CCRED — CENTRE FOR COMPETITION REGULATION AND ECONOMIC DEVELOPMENT

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Recommendations for Structural Transformation and job creation in South Africa: Towards a Smart, Open Economy for All[1]

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Countries develop by changing the structure of the economy to move from sectors of low to high productivity and complexity, and within sectors through upgrading to higher value-added activities. This is a process of structural transformation. South Africa has, however, not made significant progress in transforming its economy in this way and has prematurely de-industrialised. At the same time, the economy remains highly concentrated and unequal.

The studies undertaken by the Industrial Development Think Tank (IDTT) into key sectors of the economy (metals & machinery, agro-processing and automotive) along with the cross-cutting analysis identified: key challenges for a new development path; an over-arching agenda for re-industrialisation; and, specific recommendations in each of the sectors studied.

Key challenges for new development path

Limited collaboration for 'learning' and building capabilities: The process of adopting and adapting technology requires learning and investment in capability-building in a number of related activities. Extensive company and industry-level analyses make it clear that achieving competitiveness is about understanding value chains and building clusters to address collective challenges in productive capabilities at different levels of the chain. In South Africa there have been very few effective cluster initiatives in the areas where structural transformation is required, such as in Metals, Machinery and Equipment industries. Furthermore, co-ordination with other areas, notably public procurement, has been lacking in design and especially in implementation.

Lack of coherence between technology and industrial policies: The lack of coherence between skills development policy and industrial policy means that firms often privatise the necessary training which merits public provision, which implies a bias against smaller firms. Furthermore, government's technology policy and industrial policy are fragmented and ineffective in working together towards industrialisation. While the fourth industrial revolution brings opportunities, there is a question around how to create an environment for smaller firms to participate in the changes, with the risk that technology advancements leave South African firms even further behind.

Over-reliance on competition law enforcement for making markets work: Understanding competition issues through the value chain is critical for industrial policy, since industrial policy interventions at one point of the value chain may result in sub-optimal outcomes in another point of the value chain. For example, the study of agro-processing demonstrates the central role of supermarkets in routes to market for food producers. However, competition law enforcement does not create competition in the face of barriers to entry, as the competition authorities only address the conduct of existing businesses. The proposed amendments to the Competition Act, published in 2017, provide for market enquiries, which broadens the scope of the competition authorities to enable proactive interventions.

Design, co-ordination and implementation of policy instruments: In order for government incentives and other support measures to have a wider impact on the

[1] The policy brief draws from industry studies done under the Industrial Development Think Thank (IDTT). https://www.competition.org.za/overview/ To better understand the challenges of industrialisation, the Industrial Development Think Tank (IDTT) was established in 2017 at the University of Johannesburg. The IDTT is housed in the Centre for Competition, Regulation and Economic Development, in partnership with the SARChI Chair in Industrial Development, and supported by the Department of Trade and Industry (DTI).

economy, it is necessary that incentive packages are designed with robust conditionalities. Incentives should be carefully designed, taking the roles of various government departments into account. The record has been of inconsistencies across government department and conditionalities not being applied.

Poor coordination between macro policy and industrial policy: Managing the exchange rate to ensure exports are competitive has been a key pillar of industrial policy of industrialising countries. South Africa's monetary policy of inflation targeting, however, has at times resulted in significant exchange rate over-valuation and import penetration. The uncertainty around the exchange rate, as well as its level, has proved a major deterrent to investment in tradable goods and services. As far as fiscal policy is concerned, the focus has been to reduce the government deficit, with the underlying assumption that the private sector will lead if the role for government is reduced. Instead, the effect has been to undermine public sector investment while the public-sector wage bill has continued to grow.

Agenda for re-industrialisation

The key priorities for a re-industrialisation agenda are:

(a) Building broad coalition for reindustrialisation

South Africa's course for reindustrialisation and inclusive growth needs to be based on a broad coalition which focuses on productive investment and widening economic participation. The narrow coalition of elites, buttressed by higher government salaries and social grants for important constituents has undermined investment and reinforced rather than changed the existing structure of economic power. Reindustrialisation requires public investment to provide effective public transport and education for economic activity, alongside long-term private investment and entrepreneurship.

(b) A plan for industrialisation, consolidating fragmented government structures

South Africa needs to commit to an integration of industrial policy with overall economic planning, based on an understanding of sectoral dynamics and opportunities, and taking land, water and energy into account. Experience from other countries highlights that this is politically-led and that lessons learnt along the way need to be incorporated in an iterative process. Improving the capacity of public institutions and holding them accountable to the core priorities is essential, rather than a plethora of different objectives and growing number of different bodies.

(c) Pursuing regional opportunities

The most important market for much of South Africa's diversified products and services is in the wider southern African region, although it is losing market share in a number of products. Partly this reflects the lack of commitment to a regional vision. South Africa's reindustrialisation must therefore be in line with the Southern African Development Community's (SADC) regional industrial development strategy, which seeks to *jointly* uplift the economies in the region. Regional value chains are crucial, for instance, in the mining capital equipment sector. In agriculture, as South Africa moves to higher value products it needs to import more staple foodstuffs which should be from the region. In the context of climate change, it is important to recognise that the great majority of water resources in SADC are not being used effectively and, in periods when South Africa is experiencing drought conditions, it could take advantage of the ample rainfall in the countries to the north west by supporting agriculture in these countries, importing staple foods, and ensuring a more competitive regional agro-processing sector.

(d) Incentivising investment in capabilities development

The "fourth industrial revolution" is sharply bringing into focus the role of technology in moving countries forward. While the apartheid government heavily supported innovation and industrial development in organisations related to its own national objectives (military, food security, energy), the intent of post-apartheid governments has been to support a more broad-based innovation strategy. Technology is, however, embodied in investment, and the low level of investment in the economy therefore goes hand in hand with poor technological improvements.

Incentives, technology change and development finance therefore all need to work together along with cluster initiatives at the local level. Incentive programmes should include conditionalities to ensure that there are wider benefits to the economy and care needs to be taken to avoid creating/entrenching firm dominance. Cluster initiatives are critical for skills transfer and technology development, to support firms to pool resources, create economies of scale and develop supplier markets.

(e) A stronger competition policy

The South African economy requires a broader competition policy, as part of industrial policy, which facilitates the entry and expansion of businesses, and reduces barriers to entry. In addition to noting concentration, the industry studies point to the importance of understanding vertical integration in some value chains and the need to have coordinated interventions at the different levels in order to support entry. This needs to be coupled with development finance to enable the investment in capabilities and learning necessary to grow efficient businesses. Effective regulation for competition and entry is an important aspect, especially in sectors where there are strong network effects such as telecommunications. Local government policies are also crucial for opening-up opportunities for rival businesses such as in the ways in which retail space is configured. The analysis of barriers to entry has further highlighted the importance of access to markets for rivals, such as can be captured in a possible 'supermarkets code' where retailers commit to open-up shelf space to smaller businesses and engage in supplier development initiatives.

(f) Reforming macroeconomic policy for industrialisation

A review of macroeconomic policy must be undertaken to ensure the long-term management of natural resource earnings, consider the appropriate exchange rate, take into account the causes of inflation and dis-incentivise volatile capital flows. Fiscal policies need to prioritise longer-term investment.

Recommendations for Metals, Machinery & Equipment

The Metals, Machinery and Equipment industries have seen a hollowing out of capabilities and jobs, and increased imports in the downstream, more diversified industries. This was mainly as a result of failure to manage resource earnings during the commodity boom years to ensure the exchange rate was not over-valued, and to invest in downstream capabilities. Various forms of continued support for the upstream basic metals sectors has also contributed to this trend. The strong growth in machinery exports into the SADC region suggests considerable potential.

- Learn from past policy mistakes regarding support to the steel industry which was provided after the low point in the steel price cycle and continued after it was required, at the expense of downstream steel users. Rather than having piecemeal agreements for individual value chains and upstream protection which raises costs for downstream manufacturing, introduce a Resource Rent Tax mechanism which provides relief during price downturns in exchange for capping windfall profits during price booms.
- Use available instruments in the mining licence regime to support downstream production including provisions stopping discrimination against local buyers of minerals and products made from the minerals.
- Finalise the mining charter: This will provide certainty for firms in the mineral processing sector as the changes in ownership and local content have a direct impact on the investment and/or relocation decisions by firms.
- Effective competition policy that disciplines conduct of dominant firms, especially upstream heavy industries.
- Reignite domestic demand through state procurement, including effective review of compliance. Make it much more difficult for bidders of government procurement contracts to receive exemptions and ensure that there is a credible threat of sanction in the case of non-adherence. The capacity and funding process for verification needs to be clarified.
- Make the downstream sectors more competitive by reducing cost of electricity for high energy using firms that are supplied by municipalities. DTI to work with NERSA and the metropolitan municipalities to develop an explicit "foundry friendly" tariff applicable to all foundries regardless of where they are located that reduces electricity costs for foundries to, or near to, Eskom levels.
- Review scrap pricing measures: Foundries face high material inputs costs, due to import parity pricing practices of upstream firms and the high export prices targeted by scrap metal merchants. The Price Preference System for scrap metal needs to be improved to make it more effective and limit the scope for abuse, to provide quality scrap to foundries at a developmental price, such as through an export tax.
- Improve development finance for machinery & equipment, foundry and metals fabrication. This needs to include finance for a foundry recapitalisation programme for investment in new machinery and technology in foundries that do not necessarily qualify for support from the "IDC Downstream Steel Industry Competitiveness Fund".
- Provide better access to export finance for the capital equipment sector. This is necessary since other countries are already providing favourable export finance to their companies.
- Formulate regional strategy for machinery & equipment including building network of institutions for skills and technology to build regional clusters and value chains, in industry-led initiatives.[2] There

[2] Such as South African Mineral Processing Cluster, Valves & Actuators Manufacturing Cluster as well as the Casting, Forging and Machining Cluster.

needs to be committed long-term support for machinery and equipment clusters which is grounded in partnerships at the local level, between firms and with local institutions engaged in training, research and testing and certification.

Recommendations for Automotives & Components

The auto industry represents South Africa's single most important industry policy intervention. It has been partly successful with some important gains but also serious failings. The industry continues to run a significant trade deficit while local content remains relatively low. As such, South Africa has not developed the capabilities to match those of more sophisticated auto hubs in countries such as Thailand. The design of the incentive system favours the multinational vehicle exporters by allowing import rebates and has resulted in significant downstream import penetration, with tier 2 and 3 producers increasingly isolated from vehicle manufacturers.

- Policy instruments refined to secure stronger developmental outcomes, particularly in respect of localisation, associated black economic empowerment, and employment creation. The period from 2021 to 2024 represents a key opportunity to review the impact of the revised APDP to the realization of the auto masterplan.[3] It is critical that performance through Key Performance Indicators (KPIs) is monitored and that individual OEM contributions to the targets set are closely evaluated.
- Correct APDP distortions post-2020 to focus on its excessive import bias, and on ensuring APDP benefits earned are correlated with industry localisation levels. The two critical elements in this regard relate to the correction of the ad valorem import bias and the replacement of the VAA with a Volume Assembly Localisation Allowance (VALA) that is based solely on localisation levels.
- Address the EU-SA EPA that permits the duty-free importation of 1000cc and smaller engine EU-sourced vehicles into South Africa, which has a potentially major negative impact on the future of the automotive industry, and hence the effectiveness of the APDP post-2020. Substantial growth in domestic market demand is anticipated for vehicles of less than 1000cc.

Recommendations for Agriculture & Agro-processing

Structural transformation within agriculture involves the application of industrial processes to move production to higher value agricultural products, as well as to build capabilities in processing. This includes the logistics required for delivery of fresh goods to supermarket shelves around the world (the 'industrialisation of freshness'). To understand the performance of the agriculture and food value chains, including the linkages and the role of policies, three areas were examined in detail, namely, fruit, sugar and dairy.

Fruit: Fruit received little support under apartheid and until recently was not the focus of industrial policy. However, South Africa has made notable strides in moving production to higher value fruits, with fruit exports now accounting for the largest share of agriculture exports. The sector thus demonstrates the potential for structural transformation and significant potential for job creation. South Africa's performance is, however, far behind that of countries such as Chile and Peru, especially in terms of accessing high growth Asian markets.

The participation of smaller farmers in high value fruit exports has been limited by inadequate infrastructure, particularly ripening facilities, transport and logistics, pack-houses and cold storage facilities. Furthermore, stringent import regulations in developed markets (import tariffs, import permits and sanitary and phytosanitary standards) constitute key barriers to trade in fresh fruit, worsened by lack of harmonisation between multiple private standards, and between private standards and official standards.

- Support investments in productive capabilities: Deepening and broadening structural transformation of the fruit sector requires supporting investments along the value chain in productive capabilities. This includes: (i) investments in pack-houses, cold chain facilities, transport and logistics; (ii) linking smaller farmers to international buyers, and negotiating market access; and (iii) lowering the costs of meeting standards and certification. The IPAP and APAP aim to address certain key constraints in the value chain.[4]
- Build capabilities through partnering: Government can incentivise producer-exporting companies in niche, high value agricultural products (such as

[3] Recommendations made for the post-2020 period could play a critical role in correcting existing APDP deficiencies and fostering alignment between national automotive policy and the objectives of the SAAM through to 2035.

[4] There are initiatives such as the AgriParks programme launched in 2015 and the Strategic Infrastructure Project 11 by the Departments of Rural Development and Land Reform, and Agriculture, Forestry and Fisheries that aim to promote growth of smallholder farmers by providing key infrastructure and marketing support to emerging and marginalised farmers. However, these plans are yet to be implemented and small farmers continue to be excluded from supply chains. There is also limited capacity and skills in government to provide support and regulatory services throughout the value chain to the point where the fruit is ready for export markets (Chisoro-Dube, Paremoer, Jahari and Kilama, 2018).

berries and avocados) to partner with smallholder producers. Large companies can extend technical services and information on production and standards to small farmers in return for tax breaks from government, subsidies for investments in storage and cold chain facilities, or assistance with raising capital.

- Government working more effectively across departments and with industry bodies. The Departments of Trade and Industry, Rural Development and Land Reform, and Agriculture, Forestry and Fisheries are all working to improve access to markets for fruit producers. There is a need to work closely together with the industry associations, which have focused on improving market access and has been successful in finding new markets.

Sugar: The sugar industry had substantial support under apartheid and is the only sizable agricultural sub-sector to maintain a system of protection and regulation. Value-adding activities are in downstream processing in which competitiveness depends in part on the price of sugar. Growth in value added confectionary products has been constrained by skewed support for cane-growing and milling, thus limiting growth at the downstream level. The current domestic pricing mechanism and benefits of protection at the upstream level do not ensure that downstream levels of the value chain have access to competitively priced input sugar.

- Changes to the regulatory framework: The regulatory framework that affects the upstream level needs to be amended in order to achieve competitive input sugar prices for downstream confectionery producers.

Dairy: The dairy sub-sector was liberalised in 1996 and has undergone consolidation with much fewer farms and higher levels of productivity. There are opportunities for entry of small-scale players in niche value-added products, but high levels of concentration and market power have limited the growth of small and new entrants. There is some indication of structural transformation in the sector. This can be attributed to increased demand for milk-based products and the significant presence of South African retailers in the region sourcing these products from South Africa. However, due to significant capital requirements, the behaviour of incumbent firms and capabilities required in the sector, small-scale farmers and processors have not been able to take advantage of the growth in the demand for processed dairy products.

- Invest in capabilities: In order for small players to actively participate in dairy value chains, significant investments in capabilities and infrastructure (such as cold chain technologies) are required. There are opportunities particularly in further downstream processing levels where barriers to entry and scale requirements are relatively lower, such as in cheeses and yoghurts. Supporting new entrants at these levels of the dairy sector can therefore contribute to structural transformation.

Cross-cutting recommendations

There are cross-cutting interventions that can potentially benefit all three of these value chains.

- Improve access to retail to open-up routes to market for farmers and food processors, given the expansion of supermarkets in the southern African region.[5] The development of focused supplier development programmes, and codes of conduct which guide the relationship between suppliers and supermarkets, are important to develop supplier capabilities and to ensure the sustainability of suppliers.[6] The production of house brands for major supermarkets as well as allocating a certain proportion of shelf space to SMEs are also ways in which small-scale processors can access supermarket shelves.
- Develop capabilities: Support in developing technical capabilities to take advantage of the growth in global demand for fresh fruit, dairy and confectionery products, including training, skills and technical knowledge.
- Ensure effective competition policy: There needs to be continued and greater effort to incorporate black industrialists into concentrated agricultural value chains who can access competitively priced inputs and access routes to market. There is thus an important role for policy in ensuring that the exertion of market power does not hinder growth of smaller players in these value chains.

Coordination and alignment of incentives across government departments, especially the programmes which exist under DAFF and under DTI, including development finance from Land Bank and the IDC. The ability of small firms to enter and grow in these value chains is highly dependent on the support received in terms of development finance, amongst other factors. There is a need for the provision of patient capital with concessionary interest rates for longer-term investment.

[5] The DTI's Agro-processing Supplier Development Programme (Industrial Policy Action Plan 2017/18-2019/20) aims to do this by integrating smallholder farmers into supply chains through increasing procurement of smallholder farmers' produce by large retailers and processors.
[6] Both these initiatives have been introduced in IPAP 2017/18.