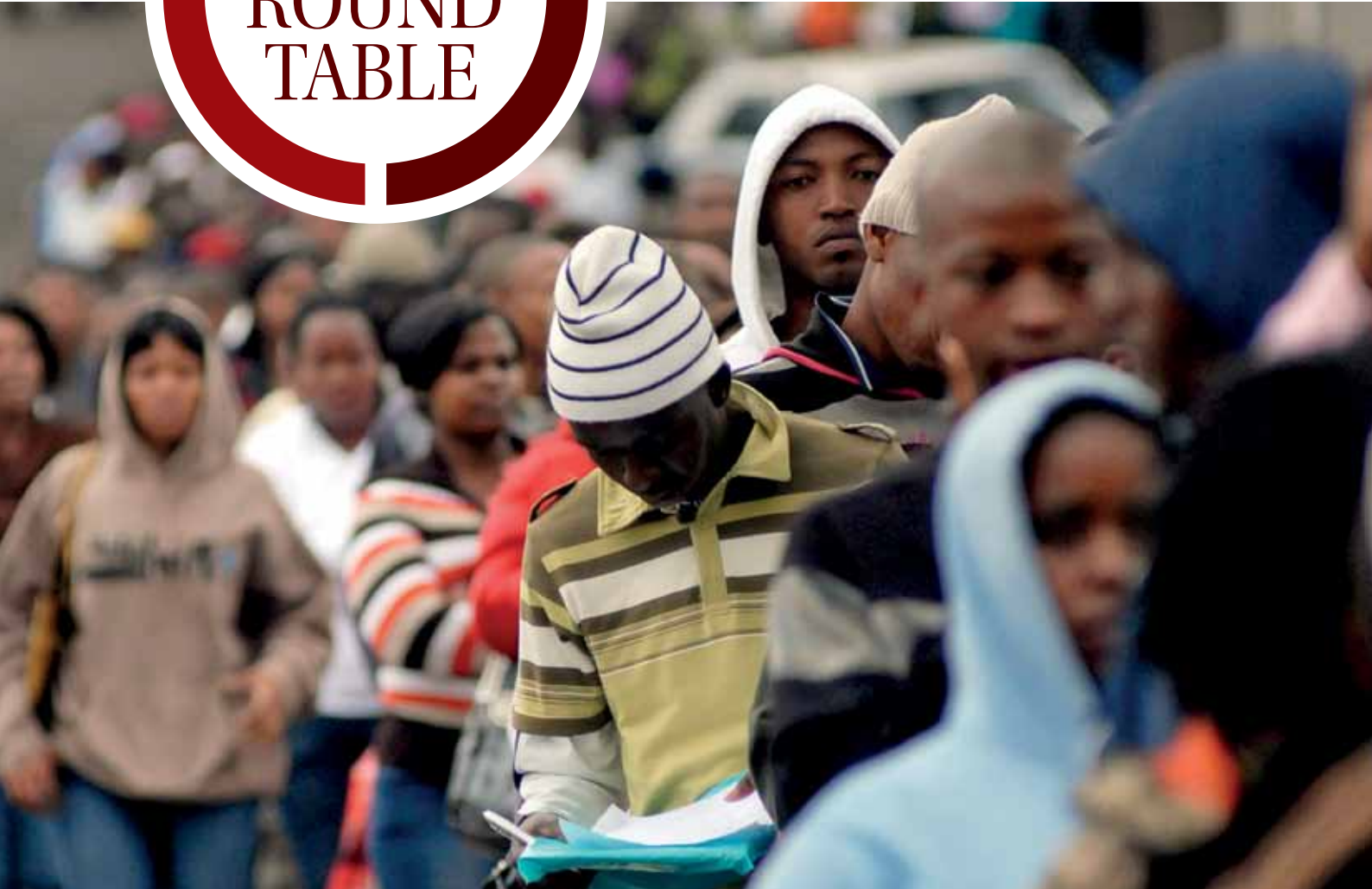




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# JOBS FOR YOUNG PEOPLE

Is a wage subsidy a good idea?

Edited proceedings of a Round Table convened  
by the Centre for Development and Enterprise

The Centre for Development and Enterprise is a leading South African development think-tank, focusing on vital national development issues and their relationship to economic growth and democratic consolidation. Through examining South African realities and international experience, CDE formulates practical policy proposals for addressing major social and economic challenges. It has a special interest in the role of business and markets in development.

Series editor: Ann Bernstein

This report summarises the proceedings of a Round Table hosted by CDE in November 2010. It was written by Antony Altbeker and Ann Bernstein.

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Cover: In September 2009, the Durban Metro Police invited applications for 200 learnerships. Thousands of youths applied, some of them queueing overnight. The massive turnout demonstrates the desperate need for jobs among young South Africans.

Picture: Reuters / Rogan Ward

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## EXECUTIVE SUMMARY

ALMOST THREE quarters (72 per cent) of South Africa's unemployed workers are younger than 34. The unemployment rate of people younger than 25 is almost twice the national average (49 per cent compared with 25 per cent). And the 50 per cent of South Africans aged 15 to 24 who want jobs and actually have them is significantly fewer than the 80 per cent which the OECD reports as the norm in other emerging market economies. We have a national crisis of youth unemployment.

The government has begun to acknowledge the seriousness of the situation, and has proposed a range of interventions to address it. Some of these are of doubtful merit or contradict other government policies or proposals. One initiative, proposed by the National Treasury, is to introduce a wage subsidy for young workers. The logic of this idea is that employers will be encouraged to employ more young and inexperienced workers if the costs of doing so are subsidised.

The Treasury has proposed that the wages of all workers between the ages of 18 and 29 earning less than R60 000 a year – the current tax threshold – should be subsidised for a period of two years. Registered employers would receive the subsidy via credits on their PAYE accounts.

In the first year, the subsidy would comprise 50 per cent of monthly wages up to R2 000 a month, reducing to nothing for wages of R5 000 a month or more. The value of the subsidy would decline by 50 per cent in the second year. Young people who are currently employed would be eligible only for one year and at the lower rate.

The Treasury estimates that the programme would subsidise 423 000 workers. Of these, 245 000 jobs would be created in any case, and the remaining 178 000 would be created in response to the subsidy.

The Treasury estimates that some 45 000 workers would drop out of the labour force after having benefited from the programme, so the net result would be 133 000 more people employed by 2015, when the programme would end. The programme would cost R5 billion over three years. Each job would have cost an average of R37 000, although the actual subsidies would be considerably less.

In November 2010, CDE convened a Round Table of

senior economic policy-makers, economists, and leaders from business and civil society to examine the key issues surrounding this proposal. It was also attended by two international experts: Professor Paul Romer, a renowned growth economist from Stanford University, and Prof Hian Teck Hoon of Singapore Management University, a leading labour market economist and expert on wage subsidies. Questions addressed included: Would a wage subsidy raise employment levels, by how much, and at what cost? Is this an appropriate response to the unemployment crisis? And would it be sustainable?

While some issues of policy design were discussed, the main focus of the Round Table was the feasibility, desirability and possible impact of the proposed wage subsidy.

### **A job-centred approach to growth**

Employment is vital for South Africa's social, economic and political development. It is the key mechanism for addressing mass poverty. In addition, many other benefits flow from higher levels of employment. Many of the skills needed to improve a worker's employability – punctuality, discipline, the ability to work with others, and so on – are most easily acquired on the job. This is especially important in South Africa. Millions of people are the products of South Africa's dysfunctional education system and have had few opportunities to acquire skills. For many, the workplace is the institution in which they are most likely to be able to acquire skills. Jobs also generate a sense of accomplishment, dignity and participation.

While welfare grants can provide a modest income, they cannot offer any of these other benefits, making employment growth vital to creating a more inclusive society.

As the National Treasury has stated, the proportion of working age adults with jobs may be the best measure of social inclusion in a modern society – far better in many respects than the Gini coefficient. On this measure, Brazil, where close to 70 per cent of adults have jobs, is a far more inclusive society than South Africa, where barely 40 per cent of adults have jobs even though levels of income inequality are similar.

If South Africa is to be more inclusive, far more people must find jobs. But what kind of jobs?

South Africa's labour laws mean that any job that is fully compliant with the law is also, from an employer's point of view, a reasonably expensive job. This is especially true when compared with the costs of employment in other developing countries. Minimum wages in South Africa's clothing industry are two or three times higher than those for similar jobs in Swaziland and Lesotho, let alone India, Vietnam, Bangladesh and Pakistan. To justify this, levels of productivity have to be high, resulting in employers' offering fewer jobs but for more skilled workers.

In recent decades the South African economy has generated fewer and fewer new jobs for every unit of economic growth. While some of this reflects increased productivity, much of the decline in job creation can be attributed to rising wages and increased labour market regulations, which have made employers more reluctant to hire workers, particularly those who are young and unskilled. Employers, who might be willing to incur the costs of employing highly productive workers with significant skills, are much more reluctant to do so for workers whose lack of skills and experience mean they will be less productive. This is a key reason why so many young, inexperienced workers are unable to find work.

While South Africa has sought to ensure that jobs are well paid and well protected, dynamic emerging economies in Asia have sought to expand the absolute number of jobs as rapidly as possible. Many of these jobs do not pay high wages or offer very good conditions of employment, but they do pay better than almost any alternative form of employment for unskilled people. Critically, they exist in very large numbers. Experience in Asia and elsewhere shows that once high levels of employment have been reached, productivity gains and progress up the industrial value chain lead to a rapid rise in workers' incomes and quality of life. It also leads to much higher rates of growth for the economy as a whole.

This is the process that has lifted hundreds of millions of people out of poverty over the past 40 years. And, apart from the discovery of previously untapped natural resources, it is the only process that has ever improved the quality of life of large numbers of people in poor countries both rapidly and sustainably.

The story of Singapore's rapid development is instructive. There, economic growth has generated a rapid change in its areas of comparative advantage. In the

1960s, shortly after independence, when unemployment was high, the country concentrated on attracting manufacturing firms, particularly in the garment and textile sectors. This was low-skilled work, but it lifted the incomes of the poor. In the 1970s, Singapore began to produce simple electronics, after which it began making hard-drives and semi-conductors. Since then, it has moved further up the value chain, with the country now having a comparative advantage in bio-medical research and development. Thus, over the decades, the country has steadily moved up the ladder of comparative advantage, with very positive implications for average wages as well as economic growth.

### **The Treasury's case for a wage subsidy**

In response to the need to create jobs for young, unskilled workers, the Treasury has proposed the introduction of a wage subsidy for young workers at the bottom of the pay scale. Such a subsidy would narrow the gap between the costs employers incur when employing these workers and those workers' likely levels of productivity. The Treasury argues that this would induce firms to employ more young people.

The subsidy directly lowers the cost of employment to the employer. And, by getting inexperienced young people into jobs, it would enable them to acquire skills which will raise their productivity. This is also why the Treasury proposes that the subsidy would be offered for only the first two years of employment. This is on the basis that the beneficiary's rising productivity reduces the need to subsidise his or her employment.

### **The risks of implementing a youth employment subsidy**

There is a strong case for instituting wage subsidies in South Africa. Promoting employment would generate far more inclusivity than increasing welfare payments. At an appropriate level, these subsidies could also stimulate significant employment creation. There is good evidence from countries as diverse as the United States, Belgium and Singapore that wage subsidies do encourage employment and help to reduce poverty.

Nonetheless, there were a number of concerns about the introduction of a wage subsidy. These included:

- *Cost and sustainability:* The number of jobs created by a wage subsidy depends on how many workers it induces firms to employ. This depends on the size of the subsidy, but larger subsidies raise issues of affordability and sustainability.
- *Waste:* Wage subsidies can be more efficient than other forms of public policy, but they can also generate wasteful spending when jobs that would have existed in any event are also subsidised.
- *Employer response:* Many employers may feel that it would be too risky to take on potentially unsuitable (albeit subsidised) workers unless the process of dismissing them was made considerably less onerous.
- *Opportunity costs:* The funds devoted to a wage subsidy might be better used for other government initiatives.
- *Sustainable jobs:* The Treasury's proposal assumes that, after two years of subsidised employment, a young worker will be productive enough for employers to keep him without the subsidy. Whether this will happen is impossible to know.
- *Creating new distortions:* A wage subsidy could result in the growth of businesses whose only rationale is to absorb public money through subsidies. Employers might also replace unsubsidised workers with subsidised ones.

Two of the most significant concerns were that a wage subsidy would do nothing to address the current regulatory regime, which plays a key role in raising the costs of employment, especially of unskilled and inexperienced workers; and that the Treasury's proposal was too small to impact significantly on South Africa's unemployment crisis or on the politics of reforming the labour market.

### **The wage subsidy and the costs of employment**

In some respects, the Treasury's proposal represents a significant break from existing government policy. For the first time, an intervention is being proposed that takes seriously the negative impact of high employment costs on people's chances of finding work. It suggests that some policy-makers have recognised that high and rising employment costs are a key reason for South Africa's unemployment crisis. This injects a dose of realism into the debate about

the choices facing the country. However, this does not necessarily mean that a wage subsidy is the best way to create jobs.

### **Is a wage subsidy desirable in principle?**

Employment incentives are common across the world, with OECD countries spending an average of about 0,15 per cent of GDP on programmes of this sort. In South Africa, this would amount to R15 billion over three years, or three times more than the costs of the programme that has actually been proposed.

There are many reasons why governments subsidise wages, and the relevant literature suggests that these programmes are quite effective in relieving poverty or increasing employment levels. In South Africa, however, questions need to be asked about the desirability of introducing wage subsidies when it is existing labour market regulation that has ensured that labour costs have risen quickly over the past few decades. In these circumstances, a wage subsidy – which transfers some of the costs of employment from employers to taxpayers – may not be the most appropriate way to close the gap between employment costs and productivity. Instead, it may be more appropriate to address directly the reasons for high and rising labour costs.

### **Is government doing enough to reduce employment costs?**

In general terms, the outlook for labour market reform that would reduce labour costs is poor. As recently as December 2010, the government proposed amendments to the Basic Conditions of Employment, Labour Relations and Employment Equity Acts, and proposed a new law – the Employment Services Bill – aimed at governing labour brokers. There is widespread agreement that these proposals would have increased the cost of employment and resulted in more unemployment. As a result, the 'social partners' represented in NEDLAC – national government, organised business and organised labour – agreed in April 2011 that the four bills should be re-drafted.

A process of consultation is currently under way regarding these bills. It is not yet clear what will emerge from this. The fact that these bills were drafted at all, however, suggests that key government institutions

want to increase labour market regulation rather than decrease it. It is especially telling that government proposed these measures even after its own regulatory impact assessment concluded that the changes would reduce employment. It seems unlikely, therefore, that reforms will emerge from this process that will significantly reduce the direct and indirect costs of hiring young, unskilled work-seekers.

There is no indication that the proposed wage subsidy is part of an incremental strategy to reform the labour market. If the wage subsidy is an isolated initiative, is it worth implementing anyway?

### **Is the National Treasury's proposal worth implementing?**

If the Treasury's estimates are correct, and the subsidy would increase employment levels by 133 000 at an overall cost of R37 000 per job, it would use public funds more efficiently than some other interventions. In fact, to the extent that these jobs would generate taxable profits for employers, they would actually cost government less than this estimate. By contrast, the Expanded Public Works Programme creates short-term, low-wage jobs at an annual cost to the taxpayer of R100 000 for the equivalent of a full-time job. Similarly, the Industrial Development Corporation's newly announced fund, which will provide concessionary finance to job-intensive investments, will target projects that create jobs at an average cost of between R250 000 and R500 000 a job.

From the point of view of employment creation, the proposal also appears to be far more efficient than other subsidies, such as the estimated R18 billion that public support for the automotive industry cost the economy in 2009/10. While there are other benefits associated with having this industry, and while getting accurate figures is not easy, one estimate suggests that this support costs the economy between R200 000 and R600 000 per job, depending on whether employment in upstream industries is included. Including down-stream workers as well lowers the annual cost per job to R60 000. But, unlike the estimated once-off R37 000 cost per job of the wage subsidy, these costs are incurred by the economy every year.

An important advantage of the Treasury's proposal is that if new jobs are not created, the money would not be spent. Furthermore, because the jobs created would be in

the private sector, they would probably be in areas of the country (and sectors of the economy) in which sustainable employment is a more plausible outcome than is the case with other proposals.

All this – and the fact that the programme is expected to cost less than 0,2 per cent of anticipated government spending over the next three years – suggests that, on its own terms, the wage subsidy is a sound use of public resources. There are, however, other issues to consider.

The proposal to subsidise the employment of young workers whose salaries fall below the income tax threshold is intended to increase the chances that people in this demographic will find work. Subsidising their employers is one option for achieving this. An alternative would be to engage directly in the process of reforming the labour market in order to reduce the costs of employment – in general, or for this group of workers.

The proposed subsidy does not do this even though there are ways in which the two kinds of intervention could have been aligned. For example, when a proposal to institute a wage subsidy was endorsed by the team of Harvard-based economists that advised the National Treasury on South Africa's economic strategy in 2006/7, it was deemed 'essential' to link the subsidy to the creation of a probationary period during which subsidised workers could be dismissed on a 'no questions asked' basis.

No one has tried to calculate how many more jobs might be created if the wage subsidy were linked to a probationary period of this kind. This could be considerably more than the 133 000 that the Treasury projects for a subsidy on its own. By allowing employers to dismiss unsuitable workers relatively quickly, a probationary period could increase the number of jobs created, help target subsidies to the most productive and capable workers, and increase the likelihood that those employees who were retained by their employers would be kept on when their subsidies expired.

Such a proposal might provoke political resistance. However, if the government is serious about dealing with mass unemployment, it will have to confront these sorts of issues. As it stands, the Treasury's proposals – assuming its projections are accurate – would have only a modest impact on the crisis of unemployment.

### Could this proposal be scaled up?

In principle, a subsidy would have a greater impact if it were larger. This could be accomplished either by making each subsidy larger or by extending the length of time for which beneficiaries are eligible. Doing this would increase the costs per job and the overall costs of the programme. While this raises questions of affordability and sustainability, it may be that a programme costing R15 billion over three years but which also created significantly more jobs would be worth having. South Africa would then be spending as much as OECD countries spend on wage subsidies, but it would still be less than 1 per cent of the national budget. If 350 000 new jobs were created, the subsidy programme would more than double the chances of a young person finding work in the next three years.

One reason for framing the issue in these terms is the sense that 133 000 new jobs are simply too few to make a meaningful difference to the employment prospects of the jobless. Equally important, this number may also be insufficient to shift the debate about labour market policy. In practice, a much larger programme could help change the terms of the debate and start convincing those who would like to increase regulation of the labour market that creating more jobs actually requires lowering the costs of employment.

### Concluding remarks

The government has announced or introduced a large number of proposals, policies and programmes with the stated aim of creating more jobs. Some of these would create a small number of relatively high-skilled and capital-intensive jobs for which the majority of the unemployed are not unsuitable. Others have created a larger number of temporary 'make-work' jobs that offer transitory and modest relief from poverty with little prospect of a sustained improvement in the beneficiaries' quality of life. Both approaches are expensive, and neither offers a realistic long-term solution to South Africa's crisis of unemployment.

The Treasury's wage subsidy proposal is also not a comprehensive response to the crisis of unemployment. It is, nonetheless, a step in the right direction and should be introduced. It would be preferable, however, if it formed part of a series of initiatives.

One option would be to introduce a national wage subsidy and to encourage and support a variety of policy experiments at the provincial, municipal, or even sub-municipal levels. Another would be to subsidise wages in some sectors or areas and introduce other initiatives in others, so that the impact of different approaches could be assessed. Such policy experiments could include:

- Allowing employers to offer young people jobs at wages lower than the established minimum wages;
- Allowing young people to opt out of employment regulations altogether as a part of their employment contract; and
- Establishing special economic zones with different rules and regulations aimed at promoting low-cost, export-oriented manufacturing firms.

These are all potentially useful initiatives. Perhaps the most straightforward and appropriate policy change to link with the institution of a wage subsidy is the one originally proposed by the Harvard-based team advising the Treasury: any new hire who benefits from a wage subsidy should be subject to a ten-week probationary period during which employers can dismiss them on a 'no questions asked' basis. If this were implemented, employers would be less concerned about being stuck with unsuitable employees, while new hires would have every incentive to show that they are suitable. The results would be that only those people who are most likely to be suitable would be subsidised, dramatically improving the efficiency and effectiveness of the wage subsidy itself.

Locating wage subsidies in a wider programme of labour market reform and experimentation could extract far greater value out of government spending. The key is to try to leverage as many jobs as possible from policy initiatives of this kind, and to shift the policy debate to the fundamental reasons for South Africa's high and rising labour costs.

There is merit in the Treasury's proposal, but South Africa could do better. First prize would be to address directly the high costs of employment, especially of young, unskilled and inexperienced workers. While this would be politically difficult, the benefits could be significant.

Even if political circumstances effectively rule out more fundamental labour market reform, serious questions remain about the current Treasury proposal. Chief among these is why it is so modest. If the Treasury is confident



about its projections, why it is not pushing for a more ambitious programme? Is it concerned that it would cost too much? Is it seeking to avoid a more serious political battle?

That said, there is also an argument that the modesty of the proposal is a virtue. The success and affordability of a wage subsidy is not guaranteed. If there is some chance of failure, the relative modesty of the proposal insulates it from incurring significant costs.

Whether or not the proposed wage subsidy succeeds, questions need to be asked about what government will do next. If the programme does succeed, will more resources be devoted to subsidising employment, or will a new debate about addressing the costs of employment be instigated? And if the proposal fails to increase employment, what lessons will government (and others) draw from this experience? Will efforts to tackle the costs of employment be expanded and enhanced, or will there be a retreat from any reform at all?

These are vital questions because, even if it achieves its stated goals, the Treasury's proposal will make no more than a modest dent in South Africa's massive challenge of unemployment.

Addressing unemployment is South Africa's most pressing national priority. As the Treasury itself recognises, a relatively small wage subsidy programme would not have a very significant impact. Nonetheless, this proposal – if seen as a learning experiment with vital policy implications – does seem a sound use of public funds. It certainly holds more promise than many other government initiatives costing considerably more. It would be a tragedy if this modest experiment was defeated or abandoned.

The Treasury's proposal is premised – rightly – on the recognition that for South Africa to become a more inclusive society, much more needs to be done to help unskilled and inexperienced young people to get jobs. This is an important first step.

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Hian Teck Hoon is a Professor of Economics and Associate Dean of the School of Economics at Singapore Management University (SMU). He has worked at SMU since 2001. Prior to this he taught at the National University of Singapore in various positions. His research interests relate to labour market theory, and he has worked extensively with Edmund Phelps, a Nobel Prize-winning economist. He is the author of numerous publications, including the book *Trade, Jobs and Wages* (2000). He received his master's and doctoral degrees from Columbia University and his bachelor's degree in science from the National University of Singapore.

# Introduction

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ALMOST THREE quarters (72 per cent) of South Africa's 4,4 million unemployed workers are younger than 34. For people under the age of 30, unemployment rates are almost twice the national average (49 per cent compared with 25 per cent). At the outset, it is worth setting out some basic facts about South Africa's crisis of unemployment. And the 50 per cent of South Africans aged 15 to 24 who are in the labour market and actually have jobs is a significantly smaller proportion than the 80 per cent which the OECD reports as the norm in other emerging market economies. We have a national crisis of youth unemployment.

In his budget speech in 2010, the Minister of Finance, Pravin Gordhan, spoke of the government's intention to rapidly create more jobs for young people. Noting that 'employers are reluctant to hire inexperienced work-seekers,' and that 'our bargaining arrangements push up entry-level wages, pricing out inexperienced work-seekers,' he proposed that a wage subsidy be introduced in order to reduce the cost of hiring young and inexperienced work-seekers.

In November 2010, CDE hosted a Round Table to examine some of the key issues surrounding this proposal. These included: Would a wage subsidy raise employment levels, by how much, and at what cost? Would this be an appropriate response to the unemployment crisis? And would it be sustainable? Participants included some of South Africa's most senior economic policy-makers, business leaders, leaders from civil society, and academic economists. Also in attendance were two international experts: Professor Paul Romer of the Stanford Institute for Economic Policy Research, and Professor Hian Teck Hoon of Singapore Management University.

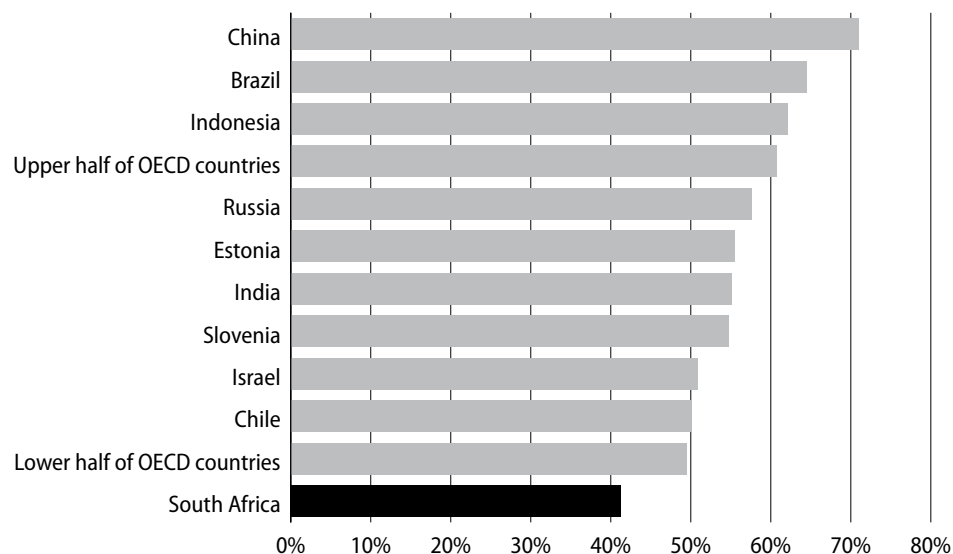
The issues involved are complex, and sometimes quite technical (see box, page 12). The workshop sought to address them as systematically as possible by addressing, first, the central importance of employment growth in shaping South Africa's long-term developmental prospects. Next, it dealt with the international experience of wage subsidies. It then analysed the effect of South Africa's existing labour market policies on employment levels. Finally, it examined the results of a number of attempts to model the impact of wage subsidies on the South African labour market and to estimate the costs and benefits of such a policy. While some issues of policy design were discussed, the main focus of the Round Table was the feasibility, desirability and possible impact of the proposed wage subsidy. This report summarises the presentations and discussions, followed by concluding comments.

In 2010, Pravin Gordhan proposed that a wage subsidy be introduced in order to reduce the cost of hiring young, inexperienced work-seekers

## UNEMPLOYMENT IN COMPARATIVE PERSPECTIVE

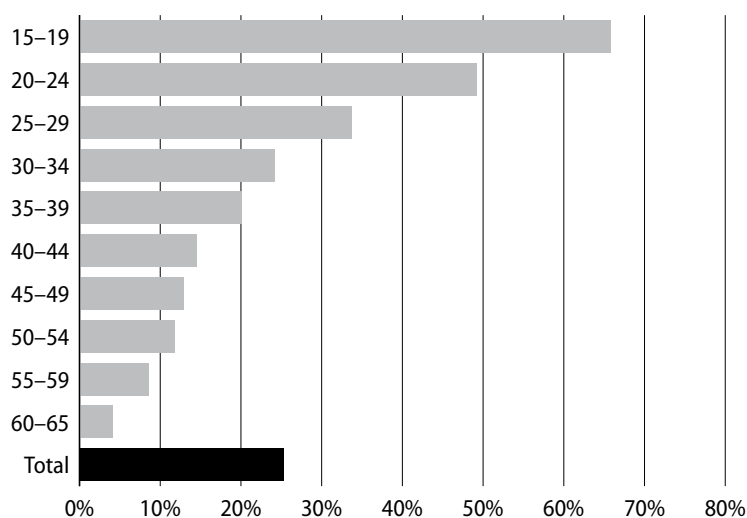
THE BEST indicator of the scale of unemployment is that only 41 per cent of adults have a job, a figure that is almost uniquely low in the developed and developing worlds (see figure 1). In Brazil, Indonesia and China, more than 60 per cent of adults work. Similar rates are also achieved by the world's richest countries.

**Figure 1: The employment rate in SA and selected countries, 2008**



Source: OECD, Economic Survey: South Africa, 2010 and OECD, Economic Policy Reforms: Going for Growth, 2010.

**Figure 2: Unemployment by age group, 2010**



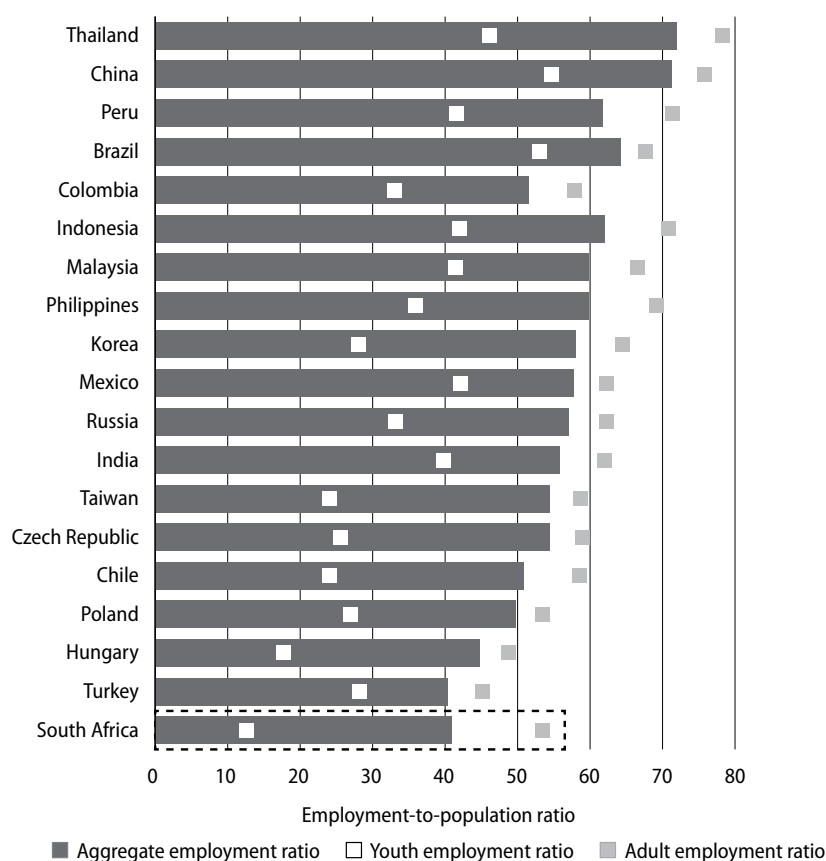
Source: Statistics South Africa Quarterly Labour Force Survey, September 2010.

Only 41 per cent of adults have a job. In Brazil, Indonesia and China, more than 60 per cent of adults work

The burden of South Africa's crisis of unemployment is shared unequally. Men are more likely to be employed than women (48 per cent to 35 per cent) and white people are more likely to be employed than Africans (66 per cent to 37 per cent).<sup>1</sup> Levels of youth unemployment are astronomically high (see figure 2).

In fact, at less than 15 per cent, employment levels for South Africa's youngest workers are lower than those in any other country with recorded statistics (see figure 3).<sup>2</sup>

**Figure 3: Youth and adult employment-to-population ratios in SA and selected emerging market economies, most data from 2009**



At less than 15 per cent, employment levels for South Africa's youngest workers are lower than those of any other country with recorded statistics

Source: ILO (Key indicators of the Labour Market, 6th Ed.), Statistics SA Quarterly Labour Force Survey, June 2010.

## Opening remarks

**Ann Bernstein**

*Executive Director, CDE*

THE SUGGESTION by the Minister of Finance that South Africa should consider introducing a wage subsidy for young people has opened the door to a rational discussion of a set of issues which – given the extent of unemployment – are vital to the economy and indeed the future of our country. Central among these are the cost of employment, and its impact on job creation and economic growth.

Many questions arise, but the most important is this: is a wage subsidy the best way of getting more young people into jobs? Will it displace other workers, and how might it affect the costs of employing them? Will it create jobs at the scale the country needs? Can

Is a wage subsidy the best way of getting more young people into jobs?

### KEY TERMS

While we have sought to restrict the use of technical language, we need to introduce and define a few key terms.

Governments around the world subsidise the full costs of employment in many ways. One could argue that almost any business subsidy or tax concession is a mechanism for lowering production costs, and that it is, therefore, a form of employment subsidy. A wage subsidy, however, can be defined as a direct contribution by government to the income (whether before or after tax) of an employee of a private company.

Wage subsidies may be either *general* or *marginal*. A general subsidy applies to all workers, while a marginal subsidy is paid only to workers hired in the course of expanding an existing workforce.

Wage subsidies can be more or less closely *targeted*. A targeted wage subsidy applies only to workers of a certain class, defined in terms of income, age, geographic location, employment in a particular industry, or some combination of these. For example, a wage subsidy could target workers earning less than R50 000 a year, who are younger than 25 and are working in the manufacturing sector. Although this would be a targeted subsidy, it would still be a general subsidy because it would apply to all workers of this particular class. It would be a marginal subsidy, however, if it applied only to newly hired workers who met the other criteria.

There are many different ways of introducing a wage subsidy, each of which creates different incentives and administrative burdens. One common approach is to provide tax credits to individual taxpayers. These are designed to boost the after-tax income of people earning small salaries. Another approach is to provide job-seekers with vouchers to be cashed in by their new employers. A third approach is to provide tax credits to the employers of low-wage workers. In addition, some training subsidies – including those offered to support learnerships in South Africa – operate as *de facto* wage subsidies in that employers can earn back some or all of the value of an employee's salary if that employee is provided with training.

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low-wage jobs not be created without subsidies? What will this cost taxpayers? Should public money not be spent in other ways?

We also need to establish whether it would make sense to spend a lot of money on a wage subsidy for young people while persisting with other policies that raise the risks and costs of employing them.

The government's proposal is a tacit admission that employment costs matter; that the more expensive it is to employ people, the fewer people will be employed. The argument is that a wage subsidy, by reducing the costs firms incur when they employ someone, might induce them to employ more people. This is one of the reasons why CDE supported the idea of such a subsidy in our 2008 project on how the country might create five million new jobs.<sup>3</sup> We said the country should – amongst other initiatives – experiment with the impact of such a subsidy to assess how employers and new investors respond to this method of reducing the cost of employment (see box, this page).

Once we accept that employment costs matter, we need to ask whether wage subsidies are the best way of reducing them. Are there other ways to reduce costs? Is shifting some of the costs of employment from employers to tax-payers the best approach? And if employment costs matter enough to justify subsidising them, shouldn't we reject out of hand any policies (current or new proposals) that raise these costs?

Some argue that a wage subsidy is preferable to other ways of reducing labour costs because it is undesirable and politically impossible to introduce reforms that would reduce workers' take-home pay. But the hostile reception that has greeted the Treasury's

Once we accept that employment costs matter, we need to ask whether wage subsidies are the best way of reducing them

## WAGE SUBSIDY PROPOSALS IN SOUTH AFRICA

In an attempt to find ways of dealing with growing unemployment, President Jacob Zuma announced a proposal for a youth wage subsidy in his state of the nation address in 2010. In February 2011, the National Treasury released a discussion document which set out the terms of a wage subsidy to be implemented from April 2012.<sup>4</sup> The proposal envisages a wage subsidy that will:

- run through the Pay as You Earn system operated by SARS (which means that it will only be available to registered employers and will be implemented through the provision on credits on their PAYE accounts);
- be available for young people aged between 18 and 29 earning below the personal income tax threshold R60 000; and
- be available for a maximum of two years.

The subsidy will be worth 50 per cent of a beneficiary's wage up to a monthly wage of R2000. Beyond that, the value of the subsidy will fall until it is worth nothing for individuals earning R5000 per month or more.

The Treasury estimates that such a programme will subsidise 423 000 workers, of which 178 000 will be jobs that would not have existed without the subsidy. This is projected to cost R5 billion over three years.<sup>5</sup> It also estimates that of the 423 000 subsidised workers, some 45 000 will drop out of the labour force after having benefited from the programme. The net result will be 133 000 more people employed in South African in 2015 than would have been the case in the absence of the wage subsidies. Each new job will have cost R37 000.

If employment costs matter enough to justify subsidising them, shouldn't we reject out of hand any policies that raise these costs?

In 2009, as part of its Five Million Jobs initiative, CDE proposed a number of policy experiments, including implementing a combination of tax breaks and labour law exemptions for firms hiring first-time employees between the ages of 18 and 24.<sup>6</sup> The report was supported by Business Leadership South Africa, while James Motlatsi, deputy chairman of AngloGold Ashanti and former president of the National Union of Mineworkers of South Africa, and Jayendra Naidoo, former chief executive of Nedlac, spoke at the launch of the report and helped to promote its ideas.

In 2006 the International Growth Advisory Panel, commissioned to advise the National Treasury, and consisting largely of economists from Harvard University, proposed a two-year subsidy of between R700 and R1 000 a month that would subsidise the cost of hiring 18 to 24-year-olds.<sup>7</sup>

Responses to these proposals have been mixed:

- COSATU rejected direct wage subsidies, claiming they would create a two-tier labour market in which some employees would be protected by labour law and others not.<sup>8</sup> COSATU appears to be concerned that the wage subsidy will displace full-time employees in favour of cheaper labour, and will encourage employers to get rid of workers when the subsidy falls away. These sentiments have been shared by the National Union of Metalworkers of South Africa as well as the Young Communist League.
- FEDUSA, a federation of trade unions, has come out in support of a training-based youth employment subsidy for employers which implement apprenticeship and learnership programmes.<sup>9</sup>
- The official opposition, the Democratic Alliance, has expressed support for a youth wage subsidy, and proposed that the country implement a pilot project.
- The idea has also drawn cautious support from some private sector economists – some of whom expressed concern that the subsidy could increase the administrative burden on businesses – and, previously, from the OECD.<sup>10</sup>

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proposals in certain circles – and which may result in long delays in the possible implementation of such a wage subsidy – raises doubts about whether introducing a wage subsidy will be any easier. Given this, should we not try to address the roots of the unemployment crisis head-on rather than by subsidising the wages of unskilled and inexperienced workers?

In a country like ours, in which debates are so heated, we need to find ways of breaking through the logjam. One way of doing this would be to conduct a series of experiments to establish which measures work and which don't. We could introduce a wage subsidy in one region of the country and other measures – such as reducing the regulatory burden on employers, or exempting firms from Bargaining Council agreements in which they were not participants – in another. In this way, we could establish what the practical effects of these approaches are, and which could and should be applied on a national scale.



# Why developing countries should maximise employment growth

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**Prof Paul Romer**

*Fellow, Stanford Institute for Economic Policy Research*

EVERYONE AGREES that the goal of development is for everyone to live a satisfying life. The real debate is about the means of getting to this goal. And, in thinking about the means, we have to recognise that some people are much further away from this goal than others. A key policy goal, then, must be to try and address the needs of those people who are furthest from this goal.

What I want to argue is something which notable economists like Edmund Phelps and Hian Teck Hoon have emphasised: that jobs in a market economy are central to living a satisfying life. The most important reason why this is so important is that jobs generate wages and income. But jobs do more than that: they also generate skills. The skills learnt on the job, especially by young people who haven't worked before, are a vital part of the way in which jobs raise the lifetime satisfaction of individuals.

You can see that by thinking about schooling. You could think of education as being like a job. In fact, it's a pretty demanding job. Cognitively, it's not easy. It takes up a lot of time. It's frustrating for many people. And, worst of all, it is unpaid. Yet it's a job we want everyone to have; in fact, we compel people to have it. The skill-formation role of jobs could be seen as just as important as this.

Everyone knows that many people have been poorly served by South Africa's education system. Unfortunately, most adults who have endured this can't go back to school. So, as important as it is to improve the effectiveness of the school system for the next generation, you also have to help people who are beyond school-going age. For them, the skills formation aspect of employment is even more important than usual.

Besides skills and income, jobs also provide a kind of a dignity and satisfaction that is quite subtle and difficult to measure. The mere fact of accomplishing something at work, producing something, even in difficult work environments, brings with it a sense of dignity and accomplishment.

Then there is the social dimension, particularly the sense of inclusion that comes with having a job. This is not an easy concept to define, but it has something to do with everyone feeling as if they are playing the same game by the same rules. In many countries, there are social and statutory rules that are deliberately exclusionary. In Dubai, for example, temporary workers are treated very differently from permanent residents, and are really second-class citizens. In many countries, the same could be said about women. This is bad for the people treated in this way. Arguably, it is also bad for the people who are most advantaged.

In South Africa, the problem now is not that the laws explicitly discriminate against people; it is that some of your laws implicitly discriminate against people who are dealt the worst hands. It's as if the rules say, 'You can only participate fully in the game if you have been dealt a good hand.' That's about the same as having rules that say some people don't

Having a job is central to living a satisfying life

The proportion of adults who have work is a much better measure of participation and inclusion than inequality or unemployment levels

get to play at all. It's not a question of rules excluding people explicitly. They do, however, have the implicit effect of marginalising or excluding some of your most vulnerable people.

A key measure of inclusion is the extent to which people are able to get work. Having a job is the sign that one is allowed to play in the game of the market economy. That's why I think the proportion of adults who have work is a much better measure of participation and inclusion than inequality or unemployment levels. Thinking about inclusion in this way has important implications. Brazil, for example, is very unequal when one uses the Gini coefficient, but almost 70 per cent of people of working age have a job. South Africa is just as unequal, but only 40 per cent of adults have jobs. By this measure, Brazil is much more inclusive than South Africa.

In principle, it's possible to try to reduce inequality in South Africa through cash transfers from rich to poor. This could address the lack of income from employment. But I doubt whether it would deal with the extent to which so many people are denied an opportunity to participate in the economy.

A comparison with Brazil also shows the extent of South Africa's challenge. Five million new jobs, which is what the New Growth Path promises, would be an enormous achievement. But it still wouldn't get you to the same level of employment per capita as Brazil.

So how could a society approach the issue of employment and income growth? Essentially, there are two broad approaches: one is to insist on creating only high-quality jobs, and to make quality the focus of one's policies. This is the 'decent work' agenda. The second is a 'quantity first' strategy in which you start by maximising the ratio of employment to population, after which productivity growth raises wages.

One way to understand the Asian model of development is to say that its main characteristic has been the aggressive pursuit of large numbers of jobs. These have often been low-paying, but they have gone after employment growth first, and allowed productivity and income gains to come later.

The big problem with the 'quality first' approach is that higher wages usually lead to fewer jobs. This isn't always true: in some sectors, such as mining, in which resource rents can be shared between business and labour, wages can sometimes be raised without reducing employment. As a general rule, though, higher wages will preclude a given society from generating certain kinds of jobs, and many, many employment opportunities.

High wages may be less harmful in mining because producers can't really go anywhere else. However, if a society insists on paying similar wages in other sectors, some of them will not exist at all. It's not possible, for example, to attract garment manufacturers and also insist that they pay wages similar to those in mining.

Importantly, slightly lower wages than those paid in mining will probably not generate many jobs because they are still well above the levels that will attract light manufacturing. That might explain why studies of your labour market report very low elasticities of demand for labour. But if the wage adjustments were large enough, you might get a significant employment response. In fact, millions of jobs could be created in light manufacturing if conditions were made attractive enough for firms to relocate to South Africa.

This is vital because it would help South Africa deal with one of the areas in which it has struggled, namely exports. Export growth has been a real problem here, but there are no economic reasons why you couldn't aspire to the same export levels as China. And a wage subsidy could play an important role in helping to expand the tradable goods sector.

A subsidy could be used to attract firms that could rapidly expand exports and employment, while keeping the take-home pay of workers relatively high. It could help grow employment without lowering wages too much. But it might have to be a large subsidy.

The problem with a small subsidy might be that the employer's costs might remain too high. A larger one, however, could end up being very expensive, especially if it was offered across all sectors of the economy and to all workers. But you could reduce the fiscal costs of the subsidy by targeting it at young people or at the tradables sector (ie, the economic sector which produces goods that can be exported or replace imports). Or it could be a marginal subsidy aimed at new employees in the tradables sector. This will come up in the discussion later, but targeting something like manufacturing, and even targeting exports only, might make the programme significantly more cost-effective.

In fact, you could even apply a wage subsidy only to new investors that manufacture exclusively for export. For them, wage subsidies might be a very attractive proposition, akin to other kinds of generous investment promotion schemes. At the same time, there might be important complementary policies that you could think about. For example, better infrastructure might raise the wages a manufacturing firm would be willing to pay because other costs would be lower. One important aspect of this approach might be to promote effective urbanisation, which is an investment that pays a very high return. That is part of the story of the success of both Brazil and China. Getting urbanisation right is a vital supporting policy that could improve the effects of a wage subsidy.

To conclude: it's very important to increase inclusion, defined by per capita employment levels. There are many reasons for saying this, but one of the most important is that there are other benefits associated with high levels of employment, including the acquisition of skills across the workforce. This is crucial for growth down the road.

## PANELIST

### Lesetja Kganyago

*Director-General, National Treasury*

DEVELOPMENT economists, myself included, often take simple concepts and complicate them. So when people talk about growth, we add adjectives to it such as 'inclusive', 'job-creating' or 'participative'. Developing an economy is already complicated, and the more adjectives you add, the more complicated it becomes.

South African policy-makers have tried to grapple with the concept of inclusion. We say we want 'inclusive' growth. But how do we understand this? Usually, we approach it from the point of view of trying to deal with inequalities with respect to asset ownership. So when we talk about inclusion, we say, 'Let's change the ownership structures of the economy'. But South Africa has a very skewed distribution of income, because we have too few people who work. That being so, if South Africa is to deal with the issue of inclusion, we had better talk about creating jobs.

A core challenge we face is the division between insiders and outsiders in the economy. You can see how important this division is in our tax collection: in the past year, South Africa has shed jobs, but the personal income tax take has gone up. Why? Because those who are still employed are earning more.

Even in the period of rapid growth, we didn't raise the ratio of employment to population as much as we could have. But we did create jobs. And this created a controversy, because some people said, 'Oh, but what kind of jobs were they?' My view was that it's a

It is important to promote effective urbanisation, which is an investment that pays a very high return

very important discussion to have, but mainly because in the period before that, no jobs were created. So debating the quality of jobs at least reflected the improved performance of the economy.

Using the ratio of employment to population as a measure of inclusion would help to change the way in which we make public policy. At the moment, South Africans are obsessed with the Gini coefficient. We can't measure it properly, but we have included it in ministers' delivery agreements.

The current public policy discourse has made a difficult task even more difficult. We have shed jobs, but we insist that we want to create only 'decent jobs,' which means there are some kinds of jobs we don't want. The example of Newcastle is quite striking – particularly because it was workers who rebelled, saying, 'You are not going to take our jobs away even though they don't pay minimum wages.'

The debate about a wage subsidy has raged for months. One issue that arises is whether it will help create a second tier of the labour market. I don't understand this view. All a subsidy does is enable a firm to employ more people or to pay them more. Having said that, a wage subsidy cannot be a panacea. We will need other interventions, such as public works programmes. A wage subsidy wouldn't exclude this, but could play a very helpful role.

## GENERAL DISCUSSION

THE DISCUSSION focused largely on the extent to which it was appropriate for South Africa to focus on expanding the number of jobs irrespective of their quality, with quality defined in terms of both wage levels and job security. Some participants argued that it would be better for South Africa to create better-paying, higher-quality jobs, and that it could do so by adopting the right set of policies. Questions were also raised about the viability of a low-wage growth path. Key points included:

- Employment growth before the recession consisted largely of low-quality jobs, many of which simply evaporated when the economy stopped growing. This is characteristic of these kinds of jobs.
- Vulnerable, low-paying jobs did not build significant, portable skills.
- Jobs in which people did not feel secure and which offered little prospect of further training or career progression would inevitably create a class of workers whose productivity would not improve, and whose employment would therefore end the moment a wage subsidy were withdrawn.

Some participants questioned whether a wage subsidy would boost investment. Other cost-related incentives, including tax incentives, had been offered to investors in the past, but did not result in new investment. A wage subsidy was a similar form of 'tinkering' and it would be a mistake to expect better outcomes.

By contrast, others argued that the reason why businesses did not create more jobs were the disincentives implicit in the laws regulating the labour market. These encouraged employers to retrench workers and adopt more capital-intensive production techniques. A wage subsidy would have to be very large to offset these factors.

Others noted that a wage subsidy would not address the most important cause of the lack of jobs, namely low levels of economic growth. If the main reasons for this were poor

We have shed jobs,  
but we insist that we  
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'decent jobs'

infrastructure (especially transport and electricity) and the lack of skills, a wage subsidy would do nothing to increase employment growth. Therefore, it might be better for South Africa to spend its resources on infrastructure and other constraints on growth rather than on a wage subsidy.

While many participants agreed that growth was a crucial variable in determining how much employment would be created, one suggested that this was not a reason to dismiss a wage subsidy for low-wage workers: 'It is correct that a wage subsidy won't work without addressing the structural impediments to growth. But the opposite is also true: that a growth strategy will not work without a wage subsidy. The reason for this is that I would add one more factor to Prof Romer's list of the good things delivered by employment – skills, dignity, income, inclusion – namely economic growth. Unemployed people are by far the largest unused resource in our economy. We have to have a growth strategy that brings more people into work, otherwise our growth is going to fail. So it is wrong to set up growth strategies in opposition to wage subsidies. In fact, by getting people into work, and helping them acquire skills, a wage subsidy might be needed to bring people into employment.'

Responding to some of these arguments, Prof Romer agreed that putting unused resources to work presented South Africa with a big opportunity to grow quickly. But this was not the only growth effect that a wage subsidy could have. If a wage subsidy succeeded in getting unemployed and inexperienced people into real jobs, it would also improve the skills profile of the South African workforce. From this point of view, a wage subsidy would not just create jobs and stimulate growth, but would also improve productivity and, in that way, South Africa's growth potential. However, trying to accelerate growth only by improving productivity would ignore the enormous gains that could be made just by putting unused resources to work. Because unemployed people also tended to be unskilled, they were most suitable for low-skill, light manufacturing industries. Trying to improve their skills to make them suitable for other industries would be costly, slow and ineffective.

Trying to accelerate growth by improving productivity would ignore the enormous gains that could be made just by putting unused resources to work

## Singapore's use of wage subsidies

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### Prof Hian Teck Hoon

*Associate Dean, School of Economics, Singapore Management University*

SINGAPORE comprises 700 square kilometres against South Africa's 1,2 million, and we have 4,8 million people while you have ten times as many. These differences in scale may have important consequences for economic policy, but Singapore's experience with wage subsidies may still be helpful for you.

### Singapore's wage subsidies

Singapore has implemented two kinds of wage subsidies. In 2007 we introduced what is today called a Workfare Income Supplement (WIS), in terms of which the government boosts the income of 20 per cent of workers who earn the least by up to 20 per cent if they work for at least six months a year. This subsidy is designed to encourage people to work.

In order for South Africa to close the gap between living standards here and those in the developed world, it will need a long period of 'catch-up growth'

In 2009, in response to the global recession, we implemented a second kind of wage subsidy, which quickly rose to consume about 2 per cent of GDP. It sought to increase the demand for labour by providing that employers who did not retrench anyone would be entitled to a subsidy for low wage workers. This could amount to 12 per cent of payroll. In this way, government hugely subsidised employment, and, despite negative economic growth in 2009, employment levels did not fall much. This programme – which was intended to be countercyclical – is now being phased out, with the value of the subsidy falling through 2010.

Of the two programmes, the WIS is more structural in character. It is not welfare because recipients have to work, but it has encouraged low-skilled workers to look for work. If they do, they enjoy higher incomes.

Unskilled workers in Singapore tend to be our older workers – people like my father who missed school and entered the workforce early. They don't benefit from the salaries paid to high-skill workers. This is why the scheme applies only to workers older than 35 who earn less than \$1 700 a month. The programme has recently been expanded so that all those who qualify for income support also qualify for training support, which is paid to employers to cover workers' absence while they are attending training programmes. The effect is to help people who would be paid very little by the market because of the skills bias in our economy, especially because many low-skilled industries have moved to Vietnam or China. This has resulted in increased wage inequality, which the wage subsidy helps to reduce.

### Catching up to the US in three decades

In order for South Africa to close the gap between living standards here and those in the developed world, you will need a long period of 'catch-up growth'. This is something Singapore managed in three decades. One of the prerequisites was that all interest groups in our society agreed on how this should be done.

People often say that Singapore's only resource is its people. We don't have mining. We don't have agriculture. At independence in 1965, there were two things that bothered the new prime minister. The first was the number of people without jobs, which was about 14 per cent, but might have risen further when the British, whose troops contributed 30 per cent of our GDP, pulled out. The second was housing: Singapore is a very densely populated island, and many people lived in slums.

This was the context in the 1960s. But, by the 1980s, unemployment was down to 3 per cent. Now, if one makes the appropriate adjustments to the exchange rate, living standards are higher than those in the United States.

This process of catch-up has really been one of shifting comparative advantage. In the 1960s, employment rose because manufacturing firms (textiles at first) started to base their operations in Singapore. This was low-skilled work, but it lifted the incomes of the poor. In the 1970s, we began to produce simple electronics. Then we moved to making hard drives and semi-conductors. Now the semi-conductors have moved out. And so, in each decade, Singapore moved up the ladder of comparative advantage, with very positive implications for average wages even for the unskilled. Recently, globalisation and skills-biased technological change have put pressure on the wages of low-skilled workers. But the broader trend has been one of rising wages and a shrinking wage gap.

### Three key factors for success

In the 1960s the conventional wisdom in the development literature was that developing countries needed to adopt an import substitution strategy. Singapore rejected this. We realised that the only way in which a country of 3 million people could thrive was to woo multinational corporations. The policy was very unpopular: we were a newly independent nation, and the prime minister was acting like a salesman trying to attract foreign companies. Then, bit by bit, companies came, and we established a reputation for reliable infrastructure, secure electricity supplies, good roads, and so on. And growth followed, so that today we export capital.

This lesson remains valid: catch-up growth can be attained by integrating your economy into the world economy. Today, production is broken into multiple supply chains, and there is a lot of potential to produce something for companies whose headquarters are elsewhere but which want to manufacture where labour costs are low.

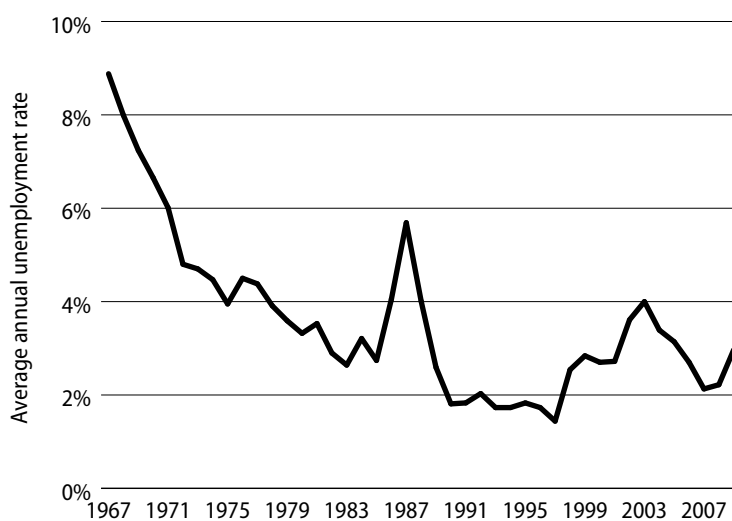
This ties in well with the idea of a wage subsidy. You want a wage subsidy both to boost employment as much as possible, and for a large portion of it to be passed on to workers. Singapore's experience is that a wage subsidy does boost take-home pay if labour demand is elastic, which it is in export-oriented light manufacturing.

The second important strand in the story of Singapore's development has been the role of the labour unions. In the 1960s there were lots of strikes, which is not conducive to attracting multinationals. In response, the prime minister sought to build greater trust between trade unions, business and government. An example of the importance of this was the recession in 1986, when unemployment spiked. The policy response was to reduce employers' costs of employing people, which is exactly what a wage subsidy does.

At the time, employers contributed 25 per cent of a worker's pay to a retirement fund, with the employee contributing a further 25 per cent. The key response to the 1986 recession was a 15 percentage point cut in the employer's contribution. As a result, unemployment dropped rapidly (see figure 4).

When unemployment in Singapore spiked in 1986, the policy response was to reduce the costs of employing people

**Figure 4: Unemployment in Singapore, 1966–2008**



Source: Ministry of Manpower, Labour Force Survey except for June 1995 and 2005 (General Household Survey) and June 2000 (Census of Population).

There is a serious misalignment between employment costs and productivity among young people.

The vital point is that it was workers who paid for this. The government did not make up the difference, so cutting the employer's contribution meant that there was less money going to an individual's retirement fund. Workers accepted this only because they understood that reducing employment costs would save jobs. This was why they were willing to sacrifice some future income.

That is the second part of Singapore's story. We have created a social consensus of give and take in dealing with economic shocks, which we often address by lowering the costs of employment. We did this in 1986 and again in 1998, when employers' contribution to retirement funds was cut once again. At the time their contribution was 20 per cent of salaries, and that was cut in half. Something similar happened in 2003. The big difference between these events and the introduction of a direct wage subsidy in 2009 is that, until then, reductions in wage costs had effectively been paid for by workers themselves. Only in 2009 did the government pay the bill for lowering employment costs through subsidies. Still, we have always fought recessions by reducing the cost of employment, not by other kinds of fiscal stimulus.

The final element has been government. Right from the beginning, the government understood that even if it supported industry, it should not try to protect existing firms and workers at the expense of inhibiting industrial restructuring. If we did that, we would not move up the value chain. So, even when particular firms and jobs were lost, the government did not try to help save them. What it did do was to help on the supply side.

One example is the story of the last decade, which has seen the emergence of bio-medical firms. The government has aided this by providing scholarships for gifted students to study at the best universities overseas. The government has also been very good at talking to business and making sure that it understood its needs, so that we could attract new industries and open up new markets.

## PANELISTS

### David Faulkner

*Director: Growth Policy, National Treasury*

THE TREASURY'S view is that we should be looking at a youth-targeted wage subsidy. We know that unemployment levels in that group are 50 per cent and more. We also know that 20 per cent of young people who had jobs lost them over the past two years. These are significance challenges.

There is a serious misalignment between employment costs and productivity among young people. Whether it is productivity that is too low, or costs that are too high, this is the challenge. One or the other must be addressed, either by raising the productivity of young workers, or adjusting the cost of employing them.

In this regard, consider that minimum wages in OECD countries are typically about 40 per cent of the median wage. In South Africa, they are 62 per cent. This leaves very little room for employers to reduce wages to reflect the much lower productivity levels of inexperienced workers. Other countries also have age-related minimum wages, so that young workers can be paid less. South Africa doesn't make this concession.



It's not easy to fix a misalignment of employment costs and productivity, but a youth-targeted wage subsidy could be an important tool. The essential idea is that a subsidy will help young people access jobs and gain experience so that their skills develop. The subsidy would be temporary to reduce cost, but long enough – two years – so beneficiaries gain the skills. At that point their productivity will be higher, and the misalignment will be addressed so that firms can hire them at full wages.

A wage subsidy is just one facet of a much larger set of policies that have to be implemented. By itself, it could have a large impact on employment. But we have 2,5 million unemployed people between the ages of 15 and 29, so we will either have to run a wage subsidy for a very long time, or we are going to need a plethora of interventions. These would include the Expanded Public Works Programme, youth brigades, skills development, and improved employment services that assist in job search and matching. We have to find a way for all these interventions to work together to create jobs in the most cost-effective and sustainable way. This means getting young people on to schemes that create permanent, full-time employment, primarily in the private sector.

## Prof Charles Simkins

*Head of School, St Augustine College of South Africa*

THE ROLE and impact of a wage subsidy depends on the context in which such a policy is implemented. Its impact would depend on how it articulates with reform of the labour market regime, as well as education and social policies. There are other factors, but I will only deal with the issues of how a wage subsidy should fit in with labour market and with educational and social policies.

### A wage subsidy and education reform

How a wage subsidy articulates with education policy is an important issue, especially if it is targeted at new entrants to the labour market and young workers. The first development that may be relevant to the design of a wage subsidy is the reform of the senior certificate – the exit qualification from Grade 12.

Under the old system, one could pass either with or without an endorsement for university study. This has been replaced by a three-level classification: you can pass with permission to go to university, permission to study for a diploma, or permission to study for a certificate. Each category receives roughly a third of all those who pass the senior certificate exams.

Government plans to expand further education and training colleges. These enrol about 550 000 people today, but the aim is to double this by 2014. This will not be easy, and may worsen the already bad ratio of students to educators.

Then there is the question of the responsiveness of the higher education institutions to these changes. This varies: Wits University, for example, is much more interested in undergraduate and postgraduate degrees, while the University of Johannesburg has a bigger trade in certificates and diplomas. But there may not be sufficient diploma programmes for those who qualify.

So there is a lot of uncertainty about how these changes will play out in the medium and long term, and what they will mean for the skills profile of the unemployed. We also don't know how these qualifications will impact on the ability of young people to find work.

The essential idea is that a subsidy will help young people access jobs and gain experience so that their skills develop

Trade unions are concerned that a wage subsidy might be the thin edge of the wedge for lowering wages across the system

## Reform to the labour market and social policies

An important factor in designing a wage subsidy and assessing its impact is what else is being done in and to the labour market. There is, for example, talk about the possible implementation of a grant to support job search. That wouldn't necessarily be a wage subsidy, but it could impact on employment.

Another issue is the possible impact of a more generous unemployment insurance scheme, which might involve increasing the costs of unemployment insurance paid by employers even as wage subsidies come on stream. Similarly, we need to think about the impact of changes in social insurance. If, for example, it becomes mandatory for all employed people to save for their retirement, the system would probably require a wage subsidy for low-wage workers. This would seek only to protect take-home pay for current employees, but it might impact on the design and affordability of a wage subsidy aimed at boosting employment.

Then there are institutions such as Sector Education and Training Authorities. In principle, these could be disbursing large sums for training and, in the process, subsidising the wages of people on learnerships. But success has been mixed. The wage subsidy would also have to articulate with the Expanded Public Works Programme.

Finally, there are the trade unions. South African trade unions are very concerned that a wage subsidy will result in subsidised employees displacing existing workers. They are also concerned that a wage subsidy might be the thin edge of the wedge for lowering wages across the system. Whether these are reasonable concerns depends on the particular form of wage subsidy.

The fact that our product market is dominated by large firms is also an issue that designers of a wage subsidy need to think about. If there were more competition, it is doubtful that wages in the formal sector could be as high as they are. Greater competitiveness in our product market would change the landscape for trade unions, whose bargaining power would be reduced.

The bottom line is that there are many uncertainties in the policy and economic environment, and it's not clear that a wage subsidy will articulate well with what emerges from these dynamics. One concern, for example, is that a wage subsidy might result in the growth of firms that are not economically viable in the absence of a subsidy.

## Milan Vodopivec

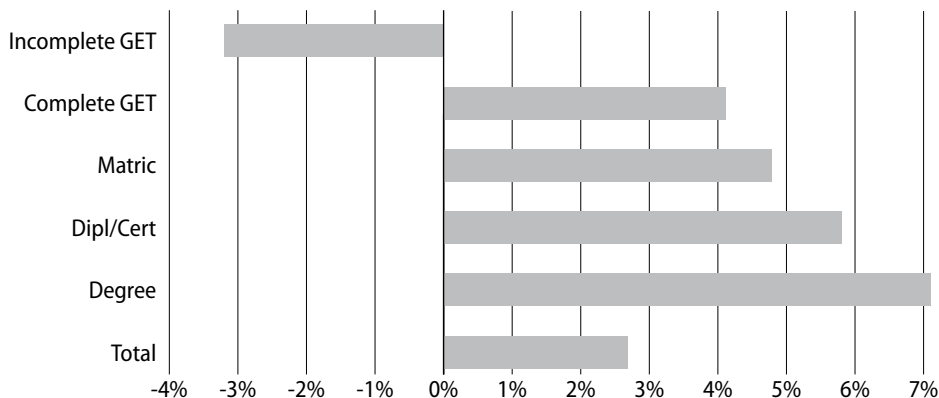
*Lead Economist: HD Sector Leader, Human Development Network,  
The World Bank*

THERE IS something fundamentally wrong with a growth path that has generated as few jobs as South Africa's. By itself, this kind of growth will not take care of unemployment. But South Africa can and should adopt policies that will help to do so. A wage subsidy is an option. Whatever policy is chosen, however, it is important not to lose sight of existing labour market imperfections, which must also be addressed. Another issue that must be addressed is skills-biased technological progress.

Post-apartheid South Africa has created 3 million jobs, but employment creation has been much faster for workers with degrees than for people with general education and training. In fact, since 1994 South Africa has lost jobs for people with incomplete general education and training. While jobs for people with degrees have grown by about 6 per

cent a year over the last 15 years, they have fallen by 3 per cent a year for people without a matric (see figure 5).

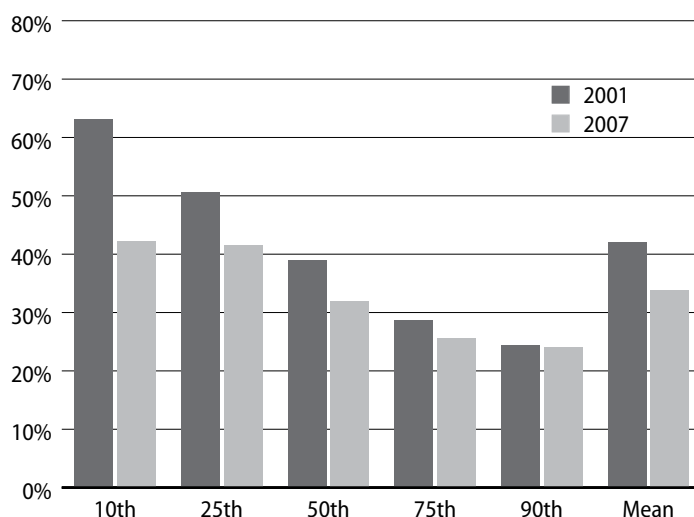
**Figure 5: Average employment growth by education level in South Africa, 1995–2009**



Source: H Bhorat and N Mayet, Labour demand trends and the determinants of unemployment in South Africa, DPRU, 2010.

Then there is the question of union power and the associated wage premium. Figure 6 shows that wage premiums are highest at the lower end of the wage scale. This must be addressed. These premiums go a long way to explaining why the labour market doesn't clear, leaving so many people unemployed, especially young people.

**Figure 6: Union wage premiums in South Africa, 2001 and 2007**



Source: H Bhorat and N Mayet, Labour demand trends and the determinants of unemployment in South Africa, DPRU, 2010.

Would a wage subsidy help to fix this? In the United States, a wage subsidy implemented between 1979 and 1994 enrolled 9 per cent of eligible youths, and created 13 to 30 per cent more jobs than would have been created otherwise. Belgium's experience also shows that

While jobs for people with degrees have grown by about 6 per cent a year over the last 15 years, they have fallen by 3 per cent a year for people without a matric

In Singapore, workers were willing to forgo their rights in the 1960s because they knew that ten or 15 years later they would be much better off

wage subsidies can improve prospects for employment. However, a wage subsidy may be just one response to youth unemployment. Other promising options include providing training opportunities together with employment services such as job search assistance.

## Rudi Dicks

*Executive Director, National Labour and Economic Development Institute*

PROF HOON has correctly emphasised the importance of trust between social partners. In Singapore, workers were willing to forgo their rights in the 1960s because they knew – or trusted – that ten or 15 years later they would be much better off. But that kind of trade-off is not realistic in South Africa. If unions gave up their rights, they would wind up being worse off than before.

Singapore's unions accepted the sacrifice in the context of other major interventions in economic policy, including significant investment in light manufacturing, shifts to a hi-tech economy, and so on. There was a package of reforms, and they could support that package. Is this true in South Africa? What is our package? Which industries are we going to build?

South Africa is already on a low-wage economic trajectory. Data from the Labour Force Survey shows that about 19 per cent of workers in the formal sector earn less than R1 000 a month, while about 50 per cent earn less than R2 500. These people are predominantly in domestic service (which employs around about a million people), agriculture (which employs somewhat less), and business process outsourcing, including private security. This is a serious problem. In fact, the Expanded Public Works Programme – which pays between R60 and R75 a day – is now paying more than the minimum wages in agriculture and domestic services. The bottom line is that income is at crisis levels.

The big question is whether or not a wage subsidy will help to raise incomes and inclusion. One concern is that a wage subsidy targeted at young people might create a significant substitution effect. Older workers are part of unions and have negotiated better rights and wages. Employers would be happy to replace them with younger workers who qualify for wage subsidies because this would reduce costs.

There is also an idea that a wage subsidy should be tied to changes in the regulatory environment, and even the exemption of young workers from their statutory rights. This would exacerbate the insider/outsider problem because older workers would then have more rights than younger ones.

## Setepane Mohale

*Director: Economic Policy Development, Economic Development Department*

WE DON'T know how much we spend on developing young people, so we don't know how much we already target them. We do know that if you're an unemployed, under-skilled young person, the longer you're unemployed, the less likely you are ever to become employed. So, targeting young people through various measures is necessary. But we also need to worry about displacing older workers.

One issue to think about is how we ensure the quality of that training. We now have a lot of money going to training, but the quality and impact are questionable.

A wage subsidy has to be linked to a growth strategy, and that needs a social compact. Government cannot do it alone. This is at the centre of our thinking about the New Growth Path: that we need a social consensus and a common vision for growing the economy.

## GENERAL DISCUSSION

MUCH OF THE discussion revolved around the idea of linking skills-formation and the wage subsidy. Views diverged on this. One view was that a wage subsidy had to articulate well with existing policies. These did not always work optimally – for instance, learner-ships (which operate like a wage subsidy) had not been taken up very widely, but did generate recognised, portable skills. The danger with a system in which skills-formation was unstructured is that it would produce fewer skills and provide less mobility.

Against this, some participants warned against attempting to align too many objectives, which could lead to paralysis. It was also argued that the skills generated by employment were not the kinds for which certificates could be issued, but rather softer, work-related skills like punctuality and reliability. These skills were valued by employers and were learnt simply by having a job and an employer who imposes reasonable workplace discipline. They did not require training programmes, but were nonetheless essential. This being so, a wage subsidy that actually got people into work would generate valuable skills irrespective of any other policies or reforms that might be instituted.

Participants also discussed the relevance of the Singaporean experience to South Africa. One noted that Singapore's story was one of progressive movement up the industrial value chain, while the introduction of a wage subsidy for unskilled and inexperienced workers in South Africa could be interpreted as encouraging a move down the value chain. This could have two implications. The first was that, because a high-wage sector would continue to exist side by side with a low-wage one, some workers would continue to look for jobs only in the high-wage sector, thereby reducing the impact of the policy. A second issue was more political: some people might be resisting the idea of a wage subsidy because they believe this would mean that South Africa would not progress as smoothly up the value chain as Singapore had, and that our industrial and economic development would be discontinuous. This may explain some of the resistance to the idea of having the state support the expansion of low-wage work.

Other participants agreed that a wage subsidy could cause some discontinuity, but argued that this was desirable and inevitable. According to one, 'the idea that we will encourage employment growth by shoe-horning extra people into existing capital-intensive firms and industries is a complete misconception.' The mining sector, for example, had accepted as long ago as the 1980s that it could not continue on the basis of low-skill, low-wage labour, and that its workforce would become progressively smaller, better skilled and better paid. Existing industries could not absorb all the unskilled and inexperienced workers who had no jobs, so the challenge was to build new firms and industries that would be significantly more labour-intensive in their choice of product and production technique.

Another noted that it was precisely because the unemployed were unskilled and inexperienced that the emergence of new industries should be encouraged. This implied that the mix of firms would change, and that, on average, South African industry would be

The idea that we will encourage employment by shoe-horning extra people into existing capital-intensive firms is a complete misconception

Employers are  
enormously  
wage-sensitive

further down the value chain. But for individuals who had no prospect of employment by high-skill, high-wage firms, these more labour-intensive firms would actually represent a progression up the value chain. In fact, it is only in this way that further productivity and wage gains could be secured.

One participant noted that Singapore 'always subjected itself to the market test' This was achieved simply by asking multinationals what was needed to get them to invest in Singapore, and listening to the response. South Africa could also attract multinationals involved in light manufacturing. However, it would then have to ask Chinese and other firms about what it would take to bring them here. In the beginning they might say things that South Africans would not want to hear, but this might help to change the terms of the policy debate.

## The costs of existing regulation

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### EXPLAINING UNEMPLOYMENT

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**Loane Sharp**

*Labour Economist, Adcorp*

ADCORP IS South Africa's largest employment agency. Our main role is finding work for people, which we do for about 200 000 people a year. Of these, 92 per cent are African, 85 per cent are younger than 24, and 50 per cent have never worked previously. So our employees closely fit the profile which the wage subsidy is intended to address.

There is no definitive answer to the question of how sensitive employment is to wages, but over the past eight years an entry-level employee in our organisation has earned the same nominal wage. So an 18-year-old employed by us today earns the same as an 18-year-old with equivalent qualifications did eight years ago. Why is this? Because employers are enormously wage-sensitive. We can't raise the charge-out cost of providing people to them. And the rise in the costs of employment is precisely the reason why firms like mine have grown so quickly over the last eight years. We're one of the ways in which businesses try to keep costs down.

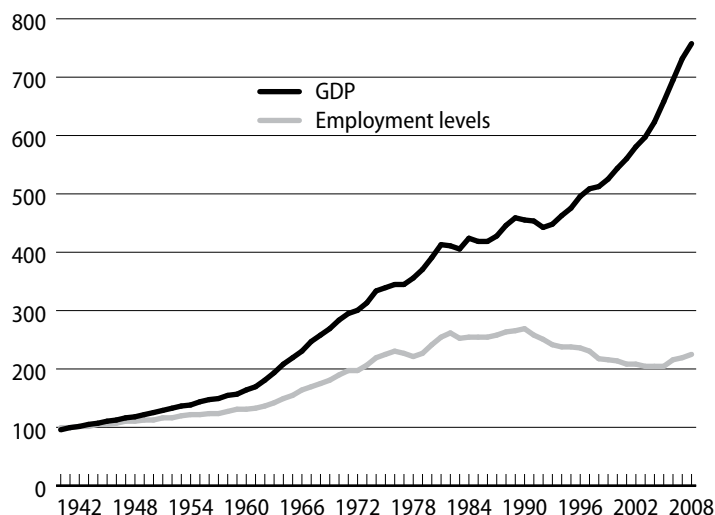
A wage subsidy is a potentially important intervention because it helps to reduce employment costs. But it does have defects. One is that it may keep other important policy issues off the table. It's a bit like the debate about skills shortages. At Adcorp we can convert an unskilled person into a skilled person in five to eight weeks. That is why we don't think the skills shortage is the fundamental cause of youth unemployment. However, by exaggerating the skills shortage in discussions of public policy, some of the most important issues – like the escalation of wages in our collective bargaining system, and the level of conflict and militancy in our labour relations – are kept off the table.

If youth wage subsidies do materialise, they will raise levels of youth employment only if they make a meaningful difference to South Africa's competitiveness. At the moment, if you look at data about the competitiveness of our labour, you get a mixed bag of results. By international standards, non-wage benefits are very low as a proportion of wages. The professional merit of our management is ranked in the world's top 20. We pay very low

severance packages. On the other hand, we score very low in the category of co-operation in employer-employee relations, largely because of trade union militancy. We fare just as badly when it comes to the flexibility of our wage determination process and the regulatory burden associated with hiring and firing.

Mixed bag though it is, you can see the net effect of changing regulations in the workplace by looking at the relationship between economic growth and employment growth (see figure 7).

**Figure 7: SA economic growth and levels of employment, 1940–2009**



Source: Reserve Bank data, processed and adjusted for anomalies by Adcorp, 2011.

Between 1940 and 1977 there was a close relationship between the economy and the labour market; economic growth generated good employment growth. Then, in 1978, the Wiehahn Commission proposed sweeping changes to the labour relations landscape. From that point on, the economy's trajectory and the trajectory of employment diverged.

The same thing happened after the introduction of the new Labour Relations Act in 1995. This was supposed to modernise South Africa's labour relations framework, but it widened the gap between rates of growth and rates of employment creation. Of course, this is just the flip side of rising labour productivity. What's interesting is the sharp falls in labour intensity in the three or four years after the Wiehahn Commission, as well as the Labour Relations Act. Those are the most obvious regulatory impacts we have had over the past 15 years.

Another key issue is that, since 2002, remuneration per worker has increased dramatically while productivity per worker has dropped (see figure 8). This is not an ideal employment creation scenario.

By way of conclusion, it's worth thinking about the consequences of present trends. To my mind, Julius Malema is not a historical accident. He has emerged because millions of people younger than 35 are not employed. His rhetoric gives one a sense of the direction our policies will take if we don't solve this problem.

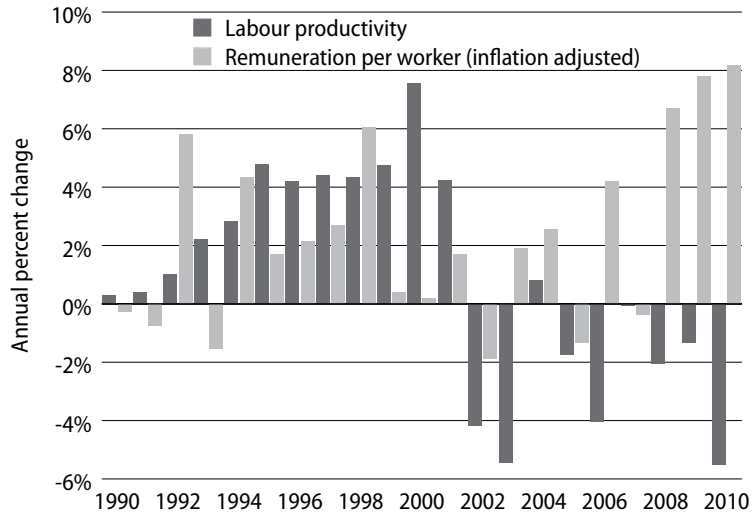
If you want to be really afraid, think about this: according to StatsSA, 6,2 million people are currently unemployed or discouraged. There are 5,6 million more people in the secondary and tertiary education systems who will look for work over the next five years.

We score very low in the category of co-operation in employer-employee relations, largely because of trade union militancy

Broadly defined,  
unemployment could  
exceed 45 per cent in  
eight years' time

Our estimate is that we will have jobs for no more than 2 million of them. If that happens, unemployment – broadly defined – could exceed 45 per cent in eight years' time.

**Figure 8: Labour productivity and remuneration, 1990–2010**



Source: South African Reserve Bank

## EMPLOYMENT TRENDS IN AGRICULTURE

**Dawie Maree**

*Economist, Agri SA*

AGRICULTURE accounts for about 2,9 per cent of GDP, but its linkages to other sectors raise its overall contribution to more than 15 per cent. That's why 1 per cent growth in agriculture leads to more than 1 per cent growth in the rest of the economy. But the sector has gone through a lot of changes which have affected its impact on the economy.

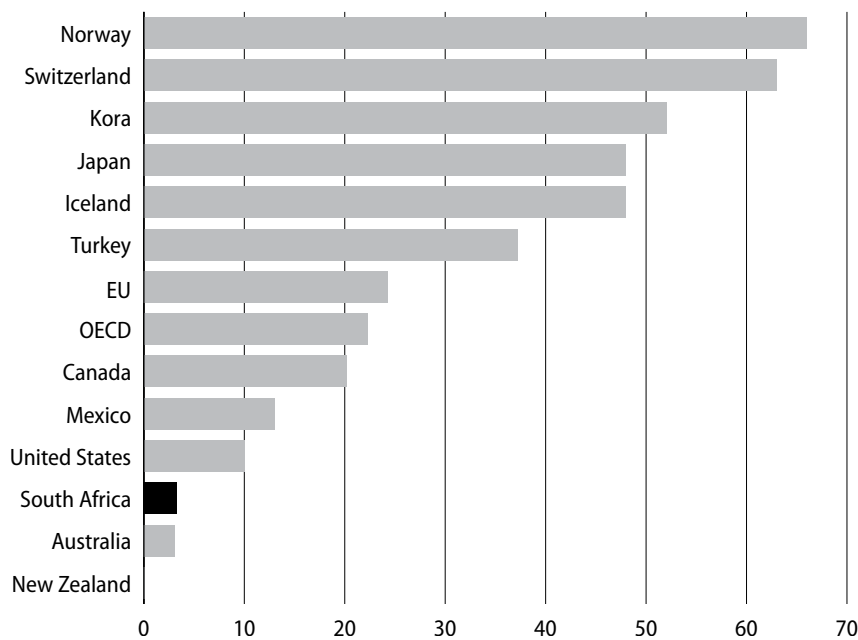
In 1996 there were 60 000 farms; today there are 40 000. The sector is also very much less labour-intensive than it used to be. It still employs about 640 000 people – or 5,1 per cent of workers – even though the absolute number in 2010 is about 20 000 less than the same time last year.

Labour costs are among the most significant of the sector's input costs. These include wages – the minimum is about R1 300 a month – as well as housing, transport support, training, health benefits, and recreation facilities. There are also some indirect costs of labour regulations which are very difficult to measure but can have a significant impact. For example, SARS has instituted new Pay-As-You-Earn regulations which require that every employee must be registered for tax purposes. This is an additional administrative burden on farmers. Then there are other additional costs like the proposed retirement, medical and funeral funds. There are also employment equity and skills development policies that must be considered. These labour costs are hard to control, so farmers look for other production methods such as increased mechanisation.



The South African agriculture sector receives less state support than those in most other countries with which we trade (see figure 9). In South Africa, farmers receive state support amounting to about 3 per cent of the value of our production. In the European Union, the figure is 24 per cent, and some countries provide even more. By that measure, there is definitely space for wage subsidies to help support agriculture.

**Figure 9: Support to agriculture in selected countries, 2009**



Source: OECD, *Agricultural policies in OECD countries*, 2010.

Labour costs are hard to control, so farmers look for other production methods such as increased mechanisation

## NEWCASTLE'S CLOTHING FACTORIES

### Alex Liu

*Chairman, Newcastle Chinese Chamber of Commerce*

I WOULD like to compliment you for inviting a criminal to be a speaker. I represent the Newcastle Chinese Chamber of Commerce. With 180 other alleged criminals, we employ about 18 000 workers, mostly in the textiles business.

Since the sewing machine was invented 100 years ago, the nature of the work of putting garments together has stayed the same. The operator has to take two pieces of fabric, line them up, and put them through the sewing machine. It's a unique industry, and it creates lots of jobs because you cannot replace the operator with a machine. No matter how good your machine is, you still need an operator.

This is what the United Nations Industrial Development Organisation has said about our industry: 'The South African textile and clothing industries constitute an important sector of South Africa's economy. It is the most labour-intensive sector of manufacturing,

South Africa's  
textile and clothing  
industries are the  
most labour-intensive  
manufacturing sector.  
The operators are  
predominantly  
female and black

and the operators are predominantly female and black. Therefore, this sector has a significant impact on gender equality, social inclusion and poverty reduction.<sup>11</sup>

Foreign investment in Newcastle took off in 1985 when the previous government provided incentives and land for foreign investors. Today, there are 24 000 workers employed in the manufacturing sector. The clothing sector alone has 8 000 workers.

But the South African clothing sector is in trouble. In 2003 it employed 206 147 workers; in 2006 the figure was down to 142 000. Today, we think the figure is between 80 000 and 120 000. We're uncertain of the exact number because many employers have gone underground as a result of the legal action instituted by the Bargaining Council. We know, for example, that in 2004 there were 1 488 companies registered with the Bargaining Council. In 2006 the figure was 1 270 companies. Of those, 60 per cent were deemed to be non-compliant with bargaining council decisions. Now there are 1 058 registered factories, 385 of which are being targeted by the Bargaining Council. In KwaZulu-Natal, 80 per cent of factories are non-compliant.

So who formed this Bargaining Council? And who sets and enforces its policies? When the Bargaining Council started it comprised seven employer associations and one trade union, SACTWU. Today it comprises only one employer association – the Apparel Manufacturers of South Africa (AMSA) – while SACTWU is still the only trade union. Interestingly, AMSA's members employ only about 40 000 workers, and SACTWU has a membership of about 50 000 or 55 000. Many, perhaps even most, of SACTWU's members work in non-compliant factories. Even so, it only represents about half the workforce.

Non-compliant factories are not permitted to participate in wage negotiations or policy-making. So we are unrepresented. Sometimes, we are not even informed of decisions – like the one in 2006 to implement a provident fund contribution in factories located outside the metropolitan areas.

When the Bargaining Council started to take legal action in Newcastle, our stand was that if they closed down one factory, we would all close down together, because we feel we are not part of this game. It's hard for us to be part of this law.

On 31 August 2010 the Free State MEC of Economic Development met with the Bargaining Council. A 30-day moratorium on legal action was agreed. We had another meeting in Pretoria on 6 September, where we agreed that the non-compliant factories must submit a proposal to resolve the current situation. A new wage model was proposed on 20 September. We had only two requests: first, a wage model that is more flexible and better able to create incentives for increased productivity; and second, a moratorium on all inspections by the Bargaining Council, because its procedures are flawed.

A new wage model is needed if the industry is to survive. The only reason we can't compete with imports is because of high wage costs. According to ILO data, in 2006 average labour costs in South African manufacturing were 3,5 times higher than in China. Local manufacturers could be competitive, however, if we were allowed to introduce production incentives. We are hoping that we can persuade the Bargaining Council to let individual employers negotiate wages and incentives, rather than letting those be decided in Cape Town. Maybe this is why wage costs have gone up so quickly. In 2005, the minimum wage for qualified machinists was R272 a week; today it's R479. Our view is that this makes us uncompetitive.

In cut, make and trim operations, which are the simplest, labour costs are about 40 to 60 per cent of all costs. If they double, we are uncompetitive. Our proposal is that the minimum should be R280 a week, but again with performance bonuses. It sounds like a

little, but remember China. And China is not our only competitor: in in Lesotho they pay R160 a week, and in Swaziland, R120.

We know we are uncompetitive because South Africa imports almost all its clothing. In 2006 we imported 357 million pieces of clothing, or 88 per cent of all clothing sold in the country. With more flexible wages, we could produce much more clothing locally.

## DEVELOPMENTS IN NEWCASTLE

This Round Table was hosted on 2 November 2010. At that time, a moratorium on the enforcement of Bargaining Council wage minimums was in place while the Ministers of Labour and Economic Development reviewed the position and decided on a future course of action. That moratorium was lifted in January when it was decreed that all garment factories would have to be 70 per cent compliant with Bargaining Council agreements by 31 March 2011, 90 per cent compliant by 1 January 2012, and 100 per cent compliant by 1 April 2012. This would be enforced by the Council's inspectors.

According to local employers, some 29 factories employing 1 200 people closed their doors between 1 January and 29 April 2011 as a result of this. Media reports suggest that some factory owners are planning to move their operations to Lesotho or Swaziland.

In May 2011, two factories deemed to be non-compliant – one of them belonging to Mr Liu – were closed on the orders of the inspectors. Some 90 factories downed tools for two days in a gesture of support. SACTWU threatened them with legal action for the so-called 'illegal lockout'.

CDE 2011

We know we are uncompetitive because South Africa imports almost all its clothing – 357 million pieces in 2006

## PANELISTS

### Ian Macun

*Director: Collective Bargaining, Department of Labour*

I WOULD like to touch very quickly on three points relating to issues of institutions and policy.

- *Labour rights.* To my mind, we are a moderately and fairly benignly regulated economy. There are certain rights and obligations that go with this. We could seek legal changes governing the conditions of employing young people, but I'm not sure that that is the best way to take this debate forward because, as in the case of Singapore, we need to win over the unions and social partners in a policy debate of this sort.
- *What kind of employment do we want?* I think we want employment that has as much security as possible. We do not want to perpetuate the growth of insecure, short-term employment. Apart from anything else, low-wage, insecure jobs don't generate much consumer demand. So, we need to look at the issue of employment security and how the wage subsidy might affect this.

If you're hiring a hot-shot scientist, you're prepared to incur all the regulatory costs, but not if you're hiring somebody for R2 500 a month

- *Newcastle.* Discussion of a wage subsidy raises the issue of the cost of employment, as well as competitive wage levels. We do need to talk about a wage policy for the country. The story of Newcastle seems to be about a problem in the wage determining mechanism in that particular Bargaining Council, and this is something we could debate. But the real issue is the degree of flexibility within sectoral bargaining arrangements. There is a way forward in clothing, but we may need to look at the role of sectoral determination.

## Dr Neil Rankin

*Professor Department of Economics, Wits University*

The issue of labour regulations is more nuanced than people often think. There are issues about how the constitution and the regulations were framed, and how they are actually implemented. There are issues about the institutional framework, including the Bargaining Councils, and about the differential impact of wage agreements on different kinds of firms, both across sectors and industries. Four points are worth making.

- *Are these regulations as bad for firms as they say?* Well, it depends on whose research you read. Borat and Cheadle suggested that they are not so bad in an international context, though the firing provisions are out of line. Jeremy Magruder's work, on the other hand, suggests that institutions like bargaining councils restrict the growth of firms, especially small firms. My own work suggests that the impact of labour regulations differs depending on the type of firm, and particularly its size. The costs for smaller firms are proportionately higher than they are for big firms. Big firms can afford HR departments whose officers can go to the CCMA. For a small firm, it's the managing director or owner who must go.
- *The costs of regulations are proportionately higher for unskilled workers.* If you're hiring a hot-shot scientist, you're prepared to incur all the regulatory costs. That may not be true if you're hiring somebody for R2 500 a month.
- *How do firms react?* Regulations can shape a firm's strategic choices. One response is to stop growing to avoid employment equity and BEE regulations that kick in at thresholds defined by the number of people employed. Those regulations can keep firms small. Then, because they are small, they don't reach the size needed to achieve the economies of scale needed to compete in export markets.
- *Who do firms employ?* Because employers don't know who is worth hiring and who isn't, they often hire through people they already employ. This means that people who live in households where no one is employed have much less chance of finding work than people who live in households where someone else is already employed. This perpetuates the insider/outsider divide. A wage subsidy may be one way of levelling the playing field for those people who are outside the labour market with no links to it.

## GENERAL DISCUSSION

PARTICIPANTS focused on whether a wage subsidy would help businesses to become more competitive and to employ more people.

Prof Romer proposed the following thought experiment using figures provided by Alex Lui. Suppose, he said, a competitive salary for a qualified machinist was R280 a week. Now suppose it was decided that garment manufacture in Newcastle could expand significantly, but only if firms paid wages of about R280 a week, with some variation for productivity. If R280 per week was too low, but workers would accept R400, then government could pay the extra R120 a week. The wage subsidy, then, could close the gap between an expectation of what people should take home and the business reality facing firms. In these circumstances, a wage subsidy could be the difference between expansion or shutting down.

An immediate question arose as to whether a wage subsidy, instead of closing the gap between wage expectations and business realities, would be used simply to raise wages. In response, Prof Hoon said in theory there was no reason to think a wage subsidy would push up wage levels. Much depended, however, on whether the subsidy was paid to workers or employers. If a system of binding minimum wages existed, as it did in South Africa, and workers earned a minimum of R400 a week, then a subsidy to workers who got jobs would allow them to make R520 a week unless the statutory minimum that firms had to pay was lowered to R280. If, on the other hand, the R120 a week went to the firms, their out-of-pocket costs would be R280 even if they paid workers R400. It would therefore make a huge difference if the subsidy went to the worker or to the firm.

Other insights included:

- *Wage costs are not the only source of pressure on South Africa's competitiveness.* The cost structure of South African manufacturing is both high and rising. Labour costs are important, but other costs – including logistics, electricity, and municipal rates and taxes – are rising quickly too. One response by companies to these rising costs is increased mechanisation which, while not reducing non-labour cost pressures, has the merit of reducing pressure on payroll costs.
- *To see the Wiehahn Commission only in terms of its impact on labour costs is a mistake.* Wiehahn was necessary largely because the 1970s was a period of labour shortage, and the Commission and its recommendations was a vehicle used to mitigate this: by improving employment conditions for black workers, more would be induced to look for work. In addition, the rights acquired by black workers played a key role in driving South Africa towards democracy, and the latter would not exist without the former.
- The ILO rated South Africa's policy response to the financial crisis as among the best in the world, but found that the impact of the crisis on employment was among the worst in the world.
- *Though the economy shed a million jobs in two years, this was not the result of large-scale retrenchments.* The number of people leaving existing jobs during the recession was not exceptional, and matched existing patterns in the labour market. What changed during and after the recession was that the number of new hires fell off dramatically. The result was considerable net job losses, but this happened without a significant

Though the economy shed a million jobs in two years, this was not the result of large-scale retrenchments

It is in young workers' interests for their employers to have the right to fire them

increase in the number of people losing their jobs in any given period. The loss of these jobs does not, therefore, show that the labour market is flexible.

- *It is in young workers' interests for their employers to have the right to fire them. Giving firms a no-questions-asked right to dismiss young workers helps ensure that they learn the discipline needed to make the most of their potential.*

## Calculating costs and benefits

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### Dr Justine Burns

*Economics Department, University of Cape Town*

*AT LEAST four papers have been written by economists at various universities and at the World Bank, each seeking to model the costs and benefits of a wage subsidy in South Africa.<sup>12</sup> CDE asked Dr Burns to analyse the similarities and differences among the models used, as well as the resulting estimates of costs and benefits. Dr Burns's presentation was quite technical, and space restrictions mean we cannot present all of it.<sup>13</sup> Instead, we have retained the core of her conclusions, while a box (facing page) sets out some issues that arise when comparing the costs and benefits of wage subsidies as projected by different models.*

### By how much might a wage subsidy increase employment?

The models show a wide range of employment effects. If the subsidy is tightly targeted, there are lower employment effects than if one assumes that a wider range of workers and employers will be eligible. The spectrum of results runs from 88 000 additional jobs to 740 000. The bulk of results, however, lie in the range of 320 000 to 520 000 new jobs, the majority of which will be for unskilled people.

Assumptions matter. One of those is about the degree to which the economy can create unskilled jobs if it lacks either capital or skilled workers. In one model – which assumes a general subsidy offered to employers in most sectors of the economy – the modellers run through a number of different simulations. In one, where these constraints do not matter much, the wage subsidy generated about 700 000 more jobs. If these constraints were assumed to matter more, however, the employment effect fell by half or even more.

### The impact of complementary policies

One of the models asked what would happen if a wage subsidy coincided with a five per cent increase in skilled workers – perhaps through increased immigration. Surprisingly, the increased number of skilled workers actually reduced the employment effect of the subsidy on unskilled workers. The authors argue that this is because skilled workers and unskilled workers are poor substitutes for one another, and that capital constraints mean that South Africa cannot expand production in such a way that it employs all the new skilled workers and more unskilled workers. However, when capital is increased by 5 per

## MODELLING THE COSTS AND BENEFITS OF WAGE SUBSIDIES

There have been a number of attempts at modelling the costs and benefits of a wage subsidy. The conclusions depend on the assumptions made by the modellers, so it's important to understand the nature of the models used and the differences between them.

- The models only predict the once-off benefits and costs of a wage subsidy. Essentially, they compare the economy today with a hypothetical economy in which a wage subsidy has been implemented.
- How the models compare these two situations depends on how the current economy is modelled as well as assumptions about the value of the subsidy assumed to be implemented, who it targets, and the extent to which it is taken up.
- Although assumptions about the value of a wage subsidy were reasonably consistent across the models under review, assumptions differed about whether the wage subsidy would apply to all young workers (a general subsidy targeted at the youth), to all young workers in particular sectors (a more narrowly targeted general subsidy), or only to young new hires (a marginal subsidy targeted at young people).
- Given its assumed value, the fiscal costs of a wage subsidy increase the larger the number of people that receive it. This means that marginal subsidies are cheaper than general ones, and the narrower the set of beneficiaries, the lower the cost. On the other hand, the more narrowly a subsidy is targeted, the smaller its employment impact will be.
- A key variable in determining the employment effect of a wage subsidy are assumptions about whether there is enough capital and skilled workers available to accommodate the employment of more unskilled workers, or whether unskilled workers could be used efficiently even in the absence of more capital and more skilled workers. Modellers' assumptions about this varied a great deal, with important consequences for the projected impact of a wage subsidy on employment levels.
- All the models assume 'perfect pass through' of a wage subsidy to its beneficiaries. This means that the wage subsidy is not used to increase wages currently being paid, and is not treated as a windfall profit by businesses.
- Because the models only compare the present economy to a hypothetical economy in which a wage subsidy is being paid, they cannot make predictions about any long-term costs (such as higher tax rates, if that is how the subsidy is funded) or benefits (such as raised productivity as a result of employment-related skills-formation).

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All the models project that a wage subsidy will have a positive effect on GDP

cent, the wage subsidy together with the increase in skilled workers leads to a further increase in the employment effect for unskilled workers.

### Comparing economic costs and benefits

The models help to estimate the effect of wage subsidies on GDP. Again, estimates differ depending on assumptions. All suggest that there will be some positive impact, ranging from 0,2 per cent to about 2,4 per cent, depending on what they assume about the design of the subsidy and about the economy's ability to employ more unskilled workers without

Wage subsidies seem to help when unemployment is wage-induced, and the cost of labour is too high

acquiring more capital or more skilled workers. At the same time, the programmes also have fiscal costs, which, again depending on assumptions, are projected to be between R1,3 billion and R20 billion a year (or between 0,01 per cent and 0,8 per cent of GDP).

Perhaps the most helpful way to look at the projected costs of the programme is to look at projected costs per job. A lot depends on how many jobs are estimated to be created, which depends on targeting and other assumptions. So, again, there's a range – this time a wide one – from about R15 000 per job (which assumes very tightly focused targeting) through to about R98 500 (where all workers get a subsidy). But most of the models predict a cost per job of R25 000 to R30 000.

## Conclusion

So is a wage subsidy worth introducing? Part of the answer is that it depends on whether one is talking about a general subsidy or a marginal one, and whether it is targeted at specific sectors or not. The wider the subsidy, the more it costs, and the more it costs per job.

Wage subsidies seem to help when unemployment is wage-induced, and the cost of labour is too high. They are less helpful when unemployment is structural in the sense that the economy requires workers with a profile that differs from the profile of people who are actually available to work: if the economy cannot make use of unskilled labour, for example, because of the absence of skilled people with whom they can work, then a wage subsidy will not significantly increase the employment of unskilled people. To the extent that the problem in South Africa is the lack of skills, wage subsidies will not drive up employment unless they are accompanied by extensive complementary policies relating to training, infrastructure development, and so on.

## PANELISTS

### Dr Greg Farrell

*Head, Monetary Policy Research Unit, SARB*

GIVEN THE magnitude of the unemployment problem, policy intervention is required. Monetary policy is not well-suited to this; a wage subsidy seems more appropriate.

The models discussed in the paper generate interesting results, but they should be treated with caution. One reason for this is that the cost estimates generated by the models come from studies that use similar methods. This makes them more comparable, but the approaches may not be sufficiently diverse to really estimate the possible cost of a wage subsidy. It may be better to compare these results against a totally different approach.

Before we can really assess the costs and benefits of a wage subsidy, we also need to get a sense of dynamics, of what happens over time. These models are a form of comparative statics, so they do not tell us what happens to costs and benefits as the circumstances underlying the models change. Overall, the models suggest that the effects on employment and GDP will be relatively small. They mostly predict a positive impact on GDP of only about 1 per cent.



## Andrew Donaldson

*Deputy Director-General, National Treasury*

I THINK THE most compelling case for a wage subsidy has nothing to do with its costs and benefits. It simply flows from the idea of justice.

A broad range of theories of justice suggest that when human capital endowments are very unequally distributed, society should tax progressively those who are well endowed, and use the proceeds to distribute income more fairly through social assistance programmes. We do this already, and the effect of a wage subsidy is similar. That is why almost all OECD countries use this tool, and their reasons have more to do with justice than with economic efficiency. So I think there is a case for a wage subsidy even if it has no dynamic impact on employment.

Having said that, one of the huge benefits of anything that brings more people into employment is that it increases economic output, with the result that programmes that grow employment have the potential to be comparatively costless. By increasing employment, a wage subsidy would also help address high levels of inequality.

The reasons for high levels of inequality are embedded in history, especially in our unequal education system. There are other factors: conventions that determine remuneration, the monopoly rents that accrue to the concentrated parts of the economy, and so on. Interventions that have the effect of broadening employment are appropriate for dealing with this, especially if they increase output, productivity and growth. This is why a wage subsidy can be comparatively costless from the point of view of the level of overall economic activity.

None of this is captured in these models. This is an economy in which a very large part of the productive capacity is unemployed. We want to intervene to encourage its employment because this has some redistributive effects, but also because it has the potential of creating dynamic gains over time. Models can only deal with these issues quite crudely when estimating costs and benefits.

An example of what models cannot capture is that a youth subsidy would help get young people into employment. One benefit is that young people spend a few months rather than a few years finding their first job. This is enormously desirable because of the huge trauma that every family goes through when a young person, who has been fully occupied for 12 years, is suddenly left completely unoccupied. The social and economic costs of this are huge. Young people who get into jobs quickly are much more likely to stay employed, and much more likely to have a stable career. So even if we don't know what difference a wage subsidy will make to their prospects, we do know that if you get into a job quickly, you learn more and faster, and that this feeds into productivity improvements over time.

The cost per job of wage subsidies needs to be compared with other programmes that generate jobs, such as skills programmes and public works. For various reasons, our public works programme is quite expensive, with each job costing about R100 000 a year. By that comparison, the numbers that emerge out of these studies look good. I will ask my colleague, David Faulkner, to tell you something about our estimates of the wage subsidy proposal we have tabled.

There are a couple of important advantages to a youth-focussed wage subsidy. One is that it is easier to do as a first step, as a way of piloting the possible impact on employment of subsidising wages through employers. The second is that it is forward-looking – focusing on getting young people into work is about taking the future seriously. Here the contrast with Singapore is instructive. In Singapore, 30 years of extraordinary growth

By increasing employment, a wage subsidy would also help address high levels of inequality

has left the older generation behind, so the state introduced a subsidy to help them find employment. We are at exactly the other end of that trajectory. Perhaps in 30 years' time, we may need to do something similar for those who have been left behind now.

## David Faulkner

*Director: Growth Policy, National Treasury*

TREASURY HAS tried to model a youth-targeted wage subsidy using a similar method to that used to estimate the costs of social security policy proposals. In effect, we are using the current income distribution for young people aged between 18 and 29, and applying a phased 50 per cent subsidy for those who earn R2 000 a month or less. We then assume that the subsidy will get smaller as income rises, and will vanish completely if people earn enough to qualify to pay income tax. Each individual's subsidy would last for two years, with the second year being of a lower value than the first. The idea is that you give a larger subsidy when people have no experience, and a smaller one after they have acquired a year's experience. Hopefully, after two years, beneficiaries will be more productive and their employment no longer has to be subsidised.

When we cost this, we have been assuming that it will be a marginal subsidy, not a general one, so it will apply only to new hires. This is intended to prevent employers from retrenching existing workers who don't qualify for a subsidy and replacing them with subsidised employees.

We have assumed a medium level of substitutability so that employers can use some unskilled labour even in the absence of new sources of skilled workers and capital, and we are also assuming some new employment that would have been created in the ordinary course of things through economic growth.

In the end, we are looking at costs of about R5 billion over three years. We think we will end up subsidising about 420 000 jobs, of which 170 000 or 180 000 would not have been created without the subsidy. Even that may be an overestimate, however, because young people enter and leave the labour market all the time, so some people whom we subsidise won't stay in employment. In effect, we think we will create 130 000 jobs at about R40 000 per job.

## GENERAL DISCUSSION

MUCH OF THE discussion centred on the vital question of whether the proposed wage subsidy would be worth the money, with participants emphasising both the proposal's costs and benefits, as well as its potential impact on the national debate about unemployment.

### Costs and benefits

Some participants expressed concern about the relative modesty of the programme that Treasury had described. A programme that cost R5 billion over three years but generated

Hopefully, after two years, beneficiaries will be more productive and their employment no longer has to be subsidised.

only 130 000 new jobs was felt to be too small to change the employment outlook of the country, since the economy needs about 6 million more jobs.

A number of points were made by way of qualification. One was that the 130 000 jobs was an estimate of all the jobs that would exist after some of those who got work experience as a result of the wage subsidy left the labour market – whether to start families or to acquire further training. In fact, 180 000 additional young people would obtain some work experience during the three years of the programme. In addition, a further 250 000 jobs would be created for young people in those three years. Therefore, projected employment growth, particularly from the point of view of young people who face terrible prospects in the labour market, was not as trivial as it might seem. Thus, the wage subsidy, should it work as projected, would increase the odds that a young person would find work by more than 50 per cent, with larger increases for unskilled young people. While this growth was off a low base, the social and economic consequences of improving young people's chances of employment would be important and might shift expectations among young people.

How realistic is the prediction of the creation of 130 000 jobs? Some saw the figure as overly pessimistic because it was premised on estimates of the wage elasticity of demand for labour that assume an industrial structure similar to the one that exists now. If the wage subsidy was able to make South Africa competitive in light manufacturing (such as garment assembly), many more jobs could be created than present predictions would suggest. But, to achieve this, the subsidy would have to be large enough to make South African labour costs competitive. If it did that the employment response might be very large.

Participants highlighted the difference between a wage subsidy and other kinds of transfers, such as welfare payments. Because wage subsidies are paid only when someone is employed in the private sector, every new job that was subsidised raised GDP. This was not true of other forms of redistribution. And, even if each job cost the fiscus more than the value that the job created – because of the deadweight cost of subsidising jobs that would have existed anyway – the effect would not be to reduce GDP. All that would happen is that some spending power would be redistributed. There would be no net loss to society. A wage subsidy could only lower GDP if it required substantially higher taxation and if this reduced economic activity. Treasury's proposal was too small to have this effect.

It was suggested that it would be more effective for the Treasury to fund job search subsidies, which a participant said had wide success internationally, rather than wage subsidies. 'Informational asymmetries in the job search are extraordinary for unemployed people. They don't have any idea where to find jobs. They're not in connection with anyone who has a job. They've left school, typically at age 15 because they don't anticipate finding work. So I don't know why the wage subsidy was pulled out and a search subsidy omitted.'

In response, an official from the Treasury said job search subsidies were administratively much more complicated because it was much harder to track what was being done with the money. A wage subsidy, by contrast, is administratively straightforward because it is a simple rule creating clear entitlements and could be administered through the tax system.

### The political consequences of a wage subsidy

A key issue in thinking about the desirability of a wage subsidy is its ability to help change the nature of the debate about economic and labour market policy in South Africa. Some participants took the view that the wage subsidy would be worthwhile if it helped open up debate about the desirability of more extensive labour market reform, particularly if it

A wage subsidy could only lower GDP if it required substantially higher taxation and if this reduced economic activity

The failure to link wage flexibility to the wage subsidy proposals ignored 'the elephant in the room'

helped show that millions of unskilled, inexperienced workers could get jobs if the cost of employing them were lowered.

To have a chance of doing this, the wage subsidy would have to create a large enough number of jobs to shift the balance of public and political opinion. Much, therefore, depended on the scale of the programme.

For many participants the failure to link wage flexibility to the wage subsidy proposals ignored 'the elephant in the room'. They expressed disappointment that Treasury did not intend to link wage subsidies to the relaxation of labour regulations, something that would make expanding employment even more attractive to potential employers. While this was beyond the Treasury's policy remit, attention had to be paid to addressing labour market reforms if millions of jobs were to be created.

Events in Newcastle's clothing industry suggested that large numbers of unsubsidised jobs had been created and could be created, and that, if there were some change in the rules governing minimum wages, this would be entirely legal. One participant stated: 'It's possible that if we freed up the labour market, entrepreneurs would be able to generate large numbers of jobs without a subsidy. We shouldn't just accept that a wage subsidy is desirable without thinking about the potential that might exist in simply changing our labour laws.' While it was recognised that it might be politically difficult to achieve those kinds of reforms, she added that the same was true of getting a wage subsidy accepted. 'If there's going to be a political battle, then why not have a political battle over more significant reforms rather than over a small programme of wage subsidies?'

## Key insights from the Round Table

ALMOST THREE quarters (72 per cent) of South Africa's 4,4 million unemployed workers are younger than 34.<sup>14</sup> The unemployment rate of people younger than 25 is almost twice the national average (49 per cent versus 25 per cent). And the 50 per cent of South Africans aged 15 to 24 who want jobs and actually have them is significantly less than the 80 per cent which the OECD reports as the norm in other emerging market economies.<sup>15</sup> South Africa has a national crisis of youth unemployment.

Employment is vital for South Africa's social, economic and political development. It is the key mechanism for addressing mass poverty. In addition, many other benefits flow from higher levels of employment. Many of the skills needed to improve a worker's employability – punctuality, discipline, the ability to work with others, and so on – are most easily acquired on the job. This is especially important in South Africa. Millions of people have been poorly educated, and have had few opportunities to acquire skills. For many, the workplace is the institution in which they are most likely to be able to acquire skills. Jobs also generate a sense of accomplishment, dignity and participation.

While welfare grants can provide a modest income, they cannot offer any of these benefits, making employment growth vital to creating a more inclusive society.

As the National Treasury has stated, the proportion of working age adults with jobs may be the best measure of social inclusion in a modern society – far better in many respects than measures of inequality such as the Gini coefficient.<sup>16</sup> On this measure, Brazil, where close to 70 per cent of adults have jobs, is a far more inclusive society than South Africa,

where barely 40 per cent of adults are employed. This is despite the fact that levels of income inequality are similar.

If South Africa is to be more inclusive, far more people must find jobs. But what kinds of jobs?

South Africa's labour laws mean that any job that is fully compliant with the law is also, from an employer's point of view, a reasonably expensive job. This is especially true when compared with the costs of employment in other developing countries. Minimum wages in South Africa's clothing industry are two or three times higher than those for similar jobs in Swaziland and Lesotho, let alone India, Vietnam, Bangladesh and Pakistan.

If only expensive jobs are permitted, fewer jobs will be created. They will also tend to be filled by people with the most skills and experience, as they are most productive. This is a key reason why so many young, inexperienced workers are unable to find work.

In recent decades the South African economy has generated fewer and fewer new jobs for every unit of economic growth. While some of this reflects increased productivity, much of the decline in job creation can be attributed to rising wages and more onerous labour market regulations which have made employers more reluctant to hire workers, particularly those who are young and unskilled. Employers who might be willing to incur the costs of employing highly productive workers with significant skills are much more reluctant to do so for workers whose lack of skills and experience mean they will be less productive. This is a key reason why so many young, inexperienced workers are unable to find work.

While South Africa has sought to ensure that jobs are well paid and well protected, dynamic emerging economies in Asia have sought to expand the absolute number of jobs as rapidly as possible. Many of these jobs do not pay high wages or offer very good conditions of employment, but they do pay better than almost any alternative form of employment for unskilled people. Critically, they exist in very large numbers. Experience in Asia and elsewhere shows that once high levels of employment have been reached, productivity gains and progress up the industrial value chain lead to a rapid rise in workers' incomes. It also leads to much higher rates of economic growth.

This is the process that has lifted hundreds of millions of people out of poverty over the past 40 years. And, apart from the discovery of previously untapped natural resources, it is the only one that has ever improved the quality of life of large numbers of people both rapidly and sustainably.<sup>17</sup> By contrast, high levels of long-term unemployment may have undermined South Africa's growth potential because so many work-seekers lack these vital skills, while some of the human capital they may have acquired at school has decayed. Rectifying this means getting the unemployed into jobs – any jobs. This, then, must be a central feature of any strategy aimed at increasing productivity.

In this regard, the story of Singapore's rapid development is instructive. There, economic growth has generated a rapid change in its areas of comparative advantage. In the 1960s, shortly after independence, when unemployment was high, the country concentrated on attracting manufacturing firms, particularly in the garment and textile sectors. This was low-skilled work, but it lifted the incomes of the poor while education levels improved. In the 1970s, Singapore began to produce simple electronics, after which it began making hard-drives and semi-conductors. Since then it has moved further up the value chain, with the country now having a comparative advantage in bio-medical research and development. Thus, the country has steadily moved up the ladder of comparative advantage, with very positive implications for average wages as well as economic growth.

South Africa has sought to ensure that jobs are well paid and well protected, while dynamic emerging economies in Asia have tried to expand the absolute number of jobs

A wage subsidy would narrow the gap between the costs employers incur when employing workers and those workers' level of productivity

## The National Treasury's case for a wage subsidy

In response to the need to create jobs for young, unskilled workers, the Treasury has proposed a wage subsidy for young workers at the bottom of the pay scale. Such a subsidy would narrow the gap between the costs employers incur when employing these workers and those workers' likely levels of productivity. The Treasury argues that this would induce firms to employ more young people.

The subsidy would directly lower the cost of employment to the employer. And by getting inexperienced young people into jobs, it would enable them to acquire skills that would raise their productivity. This is also why the Treasury proposes that the subsidy be offered for only the first two years of employment. This is on the basis that beneficiaries' rising productivity would reduce the need to subsidise their employment.

## Issues and questions

Participants raised the following concerns about the introduction of a wage subsidy.

- *Cost and sustainability:* The number of jobs created by a wage subsidy depends on how many additional workers it induces firms to employ. Because larger subsidies means greater inducement, stimulating very large numbers of jobs might require a very substantial subsidy. The larger the subsidy, though, the greater the cost per job. An overly generous subsidy could give rise to issues of affordability and sustainability.
- *Waste:* Although wage subsidies may be more efficient than some other forms of public spending, they can also generate wasteful spending. The Treasury's calculations indicate that most of the jobs that would end up being subsidised are jobs that would have been created even if no subsidy were offered. The larger the subsidy for each worker, the more unnecessary spending will occur, both because more newly created jobs would have been unnecessarily subsidised, and because the average subsidy per job would be higher.
- *Employer response:* Although the costs of taking on new employees would be subsidised, employers may feel that unless it is made easier to dismiss workers, the risks of taking on new staff who may be unsuitable still outweigh the likely gains.
- *Opportunity costs:* The funds devoted to a wage subsidy might be better used for other government policy initiatives.
- *Sustainable jobs:* The Treasury's proposal assumes that, after two years of subsidised employment, a young worker would be sufficiently productive for employers to keep him or her without the subsidy. Whether this will happen is impossible to know.
- *Creating new distortions:* A wage subsidy could result in the growth of businesses whose only rationale is to absorb public money through subsidies. Employers might also replace unsubsidised workers with subsidised ones.

Besides these issues, participants raised two fundamental concerns. The first was that a wage subsidy would do nothing to improve labour market regulation, which plays a key

role in raising the costs of employment. Labour market regulation is the ‘the elephant in the room’, and the continued failure to address it is the main reason why South Africa faces such a daunting employment crisis. The second concern related to the modest scale of the Treasury’s proposal.

According to the Treasury, the wage subsidy programme would generate about 130 000 new jobs over three years. This would increase the number of jobs created for young people by almost 50 per cent. That number would also amount to about 30 per cent of the jobs in the mining industry, and about 20 per cent of jobs in agriculture. If these jobs could be created with a subsidy costing less than 0,2 per cent of the national budget, these results would be impressive. While the base is low, the fact that young people’s odds of finding work would be nearly 50 per cent higher with the subsidy than without might also spark some hope among the young and unemployed.

At the same time, the absolute number of jobs projected by the Treasury’s models is small relative to the six million people who are unemployed or who have given up looking for work. Accordingly, it will not make much difference to their bleak employment prospects. Nor will it do much to change the destabilising impact of unemployment on South African politics.

Thus, while the lives of the 130 000 beneficiaries would be considerably improved, participants expressed doubts about the scale and ambition of the Treasury’s proposal relative to the country’s needs.

### The wage subsidy and the costs of employment

In some respects, the Treasury’s proposal represents a significant break from existing government policy. For the first time, an intervention is being proposed that takes seriously the negative impact of high employment costs on people’s chances of finding work. It suggests that some policy-makers have recognised that high and rising employment costs are a key reason for South Africa’s unemployment crisis. This injects a dose of realism into the debate about the choices facing the country. However, this does not necessarily mean that a wage subsidy is the best way to create jobs.

#### *Is a wage subsidy desirable in principle?*

Employment incentives are common elsewhere in the world, with OECD countries spending an average of about 0,15 per cent of GDP on programmes of this sort. In South Africa, this would amount to R15 billion over three years, or three times more than the costs of the programme that has actually been proposed.

There are many reasons why governments subsidise wages, and the relevant literature suggests that these programmes are quite effective in relieving poverty and increasing employment levels. In South Africa, however, questions need to be asked about the desirability of introducing wage subsidies when it is existing labour market regulation that has ensured that labour costs have risen so substantially over the past few decades. In these circumstances, a wage subsidy – which transfers some of the costs of employment from employers to taxpayers – may not be the most appropriate way to close the gap between employment costs and productivity. Instead, it may be more appropriate to address the reasons for high and rising labour costs directly.

The absolute number of jobs projected by the Treasury’s models is small relative to the six million people who are unemployed or who have given up looking for work

On its own terms,  
the wage subsidy  
is a sound use of  
public resources

*Is government doing enough to reduce employment costs?*

In general terms, the outlook for labour market reform that would reduce labour costs is poor. As recently as December 2010, the government proposed amendments to the Basic Conditions of Employment, Labour Relations and Employment Equity Acts, and proposed a new law – the Employment Services Bill – aimed at governing labour brokers. There is widespread agreement that these proposals would have increased the cost of employment and resulted in increased unemployment.<sup>18</sup> As a result, the ‘social partners’ represented in NEDLAC – national government, organised business, and organised labour – agreed in April 2011 that the four bills should be re-drafted.

A process of consultation is currently under way regarding these Bills. It is not yet clear what will emerge from this. The fact that these bills were drafted at all, however, suggests that key government institutions want to increase regulation of the labour market rather than decrease it. It is especially telling that government proposed these measures even after its own regulatory impact assessment concluded that the changes would reduce employment.<sup>19</sup> It seems unlikely, therefore, that reforms will emerge from this process that will significantly reduce the direct and indirect costs of hiring young, unskilled work-seekers.

There is no indication that the proposed wage subsidy is part of an incremental strategy to reform the labour market. If the wage subsidy is an isolated initiative, is it worth implementing anyway?

*Is the National Treasury's proposal worth implementing?*

If the Treasury's estimates are correct and the subsidy would increase employment levels by 133 000 at an overall cost of R37 000 per job, it would use public funds more efficiently than some other interventions. In fact, to the extent that these jobs would generate taxable profits for employers, they would actually cost government less than this estimate. By contrast, the Expanded Public Works Programme creates short-term, low-wage jobs at an overall cost to the taxpayer of R100 000 for the equivalent of a full-time job for a full year. Similarly, the Industrial Development Corporation's newly announced fund which will provide concessionary finance to job-intensive investments will target projects that create jobs are an average cost of between R250 000 to R500 000 a job.<sup>20</sup>

From the point of view of employment creation, the proposal also appears to be far more efficient than other subsidies, such as the estimated R18 billion that public support for the automotive industry cost the economy in 2009/10.<sup>21</sup> While there are other benefits associated with having this industry, and while getting accurate figures is not easy, one estimate suggests that this support costs the economy between R200 000 and R600 000 per job, depending on whether employment in upstream industries is included.<sup>22</sup> Including down-stream workers as well lowers the annual cost per job to R60 000, but unlike the estimated once-off R37 000 cost per job of the wage subsidy, these costs are incurred by the economy every year.

An important advantage of the Treasury's proposal when compared to other state-led job creation programmes is that if new jobs are not created, the money would not be spent. Furthermore, because the jobs created would be in the private sector, they would probably be in areas of the country (and sectors of the economy) in which sustainable employment is a more plausible outcome than is the case with other proposals.



All this – and the fact that the programme is expected to cost less than 0,2 per cent of anticipated government spending over the next three years – suggests that, on its own terms, the wage subsidy is a sound use of public resources. There are, however, other issues to consider.

The proposal to subsidise the employment of young workers whose salaries fall below the income tax threshold is intended to increase the chances that people in this demographic will find work. Subsidising their employers is one option for achieving this. An alternative would be to engage directly in the process of reforming the labour market in order to reduce the costs of employment – in general, or for this group of workers.

The proposed subsidy does not do this even though there are ways in which the two kinds of intervention could have been aligned. For example, when a proposal to institute a wage subsidy was endorsed by the team of Harvard-based economists that advised the National Treasury on South Africa's economic strategy in 2006/7, they regarded it as essential to link the subsidy to a probationary period during which subsidised workers could be dismissed on a 'no questions asked' basis. At the time, James Levinsohn argued that:

'A targeted wage subsidy will encourage a bit more risk-taking, but a much more direct policy response is to tie the targeted wage subsidy to revised rules for dismissal for those workers receiving the subsidy. For this reason, it is essential that the targeted wage subsidy entail a probationary period during which a "no questions asked" dismissal policy is in effect. ... By allowing firms to easily dismiss recently hired workers, the risk is borne by the worker (who has every incentive to prove his or her abilities) rather than by the firm. Current regulations make it too cumbersome to dismiss a new worker and this puts the risk on the firm. By giving firms the ability to dismiss new hires, employment is likely to increase for exactly that group of South Africans who are currently most shut out of the formal labour market.'<sup>23</sup>

No one has tried to calculate how many more jobs might be created if the wage subsidy were linked to a probationary period of this kind. This could be considerably more than the 133 000 that the Treasury projects for a subsidy on its own. Such a proposal might provoke political resistance. However, if the government is serious about dealing with mass unemployment and achieving far higher levels of employment growth, it will have to confront these sorts of issues. As it stands, the Treasury's proposals – assuming its projections are accurate – would have only a modest impact on the crisis.

### *Could this proposal be scaled up?*

In principle, a subsidy would have a greater impact if it were larger. This could be accomplished either by making each subsidy more valuable or by extending the length of time for which beneficiaries are eligible. Doing this would increase the costs per job and the overall costs of the programme. While this raises questions of affordability and sustainability, it may be that a programme costing R15 billion over three years, but which created significantly more jobs, would be worth having. South Africa would then spend as much as OECD countries on wage subsidies, but this would still be less than 1 per cent of the national budget. If 350 000 new jobs were created, the subsidy programme would more than double the chances of a young person finding work in the next three years.

By allowing firms to easily dismiss recently hired workers, the risk is borne by the worker (who has every incentive to prove his or her abilities) rather than by the firm

One reason for framing the issue in these terms is the sense that 133 000 new jobs are simply too few to make a meaningful difference to the employment prospects of the jobless. Equally important, this number may also be insufficient to shift the debate about labour market policy. In practice, a much larger programme could help change the terms of the debate, and start convincing those who would like to tighten the regulation of the labour market that creating more jobs actually requires lowering the costs of employment.

## Concluding remarks

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THE GOVERNMENT has announced or introduced a large number of proposals, policies and programmes with the stated aim of creating more jobs. Some of these would create a small number of relatively high-skilled and capital-intensive jobs for which the majority of the unemployed would not be suitable. Others create a larger number of temporary 'make-work' jobs that offer transitory and modest relief from poverty with little prospect of a sustained improvement in the beneficiaries' quality of life. Both approaches are expensive, and neither offers a realistic long-term solution to South Africa's crisis of unemployment, especially among young, unskilled and inexperienced workers.

The Treasury's wage subsidy proposal is also not a comprehensive response to the crisis of unemployment. It is nonetheless a step in the right direction, and should be introduced. It would be preferable, however, if it formed part of a series of initiatives.

One option would be to introduce a national wage subsidy and to encourage and support a variety of simultaneous policy experiments at the provincial, municipal, or even sub-municipal levels. Another would be to subsidise wages in some sectors or areas, and introduce other initiatives in others, so that the impact of different approaches could be assessed. Such policy experiments could include:

- Allowing employers to offer young people jobs at wages lower than the established minimum wages;
- Allowing young people to opt out of employment regulations altogether as a part of their employment contract; and
- Establishing special economic zones with different rules and regulations aimed at promoting low-cost, export-oriented manufacturing firms.<sup>24</sup>

These are all potentially useful initiatives. Perhaps the most straightforward and appropriate policy change to link to a wage subsidy is the one originally proposed by James Levinsohn: new hires who benefit from a wage subsidy should be subject to a ten-week probationary period during which employers can dismiss them on a 'no questions asked' basis. If this were implemented, employers would be less concerned about being stuck with unsuitable employees, while new employees would have every incentive to show that they are suitable. The results would be that only those people who are most capable would be subsidised, dramatically improving the efficiency and effectiveness of the wage subsidy programme.

Locating wage subsidies in a wider programme of labour market reform and experimentation could extract far greater value from government spending. The key is to try to leverage as many jobs as possible from policy initiatives of this kind, and to shift the policy debate to the fundamental reasons for South Africa's high and rising labour costs.

The Treasury's wage subsidy proposal is not a comprehensive response to the crisis of unemployment. It is nonetheless a step in the right direction

There is merit in the Treasury's proposal, but South Africa could do better. First prize would be to directly address the high costs of employment, especially of young, unskilled and inexperienced workers. While this would be politically difficult, the benefits could be significant.

Even if political circumstances effectively rule out more fundamental labour market reform, serious questions remain about the current Treasury proposal. Chief among these is why it is so modest. If the Treasury is confident about its projections, why it is not pushing for a more ambitious programme? Is it concerned that it would cost too much? Is it seeking to avoid a more serious political battle?

That said, it could also be argued that the limited scope of the proposal is a virtue. The success and affordability of a wage subsidy is not guaranteed. If there is some chance of failure, the relative modesty of the proposal insulates it from incurring significant costs.

Whether or not the proposed wage subsidy succeeds, questions need to be asked about what government would do next. If the programme does succeed, would more resources be devoted to subsidising employment, or would a new debate about addressing the costs of employment be instigated? And if the proposal fails to increase employment, what lessons would government (and others) learn from this experience? Would efforts to tackle the costs of employment be expanded and enhanced, or would there be a retreat from any reform at all?

These are vital questions because, even if it achieves its stated goals, the Treasury's proposal would make no more than a modest dent in South Africa's massive challenge of employment.

Addressing unemployment is South Africa's most pressing national priority. As the Treasury itself recognises, a relatively small wage subsidy programme would not have a very significant impact. Nonetheless, this proposal – if seen as a learning experiment with vital policy implications – does seem a sound use of public funds. It certainly holds more promise than many other government initiatives costing considerably more. It would be a tragedy if this modest experiment was defeated or abandoned.

The Treasury's proposal is premised – rightly – on the recognition that for South Africa to become a more inclusive society, much more needs to be done to help unskilled and inexperienced young people to get jobs. This is an important first step.

It would be a tragedy if this modest experiment was defeated or abandoned

## Endnotes

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The Treasury's proposal is premised – rightly – on the recognition that for South Africa to become a more inclusive society, much more needs to be done to help unskilled and inexperienced young people to get jobs. This is an important first step.

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