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Manufacturing Performance And Policy In South -Ò A Review

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Manufacturing Performance And Policy In South Africa – A Review

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The Challenge of Growth and Poverty: The South African Economy Since Democracy

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INTRODUCTION

Section 1 examines South Africa's comparative industrial performance over approximately the last two decades – manufacturing value added (MVA), manufactured exports in aggregate and exports of dynamic manufactured products, and industrial structure. Two "equity dimensions" of this performance that feature strongly in government's objectives for manufacturing are then outlined – namely manufacturing employment and remuneration and the geographical spread of manufacturing.

Section 2 examines the policies effected by **the dti** to promote the development of industry. These include the policies and supports that are available to all firms and the supports that are for selected sectors, namely autos and auto components and clothing and textiles.

Section 3 advances some broad proposals that could enhance the institutional and organisational capacity to support industrial and business growth and development.

1. SOUTH AFRICA'S INDUSTRIAL PERFORMANCE – A SCORECARD

INDUSTRIAL PERFORMANCE - OUTPUT

1.1 Manufacturing Value Added

South Africa's manufacturing growth in the 1990s was only marginally higher than in the 1980s and significantly lower than the growth in the developed countries, the world and the developing countries.

TABLE 1. GROWTH OF MVA, 1980 – 2002: SOUTH AFRICA AND MAJOR REGIONS

Total MVA Annual Average Growth Rate	SOUTH AFRICA	INDUSTRIALISED COUNTRIES	DEVELOPING COUNTRIES	DEVELOPING COUNTRIES (excl. China)	WORLD
1980-1990	1.1	2.8	5.1	4.3	3.1
1990-2000	1.2	2.3	6.4	4.5	2.8
2000 – 2002	2.5*	1.1	4.9	3.9	2.0
Total MVA Index					
1990	100	100	100	100	100
1997	106	108	157	137	---
2000	106	118	181	152	139
2001	108	120	190	157	141
2002	113*	121	199	162	144

Notes:
*Estimate
2000-2002 data are calculated by applying the UNIDO forecast annual percentages to the 2000 data
Source:
UNIDO (2003) Table 1.3 for 1980-2000; Table J for World and 2000 - 2002
South African data for 2000 and 2001 supplied by Olga Memedovic, UNIDO

The manufacturing growth rate for South Africa accelerated in 2001 and, even more so in 2002. No 2003 data are yet available. However, growth has probably been mildly negative.

Consequently, over the last two decades, South Africa's share of developed market and world MVA has declined persistently. Given the more rapid rate of population growth in South Africa, the relative decline in South African MVA per capita has been particularly pronounced. Thus South Africa's MVA per capita was 20% of the industrialised countries in 1980, but only 12% in 2001. MVA per capita in China was 12% of South Africa in 1980. In 2001, MVA per capita in China was 72% of MVA in South Africa.

TABLE 2. SOUTH AFRICA'S SHARE IN REGIONAL AND WORLD MVA in %, 1980 -2001

	Year	Of Developed Market Economies	Of World Total
MVA (share in %)	1980	0.7	0.6
	1990	0.7	0.5
	1999	0.6	0.4
			China as % of South Africa
MVA per capita (% share)	1980	20	12
	1990	15	25
	2000	12	70
	2001	12	72

Source:
UNIDO database. Table A and Table K. 2001 data are projections.

Apart from the Transition Economies of Eastern Europe, Sub-Saharan Africa has experienced the lowest regional growth rates for manufacturing – MVA growth in Sub-Saharan Africa averaged 3.1% in 1980-1990 and 2.3% in 1990-2000. However, the regional growth rate is considerably more rapid than for South Africa at 1.1% and 1.2% for the two decades respectively. There has accordingly been a consistent decline in South Africa's share of Sub-Saharan Africa's MVA, particularly in the second half of the 1990s.

TABLE 3. SOUTH AFRICA'S SHARE OF SUB-SAHARAN MVA, 1980 – 2000.

	1980	1991	1995	1997	1999	2000
SA's share of Regional MVA (%s)	52.8	50	51	49	48	47

Source:
World Bank (2003) African Development Indicators, 2002. Drawn from the World Bank Database 2002. Table 2-3.

Lower growth rates are also manifest in a poor export performance. Over the last two decades, there has been a pronounced decline in South Africa's share of world and developed country manufactured exports.

1.2 **Exports**

1.2.1 Aggregate Manufactured Exports

TABLE 4. SOUTH AFRICA'S SHARE OF DEVELOPED MARKET ECONOMIES AND WORLD EXPORTS, 1980 – 1999.

	Year	Of Developed Market Economies	Of World Total
Manufactured Exports (share in %)	1980	0.5	0.5
	1999	0.4	0.3

Source:
UNIDO Country Tables. South Africa. Table B.

1.2.2 Dynamic Export Products

The weak performance of South African manufacturing exports is also evident at the product level. The Table below shows the shares of developing countries and of South Africa in the 20 most market dynamic products – these are the products that over the period 1980-1998 showed the highest growth rates in global exports.

In 1998, these dynamic products constituted 22.6% of world exports. They had an average annual growth rate of 12.9%. In 1998, these products constituted 28.7% of developing country exports, but constituted only 3% of South Africa's exports. By 2001, the share of these products in South African exports had increased only very marginally to 3.06%.

EXPORT VALUE GROWTH AND SHARE IN TOTAL EXPORTS OF THE 20 MOST MARKET-DYNAMIC PRODUCTS: DEVELOPING COUNTRIES AND SOUTH AFRICA, 1998-2001.

Product Group	Ave annual export value growth 1980-1998	Share in total world exports (1998)	Share in total exports from developing countries (1998)	Share in total SA exports (1998)	Share in total SA exports (2001)
Transistors and semiconductors	16.3	4.0	7.7	.05	.15
Computers	15.0	3.4	5.0	.17	.18
Parts of computers & office machines	14.6	2.3	3.6	.31	.28
Optical equipment	14.1	0.3	0.3	.01	.01
Perfumery and cosmetics	13.3	0.5	0.2	.18	.21
Silk	13.2	0.0	0.0	.00	.00
Knitted undergarments	13.1	0.6	1.4	.03	.02
Plastic articles	13.1	1.2	1.1	.33	.29
Electric Power machinery	12.9	0.6	0.8	.10	.11
Musical instruments and records	12.6	0.7	0.5	.04	.04
Leather manufacturers	12 .4	0.1	0.2	.08	.02
Non-alcoholic beverages	12.2	0.1	0.1	.10	.13
Medical instruments	12.1	0.4	0.2	.08	.05

Electricity distribution equipment	12.0	0.7	1.0	.24	.31
Telecommunications equipment & parts	11.9	3.0	2.9	.63	.59
Textile undergarments	11.9	0.3	0.8	.07	.13
Cereal preparations	11.9	0.4	0.2	.07	.05
Knitted fabrics	11.7	0.3	0.6	.04	.02
Pharmaceutical products	11.6	2.0	0.6	.09	.11
Electrical Machinery	11.5	1.7	1.5	.37	.36
20 most dynamic products	**12.9**	**22.6**	**28.7**	**2.99**	**3.06**

Source:
UNCTAD (2002):57 Table 3.2.
SA data compiled by Krzysztof Wojciechowicz from the dti database

1.3 **Industrial Structure**

South Africa's poor relative aggregate output performance is evident also at the sector/branch level. Almost all of the main branches of industry exhibit lower growth rates in the 1990s, as compared to the developed and the developing countries and the world.

TABLE 5. ANNUAL AVERAGE GROWTH RATES OF MVA BY BRANCH, SOUTH AFRICA AND SELECTED COUNTRY GROUPS, 1990-2000

BRANCH (ISIC)	SOUTH AFRICA	DEVELOPED MARKET ECONOMIES	DEVELOPING COUNTRIES*	WORLD
31- Food, beverages, tobacco	0.3	1.2	2.9	1.2
32 - Textiles, wearing apparel, leather, footwear	0.1	-1.7	-0.0	-2.0
33- Wood products, incl. furniture	4.1	0.9	0.1	0.7
34- Paper, printing and publishing	1.1	1.4	3.6	1.6
35- Chemicals, petroleum, rubber and plastic	2.0	2.6	4.6	2.8
36- Non-metallic mineral prods.	-0.6	0.9	4.1	1.3
37 – Basic metals	4.3	1.2	5.2	1.7
38 – Metal prods. Incl. Machinery and equipment	1.9	6.3	5.8	5.9
39 – Other manufacturing industries	-0.2	0.9	1.9	0.2
MVA Average Annual Growth Rate	1.2	2.3	4.5*	2.8

*Developing Countries excluding China

Source:
UNIDO database

Wood products including furniture (33) is the only branch in which MVA grew more rapidly in South Africa as compared to other country categories and the world. However, apart from other manufacturing industries (39), this is the smallest industrial branch - responsible, in South Africa, for less than 4% of MVA.

It is the labour intensive branches, food and beverages and textiles, clothing and footwear, that have grown more slowly than the average. As a result, they have declined significantly, from 23% of MVA in 1980 to only 20% in 2000. Wood products increased its relative share to 3.9% in 2000. The branch that saw the largest gain was basic metals (37) – its share increasing by 3.1%.

TABLE 6. MVA STRUCTURE (% share), 1990 and 2000

BRANCH (ISIC)	1990	2000
31- Food, beverages, tobacco	14.5	12.8
32 - Textiles, wearing apparel, leather, footwear	8.4	7.1
33- Wood products, incl. furniture	3.4	3.9
34- Paper, printing and publishing	8.5	8.3
35- Chemicals, petroleum, rubber and plastic	19.9	20.8
36- Non-metallic mineral prods.	4.9	3.7
37 – Basic metals	12.9	16.0
38 – Metal prods. Incl. Machinery and equipment	25.7	26.0
39 – Other manufacturing industries	1.9	1.5

Source:
UNIDO database

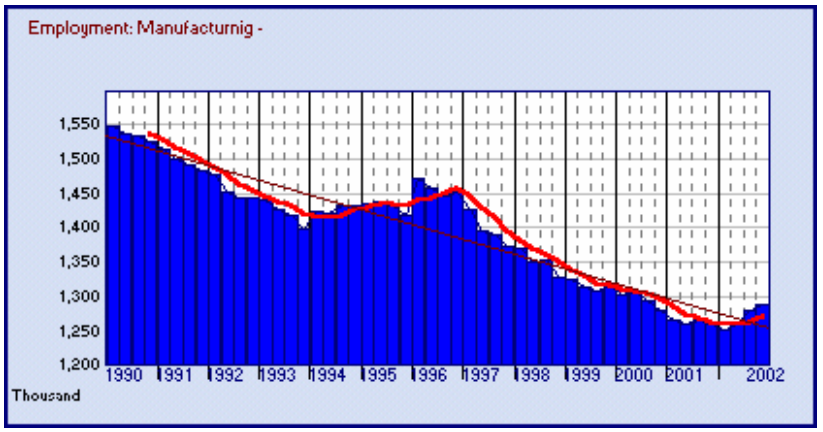
INDUSTRIAL PERFORMANCE - EQUITY

1.4 **Employment**

Low rates of growth in MVA,and particularly low rates of growth in the labour intensive sectors, have combined with overall rising capital intensity resulting in consistent declines in manufacturing employment.

The graph below shows quarterly employment data; the trend line and the two-year moving average. Prior to 1990, manufacturing employment exhibited a slow but persistent increase. There were clear cyclical patterns – manufacturing employment rose and fell with the business cycle. However, since approximately 1995, manufacturing employment has been on a persistent downward trend, and this has not reversed even when the economy or the manufacturing sector has experienced an upturn. With the very rapid rate of manufacturing growth in 2001-2002, manufacturing employment rose marginally, but the indications are that manufacturing employment has fallen in 2003. It should be noted that similar trends are evident in the construction sector and in mining – although the declines in mining employment commenced earlier, from about 1990. Only trade has seen a consistent trend to increasing employment post-1995.

GRAPH 1. MANUFACTURING EMPLOYMENT, 1990-2002



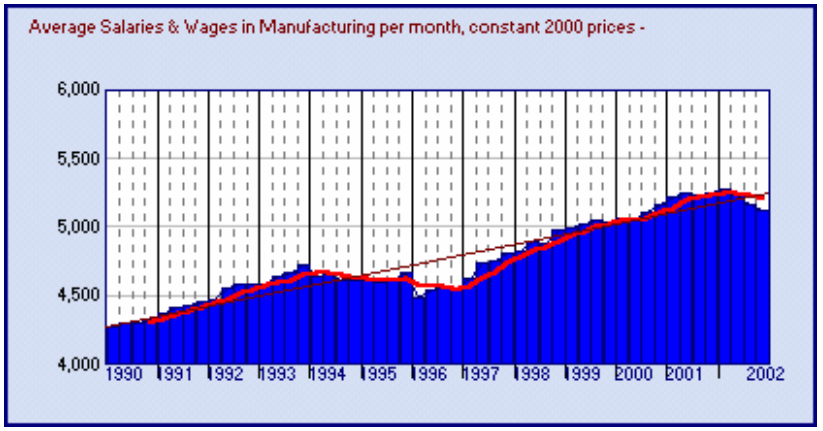
Source:
DTI database (derived from StatsSA)

That the decline in the employment/output ratio is evident in the other productive sectors, including the non-traded construction sector, suggests that while there may be specific factors affecting manufacturing employment, there are also likely to be factors that impact more widely.

1.5 **Productivity and Remuneration**

With a slow rise in manufacturing value added and a significant decline in employment, labour productivity in manufacturing has been rising steadily. Rising labour productivity has resulted in a slow but steady increase in labour remuneration. Average manufacturing wages in June 2002 were 21% higher than in June 1990 – with 2/3 of the increase post-June 1995.

GRAPH 2: MANUFACTURING REMUNERATION, 1990-2002



Source:
DTI database (derived from StatsSA)

Moreover, while more data are needed here, there are clear indications that the earnings of unskilled and lower paid employees in manufacturing increased more rapidly than those of the skilled and higher paid employees. Preoccupation with the employment numbers has led to a neglect of this important dimension of equity – for those in formal manufacturing employment, and more particularly for lower paid employees, there have been persistent and solid gains in remuneration.

1.6 **Geographical Spread**

South African manufacturing has always been spatially highly concentrated. One of the explicit objectives of South Africa's manufacturing policy for the new government is a "more equitable geographic spread of economic activities."[1] A number of incentives were accordingly developed in order to encourage manufacturing investments in less industrialised areas. However, the geographic spread of MVA has altered very little over the period 1995-2001.

The aggregate share in MVA and the individual shares of the three major industrial provinces have shown little change. While Mpumalanga and Free State, and more recently Limpopo, have had some increase in their relative share, none of the less

[1] Dti (2003) Medium Term Strategy Framework, 2003-2006. p. 10.

industrialized provinces exhibits a significant or consistent change in their relative position.

A number of incentive programmes were designed to favour the less industrialised provinces. The Table below shows the provincial shares of MVA as well as the expenditure by province of the major investment incentive programmes.

TABLE 7. PROVINCIAL SHARES OF MANUFACTURING VALUE ADDED AS COMPARED TO PROVINCIAL SHARES OF RIDP, SRIDP AND SMMDP INCENTIVES, 1995-2001.

INDUSTRIAL PROVINCES – WESTERN CAPE, GAUTENG AND KWAZULU-NATAL

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
WESTERN CAPE							
Man. %	15.7	15.7	15.6	15.7	15.8	15.3	15.0
RIDP %	24.3	21.7	29.3	27.3	33.8	29.1	29.3
SRIDP %	21.92	9.75	23.12	20.30	22.92	31.48	16.31
SMMDP%	-	-	-	19.19	18.44	19.52	21.84
GAUTENG							
Man. %	40.8	40.5	40.8	41.1	40.0	40.1	39.9
RIDP %	-	-	0.1	0.1	0.4	0.1	0.3
SRIDP %	-	-0.85	0.22	0.61	-	0.03	0.13
SMMDP%	-	-	-	38.59	35.14	31.98	30.73
KwaZuluNatal							
Man. %	21.3	21.4	21.3	21.3	21.5	21.3	21.3
RIDP %	26.2	25.6	26.8	28.9	26.7	32.3	34.3
SRIDP %	17.14	28.69	27.48	26.08	21.58	18.63	38.40
SMMDP%	-	-	-	29.51	24.13	26.65	25.13
TOTAL							
Man. %	77.8	77.6	77.7	78.1	77.3	76.7	76.2
RIDP %	50.5	47.3	56.2	56.3	60.9	61.5	64.5
SRIDP %	39.06	37.59	50.82	46.99	44.50	50.14	54.84
SMMDP%	-	-	-	87.29	77.71	78.15	77.7

NON-INDUSTRIAL PROVINCES

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
EASTERN CAPE							
Man. %	7.8	7.6	7.4	7.2	7.5	7.6	8.0
RIDP %	28.5	31.6	25.3	23.27	19.58	21.03	19.61
SRIDP %	21.92	9.75	23.12	20.30	22.92	31.48	16.31
SMMDP %	-	-	-	-	5.10	4.29	5.42
FREE STATE							
Man. %	3.2	3.5	3.5	3.5	3.7	3.9	3.9
RIDP.%	5.51	3.59	4.62	5.77	5.25	4.77	3.13
SRIDP %	9.90	25.82	11.30	12.60	10.85	9.44	9.07
SMMDP %	-	-	-	4.26	5.66	4.89	4.70
LIMPOPO							
Man. %	1.5	1.5	1.5	1.4	1.3	1.5	1.7

RIDP %	3.17	2.68	2.32	2.76	2.68	1.46	2.37
SRIDP %	12.01	2.52	2.97	2.81	3.44	0.81	6.14
SMMDP %	-	-	-	0.75	1.86	2.54	3.21
MPUMMALANGA							
MAN %	6.6	6.8	6.9	6.9	7.0	7.3	7.2
RIDP %	6.31	5.56	4.57	6.62	5.47	6.73	6.70
SRIDP %	11.22	8.28	9.29	3.22	11.02	13.43	1.84
SMMDP %	-	-	-	5.75	7.74	8.32	6.32
NORTH WEST							
MAN %	2.7	2.7	2.6	2.6	2.7	2.6	2.5
RIDP %	5.03	8.04	6.26	5.08	6.05	3.25	3.69
SRIDP %	3.91	5.56	6.58	7.00	1.68	5.14	2.73
SMMDP %	-	-	-	-	0.46	1.24	2.04
NORTHERN CAPE							
MAN %	0.5	0.5	0.5	0.4	0.4	0.5	0.4
RIDP %	0.95	1.05	0.74	0.20	0.08	1.18	-
SRIDP %	10.73	3.84	2.95	0.87	5.00	3.16	1.88
SMMDP %	-	-	-	1.95	1.48	0.57	0.61
TOTAL							
Man. %	22.3	22.6	22.4	22.0	22.6	23.4	23.7
RIDP %	49.47	52.52	43.81	43.70	39.11	38.42	35.5
SRIDP %	60.93	60.71	49.17	53.01	55.5	49.86	21.66
SMMDP %	-	-	-	12.71	22.30	21.85	22.30

Source:
Statistics South Africa (2002) Discussion paper. Gross Domestic Product per region. Annual estimates, 1995-2001 (November): 32
Data on the provincial shares of incentives provided by dti

The industrialized provinces of Western Cape and KwaZuluNatal received a disproportionate share of all three investment incentives as compared to their share of national MVA. Gauteng was effectively excluded from RIDP and SRIDP, but received significant support from the SMMDP. Among the non-industrialised provinces that had the most significant increases in share of MVA, Mpumalanga, tended to receive a lower share of investment incentives - RIDP and SRIDP, in particular - as compared to its share of MVA.

While the policy impact of these measures is not considered in this paper, there is little evidence to suggest that the investment incentives, individually or collectively, had a significant impact on the location of industry on a provincial level.

2. POLICIES TO ENHANCE INDUSTRIAL PERFORMANCE

GENERAL SUPPORT

2.1 The Supply Side Measures

After 1994, GEIS was phased out and replaced with a large number of supply-side measures. No clear objectives were developed for the supply side measures, monitoring in many cases has been deficient and no systematic evaluative data exist as to the effectiveness of these measures.[2]

In this context it is difficult to pass definitive assessments on the effectiveness of any particular supply side measure or of the collectivity of measures. However, anecdotal evidence together with surveys, commissioned by the dti, of a representative sample of manufacturing firms suggest that the number of firms making use of the supply side measures is not high and that the effectiveness of the supply side measures is limited. Moreover, there is little evidence to suggest that the situation is improving significantly.

2.2 Overall Sector Strategies

After 1994, the dti spent considerable time and resources developing overall strategies for different sectors – much of this work under a cluster framework that owed a great deal to the ideas of Michael Porter. Integral to **the dti's** current Industrial Strategy document are the development of strategies for a number of so-called priority sectors. Well enunciated strategies based on sound analyses that set out a clear vision and route forward can do much to unveil new opportunities, spur confidence and overcome coordination failures. This is particularly the case where strategies result from a close working relationship between government and industry and sectoral strategies consequently enjoy the support of the firms in the sector.

How does business perceive **the dti's** strategies for the development of their sectors? Once again, anecdotal evidence and a survey commissioned by the dti show that few firms regard the dti as having industrial and trade policies for their particular sector and only a limited number of those regard these policies as being effective.

However, in two sectors – clothing and textiles and, more especially, transport equipment, a significant percentage of firms regard the dti as having trade and industrial policies for their sector and further regard these policies as exerting a considerable impact on the development of their sectors.

[2] "Up to now, assessment of the impact of our industrial policy in general, and of particular policies, has been lacking." DTI (2001):43

2.3 SECTOR SPECIFIC POLICY SUPPORT

A Tale of Two Industries

In fact, since 1994, only these two manufacturing sectors, namely autos and components and clothing and textiles, have been the recipients of sectorally specific support measures. For both sectors, support has taken the form of import-export complementation – an exporter earns either the right to import on a duty-free basis (the IMPORT Credit Certificate Scheme in autos and components) or an offset against the duty paid on imports (the DUTY Credit Certificate Scheme in clothing and textiles).

Autos and components have been hailed as a dramatic success. Clothing and textiles have been condemned as a significant failure.[3] The success of the one import-export complementation scheme and the failure of the other is generally held to lie in the different industrial and export structures characterizing the two industries – a producer driven value chain for autos and a buyer driven value chain for clothing and textiles – and even in the "character" of the producers whereby the fractious and divisive clothing and textile firms are negatively contrasted with the collective organization of the auto and components sector.

While not discounting the importance of differences in industry structure, a major reason for the differential impact of the two different incentive schemes may lie elsewhere. Simply put, the IRCC provides a far more powerful incentive to the autos and auto components sector by comparison with the incentive that the DCCS provides to exporters of clothing and textiles. Furthermore, the supposed self-evident "success" of import-export complementation in auto and auto components needs to be carefully assessed in the light of the magnitude of the incentives as well as the biases and implicit costs entailed in the support programmes for the sector.

2.3. **Autos and Auto Components**

The South African auto industry was established in the early 1920s with high tariff protection. Commencing in 1961, there were a series of programmes to enhance local content and in 1989 policy moved away from import substitution to export promotion. The Motor Industry Development Programme (MIDP) was initiated in 1995. The MIDP entailed a phase down of tariffs; a removal of local content requirements; duty free imports of components up to 27% of the wholesale value of the vehicle and duty rebate credits to be earned on exports.[4]

The key objective was to enhance higher levels of specialisation and exports, thus allowing for much increased economies of scale and accompanying gains in efficiency and productivity. In evaluating the MIDP therefore it will be critical firstly to assess the

[3] Average annual growth of exports for the period 1997-2001 for motor vehicles, parts and accessories was 29% (11.4% 1991-96); for clothing 17.6% (2.7%) and for textiles -2.3% (8.4 1991-96). Over the period 1997-2001, Motor vehicles parts and accessories exports grew faster than any other sector (at a 46 sector categorisation). TIPS (2003);3-4.

[4] Black and Mitchell (2002):1281

extent to which productivity and efficiency have advanced and secondly to determine what resource costs and rents are entailed. Finally, in the longer-term, the key question is whether South African producers are indeed able to exploit economies of scale so as to become internationally cost efficient.

Exporters of autos and auto components earn an Import Rebate Credit Certificate (IRCC) equal to the local value of the export. By way of illustration, an export of R100 requiring imports of R40, would have a local value of R60. An IRCC would allow for R60 to be imported without payment of duty. With a nominal duty of 40%, the duty reduction would be R24. In addition therefore to what is earned on the export market therefore, the exporter receives an additional benefit in the form of a duty reduction of R24 or 40% of the local value added. [5] The extent of the IRCC benefit depends on whether autos or auto components are exported, and on whether the IRCCs are used to import autos or components. Flatters summarises the additional benefits conferred through the IRCCs, denoting them as effective protection afforded to exporters.

Table 11. Effective Protection Given to Exports by IRCC Facility

	Item Exported	
Use of IRCCs	Vehicles	Components
Vehicle Imports	40%	26%
Components Imports	30%	30%

This is a very significant support to exporters of vehicles and components. Flatters argues that it is therefore unsurprising that exports and resultant investments have risen since the IRCCs were introduced. The IRCCs entail a support to exporters with the incidence falling on local consumers in the form of prices that are higher than they would be in the absence of tariff protection.

Barnes *et al* provide an alternative position. Based on detailed empirical work, they argue firstly that the export success of the South African auto industry results, not from any support, but from the industry's competitiveness and efficiency. [6] Secondly, Barnes *et al* argue that no incidence of higher prices falls on South African consumers. On the contrary, the MIDP has resulted in lower prices for domestic consumers by comparison with prices prevailing elsewhere.[7]

Barnes et al in a Table summarize evidence for the competitiveness and efficiency of the South African auto and auto components sector. South African auto component firms are

[5] Import duties are being progressively phased downward and are currently 38% on vehicles. The qualifying value of eligible export performance that determines the value of import duty credits earned in respect of exports is also scheduled to decline.

[6] "The rise of South Africa's auto and components sector and its growing contribution to output, employment and exports reflects the growth of capabilities and dynamic comparative advantage." Barnes *el al* (2003): 10

[7] "..on balance there is certainly no evidence for suggesting that the MIDP selective industrial policy has systematically raised prices for domestic consumers. If anything…..it would appear that the opposite is the case, that is it has resulted in lower final product prices at equivalent levels of quality and specifications." Barnes *el al* (2003):22

compared with auto component firms in Western Europe and Emerging Economies. South African data are for the period 1998-2001. Western Europe and Emerging Economies data is only for 2001. Improvements are charted in respect of a number of Critical Success Factors (CSF) - cost control, quality, flexibility, capacity to change and innovation capacity.

Between 1998 and 2001, performance in the South African auto component firms has improved significantly. Nevertheless, in 11 out of the 13 measures, South African firms still lag both Western Europe and Emerging Economies. Only in training expenditure and R&D does South Africa (surprisingly) perform better than Western Europe and only in work in progress and absenteeism does South Africa perform better than Emerging Economies.

Barnes *et al* state that "Despite improvement, the South African components sector has in most respects some way to go before it reaches the global frontier...However the upper tier of South African component suppliers operates close to the global frontier…" Moreover, in some respects "…the upper quartile of South African firms (the major exporters) outperform the upper quartile of international firms."[8] Barnes *et al* conclude as follows "In summary, therefore, the improved performance of the auto and auto components sector as a whole – in terms of output-growth, net exports and employment – is built on a foundation of rapid and sustained improvement in productive efficiency."[9] Barnes *et al* (2003): 11-12

However, there are difficulties in interpreting the data for these auto component firms and also in drawing conclusions that are applicable to the autos and auto components sector as a whole:

- Since no weightings are apportioned to each of the different measures, the relative importance of those measures in which the South African firms auto component in the sample perform worse as opposed to those measures where South Africa auto component firms perform better than other firms is unclear. How far, in aggregate, the South African auto component firms are behind the other auto component firms in the sample cannot be determined.
- Since no weightings are apportioned to each of the different measures, no aggregate measure of overall efficiency gain on the part of the South African auto component firms in the sample can be derived. Without weights, it is not possible to determine how rapid the aggregate gain was for the South African auto component firms in the sample.
- Many of these measures relate to comparisons of efficiencies at the plant level. In autos and auto components, as in many industries, competitive edge, or the lack of it, will also depend heavily on extra-plant factors, most notably transport and logistics. It is these extra-plant factors that are the most critical constraints to

[8] The data to support this conclusion are not given

[9] This overall conclusion is reiterated "The rise of South Africa's auto and components sector and its growing contribution to output, employment and exports reflects the growth of capabilities and dynamic comparative advantage." Barnes *et al*:10

South African auto and auto component firms becoming internationally competitive (see below).

- The number of South African auto component firms whose improvement in performance is charted by Barnes et al. varies from a minimum of 17 to a maximum of 32. The comparator, namely Western Europe and Emerging Economies uses an even smaller sample – 14 and 12 firms respectively. The limited number of auto component firms assessed, as compared to the number of firms making up this sector, raise questions as to how conclusions drawn from this data are to be generalised so as to be applicable to the sector as a whole, or even the upper quartile. This is more particularly the case since the sample is not random (see below). The precise number of auto component firms is difficult to determine because firms may not be dedicated only to production of auto components, but by any calculation, in South Africa, there are several hundred firms. There are currently 212 members of the National Association of Automotive Component and Allied Manufacturers (NAACAM).[10] These are mostly first-tier auto component suppliers. According to the dti "there are approximately 250 first tier suppliers and over 300 second/third/fourth tier suppliers."[11]
- No data are available for auto assembly firms.
- The South African sample is not drawn at random but from the Kwazulu-Natal/Eastern Cape and Gauteng Benchmarking Club database Auto component firms that enter a programme specifically to improve their productivity are likely to be atypical and to exhibit productivity gains well in excess of the industry average.

Productivity data that encompass the auto and auto components sector *en toto* are presented in the Table below. For the period 1995-98, labour productivity growth in motor vehicles, parts and accessories was below the average for manufacturing. Since 1998, labour productivity growth in autos and auto components has exceeded that for manufacturing in aggregate. For the entire period 1995-2001, labour productivity growth has marginally exceeded the average for manufacturing. Capital productivity in the autos and auto components industry has persistently declined throughout the period 1995-2001 and the decline has been more pronounced than the average for manufacturing. By contrast, for the manufacturing sector, there has been significant growth in capital productivity since 1999. While the auto industry has expanded output rapidly, there has also been a considerable expansion in inputs (particularly imported inputs), such that the increase in value added is far less impressive and the growth in capital stock has exceeded growth in value added. Multi-factor productivity provides the best measure of efficiency growth. Over the period 1995-2001 taken as a whole, motor vehicles parts and accessories have experienced lower growth than the average for South African manufacturing. In the period 1998-2001, multi-factor productivity growth has been significant in manufacturing as a whole, and more so in autos and auto components. For the whole period 1995-2001, with the marginal exception of labour, motor vehicles parts and accessories have experienced lower growth than the average for manufacturing

[10] List of firms members supplied by NAACAM 29/7/2003
[11] Norman Lamprecht, Manager Automotive, TISA. 31/7/2003

industry. South African manufacturing industry has itself enjoyed only modest productivity growth.

TABLE 12. MOTOR VEHICLES PARTS AND ACCESSORIES AND MANUFACTURING PRODUCTIVITY, 1995-2001 (1995 = 100)

	1995	1996	1997	1998	1999	2000	2001
LABOUR PROD.							
Manufacturing	100	100	106	108	110	118	124
Motor v.p. and a.	100	96	97	96	105	117	126
FIXED CAPITAL PROD.							
Manufacturing	100	98	96	92	90	94	95
Motor v.p. and a.	100	94	94	87	87	83	84
MULTIFACTOR PROD.							
Manufacturing	100	99	101	100	100	105	109
Motor v.p. and a.	100	95	95	92	96	100	104

Notes:
Labour and capital productivity are real output per unit of labour or capital.
Multifactor Productivity (MFP) employs the Solow growth accounting approach. This measure measures shifts in the production function. While this is loosely described as technical change, it aggregates all factors that underpin efficiency. MFP is equal to the rate of output growth less rates of growth in labour and capital inputs weighted according to their GDP shares.
Source:
Data from the TIPS database
Motor vehicles part and accessories [381-383]: manufacturing [3]

The sector wide productivity data therefore suggest that while there have been some productivity gains in autos and auto components in the last few years, these gains have not been exceptional by comparison with many other local manufacturing sectors. Nor does it seem likely that productivity gains have been rapid enough as to underpin an industry-wide transition from what is universally agreed to have been a highly inefficient industry prior to 1995, to a situation where, in a short space of time, the industry is now internationally competitive.

Despite some productivity gains, and some improvement in its ability to compete internationally, the South African auto and auto components industry has been and remains internationally uncompetitive. This would suggest that the rapid growth of auto and auto component exports has been underpinned by other factors.

What are the resource costs entailed in supporting exports and who bears the incidence?

The IRCC is an additional "benefit" earned by auto and auto component exporters. The IRCCs can only be utilised for imports. IRCCs enable most auto and auto component imports to enter without payment of tariffs.[12] Government accordingly collects less tariff revenue. But, do local consumers, despite the fact that imports enter without payment of duty, still confront prices that are higher than the duty-free i.e. world price? Flatters argues that consumers do and that so provide a subsidy to auto and auto component exports.

"*Who pays this subsidy? Superficially, the cost of subsidy is borne by the government budget in the form of tariff revenues foregone. In a more fundamental sense, however, it is born by South African consumers of automobiles. The import duty on motor vehicles means that the domestic price is higher than comparable world prices. Although IRCC holders can import vehicles duty-free, domestic consumer prices do not fall, and the benefits accrue to the exporters/importers as extra profits on vehicle imports and/or cross subsidies to exports. This is an export subsidy paid for by consumers of vehicles in the protected domestic market."* (Flatters (2002):7.[13]

Barnes *et al* refute the contention of a support to local producers/exporters, the incidence of which is born by local consumers. They do this through an empirical exercise. They compare retail car prices in South Africa in 2001 and 2002 to retail car prices in, the UK and in the EU, differentiating between those countries with a significant domestic auto industry and those countries without significant auto production.[14] They argue that this data shows that, at equivalent levels of quality and specifications, South African consumers confront lower product prices.

Flatters (2002) raises four principal objections to the price comparison:

1. There are very significant difficulties involved in international price comparisons of complex consumer durables and in controlling for all the variables and product characteristics
2. Several models are only available in South Africa. This makes comparison over the entire product range, necessary to pick up possible cross-subsidisation as between different models, impossible. [15]
3. Retail Selling prices include distribution, selling and financing costs in addition to the ex-factory cost. Customer list price is not therefore equivalent to ex-factory price.

[12] The collection efficiency rate – the actual duties collected as compared with the potential duties collected – for the broad category of vehicles, aircraft and ships is only 18.5%. The Effective Rate of Protection (Corden) for motor vehicles is 81% and for motor vehicles parts 64.8% - but based on collection rates the ERP for motor vehicles is 10.6% and 0.5% for motor vehicle parts.
Cassim, Onyango, Van Seventer (2002): 52;56;59

[13] Black and Mitchell (2002):1283 argue that it is "unlikely" that imported cars will be sold at world prices, as long as the supply of IRCCs are less than the demand.

[14] Data are only provided for 2002

[15] Barnes *et al* data are for 4 models produced in South Africa; 3 models fully imported into South Africa and 3 budget models

4. Most critically, the question of whether consumer prices are higher in South Africa than they would be in the absence of the MIDP, is not resolved by the comparison presented. The resolution of this question requires a comparison of ex-factory prices of South African assembled autos with the c.i.f. import price for the same auto.

In addition, currency changes in the value of the currency make cross-border price comparisons very difficult. This is particularly so for an industry that has large fixed capital costs that are amortised over a lengthy period. With the Rand constantly depreciating, auto producers did increase their local prices, but could not increase their prices rapidly enough to compensate for the declines in the currency. This was more particularly the case following the accelerated depreciation of the currency from the third quarter of 2001. As a result, for a number of years but particularly after the third quarter of 2001, local consumer car prices, when converted to foreign currencies, have been substantially lower than the auto producers would have liked. This has, in turn, impacted negatively on the profitability of the local manufacturers. In the last few years therefore South African auto prices have been **well below their long-run equilibrium level**. As Toyota SA CE Johan van Zyl explained recently -
*Although we put up our prices, we could not catch up with the deteriorating currency – **not just last year, but in previous years**. However, the recovery of the rand towards the end of last year helped and if things continue as they are, we will return to profitability this year."*[16] (own emphasis)

South African auto prices for 2001 and 2002 were artificially low. Local auto and auto component prices are likely to increase despite the appreciation of the Rand, and prices will increase substantially when converted to foreign currencies. While this is hardly definitive evidence, in the six month period September 2002 to March 2003, the South African list price of the BMW 318i, converted to Euros, increased by 34% (8% due to the increase in the Rand list price, the rest due to the appreciation of the Rand); the South African list price of the Mercedes C-Class 180K Classic increased by 28% (3.5% due to the increase in the Rand list price, the rest due to the appreciation of the Rand). [17]It is therefore likely, at the prevailing exchange rates, the current list prices for SA autos are higher than those in Europe.

For all of the reasons stated above, the debate as to whether or not the MIDP provides a rent to auto and auto component exporters, the incidence of which falls on South African consumers in the form of higher prices for locally produced and imported autos and auto components, has not been resolved, and indeed cannot, be resolved – either way – on these price comparisons, or indeed through any such price comparisons.

An alternative way of "demonstrating" that the IRCC constitutes a support, the incidence of which falls on local consumers, is through a consideration of the process by which an exporter can benefit from utilizing an IRCC.

[16] Business Day 'Toyota SA's growth hurt by weak currency' 31/03/2003: p.11
[17] Rand values from the manufacturer's published list price. Exchange rates are the monthly exchange rates published by the South African Reserve Bank.

Any exporter who has earned IRCC can choose to realise the IRCC in one of three "modes":

- The exporting firm itself imports vehicles and/or components to the value of the IRCC duty free
- The exporting firm transfers the IRCC directly to a firm that utilises the IRCC to import vehicles or components
- The exporting firm sells the IRCC to a local firms who then utilises the IRCC to import vehicles or components

Where the exporter utilizes the IRCC "in-house" or where the exporter transfers the IRCC to another firm in return for some service rendered (often this is in exchange for marketing and distribution services rendered in respect of the export by the firm acquiring the IRCC), no "price" is fixed and no money changes hands. There is no evident means of determining the benefit that the exporter derives from the usage of the IRCC in either of these two modes.

By contrast, the third mode, by which an exporter can realize the benefit of the IRCC, namely via direct sale, reveals the situation in a transparent manner - the value of the IRCC to the exporter is immediately and directly evident.

An exporter who earns an IRCC and who sells this IRCC, quite evidently receives a return in addition to what is earned on the export market. This is the export subsidy or support. Where the IRCC is sold at arms-length in the market at a recorded price, the revenue earned by the exporter from the IRCC can be clearly established. There is, in fact, a well-established spot-market for arms-length sales of IRCC known as the Export Credit Exchange (ECE). The price obtained through the sale of the IRCCs in the ECE provides a clear indication of the value of the IRCC to the exporter viz. the export subsidy.

Who bears the incidence of this export support? The firm that purchased the IRCC will utilise this IRCC for importation. The IRCC will accordingly allow the firm to import at lower cost through paying less duty. Will this reduction in duty paid be passed on to the consumer? The answer must be in the negative. The firm will recoup the costs of purchasing the IRCC by adding this cost to the selling price to be paid by the consumer. The consumer therefore pays the import cost less tariff, but must also bear the cost of the importer acquiring the IRCC. The price of the IRCCs prevailing on the ECE therefore gives a fair indication of the difference between the price paid by the consumer and the tariff free price.

In 2002, R550million of IRCCs issued were sold through the ECE out of a total of some R21billion. Thus only 2.6% of total IRCCs are sold on the ECE. A further 10-15% of IRCCs are sold, but outside of the ECE.[18] It might therefore be objected that the value to exporters of the IRCCs they earn cannot be "read" from the prices prevailing in a market in which only a small percentage of IRCCs are traded.

[18] Interviews

However, there are many instances where only a tiny share of product is traded and the market nevertheless provides a fair indication of value. Suburban housing and grain markets in largely subsistence economies are just two examples. Despite a low proportion of the housing or grain stock traded on the market, housing prices and grain prices are, nevertheless, determined in these markets. The producers of grain or suburban houses who choose to consume their home or their grain (the vast majority), forgo the revenue given by the return that they would have obtained in the market had they sold their grain or suburban home. Abstracting from transactions costs, consumers will consume their home or their grain only so long as the "benefit" obtained from so doing is equal to or greater than the benefit or revenue foregone through not realizing their house or their grain on the market. Similarly, those who choose not to sell their IRCCs on the open market will only do so if the "benefit" they so derive is equal to or greater than that they could obtain on the open market. The "benefit" derived through alternative uses of IRCCs can therefore be imputed from the price prevailing for IRCCs in the open market.[19]

There is an alternative way of demonstrating this. In order to maximize profits, firms will allocate their IRCCs so that the returns from the various usages to which they can put their IRCCs are equal at the margin. A holder an IRCC will ensure that returns at the margin obtained through any usage of the IRCC will be equal to the return at the margin obtained through the sale of the IRCC. The equivalent of what could be obtained through the sale of an IRCC will be added to the price charged to the local consumer for the import.

The IRCC therefore does constitute a support to exporters and it is a support borne by local consumers in the form of prices paid for autos and components in excess of the tariff-free or world price. The support is substantial. The existence of a market price for the IRCCs can allow for the precise extent of this support to be calculated. This exercise is not attempted here.

There are a number of other indicators that suggest that the MIDP may not have been as effective as is generally perceived.

The first concern relates to local content. Local content for CBUs has actually declined. This is particularly evident in respect of vehicle exports and first-tier components. Many of the local component exporters established under the MIDP do not supply domestic assemblers but rely rather on export markets and the sale of IRCCS to subsidise their exports (see below). Furthermore, there seems little likelihood of this changing at current production volumes. Given that the IRCC benefit is realized through duty-free importation, this result is unsurprising.

The second concern relates to the range of components exported. The range of export components has not increased significantly – much of the export growth has been in catalytic converters and leather seats and these two items make up 62% of component

[19] This example is not designed to suggest any comparison between very different commodities – only to suggest that prices can be "read" or imputed from markets, even where a small share of the product is traded there.

exports,[20] with catalytic converters accounting for 48.4% of component exports.[21] Although it has been increasing with the manufacture of the porcelain substrate, the value add in catalytic components is very low, while the leather export handicaps other potential users of leather where value addition and employment are likely to be much higher.[22]

The third concern relates to the distribution of the IRCC benefits within the industry. Exporters are most likely to sell a high proportion of their IRCCs on the market (mode 3 above) where their exports have a low import content, such that they have limited "in-house" use for the IRCCs earned, and where they have their own independent export channels, such that they do not require the services of other auto firms to engage in exporting. These characteristics are most in evidence in the regard to the independent component producers, and indeed they are the preponderant sellers of IRCCs on the EDE.[23] The revenues from the sale of their IRCCs is critical to many component suppliers who would otherwise not be competitive on export markets.[24] In respect of these exporters, the IRCCs are quite evidently an export subsidy. To reiterate, the main buyers, as would be expected, are the large producers with high import content and more particularly groups such as tyre manufacturers and the distributors of imported vehicles who do not have an export component and are "pure" importers.[25] With the expansion of exports and the consequent increase in the supply of IRCCs, the price of IRCCs has fallen and have recently been sold at a considerable discount.[26] The result is a redirecting of a significant and increasing share of the IRCC benefit from those exporters selling, to those firms purchasing IRCCs for imports, including those who are "pure" importers and have no export component. This considerably dilutes the support obtained by the independent, smaller, locally owned, component exporters from the IRCC – precisely those firms that, it could be contended, should receive the highest level of support.[27]

Finally, and this relates to the concerns regarding the costs of the MIDP to the local consumer, domestic demand has been effectively stagnant since 1995. There clearly are a number of factors that have constrained demand for autos. The high cost of financing auto purchases for many, particularly lower income, consumers, for example, is a significant constraint. However, the lack of low-cost cars at the bottom end of the market

[20] DTI database
[21] NAACAM quoted in Financial Mail "No Fuss Success" 8/08/2003:14
[22] Black and Mitchell (2002):1291 show that where component production is solely for export, the IRCC results in exports below average costs resulting in a clear welfare loss.
[23] Information provided by EDE
[24] "…some component makers rely heavily on the proceeds of the sale of certificates for profitability. Some of the component manufacturers would have used the proceeds from the sale of import rebate credit certifications to make up what they lose on the export markets – where they are constantly under pressure from multinational motor companies to keep prices low." Sunday Times Business Times 'Import certificates lose their vooma' 30/3/2003: p. 3. Also EDE interview.
[25] ibid…
[26] Previously IRCCS were being sold on the EDE at between 82.5% and 86% of their value. But, in March 2003, this had fallen to 67%. Ibid…
[27] Anthony Black has pointed out that the fall in the price of IRCCs is in some way a positive development as it reduces export assistance and protection. A surplus of export credits will reduce their value. Correspondence 25/08/2003.

and the higher prices borne by consumers generally are also important. The increases in local vehicle prices have consistently exceeded the increase in consumer prices.[28]

It is clear that, despite evident success in terms of exports and investment, an assessment of the desirability and the impact of government support for the auto and auto components sector must be cast far more widely.

We return, briefly, to this issue below (section 2.5).

2.4 **Clothing and Textiles**

By contrast with the auto and auto component sectors, clothing and textiles have, post-1995, experienced stagnant or declining production and a much slower growth of exports. For textiles, output has declined marginally between 1995 and 2002, while exports have risen steadily but only slowly. For clothing, there has been a more significant fall in output, and a more significant rise in exports. The export/output ratio for textiles rose from 9% to 22% and for clothing from 6% to 22%.[29] Exports are clearly the key to future growth.[30]

Of particular concern is the slow rate of growth of clothing exports. The growth of South African clothing exports to the principal market, the United States, following the implementation of AGOA has been much slower than expected.[31] This weak export performance for clothing is particularly evident when South Africa is contrasted with that of other countries in the region who also enjoy access to the US under AGOA. South Africa's share of the US market has been declining post-AGOA while the share of other African countries that are eligible under AGOA are rising rapidly.[32]

[28] According to WesBank CEO, "…the rise in vehicle prices outstripped consumer price inflation. In 1985 it took 40 week's net income to pay off an entry-level executive vehicle, but today it takes 72 week's net income." Vehicle leasing 'could transform automotive industry'" Business Day 20/08/2003:4.
There is concern that the official data on vehicle prices understate the extent of the price rises. In 2002, StatsSA reported a 9.4% rise in vehicle prices while the List Price Index provided by the National Association of Automobile Manufacturers (Naamsa) reported an increase of 18.4%. 'Statistical Gremlins 2' Financial Mail 15/08/2003:16

[29] Expressed in 2000 Rands. DTI database.

[30] In 2002, exports of clothing and text iles were a little over R7billion.

[31] It is worthy of note that South Africa's clothing exports to the US were increasing more rapidly in the period immediately prior to AGOA than in the post-AGOA period.

[32] Peter Minor first pointed this out in a study done for the dti. Minor (2002).

TABLE 13. CLOTHING EXPORTS FROM AFRICA TO THE US AND THE EU, LEADING SUPPLIERS, 1990-2002 ($Usmillion)

	Kenya	**Kenya**	**Lesotho**	**Lesotho**	**Madag'r**	**Madag'r**	**Mauritius**	**Mauritius**	**SA**	**SA**
	> US	> EU	> US	> EU	> US	> EU	> US	> EU	> US	> EU
1990	2.5	2.5	24.5	5.6	0.4	10.8	121.2	522.7	0.0	32.3
1991	4.5	6.3	27.0	18.2	0.1	15.1	97.7	536.5	0.7	72.7
1992	7.8	17.4	50.8	18.3	0.2	18.5	113.1	533.9	2.4	73.2
1993	22.1	10.3	55.1	14.7	1.5	46.3	161.2	501.0	12.7	75.5
1994	35.2	7.1	62.4	13.5	2.8	92.6	186.2	518.8	34.7	73.4
1995	34.0	6.3	61.7	12.6	6.7	122.0	190.3	573.3	16.6	66.9
1996	27.1	3.3	64.9	12.7	11.0	147.7	164.7	616.0	60.4	67.1
1997	31.3	2.6	86.5	4.5	15.3	177.1	184.4	658.0	70.9	62.3
1998	33.5	2.3	100.2	0.8	22.0	218.0	233.3	693.2	78.7	69.4
1999	39.3	2.5	110.7	0.2	45.7	213.9	231.6	625.2	96.9	68.3
2000	43.8	1.7	140.1	1.6	109.5	244.7	244.7	638.5	140.9	78.6
200	64.4	1.7	216.7	3.2	178.2	238.3	238.3	591.2	173.	69.

1									3	0
2002	125.5	n/a	321.1	n/a	89.3	n/a	254.5	n/a	181.0	n/a

Source:

Gibbon (2003):47 (US ITC, US Department of Commerce, Otexa. Eurostat. Euro/$US based on rates for 31December for relevant year.

Concomitantly, despite AGOA, there have been very few new investments into South Africa– particularly on the part of large integrated clothing firms focused on the US market. There has also been little new investment on the part of existing export-oriented clothing firms. By contrast, other African countries have attracted significant new investments in clothing and, more recently, in some countries, notably Lesotho, in textiles as well.

AGOA represents a singular window of opportunity for the expansion of the South African clothing industry. If this opportunity not exploited, there are potentially serious adverse consequences for the future of the industry.

South African exports to the US are overwhelmingly located in those categories that are most regulated by quotas – more especially in cotton trousers and knit cotton shirts and blouses. [33] Thus, South African exports of clothing will be very vulnerable when quotas are removed on US and EU imports in 2005. Moreover, with the removal of quotas, all the indications are that US buyers will significantly reduce the number of source countries. This was clearly outlined by a US based consultant in a presentation to the dti in May 2002 -

"***The window of opportunity for South Africa to join the international garment production community is closing***. *The LDC provision will expire in October 2004 and most ominous, quotas will be eliminated in 2005.* ***If South Africa does not build its capacities now, it will most certainly be left behind****. Extensive interviews of US buyers concluded that most will decrease the number of countries they source their apparel from by two-thirds shortly after 2005. If South Africa does not expand its exports rapidly to service the needs of buyers, they will likely suffer severe losses when quotas are eliminated.*" Minor (2002): 3 (Minor's emphases).

As in autos and auto components, policy in the clothing and textiles sector has entailed a tariff phase down combined with an export incentive.

[33] 75% of South African exports to the US are in these two top quota constrained categories. These two categories account for 33% of US imports overall. Minor (2002):4

Following its rejection of the Swart Panel recommendations[34], government introduced a 7 year tariff phase down for clothing with the elimination of specific tariffs and reduction of ad valorem tariffs to a maximum of 40% by 2002. For textiles, tariffs were also significantly reduced with average tariffs for yarn falling from 50% in 1993 to 22% in 2003 and for yarns from 35% to 15%. In addition, firms importing yarn, fiber or fabrics in order to produce clothing for export were able to do so on a duty free basis. This is the regulation known as 470.03.

An explicit export incentive, known as the Duty Credit Certificate Scheme (DCCS), was introduced to coincide with the phase down and this was subsequently extended to the end of 2005. The DCCS allow firms to claim a remission of duty (hence duty credit) for proven exports. The level of support depends on the product exported – with highest support for clothing followed by fabric and then yarn. Also, there is greater support for firms exporting more than 15% of their turnover. The value of the DCCS has been declining and is currently due to expire in 2005.

[34] The Swart Panel, set up by government with tripartite membership following accession to the WTO, recommended a 10 year phase down period together with investment and input subsidies and export and training incentives.

TABLE 14 . VALUE OF DUTY CREDIT CERTIFICATE AS % OF VALUE OF PROVEN EXPORT SALES

BENEFIT LEVEL	2001/2				2002/3				2003/4				2004/5			
	Product Exported				Product Exported				Product Exported				Product Exported			
	c	hh	f	y	c	hh	f	y	c	hh	f	y	c	hh	f	Y
1	25	17.5	12.5	8	20	15	10	6	20	15	10	6	15	12	8	5
2	35	23	17	12	30	20	15	10	30	20	15	10	25	17.5	12.5	8

KEY:

c - clothing
hh - household textiles
f - fabric
y - yarn

BENEFIT LEVEL:

1 = Export Turnover less than 15% of Total Sales Turnover
2 = Export Turnover equal to or more than 15% of Total Sales Turnover

Source:
DTI, July 2003.

Thus, in addition to their export revenues, clothing and textile exporters earn via the DCCS, a remission of duty paid on imports equivalent to a significant percentage of their export revenues. This would appear to be a powerful export incentive. Why has it not had a more significant effect on exports of clothing and textiles – more particularly for clothing where the DCCS incentive is far higher?

Four factors reduce the impact of the DCCS on exports. (It may be useful to contrast the DCCS, in this regard, with the IRCCs in autos and auto components).

1. The DCCS is an alternative to 470.03. Firms availing themselves of 470.03 are prohibited from utilising DCCS. It is not known exactly how many firms or what share of total exports is subject to 470.03, but a large number of exporters are "470.03ers" as they are commonly called.[35] The best estimate is that they currently account for between 55-60% of total clothing exports.[36] While there are some variations, these firms typically focus their entire, or close to their entire, production on the US export market.

It is important to note therefore, that more than half of South African clothing exports enjoy access to imported inputs duty free, *but they enjoy no export incentive*. These firms are internationally cost-efficient and enjoy no special export supports. By contrast with the auto and auto components industry where all exporters receive imported inputs

[35] In 1997, 67 exporters were exporting under 470.03, Gibbon (2002):18. It has not been possible to get more recent data

[36] The estimates are from Gibbon and from the Export Council for the Clothing Industry

required for production for export duty free *and* the IRCCs in addition, the bulk of South African clothing exports *only* receive imported inputs required for production for the export market duty free. One major reason for the limited impact of the DCCS on exports is simply that more than half of South Africa's clothing exports do not receive the DCCS. These exporters opt rather for duty free importation.

2. In order to qualify to earn DCCS, exporters must have paid all duties in respect of their imported inputs. The incentive to exporting provided by DCCS is considerably diluted in that DCCS can only be accessed by firms that face high tariffs on their imported inputs. These duties are considerable. In important part, the DCCS serves to compensate for the fact that South African exporters, availing themselves of this incentive, have to pay substantial duties on their imported inputs. Auto and auto component exporters, by contrast, pay no duty in respect of inputs required for export markets.

3. There are significant restrictions on the usage of DCCS. DCCS can only be used for inputs in respect of the domestic market and then only for a same stage product or one stage back. Thus, a clothing exporter for example, may only use the DCCS in respect of importation for sale or production for the domestic market and then only in respect of clothing or fabric. One consequence of this restriction is that exporting firms earning DCCS utilize only a minority of DCCS in-house for own account imports. The majority of DCCS is accordingly sold. The major purchasers of DCCS are the large retailers. The retailers then utilize the DCCS in respect of their imports – particularly for clothing. The large retailers have considerable market clout and the discount incurred on the sale of DCCS is typically 30-40%. As with the IRCCs, the discount represents that value "captured" by the importer and the discount is a measure of the extent to which the actual value of the incentive to the exporter is below that of its face or nominal value. Largely as a consequence of the restrictions placed on in-house own account usage of DCCS - restrictions that do not apply to the IRCCs - a larger share of DCCS is sold and the discount is considerably higher for DCCS as compared with IRCCs.

4. There are two other, albeit less important, factors relating to DCCS. Firstly, in order to qualify for DCCS, a clothing or textile exporter has to meet certain requirements. [37] No such requirements exist in respect of IRCCs. Secondly, only exports on which duty has already been paid qualify for DCCS. Thus the expenditure in respect of duty payment will be incurred generally several months before the DCCS is earned. Time delay imposes further costs.

Most clothing exporters utilising DCCS are adamant that exporting would not be profitable without the DCCS.[38] Without the DCCS fewer firms would engage in export.

[37] In order to qualify for DCCS, firms must meet certain conditions relating to labor relations, training and improving competitiveness. Thus, firms are required to spend a certain share of their wage budget on training and to participate in achieving competitiveness targets set by a Productivity Performance Monitoring Scheme. In addition, amenities and facilities are inspected and reviews are undertaken of management practices. It seems that these requirements add little value to the companies and are only done to secure the DCCS. Compliance costs may nevertheless not be insignificant. There are no such requirements in respect of IRCCs.

[38] Gibbon interview 20 clothing exporters based in the Western Cape and Durban Metro. Only 4 stated that their exports would be profitable in absence of DCCS. Only one listed company published data on income

Nevertheless, the costs and restrictions entailed in DCCS and the applicability of the DCCS, to less than half of the export total, has significantly limited the impact of the DCCS on exports.

How might exports, particularly of clothing, be more effectively encouraged?

As already outlined, there are currently two distinct categories of clothing exporters. The first "the 470.03ers" are almost entirely export oriented, invariably foreign owned (mostly Taiwanese) and located in decentralized areas. These firms have a long-established track record of successful exporting and, as noted above, have done so without any export incentives. They are internationally cost efficient. Since South Africa already has a well-established and internationally cost-efficient clothing sector exporting to the US, one would have expected that easing of entry into the US market under AGOA would have resulted in substantial expansion of this part of the clothing industry. However, the existing firms are not significantly expanding their production or investment for the export market and South Africa is not currently attracting new export-oriented firms. By contrast, other countries in the region are seeing the rapid expansion of existing export-oriented firms and are attracting new entrants.

One part of the reason is labour costs. However, these firms are invariably located in the former decentralized areas where wages are very low and comparable to those elsewhere in the region. There is also a concern about labour regulations, particularly inflexibility with regard to hiring and firing. However, these also do not appear to be onerous. Moreover, any disadvantages of locating in South Africa as a consequence of higher labour costs or labour regulations are offset by generally higher productivity and better infrastructure.[39] Thus, these firms were already well established in exporting to the US profitably even prior to AGOA.

For these firms, the major constraint in expanding their exports to the US is access to fabric. In order to qualify under AGOA, South African clothing exporters are subject to a three-stage rule-of-origin – spinning, weaving or knitting and assembly and finishing must take place in South Africa, the US or another beneficiary country. Less Developed Beneficiary Country (LDBC) status is conferred on other countries that qualify under AGOA, except for Mauritius. LDBC status entails only a one-stage rule-of-origin i.e. only assembly and finishing need to be undertaken in the exporting country.
The large clothing internationalised clothing producers source cloth globally in large quantities. This is an important part of their competitive advantage. They then allocate production amongst their different plants located in a variety of low cost locations. Rules-of-origin restrictions in respect of plants located in South Africa interferes with this process and renders South Africa a less advantageous location by comparison with other sites which are free of such restrictions.

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derived from export incentives. This amounted to R39m and R62m, in 2000 and 2001. Pre-tax profits were R46m. and R67m. respectively and turnover R1537m. and R1421m. Gibbon (2002):42. According to Velia (2001):41 84% of clothing firms interviewed reported that they would face severe short run problems if DCCS without DCCS.

[39] A further issue is the difficulty that foreign investors face in acquiring residence visas in South Africa as opposed to, for example, Lesotho

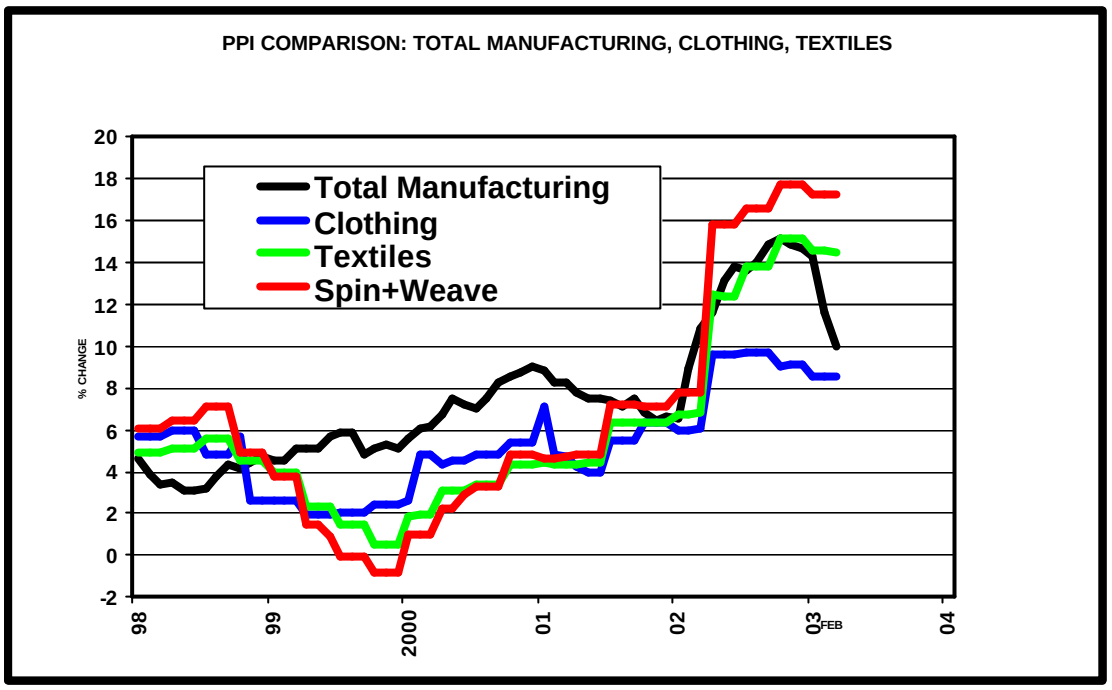
While this is subject to differing views, apart from the chorus of cries emanating from clothing exporters,[40] there is evidence that suggests that fabric shortage is a major constraint retarding clothing exports to the United States.[41] Firstly, where South African clothing producers do have access to the requisite fabric – man made fibers and wool, in particular – there has been significant export growth and South African producers have been expanding their share of the US market. By contrast, in the case of cotton apparel, exporters have had major difficulties in sourcing the requisite fabric locally and the consequence has been a significant decline in cotton-based apparel exports (Minor, 2002). Prior to AGOA, cotton apparel constituted more than 90% of South Africa's apparel exports to the US, Minor (2002): 10, and it is cotton apparel that has accounted for the comparatively poor performance of South African clothing exporters to the US. Moreover, this decline is unique to South Africa.

Secondly, recent producer price indices for textile inputs are very revealing. Textile and particularly spinning and weaving manufacturers were able to increase their prices very significantly early in 2002. While for total manufacturing and clothing prices also increased with the sharp depreciation of the currency, the increases were far larger in respect of textile products. Moreover, the rate of increase of manufacturing and clothing prices begun to decline thereafter. But, as AGOA came into effect, textile product prices maintained their rate of price increases. This is strongly suggestive of considerable fabric shortage and the power of fabric producers.

[40] For example Export Council for the Clothing Industry (2002) October:2; Export Council for the Clothing Industry (2002)July:1-4.

[41] In the 12-month period to the end of May 2003, 48% of South Africa's clothing exports to the US were AGOA eligible. The figure for Mauritius is 43%. For all the other countries that have LDC status, the percentage is far lower – above 90% being AGOA eligible. Tralac. AGOA. Info. http://www.agoa.info

Graph 3: Price Comparison: Clothing, Textiles and Total Manufacturing



Source:

Supplied by the Export Council for the Clothing Industry in South Africa. May, 2003.

Finally, only 42% of South Africa's clothing exports to the US are currently AGOA compliant and the percentage has been growing only slowly.

The fabric shortage will have to be addressed if South Africa is to attract further investment on the part of the large integrated clothing firms focused on the US market. This can only be satisfactorily achieved if rules-of-origin regulations for South African clothing exports to the United States are altered significantly- very preferably to be the same as that enjoyed by other AGOA-eligible countries i.e. that South Africa clothing exports wholly manufactured from fabric derived from third countries be permitted to the US under AGOA.[42]

Any change in rules of origin regulations in respect of South African clothing, would almost certainly require reciprocally that US textile exports into Sacu face substantially reduced tariffs or be allowed tariff free entry. This is the proposal that the clothing

[42] Reducing duties on imported fabrics and abolishing the requirement that local textile firms purchase locally produced raw cotton would also help ease the fabric shortage (see below). But, these measures would only ameliorate the problem.

industry is currently advancing as a central objective for the proposed US-Sacu Free Trade Agreement.[43]

Shortage of fabric also impacts negatively upon, the other clothing exporters who receive DCCS support. But, these exporters are subject to additional constraints.

Many of these firms are located in established metropoles – Cape Town and Durban especially- and are accordingly faced with much higher labour costs and a strongly unionised workforce. Higher labour costs and high tariff levels for inputs, results in a high cost structure and this severely constrains the ability of these firms to compete in export markets.

As Gibbon (2003) has explained, largely as a consequence of these constraints, these firms adopt a different production model as compared to the model employed by firms that are strongly focused on exporting to the US. By contrast with the latter that specialise in the assembly and finishing of long runs of basic garments, the former focus on shorter runs with much more investment in other activities such as design and sampling. Indeed, this different model severely constrains the capacity and willingness of such firms to engage in exporting to the US. Many firms export only a small share of their total production, often only what is surplus to their domestic production, and more often to the EU than to the US. Unlike the "470.03ers", these firms cannot export competitively and they rely heavily on the DCCS to subsidise their exports

A high cost structure resulting in a particular production model that further raises costs, significantly inhibits export on the part of these firms. The DCCS is designed to overcome these obstacles – and to compensate for the higher costs that exporters incur in respect of labour and imported inputs.

As outlined earlier, while the DCCS does provide a significant incentive to exporting on the part of these firms, its efficacy is constrained by a number of factors. Most critical is the limited usage to which the DCCS can be applied. To reiterate, DCCS can only be used for imported inputs in respect of the domestic market and then only for a same stage product or one stage back. This limited usage for the DCCS results in exporters selling a large part of their DCCS to importers at a very considerable discount. The DCCS would be a more effective export incentive if its usage could be widened. DCCS could be used as against imports not only for production for the domestic market, but *also for the export market*. Furthermore, DCCS could be used not only for the import of the same product plus one stage back, but *also for all imported inputs*.

Widening the usage to which DCCS could be put would not result in an exporter earning more DCCS, but it would allow the exporter more possibility of using DCCS "in-house" rather than selling DCCS at a discount. Less DCCS would be supplied to the market and the price of DCCS would rise, reducing the discount and the value captured by the importer as opposed to the exporter.

[43] Clotrade and Export Council for the Clothing Industry in South Africa (2003)

As outlined above, the DCCS is necessary to compensate clothing exporters who face higher imported input costs. In the longer term, policy should aim at allowing clothing exporters access to inputs at international prices. If tariffs on textiles are reduced, *pari passu* this will allow the level of the DCCS benefit to be accordingly reduced, without a reduction in the incentive to export. Thus, the level of benefit enjoyed by clothing exporters through DCCS can be adjusted and synchronized in line with tariff reductions on textile inputs.

Addressing the fabric shortage and widening the usage of the DCCS will give a significant fillip to export expansion on the part of the South African clothing industry. However, there would clearly be some negative impacts on the local textile industry, more especially if, as suggested, this is combined with tariff reductions for textiles in general and, as suggested above, tariffs are reduced for US textiles**. The dti's** Industrial Strategy is committed to developing the textile-clothing value chain.[44] Further consideration will need to be given to considering what form of policy support would, in this context, be most appropriate for the textile industry.

However, it is important to recognise that an expanding export-oriented local clothing industry will be of immediate benefit to the local textile industry, at least that part of the textile industry that produces inputs for clothing production. [45] International experience is that expansion in clothing leads expansion in textiles. There is little likelihood of significant growth in textiles without a significant expansion in local production of clothing.

But, similarly without the expansion of the local textile industry the local clothing industry will be significantly constrained. In the immediate term this constraint arises from the shortage of suitable AGOA compliant fabric. In the short-medium term, a very close integration with the supplier of fabric will be an essential for the success of any clothing manufacturer intending to export to the US.[46]

Clothing exporters need the local textile sector to expand – both in the immediate short-term in order to alleviate the fabric shortage and in the longer-term to secure markets. Local textile firms are hanging back because they are not convinced that clothing exports will take off. Textile firms are accordingly focusing on reducing fabric variety and producing longer runs of higher quality fabrics. This further limits the access of potential clothing exporters to the requisite fabrics. The scepticism of the local textile producers as to the expansion of a local export-oriented clothing industry is thus rapidly becoming a self-fulfilling prophecy.

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[44] DTI (2002):30

[45] Currently, clothing manufacture accounts for about 30% of the textile industry's output.

[46] In the fashion-basic segment of the market where South African clothing exporters have the best chance of competing internationally, "Buyers …are looking for "full package" producers that can manage every detail of the supply chain, from fiber to the showroom floor…Apparel companies successful in this market segment are moving towards close coordination with textile producers and retailers." Minor (2002):21
On the growing importance of full-package production in the global apparel value chain see Gereffi and Memedovic (2003): 31

What role is there for industrial policy in this conundrum? This issue is addressed briefly below.

2.5 Sectoral Support Measures and Industrial Policy

This section discusses the support extended to autos and auto components and clothing and textiles sectors in South Africa in the light of some broad perspectives on government support for specific industrial activities. Drawing on these perspectives, some directions for future policy design are proposed – very generally in respect of autos and auto components and, somewhat more specifically, in respect of clothing and textiles.

2.5.1 Autos and Auto Components

Hausmann and Rodrik (2002) argue that in a developing country context the promotion of non-traditional activities may require government-supported inducements. Potential investors in non-traditional products in a developing country context operate in a situation of a high level of information uncertainty. Once the investment is successfully made however, the information is disseminated – other producers can readily see what the costs and gains might be of further investment. In Rodrick's terms, industrial policy acts as a coordination device. [47]

Industrial and broader economic development in South Africa, as elsewhere, requires that new areas of investment and of specialisation are developed - more especially, new non-traditional products that have a higher value added and that have high growth rates in international markets. Autos and auto components represent one such category of products and indeed autos and auto components have been the major addition to South Africa's export product basket that has otherwise changed very little.

Producing highly sophisticated German designed autos for the most demanding export markets of Europe and Japan in South Africa could certainly qualify as a non-traditional activity and with a highly uncertain outcome for the auto producers. *Ex ante* the decision to produce high quality German-designed cars in Africa for discriminating Japanese and European consumers was a considerable gamble. Would the South African firms be able to produce at the demanding standards of the markets in industrialised countries and would the consumers recognise and accept these standards in products produced in Africa? But, the auto producers were prepared to take that gamble *as long as* support was forthcoming from government. Demonstrated success on the part of the initial investments has removed the uncertainty. Combined with continuing government support, the removal of the uncertainty has subsequently crowded in new investors.

Very broadly, this is typically the "arena" where an active industrial policy on the part of government could potentially play a positive role. And there have indeed been many positive spin-offs resulting from the expansion of the autos and auto component sector. This is more especially so in that production was aimed at highly discriminating export markets that would discipline inefficiencies and exports could be coupled to policies that,

[47] Rodrick (1995):21

while they would continue to ensure high levels of protection in the local market, would simultaneously aim at enhancing efficiencies in the local market, principally through enhancing the scale of production by reducing the proliferation of locally produced models. Moreover, there are considerable externalities, particularly as the auto exporters encourage and support their local suppliers to enhance the quality of their products and as they facilitate the opening of new export markets for auto component producers.[48] More widely, the demonstrated capability of making sophisticated products for the most discriminating markets provides a positive lesson and reduces the risks entailed for producers in other areas contemplating South Africa as a production site for other sophisticated products.

Now that the considerable uncertainty surrounding the ability of South African firms to produce autos and auto components for the most discriminating export markets has been removed and consumer acceptance secured, there is a clear case for significantly reducing the levels of government support.

Reductions in government support have indeed been forthcoming in subsequent revisions to the MIDP.[49] However, support extended under the MIDP remains very significant. Moreover, additional supports for the sector have been recently implemented. Despite its name, the MIDP is a trade measure confined to export facilitation. The two hallmarks of, an active industrial policy, namely support for investment and technolo gical advance have however been added very recently - support for investment through the Productive Asset Allowance[50] and support for technological upgrading provided by national government and provincial government.[51]

Sector specific trade and industrial policies should be predicated on an assessment of dynamic competitive advantage – the sector's prospect, in a defined period, of competing internationally without government support. The South African domestic market is small and the regional market very minor. Most of the inputs must be imported over a considerable distance. This is a scale intensive industry and sales volumes are critical. Accordingly, even if in their own operations, domestic firms become internationally efficient, location imposes on them very considerable transport, logistics and marketing costs. Critically, there is no evidence that this is becoming less constraining – domestic demand, in particular, has been essentially static for several years.

This would suggest that this sector would continue to rely on government support. The economy-wide impact – especially on local consumers, particularly business consumers

[48] Barnes *et al*:21
[49] Black and Mitchell (2002):1295
[50] The PAA is an investment subsidy linked to investment performance. New capital investment earns import duty credits of 20% of the value of the investment spread over 5 years. To qualify investment must entail an increase in scale of production and increased production for export.
[51] The Gauteng provincial government Blue IQ programme is investing R200million in an automotive supplier park that is designed to service the auto industry. The Advanced Manufacturing Strategy developed by the Department of Science and Technology will direct further significant technology support to this sector.

(and more especially on small and undercapitalized businesses), and on employment [52] needs careful assessment. The results of this assessment should be factored into future policy support for the industry.

2.5.2 Clothing and Textiles

Currently both textile and clothing firms are hanging back on investment and blaming each other for the lack of any movement. Firms in the two sectors are taking different paths and employing different strategies. Textile firms are looking to longer runs for the export market and the clothing exporters are increasingly looking elsewhere for fabric. As this translates into different strategies on the part of the firms in these two sectors, the chasm between textile and clothing grows ever wider. There is accordingly very little common purpose between the associations representing the two sectors.

The further development of the South African clothing and textiles sector requires simultaneous investments by both clothing exporters who then provide an impetus to textile investors to supply the necessary inputs and by the textile manufacturers so that the clothing exporters, assured of the fabric that they need to be successful in export markets, will now be induced to invest. Investments on the part of both clothing exporters and textile input suppliers entail significant extra-sector spillovers in the form of intermediate inputs or market demand spillovers for final goods whose production entails significant scale economies. Private returns on the investments on the part of both clothing exporters and textile input suppliers are accordingly significantly below the social returns.

This is a classic case where the state needs to take the lead in order to secure coordinated and simultaneous investments. The sector associations are not likely to be able to produce a unified vision for the development of the entire value chain. Left to "the market", there will be no forward movement. Only the state can play this role. This role for the state in coordinating simultaneous investments across linked industries has a long tradition in economics going back to Rosenstein-Rodan whose planned industrialisation for Eastern Europe comprised "…a simultaneous planning of several complementary industries…." [53]

There is no attempt here to provide a policy blueprint for clothing and textiles. But, there would appear to be a strong case for reducing investment risk through some form of subsidy or support for investment. This will be particularly important in respect of investments in textiles, where the capital investment component is large and much more significant than in clothing. Any subsidy to investment should also critically include support to clothing firms who seek to integrate backwards into textiles in order to advance their clothing exports.

[52] The employment numbers downstream of production – in distribution, servicing and repair - are considerably larger and these activities are far less capital intensive.
[53] Rosenstein-Rodan (1943):204. Hirschman (1958) illustrates how investments upstream or downstream may induce complementary investments in linked industries.

There is also a strong case for critically assessing other factors that prevent the investments in textiles required to enhance the development of clothing exports. Of central importance here is the requirement that textile producers have to purchase the local cotton crop.[54] This not only constrains the textile producers directly, it also constrains clothing exports and, by so doing, indirectly but significantly, further constrains textile investments.

3. ENHANCING POLICY EFFECTIVENESS – SOME INSTITUTIONAL AND ORGANISATIONAL DIMENSIONS

3.1. Support for Business Growth and Investment

The argument thus far advanced is that manufacturing performance has been weak, in terms of both output and equity. Policy, both the generalized supply side support measures and the specific measures for the auto and auto components and the clothing and textiles sectors, has had a limited impact or has entailed significant economy-wide distortion and cost. This, of course, immediately raises the question of what should be done to render policy far more effective in order to enhance manufacturing performance?

Part of the problem lies in correcting existing policies and replacing them with better policies. This is the policy debate. Of more fundamental and longer-term import however are the institutional and organizational dimensions that currently determine and govern policy and that limit its effectiveness. These are the issues addressed, albeit briefly, in the rest of this paper.

The dti has in recent years, extended its support measures beyond manufacturing. **The dti** increasingly concerns itself with "the real economy." **The dti** has, uniquely among government departments, sought, over the last 3-4 years, to become customer-oriented. **The dti** has attempted to understand its customer/s and their needs, and to tailor what it does and the policy support that it offers, to these needs. A number of concrete measures to this effect have been undertaken. In addition, these measures have been underpinned by a substantial reorganization within **the dti** into new functional divisions. While this has resulted in some very positive changes, a number of difficulties remain in effecting a genuine re-alignment to meet customer needs.

Who exactly is **the dti's** customer? **The dti** itself has a very wide remit – its main concern may be business, but **the dti** is also concerned with a host of other activities and these necessarily engage a much wider constituency than business. These activities include gambling, lotteries, liquor, taxis and consumer protection. These activities, in turn, spawn a large number of different institutions for which **the dti** has responsibility. These activities have a very high public profile and they are very taxing in terms of time, energy and resources. As currently constituted, **the dti** does, in fact, have multiple

[54] Coughlin, Rubin and Darga (2001) detail the negative consequences of this on the textile industry. Minor reported that "It [the requirement that textile producers purchase raw cotton from South African producers] was … the most frequently mentioned problem by textile producers and by some apparel industry representatives interviewed in this study." Minor (2002):17

customers. This wider remit can serve to blunt the focus and to deflect attention from **the dti's** central mission.

In order to best accomplish its "core" mission, the dti will need to unambiguously define its customer as business. The dti can accordingly formulate and implement industrial and trade policies that are customized to the needs of business, with appropriate performance indicators to measure the impact of those policies. At the heart of the matter would be enhancing business investment. Investment is the key to business growth.

Two clarifications are in order.

Firstly, **the dti** and government should not be collapsed. Government's customer is clearly much wider than business and, as in any democracy, must necessarily encompass **all citizens**. Enhancing business investment is only one of government's objectives. While the dti should seek to enhance business investment and to seek the policies that will best achieve this objective, government will have to mediate the demands of business by taking account of the broader impact on all of the citizenry. Thus, **the dti** may well propose policies that promote business investment that are modified or rejected at government or Cabinet level when the impacts on the wider society are considered. However, **the dti** should not itself attempt itself to play the role of government and to pass its own judgment on policy trade-offs. It is only when what is required to advance business growth and investment is clearly articulated at the highest levels in government that the trade-offs can be clearly defined.

Secondly, a focus on business and growing business investment cannot ignore the equity dimensions. In the context of broad government policies, **the dti's** objective is not only to enhance business investment in the aggregate, but more especially to enhance investment on the part of particular categories of business – small and black and women-owned business and business located in less developed areas. Thus, in addition to policies that will impact on large and well-established businesses and on business investment in general, policies will be specially formulated and tailored to favor investment on behalf of those categories of business that government especially wishes to prioritise. There is a further equity dimension – namely that policies to advance business investment should, where possible, also seek to enhance the labour intensity of investment or, at the very least, not enhance the capital intensity of investments. However, the equity dimensions, while important, should not detract attention from the major objective. Firstly, the objective of **the dti** remains defined as enhancing business investment – albeit giving greater weight to particular categories of business investment. Secondly, the most important objective will be aggregate investment. The equity dimension – enhanced growth and investment on the part of particular categories of firms – will depend critically on the aggregate rate of business growth and investment. A high aggregate rate of business investment will benefit all firms. Finally, there will be understandable concerns that such pro-business policies will be of benefit to business and not to the broader citizenry and particularly "the poor" - indeed such views are widely articulated in **the dti.** While this requires much more discussion, in a society such as South Africa where businesses pay taxes and where such taxes are progressive and where government expenditure is strongly progressive in favouring poorer citizens, the benefits of business

growth will be widespread. In any case, tax and fiscal policies are more appropriate mechanisms through which government can seek to advance broader societal equity. **The dti** should accordingly concern itself with growth.

How would a dti with a clear focus on enhancing business investment, proceed in order to meet its objectives.

As with any firm, the first requirement for the dti is to know its customer. What do we know about the factors that currently impede business investment? In 2002, and again a year later in 2003, on behalf of **the dti**, the Bureau for Economic Research (BER) surveyed a representative sample of manufacturing firms on constraints to investment.

The table below gives the results for 2003.

TABLE 15. CONSTRAINTS ON INVESTMENT

If you currently were to invest in new plant and equipment, rate each of the following factors in terms of the adverse impact they would have on your decision to do so?	**No effect**	**Very little effect**	**Moderate effect**	**Strong effect**	**Prohibitive**
	% response				
The general political climate	16	30	31	22	2
Government economic policies	6	17	36	38	3
Labour regulations	4	11	26	47	12
Cost of labour	4	11	29	48	7
The availability of skilled labour	14	26	32	24	4
The cost of capital & concerns about the interest rate	3	10	30	47	9
Corporate tax rates	5	19	40	33	4
Insufficient demand for your product/poor outlook for sales	6	15	23	42	13
Growing competition from imports	12	21	24	37	6
Fluctuations in the exchange rate	2	8	27	52	12
Crime	5	18	33	34	10
Aids	9	29	37	21	5
Other factors (please specify)					

Source:
BER (2003): Table 1. Fixed Investment Constraints

As is evident from the Table, 6 factors were most critical. Ranked in order of adverse impact, these factors were:

1. Fluctuations in exchange rate
2. Labour regulations
3. Insufficient demand for product/poor sales outlook
4. The costs of capita and concerns about the interest rate
5. The cost of labour
6. Crime

Two major conclusions can be drawn:

- There are good reasons to have confidence in the validity of this data. The results were very similar to the year before – while there was some movement in relative importance, [55] the same 6 factors also topped the list in the previous survey. Moreover, in both surveys, these factors ranked highest across the different size groups and types of sector. Finally, the results by size and sector had the expected characteristics - for example, labour costs and regulations were greater for small as opposed to large firms and for consumer goods as opposed to intermediate goods firms.

- On the basis of these results, the investment climate in South Africa appears to be heavily constrained. A significant percentage of firms reported that each factor had a strongly or prohibitive effect on investment.

In brief, the data strongly suggest that there is an urgent need to address the constraints that currently impact on business investment and these constraints have been identified, in aggregate and for the different components.

Two observations can be made. The first observation is that while there are currently significant constraints on business investment, none of the major constraints on business investment can be addressed **directly** by **the dti**. Policies designed to mitigate the major constraints on business investment all fall within the mandate of other government departments – for example, exchange rate fluctuations and interest rates within Treasury and the Reserve Bank and labour regulations within the department of labour. If **the dti** were to adopt enhancing aggregate business investment as its key objective, it would need to have some way of impacting upon other government departments, in order to achieve any significant measure of success. This is elaborated on below.

[55] Crime moved from 4th to 6th place and the cost of labour and cost of capital both moved up one position. Exchange rate fluctuations increased in importance.

The second observation is that while we can identify, in broad terms, the major current constraints on business investment, we need far more information and analysis.

We need to understand much more about the precise nature of the constraint and its impact. To take one example, what aspects of labour regulation are constraining investment, exactly who is being affected and how constraining are the labour regulations? Business everywhere will regard labour regulations a constraint on investment everywhere, but are they a more significant constraint in South Africa than elsewhere? And if changes are made to labour regulations, there will need to be an assessment of the impact that these changes have had on business investment over time. One critically important source of such information will be derived from business itself. The dti is in the process of collecting this information through an Investment Climate Survey (ICS), undertaken with the World Bank. The ICS is a large-scale in-depth firm level survey, encompassing manufacturing but also other sectors, that seeks to identify the constraints on investment and performance.[56] Quantifiable data are collected on a wide range of issues. This allows for inter-country comparisons to be made e.g. to what extent is crime or labour regulations a greater constraint on investment in South Africa as opposed to Brazil? One important feature of the ICS is that it allows at least very broad estimates to be made of the impact on investment as a result of improved performance in respect of the different constraints.[57]

Such data and analysis will be critical in allowing the dti to impact on policies effected elsewhere in government. If, it can marshal evidence based on quantitative assessments that suggest a particular constraint is more severe in South Africa than elsewhere and the extent to which this acts as a limiting factor in terms of business investment, and what the results might be obtained in terms of business investment if improvements can be made, the dti will have a strong case to impact on whatever institutions of government that effect policy in this area.[58] To take but one example, the dti is committed to a strategy of business growth that lays great stress on the importance of enhancing knowledge activities as a critical element in ensuring competitiveness and growth.[59] Knowledge enhancement will be critically affected by telecommunications policy and policy relating to e-commerce. A *sine qua non* for **the dti** is to engage effectively in these policy processes, will be information on how well or otherwise business is served in relation to telecommunications charges and connection, particularly in relation to other countries, more especially competitor countries.

Of course, data and analysis, while necessary, are not sufficient. Apart from data, **the dti** will require analysts who can commission the research to produce that data and who can

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[56] Enhancing the investment climate and poverty reduction are currently the two pillars of the World Bank's strategy for development. See Stern (2002).

[57] While the ICS provides critical data on the impact of improved performance may have on business investment, it does not provide any guide as to **how** this might be achieved. The actual policy response to identified constraints will necessarily be country specific.

[58] Business will also be able to put increased pressure on government for policy reform. This, in turn, will strengthen dti's "clout" in government

[59] DTI (2002)

assimilate the data and "translate" it into policies that enhance business growth. **The dti** will need to have specific expertise and competence in the area concerned in order that, armed with the relevant data and analysis, it can engage effectively with other parts of government. **The dti** will best realise its objectives if it has regular specialized institutional capacity that can engage actively and persistently in the policy processes to ensure that policy will advance business growth.

Building genuine and effective capacity so as to engage with policy in the key areas that impact on business investment and growth will require significant resource commitments. Currently, the dti expends far less resources on these activities than in, for example, the supply side measures or "products" that are regarded as **the dti's** "core" business. **The dti** products are not unimportant, although given their limited reach and efficacy a hard look is urgently required [60] – but, if the dti is to fulfill its mandate, it will need to examine how it apportions its resources and how it might give much more attention to the development of high level institutional capacities within the dti so that it can effectively engage with other parts of government.

A second requirement if the dti is to have an effective role in policy processes elsewhere in government that impact on business investment and growth, is that the legitimate role of the dti, in this regard, be accepted within government. This is a very difficult and sensitive issue. Government departments have a tendency to guard their spheres and will frequently resist any intrusions from "outside." The government's microeconomic reform strategy that identifies areas for reform and the promotion of "joined-up government" and more especially the creation of a cluster of government economic ministries concerned with investment and employment that is led by the dti is potentially a very positive move in this direction.

Considerable organisational and institutional capacities are required to effect policies that will impact positively on business investment and growth in the aggregate. This is an exacting and demanding task and presents the dti with considerable challenges.

3.2 **Support for the Development of Selected Sectors**

While seeking to enhance the climate for business investment and growth generally, the dti is also committed to additional selective supports to enhance investment and growth in a number of so-called priority sectors.

There is, of course, considerable debate about the wisdom of selective support for certain sectors or activities. However, even those who do advocate selective support, accept that the risks of government failure are considerable. In order to reduce the risk of government failure, there are certain pre-requisites and institutional requirements that should be in place before such policies are pursued.

[60] In any assessment, two questions may be particularly important. First, are there too many offerings (programmes) so diluting impact and raising costs? Second, is the dti the appropriate delivery vehicle for these offerings? A number of "dtis" or their equivalents elsewhere, have severely rationalized their offerings and a number are looking at alternative delivery vehicles, more particularly engaging non-governmental agencies.

Firstly, since such interventions do stretch governmental capacities, governments will need to be very limited in the number and complexity of the sectors that they choose. Choosing too many sectors will be sub-optimal. Similarly choosing sectors that are very complex and where the "gap" between local capacities and best practice is very wide will be very demanding of state resources and capacities. Aerospace, for example, is likely to be much more demanding than clothing.

Secondly, selective supports require a competent bureaucracy.[61] It is important to appreciate the nature of the competency required. The bureaucracy has to be able to differentiate desireable from undesireable investment projects; to make an assessment of how much support firms require in order to compete and how rapidly firms may build their capacities and learn. These are not just complex questions. They are industry specific questions. They require a deep knowledge of the industry itself and its dynamic. Industry-specific knowledge is vital. This is tacit knowledge. It is learnt experientially, and only incompletely through academic training. Recruitment needs to give considerable weighting to business and industrial experience. Developing such capacity is time consuming and slow.

Thirdly, the relationship between government and the recipients of any selective supports is very complex. The relationship is at once intimate, since government will want to design and customise its support to the specific requirements of the sector and be able to monitor its performance- and this will require deep engagement. At the same time, the relationship is formal, since government will want to maintain a critical distance. This distance is important firstly to avoid "capture" but also so that the broader economy-wide implications of any support extended to a sector and hence its broad welfare implications can be carefully weighed. This "embedded autonomy,"[62] allowing closeness and mutual exchange and, at the same time, distance to prevent any descent into "crony capitalism" is in and of itself, very difficult and complex to manage. This is a task for the political leadership rather than the industry specialist. It is no less taxing on limited resources.

The dti's industrial strategy document identifies eight priority sectors – clothing and textiles; agro-processing; metals and minerals; tourism; automotive and transport; crafts; chemicals and biotechnology and knowledge-intensive services.[63] Other priority sectors have been added since then, including aerospace, call centers and back-office operations. Given the large number of sectors that the dti has prioritised and the complexity of some of these sectors, questions will need to be asked if the dti has not spread its resources and capacities too thinly. Given the demands made on the bureaucracy, both industry specialists and the political leadership, if it is to commit to selective support, **the dti** may need to be far more focused and limited in the number and scope of the sectors that are prioritised for customized policy support. As importantly, **the dti** will need to pay considerable attention to securing the personnel with the requisite training and, above all,

[61] A number of the organisational and institutional requirements to conduct selective industrial policy in South Africa have been raised by Ha-Joon Chang (1997): 5-6.
[62] Evans ….
[63] dti (2002):30-31

experience. It willneed to pay considerable attention to building the capacities that are critical for the success of selective sectoral support.

3.3 **Conclusion**

Enhancing investment and growth for business in general and for particular sectors are both very demanding of organisational and institutional capacities. In industrial policy, institutions matter as much as they do in the developmental process in general. South Africa's future industrial and business performance will depend at least as much on the development of these capacities as on the identification of the "right" policies. This is a fruitful area for future policy research and engagement.

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