Economy Colloquium: Towards a new economic trajectory for South Africa

21 December 2018

Summary of Proceedings

Objectives of the Colloquium

The Minister of Finance convened an Economy Colloquium to discuss ways to achieve a higher growth trajectory for the South African economy. The Colloquium was attended by a small group of academics, private sector economists, key government officials and international experts. At the colloquium, key economic departments, the OECD and World Bank presented policy papers, with a focus on new models and paradigm shifts in support of faster economic growth.

The second colloquium will take place on 19 January 2019. The principal objective is to develop an "Economic Strategy for South Africa".

A summary of the presentations

1. Placing structural transformation at the centre of economic revival (Department of Trade and Industry)
   a. Diagnosis:
      i. Structural transformation drives economy-wide growth and employment across developing countries. Thus at the core of South Africa's weak growth and employment creation predicament lies a crisis of low levels of fixed investment, particularly in manufacturing and other increasing return sectors.
      ii. South Africa's post-apartheid political settlement and associated policies and institutions have enabled high corporate profitability particularly in largely non-tradable sectors while committing low levels of fixed investment. A large financial sector generates lower savings and investment than peers. The growth acceleration achieved over the 2000s was based on unreplicable conditions: the confluence of a commodity boom and massive expansion of household debt levels. Tensions over who gains from rents in the economy have undermined profitability in sectors such as mining over the last decade in particular.
      iii. Tepid export growth and diversification exacerbates the balance of payments constraint to growth. Low fixed investment concentrated in non-tradable and other high profitability sectors, with limited growth and employment linkages. South Africa's uniquely high levels of unemployment cannot be explained primarily as a function of labour market inflexibility.

iv. Industrial policy, deemphasised until 2008, has recorded successes but been frustrated by lack of cross-cutting support across government and State Capture. Weak economic performance has undermined the legitimacy of both economic policy and the prevailing corporate structure.

b. Recommendations:

i. There is an urgent need to raise fixed investment and black participation in increasing return activities that alleviate the balance of payments constraint through government-wide policy reconfiguration and commitment, and "New Sectoral Deals". This includes:

ii. A step increase in industrial financing recognising prevailing fiscal constraints, including mobilising tax incentives and scaling up concessional flows via Development Finance Institutions like the Industrial Development Corporation (IDC) and Land Bank; A prudent yet developmental shift in the Public Investment Corporation's "investor activism" mandate; Strengthening preferential procurement legislation; A strategic approach to competition and rivalry; Developmental regional integration; Responding to expedited technological change; and Addressing currency volatility and periodic overvaluation;

iii. Economy wide "Sectoral New Deals" that lock in both policy certainty and public support in exchange for reciprocal commitments to raise fixed investment in increasing return sectors and strengthen inter-sectoral linkages, including building on existing manufacturing capabilities; exploiting the potential for structural transformation in horticulture and strengthening manufacturing linkages with mining and retail.

2. Economic transformation, inclusive growth and competitiveness (National Treasury)

a. Diagnosis: Several structural faults limit the potential growth rate of the South African economy. These include: (i) Inefficient public monopolies imposing high cost structure for network infrastructure; (ii) Disappointing export performance and exports that are concentrated in minerals and metals products; (iii) Highly concentrated industrial structures, limited competition and high barriers to entry; (iv) Low levels of labour intensive growth; (v) Severely skills constrained economy; (vi) Poor educational outcomes that perpetuate inherited disadvantage; and (vii) Spatial fragmentation of the urban landscape and high travel costs.

b. Recommendations:

i. Addressing these structural faults through reforms will require concerted action across a range a different fronts to alter the economic landscape.

ii. Specific interventions discussed include: inviting private sector participation where the government cannot afford to invest or where value for money can be demonstrated for a private sector risk premium; effective economic regulation of the transport sector; addressing exclusive leases is critical to create more competition in among supermarkets; leveraging export-oriented and labour intensive agriculture to boost the rural economy and absorb unskilled workers (specifically resolve outstanding sanitary and phytosanitary standards related market access issues and expand water for irrigation); expanding on the current process of reviewing and amending South Africa's visa regulations to make it easier for tourists to enter and to facilitate more rapid high-skilled immigration; leveraging regional opportunities particularly in transport, energy and construction to promote export growth and improve intra-regional logistics by implementing joint action across a range of areas (e.g. border controls, standards, storage facilities and increasing investment in infrastructure).

iii. Fundamental building blocks of growth include: Improving educational outcomes throughout the educational life-cycle, with a special emphasis on early childhood development; Increasing support for youth employment interventions; Expanding effective, affordable and integrated public transport systems and prioritising targeted housing and urban development interventions to overcome spatial legacies; Building economic institutions that support growth require a capable state as well as a functional relationship between the state and the private sector; Ensuring stable macroeconomic policy that emphasises low inflation and sustainable fiscal policy to boost savings and support competitiveness and export growth.

3. An OECD perspective
    a. <u>Diagnosis:</u> The challenges South Africa is facing can be summarised by the costs of producing which are high. Three main factors/constraints are at play: competition in product and service markets, skills shortage/dysfunctional labour market and governance. The OECD Product Market Indicators (PMR) show that there is room to improve competition in these markets. High distortions introduced by state involvement in the economy together with high barriers to both domestic and foreign entry into SA product markets. Scope of state-owned companies (SOCs) in South African economy remains very high. Complex regulatory procedures further inhibit growth due to administrative burden for start-ups and the burden of licences and permits in general. The labour market is not functioning well and is characterised by high premiums for skilled workers affecting the competitiveness of the economy. This is illustrated by important skills mismatch in the economy – both fields of study as well as qualification mismatch; while school completion rates remain low. Governance is an issue affecting the delivery of public services and therefore limiting the competitiveness of the economy too. The large government wage bill, low state capacity (including local government) and issues around public procurement remain problematic.
    b. <u>Recommendations:</u> 1) More competition and better regulations in product and service markets: Open up telecommunications, energy, transport and services sectors to competition. Review the regulation of legal and professional services to increase affordability and access. Introduce a "silence is consent rule" for licensing procedures that have low associated risks. Systematically review and reduce the stock of red tape and licensing requirements. 2) Urgent attention should be given to fix the education sector at all levels to increase skilled labour supply. 3) Improving the delivery of public services is important for reviving the social contract in particular the possibility to raise more taxes. This requires, amongst others, rethinking the delivery of certain services, in particular where municipalities have demonstrated an inability to deliver. Given their impact in the economy, reforming the management of SOCs and reducing government participation in some, may be necessary to open up these markets.

4. Accelerating inclusive growth (World Bank)
    a. <u>Diagnosis:</u>
        i. World Bank estimates South Africa annual GDP growth potential until 2030 at 1.4%. There is no significant space for macroeconomic stimulus: exchange rate is undervalued, public and private debts are high. There are several sustainability

risks including carbon and water intensity, debt and mineral dependency. Innovation/automation is not a threat for job creation in SA, since the country is so far behind the technology frontier. GDP growth cannot be significantly and sustainably elevated if not more inclusive – current growth patterns fuel inequality: skills gap, poor internal and external competition, insufficient spatial integration (despite massive fiscal redistribution). Record high income inequality combines with strong political rights to demand radical redistribution, which creates policy uncertainty and deter private investment, in growth enhancing activities. Strong political rights and record-high inequality combine to exert immense pressure on the fiscus, resulting in a budget over GDP 10 to 15 percentage points higher than Sub-Saharan average.

   ii. There are five binding constraints to growth: (i) insufficient skills (labour supply, total factor productivity, economic management, small and medium enterprise (SME) development); (ii) skewed distribution of land and productive assets, and weak property rights (investment, SMEs and rural development); (iii) low competition and low integration in global and regional value chains (investment, SME development, innovation, factors' markets allocative efficiency, external competitiveness, regional integration); (iv) limited or expensive connectivity and under-serviced historically disadvantaged settlements (labour supply, human capital development, SME development, externalities of agglomeration, social cohesion); (v) climate shocks: transition to low-carbon economy and increasing water insecurity (economic participation through greater protection against irreversible shocks; access to external markets; allocative efficiency of inputs).

b. <u>Recommendations:</u>
   i. Labour supply interventions: Greater support to school education (teachers' capacity and accountability) and post-school education and training poor students (through NSFAS), collective transports and social housing investment for spatial integration. Strong impact on inequality. Fiscally costly and impact lessened in a weak environment growth.
   ii. Labour demand interventions: skilled migration, greater products market competition, improved mining charter. Do not reduce inequality, but generate labour demand and create fiscal space.
   iii. Strengthening the social contract through building consensus with business, labour and civil society will be important to manage expectations. Continued efforts to support chronically poor and redistribute wealth while protecting property rights will equally be key to sustain social progress and, ultimately, GDP growth.

5. Reflections from Harvard professors
   a. <u>Diagnosis:</u>
      i. South Africa is in a vicious cycle: limited inclusion is driving high demand for redistribution, which in turn is driving high uncertainty that dampens investment, which lowers growth, which in turn drives limited inclusion.
      ii. Why is SA not growing? Can it really be due to poor network sectors, when Ethiopia and other emerging markets, with much worse conditions compared to SA, are growing so much faster?
      iii. Can it really be implementation, when so little has been done in achieving past recommendations? Is the problem instead not a political one?

iv. There has been a sharp breakdown in social dialogue: the sense of "us" has disintegrated.
v. South Africa is not politically serious about putting economic growth first and foremost.
vi. People act not just in their self-interest, but on their beliefs. Unfortunately, there are a number of influential decision makers whose beliefs about the world are not accurate.
vii. It should be borne in mind that higher local value added at world prices raises living standards – multiple objectives make it hard to run industrial policy properly.

b. Recommendations:
   i. South Africa should pay attention to the fourth factor of production: "know-how", which is channelled via foreign direct investment (FDI), immigration and the diaspora. South Africa needs to find ways to help firms get and use know-how to help their workers move into different areas.
   ii. South Africa needs to find a way to drive greater confidence in the future – by being much more selective about the types of industrial policy that is supported – for example strategically choosing 1 or 2 areas for public procurement that are large problems for the country and the solutions to which currently don't exist and that require a supply response.

Key themes from discussions

6. The political economy of reform

a. *What can be done to change the narrative to affect a lot of people positively in terms of the growth story?* How can this be a key driver of a growth story which does not polarise? This is linked to rekindling the idea of the sense of "us". ZZ2 gave examples of how by working in partnership with the community, it is possible to generate win-wins. However, it requires thinking of oneself as part of the community, rather than outside it or to be served by it. There was some discussion around whether the objectives of Black Economic Empowerment (BEE) were helpful or a hindrance, particularly with regard to its impact on the successful conduct of industrial policy.
b. *What is the political appetite to undertake reforms?* A number of issues were raised as taboo. For example, there were those who felt that there was no appetite to allow foreign skills into the country and that this debate should be shut down. Others argued that skills are a complement, not a substitute for low skilled workers, and that it was critical for policy makers to make this point repeatedly (e.g., Panama increased the number of skilled migrants and saw demand for employment and wages increase).
c. *What level of accountability is required to start holding failing ministries to in order to ensure delivery?*
d. *What are the focal areas of reform?* Should we just go on and tackle the issues we know are obstacles? Or are these really the binding constraints? Do benchmarks distract us from the most important factors and give us a (false) sense of progress?
e. *How important is an external orientation?* Does South Africa see itself as part of the broader global economy, or is the focus internally? Is an Africa focused strategy enough?
f. *How do we resolve the issues relating to implementation when coupled with policy ambition?* Are we reasonable in terms of our expectations of the state to deliver on a wide range of reforms and policies, whilst the capacity of the state remains relatively stretched?

g. *We must be cognisant of the limited macroeconomic space when coming up with solutions.* Monetary policy conduct is constrained by fiscal policy, higher administrative prices. Macro policy space in a world of globally tightening monetary policy further reduces this space.
h. *Does our lack of execution reflect an implementation challenge or a political one?* Why are the obvious areas of competitive advantage (e.g. tourism and mining) deliberately being blocked? We cannot continue to avoid the difficult conversations as to why our education system continues to fail our learners. It is not sufficient that we accept that we are poor performers.

7. Industrial policy, government procurement and localisation

a. Tourism and agriculture should be an important part of our development plan, but manufacturing is not unimportant given how few economies have successfully developed without a strong manufacturing base. This may mean that specific industrial policy interventions will always be required. But a massive state-led industrialisation strategy has not worked anywhere in the OECD (more mistakes than success stories).
b. Multiple objectives make it very difficult to effectively run an industrial policy programme – e.g. special economic zones (SEZs) are tasked with rural upliftment and building up a trade port. Need to understand that an inclusion strategy is not a growth strategy.
c. State capture has negatively impacted localisation through government procurement. Value chains and concentrated markets need to be the future focus for targeted localisation policies. Government procurement should be targeted with more foresight and evidence based. Monopolists may add value but the higher prices would reduce national income with several negative consequences.
d. Current industrial policy does not seem sufficiently export oriented, and very reliant on Government procurement.
    i. Localisation only raises living standards if it is done at world prices.
    ii. Scattered government procurement approach limits impact and takes away resources.
    iii. Strategic procurement works if there is a domestic supply challenge and there are broader strategic aims that can be achieved with it (e.g., defence industry in the United States). We should consider having a much more focused strategic procurement strategy, which is highly successful if: it is focused on one or two areas that are a major source of concern for the government; the solutions currently don't exist; there is a large fixed cost in finding solutions that the government is willing to share and the Government wants a supply response.
e. There are some potential avenues to make our existing industrial policy work better (thinking more about future growth; the need to concentrate; focus on vertical vs just horizontal opportunities).
f. Discussion on the value of BEE beyond transformation to also influence growth more directly. To the extent that BEE is about redistribution, then it should explicitly be about that, rather than placing it under a growth enhancing strategy.
g. How do we make BEE more productive? Should start-ups be burdened with BEE legislation? Although it is laudable to want to experiment with IP, it is important to bear in mind that it can be very difficult to stop IP when it begins, due to political capture. Is there a way that South Africa can use its concentrated markets to its advantage when designing IP? Instead of simply trying to fight them with competition policy?

8. ***Market concentration and competition policy***
    a. Competition policy will in the future also focus, amongst others, on market structure and market behaviour. This will entail the competition authorities crafting remedies that remove distortions to the effective operation of markets, including those introduced by government policy and action. Competition policy reform can contribute to growth in a significant way, but effective implementation by a strengthened Competition Commission will be critical.
    b. There is a policy dilemma here because dominant firms are also large employers and exporters.
    c. How much growth traction can one get from more effective competition policy? Can it move the dial?
9. ***Export led growth with value added for future growth markets***
    a. As a small open economy, South Africa needs to have an export orientation – but this seems largely lacking. It does not seem linked to the real exchange rate.
    b. How can South Africa nudge large conglomerates to export more?
    c. Tourism is an obvious low-hanging service export, but needs more enabling immigration policy and visa regime.
    d. Agriculture exports is a critical area of competitive advantage, but the sector has very high capital requirements. Also, tenure rights on traditional land, the inability to commercialise communal livestock, and broader concerns with property rights will remain binding constraints.
    e. Regional economic development and manufacturing exports to the rest of Africa. Logistically, would trade beyond countries in the Southern African Development Community (SADC) region be easier or more difficult for South African companies?
    f. Export response to exchange rate movements remains muted. Why is this?
    g. How can SEZs be leveraged to support export oriented growth?
10. ***Investment***
    a. Real interest rates remain low relative to competitors, so low investment rates are a puzzle – unless low confidence is taken into account
    b. Lack of confidence in the future exacerbates low levels of investment. Investment is a fundamental driver of growth and so the question should be how the microeconomic reforms will unlock investment.
    c. Certain basics hold investors back as they have a fiduciary duty to their shareholders, so struggle to convince them in context of uncertain property rights, uncertain fiscal pathway (and implications for social stability and cost of capital), etc.
    d. South Africa needs a new investment compact with the private sector.
11. ***Human capital and labour market issues***
    a. It is clear that employment growth in the past decade came from a rise in general government employment and that labour share of income has increased since 2009.
    b. Apartheid legacy seems to be an excuse for high unemployment – not a reason anymore as spatial problems should be much less now but there is still a rising level of structural unemployment.
    c. Focus should be to create opportunities for the labour force as well as how to create the kind of labour force that can compete in the future. Deep educational reforms, that focus on early childhood development, early reading and foundational phase learning is critical for long-run growth. While deep reforms are needed, we now have knowledge of the focused steps needed to improve early foundation level reading.

d. The national minimum wage places a high burden for employers to pay for social protection; social reforms should be considered which the government explicitly funds. Perhaps South Africa needs to focus on labour market reforms (e.g. reviewing extension of collective bargaining wage agreements). The NDP also argues that the cost of living needs to fall to address extensive working poverty.
e. Should South Africa be encouraging informalisation? What in South Africa makes it different with the result that the informal sector is not flourishing as in many Latin American countries and elsewhere in Africa? There are fiscal risks to informalisation due to its potential impact on tax revenues (but these people are outside the tax net anyway?). Are the rules based system the reason South Africa does not see higher levels of activity in the informal sector?
f. Land tenure in former homelands and transport and housing services in metros are important factors that could improve growth. Basic education and trade training are also important focus areas that seems to have been lost in South Africa.
g. Skilled immigration would be important for South African growth. When it comes to immigration policy, it is important to err on the side of excess otherwise the potential for leaving gains on the table is too great. Immigration does not have to be a political issue; South Africa should simply implement a more open immigration regime. The visa issue has not been fixed and the view should not be that skills simply flow to big firms – allowing skilled foreigners in without being attached to a large firm also has merits.

12. *Governance and capability of the state*

a. State capture. Should the incentives in the public sector be structured differently for better execution? Given how much state capture has weakened the ability of the state to deliver (especially SOCs), do we need to think differently about implementation.
b. Specific governance interventions could boost confidence of investors (e.g., new leadership of the SA Revenue Service installed, sustainable financial pathway identified for Eskom, narrowing of areas of contention in respect of property rights, and similar.
c. Government presentations should focus on what government can do for better government delivery. An acceleration may depend on what government can do to stimulate better private sector response.
d. Actions to strengthen governance in a way that gives confidence to investors could lead to rapid improvement. As South Africa currently performs below its potential growth rate, it means there is capacity that could come into play quickly.

13. *Implementation and execution*

a. There is a large disconnect between policy and implementation. We haven't sufficiently implemented many of the recommendations received over the years – why is that?
b. The South African government has failed to address any of the issues raised in diagnostic studies. This is related to failures in economic regulation and policy making, but there are two fundamentally deeper problems:
    i. An unwillingness to be pro-growth as policy makers – so perhaps the challenge is not one of implementation, but rather political will.
    ii. A parochial attitude towards gathering "know-how" (information, skills and investment) from the rest of the world, that makes us closed to taking in what we can do – and which also limits how much we are prepared to do / be the best.
c. We need to differentiate between actions for growth acceleration (that can be immediately implemented in 2019) versus actions for sustained growth (i.e., the fundamental building blocks of sustainable long-run growth). The immediate growth accelerators will depend on stimulating capacity that is sitting on the side, awaiting more

certainty in relation to property rights, fiscal stability and similar. By definition, anything that requires policy design, new budgets and similar will take years to have impact. Early stimulation of growth can in itself generate confidence and broader society engagement, winning access to the next round of improvements and a virtuous circle of growth.

Areas of consensus

a. Diagnosis:
   i. Investment is low and undermined by South Africa's very low inclusiveness and high inequality. Growth cannot be accelerated if not more inclusive. The sense of "us" needs to be restored, in policy design and narrative
   ii. Low competition (SOCs, non-tradable sectors, and inward orientation), poor educational outcomes, low skills, insufficient know-how, and a lack of spatial integration (townships, homeland/communal land), are strong deterrents to higher and sustained inclusive growth in the long run.
   iii. There is little macroeconomic space for stimulus (already low real interest rates, undervalued currency, high public and private debt, tightening global conditions).
   iv. Private sector participation in public projects needs to be encouraged.

b. Recommendations:
   i. Skilled migration, and a few regulatory reforms (visas, barriers to entry in some sectors, e.g. telecommunications) can provide a short term boost to the economy (while longer-term challenges (e.g. reform of the education system) are addressed).
   ii. Efforts in policy implementation need to more focused and selective, and systematically evaluated (including BEE, procurement, localisation and industrial policy).
   iii. Political and administrative incentives for better delivery may need to be re-evaluated.
   iv. There is a need to dramatically and rapidly raise fixed investment in increasing return sectors that have high growth and employment multipliers and a positive impact on the quantum and diversification of net exports. This includes not only manufacturing but sectors like tourism and horticulture (high value agricultural exports).