

Trade and Industrial Policy in South Africa

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1 Introduction

South Africa has undergone a decade of extensive and in many ways remarkable transformation as it emerged from a combination of self- and externally-imposed economic isolation. The adjustment has been made even more remarkable by the fact that it has taken place simultaneously and in parallel with an even greater reform of social and political institutions. Both the political and economic reform programs have been home grown—designed by South Africans in response to South African needs, circumstances and constraints.

The focus of this report is on the economic reforms. These have involved extensive deregulation of domestic and external trade. Price and quantity regulations that typified earlier economic management have been largely dismantled. The tax system, including the structure of import duties, has been simplified and its administration improved. Financial markets have been liberalized and foreign exchange controls gradually reduced.

At the same time the government has continued to guide and regulate the economy in numerous ways, direct and indirect. Industrial policy has been a major focus of attention and is seen as a key element in the government's Accelerated and Shared Growth Initiative of South Africa (ASGISA).

The future direction of South African industrial policy is the subject of vigorous and healthy debate. The outcome is important for the country's economic development. This study is an attempt to contribute to these discussions through an overview of and some questions about the economic impacts of South Africa's post apartheid trade and industrial policy. It comprises two main parts. These parts can be read independently.

The first part reviews some key themes in international policy discussions and draws lessons from the recent experiences of other developing countries. We focus primarily on generic lessons related to openness, the nature and importance of global production networks, infant industry protection, subsidies and anti-dumping duties, resource development and beneficiation, and policy processes and the problem of capture. Inevitably, much of it draws on the successful development experience of east and southeast Asia in the last quarter of the twentieth century, and one section addresses some specific lessons from that experience.

The second and largest part of this report reviews South Africa's industrial policy over the past decade. While not comprehensive and perhaps a little out of date (this paper was written in 2006), the range of policies examined is sufficient to dismiss the claim made by some that South Africa has not had an industrial policy. In fact, whether by intention or not, South Africa has experimented with a very wide range of policies that have had a direct impact on the path and success of its industrial development.

Two specific sectors—the motor industry and textiles and garments—have received the greatest amount of attention and support. Furthermore, the government has signalled that its future approach to industrial policy will be based on such sector-specific initiatives. These two sectors are therefore dealt with in some detail. But the set of policies that have influenced South Africa's industrial development is much larger than this. Our discussion also covers:

- tariff policy, and multilateral and preferential trade negotiations,
- import parity pricing of basic industrial raw materials,
- investment incentives,
- industrial offsets and government procurement,
- development finance through institutions such as the Industrial Development Corporation (IDC),
- industrial development zones,
- provincial initiatives such as Gauteng's Blue IQ,

- a broad range of cross cutting regulatory, infrastructural and public utility issues such as telecommunications, ports and transport, and
- basic macroeconomic questions related to fiscal and monetary management, resource revenues and the real exchange rate.

This review raises some serious questions about the economic impacts of South Africa's industrial policies and of some future alternatives that are now under discussion. Despite the intensity of and broad interest in the debate, there appears to have been very little serious economic analysis of past policies or of future plans. Basic assumptions about the effectiveness of sector-specific interventions, for instance, appear to be poorly founded. Many policies have impacts that are at variance with stated intentions. International experience is drawn upon with great selectivity to support particular views about preferred policy directions.

The real questions facing South Africa are not whether South Africa does or should have an industrial policy. They are not about whether there should be more or less government intervention. The most important questions are pragmatic and not ideological—they are about what works and does not work in South Africa and why.

PART I: Lessons and Themes

In this part we explore a number of major lessons and themes from international experience. The increased openness and fragmentation of the world economy has created new challenges and opportunities for developing countries. This requires an informed and appropriate policy response. It also requires independent, intelligent and transparent institutions. Insulating the domestic economy, through incentives, subsidies and protection, is costly and short sighted. It creates a cycle of dependence, rent-seeking and capture. Government institutions and resources should instead be focused on reducing the cost of domestic and international trade and dealing with the most important market failure that arises from weak education. Some of the realities of globalisation and some of the real success stories emerging from east and southeast Asia are discussed below.

2 Openness and Growth

Growth is essential to poverty reduction. Openness is essential to growth. Low and middle-income countries that have succeeded in integrating themselves into the global economy through trade and investment have generally grown faster than richer countries. Those that have not succeeded have grown more slowly.³ These broad conclusions are not sufficient, of course, to map into a unique set of policy and institutional prescriptions that apply to all countries and all situations. Political reality and differences in economic and institutional circumstances mean that each country must find a path that works best for itself.

The most general lesson is that good economics matters. This means adapting and responding to market forces and ensuring that government interventions contribute to positive economic development outcomes (such as rising employment, rising productivity and rising wages). Government policies and regulations do have an impact on the structure and efficiency of markets—they determine the costs of entry and exit, the number of players and the extent of competition, and the standards that are applied to them. Choices made by governments can determine the economic outcomes of markets. Growth and employment tend to be supported by policies that lower barriers to entry and competition and promote productivity.

The decisions of government agencies are therefore important and need to be guided by their capacities to properly analyze and understand the implications of policy options, and to avoid capture by vested interests. Weaknesses in analytical or institutional capacities can be a serious constraint that should be taken into account in deciding on general strategies and policies. Weaknesses need to be acknowledged as policy constraints and, where critical to future progress, need to be remedied through effective capacity building.

3 Fragmentation of Global Production and Import-Led Growth

The integration of world markets that characterizes the process of globalization has facilitated, somewhat paradoxically, a fragmentation of global production. Improvements in information technology, transport and logistics, have made it possible to “deconstruct” product value chains and allocate global production tasks for goods and services much more finely and in line with comparative costs of production in different locations. Global production chains have become fragmented and truly global. Countries do not have to rely on the growth of domestic markets; they do not have to be self-sufficient in any set or subset of production; they do not need to be tempted down the self-destructive path of import-substitution as a means of developing local industrial competencies.

Countries that facilitate such trade are part of a global process that has driven down costs of internationally traded goods and services and provided large benefits to consumers and workers everywhere. The much discussed ‘export-led’ growth of east and southeast Asia is more accurately described and thought of as a story of import-led growth. Successful export industries were supported

³ See Sachs and Warner (1995) and Secretary of State for International Development 2000. While there has been much debate and many (justified) criticisms of the Sachs and Warner work, the general importance of integration with the global economy for growth remains very difficult to challenge.

by policy regimes that reduced the cost of importing raw materials and intermediate inputs through general trade liberalization and trade facilitation, boosted in many cases by special measures to further improve access to inputs in world markets. This is elaborated in the later section on lessons from Asia. The same is true of Mauritius, one of the clear post-colonial success stories in the southern Africa region (See Box 1 on Mauritius).

1. Mauritius: Gains from Globalization

At independence Mauritius' economic prospects were bleak (see Meade 1964). It was among the poorest countries in the world. The population was too high for the island's limited land and natural resources. Any wage sufficient for landowners to hire the available labour force would be too low to support a subsistence standard of living. It appeared that the only hope was large increases in sugar yields or significant increases in world sugar prices. Neither of these was very likely. Mauritius appeared to be stuck in a Malthusian trap, condemned to grinding poverty, inevitable ethnic strife and political and economic instability.

Thirty years later Mauritius would be unrecognizable to those who participated in British-commissioned studies at independence. Per capita income (PPP adjusted) is more than 5 times higher than the average for Sub-Saharan Africa and more than two and a half times that of all developing countries. Rates of growth and other human development indicators outperform these other countries by a wide margin.

Central to this achievement have been:

- recognition of special opportunities available in world markets, and
- trade promoting policy reforms—facilitation of the import of raw materials and the export of processed products, with minimal regulation or other interference.

Outward oriented investors in Mauritius were permitted to import what they wanted from any source they wished, to engage in any processing of these materials that they could do economically in Mauritius, and to export to any market in the world.

An interesting feature of trade policy was the continuation of relatively high rates of protection to a wide range of import substitution industries. Until very recently, the tariff structure was characterized by high and variable rates, with an escalating pattern that encouraged inefficient local assembly industries. A long-entrenched myth about the importance and fragility of such import substitution industries perpetuated a high cost policy regime for an unusually long time.

It is only relatively recently, after recognizing the small amounts of employment in these industries and the high costs they impose on consumers, and after introducing a VAT that reduces budgetary reliance on import duties, that Mauritius has begun to rationalize its import duty regime (see Box 7 of Flatters 2002b).

It is a testimony to the effectiveness of the EPZ system and to the market-friendliness of the rest of the investment and industrial policy regime that the export-oriented economy in textiles and other sectors developed so successfully in spite of the retention of other import substitution measures. Mauritius now exports a wide range of manufactured products, including of course garments and textiles, but also sunglasses, watches and their parts, medical equipment and many other goods. In addition she continues to earn considerable income from tourism, and has begun to export banking and information processing services.

One of the achievements of this 'miracle' was huge job creation in outward oriented manufacturing. As a result of this success Mauritius is now facing labour shortages rather than surpluses; wages and skill levels have risen to the point that Mauritius is rapidly losing its comparative advantage in labour-intensive manufacturing. It is graduating from producing low skill manufactures to exporting more skill-intensive products. It has become a regional growth engine, a hub for coordination and logistical support of production and exports of a wide range of services and manufactures, including textiles and garments.

Mauritius is an African example of the gains from participation in global markets. Central to its success has been a policy environment that has made trade as easy as possible and has permitted investors, domestic and foreign, to engage in activities that could be done best in Mauritius.

Endowments of natural resources or basic industries are no longer necessary or sufficient for participation in this global environment. Indeed, countries that erect barriers to the globalization of production in order to try to create local or regional value chains succeed only in raising costs and reducing their competitiveness. This has important implications for the role of logistics and trade

facilitation and for the structure of ‘global value chains.’ International trade is a substitute for self-sufficiency at all stages in product value chains. Indeed, logistics and trade facilitation are far more critical to a country’s industrial competitiveness than the development of integrated local or regional value chains. Protected upstream raw material production can be a hindrance rather than a help to downstream industries when the prices charged are higher than those available in global markets.

Local content rules can be a similar burden. For a variety of reasons, investors will always prefer local rather than international sourcing, all other things equal; but they can only be depended on to buy locally when costs are efficient and appropriate. Policies that force local content when it is inappropriate are a hindrance to the development of competitive downstream industries. This is discussed further below in the context of experiences in both Asia and South Africa.

4 Market Failure

Many different kinds of industrial policy are justified on the basis of standard externality arguments. Among the most common are research and development (R&D) or technology spillovers and coordination failures. The existence of such market failures is the presumed basis for industrial policy interventions. Far too often ignored in this context is one of the most important sources of market failure in any economy and certainly among the most important in terms of development strategy—the market for human capital.

The design and implementation of policies to counteract many kinds of private market failures, unfortunately, is far from trivial. Simply identifying and quantifying the order of magnitude of externalities of the type that are often discussed can be extremely difficult. Unsupported claims of major externalities can and have been used to justify large government interventions with no apparent *ex post* economic benefits. Discussions of technology externalities often ignore the possibility of market-based solutions that can arise with little government intervention other than the establishment of institutions that give some protection to intellectual property.

The technology argument arises from the observation that research and development and other kinds of productivity-enhancing investments often have public good aspects. In such circumstances private agents might tend to under-invest unless somehow encouraged to do otherwise by government policies. Once again, it is difficult to proceed from general observations about links between investment and productivity growth to useful policy prescriptions. In the absence of specific and reliable information about particular externalities, the optimal policy is usually to concentrate on establishing a secure investment environment and possibly to provide some general incentives to research and development expenditures. Anything more than this incurs the real danger of providing unnecessary and counterproductive subsidies to capital-intensive investments.

The biggest challenge facing poor and middle-income countries is not usually to invent new technologies, but rather to create an environment that encourages foreign and domestic investment that capitalizes on existing and generally well-known technologies, not only for production, but also for logistics, design and marketing.

Coordination failures refer to agglomeration economies arising from ‘chicken and egg’ problems—“to have a garment industry requires a viable textile industry, and *vice versa*.” As already observed, the new global economy has solved many such problems by linking countries and markets through international trade. The complementary institutions that are really necessary are well functioning transportation networks, ports and customs services related to the facilitation of trade, and of course, public institutions such as police and legal services. This does not call for sectoral industrial policies, but rather cross-cutting institutional support provided and/or facilitated and possibly regulated and monitored by the public sector.

Indeed, one of the greatest sources of market failure is not the kinds of externalities just discussed, but rather failures of government policy and institutions. Industrial policy interventions are often justified on the basis of problems whose roots lie in policy failures elsewhere in the economy. Investment and

other incentives, for instance, are claimed to be needed because of the “high cost” structure of the economy.

Why are costs high? The causes vary from country to country and over time. But the list generally includes some subset of the following complaints. Ports and customs are inefficient; telecommunications infrastructure is bad and highly priced; crime rates are high and law enforcement weak; labour markets are inflexible and minimum wages high; labour skills are low; financial markets are uncompetitive, with poor service and high prices; transport infrastructure is poor; electricity supply is unreliable and/or expensive; the court system is weak and contracts are difficult to enforce; financial regulation is weak with the result that foreclosure and bankruptcy processes are costly, time-consuming, uncertain and unreliable.

Many, if not all, of these problems have roots in weak government policies and institutions, and their solution provides a full agenda for most governments. Much of what we think of as industrial policy in Asia (see section 8 below)—or even the experience of many European countries in the 1950s and 1960s—is really about getting the economics of government policies and regulations right. Effective industrial policy in other countries has rarely (if ever) been about deals struck between government and one or two producers to raise investment in exchange for guaranteed returns from state-imposed limitations on competition. Instead, they are about enabling firms *throughout the economy* to raise productivity and hence value-added.

What are the practical policy implications of these arguments? International experience indicates that it is difficult to use normal externality arguments as the basis for industry- or sector-specific government support. Difficulties in identifying and quantifying genuine externalities at the sector level means that initiatives of this type are likely to be misused to support particular vested interests with few if any general economic benefits. We return to this issue below. Meanwhile, public support of market institutions is critical in creating an investment environment conducive to long-term economic development.

Finally, as observed above, investment in human capital is maybe the most important market failure from growth and equitable development perspectives. The fundamental problems arise from an almost complete absence of capital markets for the financing of human capital investment at all levels of education and from the influence of family structure and income inequality on educational choices. Public support of investment in education and skills development should therefore be a critical element in any long-term development strategy.

5 Infant and Declining Industries

One of the most commonly used arguments for protection is that an industry is ‘infant’ and as such cannot compete without some initial protection against better-established competitors. Therefore it needs to be protected for a ‘short’ period of time. The argument is often combined with the notion that the infant is somehow ‘strategic’ for the economy. Another closely related and often simultaneously used argument is that the industry in question is heavily protected or otherwise subsidized in other parts of the world, which also makes it difficult, if not impossible for local producers to compete.

Consider first the basic infant industry argument. Suppose that because of initial start-up or learning a newly established firm or industry would not be able to compete immediately upon inception. First, if some kind of assistance is justified, import protection is not usually the best policy instrument to use. Not only does it subsidize the protected industry, it also imposes real economic costs on downstream users and/or final consumers. Employment gains are often small. See Box 2 for an example from Namibia (based on Erasmus and Flatters 2003).

2. Infant Industry Protection: Pasta in Namibia

The SACU agreement includes a provision for the protection of new domestic ‘infant’ industries. Namibia chose to take advantage of this provision in the pasta sector.

The SACU MFN tariff on pasta was 25 percent. At the request of the local flour milling group that wished to build a new pasta factory, the government agreed to impose an additional import duty of 40 percent, to remain in place for four years and then be phased out gradually over another four years. Since the milling branch of the company gets wheat on a duty-free basis, its flour is also effectively duty-free, except for any excess of its milling costs over those of international mills.

The factory was completed in 2002 and operated virtually immediately at almost 100 percent of capacity—three shifts, seven days a week. It was obviously a commercial success. This should not be surprising in light of the very high levels of protection given. The effective rate of protection *vis à vis* South African producers was about 89 percent while *vis à vis* international competitors it was about 425 percent (based on cost data from the firm).

Other than rents created for the (South African owned) firm, what benefits does the infant industry protection give to Namibia?

Small increases in demand for local wheat do not affect the price received by farmers. They receive no more than the pre-tariff world market import parity price regardless of local demand (Erasmus and Flatters 2003).

What does the new pasta factory provide for consumers? Increased import duties ensure that consumers have much less choice in buying pasta. The factory employs a special high temperature process that allows the use of flour milled from inferior local wheat rather than durum wheat. This gives a product that is acceptable to some consumers, but disagreeable to many others. A tour of local supermarket shelves revealed only the local brand. ‘Specialty’ pasta (‘normal’ pasta in most other markets) has to be bought at very high duty-inclusive prices in specialty shops. High prices and low sales volumes made this an unprofitable product for most supermarkets to stock.

What about employment? The pasta factory operating at full capacity with three shifts employs a total of 20 workers (10 less than the minimum promised when applying for infant industry protection). But this low number does not even represent the net job creation from the factory. Prior to this factory, another local pasta producer served the local market with pasta made from flour purchased from the milling company that now operates the new pasta plant. Shortly after the new pasta plant commenced production, the old producer’s line of credit was revoked and the factory was forced to close. Data have not been obtained on the number of job losses this caused. But it can be stated with certainty that the net number of jobs created by this infant industry protection is less than 20.

More generally however, negative initial net cash flows are a characteristic of almost all investments. These are real economic costs and should be taken into account in private investment decisions. Why should private costs be publicly subsidized in order to generate future private profits? And if so, how can it be decided whose costs should be underwritten and whose should not? Some kind of policy intervention is justified only if there are some identifiable short run *external* benefits to the investments in question or if private start-up costs can be shown to exceed corresponding social or economic costs. Otherwise, offsetting them through some form of state subsidy or protection transfers these costs from investors to consumers or taxpayers and causes investors to base decisions on distorted price signals. It encourages wasteful investments. Of equal or maybe even greater significance is the incentives created for rent-seeking behaviour. Resisting such pressures requires strong economic policy institutions.

In practice, most governments are quite poor at picking ‘winners.’ And in countries where governments attempt to do so, investors often become very adept at picking government’s pockets. Infant industries often become perpetual children and impose long-term costs on domestic consumers, downstream users and taxpayers. Others fail before or after the end of protection. And others make excess profits from unnecessary protection and policy-sanctioned domestic monopolies.

There might, of course, be genuine problems with the investment environment that discourage new investment.

One possibility is the existence of weak or underdeveloped capital markets. If weak capital markets make it difficult to borrow against future profits, the solution is not arbitrary production subsidies and protection, but rather policies to improve the capital markets. Weak capital markets are often themselves a result of infant industry protection and poor regulation in the financial sector.

If the problem is a weak investment environment, begin to repair it; don't make it worse by inviting rent seeking and engaging in costly and arbitrary protection

If the problem is too much rent seeking, recognize that a tradition of infant industry protection is more likely to aggravate the problem than to solve it.

Declining industries might be thought of as the opposite type of problem. The rise and decline of firms and industries is a natural and healthy phenomenon in a growing economy. This should not be discouraged by policies that try to entrench existing patterns of production. This is not to deny the social and economic value of policies and institutions to assist workers and vulnerable groups that are temporarily displaced as a result of these dynamic patterns. *But adjustment assistance to workers does not require long-term industrial support to firms and industries that can no longer compete. Adjustment assistance can be given more effectively and at much lower cost if it is directed at workers rather than firms and industries.*

In fact, the industries that are often most vocal in demanding assistance in the face of declining competitiveness are exactly those that have been shielded from competition through protection and other subsidies. The (lack of) adjustment of rich country garment industries is a quintessential example. Similar examples abound in countries at almost all levels of development. Many of these are sectors that started as protected 'infants.' An unfortunate consequence of infant and strategic industry protection is that it is very difficult politically to reduce or remove protection when the chosen firms or industries do not (or claim not to) become competitive. Protection is easy to grant and much more difficult to remove.

6 Anti-Dumping and Other Contingent Protection

A related argument for protection is based on the claim that competitors are subsidizing their own industries and/or are dumping their products in our markets.

There are two issues here.

First, international experience shows that in the majority of cases the real issue has nothing to do with subsidies or dumping behaviour. Closer examination of such claims usually reveals that the real argument is simply that foreign competitors are able to produce at a lower cost than the claimant. This is not a legitimate argument for protection, at least not in a country that wishes to integrate successfully into the global economy. The whole point of engaging in international trade is to gain by producing and exporting goods and services that can be produced domestically at relatively low cost and importing those that can be obtained at a lower relative cost from foreign sources.

Second, inter-country differences in relative costs can arise for many reasons, one of which might be distorting subsidies of particular products in some countries. Subsidies by a particular seller or even by a single or small number of countries are unlikely to have an impact on the world price of the good in question and hence have little or no impact on importing countries. However, by inducing domestic producers in the selling country to produce something at a higher cost than can be obtained in the world market, the subsidy imposes a real cost on the exporting country.

In a few cases the subsidies are sufficiently large and widespread that they noticeably lower the world price of the good in question. In these cases, subsidizing countries hurt themselves even more—first by inducing high cost, inefficient production, and second by lowering the returns received by efficient producers in their own countries.⁴ Thus, the main cost of the subsidy is still felt by the exporting countries. However, in this case there is also some impact on other countries. The lower world price hurts producers in other countries and is of benefit to consumers. If the other country in question is a net exporter of the good, the losses to domestic producers are larger than the benefit to consumers.

⁴ The optimal policy for a country that can affect the world price of one of its export products is to tax it, not to subsidize it. An export tax is a way of exercising the country's monopsony power in world markets by restricting supply and raising its price. A production or export subsidy does the opposite.

For net importers of the subsidized good, the benefits to domestic consumers outweigh the costs to domestic producers,

For net importers of subsidized goods, therefore, the appropriate policy response is to thank the subsidizing countries for their generosity. For net exporters, is there any argument to be made for subsidizing or protecting domestic producers? No. The world price, whether it includes foreign subsidies or not, is exogenous and any domestic policy (e.g. subsidies or protection) that induces local producers or consumers to think the real price is different than that causes economic waste by distorting their production and consumption decisions. The resulting costs are borne domestically and, unless the domestic market is large enough to have an impact on world prices, there will be no impact on foreign markets.

The argument that we should counter foreign protection of particular products with corresponding domestic protection—they protect/subsidize and therefore so should we—is similarly flawed.

The WTO has established rules for dealing with export subsidies and with dumping. These are aimed at ruling out frivolous and harmful uses of protection and subsidies. Unfortunately these rules are less stringent than economically desirable and they leave considerable scope for policies that are harmful to the countries that use them. As a result anti-dumping actions are now widely recognized as a form of disguised protection that is unfortunately sanctioned by inadequate WTO procedures (Stegemann 1991). Fortunately the WTO rules only set a minimum standard for anti-dumping actions and do not prohibit countries from using more stringent and economically justifiable procedures, including, of course, refraining from the use of anti-dumping procedures at all.

The only legitimate economic argument for anti-dumping actions is when dumping by a foreign seller is predatory in nature and will have the effect of

- destroying all domestic competition in the importing country, and
- creating a monopoly in the domestic market by the dumping exporter and the subsequent levying of prices that are higher than those prevailing in international markets.

In other words, the real problem is not the low prices that arise from ‘dumping’ behaviour, but rather the higher prices that might result from the creation of a monopoly in the domestic market.

The simplest and best tool for preventing such predatory dumping is to maintain open international markets. In such circumstances it would be foolhardy of a foreign producer of steel or garlic to think that it could regain the losses incurred by temporarily dumping at below cost through selling later at a monopolistic price higher than in the world market. With an open domestic market, any attempt to raise prices significantly above those available elsewhere would be met by a surge of imports from other sources. In almost all cases imaginable, open markets are the simplest way to ensure that predatory dumping will never occur, and hence that anti-dumping actions will never be required.

The greatest problem with WTO-sanctioned anti-dumping procedures is that they include no requirement to take account of the interests of domestic consumers or downstream users of imported products. Imposing any tariff, temporary or permanent, to deal with so-called dumping or any other problem, without taking into account the interests of the users of the imported goods is a recipe for bad trade policy. It is an invitation to rent seeking behaviour and capture of domestic policy makers by domestic producers, especially those that are inherently uncompetitive and thrive because of protection from foreign competition. Fortunately WTO procedures do not prevent governments from taking broader economic interests into account.

Contingent protection to deal with subsidies, dumping and unanticipated harmful import surges is often argued to be a necessary complement to trade policy reform. It is seen as necessary to placate the concerns of the vested interests that fear that they will be among the short run losers from liberalization and deregulation. These concerns are certainly legitimate. It would be unfortunate for reforms that are in the long run national interest to be blocked by a small group of vocal opponents.

In dealing with these concerns, however, it is important not to lose sight of the benefits and the beneficiaries of the reforms. The short run costs of reforms to particular groups are easily overstated

and it is a small step from there to allowing the reform process to be stalled through the use of contingent protection. As discussed earlier, protection of declining industries and non-competitive firms is a poor substitute for adjustment assistance to truly vulnerable groups. Any procedures for the implementation contingent measures should include consideration of lower cost and more effective alternatives, and of their broader economic costs. Otherwise anti-dumping and other contingent protection will continue to be just another form of disguised and harmful protection (see Stegemann 1991).

7 Resources, Rents and Beneficiation

Resources are a source of wealth and that is generally good. But resource rents can be dangerous if they are mishandled and especially if they lead to political or economic excesses.

Large pools of resource rents can be an invitation to economic mismanagement.

State run oil companies in a number of countries have brought countries close to fiscal collapse by reckless spending of oil revenues and accumulating large debts based on expected future income, precisely the opposite of the prudent long-term rule of accumulating rents and spending only the current income from the fund.

In other countries, tropical forests have been exploited far in excess of sustainable or economic rates in order for particular parties to gain immediate access to the resulting rents. The result once again is a substantial reduction in the present value of long term rents generated by the forests, not to mention substantial collateral environmental damage.

Instances of gross mismanagement such as these can turn resource rents from an asset into a curse. The economic problems that arise are sometimes compounded by political instability and conflict that arises from struggles over access to the rents.

‘Dutch disease’ is the name given to the macroeconomic impact of resource exports on domestic costs and on the real exchange rate. Resource booms can raise costs and reduce the competitiveness of tradable goods producers through real exchange rate appreciation and through supply side pressures created by increased demand for non-tradable goods. This reduces the competitiveness of import competing activities and other exports. This, of course, is the economic mechanism through which resource utilization adjusts to changing patterns of comparative advantage and is not necessarily bad. However, if the resource boom is a manifestation of too rapid an exploitation of resource wealth, at a pace in excess of the optimal rate of exploitation of the resource, then the Dutch disease effect is cause for concern. But the solution lies in policies that correct the resource mismanagement problem. Investment of rents from resources managed at an economically optimal rate provides the basis for long-term development opportunities and as such can be a positive influence on development.⁵

Resource rents can be a valuable and relatively low cost source of government revenue to meet long-term development needs such as human capital investment in which the public sector often plays a key role. Lack of taxation of such rents is a foregone opportunity that can result in insufficient funding of public expenditure requirements and/or much higher economic costs of taxation through reliance on distorting taxes on trade, savings and investment. To the extent that untaxed rents end up accruing to foreign shareholders in the resource sector, the failure to tax them is a net loss to the economy—a transfer of rents from the domestic economy to foreigners.

⁵ Unpredictable and unhedgeable *fluctuations* in resource prices can have corresponding impacts on the real exchange rate and hence on the risks of profitability of investments in tradable goods sectors. If the resource prices and rents are truly unpredictable and unhedgeable, they might best be thought of as true economic risks. Offsetting industrial and exchange rate policies are very dangerous, since governments are generally less well informed about price trends than are market participants, and are, of course, much more prone to influence by special interests that would be pleased to use industrial and exchange rate policies in self-serving but not economically optimal ways.

Resources are, in principle, an ideal base for taxation, since taxation of true economic rents creates no distortions in economic incentives. The challenge of designing a rent tax that does not distort incentives is not trivial, however, and in practice many resource taxes are not economically neutral.⁶

The use of taxes and other restrictions on resource exports are examples of another potentially serious cost of resources—the temptation to use government policies to encourage or force them to be processed domestically. Abundance of a natural resource can provide a basis for economically competitive downstream processing activities. But any resulting comparative advantage arises solely from differentials in transport costs in exporting the raw material relative to the processed product. Beyond this transport cost advantage, the overall competitiveness of local processing activities depends on the availability and cost of complementary factors of production and technologies. There is no a priori reason to assume that the global distribution of endowments of these complementary factors will coincide with endowments of the natural resources themselves. To force the use of domestic resources at home can be very costly if it means foregoing export sales at higher prices elsewhere. The general economic advantage arising from domestic availability of natural resources can be quickly squandered through high cost measures to force their processing and further uses domestically. There might be much more valuable developmental uses of resource rents than to force the development of local processing industries.⁷

8 Policy Processes and the Problem of Capture

The goal of industrial policy is to expand the economic opportunities available to a country's citizens. However, the name 'industrial policy' often conjures notions of providing direct assistance to firms and industries. This unfortunately reveals a major problem in industrial policy design.

The impact of sector-specific industrial policies is highly concentrated among the relevant firm(s), but their effects on other agents, especially labour, downstream users, final consumers and taxpayers are much more broadly dispersed (just as the gains from trade liberalisation are spread across all consumers but hurt the interests of a few specific producers). This explains why there is so much pressure on governments to devise and implement sector-specific policies (and retain sector specific protection) and why sector-specific policies are so often implemented without reference to broader economic interests of the country as a whole.

'Made to measure' trade and investment policies designed by specialist industry divisions of ministries of trade and industry are common in many countries, especially poorer ones. Anti-dumping regimes that measure 'injury' by the inability of domestic producers to compete at prevailing prices with no consideration of the interests of downstream users or consumers of dumped products are another example.⁸ Telecommunications, transport and utilities regulators often fall prey to the same syndrome.

An absolutely essential role for governments in industrial policy design is to assess the impacts of industrial policy actions not only on their direct beneficiaries, but also on all other stakeholders. 'Consultative' reviews of policy alternatives are not sufficient, because of the asymmetries of interests just described above. Those who come forward to make themselves heard in such processes

⁶ The costs of distortionary resource taxes can be high. Taxes on gross resource revenues do not discriminate between high and low cost rent sources and hence encourage "high grading" and considerable waste in the form of underutilization of economically valuable resources. Presumptive cost setting can have the opposite effect if costs are set too high. Uncertainty about the stability of resource tax regimes can create unnecessary risks and can lead to either under- or over-exploitation of resources. Export taxes can encourage high cost domestic processing of resources and end up dissipating resource rents through pure economic waste. See Boadway and Flatters (1993).

⁷ See the discussion of Indonesian export restrictions on logs in the following section on lessons from Asia.

⁸ Such procedures are often consistent with WTO rules. However, these particular measures are widely recognized as (poorly) disguised protection resulting from imperfect trade liberalization bargains made in earlier days of developing the WTO system. The fact that they are sanctioned by WTO rules does not mean that countries are prohibited from employing stronger standards in dealing with dumping or even from refraining from sanctioning any kind of anti-dumping actions at all. The WTO standard is certainly far too weak and has been employed as a blatant form of protection in many poor countries, to the detriment of their long-term development interests.

are generally those with the most direct self interest in the policies under discussion, while the much larger number of indirect, smaller, but collectively often more important stakeholders are seldom heard. Policy makers need to make independent assessments of the broader economic impacts of policies and try to ensure that policy decisions are not made without reference to these wider effects.

This requires strong institutions that are capable both of maintaining their independence of special interests and of collecting and analyzing all the relevant information. Neither of these tasks is easy, and a major part of the story of industrial policy reform and development throughout the world revolves around this problem.

The problem is made much more difficult by the fact that a large part of the relevant information resides in the firms and industries that might hope to be the main beneficiaries of industrial policy actions. There is no question that industrial policy needs to be informed by what is happening ‘on the ground’ and this certainly requires strong relationships with firms and industries that will be most directly affected by the resulting decisions. But this needs to be accomplished in a manner that avoids capture by special interests.

This requires institutions that are as independent as possible from the direct influence of rent seekers, and that have the capacity to collect and analyze relevant economic information to determine the likely costs and benefits of policy alternatives, as well as their distribution among principal stakeholders. Such analytical capacities are notoriously weak in most low and middle-income country bureaucracies.

This institutional weakness is often tackled by a) limiting the scope for discretionary and sector-specific industrial policies, and b) centralizing review and approval processes for all industrial policy actions in a small but effective coordinating economic ministry or in a ministry that is better endowed with the capacity to do basic economic cost benefit analysis of government policies and understand the broader economic costs of policy alternatives.

Policy experimentation can be a useful tool for trying out different types of policies in an uncertain world. This does not reduce the need for informed analysis in decisions about what experiments to try. And it makes it even more important to institutionalize processes for periodic policy reviews and for swiftly ending experiments that do not meet initial hopes and expectations.

Transparency of policy-making processes can be a valuable tool in reducing rent seeking. Policy makers need to be made accountable by being required to explain and defend the economic basis for their decisions. In addition to being reviewed at their inception, industrial policy actions should be subject to compulsory periodic reviews in order to be continued. This is particularly true of sector specific interventions that provide protection and other forms of subsidies based on “infant industry” or “adjustment assistance” arguments. The costs of protection and other indirect subsidies also should be estimated on an annual basis and included, like tax expenditures, in notional budgets of initiating institutions and ministries.

Some of the most blatant instances of capture of industrial policy by special interests are abetted by traditions of shifting employment of officials between government ministries and industries whose profitability depends on decisions they make. Bureaucrats recently hired from an industry that they are now entrusted to oversee and regulate or who might look forward to post-retirement employment in these industries are likely to have a different view of the national economic interest in policies for these industries than those who have no such history or prospects. To avoid such problems, conflict of interest needs to be clearly defined, and there need to be clear rules about conditions under which bureaucrats and policy makers can move between the public and private sectors.

9 Asia: What are the Lessons?

The books and articles that have been written on the lessons from Asia over the final decades of the 20th century are almost uncountable. As a result, it is possible, through selective use of references, to draw almost any lesson one wishes from this vast experience.

A key feature of the success of the east and south-east Asian economies, however, has been their ability to integrate with global markets for goods and investment. This is demonstrated, unequivocally, by Asia's rapidly rising share of world trade and investment flows. In most cases this required dismantling of institutional and policy barriers to trade and investment, often with an initial emphasis on export-oriented activities. The other key requirement was broad macroeconomic stability.

In addition, sustainable growth required institutional and policy reform in many areas including tax administration, finance, regulatory regimes, contract law and property rights, ports, infrastructure, law enforcement, public administration, etc. And while trade and capital investment were certainly important, educational institutions for ensuring broadly based and efficient investment in human capital were equally critical.

No single country has ever gotten all these things "right." Asia is no exception. The Asian experience in growth-enhancing policy reform has been far from uniform and is far from complete. While it is clear that Asia provides no unique template for policy reform, it is wrong and dangerous to cite policy mistakes in Asia as models for other countries to emulate. It is equally wrong and dangerous to base policy prescriptions on incorrect descriptions of what actually happened in Asia.

It is commonly argued, for instance, that Malaysia survived the Asian financial crisis better than other Asian countries because it followed unorthodox financial market policies, and in particular because of its use of its IMF-abhorred capital controls. This interpretation is inconsistent with some important facts. See Box 3.

Government support of strategic industrial investments is another common theme in renditions of the success stories in east and southeast Asia. According to one version of this story, the support of strategic infant industries was central to the success of many of these countries. WTO rules and free trade prescriptions of international financial and development institutions run the risk of "kicking away the ladder" of protection for developing countries that wish to follow this "Asian model."

There is no question that most of the successful Asian economies employed various forms of protection of strategic, infant and other industries. The success of the region, however, rested not on this protection, but rather on the ability to reduce its impacts and, where protection could not be eliminated immediately, to reduce its harmful effects on export industries.

The electronics exporters that developed throughout south-east Asia, for instance, did not develop on the back of previously protected import substitution industries. They were based on brand new investments attracted by institutions that enabled them to be insulated from the effects of protection and permitted them to import and export as freely as possible. Two of the most successful institutional innovations in Indonesia in the 1980s, for instance, were

- the replacement of Customs by a Swiss pre-shipment inspection service that reduced the cost of importing by at least twenty percent in a matter of months, and
- an export facilitation program that freed exporters from import duties on imported inputs, from local content requirements and from import licensing schemes on basic industrial raw materials, thus permitting them to compete on a level playing field against international producers.

Malaysia and Thailand relied heavily on customs arrangements permitting exporters to operate on a free trade basis for both imports and exports.

Institutional innovations such as these served as magnets to investment in electronics, garments, footwear and other labour-intensive sectors. They resulted in average economic growth rates of 7 to 9 percent for more than a decade and a half, and reduced the incidence of poverty by massive amounts—from 40 percent in 1976 to 11 percent in 1995 in the case of Indonesia.

3. Malaysia: Riding the Myth of the Asian Financial Crisis

It is widely believed that the imposition of capital controls and other ‘unorthodox’ interventions protected Malaysia from the worst of the Asian Financial Crisis. Malaysia’s alleged flaunting of orthodox policy prescriptions is a myth that was useful for domestic political purposes, but has very little grounding in reality.¹ These are some of the facts:

- Malaysia was actually much less vulnerable to financial crisis than neighbouring Indonesia and Thailand because of a much lower share of short-term international debt in its balance of payments. This was not because of capital controls, which were insignificant prior to the crisis. Malaysia in fact had a history of welcoming foreign investment and had succeeded in developing much more mature and deep equity markets than its neighbours. In light of its lower vulnerability, the more interesting question is why Malaysia was not better insulated from the crisis, at least relative to Indonesia and Thailand.
- The much discussed foreign exchange controls were not imposed until September 1998, more than a full year after the crisis, and long after capital flight had ended. The controls were not a means of dealing with the 1997 crisis or its aftermath, but rather, if anything, an instrument to prevent possible future occurrences of the same kind. The US dollar/ringgit exchange rate was fixed at the same time as exchange controls were put in place.
- Did the foreign exchange controls work? Since they were imposed a year after the crisis occurred, it would be very difficult to argue that they had any impact on the 1997 crisis. A simple index of different exchange rate experiences would be the path of the nominal exchange rate. In that regard, the Malaysian ringgit and the Thai baht performed almost identically versus the US dollar, both before and for some time after Malaysia’s imposition of exchange controls. The fixing of the ringgit against the dollar in September 1998 eventually led to small diversions between the ringgit and the baht, but never by more than 20 percent and for the past year by less than 10 percent. The ringgit/dollar peg was finally removed in July 2005.
- Were the exchange controls effective in preventing future crises? This will never be known since they were dismantled after one year.
- Did Malaysia digress significantly from IMF/World Bank policy prescriptions? The exchange controls certainly were at odds with IMF prescriptions. But as we have seen, they had little economic impact. With respect to general fiscal and monetary stance of the Treasury and Central Bank, Malaysia’s policies were very similar to those of Thailand, including a decreasingly restrictive fiscal stance, similar to Thailand’s and in line with evolving IMF opinions over the period. One area in which Malaysia outperformed Thailand was in financial sector restructuring, where Malaysia was more aggressive and decisive, a policy stance that was more, not less, in tune with IMF “orthodoxy” at the time.

In summary, Malaysia was less vulnerable than other crisis-struck Asian economies, and yet suffered almost all of the same symptoms. Its recovery path, especially in the first two years following the crisis, was similar to Thailand’s. The much-discussed capital controls had almost nothing to do with Malaysia’s recovery (in fact local experts suggest that it was only luck that prevented the controls from slowing the recovery) and were removed too early to learn whether they might have been effective in preventing future occurrences. Malaysia did and continues to use relatively open capital markets as a means to attract foreign investment and integrate its economy with global markets.

Industry-specific initiatives to promote or protect infant and/or strategic industries were more often wrong than right, and imposed significant economic costs. Consider a few examples.

Both Indonesia and Malaysia made strategic interventions to support national car industries. The Indonesian venture was the result of a joint scheme by a Korean manufacturer and a son of Indonesia’s President. It involved tax incentives, high import duties and other restrictions and special import privileges available only to the “national” car firm. Fortunately for Indonesia, key economic ministers had managed to resist the scheme for many years and it was not initiated until shortly before the Asian financial crisis. The economic reforms made necessary by the crisis included abandonment of this costly industrial policy and saved Indonesia substantial resources as a result.

The Malaysian national car program has been in operation for much longer. It began as a cooperative venture between the government and a Japanese company and was supported by large and highly discriminatory tax benefits for the national car company, paid for by taxpayers and Malaysian consumers. While the incentives enabled the company to dominate the domestic market for many years, it had no commercial success as an exporter. Similarly, domestic components supplier networks that developed under the program’s incentives were also unable to compete internationally.

The government has continued to pour resources into this uncompetitive sector through various means including purchases of foreign vehicle and motorcycle companies (in a quest for marketing and technical expertise) and counter-trade deals on government purchases. For several years now the incentives provided to the national car firm have been in violation of Malaysia's trade liberalization commitments in the ASEAN Free Trade Area (AFTA). The government has resorted to declaring the sector sensitive and to creating new schemes that it portrays as meeting its regional trade commitments, but that obviously violate their spirit and their technical requirements. The cost to taxpayers and consumers of supporting this strategic industrial program continues to mount.

While Indonesia got off lightly by quickly correcting its policy mistakes in the motor industry, it fared less well in another strategic sector, airplanes. An influential German-trained Indonesian engineer used his close connections with the President and his position as Minister of Science and Technology to try to prove his contention that Indonesia could defy the laws of comparative advantage by leaping directly into the design and manufacture of airplanes. Over a period of more than a decade beginning in the mid 1980s the Minister succeeded in establishing an airplane factory and producing several types of small and medium sized regional passenger carriers. As part of government procurement policy planes were sold to the air force and other ministries. A very small number were sold for export on very generous terms as part of counter-trade deals, mainly on government purchases.

The project was commercially unviable. This did not matter to the minister, however, who was able to use budget and off-budget subsidies, non-commercial loans from state banks and a variety of other funding sources including a Department of Forestry timber reforestation fund derived from levies on timber companies. The costs were large and completely non-transparent. A full accounting of the costs was never done and the program was beyond the influence of the key economic ministers. It was only the 1997 Asian financial crisis that gave these ministers the clout to end the subsidies as part of the economic reforms made necessary by the crisis.⁹

Policy makers in some south-east Asian economies faced an ongoing struggle in resisting pleas for protection of upstream basic industries such as plastic raw materials, steel, and synthetic fibres. Whenever such pleas succeeded, and tariffs or other import restrictions were imposed, labour-intensive downstream manufacturing industries suffered. The key to success of both downstream and upstream industries was to minimize protection of upstream industries and ensure easy and unimpeded access to raw materials by downstream producers.

Costly policy mistakes were also made in encouraging beneficiation of domestic resources. See Box 4 for an example from Indonesia.

Clearly, the successful Asian economies were not immune from making policy mistakes. Rent seeking by special interests and well-intended but improperly understood policies are a constant danger everywhere. A large part of the success of the Asian economies can be attributed to their ability to sustain policy reform, to minimize the impact of unavoidable policy distortions on key labour-intensive sectors, and to understand when policies were causing serious harm and do something about it.

All countries are burdened by legacies of policies and institutions that are far from perfect. The pace and sequence in which they can be improved depends on assessments of the economics of the alternatives and on the political and bureaucratic realities of the policy process in each country. The Asian experience illustrates the important sense in which, for these reasons, the "optimal" policy configuration varies widely from country to country.

But, whatever other lessons are drawn, it is certainly incorrect to view Asia's growth-enhancing policy reforms negatively as "kicking away the ladder" or reducing "policy space" for protection. Rather, it should be seen as a process of removing the disabling shackles of distortionary and protectionist policies

⁹ This happened, ironically after the Science and Technology Minister had been elevated to the post of Vice President and just before he became President (for a relatively short period of time).

4. Indonesia: Costly Resource Beneficiation in the Forest Sector

Indonesia is home of one of the world's richest endowments of tropical forests. Until the late 1970s she exported almost all logs in raw form to countries such as Taiwan and Japan where they were converted into veneers and plywood. Export earnings were in excess of \$2 billion per year, but the government collected very few royalties.

In order to encourage more domestic processing, the government enacted an export tax on logs, but not on sawn timber or plywood. Labour cost differences were already beginning to shift processing investments out of high wage east Asia and into Indonesia, and the export tax was a small incentive to speed up the process. A year later, however, the government enacted a much stronger incentive, a progressive ban on log exports, implemented through an export quota designed to fall to zero in five years. The price of getting a share of the export quota and the corresponding high rents on log exports was to set up a plywood mill. Most newly built mills were inefficient and lost money. But that did not matter to investors as long as they viewed them as a necessary cost of engaging in highly profitable log exporting.

The management of the export quota was highly corrupt and virtually none of the log rents went to the government budget. Log export revenues plummeted and were only partially offset by increased plywood exports. Plywood mills were highly inefficient; their main purpose was not to produce plywood or to produce it efficiently, but rather to secure log export rights. Log rents were thus wasted in inefficient plywood production.

In the longer run, of course, plywood exports replaced log exports, and plywood efficiency gradually increased. The incentives, however, led to excess plywood capacity, creating a long-run demand for logs that was well beyond the Indonesian forest's sustainable or economic log production capacity.

The export restrictions did indeed serve the intended purpose of increasing domestic plywood capacity. But they did so at great cost. Continuation of the initial modest 10 percent export tax, together with the design and implementation of a better royalty system, would have sped up a plywood investment program that was already underway, bolstered government revenues from this valuable resource and would have avoided the other economic costs of the more drastic and less well thought out program that was implemented. Despite its economic failure, the rent-seeking cronies of the government that benefited from it persuaded the government to reapply the model in several other resource sectors.

PART II: South African Industrial Policies

South Africa's experience with industrial policy has received less attention and acclaim than that of east and southeast Asia, but it has been no less ambitious. Over the last few decades a wide range of interventions have been employed in various forms and with mixed effects. While we do not pretend to provide a complete review of South Africa's approach to industrial policy, we try to shed light on some of the most important issues through several illustrative case studies focusing on a range of sectors and policy instruments.

As in many other countries, the automotive and clothing and textile sectors have been among the largest beneficiaries of protection and support in South Africa. In South Africa this reflects not only an interest in these particular sectors *per se*, but also a sector-specific approach to industrial policy that targets support to particular industries and tailors incentives to circumstances of each relevant value chain. A major part of the current industrial policy strategy is based on refining and extending this approach to a number of additional sectors that have been determined to be "strategic" in South Africa's future industrial development.

For this reason, the motor industry and the textile and garment industries are a major focus of the following review. We begin, however, with an overview of the trade reforms of the past decade and a half and an examination of some of the major structural responses. Following that we undertake briefer examinations of the IDC, government procurement, investment incentives, strategic infrastructure investments such as the Coega Industrial Development Zone and Blue IQ, transport and trade facilitation, and import parity pricing.

10 South Africa's Trade Policies and Performance

South Africa has undergone substantial trade and more general economic reform over the past decade and a half. In this section we review some of the most salient features of trade policy reform and some of its main economic impacts. We see that the reforms have had many of the predicted and desirable effects. But overall performance has been less than might have been expected. This raises some interesting and important questions. We begin with an examination of changing trade characteristics of the South African economy, focusing on the basic question of how open it has become. We then consider the extent and contribution of trade policy reform in South Africa and ask what more could be done to raise competitiveness and export growth.

10.1 Economic Restructuring

Liberalization of trade, more general economic deregulation, and dismantling of international sanctions on trade with South Africa have led to substantial restructuring of the economy. Table 1 shows one set of indicators—the change in export orientation and in import penetration of the economy between 1994 and 2002. 'Export orientation' shows the share of production in each sector that is exported and 'import penetration' shows the share of domestic consumption accounted for by imports.

At broad sector levels it can be seen that the entire economy has become more outward-oriented, with export orientation and import penetration increasing across both primary sectors and manufacturing. The greatest change, however, has been in manufacturing where import penetration has risen by 54 percent and export orientation has almost doubled. Even more remarkable is the uniformity of this experience across all manufacturing sectors; export orientation increased in all except two of the 28 sectors shown in the table, and the same is true of import penetration.

In 10 of the 28 sectors export orientation has more than doubled over the period. This includes wearing apparel, plastic products, rubber products, communications equipment, and professional equipment. In all of these sectors export orientation has increased by more than 150 percent. The increases in import penetration have been less dramatic, increasing by more than 100 percent in only four sectors. These are wearing apparel, footwear, coke and refined petroleum, and non-metallic minerals. In two of these, including wearing apparel, it is worth noting that the level and the rate of growth of export orientation are still greater than the level and rate of growth of import penetration.

Table 1. Change in Trade Orientation by Sector, 1994-2002

Sector (SIC classification)	Export Orientation			Import Penetration		
	1994	2002	% change	1994	2002	% change
Agriculture, forestry & fishing [1]	16.0	18.6	16.3	5.7	9.1	59.6
Mining [2]	62.6	68.0	8.6	51.5	60.9	18.3
Manufacturing [3]	15.5	29.5	90.3	23.2	35.8	54.3
Food [301-304]	6.7	9.1	35.8	7.6	9.8	28.9
Beverages [305]	6.8	13.2	94.1	3.7	5.9	59.5
Tobacco [306]	3.5	7.3	108.6	1.9	1.0	-47.4
Textiles [311-312]	13.6	19.1	40.4	24.2	31.8	31.4
Wearing apparel [313-315]	9.7	25.1	158.8	8.4	19.7	134.5
Leather & leather products [316]	37.9	39.4	4.0	35.8	38.2	6.7
Footwear [317]	4.6	4.9	6.5	17.9	46.6	160.3
Wood & wood products [321-322]	14.0	22.8	62.9	10.9	15.0	37.6
Paper & paper products [323]	19.9	19.6	-1.5	14.2	9.5	-33.1
Printing & publishing [324-326]	2.3	2.8	21.7	17.9	23.5	31.3
Coke & refined petrol [331-333]	14.1	33.9	140.4	12.6	28.0	122.2
Basic chemicals [334]	40.4	51.7	28.0	45.2	52.1	15.3
Other chemicals [335-336]	5.3	15.3	188.7	22.1	32.3	46.2
Rubber products [337]	9.7	25.4	161.9	21.8	34.8	59.6
Plastic products [338]	4.6	12.2	165.2	9.9	18.8	89.9
Glass & glass products [341]	9.7	15.0	54.6	18.2	26.7	46.7
Non-metallic minerals [342]	7.8	11.6	48.7	10.3	20.7	101.0
Basic iron & steel [351]	45.3	63.6	40.4	11.2	17.6	57.1
Basic non-ferrous metals [352]	44.6	27.6	-38.1	17.5	20.1	14.9
Metal products [353-355]	10.9	17.7	62.4	10.6	18.6	75.5
Machinery & equipment [356-359]	16.8	54.6	225.0	56.3	77.7	38.0
Electrical machinery [361-366]	7.7	15.4	100.0	31.9	38.1	19.4
Communication equip [371-373]	9.6	44.2	360.4	59.4	88.1	48.3
Professional & scientific [374-376]	23.7	62.5	163.7	72.8	91.7	26.0

Source: Based on data in Dunne and Edwards (2006), Table 1.

Note: Export orientation is calculated as the share of exports in domestic production and import penetration as the share of imports in domestic consumption.

These are all signs of highly successful structural adjustment. Whatever the reasons, and there can be no doubt that economic reform and the dropping of sanctions have played a key role, the South African economy appears to have become much better integrated with the global economy and has rationalized production in ways that respond at least in part to South Africa's relative cost competitiveness. This rationalization appears to have happened not just between sectors, but even within sectors, at least at the level of aggregation shown in Table 1.

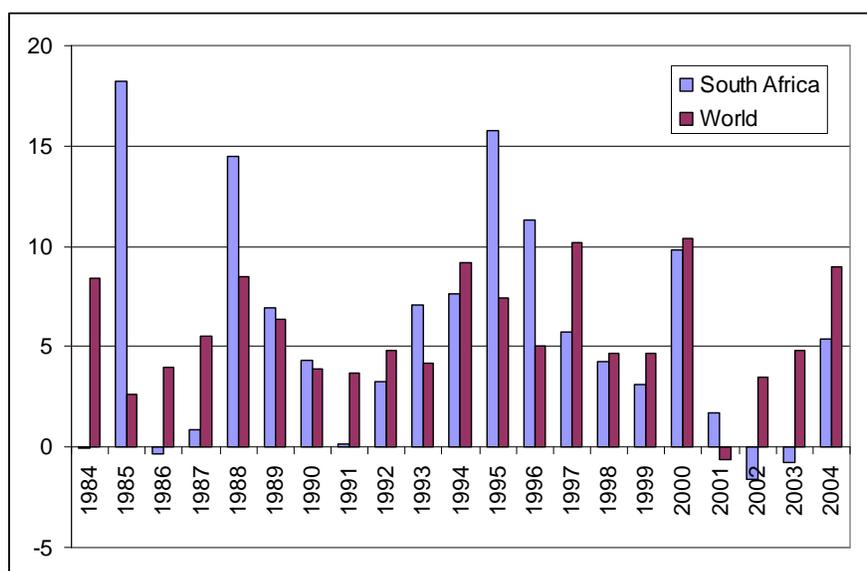
10.2 What Happened to Export Led Growth?

Despite substantial economic restructuring, South Africa's post-1994 export performance is less than might have been expected or hoped for.

From 1984 to 1994, in the decade before the end of sanctions, South Africa's merchandise exports grew at an average rate of 5.7 percent a year (in volume terms), slightly faster than the 5.6 percent growth in world exports over this same period. It was anticipated that the end of sanctions and the deregulation of trade and other economic control measures would give a substantial boost to South Africa's relative and absolute export performance. However, while world export growth increased to 6.2 percent a year over the decade since 1994, South Africa's average export growth rate fell marginally to 5.6 percent.

Figure 1 shows that, except for an immediate post-sanctions boom in 1995 and 1996, South African merchandise exports have underperformed the rest of the world's with the result that her share of world exports has fallen from 0.7 to 0.5 percent over the post-1994 decade.

Figure 1. Annual Growth in Merchandise Exports (volume; %)



Data Source: SARB and WTO

Is this simply due to the unfortunate composition of South Africa's exports? South Africa's exports are highly concentrated in natural-resource-based products, which experienced relatively low growth in world markets over most of this period.

Table 2. Annual Growth Rates (%) by Broad Technology Category, 1988-2002 (US\$)

	World	Developed Countries	Developing Countries	South Africa	Resources Group
Total exports	6.02	4.96	9.58	2.02	6.14
Primary products	3.59	2.79	4.95	-1.14	4.18
Total manufactures	6.32	5.13	10.63	6.91	7.72
Resource-based	4.89	4.09	7.89	4.26	5.63
Pure manufactures	6.59	5.33	11.13	8.57	9.52
Low technology	5.63	4.37	7.94	5.57	8.57
Medium technology	5.67	4.77	11.07	9.67	8.51
High technology	9.10	7.14	15.83	11.53	14.95

Source: Edwards and Alves (2005)

Unfortunately South Africa's relative export performance was weak even in natural resource-based products; her primary products export growth was negative, while all other country groups had positive growth at rates between 2 and 5 percent per year (Edwards and Alves 2005 and Table 2 above). Overall South Africa's export growth and diversification were poor compared to other resource-based exporters. Exports of non-resource-based manufactures have outperformed the world average over this period (8.57 percent versus 6.59 percent), but have underperformed those of other developing countries and other resource-based economies. Within manufacturing, South Africa's strongest relative performance (*vis à vis* the rest of the world) has been in medium and high technology products and it has underperformed both the rest of the world and other developing

countries in low technology products. The relatively strong performance of South Africa in ‘medium technology’ exports is almost fully explained by subsidized auto exports (see section 10 below). All other sub-sectors have performed worse than the basket of resource-based economies (and well below the average performance of other developing countries).

10.3 What Happened to Employment Growth?

A commonly expressed fear about trade liberalization is that it will result in job losses as low cost imports displace domestic products in the local market. This argument ignores the beneficial impact of trade reform on export competitiveness and the resulting job gains in the growth of activities that can compete domestically and internationally against foreign-produced goods. It also ignores the impact on employment in downstream service industries, especially in the wholesale and retail trades, that grow in response to falling consumer prices and the growing incomes that come from trade reform.

As we have just seen, the past decade has seen a substantial restructuring of the economy and this has resulted in increases in both exports and imports. What has been the overall impact on employment?

The overall picture is not attractive, especially at first glance. Between 1990 and 2002, the tradable goods sectors of the South African economy shed over 700,000 jobs (Dunne and Edwards 2006 Table 2). By 2002 the manufacturing sector had lost almost 11 percent of its 1994 jobs. A closer examination, however, shows that most of the job losses were in primary products sectors—agriculture, mining and resource-based manufacturing. These three sectors accounted for 83 percent of these job losses. Only 17 percent of the job losses over 1994-2002 were in non-resource-based manufacturing (Dunne and Edwards 2006 Table A-1).¹⁰

What was the ‘contribution’ of trade to this performance? A crude decomposition of the changes occurring in the manufacturing sector over 1990-2002, based on input shares in different subsectors, shows that, as expected, increased import penetration ‘caused’ job losses, while greater export orientation ‘caused’ offsetting employment gains (Dunne and Edwards 2005). The net effect was positive. The overall job gains from export growth exceeded those from increased import competition, and this was true of all factors of production—skilled labour, unskilled and semi-skilled labour, and capital (Dunne and Edwards 2006, Figure 3, lower). However, there are some causes for concern.

- The net effects on employment were small—less than 29,000 new jobs overall, or only 0.2 percent of the total.
- The employment gains appear to have been larger for skilled labour than for unskilled and semi-skilled labour, and the greatest increase in demand arising from South Africa’s changing trade orientation over the past decade was for capital rather than labour.

By far the largest impact on employment according to this exercise, however, has been productivity growth. This has resulted in an average decrease in the demand for labour of 3 percent per year in all tradable goods sectors of the economy and 2.9 percent in manufacturing (Dunne and Edwards 2006, Table 2).

In summary, the tradable goods sector has experienced significant job losses over the past decade. Most of this has been in primary and primary-related sectors. The main ‘cause’ of job losses in all sectors has been productivity growth. The changing trade orientation of manufacturing, on the other hand, has contributed a small increase in demand for labour.

¹⁰ A strong word of caution is necessary in interpreting any labour force and employment data in South Africa. Borat and Oosthuizen (2004) describe some of the difficulties with SA’s household survey data. The Dunne and Edwards estimates are based on Quantech (2004) data that is compiled from input-output and national accounts data with interpolation of data between the years in which IO data are supplied and extrapolation of the series for the post-1996, the data of the last manufacturing census (Dunne and Edwards 2006, footnotes 3 and 8). Borat and Oosthuizen’s household survey data show an increase in manufacturing employment of about 200,000 workers over 1994-2002; Dunne and Edwards suggest that manufacturing employment fell by almost 11 percent over the same period.

The general pattern of skill-intensive technological change uncovered by this exercise is consistent with global patterns, and it is encouraging that South Africa is not being left behind. The ability to keep up with these changes is essential for successful integration with the global economy. The weak overall impact of intra-sectoral shifts towards more competitive export activities raises some questions, however, as does the apparent capital bias in recent structural changes. Why have exports not grown faster? What explains the capital and skills bias in the evolution of the manufacturing sector since 1994? These questions certainly point to the structure of South Africa's labour markets and issues in the broader investment environment. The first question, however, is whether the trade reform whose impacts are measured by this work has been as comprehensive as is often portrayed.

Before proceeding to these discussions, it is useful to put this 'employment accounting' exercise in perspective. The major source of employment and employment growth in South Africa, as in most other growing economies, has been and will continue to be the service sector. According to household survey data, the South Africa's service sectors provided over 1.1 million new jobs between 1995 and 2002. This was over 75 percent of recorded employment growth over the period (Bhorat and Oosterhuizen 2004). According to the same data, manufacturing employment grew by only about 200 thousand jobs and in the primary sectors it was negligible.

This suggests that it is incorrect to look at the contribution of trade and employment policies simply through the lens of job creation in tradable goods sectors on their own. The principal contribution of trade and industrial policies to employment is through their impact on overall economic growth. Continued export growth requires ongoing productivity growth. Whether and how much this results in direct employment growth in manufacturing depends on the net effect of reduced labour requirements per unit of output and of the resulting growth in exports that this makes possible. Sufficient increases in manufacturing competitiveness could well lead to growing overall employment in this sector and this would certainly be a sign of success. But the real test is whether and how much trade and industrial policies contribute to overall economic growth.

The remainder of this section looks at the trade policy reform that has occurred over the past decade and a half, and the remaining sections look more closely at a range of other industrial policy and investment environment issues.

10.4 Trade and Tariff Policy in South Africa

South Africa began an ambitious set of tariff and trade policy reforms in the mid-1990s. This included substantive multilateral liberalization through the WTO; the elimination of quotas, GEIS and most import surcharges; the replacement of most formula, specific and mixed tariffs with *ad valorem* duties; and new bilateral agreements with the EU and SADC. The tariff structure has also been simplified through a substantial reduction in the number of tariff lines and some reduction in the number of rates levied. Table 3 shows the evolution of the tariff structure from 1990 to 2004.

Of considerable if not most importance of course is the fact that nominal tariff rates have been coming down. The unweighted average nominal tariff (scheduled rates, including surcharges) fell from 22.9 percent in 1994 to 8.2 percent in 2004 (Edwards 2005).¹¹ This appears to indicate substantial liberalization of trade

¹¹ Cassim and van Seventer 2005 estimate that the unweighted average nominal rate fell from 17.4 percent in 1996 to 8.3 percent in 2004 and the import value weighted average went from 11.0 to 7.5 percent over the same period.

Table 3. Structure of SACU Tariffs, 1990-2004

	1990	1994	1998	2004 MFN	2004 EU	2004 SADC
No. of tariff lines	12475	11231	7773	6697	6697	6697
Ad valorem	8649	7707	5793	6492	6504	6658
Compound	66	51	6	1	0	0
Specific	499	398	214	135	135	37
Mixed	566	2071	1736	64	53	2
Formula	2695	1004	24	5	5	0
No. of tariff bands						
Ad valorem	38	37	45	38	54	25
Other	695	686	230	62	47	18
Duty free (% tariff lines)	24	26	42	53	56	81
Domestic tariff spikes (% tariff lines)^a	0.7	3.7	4.5	8.9	8.5	14.9
International tariff spikes (% tariff lines)^b	43.7	43.5	39.4	21.2	20.1	5.8
Nuisance rates (% tariff lines)^c	12	11	6	7	6	3

Notes: Calculations based on tariff schedules including *ad valorem* equivalents.

a. Domestic tariff spikes are defined as those exceeding three times the overall simple average applied rate.

b. International tariff spikes are defined as those exceeding 15%.

c. Nuisance rates are those greater than zero, but less than or equal to 5%.

Source: Edwards (2005)

Despite initial appearances, however, trade liberalization has been far less complete than might be thought.¹²

- Despite a commitment at the beginning of the reforms to reduce the number of tariff rate bands to six (0, 5, 10, 15, 20 and 30 percent), the number of MFN bands in 2004 was 38, exactly the same as in 1990 (see Table 15 above). For imports from the EU the number of bands was 54. In 1998, several years into the reforms, the number of MFN bands had actually increased from 38 to 45. In addition, the complexity of the tariff structure has been increased by the use of special rebates and by detailed differentiation of tariffs within sectors. Special rates for particular sub-sectors have resulted in numerous different rates within 2, 4, and even 6 digit HS tariff headings and sub-headings.
- The proliferation of special sub-chapter rates and rebates reflects a product and sometimes even firm-specific approach to tariff policy. This made-to-measure approach involves deliberations on tariff policy based on the claimed or perceived needs of individual firms and based on judgements about the capacities of local producers of inputs and competing outputs. Rather than setting relatively low and uniform tariffs across all products, as intended at the launch of the reforms, *tariff policy has continued to be negotiable. This is an obvious incentive for rent seeking and a source of uncertainty for investors and producers.*
- The complexity of the tariff structure makes it very difficult to generalize about its impacts on incentives for producers and investors. Aggregate effective protection studies for the economy as a whole or for industry and manufacturing have reached differing conclusions about overall patterns. Some have found that effective protection has gone up on average (Fedderke and Vase 2000) and others that it has gone down (Cassim and van Seventer 1995 and Edwards 2005). The problem with all such studies is that they require analysis at a level of aggregation too high to judge the impact of policy at the level at which it is designed in South Africa. In electronics, for instance, such studies aggregate a wide range of products, some produced in South Africa and some not, some exported and some not, and some with high tariffs and some with low or zero tariffs. Our own examinations at the product level have found that many of the products actually produced in South Africa continue to have very high levels of effective protection and at least

¹² Edwards (2005) concludes that South Africa has liberalised no faster than other lower-middle-income economies.

some of these have experienced increases in effective protection since 1994. This is a manifestation of the DTI's made-to-measure approach to tariff policy. Edwards (2005) corroborates the view that many manufacturing sectors, including labour-intensive industries, remain heavily protected.

- With the possible exception of India, South Africa has been the developing world's most prolific user of WTO anti-dumping provisions. At the end of 2003 South Africa had 90 different anti-dumping duties in place, placing her fourth in the world, behind the US, India and the EU (Bekker 2005). The trend has continued, and in the first half of 2005, South Africa achieved the distinction of launching more anti-dumping investigations than any other country in the world (Carli Laurens in *Business Day*, 4 November 2005). The WTO reported that South Africa is among the top five users of anti-dumping actions in the world, with 113 actions undertaken in 2005. As in most other countries, the primary targets of such investigations are upstream heavy industries such as steel, chemicals and plastics—i.e. they are a form of disguised protection for 'strategic' industries, and the interests of downstream users and final consumers play an insignificant role in anti-dumping decisions. While certainly of value to highly capital-intensive companies such as Mittal Steel and Sasol, such measures impose further cost penalties on downstream labour-intensive industries and make it more difficult for them to compete domestically and internationally.
- The process of trade reform slowed to a crawl following the first wave in the mid-1990s. Further MFN-based tariff reductions are strongly resisted, in part as a 'weapon' to be used in WTO negotiations. There is even discussion of rolling back previous tariff reductions in cases where applied rates are less than WTO-bound rates. The main focus of tariff reform in recent years has been preferential trade agreements (PTAs).¹³
- South Africa has negotiated bilateral PTAs with the EU and SADC. It is in the process of planning and/or negotiating a variety of other arrangements with countries in many parts of the world. Such agreements contribute little to trade. This is particularly true in the South African case. See Box 5 below on the negotiations with Mercosur. These agreements add considerable complexity to and hence increase the costs of trade in South Africa. Although the number of lines in South Africa's tariff schedule has been reduced from 11,231 to 6,697 between 1994 and 2004, the existence of just the EU and SADC agreements means that the effective number of tariff lines in force now is actually 20,081 (three times 6,697). This is almost twice the number of tariff lines in 1994. Furthermore, implementation of these agreements requires criteria and procedures for determining where goods actually originate—rules of origin. Rules of origin are complex and costly to comply with and enforce. This is a serious impediment to trade. In addition, rules of origin can and often are designed to restrict preferential trade—to make it difficult if not impossible for importers and exporters to qualify. The EU rules are now widely recognized to be highly restrictive in this regard and to have a significant impact on the ability of South African exporters to take advantage of EU preferences. Even worse, however, is the SADC agreement, in which South Africa insisted on rules of origin in many sectors that could not be met even by South African exporters let alone those in much less developed partner countries.¹⁴
- Even if they 'work' by promoting trade, PTAs suffer from two serious economic problems—trade diversion and policy diversion. The first of these is certainly well known. Tariff preferences divert imports from low cost non-member sources to higher cost sources in member countries. The risk and cost of trade diversion increases with the gap between preferential and non-preferential tariff rates. The obvious cure for the problem is to lower all MFN tariff rates or better still to make all tariff cuts on a non-discriminatory basis. This approach was followed in a number of heavily protected sectors in Mauritius in conjunction with implementation of preferential tariff reductions in COMESA (see Box 7 of Flatters 2002b). South Africa has been

¹³ See Cassim and van Seventer 2005, especially the discussion of section 5.

¹⁴ See Flatters 2002b and Erasmus, Flatters and Kirk 2006.

loath to do this. The second problem is less well known but is critical in a policy-making environment with limited policy resources. Negotiating and implementing trade agreements is labour and time intensive. Devoting policy-making resources to this activity reduces resources available to potentially much more useful MFN-based liberalization (unilateral or cooperative) and even more importantly to much more critical domestic constraints to growth.

For all of these reasons, it is apparent that trade reform still has a long way to go in South Africa. This might help to explain why the dividends from trade reform have been less than might have been hoped, especially in most recent years.

5. The SACU-Mercosur Preferential Trade Agreement

Free trade agreements, especially narrow preferential ones, almost always disappoint. This is for three main reasons. First, they are usually driven by a strategic or political agenda, not economic interests. This is certainly the case of the SACU-MERCOSUR negotiations. Trade between these regions is low and there is no compelling reason why it should be much higher. Secondly, FTAs divert attention from the real constraints to trade at home. In South Africa, this includes infrastructure bottlenecks; skills and wage issues; distortionary sector specific interventions; and a complex system of tariff protection. Finally, free trade agreements seldom create new trade. They are much more likely to divert trade flows from one region to another, tempting consumers to purchase lesser quality or more expensive goods from producers within the free trade area.

To deal with these problems, WTO rules require that free trade agreements encompass substantially all trade. This is an important hurdle designed to promote open regionalism and discourage the creation of new regional fortresses of protected markets. But WTO rules provide an exemption to developing countries that enables them to sign preferential trade agreements which incorporate very little trade. Our own analysis confirms that the preferences agreed to by SACU and MERCOSUR negotiators are largely redundant. It would have been hard to construct a less meaningful agreement.

A tariff preference of less than 5 percent has been shown to be worth less than the cost of compliance. Of the over 10 000 goods listed in the relevant tariff books and the 962 products included in the initial agreement (this preference list has since been extended), about 85 products will gain tariff preferences of 5 percent or more in Brazil; in Argentina it is just 19 products. In 2004, there was positive and significant trade in just 1 of these products: nucleic acids.

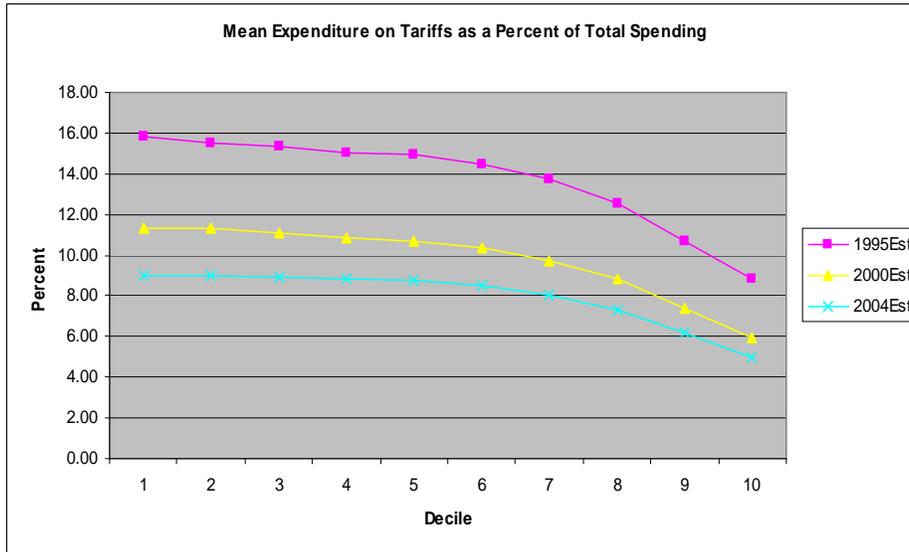
But maybe there are products for which access barriers are sufficiently high to suffocate imports from South Africa? There are a number of products that constitute a significant share of South Africa world exports, but under perform in Brazil or Argentina. There are also many products that face tariffs in excess of 20 percent in these countries in which there is little or no trade. Of these groups of products, just two will see meaningful liberalisation as a result of the SACU-MERCOSUR PTA: telephonic or telegraphic switching apparatus and apparatus for carrier-current or digital line systems. South Africa's production of these items is probably restricted to a couple of companies and the actual gains from these preferences are likely to be narrow and small, at best.

The likely export gains to Argentina and Brazil (or import gains to South Africa) are a little less sparse. Negotiators from Mercosur did secure improved access for 46 currently traded product lines. South Africa's total imports of these products from Brazil and Argentina, in 2004, were a miserly R26 million.

10.5 Tariffs, Trade and Consumption

Tariffs not only constrain competitiveness and export performance. They are also a tax on consumption. The South African data show that the SACU tariff is a regressive tax—relative to their total expenditures or incomes, the poor pay a *disproportionate* share of South Africa's tariff burden (Daniels and Edwards 2005). Although all consumers gain from tariff liberalisation in the form of cheaper prices, the poor gain *more* than the wealthy. This is illustrated in Figure 2. Despite a significant reduction in import taxes over the 1990s, the poorest decile of consumers continue to pay around 9 percent of total expenditure in import tariffs (compared to 5 percent for the richest decile). This is illustrated at the product level by textiles and garments (section 12 below) and simple electrical appliances (Box 6 below).

Figure 2. Benefit Incidence of Tariff Liberalisation



Source: Daniels and Edwards (2005)

6. The Case of Small Appliances

Two companies account for around 80 percent of the total small appliance market in South Africa: Nu World and Amalgamated Appliances. Together, they 'own' 27 brands of kettles, irons, stoves, microwaves and other kitchen equipment in South Africa. Both companies manufacture a wide range of appliances in South Africa behind a tariff of 20 percent. Almost all of this production is targeted at the domestic market and exports are very low. The recent experiences of these companies illustrate how tariffs and trade impact on markets in South Africa.

Firstly, the competitiveness of both firms is undermined by inefficient access to inputs. The impact of tariffs on import parity pricing has been discussed earlier in this paper and these companies rely heavily on plastics, steel and aluminium. They claim that Chinese firms access these materials at a considerable discount to local firms. South African manufacturers also face high tariffs on other inputs, such as valves and heating elements. Both companies have expended significant time and effort trying to obtain duty relief for such inputs, which are not made in South Africa.

Secondly, increased international trade has already led to substantial restructuring of this industry substantial improvements in quality and a real reduction in prices. Quality improvements and price reductions of simple appliances have been of particular significance to low-income consumers. More than 80 percent of domestic consumption is imported and the local manufacturing industry employs just 550 seasonal workers. Nu World and Amalgamated Appliances have shifted their core business, almost entirely, from manufacturing to brand management and marketing. Through importing they have managed to force quality improvements and cost savings on their manufacturing plants; and their manufacturing plants give them a strategic advantage in designing products and negotiating prices with foreign suppliers.

The elimination of this tariff would undoubtedly lead to further restructuring, and possibly the closure of these factories. This seems a small price to pay for an immediate savings of around 20 percent on all consumer appliances sold in South Africa. There is also some chance that deeper tariff reform (of appliances and inputs into the manufacturing of appliances) might lower production costs and encourage firms to focus on those products in which they are internationally competitive. What is certain is that the existing tariff structure has an adverse impact on the cost and efficiency of production and consumption in this sector.

10.6 Lessons

Trade and other policy reforms have resulted in substantial structural reform of the South African economy. The economy has become much more open, and almost all tradable goods sectors have seen

simultaneous growth in both import penetration and export orientation. This restructuring has been accompanied by significant productivity improvements. Nevertheless, export performance and employment growth in manufacturing have been disappointing.

A closer examination of trade policy shows that the liberalization process that began in the 1990s has stalled; much remains to be done. Persistent and complex tariffs have cost consumers and the economy. Further rationalisation and liberalisation of the SACU tariff regime is both necessary and possible.

Excessive focus on trade negotiations has led to an erroneous and harmful mercantilist approach to trade based on 'offensive' and 'defensive' concerns defined by narrow special interests rather than the long run growth objectives of the South African economy. Unilateral and MFN-based tariff reforms have been replaced by bilateral and other preferential negotiations as the engine of policy change.

WTO and preferential agreements are unlikely to deliver sufficient movement and the imminent establishment of the SACU Tariff Board will make it more difficult for South Africa to implement meaningful and unilateral tariff reforms. South Africa therefore needs to move quickly and boldly to implement its own reform program. This should include:

- completing the simplification of the SACU tariff schedule by eradicating the remaining formula, specific and mixed tariffs and reducing the total number of ad valorem tariff bands to no more than three, with a minimal degree of rate escalation between them,
- continuing the process of liberalisation that began in 1994 and on an MFN basis,
- reconsidering the role and impact of bilateral trade agreements and anti-dumping duties, and
- adapting the existing rules of origin in the SADC Preferential Trade Agreement to enable neighbouring countries to export into South Africa.

South Africa can learn from the agreement it has concluded with the European Union. This agreement explains most of the liberalisation achieved by South Africa post-2000 and it was always intended as a benchmark for further unilateral liberalisation. Extending a simplified version of this tariff schedule to all countries would not only eliminate prospects for trade diversion and the impact of rules of origin on imports, but the marginal "threat" of applying this agreement on an MFN basis seems small. The EU already accounts for approximately 40 percent of SACU's total imports and there are only 550 products which South Africa imports from the rest of the world and not the EU.

11 Sector Targeting: The Motor Industry

The Motor Industry Development Program (MIDP) is widely regarded as a major success of post-apartheid trade and industrial policies. The program was introduced in 1995, has been modified and/or extended several times, and is currently scheduled to continue until 2012. A DTI-funded review, the third since the program's inception, was initiated in 2005 to consider further adjustments to and possible extensions of the program after 2012. This coincided with high-level discussions are under way in several ministries and agencies about future industrial policy strategies for South Africa. The MIDP's success makes it an obvious model for new approaches to industrial policy, and in particular for increased emphasis on sectoral strategies and interventions.¹⁵

While most popular discussions focus on MIDP's successes, questions have been raised about some of its unintended impacts. Following complaints about the failure of prices to respond as expected to the appreciation of the Rand, the Competition Commission conducted an investigation of domestic motor vehicle pricing. The Commission has pointed to the possible role of the MIDP in restricting

¹⁵ This can already be seen in a draft DTI strategy document for the garment sector, and it has been mentioned in public discussions in connection with a wide range of other sectors.

consumer choice and maintaining prices at higher levels than in other markets. The motor industry, supported by a recent study by industry specialists,¹⁶ has disputed these claims.

Despite its importance there has been surprisingly little analysis of MIDP's economic benefits and costs. Black (2001) and Black and Mitchell (2003) did some useful historical analysis of the program and discussed some of its economic impacts. Barnes et al (2004) provided a very sympathetic review of the program but did not fully explore some of its key impacts and furthermore appear to have misunderstood some of its important features. Based on a more thorough economic analysis, a few recent papers have taken a more critical view of the program.¹⁷ These papers show that the MIDP provides very large subsidies to the automotive sector, that these have substantial economic costs, and that some of the program's alleged benefits, especially in terms of consumer interests and employment, have been overstated.

The failure of policy makers to appreciate the costs of such an important program raises serious questions about the government's capacity to design and manage sector specific policies, and about the transparency and accountability of processes for monitoring and reviewing them. The design of industrial policy requires knowledge of what is happening "on the ground" and this requires informed communication with stakeholders in the private sector. But to make and manage policies in the broader national interest, policy makers need the capacity and the independence to filter, augment and analyze the information so obtained. Otherwise policy-making processes are prone to being captured by vested interests.

The results of the analysis reported here suggest that an independent review of MIDP's economic benefits and costs is long overdue. It is recommended that such an exercise be conducted and that its findings be taken into account in making any changes to the program and in considering MIDP as a model for more general industrial policy strategies in South Africa.

In a more positive light, the MIDP has provided time and generous assistance for the motor industry to adjust to liberalization of the domestic market. The industry has responded with major internal restructuring. There have been substantial investments, accompanied by rapid growth of both exports and imports. In that sense the program can be considered a success. However, taxpayer and consumer subsidized adjustment cannot and should not go on forever. What is an appropriate schedule for finalizing this adjustment after 2012, the program's current expiry date? The Australian motor industry program, after which MIDP is modelled, would be a useful example to consider.

11.1 Background: The Rationale for MIDP

The MIDP was initiated in 1995 to help the motor industry adjust to South Africa's reintegration into the global economy. Prior to that time the industry was protected by tariffs in excess of 100 percent and burdensome local content requirements. Unsurprisingly it produced a very wide range of products at low scales of output and at high cost. It was a very inefficient import substitution sector that could not have competed either domestically or internationally in the face of immediate trade liberalization.

The MIDP was designed to help the industry adjust and increase its competitiveness in the new post-apartheid trade policy environment. The program comprised four principal elements:

- a gradual reduction in import duties on both vehicles and components,
- an export-import complementation scheme under which vehicle and components exporters can earn tradable "Import Rebate Credit Certificates" (IRCCs) to offset duties on imported vehicles and components,
- access to the standard duty drawback program for exporters, under which all import duties paid on components and intermediate inputs used in exported vehicles and components can be rebated, and

¹⁶ See Barnes et al (2005a and 2005b).

¹⁷ See Flatters (2002a, 2003 and 2004) and Kaplan (2003 and 2005).

- a duty free allowance on imported components of 27 percent of the value of vehicles produced for the domestic market.

The incentives in respect of components apply only to those sold directly to OEM manufacturers. This excludes from the program after-market components, a sector in which South Africa might have some regional and maybe even global comparative advantage.¹⁸

The idea of the program was to provide incentives to rationalize production into a smaller range of products and achieve economies of scale through exporting them. All other products would be imported.

The MIDP has been reviewed and extended twice. It now is scheduled to continue until 2012. It has been expanded to include a direct investment subsidy in the form of a “Productive Asset Allowance” (PAA) that provides import duty credits equal to 20 percent of the value of qualifying investments.¹⁹

The industry benefits as well from a wide variety of other initiatives by national, provincial and local governments. These range from restrictions on imports of used cars to provision of infrastructure, factory facilities and special financial arrangements. This analysis concentrates only on the MIDP and does not analyze the economic impacts of any of these other programs and policies. In other words, it significantly understates the degree of public assistance given to the domestic motor industry.

11.2 Post-1995 Motor Industry Performance

The general patterns of recent motor industry performance are quite well known. The highlights are summarized in Figure 3.

Vehicle exports grew from negligible amounts in 1995/96 to well over 100,000 units per year now. Imports grew from about 20,000 units per year in 1995 to 120,000 in 2004. Investment in the vehicles sector has been substantial and has grown steadily, from less than R1 billion in 1995 to over R3.5 billion in 2004, and has exceeded R2.5 billion in every year since 2001.

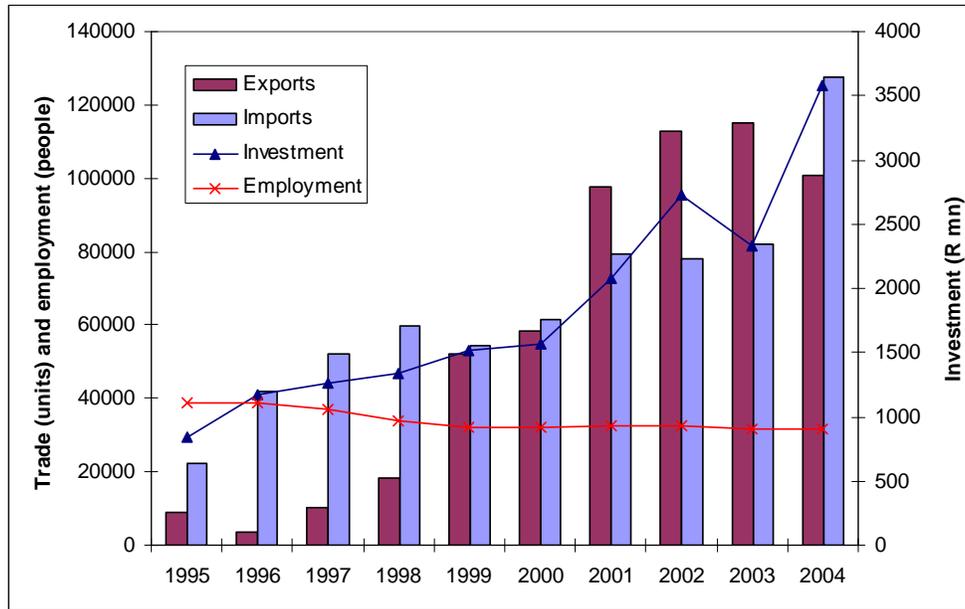
Components exports have grown in a similar fashion and are now in excess of R22 billion per year. While a wide variety of products are exported, over 50 percent of the total is accounted for by just two, catalytic converters (38 percent of the total) and stitched leather seat covers (14 percent).

Employment growth has been much less rapid, but that topic is left to a later section.

¹⁸ Despite the absence of any MIDP support some South African firms are exporting after-market parts competitively to Europe and elsewhere.

¹⁹ These credits can then be used in five equal annual instalments.

Figure 3. Vehicle Assembly in South Africa



Source: Compiled from NAAMSA data.

11.3 How the MIDP Works

The MIDP creates substantial incentives to invest and to produce for export and for the domestic market.

Producers for the domestic market benefit from tariff protection against imports and from the duty free allowance (DFA), which offsets the cost-raising effect of import duties on components.²⁰

Consumers pay for this through prices that are higher than they would be in the absence of the import duty on vehicles, and the National Treasury pays by foregoing customs duties on components.

Firms producing vehicles or components for export qualify for duty drawbacks on all imported components and also receive IRCCs in proportion to their exports. These allow them to import motor vehicles (and components) duty-free and sell them domestically at the duty-inclusive price. The value of the IRCCs depends on the price mark-up permitted by the tariff. Without this price mark-up the principal MIDP incentive would be of no value to vehicle and components exporters.

It might be argued that the MIDP creates a duty-free environment for South African consumers—i.e. that importers pass on all the duty savings from their use of IRCCs to domestic buyers and that consumers in effect face world prices in the South African market for motor vehicles.²¹ A corollary of this view would be that the MIDP does not provide subsidies to vehicle and components producers in South Africa. This would contradict basic principles of economics as well as the facts in South Africa. As long as some vehicle importers are paying import duty (and many are), market dynamics will ensure that the domestic price reflects the duty-inclusive cost of importing. Sellers would be foolish to sell at a duty-free price as long as some are having to pay duty, and if they did, no one would buy from the sellers who were subject to duty.

Evidence from the South African motor vehicle market confirms that consumers are paying at least a duty-inclusive price.

²⁰ They also benefit from a virtual ban on the import of used cars.

²¹ See Barnes et al (2004 and 2005).

- Vehicle sellers often pay 80 to 90 percent of the face value of import rebate credit certificates and have been complaining recently about shortages of IRCCs in the market. Almost all of the IRCCs purchased are used to offset the duty on imported cars, not components. Why would vehicle importers pay such a high price for these certificates (rather than just pay the duty) if at least the full cost of the IRCC could not be recovered from the consumer?
- Vehicle producers have been virtually unanimous in their chorus of announcements and press releases about the necessity for a continuation of MIDP to induce them to continue to produce in South Africa after 2012. This would appear to contradict the claim that the MIDP incentives are of no value to them, as would be the case if duty savings were being passed on to consumers.
- Discussions of market pricing with some South African vehicle sellers suggest that current prices are higher, not lower, than the duty-inclusive price. According to them domestic prices can be thought of roughly as the sum of the c.i.f. cost of importing, all import duties and taxes, all domestic distribution and sales costs, including a normal return to all capital invested, plus another 10 percent, making South Africa one of the most profitable vehicle markets in the world at the moment.

In summary, the MIDP works by subsidizing production of vehicles and OEM components for both the domestic market and for export. The subsidies are paid for by domestic consumers of vehicles in the form of restricted choice and higher prices. The system of duty credits on exports means that consumers subsidize not only vehicles produced for the domestic market, but also those produced for export. The import duties that the Treasury foregoes in honouring export IRCCs do not lower the prices paid by domestic consumers. Rather, they subsidize vehicle and components exporters while domestic buyers still pay (at least) a duty-inclusive price.²²

11.4 Size of the MIDP Subsidies

The MIDP subsidies are large. From 1996 to 2003 automobile producers received and used IRCCs worth over R55 billion. Over the first eight years of the program two German auto producers made use of over R21 billion in IRCCs. By the end of 2007 the total value of IRCCs issued reached over R140 billion. Their annual total has continued to grow and in 2007 almost R27 billion were granted to the industry.

These amounts do not include the subsidies received in the form of duty drawbacks, duty free allowances or productive asset allowance. They do not include the implicit subsidy paid by consumers on purchases of domestically produced vehicles as a result of the protection provided by import duties and the effective ban on the import of used cars. And they do not include any of the assistance provided by other government departments and agencies at the national, provincial and local levels.

It is clear that the aggregate amount of subsidy provided to the motor industry is large. What kinds of incentives do the MIDP subsidies give to individual producers and investors?

Their effects are complex. Their value for any particular investor or exporter depends on many factors, including the rates of import duty on components and vehicles and a wide variety of firm-specific characteristics such as the mix of domestic and export sales, the relative importance of imported components in production and the size of annual sales revenues relative to the amount invested. Their value has changed over time as import duties on vehicles and components have fallen and as some of the parameters of the program, most importantly the value of IRCCs granted per Rand of vehicles and components exported, have been reduced. Details of the import duty schedules and other parameters of the MIDP incentives are shown in Table 4.

²² Some MIDP supporters observe that IRCCs are only pieces of paper that can be used in lieu of import duties, but cannot be used to buy anything else. Since they are not a cash outlay from the government budget, they argue, they are not really a subsidy. By this test, neither a prohibitive import duty nor a ban on vehicle imports would be considered a subsidy to domestic producers. Defining subsidies solely as cash outlays is very different from common usage in economics. Regardless of what label one might wish to apply, the IRCCs provided by the MIDP are of real value to exporters and have real effects on their cash flows. The price-raising effect of the associated import duties on vehicles has a real impact on vehicle buyers.

Table 4. Main Parameters of MIDP Incentives, 1995-2012

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
MIDP Tariff Rates (%):																		
Cars	65	61	57.5	54	50.5	47	43.5	40	38	36	34	32	30	29	28	27	26	25
Parts	49	46	43	40	37.5	35	32.5	30	29	28	27	26	25	24	23	22	21	20
Ratios of Exports to Imports																		
Car Exp/Car Imp	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Car Exp/Parts Imp	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Parts Exp/Car Imp	0.95	0.9	0.85	0.8	0.75	0.7	0.7	0.65	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Parts Exp/Parts Imp	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Deemed Value of Exports	1	1	1	1	1	1	1	1	0.94	0.9	0.86	0.82	0.78	0.74	0.7	0.7	0.7	0.7
Converters:																		
Qualifying PGM Content	1	1	1	1	0.9	0.8	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
IRCC Values (%):																		
Car Exp/Car Imp	65.0	61.0	57.5	54.0	50.5	47.0	43.5	40.0	35.7	32.4	29.2	26.2	23.4	21.5	19.6	18.9	18.2	17.5
Car Exp/Parts Imp	49.0	46.0	43.0	40.0	37.5	35.0	32.5	30.0	27.3	25.2	23.2	21.3	19.5	17.8	16.1	15.4	14.7	14.0
Parts Exp/Car Imp	61.8	54.9	48.9	43.2	37.9	32.9	30.5	26.0	21.4	19.4	17.5	15.7	14.0	12.9	11.8	11.3	10.9	10.5
Parts Exp/Parts Imp	49.0	46.0	43.0	40.0	37.5	35.0	32.5	30.0	27.3	25.2	23.2	21.3	19.5	17.8	16.1	15.4	14.7	14.0
Catalytic Converters:																		
Parts Exp/Car Imp	61.8	54.9	48.9	43.2	34.1	26.3	18.3	13.0	9.1	8.6	8.2	7.7	7.2	7.0	6.7	6.5	6.2	6.0
Parts Exp/Parts Imp	49.0	46.0	43.0	40.0	33.8	28.0	19.5	15.0	11.6	11.2	10.8	10.4	10.0	9.6	9.2	8.8	8.4	8.0
DFA (%):	27	27	27	27	27	27	27	27	27	27	27	27	27	27	27	27	27	27

We report here on two different measures of the size of the MIDP incentives for individual producers and investors.

The first is the *effective rate of protection* given to producers of vehicles and components. This is a measure of the percentage increase (or decrease) in domestic manufacturing costs made possible by tariffs and MIDP incentives relative to what manufacturing costs would be necessary for the firm to be able to compete in the absence of any import duties on vehicles and components and in the absence of any MIDP incentives.²³

This is a standard indicator of protection used in international trade policy analysis. It measures the level of protection given to existing producers, assuming capital costs are already sunk. It is indicative of, but does not really measure the incentive to invest. It is not able to capture the incentive provided by the Productive Asset Allowance, since the duty credits received under this part of the MIDP are not a function of current levels of production, but rather on past levels of qualifying investments.

A more comprehensive measure of the MIDP incentives is the *net subsidy to investments* in the sector as a result of the program. The measure reported here is an estimate of the increase (or decrease) in the net present value of investments in the sector as a result of tariffs and MIDP incentives, calculated as a percentage of the total amount of the initial investments. It takes typical investments and resulting cash flow profiles in the sector and compares their net present value at domestic prices under existing incentive programs with their net present value at world prices, or in the absence of the import duties and other incentives provided by MIDP. The difference, calculated as a percentage of the initial investments, gives the net subsidy provided by MIDP.

Both the effective protection and investment subsidy measures were estimated with actual MIDP parameters and for investments that were typical and illustrative of the kinds of incentives provided by the program. The stylized facts on the industry were derived from government documents, press reports, NAACAM and NAAMSA publications, and interviews with industry experts in both the vehicle and components sectors. In the case of the investment subsidies, discussions with industry experts suggest that the parameters used in the estimates have erred considerably on the conservative side in terms of the resulting subsidy magnitudes.

²³ Alternatively, the effective rate of protection is an estimate of the percentage increase (or decrease) in domestic value added in the presence of prevailing import duties and incentives relative to what it would be under free trade and in the absence of incentives.

Table 5 shows effective rates of protection (ERPs) given to vehicles produced for both the domestic market and for export for each year from the beginning of MIDP to its scheduled end date of 2012. The estimates are all based on the assumption that export IRCCs are used to import built-up vehicles (CBUs).²⁴ The effective rate of protection for domestic sales depends on the share of imported inputs in total production costs. ERPs are shown for low (30 percent), medium (50 percent) and high (70 percent) levels of import content.

Estimates of effective protection provided to OEM components exports are shown in Table 6. Catalytic converters are subject to a slightly different regime that is designed to eliminate the export subsidy for their precious metals component. Therefore separate ERPs are presented for converters and for other OEM components exports. As with vehicle exports, the effective protection provided to components exports depends on whether IRCCs are used to import CBUs or other components. ERPs are shown for both cases.

Table 5. MIDP: Effective Protection for Motor Vehicles (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Export Sales	65	61	58	54	51	47	44	40	36	32	29	26	23	21	20	19	18	18
Domestic Sales																		
30																		
%	106	99	92	86	80	74	68	62	58	55	52	48	45	43	42	40	39	37
Import Share																		
50																		
%	125	116	109	101	94	87	80	73	69	65	61	57	53	51	49	47	45	44
70																		
%	175	163	152	142	132	121	111	101	95	89	83	77	71	69	66	64	61	59

Table 6. MIDP: Effective Protection for OEM Components Exports (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
IRCCs used for CBUs																		
Converters	62	55	49	43	34	26	18	13	9	9	8	8	7	7	7	6	6	6
Other Exports	62	55	49	43	38	33	30	26	21	19	18	16	14	13	12	11	11	11
IRCCs used for Parts																		
Converters	49	46	43	40	34	28	20	15	12	11	11	10	10	10	9	9	8	8
Other Exports	49	46	43	40	38	35	33	30	27	25	23	21	20	18	16	15	15	14

The results show several clear patterns of protection provided by the MIDP.

- Very high levels of protection are given to all activities—domestic sales, exports, vehicles and OEM components.
- The anti-export bias of pre-MIDP motor industry policies has been eliminated. In the early years of the program the effective protection for vehicle and components exports exceeded 60 percent, a far cry from the negative protection due to tariffs on industrial raw materials and components and the further burdens of compulsory local content requirements under the earlier regime.
- The highest levels of protection are still given to production of vehicles for the domestic market. In its early years, MIDP gave production for domestic sales effective protection well in excess of 100 percent and it remains as high as 83 percent even after ten year of operation of the program.²⁵

²⁴ Estimates for the case where IRCCs are used to import components are also available on request, as are the spreadsheets for all these calculations.

²⁵ This does not take account of the substantial protection to domestic market sales provided by the virtual ban on the import of used cars.

- Declining import duties together with the gradual discounting of IRCCs relative to the value of exports supported mean that effective protection is declining over time. Nevertheless, after 10 years of operation, effective protection remains high—29 percent in the case of vehicle exports, 52 to 83 percent for domestic vehicle sales and 23 percent for exports of components other than catalytic converters (for which the ERP is currently 11 percent). At the end date of the program vehicle exports will still receive protection at a rate of 18 percent and domestic sales will be getting 37 to 59 percent.

A more comprehensive view of the MIDP subsidies is given by the increase in the net present value of investments in vehicle and components production due to the MIDP incentives. Table 7 shows the size of this subsidy for several motor industry investments. These estimates are for typical investments in both the very early years of the program and more recently, in 2005.

The precise magnitude of the subsidies depends on a wide variety of investment parameters, including the ratio of exports to total production, the share of imported materials in costs, the size of annual revenues relative to the amount invested, the international competitiveness of the investments and the time horizon of the investment. The estimates are based on a deliberately short time horizon of six years, which certainly understates the profitability of investments. But it does seem to reflect the approach of at least some current investors in the industry. The other parameters are chosen on the basis of information from a variety of industry and non-industry sources.

The general pattern of results is robust with respect to variations in the particular parameter values behind the estimates in Table 7. Nevertheless, the model could be used to reflect parameter values that are felt by experts to better reflect the characteristics of any particular venture. Further discussions with industry experts with a view to refining and improving the accuracy of the estimates shown in the table would be most welcome.

Table 7. MIDP Subsidies to Several Typical Investments

Investment	Subsidy Provided (% of amount invested)
Automobile Assembly, 1996	494%
Automobile Assembly, 2005	269%
Components Production, 1996	681%
Components Production, 2005	264%

An interesting question that is not addressed here is the extent to which the subsidies to components producers are shared with OEM vehicle manufacturers. Since the MIDP incentives are contingent on the sale of components to the OEM producers, it is reasonable to assume that they might be able to capture at least some of the rents arising from the IRCCs attributed to the components makers. SARS data indicate, in fact, that almost all IRCCs are actually used by OEM manufacturers, not components makers. From this it would appear that the OEM's components purchase contracts must specify delivery not only of components but also of the IRCCs that are earned by the components makers. The price paid would cover component manufacturing costs as well as some premium for the IRCCs. The size of the premium would reflect the relative bargaining powers of the two parties, and it would not be surprising if the OEMs were able to extract most of the IRCC rents.

Regardless of the distribution of any rents, the rates of investment subsidy given by MIDP are very large, even for investments taking place in 2005 when MIDP benefits have declined substantially and are planned to continue to do so over the investments' time horizons.

In effect, investments in the South African motor industry are made in order to produce two joint products—vehicles (or components) and IRCCs. The high value of the IRCCs means that investments can be quite uncompetitive in the manufacturing business and still highly profitable. This is because losses from vehicle and/or components production can be offset by IRCC benefits. Detailed examination of the cash flows of the investments shown here demonstrates that factories might better

be viewed as producers of IRCCs rather than vehicles or components. In terms of contribution to profits, IRCC production is really their core economic activity.

11.5 Some Economic Implications

The MIDP has given large subsidies to investment and exports. The motor industry has responded as expected, with many new investments, especially in export-oriented, IRCC-generating activities. This has resulted in substantial growth in exports of vehicles and components. Imports have grown rapidly as domestic production has been rationalized into fewer production lines and exporters have made profitable use of IRCCs. Despite considerable rationalization, however, continued protection of the domestic market has made it possible for the range of domestically produced vehicles, relative to the size of the domestic market, to remain too large to take full advantage of economies of scale in production.²⁶ Export subsidies make it possible to compete without necessarily achieving international efficiency levels.

Consumer Prices

Gradually declining vehicle import tariffs have reduced the gap between South African and international prices. But import duties in excess of 30 percent and a virtual ban on used car imports still make car prices higher than necessary. The constraints on consumer choice at the budget end of the market are illustrated as well by the continued profitable production of two obsolete models that have been discontinued in almost all of the rest of the world for decades. Local production of a third such obsolete model was finally discontinued a couple of years ago, and continued duty reductions will eventually lead to the discontinuation of the others.

The value of MIDP incentives to producers for both exports and domestic sales depends on tariff-induced price mark ups on vehicles in the domestic market. Despite this fact and a variety of direct evidence on market behaviour in South Africa, some industry supporters (Barnes et al 2005a and 2005b) have attempted to use indirect information based on international price comparisons to prove otherwise. Based on a number of comparisons they allege to have shown that, except at the budget end of the market, South African prices are not inflated by MIDP. The comparisons are flawed and misleading.²⁷

- They compare retail rather than factory prices. Lower costs of the non-traded services in distribution and sales in South Africa would tend to make retail prices lower in South Africa even if factory costs were higher. The MIDP affects factory and c.i.f. import prices, and these are the relevant prices for any international comparisons.
- They compare South African prices with prices elsewhere, rather than South African prices under MIDP relative to what they would be without MIDP. The value of IRCCs lies in the rent they provide by allowing firms to import duty free and sell at a duty inclusive price. Firms would not buy IRCCs for up to 80 to 90 percent of the face value if domestic prices were not based on a duty inclusive price. And importers that pay import duty (and many do) would not be able to compete against those that benefit from duty free imports unless domestic prices were set on a duty inclusive basis. The import duties associated with MIDP have kept prices higher than they would be otherwise. Further duty reductions will certainly reduce prices further.

Subsidy-Induced Economic Waste

Large subsidies such as those given by the MIDP distort production and investment decisions. They can make socially wasteful activities privately profitable. Losses from activities whose costs far exceed their revenues can be made financially sustainable by offsetting MIDP subsidies.

²⁶ A senior Ford executive has referred to the unique complexity of their South African operations due to the large number of products produced in a single plant. A logistics hub in Rosslyn serves several OEM manufacturers, whereas in other countries such hubs serve only one. General Motors is building a factory to assemble 11.000 Hummers per year for export. The resulting inefficiencies and high costs would be unlikely to be sustainable in the absence of MIDP and other government support. Black (2001) provides other examples from the components sector.

²⁷ For further explanation see Kaplan 2005.

The costs of the inefficiencies bred by MIDP can be estimated by using the subsidy numbers calculated in the previous section.

The effective rate of protection (ERP) is a measure of the amount of inefficiency that is possible to maintain in domestic production and yet still remain competitive and profitable in South Africa. Consider exports. An ERP for exports of over 60 percent in the first few years of the program means that domestic exporters could assemble vehicles at 60 percent higher cost than producers elsewhere and still be able to export profitably. The resulting export earnings might appear to be a saving of foreign exchange for South Africa. However, each R100,000 of export earnings would actually use R160,000 of South African resources. Rather than saving foreign exchange, each R100,000 of exports was actually wasting R60,000 of domestic resources. As the ERP for exports has gone down, the amount of such economic waste has diminished. But even at today's ERP of 29 percent, each R100,000 of export earnings could actually be costing R129,000 of South African resources and still be profitable for the exporter.

The effective protection given to production for the domestic market is even greater—in excess of 100 percent in the early years of the program and still more than 50 percent. The potential economic waste in producing for the domestic market is thus even higher than in the case of exports. With an ERP of 100 percent, a domestic assembler could be using up to R200,000 of South African resources to produce vehicles worth only R100,000 and still make normal profits. And an ERP of 50 percent would permit them to produce cars worth R100,000 at a cost of R150,000 and still be profitable.

It is possible, of course, that domestic assemblers are more efficient than indicated in these examples. In that case, the high levels of protection provided by the MIDP would simply add to manufacturers' profits—a transfer that might result in less productive inefficiency but still saddle consumers with high prices and discourage them from purchasing vehicles that they would be willing to buy if they were sold at closer to world prices. This is also economic waste. Furthermore, to the extent that excess profits accrue to foreign shareholders, they are also a net loss to South Africa.

Another perspective on the economic costs of the program is given by looking at the estimates of the net subsidies MIDP gives to motor industry investments. As shown in Table 4 above, the magnitude of the subsidies has been very large.

What is the economic impact of these incentives on investment in South Africa? Consider two extreme cases. The first is that the investments would be competitive in the absence of any incentives. These investments would have taken place anyway, and the only effect of the incentives is to create rents for the investors, at the expense of South African consumers and/or taxpayers. For such an investment there is no direct economic waste created on the investment side; the investment is competitive and would have taken place in the absence of the incentives. The main effect of the MIDP is to transfer income from South African consumers to shareholders of the company making the investment. As Table 4 shows, the transfers in all cases are several multiples of the amounts invested.

While a subsidy given to an otherwise competitive investment does not create any direct waste by encouraging inefficient investments, it does encourage other kinds of inefficiency. First, of course, is its effect on domestic purchases of automobiles, as buyers are discouraged by tariff-protected high domestic prices. Second, the existence of large rents arising from government policies almost certainly encourages firms to devote their energies to lobbying for such programs. Such lobbying has no social value; but as the examples show, it can yield very large private profits. Third, to the extent that the subsidies accrue to foreign shareholders of the auto and components companies, they are a net loss to the South African economy. They represent a transfer from South African consumers to European and American shareholders. While this does not represent any inefficiency in the global allocation of investment resources, it certainly is a large economic cost to South Africa.

Finally, such large incentives undoubtedly will and already have attracted investments that would not be competitive in their absence. Let us now assume that the four investments shown in Table 4 were just barely competitive with the assistance of the MIDP incentives.

In this case, the subsidies provided by the MIDP are pure economic waste. They represent transfers from South African consumers that are necessary to cover the excess cost of producing vehicles or components in South Africa rather than obtaining them at world prices. For the examples shown in Table 7, the amount of economic waste created for each billion Rand invested in this case are shown in Table 8.

Table 8. Economic Waste in Non-Competitive Projects Due to MIDP

Investment	Economic Waste per Billion Rand Invested (billions of Rand)
Automobile Assembly, 1996	4.9
Automobile Assembly, 2005	2.7
Components Production, 1996	6.8
Components Production, 2005	2.6

In summary, for investments that would be competitive in the absence of MIDP, the subsidies illustrated in Table 4 are a pure rent—a transfer from South African consumers to the firms’ shareholders. To the extent that any of the shareholders are foreign, this is net economic cost to South Africa. At the other extreme, for investments that are just able to earn a normal rate of return in the presence of MIDP, the subsidy represents pure economic waste—the transfer from consumers just covers the excess costs of producing in South Africa rather than elsewhere.

The effect of the MIDP on South African motor industry investment is some mixture of pure transfer and encouragement of economic waste through uncompetitive investments. The extent to which they have subsidized investments that were and remain internationally competitive will be revealed as the MIDP benefits are gradually phased down.

According to the two main industry associations continuation of some kind of MIDP benefits is a key to their continued presence in South Africa. The greater the truth of this claim, the more relevant is the scenario shown in Table 5—i.e. the greater the amount of economic waste being subsidized by the MIDP. The recent declines in the market availability of IRCCs reported by various industry sources suggests that at least the rate of growth of components production, and maybe even its levels might be beginning to decline. Reports of financial difficulties by some major components producers are also consistent with the view that at least some producers are uncompetitive even with the large incentives currently on offer, and hence would be even less likely to be able to compete as the program continues to phase down.

Reports of declining profitability need not be alarming. First, it is quite naturally in the interest of the industry to plead for a continuation of very valuable incentives, even if they are able to compete without them. Second, even if the reports are true and they are representative of the entire industry, there surely are limits to the interest of South Africa in continuing to subsidize inefficient investments in this or any other sector. In light of the magnitude of the incentives it would be highly unlikely that at least some investors did not come in simply to “enjoy the ride” provided by the MIDP, with no illusions about ever being internationally competitive. While their closure or diminution might have unfortunate consequences for employees, their concerns could be accommodated at a cost that would be only a very small fraction of that of continuing the MIDP incentives.

Employment

This raises the question of job creation. While the economic costs of MIDP might be high, maybe they have been necessary to generate badly needed employment growth. Has there been a payoff in terms of employment? Table 9 shows that for the first five years of the program, employment in the manufacture of both vehicles and components declined by 17 percent. Since 2000, employment in vehicle production has more or less stabilized, but has not grown. Investments in excess of R12 billion since 2000 have resulted in virtually no job growth in vehicle assembly. Employment in

components production (including tyres) has grown by a modest 6 percent, or barely over 1 percent per year, over the same five-year period.

Table 9. Employment in the Motor Industry

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Assembly	38600	38600	37100	33700	32000	32300	32389	32370	31700	31500
Components	47000	45000	44000	40000	39000	38500	39000			
Components					67200	69500	72100	74100	75000	74500
Tyres	11000	10000	9500	9100	9000	8600	8700			
Tyres					6670	6575	6300	6000	6000	6000
Motor Trade	178000	180000	180000	170000	175000	180000	182000	185000	191000	194000

Note: The breaks in the series for the components and tyre industries are a result of statistical reclassifications undertaken by NAACAM, the association of components manufacturers.

Of far greater importance in terms of employment is the “motor trade,” which is the service industry involved in sales, distribution, maintenance and operation of motor vehicles. Engine repair and maintenance, panel beating, petrol pumping and vehicle sales are all much more labour intensive than vehicle and component assembly and as a result this sector accounts for twice as many jobs as in vehicle and components production together. This does not include the downstream transportation service sector, another employment intensive activity.

Employment in the motor trade depends primarily on the stock of motor vehicles on the road in South Africa, regardless of where they are manufactured. The biggest constraint to growth in motor vehicle use has been high prices, which are due in turn to the import duties and the ban on used vehicle imports through which the MIDP supports the assembly industry. The recent boom in domestic sales is due in large part to the significant reduction in import duties that has occurred since the start of MIDP. The potential for future growth has not gone unnoticed by the OEM manufacturers and other major players in local sales. These firms have begun to invest heavily in “lifestyle” sales and service centres, each of which supports a significant number of jobs relative the amounts invested.

Further liberalization of the vehicle market through tariff reductions and eliminating restrictions on used car imports would lead to continued growth in associated downstream motor trade and transportation service industries. Resulting employment growth in these sectors would offset considerably and quite probably outstrip any reductions in employment in vehicle and component assembly.

Technology

Has MIDP provided “external” benefits in terms of transfer of new technologies that might have uses beyond the immediate auto industry?

Competitiveness indicators for the components sector developed by B&M Analysts and reported in Barnes et al 2004 are meant to demonstrate that as a result of the MIDP South Africa has built or is in the process of achieving a world class and internationally competitive motor industry.²⁸ While these do not address external technological benefits, they are interesting nevertheless.

The data show that there was a significant improvement in the indicators between 1998 and 2001. The accompanying discussion pays less attention, however, to the levels of the indicators. A particularly interesting benchmark for this purpose is the set of indicators for components producers in other emerging economies.²⁹ A comparison of the levels achieved in South Africa in 2001 with

²⁸ No data are provided for the vehicle assembly industry.

²⁹ See final column of Table 2 in Barnes et al 2004.

those in other emerging economies shows South Africa to be lagging behind, and substantially so in many cases, in all but one or two of the 13 indicators.³⁰

Is there other evidence of the adoption of new technologies of more general benefit to the South African economy?

As mentioned earlier, components exports have been dominated by a very narrow range of products, most importantly leather seat covers and catalytic converters.

Leather seat covers are technologically similar to up-market garments, with the main operations involving cutting and sewing. While local and regional cattle provide substantial amounts of leather, almost all of the leather in the automotive sector is imported from South America. Other inputs such as the electric heating elements in seats for foreign markets are also imported. This sector makes surprisingly little contribution to beneficiation of local products and the jobs are certainly not 'high tech' in nature. It might be argued along more traditional grounds that the jobs are good because they make use of relatively unskilled labour, an abundant resource in South Africa. But the fact that the main inputs are imported from some distance and the product is transported by very costly airfreight raises concerns about the sustainability of these jobs without ongoing high levels of subsidization.

Much of the domestic catalytic converter production is small scale and quite low tech. According to industry sources some of the assembly activities take place in factories that are not much more than simple garages with capital equipment that could be disassembled and taken out of the country in a matter of days. The key local material that is used, platinum, would be exported regardless of the existence of a local catalytic converter industry, and platinum producers gain no price advantage from selling to the local converter industry. The technology for converters that are becoming the norm for vehicles with diesel engines is much more advanced and is not available in South Africa.

Locational advantages and implicit incentives to increase local content of vehicle production up to a point³¹ have resulted in the development of much smaller scale production of a number of other components for local CBU assembly. But almost none of this is internationally competitive. There is growing evidence that even the large-scale export production of seat covers and catalytic converters that has been fostered by MIDP is not competitive. Despite large (but decreasing) incentives to export and local availability of the main raw materials for these products, a number of producers have been facing financial difficulties recently. Products that could be exported profitably with the huge subsidies in the early years of MIDP can no longer compete at the current (and still large) levels of policy support.

In the case of CBUs, there is considerable pride in the ability of South African plants to produce high quality and relatively defect-free high-end BMWs and Mercedes Benz for export to Europe and America. But could this be sustained on a profitable basis without continued MIDP support? The other end of the market includes examples that are closer to technological regression than advance—the continued production for the local market of the Citi Golf and the Tazz, vehicles that have been phased out and replaced by several new generations of higher quality vehicles in most other markets over the past two or three decades. Two recent surveys³² of South African automobile buyers reveal

³⁰ Barnes et al (2004) refer in particular to problems with inventory control and point out the natural logistical difficulties of trying to operate a competitive industry using world class just-in-time techniques at the southern tip of Africa, far away from international markets for components and final products. To the extent that inefficient logistical, port and customs services aggravate these difficulties, this would be an obvious target for "functional" policy reform measures, but not sector specific subsidies to the motor industry.

³¹ DFA privileges that are unused on imported components as a result of sourcing locally can be used to import vehicles instead. The higher rate of import duty on vehicles than on components means that this gives an implicit subsidy to source locally. The 27 percent limit on the DFAs provides an upper bound too this local procurement incentive.

³² The vehicle quality surveys were conducted by Synovate (see *Sunday Times* 23 October 2005) and by JD Power (see story by Roy Cokayne in *Business Report* 31 October 2005).

that imports are still of higher quality than locally produced vehicles, and the Citi Golf rated second to last among all cars surveyed, with 281 defects per 100 cars sold.³³

The industry continues to develop new techniques and technologies for dealing with the peculiar characteristics of the local market. Ford Motor Company, for instance, acknowledges the challenges of producing in South Africa. Bill Ford, international chairman of the company visited the South African plant earlier this year and is reported to have said “he could not think of another Ford operation that managed as much complexity as the South African operation, where nine different models are made. Typically, other Ford plants manufacture much smaller numbers.” (*Business Day* 20 July 2005.)

The auto supplier hub in Rosslyn is another example of adaptation to unique South African circumstances. The hub has developed a set of processes for delivering locally made components to domestic assembly plants and to the Johannesburg International Airport for just in time export delivery. The difference between South Africa and other locales is that in South Africa the hub has to serve several different OEM suppliers, which apparently has made it necessary for the infrastructure to be funded largely by the local government rather than the firms themselves.³⁴ The location of the hub in the suburbs of Pretoria, almost 500 km from the nearest seaport, is another hindrance to the export competitiveness of vehicles and other products shipped by sea.

While such adaptations to South African conditions are admirable, the question is whether they are the basis for an internationally competitive industry without continued external support. If not, how can such support be justified?

Administrative Simplicity and Transparency

The MIDP is highly complex and so administration and compliance are difficult and costly. Even senior financial officers of major firms in the market admit to an incomplete understanding of the requirements and procedures involved. Partial descriptions of the program can be found on the NAACAM and NAAMSA web sites, but complete official descriptions are difficult to find anywhere, including the DTI. Most policy makers and administrators, not to mention potential investors and producers, have at best only a very weak and incomplete understanding of the values of the incentives created, their economic costs and who bears them.³⁵

Vehicle assemblers participating in the program face special Customs procedures that require them to remit duties on a quarterly basis, based not only on their own imports, but also those of their local OEM components suppliers, and, of course, claims in respect of duty credits and duty-free allowances earned under the program. A small industry of consultants, including a number of former DTI officers, has developed to assist investors through the maze of MIDP requirements.

While the complexities of the program are a burden to all investors, they serve as a barrier to entry of new investors, thus reinforcing their value to the small subset of the industry set up for OEM assembly. They also create complex trade-offs and incentives for international transfer pricing where firms must weigh both income tax and MIDP incentive implications of intra-firm pricing decisions. International experience attests to the potential for abuse in both transfer pricing and use of export incentives.

³³ This contradicts the claim by Barnes et al (2005) that higher quality and “greater robustness” of local budget cars compensate for their higher domestic price relative to low end vehicles currently sold in the UK. The only vehicle that rated lower than the Citi Golf in the Synovate survey has been discontinued, giving the Citi Golf the dubious distinction of being the lowest quality automobile sold in South Africa.

³⁴ Black (2001) describes a number of other examples from the components industry.

³⁵ Some experts who have been closely involved with the MIDP even claim, contrary to the statements of senior industry executives, that there are no subsidies provided by MIDP and that South African vehicle prices are no higher than in Europe (see Barnes et al 2004). As will be seen below, this represents a highly flawed view of how the program works.

11.6 The WTO Issue

Export subsidies such as those provided by MIDP are forbidden by the WTO. Procedurally, however, a complaint needs to be lodged by a WTO member in order for any action to be taken. Since the MIDP has been designed for the benefit of global OEM suppliers who can source vehicles from South Africa with the assistance of MIDP subsidies and use the resulting IRCCs to earn more profits from sales in the South African market, they have had no particular incentive to launch an action against the South African subsidy.

Recently, however, an Australian components producer facing competition from South African leather seat exports and in danger of losing contracts to local OEM manufacturers decided to issue a challenge. After an initial attempt to cover it up and negotiate a “private” settlement, the DTI acknowledged the problem and the search for a solution is one of the major drivers of the current MIDP review.

WTO compliance is an issue that should be addressed in the design of any trade or industrial policy. However, whether we can “get away” with a policy under WTO rules is certainly not a sufficient criterion for ensuring good policies. The first question in evaluating MIDP or any alternative is whether it is in the national economic interest of South Africa.

11.7 The MIDP Review

In 2005 the Government initiated a formal and consultative review of the MIDP. This is the program’s third formal review since its inception in 1995. The first review in 1999 extended the duration of the program from 2002 to 2007, and the second review in 2002 extended it to 2012, reduced the speed of tariff phase downs and added a new incentive, the Productive Asset Allowance.

The terms of reference for the task are extremely broad and include a review of achievements to date in light of the program’s initial objectives, and a review of the objectives themselves. While some specific requirements have been set, the scope for analysis and recommendations is virtually open-ended.³⁶

The lack of specificity in the terms of reference leaves considerable room for interpretation. The motor industry has not been shy about expressing its preferences—for a clear set of recommendations to continue the MIDP after 2012, to maintain investor benefits at no less than their current levels and to ensure that they are WTO-compliant.³⁷ Lacking alternative guidance from any other sources,³⁸ reports suggest that the Review Task Team has accepted this as its primary mandate.

This narrow interpretation of the terms of reference assumes that the MIDP has been a success and that it should be continued. It assumes no need for an assessment of the program or any alternatives. It assumes that its economic benefits for South Africa exceed its costs and that this will continue to be so for the foreseeable future.³⁹

Accordingly, the Task Team has pursued a busy schedule of data collection and meetings with stakeholders, primarily associations and firms in the domestic motor industry. It has invited participation, in the form of attendance at meetings, by a range of other government departments. But

³⁶ Among the specific tasks are to make recommendations regarding the future of the PAA program, support for medium and heavy vehicles, and the automotive leather sector (presumably in response to the Australian/WTO problem).

³⁷ The continued reference to keeping incentives at current levels suggest that the industry would like to persuade the government to refrain from implementing the previously announced schedule of tariff and other incentive reductions between now and 2012.

³⁸ The Minister of Trade and Industry apparently supported this interpretation at a recent ground-breaking ceremony for a new automotive plant. He is quoted as committing the government to continued support of the automotive sector after the expiry of the MIDP in 2012 and to saying “Our own vision and commitment is really looking beyond 2012 because this is such an anchor sector in our economy.” (*Business Day* 1 August 2005)

³⁹ Trevor Bell 2003 makes a similar observation about the 2002 review of the program.

it appears to have no clear plans for analyzing the broader economic impacts of the program and alternative sectoral strategies.⁴⁰

MIDP is an important economic policy for South Africa, both in its own right and as a possible template for other sectors and strategies. It has been in operation for 10 years now, and is planned to continue for another 7 years. There surely is enough evidence now on which to base a serious economic analysis of its costs and benefits. This would reveal it to be the success it is claimed to be and provide informed guidance for its use as a model for other sectors. Or it would reveal some of the program's unintended and/or underappreciated costs, force them to be justified in terms of other benefits, and provoke a review of ways to reduce the costs or increase the benefits by program amendments. To conduct a review without an analysis of MIDP's economic impacts is to base policy on faith and on claims made by those with a vested interest in the program as it now stands.

This is closely related to another important issue, the transparency and accountability of the processes chosen to manage and review the MIDP. The current and the previous (2002) MIDP reviews have been conducted by persons who have been closely connected with the industry and/or the management of the program at the DTI. While this experience provides the consultants with considerable inside knowledge of the program and the industry, it also raises questions about their independence and their own interests in the outcome of the reviews.⁴¹

Strong analytical capacities at the DTI or elsewhere in the government might help to overcome these concerns. In the past few months alone, however, the government's two most senior motor industry managers have announced their departure from the DTI, one to join one of the two main motor industry associations and the other to work for an industrial estate company that includes the motor industry among its principal clients.⁴²

Both the apparent substance of the current Review Task Team's activities and the processes for managing this and previous reviews raise questions about the extent to which the Task Team will be able to conduct a truly independent review of the economic impacts of the MIDP and provide recommendations that will reflect South Africa's broader national economic interest.

11.8 The Way Forward

The MIDP was designed to help an inefficient, high cost and uncompetitive motor industry adjust to South African trade liberalization that began in 1995. It has done so with very generous subsidies. It was intended to encourage firms to orient themselves to global markets and in particular to enjoy the economies of scale and specialization that could occur only by taking advantage of opportunities for international trade. The adjustment period was set initially at seven years.

The program has now been extended twice and is currently scheduled to run until 2012, for a total of 17 years. While the extensions slowed down certain aspects of the adjustment process, the direction of change has never been in doubt. Tariffs on vehicles and components have been falling steadily according to a clear and well-understood schedule, at least until 2012. At that time, tariff rates on vehicles and components will be 25 and 20 percent respectively, much lower than the levels in 1995, but still quite high relative to the rest of South Africa's tariff schedule, where the average rate at the moment is about 6.5 percent.

The industry has undergone a major structural readjustment. However, the incentives provided throughout the life of the program, and especially in the earlier years were almost certainly much larger than was recognized. As a result, the adjustment has not always been accompanied by corresponding increases in competitiveness, and voices in the industry are now calling for clarity on the government's intentions after 2012. Without a continuation of incentives, according to some such

⁴⁰ The sole economist on the Task Team is not an industrial policy specialist and has committed only limited time to this activity, primarily to review work on labour market issues.

⁴¹ South Africa apparently has no conflict of interest guidelines or rules related to the movement of officials or advisors between government and industries over which they have regulatory responsibilities while in government.

⁴² See previous footnote.

voices, the industry, or at least some firms in it, will face serious financial difficulties. Potential new investors with time horizons beyond 2012 also wish clarity on policies after that date.

The aim of the MIDP was to assist the industry to achieve international competitiveness. It was designed as a short-term intervention to give the industry space and time to adjust; it was certainly not intended to last this long, never mind to 2012 or beyond. Firms that are already or will become competitive by 2012 will not need further subsidization, and there can be little justification for a continuation of the rent transfers that have been given to foreign shareholders over the past decade. A continuation of subsidies to firms that cannot compete without them will generate even more economic waste, paid for by South African consumers and taxpayers. Workers losing jobs in uncompetitive firms that might close if MIDP subsidies were sharply reduced could be compensated at a fraction of the cost of the subsidies.⁴³ Moreover, declining car prices would increase employment in sales and service, which is one of the few areas in the overall industry that has experienced substantial employment growth since 1995.

The MIDP, and in particular the export-import complementation program, was modelled on a similar program in Australia. That program provided a DFA of 15 percent (compared with South Africa's 27 percent) and import duty rebate credits similar to those in South Africa. It ran from 1984 to 2000, by which time the import duty on vehicles had been reduced from 55 to 15 percent. In 2000 the export subsidy was replaced by a general duty credit arrangement that provided credits of 25 percent of the value of production times the rate of duty, whether for export or the domestic market, and it was announced that the import duty would be reduced to 10 percent at the end of 2004.

There is no necessary virtue in emulating the policies of foreign countries. Following the early Australian model in South Africa has generated very large subsidies to the industry. This has resulted in some combination of large rent transfers to motor industry shareholders and economic waste through uncompetitive domestic production. At this stage, however, these are sunk costs, and the Australian model would certainly bear further scrutiny as a means of winding down government support.

It might be difficult and inappropriate to accelerate the previously announced phase down of tariffs up until 2012. However, it certainly would be worth emulating Australia by a) eliminating the DFA and IRCC incentives after 2012 and b) continuing to phase down of tariffs on vehicles and components to something like 10 and 5 percent respectively, in line with South Africa's general industrial tariffs at that time. The industry is asking for clarity on the post-2012 policy regime. An announcement in the near future of a phase down in vehicle and components tariffs to normal levels in 2012 would give the industry sufficient lead time to make whatever adjustments might be needed. Since the government's commitment to the PAA even for the next few years, is much less clear, it might be possible to phase it out more quickly. However, the cases examined here suggest that the PAA is worth much less and hence causes much less damage than the export IRCCs, and so the gains from phasing it out might not be very great.⁴⁴

Would there be significant employment impacts from completion of the phase out of MIDP? Fortunately the MIDP has not resulted in significant, indeed if any, increases in employment in the sector. Furthermore, the adjustments fostered by MIDP over the past 10 years have presumably increased the competitiveness of the industry to the point where some, if not many, firms can now compete without continued subsidies. If not, the program certainly would have to be deemed a failure. This means that the adjustment burdens for workers in the motor industry will be no worse and probably far less than they would have been in the years following 1995 if MIDP had not been initiated in the first place. Meanwhile, the MIDP and other associated policies have harmed consumers and suppressed the development of much more labour intensive downstream industries that already account for twice as many jobs as in vehicle and component manufacturing. Completion of the MIDP phase down would help create many new jobs in these sectors.

⁴³ For instance, a temporary five percent excise tax on all vehicle sales would provide substantial resources to deal with labour market adjustment needs.

⁴⁴ For the same reason, of course, the protests from the industry should also be much less.

The South African motor industry has undergone enormous restructuring over the past decade. While total employment in components and vehicle production is not much different than in 1995, this does not mean that there have not been major labour market dislocations. For those who might have suffered from these adjustments, a small fraction of the subsidies provided to firms in the industry would have been sufficient to compensate for and assist in them in dealing with any resulting disruptions. The same is undoubtedly true in looking forward. The economic waste and the rent transfers to shareholders in the motor industry under MIDP are an extremely inefficient and high cost means of dealing with labour adjustment.

The issues being examined by the current MIDP Review are real and important. However, its mandate needs to be clarified. Its tasks should include an independent economic cost-benefit analysis of the MIDP and of any new proposals. This might require an amendment to the current TORs and might also require expertise that is not represented in the current Task Team.

The Review should recommend a clear time schedule for further reductions of tariffs on imported cars after the MIDP's current expiry date in 2012. It should provide an assessment of expected growth in car sales and investment and employment in associated segments of the industry, and indicate means of helping workers affected by transitional employment losses, financed through measures such as a modest temporary excise tax on vehicle sales.

Since the time this chapter was written the original MIDP review team has been replaced without ever producing a public report. A new team (of old faces) was appointed and the DTI has recently (September 2008) announced an outline of its motor industry policies for 2012-2020. No overall analysis or assessment of existing or proposed plans has been made available publicly

At a broader level, the government should reflect on the lessons from the MIDP for the future of sector-specific industrial policies in South Africa. Subsidization of an “infant industry” or “industry in transition” cannot be permanent. Among the policy scenarios considered should be a set of parameters for the final transition of the industry to a normal economic environment. In evaluating alternatives, Government must look beyond producers and examine the national interest, including that of consumers, taxpayers, and workers in downstream industries that have suffered as a result of high prices that inevitably arise from any form of infant-industry protection.⁴⁵

12 Adapting to Trade Liberalization: Clothing and Textiles

This chapter was written in 2006 and before the introduction of quotas against clothing and textile imports from China. The data and policy position may therefore be out of date; but the main lessons and recommendations remain valid today.

Like the motor industry, textiles and garments are at a critical point in their development as they near the end of one phase of adjustment following a decade of gradual but incomplete domestic trade liberalization. They have benefited less than producers in some neighbouring countries from preferential access to the US market under AGOA. Decisions made in current negotiations with the US, the EU, and fellow Member States of SADC, especially on rules of origin, might have serious implications for their future development. Most importantly, the end of the Agreement on Textiles and Clothing (ATC) has created a new trading environment in which export performance will depend primarily on basic economic factors and on international competitiveness rather than on artificial quota allocations.

These developments were not unexpected; the industry has had ten years to restructure and respond. The recent strength of the rand has raised new challenges, but has also enabled access to cheaper machinery and materials. This might have accelerated, but not changed, the intended impact of global trade reforms in this and other sectors.

⁴⁵ Recall that there are twice as many jobs in these downstream industries than in vehicle and components manufacturing.

Almost ignored in recent discussions have been the substantial benefits to the retail trade and most importantly to consumers, especially poorer ones, arising from domestic and global adjustments in this sector over the past decade.

At this late stage in the reform of this sector there is renewed pressure from some sources for the government to reconsider its basic approach to the sector. The government has responded by commissioning new studies that has proposed a wide range of additional support measures, many of which focus on increasing protection of the local market. This new policy direction is informed at least in part by the perceived success of the Motor Industry Development Program (MIDP).

12.1 Background

Faced with a clear need for substantial industrial restructuring in the textile and clothing sector in the mid-1990s, the government rejected the Swart Panel’s proposals for a wide variety of subsidy schemes to support the industry. It announced instead a gradual phase-down of protection, accompanied by an export subsidy program, also scheduled to be phased down over the following decade. The goal was to promote a textile and garment industry that could be internationally competitive and that could succeed in the domestic market without high levels of protection. It was recognized that not all sub-sectors in the industry would be able to compete and that some adjustment would be necessary to adapt to that reality. The long phase-down of protection was designed to provide time for necessary structural readjustments.

This phase-down period is now nearing an end. Tariff rates remain quite high (10 to 18 percent for yarn, 20 to 22 percent for fabric, 34 percent for blankets, linens and curtains, and 40 percent for garments).⁴⁶ These tariffs provide considerable effective protection to producers selling in the domestic market. Table 10 shows some the nominal tariff protection provided to the different stages of the value chain in 1993, 2000 and 2005. Table 11 shows estimates of effective rates of protection provided by these tariffs for typical textile and garment makers selling in the domestic market in the same years.

Table 10: Tariff Rates in the Textile Value Chain (%)

	1993	2000	2005
Synthetic Fibres	25	13	7.5
Yarn	35	20	15
Fabric	50	27	22
Household Textiles	60	37	30
Clothing	100	54	40

Source: Barnes et al 2005.

Table 11: Effective Protection, Fabric and Clothing (%)

	1993	2000	2005
Fabric	85	43	38
Clothing	217	117	82

Note: Assumes tradable inputs are 70 percent of costs.

Producers selling domestically still get substantial protection from tariffs, while consumers, of course, pay substantially more than necessary for a basic necessity of life. The domestic market, however, is very small by global standards and focusing on this market alone does not provide a basis for international competitiveness. Clothing exporters do not get similar assistance from government. They can make use of standard duty drawbacks that, in principle, compensate for the cost raising

⁴⁶ In the mid-1990s fabric was protected by import duties of about 40 percent and garments by duties in excess of 90 percent.

impact of duties on cloth and other raw materials. The alternative is to make use of the duty credit certificate (DCC) scheme that is similar in principal to the MIDP's IRCC program. However, unlike in the motor industry, they must choose whether to use duty drawbacks or DCCs; they cannot use both. Most large exporters apparently use duty drawbacks,⁴⁷ indicating that the DCCs are not of sufficient value to compensate for the high cost of imported cloth and other materials.

It is not surprising, in light of the continuing high levels of protection of fabric and cloth, that a number of South African producers remain focussed on the domestic market and that they are pressing the government for a reversal of the commitment to liberalize this sector.

Government's first response has been to reverse the phase-out of the export incentives. Rates of duty credits awarded for exports of textiles and garments have been increased and performance conditions attached to them have been relaxed and/or removed. Additional measures are promised soon, but with little indication of a long run strategy. Among those being considered are "safeguard" quotas or voluntary restrictions on imports of fabric and garments from China.

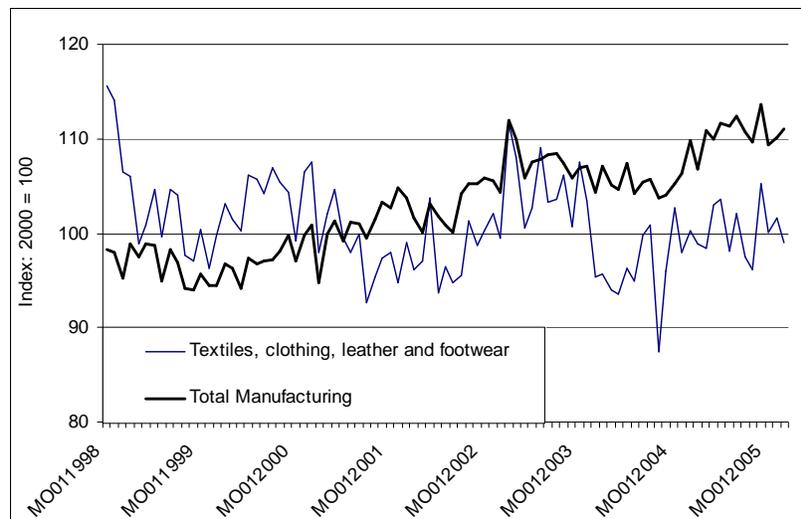
The recent sector review conducted for the DTI recommends, somewhat strangely, that DCCs be made non-tradable, so that qualifying garment exporters will not be able to sell them to garment retailers. The reviewers seem not to understand that such a requirement would make the DCCs worthless.

The new proposals have been prepared in haste and in an *ad hoc* manner, with little apparent attention to the long run considerations underlying the policies adopted in the mid-1990s. They have been based on a false presumption of a harmony of interest among fibre, textile and garment producers, among exporters and producers for the domestic market, and among producers, retailers and consumers. Implications for consumers, especially those at the lower end of the income distribution, have not been considered. Economic costs have not been estimated. Alternative policies have not been contemplated or analyzed.

12.2 What is the Problem?

Recent policy documents and press reports paint a picture of an industry in crisis. What are the underlying problems, and how do they relate to the policy issues being discussed?

Figure 4: Manufacturing Production (volume)



Data Source: StatsSA

⁴⁷ See Kaplan 2003.

Medium term trends suggest in fact that the industry has been responding to gradual liberalization more or less as might have been expected (Figure 4). Production levels have changed little over the last seven years but trade in textiles and garments has been growing steadily, and this has been equally true of exports and imports, at least until 2003 (Tables 12 and 13). This suggests some healthy rationalization in response to market forces, with growing specialization in areas in which South Africa can compete in global markets.

Table 12. South African Textile and Clothing Imports

	US\$ 000			Av. Annual Growth	
	1999	2003	2004	99-03	03-04
Textiles	613 050	731 649	908 324	5%	24%
Garments	230 394	364 990	627 811	15%	72%
Total	843 443	1 096 639	1 536 135	8%	40%

Data Source: Quantec Easydata

Table 13. South African Textile and Clothing Exports

	US\$ 000			Av. Annual Growth	
	1999	2003	2004	99-03	03-04
Textiles	416 501	470 839	455 066	3%	-3%
Garments	229 577	341 094	285 448	12%	-16%
Total	646 078	811 933	740 514	6%	-9%

Data Source: Quantec Easydata

Of South Africa's 23 leading clothing and textile exports in 2004 (those with values greater than US\$ 25 million and accounting for just over 50 percent of total exports in this sector), 18 recorded export growth between 1999 and 2004. Clearly a number of downstream and upstream producers have become internationally competitive exporters. In response to the needs of domestic retailers, others have implemented systems that enable them to meet world-class standards in terms of cost, quality and delivery schedules in the domestic market. This kind of response is critical if the industry is to adjust successfully to the post-ATC world.

The same story is confirmed by data provided in the recent DTI-commissioned study of the sector (Barnes 2005). Tables 14 and 15, taken from Appendix 3 of that study, provide data on sales, imports, exports and employment in textiles and garments in SA.

Table 14. Nominal Sales and Trade in Textiles (R billions)

	Sales	Imports	Exports	Employment
1995	8,913	2,331	1,029	61,299
1996	9,293	2,438	1,352	76,930
1997	10,333	2,735	1,552	75,955
1998	9,765	2,901	1,338	50,596
1999	9,770	2,841	1,497	55,333
2000	10,164	3,197	1,663	55,073
2001	11,022	3,476	2,054	56,874
2002	13,426	4,494	2,825	58,085
2003	12,433	3,964	2,457	53,736

Source: Barnes 2005, Appendix 3.

Table 15. Nominal Sales and Trade in Garments (R billions)

	Sales	Imports	Exports	Employment
1995	9,857	672	539	133,272
1996	9,774	1,041	724	150,407
1997	10,923	1,143	929	139,830
1998	10,640	1,315	867	135,833
1999	10,995	1,442	1,077	147,768
2000	10,524	1,806	1,414	137,804
2001	10,927	1,981	2,021	133,818
2002	12,405	2,479	2,747	119,748
2003	12,991	2,835	2,381	113,457

Source: Barnes 2005, Appendix 3.

The tables indicate considerable adjustment as a result of trade liberalization, but not necessarily an industry in deep trouble. In the garments sector, for instance, there was a relatively speedy increase in the propensity to import, followed by a slower response of exports. But over 1995-2003 imports and exports grew at almost exactly the same rates, and at a much faster pace than sales. Over that period, exports grew from a trivial 5 percent of total sales to 18 percent by 2003. Imports grew from 7 percent of sales to 22 percent.

Over the same period employment in garment production fell from about 133,000 to about 111,000, a decrease of 20 percent. One of the standard arguments is that trade liberalization was the primary cause. The sales and trade data suggest otherwise. Exports grew just as quickly as imports, and so the net effects of trade liberalization on employment were a) an increase in sales due to a steadily falling real price of clothing and b) a shift in production towards export markets. It is not changes in total output due to trade liberalization that explain falling employment. The cause of falling employment must be looked for elsewhere and the obvious place to look is productivity growth.

The international garment industry has been characterized by very large productivity gains over the past decade. This has been due in part to shifts in production from high cost to lower cost locations. But it has also been the result of rapid and continuous change in everything from cutting and assembly technologies, to new materials, design, inventory control and logistics, much of which has been assisted by innovative use of information technology.

The story of employment in the garment industry over the most of the first decade of trade liberalization is one of productivity improvement, not industrial decline due to the opening of domestic markets to foreign competition. The South African industry adjusted quite well and quite predictably to the threats and the opportunities of trade liberalization, rationalizing production away from products in which domestic producers could not compete and into those in which it was more competitive. The growth of exports is at least in part testimony to this adjustment. And of course the greatest beneficiaries were domestic consumers who, due to trade liberalization, were able to benefit from the massive gains in productivity occurring in the global garment industry.

A fundamental sector-specific problem facing the garment industry is the lack of competitive access to raw materials. Ability to compete in the new global environment requires access to wide varieties of raw materials. Global textile and garment industries are characterized by a complex and highly fragmented division of labour, with fabrics and garments produced at diverse locations all around the world, supported by complex patterns of international trade in items at all stages in the industry value

chain. No country is self-sufficient in any segment. A key to domestic and international competitiveness in this sector is to be a successful importer—to source raw material inputs efficiently on a global basis.

Inadequate access to raw materials has been identified as a key constraint to the South African textile and clothing industries (Minor 2002). The spinning and weaving industries have been hindered by a compulsory domestic purchase requirement for cotton as a condition for using imported fibre. Producers at every stage of the value chain are penalized by high import duties on raw material inputs. This is most serious in the case of garments, where producers face import duties of 20 to 22 percent on imported fabric. Garment producers cannot compete internationally in the face of such cost penalties.

A key part of South Africa's response to these problems is to compensate for the cost-raising effects of import tariffs by even higher tariffs on output at each stage in the value chain. This familiar escalating pattern of tariffs has the unfortunate side effects of a) tying producers to production solely for the domestic market, depriving them of any incentive to engage in large scale production necessary to compete in world markets and b) penalizing consumers, especially those at low income levels who are further hurt by restrictions on the import of used clothing. Duty drawbacks and other WTO-compatible measures to compensate exporters for the harmful effects of domestic policies on input costs are at best only a partial substitute for more fundamental reforms to improve access to raw materials.

Garment producers wishing to export on preferential terms in the SADC, EU or US markets (under AGOA) face another large competitive hurdle—highly restrictive rules of origin that require them to use local or regional fabric. In practice, this means sourcing in South Africa, where the fabric industry is still protected by import duties of 22 percent. A garment firm of the type shown in Table 7 that was faced with the requirement to source locally in order to export would face an effective rate of protection of -51 percent! And this assumes that the firm would actually be able to find fabric of the appropriate quality, volumes and delivery terms in order to meet a sales contract. South African garment producers have told us that they could not even survive in the domestic market (with 40 percent protection) if they had to source cloth locally. The possibility of taking advantage of preferential trading schemes under typical rules of origin in this sector is virtually zero.

This illustrates the folly and destructiveness of rules of origin imposed by the US and the EU, and makes it difficult to understand why South Africa continues to insist on the same rules in SADC. This has been based on strong pressures from certain textile interests and on a misguided perception that there is a clear harmony of interest in trade policy matters between clothing and fabric producers. Garment producers have now come to realize the harm that has been done to them in trade negotiations as a result of this view.

No garment industry in the world can compete internationally or domestically if it is constrained to source fabric locally (Flatters 2003). This is especially true in South Africa. A key challenge in improving the competitiveness of the South African garment industry is to improve access to raw material inputs. This requires a reorientation of thinking on rules of origin and further lowering of import tariffs on raw material inputs. This will then provide scope for further tariff reductions on garments, which will also help consumers of this basic necessity and ease problems with customs administration that arise from high tariff rates.

Experience elsewhere has shown that a vibrant garment industry will gradually induce development of backward linkages. But trying to force such linkages through high import tariffs, domestic purchase requirements or restrictive rules of origin stunts the development of downstream industries and is thus of no value to the input suppliers the measures are intended to help.

12.3 Consumers and Poverty

Global restructuring and corresponding productivity increases have streamlined the international clothing and textile industries over the past decade, and post-ATC adjustments will continue to support this trend. This has been of great benefit to clothing consumers worldwide. South Africa

consumers have gained as well from significant tariff reductions on clothing over the same period (see Table 10 above). The recent growth of the domestic clothing retail sector and especially the success of low price sellers such as Mr. Price and Pep Stores suggest this might be the case, and that lower income groups might be among the greatest beneficiaries.

Table 16 shows the changes in the overall consumer price index for South Africa over the past decade and the corresponding changes in the average price of clothing.

Table 16. SA Prices: Overall CPI and Clothing

	1995 (01)	2005 (05)	% Change
CPI	70.2	127.6	81.8
Clothing	90.3	95.3	5.5

Source: Statistics South Africa.

While the overall CPI has increased by 82.8 percent from 1995 to the present, nominal clothing prices have risen by only 5.5 percent. In other words, the real price of clothing has fallen by approximately 75 percent since 1995. Clothing comprises 3.87 percent of all South African household expenditures (2000), but is more important for low-income groups, comprising 4.37, 5.27 and 5.99 percent of expenditures for the very low-income, low-income and middle-income groups respectively. Reductions in clothing prices are therefore of real significance to poor and middle-income consumers in South Africa.

A significant part of the reduction in real clothing prices since 1995 is due to tariff reductions. Further reductions would have a similar effect. For simplicity assume that the tariff is fully reflected in domestic retail prices of clothing. This means that in 1995 garments worth 100 at world prices would have cost 200 in South Africa in 1995 and 140 in 2005. (The tariff rate on clothing was 100 percent in 1995 and 40 percent in 2005.) The reduction in the tariff, therefore, would have caused clothing prices to fall by 30 percent (60/200). This is 40 percent of the real price decrease observed over the period. The remainder of the reduction in retail clothing prices is due to some combination of productivity improvements in world garment production and increased efficiency and/or competition in the South African garment distribution system.

Falling prices and an expanding retail sector affect the poor not only as consumers but also as workers. Clothing retailing is a labour intensive service sector. Table 17 shows that, internationally, the retail sector accounts for almost 60 percent of value-added in the textile-clothing value chain. Expansion of this activity as a result of tariff and price reductions could be a powerful instrument for job creation and poverty reduction, in addition to its direct benefits to the poor as consumers.

Table 17. Distribution of Value Added in the Cloth Value Chain

Retail	57%
Apparel	23%
Fabric	12%
Yarn	5%
Fibre	4%

Source: Barnes 2005.

12.4 Economic Underpinnings of the New Policies

Government's response to the apparent crisis in this industry is likely to be informed by a recent report (Barnes 2005) commissioned by the DTI. The report is derived from a 'consultative' process whereby the main stakeholders in the industry were canvassed to explain their 'problems' and

develop a 'wish list' of what the government might do to solve them. There is little critical evaluation of these problems and insufficient economic analysis of the implications of alternative approaches.

The recommendations include:

- stricter customs enforcement to prevent 'illegal smuggling' with no consideration of possible costs in terms of reduced trade facilitation that would reduce rather than increase the industry's competitiveness,
- reinstating and increasing the value of the duty credit certificate (DCC) program to assist exporters while at the same time outlawing the transfer of DCCs, thus making them worthless to any exporters that do not have direct corporate links to domestic retailers,
- imposing country of origin labelling requirements that would become a major non-tariff barrier on imports of a basic consumer necessity (already implemented by the government, in an unusually speedy reaction to the draft recommendations).

Based on the faulty assumption of a harmony of interest among the fabric and garment industries, the study also recommends various measures to impose reliance on local and regional value chains while the government continues to support highly restrictive rules of origin in SADC.

This report and its recommendations are based on the presumptions that

- the textile and garment industries are in serious trouble and
- the only solution is to try to save them at any cost, even if it means increases rather than decreases in protection.

These twin presumptions ignore evidence of substantial adjustment that has taken place in the industry already, the successful export performance of a number of products throughout the value chain that have managed to surmount policy-induced protectionist barriers, and wide benefits to consumers and workers in some of the most labour-intensive parts of the value chain.

The government faces some difficult challenges in designing an appropriate policy response. Particular care should be taken to avoid influence by vocal segments of the industry without being able to take account of the broader economic implications of the self-serving policy recommendations they present. It is important to ensure that the new policy regime does not protect weakness and reward those with the loudest voices rather than encouraging and facilitating strength.

New policies for the textile and clothing industries should be undertaken only with a clear understanding of their economic costs and of their differential impacts on downstream and upstream producers, as well as on consumers, especially the poor. To the extent that labour market dislocations might result, the relative costs of continued industrial support and of different forms of income support and readjustment assistance should be estimated and taken into account.

12.5 The Way Forward

The South African textile and clothing industry faces enormous challenges. However, these problems are neither new nor unexpected, and the industry has in fact responded relatively well to a long-term and necessary restructuring exercise. Government has an important role to play in this process, and more could be done to assist apparel producers and those employed in the industry to adjust to these changes. But such interventions need to be cost-effective, forward-looking, based on accurate information and research, and should reflect the interests of poor consumers and employees.

Recent policy proposals to government suggest the opposite: they are costly; they lack supporting evidence; they are biased towards particular producers, often those that are the least competitive, and without any recognition of fundamental differences and conflicts in the interests of different groups in the industry; and they will do little or nothing to develop a more competitive and sustainable industry.

A cohesive and appropriate policy response is needed to complete the restructuring of this industry. This might take some time to develop, and more research and consultation is probably required. But in the meantime, there are a number of immediate steps that government could take that would have

unquestionable benefits for consumers and producers. First and foremost, government could do more to lower the cost and improve access to inputs. Until South African apparel and textile producers can access the best quality and most affordable fibres, yarn and cloth, they will be unable to compete within South Africa and abroad. This requires significant changes to the existing rules of origin on clothing and textiles imports in the SADC and EU Free Trade Agreements, as well as AGOA. These two agreements are currently being reviewed and FTA negotiations have begun with the US. This gives the government a short but invaluable opportunity to address this particular constraint.

Less restrictive rules of origin will facilitate improved access to key inputs. These should be accompanied by further tariff reforms, particularly on imports of the materials and equipment required for clothing and textile production. At 10 to 20 percent, these tariffs are still high relative to those in other industries. Changes to rules of origin and further reductions to the tariffs on clothing materials will help to increase the competitiveness of downstream producers in both domestic and international markets. This would then permit the government to reduce tariffs on imported clothing, with obvious benefits to low-income consumers for whom basic necessities make up a large share of household expenditures.

Regardless of what South Africa does or does not do, the global clothing and textile industry will experience major shifts and shocks over the next few years. In the short-term, subsidies may help to sustain the livelihood of some uncompetitive producers, but this cannot continue indefinitely. Factories will close and jobs will be lost in some sub-sectors, but competitiveness-enhancing reforms will permit others to gain from improved access to global markets and materials.

It is impossible at this stage to pick the future winners and losers of such reforms. Nor is it particularly important. But it is certainly possible to identify and perhaps address expected job losses in this sector if and when they arise. This might require direct assistance, in the form of skills development or financial support, or it may involve specific labour market reforms to increase the competitiveness of unskilled labour in this and other sectors.

Finally, and perhaps most importantly, this case highlights the importance of evidence-based policy making. There is some danger that government's policy response to a particular crisis in a particular industry will be strongly influenced by short-term phenomena and vociferous lobbying from particular segments within the industry. This is worrying for two main reasons. First, there is a real risk that government will implement bad policies, proven to be costly in other industries, with little long-term benefit to South African producers or consumers. And secondly, the implementation of these new policies might distract attention from some of the more serious and systemic problems in these industries that would have been revealed through better research and analysis. This case study touches on some of these issues. It does not pretend to know all the answers. But it does strongly suggest that government should engage in more detailed research and discussions, before any further policy decisions are inflicted upon this industry.

13 Upstream Industries: Import Parity Pricing and Other Problems

The "commanding heights" have long been recognized as critical to a country's long-term economic development. Access to industrial raw materials is, of course, essential for all downstream industries. But while domestic production of these materials was once thought to be the key to the development of a manufacturing base, one of the great benefits of globalization is to make international trade a viable and often preferable substitute for domestic production.

South Africa is in the interesting position of having inherited a number of upstream producers of steel, other metals and petrochemicals that were born as a strategic necessity during the sanctions period. High and cascading tariff structures from the same period fostered other upstream industries among which the textiles sector remains an important factor for the downstream garment industry.

Recent debates about import parity pricing and related practices illustrate why availability of industrial inputs and raw materials from domestic sources can be a double-edged sword for downstream industries.

On the one hand, competitive availability of such raw materials should help downstream users by reducing the time, logistical, transport and other transactions costs of sourcing internationally.

On the other hand, if the local suppliers exist in part because of import protection provided by tariffs, or if they are able to engage in monopolistic domestic pricing as a result of natural protection and/or tariffs, local prices of the raw materials will be artificially inflated, imposing a cost penalty on downstream users relative to producers in other countries that can buy the inputs at more competitive prices in international markets.

Among the interesting issues in South Africa at the moment are instances in which domestically produced raw materials are exported to world markets and sold at higher prices domestically. The most obvious cases are iron and steel and plastics. Higher domestic prices are the result of a combination of significant transport costs, import duties (5 and 10 percent on steel and plastics respectively), anti-dumping duties⁴⁸ and non-competitive business practices. This hurts downstream users and so ultimately jeopardizes the competitiveness and development of the entire manufacturing sector.

Import duties of about 20 percent on fabric and restrictive rules of origin in several preferential trade arrangements⁴⁹ cause similar harm to the South African garment sector, the most labour intensive part of the entire yarn-clothing value chain.

In the long run, of course, internationally competitive domestic upstream industries can increase the competitiveness of downstream production. But the way to achieve this is to allow the upstream industries to develop in response to the demands of successful downstream industries. Handicapping downstream industries by holding them hostage to high cost upstream industries is not helpful to either.

High costs and low quality of telecom and internet services are another examples of hindrances to the development of downstream industries. In a global world economy information technology is central not just to 'high tech' industries, but also to almost all spheres of activity including financial services, garments and offshore call services. IT services need to be provided locally, and it is essential that this be done efficiently and competitively so that downstream industries are not handicapped.

13.1 What are Import and Export Parity Prices?

Most basic industrial raw materials are traded in world markets and have prices that are quoted in international trading centres (London, New York, Singapore, Tokyo, etc.). Call the price at one of these locations the "world price", or P_w . The corresponding import parity and export parity prices in South Africa are based on P_w but depend very much on local market and regulatory conditions in South Africa.

The *export parity price* (EPP) is the net price that a South African exporter receives after delivering the product for sale in the world market and is P_w less all shipping and transactions costs incurred in getting the product to the market. If South Africa levied an export tax on the product, this would reduce the export parity price further, by the amount of the tax.

The *import parity price* (IPP) is what a South African importer has to pay to purchase the product in the world market and have it delivered for domestic sale in South Africa. This is P_w plus all shipping charges, other transactions costs, and import duties and surcharges levied in South Africa. Note that this might differ considerably among buyers depending on the size of purchase, the urgency of delivery and other factors that determine shipping and transactions costs.

⁴⁸ See Section 10.2 below for a further discussion of anti-dumping duties.

⁴⁹ Some of these, such as the SA-EU Trade, Development and Cooperation Agreement and AGOA are largely beyond South Africa's control. On the other hand, certain vocal interests in the textile sector have been strong advocates of continued acceptance of these requirements and have lobbied quite successfully to include similar provisions in the SADC Trade Protocol. The use of rules of origin to handicap downstream producers in SADC has been a consistent element of the South African position in SADC and other trade negotiations.

The wedge between the import parity price and the export parity price for any product will be the sum of the costs of shipping it from South Africa to the world market and of shipping and distributing it in the opposite direction, plus any export taxes levied by South Africa and any import duties on the product in South Africa.

The domestic price of such products in South Africa depends on whether South Africa is a net exporter or importer of the product and on competitive conditions in the local market.

13.2 Domestic Prices in a Non-Monopolistic Domestic Market

What price will prevail in the domestic market? Consider first the case of a non-monopolized domestic market, i.e. where price discrimination is not possible and there is a sufficiently strong threat of entry that pricing above cost is not a sustainable strategy for any producer or seller.

If there are no domestic producers or if they are unable to competitively produce sufficient volumes to satisfy domestic demand, South Africa will import the good and the import parity price will prevail in the domestic market.

If domestic producers of the raw material are supported by tariffs or other import restrictions, the import parity price will be higher than if the only import barrier was the cost of transport. The artificial increase in the import parity price due to the tariff imposes a real cost on downstream users and on the economy. The cost depends on the size of the tariff and on the ability of downstream users to adapt to its burden.

However, if domestic producers are competitive in world markets and do export, their opportunity cost of any additional sales will be the export parity price and that is the price that will prevail domestically. Competition among sellers will ensure that the domestic price is kept at that level and that no one will be able to charge a higher price.

In summary, if South Africa is a competitive exporter of an industrial raw material and if the domestic market for the product is not monopolistic, the existence of internationally competitive domestic production will be helpful to downstream producers. Downstream industries benefit from the availability of the raw material at the export parity price. The domestic price is still anchored to P_w , of course, but it is kept below it by the costs of shipping the product to world markets. Outbound shipping costs and export taxes serve as a penalty for the domestic raw material producers and as a subsidy to downstream domestic users.

But if domestic production is not internationally competitive and is supported by tariffs or other import restrictions, downstream users will suffer from having to pay higher raw material prices than competitors elsewhere. South African garment manufacturers, for example, must pay high prices for locally produced textiles or face high duties on imported fabric. This places them at an extreme disadvantage compared to manufacturers elsewhere who can source globally at no duty.

13.3 Domestic Prices in a Non-Competitive Market

Suppose that the domestic raw material producer can export competitively but is a monopolist in the domestic market. This would seem to be the current state in the South African steel industry. Mittal Steel South Africa is amongst the lowest cost and most profitable steel producers in the world and is the dominant supplier of most steel products in South Africa.

The exporter will still receive the export parity price in its export sales. But the absence of domestic competition provides some pricing power in the local market. Downstream buyers have two options—to import at the import parity price or to buy from the local supplier. In the absence of any domestic competition, the local raw material producer will charge the import parity price.

This is not the *economically* optimal pricing policy from the national perspective. The domestic opportunity cost of this raw material is the export parity price. Faced with the higher import parity price, downstream users will curtail demand. Downstream users that might have been able to compete with access to the raw material at the world price or at the export parity price might not be able to buy at all. This is due to the artificial price increase caused by monopolistic import parity pricing. The

economic cost of the monopolistic pricing behaviour depends on the size of the gap between the import and export parity prices.

Monopolistic import parity pricing by domestic exporters hinders rather than promotes the development of downstream industry. In the face of such practices downstream users would be better off in the absence of domestic raw material industries.

13.4 Other Dimensions of the Issue

Domestic Producers as a Hindrance to Efficient Importing and Trading

In the absence of domestic sources of raw material supply, downstream users would be dependent on imports. Transactions costs on imports are almost certainly higher than when buying locally. This would be especially true of small volume users. A major function of importing and trading companies is to specialize and reap economies of scale and of market-specific knowledge in order to reduce these costs. Efficient trading institutions are a substitute for domestic production and can substantially reduce the import parity price for industrial raw materials. In many instances, such institutions might actually be superior if the alternative is tariff-protected and/or monopolistic supply by domestic producers.

A monopolistic import parity pricing strategy depends on the ability to prevent the development of such trading networks and curtail arbitrage between domestic and export markets.

Anything that restricts the development of an efficient importing and trading industry will also help monopolistic domestic producers by raising the import parity price. South Africa's dominant producer of basic steel products, for instance, formed a Netherlands-based joint venture that has the sole right to sell Mittal-produced steel for export. Among the conditions attached to all export sales is that they be shipped by Mittal's transport. This arrangement ensures that there is no leakage of export parity priced exports back into the domestic market. Other informal agreements ensure that affiliated companies do not compete in the domestic market. All of these practices are directly contrary to Competition Board rulings at the time of relevant mergers.⁵⁰

These and similar arrangements with traders and potential competitors make import parity pricing possible, increase its profitability by ensuring a high level of the import parity price, and increase the harm to downstream users.

Product Quality

Lack of competition in the domestic market for industrial raw materials has a potentially serious impact on quality as well as the price of these goods in the domestic market. Quality problems can range from technical issues on product specifications, to lags in delivery and problems with after-sales service. Here, the cost, quality and service standards of telecommunications and internet access in South Africa highlights the cost to consumers of weak competition. Enforcement of the monopoly by government regulations, or restrictions on the activities of traders and brokers can have a further negative impact on quality.

13.5 Effects of Import Parity Pricing

Monopolistic import parity pricing artificially raises the domestic prices of essential inputs to downstream industrial users. Most of the downstream activities that are penalized by this practice are considerably more labour intensive than those that are further upstream.

This problem is not peculiar to South Africa. Prior to trade policy reform in Indonesia and Vietnam, for instance, protected monopolistic producers of plastics and steel caused considerable damage to the development of downstream manufacturing through high prices, uncertain delivery and poor quality. The affected industries were far more labour intensive than upstream steel and plastics. And many of the downstream products were consumed disproportionately by the poor.

⁵⁰ See Simon Roberts 2004, pp. 24-25

South African electrical appliance producers report similar problems and argue that their ability to compete against Chinese imports would be considerably enhanced by access to steel and plastics at world prices.

A recent study for the DTI provides estimates of the size of the import parity/export parity price wedge in the case of basic iron and steel. The study concludes that the wedge is large, often as high as 40 to 50 percent of the export parity price. Most of the wedge is accounted for by transport costs.⁵¹ The study also provides a wide range of examples of labour-intensive and often export-competitive downstream products that have been harmed as a result of monopolistic import parity pricing of basic steel (Roberts 2004). Following large investments in iron and steel in the late 1990s the steel sector has grown very rapidly, with exports providing about 50 percent of the market. At the same time, downstream industries have been virtually stagnant.

Similarly high tariffs on fabric (almost 20 percent) and restrictive rules of origin requiring the use of local fabric (and sometimes yarn as well) are a serious constraint to the development of South Africa's garment industry (see Flatters 2004b).

13.6 What Can Governments Do?

Compensating Tariffs on Downstream Products

The price raising effect of import parity pricing on downstream users can be offset by sufficiently high tariffs on the downstream products. This is effective only for goods produced for sale in the domestic market. However, a) the resulting cascading tariff structures almost always give far more protection than necessary, and b) while a tariff might neutralize the effect on the firm when selling in the domestic market, it increases the overall cost of protection, imparts a further anti-export bias to the tariff system, and causes further harm to consumers of the final products. A far superior tariff policy would be to reduce tariffs on both imported raw materials and their downstream products. This would be of obvious benefit to consumers and would reorient production to becoming competitive against global competition rather than remaining uncompetitive in a protected domestic market. This is discussed further below.

Duty-Free Imports for Exporters (and Others?)

Providing duty-free access to raw materials for export production is a commonly used means of reducing the cost penalty on exporters of import parity pricing. Its effectiveness depends in part on the efficiency of the duty reduction mechanisms. Duty-drawback procedures can be complex and delays in giving approvals and/or making payments reduce their effectiveness. Building expensive industrial development zones and forcing firms to locate in them to obtain duty-free privileges can also be costly and ineffective.

Such measures are often criticized on the grounds that they encourage exporters to source internationally rather than domestically. This argument ignores the option of the monopolistic domestic producer to engage in price differentiation and sell to exporters at a net of duty import parity price. This is exactly what has been happening in the case of a number of downstream steel users in South Africa. Duty-free raw material import privileges increase exporters' bargaining power in dealing with local suppliers.

The IPP-EPP gap is only partially accounted for by the tariff. Tariffs on basic steel and plastics in South Africa are only 5 and 10 percent respectively. Eliminating the effect of these tariffs will not remove the (double) transport wedge available to a monopolistic raw material supplier in pricing for the domestic market.

Reduce the Tariff

⁵¹ The claim is made that South Africa's geographic isolation makes this wedge larger than in most other countries in the world. This seems curious in light of South Africa's proximity to both Brazil and India, both of which are notorious "dumpers" of low cost steel in world markets. The size of this wedge might bear further investigation.

A non-discriminatory tariff reduction that applies to all imports of the raw material will increase the bargaining power of all domestic users in the same way that an exporter-specific program helps exporters. Furthermore, a non-discriminatory tariff reduction requires none of the costly administrative procedures necessary to operate a tariff rebate program. As with an exporter-specific program, however, this removes only the tariff portion of the IPP-EPP wedge and so removes only part of the burden of monopolistic import parity pricing behaviour.

Export Taxes or Other Restrictions on Raw Material Exports

In a competitive domestic market, taxes or other restrictions on raw material exports will reduce exports and lower the domestic price of the raw material, thus subsidizing downstream processing and manufacturing.

In the presence of monopolistic import parity pricing, however, the export tax has only one of these effects; it decreases the net export price received by the raw material exporter and so will have some impact on their incentive to export. However, it has no impact on the raw material producer's market power in the domestic market. The only alternative for downstream users is the same as it would be in the absence of the export tax, to source through imports at the same import parity price as before. An export tax is not an effective way of helping downstream users in the face of monopolistic import parity pricing behaviour. In addition, it creates an unnecessary and costly disincentive to efficient exports of upstream products.

Trade Facilitation

The harm done by monopolistic import parity pricing depends on the wedge between the import parity price and the export parity price. This depends in turn on the import tariff and the shipping and other transactions costs of exporting and importing the goods in question. Any trade facilitation measures that remove or reduce unnecessary impediments to export and import trade will be useful in themselves and will have the additional effect of reducing the IPP-EPP gap, hence reducing the harm done by monopolistic import parity pricing. Such changes could include improvements in transport infrastructure, port facilities and services, customs procedures, etc.

Competition Policy

Since some of the most important occurrences of import parity pricing appear to be a reflection of a non-competitive behaviour, it is quite natural to look to competition policy for remedies. In order to do so, however, it is necessary to understand the source of the competition problem.

Recent discussions of basic iron and steel start with several presumptions. The first is that the small size of the domestic market and technological economies of scale in basic steel production make the domestic market a natural monopoly. The second is that the South African market is geographically isolated and that this reduces the potential impact of import competition.

Both of these claims were true when South Africa was economically and politically isolated and ISCOR was a protected state enterprise. Since that time, however, new mini mill technologies have reduced the minimum scale for basic iron and steel operations. And as mentioned earlier, South Africa is actually very close to India and Brazil, both major steel exporters, not to mention Singapore, one of the world's transport hubs for all kinds of industrial raw materials.

Before assuming that steel is a natural monopoly in South Africa it is worth asking whether there are other barriers to entry, possibly related to arrangements for access to primary products and/or control of distribution and trading networks.

Recent work done for the DTI suggests that major players have been quite successful in controlling distribution networks to facilitate their non-competitive pricing behaviour in the domestic market and that these practices violate conditions imposed by South African competition authorities. Increasing competition in the trading (domestic, import and export) of industrial raw materials would be a very useful avenue for lowering the import parity pricing and maybe also eliminating most of the wedge between the import parity price and the export parity price. Domestic steel traders have also

demonstrated recently that anti-dumping measures have been a serious constraint on their ability to compete.

At the core of the monopolistic import parity pricing problem is the practice of price discrimination. The problem can be solved either through the creation of market institutions that facilitate arbitrage and make price discrimination impossible, or directly forbidding discriminatory pricing. Setting up cumbersome price controls and regulations is almost certainly not the most effective way of doing this. Recent experience suggests that such regulatory power would be costly and would end up being manipulated to facilitate the very practices they are intended to prevent. Much of the success of trade and industrial policy over the past decade has been due to the dismantling to complex price and other regulatory systems. But forbidding discriminatory pricing and the institutionalisation of procedures to solicit and deal with complaints should be able to be done without complex price regulation and control procedures.

Anti Dumping and Safeguards

The iron and steel case in South Africa illustrates a very important point about anti-dumping and safeguard measures of the type that are sanctioned by WTO rules.

South African exporters are selling their product at a lower price in world markets than in their domestic market. To whom is this harmful? It is not harmful to non-South African producers since South Africa is simply selling at the prevailing world price and the volumes are far too small to have any appreciable impact on world prices. In the event that the South African seller sold at less than the export parity price, this might help downstream users in that market. The main harm is to South Africa's downstream users of iron and steel, who are forced by the monopolistic import parity pricing in the domestic market to pay a higher price than users elsewhere.

The lesson is that international price discrimination of the type characterized as “dumping” is harmful primarily to buyers in the domestic market of the dumping company; it does little or no harm to foreign producers and might be of some benefit to downstream users in the country in which the dumping takes place.

This suggests another possible policy response to monopolistic pricing of upstream products in the South African market—to announce that South Africa will not engage in anti-dumping or safeguard procedures on upstream products exported to South Africa. The threat of “dumping” behaviour by foreign competitors might provide some small discouragement to monopolistic import parity pricing in the South African market. And it might provide some encouragement to domestic or foreign traders in such products to engage in aggressive pricing here. Domestic steel traders have recently made this point in submissions to ITAC.

13.7 How Did We Get Here? Lessons for Industrial Policy

The monopolistic import parity pricing problem has its roots in a view of upstream products as central to industrial development strategy. Products such as plastics and steel are seen quite rightly as key inputs into almost all downstream industrial activities. This does not mean, however, that development of these upstream industries is necessary to foster downstream growth.

Experience in South Africa and elsewhere indicates that forced development of such industries can use up large amounts of resources and can lead to high costs and/or monopolistic behaviour that impedes rather than encourages the development of downstream industries, even when the upstream producers are internationally competitive.

Acquiring industrial inputs through international trade is an alternative and proven technology for meeting the needs of downstream producers. Downstream development under competitive conditions creates the conditions for growth of upstream industries. But development of a textile, steel or plastics industry under conditions of protection not only impedes the development of the downstream users but in doing so also hurts the upstream industries by stunting the growth of their domestic market.

14 Tax Incentives

Tax incentives are relatively unimportant to most investors. Investor surveys almost never find the tax system to be a major factor in investment decisions. Within the tax system, investors give greater weight to simplicity and stability than they do to tax incentives.

The costs of incentives are high and generally non-transparent because of a variety of unintended effects. The costs include:

- revenue losses,
- a “race to the bottom” in tax policy through follow your neighbour policies,
- large subsidies that are either unnecessary, transferring money from tax payers to beneficiaries with no impact on investment, or result in waste through distortions of investment decisions,
- high administrative and/or compliance costs (another source of pure waste), and
- encouragement of rent-seeking and reduction of competition.

Targeting incentives to ensure that they are used to promote particular social or economic goals or that they are not given away needlessly—i.e. to investments that would have been made without incentives—is difficult. Experience in South Africa and elsewhere shows that targeting seldom works.

Playing the tax incentives game invites capture by particular investor interests and diverts attention from more important issues in the investment environment.

In recognition of these facts some countries are reducing their reliance on and streamlining tax incentives, paying more attention to simplifying their tax systems, and dealing more directly with underlying problems in the investment environment.

14.1 What is a Tax Incentive?

Tax incentives include not only exemptions and deductions from direct taxes, but also breaks from and/or a variety of special conditions with regard to the application of indirect taxes, including import duties. A study of tax incentives in Malaysia has shown that indirect taxes have a much greater impact on investment incentives than do the much-more-discussed corporate tax incentives (Boadway, Chua and Flatters 1995b). Similarly, South Africa’s Motor Industry Development Program dwarfs the country’s largest direct tax based Strategic Investments Program (SIP).⁵²

14.2 The Role of the Fiscal System

The main purpose of the tax system is to raise revenues for public expenditure needs. An ideal tax system in this regard is one that is efficient, i.e. that imposes the smallest costs on the rest of the economy. An efficient tax system is one that is often described as being as neutral as possible in its effects on the allocation of investment and production in the economy. In general this requires relatively low marginal rates of taxation, especially on activities that are relatively elastic in supply or demand, and a broad base.

A second desirable characteristic of a tax system is that it be equitable—that its burdens be distributed across income groups in a manner that fits with collective goals of fairness. There is much less agreement among economists and policy makers about the concept of equity than about efficiency, especially when taking account of patterns of lifetime earnings and of differences in equality of outcomes and equality of opportunities.

A third and quite distinct use of the tax system is to achieve regulatory goals such as discouraging socially undesirable activities whose costs are not fully captured in market prices, or encouraging desirable activities whose benefits are not accurately reflected by market prices. Positive and negative environmental impacts of private decisions are classic examples. While the tax system certainly can

⁵² See Flatters 2005 and a separate discussion of MIDP in this paper.

play a legitimate role here, recent experience suggests that market mechanisms (tradable carbon permits for instance) might be more effective.

It is sometimes argued that the tax system can or should be used as an instrument to promote economic growth. Fundamentally, however, this is usually just some combination of the first and third uses described above. Any tax system that discourages investment, whether in machines, new ideas and technologies or human capital will also stunt growth. This is one of the principal arguments for basing taxation on consumption rather than income. This can be done by increasing the importance of indirect taxation and lowering marginal income tax rates, and/or by adjusting income taxes to allow deductions or credits for savings in pension plans, provident funds, etc. If it is felt that certain types of activities generate significant growth externalities (such as R&D), then this becomes similar to the third argument—using the tax system as a regulatory device to correct for market failures. The problem here, of course, is to identify and reliably measure such externalities. As some of the examples below will show, tax policy can be seriously distorted by spurious claims about external benefits from the promotion of favoured ‘high-tech’ type activities, and from investments by well-connected individuals and firms.

14.3 International Experience

There are a growing number of stories of the futility of investment incentives. See Box 7 for a review of Indonesia’s experience. A recent McKinsey study reports on 14 case studies in Brazil, China, India and Mexico, concentrating on the role of tax incentives and government regulation. They find that “the incentives used to attract foreign direct investment ... are largely ineffective. Worse, they are frequently counterproductive, costing governments millions of dollars annually, protecting inefficient players, and lowering living standards and productivity” (McKinsey 2004).

Countries that got ‘hooked’ on investment incentives got drawn into costly incentive spirals, providing incentives that often are unnecessary and when they were necessary, promoted inefficient and non-competitive investments. India continues to give unnecessary tax holidays worth \$2,000 to \$6,000 per worker to business-processing and IT investments. In the mid-1980s Brazil gave tax concessions that began at \$50,000 to \$94,000 per employee in the auto industry and quickly escalated to over \$300,000 per worker, with the principal result that Brazil became saddled with an industry with high costs and enormous surplus capacity.

In their surveys of investment decision-makers McKinsey confirmed the findings of many other studies showing that investment incentives are among the least important factors for firms making strategic investment decisions. Their evidence shows, on the other hand, that investors are quite happy to accept investment incentives when they are offered, and that many companies appear to have become quite skilled at pleading for them. This is supported by a recent OECD study (Oman 2000) that finds that the auto sector, for instance has been very effective at “incentive shopping”. This is consistent with the evidence from South Africa and some of the McKinsey case studies.

7. Tax Incentives in Indonesia

Indonesia has been the site of two instructive and insufficiently recognized 'experiments' in the use of tax incentives.

In 1984, as part of a comprehensive tax reform, all tax holidays were abolished and replaced by what was advertised as a stable, predictable corporate tax regime with substantially reduced rates. The previous system of tax holidays was not dissimilar to others in the region such as in Malaysia and Thailand. Applications were reviewed with respect to their economic benefits, as measured by certain criteria such as whether they were in a 'priority sector', their size, their riskiness, and their contribution to foreign exchange earnings or savings. *Ex post* analysis conducted as part of the tax reform exercise, however, showed that the screening process was not successful. Economically beneficial investments were often rejected for tax holiday status, and wasteful investments were often accepted. The combination of tax incentives and capacity licensing led to further waste and reduced domestic competition. This was a reflection of both the weakness of the criteria and inherent difficulties for public sector investment boards in making such judgements.

Nevertheless, the repeal of all tax holidays was viewed with great scepticism and there were many forecasts of a collapse of foreign and domestic investment that would follow. In fact, both foreign and domestic investment grew at more or less the same, if not a slightly higher rate in the decade following the elimination of tax holidays as it had previously. Of even greater significance from a regional perspective is that over this decade Indonesia's share of foreign investment into ASEAN doubled, despite the fact that Indonesia's ASEAN neighbours continued to offer generous tax holidays and other incentives.

The tax reform was one part of a larger program of fiscal, regulatory and trade policy reform aimed at reducing regulatory burdens and fiscal and other distortions on investment and production decisions. The streamlined fiscal and regulatory environment evidently was far more important to investors than the loss of tax holidays.

Despite the evidence of the success of the new tax and regulatory regime, there was constant pressure from self-interested parties for the re-institution of tax incentives. A slow-down in investment in the mid-1990s, together with increased influence of certain parties in favour of 'high tech' investments and with close connections to the senior leadership of the country, provided an opportunity. In 1996 a new tax incentive law was passed.

Under the new law incentives were fully discretionary and were confined to key sectors to be defined by the government. This at least theoretically made it possible to ensure that incentives were granted only if they were necessary and if they truly met some pressing social or economic needs. The new priority sectors were never made public. The implementing team never met. Nevertheless, the law was used by the President to grant incentives to six projects, four of which were domestically owned and very closely linked to his own family.

The Indonesian experience illustrates some key lessons about tax incentives.

- Income tax incentives are not necessary to encourage domestic or foreign investment, even in an environment in which there is considerable tax competition for this purpose.
- Screening to exclude investments that are economically wasteful or that are beneficial but would occur even without incentives can be difficult.
- Discretionary authority can be abused to subsidize wasteful investments and create rents for influential parties.

14.4 South Africa

South Africa has undertaken major policy reforms as it has opened up to the global economy after years of isolation under apartheid and its own protectionist policies and traditions of heavy regulation. As in many other countries, there have been conflicting pressures on the use of investment incentives.

An early attempt at investment incentives came in the form of some schemes to promote investment in poorer regions of the country. They were eventually judged to have been a failure by almost all concerned. They did very little, if anything, to stimulate additional investment in the target regions, they were a significant drain on the Treasury, and they were subject to considerable abuse. The programs were eventually discontinued. This experience is not very different from that of many other countries, developed and developing.

Since that time the government has attempted two other selective direct tax incentives.

A selective tax holiday program was introduced in 1996. It provided tax holidays of up to six years for qualifying investments initiated within three years of the launch of the program. The tax holiday took effect when the firm first registered positive taxable income but could not be utilized more than ten years after initiation of the investment. To qualify for the incentive, firms needed to fulfil certain

criteria related to financial viability, contributions to national competitiveness, utilization of domestic resources and competitive technologies, and skill upgrading. The actual length of the tax holiday granted depended on criteria related to location, sector and human resources.

The program was terminated in 1999 as originally scheduled and was replaced by a general incentive in the form of a reduction in the corporate tax rate from 35 to 30 percent. The 1999 Budget Review described this change in approach as part of a strategy to “eliminate special tax preference schemes which only benefit particular industries or narrow sector interests and which, over the long run, compromise horizontal equity.” (RSA 199, p. 156)

The second selective direct tax incentive was the Strategic Investment Program (SIP) that was introduced in 2001. This program was aimed at promoting strategic industries through an investment tax allowance. While the DTI would have preferred full discretion in awarding these tax allowances, the legislation set out processes and criteria for judging applications for the incentive. The criteria, adjudicated by a joint DTI/National Treasury panel, included project size, employment creation, industrial linkages, (lack of) displacement of existing production, etc. Applications were allocated points based on whether they

- produced a new product in South Africa,
- filled a domestic “cluster gap,”
- incorporated a high level of value-added,
- procured from SMMEs,
- provided publicly available infrastructure, and
- met direct and indirect job creation targets measured as a proportion of the amount invested.

The number of points awarded determined the size of the resulting tax allowance, ranging from 50 to 100 percent of the qualifying investment. The program was given a four-year time horizon and a budget of R10 billion in tax allowances that could be granted.

The SIP has now ended, and was not extended, despite the DTI’s pleas to the contrary. As with previous programs, the experience with SIP raises questions about the use of selective direct tax incentives in South Africa.

Despite careful analysis of the sustainability of the investments, a number of SIP-approved projects never got off the ground. Others that did start up have already failed. A significant number of other approved projects are in protected, non-competitive, capital-intensive upstream industries whose need for the incentives is uncertain, and whose domestic pricing has become a barrier to the development of labour-intensive downstream industries. The claims about job benefits, especially indirect employment creation are difficult to verify and almost certainly exaggerated. As with the earlier failed regional incentive schemes, there appear to be serious questions about the economic value of the SIP.

South Africa has also made significant use of the indirect tax system as a vehicle for selective investment incentives. The most important of these has been the Motor Industry Development Program (MIDP) that is discussed separately in this report. In the first ten years of operation the MIDP has provided at least R80 billion in export and investment support. This has translated into investment subsidies that appear to be several multiples of amounts invested by firms in components and vehicle production, and has resulted in some combination of substantial economic waste and unnecessary transfers to shareholders of international motor vehicle firms. Design, monitoring and evaluation of the program has been undertaken with scant understanding (if not complete misunderstanding) of the size of the subsidies and their economic costs.

14.5 The Costs of Tax Incentives

The most obvious cost of tax incentives is foregone tax revenue.⁵³ What is missed in most discussions, however, is the fact this cost is considerably greater than the amount of the foregone revenue. To replace foregone revenues, it is necessary to raise tax rates somewhere else. Since the economic and administrative costs of most taxes generally increase with the square of the tax rate, the cost of foregone revenue is much larger than the amount of revenue foregone.

The administrative and compliance costs of tax incentives are high. This is especially true of discretionary and tailor-made incentives, or when eligibility depends on meeting various conditions. These costs might be justified if screening is effective in excluding economically unproductive investments and/or investments that would have been made in the absence of incentives. Experience in South Africa and elsewhere suggests that screening seldom succeeds in accomplishing either of these tasks. Selectivity more often does just the opposite. It encourages economic waste and rent seeking.

When incentives are large, the rate of return to investing entrepreneurial resources in obtaining, maintaining and increasing tax incentives can be much higher than investments in new products, cost reductions and marketing. Such rent seeking can be highly profitable to the firm, but is economically wasteful from the perspective of the national interest.

Tax incentives can have large and unintended impacts on investment decisions that are economically costly and have no obvious relationship to social or economic policy goals.

The value of an income tax incentive depends in a complex way on the characteristics of individual investments, ranging from the method of finance to the gestation period and life span of the investment and time pattern of eventual earnings. Fletcher (2004) shows this in his analysis of the incentive effects of several South African direct tax incentives.⁵⁴ South Africa's 1996 tax holiday program that was intended to promote new investments actually encouraged qualifying firms to postpone their investments. The size of the incentive provided under SIP was generally much larger than under the tax holiday and was sufficient to make uneconomic investments privately profitable. The effect of the incentives depends on many factors including the method of finance, the rate of inflation and the ability of firms to make speedy use of tax allowances and tax losses. The resulting variation in the effects of the incentives across firms and sectors would be difficult if not impossible to predict in advance and would have no necessary relation to economic objectives being pursued. This means that the incentives have significant unintended impacts on the allocation of investment and that it is virtually impossible to achieve either broad neutrality or any particular economic goal. Fletcher's analysis shows that general rate reductions have been a much more predictable and neutral way to reduce distortions in the direct tax system.

Among the frequent unintended biases imparted to investment decisions by commonly used income tax incentives are those in favour of capital intensive projects, in favour of large projects and large established companies, against small and start-up investments and against employment creating investments (see Boadway et al 1996 for Thailand).

The distortionary impact of indirect tax incentives can be even larger than for direct taxes. This was certainly the case in Malaysia, at least in the early 1990s (see Boadway et al 1995b) and is well illustrated in South Africa by the effects of the Motor Industry Development Program (MIDP).

Lest there be any doubt about the economic waste that can be encouraged by investment incentives, consider the case of the MIDP. If the auto producers are correct in saying that their recent investments would not be viable in the absence of the incentives, a privately profitable investment of R200 million in the mid 1990s imposed an economic cost of R540 to R980 million on the South African economy—two and half to almost five times the size of the investment being promoted. Looked at another way, every BMW exported to Europe or America for \$30,000 as a result of such an

⁵³ In the case of indirect taxes, the costs are often borne in the form of higher prices. The main value of an exemption from an import duty or an excise tax for a particular firm or product derives from the fact that other firms and products have to continue paying the tax or duty.

⁵⁴ See Boadway et al 1995a, 1995b and 1996 for similar conclusions from other countries.

investment might actually have used up South African resources worth about \$50,000, with the difference made up in the form of subsidies by South African taxpayers and consumers.

Measuring the success of investment incentives simply by the size of the investments that ensued is highly misleading.

The final cost of tax incentives is that they can distract policy makers and private sector stakeholders from tackling more important issues in the investment environment. Almost all investor surveys show that other issues are much more important than tax incentives.

14.6 Why Do Tax Incentives Continue?

There is a large body of evidence that tax incentives have little effect, if any, in attracting new and especially good new investments. The costs of incentives are high. Why do governments continue to offer them? There are several contributing factors.

Rent Seeking: Just as with import protection for domestic industries, tax incentives are costly, and yet governments continue to use them and are reluctant to “give up” this self-destructive tool when negotiating with others. A large part of the reason lies in rent seeking by a relatively narrow but well organized group of beneficiaries. Regardless of whether incentives are necessary, firms will happily seek and accept them if they are available. As observed earlier, certain industries have become quite effective in this game. When incentives become entrenched, new industries of “incentive advisors” develop and become a new source of rent seeking. While the benefits might be large and concentrated, the costs of tax incentives are spread over a much broader and more dispersed group of stakeholders—taxpayers and consumers.

Hidden Costs: Not only are the costs of tax incentives widely dispersed, they are also largely hidden and often unknown. The economic waste of inefficient and non-competitive investments that are made possible through tax incentives is not well understood. Despite its great costs, the MIDP is generally touted as the country’s greatest industrial policy successes. The designers of the program have never attempted to assess the financial value of the incentives being provided, and even economists and policy makers who should know better have no idea of the economic costs of the program. The complexity of the impact of both direct and indirect tax incentives makes them very difficult to understand.

An Easy Policy: Countries around the world are becoming aware of the importance of creating a market friendly investment environment. Surveys and studies by international agencies (World Bank, Foreign Investment Advisory Service), accounting and management consulting companies and governments themselves are helping countries to understand the nature of the real problems— inadequate infrastructure, high costs of public services, red tape, regulation of investment, labour and other markets, and corruption. The challenges are formidable, but the ability to deal with them is often weak. Pressed with the need to be seen to be doing something, one of the easiest things to do is to amend the tax laws to introduce new fiscal incentives. Passing an amendment to a tax law and granting new incentives under it is certainly much easier than reforming an entire regulatory environment, dealing with state and private monopolies and reducing red tape and corruption.

Institutional Imperatives: Not only are investment incentives relatively easy to pass, they are generally implemented by an agency (some kind of investment board) that is not responsible for the foregone revenues and that needs to be seen to be doing something to increase investment. With an incentive regime in place, an investment board has a mission, to negotiate with potential investors. Each incentive granted is an accomplishment, regardless of the economic value of the investment created. The DTI pleaded for an extension of the Strategic Investment Program regardless of its economic value, because the budgetary costs are borne elsewhere and they want to be seen to be doing something. Overseas representatives of global companies also need to be seen to be doing something. Successful negotiations with investment boards are an obvious achievement to be reported to company headquarters regardless of whether this is actually a key issue in making an investment.

Keeping up with the Neighbours: Governments are excessively concerned with “keeping with the neighbours” in provision of tax incentives. This is easy to understand. An obvious ploy used by companies seeking investment incentives is to find a comparator country that offers “better” incentives than the one in question. The same is true of any investment board wanting to persuade the Treasury or the Prime Minister that the agency’s arsenal needs to be improved. South Africa’s MIDP was modelled initially after a program in Australia (although with higher tariff and subsidy rates). With the end of the program coming into sight, and recognizing that in the corresponding phase the Australian government phased down its tariff rate to 5 percent (the South African rate will be 25 percent at the same stage), the auto industry and the DTI have conveniently forgotten the Australian model and are looking to India, Brazil and other countries that give much higher rates of assistance.

Regardless of the evidence that incentives are costly and of little economic value, governments and international management consultants continue to produce tables of comparative tax incentives to assist governments in their investment policy making. Academics are not immune. A recent study of the comparative impacts of tax incentive regimes in ASEAN conveniently left out Indonesia. The “problem” was that Indonesia provided no income tax incentives over the period in question and yet its investment performance completely outshone that of its ASEAN neighbours (Chia and Whalley 1996).

14.7 Lessons

We conclude with a brief summary of some key lessons.

- Tax incentives are not among the key factors in most investment decisions, especially for “good” investments. Nevertheless most investors will be happy to receive them, especially generous ones.
- The costs of investment incentives are not transparent, and are often large. An evaluation of any tax incentive requires a careful examination of these costs.
- The indirect tax system, including excises, sales taxes, import duties and preferential trading arrangements can be a very important and costly source of tax incentives.
- Tax incentives should be made as transparent as possible. As a first step all tax incentives should be included and quantified as tax expenditures annual government budgets. A review of the economic benefits and costs of all incentive programs, especially the most “successful” ones, should be part of the medium term budget cycle.
- The investment environment in almost all countries is plagued by much more important problems than the tax system. Tax incentives should not be a substitute for dealing with such problems.
- As for the fiscal system, the best tax incentive of all is a stable regime with low rates and minimal use of exemptions, special provisions and other inducements. Simplicity and predictability are the keys. These also happen to be the main requirements for the tax system to best fulfil its primary revenue-raising function, i.e. to be an effective tax regime.

15 Industrial Offsets: Government Procurement as Industrial Policy

Governments are large consumers of privately produced goods and services and it is common for them to use procurement policy to develop and promote domestic industries or to support specific sub-sectors. A preference margin given to domestic products in government purchases is equivalent to an implicit import duty on such purchases. Whatever price premium the government pays in preference for local over imported goods or services is the implicit import duty rate. This is a subsidy to the local producers and a tax on local taxpayers. Unlike an import tariff, however, there is no duty collected. Governments often set these implicit duty rates explicitly by stating the amount of price preference they will give to local producers and suppliers. In other cases, the equivalent import duty remains implicit and is often difficult to determine without explicit direct price comparisons.

Even if governments need or decide to import, as is often the case with specialized equipment and machinery, they can still support local industry through ‘offset’ arrangements that require foreign suppliers to participate in the domestic economy through investment, technology transfers, counter-trade, or other forms of ‘industrial participation.’ To the extent that this industrial participation has any real effect, i.e. that it would not have occurred without these requirements, it will have to be paid for through higher prices for the imported goods or services and/or through additional incentives (tariffs, promise of future procurement, tax incentives or other measures). The equivalent tariff in these cases is harder to determine since it might be manifested in some combination of higher prices for imported government purchases, and subsidies or tariffs on the sectors ‘benefiting’ from industrial participation. To the extent that this results in the establishment of inherently uncompetitive domestic activities that require ongoing tariff protection and other subsidies, the costs can be very high, but also difficult to attribute to particular government purchases.

South Africa has made extensive use of government procurement to promote industrial development, specifically through offset arrangements (‘industrial participation’ agreements) negotiated with foreign suppliers. The National Industrial Participation Program (NIPP) and its operating guidelines were endorsed by Cabinet on 30 April 1997. According to the DTI, this means that “all government and parastatal purchases or lease contracts (goods, equipment or services) with an imported content equal to or exceeding US\$10 million (or the equivalent thereof) are subject to an Industrial Participation (IP) Obligation.” (DTI, undated) And no contracts of this size should be awarded until the DTI (IP Secretariat) notifies the purchaser that the prospective seller has complied with its IP Obligation.

In 2005, the DTI estimated the total amount of NIPP obligations under management at US\$15 billion (DTI 2005). Most of these obligations arise from the government’s R40 billion defence procurement package. It estimates NIPP investments at \$1 billion and ‘export and local sales, technology transfer, BEE and SMME promotion’ contributing a further US\$2.5 billion. Most of the large obligors are performing well against their targets. An appendix provides details of 69 recent projects (of which 13 are in the auto industry) and the total investment and sales related to these projects. It does not show the actual contribution of the obligors to these projects.

15.1 The Rules of the Game

The government has designed a convoluted scorecard to determine the required contribution of foreign suppliers to the domestic economy and to measure their performance over time. The ‘value’ of the obligation arising from an international tender is calculated at 30 percent (50 percent for defence purchases) of the imported content and ‘IP credits’ can be earned through the achievement of various pre-defined objectives. See Table 18.

Table 18. Rules for Earning IP Credits

Objectives	Methodology	Factor
1. Sustainable Economic Growth	Revenues accumulated over the fulfilment period	\$1 = 1 Credit
2. Export Promotion	Export Revenues = Additional Credits	\$1 = 1+LC*
3. Job Creation	Salaries & Wages costs accumulated over the fulfilment period	\$1 = 1 Credit
4. Training and Development	Training & Development costs accumulated over the fulfilment period	\$1 = 1 Credit

5. SMME Promotion	Outsourcing to SMME's	\$1 = 1 Credit
6. Previously Disadvantaged Individuals (PDI)	Outsourcing to PDI SMME's	\$1 = 2 Credits
	PDI Ownership % x Revenues	\$ x % = Credits
7. Investment	Capital outlay or capital injections	\$1 = 2 Credits
8. R & D Expenses	All costs	\$1 = 2 Credits
9. Technology Transfer	On a case by case basis linked to revenues	\$1 = 1 Credit

Source: DTI (undated)

But to qualify for credits, IP projects must first satisfy a number of core 'principles':

- *No Increase in Price*: The Industrial Participation Obligation must not result in an increase in the price of the purchase.
- *Mutual Benefit*: Industrial Participation Proposal must be profitable for the seller and beneficial for the South African economy.
- *Sustainability*: Industrial Participation Projects must be economically and operationally sustainable, even after the discharge period.
- *Responsibility*: The fulfilment of any Industrial Participation Obligation lies solely with the Seller.
- *Additionality*: All Industrial Participation Proposals must reflect incremental or new business to be considered for Industrial Participation Credits.
- *Causality*: Industrial Participation Proposals must result directly from the purchase contract. The Industrial Participation Proposal would not have been initiated had it not been a condition of the purchase contract and a possible component in the adjudication process. The exception is Strategic Partnership Agreements (SPAs).

The first four principles are generally unusable. Mutual benefit, responsibility and sustainability cannot be tested *ex ante*. And it is widely accepted that IP raises the price of government procurement, but government has no basis for comparing prices of tenders that include complex offset arrangements. If the arrangement did not increase the price, it would indicate that the final two conditions were not fulfilled, or that there was some other costly subsidy provided.

As a result, the latter two principles are key in the evaluation of new tender proposals and are the only principles considered in the approval of projects arising from the defence-related offsets.

Causality is extremely difficult to prove and the majority of (all defence related) projects fall within the less stringent Strategic Partnership Agreements. Thus, in most cases, rejecting an IP claim requires the DTI to prove that the seller was not in any way responsible for causing a specific investment or export deal to take place. This is virtually impossible. Project partners have nothing to lose in attributing causality to the IP Obligor, and much to gain. Critically, even when the obligor makes a relatively small contribution to a project, it can claim credits up to the full value of the total investment or sales.

Our scepticism is confirmed by some of the actual 'success stories' published by the DTI. Westland Helicopters, for example, will provide a 'low-cost loan' of GBP 150 000 to St Lucia Sawmills in Kwa-Zulu Natal (DTI, 2005). For this small loan it will receive GBP 170 000 in investment credits and GBP 20 million in sales credits. Similarly, Ferrostaal will provide 'a secured loan at a preferential rate' to a polyester recycling plant in Gauteng, for which it will gain Euros 2 million in investment credits and Euros 12.5 million in sales. BAE/SAAB (in partnership with 3 South African companies) have got away with even less. They have put in place 'guarantees' to the value of US\$11.2 million in

support of a jewellery manufacturing scheme, in return for US\$15 million in investment credits and US\$588 million in sales. Thales ‘facilitated’ a US\$50 million commercial loan between Caylor Investment Bank to the IDC to support funding of SME’s in South Africa. They will undoubtedly leverage significant investment and sales credits from this facility (DTI, 2005).

Additionality is easier to test. A project must contribute new capital or new exports to qualify under the scheme. But it is also extremely easy to achieve. A simple shift in exports from one market to another meets the requirements of the defence SPAs. Acerinox, a Spanish company, own 76 percent of Columbus Steel. Volvo, as a large buyer of stainless steel, ‘has convinced Acerinox (Scandinavia) to favour Columbus Steel as their sourcing partner’. The net gain in South African steel exports is probably null. But for this, Volvo will reap R1.8 billion in export credits (DTI, 2005).

15.2 2002 Industrial Participation Review

In 2002 the DTI published a ‘review’ of the NIPP. Most of the review is confined to describing the objectives, criteria and staff of the NIPP and the DTI’s integrated manufacturing strategy. It is largely a marketing document, written by DTI officials, and certainly not an independent assessment.

This review draws on a select number of examples to demonstrate the benefits of IP. It combines export and investment values to provide a grossly inflated perspective of the actual contribution of each obligor to the South African economy. It also makes no attempt to strip out the actual contribution of the obligors to the total investment/export values. In all cases, this is significantly less than the value of the project; and in most cases, the IP obligors are minority investors.

But the examples described in this review help to illustrate some of the key problems of this programme.

In some instances, the links between IP obligors and investments are weak (or not adequately explained). BAE/SAAB is able to draw on IP credits from Volvo’s investment in two catalytic converter plants in South Africa. BAE/SAAB is involved in another 2 automotive projects. Thyssen, another of the defence-related obligors, has also ‘invested’ in two automotive industry projects (DTI, 2002). This is not surprising—all of these investments qualify for significant subsidies from DTI through the MIDP. It is the scale of these subsidies, not IP, that has caused this investment.

The portfolio of some of the obligors is very wide and certainly extends beyond their core expertise. We have BAE/SAAAB ‘spearheading’ tourism in PE and manufacturing oral tobacco in Boksburg; Ferrostaal testing and sealing condoms in East London; Rolls Royce financing the exports of rock drills; Augusta (Italian aeronautical firm) spinning, dyeing and knitting mohair; Thyssen producing wheat beer; Thales managing a medical waste facility; and an un-named defence company overseeing clinical trials for diabetes, depression and childhood infections. This kind of behaviour would only make sense if the price paid to these firms exceeds the obvious economic cost of these small and un-strategic ‘investments’.

The review claims that ‘overall, the evidence strongly reflects the benefits of the NIPP’ (DTI, 2002). But it provides no substantive evidence in support or against the programme. Of the 60 projects underway at the time, several are presented in the review as examples of the success of the programme. It does not try to provide an economic assessment of any of these projects or the program as a whole.

15.3 Lessons Learned

International experience indicates, that in general, offset agreements serve to justify foreign procurement but have little impact on local economic development. This is a high cost to pay for imports. Not only do offsets reduce the flexibility and efficiency of international procurement, but the costs incurred by suppliers are almost always passed onto the purchaser (Cooper, 1999 in Batchelor and Dunne, 1999). These costs may include any penalties that arise from renegeing on offset deals. For this reason, “while governments are usually only too happy to highlight the purported economic benefits of offsets ex ante, they often seem reluctant to evaluate the economic impact of offsets ex

post” (Batchelor and Dunne 1999, p.6). Where this has been done, the impact on the economy has been much smaller than envisaged (Matthews, 1996 and Martin, 1996 in Batchelor and Dunne, 1999).

Evidence from South Africa suggests that the benefits arising from the NIPP are overstated and that the government’s ability to manage and monitor offset programmes is weak. At best, IP has helped to sustain a niche defence industry in South Africa. But at what cost to the economy as a whole? A wide body of international research demonstrates that military spending is inefficient, expensive and distorts the structure of the national economies (Batchelor and Dunne 1999). In South Africa, “the absorption of scarce resources and the crowding out of non-military public and private investment contributed to the underdevelopment, declining productivity and poor international competitiveness of the civilian economy” (Batchelor and Dunne 1999, p.13).

Outside of the defence industry, the benefits of IP are even less convincing. Telkom’s procurement of equipment from offshore is subject to IP and according to the 2002 review there are more than 15 Telkom suppliers with an IP obligation. This raises two serious questions.

- What does this do to the cost of telecoms in SA?
- And how can Telkom (or SAA for that matter) be expected to compete with private sector providers who are not subjected to the same restrictive procurement conditions.

The DTI claims that the NIPP “allows government to go where no private business has gone before” (DTI 2002). But in fact, it defers industrial policy decisions to private and foreign companies and enables them to exploit existing and profitable business opportunities in South Africa while charging the South African Government a premium for goods and services procured. Negotiating and monitoring industrial offsets require significant time and resources, which could be better applied to procuring the best off-the-shelf equipment from the best supplier at the best price.

16 The IDC and Industrial Policy: Facing an Identity Crisis

The state-owned Industrial Development Corporation (IDC) was established in 1940 and is among the oldest development finance institutions in the developing world. It played a key role in financing ‘strategic industries’ of the Apartheid state, such as fuel, basic chemicals and base metals, and in ensuring South Africa’s self-sufficiency in these sectors (Mondi and Roberts 2005).

The orientation of the IDC was expected to change post-1994 to follow a more independent and commercial direction (Mondi and Roberts 2005). It was also expected to contribute to the diversification of industry across provinces and support black-owned and small business ventures. But for most of the last ten years “IDC lending went predominantly to large-scale, capital-intensive operations” (Roberts 2005, pg. 5) and this “reinforced the heavy industry and minerals-oriented industrial development path” (ibid p.27) of the South African economy over this period.

The IDC’s commitment to self-sufficiency, to capital-intensive upstream industries and to protected and subsidized industrial development should have been the subject of major attention under the market-oriented reforms of the new government. However, it would seem that the IDC has remained largely immune from independent evaluation and its programmes have not been adequately incorporated into government policy: “The IMS (integrated manufacturing strategy) conspicuously failed to identify the role of the IDC, for example. And, the links between the IMS and the AMTS (Advanced Manufacturing Technology Strategy of the Department of Science and Technology) themselves are not clearly spelt out” (Roberts 2005, pg. 32)

16.1 Recent Performance

The total value of finance extended by the IDC over the ten year period to June 2004, amounted to R51 billion (IDC, 2004a). Five very large and resource-based projects⁵⁵ account for about half of this amount. Although SMEs explain a large proportion of total financing approvals between 1996 and

⁵⁵ Sappi, Hillside Aluminium, Saldanha Steel, Hulett Aluminium and Mozal.

2002, the total number of SME approvals has declined rapidly from more than 400 a year in 2000 and 2001, to around 100 in 2005 (IDC, 2005).

BEE finance has been a rapidly growing part of the IDC's portfolio. The IDC financed 870 empowerment deals between 1994 and 2004, to a total value of R9.8 billion. The overwhelming majority of BEE finance went to a small number of very large deals, of which 41 percent were in the gold mining and mobile telecommunications industries. In value and numbers, BEE deals accounted for more than 80 percent of all IDC financing in 2004/2005 (up from 18 percent in 2001) (IDC, 2004a and IDC, 2005).

Geographically, Gauteng, the Western Cape and Kwa-Zulu Natal received around two thirds of IDC finance within South Africa. The IDC has also begun to play a more active role outside of South Africa, with 89 projects under consideration or implementation across Africa by June 2004.

The IDC claims to have created more than 175 000 new jobs and R4.1 billion in export earnings over the last decade (IDC, 2004a). These claims are not supported by any economic analysis of the incremental impact (negative and positive) of IDC investments.

At the more general industrial policy level the IDC promotes itself as government "think tank" and takes credit for major roles in the design of sector specific initiatives such as the MIDP and investment incentives such as the SIP (Roberts, 2005). It then plays an additional "supporting role" through investments in protected and subsidized industries, such as vehicle components, and is a key beneficiary of government incentives and industrial offset deals.

16.2 IDC Governance and Evaluation

The IDC's activities are governed by the Industrial Development Act of 1940 (as amended) and the IDC Mandate. The Act governs the roles and responsibilities of the IDC Board, while the Mandate specifies the objectives and reporting requirements of the IDC's only shareholder (the DTI). In addition, annual performance parameters and expectations are reflected in a 'Shareholder's Compact' between the Department of Trade and Industry and the IDC. The most recent mandate and compact (IDC, 2004b) identify 10 key performance areas (KPA's):

- Investment in human resource development,
- Catalyst for private sector investment,
- Investing in downstream manufacturing,
- Promote the development of the knowledge based economy,
- Increase support to SMEs,
- Increase empowerment investment activities,
- Support viable strategic investments in spatial development initiatives and IDZs,
- Development of viable projects in Africa and especially Southern Africa and developing the industrial capacity in SADC,
- Consider its financial affairs with prudence and maintain its strong balance sheet,
- Create employment opportunities.

These performance areas are very difficult to quantify or evaluate. Nevertheless, the IDC has set itself performance targets in seven of the KPA's that are represented in its current mandate.⁵⁶ As shown in its 2005 Annual Report (IDC, 2005), these KPA are clustered into four 'parameters' and weighted and measured as shown in Table 19.

⁵⁶ The three KPA's that are not included are investment in downstream manufacturing, promotion of a knowledge based economy and strategic investments in spatial development and IDZs.

Table 19. IDC Performance Targets

KPA	Parameter (weight)	Target	Performance 04/05
Catalyst for private sector investment	Role in the economy (5%)	R3billion approvals	R3.8 billion
Increase support to SMEs	Developmental role (40%)	100 approvals	104 approvals
Increase empowerment investment activities		70 approvals R1.2 billion	102 approvals R3.1 billion
Development of viable projects in Africa and especially Southern Africa and developing the industrial capacity in SADC		70 approvals in specified regions and rest of Africa Approvals in poor provinces R600 million Approvals benefiting townships R75 million	51 approvals Approvals in poor provinces R960 million Approvals benefiting townships R190 million
Create employment opportunities		12 500 jobs	16 700 jobs
Consider its financial affairs with prudence and maintain its strong balance sheet	Financial returns (30%)	Operating profit R536 million Doubtful debts < 9% Operating expenses / gross income = 39% Achieve subsidiary targets	Operating profit R823 million Doubtful debts = 10.3% Operating expenses / gross income = 30% Mostly achieved
Investment in human resource development	Strategic imperative human resources (?)	Not presented in annual report	Not presented in annual report

Source:

The IDC adds another 5 parameters designed to capture a number of strategic targets (procurement, systems and processes, risk management and public image) not dealt with in its mandate, which together carry a weight of 25 percent.

While most of the chosen targets have the advantage of being quantifiable, they do not in any way represent an analysis of the economic costs and benefits of the IDC's activities for South Africa. Most of them are simply ways of counting activities performed rather than measuring their economic impact.

Furthermore, the targets seem to have been set at extremely low levels—almost all of them are well below the average performance of the IDC over the last four years. For example, the average annual value of IDC approvals from 2001 to 2004 was more than R5 billion (target = R3 billion); and the average number of BEE and SME approvals over this period was around 150 and 300 a year (targets = 70 and 100), respectively. On average, the IDC claims to have created 22 000 jobs a year from 2001 to 2004 (target = 12 500). It is therefore unsurprising that the IDC achieved a score of 175 percent against its development targets, and an overall score of 136 percent for this review period. This despite the fact that the total number of projects financed has fallen from about 500 in 2001 to 145 in 2005.

But are these true or useful measures of success?

16.3 A New IDC or More of the Same?

The IDC is concerned about its recent performance and has conducted its own internal review of what it has achieved over the last ten years; and how it should position itself in future.⁵⁷ The review acknowledges that the IDC has failed to diversify out of its core metals and chemical interests and suggests that the future role of the IDC lies in correcting for ‘the intrinsic failures of the private financial sector’. It argues that the IDC’s knowledge base and appetite for risk enable it to identify and fund projects that would not be considered by commercial banks. This includes SME and BEE borrowers. The review also finds a tension between the IDCs development and financial performance objectives. It suggests that market-related criteria and interest rates compromise its ability to finance projects in new industries and conflict with its BEE and SME mandates. Finally, the IDC sees a role for itself as a ‘policy actor’ and ‘development agency’ designing and implementing new industrial policies.

This ‘new’ vision raises three sets of concerns.

- The recent performance of the IDC does little to suggest that it is more qualified or able to take on risk than the South African financial sector. Some comparison of the loan portfolio of the IDC relative to that of the private banking sector is required to support this assertion, but not provided in any of the available review documents.
- The proposition that subsidised finance is necessary for the IDC to meet its performance objectives, contradicts this previous assertion. If the IDC is willing to go where the South African private sector will not, then interest-rate subsidies would be unnecessary and irresponsible. Subsidising high-risk investments is doubly bad!
- To suggest that the IDC should be commercially independent, should not compete with the private sector and should be involved in the design and implementation of industrial policies raises multiple conflicts of objectives and interests.

The IDC is rightly concerned about its past focus on large and resource intensive investments and is seriously committed to finding a new and more development-orientated trajectory. This, it seems, lies in establishing the IDC as a preferred financier of BEE and SME transactions. To attract more BEE and SME customers, it has recently announced plans to provide R1 billion of new finance at prime less 5 percent.

If the IDC is to become more like a bank, and less like a strategic investment fund, then serious questions need to be asked about the relationship between the IDC and the private financial sector. Mondri and Roberts (2005) agree. They argue that the IDC’s “different appetite for risk” will enable it to transact where “commercial banks are least likely and able to respond” (Mondri and Roberts 2005, p.21). History shows otherwise. The bulk of the IDC’s assets are tied-up in blue-chip resource companies and its exposure to high-risk services and manufacturing is relatively low. It is not clear that the BEE deals in which it is now so actively involved are particularly high risk, or could not have been funded by the private sector.

What is clear is that private banks cannot raise or provide finance to anyone, regardless of the risk, at interest rates 5 percent below the prime lending rate; they cannot leverage ‘strategic’ assets accumulated over the last 60 years with significant support from Government; and they cannot count on privileged access to government officials and ministers to assist them in identifying and supporting specific projects. The fact that the IDC can do all of this is an extreme competitive advantage that needs to be wielded with caution. This, in turn, requires a more careful and strategic analysis of the role and responsibilities of the IDC; and a more rigorous performance management system.

16.4 Looking Forward

The change of government and policy regime in 1994 presented the IDC with a serious identity crisis and this has yet to be resolved. The IDC has continued to view itself and play a major role in

⁵⁷ The public version of this review has been written by IDC staff (with assistance from a research associate). (Mondri and Roberts, 2005)

industrial policy, but has not been able to shake its old habits. At the same time it has diversified into social areas in which the basis for its mandate is not at all clear. The IDC is an institution faced with mission confusion and conflict, and within the area of industrial policy it faces major issues of accountability, effectiveness and potential conflict of interest.

Ongoing introspection and adaptation is important, for the IDC, but Government needs to confront a much bigger set of questions. What role should the IDC and other (domestic) development finance institutions play in the future development of South Africa and the continent? What targets and controls should be put in place and how should the performance of the IDC be evaluated and managed? And how can the country ensure that it gets the maximum economic benefits out of the assets of the IDC without disrupting or crowding-out the activities of the private sector?

Here, Government needs to take the lead and provide direction to the IDC. It is not that the IDC and its Board are incapable of developing their own strategies and targets and the management of the IDC are to be commended for taking the initiative in this regard. But there is no reason to pre-suppose that the interests and objectives of the IDC are always in tune with those of the country, the economy and its people. Greater independence in the evaluation of these multiple interests and objectives can only be to the advantage of all.

17 Strategic Infrastructure Investments

Inadequate infrastructure, especially in ports, railways and roads, has been identified as another important constraint to South African growth and industrial development (Edwards and Alves 2005). This is an area in which contributions can and must be made at all levels of government. Investments can be lumpy and large. There are serious issues about the estimation and measurement of economic costs and benefits, and about the allocation of responsibilities among governments, state enterprises and private actors.

The South African Government plans to invest significant new capital in economic infrastructure. Much of this expenditure will go through provincial and local governments. In many instances, the priority seems to be on raising expenditure, regardless of the need for or economic rationale of specific projects. Some of these issues are illustrated by the Coega Industrial Development Zone (IDZ) and by initiatives undertaken by the Gauteng Province's 'virtual company' Blue IQ.

17.1 The Coega IDZ

The Coega project comprises two distinct but closely related components—a deep water port on the Coega River and an Industrial Development Zone covering 12 000 hectares of land adjacent to the harbour. The harbour is being developed and will be operated by the National Ports Authority (NPA) and the IDZ is owned and operated by the Coega Development Corporation (CDC). Other than infrastructure, Coega offers standard export-related incentives—duty-free import of inputs and capital equipment, and VAT exemption on locally purchased inputs used for export.

This is the single largest infrastructure development project in the country since 1994, with a total estimated investment so far of R8 billion, comprising R3.1 billion for the new port infrastructure, R2 billion for the IDZ infrastructure and R2.1 billion by Eskom to upgrade power supply. The funding has come entirely from the national and provincial governments and the Eastern Cape Development Corporation holds all CDC shares.

The project was first mooted in the 1970s as a privately developed port to be constructed in connection with a Grenco (now Billiton) zinc refinery. The idea resurfaced in the 1990s with the same general concept—a privately developed facility to be used primarily by a new zinc refinery.

The basic concept changed completely when the government decided to implement the project on its own accord based on a desire to attract one or more major minerals processing investments (zinc refining and a French aluminium refinery) and in anticipation of a flood of industrial investments arising from defence-related industrial participation projects (see Section 11 above). Among the additional inducements to the aluminium refinery was the offer to allow the investors to divide the

project into three virtual components to qualify for and maximize the benefits from the SIP investment incentive (see Section 10 above). While the government took over the major role in the development of the project, success remained contingent on securing a major anchor tenant in the mineral processing sector.

In any event, Alcan has since bought out the French aluminium company and has continued to defer decisions to develop this project, despite the very generous incentives on offer. Similarly, the anticipated industrial participation investments have not materialized. In its most recent annual report (2007), the Coega IDZ claims it has secured 9 investment deals worth more than R21 billion:

- Two local companies plan to relocate existing facilities from elsewhere in the Eastern Cape to Coega. Dynamic Commodities, the only company to have begun operations in the IDZ by the time of this report, is an ice-cream manufacturer and exporter. It has apparently invested R75 million. Cerebos, a local salt manufacturer, plans to follow suit at a cost of R60 million. There will be some expansion to these facilities but these hardly count as 'greenfield' investments.
- Five new investments were planned for 2007/08. This included a R50-million biomass fuel pellets project; a R50-million automotive component operation; a R50 million concrete products operation; and 2 warehousing facilities. As far as we can establish, none of these investments has actually taken place.

Looking forward, Coega has announced that a R1,1 billion chlorine manufacturing facility is to be commissioned in 2009. The same company 'plans' to invest a further R5.7 billion in a desalination plant, presumably on the back of a cosy off-take arrangement with the local government. There is also talk of a R1.1 billion stainless steel mill and a multi-billion rand petrol refinery.

The history of (non-) investment at COEGA also includes some that have come and gone with no investment at all, such as a Belgian textile mill that, despite great media fanfare and substantial sweeteners from government, never pitched up.

How many of these other projects will suffer the same fate?

At best, the nine 'secured' investments amount to R500 million, far less than the total amount of physical and electrical infrastructure sunk into the project. So the 'success' of Coega remains contingent on a single, extremely elusive and very costly aluminium smelter.

It is for this reason that Government has thrown all that is can and far more than it should to secure this anchor investment. The DTI dug loopholes in the criteria of its own investment incentives to ensure that the smelter qualified for maximum tax benefits. A highly subsidised electricity pricing dispensation has been offered to the project, which will require as much electricity as a city, at a cost that has not been made public. Finally, Alcan will provide only 25-40 percent of total equity, with government (through Coega and the IDC) and other local investors expected to provide the bulk of the funds.

The Coega strategy has clearly been adaptive, responding to changing opportunities and objectives. The initial goal was to encourage private development of a resource-, energy- and capital-intensive mineral processing facility. While this might not have contributed much to employment or general industrial development, it would have been at small cost to the Treasury. The decision to develop the zone at public expense, and with the addition of very generous income tax incentives, changed the balance considerably, and raises serious questions about the prioritization of industrial development expenditures. The most important of these is whether the R8 billion invested so far is the most effective use of government resources to promote more labour-intensive growth.

The government has established three other similar IDZs, in East London, Richards Bay and Johannesburg International Airport. The latter two have not yet been granted operating permits. East London has announced that it has secured four tenants, two in the heavily subsidized auto parts industry, an abalone farm and a transport company.

A major lesson of the east and south-east Asian experience (and also in Mauritius) is that export incentives of the type that make economic sense and that are permitted under WTO arrangements can

be provided by making any factory, regardless of location, a virtual IDZ or free trade zone (FTZ), based on simple criteria about the share of exports in total production and ability to implement basic customs controls. This is much less costly to the public sector and much more useful to private investors who do not have to distort investment location decisions simply to benefit from export incentives. It also frees the government to make infrastructure investment decisions free from the considerations and priorities of particular investors that may or may not decide to invest in a pre-determined IDZ.

This is an approach that deserves greater consideration and emphasis in South Africa.

17.2 Blue IQ: Gauteng's Plan for a 'Smart Province'

The 1997 Gauteng Provincial Government's Trade and Industrial Strategy identified a 'to do list' of 100 priority projects and interventions. From this, a short-list of 11 'strategic economic infrastructure projects' were packaged under a 'virtual company' known as Blue IQ. This new institution was allocated a small team of project managers and a budget of R3.7 billion. Critically, Blue IQ was given a maximum lifespan of five years, after which all projects were to be commercially sustainable as private or independent companies. This five-year period ended in 2005 (Blue IQ, undated).

Since writing this report, Blue IQ has been recreated as provincial public entity and now operates as a private company with the Gauteng Provincial Government as its only shareholder. Some of the original 11 projects have been transferred to new 'owners; some continue as is; and a wide range of new projects have begun. The staff, scope and life of the programme have clearly expanded well beyond the Government's initial and planned intervention.

The 11 Blue IQ projects include the Innovation Hub; the Gautrain Rapid Rail Link; the Gauteng Automotive Cluster; two industrial development corridors/zones; the City Deep Transport Logistics Hub; and five cultural and tourism sites. The Gautrain has become a project in itself, the City Deep Logistics Hub has been taken over by Transnet, and the five tourism and cultural projects fall outside the scope of this study. The remaining four projects are described and discussed below.

The Innovation Hub

The Innovation Hub is a science and technology park situated strategically between the CSIR and the University of Pretoria. Qualifying tenants pay commercial rents for which they also receive a range of value-added business support services. Substantial new land has also been made available for commercial development. The project was budgeted at R184 million, but difficulties in accessing the site increased the final cost to more than R400 million. This was partly because the site itself is squeezed between two major highways and a 'koppie'. Local by-laws raised additional problems. It is hoped that the proceeds from land sales, which were intended to go back to Blue IQ, will now be sufficient to meet these 'unforeseen' infrastructure costs. The project is perceived as commercially sustainable, but only because modest rental incomes do not need to overcome the substantial sunk costs of the Provincial Government.

Gauteng Automotive Cluster

Support to the Gauteng Automotive Cluster took place through two separate projects. Firstly, Blue IQ has provided a R130 million in subsidies to the Automotive Industry Development Centre (AIDC) to deliver support services to the Gauteng Automotive Industry. This support includes design, testing, research and human resource services required by the industry, for which the industry is only willing to pay around 70 percent of the market cost. Blue IQ recognises that this is not commercially sustainable and would like DTI to take over the annual cost of subsidising this programme. Secondly, Blue IQ agreed to spend R200 million on a shared supplier park for the industry, based on a request by the AIDC. In total, R350 million was eventually spent on buildings and infrastructure for the component industry, which have been leased back to the industry at commercial rates. This is because manufacturers are apparently unwilling to invest in long-term assets.

Wadeville Industrial Corridor

This project involved the regeneration of under-utilised infrastructure and support services in the East Rand towns of Wadeville and Alrode. According to Blue IQ, the main reason for the degeneration of these areas was ‘exogenous changes in macroeconomic policies’—specifically the reduction of tariff barriers and removal of trade sanctions. New infrastructure and significant marketing support from the Ekurhuleni Municipality have thus far done little to attract manufacturing industries to this corridor. Blue IQ now blames insufficient electricity and transport services.

JIA Industrial Development Zone

Blue IQ invested around R200 million in new infrastructure to ‘unlock’ a large area of land owned by ACSA and Denel.⁵⁸ The intention was to develop an Industrial Development Zone adjacent to the Johannesburg International Airport for ‘time-sensitive’ industries. With dedicated infrastructure now in place, ACSA and Denel appear to have lost interest in the proposed IDZ, and for two main reasons. Firstly, they claim that existing IDZ incentives are not large enough to entice new or existing industries into the area. And secondly, it has since been established that within a 20 km radius of the site there are no additional cost advantages to being located at the airport. It would seem that there was never any demand for this zone in the first place.

17.3 Is Blue IQ a Success?

Measuring the success of any industrial policy initiative is difficult and requires detailed information on both the costs and benefits of the intervention. Fortunately, in this situation, we have a fair idea of the sunk costs of each project. Moreover, Blue IQ set itself specific ‘impact indices’ against which its benefits were to be measured (Blue IQ, undated). These included:

- Blue IQ’s contribution to the composition of high value-added manufacturing in GGP;
- Blue IQ’s contribution to the composition Gauteng’s export basket;
- Blue IQ’s contribution to improving labour absorption capacity;
- Blue IQ’s contribution to sustainable GGP growth.

The relationship between such indices and the net economic impact of the investments is far from obvious. Nevertheless, Blue IQ claims that the Gauteng Government is already tracking them and that ‘movements and the trends are looking positive at this time’. This is difficult to contest, in part because the ‘Impact Assessment’ page on Blue IQ’s website remained empty until it was removed. The new website provides some crude multiplier analysis which reveals that the impact of Blue IQ investment on output is significantly lower than that of the rest of the economy; and that Blue IQ has crowded in less private sector investment (per rand spent) than the Government’s expenditure on community services.

With reference to the four projects listed above, Blue IQ has certainly succeeded in building significant new industrial infrastructure in the province.

In the first two cases, this infrastructure represents a large subsidy to a relatively elite group of companies. There is no shortage of commercial rental space in Gauteng that could have been made available without the unusually high development costs made necessary by the chosen site of the Innovation Hub. While this site was selected because of its proximity to the University of Pretoria, no direct road or pedestrian links are available to connect them.

The Wadeville industrial corridor investments appear to have failed to attract any of the desired investments. The JIA road access investments are a high price to pay to unlock land that is of little or no greater value to prospective tenants than much more accessible land within a 20 km radius of the airport. At best the investments will benefit two state-owned companies.

The real export or employment benefits for the provincial economy and its people seem relatively low.

⁵⁸ This does not include the costs of travel delays on the R21 during the lengthy construction period.

17.4 What Went Wrong with Blue IQ?

Project Identification

Initially, Blue IQ was set-up to deliver 11 pre-identified projects. The project team mostly confined itself to this work and did not question the merits of individual projects. The only official project to be added to the original list was the Automotive Supplier Park. On the other hand, Gauteng Government's financial reports indicate that Blue IQ was used as a vehicle to transfer funds to a much wider range of projects and service providers. The Government also used Blue IQ to assume a 50 per cent shareholding in Capstone 518, an arrangement that is currently under forensic investigation.

Project Planning and Coordination

Perhaps the greatest failing of Blue IQ was the determination to implement a set of pre-determined projects without sufficient initial analysis of economic benefits and costs and without subsequent consideration of changed financial, logistical or policy conditions. Budgets were exceeded, in some cases by almost 100 percent; projects were completed when there was no evident demand (Wadeville and Alrode Corridor); and institutional constraints were ignored until they were too late (JIA). In most cases commercial sustainability remained possible only because Government was willing to pour more money into subsidising consultants (AIDC) or sink more capital into unforeseen infrastructure (Innovation Hub).

Financial Management and Controls

It is difficult to evaluate the budget and expenditure on Blue IQ. Unlike other Gauteng 'agencies', Blue IQ was treated as a programme in the Department of Finance and Economic affairs and little financial detail was provided in the government's annual financial report. Blue IQ was the only expenditure item to receive special mention in the Auditor General's assessment of the 2003/04 financial statements of the Province. He drew special attention to the internal and monitoring controls relating to Blue IQ payments and indicates that "adequate documentary proof could not be submitted to audit that internal controls and monitoring controls were properly implemented when certain payments were effected to suppliers or companies receiving funds from Programme 5: Blue IQ."

17.5 Lessons

Coega and Blue IQ represent a flexible and non-institutionalized approach to strategic infrastructure investment. Both projects have attracted positive media attention and are widely advertised by their respective Provincial Governments as symbols of their economic success.⁵⁹ Coega continues to absorb significant new infrastructure investment and Gauteng has decided to extend the life of Blue IQ beyond its initial five-year mandate and is currently looking for a second round of projects to implement under a new management team.

On the other hand, these projects raise a number of concerns about the design and implementation of economic infrastructure and the level of coordination between different spheres of government and their parastatals. The experience suggests a need for deeper *ex ante* economic analysis of strategic investment projects, greater and more sceptical consideration of the need to supplement private service provision with state intervention, and more oversight of changing economic and financial circumstances in project evolution.

18 Cross Cutting Issues and Approaches

This discussion of industrial policy issues has so far focussed on particular sectors and/or policies that have their major impact through effects on particular sectors. An alternative approach to industrial policy is through initiatives that have cross cutting effects on a broader variety of sectors. This is an area that holds considerable potential for South Africa. We illustrate this through two examples, telecommunications and broadly defined trade facilitation.

⁵⁹ In 2003/04 alone, Blue IQ awarded a R50 million marketing and communication contract to an outside service provider.

Both these examples are important to South African industrial and more general economic development. But they are not the only ones. A recent investment climate survey and analysis (World Bank 2005) and the most recent World Bank “Doing Business” (World Bank 2005) provide helpful indicators of other areas with potentially high returns from policy reform. Among the other important constraints to growth that these studies identify are labour market institutions and regulations, and crime.

18.1 Telecommunications

Telecommunications is a service activity that is critical to countries’ participation in global production networks. It is of direct importance, of course, to communications intensive activities such as offshore call-centre services. Regardless of the quality and price of domestic labour available to provide such services, they cannot possibly compete without access to low cost and reliable international telecommunications networks. Provision of offshore services to financial institutions requires the same level of telecommunications facilities. Domestic financial services are also highly dependent on telecommunications.

Low-skill and labour-intensive export manufacturing such as garments, footwear and automotive parts, activities that might initially appear to be far from the frontier of high tech telecommunications, have similar needs. Competing in the global garment industry requires constant adjustment and speedy response to small and large changes in customer needs. Designs and other specifications change continuously, and to be able to adapt requires the ability to transfer large amounts of information, including complex designs, across the internet. Local producers also need to be in constant communication with suppliers, often on different continents, in the same way. Changes in cost and pricing information need to be transmitted quickly and reliably.

How does South Africa stack up?

A recent study (Genesis Analytics 2005) assessed the costs of telecoms in South Africa, measuring local pricing against countries that are similar to SA in terms of relevant characteristics including, of course, income levels and general economic development. The comparator countries were also chosen on the basis of representing some degree of ‘best practice’ performance, a goal to which South Africa must aspire if it is to compete in the global economy. The peer group of ‘best practice’ developing countries included Brazil, India, Malaysia, Morocco, Philippines and Thailand. In terms of income per capita, SA is richer than all of the peer countries.⁶⁰

Some key results of the study are summarized in Table 20.

Table 20. How Do South African Telecomms Prices Compare?

Item	SA's Rank	Compared to Average Cost	Compared to Least Cost Country
Business ADSL	Most expensive of the 15 countries sampled	148% higher	9 times as expensive
Domestic leased lines	Most expensive of 12 countries surveyed	102% higher	15 times more expensive
International Leased lines	Almost three times as high as the next most expensive country sampled	399% higher	31 times more expensive

⁶⁰ Based on our own knowledge of some of these countries, it would seem fair to suggest that the ‘best practice’ standard is not overly strong; in other words, these are *minimal* standards to which South Africa should aspire.

Retail ADSL	Most expensive of 13 countries	139% higher	8 times more expensive
ISP fees	Most expensive	45% higher	5 times more expensive
Business Voice	5 th cheapest	14% lower	3 times more expensive
Business – local calls	Most expensive	199% higher	11 times more expensive
Business – international calls	5 th most expensive of the 15 countries sampled	14% lower	3 times more expensive
Business – mobile calls	2 nd most expensive out of 15 countries	107% higher	23 times more expensive
Retail – local calls	4 th most expensive	129% higher	8 times more expensive
Retail – mobile calls	5 th most expensive	104% higher	11 times more expensive

Source: Genesis Analytics 2005

In almost all the comparisons considered the South African telecommunications sector underperforms and often by huge amounts. This has serious implications for the development of a wide variety of service and manufacturing industries in South Africa and for the benefits they might otherwise provide in terms of employment and income growth.

Government is considering a set of tailor-made incentives to call centres to offset the high cost of telecommunications in South Africa. This might be of benefit to a narrow set of investors, but it will also deflect attention from the root cause of this problem and do little to benefit the majority of telecoms consumers. Clearly, a much bolder approach to telecommunication regulation and pricing is required to have a broad and beneficial economic impact in South Africa.

18.2 Importing and Exporting

In the era of sanctions and domestic protectionism high transport and logistical costs, inefficient ports and cumbersome Customs procedures were not a problem. Nor was South Africa's relative geographic isolation. In fact they all could be viewed as supportive of the underlying policy regime. This is no longer true. Successful and competitive participation in global production networks now requires efficient ports, smooth logistics and seamless border procedures. South Africa continues to face natural disadvantages due its geographic isolation, and this requires that she strive even harder than others to avoid policy-sensitive impediments to trade.

Unfortunately old legacies are sometimes difficult to overcome. This has been true in the case of seaports.

With approximately 95 percent of her trade volume seaborne, about 85 percent in value terms (Chasomeris, 2005), South Africa is strategically dependant upon the efficiency and effectiveness of her seven commercial ports⁶¹. These ports serve not only a strategic role through trade facilitation, but also help to shape the economic growth and development of the entire Southern African region.

South African ports have been managed traditionally with a high degree of state ownership and intervention and as part of organizations involved in other key transport modes, especially rail.

Ports were generally acknowledged to be poorly managed, to provide poor service and charge uneconomic prices. In recent decades capacity problems increased and service continued to deteriorate. In 1989 the former SATS was incorporated into Transnet and its operations were commercialised. In 2000, further rationalization included the creation of a separate landlord (NPA) and port operations (SAPO) businesses under Transnet. The latter reorganization included a

⁶¹ SA's multipurpose ports include PE, East London – the only river port and Mossel Bay; the hub ports include: Cape Town, a terminal port oriented towards the western sea routes; and Durban which is ideally positioned to serve the eastern routes. The deep water ports of Saldanha and Richard's bay

commitment to a new vision focused on assisting in the development of an export-led economy. Pricing structures and operational systems were improved. Substantial new investments have increased capacity, including the construction of two state of the art car transport terminals to serve exports promoted under the MIDP.

Nevertheless a wide variety of performance and pricing issues remain. Complaints include the following (Chasomeris 2005).

- Congestion and turnaround times remain high.
- Processing of vehicle and other imports is charged at a suspiciously high rate, double that for similar exports.
- Service quality is impeded by inadequate equipment and by low skill levels and high labour turnover.

Organizational and regulatory reforms of the type now underway take time. But the costs of underperformance are high. It might be useful to rethink the state-led model of port service provision and/or seek ways to introduce real competition. This could be achieved through licensing new private operators, maybe as part of ongoing expansion plans, or by encouraging competition through the ports of Maputo and Walvis Bay by working with neighbouring governments to facilitate transit trade within SACU and SADC.

While air transport does not account for a very large share of South Africa's imports or exports, it is also critical for industrial development. Samples and high value shipments can be very important, and reliability of delivery can be critical. A garment producer in a neighbouring SACU country used to ship samples by air to and from Asia via Johannesburg International Airport. Continued pilferage led them to change the routing through Europe so that Johannesburg could be avoided. This added one or two days to shipping time but is apparently worth the extra shipping and time cost. South African-based manufacturers do not have such options available, since all shipments must ultimately come through Johannesburg.

Competitively priced and reliable passenger connections are important for international investors as well as tourists. Lack of competition on key routes to Europe, America and Asia causes high prices and capacity shortages. If buyers, sellers and investors need to delay trips by a week or two because of lack of seat availability, this is bound to have an impact on the amount of business they will want to do in South Africa. Deregulation and increased competition in the airline business can be another important instrument of industrial policy.

Transparency and simplicity of Customs rules and procedures is also important. Complexities of the tariff structure as discussed above in Section 10 are one example. Complex and time-consuming rebate procedures are another. Lack of availability of basic information about tariff rates and other rules increase the difficulty not only of doing business, but also of evaluating trade and industrial policies. The South African government does not make its tariff book or detailed trade data available on the web and it does not provide it in any form of hard copy. This basic tax document must be purchased instead from a private publisher.

The emergence of cottage industries of incentives, customs and trade consultants suggests either a healthy form of specialization of work or a proliferation of excessively costly and non-transparent regulations that increase the costs of trade and serve as barriers to entry for domestic and international competition. While progress has been made in reducing the cost and increasing the transparency of trade in South Africa, more remains to be done.

The World Bank constructs annual indices of the costs of doing business around the world, including engaging in international trade. One indicator is the number of days to undertake all the procedures necessary to clear goods for import into the country. While this is a crude index and includes a number of quite separate procedures (pre-clearance forms, port clearance, customs clearance and transport to warehouse) it is nevertheless a useful general indicator of ease of importing. The most recent survey (World Bank 2005) reports that it takes 34 days to import goods into South Africa. This

is much better than the average for all of Sub-Saharan Africa (61 days). But it is not nearly as good as in successful economies in south and south-east Asia (Singapore 8 days, Malaysia and Philippines 22 days, Thailand 25 days, Sri Lanka 27 days). And it is not as good as other useful comparators such as Egypt (29 days) and Chile (24 days). These are minimal targets to which South Africa should aspire in easing the costs of trade so that South Africa can integrate successfully in the global economy.

19 The Real Exchange Rate

Changes to the real exchange rate can have a major impact on South Africa's international competitiveness and are an important part of current discussions around trade and industrial policy. For this reason it is important to consider the role of exchange rate policy in supporting economic development and ask what might be done to reduce currency volatility and raise price competitiveness. This section is necessarily short and the analysis preliminary – clearly much more work is required in this area.

Although the exchange rate is not an instrument of industrial policy, it may be influenced by the structure of industrial development and the policies that support it. For example, the dependence of many developing countries on commodity exports is often blamed for their inability to diversify and develop. This is particularly problematic when commodity prices are rising. Unless the rents from commodity exports are somehow sterilised, the exchange rate will adjust to reflect resource flows and non-resource industries will suffer. Such countries are inflicted with the so-called 'Dutch disease.'

Commodity prices have risen strongly over the last few years and South African exporters of precious and base metals have been among the greatest beneficiaries. Rising resource exports have undoubtedly contributed to a stronger rand and the South African currency outperformed most major currencies between early 2002 and 2007. It has since weakened considerably.

Downstream manufacturers complained that the strong hurt exports and the available evidence suggests that this was true. Is South Africa susceptible to the Dutch disease? And if so, what can policy makers do about it?

Determinants of South Africa's Exchange Rate

A recent study (IMF 2003) produced some quantitative estimates of major influences on South Africa's real effective exchange rate (REER) that are sensible and correspond with previous South African studies.⁶² The main findings include the following.

- A 1 percent increase in real commodity prices is associated with an appreciation of the REER of around 0.5 percent.
- A 1 percent increase in openness (trade relative to GDP) is associated with an appreciation of the REER of around 1 percent.
- An improvement of the fiscal balance of 1 percentage point of GDP is associated with a depreciation of the REER of around 2 percent.

Other influences include relative real interest rates (a one percent increase relative to trading partners is associated with a 3 percent REER increase), real GDP per capita (a 1 percent increase relative to trading partners is associated with a REER increase of 0.1 to 0.2 percent) and net foreign assets (an increase of 1 percentage point of GDP is associated with a REER increase of about 1 percent).

From 2002 to 2007 there was a positive movement in almost all of the main determinants of the real value of the rand. But commodity prices moved particularly strongly over this period and are almost certainly the most important variable in explaining the long-run behaviour of the rand.

Mining versus Manufacturing

⁶² The real effective exchange rate is a measure of the domestic exchange rate against a basket of currencies of the country's main trading partners, adjusted for differences between domestic and foreign rates of inflation.

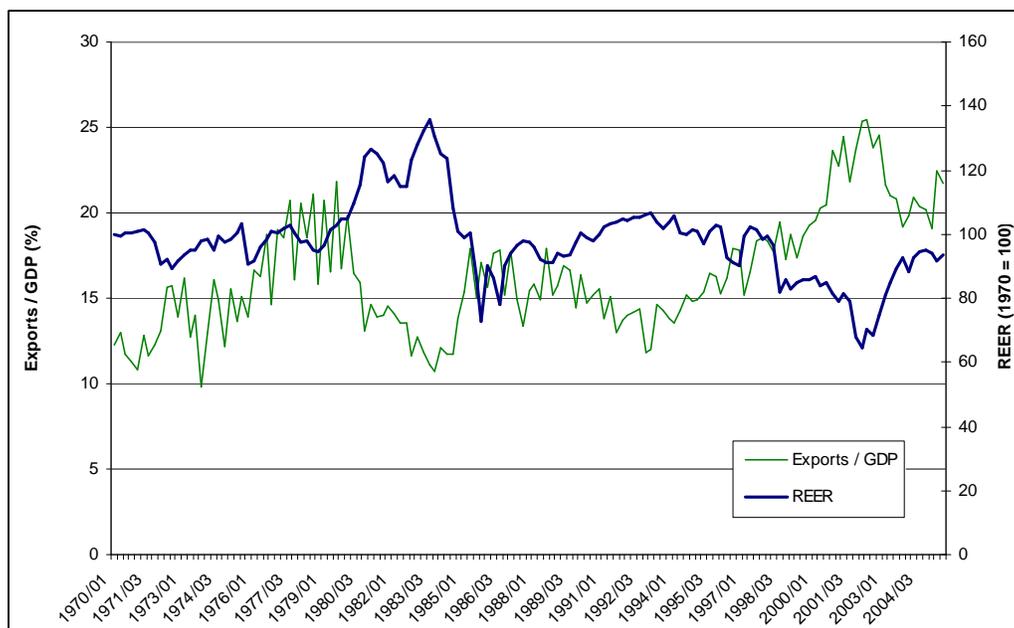
The long-term relationship between South Africa's manufactured exports, the REER and commodity prices has been explored in detail. Bell, Farrell and Cassim (1997) provide a particularly good exposition of South Africa's historical trade performance and demonstrate, for instance, how the commodity boom of the 1970s choked off a nascent new pattern of export-oriented industrialisation, with the rise in commodity prices and the associated increase in the real exchange rate making the export of non-commodity manufactures unsustainable.

This is clearly evident in Figure 5 below. The sharp appreciation in the real exchange rate over the late 1970s and early 1980s was followed by an equally rapid fall in merchandise exports (excluding gold) as a share of GDP. To some extent the declining contribution of exports to GDP reflects the lower rand value of trade, and not necessary declining volumes. That said, any decline in the rand value of exports will still have an adverse impact on the economy and the profitability of manufacturing exporters. This pattern repeats itself over the following few decades and the negative correlation between the REER and merchandise exports is remarkably strong.

The real depreciation from the late 1990s to 2002 complemented the post-1994 trade liberalization measures and helped to fuel the beginnings of a merchandise export boom. Export growth was broad-based and included not only MIDP-subsidized vehicles and motor industry components, but also products ranging from electronics to garments, food products and industrial valves.

Starting in late 2002, however, the slowdown in trade liberalization and the commodity-led rand appreciation had the opposite effect.

Figure 5. Merchandise Exports (Excluding Gold) and the REER

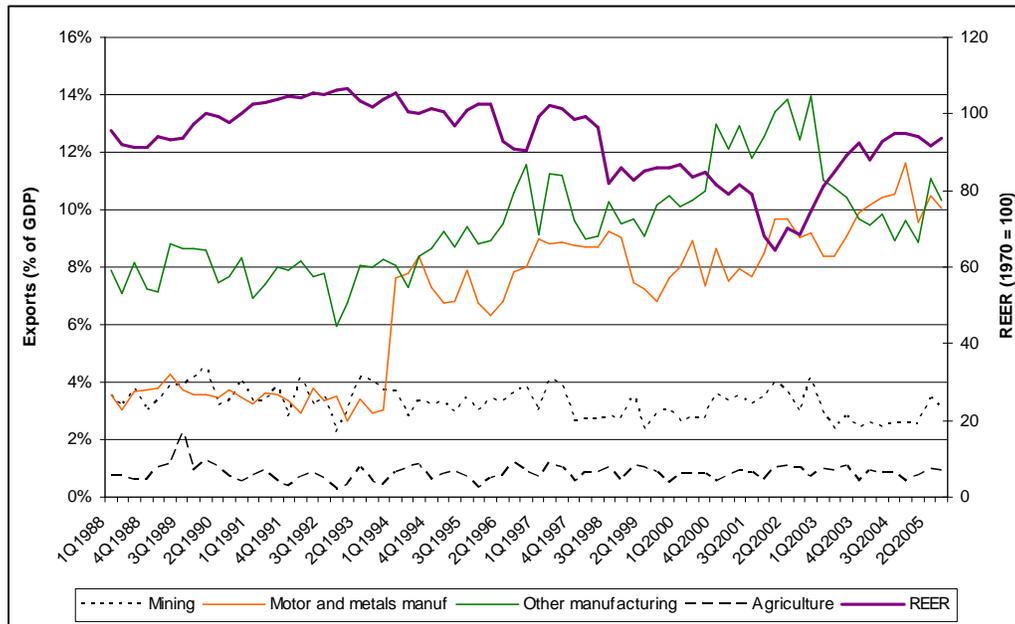


Source: Based on data from SARB and Quantec Easydata

The impact of real exchange rate has not been even across export sectors. Figure 6 breaks down exports of metals-based manufacturing (we include motor vehicles), other manufacturing, mining and agriculture, all as a share of GDP. The data exclude exports of precious metals (platinum and gold). Exports of metals-based products do not appear to be strongly affected by the REER and have continued to grow over the last few years. Strong international demand for commodities and subsidies to motor vehicles probably explain this intransigence. But exports of 'other manufacturing' have fallen dramatically since early 2003, from a high of around 14 percent of GDP to close to 10 percent. This latter category would include most labour intensive and value-added products. Sectors that have

been hurt most include clothing, paper and paper products, leather and leather products, textiles and furniture.

Figure 6. Sectoral Breakdown of Export Performance



Source: Based on data from SARB and Quantec Easydata

What Can Be Done?

Commodity-led real exchange rate volatility is clearly a problem for South African industrial development. Can the problems be solved or at least ameliorated and if so, how?

One suggestion is for the deployment of more aggressive sector-specific industrial policies, such as the MIDP. The problem with this strategy is that such policies are not sensitive to the resource cycle; they do not respond to the cyclical nature of the real exchange rate effects of resource booms (and busts).

The underlying problem is not sector-specific. Rather, it is a macroeconomic issue related to the smoothing of economy-wide impacts of resource cycles.

A sensible macroeconomic policy in the face of resource cycles is to increase national savings during resource booms and reduce them when prices relent. How can this be achieved? One means is through counter cyclical government fiscal actions—increasing fiscal surpluses during booms and decreasing them during downturns. This would be facilitated almost automatically if the government had an effective system for sharing in resource rents through a well-designed royalty system. Not only would this provide a valuable tool for stabilizing the impacts of resource booms, but it would also provide a low cost source of funding for developmental spending on infrastructure, health and above all education and skills development. Well-designed royalties are among the lowest cost form of taxation available to government.

20 Conclusions: Lessons Learned and the Way Ahead

20.1 General Challenges

South Africa has come a long way in integrating itself with the global economy in the decade since democracy. In the context of sub-Saharan Africa, its performance has been well above the average with growth rates of 3.1 percent per year between 1994 and 2004 and direct inward investment of R122 billion over this period (SARB). The initial responses to the end of sanctions, domestic deregulation and trade liberalization were strong and very encouraging. Almost all sectors of the

economy became more open and more productive, and experienced simultaneous increases in export orientation and import penetration in response to improved economic incentives.

Nevertheless, South Africa's growth performance has been less than might have been expected and certainly less than necessary to meet the country's ambitious social and economic development goals. Almost all capital inflows have gone into existing assets and the productivity of investment has been disappointing, in terms of its contribution to economic growth, to employment and to the diversification of the South African economy. Exports have underperformed the world average and that of other resource economies.

External and internal factors have posed difficult challenges for trade and industrial policy. Among the most important has been the historical 'curse' of mineral and other resource wealth. While South Africa has avoided some of the serious problems that can arise from resource dependence, commodity trade and prices have created biases against other tradable goods sectors and have hindered the development of non-resource exports. Whether intentionally or not, the government has been a net-contributor to this problem and has provided additional incentives, publicly funded infrastructure services and other support to resource industries.

The challenges and opportunities of resource abundance can certainly be managed better; they are not unique to South Africa, and other countries have found ways to deal with them. South Africa's minerals and other natural resources are a source of wealth that has been inadequately tapped for social purposes

Other challenges arise from South Africa's geographic location. Gauteng, the economic hub of South Africa, is far from the sea and even further from major markets and sources of supplies in Asia, Europe and America. It is also contiguous to a hinterland that is sparsely populated and relatively underdeveloped. South Africa itself accounts for more than a third of the entire income of sub-Saharan Africa. And the total income of all of sub-Saharan Africa is less than the Netherlands.

South Africa's industrial and overall economic development clearly hinges on successful integration with the *global* economy. While geographic isolation poses challenges, they are not insurmountable. In today's information economy, physical proximity is becoming decreasingly important. But this requires efficient and low cost telecommunications systems. To the extent that physical distance does matter, barriers can be reduced by efficient trade and transport. Seaports, airports, customs' procedures, and competition and efficiency in land, air and sea transport are all important.

It is also easy to overestimate the impact of South Africa's geography. In terms of airline distances, South Africa is no further from Europe than is south-east Asia, and the distance to south-east Asia is almost identical. It is closer to huge and rapidly growing India and is closer to New York than is Singapore.⁶³ For investors, geography is only one factor in considering where to locate and how much to invest. There are many other dimensions of South Africa's attractiveness to investors that can be improved through government policy interventions, and these should be the focus of industrial policies.

20.2 Systemic Problems

Government has a positive role to play in meeting these challenges. The focus must be on alleviating South Africa's extreme unemployment rate through education and job creation. Our review of South Africa's trade and industrial policies reveals a number of key systemic problems.

Confusion About the Role of Trade: There are strong legacies in policy-making circles that continue to identify international trade as a threat to rather than an opportunity for industrial development. It is feared that South African producers cannot compete without protection and other forms of state support. This denies the evidence of the substantial and beneficial restructuring that occurred in

⁶³ In the early second half of the 20th century it would have seemed inconceivable that Singapore would become the major global transport hub that it is now.

response to the first wave of economic reforms. It is argued that existing tariffs should not be sacrificed without concessions from South Africa's trading partners. This is a legacy of the pre-1994 environment. Trade policy and trade negotiations are dominated by narrow 'defensive' interests and a mercantilist approach, rather than by a strategic vision of South African industry as a strong competitor in domestic, regional and global markets. South Africa is among the world's most vigorous users of anti-dumping measures, an 'easy' form of protection that is still sanctioned by WTO rules, and participates in regional agreements with rules of origin in some key sectors that are so restrictive as to make most preferential tariff reductions irrelevant. Trade policy reform has stalled. Despite its name, the ministry with primary responsibility for both trade and industry acts as if it views trade and industry as substitutes rather than complements.

Anti-Labour Bias: Many of South Africa's industrial policies continue to promote resource and capital-intensive activities. Investments granted tax incentives under the Strategic Investment Program (SIP) were primarily large, capital-intensive upstream industries. The Industrial Development Corporation (IDC) has a portfolio that continues to be dominated by capital and resource-intensive industries. Development of labour-intensive downstream industries is hampered by protection on inputs and the non-competitive import parity pricing of basic industrial products such as plastics and steel.

Sector-Specific Focus: Thinking about industrial policy focuses too much on the design of policies for specific sectors, with little, if any attention to the broader economic impacts of these selective measures. This imposes high costs that are rarely recognized, let alone estimated and taken into account in policy decisions. It invites rent seeking and creates a vicious cycle in which narrow import-competing interests prevail. While governments have shown no particular skill at picking winners, vested interests have developed the fine skill of picking the government's and the peoples' pockets in seeking subsidies and protection. It is much easier to grant protection and other forms of support than to remove it or phase it out. The process is still dominated by import-substitution industries, and by a few exporters in particular sectors, especially the motor industry, where investment and production for the local and export markets benefit from huge levels of public support.

Capacity for Policy Analysis: Capacity for the analysis of overall economic impacts of industrial policies is very weak. This is best illustrated by the MIDP, widely viewed as a major success, but with no measurement of its quite substantial economic costs. This is despite two reviews and extensions of the program that have already taken place, and another major review that is underway at the moment. The same problem exists with many other issues including import parity pricing, ITAC (previously BTT) deliberations on tariff reform, government procurement policy, investment incentives, and regional and multilateral trade negotiations. Policy analysis tends to be replaced by advocacy of particular interests, raising a real and serious danger of capture of the policy process by these interests. There appears to be no government institution charged with and/or capable of conducting basic economic analysis of industrial policy alternatives.

Lack of Institutional Coordination: Although the key economic constraints are well known by policy makers and business, few of the more obvious challenges have been addressed. High telecommunication costs, weak port infrastructure, poor levels of education and other cross-cutting problems continue; and the costs arising from them are addressed through second-best and narrow initiatives designed to placate those who shout loudest. These initiatives take place at different levels of government and usually favour a small group of connected beneficiaries. No single agency has the ability or authority to coordinate industrial policy interventions across government departments, provinces and cities and to consult with a wider range of business and consumer interests.

Misunderstanding of Lessons from Asia and Elsewhere: Another contributing factor to weak industrial policy making is a fundamental misunderstanding of some of the lessons from international experience. This is related in part to an earlier point—policy analysis has tended to be replaced by adherence to 'lessons from elsewhere' that largely (and in some instances deliberately) misunderstand the economics of the issues. While no country or region has been free of policy errors, these errors should not be held up as a model for South Africa. A more useful approach would be to try to learn from errors made elsewhere and from the processes that have led to their correction.

20.3 The Way Forward

Future policy strategies need to be based on a recognition of institutional constraints. Weaknesses in policy analysis capabilities, monitoring and evaluation, and coordination make it very dangerous to engage in detailed sector-specific strategies. Policy experiments can also be dangerous unless the government has the capability to distinguish between successes and failures and has the strength to put an end to failed experiments. Judging from recent experience, South Africa is weak on all these fronts.

This review raises serious questions the ability or even the need to identify ‘strategic industries’ and develop industrial policies accordingly. The unintended capital and resource intensive biases of policies such as tax incentives, government procurement and the investment and policy advocacy strategies of the IDC need to be examined and evaluated in more detail. Strategic infrastructure investments at the national and local levels also need to be re-evaluated. Government needs to reconsider the relative costs of labour adjustment assistance and continued protection as means to deal with failing firms and industries. Protecting declining firms has saved very few jobs at a very high cost to consumers, downstream industries and general economic growth. The real aim of adjustment assistance should be to ease the transition of workers and capital out of declining industries and into growing industries, not to retard that transition.

The review also highlights the important links between trade, industrial and competition policies. It must be recognized that trade and competition are complements of, not substitutes for, welfare-enhancing industrial development. This should be the basis for improved competition policies and a rethinking of trade policies and trade negotiating strategies. South Africa has a strong interest in multilateral trade negotiations and existing initiatives should be continued. But this should not be an impediment to continued development of unilateral trade reforms that will enhance industrial development. There is not a single multilateral goal of South African trade policy that would be threatened by continued unilateral trade liberalization or by tightening of domestic anti-dumping procedures, for instance. Success in global negotiations about market opening in agriculture or reforming preferential rules of origin will never hinge on some ‘concession’ that might be made by South Africa.

Looking forward, the goal of industrial policy should be to achieve a more neutral balance of incentives to bring industrial policy in line with the country’s urgent needs of job growth and poverty reduction. This would best be achieved through ongoing and economy-wide reforms. South Africa is a long way from fully exploiting the possibilities of meaningful policy initiatives of a cross cutting nature that began in the 1990s. These kinds of policies can be highly beneficial, would have broad-reaching impacts across the entire economy and would be much less susceptible to capture by special interests. Priority constraints are well known and many have been documented in recent surveys of the business and investment environment. While these are often described as ‘investment’ problems, the most important impacts of their solution would be on the overall rate of growth, on job creation and on the reduction of poverty.

We do not suggest that South Africa should desist from economic policy interventions. To the contrary. The report reveals numerous areas where better trade, competition and industrial policies are desirable. Our main concern is that such interventions are not based on real and objective economic analysis. Trade and industrial policies, sector-specific or not, are generally cross cutting in their economic impacts. Industrial policy development has tended to focus far too narrowly on the benefits to the particular parties being helped, with little recognition or analysis of their broader economic impacts. The community of stakeholders in industrial policies must be recognized as being much larger than the particular firms that benefit from protection and other government support.

Our analysis is far from comprehensive or complete. But it raises serious questions about the developmental impacts of South Africa’s industrial policies and casts doubt on some of the basic assumptions on which they have been built. A more comprehensive and objective analysis of past policies and future alternatives needs to be incorporated into current policy discussions and into ongoing policy development and evaluation.

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