South Africa's Growth Trap – Explaining Poor Policy Choices

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Middle income countries definitionally are countries in transition between low and high income status. As of July 2014, the World Bank's analytical classification of the world's economies based on estimates of gross national income (GNI) per capita is as follows: low-income economies are defined as those with a GNI per capita of $1,045 or less; middle-income economies are those with a GNI per capita of more than $1,045 but less than $12,746; high-income economies are those with a GNI per capita of $12,746 or more. Lower-middle-income and upper-middle-income economies are separated at a GNI per capita of $4,125. Using this classification, 79 countries qualify as high income, 102 as middle income, and 34 as low income. Within the middle income group it is equally split at 51 each within the upper and lower middle categories. South Africa falls into the middle income group.

Middle-income traps (MITs) refer to the experience of countries which achieved high economic growth rates in the past but which have become marooned in this middle-income zone that has seen their growth rates decline and them struggle to transition to high income status. Felipe et al. (2012: 45) argue that a country is in a MIT if it has been longer in the middle-income group than other countries have on average. They calculate this to be 'more than 28 years in the lower-middle-income group and more than 14 years in the upper-middle-income group. These imply that a country that becomes lower-middle-income has to attain an average growth rate of at least 4.7 percent to avoid falling into the lower-MIT and that a country that becomes upper-middle-income has to attain an average growth rate of at least 3.5 percent to avoid falling into the upper-MIT.' Using these parameters they find that 35 middle income countries in 2010 were in the MIT. By region, 13 are in Latin America, 11 are in the Middle East and North Africa, 6 are in Sub-Saharan Africa and 3 are in Asia. South Africa finds itself squarely in this category.

The large number of countries in MITs suggests that there is something structural about the nature of these countries which results in them becoming marooned in this zone. There is the now infamous statement attributed to Charles de Gaulle about Brazil when he stated that 'Brazil is the country of the future... and always will be'. This comment may well ring true for many currently much vaunted emerging markets that may find themselves in the process of 'emerging' well beyond what might be considered a reasonable time period to transition into high income adulthood. There is evidence that South Africa finds itself in this category.

Alternative explanations have been proposed as to why MITs arise. But the basic economic idea is that they find themselves struggling to compete with the low wages of low income countries and the technological aptitude of advanced countries. They are therefore squeezed from below and above and find themselves increasingly with less economic space to perform. The result is their increasing deindustrialization and a growth slowdown as countries are unable to transition to higher value activities and manoeuvre through the complex product value chains necessitated by changing patterns of development and new competitive pressures.

The Political Question

The political science literature comes at this discussion from a different angle. The focus here is less on structural changes within an economy as it develops and more on the political consequences and drivers of economic processes. Modernization theory proposes that economic progress may elicit socio-political change; and that political systems themselves have consequences for overall stability and the capacity of countries to grow economically. Given that middle income countries are moving between low and high income status, it is then of little surprise to witness the ongoing political and economic travails of this group and the fact that so many appear to find themselves marooned in this zone of transition.

Samuel Huntington (1970: 319) argues that 'it is not the absence of modernity but the efforts to achieve it which produce political disorder. If poor countries appear to be unstable, it is not because they are poor, but because they are trying to become rich.' He suggests that the poorest nations tend to be less prone to violence and instability than those countries just above them, but that wealthy countries tend to be the most stable. In other words, you either want to be poor and content in a low level equilibrium, or rich and content in a high level equilibrium. But trying to move between these two equilibria trigger processes of social mobilization which can result in political and economic extremism. This ties in with our MIT literature as it suggests that countries between low and high income status are subject to extraordinary pressures of social and institutional change which result in high levels of volatility – the outcome of which is uncertain.

At lower levels of development countries generally compete on the basis of low cost structures, especially related to wage costs. This stage relies heavily on low skilled workers and relatively low levels of product sophistication. As countries develop and wage structures start to rise so they need to transition to compete more effectively on the basis of quality and innovation which requires a more sophisticated skills set with higher levels of human capital. Moving up the value chain allows countries to absorb the higher cost structure by gaining a premium for greater levels of quality and, in time, a more sophisticated and innovative product portfolio. This is the challenge facing middle income countries.

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The Production Question

Hidalgo and Hausmann (2009) use network theory methods to illustrate that a country's trajectory is influenced by its capacity to develop capabilities that are required to produce more sophisticated products. Thus they see development not only as a process of producing the existing product set more effectively but also acquiring new complex capabilities to develop new products with higher levels of productivity. What this literature argues is that not all products matter equally for growth. Countries which have successfully transitioned out of middle income status are those which had more diversified, sophisticated export baskets which allowed them to leap to higher levels. Felipe et al. (2012: 39) use a probabilistic measure of how close a product is to others and whether it is likely that the country can acquire the revealed comparative advantage in them through the transferability of capabilities. Out of the 779 products that they analysed, 352 are in the mid or high proximity ('good' products) and 427 are in the 'bad' product space (p. 41-42). They find that countries in MITs (especially lower income) export a substantial share of products that are both unsophisticated and not well connected to other products. South Africa is squarely in this category with 66.4% of our exports being located within the 'bad' product space. Thus their explanation of what is affecting some MICs is that they never fully industrialized the way most developed countries did (due to their lower levels of sophistication and product connectedness), and now are undergoing some early deindustrialization.

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South Africa's growth under-performance is not only a recent phenomenon and even during the country's high growth era during and before apartheid, its performance relative to other comparable countries had been lacklustre and uneven. Examining the long term structural changes in terms of contribution towards GDP reveals a definite pattern for South Africa. Manufacturing, value added as a percentage of GDP remains fairly stagnant at between 20 and 24 percent throughout the 1960s, 70s and 80s before starting its decline during the 1990s and more so during the 2000s to the point where in 2013 it contributed only 11.56%. High technology exports make up only 4.5% of South Africa's manufactured exports, compared to 10.5% for Brazil, 20.5% for Thailand, 26.2% for Korea, and 43.7% for Malaysia.

To make the leap up the value chain in terms of product sophistication requires a more effective use of inputs and an improvement in the quality of these inputs. South Africa performs poorly on both counts. On the human capital side, South Africa spends more on public education as a percentage of GDP than most other countries and yet its performance is dismal on almost any measure. Whilst the origins of this are rooted in apartheid, post-apartheid education has similarly performed with a focus on quantity rather than quality and this has implications for a country trying to escape the MIT through innovation and movements up the value chain. Compared to similar countries South Africa underperforms on various technological readiness measures. We spend less as a proportion of GDP on R&D at 0.76% - a country like South Korea which is one of the few which has successfully negotiated the treacherous transition beyond middle income status in recent decades, has an R&D spend of 4.04% and China which is acutely aware of the pressure to innovate for further success is spending almost 2% of GDP. South Africa has a low number of patent applications. Turkey with a population 50% larger than South Africa has over seven times the number of patent applications, Malaysia with a population half our size has almost double the number, whilst Korea has roughly the same population but has over 243 times the number of patents. The key dimensions which facilitate transitions from middle income to high income status are precisely the dimensions where South Africa fares poorest – namely those related to technological innovation and human capital.

Policy Failures

MITs are not inevitable but are the result of policy failures to recognize the malaise and to implement appropriate strategies to move countries through successive value chains. Why are states unable or unwilling to formulate and execute appropriate strategies to catapult countries between different stages of development? In South Africa, there is a broad understanding of what the issues are that are holding the country back. The National Planning Commission undertook a comprehensive diagnosis of the development challenges and developed an arguably reasonable plan for the way forward. But it has remained stuck in a limbo and contested within the very party that claims it as its overall framework. Ministers and departments that are meant to implement it often openly disagree with it or ignore it.

In countries with high levels of inequality there are questions about the appropriate level of redistribution and this creates tensions between those who are net contributors to state revenue and those who are the recipients of public goods i.e. between those who are in favour of the status quo (the current insiders) and those who call for radical change (the outsiders). Between macroeconomic conservativism and macroeconomic populism. Economic growth brings these challenges to the fore as it highlights the winners and losers as a result of this structural change. South Africa's economic inequality shows up repeatedly as amongst the worst in the world. This is not sustainable and increasingly puts pressure on decision-makers as they struggle to mediate the tensions between a focus on production versus distribution. Business, government and labour have not been able to formulate a social contract to govern a way forward and the result is increasing policy paralysis and indecision. The lack of a strong middle class makes holding the policy centre difficult. Designing public policy thus entails trying to pacify the economically marginalized without alienating the tax base – no mean feat in any society but more so in the case of South Africa given its history and extraordinary inequality. One way to do this is by 'procuring' acquiescence through a complex web of implicit deals. The lowest deciles through social spending and cash transfers, the highest decile by guaranteeing no radical change in the underlying economic system and allowing for the continuation of the status quo. The upper-middle and middle classes end up slightly worse for wear but are known for their forbearance. For good measure, the state furthermore co-opts the vast civil service (a middle class constituency) through above inflationary pay increases and through an expansion of the sector. The Budget Review (RSA, 2015: 8) states that over the past decade, 'public-sector unit labour costs have increased by more than 80 per cent in real terms, with an average annual growth rate of more than 6 per cent above inflation. Compensation of employees has contributed in large measure to the structural fiscal deficit.' Furthermore, public sector employees have grown from 1 million in 2005 to 1,251,325 in 2013 – an increase of 25.1% (Medium Term Budget Policy Statement, 23 October 2013: 28).

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This system of appeasement may result in stability but comes at the price of a low level equilibrium trap. The casualty of this is the lack of focus on expanding the productive capacity of the economy. This would require innovation and moving up the value chain which will result in a process of creative destruction and of new winners and losers. The elite rather bet on a sure thing, namely an existing share of the national income and negotiate between themselves how that is distributed, rather than the uncertain outcome which displaces the existing means of production. Labour, likewise, has an interest in the perpetuation of the status quo as long as they remain the insiders. Shifting to a new productive economy will displace some insiders even as it creates opportunities for current outsiders. This would also explain the fact that labour market reforms are left untouched. Whilst easing labour market restrictions may expand the class of the employed, it may distress the existing insiders.

Conclusion

The one 'advantage' of the current system is that the state escapes absolute capture as it appeases both ends of the spectrum. This prevents a shift to absolute policy populism – it is a form of 'bounded populism'. Unbounded populism would entail ignoring the macroeconomic constraints and see a debt and inflationary spiral, but bounded populism sacrifices innovation with an elaborate rent-granting system whilst retaining economic stability, be it at a low level.

For South Africa, unless there is a dramatic policy shift which recognizes the realities of the political and economic causes of stagnation and the appropriate investments and choices are made, we are unlikely to move beyond middle income status any time soon. Tough choices need to be made to avoid the road to nowhere or a default into a policy set of 'bounded populism'.

This is an abbreviated version of "The political economy of middle-income traps: is South Africa in a long run growth trap? The path to 'bounded populism'" originally published in South African Journal of Economics, 2016, 84(1): 3-19.

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