Promoting Growth and Employment in South Africa

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Abstract
This study examines the pressing challenge of generating sustainable growth, job creation, and poverty reduction in South Africa, drawing extensively on research supported by the World Bank over the last few years. The underlying message is that the challenge facing South Africa will not be solved by one (or more) “quick fix” solutions, but instead demands concerted policy initiatives to improve the investment climate, enhance labor market flexibility, and access global opportunities. Forward-looking scenarios suggest that faster growth is possible if pro-growth reforms are complemented by successful initiatives to accelerate skills accumulation, although the growing impact of the HIV/AIDS pandemic could threaten this success.

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PROMOTING GROWTH AND EMPLOYMENT IN SOUTH AFRICA

By

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This paper, which is forthcoming in The South African Journal of Economics, is an abridged version of a longer working paper (Lewis, 2001a) that synthesized findings from recent World Bank analyses of aspects of the South African economy. The longer working paper provides a more complete listing of sources and background materials, and is available at http://www.essa.org.za/download/worldbank.htm, along with several other background papers. Comments received from ESSA and TIPS conference participants, Johannes Fedderke, and an anonymous referee are gratefully acknowledged.
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1. INTRODUCTION

The most pressing problem facing South Africa today is the absence of sustained economic growth and job creation, which are essential to reduce poverty and improve living conditions. The transition to a multi-racial democracy in 1994 posed difficult political, social, and economic challenges, and South Africa’s noteworthy achievements in surmounting these challenges have been widely recognized. But the events of the last few years demonstrate clearly that the challenge did not end with the transition of power to a new government. What lies ahead is the daunting task of ensuring that South Africa’s rich natural and human resources are employed for the benefit of all, promoting sustainable livelihoods, improving social conditions, and alleviating poverty.

Inheriting an economy in disarray and faced with external pressures and questions over credibility, in 1994 the new government was forced to concentrate on macro policy concerns, especially the establishment of a credible and prudent fiscal stance, efforts to reduce inflation, and the needed reunification of the dual exchange rate system. The subsequent policy perseverance has yielded tangible macro stabilization successes and enhanced policy legitimacy. However, the growth-and-employment challenge facing South Africa is a daunting one. Investment rates are low, FDI inflows disappointing, and the unfinished agenda of structural reforms leaves South Africa at a disadvantage within an increasingly competitive global environment. The legacy of apartheid is evident in the pervasive distortions in all factor markets: for labor, as evident in the scale and persistence of unemployment and inadequate investment in human capital; for capital, in the low savings/investment rates and limited FDI; and for land, where land reform and rural development efforts must reverse policies that over decades have virtually eliminated the small farming sector.

Given South Africa’s success in macro stabilization, this paper confronts the problem areas of growth, jobs, and poverty reduction within a broad economywide framework. While its focus is broad, it does not try to present all the components of a comprehensive growth strategy. Instead, it focuses on key concerns regarding the investment climate, unemployment and job creation, and the external trade environment; in some areas, it points to issues where further investigation is called for. Throughout, it strives to highlight the policy imperatives that should be addressed to promote growth in a complex international and domestic economic environment.
2. **THE GROWTH PROBLEM IN SOUTH AFRICA**

Despite the macroeconomic achievements, concerns over slow growth and employment trends are widespread and growing. Throughout the 1990s, formal employment dropped, and unemployment climbed inexorably, reaching 37 percent of the working age population (including discouraged workers). The turbulence which has rocked international financial markets over the last few years has affected South Africa as well, damaging confidence, slowing recovery, and threatening macro stability. And the rapid spread of the HIV/AIDS pandemic in South Africa (there are currently more HIV+ people in South Africa than in any other country) already threatens the hard-won health and social service delivery gains of recent years, and poses an even more fundamental challenge to long-term poverty reduction.

The recent poor growth and employment performance of the South African economy is not new, but reflects a secular deterioration that has been occurring for decades. GDP growth has fallen steadily, from an average of nearly 6 percent during the 1960s, to around 3 percent during the 1970s, 2 percent in the 1980s, and erratic performance throughout the 1990s, averaging 1.3 percent (around the rate of population growth). After a prolonged period of decline, the economic rebound that began in 1994 was short-lived and weak, peaking at only 4 percent before dropping back off as a result of external pressures and business cycle movements. Throughout this period, employment has dropped, most sharply among the unskilled and semi-skilled workers: between 1981 and 1999, the level of formal sector employment for this group declined in every year but three, losing a total of 1.3 million jobs.

Structural features of the South African economy exacerbate the growth and employment challenge — the apartheid-era legacy leaves distortions every bit as pervasive and costly as those inherited by many of the economies emerging from the former Soviet Union. Compared to other middle income economies, South Africa is highly urbanized, and while half the population is rural, agriculture accounts for less than 6 percent of GDP (and only 9 percent of employment). The relatively small agricultural sector, along with a stunted informal sector, imply that South Africa is missing two standard labor "shock absorbers" that operate in other economies (especially in Africa) during periods of adjustment. The spatial dimension of apartheid meant that millions of South Africans were deliberately located miles away from urban centers where the jobs were, fostering the emergence of complex migrant worker systems and transport patterns that remain in place today. Discrimination in the provision of education and training opportunities meant that generations of black South Africans were prevented from acquiring the skills that would make them eligible to pursue productive employment opportunities.

Uneven progress on policy reforms that focus on improving productivity and competitiveness has limited the economic response. In a broad economic context, productivity refers not only to the efficiency with which primary production factors are combined, but also how well economic activity is supported by the underlying incentive structure and enabling environment. In practical terms, this suggests the need for further attention to key areas of policy concern, such as the trade regime, competition policy, privatization, exchange rate management and foreign exchange controls, public expenditure policies, human capital development, etc. While the government has made progress in these areas, it has been uneven. The unfinished agenda remains substantial, and adversely affects efforts to make the economy more productive.
Overall, the mixed performance on the structural reform agenda means that the pre-conditions for a sustained supply response remain unmet. Based on the GEAR package of policies adopted in 1996, growth was forecast to accelerate to 6 percent by 2000, with job creation reaching 400,000 jobs annually. Compared to these targets, South Africa's economic performance has been disappointing: GDP growth has remained low, formal employment continues to fall, and the key objectives of poverty reduction and improved service delivery remain largely unmet.

3. CHANGING THE INVESTMENT CLIMATE

In this section, we begin to identify additional policy reforms that could begin to ease current constraints on growth. While recognizing that there is no “quick fix” for the difficulties facing the South Africa economy, there are nevertheless numerous areas in which concerted action can generate forward momentum and over time, make a sizable difference for growth and employment creation. While the proposed policy measures cover numerous aspects of the economy, the underlying theme is the over-arching need to improve the investment climate for physical and human capital in South Africa. As such, this theme encompasses not only direct measures (such as efforts to improve the quality and quantity of physical investment, or enhance opportunities for skill accumulation for the poor), but also indirect measures aimed at making the economy more competitive and attractive to investors (through improvements in labor markets, enhanced trade competitiveness, promotion of SMMEs, etc.)

(a) Savings, Investment and Capital Accumulation

Domestic savings in South Africa is low compared to other middle income countries, and has been declining fairly steadily over the last two decades, from an average of 22 percent of GDP during the 1980s to only 14 percent at present. There has also been a significant change in the composition of savings. Government savings was responsible for much of the overall decline, as it swung from positive rates in the early 1980s (around 4-5 percent of GDP) to negative rates in the early 1990s (-4-5 percent of GDP), and more recently moved steadily back towards zero. Private savings has been fairly stable, albeit with a downward trend during the latter part of the 1990s, as household savings dropped from 4 percent of GDP in 1992 to almost zero in 1999.

While the decline in savings rates reflects long-term trends, heightened expectations since 1994 have directed attention to the factors that might underlie this poor performance. Available empirical research on determinants of savings has found that: (1) as government saves more, private savers tend to save less (limited Ricardian equivalence), so that the recent reduction in government dissavings has been associated with lower private savings; (2) private household savings are responsive to changes in corporate savings behavior (households “pierce the corporate veil”), so that as firms save more, households tend to save less; and (3) the extensive financial liberalization that has occurred in South Africa appears to be negatively related to private and household savings rates.¹

While low and declining aggregate savings constrains investment resources, this constraint is not absolute: if foreign savings can supplement available domestic resources, higher investment levels can be sustained for prolonged periods. While South Africa's history of apartheid-induced isolation limited its appeal as an international investment destination for much of the 1980s and early 1990s, the advent of a democratic and multi-racial government was expected to end its pariah status and usher in a period of significant foreign investment interest. But the evidence to date suggests that this has not occurred. South Africa has been attracting only a small share of the overall pool of foreign direct investment (FDI) directed to emerging markets. During 1994-99, FDI in South Africa has averaged less than 1 percent of GDP; for 2000, estimates are that this figure fell below 0.5 percent. By comparison, over the same period, FDI/GDP averaged 2.5-3 percent for Argentina, Brazil, and Mexico, 4-5 percent for Hungary and the Czech Republic, and 3-5 percent for Malaysia, the Philippines and Thailand.

With limited additional foreign resources available, investment levels have remained constrained at around 15-16 percent of GDP throughout the 1990s. There is evidence, however, that the sectoral composition of investment has been changing; in particular, it appears that the highest investment rates during the 1990s occurred within manufacturing sectors, perhaps reflecting the consequences of trade liberalization and broader economic reform.\(^2\)

**(b) Constraints to Investment and Growth**

To explore perceptions about constraints to investment and growth, we draw on the results of surveys undertaken by the World Bank (in conjunction with the Greater Johannesburg Metropolitan Council) in 1999, focusing on local (i.e. metropolitan) economic development.\(^3\) We look first at the results from the large firm survey, which included 325 firms (larger than 50 employees) across eight manufacturing sectors located in the Greater Johannesburg Metropolitan area (approximately one in seven).

To link up to the question of “constraints” on growth, we asked CEOs to rank key constraints to their firm’s growth, using a “major problem”, “moderate problem”, “not a problem”, or “not applicable” scale, from which an overall index was constructed to allow comparison across categories. The most important obstacles identified (and the supporting evidence from the larger survey) include:

- **Crime and theft** were rated by 94 percent of firm CEOs as the major obstacle to firm growth. Interviews with managers supported this ranking: 83 percent of firms reported they had suffered from some type of crime during 1998, with many listing more than one incident. 61 percent of firms reported that employees had been victims of crime while traveling to or from work. 60 percent of firms reported that they had increased spending on crime prevention between 1997 and 1998; spending on security averaged 1.6 percent of revenues.

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\(^3\) The overall effort included separate surveys of large manufacturing firms, small, medium, and micro-size firms, informal firms, households with informal workers, training providers, and credit providers. More background and results from the surveys used in this report can be found in Chandra, Moorty, Rajaratnam, and Schaefer (2001) and Chandra, Moorty, Nganou, Rajaratnam, and Schaefer (2001).
• CEOs ranked the cost of capital or credit as the next most important constraint. In the full survey, 61 percent of firms reported being adversely affected by higher interest rates during 1998. But as to whether lowering interest rates would lead to investment growth, only 30-40 percent of the firms reported that they would expand investment in response to a fall in the interest rate. This somewhat puzzling outcome might reflect the typical sources of finance for South African firms: firms mainly relied on internal savings to finance their working and investment capital.

• Depreciation and/or volatility of the Rand was identified as the next most prominent obstacle to business growth. There was a difference here between the largest firms (more than 200 employees), that depend more on export markets (85 percent sell in foreign markets) and more consistently hedge their foreign currency exposure through forward contracts (60 percent purchased forward contracts), and the smaller firms. The potential of export opportunities is apparent in the fact that 60-80 percent of the larger firms (100 employees and larger) said they began to export more in response to the 1998 Rand crisis. However, the overall response of firms to the currency depreciation in 1998 was muted despite various export promotion programs, excess capacity in 80 percent of firms, forward contracts that permitted imports at a stable Rand price, and strong global demand.

• The impact of recent labor regulations was also identified by firm CEOs as important. Survey results reveal just how complex the area of labor relations is in South Africa, how varied are the conditions facing different firms, and how difficult it is to disentangle the effects of labor legislation and regulation from underlying economic and industry trends. Although half of large firms face collective wage bargaining at the sector or industry level, 14 percent are not bound by collective agreements at all, suggesting that the impact of bargaining arrangements is not uniform. Looking at the impact of the four major changes in labor market regulation since 1995 (Labor Relations Act, Basic Conditions of Employment Act, Employment Equity Act, and Skills Development Act), while almost 40 percent of firms said they adjusted by hiring fewer workers, or using more machinery, nearly 30 percent of firms also said that the regulations had improved labor relations, and 15 percent asserted they had helped raise labor productivity.

• Corruption and administrative costs in government was rated as the next obstacle. The survey focused on this issue by exploring administration of the regulations and procedures required to obtain licenses and permits. 75 percent of middle managers reported that the licensing and permit procedures were reasonable; it appears that the time costs are more important than financial costs. Despite the relatively high ranking from CEOs, corruption in government did not appear so prevalent, as only around 1 percent of firms reported that they were asked to pay bribes.

• Finally, a shortage of skilled labor was highlighted as an important constraint. When asked to identify what skill classifications were scarce, 80 percent of firms indicated that it was extremely or moderately hard to find managerial and professional staff. Service and craft skills were extremely or moderately hard to find for 70 percent of firms. Firms indicated a strong preference for hiring workers with relevant work experience, a worrisome outcome in an environment where a large segment of the unemployed have been without a job for a long period (and many have never held a formal job).
While there are limitations inherent in the subjective ranking of constraints by CEOs, there is other evidence that supports the broad findings. For example, when 1400 firms included in the National Enterprise Survey were asked to choose among seventeen different possible constraints to investment, the major obstacles identified included interest rates, crime and social issues, labor regulations, and (especially for small firms), uncertainty over government economic policy, a list which broadly conforms with the survey results reported here (Gelb, 2001).

Additional evidence comes from work on the determinants of investment expenditure in South Africa, and particularly the role of uncertainty. Using a theoretical framework derived from a real options approach, Fedderke (2002) finds that systemic uncertainty (measured with an index of political instability) raises the threshold return to capital that must be met before investment occurs. If such threshold effects are prevalent (whether due to instability/uncertainty or other factors, such as crime), then discrete changes in interest rates or other investment determinants may not yield any apparent response.

(c) Measures to Encourage Investment

In many respects, South Africa would appear to provide an attractive investment climate. It is an investment-grade “emerging market,” and enjoys a mature relationship with international capital markets. Analysts agree that South Africa has delivered sound macro fundamentals, and it has been praised for its success in bringing down the deficit, pursuing a prudent external borrowing strategy, controlling public expenditure, reducing taxes, reducing inflation and improving access to information. Moreover, the financial sector is first-class; the Reserve Bank is a globally respected banking regulator; banks are privately owned and well-run; foreign banks are permitted to operate on an easy; problem loans are minimal; the Johannesburg stock exchange is the 13th biggest stock market in the world; bond markets have first-world size and liquidity; and the breadth of financial products and services is unmatched in other emerging economies.

But as already noted, despite these attributes, investment levels have remained disappointing low, leading to consideration of policies that might make South Africa more attractive to investors, both domestic and foreign. For example, there has been renewed discussion recently over the use of targeted investment incentives to encourage investment and job creation. South Africa has long experience with various types of targeted schemes: for example, the Spatial Development Initiatives (SDI) have provided a mechanism for government to identify regions with high growth potential and pressing needs, and intervene selectively to provide critical infrastructure or other facilitating investments. But traditionally these initiatives have concentrated on huge capital-intensive projects oriented towards exploitation and “beneficiation” of mineral resources, so the incentives for ordinary manufacturing enterprises has been limited, and the employment creation minimal. Overall, South Africa has had little experience with efforts to encourage non-mineral export activities through export processing zone or duty drawback and rebate schemes.

While most measures that improve the investment climate for domestic investors will likely also encourage inward flows of FDI, the responses need not be equivalent, as confirmed by the experience of many countries which fail to attract FDI even after adopting many of the “right” policies. What seems generally true is that foreigners will rarely choose to invest in situations where domestic investors lack the confidence to invest locally themselves.
If pursued, targeted schemes need to be well focused and fiscally affordable. Approaches that strive to “pick winners” (either geographically or sectorally) or create complex procedures and selection criteria that create excessive additional administrative burdens for Government or discourage participation by possible beneficiaries should be avoided. Evidence on the effectiveness of targeted incentives generally suggests that such measures rarely attract additional investment, are costly, and often distort incentives that lead to further resource misallocations (see Pigato, 2001). Instead, investors are drawn to locations that facilitate their participation in the competitive global environment. This involves factors such as the general business framework (ease of entry and exit, fairness and speed of dispute settlement), existence of supply networks, adequacy and cost of infrastructure, and availability and quality of technical and professional services.

FDI would also be stimulated by accelerating the pace of privatization of major state-owned enterprises (SOEs). South African privatization initiatives have occurred within the context of broader efforts to “restructure” state assets, a process which is viewed as including corporatization, commercialization, and both partial and full privatization. During the 1994-99 period, actual progress was quite limited; however, the current administration has produced a revised strategy, with a commitment to complete the major restructuring for the four largest SOEs (in transport, telecommunications, electricity, and defense) by 2004. But despite these clear signs of progress, the broader investor reaction has been quite muted, with concerns expressed over the continued slow pace and relatively limited scope of actual privatization. This would appear to be an area where faster progress would bring immediate benefits.

The impact of faster privatization occurs through two channels. First, there is the direct inflow related to the privatization itself: for example, from 1996-2000, the only two quarters in which gross FDI approached $1 billion coincided with the receipt of proceeds from the sale of a 30 percent share of Telkom (in 1997) and a 20 percent share of South African Airways (in late 1999). And unlike the portfolio flows that in South Africa (and elsewhere) have been so destabilizing during turbulent periods, privatization achieved through some form of “strategic partnership” with foreign firms generates a long-term investment commitment.

Second, there is an indirect channel, as a decisive privatization program signals the Government’s commitment to creating and maintaining an “investor friendly” climate. In a global environment where commitments to reform are readily made, and often just as easily broken or reversed, successful privatization initiatives seem to purchase credibility that otherwise is hard to accumulate. The experience with the Telkom privatization suggests that accelerating privatization would increase FDI, as international investors seek exposure in South African non-tradable sectors. The Government’s current policy is still more directed towards commercialization rather than privatization, thus foregoing an opportunity to attract more stable capital flows, apart from the opportunity to improve efficiency and competition.

(d) Small, Medium and Micro Enterprises

The SMME sector in South Africa presents a bit of a puzzle. In many developing economies, SMMEs contribute substantially to growth, competitiveness, and employment – SMMEs tend to be more labor intensive, and can often meet the demands of international competition more flexibly. But in South Africa, this segment is relatively under-developed: emergence of a more vibrant, export-oriented SMME sector appears to have been crowded out
by factors such as the sanctions-related closure of export markets to South Africa, a trade regime that promoted capital-intensity in domestic markets, and distortions and regulations in domestic factor markets that have hampered the emergence or expansion of informal and/or startup firms. Looking forward, it is clear that measures that can promote SMME growth can be a crucial element in South Africa’s transition to higher growth.

In parallel with the large firm survey discussed earlier, a survey of SMMEs sought to identify the factors that entrepreneurs viewed as constraining firm expansion and job creation. While limitations in the scope of the survey (Johannesburg only, only four manufacturing and four service sectors included) suggest caution in generalizing the findings to the entire economy, the results still illuminate the problems facing SMMEs. SMME owners were asked to report on constraints to growth by asking what conditions would be necessary in order for the firm to employ 10 more workers. The key results include:

- SMME firms claim that expansion requires increases in demand and in business visibility, suggesting a sizable role for aggregate demand conditions and implying that the SMME tier may not be able to expand rapidly in a poor or slow-growth economic environment. In fact, SMMEs may be more vulnerable to changing aggregate demand conditions because their financial resource base is smaller.

- SMME firms also identified high interest rates and/or limited access to capital as important constraints, even though savings are the main source of start-up and working capital for the survey firms (around half had not received a bank loan in the last five years). But where access is an issue, it is related to firm size, age, and race of owner: younger, smaller, black-owned firms are relatively more constrained by collateral requirements. For those that did borrow, high interest rates also mattered, adversely affecting their business.

- Insufficient Government contracts and weak support programs constrained expansion, as SMME firms perceive governments to have a vital developmental role, identifying interventions to increase competitiveness, marketability, and visibility. Survey data show that awareness and use of existing support programs is extremely low, and that despite the SMME procurement strategy already in place, few small firms bid for and successfully win government tenders.

- Trade plays a limited role for SMME firms, according to the survey results. Only 22 percent of the SMMEs engaged in trade, with an average export share of 15-20 percent. In many other countries, SMMEs have been strongly oriented towards external markets, and often more successful at adopting new technologies, developing new markets, and responding to changing international conditions. If the low trade dependence is prevalent throughout South African SMMEs, an important potential source of dynamism and growth is missing.

In the survey, SMMEs were also asked to prioritize government policies that would aid in their growth. For local authorities, SMMEs rank improving the business environment, both through safety and security (listed as first priority by 75 percent of firms) and infrastructure provision as the most important priority. In addition to the business environment, SMMEs rank ethical standards, attitude of local officials, and public transport as important local priorities. Given that SMMEs are looking for increased procurement and promotion programs, the fact they denote relations with the government as important is not surprising.
In terms of what national government can do to help SMME growth, policy stability and interest rates are ranked equally as the top national priorities, a ranking that reflects the importance SMMEs placed on the constraint associated with the cost and availability of capital. Education and training is ranked as second most important followed by promotion of SMMEs in public services and efficient and flexible wages. Each of these three priorities directly addresses the issue of SMME competitiveness and again confirms that SMME firms identify an important role for government in facilitating their growth and development. Comparing these priorities with those that emerged from the discussion about large firms, to a large extent, the groups appear to face similar difficulties. Sluggish domestic demand, high interest rates, limited access to capital, and skills shortages each appear on the list of concerns.

Despite concerns expressed about interest rates, it is not clear that actions to lower rates will have much success in promoting SMME growth. The share of bank borrowing in financing SMME investment is low, although one-half of the SMMEs surveyed borrowed from banks in the last five years. For these firms, declining interest rates should lead to increased investment by lowering the cost of capital and by lowering the opportunity cost of retained earnings. Since lending rates averaged around 20 percent during 1996-98, firms that used bank capital reported being adversely impacted by the high cost of credit. Interestingly, 45 percent of firms surveyed noted that lowering interest rates is necessary for them to add another 10 employees and expand employment. However, when asked how they viewed the decline in interest rates (of around 5 percentage points) that had occurred in the months before the survey, just over 15 percent thought that interest rates were still too high, while 33 percent reported that the decline had made no difference to their business. So it may be that high interest rates have a less immediate impact on investment and growth in SMMEs than demand conditions or other constraints.

Efforts to promote SMME access to finance might have more impact, but the interaction of this factor with other constraints is hard to disentangle. For example, while half of SMME firms had not used a bank loan in the last 5 years, two-thirds of this group claimed the reason was that they did not need a loan. This in turn might reflect either sluggish demand throughout the economy, in which case an upturn in growth might make the access to capital more binding, or the fact that the firms had adequate self-finance so that access to credit will not be an issue.

There would appear to be scope for improving the effectiveness of the various SMME promotion programs that are in place. When given a list of more than a dozen promotion programs supported by DTI and its implementation counterparts, Khula and Ntsika, the only program used by more than 10 percent of SMMEs was the South African Bureau of Standards. For all other programs, both awareness and usage was quite low; the only bright spot is the fact that among those firms that were aware of Ntsika programs, usage rates were fairly high. Looking forward, awareness of promotion programs needs to be increased, an effort that may benefit from targeting firms in the sectors and size-classes where programs are most relevant.

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5 This finding lends support to the hypothesis regarding the importance of threshold effects on investment expenditure discussed earlier (Fedderke, 2002).
4. EXPANDING LABOR DEMAND

South Africa’s unemployment levels are virtually without precedent: 36 percent of the total labor force in 2000, with similar levels throughout the late 1990s. Such high and persistent unemployment means that the incidence of unemployment is not confined to small “pockets” of joblessness: the unemployed include large numbers of men and women, youths and prime-aged adults, and urban and rural dwellers.

(a) Labor Supply and Unemployment

Table 1 provides a summary of the skill composition of employment and unemployment in the South African economy in 2000. Semi-skilled and unskilled labor represents half of the work force, but two-thirds of the unemployment. Informal labor (which has similar skill characteristics to the semi-skilled and unskilled group) accounts for 40 percent of total unemployment. The unemployment rate among skilled labor is lower, but not zero.

<table>
<thead>
<tr>
<th>Category</th>
<th>Labor supply (thousands)</th>
<th>Employment (thousands)</th>
<th>Unemployment (thousands)</th>
<th>Unemployment rate (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly skilled labor</td>
<td>1350</td>
<td>1350</td>
<td>0</td>
<td>0.0%</td>
</tr>
<tr>
<td>Skilled labor</td>
<td>3495</td>
<td>2928</td>
<td>567</td>
<td>16.2%</td>
</tr>
<tr>
<td>Semi-skilled and unskilled labor</td>
<td>7359</td>
<td>3669</td>
<td>3690</td>
<td>50.1%</td>
</tr>
<tr>
<td>Informal labor</td>
<td>2547</td>
<td>1494</td>
<td>1053</td>
<td>41.3%</td>
</tr>
<tr>
<td>Total</td>
<td>14751</td>
<td>9441</td>
<td>5310</td>
<td>36.0%</td>
</tr>
</tbody>
</table>

Source: South Africa CGE model based on statistics provided by Quantec Research.

Job creation over the past three decades in the unskilled and semi-skilled labor category has been dismal. Total employment (formal sector and informal sector) of unskilled and semi-skilled laborers in 1999 was 8 percent lower than the level in 1970. While the number of informal sector jobs quadrupled between 1970 and 1999, the formal sector has been marked by massive job shedding. Formal sector employment of unskilled and semi-skilled laborers in 1999 was only three million compared with four million employed in 1970. Between 1981 and 1999, the level of formal sector employment declined in every year but three, losing a total of 1.3 million jobs in the space of less than two decades.

(b) Labor Market Flexibility

A common argument used to explain low employment generation in South Africa is the “inflexible” labor market, although the mechanisms at work are not necessarily identical to those

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6 The highly skilled category includes professional, technical, managerial and executive positions; the skilled category includes clerical, sales, service, production foremen and supervisors, communications and transport workers; semi-skilled and unskilled includes all others.
in the EU, where the terminology was first adopted. The industrial labor relations system heavily favors "insiders," those who have regular jobs, especially with private employers, at the expense of "outsiders," who disproportionately include the unemployed and discouraged workers. And within the industrial labor relations system, trade unions have the upper hand. This has created a large union wage effect with wage gains only loosely tied to productivity increases. Industrial or Bargaining Councils enhance union power, by having the authority to extend statutory wages to currently uncovered firms within sectors: Pro-labor legislation also is associated with benefit (e.g., maternity leave, normal working hours, overtime differentials, etc.) and employment security provisions that reduce flexibility.

Data on the unemployment rate for the lower skilled labor categories are shown measured against the left-hand axis in Figure 1. In the early 1970s, unemployment was quite low for this group (and for other skill groups as well), although after 1976, the unemployment rate has increased steadily. In 1995, the unemployment rate for this group surpassed 50 percent, and has since continued to climb even further.

While there are numerous factors that contribute to the differential patterns of unemployment by skill group, the pattern of wage growth appears particularly significant. Figure 1 also shows the trends in real remuneration per employee for the same lower skill group.

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7 The terms "flexible" and "inflexible" as descriptions of the labor market gained popularity in the 1980s as analysts sought explanations for diverging trends in unemployment between the EU and the U.S. Proposals to increase labor market flexibility in the EU were detailed in the OECD Jobs Study and called for (a) increasing wage flexibility by reassessing statutory minimum wages and shifting taxes away from labor; (b) reforming employment security provisions by loosening restrictions on dismissals warranted by changing economic conditions, and by easing employment rules governing employees on fixed term contracts; and (c) changing unemployment insurance systems by limiting the length of benefits and reviewing eligibility conditions (OECD, 1994).

8 See Fallon and Lucas (1998) for a discussion of the labor relations system and its impact in South Africa.

9 The data series on employment, unemployment and real remuneration that underlie Figure 1 were derived from official South African statistical sources by Quanteq Research.
(against the right-hand axis) since 1970. Real remuneration per unskilled and semi-skilled worker in 1999 had grown to 250 percent of the 1970 level. The broadly parallel movement in the unemployment and wage data support the neoclassical conclusion that unskilled and semi-skilled labor has to a large extent been priced out of the market.

But rapid wage growth is not the only factor that may have hampered employment creation and contributed to labor market inflexibility. Since 1995, government has enacted legislation and regulations aimed at redressing some of the inequalities that had carried through from the apartheid era. The main regulatory reforms have been the Labor Relations Act (LRA) of 1996 which, among many other things, focuses on workers rights to organize, conflict resolution and hiring and firing laws. The Basic Conditions of Employment Act (BCEA) of 1997 focuses on better working conditions for all workers who are employed and workers’ rights in the workplace, among other things. The Employment Equity Act seeks to correct racial imbalance through, among other things, affirmative action. The Skills Development Levy of 1998 seeks to encourage firms to provide more worker training.  

While it is difficult to quantify the individual or collective impact of this legislation, it does at least appear to contribute to the impression of inflexibility (recall the survey results from Johannesburg). South African business leaders cite labor regulations and union activities as discouraging employment creation. The World Economic Forum’s Global Competitiveness Report (1999: Tables 7.02-7.05, 7.09) ranks South Africa at the bottom of its fifty-nine nation comparison on whether labor regulations on wages, hours or dismissals favor flexibility. The Competitiveness Report asks groups of domestic business leaders to rank their agreement or disagreement with statements such as, “Hiring and firing practices are flexibly determined by employers.” On this question South African executives strongly disagreed. Relative to the rankings of business counterparts in other economies, South Africa came in last on most matters concerning flexibility, labor relations and the work ethic of the labor force.

(c) Improving Labor Market Flexibility

The large-firm survey provides some confirmation on the importance of labor market flexibility. One-third of the largest firms in the group (greater than 200 employees) must deal with three or more unions. 45 percent of the full sample are bound by collective bargaining arrangements (at the sector or industry level); 30 percent experienced at least one strike during 1998; the average time required to retrench an entry level worker was 2.7 months. But the impact of the labor market environment was also varied: while around 23 percent of firms reported that each of four recent labor regulations lowered employment, around 70 percent of firms pointed out that individual regulations had no effect on employment decisions. Looking at the combined impact of all regulations, 40 percent of firms reported that they had variously hired fewer workers, substituted labor with capital, and/or hired more temporary workers, but 60 percent reported that the combined labor legislation had no impact on employment decisions.

10 One area that merits further investigation is the possible distinction between wage levels and movements versus changes in total labor costs (i.e., wages, benefits, and regulation costs).
There can be little doubt that along some margin, perhaps fairly wide, South Africa’s labor market institutions and regulations have constrained more rapid growth in employment. But can these problems of inflexibility account for African unemployment rates in excess of 30 percent? If greater flexibility were achieved, by how much would unemployment fall? According to Statistics South Africa, in 1999 formal employment (excluding agriculture) amounted to about 6.5 million jobs. Unemployment, according to the expanded definition, equaled 5.9 million. Improved labor market flexibility would expand employment. But it is hard to imagine that greater flexibility in the institutional setting would double African employment.

Recognizing that the labor market reforms introduced over the last several years might have had unintended consequences for employment creation, in July 2000 the Department of Labor proposed a number of amendments. More important features of the proposed revisions would: require bargaining councils to consult with “non-parties” before the agreements can be extended to them; introduce a six-month probationary period during which less strict dismissal procedures can apply; clarify workers’ rights when retrenchment, business transfer, or insolvency occurs; eliminate the “premium” for Sunday work; reduce the notice period to a week for those employed less than 6 months; allow collective bargaining agreements to vary the number of hours worked; and allow bargaining councils to increase the ordinary work week beyond 45 hours. Despite the fact that these initiatives are fairly modest, they have evoked strong criticism from organized labor, and have yet to be formally submitted to Parliament or ratified. The difficulty in introducing even such minimal changes suggests that the goal of achieving a major increase in market “flexibility” will remain elusive.

(d) Skills Shortages

Augmenting the skills base of the South African labor force will increase growth and create jobs. Decades of apartheid policies that restricted education and training to whites has led to enormous under-investment in the skills of the black majority, who have been denied the opportunity to invest in their most productive assets: their human capital. Furthermore, in the last decade, steady emigration among the better educated groups has further eroded the skills base.

Evidence of the skills shortage can be found in the surveys. Approximately 80 percent of large firms experienced extreme to moderate difficulty in finding managerial and professional staff; 70 percent reported extreme to moderate difficulty in finding people with service and craft skills. At the other extreme, 95 percent of firms indicated there was no particular difficulty in finding unskilled workers. Despite the apparent skill shortage, only 35-45 percent of firms provide training to approximately a third of their workers. Although firms were reluctant to reveal how much they spent on training, there was no compelling support for the hypothesis that

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11 Standing, Sender and Weeks (1996: Chapter 6) argue that the employment consequences of South Africa’s labor regulations have not been satisfactorily identified. They imply a relatively muted impact of the institutional and regulatory environment on employment. Fallon and Lucas (1998) present the opposing case.

12 Analysis by Fallon and Lucas (1998) suggested that union and bargaining council effects could perhaps explain around a quarter of total unemployment.

13 It is possible to argue that there is in fact no conclusive evidence of a skills shortage – for example, job vacancy rates do not seem excessively high, and the real remuneration data for highly skilled workers presented earlier shows a modest decline over the last 30 years, which hardly suggests growing scarcity. But as Fallon and Lucas (1998) point out, the issue is not so much whether there is in fact persistent “excess demand” for higher skilled workers, but rather whether or not the skills base is sufficient to support higher economic growth.
firms failed to invest in training because they were apprehensive about losing their trained workers to other firms – less than 5 percent of trained workers left the firms after being trained.

This pattern of skills shortages but only limited training expenditures is apparent among SMME firms as well. While African labor constitutes the majority of SMME semi-skilled employment, whites dominate skilled occupations. SMMEs face an important skills shortage: 30 to 45 percent of firms reported difficulty in finding skilled labor. But SMME firms are not providing extensive training either – less than 20 percent of firms provided any form of skills training, an outcome which may reflect resource constraints and/or lack of awareness about training programs (SMME firms do report they would like national authorities to improve education and training).

Such results point to the need for design and implementation of effective training programs. In recent years, there has been increasing recognition of the importance of skills development through worker training at all levels of civil society: labor force, unions, business sector and government. Government has enacted the Skills Development Act of 1998 that allows firms to claim a reimbursement against training costs, and segments of the private sector have introduced initiatives to accelerate worker training. But targeting and financing such efforts at the appropriate level can be difficult: for example, many of the schemes put forward to date seem targeted more at upgrading skills for those that are already employed, rather than providing skills to the unemployed. And the budgetary implications need to be taken into account as well: current plans to finance expanded government training programs through a “skills development levy” collected as a payroll tax could have unintended adverse consequences by raising the cost of labor even higher than it already is.

Even more problematic is the issue of whether there is a case for Government to engage in aggressive and large-scale training of the unemployed. If an aggressive skills development strategy is indeed an attractive option, at what level should it be pitched? Given that less than half of large firms provide training to their own workers, are there policy options that would provide incentives for firms to train workers on a larger scale? Despite evidence that firms do not lose workers following training, is there a strong case to be made for an active government role because of externality or public good arguments? The possibility of direct subsidization of employment creation is taken up below.

(e) Subsidizing Employment Creation

Employment subsidies (sometimes called wage subsidies) are labor market interventions that increase employment by lowering labor costs while sustaining the average wage income of employees. The government subsidizes employment by paying a portion of the costs of employing workers or, more commonly, providing tax breaks based on the number of employees or new jobs at a particular firm. Frequently, employment subsidy programs are targeted at less skilled workers or individuals that have been unemployed for a relatively long duration. Because employment subsidies increase employment without reducing average wage income, they can form part of a strategy of redistribution as well as job creation.

An employment subsidy is often considered a tool in a broader set of “active” labor market policies with the goal of boosting labor demand. Because employment subsidies attempt to increase the number of jobs by reducing labor costs, they can be characterized as supply-side
policies. Demand-side employment creation policies, in contrast, emphasize increasing expenditures on domestically produced goods and services in order to create jobs. In recent years, increasingly integrated global markets have placed constraints on the ability to pursue traditional demand-side policies, particularly for small, open economies such as South Africa. On the other hand, many supply-side strategies for job creation – for example, downward wage flexibility – have been criticized for their lack of attention to questions of income distribution (see, for example, Freeman 1995). For a country with a history of such pronounced inequalities as South Africa, a focus on issues of redistribution remains important. Employment subsidies provide a possible tool for pursuing job creation and redistribution simultaneously.14

Employment subsidies address another important issue often raised concerning the limitations of lowering wage incomes to create jobs. Wage reductions can provide a disincentive for employees to work productively and can create workplace tensions that reduce productivity. Therefore, questions of equity aside, there can be limits to the extent of profitable wage reductions. In such a situation, employment subsidies can be used as a strategy for increasing employment through lower labour costs without producing negative consequences for productivity and competitiveness.

As an example, consider a general employment subsidy (that is, the subsidy amount is based on total employment) financed entirely through a tax on fixed capital assets such that total revenues are exactly offset by total transfer payments. Note that such a policy would have the effect of increasing the employment effect of the subsidy beyond the effects of the reduced cost of hiring because the cost of employing scarce capital resources would rise. Relatively labor-intensive firms would be net beneficiaries because the total amount of the subsidy they receive would necessarily be greater than the total taxes on capital assets, while capital-intensive firms would pay more in taxes than they receive in subsidies.15 This is a clear example of an industrial policy aimed at raising the rate of job creation: by providing incentives for capital to move from capital-intensive sectors that provide few jobs to sectors in which a limited amount of investment generates large numbers of jobs, the trend will be towards more labor-intensive production.

What would a targeted employment subsidy program for South Africa look like and what would be the size of the costs and benefits of such a policy? The answer depends on choices of design and scale. For example, consider a marginal employment subsidy program, designed as a hiring subsidy, targeted at unemployed persons with limited (or no) labor market experience. The goal is to increase the number of jobs for unskilled workers and match currently unemployed workers with the new employment opportunities. Using existing information on the responsiveness of employment to wages (in particular, the wage elasticity of labor demand), along with data on other structural features of South African employment, we calculate that creating enough new jobs to reduce unemployment by 5 percent (around 113,000 new jobs)

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14 However, reliance on wage subsidies may lead to the imposition of one distortion (the subsidy) to offset another (wage/labor costs rigidities), with potential unintended and adverse consequences. Effective targeting of the subsidy is crucial.

15 A more detailed description of such a subsidy policy can be found in Heintz and Bowles (1996).
would require total subsidy payments of around R644 million, which represents only 0.3 percent of total non-interest expenditures in the budget.\footnote{Of course, this does not include the costs of administering the program (and we have glossed over many aspects of program design), but even if the total expenditure were doubled to cover these costs, the total budgetary demands would be quite affordable.}

5. IMPROVING EXTERNAL COMPETITIVENESS

During the 1990s, South Africa’s “openness” has increased dramatically, and the role of international markets and linkages has played an important part in its growth and structural transition. While the process of trade liberalization dates from the early 1990s, the pace of South Africa’s integration (or re-integration) into the world economy accelerated following the democratic transition in 1994. Accession to the WTO, negotiation of a free trade agreement with the EU, and discussions over a SADC free trade area collectively mark the growing contribution of trade to the prospects and prosperity of the economy.

In this section, we consider the contribution that trade expansion and liberalization has made to economic performance, especially with regard to employment and growth. We also evaluate how the trend towards greater globalization will affect the economy, with especial attention to the impact of the EU-South Africa trade agreement and SADC free trade area.

(a) Trade Policy Reform: A Scorecard

Liberalizing the external trade regime has been one of the central and more visible elements of South Africa’s drive to achieve accelerated economic growth and symbolic of its break with past economic policies. Initially, considerable progress was made in rationalizing the very complex tariff regime that prevailed in the early 1990s, and lowering the overall level of nominal and effective protection.\footnote{Holden (1992) analyzes the historical trade policy regime, while Belli et al. (1993) present a description of the regime as of 1990. Further descriptions of recent trends in protection are in Tsikata (1999), Lewis (2001b), and van Seventer (2001).} Between 1990-96, the average economy-wide tariff fell from 28 to 10 percent, while the average manufacturing tariff dropped was reduced from 30 to 16 percent. The maximum tariff rate was cut to 61 percent (40 percent if “sensitive” industries are excluded), the number of tariff lines was cut by a third, and the number of separate tariff “bands” or rates cut from 200 to 49.

But despite this strong initial progress, the picture at present is less clear. Since 1996, the pace of rationalization has slowed considerably, with only a small reduction in the number of tariff bands, a modest decline in the maximum tariff, and a small increase in the tariff code dispersion, as measured by the coefficient of variation. Moreover, while South Africa has a low (average) tariff rate compared to other middle-income countries, this is in part attributable to the very large number of “0” rated items (around two-thirds of lines in 1999), which artificially lowers the average – the average tariff for those products with positive rates was around 17 percent, while the overall average (including zeroes) was only 7 percent. In addition, many middle-income countries have developed extensive duty drawback or rebate systems that allow exporting firms to obtain inputs at world prices, and avoid the impact of higher average tariffs.

Looking past average tariff levels, the structure of protection in South Africa remains problematic. The cascading pattern (high on consumer goods, moderate on intermediate goods,
low on capital goods) typical of protection in many developing countries remains evident in South Africa, with the result that less progress has been made in rationalizing effective protection, as illustrated by the continued large range and dispersion at the more disaggregated sectoral level. More importantly, while effective protection has fallen in the aggregate, it has not fallen by enough to reduce the overall anti-export bias once the role of falling export incentives is taken into account. Including export incentives, the anti-export bias (based on nominal protection/incentive rates) was estimated in 1996 at 1.32 (1.45) for the economy (manufacturing). This was an increase over the 1993 estimates (1.19 and 1.27 respectively) and is primarily a result of the phasing out (as required by the WTO) of the General Export Incentive Scheme (GEIS).\(^{18}\)

More recent analysis of trade liberalization (Fedderke and Vaze, 2000) supports the thesis that the overall impact on the structure of protection has been mixed. After calculating average effective protection rates separately for the 1988-93 and 1994-98 periods, they conclude that half of South Africa’s GDP is produced in sectors where effective protection rose between the two periods, while only 15 percent comes from sectors where protection has fallen. This suggests that although average tariffs have fallen, they have tended to fall proportionately more on inputs into production, rather than output, leading to increases in effective protection.

(b) The Employment Impact of Changing Trade Patterns

The sectoral pattern of export expansion has also attracted attention, as evidence suggests that trade liberalization and increased openness have induced a structural change in production towards capital-intensive sectors. This shift is paradoxical as the high unemployment and abundance of unskilled labor in South Africa suggest that the economy should become less capital intensive as it adapts towards the relative labor abundance.

Part of the explanation for this unusual pattern of factor use is historical. One economic legacy of apartheid is a structure of production that is fundamentally inconsistent with the country’s factor endowments, most notably in the phenomenon of high capital intensity in the presence of abundant labor. But a half dozen years after the democratic transition (and almost a decade after restructuring began) there is little evidence that this peculiar pattern is being eroded, and indeed, trends in trade and employment suggest the problem may be getting worse.

| Table 2: Structure of Manufacturing Exports by Factor Intensity |
|-----------------|-----------------|-------------|------------|-------------|-------------|
| Natural resource intensive | 24.0 | 19.6 | 25.2 | 71.0 | 8.6 |
| Unskilled labor intensive | 8.9 | 6.8 | 40.5 | 20.5 | 36.0 |
| Technology intensive | 17.5 | 15.1 | 13.1 | 3.5 | 26.9 |
| Human capital intensive | 49.5 | 58.5 | 19.3 | 4.5 | 26.5 |
| Total exports | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

\(^{18}\) The anti-export bias calculated solely on the basis of import protection showed declines for both manufacturing and the economy. These results highlight the importance of implementing other support programs for exporters to compensate for the loss of GEIS.
Lewis (2001b) presents evidence on whether the pattern of export growth reflects any movement towards trade in products in which South Africa would appear to have a comparative advantage, using a classification scheme based on the dominant factor input: agricultural or mineral-resource natural resources, unskilled labor, technology, or human capital. The resulting classification of export structure by factor intensity is counter-intuitive, especially when compared to other countries (Table 2). The results show that South Africa has a remarkably low (and declining) share of exports that use unskilled labor, and a relatively high share of exports using more skilled labor. All of the Asian economies (including a much wealthier Korea) have a higher proportion of unskilled labor-intensive exports. These results suggest that South Africa is not taking full advantage of its comparatively abundant labor supply.

These results also help explain why the manufacturing sector has not seen any major job creation despite the rapid overall growth in exports. The largest export expansion has occurred in relatively (human and physical) capital-intensive sub-sectors, and the unskilled labor-intensive category has performed poorly relative to most of the other sectors.

The longer term structural trends (Figure 2) are revealing. With the exception of the “blips” occurring during 1994-95 (which were perhaps associated with classification changes and the end of sanctions), the compositional trends are fairly steady. The pattern suggests a shift of comparative advantage as industrialization occurs: unskilled labor-intensive manufactures have fallen in relative importance, and both agriculture and mineral resource-intensive exports have also declined in importance. Trade policy has likely played an important role in these outcomes. Agricultural trade policy, for instance, long aimed at protecting and regulating the domestic market, embedding myriad regulations and an anti-export bias that discouraged production for exports and steadily increased the importance of agriculture resource-intensive
goods. With agricultural trade and market liberalization, these goods face increased competitive pressures responsible now for their declining shares.

But at another level, the results are counter-intuitive as well. With abundant unskilled labor, one would not necessarily anticipate the share of unskilled labor intensive exports to be so low, and to decline steadily during a period when unemployment rates have risen (and the number of formal sector workers has declined in absolute terms). This may in fact reflect the “inflexibility” of South African labor markets, characterized by rising real wages and increasing unemployment among lower skill groups over a longer period. Recent analysis of the impact of trade liberalization over 1972-97 using panel data for South African manufacturing sectors finds evidence that persistent labor market distortions (in the form of high wage levels) have adversely affected labor demand; trade liberalization, on the other hand, has stimulated labor demand (Fedderke, Shin, and Vaze, 2002).

The performance of the human-capital intensive sectors is also very relevant – after increasing steadily (except for the blip) until around 1996, they have since stagnated as a share of total exports. This could reflect in part the growing shortage of skilled labor, a frequently identified constraint to growth in South Africa. As early as 1993, a survey of 200 manufacturing firms consistently ranked the “shortage of skilled technical and managerial labor” extremely high in an overview of constraints; more recently, the World Bank-GJMC survey of executives from 325 large firms concluded that skills shortages were one of the most important constraints to higher growth, investment, and job creation. Rapid growth of human-capital sectors could be jeopardized unless a sizable increase in skilled labor overcomes the growing skill shortage.

(c) The Impact of Regional Trade Agreements and Globalization

In parallel with the rest of the world, there has been a proliferation of preferential trade and/or integration initiatives in southern Africa. Negotiation of a European Union (EU)-South Africa free trade agreement (FTA) was successfully completed in early 1999, but only after more than two years of difficult and contentious discussions. While the agreement should yield real benefits to the South African economy, they will be slow to emerge: the phasing in of South African access to EU markets will occur over ten years, while the reduction of South African tariffs on EU products will come over twelve years. Moreover, the EU agreement has placed strains on initiatives now underway to form a free trade area within the Southern African Development Community (SADC), of which South Africa is a prominent member, and raised questions regarding the continuing viability of the South African Customs Union (SACU) arrangement by which customs revenues are shared among South Africa and its smaller neighbors (Botswana, Lesotho, Namibia, and Swaziland). These are not the only initiatives: independent of these regional trade agreements, the SADC countries that are part of the “least developed economies” (a group which does not include South Africa) have access to EU markets under the “Everything But Arms” (EBA) Initiative, approved in February 2001, and there are tentative discussions underway regarding a SACU-NAFTA trade agreement.

The pattern of gains and losses from preferential trade arrangements between countries and over time will depend on the existing and expected trade patterns among the participants, the extent of initial trade barriers, and the speed at which protection is reduced. While much remains
uncertain about how the various agreements will be finally implemented, it is nonetheless possible to undertake a preliminary evaluation of the different alternatives. We used a multi-country, computable general equilibrium (CGE) model to analyze the impact of trade liberalization on southern African economies, starting with the impact on the EU and South Africa of the recently signed FTA between those two countries, and then considering the effects of more extensive regional liberalization: a SADC FTA, unilateral access to EU markets, or a full SADC-EU FTA.\(^2\)

In general, we expect that an FTA between economically large (EU) and small (South Africa) partners will generate asymmetric benefits, with the largest gains accruing to the smaller economy. Our empirical results support this result, as we find that the FTA has a much bigger impact on South Africa than on the EU. South African real GDP increases by 1.7 percent, whereas there are only negligible changes for the EU.\(^2\) These lopsided gains reflect differences in both trade dependence and the bilateral tariff structure. South Africa is heavily dependent on EU export markets, with 35 percent of total exports going to the EU. The dependence is especially strong for commodities such as livestock, fruits and vegetables, other agriculture, and food processing against which the EU has larger tariffs. In contrast, only 1.2 percent of EU exports go to South Africa, with the largest share at 6.0 percent in the energy and mineral sector. For the EU and South Africa, there is no trade diversion, as trade with the FTA partner and with other countries both increase; there is only relative trade creation as trade with FTA partners increases by more than trade with other countries. The FTA has only a small impact on the other (non-SACU) SADC countries. Some (Tanzania, Zimbabwe and the rest of SADC) experience slight real GDP losses, while the others (Malawi, Mozambique, and Zambia) have a slight increase in real GDP. But the losses are exceedingly small, supporting the conclusion that the EU-South Africa FTA is not a "beggar thy neighbor" agreement.

As already noted, South Africa is pursuing a number of other preferential arrangements both inside and outside the region. Using the CGE model, we evaluate several of these alternatives, beginning with ongoing efforts to establish a SADC FTA. This would essentially place South Africa at the center of a "hub and spoke" arrangement, in which South Africa is the hub and the EU and other SADC countries as a group are the spokes. The results in many respects are similar to the EU-South Africa scenario, but with a special twist: within SADC, South Africa's economic prominence makes it the "big" partner, while all of the other SADC economies are "small." So it is the smaller SADC economies that depend most on South African markets (Zambia, Malawi) that gain relatively more, while the impact on South Africa is more modest (an additional 0.5 percent increase in real GDP on top of the 1.7 percent from the EU-South Africa agreement).

It should be emphasized that our empirical results do not "predict" or "forecast" what gains the different arrangements will eventually bring. The model is somewhat stylized, and the representation of the preferential arrangements is quite crude. For example, in the EU-South Africa FTA and SADC FTA scenarios, we assume all tariffs between the different groups are immediately set to zero, rather than phased in over time and with some exclusions; we also make no attempt to capture the other dynamic effects that should be associated with such an agreements.

\(^{21}\) A more complete presentation of these results is available in Lewis, Robinson, and Thierfelder (2002).

\(^{22}\) Note that the real GDP gains for South Africa reflect an increase in employment (at the assumed fixed real wage) as well as the standard allocative efficiency gains from lower tariffs.
agreement, such as increased investment flows, changing production technologies, or skill upgrading. The results should instead be interpreted as providing a guideline to relative magnitudes and some indication of where the bigger effects will occur.

But even with this caveat, the results point to some useful conclusions about the role of liberalization and the contribution of preferential arrangements to South Africa’s growth outlook. First, South Africa benefits more from increased access to and linkage with larger international markets (especially the EU) than from increased trading opportunities within SADC, although this ignores the broader benefits that might accrue to SADC members from other forms of “deeper” integration. Second, despite its prominence within SADC, the South African economy is not large enough to serve as a growth pole for the entire region – access to EU markets and/or world markets provides substantially bigger gains for the other SADC countries than does access to South Africa.

6. LOOKING FORWARD: CHALLENGES AND PROSPECTS

Earlier sections of this paper looked at the structure and performance of the South African economy from a number of different angles: the scope and characteristics of unemployment, the structure of labor demand in the economy and the linkages among sectors, key areas in which policy interventions could encourage faster growth and job creation, and an assessment of the impact of trade and globalization on the economy.

In this final section, we pull these various perspectives together, and provide a view of South Africa’s future in which current constraints on growth are partially eased, and economic performance improves beyond current levels, allowing sustained job creation and poverty alleviation. Because the impediments and distortions in the economy are longstanding and large, they will take time to eliminate, and the benefits will accrue slowly. But as our analysis suggests, moving forward in a number of areas simultaneously can create important synergies and momentum towards a development trajectory in which South Africa’s full potential is achieved.

(a) Alternative Scenarios

In this section, we use a CGE model of South Africa as a means to explore the potential impact of policies to accelerate growth and job creation in the medium term.\(^2\) We use the model as a simulation laboratory to examine how these different combinations of policy changes and exogenous assumptions affect growth and other key macro variables. Our approach is to compare a hypothetical status quo base scenario (assuming no major policy changes or initiatives) to two alternative “reform” scenarios, using the model to decompose the factors underlying the performance differences between trajectories. Table 3 describes in more detail the assumptions made in the base scenario and each of the different experiments presented.

Looking first at a comparison of the pro-growth reform scenario with the status quo base run, the combined macro impact works through two distinct channels. First, the (assumed) increase in FDI and domestic savings leads to higher investment: from 2005 onwards, the investment/GDP share holds steady at 20 percent, up from around 16 percent in 2000. Second,

\(^2\) See Arndt and Lewis, 2000, for more details on the model and its application.
the decline in tariff protection and increased export response promotes sustained export growth, which in turn permits faster import expansion.

Table 3: Features of Alternative Scenarios

<table>
<thead>
<tr>
<th>Status quo base</th>
<th>Assumptions for 2001-2010 include:</th>
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<tbody>
<tr>
<td></td>
<td>• continued modest inflation (5-6%)</td>
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<tr>
<td></td>
<td>• steady but small real exchange depreciation (1% annually); continued low FDI inflows</td>
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<tr>
<td></td>
<td>• no major changes in government trade, labor, or investment policies</td>
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<tr>
<td></td>
<td>• labor force growth by skill reflects expected demographic impact of HIV/AIDS epidemic</td>
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<tr>
<td></td>
<td>• exogenous real wage growth of 2% for unskilled workers (slower than the historic growth rate growth of 3.5% annually from 1970-99)</td>
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<td></td>
<td>• total investment determined by sum of (domestic and foreign) savings components</td>
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<table>
<thead>
<tr>
<th>Pro-growth reforms</th>
<th>Starts from status quo base run and adds:</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>• 50 percent cut in tariff rates phased in over two years (2001-2002)</td>
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<tr>
<td></td>
<td>• improvements in trade environment increase “responsiveness” of exporting sectors</td>
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<tr>
<td></td>
<td>• privatization/investment promotion efforts attract $2b annually in net FDI inflows</td>
</tr>
<tr>
<td></td>
<td>• private domestic savings rates rise by 25% (imposed as 5% annual increments in enterprise savings rates over 5 year period)</td>
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<table>
<thead>
<tr>
<th>Pro-growth and skills/labor reforms</th>
<th>Starts from pro-growth reform run and adds:</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>• improved training leads to 1% faster annual growth in professional &amp; skilled labor groups</td>
</tr>
<tr>
<td></td>
<td>• wage subsidy &amp; increased market flexibility lowers unskilled real wage growth 1% annually (from 2% to 1%)</td>
</tr>
</tbody>
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As Figure 5.1 shows, the implication for GDP growth is a steady acceleration over the early part of the period from the fairly constant 3 percent rate achieved in the base run. This higher growth is driven primarily by the faster capital stock growth resulting from higher investment rates. Both skilled and unskilled & semi-skilled employment grow more rapidly as well, with employment in each group growing about 1 percentage point faster during the middle of the decade (1 percent faster growth in these two groups represents an extra 75,000 jobs per year). The deceleration in GDP growth that occurs in 2008-2010 reflects the projected impact of an end to “surplus” skilled labor in the economy, which (along with professional labor) becomes a scarce factor of production. Unemployment among the unskilled & semi-skilled drops faster and further than in the base run, with the unemployment rate declining from 50 percent to 44 percent (the overall unemployment rate for the economy drops by a quarter from 36 to 27 percent over the entire period).

Recognizing the importance of the skilled labor constraint that emerges towards the end of the decade, the next simulation starts from the pro-growth scenario and adds a number of changes attributable to skills accumulation and labor market reforms. First, we assume that efforts to encourage more training and faster skills accumulation are successful, so that the professional and skilled labor groups are each able to grow 1 percentage point faster over the entire period. Second, we anticipate that efforts to encourage employment through wage

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subsidies and/or wage moderation and flexibility are somewhat successful, so that (on average) the growth rate of real wages is slowed by 1 percentage point over the period.\textsuperscript{24}

These skill and labor initiatives affect economic performance through different channels than in the earlier experiment. The investment profile is virtually identical to the previous experiment, and the export and import trends are only slightly stronger. But the greater availability of highly skilled (professional) labor eases a binding constraint on the economy, and growth accelerates more rapidly, reaching 5 percent by the latter part of the decade. An increased supply of skilled labor allows the growth surge to last longer before full employment of this group is reached, so the deceleration in GDP growth occurs several years later. Finally, the effect of wage moderation on job creation for the unskilled and semi-skilled workers is sizable: by 2008, employment is growing twice as fast for these workers (150,000 new jobs a year, rather than 75,000), and the unemployment rate drops from 50 percent in 2001 to 30 percent in 2010.

(b) The Impact of HIV/AIDS

The analysis of the previous section focused on “upside” scenarios, in which different packages of institutional and policy reform would lead to higher medium-term growth and faster job creation. But there are “downside” scenarios that could be considered as well, in which external conditions (a prolonged slowdown in the OECD countries, further crises in emerging markets) or domestic events (recession, drought) impact the economy and limit Government’s

\textsuperscript{24} Note that this does not necessarily mean that real wage growth for existing workers is reduced. One percent slower growth in average wages (which is all that matters in the model) could just as easily come about by providing a 10 percent wage subsidy that is applicable to (or taken up by) 10 percent of the firms in the economy. It would be possible to represent such variations more carefully in the model, but the underlying response would be largely the same.
ability to pursue pro-growth policies. Among the downside factors, one of the most severe relates to the growing impact of the HIV/AIDS pandemic.

The epidemic has moved beyond its earlier status as a health issue to become a development issue, with social, political, and economic dimensions. The implications of the pandemic are profound for millions of families as the primary family wage earners and/or caretakers fall sick, require care, and eventually die. The pandemic has already begun to place extraordinary pressure on institutions that confront its direct effects, such as the health care system for the care of those living with AIDS and social services/systems (broadly defined) for the care of dependents of AIDS victims. But the impact will not be limited to narrow economic segments: economic growth and structure will be affected as well. Labor supply will be reduced, its skill composition altered, and its productivity cut; affected households will be forced to spend more on health expenses or caring for the sick or orphaned; firms will be forced to cope with higher benefit costs, increased hiring/training expenses, and changing markets.

![Figure 4: Impact of HIV/AIDS on GDP](image)

Given the number and complexity of the channels through which the pandemic affects the economy, a precise assessment of the impact is difficult. But some preliminary efforts have been made. Utilizing the South Africa CGE model, Arndt and Lewis (2000, 2001) analyze the potential impact of HIV/AIDS on the South African economy. In addition to declines in labor supply, they also incorporate reductions in labor productivity (due to the incidence of HIV/AIDS among workers), total factor productivity (due to increased hiring and training costs, absenteeism), shifts in household spending (towards health related expenditures), and higher government spending (partially deficit financed) on health and social services. As shown in Figure 4, the impact on GDP could be quite large: their figures suggest that total GDP could decline by as much as 19 percent by 2010, or 8 percent in per capita terms relative to a

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Demographic work summarized in two reports prepared by ING Barings (1999, 2000) estimates that, since the onset of the AIDS epidemic, more than 500,000 South Africans have died of AIDS-related causes. By 2015, this number is projected to grow by a factor of 20, to more than 10 million deaths. By 2008, overall life expectancy in South Africa is forecast to fall from its pre-epidemic high of 65 years to only 40 years.
hypothetical "no AIDS" scenario. Decomposing the total decline in GDP into the contribution of different components, they find that the direct impact of reduced labor supply accounts for only one-eighth of the total drop in GDP, while the largest impact comes from the "crowding out" of investment linked to higher health expenditures. While not definitive, these results suggest that the adverse impact of these additional effects (which were not incorporated in the reform scenarios presented) could be substantial.

Finally, it is worth considering the impact of the pandemic on unemployment. A naive analysis might forecast that the unemployment rate should fall at least relative to a "no AIDS" scenario, since after all, the growth rate of the unskilled and semi-skilled labor pool is considerably slower. But Arndt and Lewis (2001) find that, despite slower growth in the unskilled and semi-skilled labor pool, unemployment rates for this category of labor differ very little between the "AIDS" and "no AIDS" scenarios. This is partly due to the reduced overall economic growth rates: while the supply of unskilled and semi-skilled labor is smaller, the aggregate demand for labor is smaller due to the smaller size of the economy. The shifting pattern of growth also has some impact: lower investment rates translate into reduced demand for key labor-intensive sectors (such as construction) that in turn lower labor demands.

7. CONCLUSIONS

The starting point for this paper was the premise that the most pressing problem facing South Africa today is the low rate of economic growth and virtual absence of job creation, which are both crucial to progress in reducing poverty and improving living standards. We have deliberately moved away from the past emphasis on macro stabilization concerns, and instead confronted the more fundamental growth determinants. By grounding the discussion of policy options firmly in the empirical realities, we hope to make a contribution towards broader discussions about policy alternatives.

First, it remains critically important for South Africa to maintain credible and consistent macroeconomic policies. The shift in emphasis towards growth-oriented policies does not mean that macro concerns are no longer relevant. Instead, it reflects the belief that the gains from macro stability will be wasted if not matched by growth and jobs. But South Africa's growth performance since 1994 demonstrates that macro stability is not enough. Prudent fiscal and monetary policies are necessary, but certainly not sufficient, to generate sustained growth. What is needed is equal progress on the agenda of needed structural reforms that were outlined in the GEAR, but not fully addressed.

While no single sector or individual policy change can provide a "quick fix" to the growth problem, there are a number of policy areas in which change could begin to create forward progress and create further momentum for change. Given that South African investment performance remains disappointing by international standards, one imperative is the need to improve the investment climate. Targeted investment incentive schemes should be approached with caution. International evidence suggests that such schemes frequently fail to attract the expected new investment, and are often costly and result in resource misallocation. Attention would be better directed towards efforts to improve the overall business climate.

Accelerating privatization together with market liberalization can provide an important stimulus to FDI as it draws foreign firms in directly (through the purchase of assets) and
indirectly (by sending a strong signal of the Government’s continuing commitment). The SMME sector in South Africa is underdeveloped and not dynamic, apparently constrained by inadequate demand, limited access and high cost of capital, and relatively weak support and procurement programs from Government. Efforts to increase SMME access to finance and address skills shortages would appear to be especially important.

*Labor market flexibility* is often cited as a critical concern in South Africa. The evidence on unemployment and remuneration trends seems to confirm that job creation among the unskilled and semi-skilled labor force has been constrained by rising real wages. Recent efforts to introduce modest changes in labor legislation to offset “unintended” employment consequences have proven contentious, and illustrate the difficulties in reforming labor market institutions and practices. But initiatives to enhance flexibility and market efficiency must be continued, if the steady growth in unemployment is to be reversed. Attention should perhaps focus on introducing greater wage flexibility for special groups (youth, high-unemployment areas) and reconsidering plans to extend minimum wage levels to currently uncovered groups.

While improved “flexibility” would no doubt expand employment, it will not be enough. Efforts must also be made to *augment the skills base* of the labor force, to improve their employability and productivity. Existing training schemes are a start, but are inadequate in scale, and focus more on upgrading the skills of those already employed rather than providing skills to the unemployed. More resources and more aggressive efforts need to focus on enhancing the “employability” of the unemployed. *Employment subsidies* could provide another means to encourage job creation. While there are administrative difficulties inherent in designing schemes that subsidize only new jobs (rather than existing ones), these difficulties can be minimized, and these schemes can be large enough to have an impact while still remaining affordable.

With evidence suggesting that the trade liberalization is incomplete, and that the pace has slowed in recent years, consideration should be given to embarking on a *phased program of tariff reforms* that would continue the progress made during the early liberalization period. Such a program should *bring down average rates* (given that South Africa does not compare all that favorably with its competitors) and also *reduce the number of different rates* from its current high level (nearly 50) to no more than a half dozen (as promised in its WTO offer). The ongoing trend towards *preferential trade agreements* (both within and beyond Africa) generates clear gains to South Africa and the other SADC economies, but there are also clear limits to the gains that can be achieved from increased regional trade: South Africa gains more from free trade with the EU than it will from a SADC free trade area.

Forward-looking scenarios suggest that a *pro-growth reform scenario* (that includes tariff reform, improvements in the export incentive environment, successful privatization/investment promotion, and successful encouragement of domestic investment) could increase GDP growth rates by 1 percentage point (from current 3 percent levels), increase job creation, and lead to a more rapid decline in the unemployment rate, although the results suggest that the duration of the growth surge could be curtailed if the skills shortage is not addressed. A second *pro-growth and skills accumulation/labor reform scenario* (which starts from the reform scenario and adds faster skills accumulation, and wage subsidy/market flexibility initiatives that slow the growth in real wages) would have an even bigger impact. Growth would accelerate even more (to 5 percent annually), faster skill accumulation would alleviate the slowdown, and the unemployment rate for the lower skilled groups would decline from 50 percent to 30 percent over the next decade.
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