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Structural Transformation, Competition and Economic Power[1]

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South Africa has failed to transform its economy towards the higher productivity and more sophisticated products and services required for economic development. In fact, the structure of the economy in 2018 is much too similar to that inherited in 1994.[3] Recent debates on changing this path have tended to separate questions of ownership and control from those of concentration and economic structure. There is great danger in this separation as economic outcomes are a product of interlinked decisions about the 'rules of the game' by which markets work. Changing ownership without ensuring more dynamic and inclusive markets is not a sustainable strategy.

Central to the linked issues of structural transformation and competition is the recognition that parties will inevitably have different degrees of market power.[4] This, in turn, is influenced by a range of factors, including those related to incumbency, which reflect broader patterns of economic power. Understanding the nature of this power and how it can be leveraged is important for fostering dynamic competition that leads to investment in R&D, new business models and products, including critically on the part of local black entrepreneurs. The Competition Amendment Bill published on 1 December 2017 proposes important changes to the legislation to address concerns about the effectiveness of the authorities in dealing with anti-competitive conduct; however, these changes need to be part of a much broader package of measures to open-up the economy.

Source: Udo J Kepler, Puck

A 1904 cartoon showing the control that monopolies such as Standard Oil had over both the economy and different levels of government in the USA, around the time that authorities moved to open up the economy to competitors, hence the White House is not under the control of the octopus.

Structural transformation and competition

Structural transformation involves moving factors of production (capital and labour) to activities with higher

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[3] Black, A., Craig, S. & Dunne, P. (2016). Capital intensity, industrial policy and employment in the South African manufacturing sector. REDI3x3 Working paper 23. Available here.

[4] See Roberts, S. (2017). Assessing the record on competition enforcement against anti-competitive practices and implications for inclusive growth, REDI 3x3 Working Paper 27. Available here.

levels of productivity.[5] This includes improvements within sectors to upgrade activities and shifts across sectors to those which are more dynamic and value-adding. However, South Africa, as with most African countries, has seen backwards moves with poor overall productivity performance, low investment levels and employment growth in low value services.[6]

South Africa's economy continues to be heavily reliant on minerals and resource-based industries, which together accounted for 60% of total merchandise exports, in 2016. Diversified manufacturing sub-sectors (which excludes basic metals, petroleum and chemicals) have performed poorly over the last two and a half decades, with very few exceptions, such as motor vehicles. Furthermore, as in other countries, the services sector in South Africa accounts for a growing share of economic activity. However, this growth is in low value services rather than high productivity services such as in design, research and engineering. South Africa has also performed poorly relative to its upper middle-income counterparts in terms of accumulation of technological capabilities. In 2015, high technology exports accounted for only 6% of South Africa's manufacturing exports compared to Thailand's 21% and Malaysia's 43%.[7]

High levels of market concentration and barriers to the entry and growth of rivals are part of the explanation for the disappointing performance of the South African economy.[8] Rivals bring new products and business models, and spur incumbents to invest in improving their own offerings. Powerful incumbents can block rivals through various strategies and are also able to lobby for policies and regulations which make it more difficult for challenger firms. The industrial structure thus goes along with low levels of effective competition and poor productivity.

Capital-intensive industries such as basic chemicals and basic metals are, by nature, more concentrated as they have substantial economies of scale. Furthermore, in services such as telecommunications, finance, energy and healthcare, network and scale effects mean that the markets are concentrated and there are substantial first-mover advantages. In sectors such as these, regulation is required to discipline market power, including to ensure interoperability and access to essential facilities for entrants.[9]

Market power means that firms, acting unilaterally or collectively in cartels, can extract high prices (supra-competitive rents) from buyers because the buyers do not have good alternatives. These high prices are not related to the costs of production nor are a reasonable reward for investment, effort or innovation. The power to levy such prices is simply a return to incumbency. Indeed, there have been a large number of competition cases in South Africa relating to insiders exploiting their market power through cartels, as well as cases of excessive pricing.[10] The downstream customers that are charged higher prices are often diverse businesses looking to use the materials as inputs and tend to be more labour-absorbing as well as involved in manufacturing sophisticated differentiated products. The exertion of substantial market power upstream can thus hinder structural transformation.

Where the buyers are firms in potentially more productive and dynamic sectors it can stall economic growth and undermine employment. For example, high data prices in telecoms are a substantial handicap on entrepreneurs looking to develop and sell digital applications.[11] A comparison of data prices in the 6 leading economies in Africa revealed that South African prices are relatively high. The cheapest 1GB package in South Africa is over 633% higher than the cheapest package from among the 6 leading economies in Africa (Egypt), and 150% higher than the second most expensive (Kenya).[12] South African prices are also relatively expensive when compared with other SADC countries. The cheapest 1GB data package in South Africa is 281% more expensive than the cheapest 1GB package in the region (Mozambique).

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[5] See McMillan, M. & Headey, D., 2014. Understanding Structural Transformation in Africa. *World Development,* Volume 63, pp. 1-10.; Rodrik, D., 2016. An African growth miracle? *Journal of African Economies,* pp. 1-18.; and McMillan, M., Rodrik, D. & Verduzco-Gallo, I., 2014. Globalization, Structural Change, and Productivity Growth, with an Update on Africa. *World Development,* Volume 63, pp. 11-32.

[6] Industrial Development Think Tank. 2018. Structural Transformation in South Africa: Moving towards a smart, open economy for all. Forthcoming CCRED working paper.

[7] Industrial Development Think Tank. 2018. Structural Transformation in South Africa: Moving towards a smart, open economy for all. Forthcoming CCRED working paper.

[8] On some measures concentration is increasing, and has been accompanied by low levels of investment (see Bosiu, T, Goga, S. and Roberts, S. (2017) 'Concentration, profits and investment: Let's focus on the structure of the economy, not "cash hoarding"', IDTT Policy Brief 1, CCRED.

[9] Das Nair, R. and S. Roberts (2017) 'Competition and regulation interface in energy, telecommunications and transport in South Africa', in in Klaaren, J., Roberts, S and Valodia, I., *Competition law and economic regulation: addressing market power in Southern Africa*, Wits University Press.

[10] See Muzata, G., S. Roberts and T. Vilakazi 'Penalties and Settlements for South African Cartels: An Economic Review', and das Nair, R., and P. Mondliwa 'Excessive pricing under the spotlight: what Is a competitive price', in Klaaren, J., Roberts, S and Valodia, I., (2017) *Competition law and economic regulation: addressing market power in Southern Africa*, Wits University Press.

[11] World Bank. 2016. South Africa Economic Update: Promoting faster and poverty alleviation through competition. Available here

[12] Other countries that were compared are Tanzania, Ghana, and Nigeria. See full comparison here

Evidence also shows that high fertilizer and cement prices charged by cartels across southern Africa raised the costs of construction and agricultural production.[13]

Economic power and competition

Economic power extends much further than simply the power to charge high prices to customers in a given market. We need to consider how firms maintain their positions, and the ways in which they lobby to protect themselves from challengers.

For firms to overcome entry barriers and become effective competitors, they need to simultaneously overcome a number of challenges, in each of which incumbents may be able to block them. In practice, there are a range of barriers to entry relating to the ability to reach consumers which are not well appreciated, Firms need be able to build brands and to reach consumers. ,. Studies of consumer behaviour have highlighted the importance of perceptions and brand awareness, as well as consumers' reluctance to switch to new suppliers.[14] In network industries, there are substantial advantages to being the first major business to build a membership base and control the economic infrastructure and key facilities.[15]

Supply of goods and services requires investment in internal capabilities and learning-by-doing. In addition, linkages to key input suppliers and customers in the value chain have to be built, especially where coordination is required to design new and improved products. Incumbents may well be vertically integrated meaning rivals are competing with firms on which they rely for key inputs. Long-term 'patient' finance is crucial given the time required for firms to build their productive capabilities. For example, it took companies such as Capitec and Fruit and Veg City around a decade before they became effective rivals.[16]

Concerted action is therefore required across different fronts to alter the economic landscape. Finance obviously matters, but providing development finance without addressing the other barriers to effective entry is likely to be a waste of money. The existence of critical infrastructure and facilities, along with network effects, are rationales for regulation, while effective competition enforcement is necessary where dominant firms can use their market power to exclude rivals, such as through loyalty rebates and exclusive contracts.

Influential large businesses are also able to lobby strongly for regulatory regimes which are in their interests. In other words, economic power also works in the way the rules of the game are crafted. For example, in the liquid fuel industry, the major oil companies have long had a regulatory regime which favoured their control over key infrastructure such as off-loading facilities at ports, storage and access to pipelines. In telecommunications, Telkom has persuaded policymakers to support its privileged position in the name of extending access. In pay TV there has been similarly strong lobbying to obtain rules which hinder potential rivals. In beer distribution and retail, SAB-Miller (now ABInbev) headed off changes to the Liquor Act which would have opened up distribution, although some concessions were subsequently granted as part of obtaining merger approval.

Industrial policies, including access to development finance, incentives, and procurement all have a major influence on the playing field and who is effectively able to play. In addition, there are important related policies such as electricity pricing, mining rights and port charges which have differentiated between firms and sectors, skewing the markets. There are good potential reasons for differentiation, however, it is also the case that incumbents have an intrinsic advantage in lobbying for favourable treatment, as they are engaged in economic activity and employ people whose jobs they can argue may be at risk if their treatment is not continued. By comparison, the potential growth areas and firms within them are on the back foot. They have to posit an alternative world which would exist if the structure of prices and incentives changed.

It is evident that competition, with more competitors and dynamic rivalry in improved products and services, requires changing the rules of the game. This requires positing a different path, based on an alternative vision, which depends on government leadership of the 'regulatory state'. In the absence of this leadership the economic power of incumbents reinforces strong path dependency effects. On the other hand, if the rules which exclude many from participating in the economy are not changed, the danger is that the rules will be ignored as people look at other ways to access rents. This is one way of understanding the recent history and narratives of 'state capture' in South Africa.

Agenda

[13] Vilakazi, T. and S. Roberts, (2018), 'Cartels as 'fraud'? Collusion in southern Africa in fertilizer and cement', Review of African Political Economy, forthcoming.
14 Hawthorne, R., Mondliwa, P., Paremoer, T. and Robb, G. (2016). Competition, barriers to entry and inclusive growth: Telecommunications sector study. CCRED working Paper 2016/2. Available here.
15 Hawthorne, et al (2016).
[16] Makhaya, T. and Nhundu, N. 2015. Competition Barriers to Entry and Inclusive Growth: Capitec Case Study, CCRED Working Paper 2015/12. Available here; and das Nair, R. and Dube, S. 2015. Competition Barriers to Entry and Inclusive Growth: Case study on Fruit and Veg City, CCRED working paper 2015/9. Available here.

Though discussions in the public space tend to separate issues of structural transformation, competition, and ownership and control, in reality these issues are interconnected. Discussions that seek to elevate one of the issues over the others risks missing important relationships and arriving at misleading policy prescriptions. For example, small business support in the absence of addressing the power of incumbents is setting up small firms to fail. It also misses the importance of whether the incumbents themselves are competing and improving capabilities and productivity, or whether they are colluding to protect profits and ensure a 'quiet life'.

The entrenched structure of the South African economy means that meaningful steps to increase ownership and control by previously disadvantaged individuals in the economy must address barriers to the entry and growth of black entrepreneurs. This requires a package of measures to tackle abuse of market power in upstream industries, change regulations to open up markets, and effective support for capabilities development including through finance and skills. Such a package can contribute towards transforming the structure of the economy.

The Competition Amendment Bill takes steps to address these issues, however it is important to note that competition enforcement alone cannot address the levels of concentration in the economy. The track record shows that though the competition authorities have penalised cartels and prosecuted unilateral conduct, this has not necessarily led to increased participation or more effective competition. For example, the Competition Commission uncovered a cement cartel in 2012 and implicated firms were prosecuted and ordered to stop the cartel. However, it was the entry of Sephaku in 2013/2014 that led to more vigorous competition and, as a result, prices fell by 25%.[17] It is important to note that Sephaku's entry was facilitated by the "use it or lose it" provision in mining laws, whereby, Sephaku was sold limestone mining rights by Anglo American.[18] This illustrates the need for a competition policy that is broader than competition law enforcement and encompasses a set of coordinated policies that set the rules of the game in favour of creating effective competitive rivalry and which opens up the economy to wider economic participation.

We propose a positive agenda for competition policy that includes the following:

- Changing the ex-ante 'rules of the game' in many areas of economic regulation to favour entrants and ensure that incumbents can be effectively challenged. Steps taken in fuel and gas should be built on to allow independent suppliers access to key facilities. In telecommunications, the allocation of spectrum must take into account fostering greater rivalry, while local governments can open up ducts and poles to rival providers. In finance, regulations to support mobile money and branchless banking will widen opportunities. Measures should also include soft regulation such as codes of conduct for supermarket chains.

- More effective ex-post enforcement against anticompetitive conduct which excludes smaller rivals. The Competition Amendment Bill published on 1 December 2017 includes important proposed changes to the legislation in this regard. While it is welcome in strengthening enforcement, it needs to be part of a much broader package of competition policy measures. These measures need to shape the competition process, to reward investment, innovation, creativity and effort rather than incumbency.

- Proactive enabling measures to support rivals, especially black entrepreneurs. This includes a development finance fund (built up from competition penalties), which can take high levels of risk in financing entrants and smaller rivals. Development finance should also consider the different levels of the value chain (as the IDC has begun to do). In a number of value chains success is dependent on playing in more than one level of the value chain. Complementary measures are required at local government level to configure space and open up critical infrastructure to rivals.

The technological changes associated with the '4th industrial revolution' make an integrated strategy even more imperative and urgent. These technologies bring about opportunities to reduce barriers, in certain activities. For example, the use of f internet platforms to reach consumers, locally and internationally is an alternative route to market than traditional retail which entrants struggle to access.

The '4th'industrial revolution also allows local firms to readily access international technological capabilities. The emerging business models together with the new technologies allow for shorter production runs, with design to meet niche demands, which enables firms to compete without achieving large-scale production. However, these changes also mean higher demands in

[17] Roberts, S. 2017. Competition law prescriptions and competitive outcomes: insights from Southern and East Africa. CCRED Working Paper 14/2017.

[18] Vilakazi, T. and Roberts, S. (2018).

terms of know-how. Network effects are also heightened by the importance of consumer information for competitiveness which means firms with a large consumer base have big incumbency advantages.