by Eustace C. Davie

How to stop causing poverty

Why is the South African economy in such a poor state? For the same reason that most other economies in the world are in a poor state – the government won't stop meddling with it. The government should confine itself to the very important task of keeping the peace and establishing and maintaining the rule of law, and leave the economy alone. In other words in order to allow the economy to recover it is necessary merely to determine what government must stop doing.

This approach differs markedly from the conventional view that government is responsible for managing the economy and ensuring a high quality of life for all citizens. Implicit in it is the conviction that resources are allocated most efficiently when an economy is consumer-directed.

We now know, or ought to, that central planning ends in disaster. The plight of the citizens of the Soviet Union and its former satellite countries provides us with ample evidence of the failure of such intervention. Amazingly, some diehards are still not convinced. They believe that all those dedicated communists just did not do it right. What we need, they say, is a mixed economy: a little of the hated capitalism mixed with as much social engineering and intervention as the citizens can be persuaded to accept. Fortunately, the empirical evidence is making ordinary citizens wary of politicians who promise them wealth if they will just follow orders.

Comparisons between prospering and struggling economies, and between periods of prosperity and decline in the same economy show us which interventions are most detrimental. Such comparisons suffer from the difficulties inherent in all attempts to quantify economic results. Moreover, measuring the success of an economy in terms of economic "growth" requires caution. In earlier years, for example, there was great admiration for the "growth" of the Soviet economy. Yet we now know that the supposed growth was spurious. Soviet consumers did not benefit from the huge investments made by their government. According to P.T. Bauer a proper definition of economic growth must mean, "an increase in the range of effective alternatives open to people."[1] Compulsory saving, in terms of this definition, imposes losses and reduces the choices open to people and can therefore not lead to economic growth. Government "investment" suffers from the same deficiency; it also ignores the voluntary choices of consumers and does not increase the alternatives available to them.[2]

From numerous studies of successful and unsuccessful economies we can compile a checklist of good and bad policies, and use it to identify what is wrong with the South African economy. Here, then, are some of the do's and don'ts:

1. GOVERNMENT PLANNING AND INTERVENTION
   Elaborate government planning based on long-term economic predictions is generally counter-productive. The predictions tend to be inaccurate and the planning politically biased. In nominally non-socialist states the damage caused by government planning and intervention is often concealed because economic activity, though constrained by the intervention, does not collapse. The socialist economies of Eastern Europe and the USSR collapsed because production was guided by government planners and not by prices resulting from peaceful voluntary exchange ie by consumers.
2. BUDGETARY DEFICITS
   Deficit budgeting, once started, is exceedingly difficult to stop. Pressure always increases for ever-higher deficits. Failure to balance budgets and an unwillingness to raise taxes to cover deficits leads governments either to indulge in heavy borrowing or to print money. Government borrowing raises interest rates and absorbs resources that could be more productively employed by private borrowers. Printing money (monetary inflation) causes a general rise in prices (price inflation) which eventually distorts the whole economy. The most honest and least destructive way of financing government expenditure is to raise taxes and balance the budget. If taxes are raised, voters at least know how much government is costing them.
3. INFLATION
   Inflation makes it impossible for businessmen to do meaningful economic calculations. This leads to the squandering of capital through malinvestment and overconsumption. Persistent and increasing unemployment under inflationary conditions repeatedly proves that Keynesian deficit spending and cheap money policies cannot eliminate mass unemployment, especially not when trade unions are granted the power to extract wage increases which are above the marginal product of labour.
4. EXCHANGE CONTROL
   Exchange controls are an attempt to stem the tide of events that follows when the exchange rate of the domestic currency is arbitrarily set too high. Overvaluing a currency subsidises imports and is tantamount to a tax on exports. When this causes imports to rise and exports to decline the response is to impose import tariffs and subsidise exports. The cost is enormous, both in bureaucracy and in the resulting disruptive effects on the economy.
5. PROTECTIONISM
   Restrictions on imports reduce both imports and exports. Investment is attracted away from more

efficient export industries to less efficient protected industries. The result is a steady decline in the efficiency of the economy and a substantial reduction in international trade. Protection is often granted on the basis that it will be withdrawn once an industry is established and capable of competing effectively on international markets. Government's purpose in granting protection to so-called "infant industries" is to increase employment and allow the industries to train workers to a level of efficiency which will make them competitive with workers in other countries. In almost every case the day for withdrawal of protection is postponed indefinitely; the "infant" never grows up.

6. TAXATION
High taxes reduce investment and economic growth. Even worse, if they are combined with tax incentives intended to encourage economic activity favoured by government, distortions result. High taxes mean high government expenditure – the consumption of wealth and not its creation. Every Rand taken out of the pocket of a taxpayer to be spent by government means a Rand less for the purchase of goods and services, or for investment. Economies grow fastest when capital investment per capita grows fastest. General prosperity also increases most rapidly under such conditions. Policies that reduce domestic capital accumulation and foreign investment therefore also reduce growth and bring about increased poverty. It is because there is higher capital investment per capita in the USA than in South Africa that Americans earn more than South Africans. High taxes reduce domestic investment and also discourage foreign investment.

7. QUOTAS AND LICENCES
Restrictions on imports, exports, production, marketing and other economic activities are invariably arbitrary and contrary to the interests of consumers. Such restrictions always involve the possibility of corruption and result in economic inefficiency. Licensing of people involved in occupations and professions has the effect of driving up fees and reducing competition.

8. STATE ENTERPRISES
Governments are inclined to favour state enterprises by granting them monopoly statutory protection. At the same time they impose politically motivated burdens upon them. State enterprises are neither compelled nor allowed to act in a competitive manner, subject to the full discipline of the market. They are often forced to set artificially low prices (especially for electricity and transport), to apply wage and salary rates which are out of line with market rates, and to continue running non-economic operations. Because state enterprises are usually involved in crucial industries, inefficiencies and distortions caused by their non-economic behaviour have a far-reaching effect on economic activity.

In Economic Policy and Economic Growth, Arnold C. Harberger summarises the essays of various authors published earlier in World Economic Growth. Following are some of his conclusions regarding the relative success of the economies of some of the countries studied.[3]

UNITED KINGDOM
Until the introduction of Margaret Thatcher's privatisation programme there was little difference between the policies pursued by Labour and Conservative parties in postwar Britain. Conservatives were the first to institute economic planning and prior to 1980 did not reverse any of Labour's nationalisations or extensions of the welfare state. Government expenditure, under governments of both parties, rose from 27% of GDP in the late 1950's to 41% under Thatcher in 1982. Other factors which led to Britain's low growth rate (average 2,25% between 1953 and 1982) were: (i) real wages kept rising in the face of economic stagnation and growing unemployment, amidst poor labour relations, and (ii) Britain started the 1950's with a serious currency overvaluation which successive governments refused to correct.

JAPAN
Japan's growth rate averaged 11% per annum from 1965 to 1970. This declined to less than 5% per annum in the period 1970-80 and around 3% in the following years. Stagflation marred the performance of the Japanese economy in the mid-1970's. Inflation was in double digits for three years starting in 1973, and reached almost 25% in 1974. The inflation occurred because the Japanese monetary authorities, faced with higher foreign earnings, almost trebled the money supply between 1970 and 1976 instead of allowing the currency to appreciate.

GERMANY
The West German economy slid from the halcyon days of the "German miracle" in the 1950's to virtual stagnation at the beginning of the 1980's. In the early years the emphasis was on the market, private control of resources, competition and an open economy. During the 1970's policy shifted towards the welfare state. Entry of foreign labour was almost stopped, labour-intensive industries received protection, compulsory employee benefits were increased, and the dismissal of employees was made increasingly difficult. Government introduced new programmes to aid the disabled, the unemployed and workers in general. "Subsidies and benefits for education, retraining, child care, housing and savings were substantially increased, pensions were raised, ... and subsidies for weak firms, weak industries ... and weak regions were piled up. In addition the public sector increased its supply of services and engaged in large-scale promotion of civil servants. As a result there was a massive expansion of public expenditures ... and a shift from public investment to public consumption."[4]

The conclusions are: (i) growth was rapid when government was small, and slowed when government became large; (ii) rapid development occurred when government followed a supply-side policy, deregulating the economy and removing the barriers to trade; (iii) when wage policies were moderate, economic growth was high, real wages increased rapidly and there was full employment. Aggressive wage demands pushed up the share of wages in the GNP, the rate of increase in real wages declined and mass unemployment occurred; (iv) growth was rapid when government expenditure was moderate, but declined sharply after some years of emphasis on redistribution.

SWEDEN
Sweden's economy grew at an annual rate of over 4,5% of

real GDP in the 1960's, declined to less than 2% in the 1970's, and started shrinking in the 1980's. Inflation rose from 4,4% in the 1960's to over 10% per year in the 1970's. Stagnation became marked in the mid-1970's when inflation exceeded 10%. Budget deficits increased rapidly from under 2% of GDP in the 1960's to 5% in 1978, over 7% in 1979, over 8% in 1980, and over 9% in 1981, financed largely by borrowing from financial institutions. Government expenditure grew at the same time from approximately 50% of GDP in 1975, to 70% in 1983, while taxes and fees remained static. The number of government employees, together with employees working in government-financed programmes, increased from 44% of the total workforce in 1965 to 59% in 1970, 69% in 1975, and 84% in 1981. Marginal rates of taxation of blue-collar workers had increased to almost 70% by 1970, whilst the marginal rates of white-collar workers increased to 80% in 1980-82. At these levels an upper limit was reached beyond which higher tax rates could not be expected to yield higher tax receipts.

TAIWAN

At the beginning of 1950 Taiwan followed the then fashionable economic policies of high trade barriers and low interest rates, with a rate of price inflation that was as high as 10,3% per month in the first three months of the year. Exports totalled US $96 million in 1954 and imports exceeded exports by more than 50% from 1951 to 1954. Over the next three decades conditions changed dramatically. By 1980, per capita income had increased fourfold. Exports had increased by a multiple of 200, and imports by 100, measured in US dollars. Exports in 1980 were nearly 20 times those of 1969, 100 times the 1961 figure, and 200 times the 1954 exports. This remarkable performance followed the abandoning of protectionist trade policies (high protective tariffs, import licences and quotas, and multiple exchange rates), and liberalisation of the economy. Apart from a brief lapse in 1973, interest rates remained positive after the low-interest policy was discarded in 1950. Both these measures were directly contrary to the import substitution and low interest rate policies that were at the time considered to be essential for the promotion of economic growth.

Positive interest rates led to a high level of savings even though per capita incomes were initially relatively low. In the 1970's domestic savings as a percentage of national income reached the remarkable level of 35,2%, compared to 20,0% in Japan, 8,3% in the U.K., and 6,5% in the U.S. This meant that Taiwan could finance growth from domestic saving and was no longer dependent on foreign investment. Between 1964 and 1979 the incomes of the poorest 20% of the population rose (from 7,7% to 8,6%) whilst the incomes of the wealthiest 20% declined steadily (from 47,1% to 37,5%) as a percentage of national income. Professor S.C. Tsiang, one of the principal architects of the economic liberalisation programme, said about Taiwan: "It has demonstrated how sustained rapid growth without tears and bloodshed can be achieved in a peaceful and humane way based on sound classical economic principles."[5]

PROPOSALS FOR POLICY CHANGES IN SOUTH AFRICA

Obviously our economy must grow if we are to reverse the fall in per capita incomes while at the same time improving equity. Everyone must become richer, but the poor must become richer faster. Timid changes will not bring about the necessary growth as rapidly as it is needed. Bold and fundamental changes will have to be implemented. Drawing from the above information, and considering particular interventions which exist in South Africa, my recommendations are:

1. ABANDON PROTECTIONISM
   Trade with other countries will improve rapidly when tariff barriers are removed. If the Rand is unified and exchange controls are abolished at the same time, existing industries will receive protection from an initial lower Rand exchange rate against other currencies.
2. DEREGULATE FINANCIAL MARKETS
   Stop inflation. Inflation can be stopped in its tracks by freezing MO (notes and coins in circulation, plus deposits of financial institutions with the Reserve Bank) a monetary measure over which the Reserve Bank has complete control.[6] Although not the best solution to the problem of inflation, it is at least second best, and can be implemented immediately. Competing currencies provided by private issuers offer a more lasting solution.[7]

   There has been a close correlation between the growth of MO over the past ten years and the general increase in consumer prices.[8] The annual rate of increase in MO declined to 13,5% in August 1990 from a rate of 35% over the past few years. Significantly, price inflation has also declined.

   Freezing MO must be accompanied by the simultaneous deregulation of financial and other markets. If the general public is convinced that the government will honour this sound money policy, price inflation will decline rapidly.

   Abolish exchange controls. This will allow a real exchange rate to be established. The financial Rand would have to disappear. Perceptions as to the credibility of the government and the Reserve Bank in halting inflation would play a role in determining the exchange rate at the outset.

   Deregulate foreign exchange. A foreign exchange market, outside the control of the Reserve Bank, should be allowed to develop. All barriers which prevent or discourage foreign banks from operating in South Africa, such as minimum requirements for local shareholding should be abolished. Foreign currencies should be allowed to compete with the Rand on the local market and Legal Tender laws should be repealed to make this possible.
3. PRIVATISE STATE ENTERPRISES
   Shares should be given to all citizens in a comprehensive programme to privatise all state enterprises. Increased efficiency in the management of the enterprises would result, past inequities would be addressed, and a massive transfer of capital to millions of productive people would occur.
4. SLASH GOVERNMENT SPENDING
   This would allow the budget to be balanced, accumulated debts to be paid off and taxes to be reduced. All of these are essential if productive enterprise is to be allowed to create the wealth and the jobs which are so sorely needed.

5. ABOLISH INTERVENTION ON A GRAND SCALE
   Deregulation is necessary to remove all obstacles to peaceful voluntary exchange. Apartheid laws such as those preventing black South Africans from engaging in farming should be high on the list for removal. At the same time, all those regulations which interfere with the production, marketing and financing of farming activities must be repealed. The same applies to regulations in manufacturing, building, transport, services, retailing and every other aspect of economic life.

CONCLUSION

Abandoning protectionism, providing a sound currency and deregulating the financial markets can be done without opposition from the radical political parties in South Africa. They therefore top my list for immediate implementation. Taiwan doubled its foreign trade every few years by liberalising trade and financial markets. South Africa can do the same. Other potential benefits are rapid wealth creation, and the raising of the standard of living of the poor at a faster rate than that of the wealthy, something that most South Africans would like to see. Peace will not be achieved whilst there is abject poverty and mass unemployment in this country. Economic initiatives that equal the daring yet fundamentally sound political changes we have witnessed during the past year are vital. Trade liberalisation would send a message to the world at large that we want to do business. It would also send a message to the people of South Africa that a secure and prosperous future is possible.□

NOTES

1. P.T. Bauer, *Economic Analysis and Policy in Underdeveloped Countries* (Duke University Press, 1957), pp. 113 ff.
2. Murray N. Rothbard, *Man Economy and State* – Volume 1 (Nash Publishing, Los Angeles, 1970), p. 838.
3. Arnold C. Harberger, *Economic Policy and Economic Growth* (ICS Press, San Francisco, 1985).
4. Frank Wolter, *From Economic Miracle to Stagnation: On the German Disease*, in Arnold C. Harberger, ed., *World Economic Growth* (ICS Press, San Francisco, 1984), p. 109.
5. S.C. Tsiang, *Taiwan's Economic Miracle: Lessons in Economic Development*, in Arnold C. Harberger, ed., *World Economic Growth (ICS Press, San Francisco, 1984), p. 323.*
6. *Richard J. Grant, Stopping inflation and lowering interest rates*, FMF Paper, (The Free Market Foundation of Southern Africa, Johannesburg, 1989).
7. F.A. Hayek, *Denationalisation of Money* (The Institute of Economic Affairs, London, 1976), P. 82.
8. Don Caldwell, *South Africa: The New Revolution* (The Free Market Foundation of Southern Africa, 1989), p. 153.

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