FM Cover Story

Growth

NO SACRED COWS

Achieving 6% economic growth will require bold thinking and political courage

The need to accelerate economic growth to create jobs and reduce poverty is the single greatest imperative facing SA. But without much bolder and more urgent action to raise the level of investment, competitiveness, education and skills development, rapid growth will continue to elude the country.

The most crucial ingredient is political commitment. President Thabo Mbeki demonstrated his at the cabinet *lekgotla* last weekend by creating a high-powered team to draft an economic blueprint on how to ramp up SA's growth rate to 6%.

But the challenge remains daunting.

Six percent is the magic rate economists believe needs to be achieved if SA is to dent unemployment. Narrowly defined, unemployment afflicts 26% of the economically active population, or 4,4m people.

Government's growth, employment & redistribution (Gear) strategy lifted growth from nearly zero in the early 1990s to an average of 3% over the past five years. This year, thanks to a favourable global climate and robust consumer spending, the economy is on track to achieve 4% growth.

Many economists believe that SA is on a structurally higher growth path capable of delivering average annual growth of around 4%, and possibly higher, for the next three to five years.

But this isn't enough to meet government's target of halving unemployment by 2014, says Miriam Altman, executive director of the Human Sciences Research Council. To do that, the private sector alone needs to generate 500 000 jobs a year – which can be done only if average annual growth of 6% is achieved for the next 10 years.

So, in Mbeki's words: "What must we do to encourage growth?"

The question is focusing minds in government nicely: the department of trade & industry (DTI) is drawing up targeted sector strategies and incentives; the department of education is looking into recruiting foreign maths and science teachers; the treasury, department of public enterprises and presidency are focused on raising levels of public investment; and the department of public service and administration is finally getting a grip on the appalling vacancy rates in departments and municipalities.

All this will culminate in a 6% plan to be drafted by a team led by deputy president Phumzile Mlambo-Ngcuka – which is to be at least in draft form by September, when finance minister Trevor Manuel tables his medium-term budget policy statement.

Some elements of the strategy are obvious, Mbeki said after the *lekgotla*, referring to government's relatively new focus on infrastructure investment and its microeconomic reform strategy, geared towards lowering input costs for business. Other elements are still to be finalised by the task team. And Mbeki wants it to add a new ingredient – incentives for specially targeted sectors.

But will this be enough? Not quite.

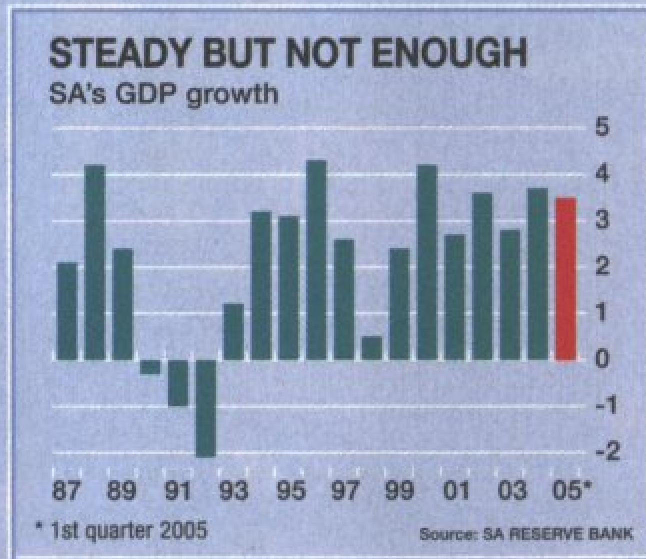
A more comprehensive strategy would go beyond government's present thinking. This is set out in a 10-point plan (see table) which the *FM* believes needs to be implemented if the 6% target is to be met.

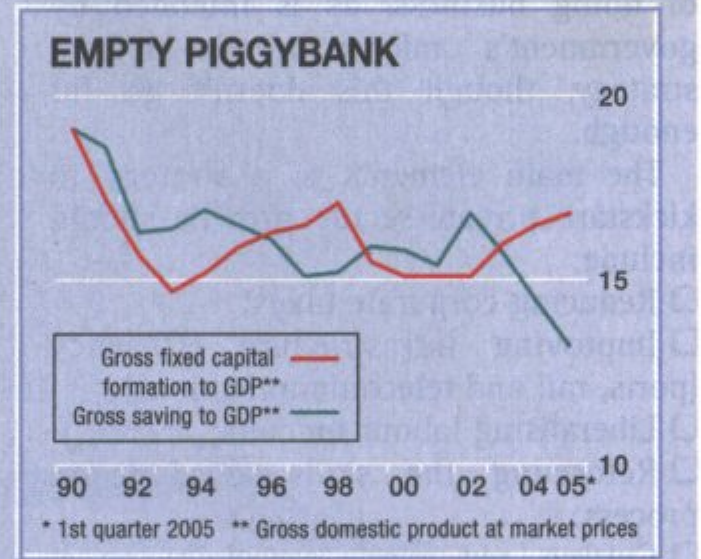
There is growing consensus in the public and private sectors that investment is key to accelerated growth. Fixed investment needs to reach 25% of GDP for growth to lift off, but despite new commitments from government the ratio last year stood at only 16,8%.

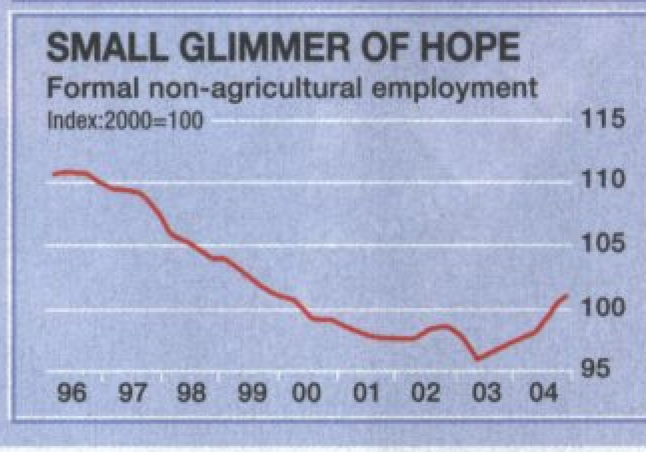
Public investment, which slowed after the mid-1980s and finally collapsed in the late 1990s, is lagging way behind target. Reserve Bank figures show that over the past four years the private sector has contributed 75% of all new capital formation in the country, hence Mbeki's comment after the *lekgotla* that "the private sector has been increasing

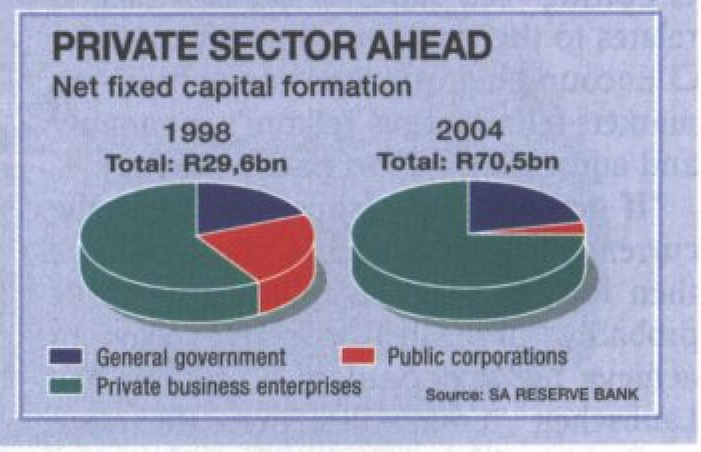
10 STEPS TO FASTER GROWTH:

- Increase government investment
- Tackle government lack of capacity
- Liberalise labour markets
- Plug skills gap (train or import) and stem brain drain
- Fix education system
- Cut red tape
- Pick winners through sectoral policy
- Cut corporate taxes
- Reduce input costs
- Raise the savings rate









its rate of investment quite significantly ... We need to be looking at what government should be doing to increase its contribution ..."

But one of the biggest constraints on investment is the poor state of the state itself.

Its R180bn investment programme has yet to be implemented, with the exception of Eskom's refurbishment of three power plants. But expertise in huge projects is "not as abundant as it used to be", warns a government official.

In a sobering critique of government's second economy programmes, the "2005 Development Report" released earlier this month by the Human Sciences Research Council, Development Bank of Southern Africa and the UN Development Programme, said government "appeared incapable of effecting the shift away from welfare towards development" and that most of its interventions tended to "fall well short of what might be hoped of them".

Another sure sign that there is a problem with government's capital spending was the R2bn underspend of the municipal infrastructure grant, which funds capital projects at municipal level, in the past financial year.

With the political will to spend and the funds all lined up, slow public investment comes down to poor government capacity – the inability to plan and implement capital projects within a reasonable amount of time.

The state's lack of capacity, a problem of many years, has now become a burning priority – not only because the poor are running out of patience, but also because it has become clear that there is a strong link between state capacity and attracting investment.

Economist Iraj Abedian, CEO of consultancy Pan African Advisory Services, says state capacity is the single most important factor constraining growth.

"Our macroeconomic constraints are all but gone. The next phase of development has to be at local economic level. Anyone who invests, invests not in SA in general but in a local area with a local authority. If that local government is not up to speed or can't plan for electricity or traffic for the next 10 years or takes an awful long time to make decisions, then the rate of return is affected," he says.

Related to weak state capacity is the skills crisis – number two on Abedian's list of constraints on growth. SA's mismatched skills profile – large numbers of unemployable people, including graduates, and large numbers of vacancies (Abedian estimates vacancies to be in the region of 500 000) – means that even if funds for investment are available, the right people to work in the enterprises are not.

First National Bank chief economist Cees Bruggemans also believes this is SA's Achille's heel. "The key ... lies in productivity growth," he states in his book *Change of Pace: SA's Economic Revival*, and the biggest bottleneck still lies ahead: a shortage of skilled labour.

Skills shortages bite worst in the public sector, as the private sector tends to win the competition for scarce human resources. Mbeki said the state's poor capacity was due largely to the skills deficit. An audit of the capacity of municipal managers in one province, he said, rated their skills at 1,6 on a scale where 1 was poor and 4 excellent.

Nowhere is the skills deficit clearer than in the schools – the incubators of essential basic skills. The poor quality of school and further education is what lies behind the skills mismatch. Augmenting skills where so few exist in the first place is impossible and Mbeki's frank statement that "we are not going to find the people we need in SA society" indicates that, after much vacillation, getting skilled people from other countries will now be considered a critical part of building a 6% growth platform.

Mbeki used the example of engineers at local government level, but also under consideration is bringing in maths and science teachers – perhaps from Eastern Europe or Iran – to improve the quality of basic education, and information technology skills from India.

Another brake on fixed investment has been low domestic savings. Foreign borrowing and foreign investment can make up the domestic shortfall in the short term, but SA cannot escape the necessity of raising domestic savings to sustain higher growth in the long term.

This will be an uphill battle. SA's savings rate is at its lowest level in history – 13,2% of GDP. Gear indicated that SA's aggregate savings rate (corporate, household and government savings) would have to rise above 20% of GDP to support annual average growth of more than 4%.

To raise the savings rate, government must stop dissaving (financing current expenditure out of loans). Throughout the 1990s, government subtracted 2,6% from the national savings rate on average each year by spending more on recurrent expenditure than it earned. This trend has to be reversed.

Government could also boost household savings by reducing income taxes while raising consumption taxes (Vat) and by scrapping the tax on retirement funds.

Given the constraints on public-sector delivery, the obvious way to ignite the economy is to fuel the private-sector growth engine. This calls for a much greater commitment to reducing the cost of doing business, as is intended by government's microeconomic reform strategy, though this doesn't go far enough.

The main elements of a strategy to kickstart private-sector growth should include:

❑ Reducing corporate taxes;
❑ Improving infrastructure efficiency (ports, rail and telecommunications);
❑ Liberalising labour markets;
❑ Reforming the skills development process;
❑ Cutting red tape (especially as it relates to the small business sector); and
❑ Encouraging greater competition in markets (eliminating Telkom's monopoly and addressing import parity pricing).

"If government wishes to cement the current buoyant mood in the economy, then lowering the company tax rate is probably the most effective way to achieve it," says Sanlam economist Jac Laubscher. "Companies that are more profitable will invest more and employ more people."

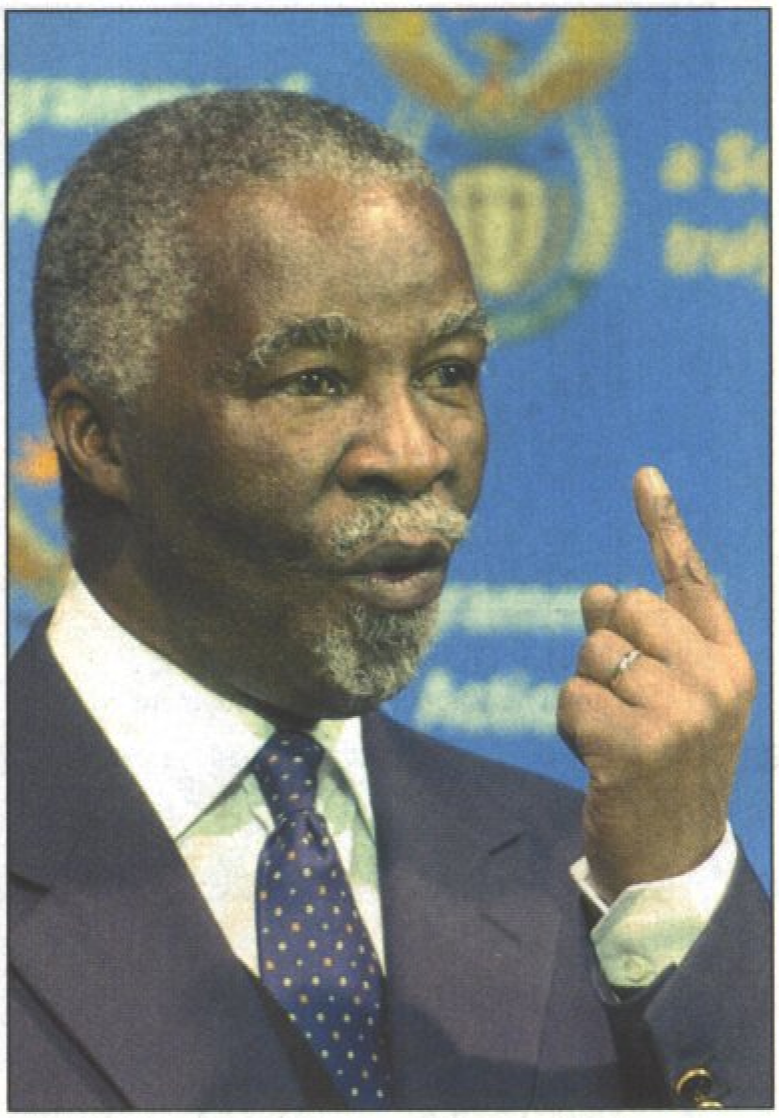
Economists were disappointed that government failed to reduce corporate taxes by more than one percentage point, from 30% to 29%, in this year's budget. SA's generally accepted average tax rate is about 34%. So even after the tax cut, SA is still out of line with emerging-market competitors such as Malaysia (28%) and Russia (24%). Ireland's is 12,5%.

Chamber of Mines chief economist Roger Baxter calls on government to commit itself to multiyear tax reductions, as many of our competitors are doing, aiming for a corporate tax rate of closer to 25% and phasing out the 12,5% secondary tax on companies.

"It is not enough to equalise SA's corporate tax rates; they must be lower than our competitors' if we want sustained, high levels of investment in the economy," he argues.

Baxter also believes that if government wants to generate growth and employment it has to take bold, decisive action to stimulate (supply-side) investment to generate a manufacturing export boom, because this is the engine of job creation.

It is common cause that SA desperately needs more balanced growth. Over the past 18 months, growth has been driven by a (demand-side) consumer spending boom. Though household spending is expected to stay strong in 2005, it should begin to taper off next year (*Economy & Markets* page 35).



Thabo Mbeki Showed political will

This implies that the kind of jobs growth SA has enjoyed over the past year may not be sustainable. The export industries need to recover and employment growth to become more entrenched.

Mbeki acknowledged this last weekend when he said that one of the tasks of the committee under Mlambo-Ngcuka was to "identify key sectors for investment". It's a sure sign that supply-side incentives – so frowned upon by the Washington consensus of the 1990s – are another part of the 6% package.

The outcome is likely to be targeting a maximum of four sectors for special attention and government incentives. For the past few years, the DTI has been working on the basis of 12 priority sectors, which include tourism, chemicals, autos and agro-processing. The list will be honed down to three or four, says DTI deputy director-general Lionel October. Business process outsourcing (BPO) will be a certainty.

"The criteria include areas that are growing globally or that are labour-intensive themselves or have labour-intensive linkages downstream," says October.

Government is said to be ready to put R100m-R200m into BPO and has already lined up private investment.

The most contentious policy shift is the injunction for a more liberalised labour market to raise SA's productivity. The problem is not that labour is paid too much, but that it is relatively unproductive and this raises the cost of doing business.

According to the UN Industrial Development Organisation, for every US$1 of labour bought in SA's manufacturing industry, there is $2 worth of value added. In Ireland, this figure is $5,30, in Brazil it is $5,00 and in Malaysia $4,80.

The reasons include the legacy of apartheid education, parochial industrial policy, poor levels of competition in key markets and poor management practices.

The IMF's 2004 country report took serious issue with SA's slow pace of labour market reform, noting that "rigidities, skills deficiencies and relatively high costs in the labour market continue to impede efforts to achieve a significant reduction in unemployment".

It predicted that SA was poised for a recovery and could grow at 5%/year for the next five years if current policies were accelerated. But it warned that if the status quo prevailed, growth of 3%/year was more likely.

Mbeki's aims on the labour market remain limited to small business. There can be little doubt anymore that government plans to do away with the extension of centralised bargaining to small business. This particular provision of the Labour Relations Act is singled out time and again by Mbeki as a threat to the part of the economy government would most like to nurture – small and medium enterprises. Other changes to labour law affecting small business are also likely but will depend on the review being carried out trade & industry minister Mandisi Mpahlwa.

Institutional changes to government's assistance to small business, including access to finance for micro enterprises, have recently been completed and government has come to realise that the regulatory environment – especially rules related to labour and taxation – is the biggest obstacle to growth here.

Labour market reform is unlikely to go any further, for the moment, than some form of relief to small enterprises.

This is not enough. As long as skill levels remain low and labour market rigidities persist, firms will favour labour-saving technologies and unemployment will remain high.

If government is able to take bolder steps to enhance the economy's competitiveness, then its 6% growth ambition need not remain a pipe dream.

Claire Bisseker and Carol Paton