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Market Power, Growth, and Inclusion:
The South African Experience

Vimal Thakoor

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Market Power, Growth, and Inclusion: The South African Experience¹

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Abstract

Before the pandemic, the South African economy remained stuck in low gear, with anemic growth, stagnant private investment, and a shrinking tradable sector. Subdued growth has raised unemployment, poverty, and inequality, hindering inclusion efforts. The pandemic has worsened economic and social vulnerabilities. Economic recovery and social inclusion hinge critically on structural reforms to boost competitiveness and growth. Product markets represent a cornerstone of the reform strategy. Firms have used their market power to drive up prices and limit competition. Important state-owned monopolies provide low-quality services, while representing a fiscal drag. Existing regulations inhibit the entry of both domestic and foreign firms. Addressing product markets constraints could boost per capita growth by 1 percentage point—adding about 2½ percentage points to headline growth—and foster greater inclusion.

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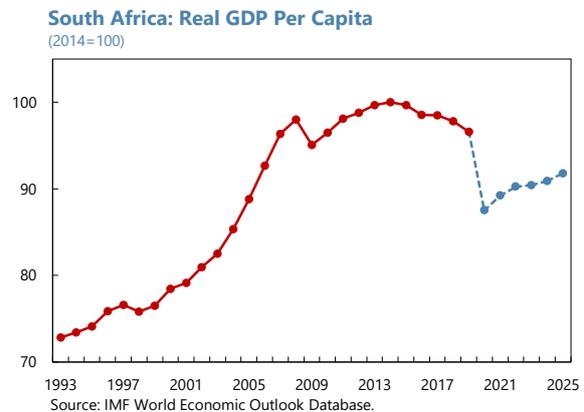
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I. INTRODUCTION

Covid-19 is exacerbating South Africa’s existing economic and structural vulnerabilities. The pandemic has created further headwinds in addressing the social legacies of apartheid and meeting the aspirations of a new generation. Following a robust performance in the run-up to the 2008-09 global financial crisis (GFC), growth has stagnated for the best part of the last decade, with per capita income declining since 2014. The pandemic will lead to a severe economic contraction, with a gradual recovery expected. Low growth will continue to hamper the government’s attempt to stabilize the economy and foster greater inclusion through lower unemployment, poverty, and inequality.



Weak growth is a result of structural constraints that have worsened over time, thus deterring private investment and productivity improvements. Structural constraints relate to factor market inefficiencies which inflate the cost of doing business. In product markets, inefficient state-owned enterprises (SOEs) and dominant players control strategic sectors, hindering healthy competition and the provision of cost-efficient inputs. Excessive regulation in some markets creates uncertainty for investors. Labor market rigidities and skills mismatches constrain entrepreneurship and job creation. Financial markets are subject to segmentation, with small businesses having limited access to financing. Additionally, the deterioration in governance has inhibited the capacity of important institutions, while policy uncertainty has dampened investor confidence.

This study focuses on market power and economic outcomes in South Africa, and how product market reforms could support growth and inclusion efforts. Measuring market power is fraught with uncertainty due to the technical complications associated with estimating markups and concentration indices². Moreover, any discussion of market power in South Africa cannot be disconnected from the unique market structures inherited from the apartheid-era. Against this backdrop, we adopt a narrative approach and use various existing measures of market power to assess their links with economic and distributional outcomes. We use the following data: aggregate mark-up (Diez, Leigh, Tambunlertchai, 2018; IMF, 2019b); industry-level mark-ups (Aghion, Braun, and Fedderke, 2008; Fedderke, Obikili, and Viegli, 2018); market concentration (Buthelezi, Mtani, and Ncube, 2018); and regulation indices (OECD, 2018).

The literature provides mixed evidence on the links between market power and economic outcomes. The increase in market power is a global phenomenon, which has been associated with decreasing labor share and increasing reliance on network goods;

² The conventional approach to measure market power focuses on markups defined as firms’ ability to maintain prices above marginal costs. Under perfect competition, such a situation would result in the entry of new players, and prices would equal the marginal cost. However, in dynamic settings, firms with significant market power may choose not to exercise this option at the risk of increasing the incentives for new entrants (Baumol, 1982). Another measure of power is the use of concentration indices, which relate to the market share of the biggest players. Such indices however do not control for market entry and exit and can thus overestimate the real power of big players (see Syverson, 2019). Computational challenges are also discussed in Diez, Leigh, Tambunlertchai, 2018; Basu, 2019; and Budlender, 2019.

frictions in goods markets; and product differentiation. These factors have influence on price dynamics and consumer access to niche products, with positive or negative influence on welfare and income distribution (Syverson, 2019). Hence, the link between market power and economic outcomes is not always clear³. High market power can support greater innovation and investment (Autor et al., 2020), but can also constrain economic growth by stifling competition, job creation, and innovation.

There are strong suggestions that the product market structure is a major contributor to South Africa’s weak economic performance and hinders inclusion. On average, elevated market concentration has translated into higher prices, as firms have leveraged their market power to hike markups, albeit with heterogeneous effects across industries. Network industries have passed on their inefficiencies to the broader economy, including through regulated prices and unreliable services. Evidence suggests that market concentration is more correlated with lower entrepreneurship, private investment, exports, and growth in South Africa than in comparable peers. As a result, consumers, particularly low-income groups, pay high prices for their goods basket, while being excluded from the workforce amid limited job and entrepreneurial opportunities, thus worsening distributional outcomes. The pandemic will exacerbate concentrations trends and social outcomes as small businesses and low-income households are disproportionately affected.

Product markets reforms could support the economic recovery and boost competitiveness. Per capita growth could be higher by up to 1 percentage point, with headline growth increasing by 2.5 percentage points. Even higher gains could be possible when complemented with other reforms. Major reforms under consideration entail changing the model that gives network industries—energy, telecommunications, transportation—monopoly power; fostering competition, including by leveraging technology, for example, in banking and manufacturing; and streamlining regulations to support entrepreneurship. Greater contestability will enable investors to competitively produce goods and services domestically and better integrate global value chains, thus reversing the declining contribution of the tradable sector to domestic output. In most cases, the reforms entail credibly advancing already announced government policies. Absent reforms, South Africa faces the risk of another lost decade and a lost generation.

Starting with product market reforms is also aligned with the deteriorated post-pandemic social situation. These reforms can increase the purchasing power of consumers and create more jobs. For instance, many countries have seen significant reductions in data prices and the emergence of new industries following an injection of competition in the telecommunication sector. Successful implementation would also generate buy-in for other more difficult reforms, particularly in labor markets, and complement post-pandemic economic stabilization. While country- and time-specific, successful reforms elsewhere share characteristics as regard political ownership, design, sequencing, and communication. Importantly, reform implementation should ensure that groups that see their benefits eroded do not become stumbling blocks to national interest.

The rest of this paper is organized as follows. Section II surveys product markets in South Africa. Section III discusses the economic consequences of high concentration and markups. Section IV presents various policy options to promote competition. Complementary policy measures are elaborated in Section V. Section VI concludes.

³ See Aghion et Griffith (2005) for the theory; Autor et al. (2020) for the declining share of labor and the rise of superstar firms; and De Loecker, Eeckhout, and Unger (2020) for the stylized facts linking competition and macroeconomic outcomes; and Baqaee and Farhi (2020) for mark-ups and productivity.

II. UNDERSTANDING SOUTH AFRICA'S PRODUCT MARKETS

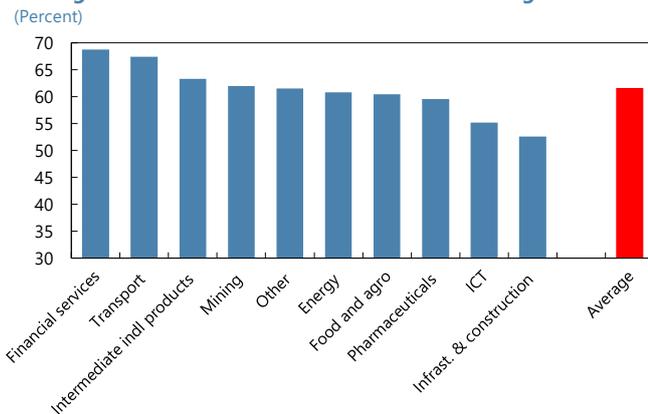
Drivers of Market Concentration

Three main factors explain South Africa's high product markets concentration:

- **First, the apartheid-era sanctions resulted in a concentrated market structure that has not changed fundamentally following black economic empowerment (BEE).** During apartheid, large SOEs ("national champions") were established to provide subsidized inputs for industrial production, while dominant market players emerged to meet the financial needs of those industries, mainly mining (Roberts, 2004; Faulkner and Loewald, 2008). This scheme led to a concentration of ownership and anti-competitive trade practices. International trade and import restrictions inadvertently strengthened these trends, increasing incumbents' market power. With BEE, companies opened their shareholding to previously marginalized groups, but the market structure remained fundamentally unchanged.

Hence, most incumbents and large SOEs remain unchallenged from competition and continue to have a large economic footprint a quarter of a century later.

Average Market Share of Dominant Firms in Strategic Sectors (Percent)

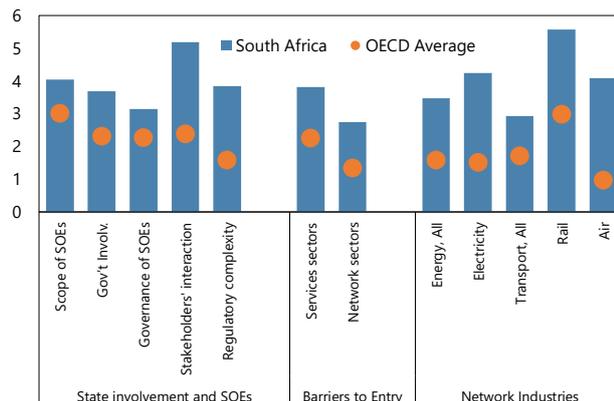


Source: Author based on Buthelezi et al (2018).

- **Second, government policies have shielded existing industries from competition.**

South Africa's levels of regulation are higher than the OECD average. The complexity of procedures and controls has not been addressed over time, creating strong barriers to entry to both domestic and foreign investment, and inhibiting contestability in services and network industries. Moreover, the market power of SOEs has at times allowed them to design their own policies and even deviate from statutory laws. Regulatory constraints relate to ownership, domestic procurement, and content requirements. Beyond the cost of enforcing compliance, these policies have contributed to inflating production costs due to limited supply and high mark-ups by suppliers.

Selected Products Market Indicators



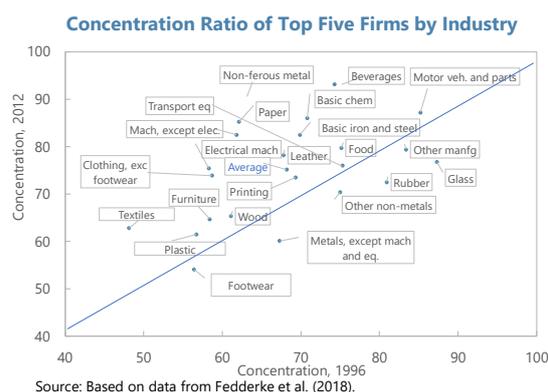
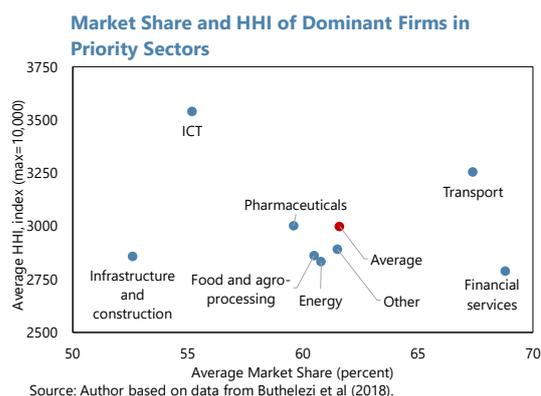
Source: OECD (2018).

- **Third, incumbents tend to engage in uncompetitive practices to preserve their market shares.** The Competition Commission of South African (CCSA) has shown evidence that firms resort to mergers, exclusionary conduct, and lobbying for entry—all practices that inhibit competition (CCSA, 2017 and 2018). The CCSA also found evidence of collusive behavior to segment markets and set prices for a wide range of products, such as bread, flour, steel, wire, cement, plastic pipes, bricks, concrete, and

construction. For instance, consumers have few alternative options for supermarkets due to barriers to entry (Das Nair and Dube, 2015). New entrants struggle across the value chain including advertising, distribution, logistics, and finance. Exclusivity clauses prevent the entry of competitors⁴. There is acknowledgement that competition policy has been effective in blocking anti-competitive mergers and uncovering explicit cartel behavior, but relatively ineffective in addressing entrenched market power and opening up the economy to greater access (Makhaya and Roberts, 2013).

Evolution of Competition and Markups

Market share indicators point to high and increasing concentration, with some variation across industries. A few firms controlled, on average, 62 percent of the relevant markets in strategic sectors, with the financial and transport sectors exhibiting the highest levels of concentration (Buthelezi, Mtane, and Ncube, 2018). Another indicator (the Herfindahl-Hirschman Index)⁵ also suggests that markets are highly concentrated. Based on data from Fedderke, Obikili and Viegi (2018), even the manufacturing sector, which is relatively more exposed to foreign competition, the top five percent of firms raised their market shares from an already high 68 percent in 1996 to 75 percent in 2012. Increased concentration in the manufacturing sector could be partially due to the consolidation that took place as South African firms were exposed to international competition and uncompetitive firms exited the domestic market.



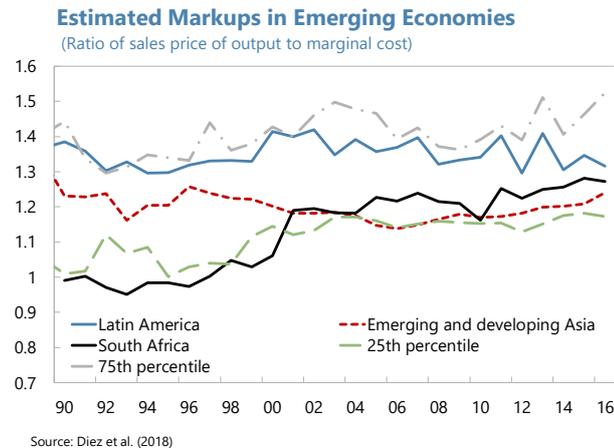
High concentration has been accompanied by elevated and increasing markups at the economy-wide level, albeit with sectoral divergence. Recent works have exploited the National Treasury's firm level database covering the period 2010-14. Budlender (2019) finds suggestive but not definitive evidence of high markups and calls for nuancing the narrative surrounding high and rising markups. Cross-industry analysis do not yield conclusive insights. Dauda, Nyman, Cassim (2019) find that average markups rose between 2010 and 2014, with the rise driven disproportionately by large firms. In both cases, the magnitude of markups varies with the methodology and indices used to measure competition.

⁴ Regulatory measures were put in place to limit predatory pricing and relax exclusivity clauses in 2019.

⁵ The HHI, which controls for market size, gives scores that range from close to zero (large number of firms of relatively equal size) to 10,000 (monopoly). Values above 2,500 point to highly concentrated markets.

We analyze the evolution of markups using three databases that cover a longer time period than the National Treasury database.

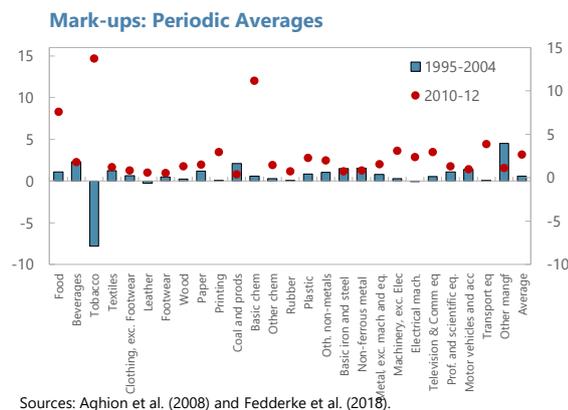
- First, we look at publicly listed firms in South Africa (based on Diez, Leigh, and Tambunlertchai, 2018). Since 2000, South Africa's markups have increased by nearly 25 percent. IMF (2019a) finds that globally, markups increased by an average of 6 percent over the same period, with only the top ten percent of global firms achieving increases similar to the South African levels. South Africa's markups now exceed those in emerging and developing Asia, while remaining marginally below those prevailing in Latin America.



- Second, we look at the estimates from a richer firm-level database published in IMF (2019b). The study finds that markups in South Africa have decoupled from the SSA average following the GFC, with an increase of almost 30 percent.



- Finally, we compare the average markups across selected industries within the manufacturing sector for 1995-2004 from Aghion, Braun, and Fedderke (2008) and 2010-2012 from Fedderke, Obikili, and Viegi (2018). As discussed, this sector has been most exposed to foreign competition through trade⁶. We find that for most industries, the estimated markups were higher during 2010-12. Food, tobacco, and chemicals experienced the biggest increases in markups.



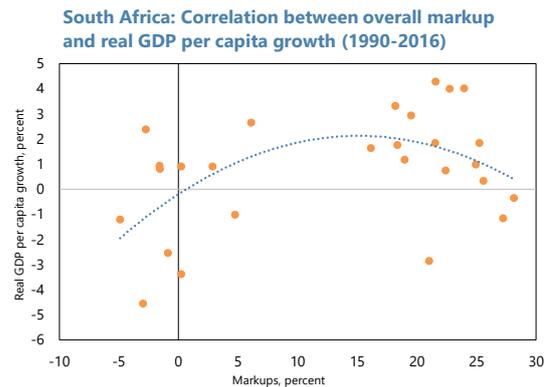
⁶ Increased enforcement by the CCSA, not captured by the available data, could have since resulted in declines in markups. Please see CCSA annual reports for enforcements and interventions.

III. HIGH MARKET POWER AND ECONOMIC OUTCOMES

In this section, we try to understand how the industrial structure and conduct might have influenced South Africa's economic performance. Is it a virtuous story of growth-enhancing innovation, or is it one of growth-inhibiting rent-seeking? We focus on growth, TFP, private investment, inflation, exports, and the ability of small and medium enterprises (SMEs) to operate. We conclude with some distributional implications.

The data show that rising market power that fuels markup levels beyond double digits is correlated with low growth and productivity⁷. While in the context of contestable markets high markups may provide important incentives for firms to invest and innovate, in South Africa private investment has been weak and innovation is flagged as a weakness in competitiveness surveys.

Elevated concentration and markups increase production costs, thereby undermining competitiveness and growth. In the case of South Africa, the rising markups during the past decade have been associated with slowing economic growth and contracting per-capita income. This suggests that market mechanisms are not working as efficiently as prices are not responding to slowing demand.

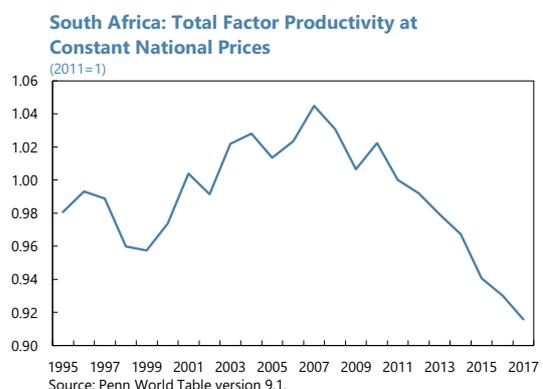


High concentration in network industries has allowed SOEs to pass on their inefficiencies to the economy while generating fiscal costs. Several SOEs are burdened by outdated business models and weak finances due to operational and governance weaknesses, and remain shielded from competition. These inefficiencies have had spillovers on the rest of the economy as SOEs provide essential inputs and services, particularly in network industries. Customers must pay high prices for low-quality services and taxpayers end-up footing the bill of the associated bailouts.

The large footprint of SOEs and the associated path dependency prevent more innovative and efficient companies from entering the market. Eskom, whose declining productivity and deteriorating service delivery has translated into rising prices and disruptive load shedding, is one example of these dynamics. Efforts to protect Eskom's balance sheet have had the unintended consequence of slowing down the entry of much more efficient producers with cleaner and potentially cheaper technologies.

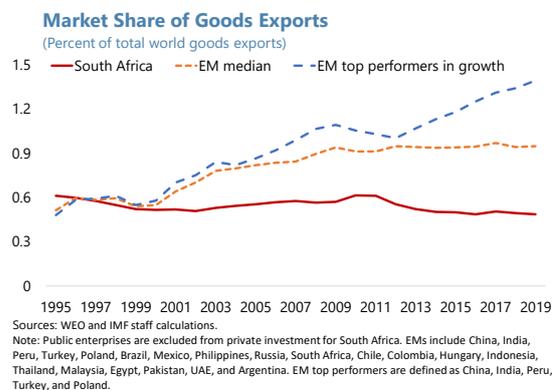
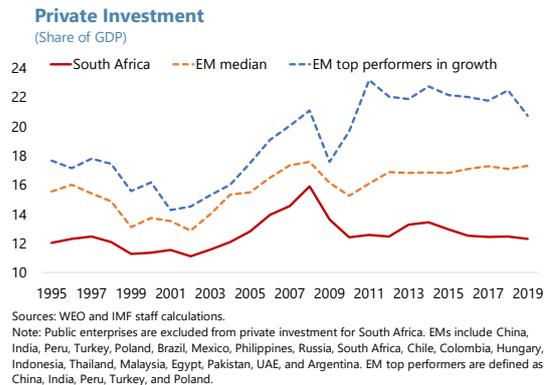
The rising markups are associated with declining total factor productivity (TFP) growth and stagnant private investment and exports.

- There is a strong link between South Africa's growth slowdown and TFP. The strong growth in the early 2000s was associated with rising TFP until the GFC. TFP has failed to rebound after the GFC and has since been on a declining trend.



⁷ For the macroeconomic effects of high markups in the US see Baqaee and Farhi (2020); De Loecker, Eeckhout, and Unger (2020). For South Africa see Dauda, Nyman, and Cassim (2019).

- Private investment has also followed a broadly similar trend to TFP: rising in the run-up to the GFC and failing to rebound thereafter. Evidence shows that other emerging markets also suffered a dip during the GFC, but in most cases private investment rebounded thereafter. The decline in private investment is associated with both a deterioration in the ease of doing business as well as rising cost of doing business, which put together have reduced the returns to investors. Private investment has also suffered from policy uncertainty arising from state capture as well as protracted processes to provide policy clarity in important areas, such as mining and telecommunications.
- Given the deteriorating competitiveness, South Africa has faced both a stagnant share of exports as a percentage of the global economy and the overall contribution of the tradable sector to domestic value addition has been declining from 35 percent in 1993 to about 25 percent. South Africa's share of global exports has remained stagnant at about 0.6 percent. Firms facing international competition are more exposed weakened competitiveness as they are unable to pass-on the higher costs to international consumers. This results in a shrinking of the tradable sector, while favoring firms producing non-tradable and sheltered from international competition.

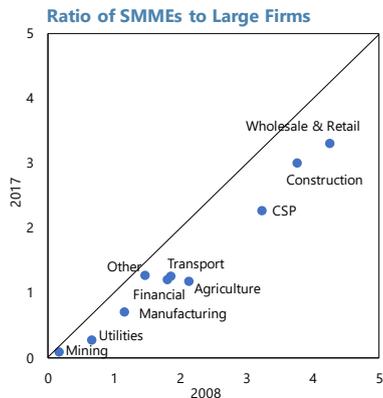


Rising market power has also been associated with a slowdown in job creation, thus translating into rising unemployment. The growth slowdown in South Africa has undermined job creation in a context of large numbers of new entrants in the economy. While there are labor market issues—unionization, regulatory rigidities, and skills shortages, to name a few—the interaction between market power and labor market is not supportive of the country's employment needs. Such a situation contributes to higher levels of unemployment: firms adjust employment numbers in response to rigid wages. Flexible wages would have allowed for increased wage adjustment in response to economic shocks, mitigating the impact on employment levels.

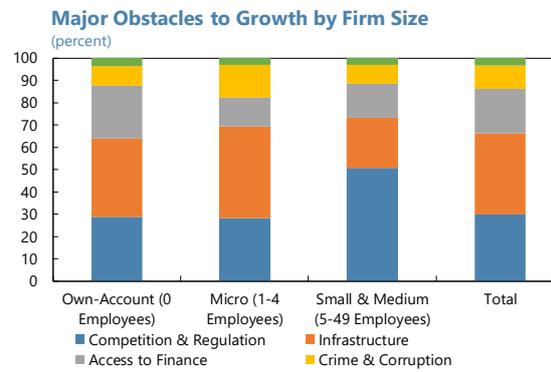
Market concentration has inhibited the emergence of SMEs—a usually dynamic and labor-intensive sector in many countries. South Africa's SMEs space, already one of the smallest in the world in 2008, has shrunk further. Entrepreneurship rates have stagnated at low levels compared to peers⁸. Surveys conducted within SMEs reveal their perception of strong barriers to entry and access to finance, insufficient infrastructure, and regulatory burdens as inhibiting factors. Small firms are disproportionately impacted by weak infrastructure and crime as these exert a higher cost relative to their turnover. A similar argument arises as regard the cost of regulatory compliance. Job creation in South

⁸ See Kaplinsky and Manning (1998) for earlier work on the small share of SMEs in output and employment, and the constraints to integrate the value chain.

Africa is thus more skewed towards large firms, which account for over 90 percent of new jobs. SMEs also note that unfair competition inhibit their ability to integrate the value chain.

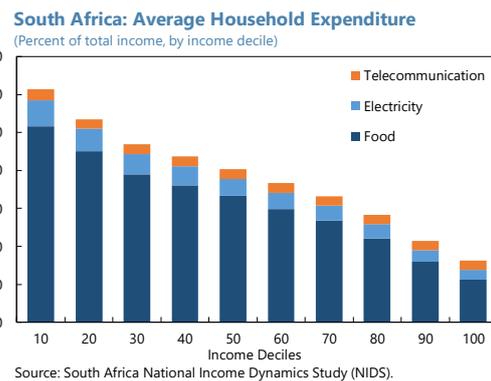
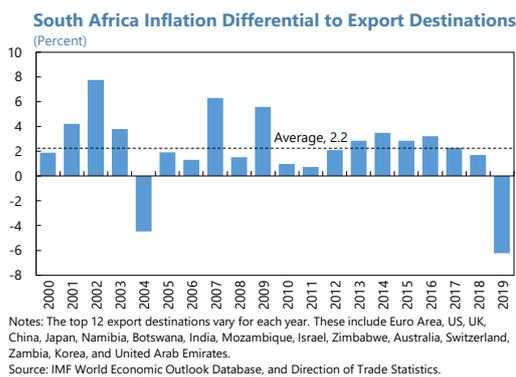


Source: Labor Force Dynamics in South Africa.
Note: Higher ratio means more SMMEs relative to large firms.



Sources: FinScope SMME Survey (2010).

Rising market power creates adverse distributional dynamics by limiting employment opportunities and simultaneously sustaining high price levels. Such dynamics erode consumers’ purchasing power and accentuate inequality. South Africa faces relatively high structural inflation in part due to its market structure (high cost due to inefficient SOEs and high markups) and regulations (contributing to higher costs and price rigidities), which contribute to higher inflation expectations. While the inflation differential relative to the main export destinations has been more stable and declining in recent years, it has undermined competitiveness over time. Consumers are subject to higher prices of essential goods (food and petroleum products) and services (energy, telecommunications, transport) due to providers’ markups and inefficiencies (see World Bank, 2016). Low-income households are disproportionately hurt as these products represent a large component of their consumption basket.



IV. REFORM OPTIONS

Given the evolving market trends and the economic outcomes, the South African economy stands to gain from increased competition. A three-pronged reform agenda, supported by complementary policies, could be pursued to open product markets for new businesses and facilitate their operations. The reforms would focus on: (i) reforming SOEs and rethinking their business model; (ii) leveraging innovation to allow increasing

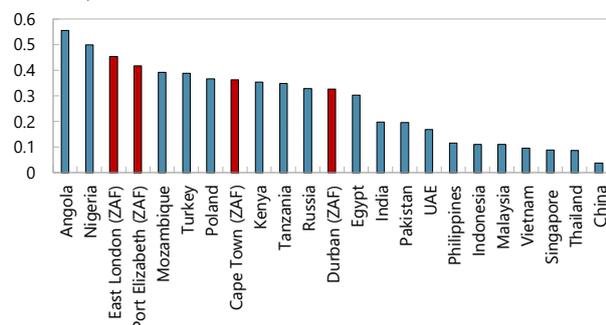
private sector participation in strategic sectors; and (iii) reviewing the regulatory architecture and enforcing competition policy to facilitate firm entry. The proposed reforms are either in line with or complementary to measures announced by the National Treasury (2019)⁹. In various cases, it is about credibly implementing adopted policies.

A. Reducing the footprint of SOEs and introducing competition in network industries to reduce key input costs and increase business opportunities.

SOE reforms should focus on fostering greater efficiency and competition, starting with the network industries. This can be achieved by implementing previously announced plans to restructure, liquidate, or divest SOEs based on commercial viability. The National Treasury’s proposals to strengthen SOE governance, harden budget constraints, and increase private participation should be credibly expedited. Options to free up scarce monitoring resources, and transfer needed government functions of non-viable SOEs to the budget should be assessed. As with all entities with dual commercial and developmental mandates, the developmental aspect should be properly costed and transparently financed through the budget. Eskom, Transnet, and SAA are priorities.

- Improving Eskom’s efficiency and productivity and tackling load shedding will reduce overall business uncertainty, while containing the drain on the budget.* Linking any financing, notably transfers from the government, to addressing the root causes of Eskom’s underlying operational and financial problems is crucial. Unbundling, while needed, will not address those issues. Nor will initiatives that are just oriented to restructure debt (through SPVs) without addressing Eskom’s vulnerabilities. Every effort must be made to tap the pent-up private investment that awaits to be unleashed. Eskom’s Roadmap (DPE, 2019) and the Integrated Resource Plan (DMRE, 2019) need credible implementation to meaningfully address the fundamental issues in the electricity sector. Separation of generation, transmission and distribution and introduction of private sector competition into generation and retail supply have helped improve efficiency in some countries.
- Lowering South Africa’s transport costs could be possible if the monopoly power of Transnet is curtailed.* Transnet effectively controls the maritime and railway sectors, as well as the oil pipelines. Its management of the ports is criticized both for the logistics inefficiencies as well as the prevailing cost charged. In some cases, rail freight is charged at a higher rate than road (see also Pieterse et al., 2015). South Africa’s port cost is significantly more expensive than its Asian competitors. The corporatization of Transnet National Ports Authority currently under consideration could be leveraged to improve the performance of the port and inject greater corporate discipline. South Africa needs competition to Transnet in the ports sector, while

Main Port Transportation Cost
(USD per nautical mile)



Sources: iContainer, Sea-Distances, and IMF staff calculations.

Note: Cost is measured by the total price for transporting a 20-ft container divided by the total nautical mile from New York to the main port of the destination country.

⁹ The National Treasury (2019) reforms focus on modernizing network industries, lowering barriers to entry, promoting agriculture, improving export competitiveness, and implementing flexible industrial and trade policies.

allowing new operators to use the rail network. The cross-subsidization of Transnet's operations must be stopped to allow fair pricing and enable private players to join in. Transnet's monopoly power could be controlled through clauses within its contract to guarantee access to other players and ensure price transparency.

- *Similarly, SAA's business model needs an overhaul.* The implementation of the Business Rescue Plan needs to be expedited to meaningfully address the over-spending and operational inefficiencies, and the equity structure reengineered to leverage private sector expertise and market discipline. The routes should be reassessed to optimize the company's commercial objectives.

B. Leveraging innovation for an enabling and inclusive business environment

There is significant potential for additional private investment across the economy and digitalization can accelerate innovation, while fostering inclusion and efficiency.

A conducive business environment requires market-friendly policies to promote and maintain consumer and investor confidence. Additionally, the existing regulatory constraints (see item C) must be alleviated to provide greater policy clarity and reduce policy uncertainty. Electronic processing of tax submissions, refund payments, and customs declarations saves time and reduces costs, while also reducing the scope for corruption. Similarly, the use of the government's procurement platform must be expanded. Reducing the cost of data is key to accelerate digitalization.

- *Accelerating the allocation of broadband spectrum could be transformational.* It would accelerate digitalization and support the emergence of new products and improve service delivery, while creating business opportunities with minimal trade-offs. In many countries, new players have contributed to reduced prices and improved service delivery by shaking up the behavior of incumbents. Following the entry of new players in the market, prices for telecommunication services substantially decreased, access improved, particularly in mobile broadband subscriptions and data usage, and broadband speeds increased. Even the entrance of an aggressive small player in the telecommunications sector could force incumbents to compete.
- *Leveraging the innovative and inclusive benefits of Fintech.* The financial industry has the highest concentration levels in South Africa, and their operations exclude a large segment of households and firms. Promoting innovation and expansion of financial products would result in higher financing for development and better financial services. South Africa is already witnessing how new Fintech players have contributed to the development of new products for the previously underbanked while contributing to a lowering of prices. Regulations must be adapted to this new environment, including to safeguard financial stability.
- *Making government procurement more transparent, inclusive, and efficient.* Centralized procurement can be used to promote transparency and competition, while tackling conflicts of interest and corruption. South Africa's centralized procurement disseminates all contracts while capturing such information as state employees, taxpayer IDs and status, and the ultimate owners of companies. The database is also used to support law enforcement agencies regarding ethical violation and corruption investigations. The use of the platform must be fully extended to include SOEs, provinces, and local governments. Procurement design could be enhanced to create opportunities for SMEs, while mitigating against abuse.

C. Levelling the playing field to increase market contestability

A reduction in entry barriers and deregulation would allow greater contestability and increase the private sector's contribution to growth. While some large companies are contributing to growth, smaller businesses need more space to innovate, compete, and generate jobs. SMEs stand to gain the most from deregulation efforts. Leveling the playing field by reducing licensing, permits, and other onerous requirements, can improve the return on investment and encourage entrepreneurship. Other options to increase competition include facilitating access to existing infrastructure to new players in network industries, particularly in finance and telecommunication; setting clear and stable rules that apply broadly to businesses; and enforcing the competition legislation.

The CCSA has shown that effective policies and enforcement can support competition and lower prices. Competition and effective regulation thus need to go hand in hand to ensure that the CCSA has the legal and operational mandate to enforce the rules of the game and tackle market abuse¹⁰. The CCSA should also continue to inform its interventions based on industry-specific determinants of market concentration. Initiatives such as those limiting predatory pricing and exclusive agreements in retail can lower prices and create opportunities for new entrants.

- *Alleviate regulatory constraints that inhibit competition.* There are various regulations that reduce domestic competition and/or the choice of consumers. While not unique to South Africa, some competition-inhibiting regulations result from policy capture by domestic incumbents to protect their market share from foreign competition through regulations and non-trade barriers.

Similarly, competition can be accentuated in network industries through network sharing and digitalization. For instance, customers face high costs and constraints when switching service providers, whether in banking or mobile telecommunications. Measures designed to prevent incumbents from locking in clients are thus needed. Alleviating the constraints on the usage of mobile money and point-of-sale (POS) withdrawals will allow customers to bypass ATMs. In some countries, allowing for system interoperability in the provision of mobile services reduced the market power of incumbents and increased market entry, resulting in significantly lower prices.

- *Increase the power of the CCSA to address market power abuse.* Until 2019, firms were not formally subject to penalties for a first offense in the competition legislation and the onus of proof was on the CCSA. Amendments to the competition law have since been enacted to allow the CCSA to examine factors with adverse impact on competition and make its resolutions binding. The CCSA was also granted greater authority to block mergers with anti-competitive intent. The enhanced powers are also supported by more stringent sanctions. Remaining exemptions to the competition law along broadly defined firm characteristics or objectives could provide incentives for eligible firms to seek exemptions even if they engage in anti-competitive behavior. These loopholes should be closed and practices aligned to international standards.
- *Carefully assess M&A plans that seek to preserve market dominance.* Some vertically integrated firms use their market power to constrain the entry and operations of smaller players in the value chain. The market impact of mergers needs much closer scrutiny and clarity to address market dominance. Similarly, efforts initiated to review exclusive arrangements must be furthered to create more space for SMEs to operate.

¹⁰ The Data Market Inquiry report provides a thorough analysis of market power and pricing in the telecommunications sector (CCSA, 2019).

- *Enhance competition by combating policy capture and rethinking industrial support.* The industrial policy being pursued needs to be fine-tuned and focus more on horizontal strategies that benefit the whole economy instead of fiscal incentives driven vertical strategies to specific industries¹¹. The vertical strategies have largely focused on sectors where South Africa's comparative advantage is debatable and, in cases like textiles, declining. These policies come at a significant fiscal cost, while failing to create domestic linkages on an adequate scale. Hence, the contribution of these projects to net exports remains low. In some cases, countries have preserved favorable credit allocation and tax exemptions on the condition that firms met export (value-added) targets. The focus on measurable targets and the government's ability to withdraw favorable treatment to incumbents that failed to meet the targets, mimicked market incentives, while preserving sizable rents for firms that were able to improve their efficiency.
- *Inject greater clarity for regulated prices.* The pricing decisions must be made more transparent, with a greater focus on efficiency. For instance, the tension between the electricity regulator (NERSA) and Eskom regarding price adjustments creates uncertainty for consumers and businesses. Similarly, cost-recovery pricing must be subject to increased scrutiny to avoid inefficiencies from creeping in and being passed on to the broader economy. In the same vein, contracts with independent power producers should not be subject to frequent calls for renegotiation, as they exacerbate policy uncertainty, and deter investment and new technology adoption.

V. COMPLEMENTARY POLICIES, GAINS, AND IMPLEMENTATION CONSIDERATIONS

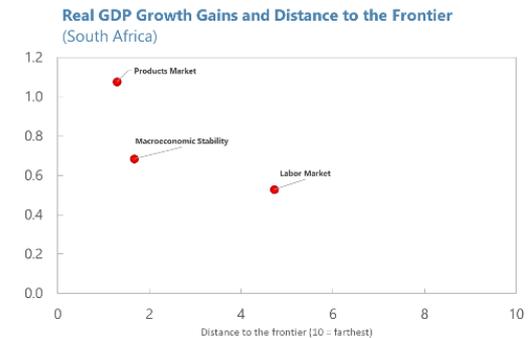
There are three complementary policy priorities that are needed to support product markets reforms and need to be looked at simultaneously. A piece-meal approach focused on addressing constraints only in the product markets would inhibit the achievable gains, and in some instances fail to deliver on the policy objectives as other underlying constraints remain binding. Covid-19 has magnified the urgency of reforms. The complementary policies relate to:

- *Reversing the underlying deterioration in fiscal outcomes and contain risks from SOEs.* The pandemic has further accelerated the deterioration in fiscal outcomes. Several SOEs will be further weakened. Eskom's capacity to provide reliable electricity will be a key determinant of South Africa's growth performance going forward. A credible consolidation strategy will contain the cost of financing and reduce uncertainty regarding the overall direction of macro-policy.
- *Addressing labor market rigidities and alleviating labor regulations to help open the economy for business and boost contestability.* The pandemic will exacerbate unemployment levels that are among the highest level in the world, including for the youth. While some of the regulatory constraints will need to be phased-out over the medium-term, given the current deterioration of the labor market and social outcomes, policies aimed at enhancing human capital and employability, including facilitating workers' access to jobs through enhanced transport systems, can be readily rolled-out.
- *Furthering governance reforms and providing greater policy clarity.* In addition to rebuilding institutions weakened by state capture, close coordination among

¹¹ There is strong international evidence that most firms would invest without fiscal and financial incentives, if the business and social environments are right (see IMF, 2015).

government agencies is needed to define responsibilities and enforce accountability, including for implementing reforms. Strong institutions will buttress policy credibility and their independence will also mitigate the risk of reform reversals.

Implementing these reforms could boost growth potential by at least 1 percentage point of GDP. The approach follows Prati, Onato, and Papageorgiou (2013) and Ganum and Thakoor (forthcoming). South Africa is furthest from its EM peers as regard labor markets, while it is closer for products markets. It is assumed that South Africa, over a five-year period, moves to the median of EMs across the various indicators. Product market reforms could deliver a per capita growth gain of about 1 percent of GDP—equivalent to 2.5 percent of GDP overall. Closing the gap on macro-stability (by reducing policy uncertainty, stabilizing debt, and anchoring inflation at a lower level) and labor markets would give per capita growth gains of about 0.6 percent of GDP each¹².



Source: IMF staff estimates.
 Note: The chart shows the distance from the frontier and the estimated increase in annual growth rate of real GDP if the gap is closed in five years. For institutional and human capital reforms, a longer time horizon is assumed. The frontier is the 75th percentile value for each indicator in a sample of 20 EM countries.

South Africa needs credible reform implementation calibrated to the domestic political economy to address the bottlenecks identified in various growth diagnostics. The National Treasury (2019) paper provides the underlying elements of a reform strategy which, if implemented, can address some of the underlying causes behind the weak growth. Political economy considerations relate to gaining reform credibility, building broad consensus and bringing on board groups that stand to see their benefits eroded, as well as, sequencing reforms to the current socio-economic conditions.

- *Enhancing reform credibility by finalizing long-standing reforms that can have high payoffs.* Finalizing broadband spectrum allocation and streamlining rules for mining would facilitate advancing other reforms later. Initiatives to reduce the cost of data and allowing more competition in retail represent steps in the right direction.
- *Communicate the urgency and trade-offs.* Rethinking the development strategy and advancing the urgent reforms requires clear and transparent communication regarding South Africa's highly vulnerable economic situation and the severe cost of inaction.
- *Find ways of compensating groups that find their benefits eroded during reforms in a fiscally responsible manner during the transition.* Some reforms will entail job losses, while others would increase firm churning. Time-bound transfers, with well-defined sunset clauses, to the unemployed and transitional periods of employment protection (with job search incentives) can avoid a heavy frontloading of political costs.
- *Ensure reform pace is cognizant of local economic and political conditions.* Some sectoral reforms (like telecommunications and energy) have broader spillovers on the economy and the population, while others (easing regulatory constraints) benefit

¹² The estimates are somewhat higher than other work on OECD and advanced economies. Bourlès et al, (2013) find that deregulation increased growth by up to 1.5 percent in 20 advanced economies. Duval and Furceri (2018) find growth from product market reforms gradually increase growth to 1.5 percent after 4 years, with a levelling off at 2.25 percent after 7 years. Given South Africa's income levels and extent of structural constraints, higher gains are possible. Muncaksi and Saxegaard (2017) estimate reform packages where growth gains are significantly higher in South Africa. The reliance on labor markets is however not adapted to the economic and social conditions prevailing after the pandemic.

businesses first, before trickling down through investment and employment opportunities, and potentially lower prices. But, in general, product markets reforms complemented with an effective regulatory framework can support job creation and aid price reductions. This will also contain resistance to other reforms through their positive impact on the population's purchasing power. Optimal sequencing is even more critical in the post-pandemic environment.

VI. CONCLUDING REMARKS

South Africa's economic and social vulnerabilities have been exacerbated by the pandemic and product markets will be a cornerstone of a credible reform strategy.

Market concentration and mark-ups in South Africa were high in the run-up to the pandemic. The prevailing market structure reflects both the apartheid legacy as well as regulatory constraints and anti-competitive behavior that have inhibited the emergence of new firms, including labor-intensive SMEs. Inefficient SOEs, particularly in network industries, have a large footprint in the economy. Market concentration has thus partly contributed to low growth as private investment, exports, and overall TFP have remained weak or deteriorated. Distributional outcomes are also worsened as weak growth inhibits job creation and high prices, particularly on basic goods and services, exacerbate poverty and inequality. The pandemic will worsen these dynamics.

A credible reform strategy needs to address market inefficiencies and increase competition. The operational and financial situation of SOEs need urgent attention with a view to improving the cost-effectiveness of input and reducing fiscal risks. Regulatory constraints inhibiting competition need to be alleviated and anti-competitive behaviors curtailed to allow the emergence of new firms and enable their integration in the value chain. Leveraging the potential provided by digitalization and allow the sharing of existing infrastructure can readily increase the scope for competition. The CCSA should continue to inform its interventions based on industry-specific constraints to competition. Product market reforms need to be supported by post-pandemic policies to stabilize the economic situation, address labor market inefficiencies, and continued efforts to improve governance and rebuild institutions.

Appropriate sequencing informed by political economy considerations can increase the prospects for reforms to succeed. While there will be trade-offs between protecting the interest of existing players and allowing new entrants to contest the market, overcoming the path dependency is crucial to putting the economy on a more sustainable and efficient growth path. Successful reform implementation will create opportunities for millions currently not fully integrated in the economic structure. Growth and job creation can support the emergence of a fairer and more inclusive society.

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