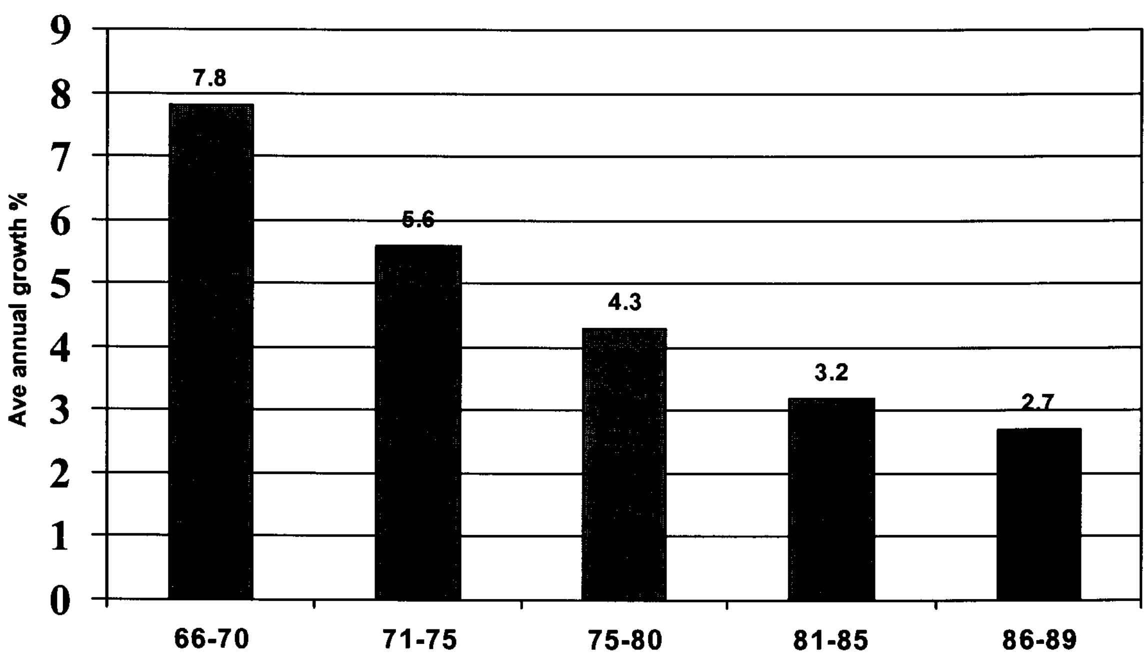
4.8 ECONOMIC PERFORMANCE OF THE USSR – A STATISTICAL OVERVIEW

A description of the Soviet economy by way of statistical indicators will be used to measure its performance. It should be kept in mind that the Soviet Union used different calculation methods to determine economic indicators. Direct comparison between Soviet statistics and western statistics is difficult, since Soviet statistics are based on these different calculation methods. Economic statistics published by a joint study of the IMF, the World Bank, the OECD and the European Bank for Reconstruction and Development in conjunction with Soviet authorities in 1991 will be used (IMF, 1991).

The Soviet economy experienced positive growth in the 1930's and 1940's as a result of a renewed focus on implementing socialist economic plans. This period was characterised by economic experimentation. During these years the new socialist economic system appeared to be working well, while many analysts argued that it could even perform better than capitalist systems. The success of the Soviet economic system lay in the fact that it was able to survive and sustain a population for some seventy years, while at the same time, develop into a military superpower. Many questions can, however, be raised about the degree of economic development, given the multitude of factors that had a negative impact on economic performance. The Soviet system used the term Net Material Product (NMP instead of Gross Domestic Product) to express the totality of its economic activity. The difference between NMP and GDP is that NMP does not include allowance for depreciation and does not include services provided to the so-called non-material sector.

After the relative success of the Soviet economy in the period 1930-1960, NMP started to decline in the second half of the 1960's as various inefficiencies started to take their toll. As can be seen from Graph 4.1, growth in Soviet NMP declined consistently from the 1966-70 period dropping from 7.8% to 5.6% in 1971-75, 4.3% in 1975-80, 3.2% in 1981-86 and 2.7% in 1986-89. One of the most important factors which contributed to this decline was the policy choice used for stimulating economic growth. The aim of this policy was to obtain a rapid mobilisation of production factors such as labour, raw materials and capital. The policy was pursued instead of rather seeking to increase the productivity of factor inputs.

Graph 4.1: USSR - NET MATERIAL PRODUCT (1966-1989)



Source: IMF, 1991:84

Rapid factor mobility was achieved by following specific policies. Labour supply was increased by accelerating the number of people available to enter the labour market, especially women. Rapid capital accumulation was achieved by allocating a higher share of national income to investments. Normally, growth in capital accumulation was higher than growth in national income. The approach towards natural resources, stemming from the socialist view that these resources were free, resulted on most occasions in full utilisation of these resources. All accessible resources which could be exploited at a minimum cost were exploited first. The availability of these inputs (labour, capital and natural resources) at some point reached constraints. As the availability of resources reached its saturation point, the Soviet Government had to exploit resources which were remotely located, with the attached cost implications. When the supply of labour reached its saturation point, very little could be done to further increase it, even migration to various regions where a labour supply shortage was experienced was difficult because of constraints on the movement of people. Investment growth also reached a point where it was difficult to achieve similar rates of growth, mainly because the share of income available for consumption had fallen towards the limit of what was considered politically sustainable (see Table 4.1).

Table 4.1 : USSR - Economic indicators for the period 1966-1989

INDICATOR	1966-70	1971-75	1976-80	1981-85	1986-89
Retail prices (average annual change %)	-	-0.1	0.7	1.1	1.5
Labour productivity (average annual growth rate %)	6.8	4.5	3.3	2.7	2.7
GFI (average annual growth rate %)	-	6.8	3.3	3.5	6.2
Industry GFI (average annual growth rate %)	-	6.5	3.4	4.2	7.0
Agriculture GFI (average annual growth rate %)	-	10.3	2.7	1.1	5.1

Source: IMF, 1991:90-91,100

Given these constraints, the only way to maintain Soviet economic expansion was to accelerate productivity growth. Labour productivity declined consistently from the 1966-70 period (see Table 4.1). The issue of Soviet productivity growth still remains controversial. Two factors can be mentioned that could have had a negative impact on productivity in the Soviet economy. Firstly, it seems likely that the efficiency with which the state could balance physical input and output declined as the economy became more complex. It is also possible that as economic growth slowed, the continued diversion of productive resources towards the defense sector increased the burden on other productive sectors (IMF, 1991:13). Despite the claims of the Soviet Government that its economic system is based on scientific principles, the very nature of the economy's structure and the procedures involved made it difficult to measure productivity, let alone improve it.

Towards the end of the 1980's, the Soviet economy experienced major organisational and structural problems. Supply-side constraints on the economy were the most important structural problem. Other important problems were industrial restructuring, transportation bottlenecks and problems in the energy sector. In terms of industrial restructuring, the aim in 1988/89 was to convert the defense-related manufacturing facilities to the production of consumer goods, in an attempt to improve the quality of consumer goods. Despite the re-tooling of the defense industries, the desired results of improved consumer goods were not achieved. This process proved to be more and costly than what had been anticipated.

Transportation bottlenecks were caused by the generally lower priority given to the maintenance of the transportation infrastructure, especially roads and railways. The Soviet system was expected to work with clock-like precision in terms of the delivery of goods and intermediate inputs. The breakdown in transportation caused serious economic problems.

Since the energy sector played an important role in the Soviet economy, the problems of maintenance and extraction of particularly the oil and coal industries towards the end of the 1980's also contributed to the economic problems of the USSR. Despite these problems, the careless exploitation of natural resources had a severe impact on the environment.

Worsening government finances were another constraint on the economy towards the end of the 1980's (Table 4.2). On the one hand, revenues either declined or increased very slowly, while on the other hand expenditure increased rapidly. By 1987 revenues declined by 2% of GDP as a result of enterprise reform and a deterioration in the terms of trade, which reduced receipts from foreign trade by 11%. This reform led to substantially fewer transfers of "profits" from enterprises to the central government. At the same time government expenditure came under increased pressure mainly as a result of an increase in subsidies to the agricultural sector as well as increased social spending to counter the economic effects of the previous five years. As such, the budget deficit increased from 18.3 billion Roubles in 1985 to 80.8 billion Roubles in 1988. At this stage the budget deficit as a percentage of GDP increased to 11%. The government was facing increased external pressure as well as the emergence of inflation, and it started to reform government finances, with positive results as can be seen from Table 4.2. *"The rationing character of a centrally-planned economy destroyed incentives for utility maximisation by households and profit maximisation and innovation by enterprises. All the distortions culminated to an ever expanding budget deficit and hyper inflation"* (Kojima, 1994:3).

Table 4.2: USSR - State budget revenue & expenditure (1985-1990)

	1985	1986	1987	1988	1989	1990
Total revenue (bn of rubles)	367.7	366.0	360.1	365.1	384.9	410.1
Revenue as a % of GDP	47.3	45.8	43.6	41.7	41.0	42.8
Total expenditure (bn of rubles)	386.0	415.6	429.3	445.9	465.1	485.6
Expenditure as a % of GDP	49.7	52.0	52.0	51.0	49.5	50.6
Overall balance (bn of roubles)	-18.3	-49.6	-69.2	-80.8	-80.2	-75.5
Balance as a % of GDP	-2.4	-6.2	-8.8	-11.0	-9.5	-8.3

Source: IMF, 1991:282, 289

On the external front the government was also experiencing problems (see Table 4.3). Foreign trade was dominated by exports of energy products and raw materials, while processed goods and food products were the main imports. Although the Soviet economy experienced trade surpluses for most of the 1980's, these surpluses turned into deficits in 1989 and 1990. These deficits, coupled with increased deficits on the service account, turned the current account surplus of US $3.9 billion in 1989 into a deficit of US $10.7 billion (excluding gold) in 1990. Since the capital account also experienced increased outflows, the overall balance on the balance of payments reached critical proportions in 1990 with a US $14.3 billion deficit. This saw foreign reserves drop from US $14.7 billion in 1989 to US $8.5 billion in 1990 (see Table 4.3). The USSR's foreign debt also increased dramatically over the period 1985-1990. In this regard, foreign debt increased by 80.6% from US $28.9 billion in 1985 to US $52.5 billion in 1990. Debt service as a percentage of exports increased from 27.7% in 1986 to 33% in 1990.These developments on the external front, coupled with internal economic constraints eventually forced the Soviet Government to consider reforming the economy.

Table 4.3: USSR- External indicators in US Dollar, 1985-1990						
	1985	**1986**	**1987**	**1988**	**1989**	**1990**
Export	27.0	26.8	31.3	33.4	35.2	36.9
Import	-26.3	-23.2	-23.1	-28.7	-35.4	-42.6
Trade balance	1.3	3.6	8.2	4.8	-0.1	-5.7
Service balance	-1.8	-1.8	-1.7	-3.3	-3.8	-5.0
Transfers	-	-	-	0.1	0.1	-
Current account (excl gold)	-0.5	1.8	6.6	1.6	3.9	-10.7
Gold export	1.8	4.0	3.5	3.8	3.7	3.6
Capital account	-2.8	-5.2	-12.4	-6.1	-3.5	-7.2
Balance on the BOP	-1.5	0.6	-2.3	-0.7	-3.7	-14.3
External debt	28.9	31.4	39.2	43.0	54.0	52.2
External debt service as % exports	-	27.7	26.5	23.1	24.2	33.0
External debt as a % of GDP	3.1	2.8	3.0	3.0	3.7	-
External debt as a % of export	101.8	111.1	117.3	120.5	139.4	129.1
Foreign exchange reserves	12.9	14.7	14.1	15.3	14.7	8.5
Source: IMF, 1991:58-59						

As can be seen in Table 4.4, the Soviet economic system did not achieve much success in terms of social development. Many of these social indicators compare more with social indicators from developing countries than with those of developed countries. In this regard, it can be questioned whether the Soviet economic system was really designed to promote the social development of its population. It is common knowledge that the average Soviet citizen lived in extremely poor conditions, especially in terms of the quality of housing, educational facilities and health services. A huge discrepancy existed between living conditions in rural and urban areas, with the rural areas experiencing the worst of the poor living conditions. These conditions were the cause of many social problems in the former Soviet Union such as high crime levels and alcoholism. Many Soviet citizens, even at the beginning of the 1990's, still believed that the Soviet system would bring about a new and better future, which until today has not yet materialised. On the other hand, many citizens had realised by the late 1980's that the Soviet system could not deliver on the promises of a better future for all.

Table 4.4 : USSR social indicators, 1989	
per 1000 of population unless otherwise indicated	**1989**
Total population	285.7 m
Average family size (number)	3.5
Crude birth rate	17.6
Crude death rate	10.0
Natural growth rate	7.6
Infant mortality rate	22.7
Life expectancy at birth (years)	69.5
Diagnosed alcoholism	14.9
Doctors	44.4
Hospital beds	133
Abortions (1988 - per 1000 women aged 15-49)	82
Source: IMF, 1991:232	

4.9 LESSONS TO BE LEARNED FROM THE SOVIET ECONOMIC EXPERIENCE

The following lessons can be learned from the Soviet Union's experience with economic policies, systems and development:

- The most important lesson to be learned is that no government actions and plans can substitute for individual initiative.
- Despite having access to all and any resources, as was the case in the former USSR, no government can effectively control and manage an entire economic system consisting of millions of people without making use of force.
- Economic systems involving millions of people cannot be based on the efforts of workers alone.
- Labour is not the only generator of value in the economy.
- Disregard for the roll of surplus value in the economy (profits) will eventually lead to unproductive production and a lack of motivation to improve economic deficiencies.
- Disregard for the role of genuine cost in the economy will lead to a massive waste of valuable resources.
- If the socialist system is supposedly designed to improve the living standards and conditions of all people, then all people should share in the economic fruits of that system and not only the government elite.

- Even with access to unlimited resources, governments do not always follow economic policies which will result in the optimal utilisation of economic potential.
- Central planning of all economic and other activities in society will eventually lead to the creation of a super-bureaucratic system, which will accelerate government inefficiency. This process will at a certain point suffocate itself and implode.
- Socialist systems tend to place a great deal of emphasis on military matters, leading to the misallocation of resources. Eventually, a superior defense capability is created but with little economic backing, while the population suffers in poverty.
- Total government responsibility for stimulating economic growth and development is a continuous process, especially in terms of maintaining what has already been established.
- Government is the "worst price-setter," especially when profits and genuine costs are disregarded.

4.10 CONCLUSION

The break-up of the former USSR has clearly demonstrated that the type of socialism followed in the USSR did not have the ability to effectively sustain economic growth and development. Although the initial ideology and aims of socialism and communism were noble and humane, the Soviet system proved that if too much power is concentrated in government's hands, it will eventually lead to chaos in the country and self destruction. The only way to ensure the functioning of the Soviet system for so long was by way of force and the suppression of individual freedom. This immediately raises a moral question as to whether any government, or for that matter, any individual has the right to exert the type of control over individuals that was the case in the Soviet Union.

In a world governed by rapid economic and political change, competition and inter-dependence, it is naive to believe that government can perform better in controlling all aspects of human life. Many functions of economic life are better performed by individuals pursuing their own interests.

It must be kept in mind that the concept of socialist policies and actions by governments is not entirely useless. Certain functions in an economy still necessitate government intervention such as providing education and health services, the eradication of poverty and income differentials, and provision for security and defense.

" ***However, in reality the Soviet economic system is the fruit of an ill-considered, poorly thought out, and crudely conducted experiment. In the beginning it was entirely natural to have some hope for it, despite all the brutality of its measures. These hopes are now groundless. Nevertheless, the experiment is not useless, in the same way that unsuccessful experiments in science are not useless. It demonstrate with utmost clarity that the chosen path is wrong. If experience teaches anything, then others should not choose to take the same erroneous path*** " (Krylov, 1979:244).

CHAPTER 5

SOUTH AFRICA'S ECONOMIC PERFORMANCE UNDER APARTHEID

5.1 INTRODUCTION

The policy of apartheid impacted in the everyday lives of all South Africans and had a profound influence on economic performance since the 1960's. This included issues such as where to work and live, the level and quality of education and health services, who could vote and who not, public transport and a host of other matters. In this regard, the government played a crucial role in designing, implementing and monitoring apartheid laws. *"South Africa's economy is inextricably bound up with the politics of apartheid. In few other countries do political considerations affect economic decisions in such a stark fashion. Indeed, for many years economic requirements have been subordinated to the overriding political imperative of racial separation, especially in the field of labour"* (The Report of the Study Commission on U.S. Policy Toward Southern Africa, 1981:128).

In many cases government was brutal in enforcing apartheid. The high priority given to the apartheid system was clearly demonstrated by governments political, security, economic and social policies, resulting in the militarisation of the country by increased spending on defence and police services. As in the case of the former Soviet Union, the South African governments over the years also had to expand their defence and police capabilities disproportionate to the economic development level of the country in order to protect and sustain system. *"White South Africa's rising concern about security led to major expansion of military strength throughout the 1960's and 1970's"* (The Report of the Study Commission on U.S. Policy Toward Southern Africa, 1981:234).

According to Jahed (1995:153) the South African economy developed a number of structural economic problems since the 1960's, including economic growth and balance of payments constraints, declining levels of employment, higher inflation, chronic fiscal deficits, and declining saving and investment levels. *"One of the reasons for the low rate of saving in South Africa is the excessive use of credit that enables the population to absorb tomorrow's production already in today's consumption"* (Stals, 1996:5). In many instances, the apardheid system exacerbated these economic problems.

Although the policy of apartheid contributed to many of South Africa's political, economic and social problems between 1965 and 1990, South Africa did at the same time develop into a major economic power in Africa, especially in terms of infrastructure and financial services. *"South Africa has arguably the most developed commercial infrastructure in the African continent. Close to 70 per cent of the electricity generated in Africa is produced by the South African Electricity Supply Commission (ESKOM); South Africa's rail, port and road transportation system has the capacity to service the entire Southern African region; the country has a financial system, the equivalent of most modern economies, to help finance, facilitate, and service the needs of industry; and also it has the continent's major, by far, Stock Exchange"* (Brown, 1993:14). As such the South African economic system became fairly well diversified when compared to other African economies, enabling the government to sustain apartheid for decades. *"The broad base of the economy helped to generate a degree of economic stabilisation during the difficult years of the mid to late eighties, when poor commodity prices; political traumas; sanctions and drought put the economy under siege"* (Brown, 1993:2).

The aim of this chapter is to investigate the impact of apartheid on broad economic performance in the period 1965 - 1990, focusing specifically on the manifestation of policy on the social, public and economic realities of the country. The aim is not to discuss the moral correctness of the policy, or absence of thereof. Reference will be made to those policies that had a major impact on overall economic performance. Despite the political nature of apartheid, this study will focus only on the economically relevant aspects of apartheid. Statistical data will be used to support certain views.

5.2 GOVERNMENT MACROECONOMIC POLICIES IN SUPPORT OF APARTHEID

Two distinctive factors shaped the South African political, economic and social environment between 1965 and 1990. First, there were the policies governing separate development, or apartheid influencing every aspect of the daily lives of all South Africans. These policies and ideology formed an integral part of the way economic development progressed in this period. Secondly, the government of the day also designed and implemented broad economic policies and other measures in support of apartheid. These included <u>inter alia</u> fiscal, monetary, industrial, external, social and labour policies.

Whichever broad ideology a country follows, will undoubtedly influence a range of other policies in support of that ideology. In the former USSR, the ideology of communism was followed, which saw the implementation of centrally-controlled socialism. As described in Chapter 4, these policies affected every aspect of daily life in the former USSR.

In South Africa's case the ideology was apartheid, leading to the implementation of 'other' policies in support of apartheid. As such, government's fiscal policies and its role in the economy took on a distinctive character, which had economic results. Characteristic of government behaviour under apartheid were:

- *"Restrictions on black economic participation in the labour market generally and as entrepreneurs;*
- *Under-investment in black education and skills;*
- *Market distortions through ideologically motivated market interventions (e.g. restricting black urban employment to induce industrial decentralisation to the homelands, residential segregation that influenced settlement patterns and transport costs of the poor, Group Areas Act that created artificial housing shortages, etc.);*
- *Distortion of demand patterns, introducing a bias in favour of luxury goods (resulting from inward industrialisation policies);*
- *Maintenance of a siege economy that influenced availability of investment finance (thus magnifying the balance of payments constraint) and access to international markets; and*
- *Industrial and social conflict and their effect on investor confidence"* (Van Der Berg, 1992:62)

Le Roux (1992:16) identified some effects of the apartheid system as follows:

- *"The Land Act of 1913, which reserved 87% of South Africa's land for whites, forced blacks to become labourers on white farms and on white-owned mines;*
- *The trade union legislation of the twenties, which excluded Africans from the definition of employee, delayed the establishment of trade unions which could effectively take care of the interests of Africans until the seventies;*
- *The job reservation laws of the fifties which excluded blacks from most of the better paid jobs;*
- *Discriminatory social security payments and discriminatory wages in the civil service*

which further biased economic progress in favour of white South Africans;

- *The pass laws which separated a father from his family, and kept a large proportion of the black population in the poverty-stricken rural areas; and*
- *Bantu education which was designed to educate black South Africans to remain slaves in the land of their birth".*

5.2.1 Fiscal policies

As the theory of economics developed over the years, particularly government economics, so has the role of government changed and expanded. It was stated in Chapter 2 that government has a specific role to play irrespective of the economic system it follows. In South Africa's case, government played a specific role based on theories dictating that it should supply collective goods and services to the public. With or without apartheid in South Africa, government would still have played an economic role. The effectiveness of this role can, however, be questioned. Between 1965 and 1990 South African governments designed and implemented a number of policies dealing with economic issues such as labour and industrialisation. These issues will be addressed later in this chapter. Regarding fiscal policy, two issues will be dealt with. They are government finances, which include state income and expenditure and debt financing, as well as government's role as an economic subject.

5.2.1.1 State finances

Government makes use of state finances for a number of purposes such as:

- To provide basic collective goods and services, which cannot be provided by the market mechanism.
- To influence economic trends such as investments and savings.
- To implement its own economic policies.

Botha (1986:64) differentiated between fiscal measures that focus on the provision of collective goods and services, and fiscal measures that focus on achieving economic stability (growth, employment and prices). State finances in South Africa underwent some dramatic changes from 1965 to 1990, reflecting the new realities and options available to government to influence economic activity. As such, state finances became a powerful tool for government involvement in the economy. South Africa's state finances consisted of three parts, i.e. expenditure programmes, tax programmes and efforts to finance any budget deficit. According to Botha (1986:66) changes to any of these three parts could be either functional or focused on broad policy goals. Ultimately any change would influence the economy in the following manner:

- It would have a direct impact on the availability of production factors.
- An indirect impact on available income as a result of tax changes.
- A substitution effect of tax changes' influence on relative price changes.

In South Africa's case state finances were subjected more to political considerations and influence than that of economic factors, especially as a result of apartheid (Botha, 1986:69). This was also reflected in the large number of state departments duplicated to cater for the different population groups, the dualistic economic system and political developments.

A number of considerations are important when dealing with state finances. On the expenditure side there are specific needs for collective goods and services, cost advantages, efficiency in resource allocation and the relative size of state expenditure in the economy. The last point is of particular interest since many western industrialised countries in the period 1960 to 1979 experienced an increase in government expenditure relative to economic activity (Gould, 1983:38-69), which had the tendency of "crowding-out" the private sector. On the state income side the most important considerations are: fairness in the tax system, correct determination of tax levels, and efficient resource allocation and bureaucratic administration. On state debt (financing any budget deficits) the most important consideration is the source of finance whether domestic or foreign. Financing budget deficits became increasingly important during and after the 1970's when many governments were confronted by such deficits. Botha (1986:83) identified the possible impact associated with financing budget deficits:

- An interest burden: interest on loans to finance deficits tends to lead to redistribution of income between tax payers on the one hand and owners of such loans on the other hand. This ultimately leads to the uneven and wasteful allocation of resources, which influences output on the long-run.
- Influence on private investment as government increases its domestic borrowing to finance its deficits. This limits the available capital that could finance private

investment and tends to put pressure on local interest rates. In the long run, the economy grows at a much lower rate. Evidence of this problem existed in South Africa between 1965 and 1990 and will be dealt with later in this Chapter).

- Financing methods could influence the money supply and price stability: depending on the financing methods used, for example making use of local and foreign borrowing and accumulated balances at the central bank.

State finances are thus one of the most important tools available to government to influence economic activity and serve as an instrument for government to implement its fiscal policies.

5.2.1.2 State finances in South Africa between 1965 and 1990

Between 1965 and 1990 government made many changes to its expenditure, tax and deficit financing programmes. Although any government must adopt its policies to keep track of current realities and changes, South African governments were mainly required to make such changes because of:

- The implementation of apartheid laws which necessitated the design and implementation of economic policies in support of apartheid. This was evident in expenditure patterns during this period, for example social spending on whites versus blacks, and defence and security spending.
- Disappointing macroeconomic results, which required adjustments to expenditure and income programmes.
- Domestic and international pressure on the apartheid state.
- International economic trends such as the oil shocks in the 1970's and gold price movements.

Although a detailed trend and policy analysis is impossible the most important developments regarding state finances will be addressed.

(a) State revenue

The main source of state income in South Africa is tax collection, and this took place in terms of the income tax law of 1962. Central government was responsible for collecting taxes and made use of a wide spectrum of tax instruments to generate revenue, including customs and excise, gambling tax, income tax by individuals, non-mining companies, gold mines and other mines, sales tax (later VAT), goldmine rent contracts, tax of foreign shareholders, estate tax, interest and dividends, transfer duties and stamp duties.

However, the range and scope of the tax system were narrow, leading to relatively higher marginal tax rates than the average tax rate. According to Botha (1986:100) the most important factors limiting the tax range included:

- Capital gains taxes use to be collected only in special circumstances.
- Only sources of income inside the Republic were taxed.
- A wide range of costs and losses could be deducted for tax purposes.
- A number of fiscal measures were implemented to promote and achieve economic, social and political goals.
- The practice of taxing married couples as one entity was counter productive.

A number of important changes occurred in the structure or composition of government revenues in the period 1965 to 1990. In this period tax collected from individuals as a percentage of total revenue increased dramatically. The burden on individuals further increased with the implementation of general sales tax at the end of the 1970's (see Table 5.1). At the same time tax collected from companies and other sources decreased. As such, by 1990 individual taxes contributed more than 40% of total government revenue.

Table 5.1: South Africa - tax revenue breakdown by category: 1965-1990 (in % of total)

Year	Individual Income Tax	Sales Tax	Companies	Other	Total
1965	28	0	32	40	100
1970	18	0	47	35	100
1975	28	0	51	21	100
1980	22	14	40	24	100
1985	33	27	27	13	100
1990	34	29	24	13	100

Sources: Lombard, Special Focus no 1:62 and Lachman (IMF), 1992:26

The factors accounting for the high individual tax contribution to government revenue were:

- High marginal tax rates.
- "Fiscal creep", where income increased at rates higher than the inflation rate pushes individuals into higher tax brackets. At the same time these brackets were not adjusted according to price movements.
- The impact of global commodity price declines in the 1970's and 1980's. As such, mines experienced profit and survival problems, which were made worse by rapid wage and cost increases. This led to decreased tax revenues from this source, which left the government little alternative but to shift the tax burden onto the individual.

In a study by the IMF (1992:28) the social distribution of taxes and the respective benefits each race group received from government's social spending were examined. According to the study the race distribution of taxes and benefits was highly distorted (see Table 5.2). In 1975 whites contributed 77% of total taxes for which they received only 56% of total government social benefits. For the same year blacks contributed 16% of total taxes for which they received 28% of total benefits. In 1987, the contribution of whites to taxes declined to 72.1% of total taxes, but their benefits received amounted to only 35% of total benefits. In this regard, the drop in benefits (a 21% drop) was not accompanied by a similar drop in the contribution to total taxes. For the same year however, black contributions to total taxes increased to only 19.8%, but the benefits they received increased by 17% to 45% of total benefits. For the same year both the asian and the coloured groups' contribution to taxes increased, while only the benefits of coloureds increased. The decrease in white benefits and the increase in black benefits *"stemmed from the market redirection of the Governments budget priorities and which more than offset the relative decline in the white sector tax burden during the 1980's"* (Lachman, et al, 1992:28). Expressed as a percentage of per capita income in 1987, whites spent 35.3% of their income on taxes, while receiving benefits to the value of only 10.6% of their per capita income. Blacks on the other hand spent 17.5% of their per capita income on taxes, while receiving benefits to the value of 24.7% of their income.

Table 5.2: South Africa - interracial distribution of taxes & benefits: 1975 and 1987								
	Taxes				Benefits			
	In % of total taxes		In % of per capita income for each group		In % of total benefits		In % of per capita income for each group	
	1975	1987	1975	1987	1975	1987	1975	1987
Asian	2.6	3.2	18.4	25.2	6.0	6.0	-	28.9
Black	16.0	19.8	12.5	17.5	28.0	45.0	-	24.7
Coloured	4.4	4.9	12.2	17.2	10.0	14.0	-	30.6
White	77.0	72.1	23.9	35.3	56.0	35.0	-	10.6
Source: Lachman (IMF), 1992:28								

The IMF study also pointed out that the "net tax burden" is unevenly distributed. Compared to industrial countries, the white tax contribution as a percentage of income is similar. The "net tax burden", that is the difference between the tax burden and social benefits of whites, was, however, among the highest in the world at 23.31%, compared to an average for the industrialised countries of 10.53% and for the world of 9.08% (see Table 5.3). For coloureds the "net tax burden" in 1987 amounted to -11.11%, for blacks -3.41% and for Asians 1.77%. It can be deducted from these figures that:

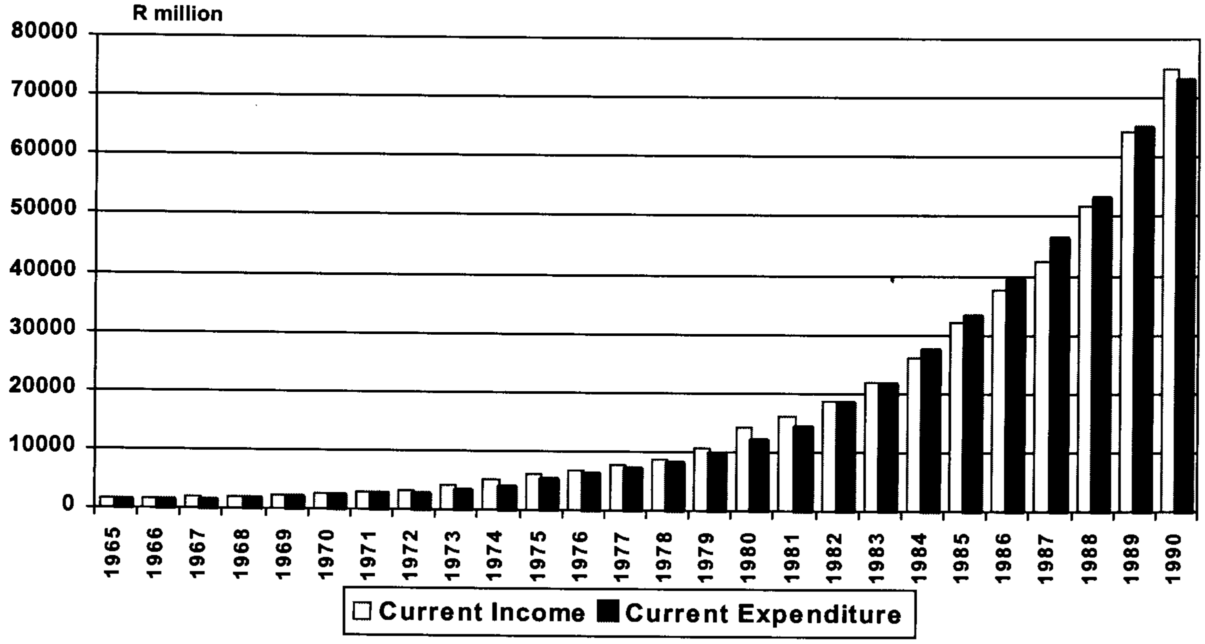
- South African whites paid a very high price for the "privileges" of apartheid.
- Government (willingly or unwillingly) was busy with the redistribution of wealth, away from whites towards the other social groups as early as the 1970's.
- Government constantly changed its tax policies to achieve different goals.

Table 5.3: South Africa - comparative racial tax burden: 1987 (in percent of GDP)					
	Tax Revenue	Education expenses	Health expenses	Welfare & housing expenses	Tax Burden
Asian	24.27	10.00	3.75	8.75	1.77
Black	13.04	6.23	5.51	4.71	-3.41
Coloured	17.68	12.27	3.64	2.88	-11.11
White	32.03	5.40	1.74	1.58	23.31
Overall Population	23.94	6.30	3.30	3.70	10.64
Industrial World	33.05	5.01	5.42	12.09	10.53
World	30.37	4.89	5.02	11.38	9.08
Source: Lachman (IMF), 1992:30					

(b) Government expenditure

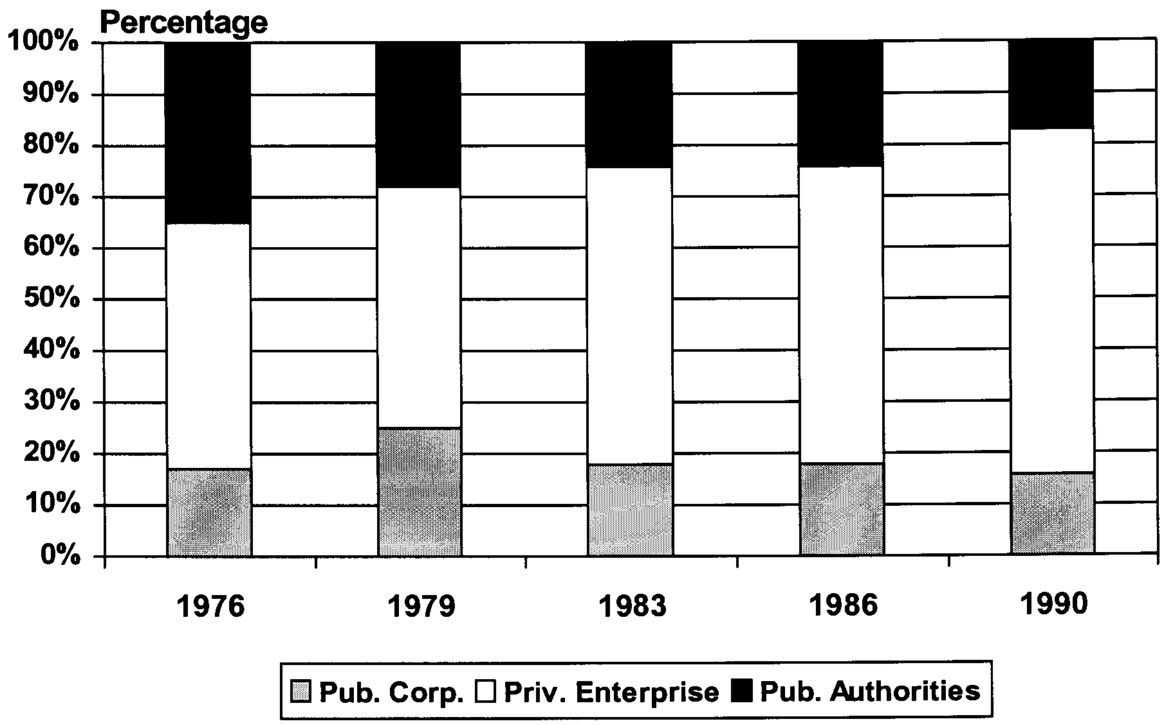
During the period 1965 to 1990, total public sector expenditure grew constantly. This trend was in line with international trends of increased government participation in the economy. *"Measured by virtually every yardstick, the public sector in South Africa has grown rapidly in relation to the rest of the economy since soon after the end of the Second World War"* (Gouws, 1992:27). This increase in government participation in the economy came at great cost, namely poorer economic growth, lower levels of private fixed investment, lower overall economic efficiency and higher inflation (Gouws, 1992:27, quoting Calitz, 1988:34 and the White Paper, 1987:5). Government believed, however, that the benefits derived from a bigger government role surpassed these costs. It was especially in the decade 1980 to 1990 that government current expenditure increased substantially (see Graph 5.1), while gross domestic investment of public authorities and the public corporations declined (see Graph 5.2).

Graph 5.1 Current income and expenditure of the central government at current prices (1965-1990)



Source: SARB Quarterly Bulletin (various issues)

Graph 5.2: Investment components % of total (1976-1990)



Source: Brown, 1991: 6

Table 5.4 gives an overview of current expenditure by the government for the period 1965 to 1990. As can be seen, current expenditure between 1970 and 1979 at current prices, increased by more than 350%. Between 1980 and 1990 it increased by more than 500% in nominal terms.

Table 5.4: South Africa - current income and expenditure of the general government at current prices (R million)

Year	Current Income	Current Expenditure	Balance
1965	1471.0	1171.0	300.0
1966	1561.0	1310.0	251.0
1967	1919.0	1428.0	491.0
1968	2059.0	1574.0	485.0
1969	2393.0	1847.0	546.0
1970	2632.0	2126.0	506.0
1971	2846.0	2523.0	323.0
1972	3175.0	2729.0	446.0
1973	4191.0	3116.0	1075.0
1974	5298.0	3939.0	1359.0
1975	6048.0	5060.0	988.0
1976	6784.0	6206.0	578.0
1977	7649.0	7042.0	607.0
1978	8832.0	7912.0	920.0
1979	10500.0	9629.0	871.0
1980	14227.0	11861.0	2366.0
1981	16101.0	14160.0	1941.0
1982	18791.0	18462.0	329.0
1983	21913.0	21683.0	230.0
1984	26086.0	27282.0	-1196.0
1985	32087.0	33077.0	-990.0
1986	37466.0	39134.0	-1668.0
1987	42353.0	46332.0	-3979.0
1988	51667.0	52914.0	-1247.0
1989	64152.0	65021.0	-869.0
1990	74761.0	73065.0	1696.0

Source: South African Reserve Bank Quarterly Bulletin (various issues)

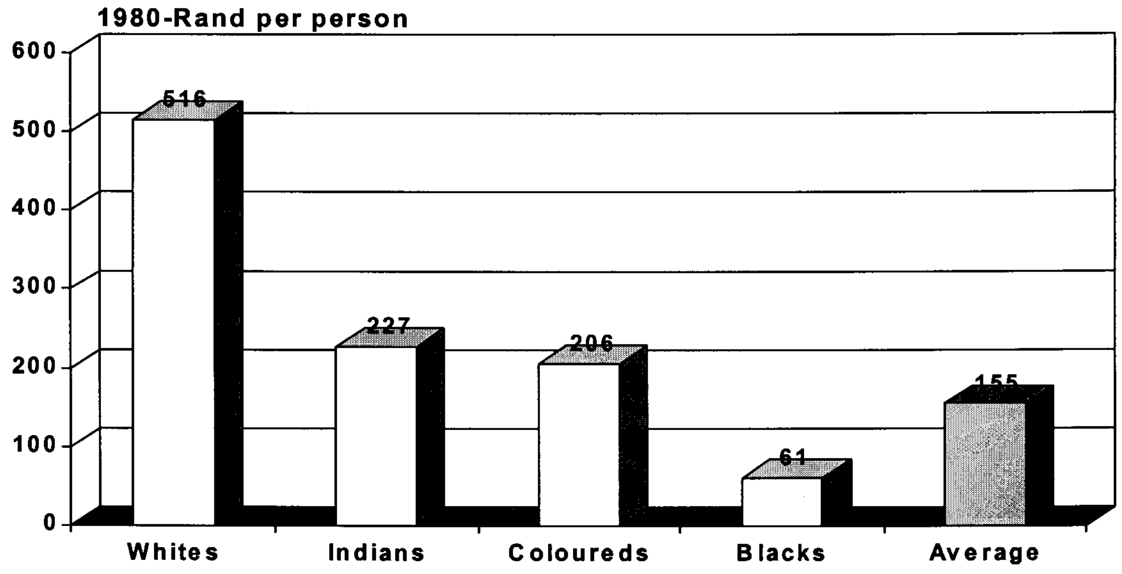
The progressive increase in government's current expenditure, accompanied by a decline in government gross fixed investment in infrastructure, is an indication of the channelling of increased economic resources into current spending. An indication of the rapid increase in governments' current expenditure is that it increased from 10.4% of GDP in 1962 to 20.9% of GDP in 1991 (Gouws, 1992:28). Contributing to this increase were:

- Rapid increases in the number of people employed by government (between 1973 and 1991 employment by government increased by more than 68% in comparison with 17% growth in the private sector) (Gouws, 1992:28).
- As a result of political developments, government increased its security spending.
- Increased state debt led to increased current expenditure on interest payments.

Official policy in the early 1980's appeared to switch towards the promotion of consumption expenditure as the chosen multiplier for economic expansion. The manifestation of increased consumption expenditure was as follows:

- *"Interest rates were lowered to well below the current and anticipated inflation rate;*
- *Tax cuts were directed towards individual taxpayers;*
- *Credit extension by the banking system was encouraged; and*
- *Probably most importantly, the focus of State expenditure shifted away from investment expenditure towards consumer spending"* (Brown, 1991:6).

Graph 5.3: Benefits from government social expenditure on different groups (1975)



Source: Van Der Berg, 1989:27

By 1975 the disparity in government social expenditure on different racial groups was already high (see Graph 5.3). The average for that year was R155 per person. Whites received the highest amount at R516 per person, nearly ten times more than average social spending on blacks. Government did subsequently try to address this imbalance, but by 1990 government social spending was still biased in favour of whites.

Total government expenditure as a percentage of GDP increased from 21.9% in 1962 to 36.6% in 1985, whereafter it declined to 31.8% in 1991 (Gouws, 1992:27). For 15 of the 25 years between 1965 and 1990 growth in government consumption expenditure outperformed growth in private consumption expenditure (see Table 5.5), which indicates that government used its budget on the expenditure side to stimulate economic growth and activity. This increase in spending resulted in an increase in the tax burden and a growing appropriation of the country's capital resources by government (Gouws, 1992:29). Gouws has also identified other domestic and international factors contributing to increased government spending, such as:

- The impact of slower world trade growth on South African export volume.
- Gold price instability, which contributed to financial market instability and complicated business planning.
- Increasingly unstable domestic political and social environments.
- Declining foreign direct investment and the drying-up of foreign loans (Gouws, 1992:29).

The expansion of government spending saw a rapid increase in government participation in nearly all aspects of economic life, inter alia gross fixed investment, employment and wages. As indicated in Graph 5.2, government gross fixed investment including public corporations, fell dramatically between 1976 and 1990. *"In other words, the government appears to have been the worst culprit contributing to the inward looking neurosis which afflicted the economy over the sanctions years. The private sector has been required to take up the capital spending vacuum created by State withdrawal, without being given any compensation through tax incentives or other inducements to promote such fixed investment"* (Brown, 1991:6).

Table 5.5: South Africa - GDP expenditure at constant 1985 prices: 1965-1990 (% change)

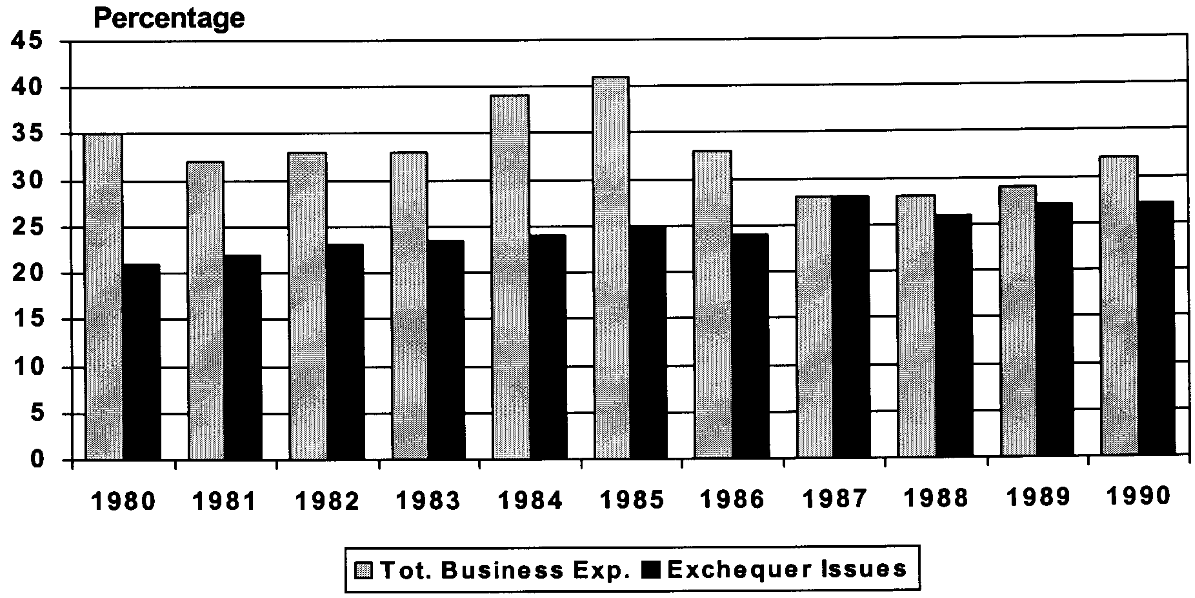
Year	Private Consumption Expenditure	Government Consumption Expenditure	Gross Domestic Fixed Investment	Gross Domestic Expenditure	Change in Inventories
1965	3.59	8.68	17.45	9.36	47.98
1966	4.67	4.98	-1.14	-0.12	-90.64
1967	4.49	3.96	2.58	11.85	2805.56
1968	7.35	6.9	4.53	2.14	-66.06
1969	6.96	6.17	12.53	9.87	35.99
1970	6.55	7.95	14.27	10.16	67.32
1971	4.71	7.95	10.81	7.11	15.04
1972	4.28	-0.45	5.84	-4.69	-129.35
1973	7.58	4.4	5.22	11.57	-140.05
1974	5.25	7.74	6.53	15.24	636.84
1975	3.63	12.1	9.76	0.71	-33.88
1976	1.58	5.5	-1.24	-2.92	-168.48
1977	2.76	3.83	-5.96	-6.34	-34.71
1978	-1.95	0.67	-2.81	1.99	22.69
1979	2.48	4.8	4.21	3.08	-141.1
1980	8.59	9.12	17.08	12.68	807.5
1981	7.3	1.89	8.95	11.56	29.43
1982	2.1	6.32	-2.15	-5.29	-153.42
1983	3.01	1.81	-3.54	-4.87	-72.24
1984	4.6	6.81	-1.49	7.73	-150.36
1985	-3.46	3.44	-7.03	-8.03	-986.94
1986	0.16	2.29	-18.19	0.06	-56.13
1987	3.86	3.74	-2.4	2.95	-117.77
1988	5.27	1.66	8.93	8.2	625.77
1989	2.4	3.53	5.42	-0.76	-85.56
1990	1.52	1.0	-1.4	-3.12	-1129.84

Source: South African Reserve Bank Quarterly Bulletin (various issues)

"But the view that the rising share of government spending in the total has detrimentally affected the performance of the economy seems now to be fairly generally accepted, and has been expressed by the former Minister of Finance, as well as the Minister for Economic Coordination and Public Enterprises." (Gouws, 1992:27, quoting Du Plessis, 1988:17 and De Villiers, 1988:8-11).

When comparing government expenditure with total business sector expenditure expressed as a percentage of GDP, we see that governments' share increased to 27% in 1990 from 21% in 1980, while the private business sectors share decreased from 35% in 1980 to 32% in 1990 after peaking at 41% in 1985 (see Graph 5.4). It changed especially after the implementation of sanctions in the mid-1980's. This led to a *"crowding-out"* of the business sector by government (Brown, 1991:9).

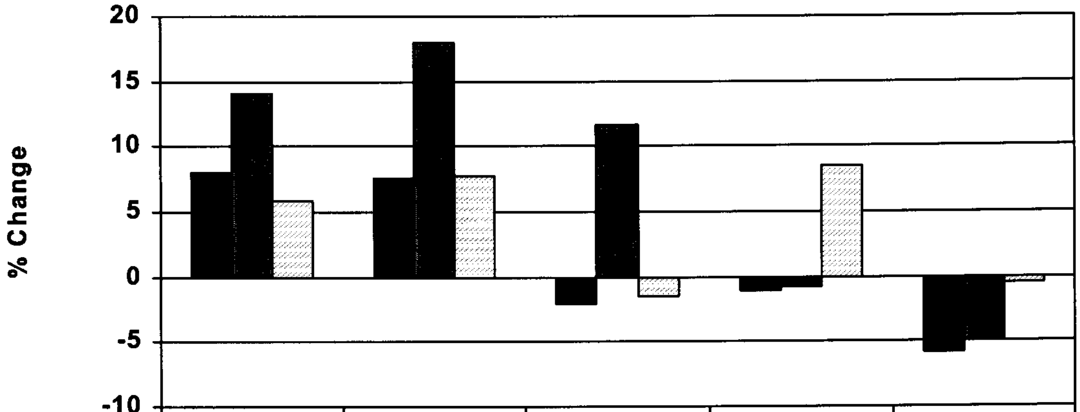
Graph 5.4: State vs. business share of GDP (1980-1990)



Source: Brown, 1991: 9

Trends in gross domestic fixed investment also highlight the rapid decline in growth of investment by the public sector and public corporations (see Graph 5.5). In the period 1965 to 1979, public investment growth outperformed private business investment growth. Between 1980 and 1984, private business sector investment growth outperformed government investment growth for the first time. Average gross domestic fixed investment for both sectors was negative between 1985 and 1989.

Graph 5.5: GDFI - Average annual percentage change (1965-1989)

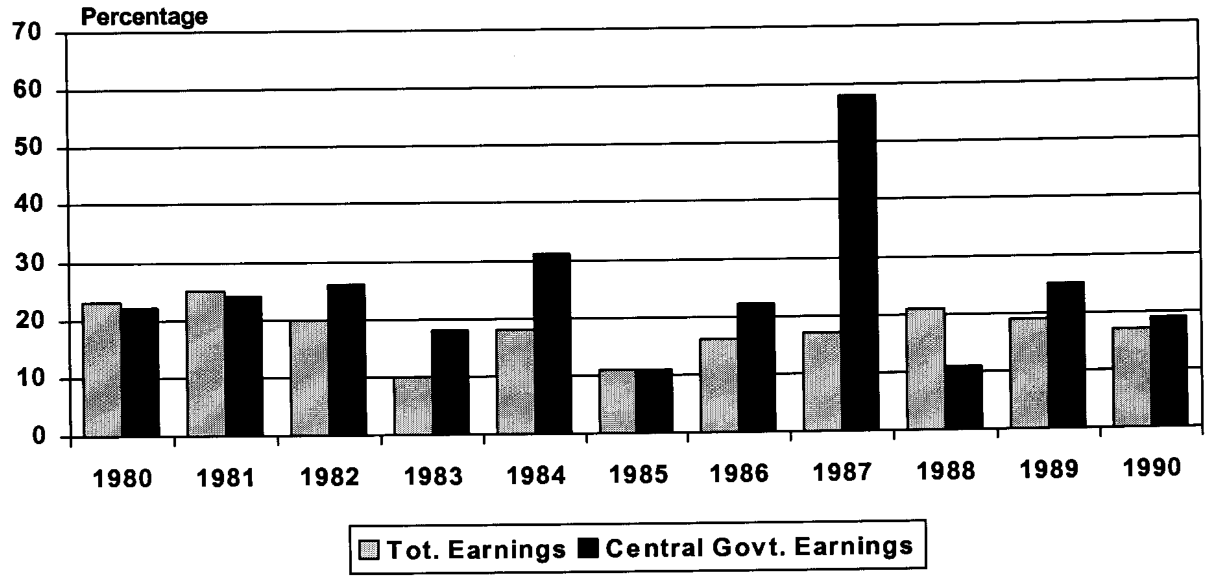


	1965-69	1970-74	1975-79	1980-84	1985-89
■ Pub Sector	8.09	7.53	-2.02	-1.02	-5.84
■ Pub Corp'	14.02	18.04	11.66	-0.8	-4.77
□ Priv Sector	5.84	7.69	-1.44	8.47	-0.49

Source: SARB Quarterly Bulletin (various issues)

Increased government participation in the economy also impacted on employment and wages. *"For instance, whereas total employment in the economy only rose by a cumulative 12% during the whole of the eighties - a frighteningly inadequate figure - employment by central Government increased by nearly 60% over the same period. South Africa has truly become a nation of civil servants"* (Brown, 1991:7). As far as government wage increases are concerned, these expanded faster than wages in the rest of the economy, especially during the sanctions years (see Graph 5.6). *"This trend appears to have noticeably accelerated in the sanctions era. The Government seems to have insulated those fortunate enough to be in its employ from the ill effects of sanctions. Undoubtedly, this is the great irony of the sanctions campaign - it punished the private sector and the general creation of employment, but those privileged to be in the State's employ (surely the prime target for sanctions) were seemingly untouched. The Government sector appears to have been the least affected by the sanctions campaign"* (Brown 1991:8).

Graph 5.6: Growth in central government wage earnings vs. growth in the rest of the economy (1980-1990)



Source: Brown, 1991: 8

(c) Budget deficits

Developments in state income and expenditure between 1965 and 1990 led to disturbing government budget deficits. The problem with budget deficits is the financing thereof. When government finances such deficits by borrowing on the domestic capital market as was the case in South Africa, a trend of "crowding-out" the private sector develops. Although many foreign governments embarked on a programme of lowering their budget deficits in the 1980's, the same did not happen in South Africa. As pressure on government spending increased, and sources of revenue were unable to keep up with demand, so did the pressure on the economy increase. This problem had been experienced since the mid-1970's, but especially after 1982. In 1980 and 1981 a temporary change occurred when the high gold price relieved the pressure on government revenue. As such the practice of continued budget deficits eventually gave rise to dissaving by the South African Government, especially after 1982. According to Gouws (1992:31) *"the dissaving by government has had, and will continue to have, major implications for:*

– *The country's balance of payments, because dissaving by government reduces gross domestic savings, and so impacts adversely on the gap between gross domestic* *savings and gross domestic investment;*

- *The size of the government debt and the debt servicing burden, and therefore the size of future budget deficits;*
- *The rate of real capital formation, by putting pressure on interest rates and "crowding-out" the private sector from the flow of savings;*
- *Price stability, because even if they are not directly monetised, budget deficits tend to have eventual inflationary consequences; and*
- *Future generations, who will have to carry the burden (either through higher tax or higher inflation) of present government current expenditure".*

As a result of government fiscal policies under apartheid between 1965 and 1990 a huge mis-allocation of resources occurred. Since government was an important allocator of resources *"the deployment of resources under apartheid has bred inequality, waste and duplication"* (Van den Berg, 1992:61).

5.2.1.3 Highlights of fiscal policy between 1965 and 1990

During this period government introduced many changes to its fiscal policies by way of special commissions. Since many changes were made to fiscal policy, it is difficult to categorise fiscal policy. It can rather be described as a combination of different approaches based on ad hoc requirements and realities. The following were common characteristics:

- Keynesian demand management by manipulating the budget, which was important in the post-1970 period.
- Counter-cyclical expenditure during the 1960's and 1970's with government spending to boost economic activity during slowdown.
- Botha describes fiscal policy as eclectic and pragmatic, consisting of a mix of stricter or accommodating fiscal instruments depending on economic circumstances (Botha, 1986:111).
- Expansionist fiscal policies, with government finances expanding consistently between 1970 - 1980 and rapidly between 1984 and 1990 (see Graph 5.1). Although the 1970's was characterised by fiscal discipline, with concerted efforts being made to lower budget deficits, overall fiscal policy had a decidedly expansionist nature.
- The beginning of the 1980's was characterised by restrictive fiscal policies as a result of increased price inflation and excessive real GDP spending.

- By 1986/87, restrictive fiscal policy switched and became expansionist again as a result of increased domestic security problems and social unrest, drought, the cost of government debt and weak control over state expenditure.
- Since the mid 1970's more attention was given to supply side instruments.

In 1970 fiscal policies underwent a dramatic change as a result of the recommendations of the Franzsen Commission, which submitted three reports to government in 1969 and 1970. Many of these recommendations were implemented during the 1970's. The most important recommendations of the Franzsen Commission can be summarised as follows:

- The establishment of a Cabinet Finance Committee to improve and oversee control of state finances. By 1975, this committee had ceased to exist.
- The lowering of the individual marginal income tax rate to 60%, which reached a high of 78% by 1972.
- Centralisation of the responsibility to collect taxes. Provinces would no longer be able to collect individual taxes as recommended by the Schuman Commission in 1964.
- Expanding the tax base.
- State expenditure was to be planned five years in advance. This system of budgeting was already in use in major industrialised countries and was adopted in South Africa in 1975/76. The distinction between the current and capital account in the budget was also abolished.
- An increased focus on indirect policy instruments, especially with regard to stabilisation policies.
- Creation of the Standing Committee on Tax Policy to oversee the effectiveness of the tax system. This committee was responsible for the implementation of many of the Franzsen Commission recommendations, such as the lowering of the individual marginal tax rate, the introduction of general sales tax in 1978, the integration of tax laws for blacks and whites in 1982/83, and the tax system on fringe benefits.

Fiscal policy in South Africa had both positive and negative implications. Botha (1986:117-118) identifies the following positive developments:

- Coordination between fiscal and monetary policy improved based on the Franzsen Commission report in 1969/70 and the De Kock Commission report of 1979.
- The tax base expanded with the introduction of GST.
- The tax system was simplified and became more fair.

- Between 1972 and 1980 the marginal tax rate on individuals declined substantially.

Botha (1986:119-130) also identifies certain shortcomings of broad fiscal policy. They are:

- Weak control over state expenditure. In the period 1981/82 to 1986/87 actual expenditure overshot budgeted expenditure by an average of 7% per year. This had negative implications for budget deficits, the financing of budget deficits, increased state debt and inflationary pressure.
- Flaws in the tax system. Changes in the tax system were implemented on an ad hoc basis, while the effective tax rate on individuals and companies increased sharply, which had a negative impact on productivity and profitability. Botha makes the statement that a negative correlation exists between high effective tax rates and low economic growth, which was proved by the Reagan and Thatcher governments. This problem is identified as one of the possible reasons for weak economic growth in South Africa since 1981. The combination of inflation-related salary increases and fiscal creep impacted negatively on the disposable income of individuals. Relatively high tax rates also discouraged personal savings, while companies increased product prices to compensate for higher taxes (transferring the high cost of taxes to individuals). The practice of taxing the combined salaries of married couples tended to discourage qualified women from entering the labour market, increasing the need for skilled labour. These negative implications of the tax system prompted the government to appoint the Margo Commission in 1984. Many recommendations by this commission were adopted in an attempt at rectifying a number of the tax system flaws mentioned above.
- The decision to centralise tax collection proved to be the wrong one for two reasons. Firstly the goal of more efficient fiscal control was not realised. This is illustrated by the huge percentage increases of state expenditure after centralisation. Secondly, the danger of an increased centralisation of government functions versus the advantages of the decentralised provision of collective goods. Botha (1986:127) warned that this trend would move the economic system towards socialism, a system in direct conflict with broad government ideology and policies.
- Despite improved coordination of fiscal and monetary policy from the 1980's, a lack of sufficient coordination between fiscal demand management and other economic policy instruments continued to undermine economic growth.
- The use of state finances to implement questionable political ideologies. Although Botha (1986:128) admits that it is difficult to quantify the impact hereof on state

spending, debt and economic growth, he did point out that apartheid forced the government to use many of its resources to defend apartheid, which led to an increased role for government in the economy. Apartheid also increased the distrust of blacks in the market mechanism, because they were exposed to the same fiscal rules and laws as whites, but without any say or influence over the political system.

From the evidence mentioned above it is clear that between 1965 and 1990, government actively used fiscal policy as a tool to direct and implement the policy of apartheid. Fiscal policy was also used by government to influence the direction and development of socio-economic factors such as education, health and housing. From all policy instruments available to government to influence economic development, fiscal policy proved to be the most effective tool for these purposes mainly because government had direct control over it. It is exactly this instrument that could be used by the current government to address the many challenges and backlogs created by the legacy of apartheid if South Africa is to emerge as a stable, growing economy able to play a meaningful economic role in the continent and in the world at large.

5.2.2 Monetary policy between 1965 and 1990

Monetary policy has played an important role in South Africa's overall of government policy. Although monetary policy was not openly used to promote apartheid, certain aspects of monetary policy did promote the ideology. In South Africa the South African Reserve Bank (SARB), established in 1920, is responsible for planning, implementing and monitoring monetary policy. The autonomy of the SARB has to some extent protected it from directly supporting and implementing politically motivated policies.

The aim of this section is not to discuss the theoretical basis of monetary policy, but never to look at broad trends in the development of monetary policy in South Africa between 1965 and 1990, and the successes and failures thereof. Because it was centrally planned and a government instrument, monetary policy had an impact on overall economic growth, development and failures in the South African economy. Reference will be made to the most important policy changes. These changes were mainly the result of the recommendations by two Commissions.

The first of these was the Commission on Fiscal and Monetary Policy in South Africa, the Franzsen Commission, which published its final report in 1970. The second was the Commission on the Monetary System and Policy in South Africa, the De Kock Commission, which submitted three reports to government between 1975 and 1985. These are considered the most comprehensive research work ever done on monetary issues in South Africa (Botha, 1986:167). The recommendations of the De Kock Commission have played an important role in monetary policy in South Africa since 1980.

5.2.2.1 The period before 1980

"Policy makers in South Africa have generally favoured monetary policy to manage inflation and the balance of payments" (Harvey, 1994:10). During the 1960's and 1970's the government made use of direct monetary control measures such as credit ceilings and exchange control, while ignoring recommendations by the Franzsen Commission to make more use of indirect measures such as open market transactions. According to Botha (1986:167-168), quoting the De Kock Commission Report the absence of market-oriented measures in monetary policy was reflected by:

- Scepticism on the part of the authorities as to the ability of the financial system to react to market measures.
- Related to this, government was sensitive to the socio-political effects of such market measures as higher interest rates.
- Monetary policy was applied in a very strict manner and concentrated primarily on controlling credit supply.
- The capital account in the balance of payments was not permitted to play its traditional economic stabilisation role because of a lack of coordination between monetary policy and exchange control measures and policies.
- The absence of clearly delineated interest rate levels and increases in money supply.

Until the 1960's the Reserve Bank played a traditional role of managing the balance of payments and inflation, but changed its role *"when the government consciously imposed a greater degree of control on every aspect of the economy, both because it believed in the superiority of planned development and because it was systematically implementing apartheid. Monetary policy consequently consisted of direct measures aimed at achieving specific goals: interest rates were stabilised at relatively low levels to stimulate investment,* *and direct or indirect interest rate subsidies were paid to selected sectors like agriculture, exporters and homeowners. In general, these policies were not successful"* (Harvey, 1994:10).

Some of the consequences of this approach were (Botha, 1986:168-170):

- Excessive and unstable growth in money supply.
- Weak impact of monetary policy.
- Control of interest rates resulted in artificially low interest rates in the long term, which stimulated gross domestic expenditure.
- Strict and at the same time uncoordinated exchange controls expanded domestic liquidity at times of higher export earnings.
- High inflation as a result of strong consumer and investment demand, was accommodated by a fast-growing money supply.
- The high inflation rate also had a long-term downward effect on the rand/dollar exchange rate, which in turn caused higher import prices.

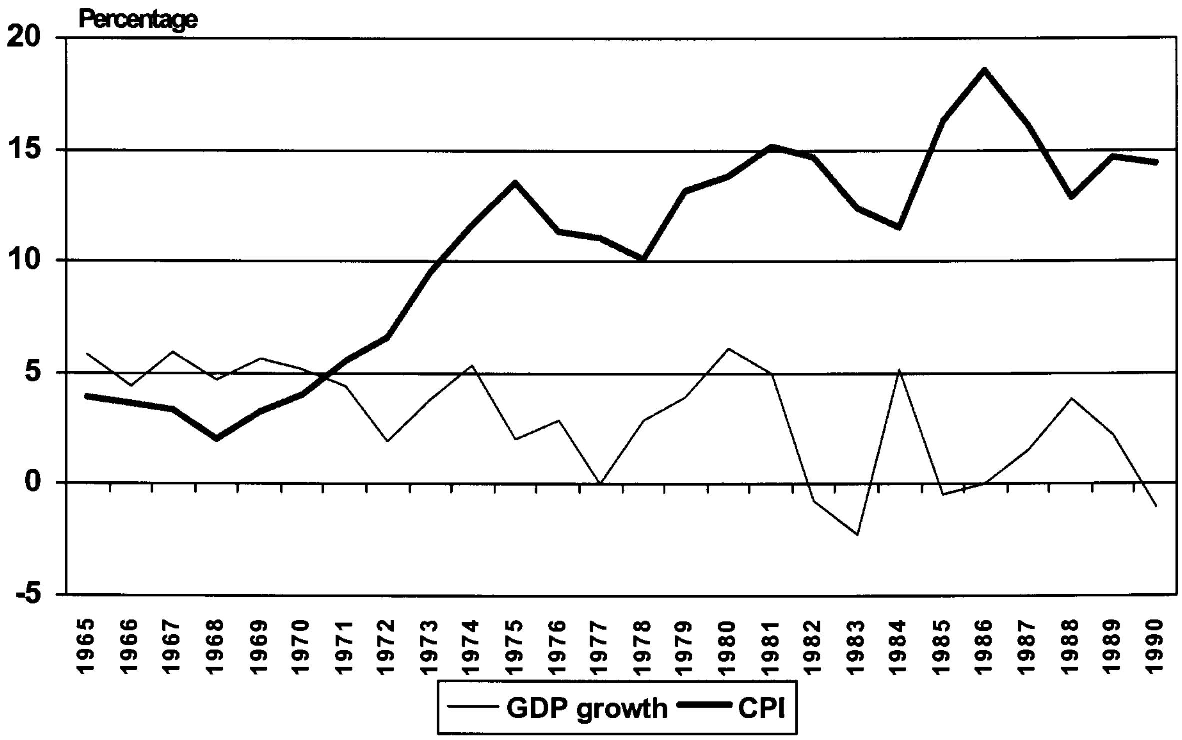
The monetary policy framework during this period is described by Botha (1986:178) as:

- Policy approach:
  - Mainly non-market
  - No money supply goals
  - Poor coordination among different policy instruments
- Instruments:
  - Credit ceilings
  - Deposit rate control
  - Extensive exchange control
  - The liquidity asset system of bank credit control
- Intermediate consequences:
  - Artificially low interest rates
  - Excessive growth in the money supply
- Final consequences:
  - Weak control over money and credit provision
  - Demand-pull inflation
  - Exchange rate depreciation and further inflationary pressure

5.2.2.2 The period 1980 - 1990

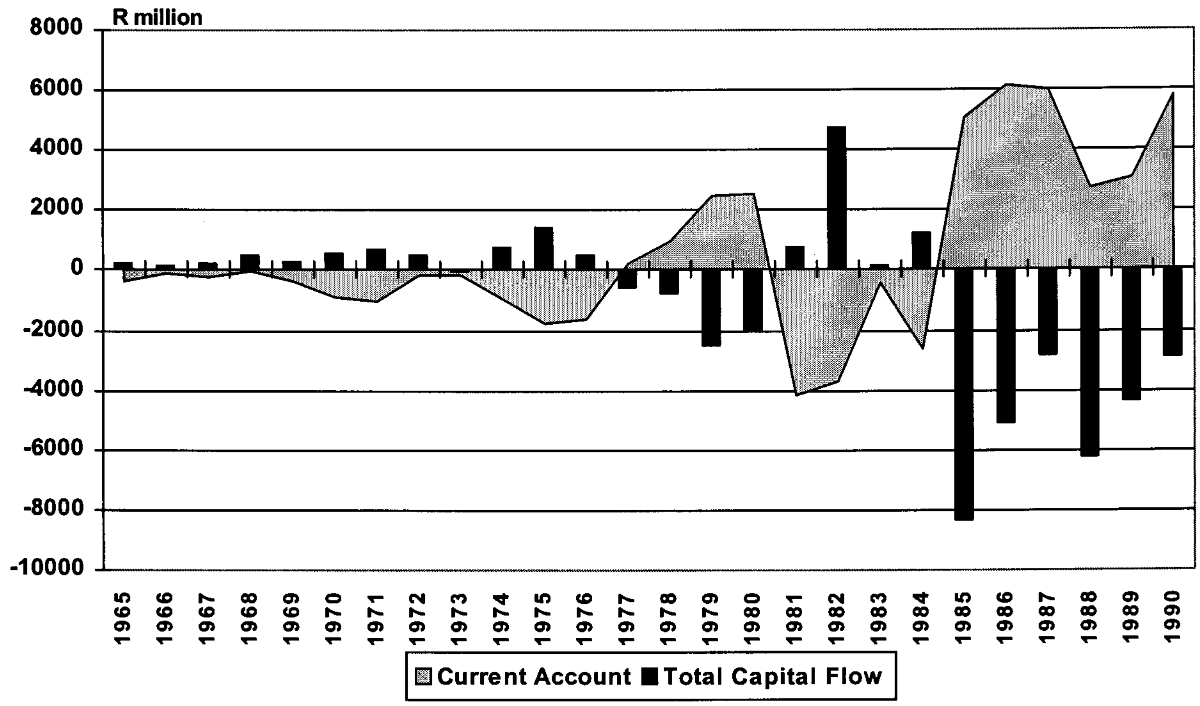
The deteriorating long-term economic performance of the South African economy, since the mid-1970 led to government seriously revisiting its economic policy approach. The deterioration was evident in major economic indicators such as low growth in gross domestic product, persistent double-digit inflation rates and balance of payment fluctuations. Graphs 5.7, 5.8 and 5.9 reflect the major trends in economic performance for this period.

Graph 5.7: Trends in GDP vs. the CPI (1965-1990)



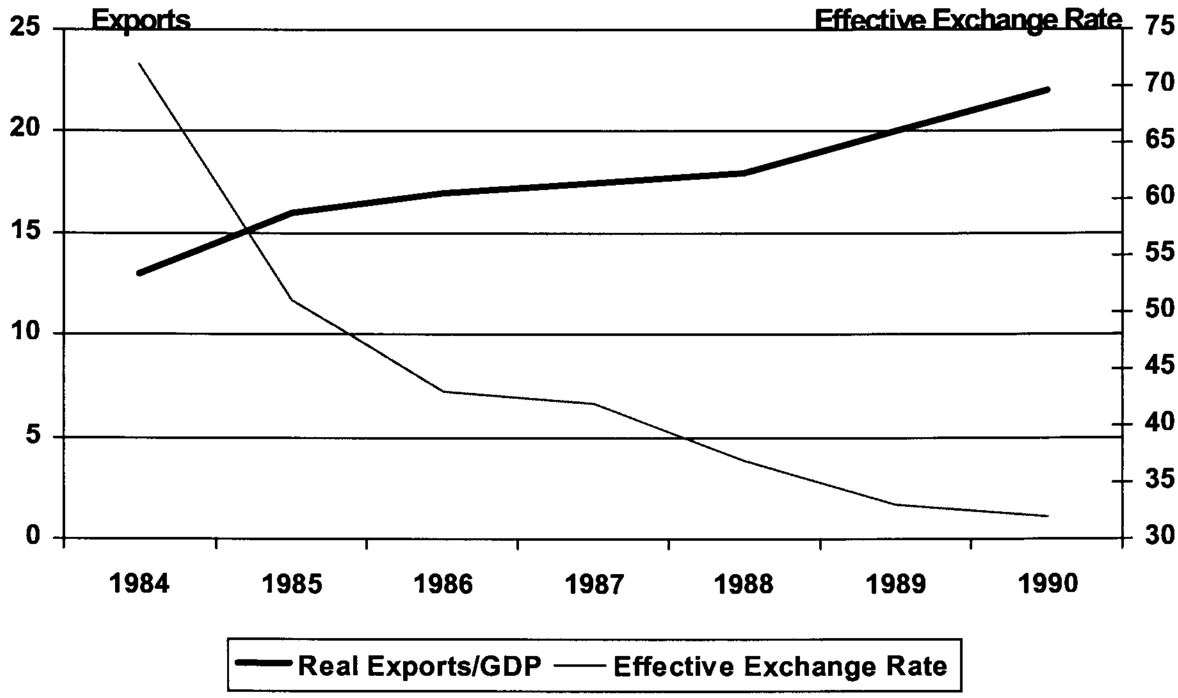
Source: SARB Quarterly Bulletin (various issues)

Graph 5.8: Balance of payments (1965-1990)



Source: SARB Quarterly Bulletin (various issues)

Graph 5.9: Real exports as percentage of GDP vs. changes in the effective exchange rate (1984-1990)



Source: Brown, 1991: 1

On the monetary front *"the unsatisfactory results of the non- or semi-market oriented methods, changing world monetary conditions, and a shift towards monetarism led the policy makers to believe that fundamental reform in monetary policy had become necessary"* (Harvey, 1994:11). The combination of these developments led to the appointment of the De Kock Commission to investigate South Africa's monetary policy and system. Regarding the broad monetary policy framework the Commission identified the most important aspects to be (Botha, 1986:180-186):

- Market-based monetary policies would serve the sophisticated South African financial sector better than direct measures. This was the most important finding of the De Kock Commission's work and formed the basis for monetary reform.
- The primary long-term goal of monetary policy should be price stability. The argument was that price stability would support the attainment of other economic goals such as increased economic growth and job creation.
- Monetary policy should form part of broader stabilisation policies.
- The introduction of specific money supply targets.
- The establishment of realistic market-based interest rates.
- Important changes to the exchange rate policy affecting exchange control and the value of both the commercial Rand and financial Rand. During the 1980's these policies played an important role and affected South Africa's balance of payments;
- Monetary policy ought to include market instruments to achieve specific goals.
- The Reserve Bank ought to be granted greater statutory independence and the responsibility for achieving stability goals without hurting existing good cooperation between the Bank and the Treasury.

The government accepted most of the important recommendations of the De Kock Commission, with far-reaching implications for the conduct of monetary policy. Botha (1986:186) summarises the broad monetary policy framework after 1980 as follows:

- Policy approach:
  - Mainly market oriented
  - Flexible money supply goals
  - Complimentary policy instruments
- Instruments:
  - Open market transactions

- Public debt control
- Selective exchange controls
- The cash reserve system of bank credit control

– Intermediate goals:
  - Moderate and stable growth of monetary aggregates
  - Control over the velocity of money
  - Realistic and market based interest rates
  - Moderate credit supply
  - Exchange rate stability

– Final goals:
  - Price stability
  - Balance of payments equilibrium
  - Optimal and steady economic growth
  - High and steady employment levels

The implementation of the De Kock Commission recommendations saw the introduction of very tight monetary policy during the 1980's. As such, government used monetary policy as an instrument in its attempts to stabilise and stimulate economic growth and development. This proved to be a very useful approach during the 1980's, when the South African economy increasingly came under pressure, internally and externally, to address the growth constraints as a result of its apartheid policies. *"During the 1980s tight monetary policy proved to be successful in dealing with problems on the balance of payments, suppressing domestic demand for imports and switching off-shore borrowing to finance trade. Although the rate of inflation was not reduced, anti-inflationary policy was at least partially successful: the depreciation of the exchange rate resulted in only a small increase in inflation, and this relative stability was achieved in spite of political upheaval and international sanctions. On the other hand, it was achieved at high cost. The economy did not grow when controls were loosened and there was an absolute decline in formal sector employment. Extraordinary pressure on the capital account of the balance of payments necessitated a reversal of one aspect of liberalisation, namely the re-imposition of exchange controls"* (Harvey, 1994:12).

A number of negative aspects can be identified regarding monetary policy in South Africa in the period 1965 - 1990. They are:

- The use of direct monetary instruments before the 1980's caused inefficiencies in the economy. Firstly, the relationship between interest rates, inflation and the exchange rate was affected. This led to negative real interest rates and an over-valued currency, which promoted capital-intensive manufacturing, low levels of domestic savings and pressure on the balance of payments (Botha, 1986:189).
- Although the introduction of market-related monetary policy and instruments greatly improved the monetary management of the economy, it failed to achieve its major goal of price stability. Other factors impacted on the inflation rate, such as the unstable domestic socio-economic situation during the 1980's, high wage increases not accompanied by similar productivity increases, exchange rate depreciation and continued increases in administered prices (Botha, 1986:189).
- For most of the 1980's the Reserve Bank was accused of implementing questionable high interest rate policies given the recessionary situation in the country. This was believed to have caused higher levels of unemployment and lower economic growth (Botha, 1986:190).

Positive results from the post-1980 monetary approach as identified by Botha (1986:189-192) are:

- Financial markets were allowed to achieve a higher level of sophistication.
- A number of inefficiencies caused by earlier direct measures were rectified, especially those related to the relationship between interest rates, inflation and exchange rates.
- Realistic market-related interest rates were adopted to counter the effects of negative real interest rates on the economy. This did not, however, weaken the inflationary pressure, since other factors kept it high.
- The abolition of exchange controls on non-residents in 1983 had a positive effect on foreign investment in South Africa. However, the worsening domestic socio-political situation, which led to the introduction of the state of emergency in the mid-1980's largely nullified it.
- Monetary policy was applied more effectively to address the problem of over-expenditure in the economy. By 1985 gross domestic expenditure decreased by 7%. This period saw high interest rates as the preferred instrument.
- The new monetary approach led to more effective control over the money supply despite difficult economic developments such as fluctuations in the gold price and the depreciation of the Rand. In March 1986 the first growth targets in the money supply,

based on the new definition of the M3 supply, were introduced. Target-based growth in the money supply was set to such an extend that it would still allow for sufficient economic growth without stimulating excessive inflationary pressure.

- Improved coordination between monetary policy (Reserve Bank) and fiscal policy (Treasury), mainly as a result of the influence of public sector expenditure, financing and tax policies on monetary aggregates.

Botha (1986:192-197) has the following critique of the new post-1980 monetary approach:

- The primary goal of price stability had the inverted result of higher unemployment. The socio-economic and political situation in South Africa during the 1980's could hardly afford higher unemployment. The unemployment problem contributed to social unrest situation in the country. The domestic situation reach a violent peak in 1985, which had a negative impact on nearly every aspect of economic life.
- It is not technically possible for the monetary authorities to control the money supply for two reasons. Firstly, money supply has an endogenous character, meaning that markets influence the demand for money. Secondly, the sophistication of the South African financial market. The De Kock report suggested, however, that certain instruments could be used to control the money supply, such as interest rates.
- Control over the money supply would not necessary effectively fight inflation. Botha argues that if the correlation that exists between an expansion of monetary aggregates on the one hand and domestic expenditure and inflation on the other hand is not acknowledged, controlling the money supply will not be an effective tool for fighting inflation.
- The implementation of a coordinated monetary and fiscal policy approach was limited because inflation in South Africa is structural in nature and is influenced by cost factors. The De Kock report also provided evidence that inflation in South Africa since the late 1960's was mainly caused by fiscal and monetary factors; both demand pull and cost push factors all contributed to the inflation problem, especially in those economic sectors with limited competition.
- Discretionary determination of interest rates by the Reserve Bank could discriminate against certain economic sectors. Small and medium-sized companies suffered under high interest rates and costs. At the same time, credit sales also decreased, leading to increased bankruptcies and unemployment.

Although monetary policy remains a vital government instrument for affecting economic development, monetary policy in South Africa since the 1970's was not as visible in furthering apartheid. This does not imply that certain aspects of monetary policy were not related to the issue of apartheid, or had specific goals and plans regarding apartheid, especially in the 1960's. Monetary policy had to, however, address economic problems caused by other government economic policies and the broad macroeconomic system that unfolded under apartheid.

5.2.3 Industrial policy

Internationally in the past forty years, governments have played an important role in the industrial development and growth of countries. In South Africa government also played an important role in industrial development. Within the framework of industrial policy, traces of apartheid promotion were visible which had a profound impact on overall economic development and growth. History has proved that a close relationship exists between economic growth and industrial development (Botha, 1986:204), especially the positive impact of successful industrialisation on employment. Industrialisation also relates to basic economic choices of resource allocation, where and how much to produce, productivity and technology development.

Because industrial policy is closely related to the broad macroeconomic policies of government, it is worthwhile taking a closer look at this policy instrument. Industrial policy and development touch on fiscal aggregates (e.g. import tariffs as a source of government revenue), monetary policy (e.g. exchange controls to influence a country's propensity to import), trade policies (e.g. to produce products for the international market where the country has a competitive advantage), and competition policies (e.g. rules to govern domestic competition). As such, industrial policy forms part of the broad economic development strategies that government chooses to follow, which are also influenced by the economic system or framework of a country. The most common objectives and strategies of industrial policy relate to the policy options of export promotion or import substitution.

In South Africa's case Botha (1986:219) identifies 1971 as a watershed year in the country's industrial policy approach. This was firstly because of the number of reports published; between 1971 and 1986 a total of eleven reports were published on the subject, while only two were published prior to 1971. Secondly, the circumstances which prevailed with the appointment in 1971 of the Reynders Commission.

5.2.3.1 The period before 1971

By 1971 the South African Government had already implemented a number of industrial policies with the aim of achieving certain economic goals. The most important of these were (Botha, 1986:220-223):

- Protection policies: For more than 50 years government followed a policy of import substitution and industrial protection using traditional instruments. This policy option was the most important of all industrial policies. The major objective was the establishment, protection and promotion of specific economic sectors such as agriculture. The Commission of Enquiry into Protection Policies of Industries (the Viljoen Report) was the major proponent of this policy. The following negative effects were associated with this approach (Botha, 1986:213-216):

  - It had a negative impact on domestic prices.
  - Many of the infant industries never reached the point where they were able to operate without support.
  - Governments became used to revenue from instruments such as import tariffs.
  - A paradox exists in the early stages of import substitution in that the process leads to a higher propensity to import. This results from the need to get hold of certain technology and equipment to kick-start the process.
  - Net international consumption decreased as a result of import tariffs.
  - A redistribution of income takes place when producers are financially supported to the detriment of consumers.
  - It leads to discrimination against exporters.
  - It also leads to counter-action by other countries who impose import tariffs, creating a vicious circle.
  - The policy is counter productive to competition policies.
- Export promotion: By 1971, few measures existed to support exporters. These were limited to tax breaks on marketing costs and the provision of information on external markets.
- Decentralisation policy: The Tomlinson Report of 1955 set the stage for the implementation of decentralisation policy as part of industrial policy in 1960. The

recommendations of this report were followed until 1971. According to Botha (1986:221), decentralisation policy was not based so much on economic considerations as on political and social factors. It was seen as an instrument for implementing apartheid. Many measures were introduced to establish the policy of decentralisation which was to take place near border areas and black townships and rural areas. Blacks were not allowed to own or operate a private business in white areas. The aim of the decentralisation policy was the concentration of manufacturing in "politically correct" areas as well as the establishment of manufacturing outside over-populated cities. The most important advantage of the decentralisation policy was the limited infrastructure development that took place in rural areas.

- Competition policy: The Guiding Monopolistic Situation Act of 1955 served as the basis for competition policy until 1971. It was later revoked in its entirety. The act was weak and made only provision for certain codes of conduct when monopolistic tendencies occurred. This act was in contradiction to its aims, since many of the largest monopolistic industries were owned by government (e.g. in the electricity supply, telecommunications, steel and railroad sectors).
- Participation in production: Since the 1920's industrial development was stimulated by direct and indirect government participation in production. According to Botha (1986:222) the small size of the domestic market and the unwillingness of the private sector to become involved in certain capital-intensive industries were the main reasons for this. Although government's decision to participate in production (e.g. Iscor and Escom) was not based on free market principles, the creation of these companies proved to be extremely valuable in expanding the South African economy. These companies could expand their services into the rest of Africa.

5.2.3.2 The period after 1971

The industrial situation, especially the country's international trade position, accompanied by structural balance of payment problems, saw an increased focus by government on industrial policy. Eleven reports were published between 1971 and 1986. The aim is not to discuss the content of each, but only to refer to them. The content of these reports nonetheless, had a clear apartheid focus. The following reports were important:

- The Report of the Commission of Enquiry into the Export Trade of the Republic of South Africa, the Reynders Report, 1971-1972.

- The White Paper on the Report of the Inter-departmental Committee on the Decentralisation of Industries (1971) under the chairmanship of Dr PJ Rickert.
- The National Fiscal Development Plan of 1975.
- The Report of the Study Group on Export Support of 1977 (Van Huyssteen Report).
- The Report of the Technical Committee on the feasibility of the Huyssteen Study Group's Recommendations of 1978 under the chairmanship of Dr HJJ Reynders.
- The Report of the Commission of Enquiry on the Law of Regulating Monopolistic Situations of 1955, the Mouton Report, 1977.
- The White Paper on the Promotion of Industrial Development as an Element of a Regional Development Strategy for Southern Africa, 1982.
- The Report of the Study Group on an Industrial Development Strategy, the Kleu Report of 1983.
- The White Paper on a Strategy for Job Creation in South Africa, 1984.
- The Report of the Committee of Enquiry into the Application of the Industrial Protection Policy, the Van der Horst Report of 1984.
- The Interim Report of the Committee dealing with Export Promotion, under the chairmanship of Dr SJ Kleu, 1986.

By 1986 industrial policy in South Africa had the following characteristics:

- Institutional framework: The Department of Trade and Industry was and is the primary government department for administering the country's industrial and trade policies.
- Protection policy: This policy and the import substitution policy were extensively scrutinised after 1971. It was found that the effectiveness of these policies in the stimulation of growth was declining and that South Africa's international competitiveness was negatively affected. It was thus necessary for greater coordination between import protection and export promotion, especially since the Rand depreciated rapidly during the 1980's.
- Export promotion: By 1980 a number of additional measures were introduced to expand the scope of the export promotion policy.
- Decentralisation: The need to stimulate economic growth and development in different geographic areas in South Africa was acknowledged by government. Since 1971 government's role in this regard expanded (Botha, 1986:245). Growth points were also identified in white, black and Indian areas. Many changes were implemented to increase the effectiveness of decentralisation policy.
- Competition policy: The establishment of a Competition Board was one of the most

important developments in this regard since 1971.

- Participation in production: Despite many commitments by government to the principles of the free market and statements that private initiative should be the driving force to stimulate economic growth and development, it nevertheless continued to participate in production. Limited efforts to promote privatisation were launched, and by the end of the 1980's, government still owned large parts of the economy.

5.2.3.3 Characteristics of industrial development between 1965 and 1990

Between 1965 and 1990 the South African industrial development process developed a number of distinctive characteristics:

- *"Manufacturing value added has not increased since 1981.*
- *Employment in manufacturing has been stable since 1980.*
- *The economy-wide rate of investment has fallen, from more than 26 per cent of GDP in 1980 to 15 per cent in the first quarter of 1993. The size of aggregate capital stock in the industrial sector fell by ten per cent between 1984 and 1990.*
- *It is the most capital intensive sectors which have maintained their growth rate. For example, the sanctions-busting chemicals sector (with a capital cost per job in 1990 of R631,000) now accounts for almost 40 per cent of total capital stock, whereas the combined share of the labour intensive clothing (R 2400 per workplace) and shoe industries (R 7400) is only 0.6%. The absolute value of capital stock in the clothing sector fell by almost 40 per cent between 1972 and 1990.*
- *Export performance has been poor, in part because of sanctions. The recent growth in manufactured exports has been fuelled by a costly export-incentive scheme and our researchers have found little evidence of a strategic reorientation by manufacturing firms towards the external market.*
- *Total factor productivity growth in manufacturing declined by 1.02% p.a. between 1972 and 1990.*
- *Unlike other countries with similar per capita incomes, South Africa's informal manufacturing sector is very poorly developed.*
- *One of the paradoxes of South African manufacturing is that high relative wages coexist with low standards of living. This is a complex phenomenon, partly arising from the apartheid's grotesque priorities in social infrastructure provision and partly*

as a consequence of the under-specialised nature of South African manufacturing" (Joffe, et al, 1994:18-19).

- The industrial sector did not develop to the extent it could meet the basic needs of the population (Joffe, et al, 1994:23).
- Declining rates of industrial accumulation played a central role in falling per capita income levels (Joffe, et al, 1994:17).
- Since 1970, the South African manufacturing sector could not effectively compete on international markets. Nonetheless, *"in many sectors the ability of manufacturers to compete in the domestic market reflected the effectiveness of import controls"* (Joffe, et al, 1994:17).
- *"Most explanations of why so few micro enterprises in South Africa engage in manufacturing activities focus on restrictive apartheid policies. These not only legally prohibited Blacks from becoming entrepreneurs, but also systematically deprived them of any of the education, skills and experience essential for the emergence of dynamic entrepreneurship, and especially for the emergence of a skilled class of manufacturers. The impact of repressive regulation cannot be under-estimated. It was only in 1979 that official policy shifted from preventing Blacks from having manufacturing businesses."* (Manning, et al, 1994:30).
- *"There is in South Africa a remarkable concentration of economic power in the hands of a very small number of corporate players who control diffuse but extremely powerful conglomerate groups. Because of the distortions introduced into South Africa by the apartheid system it cannot be assumed that protecting that group from competition from outside investors will confer any benefit on Black South Africans, the dispossessed of the apartheid era"* (Brown, et al, 1994:44).
- *"Despite the relative success of this strategy, the country's dependence on foreign technology remains considerable. The process of import-substituting industrialisation itself requires technology and capital equipment from abroad, and in South Africa, protection has been geared to assisting manufacturers of consumer and intermediate goods rather than complex capital equipment. Consequently, in capital-goods, high-tech and large scale manufacturing sub-sectors, dependence on imports remains heavy"* (Jenkins, 1990:11).

5.2.4 South Africa's trade performance under apartheid

The different industrial policies implemented between 1965 and 1990 had a profound impact on the economy's trade performance. Two broad policy approaches had a direct impact on this, namely the policy of inward industrialisation (import substitution) coupled later with limited export promotion. This policy saw the diversification of production with increased focus on manufacturing. *"In fact, import-substituting industrialisation served to increase the economy's dependence on foreign trade by creating a high degree of dependence on imports by the manufacturing sector, necessitating greater export earnings to finance this"* (Jenkins, 1990:1). As early as 1972 a slight shift from import substitution to export-orientated industrialisation occurred (Bell, 1997:71), based on the recommendations of the Reynders Commission of 1972.

As early as 1925 with the implementation of the Customer Tariff Act, a "protectionist approach" was adopted rather than a revenue-orientated tariff approach. *"The new government was nationalistic and committed to the elimination of white poverty, and a policy of import-substituting industrialisation would address both issues by assisting greater economic independence and creating employment in manufacturing. As a consequence of the protection of domestic industry, considerable diversification of the economy occurred"* (Jenkins, 1990:1). The policy of import-substitution was characterised by selective tariff protection and binding import control. *"In the early 1970s, the costs of the import-substitution strategy to the South African economy began to make themselves apparent and various advisory groups recommended greater emphasis on exports. Quantitative restrictions were gradually eased - partly under pressure from external trading partners - during the 1970's, but the process came to a halt in the early 1980's in response to a deterioration in the external payments situation. Export incentives, to compensate for the anti-export bias implicit in import restrictions, were introduced in the 1970s and expanded in the 1980's. Nevertheless, until the early 1980's, the binding constraint on imports was an extensive system of import controls. The dismantling of import control was resumed in 1983; when the positive list of permitted imports was replaced with a negative list of imports. Tariffs were increased selectively to compensate for the removal of quantitative restrictions. These developments were consistent with the cautious approach to moving away from import substitution taken by the Kleu Study Group of 1983, and with the dual approach of maintaining protection and promoting exports emphasised by the 1985 White Paper on Industrial Development"* (WTO Report, 1992: IX).

Coupled with these major policies affecting trade, other economic and non-economic factors also influence trade performance between 1965 and 1990, such as international commodity price movements, major global economic fluctuations, the domestic socio-economic and political situation, and technology changes. Highlights of South Africa's trade performance between 1965 and 1999 are:

- The 1960's saw a relatively fast increase in South Africa's exports, particularly gold and other mineral exports, while protectionist policies on imports remained in place;
- By 1972, the Reynders Commission led to a change in major trade policies.
- Between 1950 and 1970 the composition of imports changed substantially when capital goods as a portion of total imports increased from to 41.5% (Jenkins, 1990:2).
- Exports increased by an average of 7.3% between 1973 and 1979 despite the political upheavals of 1976. The share of manufacturing in exports, however, remained relatively the same at 33% of exports (Jenkins, 1990:2).
- South African agriculture as a percentage of exports consistently declined between 1950 and 1978 from around 20% in 1950 to some 7.4% in 1978 and less than 5% by 1985 (Jenkins, 1990:2). Import substitution continued to be effective and led to a steady decline in imports between 1974 and 1979. This slowdown in imports was also the result of slower economic growth and a fall in the real value of the Rand.
- By the 1980's trade was playing an important role in the economy. Many domestic economic and especially political developments influenced the trade performance. The 1980's also saw the intensification of trade and other sanctions against South Africa. *"Foreign trade continues to play an important role in the growth of the economy. From 1980 to 1989 imports of goods and non-factor services averaged 25,6 per cent of GDP, while exports averaged 31,7 per cent. The indications are that, despite sixty-five years of protectionist trade policy and a decade of increasing isolation, the economy remains open and highly dependent on foreign trade"* (Jenkins, 1990:4-5).

5.2.4.1 Apartheid South Africa and sanctions: the 1980's

As the policy of apartheid continued, so did international attitudes against South Africa harden. The process of isolation by the international community already started in the late 1940's, with intensified oil and weapon sanctions in the 1970's. It was, however, only from the mid-1980's that a full scale international sanctions campaign against South Africa took effect. These sanctions included trade, financial and people sanctions (see Table 5.6).

Table 5.6: Sanctions adopted against South Africa

	Arms/Military Co-operation	Oil	Nuclear Technology	Computer Hardware/Software	Other Technology Transfers	All Government Procurement	Termination of Export Support	Fruit & Vegetables	Sugar	Wine	Iron & Steel	Coal	Uranium	Krugerrands	Other Manufactured Goods	Products of Parastatals	New Direct Investment	Private Loans	Government Loans	Termination Double Tax Agreements	Landing rights to SAA	National carriers to SA	Tourist Promotion	Penalties for Breaking
UN SC	●	●		●	○			○							○			○						
Commonwealth	●	●	●	●	●		●		●	●	●	●	●	●	●			●	●	●	●	●	○	●
EU	●	●	●	●	●							●			●			●						
Nordic States	●		●	●	○	●	●							●			●	●	●			●		
Org. E Caribbean	●	●	●		●		●	●	●	●	●	●	●	●	●			●	●	●	●	●	●	●
OAU (SDCC)	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	
Socialist Block	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	
Australia	●	●	●	●		●	●	●	●	●	●	●	●	●	○		○	○	●		●	●	●	
Austria	●	●	●	●			●				●			●			●	○	○					○
Belgium	●	●	●								●			●			○							
Brazil	●	●																						
Canada	●	○		●		●	●	●	●	●	○	●	●	○			○	○	○	●	●	●	●	○
Denmark	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●		●	●		○
Finland	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●		●	●		
France	●	●	●	○	○						●	●		●			●							
Greece	●	●									●			●			●							
Hong Kong											○			○			○	○	●					
Iceland	●	●	●	●	○	●								●			●	●	●					
India	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	
Ireland	●			○		●	●	●	○	○	●	○		●				○	○					○
Israel	●	●									○			●			●	●	●					
Italy	●	●	●	●							●		●	●			○							
Japan	●		●	●	●			●			●	○		○			●	○	○		●	●		
Luxembourg											●			●			○							
Netherlands	●	●	●	●			○	●			●	○	●	●			○	○	●					●
New Zealand	●		●	●		●	●	●	●	●	●	●	●	●				○	○				●	
Norway	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●		●	●		●
Portugal	●	●	●	●							●		●	●			●							
Seychelles	●																				●			
Singapore	●		●	●				●	●	●	●	●	●	●	●	●			●					
South Korea																	●	●	●					
Spain	●	●	●	●							●		●	●			●					●		
Sweden	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●		●	●	●	●
Switzerland			●	●															●					
Turkey			●										●						●			●		
United Kingdom	●	●	○	●		○					○	○	●	●		○	○		●				○	●
U.S.A	○	●	●	○		●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
West Germany	●	●	●	○							○			○			○		○					○

Source: Jenkins, 1990:17

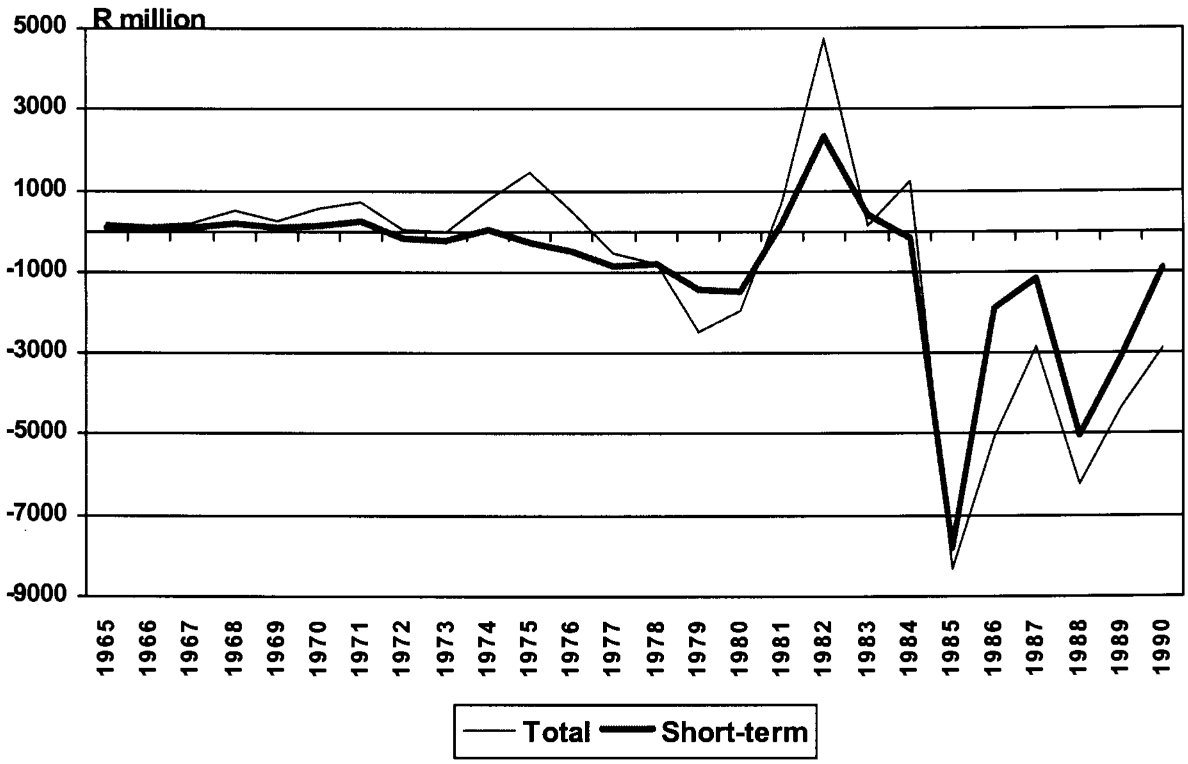
The impact of sanctions, especially trade and financial sanctions, was as follows:

- Exports (excluding gold) performed relatively well between 1984 and 1990, when real exports as a percentage of GDP increased from 13% to 22% (see Graph 5.9) (Brown, 1991:1).
- *"On the surface, the economy appeared to survive sanctions relatively unscathed, but it was also true that five years of sanctions brought to the fore underlying economic frailties, structural deficiencies and lack of growth performance. Also, of course, the isolation of South Africa brought substantial moral and psychological pressures to bear on its society. This global obloquy was in the end probably the single most important weapon against South Africa"* (Brown, 1991:1).
- Sanctions had a negative impact on investment and the creation of new capacities. *"The great hidden danger of the sanctions campaign was not its impact on current output and activity in the South African economy, but rather the effect of foreign capital starvation on the creation of new capacity. Sanctions did not destroy the ongoing momentum of the economy to the same extent that they appear to have blocked the generation of new investment and job creating activity, thereby strangling the future potential of the economy"* (Brown, 1991:4).
- *"The seemingly 'sanctions-proof' government sector raises concerns about it competing with private sector - justifiably as it proves. Business expenditure relative to GDP, contracted drastically after the implementation of sanctions, whereas government expenditure continued to expand. Clearly 'crowding-out' of the business sector was also one of the legacies of sanctions"* (Brown, 1991:9) (see Graph 5.4).
- Sanctions led to a loss of business. *"It also placed pressure on the margins of companies in terms of higher administration costs for 'dubious routes', including trans-shipment. Sanctions generally made the world a smaller place for South African business through lost and blocked markets."* (Van der Hoff, 1991:10).
- Trade sanctions affected export destinations, composition and sources of imports. *"In terms of the cutting of trade links and consequent need to find alternative trading partners, sanctions have had a far less significant effect on South Africa's imports than on exports. The reason is obvious: governments and businesses are reluctant to take actions which jeopardise their own industries, and it is generally easier to find an alternative foreign supplier than an alternative foreign market. Sanctions have, however, affected imports to a significant degree."* (Jenkins, 1990:7).
- Sanctions had a negative effect on the balance of payments, especially on the

current and capital accounts. *"Since the debt crisis in 1985, it has been necessary to restrain the growth in imports so as to run current account surpluses in order to finance continual capital outflows. By 1987 imports were down about 30 per cent from their 1974 peak in volume terms. The pressure placed on the balance of payments by increased imports in 1988 necessitated the imposition of direct import controls to curb foreign purchases."* (Jenkins, 1990:7-8).

- South Africa's world exports rank in value terms fell from the 16th to the 30th position between 1980 and 1991 (WTO Report, 1992:VI).
- Similarly, South Africa's rank among world importers fell from the 25th to the 36th position between 1980 and 1991 (WTO Report, 1992:VII).

Graph 5.10: Capital flows at current prices (1965-1990)



Source: SARB Quarterly Bulletin (various issues)

- Between 1985 and 1990 the capital account of the balance of payments came under extreme pressure as a result of financial sanctions leading to short-term capital flight. The situation was made worse by the debt crisis, which resulted in the debt standstill of 1985 (see Graph 5.10). In 1985, capital outflows from the capital account reached

7.4% of GDP. Between 1986 and 1989 they averaged 3% of GDP (Leape, 1991:17). *"The effect of the debt standstill has been to impose a stringent balance of payments constraint on the South African economy. In the early 1980's, South Africa had a string of current account deficits financed by borrowing from abroad. The situation changed abruptly in 1985, when the debt crisis forced South Africa to switch from being a capital importer to being a capital exporter. Capital outflows, which totalled R26.8bn between 1985 and 1989, were financed almost entirely by a cumulative current account surplus of R23bn."* (Leape, 1991:IV). A combination of developments such as the debt standstill, financial sanctions and changed investor attitudes toward investment in South Africa, saw the country completely cut off from international capital markets in the second half of the eighties (Garner, et al, 1991:10-11).

- The cost of lost opportunities for South African business (Finansies & Tegniek, 1992:12).
- Because the economy performed below its optimum level between 1985 and 1990 as a result of sanctions, some 500 000 job opportunities were lost (Finansies & Tegniek, 1992:13).
- It is estimated that the sanctions campaign cost the economy some 10% of GDP in 1990 terms or R45 billion between 1985 and 1990. Put in another way, each individual is 10% poorer in terms of per capita income (Finansies & Tegniek, 1992:12).
- Sanction-busting activities cost South Africa billions. According to the Finansies & Tegniek (1992:13) South Africa have spent R22 billion between 1973 and 1984 to circumvent the oil boycott.
- Sanctions were one of the factors that contributed to slower export growth in the 1980's. Between 1980 and 1989 external trade grew by 206.4% while GDP grew by 326.7%. South Africa therefore did not experience export-led economic growth (Jones, 1994:110).
- Sanctions contributed to the depreciation of the Rand against major currencies. Between 1980 and 1990 the Rand depreciated by 154.8% against the British Pound and by 232.3% against the US Dollar (see Table 5.7).

Table 5.7: South Africa - exchange rates: 1965-1990

Year	SA Cent per British Pound	SA Cent per US Dollar
1965	200.30	71.63
1966	200.27	71.70
1967	196.95	71.71
1968	171.63	71.71
1969	171.64	72.00
1970	171.64	71.64
1971	174.23	71.32
1972	193.33	77.29
1973	170.22	69.44
1974	158.97	67.95
1975	163.49	73.98
1976	157.21	86.96
1977	151.75	86.96
1978	167.03	86.96
1979	178.58	84.20
1980	181.05	77.88
1981	176.55	87.75
1982	189.42	108.59
1983	168.91	111.41
1984	195.20	147.57
1985	291.18	222.79
1986	335.15	228.35
1987	333.40	203.57
1988	404.30	227.26
1989	429.31	262.22
1990	461.35	258.77

Source: South African Reserve Bank Quarterly Bulletin (various issues)

It is evident that the sanctions campaign against South Africa, coupled with the inefficiencies of apartheid economics, had a devastating effect on the economy. The 'added' pressure of sanctions and the debt standstill of 1985 caused the economy to reach critical levels by the end of the 1980's. This situation played a crucial role in government's decision to embark on the road of political transformation in 1990, which led to the demise of apartheid.

5.3 SOCIO-ECONOMIC DEVELOPMENT UNDER APARTHEID

The implementation of the apartheid system in South Africa was evident in social aspects such as education and health. Throughout the history of apartheid the aim was to suppress the social development of non-whites so as to ensure white supremacy. The focus now falls on social aspects such as demographics, education, health and income distribution.

"Apartheid has involved substantial public spending on white social services, alongside retarded human development of a majority of the population. Racial discrimination in public policy, cutting across indices of needs, interests, abilities or circumstances, is both unfair and inefficient, contributing both to the injustice of the South African policy, a stagnant economy and depressed standards of living" (Donaldson, 1992:155).

5.3.1 Demographic composition

The policy of apartheid affected the demographic composition of the country. In this regard the most important policy aspects were influx control, population resettlement in the homelands and restrictions on black urbanisation outside the homelands (Van der Berg, 1989:27). These policies had a major impact on the movement and settlement of the entire population. Van der Berg (1989:25) also identifies two major factors in the history of South Africa that led to the placement of metropolitan regions. They are:

- *"Colonial trade, leading to the growth of the harbours at Cape Town, Port Elizabeth, East London and Durban.*
- *The discovery of gold, leading to the rise of the Witwatersrand and its adjacent areas in the interior, thereby giving South Africa an interior metropole, in which respect South Africa differs from most former colonially settled countries."*

The development of the five metropolitan areas led to the polarisation of economic activity, while at the same time the population was not spatially concentrated (Van der Berg, 1989:27). Table 5.8 indicates the spatial distribution of economic activity and population, highlighting the imbalance between the two. By 1978 the metropolitan areas generated 61.1% of all economic activity while only 30% of the population lived there, while the homelands generated only 4.3% of all economic activity while nearly 40% of the population lived there. This clearly illustrates the effects of the apartheid policy of separate development.

Table 5.8: Spacial distribution of economic activity and of population

	Population (1980)	Economic activity (1978)
PWV-area	18,3%	40,0%
Coastal metropoles	11,7%	21,1%
Total: Metropoles	30,0%	61,1%
Non-homeland rural areas	32,5%	34,6%
Homelands	37,6%	4,3%
Total: South Africa	100,0%	100,0%

Source: Van der Berg, 1989: 28

The relaxation of certain aspects of influx control by the late 1970's led to the concentration of the black population on the edges of homelands near the metropolitan areas such as Pretoria, Johannesburg, Durban and Cape Town. This migration of blacks to economic areas in the hope of finding better jobs, increased the pressure on social infrastructure and the supply of social services in these areas, leading to further socioeconomic deterioration.

The policy of population relocation or *'forced relocation'* (Murray, 1988:36) had an impact on the everyday lives of millions of people in South Africa and also on issues such as education, health, housing, the provision of sanitary services, employment, and a host of other related economic aggregates. Of all the apartheid laws, the Group Areas Act of 1950, re-enacted and consolidated in 1957 was probably the most significant, impacting on the above issues. By the late 1970's *"there has been a gradual move away from the old apartheid paradigm as evidenced by:*

- *Acceptance of the 'permanence' of urban blacks outside the homelands;*
- *Home ownership of these blacks;*

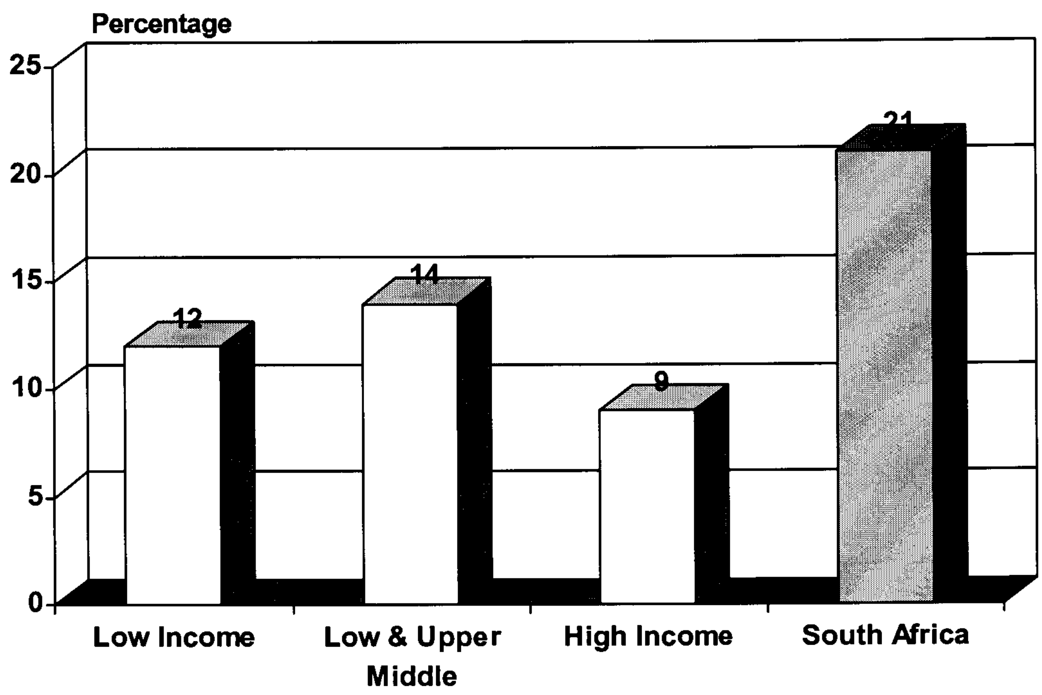
- *The move towards 'orderly urbanisation';*
- *The relaxation of influx control;*
- *The acceptance of certain forms of squatting, and*
- *A slightly less ideologically based industrial decentralisation policy"* (Van der Berg, 1989:27-28).

Despite these shifts in attitude and policy by government, many of the major socioeconomic problems caused by the Group Areas Act remained and even worsened during the 1980's as the domestic political situation deteriorated.

5.3.2 Education under apartheid

As in many other social spheres, education was also negatively affected by apartheid. This was evident from government education spending on the different social groups as well as the difference in education standards. Although government's education spending as a percentage of its central budget by 1990 was among the highest in the world, the allocation between races was very skewed (see Graphs 5.3 and 5.11).

Graph 5.11 Education - spending as % of central budget (1990)



Source: Brown, 1993:8

Whites received by far the highest government financial support as demonstrated in Table 5.9. White pupils received more than three times the amount received by blacks in secondary schooling and more than four times more for primary schooling.

Table 5.9: Average government subsidisation of education by race - 1990			
	Rand per capita		
Race	**Primary Schooling**	**Secondary Schooling**	**Teacher Training**
White	2910	4170	17060
Indian	2020	3340	18400
Coloured	1450	2630	15240
African	660	1300	5430
Source: Donaldson, 1992:163			

Pupil progression from standard one to standard ten was equally skewed between races, with 68.9% of white pupils progressing to matric, starting in 1971 and matriculating in 1980, while the figure for Indians was 42.1%, for coloureds 12% and for blacks 3.9% (based on 1969-1978 figures for blacks). One of the reasons for this identified by Cobbe (1988:147) was the opportunity cost associated with education, which included the opportunity cost of education versus employment as well as the cost of clothing, food and transport associated with going to school. According to him these costs as a percentage of disposable income for different races in South Africa was a major reason for so few black pupils finishing matric, while the huge subsidy paid by the government to white pupils enhanced the likelihood of their progressing to matric.

Another problem in the education system was the pupil-teacher ratio (see Table 5.10). Whites had the lowest pupil-teacher ratio, while blacks had the highest ratio of 45:1, including the TBVC states.

Table 5.10: Pupil-teacher ratios	
Whites (1984)	19:1
Indians (1984)	23:1
Coloureds (1984)	26:1
Blacks (1982)	45:1
Source: Cobbe, 1988:156	

The apartheid system made provision for separate education. This issue was closely related to the movement and settlement of people. By the seventies, Afrikaans was introduced as the medium of instruction in black schools, which contributed to the 1976 Soweto uprising. *"Like housing, education is a key issue for blacks. Inequalities in education cause deep frustration and discontent among South Africa's black youth. In 1980, four years after the Soweto riots, a new wave of student unrest swept across South Africa, catching up in its swell the anger and dissatisfaction of the larger black community and emerging as a major political issue"* (The Report of the Study Commission on U.S. Policy Toward Southern Africa, 1981:112).

As such, black schooling found itself in a rapidly deteriorating spiral. *"Broadly speaking, social services in townships and rural areas are characterised by pervasive congestion, brought about by inadequate public funding, poor organisation and management, callous political and bureaucratic disregard and relentless growth in demand"* (Donaldson, 1992:157). Donaldson also identified the following symptoms of congestion in black schooling:

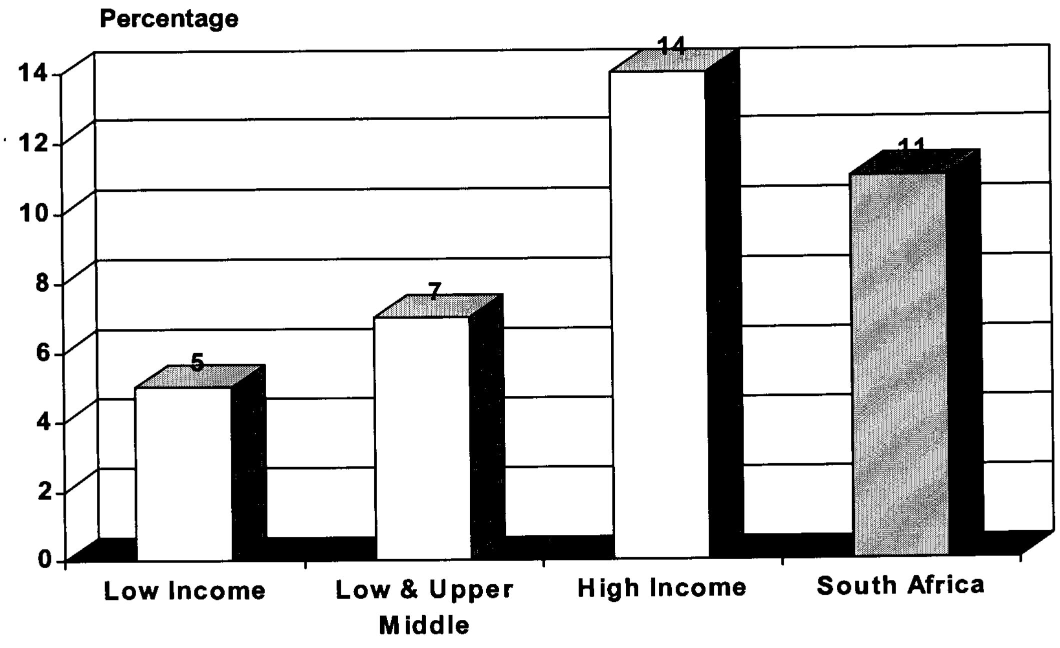
- *"Pupil-teacher ratios are well above the norms set by government, with as many as 80 pupils per class in homelands;*
- *Teachers are overworked, particularly in primary and junior secondary schools;*
- *Teachers with primary teaching qualifications are often expected to teach at secondary level;*
- *Repeater rates and absenteeism are high;*
- *Books, writing materials, teaching aids and equipment are scarce and inadequate;*
- *Poor staff morale, lack of commitment, administrative inefficiency, drunkenness and weak teaching methods are rife;*
- *School discipline is poor and teaching is frequently disrupted; and*
- *School facilities are over-crowded"* (1992:157).

A host of economic aggregates suffered as a result of the indifference of the apartheid education system. The most important of these probably manifested in the labour market, where the lack of qualified, skilled and experienced labour has choked the economy and prevented it from reaching higher growth levels.

5.3.3 Health services under apartheid

Apartheid also impacted on the provision of health services in South Africa. Although the government claimed that it provided sufficient health services to all racial groups, statistics prove the opposite. Compared to many other developing countries, South Africa's health spending as a percentage of the central budget by 1990 amounted to 11% (see Graph 5.12).

Graph 5.12: Health - spending as % of central budget (1990)



Source: Brown, 1993:8

"While racial bias is not explicitly written into health legislation, economic and political inequalities inevitably influence health care. Like all other spheres of life in South Africa, health care is affected by the law and custom of apartheid, which determine decisions regarding the distribution of resources. As a result, there are serious discrepancies in the quality and quantity of services provided to blacks and to whites" (The Report of the Study Commission on U.S. Policy Toward Southern Africa, 1981:123-124). As a result, health indicators such as life expectancy at birth and infant mortality were all heavily skewed in favour of whites (see Table 5.11). By 1980, life expectancy for whites was the highest for any race group at 69.5 years, more than ten years in excess of that for blacks. Although infant mortality for all race groups declined after 1950, white infant mortality was more than four times lower than for blacks.

Table 5.11: Selected health indicators for South Africa

Year	White	Coloured	Asian	Black
Life expectancy at birth (in years)				
1970	68.5	58	62.5	N.A.
1980	69.5	58.6	65.5	58.5
Infant Mortality				
1950	35.7	134.3	68.5	165
1960	29.6	128.6	59.6	95
1970	21.6	133.5	36.4	85
1980	13.1	60.7	24.4	70
1988	13.2	57.5	17.4	57.4

Source: Lachman, et al, 1992:6

Donaldson (1992:158) identifies the following symptoms of congestion in health services:

- *Long queues of outpatients and overcrowded wards characterise black hospitals;*
- *Rural hospitals and clinic services are under-equipped and under-supplied, often lacking essential drugs and other consumables;*
- *Workloads in hospitals are often excessive and key posts remain unfilled;*
- *Despite policy statements in favour of preventative and promotional health services, state spending remains heavily dominated by the requirements of curative hospital services;*
- *Hospitals frequently fail to maintain contact with and treatment of TB and other outpatients;*
- *Clinics are unable to provide the comprehensive family care which should substitute for access to a general practitioner in rural township contexts; and*
- *Access to paramedical and ancillary services (e.g. dental care and physiotherapy) is largely non-existent."*

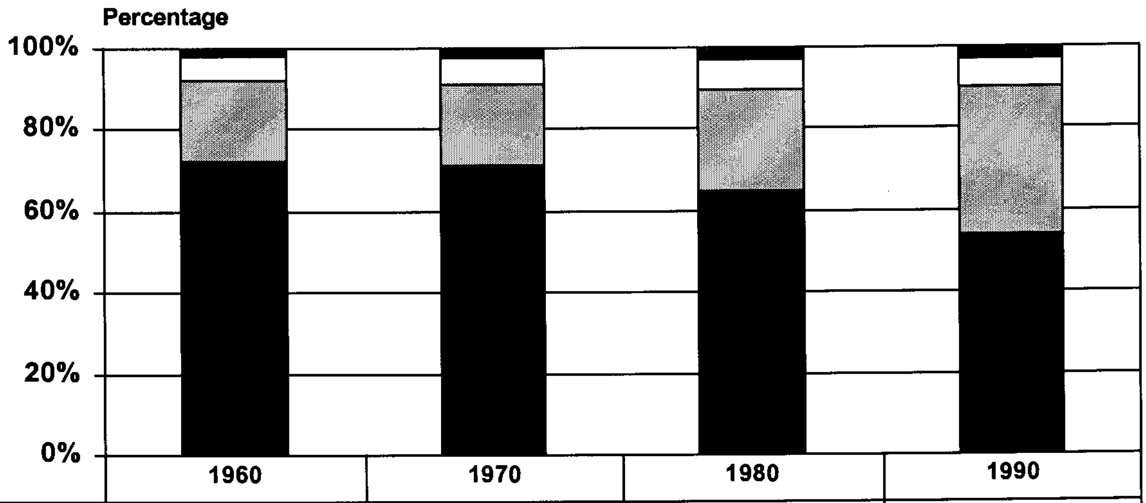
As a result of the homeland policies, health care in these regions was even more lacking, resulting in worse and more scarce health services than in the major metropolitan areas and townships. Health services in the homelands were characterised by few clinics and patient-to-bed ratios in the region of 1000:1 (The Report of the Study Commission on U.S. Policy Toward Southern Africa, 1981:125-126).

5.3.4 Income distribution under apartheid

A clear economic result of the apartheid ideology was the huge inequality in income distribution among the different races in South Africa. *"White South Africans are wealthier, better educated, have better jobs, and live longer than any other group in South Africa. In descending order of economic well-being come Asians, Coloureds, urban African men, urban African women, and at the bottom of the economic ladder, rural Africans, who are considerably poorer than anyone else"* (The Report on the Study Commission on U.S. Policy Toward Southern Africa, 1981:133).

Graph 5.13 gives an indication of the income distribution between different race groups in South Africa for the period 1960-1990. Although the share of income of whites declined over this period from 72.5% in 1960 to 53.9% in 1990 and that of blacks increased from 19.9% to 36.3% over the same period, the population composition results in a huge difference in the average per capita income between blacks and whites.

Graph 5.13: Income distribution (1960-1990)



	1960	1970	1980	1990
■ Asian	2.1	2.4	3	3.2
□ Coloured	5.6	6.7	7.2	6.6
▨ Black	19.9	19.8	24.9	36.3
■ White	72.5	71.1	64.9	53.9

■ White ▨ Black □ Coloured ■ Asian

Source: Lachman (IMF), 1992: 4

Expressed in US Dollar terms, the average per capita income for South Africa in 1990 was $2460. However, white per capita income amounted to $6530, while black per capita income amounted to only $670, nearly ten times less than white per capita income (Lachman, et al, 1992:7). According to Smith, et al (1996:661) the top 10% of the population earned 43% of the income in 1990, while the bottom 50% earned only 10% of the total income. These figures are racially grounded, with the top 10% of the population representing mostly whites and the bottom 50% mostly blacks.

This led to a situation where absolute poverty exists mostly in the rural homeland areas and affects primarily women, children and the aged, who are not participants in the formal economy. Although the gap between whites and blacks narrowed during the 1970's as a result of relatively high and stable economic growth, this trend was reversed during the 1980's as a result of a stagnant economy.

The disparity in income among racial groups has had a profound impact on the living standards of millions of South Africans and is one of the legacy's of apartheid. The equalisation of income levels among racial groups is thus one of the major challenges South Africa will face for many years and which will have to be addressed if South Africa is to become a prosperous nation.

The skewed income distribution in South Africa is closely related to absolute levels of poverty. The IMF study (1992:4-5, quoting the findings of the Carnegie Report) indicates that by 1980, some 50% of all South African households, including the TBVC states, lived below the poverty line. The argument cannot be made that poverty levels between 1980 and 1989 have decreased because the figure for 1989 excluded the former TBVC states. The most vulnerable of the poor were black children, women, especially the wives of migrant workers, the elderly and the disabled.

5.4 LABOUR UNDER APARTHEID

"Government control of the labour market in South Africa has a history dating back to the introduction of slavery in the early years of the Cape settlement" (The Report of the Study Commission on U.S. Policy Toward Southern Africa, 1981:81). Since the inception of apartheid, government control of labour was one of the most discriminating elements of apartheid. Many laws were introduced to govern labour, which resulted in a racially-based

labour market in South Africa. *"Apartheid policies were directed at the supply, control and allocation of labour and the cost of this labour to capitalists"* (Cosatu, 1987:31). The colour of a person's skin determined the job he or she could hold, which was influenced also by the level and quality of education that person received. In any economy or society, a job is the baseline which influences many related socio-economic and political developments such as:

- Earning a decent wage to spent on consumer goods and hence completing the economic cycle.
- Living standards.
- Wealth of a nation.
- Employment versus unemployment.
- Socio-economic consequences of unemployment.
- Poverty levels.
- The ability of an economy to sustain growth.
- Government's ability to finance its budget and deliver goods and services.

Although economic recession and the structural reorganisation of the workforce had changed the demand for labour in South Africa in the 1960's and 1970's (Hindson, 1991:228), the policy of apartheid had a direct impact on the performance of the labour market, which in turn had a direct impact on a host of other economic and political developments.

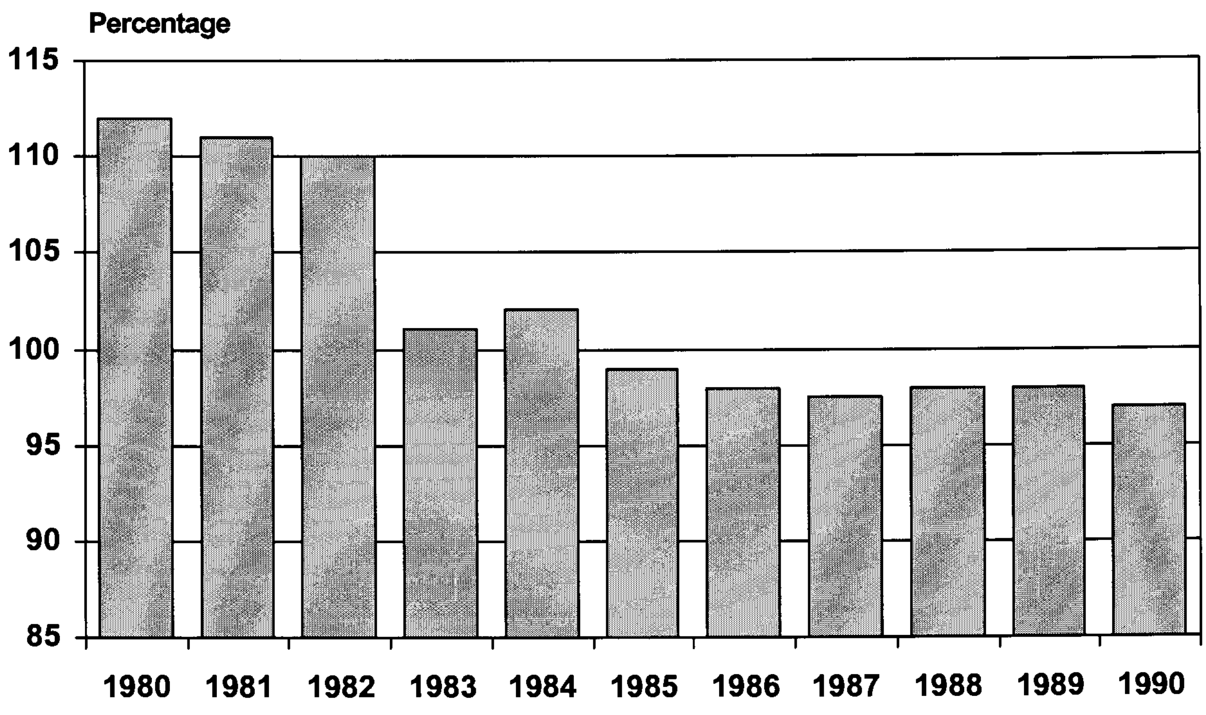
By 1979 the South African labour market was characterised by a dualistic, discriminatory and paternalistic system (Botha, 1986:278-282). Botha (1986:284-287) identifies the following problems and effects of apartheid labour practices:

- Limited effective participation of blacks in decision making regarding their jobs.
- Attempts to limit and control trade unions failed, and saw the rise of unregistered black trade unions.
- Policies governing job reservation caused conflict between racial groups.
- Limited vertical and horisontal job mobility for black workers as a result of inferior education and skills training.
- South Africa's labour policies affected international perceptions of South Africa.
- Limited freedom of choice associated with market systems.
- Affect on the principle of freedom of association.

- Affect on labour productivity and promotion of capital intensive processes.
- Increased bureaucratic red tape and administrative cost implications and duplication.
- Immigration laws and practices that caused increased unemployment during depressed periods of economic growth.
- Market distortions by creating abnormal labour surpluses and shortages.

Graph 5.14 shows the decline in productivity as measured by the output to labour ratio. This decline in productivity had a major impact on South Africa's overall competitiveness in international markets and forced many businesses, especially in manufacturing, to shift to capital intensive production processes.

Graph 5.14: Productivity - average output/labour ratio (1980-1990)



Source: Brown, 1991: 35

Declining productivity in South Africa also increased unemployment among particularly unskilled black workers, a structural problem in the South African economy. Table 5.12 shows the employment and unemployment figures for South Africa for the period 1960-1985.

Table 5.12: South Africa - employment and unemployment: 1960-1985				
	1960	**1970**	**1980**	**1985**
Economically Active Population EAP ('000)	6258	8446	10793	12268
Skilled Employment ('000)	1655	2233	2807	2879
Percentage of Total EAP (%)	26.4	26.4	26.0	23.5
Unskilled Employment ('000)	3027	3935	4687	4842
Percentage of Total EAP (%)	48.4	46.6	43.4	39.5
Unemployment ('000)	1576	2278	3299	4547
Percentage of Total EAP (%)	25.2	27.0	30.6	37.0
Source: Mboweni, 1992:202				

During this period skilled employment increased by 74%, unskilled employment increased by 60% and the economically active population nearly doubled. A major problem however, was the rapid increase of unemployment, up 188.5% between 1960 and 1985. As such, the unemployment rate increased from 25.2% in 1960 to 37% in 1985 (in terms of economically active population). *"Blacks are the major victims of employment scarcity in South Africa, given that major parts of the black labour force:*

- *Have lower levels of education;*
- *Have had a limited exposure to modern production processes and an industrial society;*
- *Are geographically separated from the formal sectors (homeland rural areas);*
- *May be a relatively large cultural distance from predominantly white management; and*
- *In 1985, approximately 38,6% of the Black labour force did not have formal sector jobs, as against an average of 9,5% of the labour force from other groups"* (Van Der Berg, 1989:21).

The huge difference between the expansion in employment and the increase in the economically active population left the rest:

- *"In subsistence agriculture in the homelands;*
- *In the informal sector; and*
- *Unemployed"* (Van der Berg, 1989:17).

Given the magnitude of the problems on the labour front, the government appointed two Commissions during 1977. The first was the Commission of Enquiry into Labour Laws, the Wiehahn Commission; the second was the Commission of Enquiry into the Legislation Governing the Utilisation of Manpower, the Riekert Commission. Although the recommendations of these commissions led to a drastic shift in labour policy in South Africa, many of the problems in the labour market remained and in some cases even deteriorated. For a more detailed discussion on the Wiehahn and Riekert Commissions' recommendations and effects, see Botha (1986:288-303).

The above clearly demonstrates the many inefficiencies of apartheid labour laws aimed at directing and controlling labour in South Africa. Although a portion of this unemployment was also the result of cyclical economic trends, it can be argued that the ideology of apartheid failed to generate sufficient employment opportunities, a situation impacting on all other socio-economic and political developments.

5.5 THE GROWTH, EMPLOYMENT AND REDISTRIBUTION STRATEGY

Since the advent of democracy in South Africa in 1994, the new government has formulated and implemented its own economic policies in the Reconstruction and Development Program (RDP). The RDP was later replaced and absorbed into the new Growth, Employment and Redistribution (GEAR) strategy. The major focus of the GEAR strategy is the eradication of poverty created by the apartheid economy.

The aim of this input is not to evaluate the different aspects or the impact of the GEAR strategy, but only to refer to government initiatives aimed at rectifying the economic problems caused by apartheid.

The departure point of the GEAR strategy is the removal of economic growth constraints and the establishing of policy frameworks for social delivery (Business Report, 1996:4-6). GEAR seeks to address some of the most pressing economic problems of post-apartheid South Africa which include:

- High unemployment levels.
- Economic stagnation.
- Limited resources available to expand social services.

- High levels of poverty.
- Unbalanced income distribution.
- High inflation.
- Depressed levels of investment and business expansion.

The macro objectives of GEAR are the attainment of six per cent growth in GDP and the creation of 400 000 jobs per annum over a six-year period, while the long-term vision makes provision for (Business Report, 1996:4-6):

- The redistribution of income and opportunities in favour of the poor.
- A competitive fast-growing economy that creates sufficient jobs.
- Sound health, education and other services accessible to all.
- An environment in which homes are secure and places of work are productive.

The broad framework of GEAR is based on:

- Human resource development.
- Industrial and infrastructure development.
- Labour market flexibility.
- A competitive platform for exports.
- A stable environment for private investment.
- Restructuring of public services and government capital expenditure.

In achieving these goals, government has formulated GEAR to contain several elements. Highlights of these are (Business Report, 1996:4-6):

- Tighter fiscal discipline through a budget deficit reduction programme with the aim of containing debt service obligations, countering inflation and freeing up resources for increased investment. It also includes budget reform to strengthen the redistributive thrust of expenditure.
- A consistent and appropriate monetary policy which stabilises the real exchange rate at a competitive level and contains inflation.
- The facilitation of industrial restructuring through <u>inter alia</u> tariff reductions to contain input prices, especially imported inputs.
- A flexible labour market with the commitment to moderate wage demands.
- Further relaxation of exchange controls.

- Restructuring of state assets.
- An incentive scheme to attract new investment to competitive job creation projects.
- Infrastructure development to address service deficiencies and backlogs.
- Human resource development through a levy system to finance training.

5.6 LESSONS FROM THE APARTHEID ECONOMIC SYSTEM

A number of lessons can be learned from the economic experience of the apartheid economic system. South Africa is still searching for and formulating economic policy options that will lead to sustainable economic growth and development and improve the living conditions of its people. Sustainable development means *"a process whereby future generations receive as much or more capital per capita as the current generation has available"* (World Bank, 1997:75). These lessons could serve as an input in the ongoing debate:

- Any government action, whether economical or political, impacts on the entire economy and the well being of all of its people.
- Government policies and actions in the economy must create wealth not destroy it.
- Government is responsible for and in a position to formulate, implement, monitor and improve a broad economic, political and legal framework within which all citizens have a free and fair chance to improve the quality of their lives.
- Favouring any particular ethnic, racial, minority or even majority population group will eventually lead to economic stagnation, deteriorating living standards, social degradation and social unrest.
- Equal treatment of the entire population, fairness in government action and accessible opportunities for everyone to participate in the economy will eventually lead to overall wealth creation and improved living standards of a nation.
- Experimental ideologies such as apartheid impact negatively on the entire economy. Such systems usually lead to wasteful resource allocation, lost growth opportunities and human suffering, especially if the system requires huge security spending to defend it. Economic degradation normally precedes system failure, and will take years if not generations to repair at very high cost.
- Unbalanced and unfair economic development creates instability.
- Political and social instability is a key ingredient for economic stagnation.
- High quality human resource development is a prerequisite for sustainable economic

growth and development.

- The public service should not be used to create jobs that serve as a safety net for particular race groups. This only leads to wasteful resource allocation and eventually becomes self-perpetuating.
- Political and economic stability in the immediate geographical region will promote economic growth and development.
- Sound economic fundamentals such as healthy domestic savings, good macroeconomic management, minimal price changes and broad-based human capital form the basis for rapid and sustainable economic growth and development.
- A repressive political system attracts unfavourable international attention that can lead to actions against such a system. The globalisation of the world makes it difficult to implement and sustain such repressive systems. Countries cannot survive economically in isolation from the international community. The entire South Africa suffered from the international sanctions campaign.
- Governments legitimacy is as important for economic growth as the policies it implements. Legitimacy also creates a stable environment that promotes confidence in the economy, an important factor influencing investors' willingness to invest in the economy.
- Economic growth that benefits the whole population is a prerequisite for a stable domestic security situation. Such growth tends to promote confidence in an economic system.
- Ideologically motivated market intervention by the government leads to market and demand distortions.
- Government actions must lead to the effective delivery of collective goods and services, cost advantages and efficiency in the allocation of resources.
- Protectionist policies to promote inward industrialisation breed uncompetitive behaviour in the domestic market and lead to market distortions. It also has a tendency to increase inflationary pressure.
- Rigid labour policies are counter-productive and destroy jobs, while scaring potential investors away. A competitive and flexible labour market has become one of the driving forces in the globalisation process as multinational companies expand and shift their production processes.

5.7 CONCLUSION

The implementation of apartheid in South Africa over the years influenced the lives of all citizens in the country. To make the ideology of apartheid work, the governments of the day had to formulate and implement a range of policies, including economic policies, which were made subservient to the overriding ideology of apartheid.

Although it is impossible to blame only apartheid and the economic policies that supported it for South Africa's economic deterioration between 1965 and 1990, it is fair to assume that it played a major role in many of the problems South Africa experienced. Besides the political problems caused by apartheid it also played its part in a host of economic and social ones, such as economic stagnation, huge income differentials, social deprivation, poverty, high and rising inflation, a rigid labour market, uncompetitive industries, sanctions, capital flight, deteriorating living standards, huge budget deficits and weak human capital formation. The monetary value of these problems cannot be calculated. Suffice it to say that they resulted in an enormous waste of valuable and scarce resources.

"Although the poor were the first to suffer the consequences of the apartheid policy, the economy as a whole is today grinding to a halt as a consequence of the apartheid policies that were pursued" (Le Roux, 1992:16).

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 SUMMARY

By implementing the system of apartheid in South Africa, the government of the day was obliged to formulate and implement specific economic policies to give effect to its vision of the apartheid's state. Government had to play a particular role in the economy besides providing traditional collective goods and services. This role of government is influenced according to the literature by the broad political and economic system being followed in a country. The broad political systems of communism and democracy usually give rise to either a centrally planned or a market-based economic system respectively. This has a huge impact on the eventual economic policies designed and implemented by government.

Although all economic theory acknowledges that governments should play some role in the economy, the broad political and economic systems implemented lead to 'more' or 'less' government. The economic problems created by the Great Depression in the 1930's saw a drastic change in the role of government, even in so-called market-based economies. Governments increased their participation in the economy, mainly to stimulate economic activity and growth. Since then, governments have experimented with different economic policies to achieve certain goals. Government's role is characterised by the manner in which it intervenes in the economy as well as the nature of its involvement, which can be on any of or in most instances a combination of the following four functions:

- Provision of traditional goods and services.
- Support to business.
- Direct participation in the economy.
- Implementation and managing the regulatory and legislative framework.

Since the early 1960's East Asian countries have followed economic systems and implemented policies associated mainly with market-base principles, with government playing a unique role as far as participation in the economy was concerned. The economic success of these systems and policies, necessitates an examination of the reasons for their success, especially regarding the role of government in the economy. It is widely acknowledged that the economic success of East Asia was based on a combination of market-based principles and state-led intervention. *"East Asian development policies are not basically a question of whether markets or states should have the leading role in the development process. It is rather a question of how, within a globalised context, national policy can be formulated and implemented so that markets and States work together to promote development"* (Gore, 1996:14). The most important economic lessons from successful economic growth in East Asia can be listed as follows:

- Getting the economic fundamentals right is important.
- Market-base economic systems deliver desirable results.
- Government actions and policies created wealth, and did not destroy it.
- Government, business and interest groups functioned in a partnership.
- Government policies were fair, leading to equitable and shared economic growth.
- Governments succeeded in eradicating poverty through their social programmes.
- Political and social stability promoted economic growth.

In contrast to this, the former USSR followed a socialist political system supported by a socialist economic system. The economic problems created by this economic system eventually destroyed the former USSR, since the system could no longer support the economic inefficiencies and huge bureaucratic and security establishment. The most important economic lessons to be learned from the former USSR's economic experience can be listed as follows:

- Too much government kills economic growth and development.
- Dubious political systems usually require huge security spending to ensure their survival, which leads to tremendous human suffering.
- Too much government kills private initiative and motivation.
- The socialist system does not deliver sustainable economic growth and development.
- It failed to deliver the promised social services, the very objective of the system.
- It caused widespread poverty.
- It led to a huge waste of resources.

Similarly, the ideology of apartheid failed because of the economic deficiencies it created. As in the case of the former USSR, the South African Government had to develop and maintain a huge security apparatus to defend the apartheid system. The government also had to design and implement economic policies in support of the apartheid system.

Apartheid economics resulted in a number of economic problems such as economic stagnation, high unemployment, uneven income distribution, social backlogs and poverty, which gave rise to increased domestic unrest and international condemnation. Government had no choice but to initiate political change. The economic problems and realities caused by the apartheid ideology are the major challenges facing South Africa today, and will probably take years to correct.

6.2 PRIORITY AREAS FOR ECONOMIC POLICY FORMULATION, COORDINATION, IMPLEMENTATION AND MONITORING IN SOUTH AFRICA

The aim of this section is to make proposals on a framework for economic policy formulation and implementation in post-apartheid South Africa. Since South Africa is still designing economic policy, it could serve as an input into this process. It is not an attempt to formulate the specific economic policies required to address the many challenges the country faces, but to highlight some ideas that could be applicable to this process. It deals only with issues concerning governments' role in the economy. In transforming economies government usually sets *"the initial conditions for subsequent institutional development; its choices over numerous institutional parameters are not neutral"* (Sheard, 1994:4-5).

Economic policy has been the battleground on which elections in various countries have been won or lost. Issues like unemployment, inflation and prosperity remain at the centre of political debate and no political party can determine its economic policies on economic grounds alone. Economic policy is determined by the interface between political and economic factors. In this regard it is important to consider the relationship between political autonomy, that is the ability of government to give direction to the economy, and economic constraints, those economic events that are not within the immediate control of government.

The examples of successful and failed economic systems discussed in previous chapters provide South Africa with valuable lessons as to what works and what does not. Based on the economic lessons of East Asia and the former USSR, a broad market-base economic system is the only viable option at this stage. Within this framework, two aspects are important, firstly the specific areas of attention, and secondly government implementation and coordination of its economic policies. Accordingly, government's economic development should:

- Be consistent with market forces without distorting market signals and avoiding duplication of activities that can be better performed by other actors.
- Promote the efficient allocation of resources, including offsetting market failures.
- Improve the efficiency of markets by encouraging increased private sector participation.
- Have explicit objectives and timetables.
- Contain performance criteria.
- Ensure a positive balance of benefits over costs.

To realise South Africa's full potential, government could focus on activities that:

- Develop human resources.
- Enhance the institutional capacity of the economy.
- Strengthen the technological capability of the country.
- Reduce economic disparities.
- Support private investment in economic infrastructure.
- Capacity building.

The priority areas for economic planning and coordination in South Africa could be divided into five broad categories, namely:

1. Macroeconomic policy
2. Foreign economic relations
3. Industrial development
4. Physical infrastructure development
5. Socioeconomic development

1. Macroeconomic policy

Macroeconomic policy planning and coordination are essential in determining South Africa's overall economic development strategy, based on a short, medium and long term vision. It is important to take South Africa's economic development level into consideration in designing a macroeconomic framework. *"Though a mineral rich country, South Africa is still in the early stages of the transition to industrial maturity and therefore has limited resources"* (Van der Berg, 1991:9). The function of government macroeconomic policy should be to establish, develop and enhance the broad parameters within which economic activity is conducted. The objectives of macroeconomic policy could include the following:

- To develop South Africa into a competitive global player in terms of products, trade, technology, investment, production processes and distribution.
- To develop and expand South Africa's physical infrastructure.
- To achieve maximum economic growth at the lowest possible inflation and unemployment rates.
- To improve the living standards of the population.

The focus areas of the government's macroeconomic policy could include the following:

- **Fiscal policy**: Government should pay attention to fiscal policy in order to ensure that it plays a constructive role in the economy through the budget. It should also support the objectives of the private sector. Government's fiscal policy could be the single most important instrument to achieve sustainable economic growth and development. This is especially true given the fact that its budget touches on all aspects of economic life: taxes, infrastructure and investment.
- **Monetary policy:** Monetary policy, although to a large extent autonomous, should form an integral part of South Africa's overall economic strategy. Areas of importance are interest rates, exchange controls, money supply, foreign reserves, the inflation rate and the balance of payments.
- **Privatisation**: Internationally, governments are in the process of scaling down their direct involvement in the economy by way of privatisation. This policy forms part of attempts to streamline budgets, curb expenditure and generate new capital to service growing public debt. At the same time as governments are implementing this programme, they are also focusing on creating an environment conducive to investment through legislation.

2. Foreign economic relations

Since the South African economy is on balance an open economy, planning and coordination of foreign economic policy is vital to achieving broad macroeconomic objectives. The effects of the globalisation of the world economy and the rate at which it is changing are already visible in many African countries in the form of marginalisation, a lack of new technology and technical knowhow, increased vulnerability to foreign pressure, lack of new capital and outdated production processes. An ability to understand the dynamics of the world economy and to adapt to these challenges will impact on the country's economic development. The objectives of a foreign economic policy could include the following:

- To develop new markets for South African products, especially for those products where South Africa has a comparative advantage.
- To acquire new technology and technical knowhow.
- To attract more foreign capital so as to develop and expand South Africa's manufacturing base and alleviate the unemployment problem.
- To contribute regional development in Africa.
- To maximise development aid to South Africa.

The focus areas of the government's foreign economic policy could be the following:

- Technical cooperation agreements with other countries.
- Investment promotion and facilitation by ways of double taxation agreements, tax holidays, exchange controls and establishment procedures for foreign companies.
- Trade promotion and facilitation through trade agreements, trade liberalisation, trade finance, the establishment of export processing zones, trade standardisation, trade offices abroad to identify new opportunities, identification of countries and markets with which South Africa has limited trade relations, and incentives to promote exports.
- South Africa's economic relations with Southern Africa. Any economic strategy for South Africa should also include the region. If it fails to do so, long-term stability and prosperity in South Africa are questionable.
- South Africa's economic relations with industrialised countries, especially its major trading partners to facilitate the transfer of technology and technical know-how.
- South Africa's relations with international economic organisations such as the IMF, the World Bank and the United Nations Development Program.
- South Africa's relations with international banks regarding public and private financing.
- South Africa's relations with donor countries so as to coordinate development assistance to deliver maximum results.
- South Africa's involvement in regional initiative such as the Indian Ocean Rim, the Zone for Peace and Co-operation in the South Atlantic, the EU, SACU and the SADC.

3. Industrial development

Despite the fact that the constant development of new technologies in terms of production and distribution processes is having a negative impact on job creation, the industrial sector still has a large labour base. The possibility of expanding this base in South Africa is considerable, given the structure of the industrial sector. The change that is taking place worldwide in terms of the way in which multinational companies (MNC) conduct their business by way of multi-dimensional production and distribution processes is one of the most significant characteristics of the world economy. These companies are in the forefront of identifying and exploring new and cheaper production bases. Since the beginning of the 1990's, MNC's have started new production bases in and shifted others to many developing countries. This has contributed to developing countries achieving a higher economic growth rate on average than industrialised countries. This "second industrial revolution" is taking place in developing countries in Asia and Latin America. As a result, these countries are also developing into potentially huge consumer markets, particularly India, China, Indonesia and Brazil, with middle class people buying TV's, cars, fridges and other items for the first time. Some of the advantages of embarking on a path of industrialisation are the following:

- Increased exports and hence also improved foreign reserves, balance of payment situations and more stable currencies.
- Technology transfers and increased technical knowhow.
- Job creation.
- Improved living standards and expanding consumer markets.

The objective of industrial policy could be:

- To enhance / develop an environment in which industrialisation can take place.
- To develop South Africa as a major production base for products such as value-added consumer goods and mining equipment.
- To increase South Africa's international competitiveness.

The focus areas of government's industrial policy could be the following:

- Initiatives to promote technology transfers into South Africa.

- The promotion of small and medium-sized companies to be extended to rural areas in order to stimulate economic activity in those parts of the country.
- The establishment of economic zones to act as magnets for industrial development.
- The mining, agricultural and service sectors (e.g. banking and tourism).
- Incentive to attract local and international investors / companies.
- The optimum management of South Africa's natural resources.
- Waste management and the impact of industrialisation on the environment.
- The development of the necessary infrastructure in support to industrialisation.

4. Physical infrastructure

The development of physical infrastructure such as roads, dams, electricity generation and telecommunications is essential in order to support increased economic activity and is likely to create new jobs. This will require government to revisit its capital investment expenditure programmes. The focus areas could be the following:

- The upgrading, maintenance and building of roads and bridges.
- The upgrading, maintenance and building of rail and airways.
- Port development, upgrading and maintenance.
- Electricity generation and supply.
- The expansion of the telecommunications network.
- Water supply and sewerage.

5. Socio-economic development

Socio-economic development should form the cornerstone of government's economic policy and vision. Given the current level of development of the South African economy, socio-economic development is the biggest challenge the country is facing. From a government's point of view, all other economic policies and planning should be supportive of socio-economic development and seek to improve living standards. This is especially the case given that socioeconomic development is primarily the responsibility of government, since the cost-profit principle does not allow for private sector involvement. The reality is that if the socio-economic problems and backlog are not addressed adequately, South Africa could experience increased crime and violence, which will impact negatively on the economy and any attempts to rectify the situation at a later stage. People wish to feel safe and secure with the hope of a brighter future and the means to earn a decent wage so as to improve their lives. Socio-economic issues touch on basic human needs, which makes it even more imperative that they are addressed. The objectives of government's socio-economic policy could include the following:

- To uphold the law and protect basic human rights.
- To improve the quality of education and to make it more accessible.
- To improve the quality of health care and make it more accessible.
- To provide low-cost housing for the poorest portion of the population.

The focus areas of government's socio-economic policy could be the following:

- Priority attention to the provision, upgrading and development of education in South Africa. This is vital so as to ensure each person is equipped for life and can contribute to society and the economy. Educated people form the backbone of any economy.
- The development and upgrading of health services.
- A programme to increase the building of low-cost houses.
- A rural development program to stimulate economic activity in these regions.
- A programme to regulate and restrict urbanisation.
- Law enforcement.

6.3 A COORDINATING MECHANISM FOR ECONOMIC POLICY IN SOUTH AFRICA

As a result of the uncoordinated manner in which economic policy formulation and implementation took place in South Africa in the past, recommendations are now made regarding possible alternatives to the existing system.

Institutional and procedural reform has been on the agenda and macroeconomic policymakers have been almost as concerned with the policy process as with the policies themselves. With market mechanisms now playing an increasingly important role in the development process, the role of the government is becoming progressively less and is shifting toward providing an appropriate enabling environment for private enterprise. This is not necessarily a passive or indirect role. A number of governments in both developed and developing countries continue to successfully implement pro-active policy interventions.

Economic liberalisation nonetheless narrows the range of policy instruments and options available to governments. Liberalisation has given impetus to the interdependence of national economies, as well as the link up of economic activities related to trade, investment, money and finance. Government needs to be aware of this interdependence and the potential disruptive effects of policy in these fields.

It is widely recognised that in a system of government with a large number of powerful departments each with its own statutory responsibilities, it is vital to have a powerful structure at the centre that can oversee the broad spectrum of economic policy issues. The emphasis is not on the 'what' regarding economic policy but rather on the 'how', i.e. the procedural mechanisms to ensure a coordinated, long term, strategic approach to economic policy formulation and implementation.

In order to understand economic policy coordination at least three approaches to economic planning are important, namely a laissez-faire, liberal approach; a type of managed economy or "Keynesian" approach; and at the extreme, economic planning through comprehensive control of the economy. The choice of approach is essentially an ideological one, but it has a clear impact on the nature of economic policy making and implementation and the coordination of the policy process.

In all states a degree of central government direction of and participation in economic activity is necessary to ensure the provision of essential goods and services. Economic planning commences with the definition of the desired outcome of economic activity over a given period and then seeks to use, modify and steer the market mechanism to achieve the stated goals. The effective coordination of economic policy requires more than simply commitment; it also needs inter alia political will and responsiveness to external pressure, structures that reflect the needs of the economy and not those of public servants, expertise, and clear planning procedures and lines of communication.

Typical of the East Asian experience is the senior level at which economic policy is coordinated. This reflects the importance of economic priorities in these countries, and the commitment to actually implement policy. This determines levels of investor confidence and trust in a country's administrative apparatus. In addition, the following important criteria for effective economic policy processes are important:

- It is necessary to properly assess the country's economic situation before designing an economic reform strategy that will impact on all fronts simultaneously. A key lesson is that it takes time for reform to produce results. It takes time for resources and projects to be relocated. In addition, in bringing about major transformation in an economy, the focus cannot be limited to economic issues. The emphasis that Malaysia placed on political and social stability as key factors for economic development reflects this.
- Technical capability and teamwork are necessary to successfully implement reform. Dedication to the established goals is vital, but at the same time it is necessary for the individuals in charge to be conscious of the need for moderate public expenditure.
- There must be strong political support for acting decisively in the national interest. There should be no doubt as to government's political will and conviction to force through its economic plans within a limited time frame.
- An important aspect is the quality of the relationship between government and other interest groups. Policies, when implemented in a transparent and non-discretionary manner and in cooperation with the constituencies most affected, have a greater chance of succeeding. Malaysia's experience underscores the importance of effectively communicating the economic plan to all relevant interest groups in order to build popular support. The dismissal or questioning of the economic strategy or a part of it by any interest group can create a perception that government does not have full control over economic policy, which in turn could undermine investor confidence.
- It is necessary to establish a central database for trade, commercial and other related economic information to support effective economic planning.
- An economic strategy requires detailed annual action plans in which all elements of economic policy that support the strategic objectives are contained. The plans must be strictly implemented and properly coordinated. For example, monetary expansion should be compatible with the level of the exchange rate, fiscal policy should be compatible with domestic credit expansion, credit policy should ensure access to credit for expanding sectors, and labour market arrangements should be flexible to enable the relocation of labour to expanding sectors.
- Economic policy coordination requires effective monitoring mechanisms. The latter should be responsive to changes in the external environment and flexible enough to take timely corrective measures. It is important, for example, not to let the key macroeconomic variables, namely the real effective exchange rate, real interest rates, public sector deficits and real wages lose their alignment.

- A proper legal framework regulating critical economic issues such as labour and the protection of intellectual property rights is necessary . In Malaysia the legal framework supported the economic decision making and policy implementation processes.
- Checks and balances should be build into the process so as to promote both vertical and horizontal planning processes, either on the national and provincial level or between line-functional and multi-functional processes. Malaysia being a federal state has succeeded in ensuring that by following such a matrix approach, economic planning and particularly policy implementation by individual departments and states are in accordance with the strategic long-term objectives of the five-year plans.
- Government should avoid the tendency of reacting automatically to every new problem by setting up a new structure to deal with it. Excessive bureaucratisation can easily lead to overlapping, inefficiency, and eventually paralysis.
- Economic management by government should take place via a set of policy innovations that enables the national economy to adapt to a changing environment. Economic management requires efficient and timely decision-making to cope with economic problems and effective implementation of policy decisions by mobilising broad-based support. Economic policy making also involves reaching consensus in defining economic goals and policy objectives.
- The government's capacity for implementing policy must rely on organisational efficiency and on mechanisms for intra-governmental coordination and the mobilisation of external support. Intra-governmental coordination will require the establishment of institutional and organisational arrangements, devices for optimal resource allocation, efficient communication among implementing agencies, and mechanisms for resolving conflicts between agencies arising from policy change.

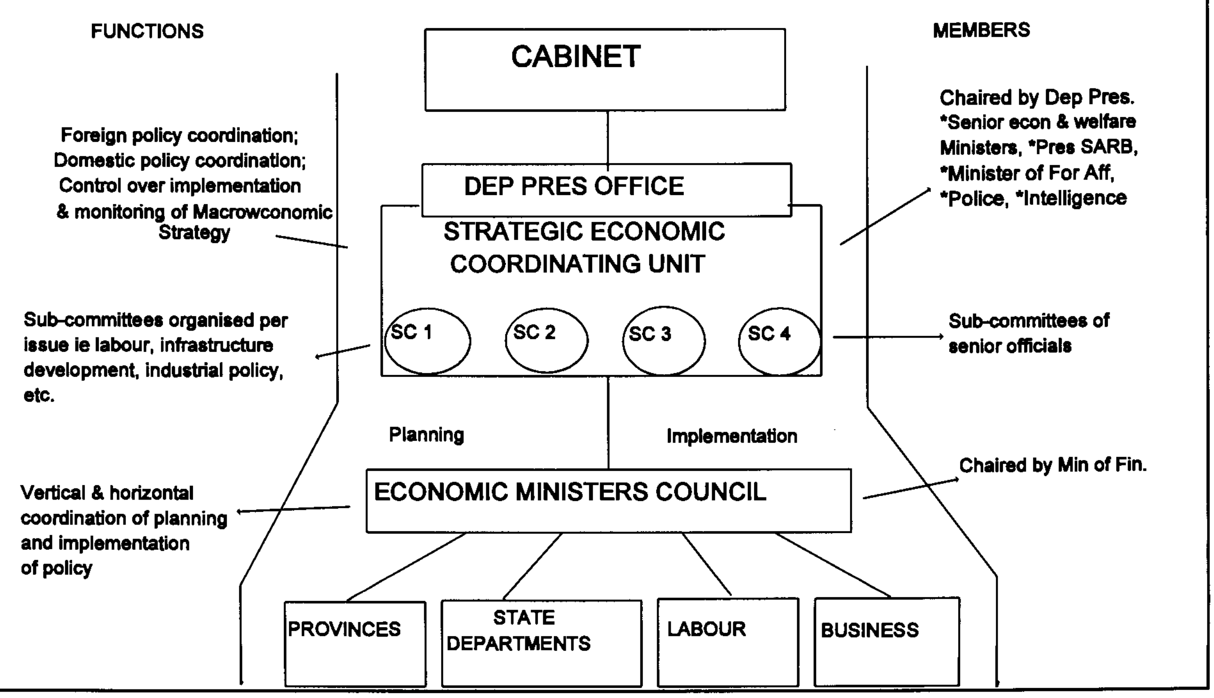
6.3.1 A possible model for South Africa

Despite the existence of inter-departmental committees, parliamentary committees and working groups, economic policy coordination in South Africa on a strategic level is still lacking. This is illustrated by the absence of a mechanism at senior level that can give strategic long-term guidance to and exercise control over ministries and departments regarding their line functional activities. The budget planning process must support long-term planning towards specific strategic goals. The challenge facing government is to create an effective coordinating mechanism for both domestic and foreign economic policy. Such a mechanism should be able to ensure that departmental and provincial actions accord with the vision and goals of the macroeconomic strategy. Such a structure will have to coordinate policy among national government departments as well as provincial legislatures and departments while accommodating the views of business and labour.

By incorporating each of the critical performance criteria into a model for South Africa, a mechanism in the Deputy President's Office chaired by the Deputy President is proposed. This would elevate economic planning to a senior level and provide the necessary authority, leadership and political support to ensure adherence to long-term strategic objectives (see Diagram 6.1). Represented on the mechanism, the Strategic Economic Coordinating Unit, could be senior economic and welfare ministers, the President of the Reserve Bank, and the ministers of Foreign Affairs, Safety and Security and Intelligence. To support this unit, subcommittees organised according to specific issues and staffed by technically capable people would needed in order to do the practical work and establish a central database that can serve as the basis for sound economic planning.

An Economic Ministers' Council could report to the Strategic Economic Coordinating Unit The council could be chaired by the Minister of Finance. The Economic Ministers' Council would ensure that on a practical level, the plans and activities of line-functional departments and the Provinces are properly coordinated. This Council could also serve to link government, labour and business.

Diagram 6.1: Possible economic coordinating mechanism for South Africa



6.4 CONCLUSION

The political transition in South Africa has provided the country with a unique opportunity to address its political, economic and social problems. Although the GEAR strategy has been implemented and has produced results, certain aspects thereof are not working optimally or have not been implemented. It is of vital importance that South Africa puts a workable and comprehensive economic strategy in place that can deliver sustainable economic growth and eradicate poverty if long-term stability is to be ensured and South African democracy deepened and strengthened.

"There is no place for ideological dogmatism in the kind of South Africa with which we are now concerned. If the country is to survive and is to meet the challenges of the contradiction between underdevelopment and sophistication in a common society, some philosophical humility will be necessary, even on the part of politicians, and this implies a need for a preparedness to approach those challenges more eclectically." (Bethlehem, 1988: 15)

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