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ACCELERATING GROWTH IN TOUGH TIMES

A Centre for Development and Enterprise and Business Leadership South Africa workshop on inclusive growth and job creation

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.[1] Most economists were predicting that growth would stay well below 3% for 2009.[2]

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 in CDE's view, it is even more important to keep thinking beyond the current crisis and stay focussed on how we can lay the foundation for achieving rapid, sustainable and inclusive growth over the next decade. There are two reasons for this.

First, even without the global crisis, the rate and quality of our growth have not been satisfactory. We were doing moderately well. But we had failed to capitalise on the biggest commodity boom in history and then to use this opportunity to diversify the economy. We were not growing fast enough to fulfil the promise of a better life for all South Africans within a decade or two. South Africa remains one of the most unequal countries in the world and unemployment continues at extraordinarily high levels, never falling below 22 per cent in its narrowest definition.

Second, our growth strategy has been fragile. As one participant in the day's discussion put it, 'the growth we've had in the last five or six years has been driven by credit creation plus commodity price increases. That path is now closed.' Growth has depended too narrowly on strong commodity prices and cheap credit, and has been 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.

List of participants

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

In late 2008, CDE brought together some leading international and local economists, senior government officials, as well as private sector, big business and trade union leaders to think about how South Africa can achieve faster, more job-intensive, more inclusive growth.

Introductory remarks

Michael Spicer: chief executive officer, Business Leadership South Africa and board member, CDE

CDE Round Table workshops are noted for their openness. CDE prides itself on being a venue for frank discussion. I'm sure today's workshop will live up to that.

This is a propitious moment for a searching debate about South Africa's economic policy choices. We're in a period of profound political transition. Whole areas of policy that used to be considered closed are now up for discussion.

One small but significant piece of good luck in these difficult times is that the South African economy has been getting a great deal of high quality analysis. We've had three important new commentaries on our economy this year and the release of the report of the global Commission on Growth and Development, which is probably the most significant statement for many years on what developing countries can and should do to achieve fast and inclusive growth. We're very fortunate to have representatives of each of these reports here today to talk about their work and to help us to think through what their findings mean for South Africa's economic prospects and policies.

All these analysts have identified our very high rate of unemployment – far higher than other middle-income countries – as the central feature of the South African economy. Most of today's proceedings will focus on the closely linked economic policy challenges of enhancing growth and creating more jobs.

The OECD Economic Assessment

Andreas Wörgötter: head of division, country studies branch, economics department, Organisation for Economic Co-operation and Development

This is the first in-depth report that the OECD has done on the South African economy. It's what we call an '*Economic Assessment'* rather than an '*Economic Survey*.' Our *Economic Surveys* make detailed policy recommendations based on getting very deeply involved in the specifics of a country and working closely with its government. An *Assessment* is a first step towards a *Survey* – it tries to identify the major issues and challenges facing a country, but stops short of developing very specific policy recommendations.

Of course, the first thing you see when you look at the South African economy is huge unemployment

Acronyms and abbreviations

AsgiSA	Accelerated and shared growth initiative for South Africa
BEE	Black economic empowerment
BPO	Business process outsourcing
DBSA	Development Bank of Southern Africa
FDI	Foreign direct investment
GDP	Gross domestic product
HSRC	Human Sciences Research Council
IDC	Industrial Development Corporation
OECD	Organisation for Economic Cooperation and Development
SADC	Southern African Development Community
SOE	State-owned enterprise

The OECD *Economic Assessment*

In July 2008, the OECD published its first *Economic Assessment* of South Africa. The survey examines South Africa's economic performance, evaluates AsgiSA policy prescriptions and makes a number of general recommendations. The OECD argues that the acceleration in South Africa's GDP growth rate to over 5 per cent after 2004 was mainly the result of improved global circumstances, especially higher commodity prices, rather than domestic policy successes. Moreover, the widening of the current account deficit during this time suggested – correctly, as it turned out – that this growth rate was not sustainable.

While approving of the goals identified by AsgiSA, the OECD Report warns that the policy instruments suggested are often too weak to address the constraints identified. For example, while AsgiSA emphasised the need for increased competition, industrial policy 'risks preserving the apartheid-era pattern of protected national champions insulated from foreign competition and enjoying high mark-ups.'

The report identifies a contradiction between the lack of state capacity to support economic development and the government's emphasis on state programmes and policies to address these constraints. The OECD also notes the 'striking' lack of policies to improve the functioning of the labour market despite very high levels of unemployment. They urge that a high priority be given to creating jobs for 'the millions of primarily low-skilled South Africans currently wanting work.' Central to achieving this objective would be significantly enhanced competition in both private and public sectors. This would require:

- Proactive competition policy under which the competition authorities would actively pursue perceived abuses of market dominance.
- Deregulation and privatisation of 'network industries'; electricity, transport and telecommunications. State-owned enterprises in these sectors to become subject to the standard competition rules as they apply to private enterprises.
- Lowering of barriers to entry, particularly in sectors currently dominated or monopolised by state owned enterprises.
- Lowering of barriers to foreign direct investment.

The OECD argues further that the persistence of very high unemployment over a long period indicates that labour markets here are slow to adjust. While labour market legislation in South Africa is not unduly restrictive when compared with OECD countries, administrative processes are unnecessarily burdensome and lengthy. This contributes to slower labour market flows and longer unemployment spells, as well as encouraging the use of short-term contracts, with negative consequences for training.

Because unemployment is especially acute for the young who have never had a job, the OECD recommends special measures to enable young unskilled workers to establish a foothold in the labour market, such as a wage subsidy or a probation period during which normal labour regulations do not apply. [3]

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and very low rates of labour market participation. But you can't understand why this is happening if you ignore the product market. In other words, you won't be able to understand or meaningfully discuss the underperformance of the labour market without understanding the overall structure of the economy.

The South African economy is rent-seeking, redistributive and relatively monopolised. We think that many sectors of the economy are too concentrated, though the problem is clearly worst in sectors dominated by state-owned enterprises.

What does that have to do with unemployment? Well, as any basic economics textbook would remind you, firms in monopolised markets produce less output and charge higher prices than firms in more competitive markets. These higher prices mean higher profits, or 'monopoly rents' as the textbooks call them. So there are two main links between the

product markets and the labour market. First, less output means less demand for workers. Second, existing firms and the workers they employ share the 'monopoly rents', meaning that the average wage of those in employment will tend to be higher than wages in more competitive markets. There's nothing immoral or unnatural about this – but it does mean that the South African economy produces less output and creates fewer jobs than it could if its product markets were more competitive.

To get more growth and jobs, we would recommend that South Africa focus on encouraging more competition. You should lower barriers to entry. According to the OECD's product market regulation indicator, South Africa does second worst of all the countries we have looked at in terms of the heaviness of product market regulations. We think you should consider strengthening the competition authorities – for instance, they could be given greater leverage by making their decisions less challengeable.

Experience in our member countries has shown that by doing something in these areas, you can have quite rapid pay-offs. These kinds of reforms would help to remove imbalances and inequalities in the economy. They would also improve South Africa's external competitiveness – although we don't think there's a fundamental problem with this. You already have sectors that are producing for the world market and that are rather innovative. These competitive sectors would get even stronger if there was more competition in the sectors that produce important inputs, and especially in transport, telecommunication, and energy that are currently dominated by public enterprises.

Our report puts a lot of emphasis on macroeconomic stability. One of the critical current issues is the big communication challenge about inflation targeting. During the last few years, not a single inflation targeting regime has managed to stay within its band. It is extremely important that the authorities are as transparent as possible about the reasons for the deviations from the target. It's actually less important whether inflation is within the target at any moment, than whether the policy mix consistently aims to bring inflation back within the target.

To get more growth and jobs, we would recommend that South Africa focus on encouraging more competition

The OECD advises South Africa to stick with a cautiously neutral fiscal policy and an independent monetary policy. Together with the remaining capital controls, these achieve the critical outcome of moderately positive real interest rates.

The Commission on Growth and Development

Paul Romer: senior fellow, Stanford Center for International Development and Stanford Institute for Economic Policy Research

The Commission was made up almost exclusively of people who have been senior government policy makers, except for the two Nobel Prize winners, Bob Solow and Mike Spence. I was a member of the working group advising the chairman but I was not involved in actually writing the report. At some points I will distinguish slightly my own views from those in the report. I'm going to say two kinds of things. The first is to highlight some key points of the Growth Commission view. The second is to give you a feel for the contrasts between the Growth Commission view and the OECD and 'Harvard' views.

The Growth Commission outlines an aggressive development strategy. It looks at the spectacular success of growth in China and asks what general lessons one can take from that experience. It comes to the conclusion that to get really rapid growth, a country must have a government that is capable, credible and committed.

I think this is one of the points where one could criticise the Growth Commission by saying, 'What if you don't have a government which is capable, credible and committed? Doesn't that invalidate the Growth Commission's approach?' In the Commission's defence, one can reply that if you identify valuable things that a capable, credible, committed

government can do, it is sometimes possible to build capable, credible, committed government organisations. A good example of this is the recent history of central banks. All over the world, central banks have become much more capable, much more credible and much more committed in the last 20 years, and we have better stabilisation policy as a result. So sometimes identifying a powerfully beneficial role for government can in fact lead to the creation of a government that can carry out those functions.

The Commission's report argues that if a country has this kind of government, then growth and development can be very rapid. The Commission emphasises that growth ought to be 'inclusive'. 'Inclusive growth' means growth where wage inequality is not widening dramatically.

Certain kinds of growth increase inequality – for instance, skill-biased technological change, which raises demand for highly educated workers while leaving demand for unskilled workers unchanged, or perhaps even reducing it. Of course, a combination of skill-biased technological change with investments in education to allow more people to become skilled workers would lead to inclusive growth in the long run. Indeed this kind of accumulation of human capital is an essential part of the growth process. But the problem often is – and this is definitely true in South Africa – that increasing the supply of skilled workers is a very slow process. It can take generations. The Growth Commission therefore advises countries to be patient about education and about accumulating human capital.

'To get really rapid growth, a country must have a government that is capable, credible and committed'

The Growth Commission was interested in how to achieve growth that is both rapid and inclusive. To do that, it is necessary to increase demand for low skilled workers quickly. There are four key premises underlying the Commission's argument. First, you cannot hope to increase the demand for – and therefore the wages of – low skilled labour by importing foreign know-how, skill and expertise into agriculture. In agriculture, imported knowledge and human capital are substitutes for low skilled labour. When a country modernises agriculture, the sector sheds unskilled jobs. Second, in manufacturing and services, developing countries can import knowledge and human capital that will be complementary with low skilled labour and that will raise the wages of low skilled workers. Third, manufacturing and services are much more productive when located in urban areas. Fourth, to grow fast, countries need to move away from relying primarily on domestic resources and a closed economy to more reliance on imported inputs and integration into world markets.

Now, speaking for myself rather than for the Commission, I think there's actually another line of thinking underlying the report that isn't explicitly stated. This is about export orientation as an alternative to creative destruction as the engine of growth.

Creative destruction, the process where a new technology or a new firm displaces an old one, is a critical part of potential output growth and economic efficiency. It is something that every economy should move to. But it can also be politically very problematic, especially when an economy does not have a well-developed safety net, or when labour markets are not developed enough to allow laid-off workers to get matched quickly to a new job. For this reason, export-led growth becomes politically attractive.

Here's an example to clarify this point. There are two ways to bring foreign know-how, technology and skill into an economy like South Africa. A big international retailer, such as Wal-Mart or Ikea, could come in and transform the retail sector, but that would displace people who work in small retail shops. That's creative destruction. Alternatively, a firm that does light manufacturing could come in and hire workers to export goods to the rest of the world. The new technology applied to produce these new goods need not displace any existing firms or workers, and so this export-led option is politically much more attractive.

But the export-led growth approach still requires a credible, committed and capable state. Successful export-led growth in manufacturing and services is far more likely when the government can provide safe and workable urban settings. That has to be a priority in terms of government spending. This strategy also requires the state to understand that taxes on foreign

Introducing Paul Romer

Professor Paul Romer is one of the world's most distinguished growth economists. He is the primary developer of New Growth Theory, which directs attention to the power of new ideas in creating growth. His theory has generated renewed optimism about the potential for growth in both advanced and developing economies. Professor Romer was named one of America's 25 most influential people by *Time* magazine (1997), elected a fellow of the American Academy of Arts and Sciences (2000) and awarded the Horst Claus Recktenwald Prize in Economics (2002). Professor Romer is a Senior Fellow in the Stanford Center for International Development and the Stanford Institute for Economic Policy Research.

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firms may be very inefficient. A very general result in economics is that something with a very elastic supply - you raise the price a little bit, you get much less of it – is very inefficient to tax. If foreign know-how and capital are very elastic then taxing them and deterring them from coming in could be a very inefficient form of fiscal policy. This applies to explicit taxes, like corporate tax, but it could also apply to implicit taxes, such as a minimum wage or a union wage premium that is forced on firms.

Something else the Growth Commission report doesn't mention is that some countries have used special export zones to initiate an aggressive growth strategy. These zones don't have the taxes on corporations and labour market restrictions that apply in the rest of the country. They therefore make it attractive for foreign technology and capital to come to these zones. I think zones like this are useful, not least because they help to make the political case for a broader export-led growth strategy.

Unlike the 'Harvard' report, the Growth Commission is cautious about positive subsidies to foreign capital. The Commission suggests removing as many as possible of the disincentives to invest, but argues that positive subsidies create inefficiencies and opportunities for corruption.

The Commission advocates keeping the real exchange rate low. This requires active fiscal policy in addition to monetary policy. If you rely on monetary policy alone to stabilise an economy with flexible exchange rates and inflation targeting, you will get a very volatile real exchange rate. That makes life much more difficult for exporters. And during times when the central bank is disinflating, the country will get a very high real exchange rate, which puts the export sector at a serious disadvantage. A high savings rate is also critical for maintaining a competitive real exchange rate.

Compared to the OECD, the Growth Commission is relatively less concerned about immediate privatisation and increasing product market competition. The Growth Commission is also significantly less concerned than the OECD with stabilising inflation. The OECD view is that there's urgency about stabilisation policy. In the OECD view, you have to manage inflation first. Structural policies to move the economy onto a faster long-run growth path become second round concerns, to be considered after you've addressed the urgent stabilisation concerns. The Growth Commission suggests placing the immediate emphasis on structural change, and particularly on expanding exports and bringing in the technology and skills needed for building an export economy.

I'll end with another personal observation. On-the-job training may be the most important 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 trainees may not be learning skills that are really needed in the job market. In fact, the international evidence for the success of formal government training of workers before assigning them to a job is pretty weak. By contrast, if people are learning on the job, they are, by definition, acquiring useful skills just as a side-effect of being employed. So the simple act of hiring people produces output, gives workers income, and is a very important part of the human capital accumulation process.

The Commission on Growth and Development

The Commission aimed to identify some of the distinctive characteristics of the 13 developing economies that grew at more than 7 per cent per year for more than 25 years and to suggest ways in which other developing countries could emulate their performance.

For the Commission, growth does not just happen. Instead, it 'must be consciously chosen as an overarching goal by a country's leadership.' 'In the fast-growing economies,' the authors argue, 'policy makers understood that successful development entails a decades-long commitment, and a fundamental bargain between the present and the future. Even at very high growth rates of 7–10 percent it takes decades for a country to make the leap from low to relatively high incomes… During this long period of transition, citizens must forgo consumption today in return for higher standards of living tomorrow. This bargain will be accepted only if the country's policy makers communicate a credible vision of the future and a strategy for getting there. They must be trusted as stewards of the economy and their promises of future rewards must be believed.'

The Report identifies 'five striking points of resemblance' among the 13 high growth economies. They:

- fully exploited the world economy
- maintained macroeconomic stability
- mustered high rates of saving and investment
- let markets allocate resources
- had committed, credible, and capable governments.

Other common characteristics of high growth economies include:

- High domestic savings. Investment cannot be sustained on the back of foreign borrowings. The Report notes that 'there is no case of a sustained high investment path not backed up by high domestic savings.'
- High levels of public investment in infrastructure, education and health. As the Report puts it, 'Far from crowding out private investment, this spending crowds it in. It paves the way for new industries to emerge and raises the return to any private venture that benefits from healthy, educated workers, passable roads, and reliable electricity.'

The Growth Report 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 sections of the population.
- relying on the civil service as an 'employer of last resort.' This is different from public-works programs, such as rural employment schemes, which can provide a valuable social safety net.
- 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 for long periods of time to keep domestic prices low.
- resisting urbanisation and under-investing in urban infrastructure.
- ignoring environmental issues in the early stages of growth on the grounds that they are an 'unaffordable luxury.'
- measuring educational progress by the construction of school infrastructure or by enrolments rather than by the quality of education provided.
- underpaying civil servants, including teachers, 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.
- allowing the exchange rate to appreciate excessively before the economy is ready for the transition towards higher-productivity industry.[4]

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The International Panel on Growth – 'The Harvard Group'

Lesetja Kganyago: director-general, National Treasury

I'm going to assume that everybody has seen the 21 recommendations of the International Panel on Growth and the papers that underpinned those recommendations. I'm going to use my time to give you some context about how the recommendations came about and then to talk to some of the more controversial ones.

As part of the AsgiSA process, we needed to become more dispassionate and accurate about our growth strategy and the choices we face. South Africans are endowed with the ability to talk and talk in circles. When we have an opportunity to engage with others, we will spend a lot of time justifying our own analysis of the situation. We also tend to be lazy about numbers. Any student of economics will know that policy proposals should be underpinned by rigorous analysis of data, otherwise you are just shooting in the dark. But South Africans tend to make pronouncements from podiums which are not underpinned by any serious research. That's the context in which we put together this panel. We wanted to evaluate the internal consistency of AsgiSA, we wanted a serious look at whether the AsgiSA goals are actually achievable, and if so, what has to be done to realise those goals.

South African policy debates tend to focus on macroeconomics. That's because, quite frankly, macroeconomics is the easy part. There are only two institutions that deal with macroeconomic policy; the National Treasury and the South African Reserve Bank. There are also only two policy areas; monetary and fiscal policy. The Harvard group made four recommendations on macro 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; South Africa should continue to accumulate foreign reserves; and we should remove the remaining exchange control regulations.

But macro is just the rhythm section. To get growth, you need to put the entire orchestra together. This means looking at the much more difficult and painful issue of structural reform. A serious growth strategy has to focus on trade, labour, industrial and public service policies.

Turning now to industrial policy. First, the Harvard Group recommended that the IDC should turn its project portfolio around more frequently than it does now. The IDC should focus on funding new product developments and industries and should ensure that it exits from projects once they have been set on their way.

Second, they recommended that we create an open architecture platform for industrial policy. This is necessary because, although bureaucrats often mean well, they tend to over-regulate. If India had a Ministry of IT, the IT industry would probably never have developed there. We need an open architecture to encourage the kinds of unexpected, unplanned entrepreneurial activity that's so important for growth.

Third, the international panel recommended that DTI should be given a special budget that they could use to leverage appropriate forms of support from other government departments. The problem with this recommendation is that bureaucrats, when they hear there is a pot of money, tend to be very good at creating reasons why they should have access to it. As a result the Treasury is concerned that this proposal undermines the budget process.

> If India had a Ministry of IT, the IT industry would probably never have developed there

Two of the most important of the Harvard Group recommendations concern trade policy. One of these has to do with African economic integration. They oppose unrealistic plans for customs unions. Second, they urge South Africa to simplify our tariff structure, creating fewer tariff lines and generally lowering tariff levels. This is bound to be controversial, but imagine the difficulties currently faced by customs officials. At the moment, they have to look at every import to try to determine which trade agreement it falls. They may know the item originated in Singapore, but it could have picked up added components in various places

The international panel on growth, the 'Harvard' Group

To support the AsgiSA process, the National Treasury appointed a panel of international advisors in 2006 to help identify 'binding constraints' to faster, more inclusive growth and to suggest policies to remove these constraints. The Panel published its final recommendations in May 2008.

These recommendations note that unemployment and inequality remain exceptionally high in South Africa. Past patterns of growth have not favoured job creation. Our exports have grown very slowly compared to other middle-income countries and commodity exporters. This is partly due to an overvalued and excessively volatile real exchange rate. The overly strong Rand has favoured the non-tradable sectors that mainly employ skilled people. The panel argues 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.

'Growth has to be based on the people that South Africa has, not on the people that it wished it had. A strategy based on the relative expansion of the tradable sector represents a much better match with the currently under-utilised human resources of the economy.'

The panel makes 21 specific proposals. The most important include:

- South Africa's vulnerability to current account deficits needs to be reduced. Government should do more to boost domestic saving. This will require fiscal policy to become more counter-cyclical, targeting a large fiscal surplus when commodity prices are high.
- Inflation targeting should be retained, but should be more flexible, paying greater attention to the level and stability of the real exchange rate.
- Tariff rates should be further simplified and reduced.
- Skilled and unskilled jobs are complementary. A shortage of skilled workers translates into a reduced demand for unskilled workers. Immigration of highly skilled people should be encouraged and the emigration of high-skilled whites should be reversed.
- Because unemployment is especially bad for young people who have never had a job, 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.
- Industrial policy should encourage a constant search by entrepreneurs for new products, new processes, new geographical zones and new forms of organization to create new growth and employment. The DTI should facilitate and selectively fund these searches for innovation. The IDC should fund new ideas and industries more aggressively.
- BEE should be reoriented to encourage new investment and new job creation.[7]

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before it eventually reached here. Once the officials have completed this tracking exercise, they then have to work their way through the terms of all the bilateral trade agreements relating to the item. The simplification of the tariff system can only be beneficial.

The panel recommended that we remove exchange controls. We were ready to go along with this until we discovered that in the current crisis these controls protected us against the vagaries of the global environment. We still feel that the current exchange control regulations need tidying up so that they serve the purpose for which they are intended as efficiently as possible.

The final set of recommendations relate to the

Understanding the Indian IT boom

The Indian IT industry doubled in size between 1990–2000 and 2004–5. By 2005, its total revenues were US$16.5 billion, of which 74 per cent were export earnings.[5] This incredible boom is explained by:

- Some brilliant entrepreneurship.
- India's large technically-educated population and the relatively low wages earned by IT professionals. Indian software developers earn on average 70 per cent less than their American equivalents.[6]
- Government-sponsored 'software technology parks' that provided the state-of-the-art telecommunications infrastructure needed for software development.
- Attractive fiscal incentives for export-oriented IT firms.
- *De facto* exemption from most laws regulating employment. These laws apply only to traditional manufacturing plants.

The boom was not caused by traditional activist industrial policy or by simple 'benign neglect.' In reality, the Indian government worked hard to create the right background conditions for the industry to flourish. But, having laid the right foundations, the government stepped back and allowed the sector to take off with minimum interference.

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labour markets. What we find particularly useful is that the team came to understand what would and what would not fly in South Africa. They therefore opted for a wage subsidy proposal, and stayed away from the normal things South Africans fight about, like the flexibility of labour markets.

In the next few months we will release a popular version of the recommendations and the papers so that we can start a broader debate about how to respond to these recommendations.

HSRC employment scenarios

Miriam Altman: executive director, Centre for Poverty, Employment and Growth, Human Sciences Research Council

The government has said that their top objectives are to halve unemployment and poverty by 2014. Those are great goals. Our contribution is to think about what would have to happen if we are going to meet those goals. Our approach looks to the future by considering the likely economic and development path in South Africa, but also with an eye to international experience. This helps us to identify possible or probable future trajectories. If we think we can do better than other countries, we need to specifically identify why that might be. Are we doing something special that would make us think we could outperform the average? The challenges are immense and cannot be wished away. So we need to identify the realistic policy choices and trade-offs faced by government.

I sometimes get accused of 'just promoting growth.' Well, of course we're promoting growth! Growth is an essential ingredient if we are to reach our goals - but not just any kind of growth. We're certainly not advocating a trickle-down approach. What we are saying is that if you want to achieve rapid, inclusive growth, South Africa is going to need a whole lot of new industries; a whole lot of new activities which will be labour absorbing. These will require special interventions, both directly and indirectly.

We have major problems in our labour markets; it is very expensive to travel to work, people don't have relevant skills, and they don't have the information about where to find jobs. Having said that, if we solved those problems, would that generate 4 to 7 million jobs? It would solve some part of the problem

The HSRC employment scenarios

These scenarios aim to shed light on how South Africa can tackle the challenge of unemployment. They set out what would need to be done to achieve the government's targets of halving unemployment and poverty by 2014 and achieving 'full employment' by 2024; given three different growth trajectories and assuming that economic policy stays broadly the same. The HSRC's approach is to 'identify the kinds of decisions that would be required to bolster job creation rates under different economic conditions and set some realistic expectations for how certain market-based sectors might realistically contribute to employment growth.' The HSRC report argues that:

- Reaching the government's targets depends not only on the number of new jobs created but also on the rate of expansion of the labour force. The unemployment rate will not fall if the creation of a certain number of new jobs encourages an equal number of people to enter the labour market.
- Although the informal sector is more labour intensive than the formal sector, informal employment is growing more slowly than formal employment. It is hard to predict how informal activity might expand or contract in relation to economic growth.
- South Africa cannot afford to miss global opportunities where it has existing capabilities.
- Although manufacturing is an important ingredient in the development process, there are few countries currently generating additional manufacturing employment at more than 2 per cent a year. South Africa should not place too much faith in the capacity of the manufacturing sector to create large numbers of new jobs.
- Industrial policy should aim to enable the expansion of newer industries that have the growth-inducing properties traditionally associated with manufacturing. Service sectors are the most likely source of new growth-inducing and employment-creating activities. New ways of thinking about how to stimulate these sectors will be required, as will strategies to identify ways of promoting backward linkages into manufacturing.
- Because new employment is likely to arise from many different – and as yet unknown – activities, it is important to improve the general business environment.
- Given the HSRC's growth scenarios and limited institutional and regulatory change, halving unemployment will require very substantial direct job creation by government. The higher the rate of growth, the more the public service can expand. The lower the rate of growth, the more the government will have to devote resources to public works schemes. Under the HSRC scenarios, even if South Africa grows at the Korean rate of over 6 per cent, the government would still have to double the number of jobs that the Expanded Public Works Programme (EPWP) currently creates to meet its targets. If the economy grows at 4.5 per cent per annum, it is possible that the EPWP would need to contribute 1.5 million opportunities a year by 2014, at a cost of R45 billion (2006 Rands). If the economy only grew at 3 per cent a year, 2.8 million EPWP opportunities would be needed in 2014, making it the largest employer in the country.[8]

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and it deserves attention. But labour market reforms are not going to suddenly generate all the aggregate demand we need to explode the economy and generate 4 million vacancies.

So what would? If you look globally, the vast majority of new job creation, both in low and high income countries, comes from services. Because of technological change, that's becoming true at ever-lower levels of national income. It's even true in China, where there's actually no net job creation in manufacturing. People often object that services can't develop without manufacturing. In fact, we

found that they're almost equally dependent on each other. There are really significant backward linkages from services into manufacturing.

Since our goal is to reduce poverty as well as unemployment, we don't just want any kind of jobs. We would like people to be able to afford to live properly. A way of doing that is to try to get as many jobs created in the traded sectors, where there's potential for productivity growth and real wage growth in line with that productivity growth. It's very hard to do that in restaurants – but it's easier in areas like finance, or construction. If you look at the top ten global construction companies, three originate in South Africa. So how can we get more growth out of services like this where South Africa has deep capability, global presence and capability in foreign markets? The emphasis of trade policy should shift. We need to be pushing harder in the international negotiations on trade in services. We also should use more diplomatic muscle to assist South African services firms trading internationally.

If we can't expand our traded services sectors, we can still create lots of jobs in domestically oriented services. But insofar as we also want to halve poverty, we would then need more reliance on government grants. That is not sustainable as a strategy. Domestically oriented service jobs are likely to be the main source of job creation in South Africa and elsewhere. Traded sectors are the ones that can drive growth and have more potential to generate well paid employment; they also stimulate indirect employment.

I also completely agree about the importance of getting efficient network industries. It's a very obvious thing that if your roads, railways and telecommunications industries aren't functioning in an optimal way, particularly if you can't influence the exchange rate, you need to have is a super-competitive infrastructure to make your exports competitive.

> 'Urbanisation is important. Jobs are created when one thing leads to another – which is what happens in cities'

Urbanisation is important. Jobs are created when one thing leads to another – which is what happens in cities. It is absolutely imperative that much more needs to be done to promote livelihoods in rural areas. But there's no doubt that jobs will be created in urban areas in the main. This requires deeper agglomerations and much improved urban infrastructure, particularly infrastructure that enables ease of movement.

Discussion

The presentations stimulated a lively discussion. Participants saw a lot of common ground between the reports and were in broad agreement about several challenges that must be addressed if South Africa is to achieve faster and more job-intensive growth. Significant areas of disagreement also emerged, leading to some important debates.

Areas of agreement

Continue to upgrade economic infrastructure

As Neva Makgetla put it, 'everybody agrees about infrastructure. We followed the typical post-colonial pattern of neglecting core economic infrastructure in order to extend services to the poor. Now we have to face the depreciation costs and, in the context of the current crisis, we have to worry about how to protect current infrastructure spending even though we face higher interest rates.'

Other speakers echoed this worry. Repairs and improvements to our badly neglected infrastructure have only just begun in earnest and ways need to be found to ensure that they continue, despite the global downturn. Nick Segal emphasised the importance of improving the governance and efficiency of the infrastructure and network industries. We simply cannot afford delay and waste as we struggle to remove infrastructure bottlenecks in these difficult times.

Comments by our international guests made it clear that it would be an unfortunate false economy

to scale back infrastructure investment in response to the recession. Paul Romer focussed particularly on the benefits of investment in urban infrastructure. 'The gains from this kind of infrastructure spending are particularly high,' he said, 'because of the role they play in attracting FDI, which in turn can lead to the rapid creation of new jobs.' Andreas Wörgötter pointed out that the 'the weaknesses of South Africa's current infrastructure set-up is also, to some extent, an opportunity. For instance, there would be huge gains from creating cheap and widely available broadband access.'

Maintain a more competitive exchange rate

It was agreed that the Rand should trade in a range that would strengthen the international competitiveness of South African producers and that would assist in reducing the current account deficit.

Participants discussed what policy instruments should be used to achieve this outcome. Some speakers suggested a relatively simple approach: weaken or even abandon inflation targeting. As Jayendra Naidoo put it, 'instead of a dogmatic reliance on inflation targeting, we should rather aim for stable outcomes in terms of the exchange rate and the interest rate.' Brian Kantor concurred: 'inflation targeting gets you into trouble because it is impossible to distinguish excess-demand influences, (which monetary policy is supposed to control), from supply-side shocks over which our policy instruments have no control. We need to be much more sensitive to the effects a strong Rand has on reducing employment levels.'

> We should be encouraging entrepreneurs from emerging markets, particularly in Asia, to make FDI investments here

Others advocated a more ambitious approach that would require closer coordination between monetary and fiscal policy to permit a weaker Rand without allowing inflation to spiral upwards. Paul Romer made the point that 'If you're trying to achieve both an inflation and an exchange rate target, then you have to have two instruments to achieve those two goals. You can't achieve two goals with just one instrument. The solution to the problem is to coordinate the central bank's monetary policy and the treasury's fiscal policy. The central bank would continue to follow an interest rate policy that mostly focuses on controlling inflation. Fiscal policy would be used in a counter-cyclical fashion to increase savings during upswings. This would reduce pressure on the central bank to increase interest rates during upward phases of the growth cycle, in turn reducing the likelihood that the Rand would strengthen to unhelpful levels. Of course, most countries that do stabilisation through fiscal policy, do it in ways that are not as radical as this kind of forced savings policy. But there are examples, like the Chilean Stabilisation Fund, that could be useful models.'

Participants agreed that both approaches come with risks and problems. Abandoning inflation targeting could help to entrench high inflation. Countercyclical fiscal policy would be difficult to administer and might well turn out to be politically impossible. But there was a strong sense that confronting these risks was preferable to allowing the Rand to appreciate to the point where it cost jobs. 'When the currency starts to appreciate, there should far less rapturous applause and far more reserve accumulation.'

Grow the tradable sectors

Participants agreed that South Africa should focus far more than in the recent past on tradable rather than non-tradable activities; that is, on producing goods and services that are bought and sold on the international market.

As one local economist said, 'You have much more scope if you succeed in traded activities than in non-traded activities. If I had to take one thing out of the Commission for Growth, it would probably be that those countries that have leveraged global demand rather than domestic demand have succeeded in growing at a high level, and that there are limits to how fast you can grow and how many jobs you can create with domestic demand.' Paul Romer agreed: 'I think exporting, even though it leaves you exposed to fluctuations in the world economy, is still a very attractive strategy if you can pursue it.' And he went on to endorse the point that we should not assume that manufactured goods are likely to

be the most important tradables. 'If you look ahead in this century, you will find that low skilled service exports are going to become much more important compared to low skilled manufacturing exports. You don't want to think of manufacturing as being special here. Anything you can say about manufacturing you could also say about services.'

Attract more FDI

Creating more links with the world economy, by attracting Foreign Direct Investment was regarded by most participants as a critical component of any job intensive growth strategy. Paul Romer illustrated the advantages of FDI this way: 'When somebody brings inputs into the economy that you don't own, you collect no income from them – so what's the advantage of FDI? It doesn't figure obviously in national income. But where it can be hugely influential is by improving the returns to your domestic inputs. Think about what happens when a low skilled worker moves from Africa to a developed country. They earn a much higher wage. Then think about turning this around. That's what FDI does – it brings the complementary resources to you, and so it is a very important way to rapidly increase wages for less-skilled workers.'

A South African economist agreed. 'In South Africa we tend to focus too much on the financial aspects and balance of payments issues stemming from FDI. But rather than seeing FDI as about financial flows, we need to focus much more on the benefits of the knowledge, technology, and skills that foreign investors bring into the country. The key benefit of FDI is not its impact on savings or the balance of payments, but its contribution to productivity and to raising wages. We also need to look beyond traditional sources of FDI (Europe, North America and sometimes Japan) to our fellow emerging markets like India. We should be encouraging entrepreneurs from emerging markets, particularly in Asia, to make FDI investments here. It's those entrepreneurs who are willing and able to build large labour-intensive companies. It's those entrepreneurs who are likely to provide the business models and the market access we need to create a lot more jobs.'

A senior businessman stressed the need to change official attitudes to foreign investors. He said that 'we tend to look at foreign investment as something that should have a lot of conditionality placed on it. If you do X, Y, Z, then we might allow you to come into the country. This is a disappointing contrast with several other Africa countries, where foreign investors are welcomed and well looked after.'

Industrial policy can't pick winners – but it might be able to support innovation

There was a strong consensus among participants that attempts by the state to select and support particular industries or firms was a bad idea. As Jayendra Naidoo said, 'I think it's incredibly hard for civil servants to pick winners. For example, the BPO process in South Africa is quite a disaster. I don't think we should be holding out any hope for gains from this kind of policy.'

Paul Romer agreed and discussed another of the reasons why attempts to pick winners tend to be counterproductive. 'Many times, when you hear people advocating industrial policy, what they're saying is "let's go for the high-tech, glitzy, semi-conductor kind of factory that will have very high wage jobs in them". So industrial policy tends to be a policy to create high skill, high wage jobs. That can be a trap, because what many developing countries have is a lot of low skilled labour. What they need to do is create a lot of demand for less skilled labour. Although it may seem nice to have some high-wage employment for a few high-skill, high-tech workers, it doesn't address the needs of the majority of people and actually makes inequality worse.'

David Lewis feared that there was a real risk that South Africa might now try to pursue these kinds of counterproductive industrial policies that aim to pick winners and create 'national champions.' 'If a developmental state was anything, it was a state that was associated with a strong industrial policy. Calls for a powerful developmental state have become louder and louder. As the financial crisis transmits itself into the real economy, I think the demand for actively pro-producer interventions will become louder and louder.'

'I fear that what's going to be forgotten is what led to the liberalisation of the last 15 or 20 years were precisely huge state failures in developing economies, obviously in the transitional economies, and even to a significant extent in the developed economies. But that will be forgotten because what we are grappling with now is a major market failure, and so the state

comes back onto the agenda in a big way. There's a real risk, I think, that we will go through another round of ill-conceived state intervention in markets and support for state-owned enterprises. If we do that, we will find it more difficult to re-emerge from the recession.'

But, Lewis argued, the serious risks associated with the wrong kinds of industrial policy shouldn't mean that all forms of industrial policy should be avoided. 'Good industrial policy has to be compatible with the way markets work. This may seem an odd moment to say it, but we really need to remember that markets have served the world economy rather well in the last 20 years or so. So we should try to set up industrial policies that are compatible with competition policies and with effectively functioning markets. There are a range of industrial policies that do precisely this. They don't support any particular enterprise, or even any particular sector. Instead, they aim to encourage doing new things, making new uses of human resources and technology.'

'We really need to remember that markets have served the world economy rather well in the last 20 years'

For Paul Romer, a promising way to do this would be to create special economic zones where all conceivable barriers to new forms of enterprise would be removed. These zones 'would give you an opportunity to explore "what if." What if there were a place where workers and their families could move and live in inexpensive housing, and be matched with foreign technology and capital at a market clearing wage. What kinds of new firms would be set up? What would the wage turn out to be? Would people actually choose to go and work there? These zones mean that you don't try and force reforms across the whole economy; instead you just carve out one zone to experiment. This gives this policy idea a feasibility that's at least worth considering.'

Not everyone, however, was convinced that 'self-discovery' or other forms of innovation-seeking industrial policy represented a real advance on the 'picking-winners' approach. Some participants doubted whether the Department of Trade and Industry could develop the capacity to support self-discovery. Others felt that special zones would turn out to be politically impossible. One senior public servant felt it would be wise to avoid any kind of over-ambitious scheme: 'We need to have more limited goals and focus on second best. Some agriculture; some of the high ends of services; some niche manufacturing; those are things we might even be able to manage if we got everything else right. But we shouldn't think we're going to turn into South Korea overnight.'

Better results from the education system

Participants were unanimous and emphatic that our weak education system is a major constraint on economic growth and job creation.

Murray Leibbrandt said, 'The Harvard Team emphasized that we need to direct our policies at the workers we have rather than the workers we wish we had. This is an understandable call for pragmatism – but I think we have to be braver. I think we need to confront the failure of the education system to deliver more of the workers we wish we had. The failure of the education system is incredibly wasteful. Not only do we waste much of our huge – and very redistributive – expenditure on education itself, but we don't get a long-run return on our other social expenditures. The social safety net provided by the old age pension and the child support grant and the disability grant is really very extensive – it's on a grand scale, it's something that other developing countries just don't do. These education and welfare expenditures have shifted huge resources to the needy. They fund schools; they fund the costs of going to school; they fund child nutrition. So we help parents to put their kids in the schools, and we help to some extent to make the kids healthy. But then the children still don't receive a proper education. All this investment does not produce the long run return that it should. And this is very sad. This situation was bad enough in the days of apartheid, but to be here, now, and to still be constrained by the education system in this way is just incredibly unfortunate.'

Another participant highlighted some of the main causes of the difficulties with the schooling system. 'There's not any shortage of teachers but there's 25 per cent absenteeism on any day of a school week. Teachers just don't pitch up to work. That's signifi-

Industrial innovation through 'self-discovery'

The concept of 'self-discovery' was developed by Dani Rodrik and Ricardo Hausmann of the 'Harvard Group.'[9] They argue that entrepreneurship in a developing country consists of discovering the underlying cost structure of activities that have not been tried before in that country – that is, finding out what can and cannot be produced profitably. The first investors in a new line of economic activity face a great deal of uncertainty. The foreign technology or know-how that they want to introduce always needs some local adaptation. Then, after they have incurred the risks and costs of making these adaptations, their discovery soon becomes public knowledge – everyone can observe whether their projects are successful or not. This means that the costs borne by innovators will be higher than those faced by followers. Followers will quickly be able to enter the market and reduce the innovator's profit. As a result, the innovators may not be able to obtain an adequate return on their initial risk-taking investment.

Rodrik and Hausmann argue, therefore, that in developing countries, the economic incentives are often not conducive to private entrepreneurs attempting major innovations. They are unlikely to embark on the process of self-discovery and their countries will not be able to obtain the benefits of expanding new industrial sectors.

If this argument is correct, the process of self-discovery requires some form of government subsidy and/or stimulus. Rodrik and Hausmann are opposed to the kind of industrial policy that directly places the onus on the state to 'pick winners', which would shift the process of self-discovery into government bureaucracies. Instead, they favour a process of strategic collaboration between the private and public sectors. The objectives of the collaboration are to identify blockages and obstacles to new investments and to design appropriate policies in response.

Rodrik cites the experience of Ethiopian flower producers as an example of self-discovery in action. The Ethiopian flower industry was started by some courageous entrepreneurs who had observed the success of the industry in nearby Kenya and wondered if it could be made to work in Ethiopia. Even though much of the technology is standard, local soil conditions make a lot of difference to the economics of growing flowers. A whole range of other services – from daily cargo flights to high-quality cardboard packaging – also have to be in place before the operation can succeed. The Ethiopian government recognised the problem and subsidized the pioneer firms by providing cheap land and tax holidays. Consequently, the industry took off. Exports reached $100 million from zero in just a few years. There are currently 90 flower farms in the country, with latecomers the beneficiaries of the tinkering that early investors were only able to undertake because it was supported by government.

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cant. One of the biggest confrontations coming up is between society and the teachers; to see that they do their job.'

While strongly agreeing that it is essential to get better results from the education system, Paul Romer pointed out that many governments do a bad job with education and more rapid growth may need to come before significant improvements in education. 'Good education policy produces economic results 20 years after effective interventions have been made. One should be realistic about how hard it's been to raise the quality of education in many countries, especially before growth takes off. You need to use the workers you have now.'

A much more effective state is essential

Indecision, inefficiency, delay, waste, corruption: almost everyone at the workshop identified serious weaknesses throughout the South African state as the single most important barrier in the way of generating higher levels of growth and job creation. As one speaker said, 'You cannot focus on jobs and the

Special Economic Zones

A Special Economic Zone (SEZ) is a geographical region that has significantly less economic regulation than the rest of the country. This definition covers a range of more specific zone types, including:

Free Trade Zones (FTZ): Geographical areas in which international commerce can be conducted free of tariffs or quotas.

Export Processing Zones (EPZ): Areas designed to attract new investment by export-oriented businesses. EPZs typically offer free trade conditions and minimal regulatory requirements. Investors are offered high-quality infrastructure, streamlined registration requirements, highly flexible labour regulations and very favourable tax treatment.[10]

Free Ports: A port in which imported goods can be held or processed free of customs duties before re-export. Some free ports offer infrastructure facilities, such as warehousing, distribution and transport networks and marketing services as further incentives for companies. Cargo logistics and support services can be provided as a further incentive to locate a business in a free port.[11]

Urban Enterprise Zones: Zones to encourage (re)development in blighted neighbourhoods by offering entrepreneurs and investors tax and regulatory relief if they start businesses in the area.

Some of the earliest and most famous Special Economic Zones were created in the People's Republic of China in the early 1980s. The most successful Special Economic Zone in China, Shenzhen, developed from a small village into a city with a population of over 8 million within 20 years.[12]

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economy without recognising that the state is really underperforming.' Or as another participant put it, 'I sometimes wonder why we had a Harvard project about economic policy choices because I think we know what they are. What we can't figure out is how to get a better functioning government. You see this problem everywhere you go in government.'

A clear lesson from the international growth success stories is that rapid economic development doesn't happen without a competent state. Leslie Maasdorp put it this way, 'the key issue is the competence and effectiveness of government. Enlightened and capable policy makers and bureaucrats working consistently to achieve long-term goals are essential if you want fast growth.'

AsgiSA commits the government to implementing an ambitious range of programmes, and many people in the post-Polokwane ANC seem committed to an even more ambitious agenda for the 'developmental state'. A prominent private sector economist argued that this approach could lead us into further trouble. 'South Africa has an inefficient, defective state. Speaking to different bodies around the country, as I do, that's universally accepted; by many people in the state as well. But it seems that the state wants to actually increase its range of activity. In other words, we want to shrink the efficient part of the economy and grow the inefficient part.'

Areas of disagreement

What can competition policy achieve and where should it focus?

The central argument of the OECD report is that a more comprehensive and activist competition policy could have very large benefits for the South African economy. Several participants were not so sure.

Paul Romer: 'I absolutely agree that competition is important, and if you can achieve improvements at a political cost that's not too high, one should embrace the policy as much as one can. I have no

'Speaking as a bureaucrat': top officials on the state's weaknesses

David Lewis, chairman, Competition Tribunal: I wish we could develop policies based on the state that we have rather than the state that we wish to have. We should work on rebuilding the capacity of state institutions, but we have to accept that these things take an incredibly long time. Speaking as a bureaucrat, I don't think that the weakness of the state in certain key areas can be overstated. I think it has some strong pockets, but where it is weak, it is woefully weak and getting weaker. It's getting more and more difficult to attract quality people.

Neva Makgetla, lead economist, Research and Information, DBSA and sector strategies coordinator, The Presidency: We haven't thought through what we actually need in government to achieve the new tasks we've set ourselves. We've changed at the top but we never changed in the middle. It's that systematic approach to retooling the state that we need. And then I think you could talk about a developmental state. But what I totally oppose is to change all the functions of the state and then to just put a planning commission on top. That certainly won't work.

Bongiwe Njobe, former director-general, Department of Agriculture: I speak as an ex-bureaucrat. I really do think that the quality of experience of many government officials limits their ability to make effective decisions. We need some interventions to try to bridge that gap.

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quarrel with the principle. But it may not be the kind of policy that leads to a jump-start, which then gives you fiscal resources that can let you do the infrastructure and the urbanisation that keeps feeding on itself. So if it can be achieved at low cost fiscally and politically, it will get you better productivity and innovation. But the Growth Commission's position is that competition policy should not be the very first priority in kicking into motion the self-reinforcing process of growth.'

A South African private sector economist argued 'We are already getting as much mileage as we can out of competition policy applied to the private sector. I think we're lucky to have an activist competition commission and a very seasoned competition tribunal. I think a lot of progress has already been made, so I'm puzzled by this focus on competition policy as a key area for change.' Several other participants felt that the real problem lies 'in network and some related industries, telecoms, power, many of the transportation functions, where there is dominance by state-owned enterprises.' As one speaker put it, 'the bigger problem is that SOEs are not subject to competition regulation, which means that the private sector is being excluded from contestable markets like electricity production. That's just crazy.'

David Lewis agreed that the main focus of competition policy in the near future should be on the sectors dominated by large SOEs. 'It's in energy, telecommunications and transport that the real problems exist. They are immensely politically powerful institutions that are able to outgun the regulators on every single front: access to information, technical competence, political connections. South Africa should encourage a lot more competition in these sectors and should focus on building much stronger regulatory institutions, where there are still elements of natural monopoly.'

What are the relationships between redistribution, job creation and inequality?

Some of the strongest disagreements expressed at the workshop were about this complex, vitally important area.

Wendy Luhabe began the debate by arguing that while social grants 'are a necessary investment in the short-term, they have unintended consequences. They create a culture of dependency and entitlement. This is not healthy and contributes to a poor work ethic and negative attitude to work.' A senior public servant expressed the opposite point of view: 'We

The costs of SOE monopolies

During the period of 'load shedding' imposed by the state electricity monopoly from January to May 2008, the mining sector contracted by 22 per cent, GDP growth fell to its lowest rate in more than six years and business confidence reached a 24-year low.[13]

Recent economic research has confirmed that the electricity crisis is only the most spectacular example of the costs imposed on the economy by the conduct of monopoly state-owned enterprises (SOEs.) For instance, research on the state railway monopoly found that:

- In 2004, a major iron exporter reported that delays in upgrading the Sishen-Saldanha iron export line were costing the company potential exports of R3bn a year.
- In 2005, a major coal exporter claimed that South Africa was losing coal exports to the value of around R2.5bn a year because the railway monopoly could not carry the coal to the coast.[14]

A broader HSRC study, looking at the effects of the SOE monopolies in the telecommunications and transport sectors, estimated that the economy would have grown nearly 4 per cent faster in 2003, and 5.5 per cent more jobs would have been created had these vital sectors not been dominated by state monopolies. The study points out that this estimate reflects only the once-off improvement and does not take into account the benefits that would have been felt in following years.[15]

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haven't spoken enough about the notion of solidarity. The welfare system puts the state and taxpayers in solidarity with the poor. Households that receive cash transfers are more likely to send the children to school; households that receive cash transfers are more likely to have adults go out and look for jobs.'

Paul Romer emphasised the trade-offs between redistribution and job creation and argued that it is more efficient to channel resources towards encouraging growth than to use them to make transfer payments. 'It sounds like several percentage points of GDP have been allocated in the last several years towards redistribution, with a proposal for more with the subsidy scheme to try and solve the unemployment problem. My point is you can aim to reduce poverty and inequality in two ways. You can try and raise income for the very poorest by transfers which don't increase total income, or you can try and do it through measures which actually raise the productivity of low skilled workers. In this way, you both increase the proverbial size of the pie, as well as the slice that goes to the poor. I'm worried that because it's politically very attractive to go the redistribution route, people may be underestimating the big gains that could come from trying to raise the demand for low skilled workers via the other route. Imagine, for example, that you had taken 1 per cent of GDP out of transfers and used it to deal directly with crime. It might be that you get a significantly larger response in FDI, which increases employment, which increases wages. So even though you have to be able to think a couple of steps down the chain to see this, it's very likely that many forms of investment that are designed to ultimately raise wages for low skilled workers will be more effective in reaching all of your goals than the transfers.'

Alan Hirsch replied that that it is necessary to tackle inequality before high rates of growth and job creation will be possible in South Africa. He argued that 'If you ask foreign investors, as many surveys have done over time, what concerns them about investing in South Africa, or if you look at last several years' of ratings agencies reports, they'll say that South Africa's inability to deal with rising inequality is one of their main concerns about investing in South Africa. And if you speak to individual foreign direct investors, they will point strongly to a lack of social cohesion and the potential for violent crime as being a major disincentive to investment. To see the money we spend on welfare as a cost isn't correct.'

As this discussion indicates, the effects of the welfare system on job creation are complex and hard

to assess. As several participants noted, the rapid expansion of redistributive transfers has helped to reduce absolute poverty. But – even though the welfare system is now the largest in the developing world – it is just as clear that our extraordinarily high rates of unemployment and inequality show few signs of significant improvement.

Can South Africa really learn from East Asia?

Which development experiences suggest the most useful and practical policy lessons for South Africa? Isn't South Africa much more like Latin America than East Asia, and doesn't this mean that the experience of the 'Asian Tigers' has relatively little to teach us?

Alan Hirsch kicked off the debate: 'The Harvard panel constantly compares South Africa with East Asian countries like Malaysia. They argue that because our domestic incentive structures are not right, we're missing out on opportunities to diversify into areas in which we aren't significantly invested at the moment. The OECD disagrees. They say we have very well-demonstrated and fairly effectively exploited strong comparative advantages in our resource-based industries. What we need to do to ensure that we grow more rapidly is to get efficiencies into the economy as it follows its current growth path. We need to reduce costs and reallocate resources in an appropriate way in order to strengthen our current capacities. I think the OECD approach is much more realistic. South Africa is essentially a resource-rich economy. We can learn a lot more from the diversification and competitive strategies of other resource-based economies than we can by trying to reconstruct ourselves as a manufacturing centre.'

Neva Makgetla agreed. 'We are much more like Latin America than Asia but we always talk as if we're going to develop like Asia. Like most South American countries, we have a resource-based economy, with deep inequalities and a deep rural/urban divide. Also, the fact that the inequalities are aligned racially makes them politically potent. We shouldn't ignore these realities.'

Paul Romer warned against rejecting policy lessons only because they do not mesh with our past: 'There are many cases where people have said, "We've never done it that way, it can't work for us," and yet they try it and it works for them. Take Mauritius, for example. It was entirely resource-dependent on sugar cane, had relatively high wages and was highly unionised. They created a special zone and they just said, "Anybody's welcome here. Make anything you want. The wage is the market-clearing wage. Let's just see what happens." They could easily have said the same things that some people at this workshop are saying about how we cannot expect South Africa to 'do anything special' – to grow much faster and along a different path. The Mauritians could also have said that the existing structure of their economy limited what was possible in future. As we've seen, however, their decision to try something new turned out to be a critical part of the transition to high growth.'

Should South Africa adopt a 'low wage' strategy?

Discussion of the Mauritian experience quickly led to a debate about whether it would be possible or desirable for South Africa to follow a 'low wage' strategy.

'There's a natural desire in South Africa, because of the high levels of inequality, to want to skip the creation of low wage jobs and try to jump straight to high wage jobs,' claimed one speaker. Another argued that a 'low wage strategy' would be politically impossible. 'It's one thing to try to do this in a country where incomes are generally low, but in our context, where there's so much inequality, to say that the government should step in to depress wages – because that's the way it would be seen – is just not politically viable.'

Paul Romer replied, 'Poverty and inequality are not an argument against trying to arrange a deal where people get jobs that pay a relatively low wage. A low wage is better than nothing at all. Converting your unemployment problem to a low wage problem would be an important step forward. You would get the production and the benefits from the utilisation of this resource. The mere fact of being in the job really helps people to develop new kinds of skills. It should, therefore, be an extremely high priority to push with all available tools towards reducing unemployment levels. But the way we talk about this is important – and economists are usually awful at this. I realise that the description I was giving sounds a lot like I'm advising politicians to go out and say, "We promise to create a lot of low wage jobs for all

The Mauritian experience: rapid economic growth with Export Processing Zones

From the early 1990s, the Mauritian government committed to transforming the island's economy from heavy dependence on a single commodity (sugar) to one based on four pillars: sugar, textiles, tourism and services. To achieve this, Mauritius set up Export Processing Zones (EPZ). These:

- provided good infrastructure
- offered generous tax concessions
- permitted wages to be set entirely by the market
- allowed investors to import inputs duty free
- were not limited to specific locations but were spread across the country.[16]

The EPZ policy was supported by a combination of other measures including a general tax reform and an exchange rate policy that favoured exports. EPZs made a major contribution to strengthening the nation's international competitiveness and to transforming the Mauritian economy. In 1990, per capita income was US$4 120. By 2007, this had risen to US$ 11 390; an increase of 176 per cent.[17]

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you low skilled people out there." Even an economist can see that's just a total loser in terms of communicating what you're trying to do. So I thought about whether there's another way to say what it is we're trying to say, and I came up with this. Politically, we should say "We're trying to increase the demand for the people who live in the economy right now. What we want to do is to get many more firms competing for workers. Not only will you find a job, but all that competition means your wages will rise." We need to convey the notion that wages are an outcome of market forces. We definitely shouldn't be talking as if wages are permanently attached to jobs.'

An overarching theme

As the workshop drew to a close, discussion converged on a single theme: South Africa needs a much more frank and constructive dialogue about our national economic goals and the methods of reaching them.

Wendy Luhabe said, 'I just don't think we have a coherent and shared vision for our economy. I think we've got competing needs and incoherent interests that work against each other. We need, as a country, to formulate a coherent economic growth vision that we can all contribute to systematically.' Others agreed: 'It's really important that we achieve a social consensus and an accord; a compact between government, business and labour. We should avoid the mistake that all of us made in the 1990s where we undertook that discussion in an intensely adversarial way.' Stephen Gelb noted that the core lesson to learn from the East Asian success stories is the importance of obtaining a degree of consensus about economic goals and the methods of reaching them. This was also true of Chile, where they seemed to have achieved consensus because their own history made all sides in the debate scared of the consequences of not having consensus. 'The historical record is clear. Without some level of consensus, it becomes very difficult to generate high rates of growth.'

As Nick Segal put it, 'If we cannot start talking to each other and start sharing visions and some values at a very high level, then we will continue to muddle through. We will not achieve the kinds of growth that we need and we will have to start worrying deeply about the survival of our society. It should not be an option to stay away from talks because of past experiences or because our society is too unequal. A real conversation involving all parties has to start sooner rather than later.'

Neva Makgetla strongly emphasised the need to find more honest and constructive ways of talking to one another. 'Instead of trying to find each other, we

Achieving a constructive dialogue won't be easy

Comments made by senior business and labour leaders at the workshop give a sense of the gap that will have to be bridged and the difficult issues that will have to be faced on the way to forging a real consensus on economic policy.

Business voices: 'East Asia has lower paid and more productive workers. We can't seriously compete at current wage rates.'

'A fairly small, largely corporate-driven tax base, is funding 12 million people who are living on social grants. This is not sustainable and does not make South Africa an attractive investment destination.'

'Many businesses can't rely on their workforce to deliver. Workers are unavailable when you need them most. This is because of absenteeism, or because of labour militancy, or because workers do not have the level of skill to effectively carry out their job. A lot of us are reluctant to hire additional people and will need to be given some kind of incentive to expand employment.'

'We spend a lot of energy fighting rearguard actions to defend ourselves from the many unintended consequences of legislation. There is always a plethora of new legislation and it has become extremely difficult for businesses to navigate through the legislative and regulatory thicket.'

Labour voices: I don't think you will ever convince people on the left that we should have lower wages and deregulation and privatise and so on.

You're not going to get labour's support on this issue of consensus as long as there's glaring inequality. You need to marry growth, job creation and equality. Otherwise you are going to create a suspicion that this consensus is more about benefiting a particular elite at the expense of broad society.

We must not delink the issue of skills shortages with the historical background, and what we inherited in our economy. Remember, around 1921–22 we had this huge strike in the mines. The strike was about the white artisans objecting to black people accessing skilled or semi-skilled jobs. Today we still have those kinds of people occupying positions that decide how many black people must be trained. It's a matter of having your former masters and oppressors leading you in transformation. It's not going to happen.

From 1994 onwards business played a crucial role in advising the government. But did those advisors help the government to address the social problems we have? No. If business feels like it's been sidelined, maybe that's because people have learned from experience. Your policies failed. GEAR failed. The masses are still poor and unemployed. The whole economic system needs to be reviewed.

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all just fall back on comfortable platitudes. If we can't find more creative ways to talk to each other, then we are not going anywhere. One part of the problem is the resort to sweeping generalisations instead of proving a point case by case. Unless there is evidence to demonstrate that it is essential to undertake particular reforms, those whose interests are threatened will not be convinced. We also tend to talk about other people as if they were objects when they're not in the room. For instance, if we say that grants create dependency and that people should give back to society in return, the desperately poor people who get grants are not going to be happy. What we should say instead is that we need to use grants to empower people; to help people be in charge of their own lives. There are also totally divorced discourses going on about what we mean by 'inclusive growth.' The way most people in the Alliance use this term is totally different from the way it's mostly been used round this table today. It's a real problem that a lot of people ignore the discourse that they are not familiar with. The result is that we spend too much time shouting at each other and not enough time saying, maybe the other side isn't stupid, maybe they're acting in what they perceive as their own interests. We need to find a way to accept and really listen to one another.'

Speaking from the chair, Michael Spicer said that the intention behind this workshop was precisely to contribute to starting a considered and deliberate dialogue involving business, government, labour and those outside the formal economy about changing the course of economic policy. 'This has been a really high-quality discussion. We need to keep this kind of conversation going. What's absolutely clear is that there has to be real compromise on all sides and a deep commitment from all parties to the goal of fast, sustained, job-creating growth.'

Concluding remarks

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 discussion that promote new ideas.

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

1. 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.
2. 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.
3. Experiment with Special Economic Zones. In order to create jobs for millions of unskilled and inexperienced young people, South Africa should set up Special Economic Zones with excellent infrastructure and a minimum of regulations to attract new foreign and local investment. As international experience has shown, 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 industrialisation.
4. Expose the state monopolies in electricity, transport and telecommunications to competition. In their current form 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 competition and contestation. In the limited number of situations where there are genuine natural monopolies, the legislated commitment to the independence of regulatory authorities needs to be realised in practice, and these authorities need to be equipped with sufficient authority and competence to avoid being 'captured' by the enterprises they are intended to regulate.
5. 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 rate and fiscal policy to keep the Rand relatively weak so that firms based in South Africa are internationally competitive
   - lower the regulatory and insider-created barriers to entry that prevent new entrepreneurs and new firms from competing with established players 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 a key instrument 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

6. Improve the capacity of the public service. There is a profound mismatch between the ambitions for a developmental state and the reality that – with a few exceptions – most state institutions at all levels are seriously 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 office
- expand the use of public-private partnerships for service delivery
- maximise the use of competitive markets to deliver services to poorer South Africans

7. Invest in urban infrastructure. Rapid, sustainable job-creating growth only happens in cities. South Africa needs to reverse the decline of our economically essential urban infrastructure. We need to make our cities great places to do business; places where it is very attractive for South African entrepreneurs and international investors to start new enterprises and expand existing businesses. No matter how deep the slump, we have 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 jobs. This means that we will have to draw on far more capacity and finance than is available in the public sector. A major new wave of urban development is required in which the private sector has to play a key role.

8. Fix education and training and immediately import more skills. Increasing the supply of skills 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 move as quickly as possible to 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 are losing many skilled South Africans to emigration and we have insufficient people coming through the schooling and training system for our needs. We need to reverse this trend, 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.

9. 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.

All 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.

10. 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 business should be exempted from BEE requirements. Far more emphasis should be placed in the BEE codes on encouraging firms to train staff and to create new jobs; far less emphasis should be placed on simply transferring shares from white to black members of the prosperous 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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