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Rewriting the rules governing the South African Economy: A new political settlement for industrial development[1]

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The South African economy has prematurely de-industrialised with low investment and a shrinking manufacturing sector in relative terms. This is especially so in more sophisticated activities, as reflected in the undiversified export basket.[3] The economy is also characterised by high levels of concentration and barriers to entry and expansion. While profits have been high, investment levels have been low.

The success or failure of countries to drive economic development can be understood in terms of whether the political settlement, or governing coalition of interests, supports the growth of diversified manufacturing sectors with higher levels of productivity.[4] Understanding the evolving political settlement is crucial to understand why policies that work in some contexts or countries are not adopted or implemented successfully in others, as well as how powerful groups influence specific institutions and policies.[5]

Markets are shaped by laws, regulations, and institutions. This set of formal and informal rules matters as it determines how the economy grows, and who shares in the benefits of that prosperity.[6] It is possible to trace which powerful groups have influenced policies by analysing the interests that have been served by the policies. Recent research by the Industrial Development Think Tank explores the political economy of South

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[3] Bell et al (2018).
[4] Khan, M. & Blankenburg, S. (2009). The Political Economy of Industrial Policy in Asia and Latin America. In: G. Dosi & M. Cimoli, eds. *Industrial Policy and Development.* Oxford: Oxford University Press, pp. 336-377.
[5] Khan, M. H. (2017). Political Settlements and the Analysis of Institutions. *African Affairs*, 1-20.
[6] Stiglitz, J. E. (2015). *Rewriting the rules of the American economy: An agenda for growth and shared prosperity*. WW Norton & Company.

Africa's industrial development, highlighted in this policy brief.[7]

The 1994 compromises – too many concessions?

The compromises reached in in 1994 meant that the economic structure was left intact, in effect, protecting white ownership of wealth and privileged employment positions for at least five years in exchange for improvements in labour rights. This was premised on growth by established businesses. The major changes adopted were liberalisation of trade and capital flows, deregulation of agricultural markets and moves towards privatisation. These choices effectively de-prioritised redistribution and inclusion.

The compromises reflected the strength of big business interests.[8] The ANC-led government sought to discipline business rents through liberalisation, competition from imports and the new competition law which was passed in 1998. At the same time, macroeconomic policy emphasised 'stability' and cutting the fiscal deficit, with monetary policy attempting to target the money supply to control inflation. This was despite alternatives that were on the table including the 'framework for macroeconomic policy in South Africa' put forward by the ANC's Macroeconomic Research Group (MERG), which emphasised an initial public investment-led approach for the 1990s and sustained growth in 2000s underpinned by supply side industrial policy interventions to alter the development trajectory.[9]

The small economic recovery from 1994 was unsurprising given the uncertainty of the political negotiations and violence leading up to 1994. However, it is now clear that it did not presage broader and sustained economic growth and employment generation. Indeed, the austerity under the Growth, Employment and Redistribution (GEAR) programme undermined longer-term structural transformation.

Subsequent assessments of the effect of early trade liberalisation have found that the benefactors were those firms that were already internationally competitive in 1994.[10] In addition, the competition law had had relatively weak abuse of dominance provisions, meaning incumbent's conduct was not effectively constrained, even while the Act included public interest conditions in mergers.[11]

The 2000s - the more things change the more they stay the same

In the 2000s, under President Mbeki, there were strong elements of continuity. In effect, the political settlement reached in 1994 remained largely intact in terms of the balance of power and the institutional arrangements, albeit with some important additions.[12] The benefits of liberalisation and open markets continued to be proclaimed along with the importance of macroeconomic stability. Incentives were expanded under industrial policy to encourage 'knowledge-intensive' activities and advanced manufacturing technologies. Higher levels of investment were expected from business in response. However, there was no understanding of the relationship between the economic structure and investment in capabilities and instead deindustrialisation continued as downstream and diversified manufacturing performed poorly.[13]

With the commodities boom driven by Chinese demand, coupled with domestic consumer credit extension and investment for the World Cup, the economy grew even while cheap imports on the back of the strong Rand hollowed-out local manufacturing. At the same time, the need to bridge the gap between South Africa's 'two economies' meant social grants were increased along with greater spending by government and parastatals on extending basic services.

The approach to Black Economic Empowerment (BEE) reflected this attempt to straddle divergent realities as business committed to voluntary charters with weak

[7] Bell et al (2018).

[8] The first Minister of Finance under democracy was banker Chris Liebenberg, while Chris Stals was retained as governor of the Reserve Bank.

[9] Macroeconomic Research Group. (1993). *Making democracy work: a framework for macroeconomic policy in South Africa: a report to members of the Democratic Movement of South Africa*. University of Western Cape, Centre for Development Studies. See Habib, A., & Padayachee, V. (2000). Economic policy and power relations in South Africa's transition to democracy. *World Development*, *28*(2), 245-263 for a discussion of the contestation of ideas during the transition period.

[10] Aghion, P., Fedderke, J., Howitt, P., & Viegi, N. (2013). Testing creative destruction in an opening economy. *Economics of Transition*, *21*(3), 419-450.

[11] Roberts, S. (2016). An Agenda for Opening up the South African Economy: Lessons from Studies of Barriers to Entry. CCRED Policy Brief.

[12] See Khan, M. (2010). Political settlements and the governance of growth-enhancing institutions. [Online] Available: https://eprints.soas.ac.uk/9968 (Accessed 14 March 2018); Khan (2017) and Behuria, P., Buur, L., & Gray, H., 2017. Studying political settlements in Africa. African Affairs, 116(464), pp. 508–525 for a discussion of political settlements and industrial policy.

[13] Machaka & Roberts (2003).

monitoring and an absence of enforcement.[14] In effect, white business interests offered ownership stakes, mainly to the political elite and connected persons. BEE therefore reinforced the existing economic structure and left black shareholders in debt to their white business partners and needing to ensure the flow of profits was maintained. Large businesses successfully lobbied government not to implement structural changes that would create opportunities for entrants, including black entrepreneurs, in exchange for firms creating BEE initiatives that effectively reinforced their position as gate keepers in the economy.[15]

The interests served by this policy platform included the large corporations which internationalised and the financial sector which grew rapidly. These firms were able to maintain high profits without necessarily investing in improving productivity and capabilities. Evidence of this came to light when the work of the competition authorities showed that the South African economy was extensively cartelised. From about 2008 the Commission uncovered cartels in a wide range of sectors including infrastructure, intermediate products and food.

Earnings increased for professionals such as lawyers and accountants, as well as for high-skill occupations more generally. The impact of the commodities boom and strong currency meant that imported goods became cheaper and that salaries were higher in international currency terms, further fuelling consumption but undermining companies' competitiveness.

Much of semi- and unskilled labour, the informally employed and unemployed were progressively excluded. While popular protests grew, these were suppressed through policing, and social grants were substantially expanded to ameliorate the short-term effects of de-industrialisation.[16] While the global financial crisis revealed the failings of unfettered finance, the pervasive reach of cartels demonstrated the problems with liberalised markets.[17] Economic power is evidently rooted in the historical control of wealth and resources, especially given the very limited productive transformation since apartheid, something South Africa has shared with other post-colonial African states.[18]

The South African middle class has benefitted from maintaining the status quo. This has included infrastructure spending to improve transport for car owners and commuter rail for the middle class in Gauteng, over and above the benefits from higher earnings for the public sector employees and certain professionals. This includes the expansion of the M1 highway between Pretoria and Johannesburg and the Gautrain investment. Though the M1 highway was meant to be funded through tolls on a user pays basis there has been a large-scale refusal to pay. The Gautrain is also heavily subsidised at around R60 per trip with the total subsidy a year amounting to R1.5 billion or 20% of Gauteng Roads and Transport budget in 2018/19.[19] By comparison, upgrading of PRASA rail services for low income communities has been stuck.

2008 onwards - it's our time eat

The distance from popular sentiment of an increasingly authoritarian government was revealed when Jacob Zuma won the leadership of the ANC in 2007 and effectively removed President Mbeki in 2008, with the support of COSATU and other groupings on the left inside the ANC. However, instead of a progressive economic policy agenda to engage with the country's development challenges, under President Zuma an increasingly clientelistic political settlement emerged. This included vertical fragmentation of control within the ANC as extractive rents were competed over from local to national levels of government and in state-owned corporations.[20] The message was that the market economy was rigged against the majority and so the only way to accumulate was through leveraging state influence. For a time, public sector trade unions were kept onside by higher public wage settlements for government employees, while industrial unions fractured and ultimately left COSATU. The public wage premium increased during this period and this together with the expansion of public sector employment increased the public wage bill, diverting funds away from other expenditure items such as investment in

[14] Ponte, S., Roberts, S. & van Sittert, L. (2007). 'Black Economic Empowerment', Business and the State in South Africa. *Development and Change,* 38(5), pp. 933-955.
[15] Roberts (2016).
[16] Runciman, C. (2017). 'South African social movements in the neoliberal age' In: Paret, M., Runciman, C. & Sinwell, L. (eds). *Southern Resistance in Critical Perspective: The Politics of Protest in South Africa's Contentious Democracy.* 2017. Abingdon: Routledge.
[17] Muzata, T., Roberts, S. & Vilakazi, T. (2017). Penalties and settlements for South African cartels: An economic review. In: J. Klaaren, S. Roberts & I. Valodia, eds. *Competition Law and Economic Regulation.* Johannesburg: Wits University Press, pp. 13-37.
[18] see also Behuria, P., Buur, L., & Gray, H. (2017). Studying political settlements in Africa. *African Affairs*, 116(464), pp. 508–525
[19] http://www.gauteng.gov.za/government/departments/provincial-treasury/Budget%20Information/Budget%20English%20Insert%202018.pdf
[20] Makhaya and Roberts (2014); Public Protector (2016); Bhorat et al. (2017).

public infrastructure.[21] This was the case even while the delivery of services by the state deteriorated and protests increased across the country.[22]

The impact of the clientelistic political settlement on industrial policy was profound as conflictual stances were taken across government on a host of policy areas of central importance for industrialisation, such as energy, mining and procurement policies. Levers such as local procurement were employed for short-term rent capture across government. As a result, there were missed opportunities for building local capabilities in a number of areas including machinery component manufacturing from the Transnet procurement process.[23]

A proliferation of departments made co-ordination of policy almost impossible, in any event. It is important to recognise that, while apparently not aligned with the governing coalition, large businesses in finance and non-traded services continued to make high levels of profits and further internationalised.

Leveraging the economic power

The political settlement has in many instances further entrenched the market power of large firms to the detriment of rivalry required to spur productivity, innovation and accumulation of capabilities. The market power of companies allows them to extract profits which are not related to the investments, effort and innovation being made.

In the case of the upstream basic steel producers, the change of ownership of the main companies, such that the South African operations became small parts of transnational corporations (TNC), reduced the transparency of the businesses and weakened the power of the national government.[24] The change was meant to bring transfer of technology and know-how, but in practice it appears as if a short-term view was adopted with extraction of profits in the good years but relatively little investment. The TNC ownership of the main basic steel producers also potentially makes transfer pricing easier, portraying a misleading picture of the profitability of the local operations. At the same time, the downstream businesses using steel as an input are diverse and less able to represent their interests to government.

The levers which could have been used by the South African government, including energy and minerals policies, were undermined by the fragmentation of the state. The division of responsibilities into many different departments under different ministers meant that corporate interests could lobby them separately and make a coordinated approach unlikely. It is difficult otherwise to understand why the provisions in the standard mining rights which stipulate that there should not be discrimination against local buyers compared to export customers, for the minerals and also for products manufactured from the minerals., have not been enforced. Similarly, the very advantageous energy pricing arrangements for the capital-intensive basic metals and chemicals industries were not used as a basis for conditions to prevent harm to local businesses through exploitation of market power. The separation of development finance, competition and trade from industrial policy further increased the co-ordination requirements across government. Procurement as an industrial policy lever has also foundered on lack of commitment to implementation. Instead, as widely documented, there has been extensive rent capture.

An important question is why so little attention has been paid to the more sophisticated and diversified downstream machinery and equipment sector in comparison with basic iron and steel and, the auto sector. Economic power relates not only to the relative influence of different interests in decisions on a specific issue but also to which issues are prioritised and get onto the policy agenda in the first place. The influence of the automotive original equipment manufacturers (OEMs) has ensured their interests have been high on the agenda in some ways at the expense of localisation of component manufacturing linked to the domestic machinery and equipment industry.[25] As noted above, machinery and equipment requires local as well as national interventions to change the development path and build diversified capabilities.

In the agro-processing sector there was a turn away from the historically-favoured constituency of white

[21] Bhorat, H., Naidoo, K., Oosthuizen, M. and Pillay, K. South Africa: Demographic, employment, and wage trends in Bhorat, H. & Tarp, F. (eds) (2016) Africa's Lions: Growth Traps and Opportunities for Six African Economies. Washington DC: Brookings Institution Press.
[22] Runciman (2017).
[23]Crompton, R. Fessehaie, J., Kaziboni, L. and Zengeni, T. (2017). Railway Locomotives and Transnet: A Case Study. CCRED Working Paper 2017/9.
[24] Rustomjee, Z., Kaziboni, L. & Steuart, I. (2018). Structural transformation along metals, machinery and equipment value chain – developing capabilities in the metals and machinery segments. CCRED Working Paper.
[25] Black, A., Barnes, J., & Monaco, L. (2018). Structural Transformation in the Auto Sector: Industrial Policy, State-Business Bargaining and Supply Chain Development. CCRED Working Paper

grain farmers. Reform in agriculture (outside sugar) brought a harsh restructuring, as marginal maize farmers went under, with consequent employment losses. The main failure has been to craft a constructive framework for building alternative agricultural value chains, for high value crops and for greater processing. The successes which have been realised in citrus and nuts have not been as a result of concerted policy support and demonstrate what could have been attained, earlier and on a larger scale.[26]

In the agenda and actions of the state, the interests of workers and businesses in diversified industry have not been given importance while the lobbying of the industries which prospered under apartheid have meant they have been able to continue to hold sway. Contests have largely been over the division of existing rents rather than how to create new rents. This has been true of the framing of BEE in terms of ownership in existing businesses. The issues of 'state capture' have also focused on existing rents. Without crafting a new political settlement, in which the interests of longer-term investment in capabilities have a prime position, it is difficult to see a different path being taken. Breaking-down barriers to entry and growth is one side of such a settlement, new investment is the other side of this new coin.

Building the broad coalition for reindustrialisation

South Africa's course for re-industrialisation 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 distribution of economic power. Re-industrialisation requires public investment to provide effective public transport and education for economic activity, alongside long-term private investment (on new productive assets rather than acquisitions and consolidation) and entrepreneurship.

The creation of jobs and livelihoods is a priority for avoiding further unravelling of the social fabric. President Cyril Ramaphosa is in the process of forging a "new social pact" between government, business and labour. The previous pact benefitted the insiders, with emphasis on wealth 'trickling down', but this did not drive industrial development. Though the current political settlement has accommodated the black middle class to an extent including through public sector jobs, the burden of a 'black tax' is a constant reminder that things need to change. Higher earnings for a minority of the black population is not sustainable.

What should the new deal for real economic transformation encompass? The new political settlement for industrialisation must focus on productive investment and widening economic participation. The "new deal" needs to speak to the aspirations of black workers and entrepreneurs, in supporting skills and capabilities upgrading and meaningful participation in the economy.

It must reach and sustain a shared and binding commitment which, through broad-based investment and meaningful participation by the marginalised majority, will lead to a reversal of the growing inequality in wealth. The settlement needs agreement around the expectations of large firms, rewarding long-term domestic fixed investment, innovation and dynamic competitive rivalry with effective government policies regarding infrastructure, procurement, skills development, technology and opening regional and international markets. This includes ensuring that there are effective conditions placed on the rents that are created or maintained in the process of supporting devlopment, and that the implementation of these conditions are monitored and regularly reported. It must be captured in a national agenda, which is designed and delivered locally, where people have a strong sense of identity, and a stake in the outcomes.

[26] Chisoro-Dube, S., das Nair, R., Nkhonjera, M. & Tempia, N. (2018). Structural transformation in agriculture and agro-processing value chains. CCRED Working Paper.