

Rainbow at risk

Improving South Africa's prospects

Jakkie Cilliers and Ciara Aucoin

Key recommendations

- 1** South Africa needs a labour-intensive, low-wage and less regulated growth path.
- 2** Government needs to continue but carefully manage its expansive social support programmes.
- 3** Government must strengthen South Africa's domestic technological innovation capacity. Partnering with the private sector can close the skills gap currently constraining development and, among others, increased investment in research and development.
- 4** Focus is needed on small- and medium-sized business, the reduction of red tape, better access to low-cost finance, more business-friendly market regulations and a more flexible labour market.
- 5** Broad-based black economic empowerment ought to be replaced in favour of more specific race-based initiatives.

Summary

South Africa needs to build an inclusive economy where broad-based economic growth creates productive jobs for the unemployed; increases productivity and earnings for the employed; and leads to sustained poverty alleviation. South Africa must simultaneously invest in partnerships with the private sector to establish a knowledge economy, close the skills gap currently constraining development and create an enabling environment for growth, investment and innovation. Drawing on two associated ISS papers, *Economics, governance and instability in South Africa* and *South African scenarios 2024*, this policy brief presents a set of recommendations to extricate South Africa from its middle-income trap and set it on a high-road Mandela Magic growth path.

TWO DECADES AFTER the adoption of a globally admired constitution, the image of the South African rainbow nation is rapidly fading. Since 2009 violent crime, labour and service- delivery-related protests have increased, as have the frequency and intensity of student riots and, most recently, demonstrations demanding the resignation of President Jacob Zuma. Deteriorating social stability combined with ongoing governance challenges and a structural economic crisis paint a concerning picture.

The rainbow at risk

In a 2015 paper that set out alternative scenarios until 2035, the Institute for Security Studies (ISS) noted that:

There has been much progress in South Africa but the big question is, how long will its patience with high unemployment, high inequality and poor service delivery last? Much more decisive steps are needed to change the country's current mediocre growth prospects.¹

The situation is not dissimilar to that in 1996 when the Nelson Mandela/Thabo Mbeki administration eventually adopted the Growth, Employment and Redistribution policy

programme (GEAR), essentially a self-imposed structural adjustment programme. Despite many implementation problems and unforeseen results, GEAR placed South Africa on a rapid growth trajectory that also saw employment creation and improvements in productivity, but at the expense of delays in addressing many of South Africa's urgent development needs.

In recent years a number of academics, analysts and commentators of various ideological persuasions have come to similar conclusions about South Africa's need for a paradigm shift. In his substantive work *South Africa's Suspended Revolution*,² Adam Habib, Vice-Chancellor of the University of the Witwatersrand, concluded that:

...for as long as an equitable social pact remains a distant dream, South Africa will not succeed in bridging the divide between economic growth and inclusive development, nor will it be able to address the related polarisation and social pathologies that characterise our society.³

At current growth rates, South Africa is set squarely in a middle-income trap characterised by deep-rooted inequality and sluggish growth

In a very different book, *A Time Traveller's Guide to Our Next Ten Years*, the CEO of the South African Institute of Race Relations, Frans Cronje, is blunt in his assessment:

You must be blind to South Africa's realities if you cannot see the contradiction that emerges here between this generous bounty of rights and freedoms [promised to South Africans and reflected in the constitution] and the poverty and deprived circumstances of so many people in the country. This contradiction suggests a country primed for radical change ...⁴

And, continuing the theme, Moeletsi Mbeki and Nobantu Mbeki note 'growing signs that the gains of the past 22 years of freedom are reversible. Tensions between the classes are rising at an alarming rate.'⁵

The extent of the challenge faced by a political system that is increasingly both incapable and corrupt is perhaps best captured in the subtitle of the venerable annual *South African Review 2016*, published by the Human Sciences Research Council, which asks 'who is in charge?' and dedicates the next 511 pages to dissecting this issue from various angles.⁶

Our findings

Our analysis of the relationship between economics, governance and instability and an updated set of political scenarios are set out in two new papers published in conjunction with this policy brief. They are *Economics, governance and instability in South Africa* (ISS paper no. 293) and *South Africa scenarios 2024* (ISS paper no. 294), both available at www.issafrica.org/publications/papers.

The first paper argues that at current growth rates South Africa is set squarely in a middle-income trap characterised by deep-rooted inequality, sluggish growth and, an unsustainable welfare model, from which, without sweeping change, it is unlikely to escape. It also argues that South Africa risks sliding into a long-term low-growth trajectory, driven by rising unemployment and poor performance in job creation, which



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SINCE 2010

could escalate the already worrying levels of protest and violent demonstration that have been increasing steadily since 2010.⁷

Directly fuelling these challenges is declining government effectiveness, even as the size of the public sector has increased (it is now 28% larger than it was 10 years ago), and lack of control of corruption. World Bank measures of government effectiveness dropped from a rank of 79 to 65 out of a possible 100 between 1996 and 2014, and for corruption from 78 to 54 in the same period.⁸

From this point of departure the second paper, *South Africa scenarios 2024*, illustrates that in the short to medium term the ruling African National Congress (ANC)'s factionalism, ethical challenges and absence of vision will shape performance across all crucial political and economic indicators. The paper argues that events in the ANC, specifically the decisions it will make about party leadership in December 2017, will be key to the country's medium- to long-term future.

Building on previous work we look at three possible pathways for South Africa – a desirable Mandela Magic high road, the uninspiring but most likely current pathway, Bafana Bafana, and an alarming downward scenario called Nation Divided, where the traditionalist camp within the ANC continues to hold sway. Professor John Luiz correctly contends that South Africa is squeezed from both below and above – it cannot compete with the low wages of low-income countries or the technological aptitude of advanced countries.⁹

The outcome of the factional battle between what we have somewhat simplistically called 'reformists' and 'traditionalists' is at the heart of the challenge and of opportunity. Although key structural drivers of growth are positive – a large young labour force, investments in aspects of human capital and solid if decaying infrastructure – path dependency, patronage, policy incoherence and poor implementation are some of the most evident caps on improvement. The prospects for stable development and growth require that South Africa escape from its current leadership malaise (and economic group think).

The need to break with the past

South Africa is stuck in key "path dependencies" that, at best, promise more of the same. Our thinking, our experience and the structures that have developed historically continue to determine our future.

Jeremy Seekings and Nicolai Nattrass's study of *Class, Race and Inequality in South Africa*,¹⁰ published in 2006, set out the strong continuity in public policy between the late-apartheid and post-apartheid periods. The most important of these is the capital-intensive, high-wage-growth strategy that has remained a hallmark of public policy.

The cost is a large pool of unskilled and unemployed labour – the massive South African underclass – and miserly growth.¹¹ For this reason the accompanying paper on *South African scenarios 2024* notes, for example, the deleterious impact of a large nuclear build, while recognising that a limited additional nuclear build is probably necessary. 'The main risk with nuclear is ... the impact of such a large, capital intensive procurement on the broader economy.'¹²

It is very difficult for South Africans to envisage an economic future that does not depend on a large welfare state that provides education, electricity, housing and employment and assumes responsibility for poverty reduction and dealing with inequality. The problem with this approach is that expenditure on a large, unaffordable and inefficient public sector on top of a growing commitment to social grants is steadily squeezing out more productive spending as it pushes up debt.

Various well-intentioned efforts such as the Sectoral Education and Training Authorities (SETAs), meant to develop the skills and productivity of the South African workforce, have little to show after several years of uninspiring existence, large budgets and despite numerous efforts to reform and improve them.

It is difficult for South Africans to envisage an economic future that does not depend on a large welfare state

Like its predecessor, the National Party, the ANC is trapped in a state-led paradigm of development and has formalised this approach as the need for a strong "developmental state" modelled on the success of such efforts from authoritarian development examples such as China and the Asian Tigers, none of which had South Africa's current levels of democracy or inequality.

According to this model the private sector is relegated to the role of supporter and implementer of government policy. Yet this is the only sector that is able to create jobs and wealth in South Africa's open market economy given its low savings and heavy dependence upon access to global finance. Given the current fiscal constraints the developmental state aircraft has run out of runway before achieving lift-off.

There is little leeway to expand this model without fully undermining the prospects for growth and employment creation and/or reversing the democracy project. In fact, at current mediocre growth rates, the important social grant program will, in due course, become financially unsustainable.

The response to this quandary can be conceptualised as two broad planks.¹³ The first is a labour-intensive, low-wage, and less-regulated growth path able to soak up unemployment and build an inclusive economy where broad-based economic growth creates productive jobs for the unemployed, increases productivity and earnings for the employed and leads to sustained poverty alleviation. The second is dependent on renewed partnerships with the private sector that work to close the skills gap currently constraining development, create an enabling environment for investment and innovation, and support the infrastructure required for economic development such as robust, high-speed ICT networks.¹⁴ The latter being crucial steps in the creation of a so-called knowledge society.

A labour-intensive, low-wage and less-regulated growth path would be able to soak up unemployment and build an inclusive economy

For understandable reasons the ANC has largely focussed on the former plank and many of its policies have undermined the second plank which is largely anathema to the traditionalist faction within the ANC and only slightly more palatable to the reformist groupings within the party. In a previous paper the ISS argued that:

... current approaches that lock a relatively small number of unionised employees into the formal economy and, through inflexibility, raise the bar for the entry of others into employment while keeping skilled foreigners at bay simply will not do ... [while] current efforts to improve relations between business, labour and government through structures such as the National Economic Development and Labour Council have not improved the adversarial relationship that detracts from growth.¹⁵

In August 2015 the World Bank noted:

Changing the growth and jobs dynamics will require urgent action on several mutually reinforcing fronts. The government has already introduced an employment tax incentive to encourage firms to hire young workers. Through its Industrial Policy Action Plan, it is also offering incentives to promote potentially labour-intense sectors like manufacturing and agriculture. Faster and deeper global and regional integration in trade in goods and services would bolster this effort.

But it then warned:

Nonetheless, low-cost, labour-intense production is unlikely to be the main engine for job creation for South Africa, given how these sectors have shrunk over the past two decades. Policies also need to focus on developing services, small and medium firms, and household enterprises, including in the informal economy, as engines for job creation.¹⁶

Many voices have recently been heard on the potential of the informal sector and it is indeed a reflection of desperation since the view of the informal sector as a vehicle for job creation is misplaced.

At South Africa's level of development the informal sector reflects bare survivalist motivation. Modelling work on the informal sector for the Western Cape government



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carried out by the ISS and the Frederick S Pardee Centre for International Futures at the University of Denver shows the limited contribution of the sector to economic growth. In line with the findings of a large body of literature we conclude that:

...a large informal sector can be a drag on long term, inclusive growth. The informal economy is far less productive than the formal economy, can undermine government capacity and effectiveness, and decreases the incentives of young people to further their education, [although] facilitating the expansion of the informal economy, without drawing individuals out of formal employment and education, can provide marginal economic gains.¹⁷

The real potential for South Africa lies elsewhere, as the World Bank points out: 'Policies that improve the business environment, especially for small firms, include reducing the burden of red tape, improving access to low-cost finance, and securing greater flexibility in labour-market regulations.'¹⁸

In addition to efforts for a more flexible economy, South Africa needs to go up the productivity chain and build a knowledge economy to escape its middle-income trap. Examples include changing its approach to human development by seeking the best education outcomes possible, irrespective of the funding or management model, including partnerships with the private sector where appropriate.

Perhaps the most important requirement for a country to become more productive and competitive is to strengthen its domestic technological innovation capacity.¹⁹ The approach to investment in research and development must change if the country is to reverse the steady decline in manufacturing value-add as a percentage of gross domestic product (GDP). Instead of the 0.76% that the country historically spends on research and development government should commit to at least tripling this amount to get to the 4% level, where countries such as South Korea find themselves. This is because '[t]he key dimensions which facilitate transitions from middle income to high income status are precisely the dimensions where South Africa fares poorest – namely those related to technological innovation and human capital.'²⁰

Such an approach to growth has the potential, over time, to turn the corner on poverty, inequality and unemployment. Turning potential into reality will require a much greater focus on small- and medium-sized businesses, and not only on building a small elite of wealthy black businesspeople to complement the small elite of wealthy white businesspeople.²¹

It will, among other things, require that government take a scissors to many of the 717 state-owned enterprises (SOEs),

which have, between them, total assets of R1 trillion (27% of GDP) and many of which are deeply indebted and inefficient.²² It will also require a willingness to review the poor impact of current policies on land reform. Despite 22 years of effort, land reform has only had 'minor effects on rural livelihoods.'²³ Instead of a policy that favours black smallholder farmers, the most important constraint is the extent to which traditional elites under the Zuma administration have captured land reform to perpetuate a model of communal land tenure.

A revised approach to growth would also require abandoning the stifling effect of many of the core tenets of broad-based black economic empowerment (B-BBEE) and employment equity in favour of what Habib terms a 'class-based redress agenda, supported by more specific race-based initiatives'.

While class-based elements of such a redress programme would generally address both the deracialisation and erosion of poverty across society, race-based initiatives would be confined to areas where the former did not have significant deracialising effects.²⁴

Perhaps the most important requirement for a country to become more productive is to strengthen its domestic technological innovation capacity

The reformist camp within the ANC support some elements of this approach, although the extent of the fiscal dead end in which the country finds itself is insufficiently recognised by the party. For example in the Treasury Department Budget Vote 2016/17 on 4 May 2016 Finance Minister Pravin Gordhan noted that:

The answer is not just that we need faster growth. We also need a growth strategy that is more inclusive, that creates work opportunities for all, that opens trade and business opportunities across a broader landscape. We need to take advantage of the technologies and innovation that enhance industrial productivity and reduce the costs of communication and learning.

The political challenges associated with such policies are obvious and virtually insurmountable in the current context of the governing ANC-led alliance (that includes COSATU and the SA Communist Party), given the balance of power amongst the competing factions described in the associated ISS paper *South Africa scenarios 2024*.

As a member of the tripartite alliance, COSATU is a partner of the ANC in government (and increasingly dependent upon

state employment for its membership). Furthermore, the ANC perceives that its major threat comes from populist policies to its left that feed upon social discontent and draws inspiration from failed growth and distribution policies in Zimbabwe, Venezuela and elsewhere. The instinct for the ANC is therefore to shift the debate leftward and an unwillingness to argue for growth.

As a result, current discussions about inclusive growth in South Africa are at best a shouting match amongst the deaf.

Real prospects for change

The accompanying paper, *South African scenarios 2024*, provides a source of hope for the future. If the factional politics and lack of common vision within the ruling ANC is the most important constraint on a more prosperous future, it is now possible to envisage a future where competitive politics and not liberation solidarity (and the inevitable subsequent patronage) might drive South Africa's development.

South Africa has proved its resilience over many generations, and the country should be able to weather the turbulent years ahead

The results of the August 2016 local government elections will provide a first indication of the direction of the country's political future as the ruling party heads for what could be a very important national conference in December 2017. Should either the reformists win the contest (and subsequently provide policy certainty and leadership) or the ANC splits in 2018, South Africa could be launched onto a much more positive, inclusive and pro-growth trajectory, which we have termed Mandela Magic.

But declining public support for the ANC, growing anti-government demonstrations and the inadequacies of the state's security apparatus, as well as the political and economic climate mean the years ahead could very easily play host to low growth, high unemployment and much higher levels of violence and intensified protest movements.

South Africa has proved its resilience over many generations and the country should, bar unforeseen events, also weather the turbulent years ahead. Its long-term growth prospects remain positive and, with the right confluence of leadership and a facilitating global growth environment, prospects could change for the better, and more rapidly than most expect. Such changes will, however, require many South Africans to shed their ideological baggage, and step outside their current thinking to shape their future.

Notes

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- 2 A Habib, *South Africa's Suspended Revolution: Hopes and Prospects*, Johannesburg: Wits University Press, 2013, 218.
- 3 Ibid, 218.
- 4 F Cronje, *A Time Traveller's Guide to Our Next Ten Years*, Cape Town: Tafelberg, 2014, 69.
- 5 M Mbeki and N Mbeki, *A Manifesto for Social Change*, Johannesburg: Picador Africa, 2016, 8.
- 6 D Plaatjies, C Hongoro, M Chitiga-Mabugu, T Meyiwa, M Nkondo, F Nyamnjoh, *State of the Nation 2016 – Who is in Charge? Mandates, accountability and contestation in South Africa*, Pretoria: Human Sciences Research Council, 2016.
- 7 Armed Conflict and Location Event Dataset (ACLED) Version 6, 1997-2015.
- 8 World Bank Worldwide Governance Indicators, available at: <http://info.worldbank.org/governance/wgi/index.aspx#home>.
- 9 J M Luiz, South Africa's Growth Trap – Explaining Poor Policy Choices, *The Journal of the Helen Suzman Foundation*, 78, April 2016, <http://hsf.org.za/resource-centre/focus/focus-78-the-economy-1/john-luiz.pdf/view>, 51.
- 10 J Seekings and N Nattrass, *Class, Race and Inequality in South Africa*, Pietermaritzburg: University of KwaZulu-Natal Press, 2006.
- 11 Ibid, 165-187 and 340-375.
- 12 J Cilliers and C Aucoin, *Economics, governance and instability in South Africa*, Institute for Security Studies Policy Paper no. 293, Pretoria, June 2016, available at www.issafrica.org/publications/papers.
- 13 These conclusions draw on work that the ISS and the Frederick S Pardee Centre for International Futures completed for the Western Cape Government, see E Margoese-Malin, J D Moyer, M Rafa and M Irfan, *Enterprising Cape: Building an inclusive and vibrant economy*, FuturesCape Policy Brief, 2015, available at www.issafrica.org/publications/policy-brief/enterprising-cape-building-an-inclusive-and-vibrant-economy.
- 14 See the Centre for Development and Enterprise, *Business and Government*, Growth Series Report 6, Johannesburg, 7 April 2016, www.cde.org.za/cde-growth-agenda-series/.
- 15 J Cilliers, *South African Futures 2035*, 25.
- 16 World Bank Report, *South Africa Economic Update – Jobs and South Africa's Changing Demographics*, August 2015, Washington DC, August 2015, 6.
- 17 J Cilliers, A Porter and Z Donnenfeld, *The Role of the Informal Economy in Inclusive Growth*, FuturesCape Policy Research Paper, forthcoming, Western Cape Government.
- 18 World Bank Report, *South Africa Economic Update – Jobs and South Africa's Changing Demographics*, August 2015, Washington DC, August 2015, 6.
- 19 See for example M Vivarelli, *Structural change and innovation as exit strategies from the middle-income trap*, Discussion Paper Series no. 8148, Bonn: Institute for the Study of Labor, 2014.
- 20 J M Luiz, South Africa's Growth Trap – Explaining Poor Policy Choices, 52.
- 21 Relations between business and the South African government are notoriously difficult. Writing in the *Journal of the Helen Suzman Foundation*, the former head of Business Leadership South Africa, Michael Spicer, notes that 'A dysfunctional relationship between business and government – both very far from being unified entities with coherent world views and policies – is one of the reasons why South Africa's economy continues to perform sub-optimally.' M Spicer, *The Business Government Relationship: What has gone wrong?* *Journal of the Helen Suzman Foundation*, 78, April 2016, 3.
- 22 South Africa has more SOEs than it should have given its level of development, with the average return on investment being a poor 2.9%. In addition, the debt exposure (through loan guarantees) to the SOEs in 2014/15 was a large 11% of GDP (R467 bn). G Zietsman, SA has more SOEs and government investment than it should have, *Business Day Live*, 24 May 2016, www.bdlive.co.za/opinion/2016/05/24/sa-has-more-soes-and-government-investment-than-it-should-have.
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