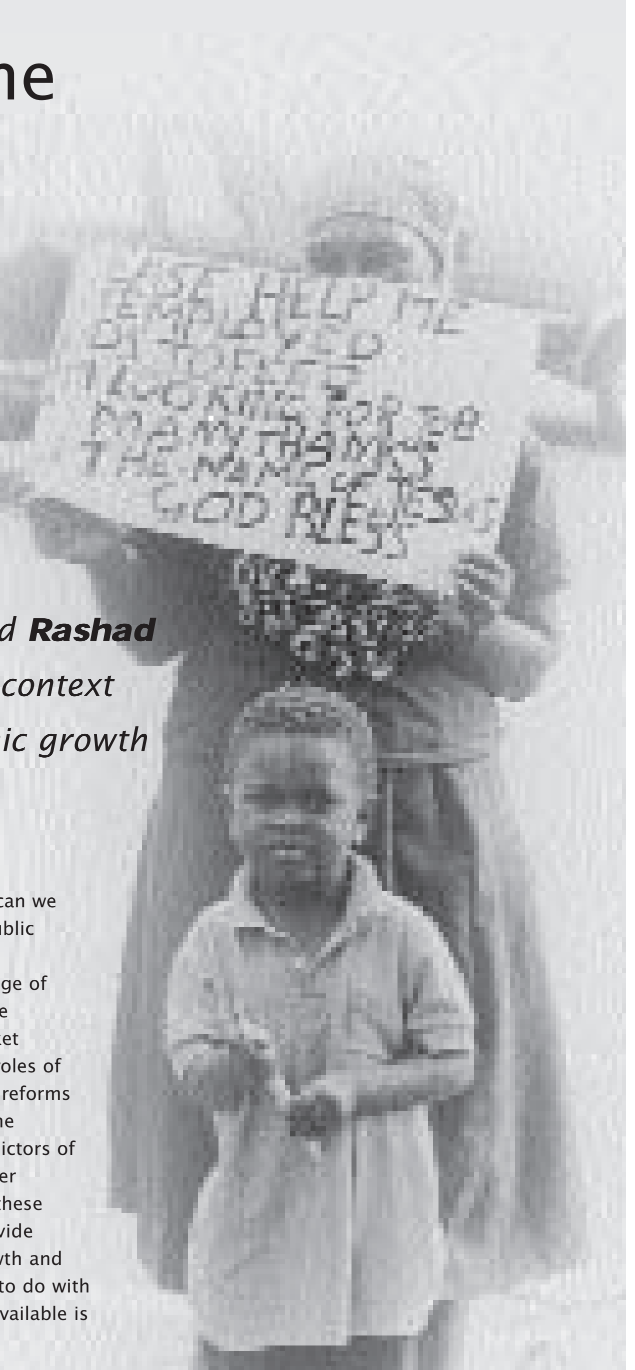
How can the South African steam engine **become a Ferrari?**



Sustained growth is critical if the country is to deal with poverty, income inequality and unemployment – the key welfare challenges. ***Haroon Bhorat*** *and* ***Rashad Cassim*** *explore these challenges in the context of the sluggish current levels of economic growth and examine what is holding us back.*

Since 1994 government has introduced policies aimed primarily at creating an environment conducive to growth. It adopted a reform package, consisting of fiscal prudence, trade reform and deregulation. These initiatives are an important precondition, for growth. The government has also introduced a series of market-friendly economic policies that have contributed to the increasing efficiency and productivity of the economy. But we simply cannot rely on growth alone to reduce poverty and inequality. We cannot rely on simply preserving jobs in protected and inefficient sectors, nor can we automatically expand the public sector (Berry et al., 2002).

Growth depends on a range of issues beyond stability, trade liberalisation or labour market flexibility. In particular, the roles of institutions, microeconomic reforms and governance have become important indicators or predictors of economic outcomes. However empirical work is sparse in these areas so it is difficult to provide concrete links between growth and reform. What we have tried to do with the limited empirical work available is

to provide some evidence, albeit incomplete, which allows us to make linkages between policy changes and growth and equality.

Growth and welfare trends

A specific area of contention in the economic policy debate is the extent to which reform such as privatisation, trade or macroeconomic policy, actually has a negative impact on distribution.

Given the size and scale of the poverty, inequality and labour market challenges the South African society faces, it is clear the current domestic economic performance has not been sufficient to begin to affect these problems.

South Africa's Gini coefficient has always served as the starkest indicator of the country's unequal distribution of income. For a long time, ours was the highest in the world. Now Brazil might have a slightly higher level of income inequality. In terms of race in South Africa, it is evident that higher levels of inequality are found amongst African households, where the Gini stands at 0.53. In comparison, the Gini for non-African households is significantly lower – ranging between 0.46 and 0.48. This highlights the fact that it has been the growing inequality amongst African households that is driving the national inequality measure.

The poverty measures, based on the simple headcount index, yield equally disturbing trends. Hence, data show that in 1999, just under a third of South African households were poor. Of the estimated total of 11.4 million households, approximately 3.7 million were living below the poverty line. The poverty line used here was an annual household income of R12 982,50.

This was based on the 1995 household poverty line of R903 per month, drawn from May et al. (1995), and updated using the core inflation figures for the period 1995–9.

The racial breakdowns reveal the maldistribution of this poverty incidence. Hence, we find that while 38% of African households are poor, only 3% and 4% of white and Asian households respectively are earning below the poverty line. Coloured households reflect poverty figures much closer to those of Africans. Given that access to income is primarily through the labour market, the differing opportunities and options available to Africans and coloureds in the labour market remain key to understanding this differential poverty status.

What drives growth?

There are a wide range of factors that influence economic growth. Typical are investment in the economy, the accumulation of human capital, and how much technology contributes to increasing productivity. While increases in investment and productivity can explain growth, the reasons behind slow growth in productivity and investment in capital and human stock depend on supply-side and demand-side factors, institutional issues and the policy environment.

It is important for policy makers to grasp how the economics literature provides a framework for contemplating the growth question. Growth in its simplest form is determined primarily by three critical variables – the growth of capital (investment), labour and technology and/or productivity.

Investment

One of the factors that explain South Africa's low growth is low investment. Investment in capital stock is generally considered the primary source of growth. During the second half of the 1990s, investment languished at around 16-18% of GDP, while other countries at comparable levels of income averaged considerably higher rates. Investment and growth do not always go together but we cannot get away from the fundamental problem that increased growth cannot be achieved without a substantial increase in the investment-GDP ratio.

Productivity growth

From the supply-side, the two factors that explain growth in an economy are growth in capital accumulation (physical and/or human), and productivity growth. Multifactor productivity (MFP) is a measure of the growth in output that is not explained by the growth in the quantity of

inputs. Rather, it is the increase in the efficiency of inputs relative to outputs that drives MFP. There has been a consistent decline in MFP in the last three decades but it began picking up during the mid to late 1990s. Average productivity growth in the 1990s was about 2% and picked up from 1995 onwards.

While the source of South Africa's productivity growth remains a subject of debate, productivity growth in the economy has, on average, increased in the 1990s relative to the 1980s. This has partly to do with increasing efficiency associated with trade reform and other efficiency-enhancing measures, as well as reductions in capital stock and labour shedding. It is important to emphasise that while we have detected improvements in productivity growth, we have to be careful of the interpretation of this growth. MFP can rise as firms shed workers (perhaps to raise competitiveness), but this is not efficient from an economy-wide point of view if it leads to unemployment of potentially productive resources.

Labour market trends

The democratic government inherited a labour market that had been subject to the long-run effects of both structural shifts and technological change in the domestic economy. Changes in the labour market have led to an increased demand for highly skilled workers combined with large-scale attrition at the bottom end of the labour market.

Much of the debate around employment trends in the post-apartheid period has become anchored around the notion of 'jobless growth', namely that simultaneously with unspectacular economic growth, jobs have been shed across most sectors in the economy. Data has revealed that during the period 1995-2002, the economy created 1.6 million jobs. Therefore, the economy did not experience an absolute decline in employment.

Applying the notion of 'jobless growth' to characterise post-1995 employment trends is simply wrong. But, we have clearly had 'poor employment growth'. The economy, in the aggregate, has been creating jobs rather than shedding them but it is important to assess the number of jobs that have been created, relative to the annual numbers of new entrants to the labour market between 1995 and 2002.

Data suggests that while employment grew by 17% over the period concerned employment would have had to grow by 52% to absorb everyone. In other words, just to maintain unemployment at its 1995 levels, employment should have risen by just over three times the existing rate.

Constraints to growth

Having tried to identify the key drivers of long-run economic growth, it is important to clarify some of the potential constraints on growth. These include the following:

Labour market policy

The structure of the South African labour market as either a source of, or deterrent to growth is a highly contentious area of economic policy. The labour market is unique because it directly contributes to equality and efficiency but it is only one of the factors contributing to unemployment. An analysis of the labour market should however, take into account the extent to which wage rates impact on growth and efficiency and what the implications are for employment.

There are arguments that wages in themselves do not constitute the main problem but there is some evidence to suggest wages may deter employment in some sectors but not in others. High wage rates matter for some sectors but not for others – or they may matter less for the semi-skilled than for the unskilled. But at the end of the day there is some trade-off between real wage growth and employment (Mazumdar & Van Seventer, 2002).

Employment losses in the past have also been attributed to non-wage variables such as structural changes in the economy. Therefore, while wage increases no doubt will result in employment losses, it is not immediately clear whether these wage increases were the sole reason.

One of the key debates concerns the extent and level of employment flexibility that exists for both employers and employees. It would appear that manufacturing firms on the whole do not view the labour legislation environment as a significant constraint on employment expansion.

Capital markets and financial intermediation

An important question is whether we are reaping the benefits of a well-developed financial sector and whether this is translating into growth. Despite the sophistication of the sector many are excluded from benefiting because of high inequality in income in South Africa.

Preliminary evidence indicates the following financial sector-related problems in South Africa:

- The cost of capital is high, and this has a negative influence on investment.
- Access to finance for small enterprises is difficult.
- The issue of financial intermediation and SMMEs remains complex.

More research is needed to come to reasonable conclusions as to how capital markets, or government intervention in the capital markets, can facilitate better access (see Berry et al., 2002).

In summary, the lack of competition in the banking sector, as well as the increasing cost of capital (both as a result of monetary policy and bank risk), has had an effect on equality and investment. Nevertheless, these are rather sweeping statements and more thought needs to be given here.

Trade reform

The economy is a moderately protected economy by middle-income country standards. The country has seen a gradual process of liberalisation since the 1980s. Has this brought productivity growth, or acted

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as a constraint? While some evidence suggests positive contributions to overall productivity growth, it can be argued that South Africa has experienced an increase in import penetration in almost every manufacturing sector, although no major deindustrialisation has been witnessed. There is also some evidence to show that trade liberalisation has had a positive effect on South Africa's agricultural sector. Trends in trade of agricultural products since the start of the trade liberalisation period indicate that the quantity of both imports and exports has increased almost fourfold.

Although further reform is desirable it will not have a correspondingly major impact on growth. It is also important to bear in mind that there is no conclusive evidence to show that South Africa's trade reform has had a major important influence on poverty or employment in either direction. Certainly at the margins it may have contributed to some employment losses or increasing capital intensity. What is clear is that trade liberalisation is not responsible for major job losses nor is it simply a major employment creator in the short term. Other factors such as low domestic demand, lack of skills, technology and so on have a more direct relationship with employment.

Macroeconomic policy as a constraint on growth

It is generally difficult to reach solid conclusions about the impact of macroeconomic policy on growth. There is a lively, if somewhat ill-informed, debate in South Africa on whether macroeconomic policy in the last five to ten years has served as a catalyst for, or deterrent to, overall growth. According to some schools of thought, a major constraint on economic growth is macroeconomic policy where fiscal discipline and conservative monetary policy are creating macrostability at the cost of growth. It is common logic that fiscal discipline will dampen the growth prospects as increasing expenditure by the government creates more economic activity. Increasing fiscal expenditure may boost short-run aggregate demand, but it depends on the behaviour of entrepreneurs whether this boost will be sufficient to ignite the accelerator mechanism by which investment will take place to meet higher demand. If the accelerator mechanism is strong enough to outweigh the possible crowding-out mechanism of fiscal deficits, a permanently higher level of output will be reached.

Nevertheless, it has been argued that the benefit of showing investors responsible management of the macroeconomy and the minimisation of the risk of increasing budget deficits in the context of economic stagnation – which is evident in many developing countries – must not be underestimated. This is not to suggest that macroeconomic management alone determines investor confidence. There are many other subjective factors (such as those in Zimbabwe), over which the government has no control. Having said this, there may be room for increases in fiscal spending in the right areas (for example maintenance of infrastructure) and this may contribute to growth.

Privatisation, regulation and competition

The slow pace of privatisation is often cited in the media and the business community as one of the major reasons for low growth. The specific mechanisms by which privatisation chokes growth have rarely been specified. This is one of the areas in which potentially high welfare gains to the economy can be generated but, unfortunately, it is also an area that we know very little about. International experience has shown that privatisation per se is not a major determinant of growth and efficiency.

The more relevant question is how the persistence of monopolies in major services and utilities hampers the growth potential in the economy. Put differently, to what extent has the slow restructuring of SA's parastatals resulted in foregoing efficiency and productivity, specifically in sectors such as energy, transport and telecommunications? These gains provide significant inputs into downstream industries and services sectors, affecting their (international) competitiveness.

The actual lack of liberalisation in

COVER STORY

services and utilities markets in the economy as whole (telephone prices that exceed international prices, high harbour costs, etc) comes at quite a cost to economic growth. In addition, there is the potential impact on poverty. Access to basic infrastructure is a central tenet of the poverty debate in South Africa. Regulation of parastatals in utilities has had an impact on the penetration ratios of vital services such as water, telecommunications and electricity, thereby affecting the quality of life of the poor. The other important issue has been the extent to which market structure or regulation policy has had an impact on infrastructural investment.

The institutional, political and social context of growth
Although South Africa has its economic fundamentals right, growth and employment creation have been limited owing to inherent policy instability, corruption, crime, weak public institutions and weak corporate governance. Factors such as property rights, appropriate regulatory structures, quality and independence of the judiciary have been identified in the international literature as major contributors to growth. These so-called non-economic determinants of growth have been critical to South Africa's growth path in the last decade. They are, however, difficult to quantify and very little research has been done in these areas. What we do know is that they are of critical importance. We subsequently highlight three prominent deterrents to growth:

- **Uncertainty –** Various firm surveys (World Bank, 1999; Gelb, 2001) and econometric analyses (Fedderke, 2001) conducted in the last few years point out that uncertainty remains one of the key deterrents to investment and therefore to growth. For example, the credibility of government policies may be questioned; the social effects of HIV/AIDS or crime.
- **Crime** – South Africa is infamous for its crime rates. There is limited empirical work on how exactly crime affects growth in South Africa but it is clear that crime could impact on investment and the loss of efficiency and skills as a result of crime contributes to systemic uncertainty in the economy owing to risk to both personal lives and private poverty. It also raises the operational cost of firms. Crime prevention can also be considered as foregoing resources and is therefore a constraint on growth; and crime contributes to skilled emigration. A fundamental question is whether the resources expanded on crime prevention were enough and whether the government, in the greater scheme of things, should be prepared to trade off, say, R3-billion in investment incentives, for an increase in police salaries.
- **HIV/AIDS –** The spread of the HIV/AIDS virus has put the economy under serious strain. South Africa has one of the largest infected populations in the world, with almost 20% of adults carrying the disease. Apart from the serious loss of human capital, there are high labour market costs as well as the pressure to direct more resources to medication, care and prevention.

Conclusion
This study has attempted to undertake an analysis within two broad areas – the nature of the welfare challenge and the determinants of and constraints to economic growth. We have excluded a range of other factors, for example the way the behaviour and performance of the state influences growth. Public sector accountability is the most important signal of a well-functioning economy and inspires confidence in investors.

Ultimately though, the article has attempted to provide a framework for understanding the nature and determinants of economic growth in South Africa. To state the obvious: for South Africa to address seriously its substantial welfare challenges, a qualitatively and quantitatively different growth path will be required. We hope to have identified some of the key trigger points required for placing the economy onto this path.

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