EXECUTIVE SUMMARY

CDE ROUND TABLE

March 2009

ACCELERATING GROWTH IN TOUGH TIMES

A CDE and Business Leadership South Africa workshop on inclusive growth and job creation

This is an executive summary of CDE Round Table no 11, Accelerating Growth in Tough Times. We hope this summary will stimulate interest in the full-length report on the workshop, in which the ideas briefly presented here are placed in context and discussed in full.

BY EARLY 2009 there was no longer any doubt that the crisis in the financial markets had triggered a severe global downturn. In the last quarter of 2008 the South African economy shrank by 1,8 per cent quarter-on-quarter, a dramatic reversal from previous annual growth rates of 5,1 per cent in 2007 and 5,3 per cent in 2006.

In this kind of economic climate, it seems natural to think defensively. What can we do to shorten the recession? How can we protect existing jobs? We undoubtedly need answers to these questions. But it is more important to keep thinking beyond the current crisis and to stay focused on how we can lay the foundation for achieving rapid, sustainable, and inclusive growth over the next decade.

Even before the global crisis, the rate and quality of South Africa's economic growth were not satisfactory. We were doing moderately well, but despite the biggest commodity boom in history, we were still not growing fast enough or creating enough jobs to fulfil the promise of a better life for all South Africans. Growth depended too narrowly on strong commodity prices and cheap credit, and was constrained by a rapidly growing current account deficit, a volatile currency, persistently high crime rates, dangerously stretched infrastructure, and the very poor performance of much of the public service, particularly the education system.

The global crisis is a local wakeup call. This shock makes it more necessary, more urgent and – unfortunately – also more difficult for South Africa to move on to a new and more robust growth path.

CDE therefore invited some leading international and local economists as well as senior government, business, and trade union leaders to think about how South Africa can achieve faster, more job-intensive, more inclusive growth.

This executive summary captures the essence of the main presentations, and encapsulates what CDE learned from the day's conversation.

THE OECD ECONOMIC ASSESSMENT: SOUTH AFRICA

Andreas Wörgötter
Head of Division, Country Studies Branch,
Economics Department, OECD

- AsgiSA has the correct goals, but the policy approaches suggested are often too weak to address the constraints identified by AsgiSA itself.
- There is a serious contradiction between the lack of state capacity to support economic development and the government's emphasis on state programmes and policies to stimulate development.
- The economy produces less output and creates fewer jobs than it could if there were more competition.
- It is essential to end the dominance of state-owned enterprises in the electricity, transport and telecommunications sectors. State-owned enterprises in these sectors should be subject to standard competition rules that apply to private enterprises.
- South Africa has several sectors that are producing successfully for the world market. These competitive sectors would become even stronger if there were more competition in the sectors dominated by public enterprises.
- South Africa should also focus on encouraging more competition throughout the economy by lowering barriers to new foreign and local investment.
- It is essential to maintain macroeconomic stability. However, it is less important whether inflation is within the target at any moment than whether the policy mix is consistently aimed at bringing inflation back within the target.
- South Africa should maintain a cautiously neutral fiscal policy and an independent monetary policy in order to achieve the critical outcome of moderately positive real interest rates.
- Despite very high levels of unemployment, there is a striking lack of policies to improve the functioning of the labour market. Because unemployment is especially acute for the young who have never had a job, special measures are required to enable young unskilled workers to find their first jobs. These should include a wage subsidy for first-time workers, or a probation period during which normal labour regulations would not apply.

THE GLOBAL COMMISSION ON GROWTH AND DEVELOPMENT

Paul Romer
Senior Fellow, Stanford Center for International Development

- The most important lesson from the spectacular success of China is that to achieve really rapid economic growth, a country must have a government that is capable, credible, and committed to growth over several decades.
- Growth ought to be 'inclusive' – in other words, income inequality should not widen dramatically as the economy expands.
- It is therefore necessary to increase demand for low-skilled workers. In manufacturing and services, developing countries can import knowledge and human capital that can rapidly increase the productivity and wages of low-skilled workers.
- Rather than concentrating on their own small domestic markets, countries should aim to export their goods and services into the much larger world market.
- Successful export-led growth in manufacturing and services is far more likely when the government can provide safe and workable urban settings. This has to be a top priority for government spending.
- Foreign know-how and capital are very sensitive to the tax rate, and can easily locate elsewhere. Taxes on foreign direct investment should be low.
- Special economic zones can be used to kick-start an aggressive growth strategy. New foreign and local investments in these zones should be exempt from most or all the taxes and labour market regulations that apply in the rest of the country.
- On-the-job training is a vital part of an aggressive growth strategy. Education and training prior to work are very expensive because the recipients are out of the workforce while being trained, and because the trainees may not be learning skills that are really needed in the job market. But if people are learning on the job they are, by definition, acquiring useful skills just as a side-effect of being employed. The simple act of hiring people produces output, gives workers income, and is a very important part of the human capital accumulation process.
- It is important to keep the real exchange rate competitive. This requires active fiscal policy in addition to monetary policy.
- High levels of domestic savings are essential. Rapid growth requires rapid, sustained investment. This cannot be funded by foreign borrowings alone.

THE NATIONAL TREASURY'S INTERNATIONAL PANEL ON GROWTH: 'THE HARVARD GROUP'

Lesetja Kganyago
Director-General, National Treasury

- The Treasury's advisory panel – more commonly known as 'the Harvard group' – made four recommendations on macroeconomic policy:
  - fiscal policy should be counter-cyclical;
  - the Reserve Bank should maintain inflation targeting, but should also take cognisance of fluctuations in the exchange rate;

POLICIES TO AVOID

The Report of the Global Commission on Growth and Development includes a list of 'bad ideas' that generally lead to high costs and slower growth. These are:

- subsidizing energy except for very limited subsidies targeted at highly vulnerable people;
- reducing fiscal deficits by cutting expenditure on infrastructure investment or other public spending that yields large social returns in the long run;
- providing open-ended protection for specific sectors, industries, firms and jobs;
- using price controls to try to fight inflation;
- banning exports;
- resisting urbanisation and underinvesting in urban infrastructure;
- ignoring environmental issues;
- measuring educational progress in terms of the building of schools and levels of enrolment rather than by the quality of education provided;
- underpaying teachers and other public servants relative to what the market would pay for comparable skills;
- failing to develop credible methods to measure and reward performance in the civil service;
- poor regulation of the banking system combined with excessive direct control and interference in the financial markets; and
- allowing the currency to strengthen excessively.

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  - South Africa should continue to accumulate foreign reserves;
  - Remaining exchange control regulations should be removed.(In the Treasury's view, this recommendation needs to be reconsidered in the light of the financial crisis.)
- The panel noted that South Africa's exports have grown very slowly compared to other middle-income countries and commodity exporters. This, they argued, is partly due to an overvalued and excessively volatile real exchange rate. This has favoured the non-tradable sectors that mainly employ skilled people.
- The panel argued that South Africa now needs policies to encourage growth in the 'tradable sectors' – mining, agriculture and manufacturing. These sectors require a lower level of skill than the non-tradable sectors and serve the large global market rather than the restricted local one. Such a change in the structure of growth would therefore simultaneously generate more jobs and raise the growth rate.
- We need an 'open architecture' industrial policy to encourage the kinds of unexpected, unplanned entrepreneurial activity essential for economic growth. This is necessary because, although bureaucrats often mean well, they tend to over-regulate.
- The panel made two important recommendations on trade for South Africa:
  - Avoid entering unrealistic and premature customs unions because these actually restrict regional integration.
  - Simplify our tariff structure, creating fewer tariff lines and generally lowering tariff levels.
- The panel came to understand what kinds of labour market reforms would be politically possible in South Africa. It therefore kept away from the debate about labour market flexibility, and recommended that a once-off wage subsidy should be given to all 18-year olds. This could be used immediately or after further education. The subsidy would be activated

when a young person enters a job. The first four months of employment should be regarded as a probation period in which there are no restrictions on dismissals.

THE HSRC EMPLOYMENT SCENARIOS

Miriam Altman
Executive Director, Centre for Poverty, Employment and Growth, Human Sciences Research Council

- Economic growth is essential if we are to reach our goals – but not just any kind of growth. We're not advocating a trickle-down approach. If we want to achieve rapid, inclusive growth, South Africa needs some new, highly labour-absorbing industries. These will require special interventions, both directly and indirectly.
- We don't just want any jobs. We would like people to be able to afford to live properly. We should try to get as many jobs created in the traded sectors, where there is potential for productivity growth and real wage growth in line with this. The emphasis of trade policy should shift. We need to be pushing harder in international negotiations on trade in services. We should use more diplomatic muscle to help South African services firms trade internationally.
- Urbanisation is vital. Jobs are created when one thing leads to another – which is what happens in cities. Although much more needs to be done to promote livelihoods in rural areas, there is no doubt that most new jobs will be created in urban areas. This requires greatly improved urban infrastructure, particularly infrastructure that enables ease of movement.
- Under the HSRC's assumptions about how fast the economy can grow and create jobs, the government's goal of halving unemployment would still require very substantial direct job creation in public works schemes.

WHAT CDE LEARNED

CDE strongly endorses the calls made at the workshop for intensified dialogue about how to get the economy to grow much more quickly and how to create many more jobs. South Africa needs more open, no-holds-barred discussions that promote new ideas.

As an initial contribution to this more open debate, CDE makes the following suggestions:

- **Jobs must come first.** Many of South Africa's most pressing social and economic problems – poverty, inequality, crime – are caused, worsened or sustained by our extraordinary level of unemployment. The first economic policy priority must be to encourage the creation of more jobs. Every other economic goal and policy should be tested by whether it helps to create jobs. The most effective way to generate these jobs quickly is by removing the barriers to economic growth and increasing the opportunities for productive investment.
- **Create jobs for the people we actually have.** The problems created by our very high unemployment are far worse than any conceivable difficulties that might be caused by large numbers of people earning relatively low wages. We therefore have to remove all but the most basic minimum regulatory barriers in the way of employers willing to start enterprises that need South Africa's mostly unskilled workers. We should also consider using

age-related subsidies and exemptions to encourage employers to hire more unemployed young people.

- **Experiment with Special Economic Zones.** In order to create jobs for millions of unskilled, inexperienced young people, South Africa should set up Special Economic Zones (SEZs) with excellent infrastructure and a minimum of regulations to attract new foreign and local investment in manufacturing and services. As international experience shows, this strategy creates jobs for the people who need them most – particularly young women often newly urbanizing and looking for a first job – while also giving the country much-needed new investment, innovation and export earnings. If handled correctly this strategy soon leads to expanded national economic growth and industrialization.
- **Expose the state monopolies in electricity, transport, and telecommunications to competition.** In their current forms, the state monopolies create serious bottlenecks, raise costs, and reduce employment throughout the economy. Legislated barriers to entry to these industries should be removed, and state monopolies should be exposed to open competition. In the limited number of situations where genuine natural monopolies exist, the legislated commitment to the independence of regulatory authorities needs to be realised in practice.
- **Open the economy to competition and innovation.** Even outside the sectors dominated by state monopolies, the economy is hobbled by a lack of competition and innovation. We need to:
  - become much more open to foreign direct investors who can create innovation, jobs and competition. In SEZs there should be minimal taxes on new foreign direct investment
  - use interest rates and fiscal policy to keep the rand relatively weak so that firms based in South Africa become internationally competitive.
  - lower the regulatory and insider-created barriers to entry that prevent new entrepreneurs and new firms from competing with established players, both locally and internationally.
  - rethink government's entire approach to legislation and regulation directed at business. At present, individual departments are allowed to create laws and regulations which undermine national goals such as employment creation. Regulatory Impact Assessments are essential, and should override departmental mandates.
  - encourage innovation by providing once-off government subsidies to sectors, firms or entrepreneurs that are trying genuinely new things and by requiring the government's development finance institutions to invest more of their portfolios in new ventures.
- **Improve the capacity of the public service**. There is a profound mismatch between the government's ambitions for a developmental state and the reality that – with a few exceptions – most state institutions at all levels are dysfunctional. We need to:
  - re-establish merit as the key criterion for civil service appointments;
  - ensure much greater managerial capacity at all levels of the state;
  - promote a culture of accountability and performance from top to bottom;
  - reform the incentives that influence civil servants and the training they receive;
  - establish clear rules about private gain from public service
  - expand the use of public–private partnerships for service delivery; and
  - maximize the power of competitive markets for delivery to poorer South Africans.
- **Invest in urban infrastructure.** Rapid, sustainable, job-creating growth only happens in cities. South Africa needs to reverse the deterioration of essential urban infrastructure. We need to make our cities highly attractive for South African entrepreneurs and international

investors to start new enterprises and expand existing businesses. No matter how severe the slump, we need to upgrade and expand our urban road, rail, water, sanitation, and telecommunications networks, and we have to create a lot more affordable housing opportunities close to economic opportunities. A major new wave of urban development is required in which the private sector has to play a key role.

- **Fix education and training and immediately import more skills.** Increasing the supply of skills in South Africa is vital for economic growth. It will remove one of the major growth constraints; help train South Africans and increase levels of entrepreneurship. There are two ways to increase the supply of skills:
  - the longer-term strategy must be to reform the education system so that it produces better quality graduates, especially in job-oriented vocational areas, language and mathematics. To do this we need to improve the quality of our teachers and of school management and to establish a vocational education system with close links to industry. We must make teachers more accountable to learners and their families and put systems in place that effectively monitor teacher performance and that can take the necessary steps when results are not satisfactory.
  - a complimentary short-term priority should be to attract thousands of skilled immigrants. We need to actively recruit skilled people from all over the world and remove the political, regulatory and administrative barriers in the way of the skilled and entrepreneurial immigrants who can create jobs and provide training for South Africans.
- **Finalise land reform, and invest in rural development.** The stalled land reform programme is creating unnecessary political tension and anxiety about property rights throughout the economy. We can afford neither. We need to end the persistent uncertainty about when and how the land reform process will be completed. A great deal of productive land that could create many jobs and provide better livelihoods for the rural poor is effectively 'frozen' because it is under claim, or still held under traditional communal tenure. All outstanding restitution claims must be settled. We should establish clear and credible goals and deadlines for land redistribution and tenure reform. We need to provide essential post-settlement support and training in agriculture for land reform beneficiaries. South Africa needs a new rural development strategy that is realistic, comprehensive and provides routes out of poverty for millions of people. This will include upgraded infrastructure, reform of property rights, and improved education and training opportunities.

  These initiatives are necessary so that large-scale commercial agriculture can start to reinvest, new farmers can begin to flourish, and many more rural people can start to escape from poverty. All this will require a new approach to how land reform and rural development are conceived and managed. The country should pay more attention to these issues and immediately establish a talented, action-oriented partnership that will report every six months to parliament on progress. This partnership should include senior cabinet members and private sector leaders.
- **Reform Affirmative Action and Black Economic Empowerment.** South Africa is trading off broad-based economic growth and job creation for the advancement of a relatively small number of well-connected black middle-class people. There has been some progress in making Affirmative Action and BEE polices more broad-based, but they still need a major overhaul if they are to empower the vast majority of black people. All genuinely new businesses should be exempted from BEE requirements. Far more emphasis should be placed in the BEE codes on encouraging firms to train staff and create new jobs; far less emphasis should be placed on simply transferring shares from white to black members of the pros-

perous middle class. And all of this should be secondary to rebuilding the educational foundations which are the prerequisite for expanding opportunities and for sustainable broad based wealth creation.

South Africa's recent growth was modest by the standards of many other emerging economies. We did not capitalise effectively on the high commodity prices we enjoyed in the good times. We now face the worst economic crisis in 60 years. But the crisis is also an opportunity. It has shaken us out of complacency induced by good macroeconomic management and a long commodities boom. It has highlighted the structural weaknesses that prevent the economy from diversifying and creating many more jobs. How we deal with this crisis will determine the shape of the next decade and perhaps beyond.

South Africa is a high-cost economy. Some of these costs were inherited from the apartheid era, and some have been created since then. Now more than ever we need to reassess our competitiveness as a place for investment and enterprise promotion. We must address the economy's structural weaknesses so that we hold on to as many jobs as possible in the short run, and are then well positioned to take advantage of the global upturn when it comes. When the global economy recovers, South Africa must be ready to achieve much higher rates of growth and create many more jobs. This is essential if we are to transcend our deeply divided and unequal history and build the inclusive opportunity society we all want.

Our welfare system is already the largest in the developing world. Although it has alleviated the worst of poverty, it has not helped to reduce unemployment or inequality. We cannot afford to expand it any further. Even if we could, larger transfers simply cannot create the millions of new jobs and entrepreneurial opportunities that we really need to end unemployment, reduce inequality and banish poverty.

After the 2009 elections, the new cabinet will have to make the tough decisions needed to help create the successful and globally competitive economy that will expand opportunity to millions of people.

There is little to be gained from assuming that the future has to be very much like the past and therefore adopting a cautious and conservative approach. We already know what happens when we use high commodity prices, cheap credit, and an expanding welfare system to paper over our structural weaknesses - we fail to fulfil the promise of a better life for all South Africans. The gains from the kind of bold and optimistic policies outlined here will be much greater.

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