THE GROWTH AGENDA

Priorities for mass employment and inclusion

ACCELERATING INCLUSIVE GROWTH

GROWTH SERIES
Report 3

CDE
CENTRE FOR DEVELOPMENT AND ENTERPRISE

CENTRE FOR DEVELOPMENT AND ENTERPRISE

About CDE

The Centre for Development and Enterprise (CDE), an independent policy research and advocacy organisation, is South Africa's leading development think tank. Since its establishment in 1995, CDE has been consulting widely, gathering evidence and generating innovative policy recommendations on issues critical to economic growth and democratic consolidation. By examining South African and international experience, CDE formulates practical policy proposals outlining ways in which South Africa can tackle major social and economic challenges. CDE has a special focus on the role of business and markets in development.

CDE disseminates its research and proposals to a national audience of policy-makers, opinion formers and the wider public through printed and digital publications, which receive wide media coverage. Our track record of successful engagement enables CDE to bring together experts and stakeholders to debate the policy implications of research findings.

The CDE Growth Agenda Series
Series editor: Ann Bernstein

Reports in the Growth Agenda series are based on CDE's many policy initiatives, commissioned research and think pieces, as well as consultations and workshops with experts and stakeholders. They were written and edited by Ann Bernstein, Antony Altbeker and Professor Alexander Johnston. The entire project has been guided by a reference group of CDE Board members, supplemented by other senior advisers. We are grateful for the advice and assistance of many other people in helping CDE to produce this series of reports.

This document and the six other reports in the Growth Agenda series are available from CDE; they can be downloaded from www.cde.org.za.

The initial research was funded by The Atlantic Philanthropies. The funders do not necessarily agree with the views expressed in the report.

Published in April 2016 by The Centre for Development and Enterprise, South Africa.
5 Eton Road, Parktown, Johannesburg 2193, South Africa
P O Box 1936, Johannesburg 2000, South Africa
Tel +27 11 482 5140 | Fax +27 11 482 5089 | info@cde.org.za | www.cde.org.za

ISBN: 978-1-920653-25-5

The Growth Agenda
Priorities for mass employment and inclusion

For the past two years the Centre for Development and Enterprise (CDE) has been working on a major project to identify national priorities for faster economic and employment growth.

More than 20 years after apartheid far too many South Africans live in poverty, largely because far too few have jobs. This has serious implications for our society; South Africa's considerable democratic achievements are being put at risk by the political, social and economic consequences of low growth, unemployment, poverty and inequality.

As we have worked on the project – commissioning research, taking soundings and consultations, testing ideas with stakeholders – concerns about the country's trajectory have deepened and been more widely expressed by people from all walks of life. There is a broadening consensus that we are in deep trouble; this is an opportunity to focus on priorities for action.

This report is one of the CDE Growth Agenda series of publications. We have identified the catalytic priorities which form the essential building blocks for a fundamentally new approach to accelerating growth and employment in South Africa. These priorities comprise a basis for encouraging a wide conversation across South Africa, by offering a diagnosis of what is going wrong and focused recommendations for getting the country back on track.

The CDE Growth Agenda series consists of seven reports:

- Summary overview: Insights and key recommendations
- Jobs
- Accelerating inclusive growth
- Cities
- Skills
- Business and government
- An export processing zone for the Nelson Mandela Bay Metro

"The bottom line is this: South Africa needs accelerated growth that is urban-led, private sector-driven, enabled by a smart state, and targeted at mass employment."

ACCELERATING INCLUSIVE GROWTH

INTRODUCTION

South Africa's developmental goals are clear: the reduction of unemployment, poverty and inequality; the transformation of the economy to better reflect the country's demographics; the creation of a just and inclusive society; and the consolidation of our democracy. However, debate about them often fails to acknowledge that they cannot be achieved without robust economic growth sustained for a significant period.

According to the National Development Plan (NDP), the economy needs to grow at more than 5 per cent a year until 2030 if we are to achieve the goals of eliminating poverty, ensuring that 60 per cent of adults would be in work (up from about 44 per cent at present) and reducing inequality as measured by the Gini coefficient from 0.69 to 0.60. In this regard, the NDP is exactly right; if South Africa is to end mass poverty and unemployment, its economy needs to grow far more rapidly. This makes its performance in recent years nothing less than disastrous.

"South Africa can do a lot better than this if we build on some of the strengths of the economy, notably its many efficient, well-managed firms."

Over the past five years, the economy has grown at just over 2 per cent a year and, following a rapid further drop, is now expected to grow at about 1 per cent a year for the next few years. This is lower than the rate of population growth, which means that however the fruits of economic activity are shared, the average South African will be getting poorer in the years to come.

South Africa can do a lot better than this if we build on some of the strengths of the economy, notably its many efficient, well-managed firms. This asset is underappreciated by many policy-makers, whose disdain for business is one reason – among others – why business confidence is at an all-time low.

Sustaining rapid growth over a long period would be unusual for a middle-income country. A lot needs to go right for this to happen: education policy must work; savings and investment rates must be high; benign international environments and technological changes are helpful.

This report does not address all of these issues. Some – labour market reform, skills development, business-government relations, cities – are the subject of companion reports in the CDE Growth Agenda series. This report focuses on one of the most important reasons why the economy has performed so sluggishly: the fact that our policy-makers have generally failed to address the most significant constraints on economic growth and have often chosen, instead, to pursue policies with an adverse impact on growth.

GROWTH MATTERS

Only rapid growth will establish the necessary foundation, opportunities and resources that will enable South Africa to achieve its developmental goals. Whatever other policies are put in place, the failure to achieve faster growth will condemn millions to continuing unemployment and poverty. This would be a terrible betrayal of the post-apartheid social contract and would threaten our constitution and democracy.

South Africa's political stability and economic prosperity cannot be sustained without far-reaching social and economic transformation. Black South Africans have legitimate expectations of far deeper and broader economic inclusion than has been achieved until now. A massive change in the structure of economic opportunity and access to education and employment is needed. In its absence, growth will remain stunted by the fact that only a relatively small number of people have the skills and know-how needed to expand economic activity. This has been clear since at least the 1970s, and it is even clearer today.

So transformation needs growth, and growth needs transformation. But some caution is needed: just as not all forms of growth will drive transformation, not all approaches to transformation will drive growth.

"A massive change in the structure of economic opportunity and access to education and employment is needed."

Take the first relationship – that between growth and transformation. The benefits of South Africa's decades of modest growth have been shared exceptionally unequally. Future growth must be much more inclusive if inequality is to fall. For this to happen, the incomes of the poor must rise more rapidly than the incomes of the rich, which can only happen if many more people move into employment. In turn, this depends on faster and more labour-intensive economic growth.

The main reason why rapid growth is so important for South Africa's prospects is that it drives job creation. But it does more than that. Economic growth increases company revenues, making possible higher profits and salaries. Rising profits and wages mean more tax revenues with which the state can build social and economic infrastructure, widen the social safety net, ensure improved education and training, and deepen and widen service delivery. Growth is therefore a prerequisite for our most important redistributive measures: social grants, RDP housing, free education and healthcare, the expanded public works programme, and other initiatives.

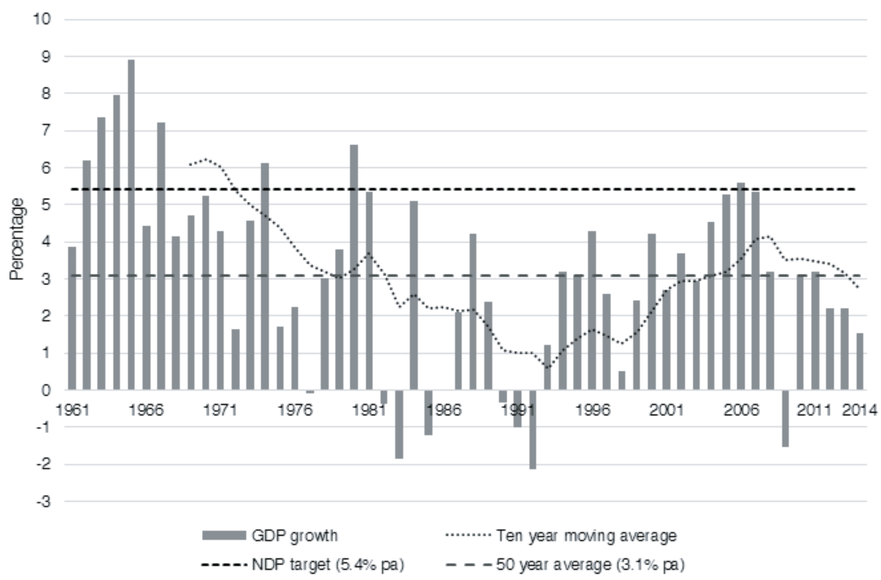
However, public provision of incomes, goods and services to the poor is a form of inclusion that is significantly less empowering than employment. In fact, no conceivable set of redistributive interventions rivals the potential of economic growth to transform a country's fortunes. One way to see this is to think about China, where average per capita incomes have risen by nearly 250 per cent since the late 1990s. Even though inequality has widened – suggesting that redistribution is not a key driver of poverty reduction – its effect has been swamped by the enormously positive effect of growth, which has lifted hundreds of millions of people out of rural deprivation. In South Africa, by contrast, growth has been slow, and, even as we have built one of the developing world's more redistributive states, poverty rates have barely changed.

The bottom line, then, is that South Africa cannot address its many socio-economic challenges without inclusive and sustained economic growth. It is not just the material effects of growth that matter – the jobs and income created, the expanded quantity and quality of goods and services produced. Growing economies generate optimism and hope, a sense that the country is succeeding, and that the prospects of individual citizens and their children are improving. These intangable benefits help make the promise of growth self-fulfilling. It is a tragedy, therefore, that economic growth in South Africa has been so modest for so long.

SOUTH AFRICA'S MODEST GROWTH PERFORMANCE

Rapid growth is so important that the NDP – which sets as its goals the elimination of poverty, the reduction in inequality and the creation of 11 million new jobs before 2030 – argues that for South Africa to achieve these goals, annual economic growth must average 5.4 per cent a year between 2012 and 2030. As even the briefest glance at South Africa's growth record over the past half century will confirm (see Figure 1) this is a very ambitious target, one that has rarely been achieved since the middle of the 20th century, and only for short periods at that.

Figure 1: South African GDP growth over 50 years - 1961 to 2014



Source: *World Bank database*

"South Africa cannot address its many socio-economic challenges without inclusive and sustained economic growth."

Apart from South Africa's own relatively modest long-term growth record, another concern is that we have entered a period of slower global growth, coinciding with rising domestic challenges to social and political stability. These dynamics could feed on one another and create a self-reinforcing chain of events that could dash any hope of material progress and threaten our hard-won constitutional democracy.

However, to blame all South Africa's economic woes on the global economy is wrong. Much of the blame for our poor growth performance over the past 50 years lies in choices made by policy-makers across those decades. Those choices violated many of the core principles followed by countries that have grown rapidly. For example:

- In the long term, economic growth depends on rising productivity which, in turn, depends on the quality and reach of education and skills development. South Africa has a very poor record in this regard, resulting in a skills base which is far too narrow to meet the needs of the economy.
- Growth requires the effective use of human capital. Under apartheid, the majority was excluded from the most important aspects of the formal economy, robbing it of talents that might have pushed out the boundaries of the possible.
- Sustained growth requires political stability and inclusive institutions. For most of the past 50 years, South Africa has had neither.
- Sustained growth requires high savings and investment levels, and a strong export orientation. South Africa has a mixed record in these respects, but its performance has generally been worse than the average for developing countries, and nowhere near those of the fastest-growing East Asian economies.
- Economists increasingly agree that that high levels of inequality work against sustained economic growth. Despite two decades of post-apartheid policy reform, South Africa remains one of the most unequal countries in the world.
- Expanding economies require capable states that recognise the importance for development of functioning markets. Neither the apartheid nor the post-apartheid state has met this requirement.

"We have entered a period of slower global growth, coinciding with rising domestic challenges to social and political stability."

The bottom line is that South Africa's long-term growth performance of a little over 3 per cent a year over the past 50 years has been achieved despite the fact that domestic policy has been inimical to rapid growth. This is not surprising – rapid and inclusive growth has not been the overriding goal of public policy either during apartheid or during the first two decades of democracy. If policy-makers were to concentrate on achieving rapid, labour-intensive growth, much more could be achieved. But this would mean adopting policies that promote growth, and rescinding those that stifle it. In particular, policy-makers would need to focus on creating a more favourable environment for all types of enterprises, whether large, medium or small.

South Africa needs to put growth and mass employment at the top of its list of national goals. This means that all policies need to be assessed in terms of their impact on achieving faster and more inclusive (i.e. more labour-intensive) growth.

MANY OF OUR POLICIES CONSTRAIN GROWTH

One explanation sometimes offered for sluggish growth is the poor delivery of good policies. 'We have world-class policies,' we often hear. 'It's the implementation that's the problem.' This analysis is wrong: many of the policies are themselves obstacles to achieving growth.

Policy-makers are slowing growth in four major ways: by playing high-risk games with our public finances; by allowing economic transformation to degenerate into elite enrichment; by undermining policy certainty and stability; and by neglecting the role of business in generating economic growth.

Playing dice with fiscal policy

One of the successes of post-apartheid governance until the onset of the global financial crisis was the careful stewardship of fiscal policy, which, together with relatively rapid economic (and tax revenue) growth in the early 21st century, meant that the value of public debt fell to less than 25 per cent of GDP. Since 2008, however, the ratio of debt to GDP has risen to almost 50 per cent, even before full account is taken of the many contingent liabilities on the government's balance sheet, including SAA, Eskom, and the Road Accident Fund. The many as-yet-unfulfilled policy commitments the government has made, which include national health insurance and greatly expanded access to tertiary education, also contribute to worries about debt. These fiscal pressures combined with a seeming inability to stand up to public-sector unions, are the main reason why South Africa's credit rating has been reduced to just above junk status, and is hovering on a downgrade.

The basic story is quite clear. In the mid-2000s, government looked at its swelling coffers, and concluded that economic and tax-revenue growth were here to stay. As a result, it allowed public expenditure to grow rapidly, notably by increasing the size of the civil service by 25 per cent between 2006 and 2014, even as it increased civil servants' pay faster than the rate of inflation. This locked rapid expenditure growth into the system. When the financial crisis struck in 2007/8 government's initial response was to maintain the projected rate of growth of public expenditure. This would have been appropriate for a temporary economic downturn, but not one that could drag on for years. It is this that explains the rise in government debt, and the loss of its credibility in capital markets.

"'South Africa's deteriorating fiscal condition is a result of slower growth and is increasingly a cause of it. Policy makers have been too insensitive to this."

This policy drift has been very expensive. A greater proportion of taxes has to be used to service government debt, which has been the fastest rising area of expenditure in the budget for some years, even as the costs of borrowing new money have risen rapidly. Worse, rising interest rates mean lower levels of private-sector investment.

South Africa's deteriorating fiscal condition is a result of slower growth and is increasingly a cause of it. Policy-makers have been too insensitive to this – a fact most obviously true about the president, whose reckless dismissal of Nhlanhla Nene as Minister of Finance was seen by many investors as proof of government's indifference to, or ignorance of, its precarious financial position. Exerting greater control over public finances and curbing expenditure are essential for reducing the actual and perceived risk of investing in South Africa.

From transformation to elite enrichment

Redistribution is an essential function of government and is particularly important after our long history of white domination. However, efforts to right the wrongs of the past have increasingly evolved into polices that enrich members of a small elite, rather than redistributing the benefits of economic activity to the millions of people whose circumstances were (and still are) shaped by a discriminatory past. This shift from transformation to elite enrichment is a betrayal of post-apartheid promises to South African voters. It also diverts attention away from what needs to be done to generate the kind of growth required for sustainable, broad-based and rapid redistribution of assets, incomes and opportunities. The increasing emphasis on policies that enrich a small elite is a key reason why overall inequality has not fallen, despite the fact that the gap between the average incomes of white and black South Africans has fallen over the past 20 years. Indeed, one expert on this subject has calculated that while inequality between races accounted for 61 per cent of all inequality in 1993, it accounted for only 35 per cent in 2008.

The elements of redistribution

"This shift from transformation to elite enrichment is a betrayal of post-apartheid promises to South African voters."

All South Africans need to be involved in the economy, and this means ensuring that those who were denied opportunities in the past have greater access to them now. There are several possible approaches to redistribution and transformation, each of which can have different effects on the distribution of wealth, income and opportunity, and on economic growth. It is worth reviewing the current mix of approaches and their impact:

- **Fiscal redistribution:** This is the lynchpin of the post-apartheid social contract – the rich are taxed reasonably heavily in order to allow government to spend more on delivering goods and services to the poor. By the standards of other developing countries, South Africa's redistributive spending is significant; it has a large impact on measures of income distribution, depending on whether they exclude or include taxes and public spending. Our high level of pre-tax inequality, however, means that we are still an exceptionally unequal society. Relative to the social order under apartheid, government has greatly widened access to education, healthcare, housing and social security. At the same time, a substantial portion of redistributive spending produces little or no value for the poor, and is captured instead by (non-poor) civil servants who do not deliver: too many teachers don't teach, too many police officers don't police. In addition, a significant portion is simply stolen.
- **Labour market regulation:** In seeking to protect workers by increasing their bargaining power in various ways, and by raising employment standards and minimum wages, the state has pushed up the costs of labour. This has been good for many workers, but has imposed costs on firms that make them less competitive and less likely to employ workers, especially those with few skills.
- **Asset redistribution programmes:** South Africa has sought to transform patterns of asset ownership through land reform and black economic empowerment. Both of these involve considerable public-sector outlays because white-owned land is generally purchased by the state before transfer is effected, and because empowered businesses are able to obtain state contracts on a preferential basis, even if they charge higher prices.

- **Affirmative action and employment equity:** Government has sought to ensure that firms employ more black South Africans and women, but has generally failed to recognise how difficult this is, given the inefficiencies of our skills development system, and the consequent dearth of appropriate black candidates. Nor has it taken into account the impact that the lack of supply has on the cost of attracting and retaining skilled black staff.
- **'Preferential procurement'*:*** The state and SOEs are increasingly using public procurement processes to support black business. This allows 'empowered' businesses to offer goods and services at a higher price than 'unempowered' companies. It has also opened the door to a range of abuses in tender and procurement processes that benefit officials and the politically connected.
- **Cadre deployment:** This ensures that a favoured group of political insiders is able to secure important positions, often without regard to their suitability for the post or even of their interest in it. This often starts a process in which more jobs as well as contracts for servicing the relevant entity are directed to favoured clients.

Redistribution's balance sheet

South Africa's economy needs to become much more inclusive if it is to stand any chance of growing more quickly. This means that redistributing assets, incomes and opportunities to black South Africans is not just a moral imperative, but an economic one as well. However, redistribution of the wrong sort can undermine growth, and even slow down economic transformation.

"The increasing emphasis on policies that enrich a small elite is a key reason why overall inequality has not fallen."

To take an example: fiscal redistribution, which helped households to increase their human capital (for example via effective education and training) would be a huge boon to those households, as well as society at large. On the other hand, the effect of deploying ill-suited 'cadres' to run important SOEs is quite different; the few appointees do extremely well, but if they are unable to deliver on their institution's goals, their appointment reduces the country's growth prospects, sometimes dramatically so. It also wastes scarce resources through increased corruption and, sometimes, public bailouts of failing enterprises. Conflict and instability in the management ranks and the boardroom, which often accompany these deployments, have other costs such as reduced organisational morale and managerial attention, steep legal fees, and golden handshakes.

In what follows, we identify some of the more problematic aspects of transformation. Labour market regulations and employment policies are dealt with in another report in this series. We also do not examine fiscal redistribution, a policy whose goals we largely share, though we would qualify this by noting two important caveats, shared by the National Treasury and successive ministers of finance. That is, significantly expanding redistribution increases the risk of a fiscal crisis, and poor state management undermines the results of fiscal redistribution in vital areas of national concern such as education and training. What we focus on here is the way in which the legitimate goal of redistributing assets, incomes and opportunities has turned into a programme for enriching a small elite. A telling example of how aspects of the elite enrichment agenda have undermined the pursuit of the country's core social and economic goals can be found in the SOEs.

Elite enrichment and the SOEs

Many if not much of South Africa's largest SOEs have been in a state of crisis for most of the past decade. For some, notably Eskom, the Post Office, the SABC and SAA, chronic crises are threatening to turn into a terminal decline. Of course not all of this is the result of the approach taken to transformation; the mandates of SOEs have expanded significantly over the past two decades, often faster than their financial or operational capability. At the same time their management has been complicated by poor, often inconsistent, and contradictory guidance by their shareholder (i.e., the state). However, SOEs have also been vital arenas for elite-focused transformation, having applied both affirmative action and preferential procurement policies more thoroughly and more rapidly than most other organisations. In September 2015, for example, SAA had to be instructed by National Treasury to stop implementing a rule requiring that 30 per cent of all contracts go to small, black-owned businesses, as this was violating existing policy. Above all, cadre deployment has played a greater role in the selection of SOE board members and managers than in any other economic sectors.

All this has resulted in extremely poor management, leading to considerable waste, inefficiency and corruption. Goods and services vital to social welfare and the success of firms are not being delivered, and in many cases, prices charged by SOEs have risen steeply. SOEs have also squandered their potential to serve as training grounds for a new generation of technicians, operational managers and business leaders. The growing trend towards elite enrichment, marked by crony capitalism and corruption, has also created incentives for the powerful to manipulate the country's legal institutions. The police officers and prosecutors involved in investigating or prosecuting high-profile politicians attract a disproportionate share of disciplinary action. The result is a weakening of institutions whose independence and credibility are vital for the rule of law, with potentially serious consequences for long-term growth, which requires sound, honest and reliable institutions.

"Most of South Africa's largest SOEs have been in a state of crisis for much of the past decade."

Transformation in the private sector

The transformation of business has been pursued with increasing intensity since the mid-1990s, and various rules adopted in its wake now affect every key decision a firm must make: whom it can employ; with whom investors should partner; how ownership should be distributed; which suppliers should be contracted; whether a firm can do business with the state (and even do business with firms that do business with the state); who should be trained; and much more.

It would be wrong to say that BEE and employment equity (EE) rules impose only costs on business, and generate no benefits besides the gains of direct beneficiaries. It would be wrong also to think that imposing some obligations on business to effect transformation is unnecessary, and that all the changes we have seen would have been effected without pressure from policy-makers. These changes are important for the country's future stability and prosperity because they have the potential to expand economic opportunities throughout South African society. The benefits of increasing the participation of black South Africans in the economy, in other words, are enormous. However, it is important to recognise that there are also costs involved in our current approach.

Consider, in this regard, the demands on the time of senior managers who wish to pursue the goals set out in our "transformation" legislation. They have to fulfil many requirements: prepare BEE and transformation strategies, and monitor and evaluate their progress; establish workplace transformation forums, and ensure their proper functioning; and appoint an accreditation agency and submit relevant documentation to it. They must also identify and recruit black staff from a small pool of candidates, a process that is time-consuming and expensive, particularly when head-hunters are involved.

This is a partial list of expectations and obligations, and a case might be made that their costs are low relative to the pressing need for transformation in the workplace. However, the vital point to recognise is that they demand time, energy and resources from firms and their managements, with consequences for the cost of doing business. Some of these costs are passed on to customers; others are paid for in smaller profits, reducing the ability of firms to expand and create employment, and discouraging new firms from entering the economy.

BEE and EE requirements have a disproportionate impact on smaller firms, which have fewer financial and managerial resources. In this regard, there is considerable evidence that, over the past two decades, more and more business activity has been concentrated in larger firms which are better able to absorb the costs and managerial requirements of complying with business regulations. This is often because (non-specialist) owners of smaller firms must also manage their human resources, procurement and compliance policies, the complexity of which may be too demanding for them. StatsSA data show, for example, that between 2001 and 2008, between 72 and 75 per cent of all people in work were employed by businesses with fewer than 50 workers. By 2013, that figure had fallen to 66 per cent.

"BEE and EE requirements have a disproportionate impact on smaller firms, which have fewer financial and managerial resources."

The point to recognise is that BEE and transformation in their present form impose real costs on South African firms, which detract from their ability to maximise their business operations. Ultimately, this reduces economic and employment growth. Among other things, it detracts from firms' ability to compete against firms in other countries that do not have to meet these kinds of obligations.

Transforming the racial composition of South African business, in the boardroom as well as the workplace, is central to the country's future. It is a moral imperative, and also essential for faster growth. How this is implemented and how it affects growth and employment, are key questions that need to be carefully reconsidered. CDE is therefore calling on the business community to fund a blue-ribbon commission on transformation. This should assess what has been achieved, for whom and at what cost; what remains to be done, and, critically, whether an approach to empowerment and transformation can be devised that is truly broad-based, that helps accelerate inclusive growth and that is less harmful to the competitiveness of South African firms.

Transformation and property rights

One of the most significant links between transformation and slower growth is the way in which some policies aimed at redistributing assets, incomes and opportunities affect the security of property rights. This raises owners' risks, and results, inevitably, in less investment. This happens even if those assets are not eventually redistributed; when senior policy-makers float the idea that ownership rights in a class of assets may be changed in the future, it raises the perceived risk of a given investment and reduces its (risk-adjusted) expected return.

Uncertainty is worsened when transformation policies – such as land restitution – are repeatedly revised, making it impossible to guess when and in what form property rights will stabilise. This again results in diminished investment and, ultimately, slower growth and fewer jobs. How, for example, is a potential buyer of a farm to respond to the suggestion made by the responsible minister that farmers ought to be compelled to give 50 per cent of their farms to their workers? This may not be policy today, but will it be five or ten years from now?

"When senior policy-makers float the idea that ownership rights in a class of assets may be changed, it raises perceived risk."

This is what has happened in the mining sector, where the costs and risks associated with the many changes to property rights have been magnified by other policy proposals such as those affecting the pricing of 'strategic minerals', and the state's potential assertion of a prerogative to take controlling shares in firms involved in certain extractive activities. These sorts of changes have real effects on costs, prices and profits. The long-running and expensive three-way legal battle between Imperial Crown Trading (ICT), Kumba Iron Ore and Arcelor-Mittal is an example of this. Kumba and ICT (a little-known but politically well-connected mining company), using fair means and foul, took advantage of the lapsing of Arcelor's rights in Sishen Mine to try to secure those rights for themselves. Allegations (and evidence) of conflicts of interest, corruption and self-dealing abound, with all parties, including the Department of Minerals and Energy and the NPA, being dragged into the mess. This is all but inevitable when complex, opaque processes affecting valuable assets are subject to repeated policy change, and high levels of regulatory discretion.

Another example is the 2015 Expropriation Bill which would allow the state to expropriate private property 'in the public interest, or for public purpose', with owners paid as little as 70 per cent of market value as compensation. At the same time, the Property Valuation Bill (2014) would give a newly created 'Valuer-General' exclusive power to value property in cases of expropriation, land reform or other form of acquisition by the state. Market value is only one issue the Valuer-General would need to take into account. The Bill defines the kinds of property that might be expropriated very broadly.

Uncertainty about property rights and unnecessary expenses are also key problems with BEE, where ownership targets remain unstable, while questions remain unanswered about whether a once-empowered-always-empowered rule will be honoured.

All these factors raise the costs of doing business, and signal to potential investors that doing business in South Africa is riskier than it might be in other countries.

Policy uncertainty

Policy uncertainty is an important driver of political risk for investors and would-be investors. In South Africa this uncertainty has many sources, but they can be grouped around the kinds of questions that investors ask analysts and ratings agencies, including:

- **What is South Africa's growth strategy?** Over the past 20 years, the RDP, GEAR and AsgiSA have all been adopted, partially implemented, politically contested, and superseded. At present, three separate documents – the New Growth Path (2010), the Industrial Policy Action Plan (first published in 2009, but now in its seventh iteration) and the National Development Plan (2012) – address the question of national development and growth, and the policy choices needed to achieve it. They differ significantly from one another in tone and substance, with some of the differences being irreconcilable: the NDP, IPAP and the NGP all envisage employment growth coming from different sectors; IPAP and the NGP make the case for managing a strategic depreciation of the currency, while the NDP says this is not possible; the NGP is premised on a purported imbalance between a growing consumer economy (heavily reliant on consumer debt) and slow growth on the production side, while the NDP thinks that South Africa is stuck in a classic middle-income trap. This failure to settle on a single analysis and plan reflects a lack of coherence at the heart of government thinking.
- **Is South Africa serious about maintaining fiscal stability?** This set of issues has a bearing on the future value of and returns on investment in terms of exchange rates, inflation and debt repayments. Despite the solid international reputation the National Treasury and the Reserve Bank have enjoyed for many years, by late 2015 there was justifiable concern that the grip of these institutions on public finances was slipping. These concerns were greatly enhanced by events in December 2015 when the president replaced the highly regarded minister of finance with an inexperienced newcomer, only to replace him with a previous minister a few days later, after investors had sent the rand and bond prices tumbling. The tricky issues the new minister of finance has to manage include: the expensive public wage settlement that included a 10.1 per cent increase in remuneration in 2015/16, and above-inflation increases in the next two years; Eskom's continuing need for assistance from the Treasury, and SAA's near-bankruptcy and mismanagement; each of these has enormous financial implications.
- **Is South Africa serious about international trade and foreign investment?** Several recent legislative trends suggest that we that are not: the unilateral revocation of bilateral investment treaties with EU countries; legislation to force divestment of foreign holdings in private security companies on doubtful national security grounds and proposals to limit land ownership by foreigners. These impose increasingly onerous conditions on foreign businesspeople who might want to move to South Africa. Collectively, they suggest a trend away from openness in trade and investment towards an unnecessarily narrow view of how economic development should proceed.

"The failure to settle on a single analysis and plan reflects a lack of coherence at the heart of government thinking."

The misunderstood role of business in society

Modern economies need effective states and dynamic markets. *(See box on page14: Firms and the 'miracle of productivity'.)* As the NDP concludes, South Africa needs a professional civil service. We would add that the state must also recognise the power of competitive markets, and the regulatory role that this implies for government. This is not, however, presently the case.

In fact, some of the key challenges we face arise from government's persistent failure to appreciate how the market economy works and, in particular, why a stable and enabling business environment is vital for economic growth. This also amounts to a failure to understand that firms, not states, create the bulk of wealth and jobs. While states play an important role in providing a framework for economic activity, direct state involvement in the economy seldom leads to faster growth. All societies (including the rapid industrialisers of East Asia) that have become prosperous, have done so because of the value created by increasingly productive firms.

"Some of the key challenges we face arise from government's persistent failure to appreciate how the market economy works."

The success of a firm depends on its solving two problems:

- Identifying a good or service for which there is a market, or for which a market can be created, and
- Calculating how to bring its goods to market at a price that is low enough to attract customers, but high enough to cover all the costs of production and generate a return for owners and investors.

Solving these problems is not easy, which is why most new businesses fail. However, firms that succeed make an enormous contribution to society because they take scarce resources of various kinds – different kinds of labour, different kinds of material and non-material inputs – and transform them into something which customers are willing to buy for more than they would pay if they bought those inputs themselves. This is what creating value means, and firms that achieve this are making their societies better-off. Policies should encourage these activities, not inhibit them. In the absence of such encouragement, less value is created, and societies are worse off than they might have been.

Some regulation is essential to a sound business environment. Among other things, policies must prevent firms from offering harmful or undesirable goods and services. For example, governments should regulate the ownership of firearms. Similarly, the state has a legitimate interest in preventing abusive practices by dominant firms seeking to protect themselves from competition: basic health and safety standards must be maintained in the workplace; children should be in school rather than in factories; workers must be afforded basic rights, and so on. All of this should be done efficiently, in the interests of society as a whole, while minimising any harm done to other objectives such as the pursuit of economic growth. However, policy-makers often impose obligations on business for reasons that have little or nothing to do with firms' core activities. This is generally an inefficient and expensive way of pursuing public goals, and, in extreme cases, can make it impossible for firms to operate profitably.

Firms, then, are primarily value-creating organisations whose profit-driven activities usually benefit society. As unrelated obligations on firms mount, the costs imposed on them become much harder to carry. This prompts them to cut down on their business activities, without generating genuine social benefits elsewhere.

AN ENABLING BUSINESS ENVIRONMENT

The South African economy will only grow more rapidly if new businesses are able to start up and existing businesses are able to expand. This will only happen in an enabling environment, the creation of which should be a core goal of government policy. This would require government to take seriously the needs of business, and to undo the many existing policies that hamper their activities and prevent them from expanding. This does not mean that the state should simply get out of the way of business; what is needed is a concerted effort to strengthen competitive forces across the whole economy, thus unlocking innovation and productivity.

South Africa needs to become a much more competitive economy. International evidence abounds that adverse regulatory environments, especially when combined with high levels of industrial concentration, reduce competitive pressures. In South Africa, this is evident in relatively large profit margins in many sectors which should have been moderated by competition, but which have persisted for long periods. Addressing this requires the reform of labour and product markets, including the removal of barriers that protect existing companies and make more difficult the entry of new firms. This should be coupled with an invigorated, as well as more accessible and affordable system of enforcing competition policies. This should apply throughout the economy, including those sectors in which SOEs dominate. In addition, the instinct that sometimes emerges to use competition policy and its enforcement mechanisms to achieve policy goals far removed from maximising consumers' welfare, must be rejected. Competition tribunals are not the right forums for seeking to manage the supply-chain decisions of large retailers or the protection of township retailers from large chains.

"The South African economy will only grow more rapidly if new businesses are able to start up and existing businesses are able to expand."

Many SOEs are in financially precarious positions and their futures should be fundamentally rethought. In particular, we should look more actively for opportunities for the private sector to invest in SOEs and for privatisation where appropriate, while ensuring that the markets in which newly privatised firms operate are liberalised as well. Particular attention should be paid to restructuring those SOEs – SAA for example – that operate in industries and markets in which private firms could very easily provide the same goods and services.

"The South African economy is home to a wide range of very effective firms."

FIRMS AND THE 'MIRACLE OF PRODUCTIVITY'

Measured on an output-per-worker basis, levels of productivity in South Africa are unusually high for an upper-middle income developing country. In order to understand this, one has to take account of the vital role played by firms in the near-miraculous explosion of global economic output over the past three centuries.

For most of human history – and in many poor countries today – human labour has been incapable of generating output worth more than the equivalent of about $2 per day per person. However, workers in modern, formal-sector firms can generate value hundreds of times greater than this figure. Prof Paul Collier, a leading development economist, calls this the 'miracle of productivity'. What has made this possible?

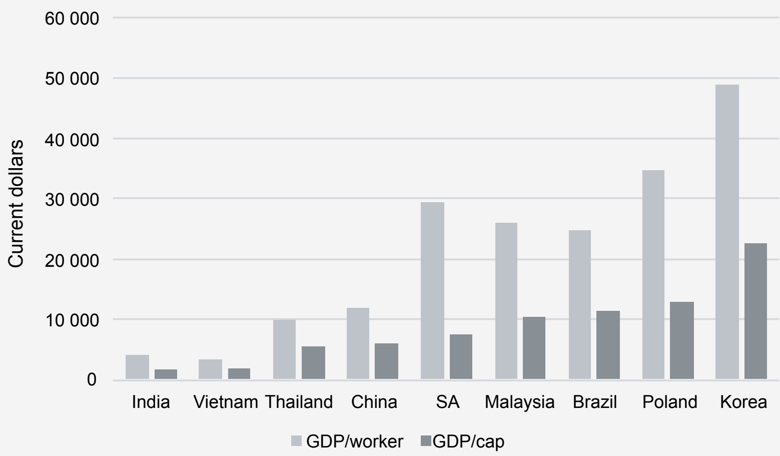
Firms allow productive activities to increase in scale while also enabling workers to specialise in a production process that is broken down into a series of separate tasks. Both factors – increasing returns and increasing specialisation – make economic activity much more productive.

Given this, we should ask why we don't see firms everywhere. If people are unemployed, why don't they spontaneously organise themselves into firm-like entities to produce value for themselves? The answer is that both scale and specialisation have downsides. Scale makes it much harder to motivate people and to ensure that no one is slacking off or even stealing from the firm in which he or she works, while greater degrees of specialisation imply a need for more and more sophisticated managerial skills.

It is not enough, therefore, to establish institutions. They have to be well-managed, to ensure that everyone is contributing and that their efforts are co-ordinated. When that happens, output per person is far greater than in any other form of industrial organisation.

The South African economy is home to a wide range of very effective firms, permitting much higher levels of output per worker than the norm for countries with our level of per capita income (see graph below). This is a key comparative advantage, and one that should be leveraged much more effectively.

Figure 2: GDP per worker and per capita in selected countries - 2012



Source: *World Bank database*

Small business is being crushed

Policy relating to small business needs to be rethought. Improving the business environment and preventing large companies from abusing their positions are important, but if entrepreneurship is to flourish, we need to think differently about small business. In particular, we have to recognise that, particularly in a global economy, small businesses are faced with enormous challenges in designing competitive products and getting them to market at competitive prices. Many small businesses fail outright, or fail to grow. These difficulties exist everywhere, but small businesses in other countries are often far better off than those in South Africa, due to higher skills levels, greater scope for specialisation and larger markets.

Given these market realities, great care should be taken not to disadvantage small businesses in any other ways. Nor should we impose costly regulations on them when they cross some relatively low size thresholds, as this deters them from growing even when they are successful. In practice, our policies – especially those relating to labour markets and to transformation – impose burdens on small business that do not exist in most developing countries and are absent also from many developed ones. Add to this the fact that apartheid prevented generations of black South Africans from starting their own businesses, and it is little wonder that we perform so poorly in international studies of comparative entrepreneurship. The fact that we have failed to reverse this trend is an indictment of economic policy-making over the past 20 years. Nor is it all that surprising that – as noted earlier – the small business share of employment has fallen dramatically in recent years.

"We need to recognise that small businesses are at a disadvantage."

In seeking to encourage the emergence of new firms, which usually have far greater job creation potential than larger, older ones, we need to recognise that small businesses are at a disadvantage. Large companies are generally better able to cope with the requirements set by regulators and policy-makers, whether these relate to internal management (HR policies, protection of information rules, etc.) or to standards set for firms' products. Small firms are often run by one person, and meeting demands for compliance diverts his or her energy and attention away from the core aspects of the business. Exempting small businesses from as broad a swathe of regulations as possible would ease their entry and survival, and increase competition in the economy.

This approach should not be restricted to regulations alone. Under the current system, wage agreements reached in bargaining councils are extended to all firms in an industry, irrespective of whether only the largest firms represented in those councils agreed to them. The result is that small firms, which are generally less skills- and capital-intensive than large firms, and therefore less productive, are forced to pay the same wages, making them less competitive and less viable. *(For more on this, see the CDE Growth Agenda series Report 2, Jobs, available at www.cde.org.za).*

SOUTH AFRICA SHOULD FOCUS ON INCLUSIVE GROWTH

Instead of making growth the overriding goal of economic policy, South Africa has:

- Raised the price of some key inputs into the production process that are provided by the state and SOEs;
- Made the business environment more complex, costly and unpredictable, reducing growth of existing firms and the emergence of new ones; and
- Inhibited investment through policy uncertainty, inappropriate policies, and the weakening of ownership rights to assets and property.

This is exacerbated by an interpretation of 'economic transformation' that focuses too heavily on elite enrichment and too little on expanding effective education and training, creating millions of jobs (which are also opportunities to learn), or improving the environment for smaller firms. This has been coupled with a lack of understanding of the central role of business in national development and what firms need to start up and prosper.

These factors are undermining confidence in the state and its institutions. They are also fuelling popular anger, as people conclude that the system is rigged in favour of the wealthy and that market economies are incapable of improving their lives. This is already driving some to look for more populist political alternatives, whose pressures on politicians and policy options will have further adverse consequences for growth and inclusion.

"South Africa can only be transformed by rapid, labour-intensive and inclusive growth."

If these trends continue, the country will not achieve its developmental goals. South Africa can only be transformed by rapid, labour-intensive and inclusive growth.

In an increasingly challenging global context, South Africa needs to focus on domestic policies over which we have control. We need to make our economy as competitive as possible. To this end, we must:

- **Stop being distracted by peripheral issues** and focus on promoting trade, investment, and enterprise growth.
- **Understand that growth and transformation are interdependent**. At present, the pursuit of these goals exists in two parallel policy universes. Sustainable growth needs the political and social stability that can be provided only by the kind of transformation that gives everyone a growing stake in the economy.
- **Play to our economic strengths**. Our efficient private sector, our commitment to constitutional democracy and the rule of law, our macroeconomic stability, and our urban systemS provide us with unique advantages which could and should be used as a springboard for revitalising our economy.

RECOMMENDATIONS

1. Place inclusive growth at the centre of the policy agenda

Policy-makers across government need to appreciate that dynamic firms operating in competitive markets are the drivers of economic growth. Sustained growth will require more than mere tinkering with this policy or the other; it requires a fundamental transformation of the way policy-makers approach their work. It also means that all policies must be assessed against this apex priority. The country's desperate need for economic growth must trump Alliance politics, cadre deployment and cronyism in key appointments in and around government.

2. Build a smarter, more capable state, one that can partner business for growth

Growth, particularly in middle-income countries, requires competent states capable of ensuring that essential goods and services are delivered, including those needed by business to function and flourish. They must be able to formulate and implement policies that underpin high levels of savings and investment, and rapid human capital accumulation. Despite extensive and expensive attempts at reforming the public sector, we are far from achieving this.

"Policy-makers need to appreciate that dynamic firms operating in competitive markets are the drivers of economic growth."

South Africa needs to develop a much more rigorous system for vetting and assessing policy proposals. Government has committed itself to the principle of regulatory impact assessments, but this has never been properly and consistently applied. And, in some cases (such as the proposal to ban 'labour brokers'), politicians have simply ignored unwelcome results. This is a huge gap in our policy-making machinery, which needs to be filled. South Africa needs evidence-based policy-making.

3. Recognise that neither growth nor transformation can be achieved on its own

Any government serious about revitalising the economy must recognise that inclusive growth and broad-based transformation are complementary. Elite-focused transformation undermines and hampers faster, more inclusive growth. Sustained economic and employment growth requires an environment in which the majority of people have a genuine and growing stake in the economy. Transformation, if practised in a way that empowers the vast majority of citizens, achieves this. In this regard, government must also recognise that rapid, labour-intensive growth is the key that will unlock the transformation of our society.

Instead of blaming global factors, we need an honest appraisal of the constraints on economic growth, aimed at identifying the policy reforms we need. This would include excessive labour market regulation, the government's poor relations with business, weak education and training, and the ambivalence of policy-makers towards urban-led growth. (Each of these factors is dealt with in companion reports). Government also needs to address the myriad ways in which the business environment is undermined by current broad-based empowerment policies, which have morphed into elite enrichment. This means that policy-makers must put inclusive growth and genuine broad-based transformation at the top of their agenda, and must stop favouring privileged groups and individuals.

4. Hold the line on fiscal policy

For more than a decade, one of South Africa's strongest assets has been its reputation for sound and stable macroeconomic management. Declining confidence in the integrity of public finances slows growth by deterring investment and raising the cost of borrowing money, whether by the state or private parties. To reverse this trend, government should formulate prudent deficit and debt targets, commit itself to meeting them, and actually meet them. Any temptation to weaken the independence of the Reserve Bank must be resisted: crossing that line would irretrievably damage our macroeconomic credibility. As the market reaction to the firing of Nhlanhla Nene showed, missteps in this field can cost the country very large sums of money, to say nothing of its reputation.

"Inclusive growth and broad-based transformation are complementary."

A developing country will always find that its needs outrun its resources. South African has to ensure that we use scarce public resources as effectively and efficiently as possible. The returns on our public investments are far too low. We need to take a long hard look at the way we spend public money and what outcomes we achieve, and block the many leakages that exist. To achieve this, politicians and public managers at all levels need to be far more accountable for public spending and delivery.

5. Fix the SOEs

The ideology prevalent in government and alliance circles misconceives the role that the state should play in the economy, including in the delivery of public and economic infrastructure.

One of our most urgent developmental challenges is to implement an adequate and effective infrastructure programme. Government's insistence on SOEs' assuming full responsibility for this is crowding out the private sector, and entrenching a range of uncompetitive practices. Capacity constraints in the SOEs are also hampering implementation. South African business is keen to invest in infrastructure, as is evident from its investments elsewhere on the continent. However, it seeks certainty, reasonable profits, a transparent regulatory regime and disciplined political and economic leadership. A prime example of how public-private collaboration could and should work can be found in the Renewable Energy Independent Power Procurement Programme (REIPPP), whose design has allowed market forces to drive down the cost of renewable energy, dramatically increasing supply while transferring many of the risks to private providers. Adopting this approach more widely would unlock the infrastructure build programme, and spur economic growth.

RENEWABLE ENERGY PROJECT MODEL POINTS THE WAY

Since late 2011, government has signed nearly 70 contracts with independent power producers, which have undertaken to invest more than $14 billion in infrastructure to provide Eskom with nearly 4 000MW of renewable power, or about 80 per cent of the output expected from Medupi. Although the project was initially based on a feed-in tariff model, with Eskom determining the price, this was abandoned in favour of a competitive tender model in which bidders compete to provide power on the basis of price.

The result is that, over three bidding windows, average prices have dropped substantially, with the cost of energy from solar photovoltaic falling by 68 per cent, and the price of wind-generated power by 42 per cent. Sensible programme design has meant that bidding windows have been over-subscribed and competitive, and projects have been financed in a way that transfers risk to investors.

A World Bank report on the Renewable Energy Independent Power Producer Procurement (REIPPP) programme quotes one investor as describing it as 'the most successful public-private partnership in Africa in the last 20 years.'

CDE 2016

"Isolating SOEs, with their soft budget constraints, from the discipline of the market has led to widespread failure."

Isolating SOEs, with their soft budget constraints, from the discipline of the market has led to widespread failure, on a number of levels. This is unsustainable; the balance sheets of many of the most important SOEs have been stretched to breaking point at the same time as their leaderships have been weakened by unsuitable appointments. This has resulted in varying degrees of institutional collapse, corruption, and cronyism. Government needs to attract private investment in SOEs, restructure their boards and, in some cases, replace much of their existing management.

If our economy is to function more efficiently, the dominance of SOEs in some sectors must be revisited. This means that every SOE in every major economic sector should be rigorously scrutinised and restructured, notably by breaking up monopolies and introducing private-sector participation and competition in liberalised markets.

6. Treat corruption as a growth retardant

The link between corruption and slow growth must be recognised. Much more must be done to root out the corrupt by adopting international best practices such as an effective, independent integrity commission, and by strengthening the office of the Public Protector. Public and private sector managers who have allowed corruption to flourish must be fired. Both public and private leaders need to take action to encourage a culture of 'I don't take or make bribes' in the institutions they run.

7. Reduce policy risk

Many aspects of public policy undermine current and future growth. In particular, perceptions of risk play a major role in strategic business decisions about investment and growth.

Firms invest in countries with stable and inviting regulatory regimes and well-established and protected property rights. When these conditions do not exist, or are being eroded, they go elsewhere. The 'rules of the game' have to be clear and predictable. When this is the case, businesses can make informed decisions about committing their energies and resources.

8. It's time to get serious about small business

South Africa's small business sector is in trouble, with low levels of new firm entry into the economy and high levels of failure. This is not surprising. Too many policies – as well as institutional failures such as Eskom's – increase the costs and risks faced by small firms.

What small business needs to flourish is reasonably simple: a sound environment for doing business; reliable economic infrastructure; predictable government policy; a reduction in red tape; effective competition policies; a manageable labour market regime; and, above all, economic growth.

"Firms invest in countries with stable and inviting regulatory regimes and well-established and protected property rights."

Getting the environment right for smaller businesses generates a policy agenda that corresponds closely to the agenda needed for all businesses to succeed. There are two partial exceptions to this:

- Besides the other aspects of an improved business environment, small business should qualify for a range of exemptions from some aspects of the labour market regime (as proposed in the companion CDE policy report on jobs and the labour market).
- Small and medium-sized business would benefit from strengthened competition policy across the economy, particularly the development of enforcement mechanisms that are more affordable than existing procedures, and which focus primarily on serving the interests of consumers.

9. Business needs its own agenda for black empowerment, poverty and inclusion

In the light of South Africa's history and its consequences for black South Africans, business needs to pay special attention to creating a much fairer and more sustainable distribution of resources and opportunities in the private sector and in the broader economy.

In a recent speech, Sipho Pityana, chairman of AngloGold Ashanti, lamented that transformation had become '... something of a zero-sum game ... with little thought given to how BEE can contribute to growth, employment and economic development. ... Unless we grow the economy and jobs, we are all reduced to a fight against each other for crumbs ... and a mindless and relentless race to the bottom.'

Business must unequivocally commit itself to dealing with racist attitudes in the workplace and to expanding opportunities for previously disadvantaged people. It must communicate its policies and approaches within its own companies and networks, and to the broader society. It should reject attempts to distort the desirable national objective of expanding opportunities for all to various forms of elite enrichment, and new types of exclusion.

"Business must unequivocally commit itself to dealing with racist attitudes in the workplace."

Instead of being at the receiving end of a government agenda increasingly shaped by narrow vested interests, business should develop its own approach to BEE. This should support faster growth, widespread inclusion and national development. It should prioritise the unemployed and the poor – the 'outsiders' – while not neglecting what needs to be achieved in the rest of society. This approach would be built on quality education and training for the vast majority of South Africans. Its priorities would be mass employment through faster and more labour-intensive growth, including low-skilled manufacturing, as well as nurturing existing companies and dramatically expanding opportunities through an enabling environment for new, especially black-owned and initiated firms.

All the options could be examined by an independent, growth-oriented commission tasked with reporting to leading business organisations within a year. The aims of such a commission would be to assess: what has been achieved until now, for whose benefit, and with what consequences. It should look at unintended negative consequences of the current approach. It should then go on to define an approach to broad-based empowerment which should create new opportunities for millions of South Africans. *(See the CDE Growth Agenda series Report 6, Business and government.)*

CONCLUDING REMARKS

Except for a brief period in the 2000s, the South African economy has grown slowly for almost 50 years. If it had grown just 1 per cent a year faster, we would have been in an entirely different situation: the economy would be about two thirds larger and per capita income about two thirds greater. Poverty rates would be much lower, and infrastructure deficits much smaller. Tax revenues would be much greater, permitting more meaningful interventions by a much richer state seeking to address a much smaller problem of poverty and inequality.

Apartheid and the struggle against it resulted in two generations of slow, inequitable growth. If we continue on our present path, laid out for us by bad policy choices, we too will produce slow, inequitable growth, leaving enormous challenges for our children.

South African development is held back by many factors, but the core problem is that we have failed to put growth and jobs at the centre of public policy. Instead we have allowed other issues to distract us from this most important objective. In particular, an increasingly flawed set of transformation policies have come to dominate the agenda. In the process, we have enriched an elite instead of creating new opportunities for many millions of people. This is a pattern of careless leadership that manifests itself in many areas: in the appointment of incompetent but well-connected people to lead our SOEs; in the failure to rein in the teacher's unions which have crippled basic education; in the misbegotten firing of Nhlanhla Nene.

Placing South Africa on a path of rapid economic and employment growth will require an honest assessment of the shortcomings and failures of current policies, and a willingness to do things differently. Current policy is undermining both inclusive growth and widespread and broad-based transformation. A fundamental change of course is overdue.

The CDE Growth Agenda Series

This series consists of seven reports.

1. Summary overview: Insights and key recommendations
2. Jobs
3. Accelerating inclusive growth
4. Cities
5. Skills
6. Business and government
7. An export processing zone for the Nelson Mandela Bay Metro

These reports are available at www.cde.org.za

CENTRE FOR DEVELOPMENT AND ENTERPRISE

5 Eton Road, Parktown, Johannesburg 2193,
South Africa
P O Box 1936, Johannesburg 2000,
South Africa

Tel +27 11 482 5140 | Fax +27 11 482 5089
info@cde.org.za | www.cde.org.za