The Political Economy Growth and Reform in South Africa: Some Lessons from India's Licence Raj System[1]

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"An excessive focus on the role of vested interests can easily divert us from the critical contribution that policy analysis and political entrepreneurship can make. The possibilities of economic change are limited not just by the realities of political power, but also by the poverty of our ideas."- Dani Rodrik.[2]

Introduction

This paper seeks to draw out some policy implications for South Africa by looking at the political economy of growth and reform with respect to India. It will dispense with detail and get to the broad policy issues. The key question that we confront is whether we can increase the growth rate and what the impediments are that prevent us from achieving a higher rate of growth.

The rationale for choosing India – even though Brazil may be a more appropriate country in terms of common characteristics – is that the Indian experience is telling in what it suggests about the relationship between government and the private sector. More so because the current ambivalence between the private sector, trade unions and the government in South Africa cannot continue to persist. Despite the emergence of the National Development Plan (NDP), the different forces in South Africa still need to find a way to work towards a common vision.

The reason for touching briefly on mining, skilled labour and immigration, small business and black economic empowerment, and not on some of the other major challenges like electricity, unemployment, transport, is that we should not lose sight of the smaller areas of reform which potentially can yield large dividends. The other reason being that microeconomic factors are at times even more significant in igniting growth and prosperity. Marginal changes to the regulatory environment can trigger an investment response. This can change the nature of the conversation as well as the narrative for growth and structural change in the economy.

The Challenge of Inclusive Growth

No matter how intensive the debate one cannot hide the urgent fact that we need not only growth, but inclusive growth, in South Africa. This is particularly so, given South Africa's persistently high level of inequality and unemployment.

Ricardo Haussmann succinctly states that "a strategy for inclusive growth must empower people by including them in the networks that make them productive. Inclusiveness should not be seen as a restriction on growth to make it morally palatable. Viewed properly, inclusiveness is actually a strategy that enhances growth."[3]

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We should do everything possible to achieve a higher growth rate. Our potential rate of growth – that is the maximum that can be attained given favourable internal and external conditions – is determined not only by improving our productivity and efficiency of investments, but also by improving governance in the overall political economy. Whether it can be achieved depends on domestic conditions as well as the global environment. However, potential growth is only part of the story. To achieve a higher and sustainable growth rate, South Africa will have to pursue reforms and eliminate distortions and imbalances in the economy. The budget for the 2015 fiscal year and the measures announced attests to this.

This requires government not only to be proactive but to be innovative as well. If South Africa is to succeed it will have to become more competitive, strengthen its institutions, and integrate its micro and macro-economic strategies in a coherent and coordinated manner.

The failure to grow remains a key challenge. It is unlikely that a single grand strategy – whether it is improving access to finance, regulating capital flows or deregulating the labour market – can unlock the path to rapid, inclusive growth. This challenge highlights the need for government to become ever more agile and responsive. In so doing, it will move on many fronts simultaneously, engaging with the real economy, and learning about the problems confronting civil society, as well as responding smartly and creatively. Above all it will have to rebuild trust to foster the conditions required for structural change and reform.

Although our economy is subject to movements in the global business cycle, ultimately we have to improve the structure of the economy. Structural reform in the South African economy is essential to increase productivity. But this takes time. Hence, it entails reforms in the product and labour markets. The product market requires that we reduce the barriers to entry by increasing the scope for new entrants and to making the economy more competitive and less concentrated. The labour market needs to become more efficient and labour absorbing for small and medium enterprises. More fundamentally, the economy needs to make a structural shift towards an investment led growth path as opposed to its traditional reliance on consumption as a driver of economic activity. As stated in the Budget Review 2015 "restoring confidence in the future growth of the economy is the key to unlocking the long-term investment commitment of private funds."[4] If we do not generate robust inclusive growth by tapping into our indigenous sources in quick

time, we will be left worse off both politically and economically. This is a lesson drawn from what is unfolding in the Eurozone at present. While global growth is a major factor in slowing down domestic growth it is not the sole factor. South Africa needs to become more ambitious and raise the bar towards a higher rate of growth. So a fundamental question becomes, how fast can we expect to grow despite the headwinds that confront the global economy? How has India done it? What lessons, if any, can we draw from the Indian case?

The Indian Economy and Economic Growth

Various economists have attempted to explain India's break from its low or, what has been called, the "Hindu" rate of growth. In other words, India was known to grow at a maximum of 2-3% and not higher for a long period of time. This prevailed from the time of independence in the late 1940's until 1980. Some stress the role of "pro-business" reforms that began in the early 1980's (Rodrik and Subramanian, 2005)[5], while others have noted the importance of the systemic reforms in the 1990s and 2000s in accelerating the growth rate (Panagariya, 2008; Srinivasan and Tendulkar, 2003)[6]. This debate, though not settled, is nevertheless illuminating in a number of respects, mainly that the early reforms in the 80's did play a significant role in igniting growth.

The standard explanation for India's recent growth spurt has been ascribed to economic reforms initiated by Manmohan Singh in 1991. However, the evidence shows that this is not the case. Economic growth began to double in the mid 1980's. Dani Rodrik and Arvind Subramanian[7] (currently, Advisor to the Indian government) have argued that the acceleration in the rate of growth was primarily due to a change in the attitude of the national government towards the private sector. It is now conventional wisdom that India's growth acceleration predates the 1991 reforms.

The political logic was to win the support from the business sector as opposed to alienating it. The business sector responded positively, confidence improved and investment by the business sector increased rapidly.

Rodrik and Subramanian have attempted to explain the challenge of igniting growth and the story of how India seems to have overcome it. Their explanation comprises four elements.

- There was an attitudinal change on the part of the government in the 1980s, signalling a shift in favour of the private sector, with this shift validated in a very haphazard and gradual manner through actual policy changes.
- This shift and the limited policy changes were pro-business rather than pro-competition, aimed primarily at benefiting incumbents in the formal industrial and commercial sectors.
- These small shifts elicited a large productivity response because India was far away from its production possibility frontier.
- Manufacturing, which was built up through previous efforts, played a key role in determining the responses to the shifts.

The policy changes in the 1980's were essentially confined to internal liberalisation related to industrial licensing. The political logic was to win the support from the business sector as opposed to alienating it. The business sector responded positively, confidence improved and investment by the business sector increased rapidly.

What India's growth experience suggests is that it is possible to unlock growth, and that the route to achieving this is not necessarily the Washington Consensus route. What was the key difference? In India the reforms were in favour of existing business. This approach avoided the creation of losers. It may not be the most efficient, but turned out to have had a positive impact. This was also different from the Chinese approach which opened the economy to new entrants and activities.

The case of India provides an interesting case for understanding what inhibits the growth process. India's growth accelerated in the early 1980's. The change in attitude by the Indian government was key. Quite simply, it entailed eliminating the License Raj System or making small adjustments such as reducing some business taxes and easing access to imported inputs. India doubled its growth rate from 2% to 4% during the 1980's. Yet India is still plagued with bureaucratic inefficiency and a poor infrastructure. Later, in 1991, India liberalised the economy much further but the initial spurt to growth took place in the 1980's. The point is that when a country is performing below its potential, it does not require much to unlock inefficiency to boost the growth rate. Small changes can turn into big outcomes.

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What this kind of reform indicates is that governments do not need to do an enormous amount to unlock the growth potential but simply clean up the regulatory impediment to generate investment. Rodrik and Subramanian sum up their argument in suggesting that the "evidence points to an unleashing of the organised and incumbent private sector sometime in the early 1980s. While it is impossible to pinpoint exactly the source for this, there is circumstantial evidence that the trigger was a shift in the national government's attitude towards the private sector. This evidence also indicates that the beneficiary of this attitudinal shift was the formal sector built up under the earlier policy regime. Hence, to some extent, the learning generated under the earlier policy regime and the modern manufacturing base created thereby provided a permissive environment for eventual take-off once the policy stance softened vis-à-vis the private sector. So, unlike what one may have otherwise expected (from accounts of how costly ISI was), growth occurred where the earlier investments had been made. This is in contrast to the experience of the former socialist economies where post-transition growth was greatest, and where the drag exerted by the previous state sector was smallest."[8]

The South African Economy

South Africa in the post-apartheid phase has witnessed a material change for the better. Welfare gains are tangible in access to social services, housing and infrastructure services. However, it is of concern whether this can be sustained in the midst of low growth persisting as in the recent past. Moreover, since 1994 the economy has become a far more open economy compared to its past, which introduces new constraints but considerable opportunities as well. Compared to other emerging markets, South Africa's growth looks weak and is faced with considerable competitive pressures and constraints. The recent global financial crisis did not spare the economy and South Africa lost about 1 million jobs. The fact that electricity has become the immediate binding constraint simply adds to our woes.

The economy has gone through a whole series of reforms since 1994. Though the economy peaked in mid-2000, at present growth is low and well below potential. Yet,

we have the NDP which attempts to embrace the broad population in the country. The question that arises is: what is the problem? Is it an implementation problem or does more need to be done? Is there something wrong with the development strategy in place? Alternatively, what is South Africa's License Raj?

There are numerous responses to this but here we focus selectively on a few factors with the hope of advancing a discussion on the possibility of generating a higher rate of growth.

The South African economy grew at 3.2 percent a year on average from 1994 to 2012. Potential growth is currently thought to be around 3.5 percent, though it was estimated at around 4.5 percent during the four-year period from 2004-2007 when growth averaged around 5.5 percent. Economic growth however, has mainly been driven by domestic demand and financed through a persistent current account deficit. The current account balance was close to zero around 2003 but has subsequently increased, and regularly is at around 6 percent of GDP.

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Let us now look at some areas where growth enhancing reforms could take place and which will signal a change in attitude and enable a more dynamic relationship with the private sector and the trade unions. This will require more than a decision from the market or legislation. It will have to involve labour, government and business. Michael Spence suggests while "public and private interests are not perfectly aligned today, they are not perfectly opposed. Relatively modest shifts at the margin could them bring them back in sync."

In economic discussions, the issues that feature predominantly are fiscal policy, interest rates, money supply, etc. While these policy instruments are obviously important, they are not the primary engines that ignite growth and drive innovation and jobs. This comes through new companies and new innovations that create new jobs. More often than not our discourse is dominated by big business, big government and big unions. Though these are dominant forces in most economies, including our own, they do not constitute the sum total of all economic activity.

Subtle changes we re-iterate in economic policy can have significant effects on the nature of the growth process of a developing economy. This area deserves significantly more attention in the policy discussions on economic policy.

Regulatory Uncertainty – The Mining Sector

The mining sector has historically been the bedrock of the South African economy. Even though its aggregate contribution to GDP has declined significantly it is still the largest contributor to foreign exchange revenue. Any negative developments in the mining sector are rapidly transmitted to other sectors. In this sense it can have rapid external effects. This was the case with the outbreak of strikes in Marikana. The impact was felt through the entire economy and not only in the mining sector.

South Africa's mining sector has been plagued with regulatory uncertainty and acute labour problems. The failure to take advantage of the commodities boom and the increasing emphasis on BEE and ownership has undermined the positive role that mining can play in our economic development. Short term redistribution has undermined long-term growth and investment in mining.

Fixing this problem may not result in short term gains, since mining investment is a long-term activity. However, the signal it will send can have demonstrable effects not only for mining but other sectors of the economy as well.

Immigration and Skilled Labour

It is evident that the South African economy is skills constrained. This is in line with global trends as economies are becoming more knowledge intensive and production processes are changing at the same time. South Africa is not isolated from these trends, and we ought to reap the advantages that globalisation does offer. Skilled labour has become more mobile and can be attracted to new growth opportunities.

New regulations are becoming restrictive for immigrants who want to open a business in South Africa. Whereas previously foreigners had to prove that they would invest at least R2.5 million in the country, now they have to show that at least 60 percent of the workforce will be South African.

The unintended result of immigration policy has been to choke the flow of skilled immigration as opposed to easing the skills constraint on the economy.

The problem we face in this instance is that we have made it more difficult for skilled labour to enter our borders and gain easy access to prospective job opportunities. This again does not require major system-wide reforms in education or the labour market. The solution is simply to ease the administrative difficulty so that skilled labour shortages do not become an impediment to growth.

To produce these skills domestically is a long term project but to tap into the existing global pool of skills is a much more plausable short term opportunity. The high level of global unemployment in developed economies makes this an attractive proposition.

Ricardo Haussmann[9] made an interesting observation on the skills issue on a recent visit. The Harvard team who came to advise the South African government were not all born in the US. He argued that if the US had South Africa's immigration policy, this team would not exist and probably Harvard as an organisation would not exist. That is why migration is so important to skills acquisition and therefore to growth and job creation. The unintended result of immigration policy has been to choke the flow of skilled immigration as opposed to easing the skills constraint on the economy.

Small Business

An independent private sector development and research company found that the time taken to start a new business is much longer than previous research has suggested. The Index discovered that it took on average 60 to 90 days to open a new business in South Africa compared to the World Bank's Doing Business Survey of 2013 which stated that it took 19 days to start a new business in this country. According to Small Business Project's (SBPs) Professor Neil Rankin, the South African Small, Medium and Micro-sized Enterprises ("SMME") sector is generally slowing down. Business owners identified that some of the top barriers to growth were lack of skills (15 %), red tape (12 %), lack of finance (10 %) and the cost of labour (10 %). The Index found that on average SMMEs spent an average of 75 hours a month dealing with red tape.

The most competitive nations are those that have the highest level of entrepreneurial activity. Small and medium size businesses tend to be the greatest creators of jobs

and collectively, the greatest creators of wealth in emerging economies. Aspiring entrepreneurs in South Africa face huge challenges; financial, institutional, infrastructural and cultural challenges. Entrepreneurship is not yet recognised for the impact on growth, and the possibilities it can offer the South African economy, or for the impact it can have on unemployment and other social tensions in the country.

In South Africa, as in other emerging economies, these potentially transformative entrepreneurial champions must be supported and ignited. In this context we must distinguish between productive and unproductive entrepreneurs. Productive entrepreneurs create social benefits in addition to their private benefits. Unproductive entrepreneurs, in contrast, engage in rent-seeking behaviour that attempts to reduce another person's share rather than increasing the size of the cake. This sort of behaviour is highly prevalent in our context (i.e. the tenderpreneurs) who engage in corrupt practices and generate unproductive opportunities.

Black Economic Empowerment (BEE)

The key idea underlying BEE was to attain a significant shift in economic power to the previously disadvantaged and marginalised. This is a project that will not be achieved through the equilibrating tendency of the market mechanism but requires the state to play a role. However, in an attempt to achieve the objective of redistribution, we should guard against the tendency to use the regulatory power as the only route to solving economic problems. BEE is indeed necessary, particularly in a society that is distinguished globally for its high level of inequality.

A change in attitude can come about through lifting the regulatory burden, or License Raj, and broadening economic activity whereby it becomes more inclusive and participatory.

We need to identify what factors impede the growth of entrepreneurship and investment in South Africa. It is often argued that BEE is a problem since it militates against more risk based activities and therefore does not incentivise investment in innovation and growth. Rent seeking activity becomes the preferred option as opposed to activities that are growth enhancing.

Entrepreneurship or "entrepreneurial society", a term that is often used by the NDP, is an important objective. It can give rise to new firms and employment generating activities. The important challenge, then, is ensuring the growth of black entrepreneurs in South Africa.

Conclusion

The aim of this article is to suggest some lessons can be drawn from the Indian experience despite the very different context. The primary reason for choosing India as a comparative experience is because of the distrust that existed between the private sector and government. A similar situation prevails in South Africa which will require adjustments on both sides. A change in attitude can come about through lifting the regulatory burden, or License Raj, and broadening economic activity whereby it becomes more inclusive and participatory. This can change the conversation from pessimism to one of hope and inclusion. The private sector will equally have to demonstrate its ability to invest in a way that is less about the short term but more towards the long term.

The National Development Plan states, "leadership, unity and cohesion are difficult in our still-divided society. Yet these are the very things that help to anchor successful

nations and development strategies. Leadership is required to win broad agreement for the plan, to implement it, and to make sacrifices for a better future. A capable, efficient, and fair state is needed to support it, and partnerships, based on mutual trust are vital. Unless we work together, sacrificing short term gain for long-term prosperity, no single part of South African society can achieve its objectives"[10]

The South African economy holds great promise which can be realised if we recognise the flaws and attempt to correct them, and find a consensual way forward with a shared sense of responsibility. We most certainly cannot afford to succumb to pessimism. As Paul Samuelson, puts it, – "every good cause is worth some inefficiency" - equity and social cohesion are among them. While there is a demand for jobs, a hunger for education, and a desperate need for health, growth enhancing reforms cannot be paralysed. The challenges facing us are immense but so are the policy choices confronting our economy. We have to ensure that the national interest and inclusive growth trumps other impediments, including vested interests.

Though we may not have a perfect formula for igniting growth, we will have to be persistent, determined, pragmatic, and experimental, as in other emerging economies where these issues are being dealt with on a regular basis. We need to draw on some experiences which can strengthen our economy and make it more resilient in the face of adverse pressures emanating from the global economy.

FOOTNOTES

1 The views expressed in this paper are those of the author writing in his personal capacity.
2 Dani Rodrik. - The Tyranny of Political Economy
3 R.Hausmann "The Economics of Inclusion" – Project Syndicate
4 The Budget Review 2015, p9.
5 D. Rodrik and A. Subramanian From "Hindu Growth" TO PRODUCTIVITY SURGE: The mystery of the Indian Growth Transition, Working Paper 10376 http://www.nber.org/papers/w10376
6 Panagariya, Arvind (2008), India: The Emerging Giant, Oxford University Press
7 Rodrik, D and Subramanian-
8 Ricardo Hausmann from Harvard University who chaired the International Panel on the Accelerated and Shared Growth Initiative for South Africa (ASGISA), shared this comment on a recent visit as well at a seminar presented to the CDE.
9 National Development Plan 2030, P.6.