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Addressing structural change issues in the context of South Africa's political dispensation

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Summary

The current structure of South Africa's economy is partly a product of the terms of the country's political dispensation. The availability of capital mobility as an exit option is a key aspect of South Africa's negotiated democracy. As long as inequality remains high, capital continues to gravitate towards sectors emendable for expedient capital mobility such as finance. Promoting manufacturing investment in a high inequality environment may require tailor-made policy innovations that are compatible with existing political constraints. Such policies include weaving industry-specific property rights provisions with the industrial policy framework and creating a sizable political constituency for industry-led development.

I. Introduction

Structural change – as defined by the long-term reallocation of resources from low to high return sectors of the economy – remains a major preoccupation of policy-makers in South Africa. This concern is predicated on the fact that the share of the industry sector in the economy has declined substantially over the past 30 years. In a study examining the sectoral structure of the South African economy, Johannes Fedderke (2014) shows that South Africa compares unfavourably with a great majority of 16 emerging economies in terms of the growth of the industry sector. Considering that the manufacturing sector is key to generating the kind of jobs the South African economy needs to put a dent in the stubbornly high unemployment rate, the lack of vitality in that particular sector proves rather worrisome. In this policy brief, I highlight the political origins of the structural imbalances of the South African economy and argue for policy innovations that might help ameliorate the situation.

The central argument in this brief is based on the in-depth theoretical and historical analysis conducted in Bedasso (2014). To have a fuller understanding of the current structure of the South African economy, one may have to examine the nature of the political transition in 1994. I argue that democratization was attained with the threat of capital flight providing a guarantee for the economic elites against extreme redistribution. This was complemented by the prospect of moderate inequality in income and human capital to be realized in subsequent periods. As far as the terms of this political settlement are concerned, the economic elites in South Africa will continue to invest in areas that are amenable to capital mobility. This will be specially the case as long as income inequality remains high.

This brief makes the case for including institutional innovations targeted at the protection of property rights in the manufacturing sector in the mix of instruments of industrial policy in South Africa. Through its positive effect on growth and employment, such strategy is expected to dynamically modify the terms of the political settlement to a long-run equilibrium that fosters stability and innovation.

II. Approaches and Results

a. Research methods

In order to understand the nature of a political economy equilibrium following a regime transition, it is useful to first build a logically sound model of the transition itself. Therefore, in Bedasso (2014), I present a theoretical model of democratization using a simple game-theoretic framework. At the same time, I put together a series of narratives based on the political and economic history of South Africa since the beginning of the 20th century. Then I inspect the narratives with respect to the theoretical propositions generated by the model to come up with a logically consistent explanation for the political transition in 1994. One can readily infer from the analysis in the paper the type of economic structure that the political settlement in South African may entail.

b. Theoretical predictions

The likelihood of transitioning from non-democracy to democracy is a function of income inequality. The more unequal a non-democracy is, the more incentives the citizens have to push for democratization. However, if inequality exceeds a certain threshold, the elites will have too much to lose to concede political power to the citizens. Bedasso (2014) attempts to offer a more accurate model of the democratic transition in South Africa by introducing capital flight as an exit option to the canonical model of democratization formulated by Acemoglu and Robinson (2001). The new framework maintains that the costs of revolution and repression are important determinants of the choice between repression and redistribution under non-democracy. However, once full democratization is considered by the elites as a third option, the composition of the portfolio of the elites in terms of mobile and immobile assets becomes an important factor determining whether democratization is a potentially viable outcome. If the structure of the economy is such that most of the wealth of the elites, including their human capital, is mobile, democracy will be bedeviled by capital flight and elite exodus. Conversely, if wealth is largely immobile, even a highly redistributive democracy will be tolerated although it is less likely that it would be instituted in the first place. If the degree of wealth mobility is somewhere between the above two extremes, the threat of capital flight may be used as means of obtaining tax concessions, and therefore instituting a negotiated democracy. However, the willingness of the majority to offer tax concessions is not automatic. It depends on the joint effect of two factors: the proportion of mobile wealth and initial inequality. Accordingly, the amount of wealth that would be left behind in case of elite exit should be small enough for tax concession to be offered by the poor in democracy. Moreover, inequality should be sufficiently low for the majority to concede lower taxes. This is because even a small amount of wealth that would be left behind after capital flight could be too tempting for the majority to offer tax concession when the median-voter is extremely poor.

The above theoretical predictions lead to the following empirical expectations:

- Moderate ratio of mobile assets – including physical and human capital – is likely to result in a negotiated democracy.
- Inequality should be low enough for a negotiated democracy to remain economically stable.
- The elites will have an incentive to maintain a reasonable degree of capital mobility under democracy as long as inequality remains high.

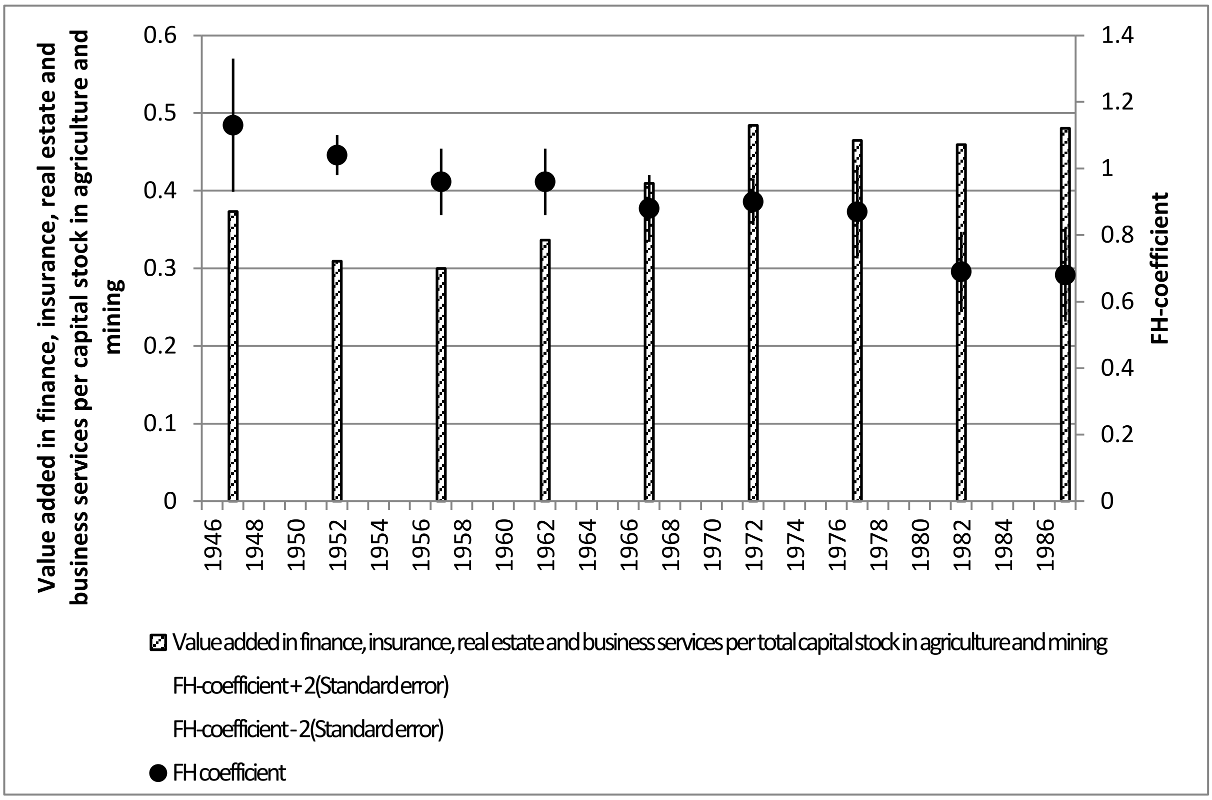
c. Empirical evidence

South Africa's history indicates that the stage for the emergence of democracy was already being set in the 1970s due to the rising cost of repression and higher probability of revolution. The cost of repression is embodied in the ex-post loss of foreign direct investment and intensifying sanctions. The likelihood of revolution, on the other hand, can be proxied by the schooling of the African population which increased substantially in the 1970s. However, democratization could not have been inevitable until the wealth of the white (particularly, the Afrikaner) population became more diversified, gaining further potential for international mobility. This development was bolstered by the emergence of a global environment in the 1980s and 1990s that was more conducive to capital mobility. Fig. 1 shows that capital became considerably more mobile across national borders in the 1980s compared to, particularly, the 1940s when Apartheid was instituted. I use the Feldstein-Horioka (FH) coefficient of capital mobility provided in Taylor (1996) as an indicator of the conduciveness of the external environment for capital mobility. The lower the FH coefficient, the more conducive is the global environment for capital mobility.[1] Additionally, fig. 1

[1] The set of coefficients I use in this paper are estimated using cross-sectional data from 12 countries that are

plots the ratio of the value-added of the Finance, Insurance, Real Estate and Business Services (FIRBES) sectors to the total fixed capital stock tied up in the traditional sectors of agriculture and mining. This ratio is meant as a proxy for the mobile portion of capital in the South African economy. The relative importance of FIREBS began to increase substantially in the 1960s. Given mining was still a major part of the economy, however, capital mobility was not high enough to threaten mass withdrawal. Moreover, income and human capital inequalities were showing a sign of decline in the 1980s, suggesting that an African majority would be willing to offer certain concessions after democratization.[2]

Fig. 1: The potential for international capital mobility in the lead-up to the political transition in South Africa



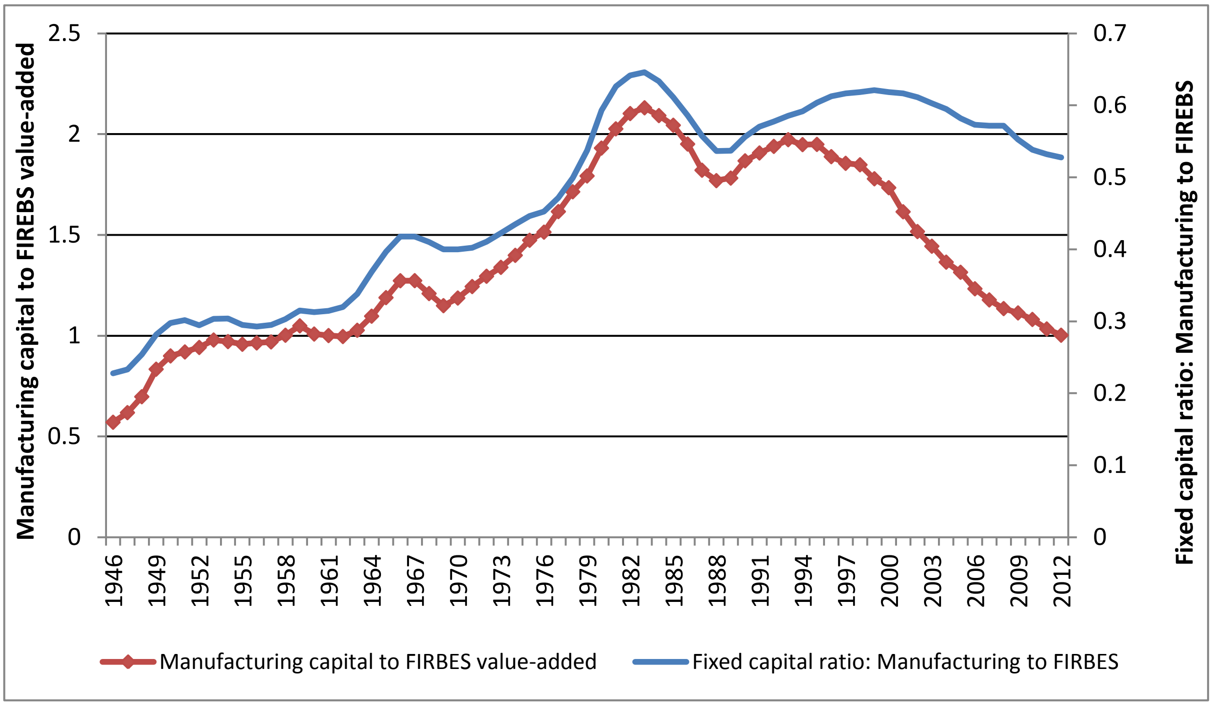
The above analysis shows that capital mobility can be considered an essential part of the democratic bargain in South Africa. Although manufacturing capital is not as immobile as agricultural land or mineral deposits, it might not be as portable as investment in the tertiary sector, especially in finance. Therefore, one cannot expect the relative value of investment in the manufacturing sector in South Africa to increase significantly given the nature of the political settlement and the persistently high income inequality. Fig. 2 shows the ratio of fixed capital stock in manufacturing to the fixed capital stock in FIREBS. The steady increase in the relative value of the capital stock in manufacturing that was registered in the 1960s and 1970s when South Africa was industrializing has been halted since the mid-1980s. The relative decline of manufacturing investment in the economy in recent decades becomes rather more visible when one examines the ratio of capital stock in manufacturing to total value-added of FIREBS.[3]

believed to be representative of global capital markets in the 20th century: Argentina, Australia, Canada, Denmark, France, Germany, Italy, Japan, Norway, Sweden, U.K., U.S.A.

[2] On the income side, Leibbrandt et al. (2010) show average African income as percentage of average white income grew from 7.7 in the 1970s to 8.5 in the 1980s. On the human capital side, Fedderke et al. (2000) show the output-adjusted rate of school enrolment of the African population expanded significantly in the second half of the 1970s and throughout the 1980s.

[3] This indicator might be more appropriate to measure potential mobility since it captures – albeit indirectly – the non-fixed portion of the FIREBS sector.

Fig. 2: Trends in the relative value of fixed capital in the manufacturing sector



III. Conclusion

As a young democracy, South Africa will have to deal with the economic implications of the political imperatives that have shaped its democratic transition two decades ago. The impact on the structure of the economy of the elites' need to maintain capital mobility is one of these issues that have to be taken into consideration. There are a number of technical and economic explanations for the relative decline of the manufacturing sector offered by several researchers.[4] However, the inertia that might have been generated by the politically necessary – but socially inefficient – reallocation of capital to sectors that are amenable to capital mobility is rarely addressed. As long as inequality remains high, the strategic calculations that were behind the democratic transition continue to be relevant in sustaining the resultant political settlement. Therefore, it is difficult to expect the allocation of capital to the manufacturing sector to increase without a substantial decline in inequality or the availability of institutional innovations to secure property right in that particular sector. In the following section, I will offer a few suggestions on the type of policy innovations that could enhance structural change within the confines of the current political dispensation.

IV. Policy ideas

The positive analysis presented in the above sections seems to suggest that the South African economy is doomed to relatively low level of investment in manufacturing so far as the existing political constraints and vested interests are in place. But there is a silver lining in the fact that policy ideas can potentially modify political constraints, giving rise to a more efficient set of outcomes consistent with existing interests. Dani Rodrik (2013) argues "successful ideas work precisely because they take politics into account… Just as ill-conceived economic ideas can produce disastrous political effects, politically well-informed ideas can move us closer to the efficiency frontier in a manner that is consistent with underlying political realities" (pp. 205). In what follows, I put forward two policy innovations that could promote investment in the manufacturing sector in South Africa without requiring fundamental changes in the

[4] Fedderke (2014) documents the effects of income elasticity of demand and productivity growth on sectoral structure. Rordik (2008) attributes the weak performance of the manufacturing sector to the decline in profitability. Hausmann and Klinger (2008) cite the peripheral nature of South Africa's productive capabilities with respect to the global 'product space' as the main reason for the slow structural transformation.

political structure or even a substantial decrease in inequality for that matter.

a. Tailor-made provisions for the protection of property rights in the industry sector

Property rights protection is normally provided at a systemic level. However, structural change might be enhanced if institutional mechanisms could be put in place to signal the state's commitment to enforce property rights in targeted sectors. Such effort might have to go beyond issuing legislations protecting industrial investment. As enforcement is key in such contexts, institutional reform should guarantee the kind of enforcement that is consistent with the complex nature of industrial operations. Policy measures to secure property rights in selected sectors could be viewed as part of the industrial policy framework of the country. In line with the logic of industrial policy, the state would be internalizing the positive externality generated by a firm willing to invest in the industry sector by affording it special protection. The enforcement of property rights in targeted sectors could take both conventional and non-conventional forms:

Conventional measures: this may include supply-side measures such as creating fast-track courts for resolving disputes in the manufacturing sector and demand-side measures such as enhancing the capacity of the chamber of industry for collective action.

Non-conventional measures: such measures may effectively entail tying the hands of the majority against predating on industrial investment. One example of non-conventional measures is decentralizing information on manufacturing investment, making it difficult for actors keen on expropriation to trace ownership.[5] The second example is relaxing capital control on manufacturing ventures.

b. Creating a political constituency with strong interest in the industry sector

A strong constituency in favor of industrial investment may emerge if parts of the middleclass who wield significant political influence possess specialized human capital with higher returns in the industry sector.[6] There will be de facto protection of property rights in the industry sector as long as a sizeable portion of the politically influential and educated middleclass can benefit from physical capital investment in sectors with strong capital-skill complementarity. Policy measures to speedup the emergence of such constituency may include promoting specialized training programs in fields relevant for the industry sector. Such training could be provided on at least two tiers: first at executive training level and second at technical and vocational education level. Executive training geared towards corporate management of the industry sector may easily attract the politically influential section of the middleclass. Technical and vocational education, on other hand, can create a much broader constituency for industry-led development as long as it is designed in such a way that it does not require too much from the average trainee in terms of background education. Moreover, the degree of capital-skill complementarity in a given sector could be taken as part of the criteria for selecting strategic sectors for industrial policy targeting.

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[5] Qian (2003) argues that 'anonymous banking' has been used as a 'second-best' institution to enhance the enforcement of property rights in China in the absence of political constraints against ex-post expropriation by the state.

[6] See Bedasso (2013) for detailed theoretical discussion on the link between elite human capital and property rights protection in specific sectors of the economy.

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