

# Research Programme on an integrated approach to unemployment and employment in South Africa

## PROPOSAL

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Position: Lecturer and PhD Candidate

**Topic:** Low employment in Small Firms in a High Wage Regime: the South African Wage Curve & Wage Subsidies

### **Focused Research Questions:**

#### *Broad Topic*

Labour market flexibility – do participation and unemployment respond to high wages? How does industrial structure influence this flexibility? Should wage subsidies be implemented on the firm level rather than be directed at labour market entrants?

This work falls broadly within the framework of the following themes outlined by the project:

- 1. The optimal role of labour market regulation and other employment-related policies in the formal and informal economies*
- 2. Labour demand and firm behaviour in the formal and informal sectors, urban and rural, in various sectors of the economy.*

#### *Abstract*

The primary hypothesis of this research is to understand sources of labour market inflexibility in South Africa. Previous micro evidence for South Africa (Kingdon & Knight, 2006) suggests that wages respond to local unemployment in much the same way as they do in developed economies. However, this defies conventional macro evidence (Fedderke 2012), which highlights wage inflexibility in the country, despite uncharacteristically high unemployment levels. Government policy objectives suggest that wage subsidies should be introduced to introduce more flexibility in this relationship and allow employment creation through lower wage bills for firms. This study is concerned with the appropriate estimation of the wage-unemployment relationship, taking appropriate definitions of "local" labour markets into account, correcting for permanent spatial heterogeneity and finding appropriate instrumental variables to causally estimate the relationship. Furthermore, the role of wage dispersion and the absence of small firms are evaluated in establishing underlying reasons for wage and employment inflexibility in South Africa. This allows a more nuanced evaluation of the wage subsidy proposal, in that particular firm types and districts that are separated from main labour markets should be targeted (rather than only focusing on the "young").

### *Details*

Despite being Africa's largest economy, South Africa still has an uncharacteristically high unemployment rate, with the formal economy unable to absorb (predominantly unskilled) surplus labour. While early claims of jobless growth in the post-apartheid era have been refuted, the rise in unemployment over the early post-transition period remains one of the largest policy issues, particularly because the youngest generations have received more education, but have not been absorbed into the labour market and have added to the stock of the unemployed (Burger & von Fintel, 2009; Burger, van der Berg & von Fintel, 2012). This study estimates wage curves to understand whether a high wage regime is contributing to the high unemployment rate. The wage curve literature suggests that a robust negative relationship between regional unemployment and wages exists based on lower bargaining power in tighter local labour markets. However, in regions with high inherent levels of bargaining power, it may be possible to have high wages and unemployment simultaneously, defying the market clearing mechanism underlying the wage curve. Indeed, this is the case in South Africa, where regions and industries that are dominated by bargaining councils are associated with lower employment in small firms and higher wages (Magruder 2012). Wage curve estimates in this study identify the mechanisms by which the standard empirical result is rendered insignificant in South Africa. Preliminary findings suggest that industrial structure and proxies for high bargaining council activity account for the lack of a wage curve in South Africa. This suggests that these factors limit the downward adjustment of wages in high unemployment regions. Furthermore, this project considers the spatial disparities in the South African labour market, by understanding the long-run impacts of apartheid policies in generating local labour markets that do not fit the wage curve theory. Particularly, the creation of apartheid homelands has resulted in a persistent situation where high unemployment, low wage regions stand in contrast to low unemployment high wage regions in the long run. At the same time, the short term relationship between wages and unemployment is not negative (as is common internationally), so that short-run wage inflexibility does not reduce unemployment in periods of economic downturn. The implications of this study support the introduction of a wage subsidy as a policy measure. This is a current proposal set before government. It is evident that the market is not willing to create jobs at high prevailing wage rates. While the policy proposal has been targeted towards young recipients who struggle to make the transition into the labour market (on the labour supply side), it is evident that an alternative effective route could be to target small firms with wage subsidies (on the labour demand side), and also regions where long-term rigidities pervade. These firms in particular experience difficulties in footing high wage bills under collective bargaining agreements and therefore reduce (unskilled) unemployment or close their doors altogether.

### **Data and Research Methods:**

Using the LFS, we construct a district level panel of local unemployment and participation rates, which are linked with wages. Using GMM dynamic panel estimators, we causally establish whether high wages fuel participation and whether

this is one of the mechanisms by which unemployment raises. We show why it is important to control for district level heterogeneity at the appropriate level, and proceed to establish mechanisms by which labour market inflexibility is driven by conditioning on appropriate variables – particularly pertaining to industrial structure and unionization. Furthermore, this study implements wage dispersion as a proxy for bargaining agreements. Districts with high average wages tend to also have lower wage dispersion, suggesting that there is an absent bottom tail, akin to the absence of low-paying small firms.

The first phase is descriptive, which is currently underway. Estimates of wage flexibility have already been conducted. However, these estimates remain descriptive. The continuation of this research requires exogenous variation in labour market circumstances. Dynamic panel estimates present the first approach in overcoming this shortcoming, by exploiting the lag structure of labour market outcomes to obtain exogenous variation. However, spatial dimensions are also important, as illustrated by Kingdon & Knight (2006).

For this purpose, I am consulting geographers for spatial data on South Africa, which exploits locational differences between areas of residence and metropolitan centres, as well as the extent of isolation from main labour markets. The geographic distribution of individuals in former homelands will also be required, as this variation is exogenous and can explain permanent differences in local labour markets across space. These variables serve in the instrumentation strategy, as an alternative to estimates using the current survey data that exploits the time dimension in the data using Arrelano-Bond dynamic panel data models.

Preliminary causal estimates using both instrumentation strategies will be available by early to mid 2013.

### **Expected Outputs**

1 to 2 journal articles/ working papers. Each of these will make up one of three components of my PhD dissertation. The first will focus on the role of spatial heterogeneity in wage curve estimates. The second will obtain causal estimates of labour market inflexibility in South Africa.

### **Time Frame**

Each of these papers will hopefully be available in draft format by the end of 2013. Publication as working papers and journal articles depends on the review process.

### **Sequencing and Prioritisation**

Since this work forms part of my dissertation, it gains first priority. I am currently involved in other work on low income labour markets as part of the RESEP research group at Stellenbosch University. Furthermore, I am completing other papers (on child poverty, labour supply and cliometrics) which are under review at various

journals with other co-authors. This finishing process will divert my attention at some stages. However, the primary new work that I am undertaking is based on this proposal

### **New or Ongoing Research**

I commenced with this research in May 2012, while on study leave in Oxford. The work is, however, still in its initial stages.

### **Other funding**

I started this work with the support of a Commonwealth Split-site Scholarship in Oxford, which has expired. I currently do not have any additional funds available for the project.