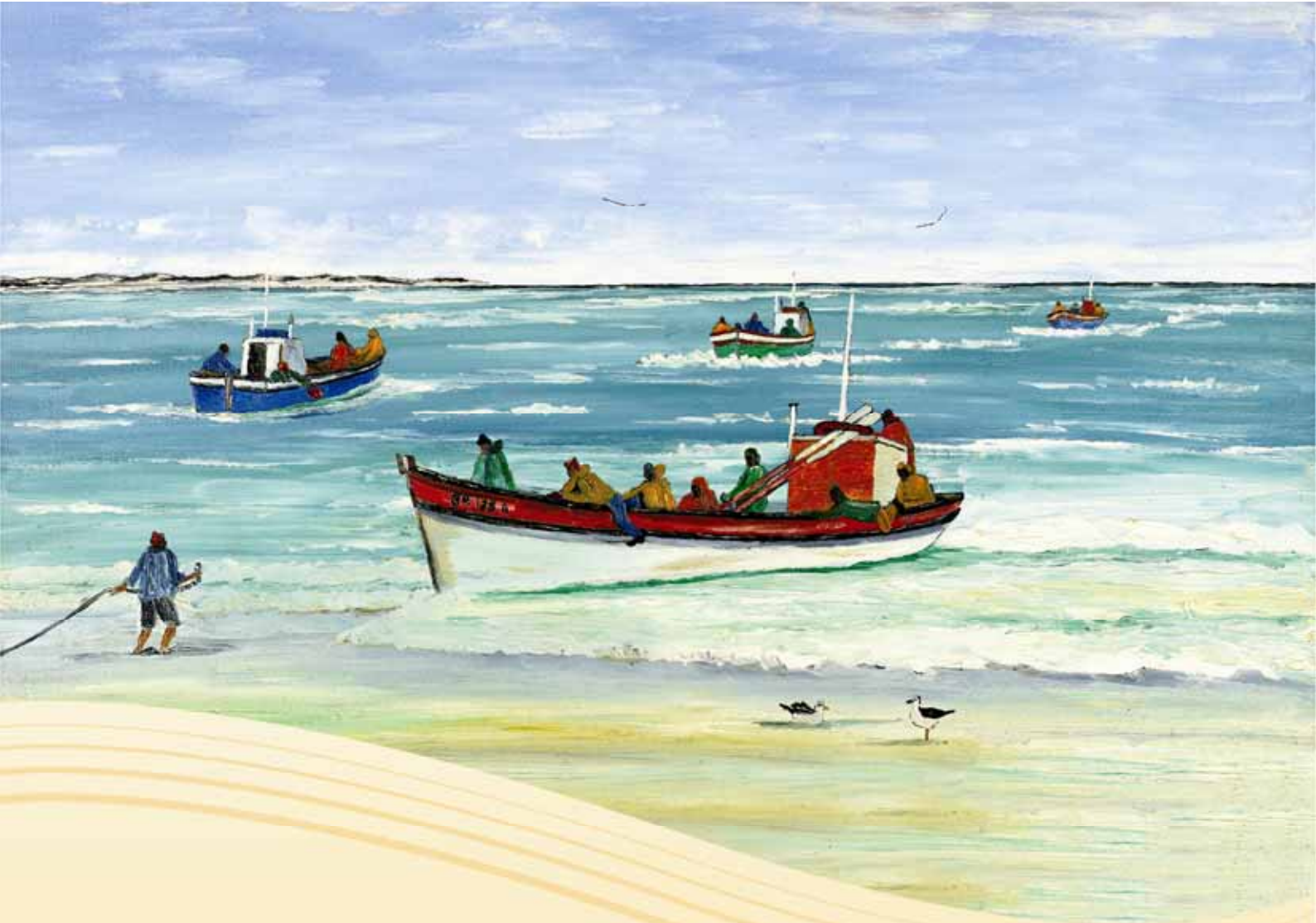


Part One

PART ONE

Chapter 1: New developments in industrial policy at the national and international level.

Chapter 2: The drivers of competitiveness in the Western Cape.

Chapter 3: The growing importance of the environment to micro-economic initiatives.

Chapter 4: The ability to provide clear policy interventions for the informal economy.

Taken as a collective, these four reviews update some of the core principles of the MEDS, and will imbue it with more substance and direction.

Chapter 1: The National Policy Environment for Industrial Policy, Sector Support and the MEDS

Since the publication of the 2006 MEDS Synthesis Report, there have been significant developments in the national environment in respect of industrial policy. A number of new policy documents and an international review of growth policy have provided new directions for industrial policy. This section reviews this altered context and the implications for the MEDS.

1. The Changing Context

At the time of writing the last MEDS Synthesis report, the national context for sectoral support activities was principally provided by the AsgiSA. AsgiSA identified a number of sector categories for development where some immediate gains might be realized. However, AsgiSA was not an industrial policy. AsgiSA provided little more than a brief listing of sector categories and no detail as to how each of these broadly specified categories was to be supported. More precise specification was to await the national industrial strategy, then being developed by the Department of Trade and Industry (dti).

The dti's policy document was long delayed, leaving an uncertain framework within which to develop a provincial strategy. This was noted in the last MEDS Synthesis Report. However, in August 2007, Cabinet approved the national industrial strategy: A National Industrial Policy Framework (NIPF) with an accompanying "plan of action," Implementation of Government's National Industrial Policy Framework: Industrial Policy Action Plan (IPAP). These two documents provide a framework with which provincial business and sectoral support activities can be situated.

At the end of 2007, a group of economists based principally at the Kennedy School, Harvard University, were engaged to examine the ASGISA programme and related economic policies. The findings and policy recommendations of the International Panel on ASGISA were delivered in August. An important and constituent part of the panel's recommendations were concerned with industrial policy. While this process is still underway, and its impact is uncertain, this international panel has brought new perspectives on industrial policy and sectoral support activities, and, in applying them to the South African context, have made a series of policy recommendations.

The sub-national policy context for industrial policies and sectoral support activities has also undergone development. The dti Regional Industrial Development Strategy (dti, 2006) and the Department of Provincial and Local Government (DPLG, 2006) National Framework for Local Economic Development in South Africa are designed to reflect and reinforce the objectives and policies developed at the national level and to "translate" these into economic development at regional and local levels.

The first section of this chapter outlines the approach adopted at the national level – the NIPF and the IPAP. The focus is on the correspondence (or lack thereof) between policies elaborated at the national level with provincial policies and specifically the MEDS. The second section outlines the approach adopted by the international panel and some of its empirical research findings. The possible implications for policies at the provincial level and specifically for the Western Cape and the MEDS are then outlined. The third section focuses on the Regional Industrial Development Strategy. At the conclusion of each section, the implications for the Western Cape and the MEDS are explored.

2. The National Industrial Policy Framework and the Industrial Policy Action Plan

These two policy documents underpin industrial policy at the national level to be implemented by the dti. The NIPF provides the framework while the IPAP sets out the action plan – the concrete actions that will be followed over the short- to medium-term. This section does not attempt to provide a descriptive account of the new policy, but rather it examines the key features of the policy approach and compares this with the approach adopted by the MEDS.

2.1 Sectoral Priorities

The NIPF did not attempt a "definitive prioritization of sectors." However, noting that government has budgetary and human resource constraints, the NIPF argued that government should prioritise five broad sectoral groupings:

- Natural-resource base sectors
- Medium technology sectors (including downstream beneficiation)
- Advanced manufacturing sectors
- Labour intensive sectors
- Tradable services.

The IPAP provided a much clearer set of priorities and identified what it termed "...four lead sectors that currently form the central focus for the implementation of NIPF" (IPAP: 4):

- Capital/Transport equipment and Metals
- Automotive assembly and Components
- Chemicals, Plastic fabrication and Pharmaceuticals
- Forestry, Pulp and paper, and Furniture.

For each of these lead sectors, there exist clear programmes for action – projects, desired outcomes, processes, engagement of other departments and specified timelines (IPAP, 2007: 7-8; 10; 12; 14). Given that the dti capacities are widely acknowledged to be very constrained, it is likely that attention and resources will be almost entirely focused on these lead sectors for some considerable period.

What is immediately striking is that none of the four lead sectors has a very significant presence in the Western Cape. Hence they do not accord with the priorities identified for the Western Cape by the MEDS.

In addition to the four lead sectors, the IPAP also identifies the three sectors that were selected by AsgiSA "for immediate and special attention." In respect of these three sectors, the momentum of the implementation under AsgiSA will be maintained.

- Business Process Outsourcing and Offshoring (BPO&O)
- Tourism
- Biofuels.

The first two are indeed high priority sectors for the MEDS.

Other sectors singled out by IPAP to receive support are:

- Clothing and textiles
- Diamond beneficiation and Jewellery
- Agro-processing
- Film and Television
- Crafts.

The future development of more comprehensive sector strategies is proposed for:

- Mining and mineral beneficiation
- Agriculture/ Agro-processing
- ICT (services and products)
- Creative industries.

Two of the MEDS priorities – namely SMMEs and the Informal Sector – are cross-sectoral and are accorded high priority by the dti and indeed in other national policies.

There is clearly some "disconnect" between the dti prioritization and ranking of sectors for support at a national level and that of the MEDS at the provincial level. This lack of correspondence is *per se* "problematic," and indeed is to be expected in so far as it reflects the particularities of the provincial economy and the challenges and opportunities that the province faces as compared with the national. However, three issues do arise.

First, the Western Cape will not be an important player in regard to much of the dti's focus in the short- to medium-term. The Western Cape is poorly "represented" in all of the current dti lead sectors.

Second, there are some sectors which the MEDS and provincial government have identified as important which may not receive any significant or, at least, very limited, national support. Oil and gas services are an obvious example. Provincial government will need to be certain that it can command sufficient resources to have a significant impact and secure its objectives. Failure to do so will lead to dissipation of resources and support that is too fragmented to be effective.

Third, in the prioritization and ranking of sector support at a national level, there appears to have been little or no consultation with the provinces. This raises the perennial question of the coordination of industrial policy across the different spheres of government (see below). An unresolved issue is whether provinces have any role in the formulation of industrial policy, as opposed to merely being engaged in the implementation of policy determined at national level.

Two further features of the national industrial policy should be noted. First, national industrial policy is strongly centred on support for identified sectors. Currently, it is government that selects and decides which sectors to support. This is in contrast with the direction for

industrial policy being advanced by the International Panel which is advocating a much less prescriptive policy (see below). Second, national has prioritized and selected a large number of sectors for support.[1] The MEDS, by contrast, has consistently argued for a much more limited focus on fewer sectors with a strong concentration on a few priorities.

2.2 Criteria for sector support

The NIPF outlines a number of criteria for the identification and selection of sectors for support.

> "…greater priority should be given to sectors that are capable of generating the highest level of employment and growth, particularly in new or expanded non-traditional tradable activities. However, consideration also needs to be given to longer-term issues such as sectors that will move South Africa closer towards a technologically sophisticated and knowledge-driven economy in the long term." Also "the economic benefits of developing the sector relative to the costs of government support must be taken into account." Finally, "the institutional implications of the proposed sector strategies must be taken into account. On the one hand this includes the ease or difficulty of organizing the sector or developing a new sector. On the other it should take into account the capacity and coordination requirements of government required to implement the strategy" (NIPF, 2007: 35).

The IPAP is much more succinct "…government will single out sectors for particular focus, based on substantial

- growth and employment potential
- potential for the diversification and growth of exports; and
- research and self-discovery processes having been completed." (IPAP: 2.3: 3).

The criteria employed by the MEDS are consonant with the criteria laid down in the NIPF and IPAP. Growth and employment are the principal objectives. The extent to which the sector is organized and therefore partners can be located that can work together with government is an important consideration. Global tradables are particularly critical. Finally, potential gains need to be assessed against the requisite governmental resources required.

[1] This is despite the NIPF stating that "The general principle is that government will focus attention on a much smaller range of high-quality sector strategies with well developed Key Action Plans… that have the potential to contribute substantially to the structural change indicated by ASGI-SA and the NIPF" NIPF, 2007: 35)

The MEDS, though, has also been concerned with sectors where barriers to entry are low and proposed policies that can encourage new company formation. The MEDS has proposed that encouraging new company entrants should be a constituent benchmark whereby the Special Purpose Vehicles (SPVs) and the projects that are supported by provincial government are assessed – most particularly if they facilitate the entry of women or historically disadvantaged individuals.

Nationally, there has been a renewed focus on the critical importance of growth. AsgiSA and the International Panel examining AsgiSA have prioritized higher growth, and seen higher growth as essential if government is to realize its other objectives. Higher growth, in turn, is seen to depend heavily on growing tradable exports. This is because the major constraint currently on growth is the growing negative balance on the trade account. Policy to support the growth of exports has been particularly emphasized by the International Panel (see below).

Significantly, this renewed focus on growth on the part of national government has been translated into policy formulated and implemented in the other tiers of government. Of most significance, the Department of Provincial and Local Government National Framework for Local Economic Development (LED) calls for the creation of an enabling environment for economic growth at local levels. Furthermore, “where specific initiatives are required, these should be designed to favour enterprises and social programmes that can demonstrate a clear and unambiguous focus on growth” (DPLG, 2006: 11) and strategy 2 of the document calls for local authorities to “arget growth sectors and industry clustering.” (DPLG, 2006: 32).

This growing emphasis on the importance of growth should be reflected in the industrial policy followed by provincial government – growth and productivity that underlie growth should be accorded the highest priority in determining sector support strategies.

2.3 Sectoral Policies

It is important that there be correspondence between the support policies for specific sectors that are implemented at national and provincial levels. Correspondence does not, of course, require that policies be identical, since there may well be different conditions prevailing in any particular region, but it does require that national and regional policies are harmonized and not at cross-purposes. There are concerns that, at least in some areas, polices are not in

harmony. Policies developed at a national level are to be applied in all provinces, but they do not accord with policies developed by the province.

One example of this lack of coordination is in the area of Call Centres and Business Process Outsourcing (BPO). This sector is of particular significance to the Western Cape and is one of the priority sectors identified by the MEDS. National policy is attempting to encourage the location of such operations into rural areas. This is being done on the grounds of equity and elevating poverty in rural areas. But, such areas are not the preferred sites of such operations and will accordingly raise costs and therefore discourage investment. Moreover, even on equity grounds, in the Western Cape, this is unjustified. In this province, by contrast with others, by far the largest proportion of the poor are located, not in rural areas, but in the metropole region. The key, therefore – and this is the thrust of policy in the Western Cape – is to locate such operations in the short- and medium-term, as well as supportive training institutions, in the metropole or near-surrounds, in a location that is accessible to poorer people.

Two conclusions are evident. First, currently the limited synchronization of objectives and coordination of policies severely undermines the efficacy of government support. Second, apart from engagements between the different tiers of government in developing the main contours of industrial policy, there is a clear need to ensure coordination at the level of the design and implementation of policy supports for particular sectors.

2.4 The Role of the Provincial and Metro in Industrial Policy

The NIPF recognizes that substantial industrial policy work has been undertaken at the provincial and even the metro levels.

The NIPF position is unambiguously in support of sub-national structures having a key role to play- “Provinces and relevant metros and local authorities need to be amongst the stakeholders that are included in the ‘Self-discovery’ processes particularly at the sectoral level.” (NIPF: 19.3.2; 51). The NIPF proposes the decentralization of access to financial and non-financial services to ensure more equal geographic access.

The NIPF and the IPAP are similarly cognizant of the importance of coordinating government support for industrial development.

In a section of the NIPF entitled Coordination, Organisation and Capacity for Implementation of Industrial Policy, the first major challenge is identified as

> "…insufficient coordination around industrial initiatives amongst and between the three tiers of government." In order to enhance coordination at the institutional level, the NIPF makes a single proposal. "The economic agencies from each province will be requested to have periodic discussions with the Economic Investment and Employment Cluster (EIEC) to ensure alignment on the overall national strategy for industrialization." (NIPF, 2007: 52).

Discussions at this, the highest level, will be important. But, they will have little impact at the level of sector selection, the policies to be followed in sectors, as well as policy alignment and coordination. Neither the NIPF nor the IPAP provide any clear direction in this regard.

3. The International Panel

The International Panel engaged by National Treasury to review AsgiSA has put forward a perspective that differs significantly from previous conceptions of industrial policy.

The panel's first proposition is that market failure in developing countries that requires an industrial policy response is "…not a rarity but rather a rampant feature of the landscape" (International Panel, 2007: 2). There are three forms of market failure:

- Self-discovery externalities: Firms experimenting and learning how to do new activities engage in an activity where social value exceeds private value
- Coordination externalities: New activities require investments upstream and downstream which market coordinate poorly
- Missing public inputs: Firms require specific public goods while government has no knowledge of what to supply and to whom.

Of particular importance to regional and local governments is the provision of missing public inputs. It is frequently regional and local governments that are required to provide the missing public good that can facilitate industrial development – road infrastructure, water supply, electricity, local by-laws, security and land zoning applications. The requirement for scarce public goods is often first articulated at the local level and implemented at that level. Regional governments therefore have a particularly important role to play in public good provision.

Firms require many public goods that only government can provide. Government needs to acquire information from firms as to their requirements, particularly as firms venture into new activities and products. Hence government and firms need to collaborate in some form of a dialogue. The key to industrial policy therefore is not what instruments government uses to promote growth, but the extent to which it has established an effective dialogue with the private sector to identify the necessary supports. Thus for the panel,

> "A government should evaluate its industrial policy framework not by asking questions of the type: which tax breaks or subsidies are we using? Which sectors have we identified? What is the budget we have allocated for industrial promotion? The relevant questions instead are: have we set up institutions that engage the bureaucrats in an ongoing conversation of pertinent themes with the private sector, and do we have the capacity to respond selectively, yet quickly and using a variety of updated policies, to the economic opportunities that these conversations are helping to identify?" (International Panel, 2007: 5).

The institutional mechanism advocated by the International Panel to effect the conversation between government and the private sector is the 'deliberation council'. These 'deliberation councils' are seen by the International Panel as deliberating and presenting to government proposals for the provision of public goods required in order to allow the firms to overcome constraints on their further development.

The sole rationale for 'deliberation councils' is seen by the International Panel as being to consider and present proposals for public good provision. However, groupings of business will have other needs and other issues that unite them. There are a range of potential collective actions that are to the benefit of members. The Western Cape government has encouraged a large number of institutions – the so-called SPVs – to effect dialogue with the private sectors. Our experience in the MEDS, and this has been confirmed in a recent institutional review, is that these SPVs do indeed function effectively in promoting a dialogue between government and firms. But, the work of the SPVs is far wider than deliberation over needed public goods. In addition to such deliberations, SPVs have engaged in a variety of activities to enhance the development of the membership – from marketing, to quality control and training programmes. The SPVs, operating effectively as *development agencies* for their collectivity of firms, have been a singular achievement that has placed the Western Cape at the forefront of the "new" industrial policy in South Africa.

For the International Panel, it appears that the 'deliberation councils' are conceived of as composed solely of private sector firms. However, if one sees such councils as having a broader spread of activities than deliberation, such that they act rather as developmental councils, there may well be a need for a different institutional form – one that includes representation of university researchers and science councils and also government. This has been the experience in the Western Cape. The SPVs are very largely made up of firms but also have some representation from government, and, on occasion, researchers drawn from universities and science councils. This broader membership enhances the capacity of the SPVs to be more effective in their role as developmental councils.

The International Panel is not in favour of industrial policy based on government pre-selecting sectors for support. Rather they prefer a system of self-organisation of any collection and combination of firms. However, firms also suffer from a bounded vision. The capacity of firms to identify and assess what public goods are required is accordingly limited. Our experience in the Western Cape is that, rather than emerging spontaneously as the outcome of firm level interaction, a broader and longer term vision wherein firms can position their public good needs is best facilitated via the engagement of government.

There will be a strong tendency for the self-organisation of firms to take the form of sectoral and industry associations. South Africa's national industrial strategy is currently sector based – as are the industrial support policies in the Western Cape. In the opinion of the MEDS this should continue.

However, it may be that, in addition to its sector based support, the Western Cape should consider developing support that is less prescriptive. To this end, the provincial government could offer support to any grouping of firms who could demonstrate their need for specified public goods in order to develop new products that have significant potential in global markets. This would be consonant with the dti's Regional Industrial Development Strategy – see part 4.

The International Panel provided data to show that South Africa's performance in export markets has been, by comparison with other countries – including other mineral exporters – very poor. Poor export performance has curtailed growth and current levels of growth, let alone the objective of 6 per cent growth, are not attainable without a significant increase in

exports.[2] Government policy should therefore, the panel argued, focus strongly on growing exports – more particularly non-traditional exports. Apart from enhancing growth, since non-traditional exports, especially manufactures, tend to be very intensive in their employment of those with low skill levels, export growth will enhance employment.

In South Africa, beneficiation has been widely seen to be a key focus for industrial policy. However, after a careful and detailed consideration of the evidence, the International Panel, made a very different and definitive assessment as regards beneficiation.

> "We think that beneficiation, in the sense of incentivising the domestic processing of natural resources is not a sensible policy. The capabilities developed through mining can be exploited in a number of different ways, but these potential developments are only accidentally connected to the further processing of ores and minerals. For example, the skills involved in cutting and polishing diamonds are quite different from those involved in mining diamond ore. Meanwhile, the needs of mining generate a host of skills and capabilities in the design and production of high performance pumps and valves and other capital equipment for the mining industry. These capacities can further be applied and developed not only in mining but in many other industries worldwide. A policy focus on beneficiation has such a narrow focus that it tends to encourage the wrong activities and generates inefficiency" (Haussman, Rodrik and Sabel, 2007:16).

The Western Cape has limited possibilities for mineral beneficiation, but there has been considerable discussion about supporting a jewellery manufacturing hub in Cape Town. Moreover, the same conclusions stand for agro-processing – there is no necessary correspondence between the production of an agricultural product and its further manufacture. At the very least, any attempts to specifically encourage downstream beneficiation will need to be based on a consideration of whether the capacities and knowledge entailed in the production of the agricultural product are closely related to the capacities and the knowledge entailed in further processing.

In their examination of the South African labour market, the International Panel reached a further conclusion that has even more import for the MEDS in the Western Cape. The key objectives of AsgiSA, and the same objectives are embodied in the MEDS, are to raise the

[2] "…the growth acceleration observed since 2004 does not appear to be externally sustainable. …To maintain overall growth and employment, the country will need to rapidly expand its exports." (International Panel, 2007: 2)

rate of economic growth, but also to enhance equity by ensuring that this growth is more inclusive. The principal equity goal relates to increasing employment.

> "…all empirical studies of labour demand show that high skilled and low skilled workers are strongly complementary, not substitutes. Coffee and tea are substitutes while coffee and sugar are complements. The implication of complementarity is that the greater the supply of one, the greater the demand of the other. The shortage of highly skilled workers causes a lower demand for low skilled workers; the lack of engineers may cause the loss of hundreds of blue collar jobs…Since the shared growth strategy involves maximizing the job opportunities of the less skilled, it is fundamental that the high skill constraint be relaxed…" (International Panel, 2007: 8)

The Western Cape is in a particularly advantageous position in respect of the supply of skilled labour. Firstly, as evidenced in the table below, the Western Cape produces a significant share of the national total of skills arising from public higher education institutions – particularly in the science technology and engineering fields.

Table 1: Graduates/diplomas in public higher education by major field of study, Western Cape and National, 2005

INSTITUTION	Science, Engineering, technology	Business and Management	Education	All other Humanities and Social Sciences	TOTAL
CPUT	2 804	1 727	581	575	5 687
UCT	1 870	2 006	214	2 000	6 089
UWC	961	287	574	1 189	3 010
U Stellenbosch	1 945	918	554	2 057	5 474
TOTAL	7 580	4 938	1 923	5 821	20 260
% of National	23	18	7	20	17

Source: Department of Education (2006) Education Statistics in South Africa at a Glance, p. 34, Table 5.2

Indeed, this significantly understates the position since the quality of the education at the Western Cape institutions is particularly high. Moreover, students in these institutions are more likely to complete a postgraduate education – for example, 30 per cent of the nations doctorates were awarded to Western Cape public higher education institutions in 2005 (Department of Education, 2006: 34).

The second advantage of the Western Cape in respect of skilled labour is that it is a highly favoured location. Skilled labour – both national and foreign – is particularly attracted to the lifestyle and natural characteristics of the region.

Given the advantages enjoyed by the Western Cape, the provincial government can do more to enhance the supply of skilled labour. This has a number of possible dimensions. First, it entails improving the local environment with which the education institutions operate. Education is an economic sector producing output and employing people as do other sectors. In 2008, the MEDS will engage with the public higher education institutions, as it has with other economic sectors, to determine how best provincial policies can facilitate their growth and functioning. Second, more can be done in respect of skilled immigration. The International Panel proposed that national government should introduce new policy – "…a liberalization and encouragement of high skilled immigration" (International Panel, 2007: 8). This would be particularly advantageous for the Western Cape as many skilled immigrants are likely to choose to locate here. The provincial government can complement national policies, and reinforce them by much more active "marketing" of the Western Cape as a preferred location for skilled immigrants. Finally, provincial government can identify where there are particularly acute shortages of skills and facilitate and support skill provision, especially through interaction with the provincial Further Education and Training (FET) colleges in regard to curriculum development. A particularly pertinent example at present is in the construction sector and recommendations have been made earlier in this regard.

There is mounting evidence that the skill constraint is binding on further output growth. The clear conclusion of the International Panel is that this constraint is adversely impacting upon the employment of the unskilled and semi-skilled. Easing this constraint thus will have a significant impact on both growth and on employment. We accordingly recommend that the provincial government give particular attention to this issue going forward.

4. The Regional Industrial Development Strategy (RIDS)

The RIDS has a number of strategic objectives. It aims to reduce regional disparities and pay particular attention to lagging regions. At the same time, somewhat in contradiction, RIDS argues that spatial uniformity is impossible and that "…the best policy is to encourage industrial development at a relatively limited number of locations which are able to develop a competitive edge in regional and international markets" (RIDS, 2006: 12).

In accordance with the new thinking on industrial policy, and the approach consistently adopted in the Western Cape, the RIDS has placed emphasis on government dialogue with the private sector. This has been underlined by the Minister of Trade and Industry. "The purpose [of the RIDS] is to provide a bottom-up rather than a top-down strategy,

emphasizing the importance of working with the local private sector and existing institutions, programmes and initiatives" (Mphalwa, 2006:2)

Like the NIPF and the IPAP, the RIDS is very largely sectorally based. However, the intention is that there should be "space" for firms to self-organise in any combination in order to secure access to public resources. "RIDS will be based on pre-selection of sectors, through research and clearly defined criteria. However, often a more promising approach is to set the stage for "self-discovery." A typical approach consists of the promotion of proactive contests, where the dti offers targeted support and calls on local growth coalitions to submit their industrial development plans for support" (Mphalwa, 2006: 6).

One specific "instrument" advanced by the RIDS to encourage groupings of firms to self-organise is the thematic fund. The thematic fund, as the name suggests, is organized around themes – a specific issue in regional development. While no themes have been definitively defined, examples include funds to encourage capacity building in industrial clusters and an innovative start-up support facility. Each theme will be the basis for a fixed-term programme of two to three years. The dti will call for proposals whereby regions in which diverse stakeholders agree on an innovative proposal can bid. The contest will be decided on the merit of the proposal, not the need of the applying region (RIDS, 2006: 73). The merit criteria will be strengthening of competitive advantage; inclusivity and potential to raise employment at all skill levels; and capacity to contribute to sustainable development, especially through efficient use of natural resources.

At this stage, the thematic fund is a concept that is not yet in operation. But, it indicates the increasing attention national policy makers are giving to promoting self-organisation of groupings of firms whose formation is catalysed by the possibility of engaging in competitive bidding for public support.

The potential participants in the thematic fund are regionally based firms. The engagement of the regions in the design and operation of the thematic fund and ensuring that the fund complements regional strategies for firm development will therefore be integral to its success. Once again, the importance of an effective engagement between the different tiers of government is critical in order to ensure that policies effected at the national level to enhance regional development do indeed accord with and complement policies at the regional level.

5. Conclusion

Since the completion of the last MEDS Synthesis report, there have been significant advances in industrial policy and a much clearer policy framework is in place in which to locate the MEDS and policy in the Western Cape. However, while there is much common ground, some tensions and unresolved issues remain.

There remains some lack of clarity as to the precise role to be played by regions in industrial policy. This problem is compounded by a lack of coordination over industrial policy as between the national and sub-national levels, the provinces and also the metropoles. One indication of this is that different choices are being made by national and provinces with respect to what sectors to select for support and how to support them. These different choices are a consequence not only of differences in the economy and potential growth sectors that of necessity characterise the national and the provincial economies, but also of the application of different criteria for selecting sectors. Furthermore, at the level of sector support, there are clear examples of a lack of coordination between the different governmental levels, and between government and other support entities.

There have been new directions in thinking of industrial policy and the role of sectoral support. The main features of this new thinking include:

- An increased emphasis on securing higher levels of growth
- An increased emphasis on enhancing exports, particularly non-traditional exports in order to raise both growth and employment
- The critical importance of an engagement with the private sector. Effective engagement is the central test of industrial policy. A corollary of this is a considerable downplaying of prescriptive government policies
- The importance of allowing and encouraging firms to self organize
- Providing competitive funding for the provision of public goods.

As outlined, industrial policy in the Western Cape has, in many respects, embodied this new thinking. However, some policy adjustments should be considered.

6. Policy recommendations

1. Clearly, there is a critical need for much more effective co-ordination between the different spheres of government. This is a perennial issue and was highlighted in the

last MEDS Synthesis Report. But, with the elaboration of the national framework, this has been underlined and the different levels of disconnect and lack of coordination are more evident. Unfortunately, at present, there do not seem to be clear ideas as to how this might be effected. This is not an area of competence of the MEDS, and we make no prescriptive proposals other than to say that this issue needs to be highlighted and discussions need to be had between the Department of Economic Development and Tourism (DEDT) in the province and the dti.

2. While the national industrial policy is focused on a very large number of sectors, we would urge that the province retains the MEDS' proposed focus on a very few sectors. There is a significant opportunity cost involved in any further proliferation of support – a cost that will be borne by the sectors already identified as meriting support.

3. Province should examine the feasibility of encouraging firms to self-organise and compete for public good provision. Producers of new products for the global market could be invited to apply and compete for support in the form of public goods.

4. In accord with national policy, province should give more emphasis to the objective of securing growth through facilitating exports. This can be effected via the SPVs, but also sub-regionally where local and district councils can be encouraged to ensure that their IDPs and LED programmes pay particular attention to the support of exporting firms.

5. Beneficiation programmes should be examined more critically – for example, the proposal to support the manufacture of jewellery. Beneficiation should only be supported where the raw material production entails similar or related capacities to production further downstream.

6. More emphasis in provincial policy should be given to increasing the supply of skills. This entails working with the regional higher education institutions to enhance the local supply of high-level skills and encouraging the inflow of high level skills from abroad.

Chapter 2: The Competitive Edge of the Western Cape

1. The importance of human capital in the Western Cape

The MEDS argued that the Western Cape's competitive advantage lay in a constellation of unique factors that gave the province a competitive edge from the rest of SA. The primary and distinguishing characteristic of the Western Cape that the MEDS has stressed is the combination of knowledge intensity, cultural activity, multi-dimensional tourism, and life style attractiveness that have classified it as a 'creative' region. Alongside this is the locational position of the Western Cape – a region with two ports that sits aside major international trade routes.

The MEDS in its 2006 report argued that the Province has, over time, become more competitive in activities where intellectual capital – as opposed to cheap labour – drives the agenda of economic activity. Although provincial data measuring the regional innovation systems is not yet satisfactorily collected, Table 1 (constructed from the MEDS 2006 report) shows that the Western Cape scores better than the national average on a host of measurements of intellectual assets, knowledge capabilities and access to critical drivers of knowledge intensive economies. For example at 94.6% the adult literacy rate is significantly higher than the national average of 86.9%. Access to critical assets such as computers, telecommunication hardware and internet capabilities is far above the national norm. The Human Development Index which measures general well being reflects this advantage. Finally, it is reasonable to say that the Province performs better than the country as a whole with four universities – one that ranks in the top 200 globally, the largest number of FET colleges and a range of science councils present in the Western Cape.

Table 1: The knowledge intensity of the Western Cape

Performance indicators.	Western Cape	National
Human development Index 2003	0.77	0.67
Adult literary rate (% age above 15)	94.6	86.9
Tertiary enrolment (% of total pop)	1.8	1.7
Household with fixed line and/or mobile phones 200l %	63	42
Household with computer	18.2	8.6
Fixed lines per capita (households with telephones %)	50.5	24.4
Mobile subscribers per capita (household with mobile phones %)	41.4	32.3
Internet users % who accessed internet last 4 weeks)	11.7	8.9
GDP per capita ($)	13,790	9,133

Source: MEDS 2006: Census 2001, DST (2004), UNDP (2003), WCPT (2005), World Bank (online). SA City Network, UNCTAD (2005), UNDP (2003)

The MEDS in its 2006 report took great pains to stress that the higher levels of development characteristic of the Western Cape is not restricted to the formal economy but is also prevalent in the informal economy. The key feature that differentiates the informal economy in the Western Cape from both national averages as well as other key provinces such as KwaZulu-Natal and Gauteng's informal economies lies in the Western Cape's higher education levels. More than two-thirds of individuals participating in the Western Cape informal economy have secondary schooling qualifications. There are substantially less people with minimal education (primary school or none) in the province (27%) than KwaZulu-Natal (50%) and Gauteng (45%), and substantially more people with Matric – 21% compared to 14% in the other two provinces. In short, the educational endowments and access to knowledge assets in the Western Cape informal economy is markedly different from the rest of South Africa.

Furthermore, as one would expect, there is a close correlation between these endowments/assets and income levels in the Western Cape's informal economy, and the MEDS based its proposals on the fact that reported earnings were higher in comparison to both national averages and other higher earning provinces. In terms of national comparisons, 2005 data show that only 16% of informal economy participants in the Western Cape reported earning below R500 in comparison to the national figure of 47%. And when comparing with other key provinces, 51% of those working in informal enterprises in the Western Cape reported earning more than R1000 a month in comparison to 33% in KwaZulu-Natal and 24% in Gauteng.

The MEDS has consequently focused its informal economy policies in trying to take advantage of, and strengthen, these endowments. To this end it has focussed on the upper echelons of the informal economy in specific sectors – trade, tourism and construction. It commissioned studies on identifying constraints for the upper income strata of informal traders and will pursue these same issues in regard to the construction industry and other sub sectors which have strong linkages with formal sector value chains. The focus on the upper income strata is driven by the fact that these segments have the capacity to grow employment in the informal economy. The stress has also been on pursuing mechanisms to build the linkages between the formal and the informal economy. These are manifested in proposals regarding strengthening the informal tourism sector through township tours, music, restaurants, residential stop-overs, and the 'creative street' projects.

2. The role of Cape Town

The Cape Town Functional Region (CTFRU), which incorporates metropolitan Cape Town, dominates the Western Cape economy. It constitutes 87.4% of the Western Cape's GDPR (13% of SA GDP). Between 1995 and 2005 it had an average growth rate per annum of 4%, whilst in 2004 and 2005 growth averaged almost 6%. This is faster than the rest of the province resulting in the CTFRU share of provincial GDP rising consistently. While the labour force is currently increasing at about 2.4% per annum, this is slower than the overall rate of growth and slower than the rate of job creation. Thus, in the CTFRU broad unemployment fell from 26% in 2004 to 22% in 2006 and narrow unemployment from 19% to 14%.

In summary, therefore, growth has been moderate and sustained, and has increased over the last few years. Moreover, growth has been associated with employment gain and falls in unemployment, despite the influx of new job seekers. However, as in the rest of South Africa, unemployment is heavily concentrated among those with few skills and among the youth – currently 39% of 15-24 year olds are unemployed.

Within the CTFRU the strongest growth has consistently occurred in the broad tertiary sector – i.e. wholesale and retail trade and catering and accommodation (including tourism) and business services. The tertiary sector now dominates the CTFRU – and by extension, the province – with the consequence that over two-thirds (68%) of the CTFRU labour force is employed in the tertiary sector, with employment growing at 6.7% per annum. Almost one third of employment is located in financial and business services.

A number of conclusions emerge from these broad overall trends. Labour demand and employment are growing. However, the tertiary sector is relatively skill demanding. The provincial growth path identified therefore demands increasing skills to meet the growing needs of the tertiary sector. The MEDS (in its various reports) has consistently stressed that skills are a major constraint to growth. The need to tackle the skills constraint is emphasised in the previous chapter as a key priority. However the MEDS has also argued that these broad overall trends also requires that particular consideration is given to facilitating growth in other areas that are more demanding of unskilled and semi-skilled labour. In this regard manufacturing plays a particularly important role and the MEDS has identified a number of sectors to prioritise – e.g. call centres, business process outsourcing, clothing etc.

Using the Cape Town city data as a benchmark provides a valuable insight into the province's competitive edge. Firstly the city constitutes over 80% of economic activity in the

province. Secondly, key districts with high concentrations of knowledge intensive assets and institutions, economic activity, and high earnings, (e.g. Stellenbosch) fall outside the lines demarcating the Cape Town metropolitan area. Thirdly, as opposed to other provinces where the poor are found in the rural areas, the Western Cape is distinguished by the fact that the Cape Town metropole has a higher concentration of poor than in the rural provincial hinterland. Hence, unlike other provinces which tend to spatially marginalise the poor, using the metropolitan area as a benchmark provides a relatively conservative measure.

Table 2: Population and employment by highest education level, 2005

CITY	Population by highest education level		Employment by highest education level	
	Degree	Post graduate	Degree	Post graduate
Buffalo City %	1.2	0.5	4.1	1.6
Cape Town %	**2.0**	**1.3**	**4.5**	**3.0**
Ekurhuleni %	1.3	0.6	2.9	1.4
eThekwini %	1.4	0.7	3.4	1.8
Johannesburg %	2.4	1.6	5.3	3.9
Mangaung %	1.4	0.7	3.5	2.4
Msunduzi %	1.3	0.7	3.6	2.1
Nelson Mandela%	1.3	0.6	3.8	1.8
Tshwane %	2.9	1.8	5.5	3.7
Average: 9 cities	**1.9**	**1.1**	**4.3**	**2.7**

Source: Quantec

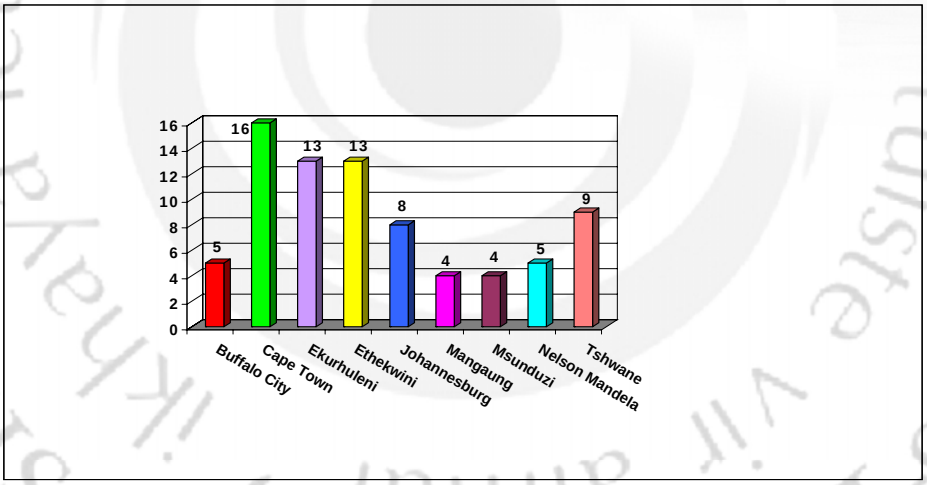
What does the available data say about the competitive edge of the economic driver of the province – the Cape Town metropolitan area? Higher education qualifications are instructive. The three cities in 2004 with the highest percentage of people with degrees and post graduate qualifications were Tshwane (2.9 and 1.8), Johannesburg (2.4 and 1.6) and Cape Town (2.0 and 1.3). This is in marked contrast to the average for the other six cities which stood at 1.1% for degrees and 0.6% post graduate qualifications. This is reflected in the equivalent data for employment by highest level of education achieved. Once again the three cities in 2004 that stand out were Tshwane (5.5 and 3.7), Johannesburg (5.3 and 3.9) and Cape Town (4.5 and 3.0) (Hall and Roodt, 2005). However, unlike Tshwane and Johannesburg, the data for the City of Cape Town exclude important districts with high concentrations of qualified people in its immediate hinterland – Stellenbosch being the most

significant. Finally, the City of Cape Town showed the highest functional literacy rate (88%) of all cities (Hall and Roodt, 2005).

Having large numbers of people with educational endowments is not the only measure of the importance of knowledge intensive activities. The manner in which this is embodied and

exemplified within the regional system of innovation is also critically important as this tends to act as a magnetic polar attraction and have a spin off effect on other forms of economic activity. The leading role of the City of Cape Town in embodying knowledge intensive activities within institutions is clearly demonstrated when comparing the number of FET institutions found within South African cities (Figure 1). With 16 FET institutions, Cape Town stands well above other comparator cities such as Tshwane (9) and Johannesburg (8). Furthermore, in comparing Cape Town as a knowledge-intensive city with Tshwane and Johannesburg, Cape Town has a large number of 'blue-collar' training colleges, while the latter two cities which make claims to be knowledge intensive have a much lower number of such colleges. In the other, more 'blue-collar', cities we do find large numbers of such colleges, as one would expect to be the case. Hence, Cape Town has an advantage in terms of educational facilities across all skill levels. Finally, one should also bear in mind that the 16 FET institutions listed for Cape Town does not include those FET institutions found in surrounding areas such as Stellenbosch and Paarl but which effectively fall within the Cape Town functional region.

Figure 1: The number of FET campuses by city, 2002



Source: (Hall and Roodt 2005)

A measure of the attractive pole of a knowledge intensive region is the extent to which skilled high income foreigners from the global pool of talent gravitate towards it. This can be partly,

and admittedly roughly, measured by the proportion of residents from other high skilled/high income countries (Europe, North America, Oceania) choosing to be legally resident there. Using data from the 2001 census, the MEDS in its 2006 report calculated that two provinces, Gauteng (1.353) and Western Cape (1.202) significantly stand out from the rest of South Africa as an attractive pole. The stock of such cosmopolitan residents for the Western Cape is more than double the national average (0.509), and way above the average for the other seven provinces which only have 0.166 foreign residents as a proportion of their provincial populations. Clearly within South Africa, the Western Cape plays a significant role in attracting high skilled/high income global talent, although, as pointed out in the MEDS 2006 report, 'in international comparisons the country as a whole has an extremely low share of (legal) residents from outside the country'.

3. Creative industries – a special role?

Associated with knowledge intensive activities is a strong emphasis in the Western Cape on the creative and cultural industries. The MEDS in 2005 reported argued that 'the Western Cape has one of the largest – if not the largest - number of culture-related festivals and events out of all nine provinces'. The global experience is that the creative industries have become increasingly important in national economies and in global trade, so that they now are the primary export-earners for some of the leading developed economies. As a vibrant tradeable sector cultural and creative activities can take the form of exported products, or they can play the same function by being articulated and linked to international tourism. In this regard the Western Cape has a distinctive comparative advantage given its extremely vibrant and growing tourist sector attracting people from all over the world.

Tourism gives the Western Cape a major competitive advantage. In 2006 a reported eight million tourists visited South Africa, an increase of 14.4% from 2005. In terms of international comparisons the global average growth for tourism was 4.5% over this period. Furthermore, South Africa is reported to have received 10% more international visitors in the initial five months of 2007 compared to the same period in 2006. Most of these go to the Western Cape, for more than one out of every two visitors to South Africa visits Cape Town. Cape Town has been ranked as the tenth best city in the world in the Travel + Leisure's World's Best Awards 2007 readers' survey.

Furthermore, Cape Town has been named as the top long-haul destination favoured by UK-based events agencies. This is according to the latest M&IT Trends and Spends Survey of delegates and organizers. Cape Town rocketed from fourth place last year to the top of the

list in 2007, beating New York as the favourite city in the lucrative Meetings, Incentives, Conferences and Events (MICE) sector in the United Kingdom. The results of the UK-based survey underscore the Western Cape's emergence as a destination of choice for conference groups.

Activities such as festivals, museums, theatre, dance and visual arts have been shown to have relatively strong linkages to tourism. Furthermore, the dynamic language schools teaching English to foreigners is very much rooted in and associated with the tourism paradigm. Increasing numbers of non-English speaking people come to Cape Town to combine learning the language in well embedded language schools with the advantages of a local tourist experience.

The importance of this association between knowledge intensive activities, education, tourism, and culture in the Western Cape was very apparent to the MEDS. The MEDS 2005 study on the importance of the cultural industries concluded that:

'It is clear that there are very definite synergies and mutually-beneficial links between the sub-sectors of the creative industries and tourism. Major events such as the Cape Town International Jazz Festival and the Mother City Queer Project attract international tourists who come primarily to be part of these events. Up to 5000 international tourists per year are attracted to the English language schools of the province. Although they may not come particularly for these reasons, when international tourists are in the province, cultural experiences such as visits to the local museums, purchasing craft, seeing local theatre or dance, eating South African cuisine, visiting various historical sites, listening to South African music, taking in the architecture of the city, buying locally-designed clothing for themselves or as gifts and visiting local art galleries are integral to the total tourist experience.'

4. Human Capital as a Driver of Regional Economic Growth

These endowments in the Western Cape augur well for what has by now been regarded as the conventional wisdom – that the key driving force behind regional growth is human capital endowments (Glaeser, 2003) – and that urban success comes from being an attractive "consumer city" for high skill people (Glaeser *et al*, 2001).

Florida (2003) has broken these endowments down into three factors. A region needs a strong technology base – e.g. a well resourced and respected research university and manifest investments in technology – which acts as the necessary foundational conditions.

However, in addition, the region/city also needs to be a place that attracts and retains talent. This he regards as embodying 'the lifestyle options, the excitement, the energy, the stimulation that talented, creative people need'. Finally, creative activity is based on the existence of diversity and hence there has to be a manifest ability to attract 'all sorts of people – foreign-born people, immigrants, woman as well as men, gays as well as straights, people who look different and have different appearances.'

Corresponding to these are three types of creativity. The first is technological creativity which finds its expression in fostering and developing new products and technologies. The second he calls economic creativity, which is the ability to be entrepreneurial and turn these new ideas, products and technologies into new businesses. The last he terms cultural and artistic creativity, which he calls the ability to invent new ways of thinking about things, new art forms, new designs, new photos and new concepts. When these three come together, in his view, they spur economic growth.

Florida makes a direct link between knowledge intensive activities and creative/cultural industries by arguing that the concept of creative people encompasses more than knowledge workers, scientists, engineers, technical and professional people. It also means understanding that creativity is multi-dimensional, encapsulating artists, entertainers, musicians and cultural producers. Therefore he advises that regions and cities intent on basing themselves on human capital (i.e. knowledge intensive activity) need to 'develop an environment attractive to the creative class by cultivating the arts, music, night life and quaint historic districts'.

Florida cautions against viewing this focus on the importance of creativity and knowledge intensity as being a middle class perspective. Given the context of the Western Cape and the goals of growth and equity set by the MEDS, he argues that a lot of creativity comes from disadvantaged, ghetto or township neighbourhoods. Hence if these are ignored or eradicated then this has a multiple retarding effect. Firstly, one wipes out the ability for low-income citizens to use the creativity that comes from and is embedded in their own communities. Secondly, it makes it harder and harder for artists and other culturally creative types to relocate to places because they can no longer afford it. Finally it acts as countervailing force against the dynamic of creativity, for sooner or later, 'that place is going to become boring'.

The MEDS has focussed on the fact that the Western Cape exhibits this unique combination (in South Africa) of knowledge intensity, cultural activity, multi-dimensional tourism, and life style residential attractiveness as a major competitive edge for the province. It has used this

to recommend a host of provincial policies based on using these endowments and growing them. These have ranged from bolstering knowledge intensive activity and learning in specific sectors, facilitating the growth of creative industries *per se*, helping informal economy enterprises upgrade and move into better economic positions, fostering activities ('creative streets') in lower income townships, expanding the tourist sector and extending it into townships to spread the experience of cultural diversity, and boosting ICT connectivity access through a broad band internet umbrella over the city. These have all depended on the creation and maintenance of strategic partnerships between the private and the public sector. This strategic partnership has been institutionalised through customised sector based bodies – clumsily termed 'special purpose vehicles' (SPVs) – for example amongst others, 'Calling the Cape', 'Cape Clothing and Textile Cluster', 'Cape Craft and Design Institute', etc. These SPVs have had a dual role – a deliberation and a developmental role. They have acted to identify specific projects and create a forum in which knowledge can be transferred between participants and learning can occur. They have, however, gone beyond this deliberation role and institutionalised development mechanisms to manage projects and advance the growth of the sectors within their specific scope.

These SPVs are in consonance with the Western Cape's stress on knowledge intensive activities. Furthermore their existence, functioning and expansion has provided the Western Cape with an additional competitive edge. They also contain the real possibility of building an enriched, extended and fairly unique regional system of innovation in the province. Whether this occurs, however, depends on the ability of the public sector (both provincial and metropolitan levels) to develop its internal institutional human capacity, create the appropriate institutional arrangements to respond flexibly and agilely, and finally, provide the necessary resource support.

5. Conclusions

The MEDS has argued that there is a link between the better endowments of the Western Cape (and Cape Town) in terms of skills and the lower levels of unemployment and higher average earnings. This is indicative of the complementarity between supply of skills and employment opportunities for unskilled and semi-skilled. As the previous chapter showed, building a higher skills base in the region is not at the expense of an attempt to also focus on the less skilled members of the region. Raising the skills base will also increase opportunities for the unskilled and semi-skilled. But focussing solely on the latter is likely to provide opportunities for neither.

Secondly, the Western Cape's major growth areas have been in the tertiary sector, such that tertiary activities dominate the provincial economy. This is particularly evident in the CTFRU where tertiary employment is now more than 2/3 of total employment. The major growth has been recorded in business services, catering and accommodation and wholesale and retail trade. Furthermore, these activities are growing faster in the Western Cape than they are nationally, and there is a cyclical mutuality driving this process. The growth of tertiary industries has been driven by higher levels of availability of skills and likewise the increased tertiary opportunities have driven the demand for skills. Hence, once again, this is where the competitive edge of the Western Cape lies.

The MEDS, therefore, stressed the policy implication that this gives rise to the imperative need to place the stress on knowledge intensive activities, to grow local skills through a stress on training opportunities, projects and attracting foreign skills. In regard to the latter it is extremely short sighted to view incoming foreign skills as crowding out employment opportunities for locals. On the contrary, the implication is that these incoming foreign skills grow the local economy substantially and hence grow the opportunities for both other skilled and lesser skilled locals.

The MEDS has identified a number of sectors where there are substantial prospects for growth and employment gain. However, while important, growth in these sectors alone will not resolve the development problem facing the province. Given the nature of the Western Cape economy, development will necessarily require an advance along a broad front with expansion in many sectors. It is important, therefore, to identify key blockages to investment and performance experienced by firms in general. In a recent investment constraints study of firms in the Cape Town area these were identified as crime, lack of skilled workers, the education system, government red tape, electricity reliability, telecommunications costs and availability, public transport, and inadequate roads and parking (Wolpe Development Strategies, 2007)

Existing Firms/ Investor's Constraints	New Potential Foreign Investor's Constraints
• Crime, safety and policing • Social issues • Public transport • Skills development • Labour legislation and productivity • Cape Town regulatory constraints • Cape Town land	• High telecommunications costs • Crime, safety, policing, national regulations regarding air access, foreign exchange controls, import duties, and labour legislation • Inadequate port facilities • City of Cape Town development facilitation and service

(Wolpe Development Strategies, 2007)

Ultimately, the major challenges facing the Western Cape and determining whether it will be able to achieve its goals of growth and equity on the basis of its competitive advantage lie outside the scope of the MEDS. The Western Cape economy is broad and diversified. As a coastal, tourism dominated, diversified, open economy sitting astride the major trade routes, it is globally very embedded, able to access global skills and markets. No particular industrial or manufacturing sectors stand out to target as quick-hit major winners. The endowments and knowledge assets are clearly in existence. They may well stand out in comparison to the rest of South Africa, but the region's advantages diminish significantly if a global comparative lens is used. The key obstacles to taking advantage of these endowments and driving the province into a long term, knowledge based, growth path lie in the enabling environment which restricts the ability of participants to take advantage of its competitiveness.

These key challenges are fundamentally infrastructural and institutional. The infrastructure problems are a dysfunctional transport system which restricts the ability of workers and tourists to move quickly, timeously and safely within its environs; a port which does not provide the rapid turn around service needed in this globalised world; a land allocation system still locked into a spatial framework inherited from the apartheid past and which was designed to separate rather than bring together workers and business in an efficient manner; and finally, a telecommunication system which is slow, expensive, and wholly inadequate in terms of broad band interconnectivity, hence restricting businesses and tourists alike in linking globally. These infrastructural issues curtail everyone, and if tackled and resolved would have a general impact, acting like a rising tide to lift all ships.

The institutional challenges are no less acute and complex, but resolving them in a rational manner would create the enabling environment required to have a multiplier impact from the various MEDS and infrastructural interventions proposed. The region's ability to grow and take advantage of its endowments and competitive advantages is restricted by the institutional problems between province and city. These are exacerbated by the complex politics of provincial and city governance. The net result is that many worthwhile economic and infrastructural projects are often tied up in bureaucratic knots. Unravelling this in order to ensure that the main goals of growth and equity are achieved may well be best served by both province and city adopting a policy of 'freeing' their officials, giving them the autonomy to work together, identify issues, propose solutions, and ultimately get on with the job of solving them.

6. Policy recommendations:

What are the MEDS policy conclusions that derive from its analysis of the region's competitive advantage?

1. **Grow skills**: Not only to directly expand the knowledge intensive character of the province, but also indirectly, thereby creating employment and income opportunities for the unskilled and semi-skilled – e.g. through the province's ability to interact with the FET's regarding curricula.

2. **Develop informal economy**: Particularly in respect of the higher income and educational strata but also assisting those sub sectors/activities in the informal economy that are well linked into the region's formal economy, and hence are generating income from outside of the sector (see the chapter on the informal economy). This will ensure that the old "townships" acquire a more diversified social base and do not just remain as worker dormitories.

3. **Free up sector and firm blockages**: Within priority sectors, through the SPVs identify constraints, elaborate suitable remedial policies, and take mitigating action to free up blockages to firm level investment and sector performance.

4. **Rapidly implement public good/infrastructural requirements:** This requires identifying the broad, major requirements that underpin further growth and acting to ensure their implementation. These often fall outside of the specific ambit and remit of sector bodies – the most important being the transport problem and the broad band, wide area, umbrella network already identified by MEDS.

5. **Empower 'government officials' to implement**: Ensuring that the provincial and city officials are mandated to fulfil agreed objectives and grant them the necessary high levels of autonomy to do so.

6. **Maintain the growth coalition through supporting the SPVs**: The MEDS has previously stressed that successful regions are based on building growth coalitions involving a variety of strategic actors and alliances. The SPVs are the deliberative and development node of the MEDS priority sector interventions, identifying blockages, raising key strategic requirements, and ensuring that implementation for sector development occurs.

Chapter 3: Industrial Policy in the Age of Sustainability

1. Introduction

When the MEDS started in 2003, it was committed to the objectives of higher and shared growth. Environmental sustainability was not explicitly part of its brief, nor did that play a major role in provincial development strategies more generally. This has since changed.

In 2007 climate change became a key priority for the Provincial Government in the Western Cape. In his State of the Province address for 2007, the Premier underlined the importance of climate change to the future of the province while the Minister of Environment, Planning and Economic Development devoted almost her entire budget speech to the issue.

This identification of climate change as a key concern for provincial government is happening against the backdrop of a much more rational discussion about global warming in the wake of the Stern Report, published in late 2006, and the renewed attempt by the international community to find a successor to the Kyoto Protocol through a framework agreement being pursued at the climate change conference in Bali in December 2007.

Of course, concern about climate change has existed within and without the Provincial Government for quite some time. But while the issue has so far been the preserve of "issue specialists" or line departments, it is fair to say that it is becoming increasingly mainstreamed. This raises the question as to the greening of the MEDS or, less prosaically, whether and how the MEDS must take climate change seriously in the research that it undertakes and in the policies that it recommends. This is what this chapter is about.

First, it briefly summarises insights from the science of climate change. Second, it synthesizes the economics of adaptation and mitigation as expounded in the Stern Report. Third, it describes policy responses at national, provincial, and municipal level in South Africa. Finally, it suggests what this implies for the theory and practice of provincial-level industrial policy.

2. The science of climate change

The Fourth Assessment Report of the Intergovernmental Panel on Climate Change (IPCC, 2007), published in late 2007, pronounced itself in five areas that are relevant to the Western Cape.

1. On the basis of observed increases in global average air and ocean temperatures, rising sea levels, and of melting of snow and ice, global warming is an indisputable fact. The last few years were the warmest since systematic records were kept from the mid-nineteenth century. Sea levels have been rising due to thermal expansion, and melting glaciers, icecaps, and the polar ice sheets. In the last century, precipitation decreased significantly in Southern Africa. It is very likely that over the past half century hot days and hot nights have become more frequent and likely that heat waves and heavy precipitation have become more frequent, along with a rise in the incidence of extremely high sea levels in the last thirty years. Regional climate changes, especially temperature increases, have affected many natural systems.

2. Greenhouse gas emissions due to human activities have risen by 70 per cent between 1970 and 2004. The concentrations of greenhouse gases now far exceed those predating the industrial revolution (i.e. mid-eighteenth century). It is very likely that this process has caused global warming. Anthropogenic influences have not limited themselves to global warming, but with varying degrees of likelihood also caused sea level rise in the second half of the twentieth century, affected wind patterns, and increased risk of heat waves, areas affected by drought since the 1970s, and frequency of heavy precipitation events.

3. There is high agreement in the expert community that global greenhouse gas emissions will continue to grow over the next few decades in the face of current mitigation and related policies. Thus, emissions are projected to rise between 25-90 per cent between 2000 and 2030. Emissions at these or higher rates would lead to further warming. As a result, changes in the global climate would very likely be larger than those observed in the past century. The IPCC has high confidence that climate change implies a decrease in water resources in Southern Africa. Apart from increased water stress, other regional impacts include reduced yields from rain-fed agriculture with attendant consequences for food security and health; very costly adaptations to sea-level rise for low-lying coastal areas, and an increase in arid and semi-arid land. Human health will suffer in populations with low adaptive capacity as

a consequence. Change in extreme weather events will have mostly adverse effects on natural and human systems. Even if greenhouse gas concentrations were to be stabilized, global warming and sea level rise would continue for centuries. Depending on the rate and magnitude of change, global warming could have some impacts that are irreversible. This refers, for example, to major sea level rises as a result of the partial loss of polar ice sheets, the loss of species, and so on.

4. Adaptation is already happening; but more needs to be done in order to reduce vulnerability to climate change. How people and societies adapt depends on their social and economic status and development. All societies are vulnerable to climate change but those with a more sophisticated productive base and with relatively more open access to this base will adapt better. The IPCC feels that there is substantial economic potential for the mitigation of emissions over the next decades so as to offset the projected growth of emissions or bring them below current levels. Adaptation plans or options exist in many sectors, including water and industry. In the latter, commercially already available mitigation technologies include more efficient end-use electrical equipment, heat and power recovery, material recycling and substitution, control of non-CO_2 gas emissions, plus other process-specific technologies. Mitigation actions can result in near-term co-benefits that may in turn lower some of the mitigation costs. Changes in lifestyle, consumer behaviour, and management practices can also contribute to mitigation.

5. In the long-term, key vulnerabilities include risks to unique and threatened systems; risks of extreme weather events; the differential impact of climate change across regions and social groups; net negative aggregate impacts; and risks of large-scale singularities (such as sea-level rise). Neither adaptation nor mitigation alone can avoid all climate change impacts – they are complementary. Conversely, unmitigated climate change would in the long term exceed the capacity of natural, managed, and human systems to adapt. The earlier and the more mitigation kicks in, the larger the opportunities are to achieve lower greenhouse gas stabilization levels. Energy supply and use, industrial processes, and energy efficiency will have to play a central role in this.

3. The economics of adaptation and mitigation

The conclusion of the Stern Report (2006, vi) would sit equally well in a report by an environmental NGO. It says that “the benefits of strong and early action far outweigh the

economic costs of not acting" (see also Arrow, 2006; Schelling, 2006). This corresponds with the findings of the IPCC report summarized in the previous section. In addition, the Stern Report contends that there is no trade-off between climate change mitigation and economic development. Thus, quite apart from the fact that unmitigated climate change would eventually limit growth prospects (see also Wolf, 2007), it is possible to decouple growth from greenhouse gas emissions. This is an important message for catch-up economies.

The Stern Report however notes history's ultimate injustice, namely that the poorest countries and people – those that contributed least to climate change – will suffer earliest and most. This is because the developing world is at a geographic disadvantage, more dependent on climate-sensitive agriculture, not fully provided with health and other public services, and with relatively less developed adaptation capabilities because of their lower incomes and higher vulnerabilities. All of this has the potential to worsen poverty.

An important insight is that greenhouse gas emissions are in direct ways linked to economic growth, but that continued growth is feasible while stabilizing GHG concentrations in the atmosphere. The mathematics is straightforward. Stabilisation occurs once emissions are brought down to the level of the Earth's capacity to remove GHGs from the atmosphere. This corresponds to five $GtCO_2e$ per year which is more than 80 per cent below current annual emissions.

Stabilisation between 450 and 550 ppm CO_2e would require that global emissions peak in the next 10-20 years, and then fall at a rate of at least 1-5 per cent annually. This would reduce global emissions by 2050 to 25-70 per cent below current levels. Since the global economy in 2050 will conceivably be three to four times larger than today, emissions per unit of GDP would have to be just a quarter of where they are today. The annual cost of these reductions is estimated at around one per cent of GDP. The range around this point estimate obviously depends on the pace of technological innovation and the efficiency of policy which may clearly differ across the globe. In general, with faster innovation and higher efficiencies, costs would tend to be lower.

GHG emissions can be cut through:

- reduced demand for emission-intensive goods and services
- increased efficiency
- action on non-energy emissions (e.g. avoiding deforestation)
- switching to lower-carbon technologies for power, heat, and transport.

It is these cuts that will translate into the costs of moving to a low-carbon economy. Foregoing one per cent growth in support of combating climate change might seem a small order. But it is important to realize that for some countries and sectors the costs will be higher. On the other hand, there will also be benefits, prominently through the exploitation of new markets for low-carbon energy products. When carbon taxes or other incentives force firms to look carefully at their operations, they may spot unrealized efficiencies. Economy-wide climate change induces an opportunity to reform inefficient energy systems. In addition, there might be co-benefits such as reduced ill health from air pollution.

Policy then needs to address the fact that climate change is a colossal market failure that requires three policy responses, namely the global proper pricing of carbon through tax, trading, or regulation (see also Stiglitz, 2006); support for innovation in and the deployment of low-carbon technologies; and finally the removal of barriers to energy efficiency coupled with broad information campaigns to educate the public.

Internalising the full social cost of carbon will provide incentives to individuals and firms to move from high- to low-carbon goods and services. With a common global carbon price, emission reductions would then take place wherever they are cheapest. It is important that these policies be credible over time. Investments in capital projects with long gestation periods and time horizons such as power stations or buildings only make sense if the commitment to a certain policy is followed through. A commitment perceived as fickle could lead to overinvestment in high-carbon infrastructure that would later make emission reductions more difficult. The current period where carbon is still largely an externality and where carbon pricing is only slowly emerging, is therefore crucial.

Support for innovation is important from R&D to demonstration and early-stage development. Because emission cuts will rely on doing things differently as opposed to doing less of them, new, low-carbon technologies are crucial to achieving this. Collaboration between government and the private sector is important in this regard. Firms will be reluctant to invest in new technologies unless they can be sure that carbon pricing won't change at some point in the future, rendering them non-competitive. Apart from that there are the usual caveats of underinvestment in innovation, all of which underlines the purpose of direct technology promotion. Public R&D in this area has actually fallen in the last two decades (Stern 2006, xix). Returns to an increase in associated outlays are likely to be high.

Barriers to behavioural change must be removed to complement the above two measures. What stands in the way of successful climate change policy is a lack of reliable information, transaction costs, or simply organizational inertia. This can be addressed through regulatory measures – for example, through minimum performance standards – aiming to provide clarity and certainty. Consumers and firms will be better able to make informed decisions if labeling is clear and best practices are shared. Where upfront costs of efficiency improvements are steep, finance measures might be required to support the investment.

4. Policy responses in South Africa

South Africa's considerations of climate change go back to the late 1990s, following the ratification of the United Nations Framework Convention on Climate Change (UNFCCC). A first country study (Kiker, 2000) concluded that the country has both significant sensitivity and vulnerability to climate change effects, but that it can also avail itself of significant resources in support of adaptation to potential harmful effects. How sensitive and vulnerable sectors are is principally related to water resources. The distribution of these effects is likely to be uneven between those with and those without access to meaningful resources. This has implications for policy – areas and populations at risk must be identified from within sectors that demonstrate both high and low vulnerability.

In 2002 South Africa acceded to the Kyoto Protocol. Two years later it published a national climate change response strategy (DEAT, 2004). As a signatory to the UNFCCC, the country is obliged to "formulate and implement … programmes to mitigate climate change and facilitate adequate adaptation" and to "take climate change consideration into account in the relevant…economic…policies and actions with a view to minimizing adverse effects on the economy, on public health and on the quality of the environment" (DEAT 2004, pp.iv-v). Of particular note is that this means to "implement sustainable industrial development through coordinated policies, strategies and incentives through the Department of Trade and Industry and the various industry sectors" (ibid, vii). Mitigation efforts should be part and parcel of cleaner production strategies. The larger ramification of this is that "mitigation action requires a long-term shift in the national economic/industrial base away from dependence on natural resource export and primary materials beneficiation to manufacturing and other value-adding activities" (ibid, 22).

Concrete proposals include:

- the development of energy efficient standards for particular sectors and/or products

- the use of industrial waste products in cement production
- the optimization of process conditions and CO_2 off-gas recovery in the ferroalloy industry
- raised energy efficiency in the chemical industry
- the upgrading or replacement of recovery boilers, the incineration of reclaimed organic residuals, and the recycling of paper – all in the interest of raising energy efficiency – in the pulp and paper industry
- the use of secondary recycled materials as feedstock in the aluminium industry.

The first vulnerability assessment for the Western Cape was undertaken in 2005 (Midgley *et al*., 2005). It confirmed that along with the Northern Cape, the Western Cape was one of the provinces most at risk from being adversely affected by climate change, mainly through warming and rainfall change. More specifically, the projections suggest that there will be a drying trend from West to East, with weakening winter rainfalls, possibly slightly more summer rainfall in the East of the province, a shift to more irregular rainfall with possibly greater intensity, and rising mean, minimum and maximum temperatures throughout the province.

The biggest problem is water. In most parts of the province water is already fully committed; in some there is a water deficit meaning that the constitutionally mandated ecological reserve is being compromised, with deleterious consequences for the integrity of ecosystems. What makes matters worse is that there is continued and rising demand on scare water resources from agriculture, the Cape Town metropole, and the coastal cities. This points to a serious trade-off. Water is already a limiting factor on growth in much of the province. With climate change, there are therefore serious conflicts between environmental integrity and socio-economic development.

Climate change is going to have an impact on all sectors in the Western Cape economy, although exactly what that impact will be is not always clear. Of most relevance to the MEDS is what is going to happen in manufacturing and industry. Climate change exerts an impact through changes in supplies, employment, operations, and consumer preferences. This is of particular relevance to those processes that add value to renewable natural resources, such as agricultural products, forestry products, and fish catch. These products account for a sizeable share of the Western Cape economy and even more so for its exports. In principle, climate change can have both detrimental and positive impacts on these sectors; more studies need to be done to get more clarity.

Some manufacturers will benefit from climate change, for example those supplying climate control solutions, water conservation and recycling businesses, providers of solutions to coastline defence and stabilization, dam construction, and alternative water supply projects. On the other hand, sectors with a high sensitivity to climate change include food, beverages, and tobacco; textiles, clothing, and leather; wood and paper; publishing and printing; and furniture. Sectors that are not *per se* especially vulnerable to climate change might of course be affected by changing consumer preferences, carbon taxes, and the like.

The impact on tourism is not clear. Since most tourists seem to come to enjoy "scenery", biodiversity loss may not be that important. The vulnerability assessment recommended further study to seek clarity. In finance and investment, the sensitivity to climate changes is quite wide ranging. Insurers are vulnerable to weather-related losses and to extreme events. If these events lead to property losses, beach degradation, flooding, or similar which in turn affect underlying secured assets, banks and asset management may be impacted.

The vulnerability assessment critically notes that none of the flagship provincial development strategies explicitly address climate change. If in this sense only, the MEDS is in good company. The assessment concludes that despite the many uncertainties associated with the magnitude of climate change impact in the Western Cape, it is clear that there is some impact, and that it is most dramatic in the water resource sector.

The focus on water is reiterated by a similar assessment undertaken on behalf of the City of Cape Town (Mukheibir and Ziervogel, 2006). Cape Town has the unenviable distinction of being South Africa's first metropole where water demand exceeds supply if current growth continues or if climate change runs its course unabated. This has serious implications for socioeconomic development. Currently, about a fifth of water demand is generated by industry and commerce. This is dwarfed by domestic use but clearly there is great scope for increasing water use efficiencies and allocating water to those users with the highest economic benefit. These are by no means new insights. Integrated water resource planning by the previous Cape Metropolitan Council had proposed that no development or investment decisions be made without taking the actual or potential effects of climate change on water resources into account. Water tariffs have been used during the drought of 2005. Water conservation by both residential and business users could be encouraged through incentives and regulations, including practices such as re-use of effluent and water harvesting. The Cape Town assessment recommends for the city to liaise with the Provincial Government in developing its adaptation strategy to exploit overlaps and synergies (see also Mukheibir and Ziervogel, 2007).

The Provincial Department of Environmental Affairs and Development Planning (DEA&DP) took its earlier vulnerability assessment one step further by publishing an action plan (DEA&DP, 2007). Again, it underlines the centrality of water and focuses on developing renewable energy, energy efficiency options, and minimization of GHGs. The strategy strongly argues to let climate change out of its silo:

> To be effective, the strategy and action plan must result in climate risk being considered as a normal part of decision making, thus allowing government, business and individuals to reflect their risk preferences as they would for any other risk assessment. … Effectively, this means "mainstreaming" climate change into other dimensions of strategic planning and risk management – dimensions that are already in place" (DEA&DP 2007, xiii).

In concrete terms this would mean to include climate change and its associated risks systematically on the supply and demand sides of the province's catchments. There is no question that increased demands on water supply systems – similarly, to the stressed energy supply situation – will have economic and social consequences, most of which are likely to be negative. This calls for the integration of risks from climate change in decision making and planning among the different tiers of government. The action plan suggests that among a first suite of projects would be an integrated water supply and infrastructure management programme as a top priority. This includes researching the cost benefit of irrigation, working toward increasing water use efficiency, establishing uninterrupted water conservancy targets, systems maintenance and repairs, and safeguarding the ecological reserve. It further calls for the reduction of the provincial carbon footprint, through energy efficiency, development of the province's relatively unexploited, yet rich, renewable and sustainable energy resources, effective waste management strategies and cleaner fuel programmes for households and the transport sector. Finally, it challenges the provinces to develop low-carbon innovations, such as the electric car or solar water heater capacity.

The Climate Change Strategy and Action Plan for the Western Cape is among the first documents in the country to consider explicitly how to make use of pricing mechanisms to reflect externalities and incentivise behavioural change. In order to achieve its energy efficiency targets, DEA&DP would need support from other government departments and agencies so as to rely on a regulatory regime and on policy in favour of more energy efficient technologies.

In this, the provincial effort is soon going to be supported by a long-term National Climate Policy, announced by DEAT for 2008/09. At its heart is supposed to be a long-term mitigation scenario process outlining a range of scenarios of future climate action, with particular attention to the cost implications of long-term emission scenarios (Olivier 2007).

5. The MEDS and climate change

Climate change has been on the provincial agenda for quite some time, championed by DEA&DP. The same is true at the national level. However, both nationally and provincially, climate change has largely been confined to a silo, a "green issue" unencumbered by pressing concerns of economic and social development. Nationally, there is reason for cautious optimism that this might soon change. The National Treasury has for some time been considering the environmental implications of the country's tax system. It has recently issued a document that talks about taxing "bads" (such as pollution) rather than "goods", and generally about re-jigging the fiscal system so as to internalize environmental alongside its other objectives. These are initial attempts to get climate change out of its silo. To be sure, this is an uphill battle. The new National Framework for an Industrial Policy, although only promulgated very recently, completely ignores the issue.

So far the situation regarding industrial policy in the Western Cape has not been much different. This is no longer tenable. It is clear that climate change demands a coordinated policy response in which its importance is reflected in all areas of policymaking, i.e. not only that strictly related to the environment. Put differently, it makes no sense for DEA&DP to think about ways to manage water more efficiently while the MEDS does not even consider water when analysing the potential contribution of an industrial sector to growth and employment targets. Climate change and socioeconomic objectives belong together because one affects the other which is why its implications need to be internalized in any commitments of resources, be they undertaken by the public or the private sector.

The MEDS cannot look to the national level for guidance because there are as yet no clear guidelines or good practice. But it can engage with the leadership of DEA&DP in an attempt to spell out what climate change means for an industrial policy whose instruments and objectives are aligned with the attempt to optimize adaptation and maximize mitigation for society in the Western Cape.

Such a discussion would likely have two directions. The first concerns what one might refer to as the greening of the MEDS. The second concerns technological innovation in support of a low-carbon economy more broadly.

5.1 The greening of the MEDS

The MEDS is aligned with the general development strategy of the Western Cape and thus predicated on shared growth. When the MEDS analyses sectors and looks for ways to support those that harbour above-average growth and employment creation potential, it has to date never entertained environmental concerns. This could relatively easily change. Although the MEDS and its principal, DEDT, are not *per se* responsible for costing carbon or for designing a regulatory regime in favour of lower GHG emissions, they could contribute to the general endeavour of aligning the Western Cape developmental agenda with climate change adaptation and mitigation.

For example, as a contribution to the knowledge base about the anthropogenic determinants of climate change emanating from the province, it could work with its principal vehicles, the SPVs, with a view to analysing the environmental footprint of their productive activities. This would produce a baseline of emission activities; it would also delineate the scope for curbing externalities and realizing higher energy efficiencies. In a subsequent step, DEDT could make it mandatory for companies and SPVs to accompany their requests for public sector support with an environmental impact assessment. It would then be possible to agree on "standards" of sustainable manufacturing practices in line with international practices. In essence, this would align the industrial policy framework with the emerging climate change strategy.

5.2 Innovation towards a low-carbon economy

The Western Cape prides itself on being an economy with many knowledge-intensive activities across a range of fields and within both high-tech and more traditional sectors. For example, it controls some of the country's most advanced technology platforms (such as the SALT in Sutherland), hosts pioneering work in the life sciences at its universities, and is putting biotechnological insights to work in its fruit and wine industry. These activities take place in reaction to market signals and in conjunction with government support programmes featuring specific technologies and their applications. In other words, they are rational reactions to incentives.

Therefore, if the Western Cape government introduced a regulatory environment that explicitly incorporated climate change considerations into investment decisions and policy design, individuals and businesses would react to this by internalizing emission costs and coming up with new and better ideas on how to do what they have been doing either more efficiently or in a completely different way. In this perspective climate change would not only be a cost, but an opportunity to define and conquer new markets. In fact, the adaptation to and the mitigation of climate change would be at the heart of the Western Cape's innovation strategy. Since the Western Cape is more vulnerable to climate change than many other parts of the world, its producers have a strong incentive to come up with cutting-edge solutions, given the right conditions. At the same time, due to its relatively sophisticated knowledge and technology infrastructure, it would have the wherewithal to search for new solutions. Because of the global character of climate change, this is likely to generate eminently exportable products and services.

Such a strategy cannot be carried forward by the MEDS alone. Nor would DEA&DP be in a position to design or implement such a strategy single-handedly. In fact, an innovation strategy would rely on multi-agency input. As far as the MEDS is concerned, it could contribute its industry intelligence which is probably unrivalled in the province. What matters is not so much who takes the lead as that all agencies agree to integrate climate change into their planning. In this perspective, climate change would not just be a serious threat but also an opportunity for the Western Cape.

6. Policy recommendations

The conclusion suggests two recommendations.

- Concern about climate change and thus the critical importance of environmental sustainability must inform industrial policy in the Western Cape. This would entail ensuring that in the selection of sectors and activities for support as well as in the policies undertaken, environmental impact factors should be systematically considered and assessed. Where significant environmental degradation is identified, the trade-offs with the objectives of growth and equity should be subject to scrutiny and alternatives should be investigated.

- The MEDS notes the existence of substantial public research capacities in the region that relate directly to "core" environmental concerns – the oceans, the Antarctic, botany, ornithology and environmental sciences, for example. Provincial government

should investigate how these capacities might be more collectively engaged to address the environmental challenges that will be faced by the province. Innovation is likely to be more successful if it is supported by a regional innovation system in which the private sector interacts with the higher education and research systems and in which both are supported by a regional government that is alert to the challenges and the opportunities that climate change presents.

Chapter 4: Understanding the Informal Economy and the Scope for (Provincial) Government Intervention

1. Introduction

This document establishes a framework for conceptualising the relationship between the formal and the informal economies in South Africa, which, in turn, should help to direct policy interventions. In doing so, we hope to aid the understanding of the efficacy of Government interventions in the informal sector, and thus guide the logic and rationale behind them.

A growing literature internationally points to the lack of ability to generalise 'good' government interventions in the informal economy. In other words, what is right for India is not necessarily right for Malawi, and for that matter, what is right for Bombay is not necessarily right for Calcutta. Best-practise policy interventions have to be sensitive to the manner in which the informal economy is differentiated – in terms of the heterogeneity across the country (urban, rural, etc.), in terms of the heterogeneity within a single geographical unit such as a township, in terms of the heterogeneity of their linkages to different sectors, and how informal economy businesses deal in tradable and non-tradable activities. It also has to recognise that rather than there being a dichotomy between formal and informal, there is instead a continuum between the two. However this is not a continuum on an even plane, but is differentiated by the reach of official governance mechanisms, and the nature, scope and reach of the informal economy activities.

The Provincial Government of the Western Cape has to develop an accurate understanding of the informal economy in the province in order to make appropriate interventions. Thus far, the MEDS has devoted resources to understanding different dimensions of the problem: a quantitative study was conducted in 2006 and a more qualitative study was conducted in 2007 focussing specifically on the retail and tourism subsectors. As the results of these studies are disseminated, they force us to engage with seemingly counter-intuitive facts, such as the finding that some businesses in the informal economy want to stay there and not enter the formal economy. Why is this the case? This document seeks to provide a framework to understand the rich empirical landscape that characterises the second economy and all its seeming perplexities.

2. A Framework for Understanding the Informal Economy

This section addresses two questions: (a) what is the role of the informal economy, and (b) what is the relationship between the informal economy and the formal?

These questions, in turn, provide a framework for understanding the economy.

2.1 What is the Role of the Informal Economy?

The informal economy plays many roles to different agents (individuals and firms) at different times. Perhaps its most important role, however, is to provide an opportunity to those who cannot find employment in the formal sector to generate a livelihood by some means. Over time, this is particularly important to a country as it experiences cyclical fluctuations of economic growth associated with (a) the business cycle (medium-term), and (b) longer-term structural change.

One of the features of the South African economy post-1994 has been its greater openness to foreign trade and investment. As this has proceeded, various sectors of the economy have experienced either growth or decline in line with increasing competitive pressure from foreign firms. For some sectors such as the clothing and textiles industry, greater openness has arguably resulted in a systemic decline of the formal sector. Thousands of workers have been made redundant in the process in the Western Cape alone. The informal economy has been a destination for many of these workers, who have either found roles as independent suppliers to their previous places of employment or who have used redundancy packages to foray into new forms of trading.

This serves two important functions:

1. It can prevent the industry from possibly closing altogether by facilitating cost reduction strategies and allowing formal firms to maintain operations; and

2. Over time, it may allow the industry to re-organise in such a way that it can regain its competitiveness – perhaps not in the same market but in a new niche.

In this instance, the role of the informal economy can be critical to the long-term survival of industries in the formal sector.

2.2 What is the relationship between Formal and Informal?

The dichotomy between the formal and the informal sector is increasingly being challenged because of their interrelationships. Value-chains in certain sectors of the formal economy often depend, to one extent or another, on goods produced in the informal sector. Interactions can be considered to be both in terms of demand for and supply of goods and services between them, and in terms of flows of factors (e.g. workers). The two economies intersect at all times, with the level of interaction changing over the business cycle and over a country's long-term development.

A traditional view of the informal sector saw the informal economy working in isolation from the formal and disappearing over time. As we've discussed above, it would be completely inaccurate to draw this conclusion, certainly in most major urban centres. In addition, the link between the informal economy and the rest of the world was under-examined, yet we know that traders in this sector often source foreign made goods at the wholesale level, even if these are first imported by firms in the formal economy. Consequently, it is important to think of the informal sector as an economy in its own right, with linkages both internal to a country (to the formal economy), and external to it (with the rest of the world).

Thinking about the informal economy as a legitimate entity in its own right helps one understand the scope for intervention. However, we also need to think about the types of industrial sectors in the informal economy and the needs of the individuals and firms that work in those sectors. To do this, we separate potential interactions into the following:

1. Firms and individuals whose outputs link into tradable sectors of the informal economy, such as clothing, construction and tourism, and thereby bring new revenue sources into that informal economy;

2. Firms and individuals that deal in non-tradable sectors, such as hair-dressers and small retail spaza shops, and hence re-circulate revenue within the informal economy.

All firms in the informal economy can benefit from the formal economy if (a) people who live there earn more money and spend it in the informal economy, in which case it alleviates demand constraints, or (b) tradable activities obtain greater market access to the formal economy, in which case new money is injected into the informal economy.

3. Conduct of Firms in the Informal Economy

One of the most important implications of the above discussion is that the objective of government policies specifically directed to the informal economy should firstly aim to understand the diverse ways that individuals improve their well-being there, and then to formulate initiatives designed to help them further improve it. Firms in the informal economy sometimes have complex interactions between themselves, their clients and their communities. This section briefly explores how this affects the conduct of firms.

Successful businesses in the informal economy follow different patterns. Some follow a traditionally expected route – they grow, concentrate their capital, and move into formal enterprises. However one of the contributions of Charman *et al*'s (2007) chapter to the MEDS has been to point out that there are social relationships that exist in the informal economy that help shape the interaction between firms. For example, it was found that successful businesses in the retail and tourism sectors sometimes keep their businesses small even when they are financially sound. Hence they either spatially proliferate similar businesses in the informal economy, or prefer to invest elsewhere in order give the impression of not taking business away from others trying to maintain their livelihoods. This suggests that we must be mindful of social norms such as establishing (or giving the illusion of) trust and reciprocity in business practises when formulating policy for the informal economy.

Firms also seem to have been in existence on average for more than five years, implying that people are able to develop livelihoods in this economy. Furthermore, in some instances there was an inter-generational transfer of the business as children of the owners matured, suggesting that there is indeed scope for maintaining livelihoods over considerable periods of time for successful entrepreneurs. The informal economy therefore provides tangible opportunities for individuals to both *attain* and *maintain* livelihood strategies.

More successful firms in the retail sector were also very reluctant to apply for a loan. This was reported to be due to entrepreneurs' hesitance to incur the high costs of debt and the consequences for themselves and their businesses should they default. However, this is classically a problem associated with operating in the informal economy, in the sense that firms are prevented from accessing finance from formal banks where interest rates are lower. The market failures associated with the formal financial sector in South Africa therefore force successful firms in the informal economy to be risk-averse and develop their businesses from retained income.

The behaviour of firms has to be understood and taken into account when policy is formulated in order to avoid sub-optimal outcomes. What, then, should the objectives of policy be?

4. Formulating Policies for the Informal Economy

Three principles should guide the formulation of specific interventions:

1. Improving the capacity of individuals and firms to self-organise and address their collective action problems by themselves;

2. Improving market access to the formal economy and other problems that arise when individuals interact through markets; and

3. Minimising the scope for conflicting government initiatives, e.g. eliminating conflicting municipal bylaws that prevent informal traders from operating.

These three principles can be seen to address (1) market failure, (2) group failure, and (3) government failure. Market failure refers to a wide range of circumstances that stifle the operation of a market and lead to less efficient outcomes. They can also be based on a problem or restriction of the system of property rights in a country. Group failure has to do with the ability of people to self-organise and address their collective action problems by themselves. Government failure occurs when a government intervention causes a more inefficient allocation of goods and resources than would occur without that intervention.

These three concepts do not operate in isolation. For example, the system of property rights designed under Apartheid led to the creation of many townships, which can be considered as a combination of both government and market failures. In the contemporary literature (e.g. De Soto, 2000), extending the system of property rights to include poor people in the townships has been one of the most widely-cited success stories for improving the living standards of the poor and reducing inequality. This is clearly something that is not necessarily easy to effectuate at the provincial level, but nevertheless must be borne in mind in this discussion.

Inappropriate city and municipal bylaws sometimes restrict the ability of poor people to trade their goods in urban public spaces, which can be considered a combination of government

and group failure. Skinner's (2006) report for the MEDS noted the legislative differences in this respect between municipalities in the Western Cape, pointing to a clear role for provincial government to intervene. Within the informal economy, an active effort by locals to exclude or restrict foreign African nationals from economic activity is another example of group failure.

An example of another important government failure is arguably the rigid labour law framework promulgated in South Africa in the 1990s. While these laws serve to provide and protect the rights of workers in the formal sector, they also impose large transaction costs on micro firms in the formal economy. Consequently, it is very expensive for informal firms to 'graduate' to the formal economy, and many therefore stay small and choose to stay out of it. Charman *et al*'s (2007) study for the MEDS provided evidence to support this argument. A different example of the impact is employees made redundant in the formal sector who get given an opportunity to continue supplying the firm, but who choose not to register as sole-traders or start their own companies, because there are financial advantages to staying small and out of the formal sector.

5. Policy Lessons for the Informal Economy

The following quote usefully summarises policy lessons for the informal economy:

"The policy issue is not one of greater or lesser reach of government being better in general, …, but one of the right reach of government. This right reach has to take into account (1) the objectives of interventions, (2) the implementation of the intervention, and (3) the response of the structuring of activities to this intervention – it being recognised that more or less structured does not necessarily correlate with good or bad" (Guha-Khasnobis, Kanbur, and Ostrom, 2006, 6-7).

The same authors then separate best-practise policy lessons for the informal economy into five components:

- Policy interventions should be placed as close as possible (both in terms of level of government and/or geographically) to where it is meant to influence markets or groups. It should also be embedded in a larger system that supports the autonomy of lower level governments and provides them with essential back-up services, including conflict resolution.

- There should be a balance between 'formal' interventions and 'informal' practises. In other words, formal interventions are more effective if they are not meant to replace or 'crowd out' informal rules, but instead help fine-tune them.

- Design interventions to be consistent with the implementation capacity of government, and the absorptive capacity of the people it is intended to help. In other words, be careful with imposing rapid changes that lead to confusion, and that people may then ignore and do something entirely different.

- Interventions should be complementary, as successful initiatives usually form part of a broader package. Therefore, considerable care should be given to designing a set of interventions with core objectives and supporting measures.

- Use 'voting-with-their-feet' as an evaluation criteria. If people try to move out of the net of an intervention in significant numbers, it should be presumed that the policy is not working. If, on the other hand, people move into the net of an intervention (including when that intervention is reduced), this is a signal of success.

6. Formulating Initiatives for the Western Cape

Perhaps one of the most important prerequisites to help provincial government formulate interventions is information. From the two studies commissioned by MEDS in 2006 and 2007, it has become apparent that different subsectors of the informal economy have very different needs. Following Gauteng and Kwazulu Natal, the Western Cape government needs to conduct a survey of the informal economy. This call was made in the MEDS 2006, and is reiterated here after having received further evidence of the complexity of the sector from Charman *et al*'s (2007) work.

The primary advantage of undertaking a specific survey for the province is that it will help shed light on the interactions between the informal economy and the formal economy, which could then be used to generate a more holistic policy plan. This is in direct contrast to simply identifying piecemeal interventions whose efficacy is difficult to establish, or monitor or evaluate.

The importance of this should not be underestimated. While the retail and tourism subsector analysis in MEDS 2007 made a very important contribution to our understanding, it is very likely that other subsectors in the informal economy will have very different needs, as

discussed above in relation to the different types of firms and their relationship to the formal economy. Therefore, we must expect that the conduct of individuals and firms will differ in important respects *within the informal economy*. For example, individuals engaged in the clothing sector will have very different needs to those in the construction sector. Without understanding this dimension, there will always be a risk that interventions are misguided. That risk is not eliminated by a survey, but it is attenuated with better information.

Interventions also need to be separated into those that have a general impact on communities and firms in the informal economy, such as improving infrastructure or enhancing safety and security, and those that have a specific impact, directed to certain industries or educational (skills) development programmes within townships. Here, an important global network that has focussed historically on urban poverty problems called the Cities Alliance: Cities Without Slums[3], has done tremendously successful work across some of the world's poorest regions. An important component of their work has been the integration of economic, social and environmental issues when formulating policies and interventions for the informal economy.

7. Conclusion

The informal economy poses one of the greatest challenges to the growth trajectory of any developing country. In South Africa, the historical circumstances that gave rise to the spatial and economic landscape of the informal economy concentrated individuals and activities within very particular geographical areas. Without successful interventions to improve the livelihoods and well-being of individuals and firms that reside in those areas, we risk the rise of social tensions that could undermine the long-term growth trajectory of the province and the country.

A key principle of the MEDS since its inception has been the need to integrate the informal economy to the greatest extent possible into the industrial strategy formulated. This has been very difficult to accomplish, in large part due to the paucity of information on the subject and the diversity of the informal economy as a whole. This continues to prevent a more comprehensive policy strategy from being formulated, but we have taken definite and positive steps to accomplish this goal.

[3] See: http://www.citiesalliance.org/index.html

This document established a framework for policy development that, with the additional information that an informal economy survey would provide, could immediately lead to the ability to formulate far-reaching policies ranging form the general (e.g. infrastructural development) to the specific (e.g. enterprise training). The document also provides a cautionary note in this regard, raising the point that more intervention is not necessarily better. Therefore the emphasis should be on understanding the informal economy first before myriad initiatives are developed.

The implication of treating the informal sector as an economy and not as an aberration to 'normal' economic development means that we have to understand it as an economy, with competitive and uncompetitive firms and industries alike. Consequently, we have to build up our informal set in order to intervene on a pragmatic and sustainable basis.

8. Policy Recommendations

1. The MEDS 2006 recommended a survey of the informal economy in the Western Cape. We strongly reiterate that call. This survey should focus on the interrelationship between firms in the informal and formal economies. Precedents can be taken from similar Gauteng and Kwazulu Natal surveys already completed, and from the template (including questionnaire design) for gathering data and conducting surveys in the City Alliance project.

2. There is a significant stratum of entrepreneurs in the informal economy who have reasonable earnings capacity and the ability to finance firm expansion from internal resources. Provincial government must target these types of firms because it is then possible to maximise the potential impact of interventions since: (1) these entrepreneurs have the greatest capacity to increase productivity, and (2) they are also the most likely to be able to create additional employment.

3. Focus interventions to individuals and firms engaged in tradable sectors that already have linkages to the formal economy. This is perhaps the most effective manner in which to help inject new money into the informal economy (as opposed to circulating flows within that economy).

4. Minimise the prospects for government failure by ensuring alignment of policy between Provincial and Municipal spheres. Where possible, encourage inter-governmental collaboration on feasible initiatives.