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Industrial policy and unemployment: Can South Africa do better in labour-demanding manufacturing?

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In spite of policy statements prioritising labour-absorbing growth, de facto policy support has favoured heavy industry and been damaging for employment. Industrial policy should be less concerned with 'beneficiation' and technological upgrading and more concerned with promoting economy-wide efficiency. In the context of massive unemployment, this means tilting the playing field towards labour-absorbing growth to mobilise the huge potential of an under-employed and poorly-skilled workforce.

Introduction

WHILE manufacturing is a not a major source of employment expansion in most middle-income countries, the poor performance of the sector contributes significantly to South Africa's unemployment problem. A striking feature has been the rapid increase in the capital intensity of manufacturing, partly due to the poor performance of the labour-intensive sectors in relation to the relatively rapid expansion of the capital-intensive sectors. While manufactured exports have grown, it turns out that South Africa's 'revealed' comparative advantage has, somewhat paradoxically, been in capital-intensive products (e.g. steel, ferro-alloys and basic chemicals). The labour-intensive sectors have struggled to compete against imports. What are the implications for assessing past and possible future industrial policy?

Comparative advantage – three distortions

If one assumes that there will be no large-scale state intervention, the (tradable) sectors that are likely to expand most rapidly will be those with a growing comparative advantage. But comparative advantage is not simply a matter of initial endowments. It develops over time and is shaped, in part, by government policy, including industrial policy. Looking at South Africa's revealed comparative advantage, one could easily conclude that we cannot compete in more labour-demanding sectors. But before accepting this conclusion at face value, it is important to note that our revealed comparative advantage has been fundamentally distorted in three ways.

Firstly, the historical, systematic undermining of black education has limited the supply of skills and, therefore, hugely raised the cost of manufacturing. Since 1994, what can generously be described as a 'false start' in the rehabilitation of black education and artisanal training has continued to militate against competitiveness in the more labour-demanding sectors. A striking feature of the labour market in South Africa is not so much that the wages of production workers are higher than those of its competitors (although in many cases they are), but the exorbitant costs of managers and skilled staff. Based on data from a detailed international survey of manufacturing and some service sectors, a 2007 World Bank study found that unskilled workers in South Africa earned slightly less than in Poland but somewhat more than in Brazil. However, managers' wages were 2.5 and 3 times higher than in Poland and Brazil respectively. Wages of professional and skilled employees in South Africa were also much higher than in the other two countries.

Secondly, the market power of large upstream producers in sectors such as steel and chemicals has profoundly disadvantaged more labour-intensive downstream production. Upstream producers such as Arcelor-Mittal and Sasol have been able to use import parity pricing, so that local fabricators of metal and plastic products have derived no advantage from the low domestic production costs of key inputs such as steel, aluminium and basic chemicals.

The third distortion has been that heavy industry has benefited enormously from very substantial direct and indirect state support. For example, aluminium production is based entirely on low-priced electricity to process imported bauxite. Cheap electricity has been a function not just of abundant coal resources, but also of the extraordinary electricity pricing policy. Eskom's heavy over-investment in electricity capacity in the 1970s and early 1980s led government to set extremely low tariffs to attract huge investments in a series of metal processing plants. And then, with capacity running out, agreements were still being reached in 2007 (for example, with Alcan for an aluminium smelter at Coega) at highly concessionary electricity prices. In addition, the smelter investment was in line for multi-billion rand investment and tax allowances. By late 2009, however, the pressure of the heavy demand on South Africa's capacity to generate electricity led to the cancellation of the project. This R21billion greenfield investment would have employed just 800 people, with almost the entire output expected to have been exported in its primary form.

There has been public outrage at the disclosure of Eskom's preferential pricing arrangements with other large, energy-intensive industries, such as BHP Billiton's aluminium smelters. Such deals are now being reviewed in the light of the changing economic circumstances. However, the long history of artificially low electricity prices has led the economy to its current predicament: where electricity supply is inadequate and prices are rising sharply as Eskom battles to fund massive expansion of capacity.

The impact of industrial policy

While the clearly stated objective of current industrial policy is to restructure the economy to promote growth and jobs, some of the very substantial support programmes provided by government have reinforced rather than altered the industrial development path. In the 1990s, an accelerated depreciation allowance, under the 37E incentive, was given to major resource-based projects such as Columbus Stainless Steel and Saldanha Steel. From 2002 to 2005, the Strategic Industrial Projects (SIP) programme provided tax relief that was equivalent to R7.7bn for large capital-intensive projects, mostly in sectors such as steel, ferro-alloys, aluminium and basic chemicals.

Another related Department of Trade and Industry (DTI) initiative has been the funding of mega projects and industrial development zones. State support for such projects is multifaceted – and includes infrastructure support, industrial subsidies, cheap land and water, as well as preferential electricity tariffs. These developments have generally been aimed at large-scale, capital-intensive and energy-intensive projects. The Coega Industrial Development Zone in the Eastern Cape is perhaps the most controversial because of its huge scale and underutilised capacity.

Further direct state support for heavy industry has been provided by the state-owned Industrial Development Corporation (IDC), which plays an important role in influencing economic growth in accordance with government's strategic objectives. Historically, it has funded large-scale mineral beneficiation projects and has been closely associated with the parastatals as well as with the large private sector conglomerates. Only recently has the IDC started to emphasize more labour-intensive sectors such as tourism, agriculture and smaller scale enterprises.

Employment as an objective of industrial policy?

So South Africa's 'revealed'comparative advantage is, in part, the outcome of its distorted pattern of development. Powerful interests have coalesced around this capital and energy intensive growth path. Naturally these interests are opposed to any reduction in this support. While industrial policy has increasingly sought to shift industrial development onto a different trajectory, this has proved extraordinarily difficult and has met with limited success.

Industrial policy should be concerned with promoting structural change in order to improve economy-wide efficiency. This is frequently interpreted to mean that the economy is moving up the technological ladder, for example, via the promotion of diversification into non-traditional or high technology sectors. But the nature of industrial policy must depend on context and the South African context is one of massive structural unemployment.

Unemployed human resources on such a scale represent the most glaring ‘inefficiency’ afflicting the South African economy. It follows that if industrial policy is concerned with promoting economy-wide efficiency, it has to be centrally concerned with the promotion of employment-intensive growth, including in the manufacturing sector.

The bulk of South Africa’s unemployed labour is unskilled or semi-skilled and can most easily be absorbed into labour-intensive activities. The point is that, intuitively, it should be much easier (require less capital resources) to raise the productivity of an unemployed worker from zero to a low number than to achieve an equivalent productivity gain in, say, a car assembly plant, where labour productivity already is relatively high. As *Business Day* commented, “…we need to create jobs for the workforce we have, not the workforce we wish we had”.

But what of objectives such as technological upgrading, promoting the ‘knowledge economy’ and moving up the value chain? These activities can and should be supported and may be complementary to labour-absorbing growth in some ways. But in the end they constitute a limited development strategy in the South African context because a large section of the labour force is not equipped with the skills to be employed in these sectors. It can also be argued that higher employment and growth in labour-demanding activities is the best way of encouraging the upgrading of skills because income growth at the low end of the distribution of income is likely to facilitate improved educational outcomes and thus create a decent platform for vocational and tertiary education.

Conclusion: Towards employment-oriented industrial policy

Placing employment at the centre of industrial policy means support for small firms and training – particularly at a basic level – and an examination of the regulatory environment. It also means providing the appropriate infrastructure and investments in order to improve competitive capabilities in more labour-demanding activities. This does not necessarily mean that wages should be driven down – although policy makers do need to address the rigidity of labour markets in certain areas. Incentives should subsidise labour and training rather than capital investment, electricity and infrastructure for capital-intensive firms. This kind of support will lower unit labour costs, increase the productivity of both capital and labour and encourage more labour-demanding investment.

The challenge for South African industrial policy, therefore, is to tilt the playing field to favour labour-absorbing growth in order to mobilise the huge potential of an under-employed and poorly-skilled workforce.