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Addressing low labour utilisation in South Africa

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Addressing low labour utilisation in South Africa

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Abstract

South Africa's stubbornly low labour utilisation rate is an international outlier and a heavy brake on the ambitions for growth and redistribution published in various strategic policy strategies (National Planning Commission 2013). More immediately, low labour utilisation is a major obstacle to the post-COVID-19 employment recovery. The purpose of this paper is to identify the reasons for the low labour utilisation rate in South Africa. We also present potential solutions based on labour market policies of countries that have achieved a significant increase in labour utilisation. We show that increasing labour utilisation requires a shift towards employment-creating policies and fewer limits to competition in product markets and in the labour market. A significant improvement in the focus and effectiveness of labour market institutions is required, alongside supportive microeconomic policies to durably raise employment levels. These microeconomic policies need to lower costs to job creation, address school-to-job transitions, improve the employability of the inactive population and make job search more effective.

JEL classification: J08, J20, J41, J58, J60

Keywords: labour policy, labour utilisation, unemployment, South Africa

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1. Introduction^{1,2}

The 2010 OECD Economic Survey of South Africa had a special chapter devoted to the high inactivity rate of people in the country (Barnard 2010). According to the OECD, the main causes of this inactivity are an overall low rate of growth, a heavy regulatory burden for entering markets, poorly coordinated wage bargaining, settlement structures that are far from economic nodes, and a high rate of youth unemployment, especially among black South Africans. Unfortunately, not much has changed since then (OECD 2019a). Unemployment is still extremely high and unevenly distributed, being concentrated among young, less-skilled black South Africans (IMF 2020).

South Africa's stubbornly low labour utilisation rate is an international outlier and a heavy brake on the aspirations published in various strategic policy strategies by the government (National Planning Commission 2013).³ It is also a major obstacle to a broader employment recovery post-COVID-19, raising a serious risk of hysteresis. The Quarterly Employment Survey estimates that the formal non-agricultural sector lost around 630 200 jobs in the second quarter of 2020. The Quarterly Labour Force Survey for December 2020 shows about 330 000 jobs created in the fourth quarter and 1.4 million jobs lost for the year. These job losses are on top of very disappointing employment growth over the last decade.

The failure of the labour market to contribute to higher activity levels implies that it also acts as a constraint at a macroeconomic level, inhibiting fiscal and monetary policies in supporting stabilisation and long-run growth. The structural nature of low labour utilisation reduces the responsiveness of wage setting to shocks. This in turn imposes a constraint on monetary policy and reduces the effectiveness of inflation targeting (Bhattarai 2016).

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² We would like to thank an anonymous referee for their useful comments and suggestions as well as participants in a seminar at the SARB on 8 October 2020.

³ A productivity gap measures how far a country is from the global productivity frontier. A labour utilisation gap measures how much labour is being used per working age adult relative to other economies.

The purpose of this paper is to identify the reasons for this low labour utilisation rate and present solutions based on policies from countries that have achieved a significant increase in labour utilisation. The implementation of these policies is more urgent than ever given the large employment losses in 2020 due to the COVID-19 crisis. These policies need to address school-to-job transition, speed up job creation, improve the employability of the inactive population, and make job search more effective. The policies should also be supported by industrial and competition policies that increase market dynamism and labour utilisation.

2. Labour market models

In this section we review three labour market models that are important in understanding South African labour dynamics. These are the “flow matching” and Beveridge curve approach; the model of union and wage-setting arrangements; and the efficient wages perspective.

2.1 Flow matching and the Beveridge curve approach

Pissarides (2000) presents the foundations of this approach. Unemployment is in equilibrium when hires (H) are equal to the separations from employment (S). Workers and jobs are heterogeneous. In this case, the role of the labour market is to achieve efficient matching of unemployed workers with available vacancies. The matching function can be expressed as:

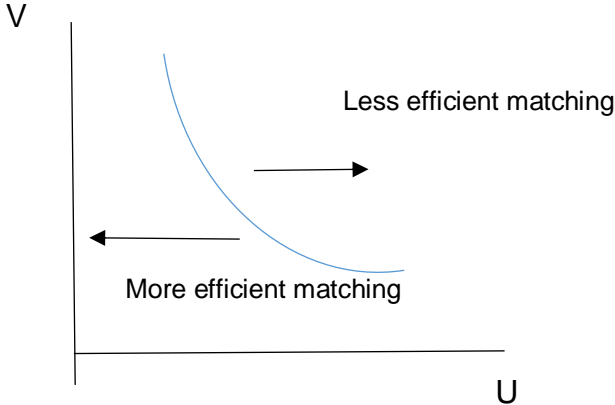
$$H = \alpha \cdot m(U, V)$$

where U is the number of unemployed, V is the number of vacancies, and α is the efficiency parameter. A higher number of new hires requires greater matching efficiency. Assuming that the separation rate is exogenous and constant and that matching takes place under constant returns to scale, we can generate the Beveridge curve. This is a vacancy-unemployment curve which shows the labour market equilibrium.

At high levels of unemployment, such as during a recession, the number of vacancies is low with a given approach for matching. When unemployment is low, such as during

a boom, more vacancies are available for each job searcher. If matching is less efficient, then the curve shifts to the right, indicating that a larger number of vacancies and job searchers is required to ensure equilibrium in the market.

Figure 1: Beveridge curve



Source: Adapted from Carlin and Soskice (2015).

Carlin and Soskice (2015) link the Beveridge curve to wage and price outcomes and show how these are affected by changes in the matching rate. A deterioration in matching increases the vacancy rate for any given rate of unemployment. The higher vacancy rate increases the wage that workers can bargain for or employers need to provide to attract good workers. The equilibrium unemployment is higher and inflation increases. Alternatively, an increase in wages and prices with the Beveridge curve remaining unchanged leads to a movement along the curve. Equilibrium unemployment is higher and the vacancy rate is lower. This change in the unemployment rate offsets the impact of higher wages on the total wage bill.

This model suggests that any factor that reduces matching efficiency leads to higher structural unemployment. These include barriers to occupational and geographic mobility; employment protection legislation that may affect the ability of employers to hire workers; entry barriers for new suppliers, which slow down the flow of new vacancies; and factors that increase wages structurally like the legal extension of collective agreements.

2.2 Unions and wage-setting arrangements

This framework is based on the work of Lars Calmfors and John Driffill.⁴ In their model, the relationship between the degree of centralised wage setting and the equilibrium rate of unemployment is hump-shaped. The framework assumes that all workers are unionised and compares the unemployment outcomes under different wage-setting regimes, at firm level, at industry level, and at the level of the economy as a whole. At the firm level, every firm has its own union, while at the industry level there is only one union for the entire industry. In the economy-wide wage-setting regime, the wage setters take into account the economy-wide impacts of their actions. The different regimes reflect different union expectations regarding the impact of wage increases on employment and the economy as a whole.

When there is one union per firm, the union will worry how higher wages are likely to decrease firm competitiveness and sales, ultimately impacting employment. This serves to reduce the power of unions imposing above-equilibrium wages. Also, the general economic conditions would be taken as given as each union is too small to influence them.

By contrast, unions at the industry level are less likely to take into account the employment effects as they assume that the industry is not facing competition from other industries due to limited product substitution. They will also ignore the economy-wide effects of their actions, because eventual losses and benefits are distributed to the economy at large (some other sector or marginal worker) and not perceived to be associated with wage-setting at the industry level. Workers may not have a clear view of how wage-setting affects the likelihood of themselves becoming unemployed.

A union setting wages for all workers in the economy is considered to take into account the impact of real wage gains deviating from productivity growth or of international product competition. They recognise that increasing all wages in the economy without increasing productivity would simply increase inflation and leave real wages unchanged. In this case, the union maximises utility by going for the highest possible employment level.

⁴ See Calmfors and Driffill (1988).

Related to this model is the insider-outsider theory of labour markets. Incumbent workers enjoy more favourable conditions because of labour turnover costs.⁵ Additional costs arise as insiders resist competition from outsiders by refusing to cooperate and harassing outsiders. Given that these costs are at least partially borne by employers, insiders are given market power. This is used to push wages above the market clearing level. The framework generates unemployment persistence and eventually hysteresis.⁶

In South Africa, many industries are characterised by insiders exercising power over outsiders via collective agreements. These are legally extended to all workers and employers in a sector and a region. This procedure also acts as an entry barrier for new suppliers and therefore incumbent suppliers can charge higher prices.

2.3 Efficiency wage model

Carlin and Soskice (2015) describe an efficiency wage model.⁷ This framework tries to explain why we observe involuntary unemployment and why wages do not adjust to clear the labour market. The key argument is that companies pay a premium over the market clearing wage to deal with shirking, fairness and turnover costs. The higher wage is an incentive to work harder but it also increases the cost of being fired. Firms can monitor effort only imperfectly depending on the industry and technology. The firms' problem is to identify the minimum wage to induce a certain effort level and monitor performance.

The optimal wage equation for firms depends positively on the level of unemployment benefits and disutility of work; negatively on the probability of being dismissed if shirking; and negatively on the unemployment rate. Higher unemployment benefits reduce the cost of being fired and thus require a higher premium to induce the required level of effort. The disutility of work also reduces the cost of being fired. A higher

⁵ Another source of insider power is bargaining on the entry level wage, which drives up the gap between wage cost and actual productivity for younger workers, reducing demand for them. This, with compression of regional pay disparities, is common in South African collective bargaining.

⁶ See Lindbeck and Snower (2001) for a detailed explanation of the model and review of empirical evidence.

⁷ The efficiency wage model is based on the seminal work of Akerlof (1984) and Shapiro and Stiglitz (1984).

probability of being dismissed due to shirking increases the probability that a worker will face the cost of being fired. A higher unemployment rate increases the shirking costs for workers and thus firms can pay a lower efficiency wage.

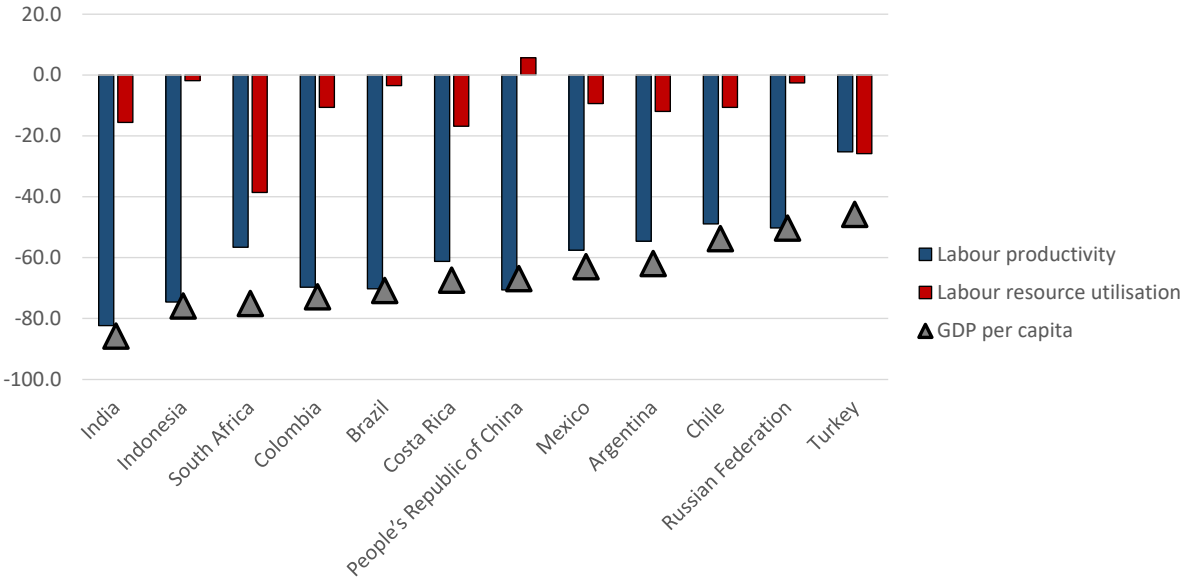
This also suggests that in this framework higher unemployment benefits increase the equilibrium unemployment rate while lower firing costs decrease the equilibrium unemployment rate. It is the relationship between firing costs and unemployment which makes this model applicable to South Africa, as we illustrate later in the paper.

South Africa's labour market is segmented. Unemployment for skilled workers is low, while unemployment for semi-skilled and in particular low-skilled workers is high. Youth unemployment is very high. These models explain different characteristics of the South African labour market. It is the interaction and interlinkages between the different skill markets that generates particularly high unemployment outcomes. The South African economy has wage setting on an industry level for certain sectors, high firing costs and inefficient matching processes. This is exacerbated by shortages of skilled labour which lead to a large wage premium for skilled workers but also lower demand for other skills through complementarity linkages (fewer skilled workers directly lower demand for less-skilled workers).

3. Labour utilisation drivers

The low level of economic activity of South Africa's working age population puts it far behind the gross domestic product (GDP) per capita achieved in other countries with a similar labour productivity level (such as Costa Rica, Mexico and Argentina; see Figure 2). Columbia and Brazil achieve a higher GDP per capita relative to advanced economies, compared to South Africa, because they employ more of the working age population (achieving a much lower labour utilisation gap (Figure 2)) and despite their lower formal sector productivity levels. This low utilisation rate is the result of several factors. These include the high unemployment of young people, the unemployment variation across different regions, the rate of economic growth, the ineffectiveness of wage-bargaining institutions to support job creation and the absence of a public employment service. We discuss each of these in more detail below.

Figure 2: Countries covered in the OECD’s Going for Growth exhibit large variation in GDP per capita (compared to the upper half of OECD countries, 2018)⁸



Source: OECD (2019a)

3.1 Youth unemployment

South Africa has one of the highest unemployment rates of its young, predominantly black, population (Figure 3). The large labour utilisation gap reflects the extreme rate of unemployment of black school leavers who do not continue with university studies. This suggests that even 25 years after the transition to a democratic system, the scars of a weak education system from the apartheid period are still present. Among these are the significant infrastructure deficiencies of educational institutions in low-income areas, high student/teacher ratios and ongoing teacher absenteeism.

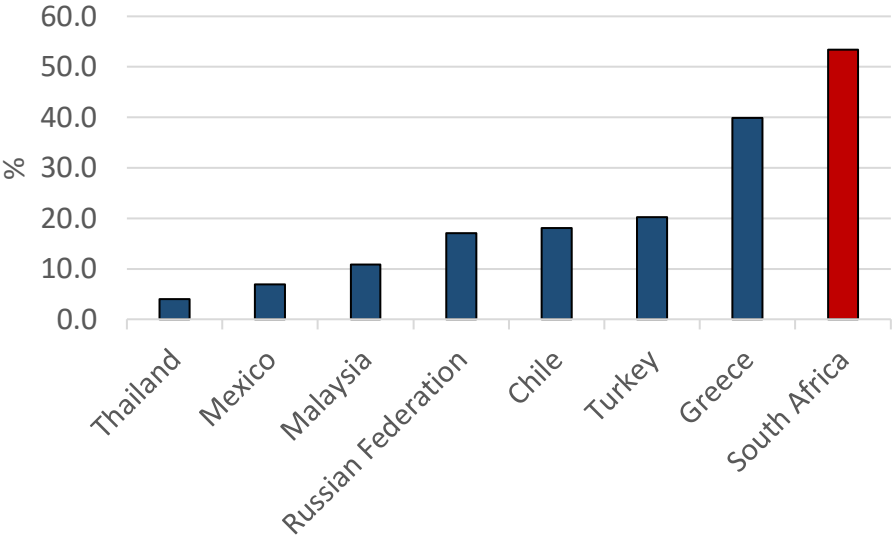
High youth unemployment occurs, in part, if the school-to-job transition does not work properly. Countries with low youth unemployment, like Germany, Netherlands and Austria, have vocational education systems with a significant share of in-work training. Employers play a key role in channelling students on these education tracks into guaranteed employment after graduation. Up to a quarter of a cohort participate in such

⁸ Labour productivity is measured as GDP per hour worked. Labour resource utilisation is measured as the total number of hours worked over the population aged 15-74. The comparison is based on the weighted average using population weights of the 18 OECD countries with highest GDP per capita in 2018 based on 2018 purchasing power parities. The sum of the percentage difference in labour resource utilisation and labour productivity does not add up exactly to the GDP per capita difference since the decomposition is multiplicative.

programmes and another quarter is enrolled in upper secondary vocational schools with experienced and qualified teachers. The quality of vocational training is regularly checked by boards with strong stakeholder (social partner) participation.

South Africa has not set up a similar institutional infrastructure to copy a comprehensive “German-style” apprenticeship system, while job-placing vocational training programmes that are in place are not popular and are seen to be low quality (Murtin 2013), limiting demand for them by students and employers.

Figure 3: Youth unemployment across countries (2018)

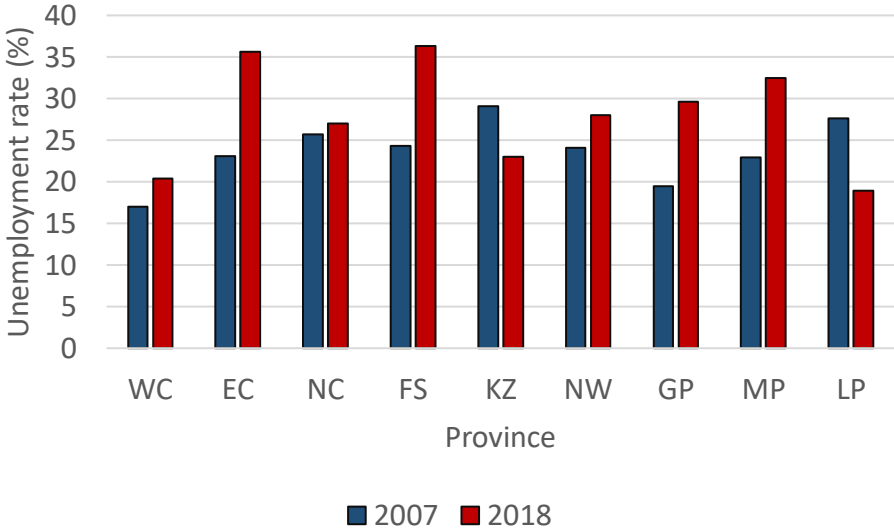


Source: Haver, OECD (2010a).

3.2 Regional and structural unemployment

Another obstacle to higher labour force participation is the geographic distribution of the population, a large portion of which is often located some distance from where jobs are available. Social housing is mainly located where land is cheap, which is usually not where employment opportunities are available. Informal housing is filling the gap with only private minibuses operating uncoordinated networks (OECD 2015). This increases job search costs and reservation wages, generating inefficient labour market outcomes (Diamond 1982). As a result, unemployment varies greatly across provinces (Figure 4). This is a visible and persistent legacy of the apartheid settlement policy.

Figure 4: Regional unemployment (2007/2018)

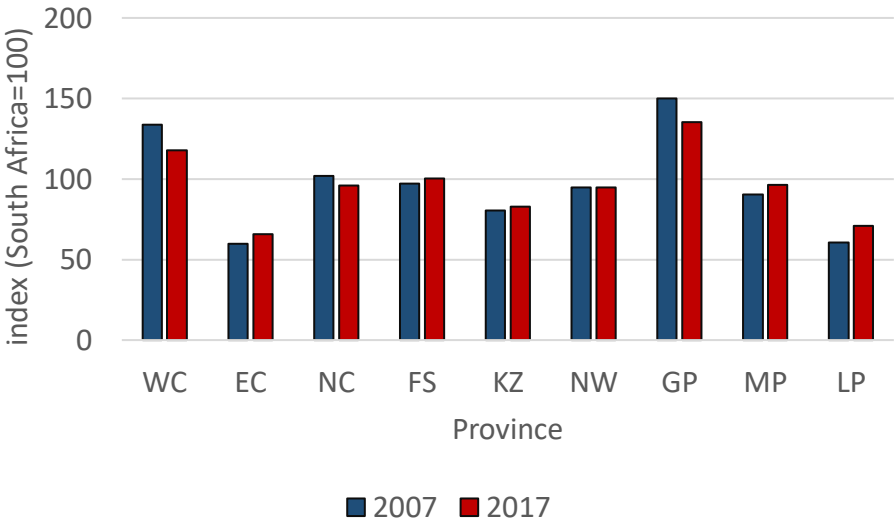


Note: WC: Western Cape; EC: Eastern Cape; NC: Northern Cape; FS: Free State; KZ: KwaZulu-Natal; NW: North West; GP: Gauteng; MP: Mpumalanga; LP: Limpopo.

Source: Statistics South Africa.

Geographic variation in the level of economic activity is even larger than of unemployment. In 2008, GDP per capita was nearly three times as high in Gauteng than in Eastern Cape (Figure 5). Over time, this variation declined and in 2017 the largest difference in economic activity between Eastern Cape and Gauteng declined to two times (of GDP per capita in Eastern Cape). In 2008, provinces with higher unemployment had lower GDP per capita. This relationship is less evident now as a lower unemployment rate in KwaZulu-Natal and Limpopo has not been accompanied by a higher GDP per capita.

Figure 5: Regional GDP per capita variation



Source: Statistics South Africa.

These differences across provinces reflect a rural-urban divide. Even 25 years after the transition to a democratic system, the mobility of the rural population is severely restricted by high transport costs, resulting in an unemployment gap of 24% between former homelands and non-former homeland areas (Kwenda, Benhura and Mudiriza 2020). The population of traditional settlement areas is black (Table 1). In these areas, more than half of families have a female head of household who relies on income from a migrant spouse. Average household income is only one third of that of urban areas. Traditional settlement areas are over-represented in pockets of poverty (Lehohla and Shabalala 2014).

Table 1: Percentage distribution of households by characteristics of household head and type of settlement

| Population group and gender of household head | Urban area | Traditional area | Farm | Total |
|------------------------------------------------------|-------------------|-------------------------|-------------|--------------|
| <i>Distribution by race</i> | | | | |
| Black African | 70.9 | 99.3 | 71.7 | 78.6 |
| Coloured | 9.7 | 0.2 | 12.7 | 7.3 |
| Indian | 3.5 | 0.2 | 0.4 | 2.4 |
| White | 15.2 | 0.1 | 14.8 | 11.1 |
| Other | 0.7 | 0.2 | 0.5 | 0.6 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| <i>Distribution by gender</i> | | | | |
| Male | 62.4 | 47.2 | 73.1 | 58.8 |
| Female | 37.6 | 52.8 | 26.9 | 41.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| <i>Proportion of the population by race</i> | | | | |
| Black African | 61.0 | 34.2 | 4.8 | 100.0 |
| Coloured | 90.2 | 0.7 | 9.1 | 100.0 |
| Indian | 92.7 | 1.9 | 0.9 | 100.0 |
| White | 86.7 | 8.6 | 4.6 | 100.0 |
| Other | 67.7 | 27.1 | 5.3 | 100.0 |
| <i>Proportion of the population by gender</i> | | | | |
| Male | 71.8 | 21.7 | 6.5 | 100.0 |
| Female | 61.9 | 34.7 | 3.4 | 100.0 |

Source: Lehohla and Shabalala (2014).

During the apartheid era, traditional settlement areas were deprived of development opportunities and (mis)used as sleeping villages for low wage-low skills labour. No wonder little economic activity happened in these areas, which were also not suitable for agricultural production. Furthermore, public services were of low quality. According to the 2011 census, the 10 poorest municipalities were located in former homelands, which are typically traditional settlement areas (Lehohla and Shabalala 2014). More

than a quarter of the South African population lives in such territories. Hysteresis of bad initial conditions and an institutional design which fosters immobility instead of entrepreneurship and innovation, make traditional settlement areas a drag on overall economic development.

However, a large part of this rural-urban gap is also explained by skills and resource differentials (Arndt, Davies and Thurlow 2019). Appropriate interventions such as increasing entrepreneurial capacity, lifting the basic education level and reforming social housing policies would increase the participation in economic activity of people living in remote and traditional settlement areas.

3.3 Gender imbalances

Provincial differences and low labour utilisation also reflect the large gap between male and female labour force participation and employment. Unemployment is more prevalent for women than for men. The transition rate into employment is also higher for men compared with women (Statistics South Africa 2016). The gender gap is wider at young ages and decreases over the life cycle, but it still remains (Mosomi 2019). In Northern Cape, Free State, North West and Mpumalanga, female unemployment is more than 10 percentage points above male unemployment rates (Table 2). Eastern Cape, Gauteng and Limpopo have a gender unemployment difference which is close to the countrywide average, while in Western Cape and KwaZulu-Natal female unemployment is only one to two percentage points higher than male unemployment.

As shown in Table 2, between 2007 and 2018 unemployment rose around 10 percentage points or more in Eastern Cape, Free State, Gauteng and Mpumalanga. It fell against the trend in KwaZulu-Natal and Limpopo. In Western Cape, Northern Cape and North West, unemployment rose broadly in line with the countrywide trend. Labour force participation is relatively high in Gauteng, Mpumalanga and Western Cape. It is very low in Eastern Cape, KwaZulu-Natal and Limpopo, and around average in Northern Cape, Free State and North West.

These differences in male and female employment are the result of human capital accumulation, the traditional role of women as care givers, the low participation of

women in male-dominated occupations, and the lower participation of African women in the labour force, among other factors (Mosomi 2019).

Table 2: Unemployment rate

| % | Sept. 2007 | Sept. 2018 | 2007 | 2018 | Participation | |
|---------------|---------------|---------------|-----------------|-----------------|---------------|----------|
| | | | Female- Male | Female- Male | 2007/III | 2018/III |
| Western Cape | 17.0 | 20.4 | 1.3 | | | 71.4 |
| Eastern Cape | 23.1 | 35.6 | 7.0 | | | 60.5 |
| Northern Cape | 25.7 | 27.0 | 13.0 | | | 67.7 |
| Free State | 24.3 | 36.3 | 11.6 | | | 69.6 |
| KwaZulu-Natal | 29.1 | 23.0 | 2.8 | | | 63.7 |
| North West | 24.1 | 28.0 | 10.6 | | | 68.0 |
| Gauteng | 19.5 | 29.6 | 6.7 | | | 75.6 |
| Mpumalanga | 22.9 | 32.5 | 13.6 | | | 72.1 |
| Limpopo | 27.6 | 18.9 | 6.1 | | | 63.8 |
| South Africa | 23.0 | 27.5 | 6.7 | 3.5 | | 68.8 |

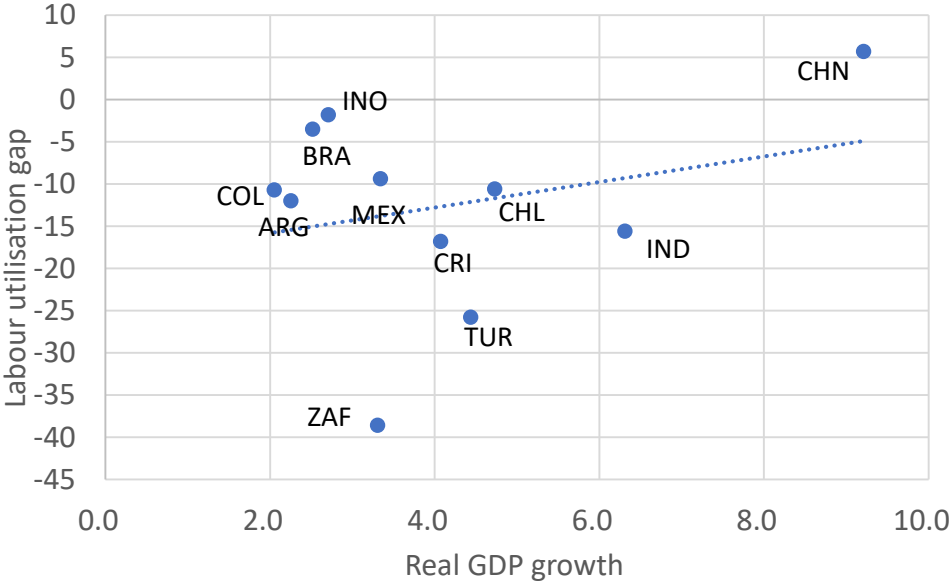
Source: Statistics South Africa, Labour Force Survey 2008 and 2019.

Note: Female-Male is the difference between female and male unemployment rates.

3.4 Low economic growth

Of course, the low trend growth rate in South Africa has not helped to absorb a rapidly growing population into the formal labour market (Figure 6). One reason for South Africa's low growth rate is the decline of (normally higher-productivity) export-oriented manufacturing as a percentage of total output since the beginning of the 1990s, which was accompanied by declining profitability in this sector (Rodrik 2008). However, there are countries with much lower trend growth rates (Colombia, Argentina, Brazil, Indonesia and Russia), which manage to keep a much higher share of the population economically active.

Figure 6: Average GDP growth and labour utilisation



Notes: ARG: Argentina; BRA: Brazil; CHN: China; CHL: Chile; COL: Colombia; CRI: Costa Rica ; IND: India; INO: Indonesia; MEX: Mexico; TUR: Turkey; ZAF: South Africa.

Source: OECD Economic Outlook Database and OECD (2019a).

Following the trend line, an increase of South Africa’s trend growth rate by one percentage point would increase labour resource utilisation by about two percentage points. In other words, if South Africa achieved the same growth rate of real GDP as China, its labour resource utilisation gap would decline from 38 percentage points to 26 percentage points. This means that South Africa needs about twice the economic growth in order to achieve the same labour resource utilisation as Turkey. Compared to Brazil or Indonesia, things are even worse. South Africa’s labour resource utilisation is about 35 percentage points lower, even though its trend growth rate has been about one percentage point higher. Growth helps, but more is needed to increase labour utilisation in South Africa.

There are several reasons why the South African economy is not generating the required growth rates to absorb its unemployed, nor making growth more labour-intensive.⁹ One of the more important factors is the low level of competition in the South

⁹ These include the availability of skilled workers, the savings rate, the cost of transportation and the regulatory environment. See for example Faulkner, Loewald and Makrelov (2013), Loewald, Faulkner and Makrelov (2020), National Treasury (2019) and OECD (2017).

African economy. This in turn is due to high barriers to entry, a rigid regulatory environment and a high regulatory burden on small and medium-sized enterprises. Table 3 shows that South Africa is among the countries with the least competition-friendly product market regulation indicators (Koske et al. 2015). South Africa is exposed to particularly heavy regulations, high market concentration cumbersome licensing and permits, and complex regulatory procedures.

Competition-friendly product market regulations foster innovation, productivity and job creation (Egert 2018; Griffith, Harrison and Macartney 2007; Nicoletti and Scarpetta 2003).¹⁰ This synergy between product market reforms and the functioning of the labour market is particularly important in South Africa. During the apartheid regime, an industrial policy of national champions inhibited competition. The effects of this policy were exacerbated by embargo-enforced isolation during this time. As a consequence, mark-ups and concentration are still relatively high (Fedderke, Obikili and Viegi 2018).

Table 3: Product market regulation indicators

| Non-OECD countries | Total network sectors | Total energy | Total transport | Total ecommerce | Interaction with interest groups |
|----------------------------------|------------------------------|---------------------|------------------------|------------------------|-----------------------------------------|
| <i>Argentina</i> | 2.58 | 2.37 | 2.88 | 2.17 | 2.05 |
| <i>Brazil</i> | 1.94 | 2.53 | 2.29 | 0.68 | 5.18 |
| <i>Bulgaria</i> | 1.35 | 1.62 | 1.81 | 0.18 | 2.73 |
| <i>Costa Rica</i> | 2.96 | 4.50 | 3.03 | 2.05 | 3.82 |
| <i>Croatia</i> | 1.53 | 1.49 | 2.15 | 0.35 | 3.41 |
| <i>Cyprus^{d,e}</i> | 1.58 | 2.93 | 0.97 | 1.84 | 3.41 |
| <i>Kazakhstan</i> | 2.60 | 2.66 | 2.39 | 2.95 | 3.82 |
| <i>Malta</i> | 1.44 | 3.83 | 1.36 | 0.38 | 3.14 |
| <i>Romania</i> | 1.73 | 1.87 | 2.11 | 0.84 | 2.45 |
| <i>South Africa</i> | 2.59 | 3.52 | 2.20 | 2.46 | 4.91 |
| OECD average^a | 1.46 | 1.41 | 1.83 | 0.79 | 2.56 |
| OECD top 5 best countries | 0.93 | 0.44 | 1.24 | 0.09 | 0.98 |

Source: OECD, Indicators of Product Market Regulation.

One origin of weak competition in the South African economy is its relatively low exposure to international trade. Because of its focus on domestic markets, commodity exports and business culture shaped in part by historical sanctions, the South African

¹⁰ The positive effects of competition-friendly regulation are recurring themes in OECD recommendations, for which a large body of economic literature exists. Numerous references can be found in OECD Economic Surveys and the Structural Policy Reform Series.

economy is not very well integrated in global value chains. Part of this deficiency could be related to high non-tariff barriers within the Southern African Development Community.¹¹ This poor level of integration suggests large losses, as experiences from other regions indicate that the international division of labour is a forceful driver of economic growth (Fengru and Guitang 2019).

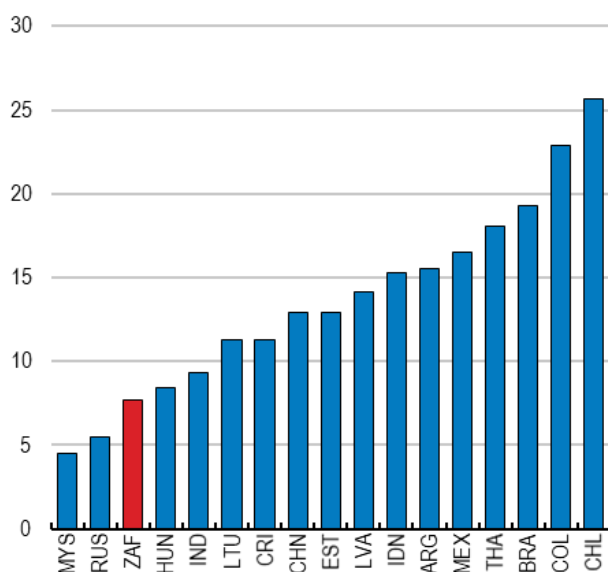
Although South Africa has a well-developed core with leading companies in some sectors, the majority of economic activity is far behind the international efficiency frontier. In this situation, access to best practice technologies (catching up to the efficiency frontier) is more important than shifting the frontier itself (Kreuser and Newman 2018).

Most chances for finding ‘missing’ jobs in South Africa to compensate for the employment losses in export-oriented manufacturing and mining are in services sectors. International experience shows that countries with a more competition-friendly regulatory framework can achieve higher productivity growth and create more employment opportunities in services sectors (Arnold and Wörgötter 2011). Job creation in services sectors have also been retarded by the insufficient and costly supply of telecommunications, transport and especially energy. These network services are crucial inputs that act as multipliers for start-ups, innovation and job creation. The fragmented availability of ‘old’ network outputs, like electricity, and volatile regulatory pricing of these services, are likely to prove to be severe obstacles to a more dynamic economic environment. Some evidence for this comes from data on entrepreneurial activity. Planning or starting entrepreneurial activity is undertaken less frequently in South Africa than in other countries (Figure 7). Informal activity or self-employment is also less widespread than in other comparable countries. Furthermore, entry rates seem to be lower than exit rates, increasing concentration and reinforcing the dominance of surviving incumbent firms (OECD 2017a).

¹¹ OECD (2017a).

Figure 7: Early-stage entrepreneurial activity is low

% of working-age population, 2014-16 average



Notes: MYS: Malaysia; RUS: Russia; ZAF: South Africa; HUN: Hungary; IND: India; LTU: Lithuania; CRI: Costa Rica; CHN: China; EST: Estonia; LVA: Latvia; IDN: Indonesia; ARG: Argentina; MEX: Mexico; THA: Thailand; BRA: Brazil; COL: Colombia; CHL: Chile.

Source: OECD (2017a).

3.5 Wage bargaining

It is hard to overstate the importance of the labour market to economic outcomes, both microeconomic and macroeconomic. Ideally, wage bargaining achieves a healthy balance between providing incentives to work and appropriate remuneration of scarce skills, while allowing firms to successfully compete in product and services markets. This task is far from trivial because of the high level of information required. Successful wage-bargaining systems address the asymmetric information situation either with highly co-ordinated collective agreements or by relying on more decentralised and effective competition in labour and product markets (Calmfors and Driffill 1988). Systems falling between these ends of the spectrum, such as those situating wage bargaining at industry level and legally extending wage agreements to all firms as in South Africa, are well-understood to be least effective in this broader coordination task, as discussed earlier. They are normally dominated by big, key players, limiting competition, but are also insufficiently centralised to take into account the macroeconomic effects of bargained outcomes. The high concentration and pricing power on output markets contributes to the bargaining outcomes, which ignore economy-wide concerns.

With the high degree of labour market segmentation (discussed below), such bargaining systems also result in real wages that are too high to clear the labour market, particularly for less skilled workers, and fail to facilitate employment growth in line with demographic developments. This, alongside high costs of firing, directly contributes to high unemployment rates. As a result of these factors, the South African labour market is generally considered to be inflexible (Fedderke 2006).¹²

Where macroeconomic constraints and inflationary consequences of wage bargaining are not internalised, wage-price spirals can emerge, leading to high-risk premia on long-term interest rates. Monetary policy interventions are less effective as labour market frictions maintain a high equilibrium inflation rate and wages are sticky, preventing monetary policy transmission (Bhattarai 2016). These then weigh on financing costs, especially for long-term investments in infrastructure and innovation, and economic growth. South Africa's inflation outcomes were until recently clustering at the upper end of an already high and wide inflation target band, supported in the main by high growth in unit labour costs (Fedderke and Liu 2018).

Where collective bargaining systematically extends wage agreements regionally, this has been shown to decrease employment opportunities, especially in small and medium-sized firms (Magruder 2012). Weakly contested product markets, together with the extension of collectively agreed wages among insiders, acts as a barrier to entry and likely impedes new firms from entering the market and growing.

Furthermore, supply-side rigidities like skills shortages and the high number of unskilled school leavers generate high wage inequality (Van der Berg 2014). These skills shortages also contribute to persistent unemployment as they limit the ability of firms to increase employment during economic booms (Stevens 2007).

3.6 Weak public employment service

Most countries with low unemployment rates also have strong public placement services and provide significant resources for active labour market programmes. South Africa's labour market primarily relies on private job matching and there are few active

¹² This section focuses on wage-related aspects of labour market rigidity. Other aspects are addressed in section 4 on South African policies to tackle inactivity.

labour market programmes. Where job matching works poorly, the positive externalities for fiscal policy and growth, like higher employment levels, are foregone. Some countries achieve good results with a clearly defined mix of private and public institutions providing activation services (Finn 2016). The following key aspects of public employment services (PES) (Baptista et al. 2016: 14) involve positive externalities not captured by private job brokers but by society as a whole:

1. Job brokerage through public dissemination of vacancies.
2. Provision of information about vacancies and searching workers.
3. Market adjustments to supply and demand.
4. Management of unemployment benefits.
5. Management of labour migration by coordinating mobility across borders. In recent years, this has become an increasing part of the service portfolio but is still neglected by national labour market policies.

PES's are established in most countries to help the reallocation of labour in the wake of structural changes, ordinary churn, school-to-work transitions, as well as recovery after a crisis. In particular, PES assist workers who want to enter the labour market, get training or requalification, enter employment and find appropriate career tracks to make the most of the transition from education to employment (OECD 2014, 2016b). These tasks require a well-resourced institution with a clear governance structure. A particularly successful example of an efficient public employment service is the German *Bundesagentur für Arbeit*, which went through a series of reforms in the early 2000s (Fleckenstein 2008). Many countries have established PES institutions to support job searchers, upgrade skills and provide wage subsidies for vulnerable groups in the labour force (Baptista et al. 2016). An important feature of PES is a focus on productivity, which helps to improve the quality of work and the outlook for higher wages.

In South Africa, PES are under-resourced and do not have the quantity and quality of counsellors necessary to provide effective services for millions of job seekers. Instead, PES have been privatised “by default” (Medforth 2005). Private recruitment and employment agencies primarily focus on profitable segments of the placement markets, leaving much of the market where unemployment is highest without service. Transition rates between states of employment indicate that 90% of those not

economically active remain in that position and only 3% manage to find a job, while around 10% of the unemployed find a job within one quarter (Table 4). This suggests the potential for large economic gains from such services.

Table 4: Retention and transition rates by labour market status, 2014 and 2019

| | Labour market status 2014Q4 (in % of 2014Q3) | | | |
|------------------------------|----------------------------------------------|------------|-------------------------|-----|
| Labour market status 2014/Q3 | Employed | Unemployed | Not economically active | 100 |
| Employed | 93.0 | 3.1 | 3.9 | 100 |
| Unemployed | 13.0 | 65.5 | 21.5 | 100 |
| Not economically active | 3.7 | 5.5 | 90.8 | 100 |

| | Labour market status 2019Q4 (in % of 2019Q3) | | | |
|------------------------------|----------------------------------------------|------------|-------------------------|-----|
| Labour market status 2019/Q3 | Employed | Unemployed | Not economically active | 100 |
| Employed | 94.0 | 3.1 | 2.9 | 100 |
| Unemployed | 9.7 | 74.2 | 16.1 | 100 |
| Not economically active | 2.6 | 6.7 | 90.7 | 100 |

Source: Statistics South Africa (2020).

A major expansion of such services should be initiated by consultation and cooperation among stakeholders and different designs tested in pilot phases in different regions and sectors of the economy. Without a well-functioning service, South Africa’s labour market will continue to be highly stressed by a range of developments, including ageing, further technological change and associated shifts in the skills required of the workforce.

4. South Africa’s labour policies over the last decade

In this section, we discuss the effects on labour utilisation of key labour market-related interventions implemented over the last decade. We focus on the introduction of the employment tax incentive and national minimum wage, employment equity and Broad-Based Black Economic Empowerment, labour market flexibility and amendments to regulate temporary employment. We draw extensively on the South African literature and our measure is whether policy instruments improve labour utilisation.

4.1 The National Development Plan¹³

The National Development Plan assessed the employment problem as follows, highlighting the link between product and labour markets:

Uncompetitive markets for goods and services and low levels of investment mean that new firms are not entering the market and employment is low. Uncompetitive labour markets keep new entrants out and skew the economy towards high skills and high productivity. (National Planning Commission 2013: 111)

The plan presents an ambitious reform to increase employment in rural areas and address spatial problems, develop new industries and new firms that support employment growth, and capture global market share. Industrial policies were meant to play a pivotal role in supporting growth and employment:

South African industrial policy will transition from its historical approach of favouring energy- and capital-intensive goods production, sometimes with limited domestic linkages, towards an increasingly diversified industrial base. It is often presumed that substantial employment might be created through trade in light manufactured goods. (National Planning Commission 2013: 127).

Chapter 3 of the plan proposes to increase employment and economic growth, recognising that eliminating constraints to economic growth would also increase employment. The recommendations for increasing the employment intensity of growth are:

- expanding the public works programme;
- introducing a tax incentive to employers to reduce the initial cost of hiring young labour market entrants;

¹³ The National Development Plan is available at https://www.gov.za/sites/default/files/gcis_document/201409/ndp-2030-our-future-make-it-workr.pdf

- providing a subsidy to the placement sector to identify, prepare and place matric graduates in jobs;
- getting business and labour to develop their own proposals to reduce youth employment;
- encourage skilled immigration;
- adopt an approach to handling probationary periods that reflects the intention of probation;
- simplifying dismissal procedures; and
- strengthening dispute resolution mechanisms in the labour market.

In addition, the plan argues for specific labour regulations for small businesses to reduce the cost of complying with the current regulations, as well as for various interventions to strengthen the capacity of labour courts and the CCMA to deal with labour cases.

Many of these proposals have not been implemented or have been only partially implemented. Although a tax incentive to support youth employment was introduced, little progress has been made on skilled migration. Efforts to boost economic growth with industrial policy, as discussed below, have failed to create the industries and jobs envisioned in the National Development Plan.

4.2 Labour market flexibility

Labour market regulations have long been analysed and understood to be major obstacles to employment creation in South Africa (Godfrey, Theron and Visser 2007; Rankin 2006). The need for greater labour market flexibility was discussed extensively in the National Development Plan. Table 5 shows several measures of labour market flexibility by country income group.¹⁴ According to these measures, it is more difficult to hire and fire workers in South Africa than in other middle income and OECD

¹⁴ The “Difficulty of Hiring Index” measures restrictions on part-time and temporary contracts, together with the minimum wage for trainees relative to worker value-added; the “Rigidity of Hours Index” measures restrictions around work hours and overtime; the “Difficulty of Firing Index” ranks specific legislative provisions on dismissal; the “Non-wage labour costs” measures the social protection costs associated with hiring a worker; and finally, the “firing cost” measures the costs of legislated prior notice requirements, severance pay and any other costs related to firing a worker.

countries. South Africa has an employment rigidity index that is comparable to those in low-income countries.¹⁵ The OECD's measures show South Africa as having long and costly firing costs for small and medium-sized companies (OECD 2010, 2017).

Table 5: Labour market rigidities

| Area of regulation | Low income | LMI | UMI | HI-non-OECD | Hi-OECD | South Africa | Total |
|----------------------------------------|------------|------|------|-------------|---------|--------------|-------|
| Difficulty of hiring | 44.3 | 33.7 | 29.9 | 27.0 | 20.6 | 44.0 | 34.3 |
| Rigidity of hours | 47.6 | 39.6 | 40.6 | 45.2 | 32.0 | 40.0 | 42.4 |
| Difficulty of firing | 40.0 | 33.0 | 33.4 | 27.4 | 14.0 | 40.0 | 33.3 |
| Aggregate rigidity of employment index | 44.0 | 35.5 | 34.6 | 33.2 | 22.2 | 41.3 | 36.7 |
| Non-wage labour cost | 12.4 | 16.0 | 17.2 | 21.4 | 10.2 | 2.4 | 15.6 |
| Firing costs | 65.3 | 50.9 | 44.6 | 31.3 | 54.6 | 24.0 | 51.3 |

Notes: LMI – lower middle income; UMI – upper middle income; HI – high income. The measures are standard and drawn from the World Development Report (2005). All indices are normalised to 0.

Source: Borhat and Stanwix (2018).

The employment chapter of the National Development Plan made proposals to strengthen labour market institutions and improve dismissal processes, making it less costly for firms to hire and fire. Specific proposals dealt with the handling of probation periods, dismissal procedures for poor performance and misconduct, and accelerating dismissal processes. Despite the recommendations from the National Planning Commission, progress to define and implement any reforms has been slow.

4.3 The employment tax incentive

The employment tax incentive (ETI) is the only clear and direct labour market intervention that increases the demand for labour and reduces the relative price of labour to capital. By increasing labour demand, the incentive contributes to higher labour utilisation. It is also the most researched government incentive due to National Treasury's provision of tax data to researchers and policy interest in its effectiveness.¹⁶

¹⁵ Borhat and Stanwix (2018) argue that despite this high rigidity level, labour regulations are less of a constraint to employers due to low compliance levels. Their survey, however, covers only workers that are subject to sectoral determination. For many of those sectors, the compliance with labour law is below 30%.

¹⁶ A recent example is Borhat et al. (2020) finding a statistically significant but small effect.

The ETI was implemented in 2011 (National Treasury 2011), although the original policy proposal to use a wage subsidy to support youth employment in South Africa dates back to 2002 (Fletcher and Loewald 2002). The initial proposal was for a tax credit targeting the supply of labour, increasing the returns to work and increasing the labour participation rate. Additional proposals followed, including for a demand-side subsidy to firms – a proposal that was eventually adopted in the design of the ETI. These proposals argued that the subsidy design should include a training and skills development component, and a probationary period with a ‘no questions asked’ dismissal policy. Further proposals added immigration reform to support youth employment through its complementarity with skilled employment (Levinsohn 2008; National Treasury 2011). Levinsohn (2008) proposed a wage voucher capped at 50% of the actual wage for recent school leavers.

In the 2014/15 fiscal year, the first full year of its existence, the ETI was claimed by 32 368 firms to support 686 402 jobs (National Treasury 2016). Several independent studies have assessed the impact of the ETI on employment. Most studies (particularly those using administrative tax data from the South African Revenue Service (SARS)) find a positive, but small, impact on job creation for youth (Bhorat et al. 2020; Ebrahim, Leibbrandt and Ranchhod 2017; National Treasury 2016). The impact is estimated at 97 850 jobs over the first two years of implementation (Ebrahim, Leibbrandt and Ranchhod 2017).

The evidence of job creation is most pronounced in smaller firms.¹⁷ There is little evidence of substitution effects – the churning of non-youth jobs – as a result of the subsidy (Ebrahim, Leibbrandt, and Ranchhod 2017; Makgetla 2017; National Treasury 2016). Another recent study finds insignificant employment impacts but strong wage effects (Ebrahim and Pirttilä 2019). However, even the most recent studies cover only a short period of time as the tax data provided by SARS lags by almost two years. More data over time is needed to generate more robust econometric results.

Overall, the studies to date suggest quite a high level of jobs are supported by the incentive but the number of new jobs *created* remains low. This can reflect data and

¹⁷ Despite take-up being higher in larger firms. This suggests that large firms use the ETI to fund jobs they were going to create anyway, while smaller firms use the incentive to create new jobs.

methodological problems but also factors such as poor targeting and lack of training. A closer analysis of successful use of such subsidies reveals that design and delivery matter greatly. A similar conclusion is found for other African countries (Boadu and Fatunbi 2020).

4.4 Employment equity and Black Economic Empowerment

Policies such as Employment Equity and Black Economic Empowerment (BEE) try to create a degree of economic equality which is impeded by negative market externalities and/or by historical structural obstacles and uncompetitive outcomes. These types of policies have the potential to improve human and capital allocation by creating new and more dynamic labour-absorbing firms and reducing concentration in the economy, while ensuring political and social stability (Acemoglu, Gelb and Robinson 2007; Andrews 2008). They can increase labour utilisation of previously disadvantaged groups but also increase overall utilisation through their impact on economic activity. These effects however depend on the design of the policies and their implementation.

The employment equity policy aims to change the racial composition of the employed workforce, supporting a fairer representation for previously disadvantaged groups. The limited literature suggests that the impact on overall labour utilisation has likely been negative but that the impact on representation is positive. A recent study by Landman and O'Clery (2020) investigates the impact of employment equity policies on gender equality. The results suggest that gender representation and wages have improved as result of employment equity representation. Horwitz (2013) argues, however, that employment equity policies have led to a brain drain, reducing the total supply of skilled workers, with negative spillover effects to overall employment levels. Other studies show that employment equity can contribute to greater skill mismatches and, because of reduced skill levels, lower total labour productivity (Burger 2014; Dongwana 2016; Kruger and Kleynhans 2014). There may also be a targeting problem, where employment equity policies do little to reduce overall unemployment because it is heavily concentrated among younger people, as shown by Levinsohn (2008). This targeting problem appears to work against the National Development Plan assessment, which recommended that "employment equity should focus mainly on

providing opportunities for younger people from historically disadvantaged communities who remain largely marginalised.”

The problem with skill mismatches is clearly illustrated using chartered accountants as an example. The South African Institute of Chartered Accountants reports that there are currently around 47 000 registered chartered accountants in South Africa, of which only 6 800 are classified as black African.¹⁸ In this case, a rigid policy requiring strict adherence to employment equity targets will make it more difficult for firms to grow due to the limited number of black chartered accountants and a very high skills premium for them. Increasing the demand for a particular skill set from a particular group can improve human and capital allocation if the supply of skills is available and the policy leads to a net improvement in overall productivity (Andrews 2008). Again, the National Development Plan labels this approach of overpaying for scarce skills as “counterproductive to the long-term development of both the individual and the company.”

Other BEE elements deal with ownership, management control, skills development and enterprise development. In the past, BEE was criticised for benefiting a small politically connected group of black entrepreneurs (Acemoglu, Gelb and Robinson 2007). The National Development Plan argues that BEE has succeeded somewhat in changing ownership but not in creating new dynamic black-owned firms. Changes to BEE legislation have tried to expand the definition of black economic empowerment, but still with strong emphasis on ownership. In its 2020 report, the B-BBEE Commission highlights the slow pace of transformation, requesting further interventions to increase compliance and stimulate the pace of transformation.¹⁹ The commission, however, has a narrow focus to report on compliance and does not assess whether these targets also translate into more productive and competitive firms. Only very few studies explore the broader economic impacts. For example, Acemoglu, Gelb and Robinson (2007) find no significant impact of BEE on firm investment, labour productivity or profitability. Kruger and Kleynhans (2014) find no

¹⁸ The statistics are available at <https://www.saica.co.za/Members/AboutMembers/MembershipStatistics/tabid/502/language/en-ZA/Default.aspx>.

¹⁹ The report is available at https://www.bbbeeecommission.co.za/wp-content/uploads/2020/07/National-Status-and-Trends-on-Broad-Based-Black-Economic-Empowerment_.pdf (accessed 9 March 2021)

significant impact on profitability and competitiveness. These studies, however, focus only on listed companies.

A narrow assessment of BEE on targets without taking into account impacts on firm performance, overall economic activity or the availability of skills in the economy will fail to identify unintended and indirect effects. Higher regulatory burdens may impose larger costs on firms and end up reducing labour utilisation. Dongwana (2016) reports that large listed companies found BEE codes onerous and costly, while compliance costs are likely to be considerably larger for smaller and medium-sized enterprises. Another possible effect operates through company ownership and the development of new and dynamic firms. If BEE's main contribution is to change ownership or board representation while maintaining the previous market structures, labour utilisation will remain unchanged. The type of firms created is important. If BEE supports the development of competitive, labour-absorbing companies then labour utilisation will increase. However, if these firms require constant support and are less productive or are less labour absorptive than non-BEE companies, then the impact on labour utilisation would be negative. These firms may turn out to be less efficient as they face limited competition and they can also engage in significant rent-seeking behaviour in order to capture lucrative contracts linked to their BEE status. Hausmann (2017) identifies another possible effect operating through the impact of BEE policies on other groups in the labour market, discouraging participation in the economy, reducing the availability of skilled labour and, similar to the example above with chartered accountants, eventually leading to decreased economic activity and labour utilisation.

A review and redesign of employment equity and BEE policies could likely generate lower costs to the economy and better outcomes for unemployed South Africans.

4.5 Amendment to regulate temporary employment work

Labour markets in many economies in recent decades have exhibited increasing duality, generally arising from legal protections and high costs for jobs in formal, often protected, sectors. Job creation then instead occurs in services and other less protected sectors with lower capital thresholds. In these latter sectors, labour intensity is higher, in part because of less restrictive labour regulations that allow lower labour costs. Firms are often able to lower labour costs by using labour brokers and temporary

workers, increasing competition with firms and employees in sectors previously protected by regulation. The international literature suggests that increased use of temporary workers often results in stricter employment protection legislation for permanent workers, worsening the duality of the market.²⁰

In South Africa, the emergence of more competitive approaches in various sectors induced amendments to the Labour Relations Act to increase protection of temporary workers effective from 1 April 2015. The changes covered temporary employment services (TES) employees, employees on fixed-term contracts and part-time employees, and increased the cost of such employees. Exemptions were provided for small and new firms. One of the key amendments was for temporary work to be limited to three months. This is in contrast to the National Development Plan recommendation of a limit of six months (National Planning Commission 2013). It is also in contrast to policies in other countries which have reduced the duality of labour markets and maintained jobs by increasing the flexibility of full-time contracts (Bentolila, Dolado and Jimeno 2019).

Various studies show that the results on employment and labour utilisation have been large and negative. Borat, Magadla and Steenkamp (2015) find that the amendments resulted in little increase in permanent employment, a key aim of the reforms. Only a quarter of TES workers were made permanent, around a quarter were fired and the rest remained as TES workers. The most affected sectors were manufacturing and tertiary sectors such as finance.

Similarly, Cassim (2020) finds that a large proportion of TES workers became unemployed, moved to the informal sector or became economically inactive. Their employment status was worsened by the reforms. Comparison of these results with other countries is difficult. Other reforms to dual labour markets have combined greater protections with eased firing and hiring regulations of temporary workers (Cassim 2020). This has shifted the balance of regulation to be less costly and more job creating. Alternatively, countries have introduced significant flexibility in permanent employment contracts for first-time employees. For example, in the major Italian reform to labour market duality, contract protection increases gradually over a period of 36

²⁰ For review of the literature see Cassim (2020).

months (Garibaldi and Taddei 2013). This approach ensures that workers are protected, but firing and hiring costs are low, particularly in the initial stages of employment when generating work experience is critical. It also reduces the need for temporary contracts. In South Africa, this transition is instantaneous at the three-month mark.

4.6 Minimum wages

South Africa introduced a uniform National Minimum Wage in 2018. This replaced some minimum wages set through a sector determination process run by committee. Sector minimum wages that are above the legislated National Minimum Wage remain in place, including those set in collective agreements. The legislated intervention aimed to raise compensation for workers in sectors with low unionisation. This intervention, however, increases labour costs directly and relative to the cost of capital. Higher labour costs unmatched by productivity gains directly reduces labour demand as jobs are shed.

Productivity gains can be achieved if minimum wages are set or increased and then induce efficiency wage responses, but it is unclear if this occurred in South African firms and industries. Job creation can rise if the minimum wage increases labour supply but remains below the maximum competitive wage level for the sector.

Certainly, South Africa's experience with sector-specific minimum wages appears to have been mixed. For most sectors, the impact on employment has been neutral; however, the introduction of a minimum wage in the agricultural sector led to large employment losses (Bhorat, Kanbur and Stanwix 2014). Bhorat and Stanwix (2018) compare South Africa's National Minimum Wage to minimum wages in other countries. They find that the ratio of the minimum wage to the median wage is relatively high compared to other countries, which can have negative effects in other segments of firms' workforce and drive up inflation as higher-skill workers try to re-establish the pre-minimum earnings differential. Only the Philippines and Honduras have higher ratios. This contributes to lower labour utilisation, particularly in sectors where salary increases are largest and there are opportunities to replace labour with capital (Bhorat et al. 2016).

4.7 Supportive policies

An array of other policies, such as tax, industrial and competition policy, also play important roles in determining and shaping labour demand and supply (Levinsohn 2008; Rodrik 2008). South Africa has considered and set out policies to boost development of most sectors, including manufacturing, mining and tourism. Endowments of minerals of course have been a primary determinant of economic activity, and greater beneficiation of domestically mined raw materials has received much policy attention (Oranje 2013). The National Development Plan and more recently National Treasury have called for more support for labour-intensive sectors such as tourism (National Planning Commission 2013; National Treasury 2019).

Despite some attempts to use industrial policy to increase demand for labour, much of the focus has been on more capital-intensive sectors and in particular automated car manufacturing. In 2018, for instance, the sector received R27 billion in tax support, more than the rest of manufacturing combined, and non-taxable grants ranging between 20% and 30% of their investment and tariff trade protection. To cap it off, manufacturers charge the tariff-inclusive prices, with added mark-up, in the local market (Kaplan 2019).

Independent assessment of the effects of industrial policy on growth and employment are scarce due to data availability. However, a recent assessment by the Department of Performance, Monitoring and Evaluation concludes that many of the industrial incentives are ineffective and not well designed.²¹ Kaplan (2019) argues that industrial policy has failed to deliver either jobs or growth as promised in the different versions of the Industrial Policy Action Plan. Certainly, manufacturing output has lagged other emerging markets and employment has decreased in the manufacturing sector relative to 2008. Industrial incentives favour capital, leading to a decline in the employment intensity of production.

Another important supportive policy is Competition Policy, where various amendments to the Act over the years have strengthened the powers of the competition authorities.

²¹ The review is available at <https://www.dpme.gov.za/publications/Reports%20and%20Other%20Information%20Products/Evaluation%20of%20Business%20Incentive%20Draft%20Summary%20Report%20V6%2005112018%20%20STC.pdf>

Some of the key changes are in the definition of the pursuit of abuse of dominance. The Competition Commission is also given more extensive powers to initiate market inquiries and provide remedies to change market outcomes (OECD 2020). The amendments ensure that the level of concentration is properly measured as well as its impact on small and medium-sized enterprises and black-owned businesses.

However, the level of competition in South Africa remains low compared to other countries. The 2020 OECD Economic Survey identifies the following reasons: a high level of government involvement in the economy; barriers to domestic and foreign entry; complex rules for licences and permits; and protection of existing businesses from competition. The regulatory restrictions are particularly high in network industries, and likely have a major impact on investment rates.²²

South Africa's policies have failed to shift far enough away from the pre-democracy, closed-economy systems of protection, and therefore do little to directly solve the unemployment problem. Labour market policies do not increase job creation and absorb workers that want jobs. Many policies deviate greatly from global best practice. Rightly, considerable emphasis has been on ensuring fair treatment and compensation of workers. But that effort improves outcomes for relatively high-skilled unionised and formal sector workers, while reducing demand for less-skilled workers and leaving many workers in a more precarious position. Moreover, the extent to which these policies reduce labour utilisation has been ignored and few mitigation or offsetting measures have been put in place. It is also worth noting that in recent years labour demand has been effectively capped by declining potential growth rates, caused in part by shortages of electricity, which place a direct speed limit on job creation.

5. Review of international examples to follow or avoid

We turn now to more specific examples of efforts conducted by other countries to boost employment.

²² The survey is available at https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-south-africa-2019_530e7ce0-en

5.1 Public employment service

After unification in 1990 and the introduction of the euro in 1999, Germany found itself locked into an overvalued exchange rate, which made the re-integration of unemployed workers difficult. As in other European economies, the unemployment rate increased in the crisis, but did not fall in the recovery. A broad-based reform programme in the early 2000s, designed together with leading employer representatives, started to push unemployment lower.

The reform package included adjustments to taxation of income support benefits, allowing greater use of temporary work agencies and arrangements, and the strengthening of the public employment service. The cornerstone of reforms, implemented over several years and stages, established a strengthened and well-resourced public employment service with a wide range of active labour market policies. At the same time, labour supply and job search was increased with incentives to accept vacancies and by significantly reducing the effective taxation of benefit recipients. Widening opportunities to deviate from the standard labour contract and employ workers through agencies and for fixed terms were provided, but care was taken not to allow the substitution of standard labour contracts. Benefit duration was limited, generosity reduced for some groups and job search obligations strengthened. Lack of compliance with agreed job search and qualification requirements was subject to sanctions.

The German public employment service is among the biggest employers in the country and enjoys operational independence to achieve its goals. New public management principles provide a relatively large degree of freedom for decisions taken by front-desk counsellors (Launov and Wälde 2016).

5.2 School-to-job transition

Most countries exhibit considerably higher unemployment for youth than for older workers. Germany is an exception, with youth unemployment rates similar to the overall unemployment rate. In other words, the school-to-job transition works about as well as the labour market overall, and in particular is free of additional hurdles for school leavers to enter the labour market. The secret behind this success story is a

vocational training and education system (the VET system), which works in close cooperation with future employers and social partners.

The German VET system rests on two pillars. One is designed for those who leave the general education system at a young age to join a combined school and on-the-job training apprenticeship programme. Participants in this programme are employed and receive practical training in the workplace, while contributing to the output of the employing company. Compensation is far below the minimum wage, but there is an employment guarantee after the successful completion of the three- to four-year programme with a skilled worker certificate in the respective trade (plumber, carpenter, car mechanic, etc.). The split between working time and school time is 3:2 days. The curriculum is standardised according to public regulation established in close cooperation with social partners.

Apprenticeship programmes are very popular and chosen by about one quarter of any cohort. Employers get first-hand access to skilled workers, whom they know already from the training programme for which they have been chosen. Job seekers receive prioritised access to employment opportunities in the region. Successful participants have access to tertiary education in the area of their profession after a certain employment period.

The second pillar of the German VET system is high school-based with teachers, who must have several years of practical experience in the area. The curriculum is designed in close cooperation with social partners and in many cases such schools become part of a sectoral cluster of companies successfully competing on world markets. Graduates from such schools have immediate access to most tertiary education programmes.

The graduates from higher vocational schools are in high demand and their entry wages are often higher than those of university graduates without work experience. The balanced mix of theoretical material brought into the classroom by teachers with practical experience generates a good foundation for the skills needed to implement new technologies in the workplace and participate in incremental innovation activities. The German VET system builds on a comprehensive general school system and productivity-minded cooperation between social partners. The distribution of benefits

from this cooperation between employers, employees and the public sector is facilitated by the exceptional stability of the German economy and society. Many of these aspects are missing in South Africa. Nevertheless, considering South Africa's widespread youth unemployment, it is worth investigating – perhaps in the form of regional or sectoral pilot studies – which aspects of the German VET system could be transferred to South Africa.

5.3 Economic growth

Several countries achieved high growth rates between 2000 and 2020. There are some common drivers of growth, while others are country specific. A common factor for smaller countries is the importance of export-driven growth, competition-friendly institutions and sound macroeconomic framework conditions, perhaps reflected best in the findings of the Spence Report of the World Bank's Growth Commission.

Besides these common factors, there is also a country- or region-specific context. For instance, Ireland and Slovakia were and still are successful in attracting greenfield foreign direct investment projects for exporting to the neighbouring European Union (EU) market. Low taxes, tailor-made regulation and a highly skilled labour force – albeit with very different sectoral specialisations – provided the right background for location decisions of internationally operating conglomerates.

Slovakia found a way to benefit from major foreign direct investment-backed export-oriented manufacturing projects in two medium-tech sectors: automotive and consumer electronics. This approach benefitted from being part of the internal market in the EU, which provided free market access. While most of the new firms are located in the Western part of Slovakia, close to the highway and railway network connecting to the EU, more remote regions also benefitted through an expanding local supplier network.

Ireland leveraged its membership in the EU to offer a low-cost platform for low-weight, high-tech goods (Buckley and Ruane 2006). Significant support from EU structural funds were used to upgrade the education system and make sure that employers found the skills they needed.

Particularly interesting for South Africa is the successful development of South Korea, which in the 1950s was a low-income country. Korea followed an export-led growth path, but its main drivers were domestic conglomerates. The government established a competitive grant system, which made sure that only productive establishments would be supported (Westphal 1990). This approach helped to avoid the middle-income trap phenomenon, which is common for countries in which industrial policies depend on import protection.

5.4 Regional convergence

Economies with higher income per capita tend to have lower regional differences (Petraikos, Rodríguez-Pose and Rovolis 2003). This relation may not be uniform over time and countries in their early stage of development are often found to experience increasing regional difference (Kuznets 1955; Williamson 1965). The negative relation between regional inequality and economic growth is confirmed by the example of the EU, although several channels are working in different directions and their balance can differ over time and between countries (Pietak 2020).

One source of employment creation is higher growth in low-income regions. This goal is the focus of one common policy area of the EU and has been evaluated by numerous studies (Bachtler and Wren 2006). Cohesion programmes mainly benefit lagging regions and are considered to have significantly contributed to job creation. Furthermore, cohesion policy is supposed to contribute to institution building and facilitate learning processes for policymakers. The Regional Economic Specialisation approach (OECD, 2016a) tries to achieve these outcomes. Its implementation requires significant analytical, monitoring and governance capacity of policymaking institutions.

5.5 Gender gap

In most OECD countries, increasing employment opportunities for women contributed to significant increases in aggregate economic growth and well-being. Obstacles to higher female labour force participation are mostly country-specific, but there are also uniform positive factors, in particular higher education and lower fertility (Klasen et al. 2020).

In countries with high female labour force participation (for instance, France and Sweden), one focus is to provide publicly available institutions that allow families to reconcile their obligations at the workplace with parenthood. Further efforts are devoted to make sure that the marginal taxes on income earned by one partner are not increased by the income earned by the other partner. For instance, this is the case in Germany where the income of the family is taxed, while in Austria the income of each partner is taxed separately. In countries with a traditional family role model for women, the availability of part-time employment opportunities contributes to an increase of female labour force participation, but at the cost of possibly contributing to the dualisation of labour markets (Barbieri et al. 2019).

5.6 Product market reforms and business development

Examples for product market reforms in OECD countries include opening network industries for new suppliers, effective procedures against cartels and reducing the influence of government. The impact of such measures is generally found to be positive with respect to economic growth, productivity and job creation. One frequently mentioned driver of positive effects of product market reforms is increased innovation activity, with governments playing an active role in supporting the implementation of new technologies and providing the necessary infrastructure for the training of employees (Ornston 2013).

5.7 Labour market dualisation

One trap to avoid is increasing employment by allowing a too-wide difference of employment protection for standard and temporary/agency/informal work. The Italian model mentioned earlier provides the right balance.

In Spain, dismissal protection is very strict.. In order to make the labour market more flexible, the government allowed the widespread use of non-standard labour contracts, thereby establishing a dual labour market. Contrary to expectations and intentions, only few workers initially employed on non-standard contracts managed the transition to a standard contract. As a consequence, the cyclical volatility of employment increased. A medium-term cost to the economy from too much volatility in employment relations is a decline in firm-specific further education and innovation spending

involving workers employed on temporary contracts, limiting growth of both firm productivity and income of workers.

Turkey combines important aspects of German and Spanish labour market reforms. On one side, work incentives are very high (the German element) and, on the other side, a dualisation of the economy is tolerated by allowing informal practices even in well-established formal sector firms.

Dualisation and a rise in precarity has also occurred where immigrants congregate in particular sectors and job categories, and in some countries this is encouraged by eased regulations.

5.8 Wage bargaining

Across countries, wage-bargaining practices and laws vary considerably. Some countries follow a more decentralised approach and favour wage determination at the company level, while other countries have legal frameworks which allow for collective bargaining agreements. OECD recommendations in the 1990s promoted the decentralisation of wage bargaining and wider scope for opting out of legal extensions of collective agreements (OECD 1999). More recently, the benefits and disadvantages of collective bargaining were reassessed (OECD 2018, Chapter 3). One reason is that collective bargaining is increasingly seen as a brake on rising wage inequality in the wake of globalisation and the widespread implementation of new technologies, in particular ICTs.

A successful wage determination system provides the right incentives on both sides of the labour market in order to combine a high labour force participation rate with decent wages. The overall success is often determined by the role played by the replacement rate of benefit systems.

One crucial aspect of wage determination is the ability of social partners to maintain international competitiveness. This characteristic is most prominently attributed to Germany, which became the European wage leader (Ramskogler 2012). The implementation of such a wage policy rests on two pillars: (i) sharing productivity advances, and (ii) widening the objective function by including full employment (Offe

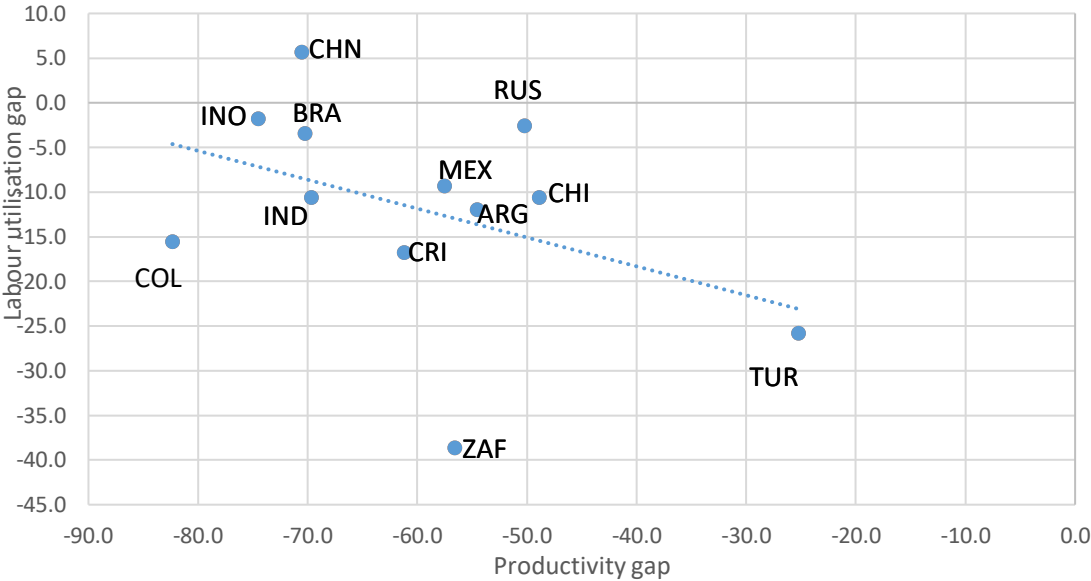
2019). In well-functioning wage determination systems, real wage gains that may be had in the short term are foregone in the interests of more sustainable real wage gains over time. This trade-off is better identified by workers where firms can commit to long tenure and low turnover and where there is a commitment to continuous training and lifelong learning. In most cases, adult learning institutions which provide training opportunities are financed by employers with the help of government.

6. Policy recommendations

Achieving full employment has become a common, cross-country economic policy goal agreed along the entire political spectrum. International organisations like the IMF, the World Bank and the OECD give high priority to policies that remove disincentives to accept vacancies (boosting labour supply) or provide incentives to offer employment opportunities (raising labour demand).

Emerging market and developing economies, by definition, lie below global production possibility frontiers – the combination of capital, labour and technology use that is both at the highest level of efficiency and of endowment use. Where economies are less productive (further from the frontier), they often try to raise earnings across the economy by enabling job growth as much as possible. This gives rise to an observed negative relationship between labour utilisation and productivity, although the margin of error is relatively large. Much of the literature on labour market reform reflects determined efforts since the 1980s by many advanced economies to increase productivity and labour utilisation at the same time.

Figure 8: Productivity and labour utilisation gaps (emerging markets)



Source: OECD (2019a).

Alternatively, some countries try to artificially boost the earnings of workers by restricting competition and limiting growth in labour demand. South Africa does this, and becomes an outlier among emerging economies, because at current output levels, and with a relatively small productivity gap, its labour utilisation gap is high (Figure 8). Closing this gap, creating many more jobs, should be an achievable target, given the experience of other countries doing so, and would go far in raising overall output and income and reducing inequality in the economy (Anand, Kothari and Kumar 2016). South Africa, however, should not seek to close its labour utilisation gap by reducing productivity in a direct trade-off for more jobs, but if jobs are created for less-skilled unemployed workers, then in the short term there will be a moderation in productivity per worker until such time as full employment causes productivity to rise.

The particular policy challenge in this situation is to find the right balance between supporting those who lose their employment/business in the course of a productivity-centred growth path and not undermining the associated incentives. Such an approach was popular in countries with a corporatist policy setting (such as Scandinavia, the Benelux and Austria) up to the mid-1970s. In these countries, wage determination, technological decisions and macroeconomic policy were coordinated between the government and social partners. The form of cooperation ranged from complete informality in the case of Austria to more formal agreements in Northern European

countries. More recently, an innovative form of 'supply-side corporatism' switched from demand management towards providing key public goods for the expansion of economic activities in new high-value added sectors of the economy (Heinisch 2001; Ornston 2013).

Increasing labour utilisation in South Africa requires a complete rethink of the current approach to employment creation away from policies that serve certain groups at the expense of the unemployed, a significant improvement of the labour market labour institutions and supportive micro- and macroeconomic policies.

The review of international experience suggests that effective systems for school-to-job transition can increase youth labour utilisation and provide a significant boost to potential growth. Successful systems rely on active industry participation and effective training. Vocational education needs to graduate from an unattractive choice to a mainstream programme. While South Africa has the TVET colleges, which are meant to fulfil a similar purpose, these institutions have been ineffective in providing the right skills. The 2013 OECD Economic Survey of South Africa provided several recommendations on how to improve the school-to-job transition. Recommendations included increasing industry involvement, addressing operational challenges, providing tax credits to support the employment of graduates and reducing firing costs for new hires. Improving the matching of employees with employers decreases the equilibrium unemployment rate in the context of the Flow matching and the Beveridge curve approach discussed earlier.

The employment tax incentive has been effective in reducing the relative cost of labour to capital but the empirical evidence shows that targeting needs to improve. The international literature suggests that reducing dismissal costs, targeting specific skill sets and sequencing labour market reforms can increase the ratio of jobs created to jobs supported (Betcherman, Daysal and Pagés 2010; Caliendo, Künn and Schmidl 2011; Chrichton and Maré 2013; Van Reenen 2004)

The German public employment scheme provides a useful example of how to implement a successful system. Provided that fiscal resources exist, this is an effective way to deal with South Africa's unemployment problem. However, one can argue that South Africa already has a public employment scheme evident in the very rapid

increase of public employment (including state-owned enterprises) over the last 13 years and characterised by high wages and fix labour contracts. This approach has put government finances on the verge of a fiscal crisis. Again, while the intention of this approach was good, its design and implementation was poor, benefitting mainly skilled workers.

The international review and the local evidence suggest that low labour utilisation rates can be reversed if South Africa better addresses the regional economic disparities and the gender gap. Again, there are useful international examples, including how the EU supports poorer regions through special funding mechanisms or how it supports temporary and part-time employment for female workers. Employment Equity has helped to reduce the gender participation gap.

In South Africa, settlement structures and economic activity are not well coordinated. Reducing mobility costs requires that this is addressed, possibly with different approaches to affordable social housing to overcome the rural-urban divide and contribute to a higher activity rate of the working age population. The OECD recently published a comparative analysis of traditional settlement areas around the world (unfortunately without South African participation). Recommendations focus on improving empirical information and coordinating with national economic policymaking on one side and entrepreneurship and land management as key drivers of economic development on the other (OECD 2019b). The key recommendations are to:

- Create an enabling environment for indigenous entrepreneurship and small business development at the local and regional levels by establishing local community-led economic development plans, improving access to finance and making public procurement an engine of local business.
- Improve the indigenous land tenure system to facilitate opportunities for economic development and foster the integration of local entrepreneurs in mining value chains as well as sustainable tourism development.
- Adapt policies and governance to implement a place-based approach to economic development that improves policy coherence, empowers indigenous communities and encourages local as well as international experience sharing.

The review of labour market models shows that a high unemployment rate and low labour utilisation can be an equilibrium outcome of the wage-bargaining process. This

also hinders the effective implementation of macroeconomic policy. In this environment, one method for optimising labour use is through negotiated, high-level social accords (Nattrass 2004), which often hold down labour cost growth rates to enable economic surpluses to feed into higher investment and job creation. Most instances of the successful use of social accords occur in high-income countries such as Austria, the Benelux, Scandinavia and Germany. Such accords are far less commonly used in developing and emerging economies. One reason for this asymmetry could be the need for fiscal incentives to reach agreements, which high-income countries can provide at lower cost.

Lindbeck and Snower (2001) identify several other interventions to reduce the insider-outsider dynamics and bargaining on a sector level. These include reducing the occupational, industrial and geographic coverage of unions, introducing schemes to convert wage claims into equity shares and profit-sharing schemes, reducing firing costs, and increasing competition in product markets. Higher competition, accompanied with a threat of entry from imports, make it more difficult for the industry to sustain high wage increases, which are not compatible with economy-wide full employment.

The review of policies affecting the employment market directly in South Africa shows that the emphasis has correctly been on ensuring fair treatment and compensation of workers, but unintended consequences of this approach have been ignored. The outcomes for relatively high-skilled unionised and formal sector workers have been positive, while reducing demand for less-skilled workers and leaving many workers in more precarious positions. Both firing and hiring costs need to be lowered further. This is particularly important in the current environment. Reducing firing costs for new workers for a period of 12 to 24 months can support faster employment recovery in the post-COVID-19 period. This can be implemented by a gradual transition to fixed employment contracts as in Italy.

Employment Equity and BEE have been important drivers of transformation. Businesses' compliance with these policies must increase to accelerate transformation. But at the same time the policies need to be reviewed for any unintended consequences or failure to create firms that are sustainable even after years of benefitting from their BEE status. Policy reviews need to focus on the direct

and indirect effects on employment, also taking into account the substitution from BEE non-compliant firms.

Supportive microeconomic reforms are key to addressing South Africa's unemployment problem. The importance of competition has been highlighted in most OECD Economic Surveys of South Africa because of positive experiences with opening markets for competition and establishing robust and independent Competition Authorities. The first survey in 2008 highlighted the entry barriers for foreign firms, the role of state ownership and intervention, and the excessive administrative burden which hinders business growth and small, micro and medium-sized enterprise development (OECD 2008). Other surveys continued to highlight problems with product market reforms, and yet progress in addressing these reforms has been slow.

Industrial and other microeconomic policies also have an important role to play in supporting higher labour utilisation. If they work at cross purposes by mainly supporting highly capital-intensive sectors, as is the case with industrial policy at the moment, then it will be difficult to increase labour utilisation. The current approach to localisation may create some jobs in the short run, but it will certainly reduce foreign direct investment and the ability to attract large exporters that are part of global value chains, especially given the small size of the South African market.

Many of these reforms were also highlighted by National Treasury in its recent paper on micro policy reforms.²³ An aspect that is particularly important in the context of South Africa as an emerging economy is to understand the dynamics behind technical progress, productivity and employment. While it is possible to imagine that delaying the implementation of labour-saving technologies could prevent employment losses, it is an illusion to assume that such an approach will have no short-term consequences for employment dynamics. That short-term trade-off is between a static low-wage/low productivity employment gain and a trajectory with rising employment, productivity and income. Where productivity gains lead to job losses, the various components of the labour market regulatory framework and broader competition framework must increase opportunity for new job gains, easing that trade-off into a longer-term economy with a

²³ See National Treasury 2019.

mix of high, medium and low productivity jobs and a transition path for workers from one to the other.

7. Conclusions and a roadmap for the short, medium and long term

High unemployment and inactivity are particularly widespread among school leavers who do not move on to tertiary studies and among women, especially in traditional settlement areas. Informal sector jobs are stepping stones for finding employment in the formal sector, although mostly for temporary contracts.

The legacies of apartheid can partly explain the increase in labour supply and the inability of the economy to absorb it, which has produced extreme levels of unemployment. More should be done to unwind those legacies, while unhelpful outcomes from other policies and institutions are also reversed.

There are several interventions that are key in accelerating employment growth in the post-COVID-19 period, although a range of others could also improve outcomes further. Most urgent, and feasible in the short term, is improving the transition from school to jobs, by widening the volume and quality of the currently minimal public employment service to improve matching in the labour market. Other reforms should lower firing costs by linking employment protection to employment tenure (similar to the Italian example). This latter reform has been shown to be central to job creation in many successful labour market reform efforts around the world.²⁴

Reforms should further reduce obstacles to the immigration and employment of skilled foreigners and improve skills development and education outcomes for South Africans. Such reforms will reduce the skill constraint directly and indirectly, increasing economic growth and employment for less skilled workers while moderating wage growth in excess of productivity (which works directly against job creation). Removing entry barriers to product and services markets and reducing administrative costs would spur innovation and job creation, especially in areas that could benefit from the implementation of new technologies, in particular around digitisation. Efforts to tackle

²⁴ See for example Cournède et al. (2016)

crime would help make commuting safer, reduce the brain drain and attract skilled immigrants, all lowering the supply cost of labour and increasing job creation.

Over the longer term, improvements in basic education will be key to reducing the excess supply of less-skilled workers. A stronger focus of BEE (including subsequent programmes) on traditional settlement areas could boost entrepreneurship among black South Africans.

Few of our recommendations are new but now South Africa is faced with an even starker choice than usual. The country can continue on the pre-COVID-19 trajectory of low economic and employment growth and expect rising unemployment, fiscal crisis, reversal of the post-apartheid gains and possibly social unrest, or it can implement a well-coordinated growth and employment agenda.

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