BRIDGING SOUTH AFRICA'S ECONOMIC DIVIDE

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Following the release of the IMF's latest World Economic Outlook, Wits Business School and the National Treasury invited Lipton to present this public lecture at the University of the Witwatersrand in Johannesburg on 19 July 2016.

Let me begin with a tribute to South Africa's achievements. This country offers an extraordinary legacy of freedom and reason that is a model to the world. But now it is a generation since the end of apartheid, and regrettably there remains a large and growing gap between South Africa's accomplishments and its concrete economic needs.

South Africa is grappling with growth that is too slow to raise average living standards, which is deeply problematic when one-third of the working population is effectively excluded from the economy. So far, there has been only limited progress on reforms to remedy that situation. What does this mean? It gives the prospect of falling per capita income and increases in a jobless rate already among the world's highest. That would spell tough times ahead, particularly given the difficulties facing the global economy.

I know this is a blunt message. But anyone who admires South Africa's many accomplishments has to worry about what it will mean if these economic problems are not tackled soon. Of course, some of these issues – particularly exclusion and income inequality – are legacies of the apartheid era. But with the passage of time, unaddressed issues can become obstacles.

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So today I would like to speak about those obstacles facing your economy and what needs to be done. Fortunately, the bottom line is that, as is often the case in economics, the root of your problems contains the seed of their solutions. Inclusion of the excluded one-third of South Africans could and should be a source of growth and dynamism for the generation to come.

Of course, much thought and effort has gone into that challenge, and many good ideas remain untested. But now the cost of insufficient action has reached the critical point. The present trajectory is simply not good enough. What is needed is a fresh and energetic review of South Africa's policies – followed by action. The litmus test must be that the policy response fosters fundamental change that opens doors for the young people who will be the workers, entrepreneurs and innovators of the next generation, those who can power the economy upward.

POSITIVES AND NEGATIVES

Before looking at what might be done, let's begin with South Africa's many positive economic accomplishments. While income inequality is a profoundly difficult problem, it also is true that living standards have improved significantly. An estimated 3.6 million people have been lifted out of poverty

– that is to say, those living on less than US$2.50 a day. The rate of extreme poverty has been more than halved to 16.5 percent of the population. Access to infrastructure and to education and healthcare has improved remarkably, and social grants benefit over 16 million people.

South Africa has a highly diversified economy and world-class companies with a footprint on the African continent and beyond. Your financial sector is deep, sophisticated and resilient. You have a strong corporate governance framework – number two in the World Economic Forum's rankings. South Africa should be proud of its world-class public institutions, including in the realm of economic management. This includes the Treasury and Reserve Bank, who have well-deserved reputations for expertise in formulating and implementing economic policy. Those institutions would be the envy of many emerging-market and developing countries. And we can point to the judiciary, the public protector, the auditor-general and many others. South Africa's institutions should be revered and protected.

However, strong macroeconomic policies and a diversified economy are not enough to generate the growth that can drive sustained gains in living standards and lift all South Africans out of poverty. In the Fund's latest annual report on the South African economy, released earlier this month, we forecast just 0.1 percent growth in 2016 and only about 1 percent next year. This is not enough growth to raise per capita income, given the annual population increase of 1.7 percent. And it implies weak enough job creation that we see unemployment continuing to rise. The implications of this are not good: if our projections for the economy materialise, per capita income in 2017 is set to fall to 2010 levels.

Why is growth so weak? What economists call "external shocks" are part of the problem. Most importantly, the rebalancing of the Chinese economy is reducing demand for exports throughout the world and contributing to the steep fall in commodities prices. This includes South African exports – iron ore, coal and platinum. The fact is that China's growth now matters more to South Africa than growth in the EU and US. On top of this, the normalisation of US monetary policy, generally tighter financial conditions worldwide and, more recently, Brexit have added elements of uncertainty. Keep in mind that a large share of South Africa's bonds and equities is held by foreign investors, which makes the country more vulnerable to rising interest rates and shifting sentiment.

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But external shocks are only one part of the story – and, in fact, it is the rest of the narrative that has assumed paramount importance. The South African economy is also reeling from the effects of some misfortune as well as some homegrown problems. The recent drought was the worst in decades. The leadership changes at the National Treasury last December and other political developments had an adverse impact. They heightened concerns about governance – a point I will return to in a moment – deepened policy uncertainty, and shook investor confidence.

THE DYNAMICS OF EXCLUSION AND INCLUSION

But something else has developed with the evolution of the economy. This involves issues that I know are very familiar to you: infrastructure bottlenecks, skills mismatches in the workforce, regulations that stifle competition and entrepreneurship and keep that one-third of the labour force unemployed or too discouraged to seek work.

The end result is that a huge part of the labour force is left on the outside looking in, undereducated and with no opportunities for advancement. I'm told, for example, that there are township youth who not only cannot find work, but who grow up without knowing anyone in their circle of family and friends with a job either! The formal economy is not absorbing them, nor are they able to strike out on their own. There is a crucial structural issue at play here. Those included and successful in the advanced economy – large businesses, banks and unionised workers – maintain entry barriers against their potential competitors: small and medium-sized enterprises and the unemployed.

In situations like this, the government should represent the interests of the excluded. However, some policies, regulations or actions only raise higher barriers. And sometimes government services may not meet the needs of the excluded: witness the deficiencies of the educational system. Some government policies may make sense in a truly advanced economy, but in South Africa, they create a situation in which the developed economy is not lifting up and absorbing those excluded from the economy.

There is another, extremely important element to the governance issue: *corruption*. Your National Planning Commission, in the National Development Plan, has said that »

South Africa suffers from high levels of corruption. What is particularly relevant here is the Commission's finding that both the private sector and the public sector are reported to engage in it. This only reinforces the dynamics of exclusion.

The current slowdown exacerbates many of these issues. When the economic pie is not growing, then it is inevitable that too much energy is spent fighting for a larger slice, and not on growing the pie. All of this is damaging to investor confidence, as well as to the trust that must be woven into the fabric of society. And without confidence and trust, it will be very difficult to put in place the reforms needed to make the economy work for all South Africans.

Let's take a moment to examine some of the policy issues in greater depth. One of the issues that keep the one-third on the outside is the impact of wage bargaining practices involving big businesses and big labour. The present approach serves well the interests of both established businesses and employed workers. But wage agreements that use extension to bind entire sectors present a huge obstacle to small- and medium-sized enterprises, which in other countries typically employ the most people, thus suppressing competition for established businesses and employed workers alike. In reality, these agreements keep low-skilled workers out of the workforce and the unemployed have no say. Small- and medium-sized enterprises, which commonly produce with less machinery and equipment and thus may be justified in paying lower wages, have no place at the table, yet they have to live with the deals that are struck.

PRIVILEGED MARKETS

At the same time, the private sector has been supported – by government regulation – in ways that create privileged markets that work against the interests of consumers. They also damage competitiveness by keeping business costs high.

In the finance sector, there are only a few retail banks, and their fees are high. Small enterprises have trouble accessing banking services, though there has been some improvement of late. Barriers to entry into the industry favour existing institutions. It is reasonable to be concerned about a sudden proliferation of new banks: recent experience with the collapse of African Bank is a cautionary tale. But other countries have achieved a balance between oversight and innovation that has resulted in higher rates of financial inclusion. See, for example, the success of mobile banking in Kenya, a development mirrored in many other countries.

Many South African companies enjoy very high profit margins, often 50 percent higher than in other countries. But these margins are often built upon barriers that both hurt consumers and block potential competitors. For example, tariffs on poultry imports – in this case, cheaper Brazilian chicken – were raised a few years ago to protect South African producers. But chicken is the meat most accessible to the poor. So those who are most vulnerable end up paying more. Or look at the transport industry, which provides a service that most South Africans rely on. In other countries, transportation is fiercely competitive and can provide poor people with a leg up in the job market. However, taxi and bus cartels in South Africa are highly organised and deter new entrants, including with violence.

Such extreme measures to deter competition may be the exception. But anticompetitive behaviour is common in other industries, including construction, maize and wheat milling, and telecommunications. Government regulations can reinforce these practices, both by entrenching vested interests and through inefficiencies that limit enforcement of anticompetitive behaviour.

Then there is the matter of state-owned enterprises (SOEs). They play a crucial role in the economy, but they are plagued by inefficiencies, poor management and weak balance sheets. Support for money-losing companies is a growing drain on government coffers. Moreover, the private sector is unable to enter key sectors dominated by SOEs. This only fortifies the bottlenecks in the economy. Even some of the best-performing SOEs pose problems that reverberate through the economy. For example, container-handling costs at South Africa's ports are some 175 percent higher than the global average. Those fees function as import tariffs and raise the cost of South Africa's exports, undermining the country's competitiveness.

A NEW APPROACH

A new approach is needed. It is just not a matter of tax cuts or spending increases. Rather, it is a question of fundamental, transformational reforms that can boost employment – particularly for young people – reduce inequality, and promote economic inclusion. This approach should focus not just on levelling but *opening up* the playing field for individuals and businesses. It will not be easy. Tackling vested interests and promoting a truly inclusive economy will require buy-in from all stakeholders, and require stakeholders to take a long-term view of their interests in a more dynamic South Africa of the future.

It is clear from my conversations with your senior officials that they fully understand the challenge. That was the core purpose of your National Development Plan. And there have been important steps:

- on the infrastructure front, electricity output finally has begun to rebound with new power plants coming online, including independent producers of renewable energy that are linking to the national grid

- the Employment Tax Incentive Act has brought 270 000 youths into the workforce in its first year, and that is just a beginning
- the Competition Commission's proactive market inquiries are facilitating market entry for smaller businesses
- recent procurement reforms should help increase the efficiency and effectiveness of government spending, reduce the potential for corruption, and give all smaller companies access to public sector contracts. They could reduce government costs dramatically.

However, there also have been counterproductive measures, such as recent restrictions on temporary employment and stricter visa requirements. While some of these restrictions have been partly scaled back, general uncertainty about South Africa's regulatory environment remains – particularly in the mining sector. Some well-intended policies have unintended consequences: take the proposed national minimum wage. It could help reduce inequality – but if the wage is set too high, or with no sub-minimum for young people and small enterprises, it risks creating more unemployment.

So we see blueprints for change and some steps in the right direction. But South Africa's core economic problems have not been tackled in a comprehensive fashion. There are several specific policies and measures that can help build confidence and lift growth, even in the short run:

- the first and foremost priority must be job creation. With public finances already stretched, the priority must be on private sector jobs, including temporary and informal jobs
- in this regard, the dialogue between government, labour and business is encouraging, but the talks need to produce substantive action. One solution to the employment problem may lie in a social bargain: build on the ongoing government-business-labour negotiations to agree on wage restraints in exchange for job retention and hiring commitments. And, as I mentioned earlier, it is important to exempt small and medium enterprises from collective bargaining agreements to create space for hiring
- the introduction of a single employment contract also could help open up jobs. The main features would be the elimination of a distinction between fixed-term and open-ended jobs, along with gradual, continuous increases of rights and benefits that would accrue with tenure. These reforms would be important to allow young people to get that first job that gives them a foothold in the economy. In the absence of quality education, on-the-job learning is crucial
- a committed "do no harm" approach in government policies would be very important. It could help to reduce business uncertainty and make policies more consistent. This might begin with centralised evaluations of all policy proposals to ensure that they do not undermine job creation
- improved SOE governance and operations would send an important signal about accountability, including greater transparency in board appointments and the remuneration of executives and board members. It would also enhance the efficiency of South Africa's public investment in infrastructure. This could reduce costs in key areas: for example, by ensuring reliable electricity supply and lowering port tariffs. Similarly, action to open up the telecommunications spectrum would increase broadband speed and reduce business costs. Taken together, these actions could increase competitiveness
- product market reforms and allocation of more resources to the competition authority to detect cartel behaviour and excessive market power would be another important step to level the playing field for businesses
- and then there is crime, which the World Bank has found is the single biggest obstacle to economic activity in the townships. It is every government's responsibility to ensure the daily security of its citizens.

CONCLUSION

Many of these policy ideas fly in the face of established interests that sometimes strive for privilege as much as principle. The challenges facing South Africa call for reforms that create opportunities and enable all people to successfully pursue them – particularly the excluded third.

The primary goal must be to re-energise growth by seeking inclusion and job creation. As I have outlined, that will require filling infrastructure gaps, encouraging more competition, reaching agreement on sensible labour market policies and industrial relations, improving education and training, and insisting on better governance.

These reforms must be undertaken with the same commitment that this nation brought to democratic change. This is how South Africa can build stronger, inclusive growth with jobs for its young people. This is how South Africa can serve as a beacon of economic change, just as it once emerged as a model for political change. While the politics of the moment may favour the status quo over sweeping change, it is helpful to recall Nelson Mandela's wise reminder: "After climbing a great hill, one only finds that there are many more hills to climb". NA