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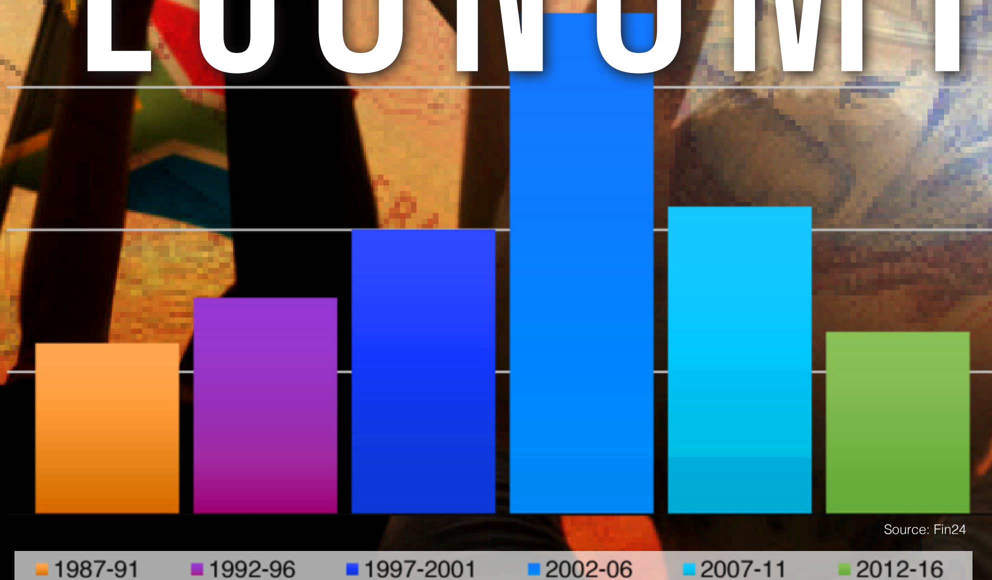
THE ECONOMY



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The Economy

Charles Simkins is a distinguished Economist. He was Vice President and Professor of Economics at St Augustine College and formerly held the Helen Suzman Chair of Political Economy at Wits University. He is a former Rhodes Scholar and is a recipient of the Helen Suzman Chevening Fellowship, a UK Foreign Office award. He is currently the Head of Research at the Helen Suzman Foundation'.

The Zuma administration harmed economic growth in several ways. There was zero interest in the patient promotion of growth. Instead, elite enrichment by any means possible was the central focus. To the latter end, institutions essential to growth were hollowed out and partly repurposed for private accumulation. Revelations of outrageous corruption failed to lead to investigation and punishment. The quality of management and accountability in the state and state owned entities declined. Fiscal space was used up rapidly and the public debt to GDP ratio soared. Vague symbolic appeals to 'radical economic transformation' were used to divert attention from the increasing mess, increasing uncertainty.

The replacement of Zuma has brought a change in tone, but it remains to be seen how far attention to economic growth can be sustained in the medium term, given competing demands for attention in the form of political firefighting and the 2019 election. Still, if achieving economic growth requires persistence, so does the advocacy of measures to promote it. Accordingly, *FOCUS* publishes four articles on growth by leading economists in this edition.

The central point is that South Africa is stuck in developmental terms. **Johannes Fedderke** argues that potential economic growth (the speed limit for the economy in the medium term has dropped to below 2% since 2010. The International Monetary Fund concurs. Its April 2018 projection implies a potential growth rate of 1.8% in the early 2020s. Given a population growth rate of 1.1% in the same period, the tiny growth in real per capita incomes, if maintained, imply that it would take a century for living standards to double.

Fedderke shows that poor growth performance has long been a feature of the South African economy, arguing that unbalanced growth, product market distortions, a misconception of the relation between inequality and growth, and political economy constraints are responsible. Unbalanced growth under South African circumstances is concentrating labour absorption in low productivity sectors, making policy that drives up the real price of labour likely to be particularly counterproductive. Instead, supply side measures are needed, with particular attention to international competitiveness and access to world markets needed to increase competition in the South African economy. High levels of concentration in output markets lead to high mark-ups, lower productivity growth and they reinforce labour market inflexibility.

While there are endless studies on inequality, there is virtually no analysis of the relationship between inequality and economic growth. Fedderke finds that growth and inequality determine each other in a benevolent way. In particular, the impact of growth on labour absorption, and hence inequality is strong. He also finds that there has been erosion in the quality of governance, dampening economic growth.

The first duty of macroeconomic policy is not to impede growth. The second is to increase competitiveness, investment and efficiency. **Christopher Loewald** argues

that fiscal deficits, while appropriate in the immediate aftermath of the global financial crisis, should have been reduced from 2011 as the output gap disappeared. In the event, rapid growth of the public sector wage bill and rising debt service costs have crowded out public investment spending. By keeping inflation and interest rates higher than they should have been, fiscal policy appreciated the exchange rate and weakened the response of exports to recovering global growth. It has also undermined desirable adjustments in relative prices. Real depreciation of the exchange rate and lower domestic demand would have shifted production to tradable goods and services and domestic expenditure switching to non-tradables, reducing the current account deficit.

Accordingly, Loewald argues for macroeconomic policy settings which lower external imbalances and creates a more sustainable pattern of domestic production, with decrease dependence on debt and consumption. Moreover, the credibility of monetary and fiscal policy should be enhanced, with an emphasis on keeping the inflation rate in the middle of the target band instead of near the top, and a more rules-based fiscal policy designed to make the current commitment to counter-cyclicality, debt sustainability and inter-generational equity. Finally, macroeconomic policy should be more closely related to growth-enhancing microeconomic measures.

Instead, they advocate policies which emphasise openness, increase in new entrants, and orientation to future generations, moving resources to accumulation of skills, technological upgrading and shifting consumption to the future.

Vincent Dadam and Nicola Viegi consider the determinants of investment. Private investment has been weak for a long time, and is now about 20% lower than before the global financial crisis. Strong structural factors are at work, and they require a strong policy response to increase foreign direct investment and investment by South Africans in home markets. The most important determinant of investment is the expected size of the market. Given South Africa's remoteness, expanding markets require integration into the global economy, which also exerts competitive pressure on firms to innovate and become more efficient. Barriers to entry into domestic production create a disconnection between wages and productivity via the extraction of rent, creating the pressures for more protection

and subsidy. South Africa has seen a widening of the productivity gap between best practice and actual production, sustained by inward looking policies.

At the policy level then, Dadam and Viegi see little hope that structural changes promoting investment will be the outcome of corporatism, which favours incumbents and rent sharing over greater competition. Instead, they advocate policies which emphasise openness, increase in new entrants, and orientation to future generations, moving resources to accumulation of skills, technological upgrading and shifting consumption to the future.

Like Loewald, **Andrew Donaldson** lays stress on the details of tax, spending and financial support programmes, the interactions between government actions and market dynamics, and the way in which public policy affects investment, trade and employment. Donaldson discusses three focus areas: urban development and housing, earnings, employment and social security, and network industries and state-owned companies. Noting that higher productivity in cities means that urbanisation is a powerful catalyst of growth, Donaldson argues that (i) greater priority needs to go to economic investment, trade, skills and enterprise development, (ii) the structure of local government finance and financial support from central government will have to change, in the direction of a blend of grant and loan based funding with private sector and Development Bank involvement, and (iii) revenue management should improve, with new settlements confined to planned and rateable areas.

Donaldson also argues for a more extensive employment subsidy than the youth employment incentive and for a more complete programme of social security and health insurance in order to increase household income security, contributing to sustaining productivity and competitiveness in more labour intensive industry. He also notes that technology and competitive adaptation have shifted against slow moving incumbents in network industries. Restructuring proposals have sought to bring better regulation and competition into the electricity, transport, water and telecommunications industries, but the complexities of transition and political resistance to privatisation has worked against progress,

In the end, proposals for pushing ahead with economic development are to be found in many places, including the National Development Plan. The problem lies with indifference to them, or active hostility, dressed up as resistance to 'neoliberalism'. What used to be known as 'cribbing' in examinations is now known to education theorists as 'rapid learning technique'. By the same token, corruption is rapid accumulation technique, and it will always be preferred to patient growth, unless it is stamped out.

As a nation, we are effectively more in love with the status quo than we care to admit, preferring to wait for a great wind to pick us up and take us to a desirable place to getting there under out own steam: to see, and work with, opportunities for improved growth requires a change in mentality with an accompanying realignment of interests. Think like economists, and get serious.

South African Growth: Context, Cause and Consequence

South Africa's growth performance in comparative context

By international standards, South Africa's growth performance over the last half century has been woeful. Recently, the growth rate barely in positive territory, finally triggered something of an engagement with growth in the South African policy debate. In fact, the problem is far more serious, and of a deeper structural nature than reference to the most recent performance would suggest.

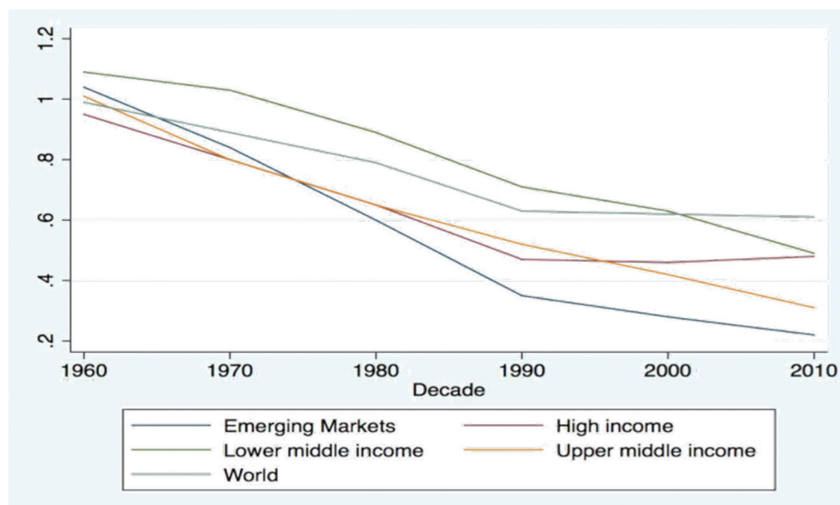
Dr. Johannes Fedderke is Director of Economic Research South Africa, Professor at Pennsylvania State University and the Wits Business School. His research interests center on the determinants of economic growth, with special interest in the role of institutions in long run economic development. His published work includes empirical and theoretical contributions, and has provided cross-country, panel and country specific time series evidence on the interaction of growth and institutions.

Figure 1 displays South African real per capita GDP as a proportion of a set of group averages, with all real GDP measures indexed to 1960, allowing for a comparison of relative rates of change.[1] Comparisons are made with five distinct reference groups of countries over six decades (1960s – 2010s):

- 17 emerging markets, [2]
- high income countries,
- lower and upper middle income countries,
- and all countries (the World),[3]

Irrespective of the comparator group the inference is the same - South Africa has lagged all comparator group averages in terms of its ability to grow.

Figure 1 – South African real per capita compared with five reference groups of countries, indexed to 1960



Source: Fedderke (2017a)

Indexed real per capita GDP declined from:

- 104% of the group average in the 1960s to 22% of the group average in the 2010s for the comparator emerging markets;
- 95% of the group average in the 1960s to 48% of the group average in the 2010s for high income countries;
- 109% of the group average in the 1960s to 49% of the group average in the 2010s for lower middle income countries;
- 101% of the group average in the 1960s to 31% of the group average in the 2010s for upper middle income countries;
- 99% of the group average in the 1960s to 61% of the group average in the 2010s for all countries in the world.

Thus while South African real per capita GDP has increased over time, the country has steadily lost ground when compared with other countries. The failure in South Africa is long-standing, profound, and of a deeply structural nature.

South Africa's growth path is not balanced, since the sectors of the South African economy are not growing at the same rate.

Currently, South Africa's growth is very low, and shows signs of secular stagnation rather than catch-up. Even under the most optimistic assumptions it is difficult to see a structural growth rate for the economy above 2% per annum (see Fedderke and Mengisteab, 2017) - insufficient to raise average welfare, given the current population growth.

Some underlying structural Constraints

Consideration of the structural characteristics of the South African economy only deepens concerns. The focus here is on some central issues of most immediate concern.

1. Unbalanced growth

South Africa's growth path is not balanced, since the sectors of the South African economy are not growing at the same rate. The result has been an ever increasing relative importance of service sectors, at the expense of the primary and secondary sectors of the economy.

Specifically, within the Ngai and Pissarides (2007) framework, where total factor productivity[4] (TFP) growth that is differentiated across economic sectors, balanced growth emerges only if the price elasticity of demand[5] is unity. By contrast, employment shifts to low-TFP-growth sectors for a price elasticity below unity, and to high-TFP-growth sectors for a price elasticity above unity. The reason is that sectors with faster TFP growth produce more real output over time, so under a price elasticity of demand below/equal to/above unity, their relative prices fall, with the price changes triggering increases in consumption demand that less than/proportionately/more than offset the price fall. Hence sectoral shares in nominal output decline/remain constant/increase, and hence employment shares decline/remain constant/increase.

Fedderke (2017a) confirms that South Africa reports differential total factor productivity growth across sectors, combined with a price elasticity of demand that falls below unity. This carries the implication that over time, the labour factor input will shift from high, to low productivity sectors. Figure 2 gives a simple verification that this empirical prediction of the underlying structural econometric modelling holds true.

These structural forces driving structural change in the South African economy have major implications for policy making. Since labour absorption is concentrated in low productivity (and output) growth sectors, labour market policy that drives up the real price of labour is likely to be particularly counterproductive in addressing an unemployment rate of 25% (or more).

Instead policies targeting the supply side of the economy and international competitiveness are likely most effective for raising employment and growth.

The analysis also suggests that policies targeting returns to labour and wage growth alone will be insufficient to address unemployment and poverty in South Africa. Instead policies targeting the supply side of the economy and international competitiveness are likely most effective for raising employment and growth. For South Africa, this may require considering sectors outside those that have historically been the focus of policy. Instead of mining and manufacturing, new service industries particularly in finance, transport and communications that report high TFP growth may have more growth potential, especially given potential exports to the African continent.

Figure 2 – Total factor productivity growth vs. employment growth

The points are sectoral 10 year moving averages over 1960-2012, for the two digit[6] economic sectors of South Africa.

Source: Fedderke (2017a).

2. Product Market Distortions

South Africa faces serious product market distortions.

One of the persistent recent findings about South African output markets is that they manifest high levels of concentration.[7] As well as high levels of pricing power,[8] with negative growth consequences.[9]

These findings interact with the nature of South Africa's unbalanced growth path. Since high mark-ups are associated with lower TFP growth, and labour is shifting to low TFP sectors, labour absorption should occur in sectors with high mark-ups. Importantly, output market distortions and labour market distortions

reinforce each other, in the sense that sectors with the strongest output market pricing power, also have the highest level of labour market inflexibility.[10]

Since productivity growth is a predictor of long-run growth, policy focussed on removing constraints on the supply side of the economy, particularly in increasing competitive pressure, encouraging economies of scale in production, and access to world markets, will be of particular importance. The structural product market forces shaping South Africa's unbalanced growth, combined with the already unusual industrial structure of the South African economy, thus points to the importance of liberalizing both labour and output markets.

3. Growth and inequality

South African academic research in economics over the past two decades has been dominated by a focus on poverty and inequality. The vast preponderance of public funding both for field work, as well as in terms of funding for research chairs has been focussed on poverty and inequality. Yet virtually no work (to my knowledge none) has emerged exploring the link between poverty and inequality on the one hand, and the fundamental motor for long-term welfare improvement that is provided by economic growth. This is surprising since there exists a deep symbiotic association between growth and inequality, that has been the subject of theoretical and empirical interest to economists for decades. Useful reviews of the literature can be found in Aghion et al (1999) and Bènabou (1996).

Thus inequality is driven by economic growth, but equally growth is determined by the level of inequality. What is more, the interdependent association is benevolent. Growth serves to lower inequality, and falling inequality is itself beneficial to economic growth.

Fedderke (2017b) empirically explores the relationship between growth and inequality in South Africa in the context of the theoretical transmission mechanisms proposed in the international literature. Robust econometric results are conditional on allowing for multiple mechanisms linking the two aggregate outcomes.

The core result is that growth and inequality co-determine one another in South Africa in the 1960-2014 period. Thus inequality is driven by economic growth, but equally growth is determined by the level of inequality. What is more, the interdependent association is benevolent. Growth serves to lower inequality, and falling inequality is itself beneficial to economic growth. Moreover both linkages are substantively significant, with a 1% increase in real per capita GDP associated with a 0,45 unit decrease in the Gini coefficient (on the 0 – 100 scale), and a decrease of 1 unit in the Gini coefficient with a 2 percentage point increase in real per capita GDP.

The impact of labour absorption on inequality is dramatic. Increasing labour absorption by only 1%, serves to decrease the Gini coefficient by 2,60 units, the single strongest driver of inequality in South Africa amongst the variables considered. In this context the empirical evidence on labour absorption in the economy is of grave concern, with approximately 10% of the population now in private formal sector employment - see Figure 3. Labour market distortions in the economy remain a critical concern.

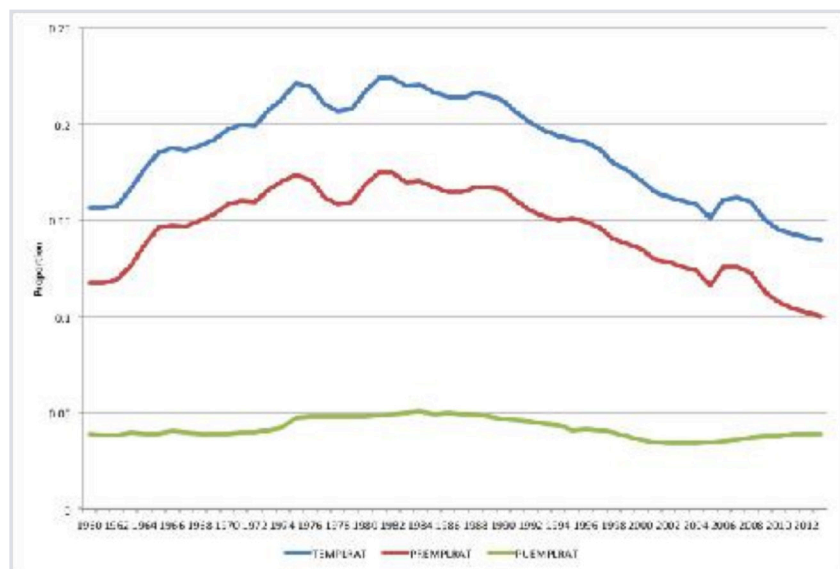
Openness of the economy contributes positively both to inequality, and to economic output. Finding a statistically significant positive impact of openness

on real per capita GDP is consistent with the literature on the positive impact of openness on growth (Sachs and Warner, 1995; Rodrik et al, 2004, Rattsø and Stokke, 2004), and with findings on openness and growth for South Africa (Aghion et al, 2013). The substantive impact is relatively weak, however, with an increase intrade as a proportion of GDP by 10 percentage points, generating a 1% increase in real per capita GDP. The impact on inequality proves substantively much stronger, with each percentage point increase in the proportion of GDP being traded generating a 0 5 unit increase in the Gini. Despite the finding of benevolent Stolper-Samuelson effects[11] in Fedderke et al (2012), therefore, the rapid opening of the economy does appear to have had significant disruptive distributional consequences for South Africa, likely through the technical change channel (see Fedderke et al, 2012; Fedderke and Romm, 2006). Note also that the rising importance of TFP growth in South Africa, is likely to amplify the importance of the technical change transmission mechanism over time.

But the impact of technological change will require a long term response in education and training policy to improve the resilience of the labour market in absorbing labour displacement through technological change.

Continuing trade liberalization is appropriate, especially in order to assist in the reduction of output market pricing power noted above. But the impact of technological change will require a long term response in education and training policy to improve the resilience of the labour market in absorbing labour displacement through technological change. Indeed, the impact of technology will be felt even behind any protective trade barriers.

Figure 3: Proportion of the South African population in formal employment outside agriculture



TEMPLOYRAT denotes total, PREMPLRAT private sector and PUEMPLRAT public sector employment, as proportions of the population.

Source: South African Reserve Bank.

Redit markets have played roles in the determination of inequality, both consistent and inconsistent with the theoretical mechanisms reviewed above. Improvements in corporate credit intermediation we find to have lowered inequality. This finding is consistent with the finding on labour absorption, since improvements in financial intermediation to the corporate sector, is likely associated with improved demand for labour. However, increases in household credit extension have been associated with increases in the level of inequality in South Africa. This may be a reflection of improved access to credit for some sections of the Black population, serving to widen inequality within the Black population group since the 1990s. Both household and corporate credit extension are important, with an increase of household and corporate financial intermediation as a proportion of GDP by 10 percentage points leading to a 1.74 unit increase, and 3.95 unit decrease in the Gini coefficient respectively.

The bottom line in policy terms is that the best way to address inequality is to raise growth and labour absorption.

Surprisingly, transfer payments, as measured for by government expenditure as a proportion of GDP do not have a statistically significant association with inequality. However, they do report a statistically significant positive association with real per capita GDP. Given that GDP growth reduces inequality, transfer payments reduce inequality only indirectly via economic growth. The insight that the execution of public policy is likely subject to public choice constraints has been made before - see Simkins (2004, 2011).

The bottom line in policy terms is that the best way to address inequality is to raise growth and labour absorption.

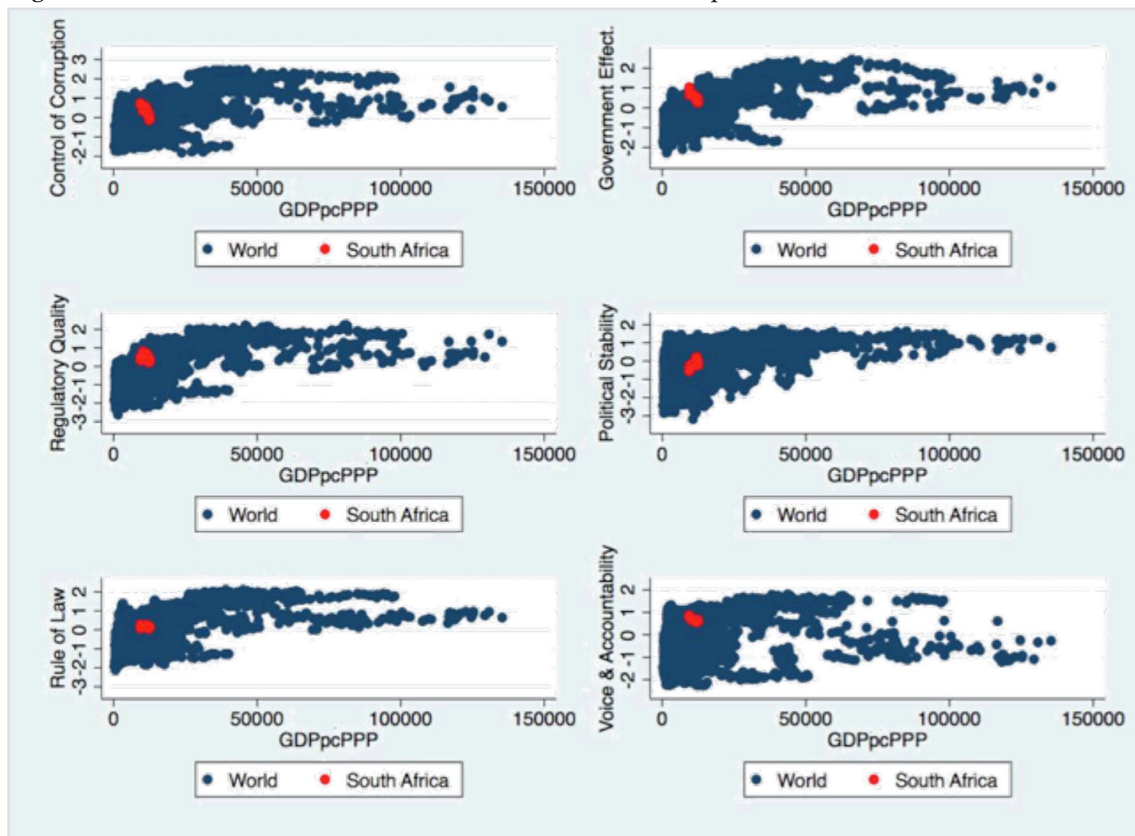
4 Political economy constraints

Political economy constraints are back.

For South Africa uncertainty from political conditions have major impacts in; (a) lowering investment in physical capital (Fedderke, 2004), and (b) lowering foreign direct investment (Fedderke and Romm, 2006), and (c) triggering capital flight (Fedderke and Liu, 2002). The reason for the negative impact is immediate and intuitive: in the presence of uncertainty, particularly systemic uncertainty, investors defer commitment. The good news post-1994 was that political uncertainty was dramatically reduced (Fedderke et al, 2001a, Fedderke and Pillay, 2010). The bad news is that uncertainty has risen again in recent years.

While Fedderke (2014) provides a more detailed discussion of corruption, here the World Governance Indicators are considered. These indicators have 6 dimensions: Control of Corruption; Government Effectiveness; Regulatory Quality; Political Stability; Voice and Accountability.

Figure 4 - World Governance Indicators: South Africa in world comparative context[12]

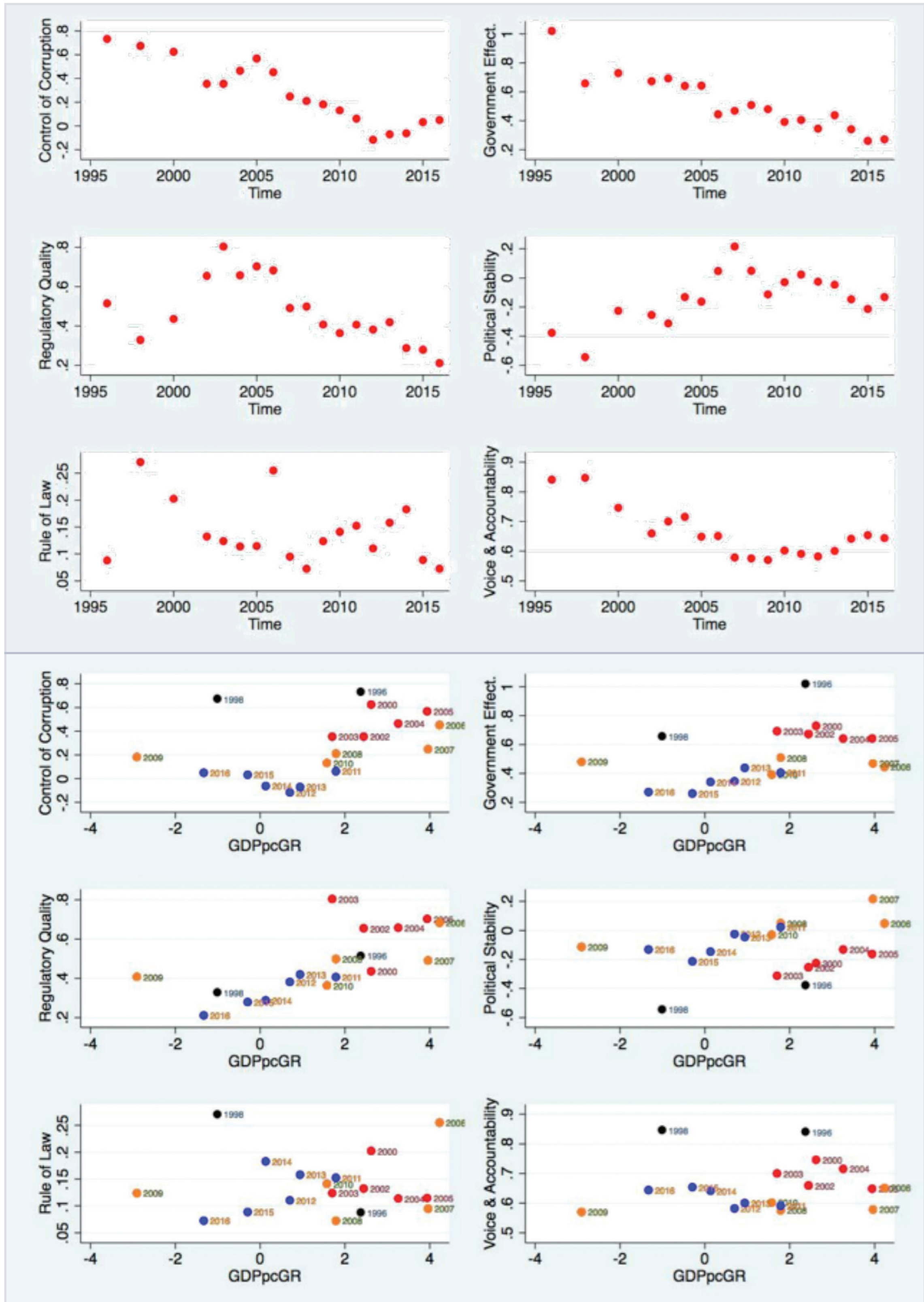


Three conclusions can be drawn:

- While South Africa improved its governance quality with the democratic transition of 1994 (see Fedderke et al, 2001), for all governance indicators it remains at best mid-table in international comparative terms. See Figure 6.
- Since the late 1990s, South African governance indicators have been on a downward trend - see Figure 5. The only nuance is that political instability began its decline in the mid 2000s.
- The positive association between the governance indicators and growth continues to be confirmed for South Africa - see Figure 6, and the evidence in Fedderke et al (2001b).

Erosion of the quality of governance thus means: (a) that South Africa's relative world ranking is declining; with (b) increasing dampening effects on economic growth.

Figure 6 – Relationship between SA governance indicators and growth



Some structural policy consequences

The implications of the structural findings are serious: labour absorption is being forced into the sectors with the lowest growth potential, reinforced by anti-competitive, concentrated output markets, and non-clearing labour markets that show an ever decreasing capacity to create sufficient jobs for a growing population.

A non-exhaustive list of policy inferences is:

- The implication of the nature of the unbalanced South African growth path is that policies targeting returns to labour and wage growth will be insufficient to address unemployment in South Africa. Instead policies targeting the supply side of the economy and international competitiveness are likely necessary complements for raising employment and growth.
- The implication of output market distortions is that policies targeting the supply side of the economy, industry concentration, but above all competitive pressure on markets are necessary for raising employment and growth.
- The strongest policy levers suitable for raising average welfare are policies designed to stimulate growth, increase labour absorption (i.e. stimulating job creation), and extending credit to entrepreneurs. All of these policy handles are much more powerful than fiscal transfer payments, which have a positive, but merely proportional, impact via real per capita GDP, and no statistically significant impact on inequality. While results support the importance of lowering inequality as an important driver of accelerating growth, we also note that the principal, if not the sole, emphasis over the past two decades in South Africa has been on welfare transfers, the single weakest driver of the growth-inequality nexus. The consequence is the singular failure in South Africa to reverse the rising trend in inequality. The core policy orientation, if inequality is to be reduced in South Africa, must be to stimulate job creation, and to raise growth. A further priority must be to reverse the now long-standing trade-off between employment and economic growth. Whatever the reason for the non-clearing labour market, this deep structural impediment constrains not only the prospects for aggregate welfare improvements (growth), but the ability of policy to address questions of distributional equity.
- The steady hollowing out of South African governance institutions must stop, and be reversed.

The core policy orientation, if inequality is to be reduced in South Africa, must be to stimulate job creation, and to raise growth. A further priority must be to reverse the now long-standing trade-off between employment and economic growth.

Currently South Africa is pursuing none of these policy priorities. Worse still, the gradual recovery of the world economy will provide a modest positive support for South African economic performance, once again allowing procrastination on the urgent need for reform, thereby locking in medium- to long-term underperformance. The country needs to move on from treating only the symptoms of an underperforming economy and to start addressing the fundamental structural constraints on economic growth.

NOTES

1 Note: given the indexing, the data are not interpretable as relative levels of real per capita GDP, merely in terms of the dynamics of change post 1960.

2 Included are: Argentina, Brazil, Chile, China, Colombia, Ecuador, Egypt, Indonesia, India, South Korea, Malaysia, Philippines, Mexico, Singapore, Turkey, and Thailand.

3 The income classification is that of the World Bank's World Development Indicators
4 Total factor productivity accounts for increases in efficiency. Thus, if a sector produces 1% more this year with the same labour and capital than it did last year, total factor productivity has grown by 1%. It is possible that a sector becomes less efficient over time, in which case total factor productivity growth is negative. Periods of strong expansion in capital stock, in anticipation of future demand/returns, would also generate negative values.
5 The price elasticity of demand measures the percentage drop in demand relative to the percentage increase in price. Thus, if demand drops by 1% while prices rise by 1%, the price elasticity of demand is 1 (unity).
6 The two digit economic sectors are a level of the Standard Industrial Classification. The first digit refers to a major sector, such as mining or manufacturing. The second digit identifies the most important subsectors within a major sector, such as textile manufacturing, or retail trade.
7 See Fedderke and Szalontai (2009) and Fedderke and Naumann (2010).
8 See Fedderke et al (2007), Aghion et al (2008, 2013), OECD (2008), Klein (2011).
9 See Aghion et al (2008, 2013), World Bank (2016), and Fedderke et al (2017).

10 Labour market inflexiblity is defined and measured as the proportion of labour cost that is part of fixed rather than variable cost - see the theory and evidence in Fedderke and Hill (2011).
11 The Stolper-Samuelson theorem states that, under certain conditions, a rise in the relative price of a good will lead to a rise in the return to that factor which is used most intensively in the production of the good, and conversely, to a fall in the return to the other factor.
12 Data are for 214 countries and territories, over the 1960-2014 period.
13 Source: World Bank.

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South African Macro-economics and Growth

By early 2016, the growth trajectories of many emerging markets had become unsustainable, with high current account deficits and falling growth rates. Since then, most of these economies have adjusted, some gradually and some abruptly forced by recession. South Africa's adjustment has been much slower, with some decline in the trade and current account deficits, but few clear steps to shift growth higher or to a more sustainable, investment and export-intensive composition. Exports barely responded to higher prices and the global recovery in demand.

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These partial adjustments and weak economic growth outcomes are endogenous to a policy stance that has relied on supportive global financing conditions, high commodity prices and a doubling of the public debt. Fiscal and monetary space has shrunk as the potential growth rate has declined to about 1.5% and long term inflation expectations remained sticky, ranging between 5 and 6%.[1]

What has gone wrong? If the intention of macroeconomic policy was simply to offset the Global Financial Crisis (GFB) shocks, then the settings to do that have long ago done whatever good could have been achieved. Economic growth did, in fact, rise to about 3% in 2010 and 2011.

But if policy intended to re-achieve a much stronger long term growth rate, then the settings were not appropriate to the task. Prolonged monetary and fiscal action to raise demand, reducing saving and pushing up inflation, have worked against the need to increase competitiveness. In addition to microeconomic reforms, competitiveness requires rigorously counter-cyclical fiscal settings to raise saving, monetary policy set to achieve permanently low inflation rate, and asymmetric exchange rate policy. These will lower long-run capital costs and reduce price-level appreciation. While I focus on macroeconomic policy effects on stronger potential growth in this article, it remains the case that microeconomic factors remain the primary impediments. Aligning microeconomic policies, the focus should be on price determination that is tied to productivity growth rates and of course much stronger investment. The last should be achieved by more fiscal emphasis on investment and efficiency, de-monopolising network sectors and increasing competition in the private sector. [2]

An unsustainable fiscal response to the GFC

The global financial crisis generated four, more or less simultaneous, shocks: a steep decline in commodity prices, in trade demand, in currency values, and in domestic demand. Most countries responded with fiscal policy and interest rate cuts, the two immediately available policy tools. South Africa did the same. A high rate of growth in government spending was maintained, even as the tax to GDP ratio fell sharply. As the economy recovered in 2010 and 2011, the fiscal deficit should have been reduced, not least because the output gap had largely disappeared. It wasn't, however,

and with subsequent annual deficits, the public debt level rose by 80% in seven years, from 27.1 to 49.4% of GDP. The largest increases in debt occurred between 2009 and 2012, persisting through the rebound in the economy. Government spending as a proportion of GDP[3] rose from 27% to 33%. As economic growth weakened from 2011 onward, the fiscal position became increasingly constrained. Efforts to spend more were confronted by an already high debt level and the risk of much higher funding costs and credit-rating downgrades.

Had growth been sustained beyond 2011, the fiscal position would have been more sustainable. But the deteriorating growth outcome has been endogenous to fiscal settings as growth in capital budgets slowed relative to exceptionally strong growth in the state wage bill (which rose from 12 to 16% of GDP).[4] Although head-count growth has been contained more recently (it grew by more than 15% across national and provincial levels alone over 5 years), wage increases for existing employees continue to grow in real terms.[5] The new budget, released on 21 February, moderates growth in the public sector wage bill but does not reduce its overall size. It grows by 7.3% per year and stays stable at 35% of consolidated expenditure, based on inflation of 5.4% a year. This growth in jobs has severely constrained fiscal consolidation and will permanently limit counter-cyclical fiscal space in future, unless the economy grows strongly.

Despite being weak, the global economy recovered as did the exports of other emerging market economies. This should have happened in South Africa also, but didn't.

Space for public investment spending was also crowded out by rapid growth in debt service costs, a function of the near doubling of the debt level and sticky inflation. Debt service costs grew at an annual average of 13.5% over the past three years, a rate of increase expected to moderate only marginally to 10.1% out to 2019/20. It remains the fastest growing expenditure item, outpacing even post-school education and training (increasing by an average annual rate of 9.2% till 2019/20). Debt-service costs have roughly tripled from 2009, reaching 3.3% of GDP in 2016/17 and rising to 3.7% of GDP by 2019/20. Contingent liabilities to state-owned enterprise have doubled since the global financial crisis, as a proportion of output, and now amount to about 18% of GDP.[6] This implies that government debt levels could, under adverse circumstances, quickly approach 70% of GDP, well above most posited sustainability thresholds.

The rise in public debt is both a consequence and cause of economic stagnation. Large, downward revisions in GDP growth have become standard: 2015/16, 2016/17 and 2017/18 growth projections have all been revised down from above 3% to around 1%. This has contributed to continuous upward revisions of expected debt-to-GDP ratios. More importantly, rescuing the situation would require a significant reversal in the fiscal trajectory. With the nominal yield higher than the nominal GDP growth rate, government needs to run significant primary surpluses to keep the debt level stable.[8]

While we can plausibly argue that fiscal policy was appropriately counter-cyclical in the immediate crisis period, substituting for falling external demand, it is much harder to make the case for continuing such large deficits after 2011. Despite being weak, the global economy recovered as did the exports of other emerging market economies. This should have happened in South Africa also, but didn't. The lack of export response and sustained leakage of the stimulus into imports implied that the fiscal deficit was the main driver of the current account deficit and could do nothing

to reverse the fall in external demand. Instead, by keeping inflation and interest rates higher than they would otherwise have been without the sustained stimulus, fiscal policy alone appreciated the exchange rate and weakened the response of exports to global growth.

As a result, the current account deficit remains substantial, at about 3% of GDP, andwill grow larger with stronger economic growth. The trade balance turned to surplus late in 2016 and into 2017, but this was caused by rising export commodity prices, weak oil imports and declining capital goods imports.[9] To get a stronger non-commodity export response will require more real depreciation (relative to equilibrium) than before, a task made more difficult by the persistent gap between South Africa's inflation rate and the low inflation environment globally. [10]

Is expanding credit and consumption, public or private, the only way to achieve more economic growth? Some commentators certainly appear to think so.

The rise in debt and poor net export outcomes occurred without a crisis, largely because of the policy framework put in place in the late 1990s and early 2000s. The floating currency allowed the exchange rate to adjust to the serial negative shocks. The floating rate has also warned the private sector away from creating foreign currency liabilities, a central problem in the Asian crisis of 1997/98 and for East European economies more recently.[11] On the fiscal side, the low level of public debt achieved up to 2008 enabled the post-crisis counter-cyclical response at an historically low short term financial cost. Without that, fiscal policy would have been constrained to consolidate years earlier.

Going in the right direction

The policy mix described above has been sustained in part by sustained high commodity prices and primarily because the global environment provided cheap financing of public and private debt. Is expanding credit and consumption, public or private, the only way to achieve more economic growth? Some commentators certainly appear to think so.[12] But that growth model depends on debt when productivity slows, and cannot be repeated unless a permanently higher growth rate is achieved. Worse, if benign global conditions dissipate and financing conditions deteriorate, a negative debt dynamic will make it more likely that policy has to tighten to maintain solvency, and potentially quickly.

The GFC was a severe economic shock that *primarily* reduced external demand. If short-term growth can no longer be supported with demand management policies, then how might economic adjustment and a sustainable composition of growth be encouraged? The adjustment to that shock should have relied on relative price adjustments – lower real industrial and input prices to maintain export and production volumes – and a temporary fiscal response. This is often thought about in microeconomic terms. But fiscal and monetary policy also have long-term effects on the composition of growth and shares of tradables and non-tradables because of their effects on the balance of saving and investment and relative import and export prices. With real depreciation and less absorption (domestic demand), the basic adjustment path is for production shifting to tradables and relatively more expenditure switching to consumption of non-tradables.

The main obstacle to greater real depreciation is domestic – the propensity for prices to rise and reverse the relative price change initially caused by currency depreciation. These serial cost-raising shocks to supply feed through into a stubbornly high

inflation rate via largely adaptive expectations and import parity pricing, and is made possible by a restricted supply of skilled labour (increasing wage inequality), weakly competitive product markets and various barriers to entry for new firms (which reduce price competition and labour demand).[13]

Getting different outcomes requires a more robust policy framework that increases credibility and lowers inflation expectations. Improving the policy framework with a lower and clearer policy target is the least cost option.[14] Fiscal policy would also benefit from a more rules-based approach to make effective budget guidelines that have been already adopted – counter-cyclicality, debt sustainability and inter-generational equity. Easing micro constraints would further create macroeconomic policy space and reduce potential adjustment costs. Product market reforms that increase competition and weaken pricing power and indexation are a needed complement to this strengthening of the monetary policy framework. If enacted they would do most of the work to lower inflation and improve competitiveness.

Allowing private firms to enter these sectors and provide competition to the public firms would lead to better economic outcomes – improved governance and long term efficiency gains in state enterprises, and also fewer demands placed on the fiscus.

For periods of currency appreciation, reserves policy can lean against appreciation, but it cannot stop it. For that reason, more flexible use of fiscal measures would be required to shift excess returns away from commodity, finance and real estate and towards raising the productivity of factors of production, provide more public investment, and perhaps use temporary tax credits for tradeables sectors. In these conditions, fiscal policy should seek to contribute to competitiveness by aiming for fiscal surpluses or smaller deficits. More fiscal consolidation would allow a slightly more relaxed monetary stance, which could then be supplemented if needed with an asymmetric forex reserves accumulation policy.

Coordinating policy to get better outcomes

Getting more growth and a lower current account deficit suggests more investment, with more of that provided by private sector exporters and import-competing firms. The macroeconomic policy suggested here will support them, but at some cost of lower returns to importers and domestic non-tradables producers. But the biggest short term economic gains are not going to be found in greater investment and production in existing industries where imports can satisfy demand (clothes, cars, food, etc.). Instead, near term growth can be induced in over-regulated network sectors where supply is costly and restricted and below demand (telecommunications, energy, transport).[15] Allowing private firms to enter these sectors and provide competition to the public firms would lead to better economic outcomes – improved governance and long term efficiency gains in state enterprises, and also fewer demands placed on the fiscus. Eventually, lower costs in these latter sectors will help to increase growth in the tradeables sectors, including import-competing businesses, and broader economic growth. These policy innovations would encourage private investment moving across both tradeables and non-tradeables sectors.

Well-targeted and managed public infrastructure programmes would also crowd-in private investment. Too much of the public infrastructure programme has occurred in areas (energy, transport, telecommunications) in which a state owned enterprise could be and should be challenged by private participants. This is a major

opportunity cost to the economy, leading to too low a level of investment at too high a cost, in particular by pulling scarce resources from other areas of public investment where a natural monopoly of provision by the public sector is appropriate (local infrastructure, free public health and education, security and other public goods).

Tax credits that create rent-seeking is another area for better use of fiscal resources. Fiscal savings could be reallocated to temporary assistance for firms and individuals that bear the costs of reforms, thus enabling faster shifting of capital and labour into more rapidly growing sectors.

The size of South Africa's public sector is probably not far from optimal, given the need for expansion of public services. But the spending that does occur needs to be efficient and the services effective, and this requires significantly greater focus by public sector management. Most importantly, steps to increase sustainable economic growth will generate an expansion in fiscal resources that the country needs.

Conclusion

In this note, I have argued for three policy initiatives. The first is to identify a general adjustment of macroeconomic policy to move the economy towards lower external imbalances and a more sustainable, less debt and consumption-dependent, balance of production. The second initiative sets out the credibility-enhancing shifts in monetary and fiscal policy that would support moving towards those balances. The third initiative is for monetary and fiscal policy to be more closely coordinated and backed up by growth-enhancing reforms. The cost of this to the economy should be relatively small, since the growth foregone is currently low and import leakage is high, and because the shifts will also pull down inflation and the cost of borrowing over the long term.

The views expressed in this article are solely those of Chris Loewald and do not reflect the views of any other institution.

NOTES

1. See Johannes Fedderke and Daniel Mengisteab, Estimating South Africa's output gap and potential growth rate, SARB Working Paper, WP/16/02, March 2016 and Vafa Anvari, Nelene Ehlers and Rudi Steinbach, A semi-structural approach to estimating South Africa's potential output, SARB Working Paper, WP/14/08, November 2014.
2. See Boris Cournède, Antoine Goujard and Álvaro Pina, How to achieve growth- and equity-friendly fiscal consolidation? A proposed methodology for instrument choice with an illustrative application to OECD countries, OECD WP1088, 2013.
3. Carmen M. Reinhart and Kenneth S. Rogoff, Growth in a time of debt, NBER Working Paper Series, Working Paper 15639 http://www.nber.org/papers/w15639.
4. In real terms, public sector wages per worker increased post-crisis by 1.62 percentage points per year before the start of the fiscal consolidation program, which started in late 2013. For more read International Monetary Fund, (2016), South Africa: 2016 Article IV Consultation, cr16217.pdf. Relative to emerging market peers, South Africa's wage bill is now among the highest. World Bank, 2016, Size of the Public Sector: Government Wage Bill and Employment, public sector data set.v
5. Government reined in employment growth from above 3% in 2008-2013 to 1.2% since the fiscal consolidation program, which started in late 2013.
6. These institutions are crucial to private-sector performance as they determine important input costs for businesses. On state control in product market rigidities, SA scores much higher than OECD average, and above Brazil, Chile and Mexico (OECD 2013 PMR indicators).
7. Paul et al., 2016, Budget Review, SARB Economic Note, March 2016. A debt to GDP ratio for general government of 50% sets a limit beyond which additional debt lowers economic growth rates. See Prudent Debt Targets and Fiscal Frameworks, OECD Economic Policy Paper No 15, July 2015, page 20.
8. A simple calculation of the long run sustainable public debt ratio at current nominal growth rates, interest rates and primary deficit is about 65%. Higher nominal interest rates (one percentage point) lowers this to 50%. The primary surplus needed to keep the debt level stable, with a nominal interest rate of 10%, an inflation rate of 6% and a real growth rate of 1% is 1.9% of GDP.
9. Up to 2017, a decline in South Africa's terms of trade had offset some volume improvement on the trade and current account balance. See JF Ruhashyankinko et al, External rebalancing: Commodity prices flatter Turkey but sully South Africa, Goldman Sachs Economic Research, 26 April 2016.
10. With lower global inflation, any rise in domestic inflation worsens competitiveness, as per the equation: real exchange rate = nominal exchange rate (foreign prices/domestic prices). See also Anand, Rahul, Roberto Perrelli, and Boyang Zhang (2016), South Africa's Exports Performance: Any Role for Structural Factors? IMF Working Paper WP/16/24. They also find that structural constraints impede export responses. See Berman, N., Martin, P., & Mayer, T. (2012). How do different exporters react to exchange rate changes? The Quarterly Journal of Economics, 127(1), 437-492.
11. Although this effect may have weakened in recent years as financial corporate borrowing increased.
12. See for instance Brian Kantor, Unleashing the household sector, Business Day Op-ed, 30 July 2015.
13. Including tighter access to finance, regulations, higher tariffs, etc.
14. The gains to this approach go beyond the lower inflation rate. Matching real income growth to productivity growth would help with external competitiveness, while greater product and labour market competition, and more skilled immigration would eventually expand demand for less-skilled workers.
15. See the growth effects of reforms in David Faulkner, Christopher Loewald and Konstantin Makrelov, Achieving higher growth and employment: policy options for South Africa, ERSA Working paper 334, March, 2013

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Investment in South Africa: Opening the Economy to Transform the Society

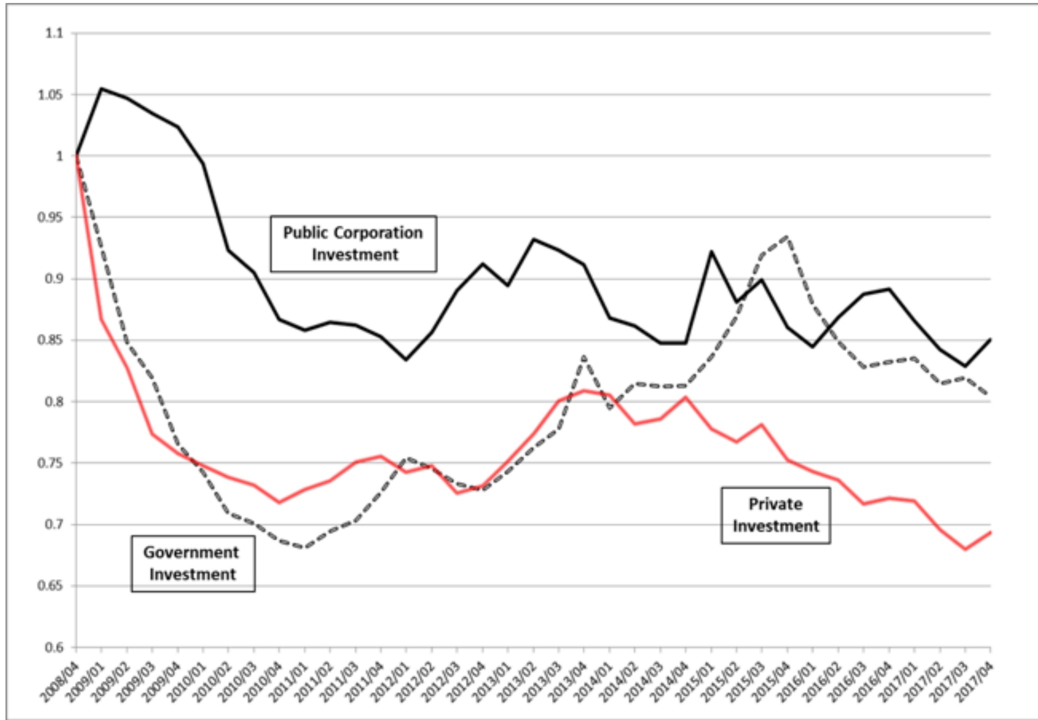
In the last ten years South African economic stagnation has been reflected in a dearth of private sector investment. The level of private sector investment today is still around 20 per cent lower than the level reached before the Global Financial Crisis in 2008 (Figure 1). This observation, together with an apparent increase of cash hoarding by private corporations, has suggested many commentators that the private business sector was on an "investment strike", driven mainly by political concerns during the Zumapresidency. [1]

The change in administration at the beginning of the year has certainly positively altered the business climate. There is an expectation that the business sector will respond positively to the government charm offensive by rapidly increasing investment in the country. For this purpose, President Ramaphosa announced an investment conference and an international investment drive targeted at foreign investors.

Can we expect these efforts to be successful? The optimism of this time of policy change should be tempered by recognising that private investment has been weak for a long time. Some of the investment trends are linked to a worldwide dearth of private investment after the global financial crisis, which is now hopefully behind us; some of the trends are linked to the political uncertainty in the Zuma's years, which has been partly overcome; but a large part of the trend has a strong structural origin which requires a strong reform effort.

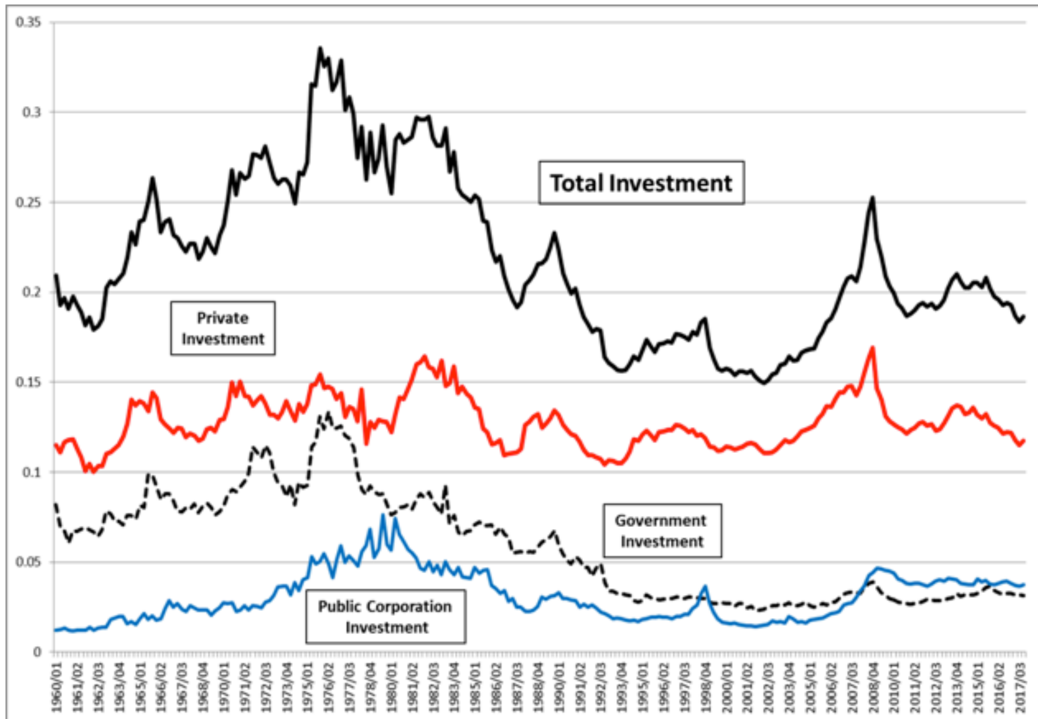
Looking back at the history of private investment in South Africa (figure 2) it is clear that the increase in private sector investment above 15 percent observed before the financial crisis was the historical exception. Even the growth in capital accumulation of the 60's and 70's was strongly driven by Government investment and investment of public corporations. Private sector investment remained between 10and 15 per cent of GDP for almost the whole period.

Figure 1 – Private and Public Investment in South Africa 2008-2017



(Source: SARB Quarterly Bulletin Dataset)

Figure 2 – Investment In South Africa - 1960-2017



(Source: SARB Quarterly Bulletin Dataset)

After 1994, investment has been considerably lower than comparable emerging countries, as shown in Table 1. The increase of investment in the last ten years is being driven by large public infrastructure investment which has not yet generated a positive response of private sector investment.

Table 1 – Total Investment over GDP in selected countries

Countries	1994-2000	2000-2008	2008-2017	1994-2017
South Africa	17.945	18.511	20.132	18.977
Brazil	18.793	18.480	20.124	19.175
Colombia	22.645	19.493	24.496	22.157
Chile	26.502	21.956	23.408	23.637
Turkey	22.715	25.012	28.286	25.665
Australia	25.454	26.693	26.801	26.424
Malaysia	39.138	24.061	24.299	27.919
India	25.016	30.626	34.748	30.769
China	37.531	39.621	46.267	41.591

(Source – IMF World Economic Outlook Database)

The structural nature of this low investment dynamic is reflected also in the low level of Foreign Direct Investment, which after 94' has never reached much more than two per cent of GDP.

In fact, South African firms are more often venturing abroad with the stock of foreign assets held by South African firms significantly higher than the stock of South African assets held by foreign companies.

Given that achieving the growth objectives of the National Development Plan requires aninvestment rate of Chinese proportion, the change needed is much more structural than a simple change in policy attitude.

South Africa is a small economy (roughly the size of Honk Kong and Israel with five to six times the population) and the size of the market can increase only by integrating into the global economy.

A significant, but never sufficient, body of research gives us some idea of the main determinants of investment in South Africa. [2] This research was carried out mainly in the 1990s and early 2000s, with some more recent work confirming and reinforcing the early results.[3] This research allows us to say a few clear things about the determinants of investment

The first thing we can say is that the most important determinant of long term investment is the expected size of the market.

South Africa is a small economy (roughly the size of Honk Kong and Israel with five to six times the population) and the size of the market can increase only by integrating into the global economy. In fact, investment is not only promoted by an increase in exports but also by an increase in imports. This is because a general increase in openness increases technological transfers, influences management practices and more importantly determines the level of competitive pressure on the firm to innovate and be more productive.

Unfortunately most of economic sectors in the country are protected from external competition by explicit or implicit barriers to entry. High mark-ups in monopolistic sectors are partly distributed to workers through the bargaining process, producing a dynamic of wages largely disconnected from the dynamic of productivity. This induces

a peculiar alliance between national capital and labour that always requires more protection and subsidies to withstand competition and increase rent extraction.

In this situation, investment and diversification of the economy is mainly driven by expectations of the level of internal demand, which is limited by the long term productivity growth of the economy. This is a catch-22 situation of investment being constrained by the lack of demand which is constrained by lack of investment.

While, in the past, mining provided revenues to sustain internal demand and finance heavily subsidized import substitution policies, mining now is constrained by regulatory uncertainty, increasing costs and uncertain market prices. The economy than has to find other sources of return to investment if it has to grow at the desired level.

South African firms do not have a problem of financing investment: they just don't want to invest at home.

Reducing the user cost of capital can certainly promote investment. This can be achieved by increasing the supply of savings, which would then reduce the risk free rate in the economy. The East Asian economic miracle received significant support by policies of forced savings and credit policies to reduce the firm cost of capital. But the marginal effect of these policies is likely to be small in a moment when the world is experiencing an excessive supply of saving. South African firms do not have a problem of financing investment: they just don't want to invest at home.

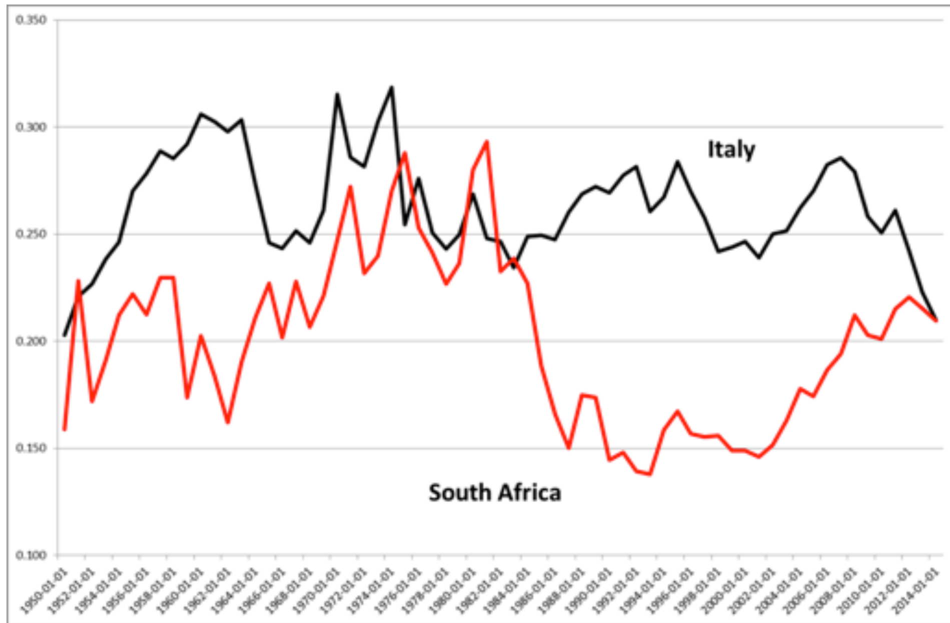
One of the possible reasons is that the economic and political environment in South Africa is "uncertain" and unpredictable. Uncertainty is certainly important: modern dynamic investment theory emphasizes the inter-temporal nature of economic decisions. If investors cannot predict the regulatory or political environment they will face, they will wait for more information to come before committing to an investment plan. The same can be said for price uncertainty in the mining sector, exchange rate uncertainty for the export sector and so forth. A particular role in the debate is played by "political uncertainty". This refers to a wide spectrum of regulatory and political events: uncertainty about the protection of property rights; levels of political corruption; legislative uncertainty and policy conflicts; general inefficiency of the state. In the most recent literature, the power of big data has been used to capture political uncertainty by just measuring the amount of times the word is used in the news, a technological twist of the old adage "I know it when I see it".[4]

While all these factors are important, their quantitative effect is not as large as we often assume. Its marginal effect is comparable to the effect of increase of the cost of capital. It is instructive to consider Figure 3 which shows the level of capital accumulation from the 1950's to the present in South Africa and in Italy, the country that defines political uncertainty and inefficiency of the state. For the whole period, investment in Italy has been higher than twenty per cent of real GDP. Political uncertainty matters in Italy as much as it matters in South Africa. Like in South Africa, political uncertainty explains a good part of the short run changes in investment. But the long run level of investment is strongly linked to the structural characteristics of the economy and the expected return of investment.

South Africa faces two obstacles that reduce the expected return on investment, one historical and one natural.

The natural obstacle is the limit to international integration imposed by the distance of the country from the main markets. The way to overcome this barrier is by productivity

Figure 3 – Share of Gross Capital Formation at Current Purchasing Power Parities 1950-2014



(Source Penn World Tables)

growth that increases the ability of national firms to compete internationally and overcome distance barriers.

Instead South Africa has seen an increase of the productivity gap relative to the frontier, particularly in those sectors that have the most potential to absorb the excess supply of labour in the economy. This takes us to the second obstacle faced by the South African economy: an historical tendency towards being inward looking both in the economy and the politics. Efforts to open the economy and increase its competitiveness are always limited by the need to protect the incumbents firms and workers. The threat of job losses in an economy with extraordinary levels of unemployment is a effective way to protect incumbent firms against external competition. The politics on the other hand is constrained by a prominence of the distributional consideration, which in a static economic situation becomes a complicit distribution of rents or a dangerous zero-sum game The net result is lack of economic dynamism, stagnation in job creation, increasing economic and political uncertainty and poor investment and growth.

The threat of job losses in an economy with extraordinary levels of unemployment is a effective way to protect incumbent firms against external competition.

While experiencing low productivity growth in manufacturing and mining, South Africa has experienced growing productivity in some service sectors, especially ones with high skill intensity. In a reverse of traditional development models, it is the non-trade sector that is driving economic growth in the country with the increase in productivity in the service sector inducing an increase in wages across all sectors.

Firms in the manufacturing sectors respond to the increase in labour costs either by contracting their labour force or by demanding higher level of protection against competition from more productive external competitors. The negative spiral of low productivity and low competitiveness is thus self-reinforcing, with an increasing

monopolistic nature of the traded goods reducing productivity and limiting access to international markets.

The process is reinforced when considering sectorial skill intensity. The services that have experience greater productivity growth are also the most skill intensive. Skills are therefore rewarded both by an increase in productivity and by an increase in skill premium. Low skill workers in the high productivity service sectors will benefit as well with an increase in wages. The manufacturing sector will instead shrink and become more inward oriented.

To reverse this vicious circle we need to start by recognizing the dimension of the task ahead. Growing at 5%-7% per year for a considerable period of time requires a truly revolutionary transformation of the South African economy and its society. At that rate of growth the economy doubles in size in ten years: double the number of firms; double the number of skills; double the number of roads, ports and houses. Can South Africa relying on the willingness of the incumbents to sacrifice their position of rent for the common good? It is unlikely. This means that any corporative solution of the present stagnation will probably suffer for a status quo bias, where the interest on the incumbents dominates the policy discussion.

The first step for this transformation of the society is thus to open the economy to contestation by integrating into the global economy and exploring the opportunities on the continent. No single policy will be the catalyst of this transformation but the research indicates some fundamental criteria all policies should adhere to.

First, all policies should have a bias for openness: although it might be necessary to manage transitions, in openness there is more opportunities of innovation and growth.

Second, all policies should have a bias for change, by favouring new entrants against the established position of rent: the incumbent cannot be the driving force of future economic growth.

Third, all policies should have a future generation bias, by favouring the interests of the young. This means moving resources from subsidizing present consumption and rent extraction to accumulation of skills, technological upgrading and future consumption.

NOTES

1 For a discussion of the "investment strike" hypothesis, see Keeton (2018).
2 The main reference is Fedderke (2004) and Fielding (1999)
3 The stability of the results while using very different data samples shows how little the economy has changed in the last twenty years.
4 See for example Hlatshwayo and Saxegaard, (2016)

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Figure 1
Private and Public Investment in South Africa 2008-2017
(SARB Quarterly Bulletin)
Figure 2
Investment In South Africa - 1960-2017
(Source: SARB Quarterly Bulletin Dataset)
Figure 3
Share of Gross Capital Formation at Current Purchasing Power Parities 1950-2014
(Source Penn World Tables

Fiscal Policy since the Great Recession

Andrew Donaldson studied at the University of Stellenbosch, UNISA and Cambridge University. He taught Economics at the former University of Transkei, Rhodes University and the University of the Witwatersrand.He joined the then Department of Finance in 1993, and in 2001 was appointed Deputy Director-General with responsibility for the Budget Office and Public Finance in the National Treasury. In 2013 he was appointed Acting Head of the Government Technical Advisory Centre, an agency of the National Treasury which supports public finance management, public-private partnerships, employment facilitation and infrastructure investment.

South Africa entered the 2008/09 recession with a consolidated budget surplus, and government net debt down to 23 per cent of GDP. In the wake of the recession, the 2009 Budget provided for a 5.1 per cent a year real increase in expenditure and tax relief equivalent to approximately 0.5 per cent of GDP, viewed at the time as appropriately expansionary fiscal measures to offset the impact of the recession and restore the momentum of growth. A deficit of 4.2 per cent of GDP in 2008/09 was anticipated – it turned out to be 6.6 per cent.

The broadly expansionary fiscal stance continued until 2012. But growth and revenue outcomes continued to lag well behind budget projections. By 2013, the budget deficit was still over 4 per cent of GDP, net debt had increased to 36 per cent of GDP and the *Budget Review* signalled that there was no further room for fiscal stimulus. Spending cuts were proposed and real growth in expenditure over the medium term was reduced to 2.3 per cent a year. Economic recovery had to come from implementation of the newly released National Development Plan.

Outside of the national budget, the borrowing requirement of state-owned companies increased from 1 per cent of GDP in 2011/12 to 3 per cent in 2015/16. Much of the borrowing was by Eskom, for the construction of two large power stations and substantial expansion of the transmission grid. The finance required for these investments could not be raised without fiscal support. In 2008 a R60 billion allocation to Eskom was made from the National Revenue Fund, and the state guarantee underwriting Eskom's debt steadily increased from R26 billion in 2009 to R220 billion in early 2018.

In 2013, following another downward adjustment in growth and revenue projections, the Budget signalled a shift in policy aimed at stabilising debt by containing future expenditure within pre-announced ceilings and phasing in of a higher revenue-GDP target. By 2017, weak economic growth, the upward drift of the debt-GDP ratio, a crisis of confidence in economic policy and successive replacements of the Finance Minister had led to credit rating downgrades to below investment grade. Nearly a decade after the global recession, and despite the partial recovery of commodity prices and a more buoyant international outlook, South Africa remained stuck in an apparent low-growth trap, with unemployment rising to over 27 per cent in the third quarter of 2017.

Government's fiscal consolidation commitment was firmly reinforced in the 2018 Budget, which saw substantial spending reductions across most functions together with the first VAT increase in over twenty years. Although the Treasury's projections for growth averaged just 1.8 per cent over the 2017-2020 period, the budget framework leaves little room for fiscal stimulus. The Budget Review indicates several

substantial risks over the period ahead – personnel spending pressures, education and health spending commitments, the weak financial position of state-owned companies and revenue administration challenges.

There are nonetheless important contributions that fiscal policy and the public finances can make to both a growth recovery and its distributional impact. These are about the details of tax, spending and financial support programmes, rather than the headline fiscal aggregates. They are about the interaction between government actions and market dynamics, and the indirect ways in which public policy reinforces – or undermines – investment, trade and employment trends.

Urban development and housing

Urbanisation is a powerful catalyst of growth. Productivity is higher in cities. And so, as emphasised by the Commission on Growth and Development in its 2009 study of *Urbanisation and Growth* – "making urbanisation work well is something that countries that want to grow quickly must learn to do."[1]

Greater priority will have to go to economic investment, trade, skills and enterprise development. Cities should be places of work opportunity, with the ease of doing business a key indicator of progress.

Urbanisation brings complex challenges. Realising its benefits depends on intelligent and well-coordinated engineering, logistical, social, organisational and fiscal capabilities. It takes time to mobilise these capabilities, and it is perhaps appropriate, therefore, that in the wake of South Africa's sweeping overhaul of the structure and functioning of local government beginning in the late 1990s the municipal fiscal framework has remained cautious and closely supervised.

Fiscal transfers to municipalities are currently largely directed to meeting basic service delivery requirements of expanding residential communities. This complements investment in low-income housing, and contributes to free or below-cost water, sanitation and commuter transport services.

If urban growth is to bring productivity and employment benefits in the decades ahead, however, the structure of local government finances and financial support from the national budget will have to change.

Greater priority will have to go to economic investment, trade, skills and enterprise development. Cities should be places of work opportunity, with the ease of doing business a key indicator of progress. Stronger engagement between civic leaders and local business chambers is needed on planning and financing urban growth. Centres of research, education and health expertise are prominent features of our urban landscapes, yet they play too limited a role in city development strategies.

Major investments in water and sanitation, transport infrastructure and services, power and communication are needed, both to expand urban capacity and to achieve a more efficient, densified and integrated urban landscape. These cannot be financed indefinitely through grants from the national fiscus – there has to be growth in local economic activity, incomes and municipal revenue. This requires a shift in emphasis in urban planning from residential upgrading, important as it is, to promotion of business investment, employment and enterprise development.

This calls for a transition from the present architecture of grant-funding for housing and urban infrastructure, heavily reliant on the national fiscus, to a blend of grant and loan-funding, and greater mobilisation of private finance through co-funding partnerships or concessions.

The Development Bank of Southern Africa (DBSA) is well-placed to serve as an intermediary between the national fiscus and municipalities, focused on long-term loans for basic infrastructure and co-funding or risk mitigation of private sector investment. The DBSA should also be mandated to support housing development, through a merger with the existing housing development finance institutions. But an expanded mandate will require a substantial capital enhancement. To achieve an appropriate scale as a regional infrastructure funder and to leverage greater private infrastructure investment, the DBSA needs a larger balance sheet.

Municipalities have room to borrow for necessary infrastructure and growth-enhancing investments. Their consolidated debt is low – under 15 per cent of total revenue – and the net borrowing requirement has averaged just R11 billion a year since 2014/15, or less than 0.3 per cent of GDP. But investment in rehabilitation and expansion of municipal infrastructure has remained well below requirements, reflected in under-spending of capital budgets by 20 per cent in 2016/17, for example.

However, sustainable urban development requires a growing revenue base. Improved revenue management is needed and progress in countering service charge boycotts. Changes in land and housing policies will also be required. Municipal services cannot affordably be provided if urban housing development continues to mushroom largely outside planned and rateable urban demarcations. Development has to be a financially viable proposition for municipalities, across the full income spectrum of household and business residents.

A well-designed employment subsidy has the added advantage of encouraging formalisation of earnings and employment – compliance with labour standards and tax obligations, and participation in social security arrangements.

Earnings, employment and social security

If South Africa is to make more rapid progress in reducing poverty and inequality, it must accelerate the pace of job creation.

As was argued by Professor Sam Bowles, advisor to the Labour Market Commission in the 1990s, the appropriate fiscal response to structurally entrenched unemployment is to subsidise the earnings of low-wage workers. This reduces the cost of job creation at the margin, and assists in meeting minimum wage or industrial agreement standards.

A well-designed employment subsidy has the added advantage of encouraging formalisation of earnings and employment – compliance with labour standards and tax obligations, and participation in social security arrangements.

The youth employment incentive introduced in 2013 and implemented through the PAYE tax platform has proved to be administratively viable, achieving a reach of over 30 000 firms and 600 000 individuals within two years. It has the right design for a market-compatible wage subsidy, with a peak value of R1 000 at an earnings level of R3 000-R4 000 a month, phasing down to zero when remuneration reaches R6 000 a month.[2]

But a temporary subsidy targeted at young work-seekers only is not an effective instrument for expanding the demand for labour. The enabling legislation provides for its extension to specific sectors or special economic zones, by agreement with the Minister of Trade and Industry. This would raise its costs considerably, but with the

benefit of creating an effective bias in favour of employment-intensive growth and support for higher wages at the bottom of the earnings distribution.

Proposals for social security and national health insurance are currently under discussion at the National Economic Development and Labour Council (NEDLAC).[3] Details of the reforms and their cost implications are not yet clear. In both cases there is likely to be a call on the payroll tax base – this is a common approach to funding social insurance benefits internationally, and it is a comparatively under-utilised revenue source in South Africa at present.

But payroll taxes raise employment costs and lead, in many countries, to informalisation or irregular forms of employment in order to avoid these costs. A subsidy operating through the tax or collection system is both a counter to this tendency and a useful redistributive measure if it is well-targeted.

The deeper problem is that these are state-owned companies operating in network industries in which technology and competitive adaptation have shifted against slow-moving incumbents.

Administratively, a standard contributory retirement pension and death and disability benefits could be added to the unemployment insurance arrangement, financed in part for low-wage employees through a wage subsidy structured like the current youth employment incentive. Fiscally, implementation would be assisted by the current surplus generated annually by the UIF. But it would have to be accompanied by resolution of the escalating deficit of the Road Accident Fund, which is an unsustainable social security arrangement.

Together with mandatory health insurance cover, these would be very substantial shifts in South Africa's income support and redistribution programmes. Social insurance cannot realistically be regarded as a catalyst of growth. But if implementation is well-sequenced once more rapid growth is under way, progress in household income security would contribute to sustaining productivity and competitiveness in more labour-intensive activities.

Network industries and state-owned companies

Sustained long-run growth also requires ongoing investment in infrastructure and adaptation to changing requirements of the network industries.

The fiscal challenges here are immense, because past mistakes cast long shadows over the period ahead.

Transnet and Eskom have invested massively in expanded capacity, but market demand has not kept pace with expectations. Leadership failures, procurement blunders and corruption appear to have raised costs substantially. Eskom's construction of two of the largest coal-fired power plants in the world, Transnet's locomotive acquisition programme, SANRAL's Gauteng Freeway Improvement Programme and PRASA's rolling stock renewal programme all illustrate the "optimism bias" characteristic of so many large infrastructure projects.[4] A similar hubris is evident inSouth African Airways's recurring failures to achieve turnaround targets. The investments and operating losses have to be paid for, with an increasing likelihood that taxpayers rather than consumers will foot the bill.

The deeper problem is that these are state-owned companies operating in network industries in which technology and competitive adaptation have shifted against slow-moving incumbents. Restructuring proposals drawn up in the 1990s took account of these trends and sought to bring better regulation and competition into

the electricity, transport, water and telecommunications sectors, but the complexity of market structure transitions and political resistance to privatisation interfered with progress.

"Private sector participation" in infrastructure is again under discussion in 2018. But it is one thing to bring private investors in, through competitive processes, to build and manage new plants or services. It is quite another to invite private bids for existing assets, operations, staff and liabilities.

There are many opportunities for efficiency-enhancing private participation in the infrastructure sectors, but these are difficult transactions to structure and manage. Replacement of public debt with private investment brings no advantages in itself, and typically leads to higher finance costs. The benefits lie in the hard work of specifying and contracting for operational efficiency, lower costs of delivery, better maintenance of assets, technological progress and greater responsiveness to customer needs.

Nations cannot prosper or reduce economic vulnerability if they fail to secure water supplies and sanitation systems, if businesses are left without reliable electricity, if transport becomes congested in cities or if telecommunications lags behind digital opportunities.

Despite the somewhat chaotic trajectory of regulatory reform, these gains have been at least partially achieved in telecommunications. There are competing providers, costs have come down and Telkom has had to adapt without fiscal support. In public transport, useful lessons have been learnt in the first phases of implementation of bus rapid transit projects. It is not helpful to generalise about private participation in network industries – the regulatory and transaction management issues are complex and diverse. Technological and engineering considerations come into play, regional and international trends are relevant and the interaction between private and public good features are not straightforward. Getting things right in the evolution of network industry structures is immensely important. Nations cannot prosper or reduce economic vulnerability if they fail to secure water supplies and sanitation systems, if businesses are left without reliable electricity, if transport becomes congested in cities or if telecommunications lags behind digital opportunities. There

is a place for government programmes and fiscal incentives in all of these sectors, but success is unlikely if the state's ambitions are to dominate through monopoly ownership or intrusive regulatory controls.

Conclusion

Although economic growth seems likely to strengthen over the 2018 to 2020 period, the fiscus will remain under stress – there will be little scope for expenditure increases or tax relief. Support for economic growth will have to come from more oblique instruments of policy: a policy environment that supports investment, promotion of urban development and industrialisation, a more employment-intensive policy mix and encouragement of private participation in infrastructure investment and services.

These are not straightforward policy shifts – the details are complex and important, and transition paths need to be carefully considered.

Shifts in public policy to strengthen growth and broaden its impact will take time to deliver results. These measures must complement – not substitute for – more accommodative trade, investment, empowerment and financial policies.

NOTES

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