

## **Economic freedom in South Africa 1998-99**

### **The end of the century and the end of socialism**

As the end of the century approaches there is some good news: this time Nostradamus got it wrong, or perhaps so did his more apocalyptic interpreters. By now it appears a reasonably safe bet that mankind, or humankind, if we want to be politically correct, will make it into the next century, despite the best efforts of Hitler, Stalin and Mao to terminate so large a part of the human race.

We can do with happy tidings. The reason we now have them is quite straightforward. The most massive experiment in social engineering known to history has been a failure. It cost the lives of many millions over many years to demonstrate a truth which seemed obvious enough when the whole sorry enterprise began. The experiment of course was socialism. The end of Soviet-style regimes in Russia and the rest of Eastern Europe has shown beyond a reasonable doubt that the early forecasters of disaster like Ludwig von Mises had been right all along. It could not work because the incentives were wrong and the institutions were wrong. If the other great “Communist” regime, the People’s Republic of China, is still around it is because it has gone capitalist in all but name, even if all the trappings of political autocracy remain, for the moment, intact.

So if free marketeers like to announce with some smugness, “We’ve won”, who can blame them? They’re entitled to rub it in after having had to put up for so long with left-wing abuse and obscurantism. When it comes to economic policy and political theory free-market capitalism is truly the only game in town. Proposed alternatives, such as the “Third Way” touted by Tony Blair’s intellectual mentor, Anthony Giddens of the London School of Economics, are so nebulous that they have as little credibility as a commitment by Bill Clinton to family values.

### **Lessons from Eastern Europe?**

Yet this silver lining does come with a cloud. As we can see from the Russian and Eastern European efforts to restructure wrecked economies, these things do not come easy. The Russian story has so far been one of the most depressing. Most of the former state enterprises were privatised in a way which left control in the hands of their former managers. Not only did Russia have no systematic body of corporate law, but such law as there was has tended to be about as lacking in cogency as the current mind-numbing rhetoric in South Africa orchestrated from above about that African Renaissance which is lurking around the corner. So managers have blithely been engaging in such illegal practices as refusing to provide minority outside owners with information, packing the board of directors, and not registering share transfers of which they disapprove.

A major reason for the ability of management to get away with such unabashed parasitism is that the state has given subsidised credits to “privatised” firms. As one student of the subject, Andrzej Rapaczynski of the Columbia University Law School, has commented, “until the sources of soft financing disappear and firms are forced to finance their operations through the market, no legal system will be able to enforce the rights of outside owners. And even then, the nongovernmental market-driven institutions necessary to support an effective legal right to corporate property will develop only gradually”.

Corporate property rights have fared little better in most of the former satellite regimes. In Poland there has been limited privatisation, the state having “lacked the power to make private ownership the rule rather than the exception”. In Hungary the government sector has remained large and property rights have been unclearly specified. Here too, because the state has not been able to transfer full ownership rights to new owners, managers of former nationalised firms have succeeded in perpetuating their own control.

But not everything has been depressing in Eastern Europe. In the Czech Republic as well the property rights of the new owners of recently privatised firms have not always been secure against the predatory behaviour of incumbent managers. But here the authorities have implemented a mass privatisation programme which gave legal title to millions of private parties. They gave away vouchers exchangeable for the shares of privatised enterprises, regardless of whether the recipients were insiders or outsiders of any firm. At the same time it became possible to deposit vouchers with investment funds that would acquire shares of privatised firms and act as their legal owners. The familiar agency problem inherent in corporate governance was mitigated, with the funds acting as monitors of shirking managers. And, as foreign financial institutions often joined with Czech partners in forming such funds, small investors could free ride on the monitoring efforts of these institutions, which had reputations to protect.

It is too early to say whether the property rights of the millions of small Czech voucher holders are secure. Like elsewhere in that part of the world, there may not be a sufficiently strong background of market-based self-enforcement mechanisms to make the reforms stick. Yet it is true that its economic freedom rating, as estimated by the annual Economic Freedom of the World report of the Fraser Institute, has improved dramatically, from 2.4 in 1990 (out of a maximum of 10) to 5.2 in 1995. The report itself concludes that “the foundation for a market economy has been laid and the Czech Republic is now on a solid, sustainable growth path. If it continues to move towards economic freedom, its future will be bright”.

There are lessons from the East European experience. Obviously it would help to have a well-defined system of legal property rights. But it may not be enough, or even of the first importance. As Rapaczynski has commented after examining the post-Soviet regimes, “contrary to the common economists’ assumption that a system of property rights is a precondition of a market economy, the development of market institutions is often a prerequisite for a viable property rights regime. Property rights, like most other goods, are produced in response to market demand. Although the state may satisfy a portion of this demand, market responses often come first and provide more effective solutions. Indeed, the legal responses are often only effective against a background of self-enforcing market mechanisms”.

### **Back home**

In this light, we in South Africa should perhaps take little comfort. Between 1990 and 1995 our freedom rating improved noticeably compared with the virtually static level of the previous decade, from 4.6 to 5.7, while in 1980 it was still as low as 4.2. But it compares poorly indeed with the dramatic Czech advance cited above. According to the 1998/1999 Interim Report on Economic Freedom of the Fraser Institute, total government expenditures consumed 37% of GDP in 1995, up from 30% in 1975, suggesting “that there has been little movement toward economic freedom” during these two decades. In fact, South Africa’s ranking has remained the same, among the middle range of countries in the study.

One reason has been the high level of government consumption, 25% of the total, a figure “seldom exceeded by nations other than the high-income welfare states of Western Europe”. State-owned enterprises are still common in many sectors of the economy. The government has not done nearly enough to reduce uncertainty about the security of property rights, which inevitably inhibits investors, both domestic and foreign.

Against this we must set the liberalising of interest and exchange rate controls. Top marginal tax rates have come down. South Africans can now maintain foreign currency bank accounts both within the country and abroad.

Although the Report does not refer to it, probably the most ominous portent for the future remains the legislation which prices the poorest South Africans out of the labour market. It is no doubt admirable for the Government to take a tough line in negotiating with public sector employees. It is sending a much-needed message which will presumably be taken to heart. But unionised labour continues to have a safety net in the form of laws which give it a privileged place in the labour market and insulate union members from competition for their jobs. Here is a local counterpart of the absent self-enforcing market mechanisms in Eastern Europe, the lack of which makes the transition to a genuinely free enterprise economy so difficult.

As for privatisation, the Government has been blowing hot and cold for as long as it has been in office. Privatisation, it tells us, often, is a good thing. But the Minister of Public Works informed the recent Pan African investment and privatisation summit in Accra that his government did not as a matter of principle believe in the privatisation or partial sale of state assets. And he stressed, in oddly familiar language, that “Sometimes the larger interests of society, the state and the workers themselves need to take precedence over narrow managerial solutions”.

So what else is new? Perhaps we should be happy to settle for any improvement in our economic freedom rating, however minuscule. As Clement Attlee replied when asked how he felt about turning 80, “It’s better than the alternative”.

### **Further reading**

Gwartney, J & Lawson, R (1999) *Economic Freedom of the World: 1998/1999 Interim Report - South African Edition*, Free Market Foundation (co-publisher), Johannesburg.

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