Labour and Unemployment in South Africa: Notes Towards a "Grand Bargain"*

Ravi Kanbur
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The Development Policy Research Unit (DPRU) specialises in socio-economic research with a core focus on the areas of labour markets, poverty and inequality. The DPRU is located in the School of Economics at the University of Cape Town.

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Introduction

The problematic is very clear: high unemployment, high inequality and low growth, combined with a lack of consensus on what to do. The last point is important. There is no shortage of specific actual policies and interventions, as well as specific further proposals for policies and interventions, and there is no shortage of detailed debate and discussion around each of them.

We could of course, and we will no doubt, debate these and even more new proposals. But perhaps we should first investigate why there is such a lack of consensus. Is the matter purely a technical one to do with disagreements on design of policies and interventions, or is it more holistic than that, related to broader vision? Is it to do with which political constraints are taken as binding, and which are not? Relatedly, is it to do with a fundamental disconnect between the fact that the key interventions will only work through over a 7-10-15 year time horizon, while the political need is to deliver high growth, low unemployment and low inequality over a 3-5-7 year time horizon?

My basic argument is going to be that although we can - and we will - have detailed discussions about the pros and cons of specific proposals, it might be more fruitful to think in "grand bargain" terms, of a package of policies whose thrust is to balance alternative perspectives, whose differences cannot be resolved through technical debate, and to set the needs of short term political economy imperatives against the long time horizon needed for the working of policies and interventions to address deep structural legacies.

1 Initial Conditions

The structural initial conditions facing South Africa, global and domestic, are well known. Let's start with global trends, faced by all countries. First, is the technological trend towards displacement of unskilled labour by capital, and by skilled labour. This shift in the structure of demand for the factors of production will, all else equal, increase returns to capital relative to labour, and returns to skilled labour relative to unskilled labour, which will in turn increase income inequality through wage adjustments, and through unemployment if these adjustments do not take place.

Second, is the great openness of the world economy now, particularly to financial flows, but also to flows of direct investment. One might wish that this was not so, and one might argue in global fora for greater regulation of capital flows, but for a small country like South Africa, this is a global structural condition which has to be taken as a given in the foreseeable future.

A third global trend often added to these two, is that of climate change, with a time horizon of twenty to thirty years or more. I will not have much to say on this structural feature in this discussion.

The domestic structural initial conditions in South Africa are also well known, but worth setting down for the sake of completeness, and for eliciting responses on whether something has been missed out.

* Notes based on a presentation to the National Treasury, South Africa, on 11 August, 2015.

Many of these are the legacy of apartheid, and of the particular coalitions that struggled against and brought down apartheid:

- Large inequalities, in financial, physical and human capital (education and health), especially along racial lines.
- A particular spatial pattern of residence relative to place of work, leading to high reservation wages.
- Strong organized labour in the private and the public sector which can mount a resistance against declines in real wages, combined with a very small informal sector.
- Significant export oriented natural resource extraction sector, with increasing capital intensity, vulnerable to global commodity price trends.
- An economy relatively open to trade, investment and financial flows.

2 Policy Dilemmas

With these structural initial conditions, the dilemmas of South African policy making in advancing the objectives of growth, employment and equity should be clear. Global technology trends, imported to South Africa because of its openness, are leading to less intensive use of basic labour.

The labour that this displaces would be hired back by employers if either or both (i) wages fell or (ii) total demand for output rose and along with it came more investment and thus more jobs. On the first, employers and policy makers face the constraint of real wage resistance by organized labour. On the second, the fact that South Africa is a small open economy surely helps to maintain demand, but South African producers face competition from producers in other countries who have had the same gains in technical change but can rely on lower real wages to enhance competitiveness.

Indeed, the question of real wages (relative to productivity) in other countries brings us back to organized labour and its ability to resist real wage declines in South Africa. Macroeconomic strategies to address export competitiveness, for example that of "a mildly depreciated exchange rate" also runs up against the constraint that this could lead to a nominal wage spiral as organized labour moves to protect real wages. Added to this is the fact that the apartheid legacy of residential patterns leads to a higher reservation wage in South Africa, compounding these dilemmas.

In fact, rather than start with technological trends, some would start with labour market institutions in South Africa as the explanation of low investment and high unemployment, in a situation where private sector in the country has the whole world market to sell to and so does not face a demand constraint. In a world of free movement of investment, surely there are more attractive destinations.

But a low real wage strategy does not seem to be available politically for South Africa, at least not for the 3-5-7 year time horizon, both because of the political salience of the organized labour movement and because of the strong aversion in the body politic at large to the perceived inequality consequences of such a strategy.

With these constraints we seem to be in the following spiral. The technical change juggernaut is displacing basic labour. With real wage resistance there is high unemployment. With unemployment comes pressure to expand public sector employment which, together with wage demands, leads to a rising public sector wage bill. If the fiscal balance is maintained through higher taxation, or if with higher fiscal deficits monetary authorities tighten credit, private sector employment is hit again. This in turn adds to the global forces making for rising unemployment and the spiral continues, ratcheted up at each turn by the global forces.

In the face of these dilemmas, a plethora of specific polices and interventions have been proposed and implemented, including (in no particular order):

- Greater expenditure on public education, health, housing, services and transfers.
- Public employment schemes.
- Skill development and skill matching services.
- Wage subsidies to employers.
- Minimum wages.
- Support for very small scale enterprises in the informal sector.
- A range of export promotion and investment promotion for enterprises in the formal sector.
- Public investment to counter infrastructure failures holding back private investment.
- At the macroeconomic level, fiscal deficit targets and inflation targeting monetary policy.

These diverse policies and interventions (and their sub-components) each have their own rationale, and there are vigorous debates on their design, their implementation and their efficacy individually. For example, the consequences of a national minimum wage are currently being debated. For existing policies, many dueling evaluations exist with alternative technical bases.

But what should also be clear is that these interventions are not necessarily consistent with each other. A range of capital subsidies favor the use of capital over labour. Wage subsidies to employers counter high wages in the organized sector, at the same time that a minimum wage puts a floor under wages. Public employment schemes can at best be a temporary device unless those so employed become a permanent charge on the public purse. And public expenditure depends on public revenue, which will grow sustainably only when the economy grows through greater investment. These inconsistencies may simply be an oversight, or a sign of lack of coordination. Or they may be a reflection of conflicting visions and of reconciling of many constraints with the result that policy undoes with one hand what it has just done with the other.

On labour and employment specifically, there are two strong competing perspectives. One is a standard labour economics view that if only the real wage would adjust downwards sufficiently, unemployed labour would be absorbed back into employment. The conventional wage elasticity of employment number of 0.7 for South Africa is marshalled in evidence—a 10% fall in the minimum wage would lead to a 7% rise in employment. The counters to this perspective are also equally well rehearsed. Halving the unemployment rate would require around a 40% decline in the real wage, which is beyond the realms of political feasibility, let alone its implications for inequality between labor and capital.

The research underlying the 0.7 number is now quite dated, and recent elasticities may be smaller given the pace of technical changes. Some support for the technical change causation is provided by the low output elasticity of employment—around 0.5, so that a 2% increase in output would be needed for every 1% increase in employment.

Further, short run wage and output elasticities are likely to be much smaller. These competing perspectives explain the range of policies proposed, and some implemented—"stealth real wage reductions" including through exchange rate depreciation, minimum wage increases, youth employment wage subsidies, employment in public works, etc.

With this background, we can pose the following types of questions:

1. How can each policy or intervention be improved in its own terms, given its specific objectives?

2. Can we identify inconsistencies between pairs of policies so that these don't work against each other?

3. Among the policies, which policy, on an individual basis, provides quantitatively the biggest bang for the objectives of growth, employment and equity?

4. What might be the contours of a "grand bargain" between competing perspectives on the economy, which advances the objectives of growth, employment and equity?

5. What types of specific policies, from the current menu and from new proposals, could fill out the contours of such a grand bargain?

I believe we have a fair amount of discussion framed in terms of question 1, but each of the subsequent questions 2, 3, 4 and 5 has had progressively less discussion. In what follows I want focus on questions 4 and 5 as being perhaps the most useful to frame the context of the current debates.

3 A Useful Comparator: Brazil

However, before doing that, I want to ask whether there are some country experiences which are relevant for the South African dilemma. By this I do not mean country experiences on specific policies such as minimum wages, or public works schemes, or school feeding, or skills development, etc. These are important and will be relevant to the detailed technical discourse. What I want to do is to look at broad country strategies which have delivered the outcomes South Africa wants in the sort of situation South Africa has faced and faces.

There is, of course, no direct comparator. South Africa's unique history makes it sui generis. No other country has emerged in modern times from the brutality of apartheid in the way South Africa did. But can we find a country which has at least some features which are structurally similar to South Africa in aggregate?

A good start might be to look at countries which are in Middle Income Country (MIC) status and which have similarly high levels of inequality and human development to South Africa. They should also be relatively open, urbanized, formalized, and have strong organized labour. They should be somewhat but not predominantly resource dependent.

Further, it should be countries which have emerged from dictatorship to democracy, from strong centralization to a more market oriented economy, and have been in this phase for a period of two decades or more. Moreover, the comparator countries should not be either much smaller or much larger than South Africa in terms of population size.

All of this is a tall order and very few countries satisfy all of these conditions. No other sub-Saharan Africa is a match for the combined criteria of income, inequality, formality and labour organization. Middle East and North African (MENA) economies are only now going into their democratic phase.
The transition economies of Eastern and Central Europe had their transition to democracy and markets, but they started off with much higher levels of equality and human development, and many are by now at EU levels of development, and indeed are members of the EU. They did not face the racial divides faced by South Africa.

So, what is left?

I would suggest that Brazil is a country from which South Africa has much to learn. It is not South Africa by a long shot, including the fact that its population is much larger, but it has many common structural features. It is a MIC; it has globally high levels of inequality. Although it has nothing like the racial divides as in South Africa, nevertheless, economic differences based on racial origins are well documented and are part of the discourse. Brazilians threw off the dictator's yoke and since then have had social democratic government. As with much of Latin America, Brazil is urbanized and formalized to a significant extent. Labour organizations are strong. Indeed, the government for the last ten years has been formed by the Workers Party.

All of the above establishes, at least in a preliminary manner, Brazil's structural similarity to South Africa. But the most important comparison between the two countries is a **difference**. In the last fifteen years, Brazil has had high growth rates combined with declining inequality, after various phases in which growth was high but with rising inequality (1960s and 1970s) and growth was slow with stable inequality (1980s).

Brazil's Gini has been as high as 0.63 at its peak, but has been on the decline since the late 1990s. Between 1998 and 2009 the Gini declined from 0.5917 to 0.5374. To gauge the quantitative significance of this decline, note that "two thirds of the decline in extreme poverty can be attributed to the reduction in inequality. For the same reduction in extreme poverty, Brazil's overall per capita income would have needed to grow an extra 4 percentage points per year."[1]

What accounts for the reduction in inequality, unprecedented in Brazil's history?

Detailed analysis shows that: "the recent decline in inequality in Brazil resulted from three main factors:
(i) decreasing wage differentials by educational level and reductions in the inequality in education;
(ii) increasing spatial and sectoral integration of labour markets, in particular among metropolitan and non-metropolitan areas; and
(iii) larger and better targeted non-contributory government transfers.
Raising the minimum wage played a role through (i) and (iii)..."[2]

Lustig, Lopez-Calva and Ortiz (2011) further report, based on the work of Barros, de Carvalho, Franco and Mendonca (2009 and 2010) on the anatomy of the decline in wage skill premia:

"The fall in inequality in the distribution of labour income per working adult is determined, among other things, by the quantity and the price effect of changes in the distribution of schooling. The 1990s was marked by an accelerated expansion of basic education in Brazil. The Gini coefficient for education declined from 0.4792 in 1990 to 0.3487 in 2009.....

This changed the composition of the labour force by educational level with low-skilled and unskilled workers becoming relatively less abundant.....

Everything else equal, the latter should have pushed down earning differentials by education level (i.e., the skill premium); in fact, relative returns to education, particularly for secondary and higher education (vis-à-vis workers without schooling or incomplete primary) fell.....

Decomposition results suggest that half of the decline in labour earnings inequality (and almost 30 percent of the decline in household per capita income inequality) was explained by the combined effect of a fall in the inequality of education and a fall in the steepness of returns to education. The latter—the price effect—was the predominant factor, accounting for 35 percent of the decline in labour earnings inequality (23 percent for household income), while the former—the quantity effect—accounted for 11 percent of the decline in labour earnings inequality (3 percent for household income)."

It is indeed remarkable that the wage premium declined in the face of the global technical change trends alluded to earlier. This was the result of the strong supply side effect of the "accelerated expansion of basic education in Brazil."

The strong backdrop to these moves in the labour arena was a policy of macroeconomic stability with control of fiscal deficits. This was extremely important given Brazil's history of high inflation, with well documented spirals of price increase being chased by nominal wage increases to maintain real wages, and nominal exchange rate depreciation thrown into the explosive mixture. A distinctive feature of both the social democratic party's Cardoso Presidency and the workers' party's Lula Presidency was the prominence of the macro stability objective. It was with this as a key component of an implicit grand bargain, and helped of course by the long period of commodity price increases which came to an end in 2008, that the other components were put in place—expansion of basic education, minimum wages, and conditional cash transfers.

It is, however, very important to note the time lags. The expansion of basic education came a decade before its effects on inequality were felt. The South African imperative is to address the unemployment problem over the 3-5-7 year time horizon, and to do so without expanding public sector employment to fiscally unsustainable levels.

[1] Lustig, Lopez-Calva and Ortiz (2011) based on Based on Barros, de Carvalho, Franco and Mendonça (2009 and 2010).
[2] Lustig, Lopez-Calva and Ortiz (2011).

4 Thoughts for South Africa

The Brazilian experience can, at best, be only a stimulus to South African thinking on how to address the core policy dilemma of overcoming high unemployment and high inequality in the context of the initial structural conditions.

But here are some thoughts on what might be the contours of such a settlement.

- We can discuss the detailed quantitative magnitudes involved, and it could be argued that the devil is indeed in the details, but fiscal rectitude will have to be a key component of the package.

- Expanding public investment in education and health, human capital, as the basis of raising productivity and reducing inequality. Again, the detail matters, but the benefits of this will only come through slowly, over a decade or more. The same is true of other medium term tracks such as industrial policy.

- Over the short run, competing in the world economy on a low real wage track is not a feasible, and in some quarters not a desirable, policy option in South Africa.

- And publicly provided employment can at best be a temporary insurance intervention; the bulk of employment will have to come from the private sector.

- Given these constraints, the focus in the short run may have to be to reduce non-labour costs of private sector employment as the feasible and desirable track.

The South African policy dilemma can perhaps be crystallized as follows: How can unemployment be reduced significantly over the short run time horizon of 3-5-7 years without lowering the real wage and without increasing the public sector wage bill? A focus on non-labour costs of employment for the private sector, in order to get quick gains on the employment front, opens up a policy agenda which might be less contentious and more amenable to consensus than a labour costs focused approach.

It also highlights, I think, how little we know in detail about the impact of non-labour costs on employment. A conventional response might be that since non-labour costs of employment account for less than 30% of total costs the impact is unlikely to be large, but this is to potentially confuse averages with marginals. Further, we can think of non-labour costs in a broad rather than narrow sense, to bring in a wider range of policy responses.

Here are some examples, each of which needs further study to quantify[3]:

- Public infrastructure improvements for enterprises in their current location.

- Infrastructure improvements and specific financial inducements for enterprises to move to high unemployment locations.

- Steps to reduce the high reservation wage induced by high costs of transportation to work.

- Steps to reduce monopoly and concentration on the product side in order to expand output and thus employment.

- Reducing the regulatory and other constraints to the expansion of activity in small scale informal activities.

Conclusion

To conclude, I think the elements of a "grand bargain" may have to be a move away from a labour costs focused approach to employment policy, which is unlikely to succeed in the short run, in return for an agreement on fiscal rectitude and non-expansion of the public sector wage bill.

Within the fiscal constraints, the medium term strategy would be to build up human capital through investment in education and health, while the short term strategy, over the crucial 3-5-7 year time horizon, would be to reduce non-labour costs of employment.

There is plenty of room for debate on the specifics, of course, but this combination may move us away from a divisive discourse towards an assessment of the details of each instrument in the context of a potential overall consensus.

[3] These, and other policy proposals, are also to be found in Haroon Bhorat, Alan Hirsch, Ravi Kanbur and Mthuli Ncube (Editors), The Oxford Companion to the Economics of South Africa, Oxford University Press, 2014.

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Note on the Author

Ravi Kanbur is T.H. Lee Professor of World Affairs, International Professor of Applied Economics, and Professor of Economics at Cornell University.

Prof Kanbur researches and teaches in development economics, public economics and economic theory. He is well known for his role in policy analysis and engagement in international development. He is President-Elect of the Human Development and Capabilities Association, Past-President of the Society for the Study of Economic Inequality, Co-Chair of the Scientific Council of the International Panel on Social Progress, member of the High Level Advisory Council of the Climate Justice Dialogue, member of the OECD High Level Expert Group on the Measurement of Economic Performance, and a member of the Core Group of the Commission on Global Poverty.

Prof Kanbur has served on the senior staff of the World Bank, including as Resident Representative in Ghana, Chief Economist of the African Region, and Principal Adviser to the Chief Economist of the World Bank. He served as Director of the World Bank's World Development Report.

He is also ranked in the top 0.5% of academic economists in the world.