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Overview

Driving inclusive growth in South Africa



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Overview

Driving inclusive growth in South Africa



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Quick wins with competitive markets and efficient institutions

The new political context emerging from the May 2024 elections provides a unique opportunity for South Africa. The alignment of economic and political incentives, in the sense that improving the economy is essential for gaining political power, offers a platform to launch a decisive transformation process, even if there is not yet an agreement on which economic reforms to implement. Such alignment was key behind the successful economic transformation of China in the early 1980s, Vietnam in the late 1980s and 1990s, Poland in the 2010s, and India in the early 2020s. Those successes were anchored on "a development bargain, whereby the country's elites shifted from protecting their own positions to gambling on a growth-based future."[1] This report offers pragmatic policy options, tailored for South African policymakers who want to obtain short-term results, while creating momentum for structural reforms, resume growth, and improve the overall welfare of their citizens, especially the most disadvantaged.

Inclusive growth through market competition and efficient institutions

South Africa needs to transform its economy to achieve robust and inclusive growth. How? By addressing two major shortcomings in its economic model.

First, strengthen and broaden market competition. Today, many of South Africa's markets lack dynamism. Firm entry and exit are a third of the average in a typical middle-income country. Further, new entrants to the labor market can't find stable and productive jobs—leaving youth unemployment above 60%. Market competition, while ensuring greater economic inclusion and enhanced household welfare, is the best way to dynamize an economy as it boosts efficiency and promotes innovation. South Africa could rebalance its economic model by making it easier for foreign and domestic investors and for young workers to enter markets, and by reducing the protection of incumbents (including state-owned enterprises). The status quo is most penalizing for small firms, which lack the capacity or financial means to navigate the complex system of rules and regulations, and for low-skill workers, who face a heavy income tax burden if formally employed.

Second, make institutions more efficient and supportive. The burden of institutions has become excessive—not only for businesses and citizens but also for public administration. South African policymakers have attempted, often with good intentions, to correct market or historical failures by intervening through hard regulations, such as Black Empowerment policies, local content, and collective labor bargaining—and direct support programs to specific groups, such as grants, tax rebates, and labor training). Today, these interventions have become so cumbersome that they smother the implementation capacity of the public administration, especially local officials, and open spaces for corruption. It has been well documented that state capture left an enduring mark on South Africa's institutions through

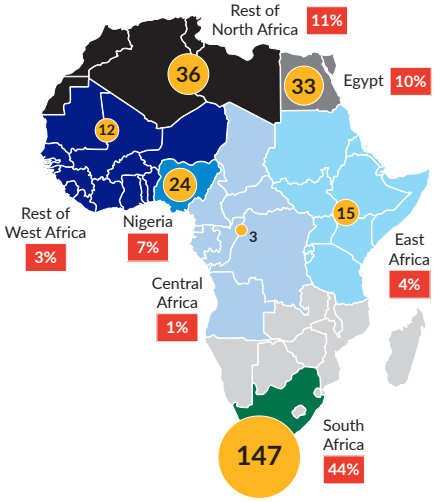
The alignment of economic and political incentives offers a platform to launch a decisive transformation process

1. Dercon, Stefan. Gambling on Development: Why some countries win and other lose. London: C. Hurst & Co.

Despite long-recognized strengths...

- Second-largest economy in Africa (after Nigeria) and 32nd-largest in the world.
- Large and diversified economy: mining, high-productivity agriculture, manufacturing including automotive, high-productivity agro-processing, and services including a well-developed financial sector and strong tourism potential (given natural endowments).
- Biggest regional transport and logistics hub: 1st in Sub-Saharan Africa and 40th (of 165 countries) in the World Bank Group liner-shipping connectivity index.
- Active corporate investors on foreign markets, representing three-quarters of 2015–19 foreign direct investment outflows from Sub-Saharan Africa.
- Research and Development (R&D) capacity —top three universities in the continent and critical mass of highly qualified labor.
- Two-thirds of the population (about 40 million people) living in cities with potential agglomeration effects.
- Large middle-income class: around 40% of people earn between $4 and $13 a day.

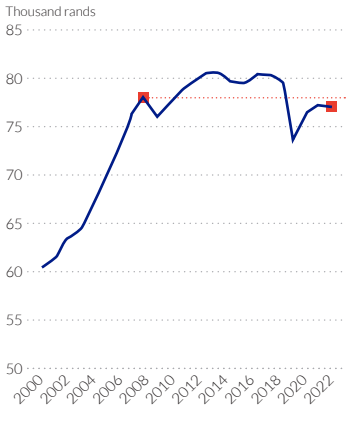
Almost half of all large companies in Africa are from South Africa



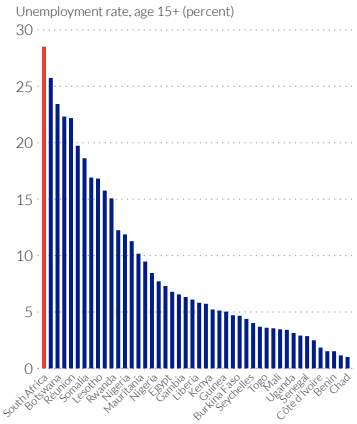
Source: McKinsey African Companies Database.

...South Africa is on the wrong growth trajectory

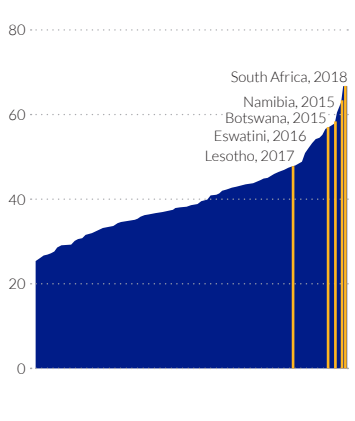
Real GDP per capita in 2023 was less than in 2007



Unemployment is about 30%, one of the highest rates in the world



Inequality is high and persistent, as shown by the Gini coefficient



Source: World Bank.

dismantling accountability mechanisms and losing skilled personnel in key entities, weakening their capacity to deliver public goods and services.

Consider this: to bring phones and IT technologies to its population, the government introduced competition to the telecommunication market in the early 2000s, making South African one of the middle-income countries with the highest rates of digital penetration and exports. In parallel, the private sector also benefited. MTN, a South African multinational mobile telecommunications provider, is now doing business in 22 countries around the world. The same approach has been used in aviation transport, with the emergence of several regional private companies, and more recently in power generation, where competition has led to an unprecedented increase in renewable energy over the past 18 months. There is no

What can the two drivers bring to the South Africa economy?

Competitive markets
- Increase incentives to attract investments, innovate and unleash private sector potential
- Lower the dominance of protected incumbents that penalize customers
- Contribute to a better allocation of the country's human, physical and financial resources
- Create economic and job opportunities accessible to all

Efficient institutions
- Improve quality of public goods and services
- Combat corruption, dismantle entrenched interests and build accountability
- Streamline complex regulations that do more harm than good
- Create efficient coordination mechanisms within the state and between the state and other stakeholders

obvious reason such an approach, when coupled with smart regulations, cannot be applied to other sectors.

Now consider this: the impact of social spending on poor population could be improved dramatically, not necessarily by spending more but by upgrading the quality of institutions. To help young workers prepare for the labor market, the government could coordinate the 100 active labor programs currently dispersed across 20 institutions that defy coordination, reduce affordability, and weaken capacity—producing suboptimal results. More generally, the government could immediately erase extreme poverty if all the financial resources allocated to social protection, about 4% of GDP, were equally distributed to the 10 million adults living on less than $2.90 a day—the international threshold under which people are deemed extremely poor. So, the challenge is not necessarily the lack of financial resources—it is how to use them efficiently using the most appropriate institutional framework.

Addressing the two fundamental shortcomings of limited market competition and institutional inefficiency and ineffectiveness, could contribute to resuming growth and making it inclusive. Beyond the successful (if limited) experiences in South Africa, several East Asian countries transformed their economies by relying more on market forces, opening selected markets to competition, and adjusting their economic institutions. Sweden in the 1990s was exhibiting similar signs of paralysis as South Africa today: slow growth (around 1.6%), high public debt (80% of GDP), and fairly high unemployment (10%). So, it switched to a new economic model. In less than five years, it reinvigorated its economy, doubling GDP growth to 3.1%, reducing unemployment to 6%, and cutting public debt to 40% of GDP. How? By opening domestic markets to competition, focusing the public footprint to areas where the state is the ideal actor to provide essential goods and services, and streamlining regulations to maximize market efficiency and affordability—exactly the kind of turnaround that South Africans are desperately looking for.[2]

From the what to the how: four priority policy areas to provide a roadmap for actions

The two drivers provide direction for South African policymakers—the road they can embark on. But they still need a vehicle for action. For greater effectiveness, they should prioritize what is impactful and above all feasible. Such selectivity is well aligned with international experience and further justified in South Africa. The state has limited financial and technical capabilities to do everything at the same time. It needs to create momentum for reforms by delivering the biggest positive results possible soon. And the political incentives to jumpstart reforms with feasible, impactful, and timely actions are enormous. Operation Vulindlela, the delivery unit created in the Presidency in 2019, produced encouraging results in electricity and in streamlining visa applications. Now, delivery units must be mainstreamed throughout the public administration for sustainable and broad-based results.

For greater effectiveness, the government could prioritize what is impactful and above all feasible

2. World Bank. 2019. "The Turnaround of the Swedish Economy: Lessons from Large Business Sector Reforms." World Bank Research Observer 34(2). August. pp. 274–308. https://doi.org/10.1093/wbro/lky007.

Four priority policy areas provide a roadmap for actions:

- Improve the efficiency of public spending and leverage private resources to enhance economic growth and job creation.
- Deliver quality, climate-friendly, and resilient infrastructure services.
- Promote efficiency and equitable urban development and mobility.
- Inject dynamism in the private sector to create jobs and productivity gains.

They were agreed on after a consultative process between the World Bank and a diverse group of local and international experts (box 1). They do not address all of South African economic challenges, such as water and agriculture. But without significant improvements in all four, it will be difficult to achieve faster and more inclusive growth.

While these priorities are presented separately, their combination will matter most for inclusive growth. Dynamic firms require good connectivity to markets and customers while individuals need physical accessibility to jobs, which is largely determined by infrastructure quality. The quality of public spending, including partnerships with the private sector, is also important to improve service delivery and the skills of the labor force, which are also key determinants for productivity and job creation. Cultivating such synergies through competitive markets and efficient institutions has been the key opening the success of fast-growing and inclusive countries.

Implementing reforms in each of the four priority policy areas is a long-term endeavor requiring sustained effort, substantial financial resources, and unwavering political commitment

Jump-starting the process with the most feasible, impactful, and timely actions

Implementing reforms in each of the four priority policy areas is a long-term endeavor requiring sustained effort, substantial financial resources, and unwavering political commitment. As demonstrated by international experience and economic theory, South Africa will have to increase its productive physical and human capital, which underpin strong

Box 1 The reform agenda proposed in this report was defined through an inclusive and participatory process

- As part of the dialogue between South Africa and the World Bank, it was agreed in early 2023 that the World Bank would produce a new policy roadmap for the government through a demand-driven and focused process.
- Three groups were constituted to support this exercise: government representatives, generally at the director-general level, from pivotal economic departments and agencies; local experts from the private sector, civil society, and academia; and international advisers, including Nobel Laureate Michael Spence and former ministers from other middle-income countries (see annex 2 for details).
- During the workshop organized in May 2023, these three groups advised the World Bank to develop a new narrative to revitalize the policy debate and create incentives for politicians to embark on critical reforms, while identifying concrete actions in the short term that can generate momentum for reforms. In doing so, the World Bank was advised to prioritize four key areas: private sector growth; infrastructure services; urban agglomeration and mobility; and public spending.
- In March 2024, in a second consultative workshop, the World Bank shared four policy notes aligned on the four above-recommended priorities, giving the members of the three groups the opportunity to provide feedback. This consultation was part of the World Bank's deliberate and constant effort to improve the quality of the notes.
- Some of the policy actions recommended in the notes have already been translated into requests from the authorities for additional technical and financial support, especially in policy areas 1 (public spending) and 2 (infrastructure services).

Feasible, impactful, and timely (FIT) actions for each policy priority area—see annex 1 for details

Increase the impact of public spending	Accelerate professionalization and the use of digital tools within public administration and incentivize sub-national governments to perform better
	Redirect public spending toward capital investment and job creation
Deliver quality and climate friendly infrastructure services	Secure electricity provision by connecting renewable projects to the grid and improve revenue collection by municipalities
	Open the railway network to multiple operators and strengthen the state regulatory capacities in the port and railways sectors
Enhance spatial efficiency and equitable access to opportunities	Improve urban transport through conditional financing to the Passenger Rail Agency of South Africa and upgrading privately owned taxi buses
	Enhance urban densification by facilitating development in strategic locations
Inject dynamism to the private sector	Increase returns in green and digital sectors with market instruments, lower barriers to entry, and tailored labor and financial support programs
	Unleash the potential of small and innovative firms through venture capital and mobile money

inclusive growth and job creation in the longterm. But such a process can be accelerated by focusing on achievable and impactful actions that can lead to tangible results on the most pressing issues, building momentum and laying the groundwork for broader reforms. Such a pragmatic and gradual approach has been preferred in several countries that have successfully implemented reforms. For example, in Vietnam, liberalizing foreign direct investment was first tested through experiments and pilot projects in a few locations in the early 1990s, before being scaled up in the rest of country during the 1990s and 2000s. Unlike shock therapy, this approach gives time to build support for reforms in a consensual but politically contested society like South Africa.

The World Bank proposes a menu of short-term actions for each of the four priorities. From the full range of possible short-term actions outlined in each note, a subset was selected for their technical feasibility, minimal political constraints, potential for significant impact, and timely implementation (labeled FIT actions). These options are appealing to policymakers because they are fairly straightforward to execute. They do not require significant changes in the legal and institutional frameworks, which are complicated and time-consuming in South Africa's political economy. Further, many of them do not require additional financing, important given the needed fiscal consolidation over the next few years, but they do require political will and vision.

And from the how to the now

What can be done now to improve the impact of public spending?

South Africa's government has limited space to increase spending. But it could spend better to support its key development objectives. Ten actions are priorities in this area (see Policy Note 1), of which three were assessed as most FIT.

The first is to improve the efficiency of public spending through better coordination within and between government Departments, strengthening data systems so there is a better focus on outcomes and consequently, promoting better accountability for results across public institutions. This can be done, for example, by gathering the management of key investment projects in a centralized gateway to realize economies of scale and accelerate implementation through improved monitoring and accountability. Several grant transfers to agencies and municipalities can be consolidated to reduce administrative costs. In social sectors, the emphasis could be on rationalizing labor market programs, which do not have an overarching system to monitor progress or evaluate outcomes, leaving significant gaps in coverage and limiting progress in addressing the employment challenges facing South Africans. The education and training sectors in South Africa should also put more emphasis on results by re-instituting national learning assessments in basic education and creating a system to

South Africa's government could improve the efficiency of public spending through better coordination within and between government Departments, strengthening data systems

track employment outcomes of TVET and university graduates. In social assistance, there are potentially large efficiency gains—in better targeting and coverage—through the establishment of a social registry and better interoperability of the current social assistance data system, which could link cash grants with labor market services.

The second FIT action is for the government to expand partnership models with the private sector. Such a move has already started in infrastructure sectors (as emphasized below) but could be broadened to social sectors. The public sector alone will be unable to finance the fast-increasing needs in education and health sectors, but private providers can also commit to high levels of accountability for improving quality and access to education services, particularly for poor communities. The recent experience of public-private partnerships in Western Cape and Gauteng could be scaled up in the immediate future.

The third FIT action is to introduce several cross-cutting measures that may generate some efficiency gains in public spending management. Among them are hiring top managers in public administration based on competencies, under the auspice of the Head of Public Administration, using digital tools to share data and streamline process and well as to improve monitoring and accountability, and encouraging e-procurement through financial awards and penalties. A key action would be to scale up the recent approach developed by the central government to further incentivize subnational governments to deliver better services by linking the allocation of central grants to specific outcomes achieved by provinces and municipalities. Today, subnational governments receive, whatever their performance, about the same resources from the central government—unsustainable but also unfair to good performers and ultimately to citizens.

Climate-friendly infrastructure services require three intertwined lines of action: opening up to competition, broadening sources of financing, and enhancing the state's capability to deliver, coordinate, and regulate

What can be done now to deliver better quality and climate-friendly infrastructure services?

The delivery of quality and climate-friendly infrastructure services requires three intertwined lines of action: opening them to competition to promote efficiency gains and innovation, broadening the sources of financing for investment and maintenance, and enhancing the state's capability to deliver, coordinate, and regulate. This framework was applied to the electricity and freight transport, partly due to close collaboration between the government and the World Bank. Still, it could be extended to other infrastructure sectors, such as water and waste management.

For electricity, eight actions are identified to achieve those goals in the short run (see Policy Note 2). From this menu, two FIT actions are screened as priorities. First, building on the recent adoption of the amended Electricity Regulation Act and the creation of the National Transmission Company of South Africa, improved access to the grid for new projects (which today is the main bottleneck) should be privileged, which is possible by enhancing the management of the existing grid (using digital tools and adjusting rules). It will also require accelerating the opening of the transmission sector to private promoters, which is currently initiated by the government. Second, the billing and collection performance of municipalities—critical to distribution and the financial viability of the sector—can be improved by introducing performance-based transfers from National Treasury. The idea is to reward good performers, currently experimented with in several initiatives from National Treasury. To make these actions most effective over time, the government will need to assess the future role of Eskom, which is called to operate in a very different environment than in the past, while considering how to reorganize the distribution segment now divided between Eskom and municipalities, with well-known challenges of coordination, governance, and efficiency.

For transport, seven actions are proposed, including two that are identified as the most FIT. First, the dominance of Transnet in the rail sector can be reduced by separating infrastructure and operational responsibilities. Establishing an infrastructure manager (independent of Transnet) will reduce existing conflicts of interests and open the door to devolving some routes to other operators. Along these lines, transferring operational responsibilities on the bulk mineral routes to mining companies could be prioritized pending the approval of clear, transparent, and equitable rules. Second, the regulatory capability of the state could be reinforced by rapidly promulgating the Economic Regulation Bill

and establishing a joint regulator for the port and rail subsectors. Implementing these two actions is backed up by the recent Cabinet adoption of the roadmap by in December 2023, after an intensive consultation process. These short-term actions should be accompanied by other measures, which will take more time but remain crucial, such as the imperative of bringing back Transnet's financial accounts on a sustainable basis, and developing cleaner and more effective transport modes. Planners will have also to account for the changes in spatial distribution of economic activities that are expected to emerge in the future, such as the shift from coal to renewable energy and the exploitation of new rare-earth minerals.

What can be done now to make cities engines of growth and economic inclusion?

Addressing economic exclusion in South African cities, which remains important even 30 years after the end of apartheid, requires improving mobility and reducing distance through more efficient and equitable transport services and improving urban development. While economic exclusion results from multiple factors, many studies have demonstrated that urban workers' limited and costly mobility (accounting for about two-thirds of the labor force) is key in South Africa. On average, typical workers could spend about half of their earnings on transport (up to 80% for the poorest), compared with 10% in Vietnam.

Of eight action priorities to improve urban transport and reduce distance within cities, two are assessed as the most FIT. First, starting with the objective of making transportation efficient and affordable, the government could reduce the cost for the poorest commuters by distributing free e-vouchers that could be used either on public transport (rail and buses) and on privately-run taxi buses. This could be implemented by, using phone and digital banking, both widely used in South Africa, and by redirecting some of the savings from devolving some services to the private sector. Indeed, the public agency responsible for passenger transport (PRASA) could be incentivized to improve its performance by linking transfers from National Treasury (which account for three-quarters of funding) to its performance, and by developing partnerships with the private sector, which is increasingly considered for the most commercially viable routes. At the same time, the operational efficiency of private minibus taxis could be improved by promoting digital management tools for better coordination and improved integration of this mode of transport into a multimodal system for the benefit of customers (see Policy Note 3). The positive externalities of such actions (overall benefits for society as the gains extend to all customers) could justify a targeted use of subsidies.

Second, to make urban development more conducive to growth and inclusion, several actions could encourage the vertical development of South African cities by making the relative value of new projects more attractive. Because the construction of new housing projects would take some years before becoming concrete, the government must act urgently. It could send strong market signals to encourage densification by relaxing some zonal regulations, streamlining the approval process for strategically social projects, and improving space management with digital platforms. With these actions, the authorities will increase the rate of return associated with investment projects in dense areas, paving the way to spatial efficiency and equity in coming years.

What can be done now to inject dynamism in the private sector?

To foster the growth of the private sector, which is crucial for job creation, the authorities could act on two fronts. First, they can promote increased competition in future industries such as digital finance and green industries. The emphasis on these sectors is well-founded, as they leverage South Africa's strengths and offer the greatest potential to enhance the country's competitiveness in response to shifting regional and global demands. Second, the government can support the development of small and medium firms, and start-ups, which possess the greatest potential for innovation and employment generation. In South Africa, these firms do not emerge as fast as in other middle-income countries and their survival rate is lower. Eight actions, of which two are assessed FIT, are identified to achieve these two goals (See Policy Note 4).

While economic exclusion results from multiple factors, many studies have demonstrated that urban workers' limited and costly mobility is key in South Africa

To develop industries of the future, the authorities can reduce entry barriers for new foreign and domestic private investors embedded in industrial and labor policies

The first FIT action aims to develop future industries by reducing entry barriers for new foreign and domestic private investors who will bring the new technologies and train local workers. This can be achieved by streamlining administrative procedures and making the standard (but simplified) tax regime the rule rather than the exception. The burden of several industrial and labor policies can be reduced by adjusting them to the reality of the market—for example, by generalizing the use of the Equity Equivalence Investment Programs by the Department of Trade and Industry instead of the hard complex conditions associated with Black Economic Empowerment policies. The Special Economic Zones can be reconfigured, as successfully done in Asia, to reduce the costs of doing business, while promoting the creation of jobs through linkages with public-private partnerships. These measures could be implemented fairly quickly since the government has already used them in some scenarios.

The second FIT action is to relax access to financing by start-ups and small firms—the biggest constraint to their development, as shown in recent surveys. While the depth of the financial market in South Africa is one of the largest among middle-income countries, small firms generally are not considered by commercial banks, even if they are innovative. One measure could be to reduce the cost of financing, which remains prohibitive for many small firms, by diversifying the options. As in many other countries, the Central Bank could adjust regulations to foster venture capital and e-money and develop a framework for open finance. These instruments compete with banks, and could reduce their fees and encourage financial inclusion, as demonstrated in several countries over the past few years. The development of small firms will need to be supported by other measures, such as skill development and simplified regulatory regimes to make them more profitable.

What's next?

South Africa needs to reinvigorate its economic model to get onto on a robust and inclusive growth path and meet the expectations from its citizens. This does not need a revolution in its policymaking but evolution to continue addressing the limited competition in many of the country's strategic sectors. This evolution also requires addressing the growing inefficiency in the country's institutions, which has worsened over time due to the increasing complexity of government interventions, significant state capture, and resulting high levels of corruption. Strengthening competition in the markets and transforming institutions into enablers have already supported the successful transformation of some strategic sectors over the past few years, such as telecommunications and aviation, for the benefit of customers and individuals looking for jobs. Such a shift should be expanded and accelerated to other sectors to adjust to today's geopolitical, economic, and technological realities—both domestic and global—shaping the world today.

As part of this evolution, the role of the state remains important, but it should be refocused on ensuring the right conditions for rapid economic growth and strong equity. This will require the capacity to deliver public services, including partnerships with the private sector by opening markets to competition, and using regulations more efficiently to align incentives, reduce costs for the private sector, and enhance human welfare. The state will have to focus on making growth as inclusive as possible by extending economic opportunities to all with an effective redistribution policy, correcting potential market failures. And it will have to manage this transition: if more competitive markets and more efficient institutions will unambiguously improve the country's welfare in the long-term, some groups (such as workers in existing state-owned enterprises) may face short-term losses leading to resistance against the reform process. However, this resistance presents a false dilemma. The government should prepare state-owned enterprises to compete with those at the forefront of global productivity and develop targeted support to affected workers and communities. In all, these interventions will cost less than any attempt to resist the forces of global competition and reduce the chances of local firms and workers as a whole reaping the benefits of such a transformation.

The actions proposed here are only a beginning since economic development is a long-term enterprise ultimately determined by a country's ability to develop and efficiently use its productive, physical, human, and natural capital. They are based on

principles of increased (but managed) competition and more efficient institutions. Yet, as Nobel Laureate Robert Lucas emphasized in his seminal article on the Mechanics of Economic Development, achieving and sustaining inclusive growth is a complicated process. As he wrote, "Is there some action a government of South Africa [Egypt] could take that would lead the South African economy to grow like China [India]? If so, what, exactly? If not, what is it about the nature of South Africa that makes it so? The consequences for human welfare involved in questions like these are simply staggering: Once one starts to think about them, it is hard to think about anything else."[3] The World Bank acknowledges that there may be multiple pathways to rapid and inclusive development in South Africa. However, we hope this study with its in-depth analysis and practical recommendations, will assist South African policymakers in addressing these issues and, most importantly, taking action to pave the way for a brighter future for all citizens. The time for action is now – it is never too late to act decisively.

3. Lucas, R.B. 1988. "On the Mechanics of Economic Development." Journal of Monetary Economics 22(1): 3–42.

Annex 1 FIT actions for inclusive growth in South Africa and how to implement them

FIT actions	How to implement them
Policy area 1: Increasing the impact of public spending on inclusive growth	
1. Increase the impact of public spending	• Establishing a centralized gateway for priority capital projects above a certain threshold • Improve the efficiency of public spending through better coordination, a sharper focus on results, and better data systems, with special attention to intergovernmental transfers and social sectors • Consider partnerships with the private sector, not only in infrastructure sectors but in social sectors, building on successful experiences in Western Cape and Gauteng • Linking the Covid-19 Social Relief Distress grant with active labor market programs
2. Accelerate professionalization and the use of digital tools in public administration and incentivize subnational governments to perform better	• Operationalize the Head of Public Administration role to strengthen the merit-based hiring of senior managers and reduce politicization • Expand the functionality of the e-procurement system to bid management and compel procuring entities across levels of government to use the system and share data with the National Treasury • Scaling up the performance-based approach used for the public transport grants to other earmarked transfers from national treasury to sub-national governments • Reducing the administrative burden associated with conditional grants to subnational governments, including through consolidation and harmonization
Policy area 2: Delivering better quality, climate-friendly infrastructure services	
3. Secure electricity provision by connecting renewable projects to the grid and improve revenue collection by municipalities	• Ensuring the financial and operational sustainability of the National Transmission Company of South Africa by adopting a new transmission tariff methodology; implementing a new wheeling framework; and updating the Grid Code • Scaling up private investments in transmission by adopting a regulatory framework for an independent private transmission model • Improving electricity distribution by municipalities by streamlining the contractual approach implemented in mid-2023 between the National Treasury and the municipalities; using conditional transfers to incentivize municipalities to perform better; improving local capabilities at the municipal level; and adopting standards for municipal performance
4. Open the railway network to multiple operators and strengthen state regulatory capacities in the port and railway sectors	• Initiating Transnet's unbundling by adopting the new draft Rail Bill • Providing nondiscriminatory access to railway infrastructure by establishing an independent Infrastructure Manager • Developing a public-private framework for allowing private sector participation in railway operations by transferring the operational responsibilities of bulk mineral rail lines to large mining companies and establishing public-private partnerships for running railways on feeder lines • Implementing the independent Economic Regulator section of the Transport Bill, while enhancing the technical and financial capabilities of the Regulator
Policy area 3: Making cities engines of growth and economic inclusion	
5. Improve urban transport through conditional financing to the Passenger Rail Agency of South Africa (PRASA) and upgrading privately owned taxi buses	• Using a result-based approach for allocating grants from National Treasury to PRASA • Distributing vouchers to poor customers, while promoting the use of digital ticketing • Building on the lessons from pilot projects in Cape Town and Gauteng to mutually corporate the minibus taxi sector
6. Enhance urban densification by facilitating development in strategic locations	• Relaxing national building and municipal zoning regulations, while amending the Spatial Planning and Land Use management Act • Introducing financial bonuses for social housing projects in high-density areas close to business centers • Accelerating the development and use of digital spatial planning platforms to boost information collection and sharing

FIT actions	How to implement them
Policy area 4: Injecting dynamism in the private sector	
7. Increase returns in green and digital sectors with market instruments to lower barriers to entry, and tailor labor and financial support programs	• Streamlining firms' entry and operational pre-requisites for foreign investors by promoting the use of "labor equivalent programs" sponsored by the Ministry of Trade and Industry • Increasing liquidity in carbon credit markets • Reorienting incentives and support programs away from fossil fuels and toward new green activities
8. Unleash the potential of small and innovative firms through venture capital and mobile money	• Increasing the provision of venture capital for high-growth start ups • Authorizing nonbank institutions to issue mobile money • Developing a framework for open finance

Annex 2 – List of contributors

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Priority 1

Increasing the impact of public spending on inclusive growth

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SOUTH AFRICA POLICY PACKAGE

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Priority 1

Increasing the impact of public spending on inclusive growth



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SOUTH AFRICA POLICY PACKAGE

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Realigning public spending to meet the country's pressing needs and make service delivery more efficient and supportive of growth

It is hard to ignore the chorus of voices in South Africa calling for radical reforms of the state to ensure better use of public resources.[1] The government's ability to deliver basic social services and infrastructure services has been eroding over the past decade, while a threefold increase in the ratio of public debt to GDP has narrowed the fiscal space to fund such services. How far and fast South Africa can go in redefining the role of the state to address these challenges remains unclear. As this process unfolds, the country may want to consider reviewing similar experiences in Canada,[2] Europe, and Central Asia.

Meanwhile, policymakers cannot afford to remain inactive.[3] To guide them in making public spending a more effective policy instrument for economic progress, this note proposes a focus on three mutually reinforcing priorities: spend more wisely and efficiently so that the public debt trajectory does not become unsustainable; leverage private resources to increase the financing needed to rebuild infrastructure and support better and more coordinated job-related programs to reduce unemployment; and improve the public sector's service delivery capacity by further professionalizing public administration, strengthening program monitoring and evaluation, and accelerating digitalization.

These three priorities apply to all levels of government, not just the central government. South Africa's fiscal system devolves many important spending responsibilities to subnational governments, autonomous agencies, and state-owned enterprises (SOEs). Unless their performance also improves, central government spending is unlikely to become more efficient or to have a stronger impact on inclusive growth.

Drivers of inefficient public spending

Nearly all countries use public spending as a major policy instrument to influence the economy and improve living conditions. While demonstrating causality is difficult, cross-country analyses show that a 1 percent increase in public spending can lift economic growth by nearly a percentage point (the "fiscal multiplier"), with, however, significant variations depending on initial conditions and the nature of the spending increase.[4] There is also a wealth of empirical evidence that sound expenditure policy can diminish economic and social disparities, promote equity, and reduce poverty while preserving growth objectives.[5]

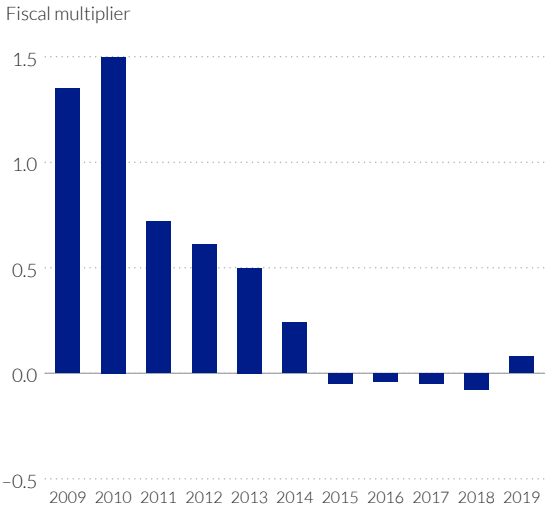
In South Africa, public spending has not delivered the desired impact on long-term economic growth and poverty alleviation. Analysis by the Reserve Bank of South Africa found that, over the past decade and controlling for other variables, increases in public expenditures have no longer been associated with growth in output.[6] The fiscal multiplier even turned negative in the late 2010s (figure 1), and poverty (at the upper middle-income international poverty line of $6.85 per person per day), at 61.6%, is well above what would be expected at South Africa's level of development.

Three complementary factors help explain why public expenditures have not supported economic growth and poverty reduction in South Africa.

First, the gradual narrowing of fiscal space due to high current expenditures and high and growing debt-service payments means that fewer public resources are available for capital and social spending programs that are likely to have the greatest impact on inclusive growth. Public debt surged from 24%

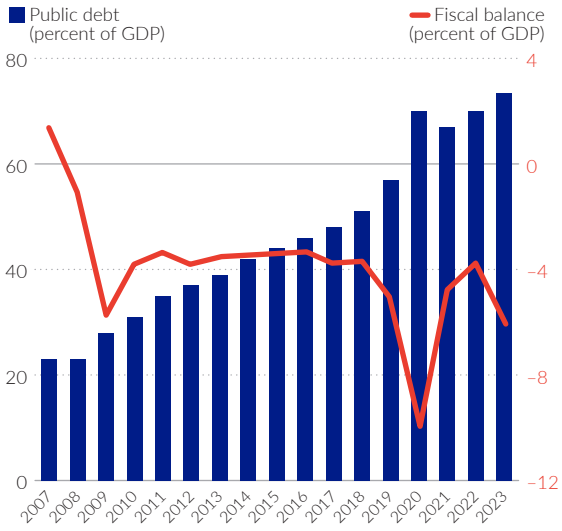
The government's ability to deliver basic social and infrastructure services has been eroding, while a threefold increase in the public debt has narrowed the fiscal space to fund such services

Figure 1 The fiscal multiplier has been declining since 2010



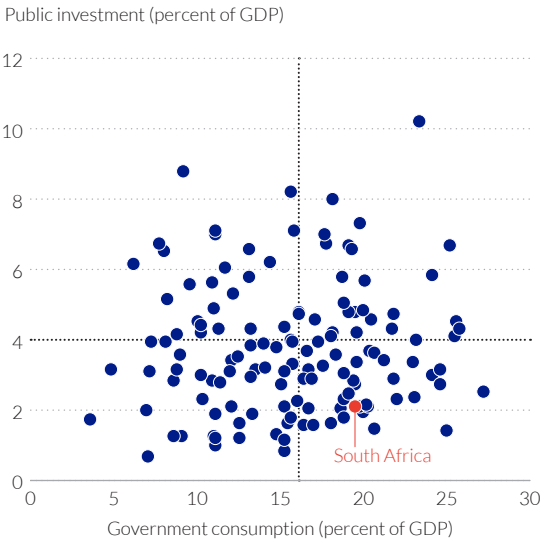
Source: T.J. Van Resburg, S. de Jager, and K. Makrelov, 2021, "Fiscal Multipliers in South Africa after the Global Financial Crisis," SARB Working Paper, South African Reserve Bank.

Figure 2 Fiscal accounts have deteriorated since 2009



Source: National Treasury and World Bank.

Figure 3 Budget allocations privilege consumption at the expense of investment compared with global standards, 2019



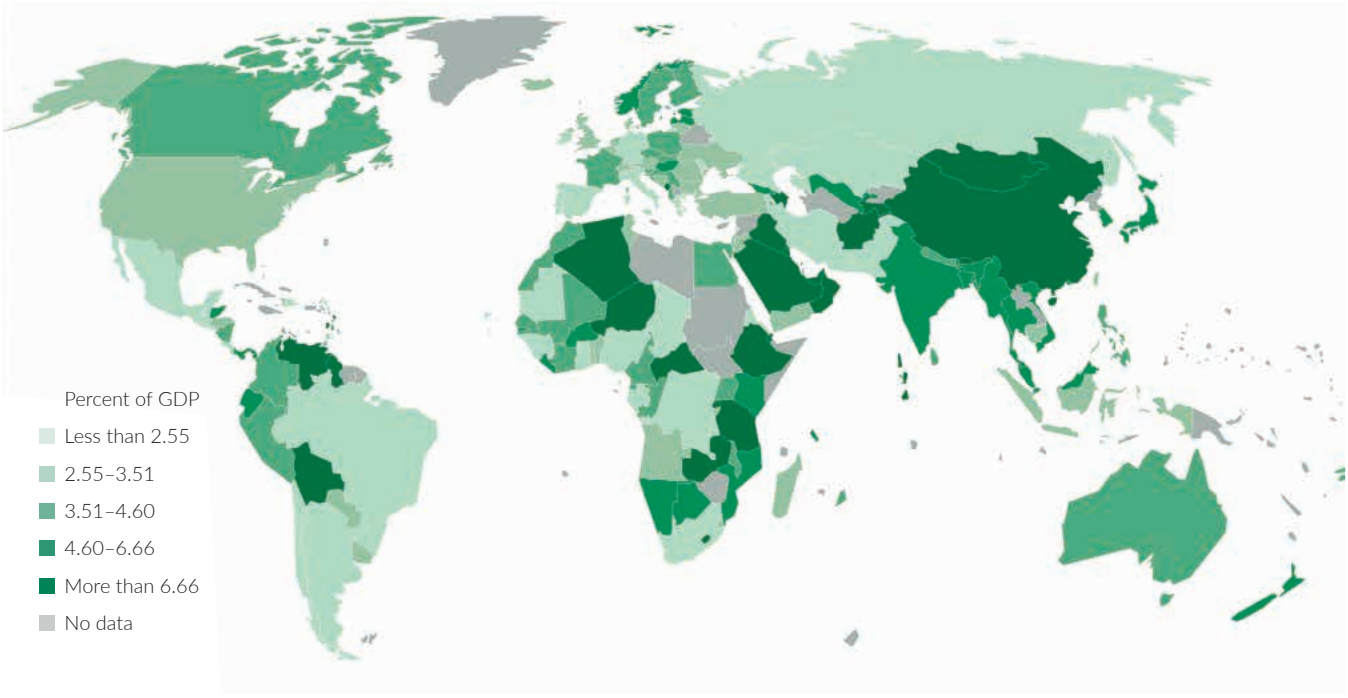
Source: International Monetary Fund's Investment and capital stock data set and World Bank's World Development Indicators.

of GDP in 2008 to almost 75% at the end of 2023 (figure 2), increasing the risk of debt distress and pushing up interest rates.[7] This has further negative consequences for economic growth because it can crowd out financing for the private sector.[8] Rising public debt can also prevent demand from responding to increased public spending as consumers increases their savings in anticipation of the future tax increases that will be needed to pay off the rising public debt (the Ricardo-Barro effect).[9] Acknowledging this risk, the government has limited public expenditure growth after the pandemic, especially by containing the wage bill. However, this has also created new challenges since contained public spending could negatively affect the aggregate demand, reducing growth, which will make in turn fiscal consolidation even more difficult.

Public spending has not been fully aligned with the country's needs as public consumption has been favored over public investment

Second, public spending has not been fully aligned with the country's needs. Public consumption has been favored over public investment (figure 3), leading to an infrastructure crisis (see policy note 2) that is strangling economic growth.[10] South Africa has invested 3%–5% of GDP per year less than fast-growing countries in East Asia and six times less than China over the past two decades (figure 4). In addition, just 11% of the budget was allocated to economic expenditures during fiscal year 2023/24,[11] well below the more than 20% allocated in Malaysia, Singapore, and Thailand. The misalignment of public spending

Figure 4 Public investment is below the world average and well below the level in fast-growing economies, 2019



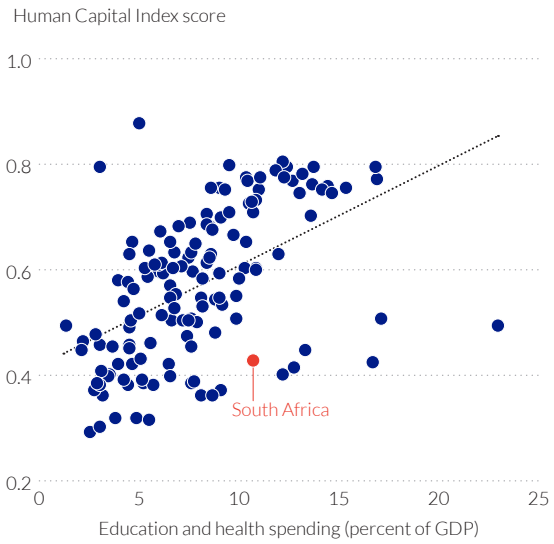
Source: International Monetary Fund's Government Finance Statistics.

with the country's needs is also evident within sectors, as discussed in the next section.[12]

Third, the declining capacity of the public sector to efficiently deliver public goods and services has lowered the value of South Africa's fiscal multiplier. Even when the government has allocated adequate resources to the right sectors, the positive impact on inclusive growth has been curbed by technical, institutional, and human resource deficiencies in the public sector. This is illustrated by the low value for money in social sector spending, despite ample budget allocations (figure 5). These weaknesses have resulted in the capture of public funds by the private sector and connected individuals, as emphasized in recent government reports.[13] This deterioration of institutions and accountability mechanisms is reflected in the decline in South Africa's Worldwide Governance Indicators over the past two decades (figure 6).[14] This decline is especially prominent in government effectiveness, quality of regulations, and control of corruption.[15]

Such spending inefficiencies are found across all levels of government, including subnational governments and SOEs. Subnational governments are responsible for 78% of public spending, including the provision of most social services (provinces) and a large share of basic infrastructure (municipalities)

Figure 5 Value for money in social sectors is low in relation to the rest of the world, 2020



Source: World Bank, World Development Indicators database.

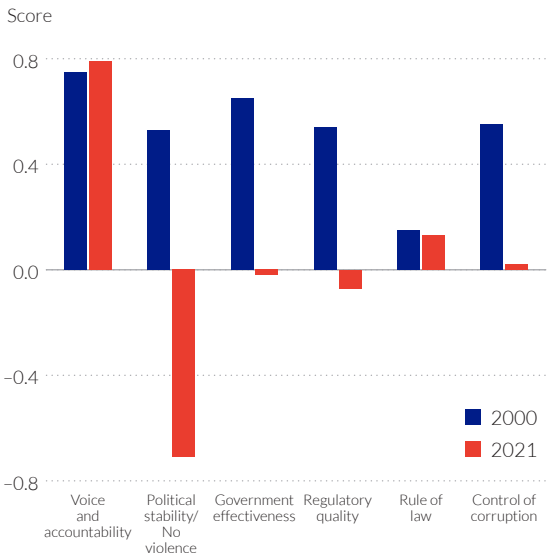
The positive impact on inclusive growth has been curbed by technical, institutional, and human resource deficiencies

(figure 7). As of 2021, 165 of 257 municipalities were classified as dysfunctional, including 30 that were under provincial or national administrative control.[16] Similarly, the mismanagement of several SOEs responsible for infrastructure services is well documented.[17] These enterprises have failed to develop and maintain the country's infrastructure networks, especially in energy (Eskom) and transport (Transnet and PRASA). Those failures have generated direct losses to the economy, estimated at 2%–3% of GDP growth in 2023 alone.[18] They have also resulted in successive bailouts that have drained public resources and cost around 6–7 percentage points of GDP between 2009 and 2023.

The poor have been disproportionately penalized by the degradation in public infrastructure and social services caused by inadequate maintenance and investment

The inefficiency in South Africa's public spending has disproportionately hurt the poorest segment of the population. Granted, the generous allocation of public resources to social protection (around 4% of GDP) has reduced poverty and inequality.[19] But this positive contribution must be weighed against the regressive effects of the suboptimal use of public resources. The poor have been disproportionately penalized by the degradation in public infrastructure and social services caused by inadequate maintenance and investment because they lack

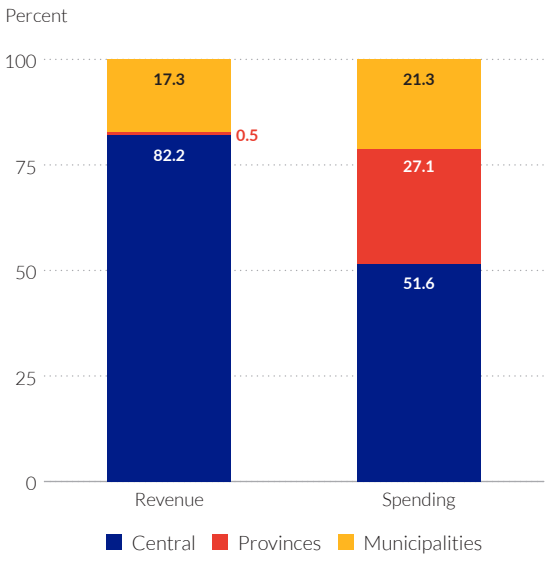
Figure 6 Most governance indicators have weakened over the past two decades, 2000–2021



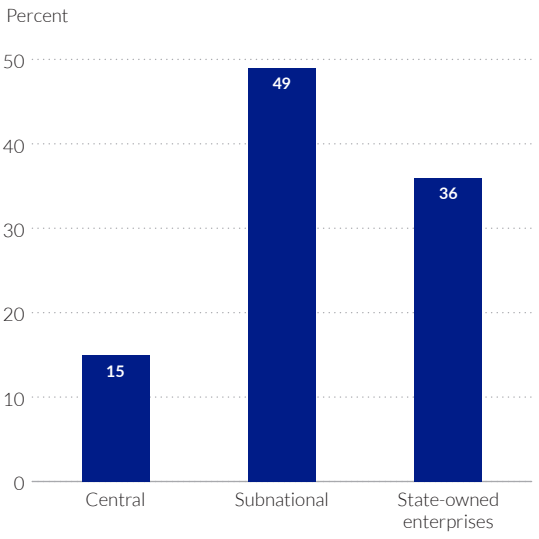
Source: World Bank, Worldwide Governance Indicators (https://www.worldbank.org/en/publication/worldwide-governance-indicators/interactive-data-access).

Figure 7 Subnational governments are responsible for the largest share of public spending

a. Public spending is decentralized to provinces and municipalities, while revenue collection is not, 2022/23



b. Subnational governments and state enterprises are responsible for 85% of public investment, 2023/24



Source: Calculated by authors using National Treasury data.

the financial resources to switch to private services (such as off-grid energy solutions or private schools and hospitals). Furthermore, the reduced impact of public spending on economic growth has constrained the emergence of new enterprises, especially micro and small firms, thus reducing demand for unskilled and medium-skilled labor.

Three priorities for making public spending more efficient

South African policymakers have introduced several initiatives to improve the efficiency of public spending. Since 2019, Operation Vulindlela, a joint initiative of the Presidency and the National Treasury modeled after service delivery units globally, has pushed for critical policy reforms in electricity, digital communications, water, transport, and immigration.[20] Similar institutional fixes led to the creation of the Presidential Climate Commission in 2020, the Presidential Youth Employment Intervention in 2020, the National Energy Crisis Committee in 2022, and the creation of the position of minister of electricity in 2023, among other measures. However, international evidence reveals that such parallel units and structures often face resistance within public administration, which can feel threatened by the parallel arrangements.[21]

The authorities could adopt a more comprehensive approach to address the factors behind the inefficiency of public spending. An overarching analytical framework of three priorities is proposed to guide interventions (figure 8). The three priorities respond to the following three questions: How can the government create fiscal space to ensure that public resources are available to meet current and future needs? How should public resources be allocated to address the country's most important needs and yield the highest returns to growth and to poverty and inequality reduction? How can the public sector's delivery capacity be strengthened?

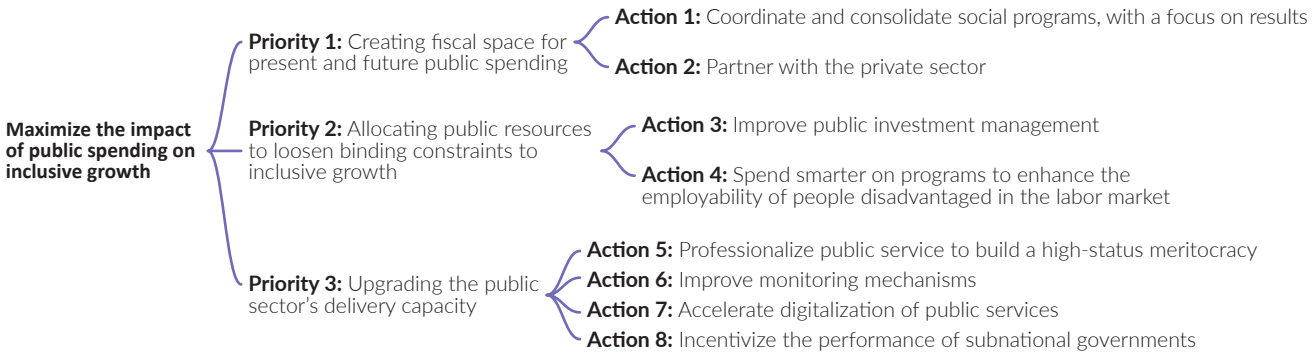
A menu of eight actions is proposed to support the three priorities. Several actions build on initiatives already launched by the government (such as incentives for subnational governments and SOEs to spend better and the digitalization of public services), while others, often inspired by successes in other countries, are more disruptive. All the proposed actions prioritize the short term to create momentum for further reforms. They are complemented by some of the recommendations in policy notes 2 and 4 that call for a smaller public footprint in the economy and the opening of infrastructure markets to private operators while reinforcing the regulatory role of the state.

The proposed actions prioritize the short term to create momentum for further reforms

To ignite the transformation in public spending, policymakers could focus initially on a subset of six reforms under the eight proposed actions. These reforms are assessed as the most politically and technically feasible, impactful, and timely as they do not require large changes in the legal framework (see table A1 in the annex). While the most desirable actions would ideally meet all three criteria, tradeoffs are likely to arise:

1. *Coordinating and consolidating active labor market programs.* For example, there are more than a hundred active labor market programs at the national level offered by some 20 government departments.

Figure 8 A guiding framework for prioritizing policies for improving the efficiency of public spending



2. ***Linking the Covid-19 Social Relief Distress grant with active labor market programs*** to enhance employability and support job creation and labor productivity in the longer term.
3. ***Making the Head of Public Administration responsible for ensuring transparent and robust processes for hiring and managing all top managers.***
4. ***Introducing a unified national ID standard*** to prepare for a digital ID that will improve access to social and financial services and data.
5. ***Incentivizing the uptake of the e-procurement system (eTenders) for procuring entities across levels of government*** by introducing financial and nonfinancial rewards.
6. ***Scaling up the contract-based approach piloted in the electricity sector to other sectors (water, waste, education, health) and other levels of government*** to incentivize them to improve their overall financial performance.

The proposed actions give special attention to social spending for three interconnected reasons. First, because social spending absorbs about half of South Africa's public budget, it will be hard to achieve large efficiency gains without improving the quality of social spending. Second, budget allocations to education and health are high by international standards yet have failed to achieve a commensurate impact on human capital (see figure 5). Third, most of the recommendations for the social sectors also apply to other sectors, including infrastructure, another major challenge (see policy note 2).

To increase fiscal savings in the short-term, the government can cut or consolidate redundant or nonperforming programs and develop partnerships with the private sector to deliver public services

Priority 1: Creating fiscal space for present and future public spending

Creating fiscal space is at the center of the Medium-Term Fiscal framework presented by the Minister of Finance in the budget speech delivered in February 2024. The two main levers are the wage bill, which at 12% of GDP is 5 percentage points above the average in Organisation for Economic Co-operation and Development (OECD) countries, and the expected increase in debt-service payments.[22] To rein in wage increases, the National Treasury has gained power and discretion to bargain with labor unions using the legal room created by a recent judicial decision that went against labor unions. Hiring new staff requires the authorization of the National Treasury and the Department of Public Service and Administration, at least for the 2024/25 financial year. To slow the rise in debt service costs, plans call for reducing borrowing by controlling the fiscal deficit, seeking more financing on concessional terms, and improving debt management. These actions will take time to have a noticeable impact because of built-in rigidities in many expenditures. In addition, controlling the wage bill while improving public service delivery necessarily involves tradeoffs. Further wage bill reforms are likely to erode service delivery in core labor-intensive activities such as education, health, and justice and security.[23] Thus, wage bill consolidation may need to accommodate greater front-line service delivery requirements and be accompanied by recruitment reforms, which are the focus in this note.

The government will have to do more to create fiscal space as the pressures on capital spending and social spending mount. As highlighted in policy note 2, South Africa's infrastructure needs are enormous, both to redress current shortcomings and to adapt to climate change. Social expenditures are also projected to increase, especially in education, where increases are needed to accommodate the growing number of students and improve the quality of education. For example, in basic education, the challenge is to build some 20,000 new classrooms and increase the teaching workforce by about 25,000 to prepare for the estimated additional 1.2 million learners expected to enter the school system by 2030. Without creating more fiscal space, the government cannot afford to pay for these education system needs. Similar challenges apply to health and social protection.

In the short-term, the government can consider two types of actions on the expenditure side to increase fiscal savings. First, it can cut or consolidate redundant or nonperforming programs, which raise administrative costs and prevent economies of scale. Second, it can develop partnerships with the private sector to deliver public services, as is already under way in some infrastructure sectors, such as telecommunication and electricity, and is beginning in social sectors in some provinces, including in education and health.

Action 1: Coordinate and consolidate social programs, with a focus on results

Several government-supported programs in South Africa are not well coordinated and do not track results effectively. For example, there are opportunities to consolidate more than 100 active labor market programs offered by some 20 government departments at the national level, with no overarching strategy or system to monitor progress or evaluate job-related outcomes. Another example is early childhood development programs, which require the engagement of multiple departments across tiers of government. Coordination is widely acknowledged to be weak, limiting effectiveness. There are also numerous early-grade reading programs that have been implemented over the last two decades, some of which have been evaluated. But these interventions have not gone to scale and are not integrated into the routine practices of the education system. There seem to be multiple programs in some areas that are not coordinated and that lack sufficient empirical data on outcomes to support continuing them or taking them to scale. And even when data on outcomes are available, there are no well thought out and clearly articulated plans for scaling up and sustaining the programs, particularly financially.

Action 2: Partner with the private sector

When properly structured, partnerships with the private sector can improve the quality of service delivery, increase access, and relieve some of the fiscal pressure. As well as contributing financial resources, private providers can bring new expertise and competencies in the delivery of services. Several countries use alternative service delivery mechanisms to improve programs and services. Prompted by concerns for the public interest, service quality, client orientation, and human resource management, Canada has encouraged public sector managers to explore creative ways of delivering services outside of the public sector, such as public-private partnerships, outsourcing, and contracting out of services. All proposals must pass a public interest test, which covers the key dimensions of affordability, external partnerships, jurisdictional alignments, and the role of government. For commercial entities in which the state is a minority stakeholder, privatization might also offer financial gains, but such programs may require time to become politically acceptable.

Partnerships with the private sector can achieve lower costs and higher quality as well if the partnership contracts are well defined and private providers commit to high levels of accountability. Public-private partnership agreements could be directed to sectors that need the greatest support, in exchange for enhanced autonomy for the private provider and with exit clauses built into the contracts in case the provider proves unable to meet performance targets. Public-private partnership are being developed in several infrastructure sectors, as discussed in policy note 2, and could be extended to social sectors. There is very little private provision of education in South Africa: in 2021, only 6% of primary school students were enrolled in private schools, against 18% in Brazil and 45% in India. Partnering with the private sector would also be in line with the government's objective to expand technical and vocational education (TVET) programs, where quality and coverage could be improved through workplace-based and technology-based learning.

Quick measures could include:

- ***Scaling up private provision in education,*** learning from the experience of Western Cape and Gauteng Provinces. Western Cape Province has had success experimenting with the Collaboration Schools model, in which a public school partners with an experienced nonprofit school support organization that provides intensive support to teachers and principals through training, additional resources, performance monitoring, and regular feedback.[24] The Western Cape Education Department oversees the performance of the nonprofit organization, holding it accountable as part of the public school system. Public-private partnerships are less common in higher education (TVETs and universities), but some of the best training institutions in Kazakhstan, Malaysia, and Morocco are organized as public-private partnerships.[25]
- ***Expanding workplace-based learning opportunities for unemployed youth in small and medium enterprises.*** The current system of workplace-based

As well as contributing financial resources, private providers can offer new expertise and competencies, lower cost, and higher quality in service delivery

learning has several shortcomings. Little training is directed to people without work experience who are seeking such experience, and numerous bureaucratic barriers prevent smaller companies from participating (about 80% of businesses are not participating). Initiatives such as the Youth Employment Services turnkey model or the Center of Specialization approach implemented in selected public TVET institutions demonstrate the feasibility of placing unemployed youth in small and medium enterprises in South Africa. The lessons are that learner registration procedures should be simplified for small and medium enterprises and that efficient monitoring and funding systems are needed to enable small and medium enterprises to participate.

- *Developing technology-based learning* to increase relevance and cost-efficiency in post-school education and training systems and improve access for learners in remote rural areas. The use of technology in education has barely been explored in South Africa, particularly in TVET institutions. Technology can enable more efficient use of physical infrastructure while also providing simulated practical experience. For example, horticulture programs at the Swiss Federal Institute for Vocational Education and Training use virtual reality glasses to enable students to create and implement landscape designs and to simulate seasonal effects on their virtual landscape. Such simulation technologies can also help bridge the gap between theoretical learning in the classroom and the skills needed in professional settings.

Dealing with the infrastructure crisis requires higher capital and maintenance spending, while reducing unemployment requires allocating resources to programs that improve employability

Priority 2: Allocating public resources to loosen binding constraints to inclusive growth

Two of the major challenges facing South Africa—inadequate infrastructure and high unemployment—require the more efficient allocation of public resources. Dealing with the infrastructure crisis requires higher capital and maintenance spending. Reducing unemployment requires allocating resources to programs that improve the employability of workers in South Africa. The authorities can consider the following two actions to better align public spending with these two challenges.

Action 3: Improve public investment management

The first-best solution to improve public investment management would be to shift some resources from current spending to capital spending, as South Africa is clearly an outlier is this area (see figure 3). However, this resource shift could be difficult to achieve in the short term. As highlighted earlier, any savings on recurrent spending (such as the wage bill) should be used to consolidate the fiscal deficit. In addition, the rigidity of many recurrent spending items, especially the wage bill, makes it difficult to shift public funds in the short term.

The second-best solution is to improve the efficiency of capital spending. If the government cannot spend more, it must spend better. This could be achieved by reducing the fragmentation in institutions and processes that inhibits the coordination, selection, implementation, and monitoring of capital projects and by streamlining processes in subnational governments, which account for three-quarters of public investment.

The authorities could consider two measures in the short term:

- *Establishing a centralized gateway for priority capital projects above a certain threshold* (for example, above R5 billion, or $250 million). The government recognizes the institutional complexity of the public investment landscape.[26] In a highly decentralized and delegated environment, over 700 public institutions operate multiple parallel systems for strategic projects. This system comes with immense costs, generates confusion, adds complexity, and requires multiple entities to administer. To create a more streamlined and transparent framework for identifying and prioritizing strategic infrastructure projects, South Africa could follow the direction taken by countries like the Republic of Korea, New Zealand, and the United Kingdom, which have established a central project information management (PIM) unit with oversight of strategic public sector projects.[27] Bringing together a few existing units/entities will encourage a stronger portfolio approach to PIM, particularly for large, strategic infrastructure projects, and help create a center of excellence by gathering expertise under one roof. Projects above a threshold

would undergo a rigorous gateway review (such as the one announced in the Medium-Term Budget Policy Statement), with support from one institution or through a reconfiguration of existing units. A crucial remaining question for the authorities is how to embed this centralized gateway mechanism in the high-level decision-making process. Countries have adopted different solutions.

- ***Reducing the administrative burden associated with conditional grants to subnational governments.*** As of 2023, provinces and municipalities had to deal with more than 42 different grants (24 for the provinces and 18 for the municipalities). Many grants have overlapping purposes, and some are for relatively small amounts (12 grants provided less than $25 million a year to all subnational governments). Reporting requirements generally differ across programs as well, adding to the administrative burden. Having a large number of grants increases transaction costs; limits the absorptive capacity of local governments, especially in small and poor areas; increases the potential for misuse; and slows execution. To ease the administrative burden on subnational governments, the central authorities can reduce the number of grants (for example, the provinces received six grants for the education sector alone) and harmonize reporting requirements. Grants can also include conditions that reinforce planned PIM reforms (for example, through mandatory gateway reviews supported by centralized institutional arrangements).

Action 4: Spend smarter on programs to enhance the employability of people disadvantaged in the labor market

South Africa is among the highest spending countries on social protection and active labor market programs. The country spends around 4% of GDP on noncontributory social assistance alone, compared with a world average of about 1.5%. This level of spending has been part of the social contract between the state and its citizens since the end of Apartheid and is justified by the high levels of entrenched poverty, inequality, and unemployment.[28] While there have been some successes, most outcomes have been disappointing over the past 10 years. The employability of the labor force, in particular, remains extremely low.

Part of the inefficiency of social and labor market programs stems from their fragmentation, raising the stakes for consolidation, as recommended above. Building on the vast literature on this topic, including some by the South African government, the following three additional actions can be considered to enhance the impact of these programs on the employability of workers, especially youth:

- ***Linking the Covid-19 Social Relief Distress grant to active labor market programs.*** Under the Covid-19 Social Relief Distress grant, South Africa provides unconditional income support (R350 per person) to about 8 million adults who can work. Introduced in 2020 to mitigate the impact of the Covid-19 pandemic, the grant was extended to 2025. As many other middle-income countries have done, South Africa could tie part of the grant to the participation of beneficiaries in job-counseling services. Panama gradually scaled down its Covid-19 response program by increasing job-search requirements for applicants. In Denmark and Finland, employment services and social assistance are often located at the same job centers and are coordinated to support clients who need both income and employment assistance. South Africa could reform the Employment Services system by providing counseling services to job-seekers and by linking the databases of the Department of Social Development and the Employment Services system.
- ***Using wrap-around approaches to improve the effectiveness of active labor market programs.*** South Africa's active labor market programs could follow the direction of programs in several middle- and high-income countries. For example, Bosnia and Herzegovina and the United Kingdom provide integrated wrap-around services to work-seekers and vulnerable households that face multiple barriers to employment, after an initial comprehensive assessment of their needs. South Africa has experimented with this approach in the Basic Package of Support pilot program for vulnerable youth, which is complemented by ongoing rigorous evaluation. Another comprehensive approach, though on

Part of the inefficiency associated with social and labor market programs stems from their fragmentation, raising the stakes for consolidation

a small scale, is the Jovenes model applied in several Latin American countries, which combines technical and workplace behavior training (three months), apprenticeships (three months), life coaching (six months), career guidance, transport vouchers (and childcare stipends for women), and job placement through publicly financed nongovernmental organization–private sector partnerships.[29]

- *Developing microentrepreneurship programs,* which are largely absent in South Africa. Operating successfully in more than 80 low- and middle-income countries, these programs complement government social assistance schemes with job-related supports, helping beneficiaries use their resources for productive endeavors and become self-sufficient. Colombia's Jefes y Jefas de Hogar and Kenya's Hustler Fund are directed to adults and youths in poor households, providing them with a bundle of services (training and coaching, savings schemes, business preparation, investment grants, and so on) over a discrete period (18–24 months) to start or expand viable microenterprises. Impact evaluations indicate that these programs have sustainable impacts on employment and earning outcomes, especially for youth and women.

Priority 3: Upgrading the public sector's delivery capacity

State capacity has severely deteriorated in South Africa. The causes for this deterioration are diverse, ranging from the declining technical capacity of staff in several strategic departments, subnational governments, and SOEs to the deliberate misuse of public resources through misguided human resources policies and corruption. Corruption has had a corrosive effect on South Africa's public institutions, in particular on accountability institutions and the management and oversight of SOEs, as documented by the Commission of Inquiry into State Capture. On the 2023 Corruption Perceptions Index, South Africa dropped below the global average, scoring 41 out of 100 (where 0 is highly corrupt and 100 is very clean), reflective of perceived stagnation in the fight against corruption. Addressing these challenges requires a comprehensive agenda, but that will take time to develop and implement given the multiplicity of views (and vested interests) in South Africa.

However, there are several opportunities to accelerate the state capacity-building agenda. Proposed below are four actions that can produce short-term results while laying the foundation for more comprehensive future reform. To produce tangible results, these actions need to be implemented at all three levels of government (central, provincial, and local), as well as in autonomous agencies and SOEs.

Measures to accelerate state capacity building need to be implemented at all three levels of government, as well as in autonomous agencies and state enterprises

Action 5: Professionalize the public sector to build a high-status meritocracy

Building a professional, high-status bureaucracy is a critical step for a country that aspires to high-income status. In response to the disturbing evidence presented in reports of the Department of Public Service and Administration and the Judicial Commission of Inquiry into Allegations of State Capture, Corruption, and Fraud in the Public Sector (the Zondo Commission), the government adopted the Framework Towards the Professionalization of the Public Sector in 2022.[30] Recent efforts have focused on legislative reforms to harmonize standards of employment across levels of government, delineation of the political/administrative interface, and extension of the Public Service Commission's oversight to provincial and municipal governments.[31]

While recognizing that building a new professional bureaucracy will take time, the authorities can consider several measures to accelerate this process:

- *Making the Head of Public Administration responsible for ensuring transparent and robust processes for hiring and managing all top managers,* which could reduce political interference in hiring and management practices for senior public servants. This role for the Head of Public Administration would draw a new line of administrative and operational accountability between senior public servants (director generals) and the Head of Public Administration, who would play a key role in appointment processes and discipline management for director generals, replacing the current practice of presidential ministerial approvals.
- *Expanding the role of the Public Service Commission, an independent body established by the*

Constitution, in reviewing key public sector appointments across all three levels of government and SOEs. As a starting point, independent technical experts can integrate the multiple selection panels for senior appointments, including heads of departments, municipal managers, and SOE board members. Many OECD countries have centralized recruitment for senior civil servants. For example, in Australia, a Public Service Commissioner is a full participant in the Senior Executive Service recruitment process, and experts from the Australian Public Service professions are systematically included in recruiting panels.

- ***Enhance anti-corruption efforts and public integrity management by reducing fragmentation and gaps in the financial disclosure framework across institutions and levels of government.*** This includes removing gaps in the coverage of high-risk officials, extending the disclosure form to address unjustified wealth, strengthening enforcement and sanctions mechanisms, and establishing the foundations for automated verification processes and public access to disclosures. A thorough review of the decentralized institutional framework for disclosure, verification, and sanctioning is also needed to introduce a uniform, centralized approach to electronic disclosure that addresses gaps in oversight and inconsistency in the application of regulations and the issuing of sanctions.

Action 6: Improve monitoring mechanisms

Experience demonstrates that appropriate monitoring mechanisms significantly improve public sector performance. To be efficient, monitoring mechanisms must be agile and transparent, results must be shared publicly, and measures must be included that reinforce good outcomes and penalize bad ones. Monitoring mechanisms in South Africa's public administration need critical improvements.

Consistent with this note's focus on the social sectors, the education system can illustrate the urgency of implementing good monitoring mechanisms. The absence of a regular national assessment of student performance has impeded the optimal use of resources for students and teachers who need further support. At the higher education level, finances are directed to institutions based on the number of students enrolled, which reinforces the country's commitment to accessibility but is a poor predictor of institutional performance. The development of innovative interventions has been discouraged by the absence of clear, measurable, and shared definitions of targets and of the rigorous monitoring and evaluation systems needed to convince policymakers to continue and scale up innovative programs.[32]

The projected fiscal consolidation process escalates the urgency of improving monitoring mechanisms in education and training systems. Ongoing budget cuts, combined with stagnating graduation rates and rising national demand for highly educated workers, make it increasingly important to ensure the efficient use of limited public resources for education.

Ongoing budget cuts, stagnating graduation rates, and rising national demand for educated workers make it increasingly important to ensure the efficient use of limited public resources for education

The following three measures are aimed at improving the monitoring of education and training programs, but the principles of just-in-time reporting, agility, and ex post corrections are relevant to other sectors as well:

- ***Instituting regular national learning assessments and functional school-based assessments in basic education.*** South Africa's annual national assessment of grades 3, 6, and 9 was discontinued in 2015. Western Cape Province is currently the only province that still conducts annual assessments. Reinvigorating annual learning assessments is vital for tracking systemwide learning performance. Improving learning through timely interventions and effective planning requires accurate and timely data on learning outcomes not only at the end of each grade but as learners progress through a grade.[33] Thus, national learning assessments need to be complemented by a system for continuously assessing student learning and recommending remedial actions to ensure that all students are on track. The School Based Assessment, which is currently used only as a tool for promoting students from one grade to the next, could be transformed to serve this continuous assessment role.
- ***Moving toward performance-based funding and instituting tracer surveys for higher education.*** As budgets for higher education shrink, governments in several countries are using performance-based funding to align their objectives with

those of higher education institutions and to ensure that limited public funds are used more productively. Higher education institutions must ensure that students complete their training and graduate with the skills to be successful in a dynamic economy. Having performance-based funding systems in place is particularly important as more private providers enter the education and training market. Most European countries and states in the United States have used performance-based funding for higher education for decades. South Africa could learn from them. At a minimum, South Africa could institute tracer surveys in all universities and TVETs to track student completion and employment outcomes. Digital systems should be leveraged for this purpose.

- ***Focusing on programs that demonstrate results and can be scaled up.*** South Africa has tried a range of interventions to improve public sector delivery capacity. Still lacking is the collaborative leadership needed to identify the priority problems to be addressed and glean the lessons from domestic programs and those in other countries. There have been numerous exercises to document the plethora of interventions in active labor market programs, early childhood development, parenting programs, and early grade reading programs. The next step is to appoint a team of leaders to assess the evidence on which programs show the greatest promise and map out ways to integrate the most robust interventions into the day-to-day functioning of related programs.

The slow implementation of the digital agenda reflects budgetary challenges as well as technical and governance problems

Action 7: Accelerate digitalization of public services

Governments across the world are using new digital technologies to improve public services. The digitalization of decision processes reduces transaction costs for public administration and for individuals and businesses. Shared digital platforms create economies of scale and improve policy decisions using just-in-time and collaborative data. Digital solutions have also reduced human interference in processes, narrowing opportunities for corruption and improving accountability through more transparent reporting mechanisms.[34]

Although the South African government has begun its digital transformation, digitalization is not progressing as quickly as in the most advanced countries. South Africa was ranked well behind global leaders (Estonia, Finland, and Korea) and regional leaders (Rwanda) on both the World Bank's GovTech Maturity Index and the UN's Online Service Index in 2022.[35] Its slow digitalization is further evidenced by the limited number of online services: only 120 public services are available online today against a target of 255. Although the e-government service portal (www.eservices.gov.za) is visited by 300,000 users monthly—a reasonable number—satisfaction is low.

The slow implementation of the digital agenda reflects budgetary challenges as well as technical and governance problems. The budget allocation to information and communication technologies shrank 5% in real terms between 2016/17 and 2020/21, with a lower share directed to developing and digitizing government services and functions for the public.[36] Public digital services are frequently disrupted by technical problems, including electricity blackouts, and by the inadequate technical knowledge and skills of civil servants. The State Information Technology Agency, the key agency responsible for digitalization of the public sector, is beleaguered by governance and operational challenges.[37]

Accelerating the use of digital solutions in four areas could increase transparency, speed transactions, and improve intergovernmental coordination. These solutions would build on several pilot projects in South Africa and successful experiences in other countries:

- ***Developing real-time dashboards to track major infrastructure projects across levels of government.*** A real-time snapshot of how investments in water, transport, energy, and telecommunications are performing would be a big step toward improved decisionmaking and collaboration inside and outside of government. Experience with South Africa's major infrastructure investments for the World Cup and New Zealand's Infrastructure Commission shows that simple, straightforward reporting to decisionmakers can reduce obstacles. Relevant information could also be disclosed to the public in an easily

accessible format to increase transparency and accountability to taxpayers on how their money is being spent.

- ***Introducing a unified national ID standard to prepare for the introduction of a digital ID for accessing social and financial services.*** The draft National Identification and Registration Bill of 2022 aims to introduce a unified national ID standard that will contribute to the development of a digital ID for use in areas such as healthcare, social protection, and financial services. Public consultations on the draft bill were held in early 2023, and the bill is awaiting submission to Parliament.
- ***Incentivizing the uptake of the e-procurement system (eTenders) for procuring entities across levels of government.*** An e-procurement system to track supply chain management/procurement stages that meets interoperability and data sharing standards is critical to improving the transparency and efficiency of public spending across levels of government. All tender opportunities and contract awards should be published on the eTenders system. Bangladesh and Rwanda used incentives to roll out their e-procurement systems fairly quickly. Incentives included team bonuses for meeting e-procurement targets, the provision of new information technology equipment to units, and awards for top achievers.
- ***Introducing digital tools and shared data platforms in strategic sectors, including machine learning and artificial intelligence.*** For example, the deployment of a fully interoperable national health information system that provide access to digitized health records for all patients and connects healthcare providers and patients could dramatically improve the quality of services. Similarly, an open logistics platform with standardized data formats available to shippers and transporters would be a critical tool for reducing information asymmetry in logistics and sharing just-in-time data on road and port conditions and waiting lines, as China and India have done, for example. As the logistics platform evolves, it could provide electronic solutions for paying multiple fees and custom duties and for submitting requested regulatory documents through a unified portal rather than separately through different agencies and local governments.

Action 8: Incentivize the performance of subnational governments

South Africa's quasi-federal fiscal system devolves key infrastructure and social spending responsibilities to subnational governments, in line with the subsidiarity principle of public finance.[38] However, limited technical capacity, especially in poor and isolated provinces and municipalities, and rising governance challenges have led to the deterioration of local services. Many subnational governments suffer from the politicization of cadre deployment, the incursion of vested interests into decisionmaking, and the poor organization of delivery processes across departments.[39] The lack of transparent, just-in-time, independent monitoring systems has also reduced the accountability of local managers and policymakers, as highlighted earlier.

Along with limited technical capacity and weak governance, subnational governments have few incentives to improve performance due to the unbalanced fiscal decentralization of responsibilities between expenditures and revenues. Subnational governments are responsible for almost 80% of national public expenditures, but they collect less than 20% of national public revenue. Provinces and most municipalities are highly dependent on transfers of about $30 billion a year from the central government to finance their activities.[40] This dependence reduces the accountability of local governments and relaxes fiscal discipline as their expenses are financed by national rather than local taxpayers. The International Monetary Fund estimates that this expenditure–revenue imbalance increases the fiscal deficit by 1 or 2 percentage points of GDP.[41]

Balancing the spending and revenue responsibilities of local governments could improve their accountability and fiscal performance. South Africa could follow the model of several countries with decentralized fiscal systems that have achieved such balance, including Canada, Iceland, Sweden, and Switzerland. But this will take time because political consensus is required to amend the constitution.

A more immediate solution is to introduce a performance-based element to subnational transfers. Subnational authorities have few incentives to perform better since they will receive transfers from the National Treasure even if they perform

Introducing a performance-based element to subnational transfers will strengthen performance incentives for local authorities in the short term and pave the way for future reforms

poorly. The central government has implemented several initiatives to remedy this situation, such as those used in other middle-income countries, including Brazil.

The government could scale up these recent initiatives and complement them with additional performance-based measures. These measures will not immediately turn around the poor service delivery performance of subnational governments, which will require deeper reforms at the local level and in the design of fiscal decentralization. However, they will strengthen performance incentives for the local authorities in the short term and pave the way for future reforms.

- ***Adding a performance-based element to the equitable formula for nonearmarked transfers (80% of total transfers),*** which is currently based solely on the needs and capacity of each subnational government. Making this adjustment is relatively easy technically but harder politically because underperforming local governments are likely to oppose it, and an efficient and transparent monitoring and evaluation mechanism will be needed as well. Some countries have been able to add a performance element to transfers by applying them to the incremental increases in transfers rather than to their total value (reducing losses for underperformers) and by focusing on simple outcome measures. To illustrate, imagine that the value of unconditional transfers to a subnational government increases from R585 billion in 2023/24 to R600 billion in 2024/2025. Applying a performance-based measure to the incremental increase only would mean that R15 billion would be allocated based on performance. The central government could further incentivize subnational governments by offering technical assistance to help them improve their performance.
- ***Scaling up the performance-based approach used for public transport grants to other earmarked transfers*** (20% of total transfers), which are directed mainly to infrastructure services. Public transport grants are determined partly on the basis of measurable outcomes.[42] The authorities expect to extend this approach to the water and energy sectors and to funds for building resilient infrastructure. The challenge is to define measurable outcomes and to ensure that local governments have the technical capacity to implement the targeted programs. Technical assistance might be required to support implementation, including the use of management contracts where appropriate.[43]
- ***Scaling up the contract-based approach piloted in the electricity sector to other sectors and levels of government*** to incentivize them to improve their overall financial performance. In May 2023, the National Treasury offered to clear municipalities' arrears with public electricity supplier Eskom conditional on meeting a set of performance indicators. By early 2024, more than 70 municipalities had accepted this contract, totaling R56.7 billion or 96.9% of total municipal debt. To further incentivize participating municipalities, the 2024 budget introduced a new conditional grant of R2 billion to fund the rollout of smart prepaid meters over the next three years to improve municipal electricity tariff collection. One lesson after a year of implementation is the need to include conditions related only to the most important objectives because of the limited capacity of municipal authorities and to tailor them to the structural constraints in the sector. This contract-based approach could be applied to other sectors and extended to provinces, which are also cash constrained and in arrears with infrastructure service providers.

One lesson after a year of implementation of the contract-based approach to incentivize financial performance is the need to include conditions related only to the most important objectives because of the limited capacity of municipal authorities

Annex table A1 Ranking of measures through the "FIT" filter of feasibility, impact, and timing

		Feasible	Impactful	Timely	Total
Priority 1: Creating fiscal space for present and future public spending					
Action 1: Consolidate and coordinate social programs	1. Cutting 60–80 small social programs (National Treasury proposal), merging some departments, and closing some units	2	2	2	6
	2. Consolidating and coordinating active labor market programs and early childhood education programs	3	3	2	8
Action 2: Partner with the private sector	3. Scaling up private provision in education	3	2	1	6
	4. Expanding workplace-based learning opportunities for unemployed youth in small and medium enterprises	2	2	2	6
	5. Developing technology-based learning to increase relevance and cost-efficiency in post-school education and training systems and improving access for learners in remote rural areas	2	2	2	6
Priority 2: Allocating public resources to loosen binding constraints to inclusive growth					
Action 3: Improve public investment management	6. Establishing a centralized gateway for priority capital projects above a certain threshold	3	2	2	7
	7. Reducing the administrative burden associated with conditional grants to subnational governments	2	2	2	6
Action 4: Spend smarter on programs to enhance the employability of people who are disadvantaged in the labor market	8. Linking the Covid-19 Social Relief Distress grant with active labor market programs	3	3	2	8
	9. Using wrap-around approaches to improve the effectiveness of active labor market programs	2	2	3	7
	10. Developing microentrepreneur programs	2	2	3	7
Priority 3: Upgrading public sector delivery capacity					
Action 5: Professionalize public service to build a high-status meritocracy	11. Making the Head of Public Administration responsible for ensuring transparent and robust processes for hiring and managing all top managers	3	2	3	8
	12. Expanding the role of the Public Service Commission in reviewing key public sector appointments across all three levels of government and state enterprises.	3	2	2	7
	13. Enhancing the financial disclosure framework by removing gaps in the coverage of high-risk officials, extending the disclosure form to address unjustified wealth, strengthening sanction mechanisms, and establishing the foundations for automated verification processes and public access to disclosures.	3	2	2	7

		Feasible	Impactful	Timely	Total
Action 6: Improve monitoring mechanisms	14. Instituting regular national learning assessments and functional school-based assessments in basic education	2	2	2	6
	15. Moving toward performance-based funding and instituting tracer surveys for higher education	2	2	3	7
	16. Focusing on programs that demonstrate results and can be scaled up	2	2	1	5
Action 7: Accelerate digitalization of public services	17. Developing real-time dashboards to track major infrastructure projects across levels of government	2	2	2	6
	18. Introducing a unified national ID standard to prepare for the introduction of a digital ID for accessing social and financial service	2	3	3	8
	19. Incentivizing the uptake of the e-procurement system for procuring entities across levels of government	2	3	3	8
	20. Introducing digital tools and shared data platforms in strategic sectors, including machine learning and artificial intelligence	2	2	2	6
Action 8: Incentive the performance of subnational governments	21. Adding a performance-based element to the equitable formula for nonearmarked transfers	1	3	1	5
	22. Scaling up the performance-based approach used for public transport grants to other earmarked transfers	2	3	2	7
	23. Scaling up the contract-based approach piloted in the electricity sector to other sectors and levels of government	3	2	3	8

Source: Authors.

Note: The scores range from 1 to 3, with 1 being the lowest. The actions with the highest score are highlighted in yellow.

Notes

1 Key policy priorities for the Medium-Term Budget Policy Statement, presentation by the National Treasury to Cabinet, September 2023.

2 For the Canadian experience, see J. Bourgon, 2009, "Program Review: The Government of Canada's Experience Eliminating the Deficit, 1994–99: A Canadian Case Study," Institute for Government.

3 This note focuses on spending-side reforms, while acknowledging that broader challenges are not covered. Fiscal policy also includes debt and revenue policy and management, but the government has faced fewer challenges in these areas than in spending.

4. See International Monetary Fund, 2015, "Policy Paper on Fiscal Policy and Long-Term Growth," June; and N. Batini, L. Eyraud, L. Forni, and A. Weber, 2014, "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections," Technical Notes and Manuals, Fiscal Affairs Department, International Monetary Fund, September.

5. In Spain, for instance, the net effects of government taxation and public spending reduced the Gini coefficient (a standard measure of inequality) significantly, from 0.45 to 0.25. G. Gomez Bengoechea, 2020, "The Welfare State in Spain: An Impact Assessment," Commitment to Equity (CEQ) Working Paper Series 95, Tulane University, Department of Economics.

6. T.J. Van Resburg, S. de Jager, and K. Makrelov, 2021, "Fiscal Multipliers in South Africa after the Global Financial Crisis, SARB Working Paper, South African Reserve Bank, WP/21/07.

7. A detailed Debt Sustainability Analysis can be found in World Bank, Sustainable and low-carbon energy transition development policy loan, 2023.

8. While this effect has not yet materialized in South Africa due to the depth of the domestic financial sector, private sector financing can become more challenging given the gradual loss of appetite from nonresidents for public debt. While nonresidents held about 40% of public debt in 2019, this proportion declined to 25% in 2023.

9. The Ricardo-Barro effect, also known as Ricardian equivalence, is an economic theory that suggests that when a government tries to stimulate an economy by increasing debt-financed government spending, demand remains unchanged because the public increases their saving to pay for expected future tax increases that will be needed to pay off the debt.

10. Throughout this note, "public investment" refers to consolidated government spending on gross fixed capital formation. This distortion would be even bigger if the expenses financed through municipalities' own resources were included. In 2023, capital spending represented only 12% of the consolidated municipal budget, or around 0.4% of GDP.

11. The International Monetary Fund's Government Finance Statistics classification defines economic expenditures as general economic, commercial, and labor affairs; agriculture, forestry; fishing and hunting; fuel and energy; mining, manufacturing, and construction; transport; communication; other industries, R&D related to economic affairs; economic affairs.

12. B. Moreno-Dodson,2008, "Assessing the Impact of Public Spending on Growth: An Empirical Analysis for Seven Fast Growing Countries," World Bank Policy Research Working Paper No. 4663, July.

13. See , for example, https://www.statecapture.org.za/.

14. World Bank, Worldwide Governance Indicators, https://www.worldbank.org/en/publication/worldwide-governance-indicators/interactive-data-access.

15. This decline is corroborated by the Berggruen Governance Index, which dropped 14 points over the same period.

16. National Treasury, 2022, "State of Local Government Finances and Financial Management," June.

17. The total cumulative amount of money spent on state-owned enterprise recapitalizations and bailouts from 2000/01 to 2019/20 is R187.4 billion or about $10 billion. https://www.treasury.gov.za/publications/other/minansw/2020/PQ%201426%20-%20Schreiber%20-%20NW1797E.pdf..
18. World Bank, 2023, "South Africa's Economic Update," December.
19. Oosthuizen, Morné, 2021, "South Africa: Social Assistance Programs and Systems Review" (English), World Bank Group, http://documents.worldbank.org/curated/en/238611633430611402/South-Africa-Social-Assistance-Programs-and-Systems-Review; World Bank, 2014 "South Africa Economic Update. Fiscal Policy and Redistribution in an Unequal Society."
20 See quarterly report for advancements of these reforms. https://www.stateofthenation.gov.za/assets/downloads/Operation_Vulindlela_Progress_Report_Q4_2023.pdf.
21 For a short review of delivery units in Africa, see https://blogs.worldbank.org/governance/four-ways-delivery-units-africa-can-drive-change-and-improve-public-sector-performance. See also, for the experience in Malaysia, D. Iyer, 2011,"Tying Performance Management to Service Delivery: Public Sector Reform in Malaysia, 2009–2011, Innovations for Successful Societies," Princeton University.
22 Since the Covid-19 pandemic, the government has tried to limit increases in wages and other compensations (resulting in a decrease of its share in noninterest expenditure to 37% of GDP over the last three years), but designing a comprehensive wage bill reform that has buy-in from all the stakeholders and is consistent with objectives and priorities for public services delivery will take time.
23 M. Sachs, A. Ewinyu, and O. Shedi, 2022, "Public Services, Government Employment and the Budget," SCIS Working Paper 9, Public Economy Project, Southern Centre for Inequality Studies, University of the Witwatersrand, October.
24 There was recently some resistance to this public-private partnership model by teachers unions and civil society organizations, who claimed that it is inconsistent with the Constitution and the 1996 Schools Act. This claim was dismissed by the Western Cape High Court in July 2023, paving the way for the expansion of various models of public-private partnerships in the province, including models like the charter schools in the United States or the academies in the United Kingdom.
25 H.A. Patrinos, F. Barrera-Osorio, and J. Guáqueta, 2009, "The role and Impact of Public-Private Partnerships in Education" (English), World Bank Group, https://documents1.worldbank.org/curated/en/453461468314086643/pdf/479490PUB0Role101OFFICIAL0USE0ONLY1.pdf.
26 Stats SA, Capital Expenditure by the Public Sector, 2022, p. 9101.
27 See New Zealand's Infrastructure Commission, Korea's Public and Private Infrastructure Investment Management Center, and the United Kingdom's Infrastructure and Projects Authority.
28 Nearly a quarter (23%) of South Africans rely on social grants as their main income source, and social grants make up, on average, 54% of household incomes (World Bank calculations using the General Household Survey, 2022).
29 O. Attanasio, A. Guarín, C. Medina, and C. Meghir, 2017, "Vocational Training for Disadvantaged Youth in Colombia: A Long-Term Follow-Up," American Economic Journal: Applied Economics 9(2): 131–43.
30. Some 21% of the public sector's 9,500 senior managers at national and provincial levels did not meet the minimum competency requirements for the positions they occupied in 2022 (National Development Plan and State Capacity Conference, Nov. 7, 2022, University of KwaZulu Natal, available at https://www.youtube.com/watch?v=zIKwH_ZNxuE&t=14228s.) A study by the Public Service Commission also revealed that 57% of public servants indicated the use of unethical practices in recruitment and selection, especially for senior and middle management appointments (Public Service Commission, 2022, "Ethics in Recruitment and Selection Processes in the Public Service").
31. These encompass the Public Service Amendment Bill, the Public Administration Management Amendment Bill, and Public Service Commission Bill.
32. South Africa has been a pioneer in testing different interventions to support improvements in education and training service delivery. However, many of these interventions have been short lived and not taken to scale because of limited funding and the absence of systematic monitoring and evaluation systems. Examples include several early grade reading interventions introduced in the early 2000s, early childhood

development and parenting programs implemented by numerous nongovernmental organizations across the country, and several government active labor market programs. Some interventions benefited from strong monitoring and evaluations systems. South Africa, for example, has been a pioneer in effective, contextually relevant structured reading programs that have been rigorously and independently evaluated to determine whether they have an impact on early-grade reading outcomes. These interventions remain an exception and have been financed mainly by nongovernmental parties, explaining why they have not gone to scale and are not integrated into routine practice by the Department of Basic Education.

33. One of the key factors helping Poland reform its education system and move from below OECD-average learning outcomes to one of the top-performing countries in Europe was using reliable learning-level data to target reforms to the poorest performers.
34. Of course, the introduction of new digital tools has also created new challenges linked not only to technical and financial capacity to implement them but also to data protection and security.
35. https://www.worldbank.org/en/data/interactive/2022/10/21/govtech-maturity-index-gtmi-data-dashboard.
36. D. Makoni and M. Mpofu, 2022, "ICT Expenditure Review with a Focus on SITA Services: Assessing the Effectiveness of a Centralised ICT Procurement System," Government Technical Advisory Center.
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38. These include 8 metropolitan municipalities, 228 local municipalities, and 44 district municipalities.
39. See, for example, National Treasury, 2024, Reforming Metro: Trading Servicers and the Role of Incentives, March.
40. An exception is the eight large metropolitan municipalities that collect about two-thirds of their revenues.
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Priority 2

Delivering quality and climate-friendly infrastructure



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SOUTH AFRICA POLICY PACKAGE

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Priority 2

Delivering quality and climate-friendly infrastructure



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Leveraging the private sector while building state delivery and regulatory capabilities

Infrastructure networks are crucial for economic development, anchoring growth, and ensuring decent living conditions. For each 1 percent increase in infrastructure spending, a country's output is expected to rise 1–2 percentage points, while poverty is substantially reduced.[1] This connection, supported by both economic theory and empirical evidence, explains why countries give so much attention to the coverage and quality of their infrastructure services and why infrastructure is often among the main priorities of development strategies.

For many years, South Africa was a top infrastructure performer. It provided reliable electricity and improved water sources to almost 90% of its population, and residents and businesses could count on a transport network with a road density higher than that of the United States and world-standard ports and airports. Fast forward to the present, and the situation has deteriorated dramatically. Electricity availability is sporadic, with outages averaging 8–10 hours a day in 2023, at a cost of about 2% in GDP growth. Major bottlenecks in railways and ports reduced the country's export capacity by about 20% (equivalent to 5% of GDP). Poor logistics cost the mineral sector an estimated $275 million annually. And disruptions in water provision have become so frequent in many urban areas, including the Johannesburg-Pretoria area, that customers face days and even weeks without water.

The infrastructure crisis has provoked social and political tensions, pushing South African policymakers to act. The electricity generation market has gradually been opened to private investors. The unbundling of state-owned enterprises (SOEs) has begun with Eskom in the electricity sector and has been announced in Transnet in the freight transport sector. A strong signal has been sent that the country is moving away from the public-centered infrastructure delivery model that had prevailed for decades. The shift is motivated primarily by the failure of the current model but also in part by the successes of the new strategy in the country's telecommunication and aviation sectors and the lessons from international experience.

This note proposes a comprehensive framework to support government efforts to provide quality and climate-friendly infrastructure. The framework is built on three mutually reinforcing priorities: enhancing the adoption of new technologies, business models, and efficiencies by opening markets; scaling up investments in infrastructure by diversifying financing sources and leveraging additional private financing; and upgrading state capacity to coordinate, regulate, and deliver (when needed) infrastructure services. This note applies the framework to the electricity and the freight and logistics sectors, but it could be extended to other infrastructure sectors (such as water and waste management) in a next step.

Implementing infrastructure reforms is a long-term endeavor requiring sustained effort and commitment to achieve comprehensive and systemic changes. In the interim, focusing on key short-term actions can build momentum and address some of the most pressing challenges, providing immediate relief and laying the groundwork for broader reforms. To guide policymakers, a menu of actions and reforms is proposed, of which seven (three in the electricity sector and four in the freight transport and logistics sector) are assessed here as the most technically and politically feasible, impactful,

and timely over the next few months (see table A1 in the annex):

Electricity

1. ***Ensure the financial and operational sustainability of the National Transmission Company of South Africa*** by adopting a new tariff methodology, a comprehensive wheeling pricing framework,[2] and a revised grid code to ensure nondiscriminatory open access to the transmission grid.
2. ***Scale up private investment in electricity transmission projects*** by setting clear and predictable rules for independent investors and offering blended finance and risk-sharing instruments.
3. ***Improve electricity distribution*** by scaling up performance-enhancing transfers from the National Treasury to municipalities.

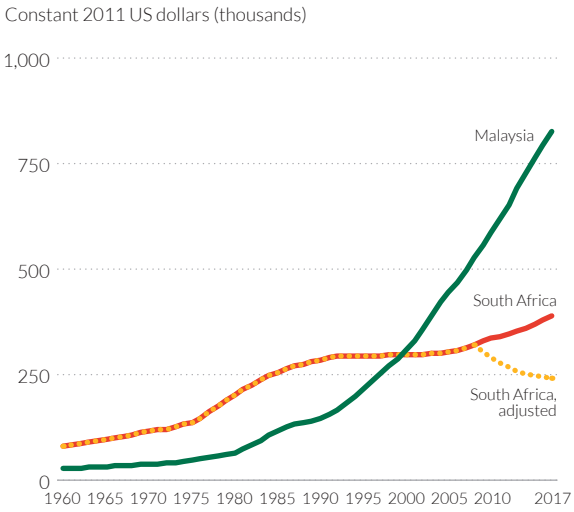
Freight transport and logistics

1. ***Initiate Transnet's unbundling*** by enacting the new draft Rail Bill that opens the sector to third-party operators.
2. ***Provide nondiscriminatory access to railway infrastructure*** by establishing an Infrastructure Manager for railways that is independent of Transnet operations.
3. ***Develop a public-private framework for allowing private sector participation in railway operations*** on bulk mining corridors and feeder lines.
4. ***Implement the Economic Regulator section of the Transport Bill*** to strengthen regulation of ports, trucking, railways, and intermodal transport.

The insupportable cost of the degradation of infrastructure networks

The degradation of infrastructure services reflects years of neglect and underperforming policies. Since the late 2010s, the value of the public capital stock—a proxy for infrastructure—has declined an estimated 20%, an unprecedented drop for a country that has not been exposed to armed conflict or significant climate shocks (figure 1). South Africa and Malaysia reported approximately the same stock of public capital in 2000, but South Africa's is three times lower today than Malaysia's.

Figure 1 Declining public capital stock since 2000



Source: Authors using International Monetary Fund data. https://www.imf.org/external/np/fad/publicinvestment/pdf/csupdate_aug19.pdf.

Note: The public stock, in constant 2011 US dollars, is adjusted by assuming a 10% depreciation rate of the existing capital and a diversion of 10% of annual gross investment from its intended allocation.

Estimating the economic losses associated with degradation of the public capital stock is not straightforward as the impacts on businesses and people take multiple forms and are not necessarily linear.[3] However, extrapolating from the results of recent cross-country studies suggests that South Africa has lost an annual average of 2–3 percentage points of GDP growth over the past decade.[4]

Further insights can be obtained by examining the electricity, water, and transport sectors in greater detail. For electricity, the economic losses have increased along with load-shedding, reaching 2–3 percentage points of GDP in 2023 according to the Reserve Bank of South Africa and the World Bank.[5] The main adverse effects occur on the supply side, with higher production costs and temporary declines in output and working hours.[6] These costs are greater for electricity-intensive sectors such as mining, manufacturing, and telecommunications and for small and informal firms that cannot afford to invest in off-grid solutions, such as diesel generators and solar panels. Mismanagement of Eskom, the SOE operating in this

sector, has cost taxpayers about $15–$20 billion in the form of cash injections from the National Treasury since 2009.

The economic cost of water shortages is immense, since water is a vital factor of production in key sectors of the economy ranging from agriculture to manufacturing and health. Recent droughts in the Western Cape and the Eastern Cape provinces are estimated to have cost about 3.4% of provincial GDP and 0.3% of national GDP.[7] As several officials have warned, these costs could rise quickly as a water crisis is looming in the Johannesburg-Pretoria area due to investment delays (as in the case of the pipeline with Lesotho), damaged infrastructure, and excessive consumption.

Freight and logistic sector failures are estimated to have cost the South African economy about $30 billion in 2023. Trade losses have affected exporting industries (such as mining), the government (through declining revenues), and customers (who experience higher prices and long delays in receiving products).[8] Some customers switched to other modes of transport, such as trucking instead of rail, or diverted their shipments to ports in other countries, such as Maputo and Beira in Mozambique. Road freight now handles nearly 90% of all freight volumes, with severe negative effects, including deteriorating road safety, rapidly worsening congestion in key urban areas, fast-rising road maintenance and upgrade costs on major arteries, and mounting carbon emissions. The crisis is regional as well as national, as South Africa's freight networks are used by neighboring countries.

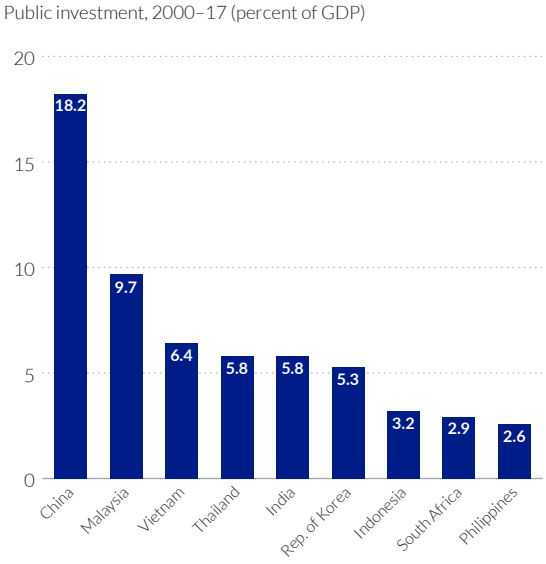
The infrastructure crisis has also disproportionately penalized the poorest segment of the population and exacerbated inequalities, working through both consumption and income channels. On the consumption side, poor customers are more exposed as they generally live in areas where electricity and water shortages are more pronounced, and they have fewer financial resources for accessing alternative, often more expensive infrastructure solutions. On the income side, businesses respond to the negative impacts by cutting jobs or working hours, especially in low-skill occupations, resulting in lower incomes for many poor people.

The causes underlying the infrastructure crisis

Responding to the infrastructure crisis requires identifying the root causes. Public investment averaged just 2.9% of GDP in South Africa over 2000–2017, which is 5–6 percentage points lower than in successful East Asian economies and about 6 times lower than in China (figure 2). This chronic underinvestment reflects a set of underlying factors that need to be better understood to avoid repeating the same mistakes. Three primary root causes are common across sectors:

- ***Limited competition.*** Infrastructure sectors are dominated by SOEs with monopolistic power, such as Eskom in electricity and Transnet in transport. Although this state delivery model worked well until the early 2000s, when they were used as a challenging mechanism of targeted state interventions such as rapid electrification, the isolation from competition allowed the SOEs to evolve dysfunctional and

Figure 2 Systematically low public investment relative to East Asia over the past two decades



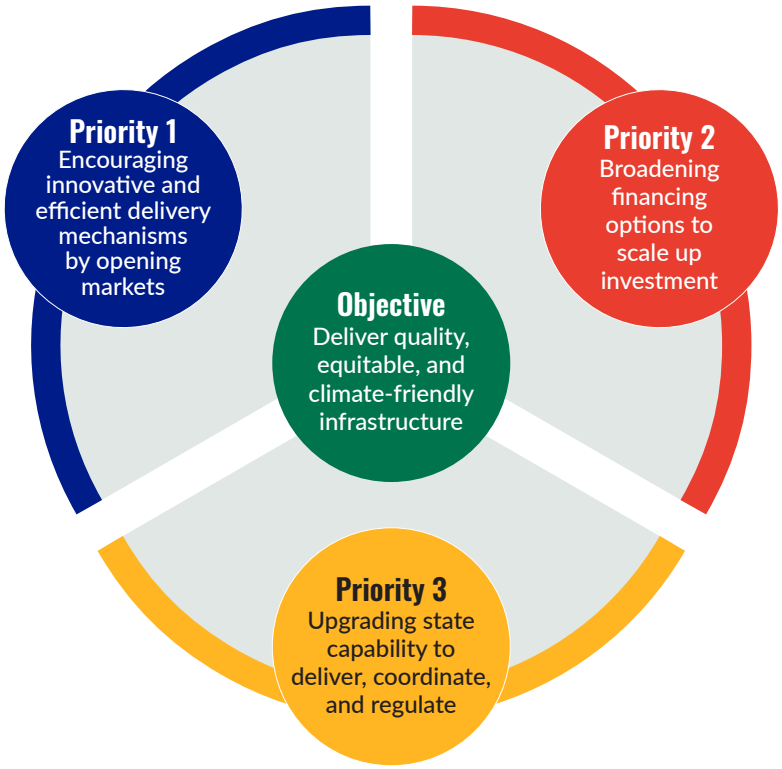
Source: Authors using International Monetary Fund data. https://www.imf.org/external/np/fad/publicinvestment/pdf/csupdate_aug19.pdf.

Note: The public stock is adjusted by assuming a 10% depreciation rate of the existing capital and a diversion of 10% of annual gross investment from its intended allocation.

noncommercially oriented services and ignore technological and financial innovations, resulting in a deterioration of services to the detriment of customers.

- *Incomplete financing options.* The public sector has been the main (sometimes exclusive) source of infrastructure financing, through end-user charges and transfers from the central government. Both mechanisms have deteriorated over time, as many end-users are not paying for services, and the central government's budget has not prioritized infrastructure in the context of budget constraints. Contrary to the practice in many other countries, the private sector has contributed only marginally to financing in the electricity, water, and transport sectors.
- *Weak management by the state.* Shortcomings include poor design and implementation of investment projects; declining technical capabilities in policy setting, regulation, oversight, and implementation; the exodus of highly skilled talent; and lack of transparency. These challenges have been exacerbated by rising corruption (or state capture) and coordination failures within and across government levels and agencies. Fragmentation of the institutional framework has diluted responsibilities and accountability. In the electricity sector, it has become difficult to distinguish the roles and responsibilities of the Department of Mineral Resources and Energy, the Department of Public Enterprises, the National Treasury, Eskom, and the municipalities. In the transport sector, in the absence of policy direction from the Department of Transport and the Department of Public Enterprises, Transnet has assumed the de facto roles of infrastructure owner, manager, operator, regulator, and policymaker, with devastating effects on the costs and efficiency of logistics services.[9]

Figure 3 An overarching framework for efficient delivery of quality, equitable, and climate-friendly infrastructure services



The impacts of these three factors on the declining performance of South Africa's infrastructure sectors have increased. They have prevented the sectors from adjusting to changes in the external environment—such as the increasing pace of innovation and the growing impact of climate change—that are reshaping the provision of infrastructure services worldwide. The low-carbon transition is reorienting investments from high- to low-emission sources in the energy and transport sectors as industries and consumers are compelled to become cleaner. Extreme climate events are revealing the vulnerability of infrastructure assets. South Africa has declared a national state of emergency for drought three times in the last four years, and Durban was devastated by major floods in 2020 and 2022.[10] The list of disasters is long and will grow longer since climate risks are projected to worsen.

Three priorities for addressing the infrastructure crisis

To guide government efforts to address the infrastructure crisis and deal with the three underlying causes, this note proposes an overarching framework with three priorities (figure 3):

1. *Encourage more innovative and efficient delivery mechanisms by opening infrastructure sectors to greater competition.* Competition will incentivize incumbent operators to deliver better and cheaper products while allowing new firms to bring in updated technologies

and competencies. Since many of these technologies are developed elsewhere, barriers to entry against foreign direct investment should be relaxed, while synergies are cultivated with local industries and the labor market. More innovative and efficient delivery mechanisms will be beneficial to domestic customers, who will get better and more affordable infrastructure services, creating additional benefits for the economy.

2. ***Broaden the sources of financing to scale up investment*** to meet the substantial needs in infrastructure sectors, which could total $100 billion over the next decade. With public borrowing and SOEs' financial distress both already high, the state cannot cover all these costs alone. Complementary options could include raising the tariffs for infrastructure services and leveraging private financing sources. Considering the current level of tariffs and the low level of affordability for most consumers, raising tariffs risks having only a marginal effect. The only realistic option in South Africa, with its deep domestic financial sector (large reserves accumulated by pension funds and the robust appetite of international institutional investors, including some development partners), is to attract and leverage private sector financing. In the short term, the state will also need to address legacy debt associated with state capture, theft, and vandalism, as well as unfunded social mandates.
3. ***Upgrade the state's capability to coordinate, regulate, and (when unavoidable) deliver infrastructure services.*** Opening the infrastructure sector to new (private) operators without first establishing rules, regulations, and incentives could end up replacing dominant SOEs with private operators with excessive market power that allows them to maximize profits at the expense of customers. Legal and institutional frameworks must first be established that would account for the targeted market structure. In addition, the state may need to continue to deliver infrastructure services in areas where attracting private sector operators might not be feasible, for example, for the poorest customers in remote areas. Further, environmental considerations could require government policy and regulatory interventions, which will necessitate strengthening institutional and legal frameworks, especially to address coordination failures, weak technical capabilities at national and local levels, and deficiencies in public investment management and procurement, including in SOEs.

Pursuing these three priorities should improve the quality and availability of infrastructure services and bring substantial benefits to businesses and households. However, some groups (such as some fractions of SOE workers) may lose out because of these reforms and might therefore resist change. But this is a false dilemma. Greater domestic competition will yield positive results and welfare gains for most of the population. Meanwhile, short-term costs can be managed by preparing SOEs to compete with businesses at the forefront of global productivity and by providing targeted support to affected workers and communities.

While each of these three priorities is important individually, they make the greatest contribution to the delivery of quality and climate-friendly infrastructure services when approached together. For example, opening markets will require risk-sharing financing mechanisms to attract private operators and effective regulations to protect customers.

In the following sections, the proposed guiding framework is applied to the electricity and transport sectors, with the objective of identifying a set of concrete actions. It can also be applied to other infrastructure sectors as well.

Case 1: Accelerating reforms in the electricity sector

Since the peak of the electricity crisis in 2023, several reforms have been implemented along the lines of the three priorities in the proposed framework. A landmark reform is the Electricity Regulation Amendment Act, which President Ramaphosa signed into law in August 2024 and is expected to be promulgated soon. Since the further opening of the power generation market and the removal in 202of the threshold requirements for licensing of renewable energy projects that sell electricity directly to private consumers (embedded generation),

the number of registered private sector projects in renewable energy has increased fivefold (priority 1). The conditional debt relief provided to Eskom by the National Treasury and the development of pilot public-private partnership projects in transmission have expanded financing options (priority 2). And better performance has been incentivized within Eskom though the conditions in the debt relief package and in municipalities through the conditional write-offs of their arrears with Eskom (priority 3). In total, more than 6 gigawatts (GW) of renewable electricity generation by independent power producers has already been connected to the grid, with an additional 5 GW currently in execution. The private sector–led distributed energy capacity (primarily rooftop solar) increased from about 2 GW in 2023 to close to 5.7 GW in 2024, and another 7 GW is expected by 2030. Thanks to these efforts, which were supported by a development policy loan, there has been a continuing supply of electricity (with no load shedding) since March 2024.

These and other measures must now be consolidated to create an efficient and equitable electricity sector. Building on the results from power generation reforms, the government should shift its focus toward reducing the sector's main bottlenecks and financial sustainability risks, namely transmission and the distribution grid. For example, although the number of renewable energy projects grew substantially in late 2024, their scope is constrained by limited access to the grid and serious gaps in transmission infrastructure. The initial steps in unbundling Eskom and amending the Electricity Regulation Act must be accompanied by new regulations and price mechanisms to implement the law. The investments needed in transmission infrastructure (up to $15 billion over the next five years) cannot be funded by the state alone, given its tight budget constraints, while the domestic financial market's interest is dulled by the risk associated with these projects. Improvements in distribution by Eskom and municipalities, which share responsibility for distribution, are required to enable end-users to benefit from the reforms in electricity generation and transmission.

To provide a sense of direction to the reforms, the authorities ought to share their vision of how they want the electricity market to look in 5–10 years, including specifying the role of the state (through Eskom) in generation. This could be achieved by consolidating several partial strategies and updating the 1998 White paper (the government's last comprehensive strategy statement).[11] Doing this can help electricity market players (including Eskom) adjust during the transition. To good effect, the government shared its vision for the telecommunication sector in the early 2000s and for the aviation sector in the 2010s.[12] Agreeing on a vision for the electricity section is likely to be slower and more contentious, however.

Meanwhile, the government cannot afford stasis. This note proposes a menu of nine actions under the three pillars/priorities to guide the government in accelerating reform in the short term (figure 4). Three of the nine actions have been assessed as the most technically and politically feasible, impactful, and timely as they do not require substantive changes to the legal framework. Ideally, the actions would meet all three criteria, but trade-offs are likely to be necessary (see table A1 in the annex).

Priority 1: Encouraging innovative and efficient delivery mechanisms by opening markets

Opening the electricity market to new operators and breaking Eskom's monopoly have already begun as private investors have entered the electricity generation market. This has been most prominent in the renewable energy segment, which is especially conducive to the development of small, agile projects. The entry of more efficient firms increases contestability, incentivizing Eskom to improve its operations to protect its customer base. This line of reforms could be accelerated by making it even easier for new investors to enter the generation market and by also opening the sector to new investors in electricity transmission.

Action 1: Ensure the financial and operational sustainability of the National Transmission Company of South Africa

Unbundling Eskom vertically into separate generation, transmission, and distribution functions is a key step in opening the electricity market. Fully operationalizing the National Transmission Company of South Africa (NTCSA) is the most urgent priority for achieving that goal. This will require

Figure 4 A menu of proposed actions to make the electricity market more efficient, climate-friendly, and equitable



ensuring NTCSA's operational decision-making independence from Eskom. The rules of the game required for NTCSA's financial sustainability should be established upfront by the National Energy Regulator of South Africa (NERSA), including:

- ***Adopting a new transmission tariff methodology,*** applicable to the NTCSA independently of Eskom, to eliminate cross-subsidization of tariff charges with generation or distribution activities.[13]
- ***Implementing a new wheeling-pricing framework*** that defines grid connection charges for the direct network connection capital requirements, network development charges to cover the network capacity required for wheeling, and use of grid charges to cover network operating and maintenance costs.
- ***Updating the Grid Code,*** based on the draft Transmission Enabling Roadmap, to better define provisions required for integrating renewable energy projects into the grid—from both public and private sources. The new Code should allow some flexibility in redundancy levels to promote more economical use of the grid.

Action 2: Continue to encourage private investment in renewable energy projects to increase generation and reduce demand

Beyond digitalizing the Energy One-Stop Shop that was established as a single point of entry for all energy project applications in July 2023, the government can encourage the development of renewable energy projects to rapidly scale up generation capacity by:

- ***Scaling up Eskom's land leasing program for investors,*** as the land is generally located close to transmission lines.
- ***Facilitating connection to the grid*** by redirecting potential investors to areas with excess transmission capacity (such as, Mpumalanga), improving grid management by introducing digital platforms to manage data and coordinate the flow of power across the national grid,[14] and adopting a new Grid Code (see action 1).

Concurrently, investments in off-grid solutions by businesses and households to reduce demand can be promoted by:

- ***Scaling up the subsidized credit scheme*** (the "bounce-back" scheme) for the purchase/lease of solar equipment by small businesses and poor households, which has had early positive results.
- ***Allowing residential investors to feed surplus power back to the grid*** by establishing time-of-use criteria. Such an approach, authorized in a pilot project in Cape Town, could be scaled up to other municipalities.

Action 3: Establish a competitive wholesale electricity market

The government has outlined its intention to allow consumers to choose their electricity supplier. The transition to a competitive power market will be

achieved through a stepwise approach that could start by:

- ***Establishing a multimarket trading platform,*** along with the necessary policies, rules, and regulations.
- ***Adopting the Market Code for NTCSA,*** which will require establishing a Market Code Advisory Committee and Market Surveillance Panel, with members appointed by NERSA.

Priority 2: Broadening financing options to scale up investment

To compensate for years of underinvestment and neglected maintenance and to finance the shift from coal to renewables will cost around $47.2 billion over 2023–2027 and up to $250 billion by 2035.[15] Because of fiscal constraints at all levels of government and financial disarray in Eskom, the state can no longer serve as the sole source of funding for the sector. The private sector can be expected to step up, given the depth of the financial sector, and end-users should be required to pay for their electricity consumption as specified by law (discussed later in action 9).

Action 4: Scale up private investments in transmission

To finance the additional 14,200 kilometers of extra-high-voltage lines and 170 transformers required to enable the projected increase in new renewable energy–based power generation capacity by 2032, the government will need to attract the support of the private sector by:

- ***Adopting a regulatory framework for an independent private transmission model*** following the model adopted in Kenya, which includes a long-term contract between a private transmission company and the power company for investing in transmission lines.[16] This approach is being tested in two pilot projects, but there is an urgent need to adjust the legal framework to provide greater predictability to private investors.

Action 5: Diversify sources of financing with new risk-sharing instruments

To catalyze more private financing for the energy transition, the government could consider:

- ***Creating a blended finance and risk-sharing platform.*** This method, which has been successful in Nigeria and other countries, has the potential to optimize the use of public finance and concessional official finance by leveraging additional private capital from private financial markets. To mobilize private capital in support of sustainable infrastructure development, the blended finance and risk-sharing platform could deploy a range of financial products, including equity, subordinated and mezzanine debt, and first losses and credit guarantees.

Priority 3: Upgrading state capability to deliver, coordinate, and regulate

Although the government has not yet shared a unified, long-term vision for the electricity sector, it is clear that the state will continue to have two important roles in the sector. First, it will adopt and coordinate policies and regulate the sector. Second, it will complement the private sector by continuing to deliver some services, especially in transmission and distribution, to ensure affordable electricity for all. To effectively fill these roles, the government needs to upgrade its capabilities.

Action 6: Strengthen the capacity of the electricity market regulator

The opening of the electricity sector to private operators has heightened the importance of the regulator, NERSA. As the sector continues to evolve, NERSA's role in market regulation, technical oversight, and tariff setting will become even more critical. Once the Electricity Regulation Act Amendment is passed, NERSA will be responsible for developing and implementing regulations that align with the evolving market structure of the energy sector and that promote transparency, competition, and efficiency.

The following steps can be taken to enhance NERSA's capabilities:

- ***Expanding technical and financial resources.*** The government will need to allocate additional resources to NERSA so that it has the technical expertise and financial support needed to carry out its expanded mandate effectively. This includes investing in modern regulatory tools, data analytic capabilities, and infrastructure. The UK Office of Gas and Electricity Markets

has successfully implemented data-driven regulatory practices to improve market efficiency and transparency.

- ***Providing comprehensive training and capacity building.*** NERSA needs training programs and capacity-building initiatives to equip staff with the skills to handle the complexities of market regulation, technical oversight, and tariff setting. Sharing best practices from successful regulatory bodies worldwide will be essential. The US Federal Energy Regulatory Commission offers extensive training programs and workshops to continually enhance the skills of its regulatory staff.
- ***Establishing a performance benchmarking system.*** NERSA needs a permanent performance benchmarking system that enables it to monitor and enforce good behavior within the sector, especially for the distribution sector. This will help maintain accountability and ensure that all market players adhere to high standards of governance and operational efficiency. Spain's National Commission on Markets and Competition has implemented a robust benchmarking system to monitor and evaluate the performance of electricity distribution companies.

Action 7: Enhance Eskom's governance, accountability, and investment management

Even as the electricity market gradually opens to other operators, Eskom is expected to remain a major player, especially in transmission and distribution. To operate efficiently, Eskom must improve its balance sheet, which has severely deteriorated in recent years because of high operational expenses, excessive debt service payments, and below-cost tariffs. Despite operational profits, net losses were as large as R25 billion ($1.67 billion) in fiscal 2021 and R12.3 billion ($821 million) in fiscal 2022, with total debt of R396 billion ($27.3 billion) at the end of March 2022, which is about 8.6 percent of GDP.

Meaningful efforts are under way to improve Eskom's efficiency, especially the conditional debt relief plan that the National Treasury approved in 2023 and Eskom's updated Corporate Plan, which includes internal measures to reduce unplanned outages through improved maintenance—a key to mitigating the impact of load shedding in the short term. Eskom has also transitioned to a new senior leadership that has committed to redoubling efforts to improve governance and financial and operational sustainability.

Short-term priorities for Eskom could focus on the following measures:

- ***Designing clear and transparent reporting and monitoring mechanisms*** to strengthen accountability and responsibilities across Eskom Group. This approach will also contribute to an environment that is less susceptible to corruption, which is essential for long-term success.
- ***Improving investment management, including public procurement, to accelerate the construction of new transmission lines.*** Over the past three years, Eskom has built an average of 125 kilometers of new lines a year, whereas the objective is to construct about 1,400 kilometers of new lines a year until 2031.
- ***Implementing key performance indicators in project design, procurement, and completion*** and sharing this information regularly with the public in a readily accessible format. Such a permanent performance benchmarking system for Eskom would enable NERSA to monitor and enforce good behavior. This system would provide for ongoing oversight and accountability, ensuring that Eskom adheres to high standards of governance and operational efficiency.

Action 8: Boost competition in generation by horizontally unbundling Eskom's generation assets

A critical step in reforming South Africa's energy sector is the horizontal unbundling of Eskom's generation assets by separating Eskom's generation operations into multiple, independently operated entities that compete with each other within a regulated wholesale electricity market. Unbundling is essential to reduce Eskom's market power monopoly, enhance competition, and enable more efficient delivery of electricity by leveraging private sector participation.

Horizontal unbundling has proven effective in other countries, where it has driven operational efficiency, improved service reliability, and reduced costs by introducing competitive pressures. In the

current structure, Eskom's dominance in generation creates excessive market power that deters private investment and stifles innovation. A horizontally unbundled generation sector would allow independent generators, including private renewable energy developers, to compete on a level playing field. To ensure transparency and equity in this environment, the government must implement robust wholesale electricity market regulations that govern bidding processes, pricing mechanisms, and grid access. These regulations would prevent market abuse, safeguard affordability for consumers, and promote investments in clean energy. By shifting the capital and operational responsibility of generation to multiple entities, some of which could be privately owned or public-private partnerships, horizontal unbundling would also reduce the financial risks borne by the state. The following step could advance the unbundling of electricity generation:

- ***Developing and implementing a detailed roadmap for splitting Eskom's generation assets into multiple, independently managed entities, with clear timelines and legal frameworks.*** This unbundling will need to be aligned with a transparent and well-regulated wholesale electricity market, including potential market trading, commercial, and subsidy mechanisms to support Eskom's legacy coal generation assets until their retirement, such as through contracts-for-difference.

Action 9: Improve electricity distribution by municipalities and Eskom

The electricity distribution subsector faces several challenges and will require restructuring in the next few years. The restructuring is likely to be prolonged because of the number of players and the rigidities in the legal and institutional frameworks. The distribution market is divided between Eskom and municipalities, with municipalities responsible for about 60% of electricity distribution.

As part of the unbundling of Eskom, the government intends to reorganize the National Electricity Distribution Company of South Africa (NEDCSA). However, some of the prerequisites are not yet in place. For example, the government's vision for Eskom's role in distribution remains unclear. An initial step could be for the authorities to conduct an inventory of electricity distribution services and create a dashboard to compare efficiency and service quality across distributors. Nigeria's Power Sector Recovery Program[17] and Ghana's Energy Sector Recovery Program[18] are examples of such government-initiated programs and could inspire South African policymakers.[19] In the short term, low-hanging fruit can be harvested by improving municipalities' performance in collecting revenue from their customers.[20] Higher revenue collection will allow municipalities to pay Eskom for its bulk-supplied electricity, contributing to Eskom's financial sustainability, and to finance maintenance and investments in their own distribution networks. Municipalities' performance could be further improved by leveraging the transfers from the National Treasury that account for the bulk of their financing. The combination of the following measures could be considered:

- ***Unbundling NEDCSA and defining distribution roles.*** The government should prioritize splitting the National Electricity Distribution Company of South Africa (NEDCSA) off from Eskom and establishing it as a separate entity with clear governance and operational independence. In parallel, there is the need for a comprehensive strategy to define and differentiate the roles and responsibilities of Eskom's distribution company and of municipalities, ensuring clarity in their mandates. This strategy should explore whether a transition to regional distribution companies is necessary to enhance efficiency and equity in service delivery. Once the strategy and the associated Roadmap are completed, reforms could begin incrementally, guided by benchmarks and performance metrics to ensure alignment with broader sectoral goals.
- ***Streamlining the contractual approach implemented in mid-2023 between the National Treasury and the municipalities that have accumulated arrears with Eskom*** (about US$3 billion as of the end of 2023). As part of this contract, the National Treasury will clear the arrears of municipalities that can demonstrate progress on a series of indicators. This initiative has been accepted by about 60 municipalities, but the results have been mixed after the first year of

implementation,[21] largely because the conditions imposed on municipalities are too numerous and too complex for their current capabilities. The National Treasury should streamline these conditions by rewarding municipalities that improve their revenue collection and that pay Eskom fully and on time.[22]

- ***Using conditional transfers from the National Treasury to incentivize municipalities to perform better.*** The rationale for such transfers, explained in policy note 4, is especially relevant for the electricity sector. The central government budget for fiscal 2024/2025 includes grants for municipalities that install prepaid meters and that use the revenues collected appropriately. Such transfers could be scaled up and linked to other performance indicators.
- ***Improving local capabilities at the municipal level,*** including the adoption of turnaround strategies by city councils that ring-fence the distribution of electricity revenues.
- ***Adopting standards for municipal performance,*** which NERSA will apply, for renewing licenses and for approving new tariffs for electricity distribution services.

Case 2: Igniting reforms in the freight transport and logistics sector

Years of poor performance in the freight transport and logistics sector culminated in crisis in 2023, when the country lost about 20% of its export capacity as the railway network failed and port congestion worsened. The South African rail system performs far below international benchmarks. Except for iron ore, the system moves too little traffic, too slowly, and with low productivity. The container terminal at the Port of Durban was ranked 365th out of 370 ports worldwide in 2022, and the terminal at the Port of Ngqura was ranked 361st.[23] Underlying the deterioration in performance are contradictory commercial, political, and social mandates for the public sector logistics company Transnet that are not supported by a clear and sustainable financing strategy,[24] as well as underinvestment in the rail network and ports, ex- acerbated by governance failures. This has created a vicious cycle as lack of investment reduces efficiency, which in turn reduces revenue and investment.[25]

In December 2023, the Cabinet adopted a new Roadmap for transforming freight transport and logistics that offers a shared vision for the sector. Produced through an intensive consultation process across government departments, labor unions, and other sector stakeholders, the Roadmap seeks to address the underlying causes of the crisis and advocates for radical change in market structure. The authorities propose to reduce Transnet's monopolistic powers by opening the market to new players. This could generate efficiency gains and fill part of the financing gap while strengthening state regulatory capabilities, which is especially important in an open and competitive market.[26] The ultimate objective of the Roadmap is to improve freight services for customers, generating an increase in traffic and in economic benefits for the country.

Opening the market to competition will require the vertical and horizontal unbundling of railway and port infrastructure services under Transnet. For ports, the Roadmap aims to separate operations and regulation. For rail, it proposes a vertical separation between infrastructure services and network operations (see figure A1 in the annex). This separation will enable increased private sector participation in running trains and providing logistics services, while the public sector will remain responsible for infrastructure through a dedicated manager that will provide fair and nondiscriminatory infrastructure access to all operators.

The Roadmap provides a shared vision for the freight transport and logistics sector, but full implementation is a long-term goal. Completing the needed institutional and legal reforms and shifting the mindset of the main players will take time, and reforms could face resistance from groups that may lose out in the transition to a new market structure. While the overall benefits to the country are clear, the restructuring of Transnet needs to be managed carefully to prepare workers for the new market structure.

Within the overarching framework of the three priorities shown in figure 3, this note proposes a menu of six actions to begin implementation of the Roadmap (figure 5). The emphasis is on short-term interventions to ease constraints and rapidly increase freight volumes, creating momentum for further reform. Four of the six actions have been

Figure 5 A menu of proposed actions to make the transport and logistics sector more efficient, climate-friendly, and equitable

Priority 1: Encouraging innovative and efficient delivery mechanisms by opening markets
- **Action 1:** Finalize the classification of railway lines to assess the potential for future ownership
- **Action 2:** Initiate Transnet's unbundling
- **Action 3:** Provide nondiscriminatory access to railway infrastructure

Priority 2: Broadening financing options to scale up investment
- **Action 4:** Improve Transnet liquidity and financial sustainability
- **Action 5:** Develop a public-private framework for allowing private sector participation in railway operations

Priority 3: Upgrading state capability to deliver, coordinate, and regulate
- **Action 6:** Implement the independent Transport Economic Regulator section of the Transport Bill

assessed as the most technically and politically feasible, impactful, and timely. Ideally, the actions would meet all three criteria, but trade-offs are likely to be necessary (see table A1 in the annex).

These short-term actions provide a useful and pragmatic starting point. They will need to be complemented by additional measures, including reforms and investments in ports, to enhance the vertical efficiency (from firms to ports) and horizontal efficiency (across locations) of the entire transport system.

Priority 1: Encouraging innovative and efficient delivery mechanisms by opening markets

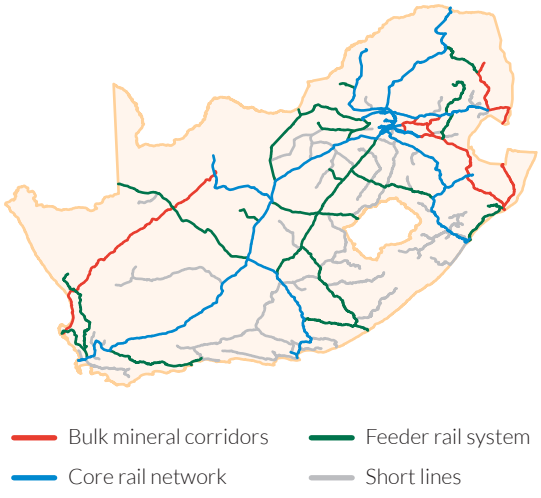
The priority is to introduce contestability to the market by opening the sector to multiple operators. To move quickly in that direction, the authorities must identify which railway lines could be effectively operated by entities other than Transnet, adjust the legal framework accordingly, and avoid conflicts of interest between operations and infrastructure management.

Action 1: Finalize the classification of railway lines to assess the potential for future ownership

Transnet inherited a network of railroads that is complex, extended, and multifunctional. Some lines, deemed to be commercially viable, were dedicated to specific mining and industrial customers. Others were built with equity in mind, to unlock the economic potential of lagging areas. Like rail reforms in North America and Europe, South Africa's Roadmap proposes switching from a single operator to multiple operators within a disaggregated delivery mechanism. The task is to assess the high-traffic lines that are commercially viable and those that would require subsidies to provincial governments to serve local social priorities. The rail lines identified as commercially viable are candidates for private sector participation. This task requires:

- *Identifying which railway lines could be effectively operated by entities other than Transnet* by differentiating four types of routes: bulk mineral corridors, core railway network, feeder rail system, and short lines (figure 6). For bulk mineral corridors, the transfer of operational responsibilities from Transnet to mining companies is proposed. The core railway network would continue to be managed by the proposed Infrastructure

Figure 6 The railways network by route classification



Source: Freight Logistics Roadmap, 2023.

Manager, with fair access to all operators. For the feeder lines that serve specific customers, such as automotive and dry bulk customers, public-private partnerships are proposed. Management of short lines could be determined by provincial or municipal governments.

Action 2: Initiate Transnet's unbundling

South Africa needs to adjust its legal framework to transition from a public sector–led to an open delivery model in freight transport. Toward that end, the government could focus on the following measure:

- ***Adopting the new draft Rail Bill that provides the legal basis for unbundling Transnet.*** The bill is expected to be ready for public comment in December 2024 and presented to Parliament by February 2025. Accelerating its enactment would send a strong signal to market players and make policy reversal more difficult.

Action 3: Provide nondiscriminatory access to railway infrastructure

Clarifying Transnet's institutional roles and mandates is urgent. The priority is distinguishing between the functions of infrastructure provision, which is the role of the public sector, and rail operations, which should accommodate multiple actors on a fair-access basis. This can be achieved in the short-term by:

- ***Establishing an Infrastructure Manager, who will be responsible for the maintenance, renewal, and development of the infrastructure network.*** The position requires organizational independence from Transnet operations (within a framework of regulatory supervision) over decisions about capacity; access to the rail network and train path allocation, including identifying and assessing the availability and allocation of individual train routes; and infrastructure charges, including setting and collecting access charges. Several support measures are needed for the Infrastructure Manager to be effective: developing a code of conduct for the Infrastructure Manager's staff that clearly separates the responsibilities of the Infrastructure Manager and Transnet, implementing a transfer pricing regime to ensure that all commercial arrangements between the Infrastructure Manager and the rest of Transnet are conducted on an arms-length or market-related basis, and establishing an independent board of mainly nonexecutive directors.

Priority 2: Broadening financing options to scale up investment

Modernizing the freight transport network will cost hundreds of billions of dollars over the next decade. The state cannot shoulder this financial burden alone, given the constrained central government budget and Transnet's limited borrowing capacity. Longer-term measures to consider include development of risk-sharing financial instruments to attract domestic and international financial institutions. In the meantime the government could act on two short-term measures, one related to improving Transnet's financial position and one that leverages private financing in line with the strategy of opening management of several railway lines to the private sector.

Action 4: Improve Transnet liquidity and financial sustainability

Strengthening Transnet's financial position is important for the sector's performance. In fiscal 2023/2024, the company was unable to settle its debt maturities of approximately R14 billion, forcing it to refinance with costly short-term borrowing. To avoid a possible default, Transnet received an additional government guarantee of R47 billion as a financial rescue package in 2024.

Several steps are needed to get Transnet back onto a sustainable financial path, in close coordination with the National Treasury:

- ***Classifying the debt stock by risk profile and identifying the debt accumulated because of state capture or the diversion of resources.*** This effort is in the initial stages of designing a strategy to restructure short-term and high-interest debt and exploring ways of attracting long-term institutional investors based on stable demand from Transnet customers.
- ***Identifying a list of disposed noncore assets along with milestones and timelines of disposal.*** Noncore assets include fixed assets, such as land in prime

locations, and movable assets that are not necessary to operating efficient logistics services. As part of the conditions for bailout, the National Treasury has required Transnet to submit by August 31, 2025, a list of disposed noncore assets, along with milestones and timelines. Disposing of noncore assets could ease short-term cashflow problems but will not solve Transnet's underlying financial problems.

Action 5: Develop a public-private framework for allowing private sector participation in railway operations

Classifying railway lines (action 1) is an unproductive exercise if it does not translate quickly into the transfers of some lines to third-party operators. To promote the participation of the private sector in the short term, two opportunities can be considered:

- ***Transferring the operational responsibilities of bulk mineral rail lines to large mining companies.*** These lines serve few customers and run freight trains only from mines to ports. As Transnet's main source of cashflow, revenue from these lines has cross-subsidized the other, non-cash-generating rail lines. In keeping with the Roadmap, a transaction advisory service should be commissioned to develop a mechanism that allows large mining customers to join in addressing the investment backlog and restoring reliable services, with Transnet having a minority shareholding. The transaction needs to be structured on commercial terms that give the private sector confidence that long-term contracts will be honored.
- ***Establishing public-private partnerships for running railways on feeder lines that serve clusters of diverse industries*** whose products can be containerized or palletized. For example, BMW, Ford, and Toyota, with assembly facilities in the Gauteng region, depend on a cheap, reliable, and functioning railway system to bring in inputs and move finished products to ports. With network rationalization, a public-private partnership strategy could help maintain the central container corridor and associated port operations, as well as the feeder lines that are not part of the core network but that are critical for complex intermodal operations.

Priority 3: Upgrading state capability to deliver, coordinate, and regulate

In the Roadmap vision, even with the transfers of some lines to private operators, the state continues to play a key role in the freight transport and logistics sector. Transnet is expected to continue to manage many railway lines, while the Department of Transport will remain responsible for designing strategies and plans. To be effective, the management of both Transnet and the Department of Transport needs to be upgraded, including through the introduction of strong key performance indicators and incentives. The government's regulatory capabilities also need to be strengthened in anticipation of an open and competitive market.

Action 6: Implement the independent Transport Economic Regulator section of the Transport Bill

The President has approved the Transport Bill, which will consolidate current regulatory agencies in the transport and logistics sector (such as the Ports Regulator, rail regulator, trucking regulator, and intermodal regulator) into the position of independent Transport Economic Regulator (TER). Such approval is pivotal as it instills confidence that the sector is based on fair, transparent, and nondiscriminatory access for all parties. Among other roles, TER will regulate the pricing of access to the network, which is critical to meaningful vertical separation. The dominant operator and its external competitors need to face the same pricing schedule for access to infrastructure, which should be cost based and reflect a fair allocation of overhead costs.

The following steps are necessary to build TER's capabilities:

- ***Enhancing technical and financial resources.*** Adequate resources need to be allocated to TER to ensure that the regulator has the technical expertise and financial support needed to carry out its expanded mandate effectively.
- ***Providing comprehensive training and capacity building*** to equip TER staff with the skills

required to handle the complexities of market regulation, technical oversight, and tariff setting. Drawing on best practices from successful regulatory bodies worldwide will be essential, including through exchange programs and internships.

- ***Establishing a performance benchmarking system*** to monitor and enforce good behavior. This system will help maintain accountability and ensure that all market players adhere to high standards of governance and operational efficiency. Spain's National Commission on Markets and Competition has implemented this type of robust bench- marking system to monitor and evaluate the performance of electricity distribution companies.

Annex table A1 Ranking of measures through the "FIT" filter of feasibility, impact, and timing

		Feasible	Impactful	Timely	Total
Accelerating reforms in the electricity sector					
Priority 1: Encouraging innovative and efficient delivery mechanisms by opening markets					
Action 1: Ensure the financial and operational sustainability of the National Transmission Company of South Africa	1. Adopting a new transmission tariff methodology 2. Implementing a new wheeling framework 3. Updating the Grid Code	3	3	3	9
Action 2: Continue to encourage private investment in renewable energy projects	4. Scaling up Eskom's land leasing program for investors 5. Facilitating connection to the grid 6. Scaling up the subsidized credit scheme 7. Allowing residential investors to feed surplus power back to the grid	3	2	3	8
Action 3: Establish a competitive wholesale electricity market	8. Establishing a multimarket trading platform 9. Adopting the Market Code for NTCSA	3	3	2	8
Priority 2: Broadening financing options to scale up investment					
Action 4: Scale up private investments in transmission	10. Adopting a regulatory framework for an independent private transmission model	3	3	3	9
Action 5: Diversify sources of financing with new risk-sharing instruments	11. Creating a blended finance and risk-sharing platform	2	2	2	6
Priority 3: Upgrading state capability to deliver, coordinate, and regulate					
Action 6: Strengthen the capacity of the electricity market regulator	12. Expanding technical and financial resources 13. Providing comprehensive training and capacity building 14. Establishing a performance benchmarking system	2	3	2	7
Action 7: Enhance Eskom's governance, accountability, and investment management	15. Designing clear and transparent reporting and monitoring mechanisms 16. Improving investment management, including public procurement to accelerate the construction of new transmission lines 17. Implementing key performance indicators in project design, procurement, and finalization	2	3	2	7
Action 8: Boost competition in generation by horizontally unbundling Eskom's generation assets	18. Developing and implementing a detailed roadmap for splitting Eskom's generation assets into multiple, independently managed entities, with clear timelines and legal frameworks				
Action 9: Improve electricity distribution by municipalities and Eskom	19. Streamlining the contractual approach implemented in mid-2023 between the National Treasury and the municipalities that have accumulated arrears with Eskom 20. Using conditional transfers by the National Treasury to incentivize municipalities to perform better 21. Improving local capabilities at the municipal level 22. Adopting standards for municipal performance	3	3	2	8

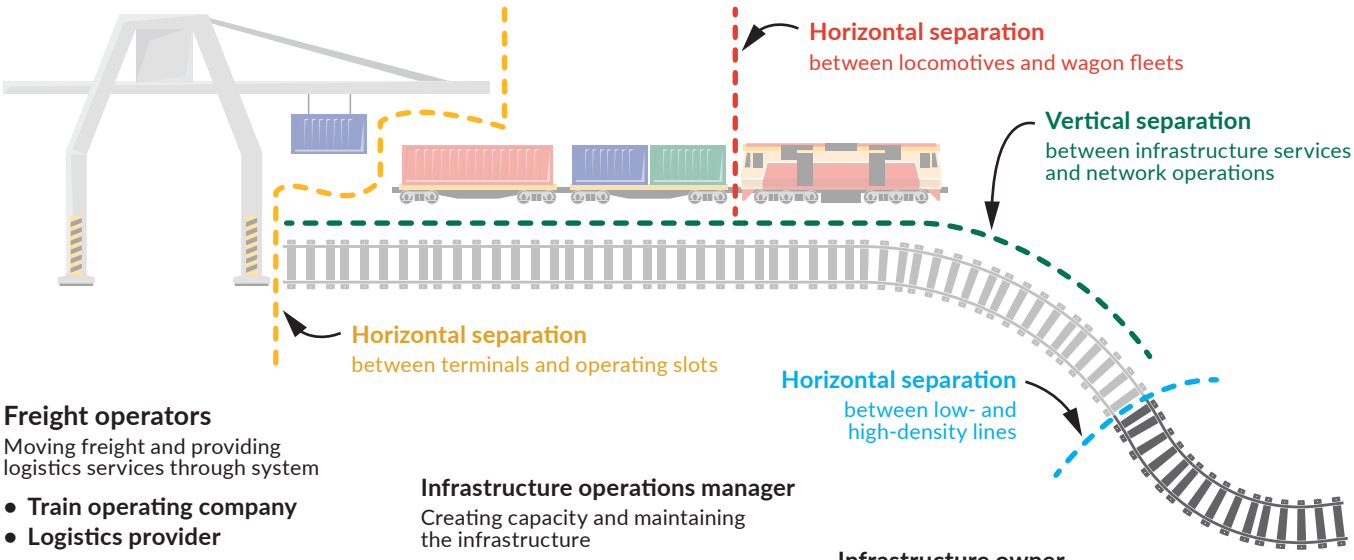
		Feasible	Impactful	Timely	Total
Igniting reforms in the freight transport and logistics sector					
Priority 1: Encouraging innovative and efficient delivery mechanisms by opening markets					
Action 1: Finalize the classification of railway lines to assess future ownership	23. Identifying which railway lines could be effectively operated by entities other than Transnet	2	2	3	7
Action 2: Initiate Transnet's unbundling	24. 18. Adopting the new draft Rail Bill	3	3	2	8
Action 3: Provide nondiscriminatory access to railway infrastructure	25. Establishing an Infrastructure Manager and issuing operating licenses to private train operators	3	3	3	9
Priority 2: Broadening financing options to scale up investment					
Action 4: Improve Transnet liquidity and financial sustainability	26. Classifying the existing debt stock by risk profile 27. Identifying a list of disposed noncore assets along with milestones and timelines of disposal 28. Completing the process for identifying critical investments for ports equipment and operational efficiency constraints and developing key performance indicators for ports	2	2	2	6
Action 5: Develop a public- private framework for allowing private sector participation in railway operations	29. Transferring the operational responsibilities of bulk mineral rail lines to large mining companies 30. Establishing public-private partnerships for running railways on feeder lines	3	2	3	8
Priority 3: Upgrading state capability to deliver, coordinate, and regulate					
Action 6: Implement the independent Economic Regulator section of the Transport Bill	31. Setting up a fully functional Independent economic regulator in line with the bill 32. Completing the merger and integration of port regulator and interim rail regulator 33. Establishing a performance benchmarking system	3	3	3	9

Source: Authors.

Note: The scores range from 1 to 3, with 1 being the lowest. The actions with the highest score are highlighted in yellow.

Annex figure A1 Proposed split of infrastructure network and rail/port operations under the Cabinet's December 2023 Roadmap for the freight and logistics sector

Reform policy and regulation: Rail freight



Freight operators
Moving freight and providing logistics services through system

- **Train operating company**
- **Logistics provider**

Infrastructure operations manager
Creating capacity and maintaining the infrastructure

- **Infrastructure Manager**

Infrastructure owner
The landlord

- **Rail owner**
  (infraBel, Network Rail, BNSF, NS)

Source: Freight Logistics Roadmap, 2023.

Notes

1. C. Calderón and L. Servén, 2014, "Infrastructure, Growth, and Inequality: An Overview," World Bank Policy Research Working Paper. 7034. https://ssrn.com/abstract=2497234. These authors also provide a summary of the literature.
2. Wheeling pricing refers to charging for electricity transmission from one system to another.
3. The impact of declining infrastructure services can take different forms depending on the type of service (for example, water is different from electricity or transport); the intensity of the failure (2 or 8 hours of disruption do not have the same impact); the location of the activity (urban or rural area); the sector of activity (production processes differ in use of energy and water); and the income level of the customers (not everyone is equally vulnerable).
4. C. Calderón and L. Servén, 2014, "Infrastructure, Growth, and Inequality: An Overview," World Bank Policy Research Working Paper. 7034. https://ssrn.com/abstract=2497234.
5. South African Reserve Bank, June 2023, Occasional Bulletin of Economic Notes. OBEN/23/01.
6. C. Calderón and L. Servén, 2014, "Infrastructure, Growth, and Inequality: An Overview," World Bank Policy Research Working Paper. 7034. https://ssrn.com/abstract=2497234.
7. For further details, see World Bank, 2022, South Africa: Climate and Development Report. https://www.worldbank.org/en/news/infographic/2022/11/01/south-Africa-country-climate-and-development-report.
8. J.H. Havenga, Z.P. Simpson, H. Neethling, A. De Bod, and S. Swarts, 2023, "The Macrologistics Effect of a State-Owned Enterprise, Transnet, on the South African Economy," Journal of Transport and Supply Chain Management, 17(0), a952. https://doi.org/10.4102/jtscm.v17i0.952. The impact of the weak management of the sector is also evident in the network statement and proposed tariffs of March 2024, which in the absence of a strong regulator could not be contested.
9. The impact of the weak management of the sector is also evident in the network statement and proposed tariffs of March 2024, which, in the absence of a strong regulator, could not be contested.
10. The Day Zero drought cost the Western Cape over R5 billion and put under strain the water and sanitation framework as the local authorities had to ration water services while having to invest in desalination, underground extraction from aquifers, and water reclamation/reuse.
11. Department of Minerals and Energy, 1998, "White Paper on the Energy Policy of the Republic of South Africa," December, https://www.gov.za/sites/default/files/gcis_document/201409/whitepaperenergypolicy19980.pdf.
12. "White Paper on Telecommunications Policy." Government Gazette 370 (March 1996) and "White Paper on National Civil Aviation Policy" 2017.
13. As defined in the National Energy Regulator of South Africa's consultation paper "Electricity Price Determination Methodology (EPDM) Rules" issued in August 2023. https://businesstech.co.za/news/wp-content/uploads/2023/08/Nersa-consultation-paper.pdf.
14. The National Treasury, Department of Mineral Resources and Energy, and Independent Power Producers Office could consider the use of regional incentives to realize the public good externalities associated with these projects for these provinces (supply increase, job creation, and other social transition considerations). Such regional incentives could include reduced or preferential tariffs for infrastructure and access to land, blended concessional financing, or even tax and tariff incentives.
15. "Making Capital Work: Unlocking US$8.5 Billion for South Africa's Just Energy Transition," 2022, Presidential Climate Transition Report (2022–2050).

16. A private transmission company has long-term contracts with Kenya Power to earn wheeling revenue from electricity transmitted through its power lines. This company is investing $298 million in two privately owned power transmission lines—a first in Africa—covering 237 kilometers.
17. https://www.psrp.org.ng/.
18. http://energycom.gov.gh/public-notices/112-energy-sector-recovery-programme-esrp.
19. For example, in the municipality of Maluti-a-Phofung, billing comes to only half the cost of bulk purchases from Eskom.
20. https://powermin.gov.in/en/content/overview-5.
21. According to the National Treasury, as of March 31, 2024, none of the participating municipalities complied with all conditions, while only 26 reported moderate compliance and 36 poor compliances.
22. One challenge is that the Electricity Regulation Act of 2006 prohibits restricting Eskom electricity supplies to nonperforming municipalities.
23. World Bank, 2022, World Bank Container Port Index. https://documents1.worldbank.org/curated/en/099051723134019182/pdf/P1758330d05f3607f09690076fedcf4e71a.pdf.
24. Commonly, when a subnational government is expected to deliver on development objectives that are not commercially viable, adequate funding is provided through subsidies. For example, in India an explicit subsidy that is calculated every year to allow Indian Railways to provide freight and passenger services to low-economic-density areas, with the understanding that the subsidy allows mobilization of labor and makes it cheaper for firms to locate to these areas, thereby creating jobs. In the case of Transnet, this explicit subsidy arrangement is missing.
25. Key aspects of the governance failures at Transnet are detailed in the *Judicial Commission of Inquiry into State Capture Report*, Part V, Volumes 1 and 2 (https://www.justice.gov.za/commissions/STCC.htm). A particular problem has been the electrified locomotive fleet procured from the China Railway Rolling Stock Corporation. Because of disputes over the procurement process, many of the locomotives stand idle or have not even been delivered.
26. Such change is not completely new for the transport sector. Partnerships with the private sector have been developed such as the Gautrain regional rail service, bus rapid transit operations, private airports, and the Richards Bay Coal Terminal.

Priority 3

Making cities engines of growth and economic inclusion



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SOUTH AFRICA POLICY PACKAGE

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Priority 3

Making cities engines of growth and economic inclusion



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SOUTH AFRICA POLICY PACKAGE

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Connecting markets and people with effective transportation and more compact cities

South Africa is a mostly urban country, with about two-thirds of the population and three-quarters of economic activities concentrated in urban areas. Yet, urban mobility is difficult for people without a car (80% of the population) or who live in remote and poor neighborhoods.[1] It can take a poor worker 2–3 hours and cost half their daily earnings on average to reach their workplace—four times higher than in many East Asian cities and one of the most expensive commutes in the world. These costs interfere with the efficient functioning of product and input markets and result in substantial losses in output and employment. The poor are disproportionally harmed; for example, employment is 86% lower in poor neighborhoods of Johannesburg than in affluent ones.[2]

Limited urban mobility is largely a legacy of the Apartheid era, but it has not been addressed convincingly over the past three decades. Investments in urban transport networks have been insufficient to achieve spatial efficiency and equity. Another obstacle is the horizontal spread of South African cities. Decades of urban development have favored urban sprawl into the suburbs, where land is cheaper. As a result, the average population density of major cities like Johannesburg is two to three times lower than in comparable cities in Latin America and East Asia.

Improving urban mobility in South Africa requires addressing two intertwined challenges.[3] First, urban centers in South Africa, like all modern cities, must offer efficient and affordable mass public transit systems (railways, bus rapid transit) integrated with more agile transport modes on feeder roads, such as buses and minibus taxis (MBTs). Second, cities need to become more compact, with shorter distances between businesses, workers, and consumers.

Reforming urban transport and development is a long-term endeavor requiring sustained effort, financial resources, and political commitment. Transforming South African cities into modern and livable hubs for their inhabitants, businesses, and workers will take time. In the interim, focusing on key short-term actions that address the most pressing issues can provide immediate relief and lay the foundation for broader reforms. To guide policymakers, this note proposes a menu of 10 actions and 24 short-term recommendations. Five of these recommendations have been assessed as the most technically and politically feasible, impactful, and timely (see table A1 in the annex). While the most desirable actions would ideally meet all three criteria, tradeoffs are likely to arise:

1. ***Using a results-based approach for allocating grants*** from the National Treasury to the state-owned Passenger Rail Agency of South Africa (PRASA) to incentivize better investment and maintenance performance.
2. ***Distributing vouchers to poor customers*** to reduce their transportation costs, while extending the use of e-payment and e-ticketing.
3. ***Relaxing National Building Regulations and municipal zoning regulations and amending the Spatial Planning and Land Use Management Act*** to encourage land development in dense areas, with special attention to national building regulations and municipal zoning regulations.
4. ***Introducing financial bonuses for social housing projects in high-density areas close to business centers.***
5. ***Accelerating the development and use of digital spatial planning platforms*** to collect and share

It can take a poor worker 2–3 hours and cost half their daily earnings on average to commute to their workplace

just-in-time and integrated information to manage urban development projects, including in partnership with the private sector.

Urbanization has not been a driver of inclusive growth

"Urban immobility" has weakened the ability of urbanization to drive inclusive growth in South Africa. Worldwide, the concentration of economic activities and people in cities has generated agglomeration effects that promote economies of scale and synergies within and across markets, contributing to economic development. Both economic theory and empirical evidence reveal a positive relationship between well-planned and managed densification and economic development.[4] South Africa has been an outlier. In fact, during the past decade, output per capita contracted more rapidly in urban provinces than in rural ones.[5] Living conditions have deteriorated for many urban households because of the declining availability of basic infrastructure services (electricity and water, higher pollution) and rising insecurity.[6] Nonetheless, people in rural areas and poor neighborhoods have continued to migrate to cities, drawn by expectations of higher wages and a better life.[7]

Together with urban sprawl, limited mobility is one of the most important factors explaining the low returns to urbanization in South Africa

Together with urban sprawl, limited mobility is one of the most important factors explaining the low returns to urbanization in South Africa. When markets are hard to access, transaction costs are high for firms and people, who will move and trade less. High mobility costs also reduce opportunities for sharing technologies and skills, which are essential for generating economies of scale and productivity gains across all sectors of the economy. Similarly, lengthy and expensive commutes weaken economic incentives to acquire human capital and look for work. On average, daily commutes are about 107 minutes for train travelers, 84 minutes for bus travelers, and 63 minutes for taxi travelers.[8] The high time and money costs of transport negatively affect labor productivity: in the most urbanized province (Gauteng), real gross valued added per worker in industry, a rough approximation of labor productivity, fell 5% between 2011 and 2019. The negative effects of urban immobility on productivity are exacerbated by the diversion of financial resources away from investments in education or other productivity-enhancing endeavors and toward transportation expenses.

While substandard and expensive urban mobility affects all households, the poor are penalized most heavily. Due to tighter budget constraints, the cost of urban transport, including commuting time (opportunity cost), takes as much as 80% of the earnings of the poorest segment of the population. This burden helps explain why almost two of three working-age South Africans are unemployed or not actively seeking employment, with poor people again disproportionately affected. For every 10% increase in transportation costs, the urban wage employment rate falls an estimated 2%.[9] By contrast, transportation costs in Vietnam are estimated at only 10% of net wages because of shorter distances and more efficient modes of transport, including motorcycles. In other words, of the same gross salary, the average South African worker retains less than half of the earnings that a Vietnamese worker retains (figure 1).[10]

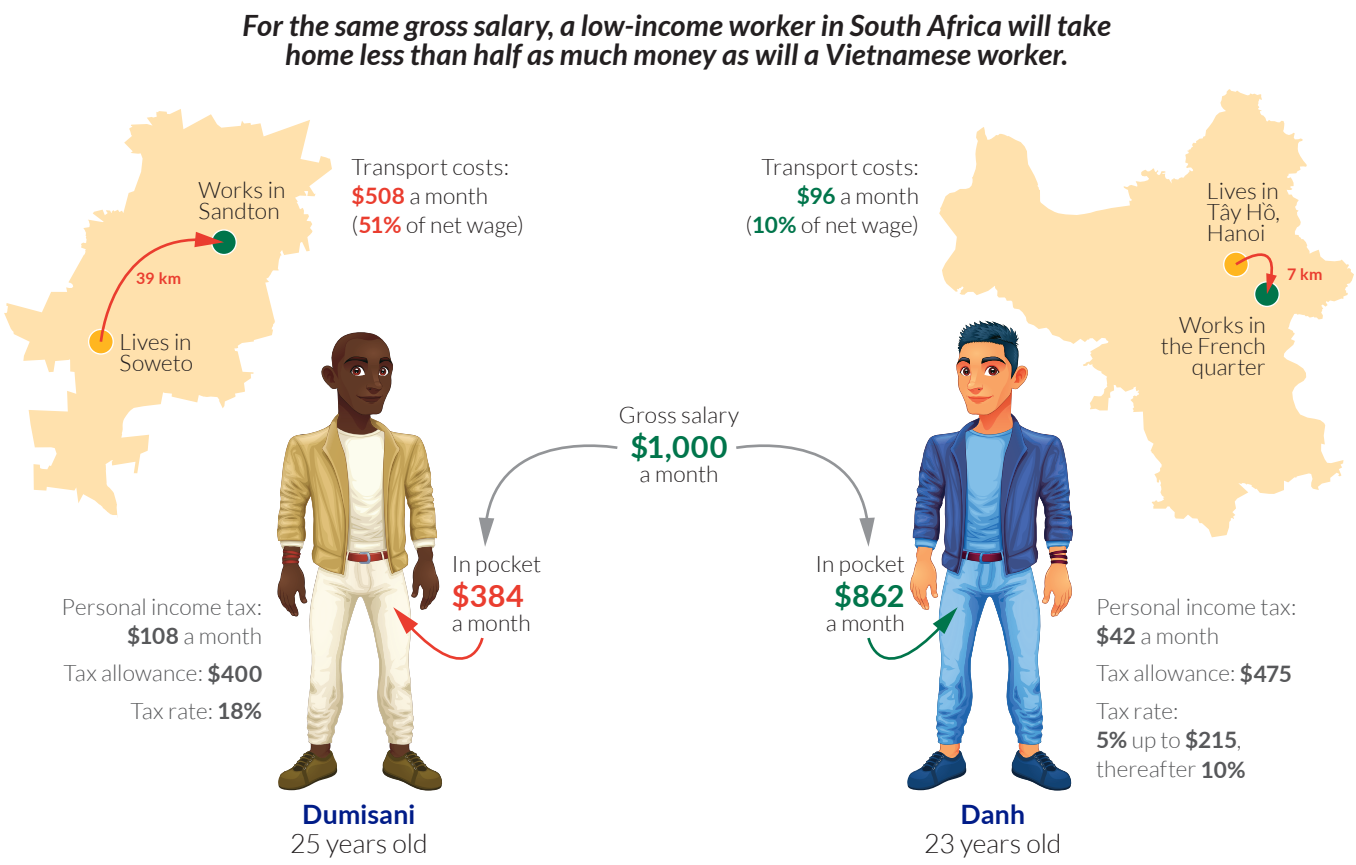
Three priorities for addressing the urban mobility challenge

To address the challenge of urban immobility, South Africa developed a two-pillar strategy as early as the mid-1990s. South Africa adopted an urban mass transit strategy based on international best practices. It also focused attention on urban development, spending billions of dollars on housing developments in poor communities. Despite some successes, especially in the first decade after the end of the Apartheid, implementation of these policies has been uneven, as reflected in disappointing results.

The urban transport strategy was clearly articulated in the 1996 White Paper on National Transport Policy. Implementation of the policy included the 2007 development of integrated rapid public transit networks, including bus rapid transport.[11] The objective has been clear, with a dual emphasis on modernizing commuter rail services and developing MBTs to make transports affordable for all.[12] However, after almost 20 years of implementation, the urban transit system remains undeveloped and costly, having contributed little to reducing spatial inequalities in South African cities.

- In passenger rail, despite large capital allocations for network renewal, service quality deteriorated rapidly after 2013, reflecting underinvestment in maintenance and delays in upgrading of networks and rolling stock.

Figure 1 High transportation costs penalize low-income workers in South Africa



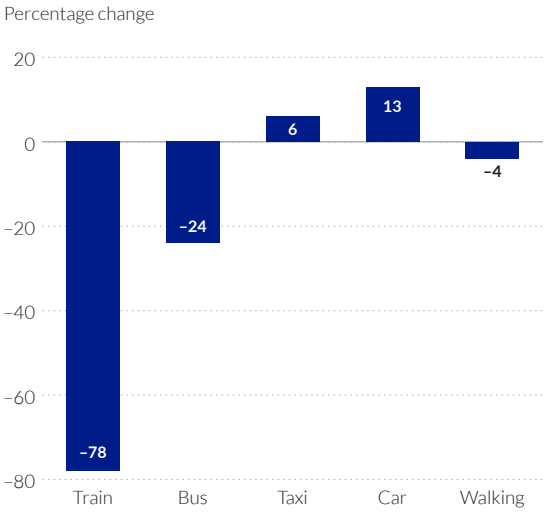
Source: Morisset 2023.

- Subsidized commuter bus services have not kept up with urban growth, partly because of the decline in operational grants from the central government. Meanwhile, the provinces, with limited own-revenue sources and largely dependent on the national government for funding, have not been able to noticeably increase funding for these services. The uncertain legal framework has also discouraged long-term investments. Interim contracts for operators are still in place and are being renewed annually, despite court rulings requiring their termination.
- As formal (subsidized) public transit systems stagnated or broke down, MBTs—privately owned, independently operated, and weakly regulated—greatly expanded their market share. However, they are an imperfect substitute for formal public transit systems because they are not integrated into public transit systems and are inefficient as a mass commuter service, more expensive, dangerous, and poorly organized.

The failure of mass public transit and the emergence of privately run MBTs have dramatically altered ridership patterns over the last decade (figure 2). As of 2020, publicly supported transportation in the form of rail and commuter buses combined made up less than 7% of the transportation mode share, while privately owned and operated transportation, in the form of MBTs and private cars, made up 72%. The remaining share (21%) of people walked, often because they could not afford or did not have access to other public or private options. One consequence of this change in the pattern of transport is that the government spends about R16 billion ($840 million) annually to subsidize mass public transit (railways and buses) for only 7% of ridership today. This underscores the large regressivity of the current state of public transit in South Africa.

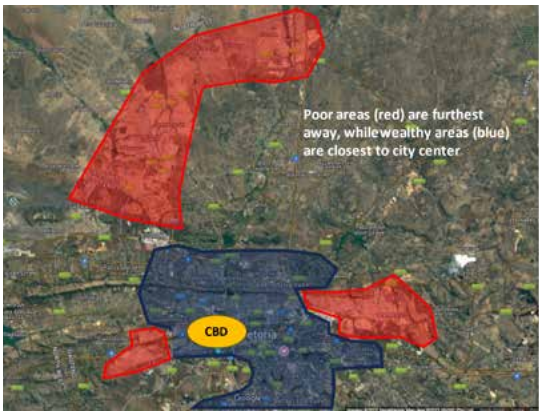
As formal public transit systems stagnated, privately owned, independently operated, and weakly regulated minibus taxis greatly expanded their market share

Figure 2 Commuters have moved away from the public transit system toward privately run buses and taxis over the past decade, 2013–2020



Source: South Africa statistical office.

Figure 3 Spatial exclusion in Pretoria, 2023



Source: Beukes, E., 2023, *Transit in South Africa*, World Bank.

Residential areas where most low-income households live are generally poorly covered by public transit

On the urban planning front, the government has focused on building affordable housing in disadvantaged communities, greatly improving access to housing and basic public services among disadvantaged groups. However, less attention has gone to improving urban mobility and densification in economically dynamic areas. Travel distances from most poor communities to business centers and jobs remain long. Residential areas where most low-income households live are generally poorly covered by public transit. Consider the case of Pretoria. The poorest residential areas are far from the business center and job opportunities, while affluent residential areas are much closer (figure 3).[13] Recent analysis using tax data reveals that employment in the most asset-deprived neighborhoods is, on average, 79% lower in Johannesburg than in the wealthiest areas and 44% lower in Cape Town.[14]

Aware of the continuing urbanization challenges, the government is taking new actions. For public transit, the foundations are in place. Strategies have focused on the right objectives by prioritizing a multimodal approach to reverse the historical trend of underinvestment and poor maintenance of public transit system and address the limitations of the privately run MBTs. The aim is to integrate MBTs into the urban transit system to increase the connectivity and utility of rail service by extending its reach and spreading the benefits of its subsidies more broadly. As for urban development, the government, recognizing past failures, has set developing more compact cities, better integrated into economic areas, as a priority. Improved land use planning and densification policies are also critical for preventing urban development in disaster-prone areas and for providing additional protection to vulnerable groups exposed to climate risks. Complementary to these two strategies are recent efforts to expand virtual connectivity (box 1).

Transforming South African urban hubs into robust engines of growth demands substantial investments. Large investments are needed in transportation infrastructure and buildings to reduce the distance between home and work and between businesses. The required level of financing will be difficult not only for the central government to meet but also for even more fiscally constrained provincial and municipal governments. In addition, decision and approval processes are long and complex, delaying impacts.

To initiate the shift toward denser and more accessible cities, this note outlines three key priorities aimed at achieving better and more equitable mobility and greater economic and population density (figure 4). In the short term, to create momentum for reform, the authorities could focus on policies and regulations to incentivize a shift toward greater innovation

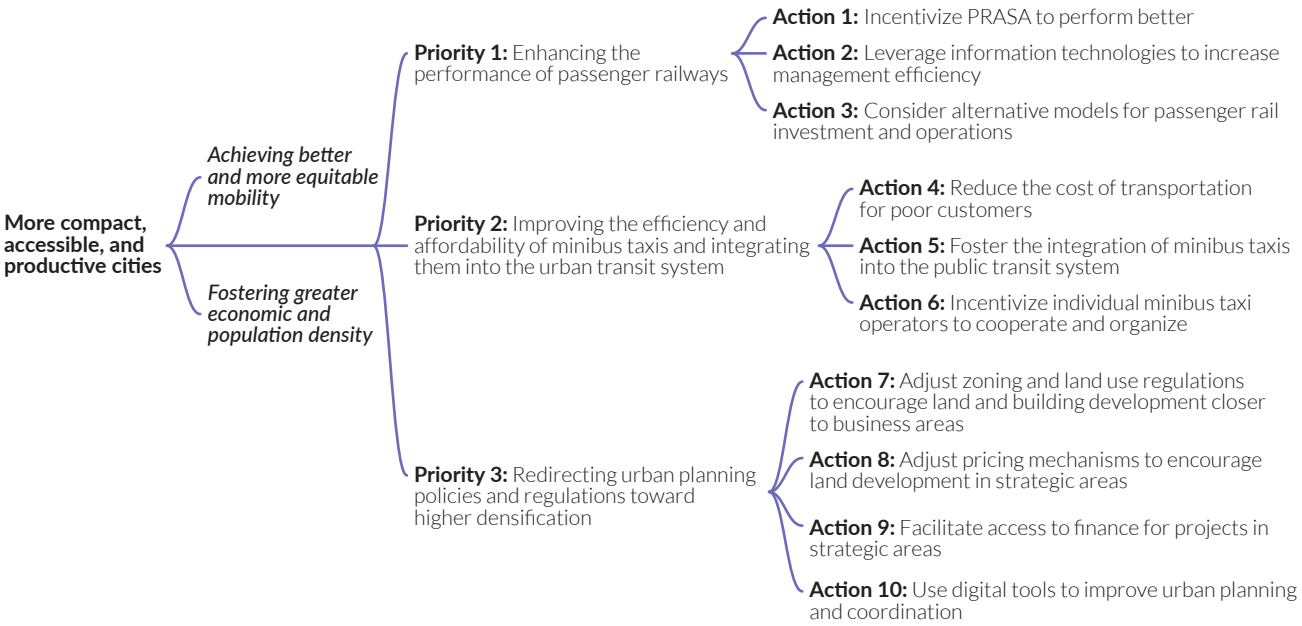
Box 1 Virtual connectivity

Virtual connectivity can help reduce distances between economic agents. Rather than traveling from one location to another to complete a transaction, it is now possible to do so by clicking on a smartphone or computer. Also, virtual connectivity can reduce the need for transportation for some types of workers, especially those with skilled and semi-skilled jobs in some service sectors.

The digital revolution is under way in South Africa, but its progress has been uneven. South Africa was ranked 58th of 63 countries on the 2021/22 IMD digital competitiveness index, behind most upper middle-income countries. This low ranking captures the fact that 36 percent of South Africans were still unconnected to the Internet in 2021/22, and those who were connected do not have the kind of high-speed connections needed to access cloud software or streaming services. Connection costs are high as well, with data approximately 20 times more expensive than the cheapest data costs globally. An additional challenge to digital connectivity is users' lack of information technology knowledge, including businesses. Weak and limited data skills impede the development of information highways (data capture, analysis, and processing at large scale).

Additionally, although digital tools have enabled South Africans to communicate and conduct financial transactions virtually, virtual and physical connectivity are not always perfect substitutes. For example, a product can be ordered online but will still need to be shipped to its destination at a reasonable cost and in a timely manner.

Figure 4 A guiding framework for prioritizing policies to leverage cities for stronger and more equitable growth



and improved delivery mechanisms. These measures can be implemented without delay as they require more political will and vision than time and money.

The three mutually reinforcing priority areas are:

- *Enhancing the performance of passenger railways.* Investments are needed to upgrade the system, which will require public-private partnerships as the government does not have the resources to do it alone. It is also critical to introduce more contestability and performance-based incentives to a sector dominated by the public agency PRASA. This can be done by opening the sector

to new operators that can bring new technologies, competencies, efficiency gains, and financial capital.

- *Improving the efficiency and affordability of MBTs and integrating them into the urban transit system* by encouraging cooperation across operators (including with new digital technologies) and coordination with the public transit system to create economies of scale and synergies for the benefit of customers.
- *Redirecting urban planning policies and regulations toward higher densification* by providing better value for money for developers, while enhancing coordination between central, provincial, and municipal authorities.

Priority area 1: Enhancing the performance of passenger railways

Since the peak of the urban transit crisis in 2021, the government has taken important steps to rehabilitate and expand passenger rail services and accelerate the development of bus rapid transit. PRASA's new corporate plan (2023–2026) allocates approximately R120 billion ($6 billion) in capital spending over the next three years, and its implementation has already led to the reopening of several stations and routes. Concurrently, the government has turned its attention to governance reforms within PRASA, such as bringing independent and private members onto the Board to strengthen its technical capacity and accelerating the adoption of new technologies. These measures are a good beginning, but more is needed.

Three actions are proposed to improve sector performance in the short term.

Action 1: Incentivize PRASA to perform better

The most direct way to incentivize PRASA is to apply a results-based approach in allocating transfers. Central government transfers account for almost 90% of PRASA's budget, at close to R20 billion a year. That gives the government (especially the National Treasury) considerable leverage over PRASA. These transfers, which are currently based mainly on PRASA's capacity and needs, could also take its performance into account. Such a results-based approach would be similar to the incentive scheme the government used in the energy sector, under the conditional debt relief offered to Eskom in 2023 (see policy note 2 for details). The Treasury could also consider opening these funds up to competition by offering them to other stakeholders as well (municipalities, private sector, taxis/buses), as discussed below.

The most direct way to incentivize PRASA is to apply a results-based approach in allocating transfers; the Treasury could also consider opening these funds up to competition

Action 2: Leverage information technologies to increase management efficiency

As technology has advanced, so has innovation in urban transit systems. New digital instruments and information-sharing mechanisms can improve the management of both supply and demand by enabling the collection and analysis of just-in-time data. South Africa, like many other countries, has started this digital transition, which could be accelerated through a few measures, including:

- ***Using digital dashboards to improve municipal management of urban transit systems.*** Running an efficient urban transit system requires access to up-to-date information that can be analyzed in real time. The development of the internet of things and the internet of everything means that transit data can be fed into other networks for more effective and efficient management of municipal transit services. Colombo, Sri Lanka, and Can Tho, Vietnam, have implemented such initiatives.
- ***Introducing digital ticketing for customers without digital bank accounts.*** While passengers can already use digital banking to pay for their tickets, many poor customers do not have access to a digital bank account or are discouraged from using it by high fees. In line with the proposal in policy note 4 to authorize nonbanking institutions to issue e-money, the authorities could implement a system of e-payment, as several African countries have done, Côte d'Ivoire and Tanzania among them. In addition to reducing transaction costs for customers, an e-ticketing system could enable the government to target vouchers to poor customers, which would reduce the high cost of transportation for them.
- ***Tightening security and reducing thefts of rail infrastructure through real-time monitoring of crime areas.*** The government could scale up the pilot project in Cape Town that uses closed-circuit television cameras to relay data to security providers

and the police in real time for immediate action. With added data analytics and artificial intelligence capabilities, the security system could reveal other information relating to possible crimes or incidents.

Action 3: Consider alternative models for passenger rail investment and operations

While government strategies call for opening the passenger railway sector to operators other than PRASA, no actions have been taken in that direction.[15] Inaction reflects mainly political economy concerns, but also an inadequate legal framework. Legal reforms are necessary to empower municipalities to choose the solution best suited to their jurisdiction and to develop an integrated transport plan that creates an interconnected transit system that includes MBTs. Currently, the licensing process is under PRASA's control.

Meanwhile, the subnational authorities could find inspiration for opening railways to private operators in the Gautrain Rapid Rail Service model adopted in Gauteng Province in 2006, which includes an independent concession manager and experienced operators. The Gautrain Management Agency was established to manage and oversee concession agreements for the province and coordinate and exchange information with institutions, authorities, and professional bodies on rail matters in South Africa. These concessions have been providing a consistently high quality of service for nearly 15 years, with operating performance and quality of infrastructure and maintenance on par with the best in the world. The model highlights the benefits of having a capable, competent, independent concession manager paired with experienced concessionaires and operators through a well-structured contract.

Another delivery model to consider is public partnerships with the private sector, especially on urban corridors with commercial prospects. A public-private partnership for passenger rail could ease government budget constraints while offering opportunities to acquire new technologies and capabilities. Such partnerships, which can take different forms, require clear and transparent risk-sharing mechanisms (box 2). One challenge is managing and coordinating the responsibilities of the central, provincial, and municipal authorities and PRASA.

A public-private partnership for passenger rail could ease government budget constraints while offering opportunities to acquire new technologies and capabilities

Priority area 2: Improving the efficiency and affordability of minibus taxis and integrating them into the urban transit system

Privately run MBT services have become by far the most used means of urban mass transit in South Africa. Private MBT services have expanded as a market response to the government's failure over many years to maintain and expand the public transit system. By conservative estimates, the MBT industry has grown to 200,000–250,000 vehicles, with annual income of approximately R50 billion. However, private MBT services have also suffered from several shortcomings that have resulted in low-quality and costly services. Passengers complain about the

Box 2 Lessons from international experience with public-private partnerships in urban transit systems

Increasingly, governments are entering into partnerships with the private sector for urban transit projects. While most experience with such public-private partnerships has been in high-income countries (Australia, United Kingdom, United States), some middle-income countries (Brazil, Malaysia) have adopted such partnerships in recent years. The main lessons of experience are the following:

- Design long-term contract because gains take time to accrue.
- Set up clear and transparent risk-sharing mechanisms and responsibilities, especially for maintenance.
- Agree up front on payment mechanisms, including procedures for tariff adjustments.
- Provide technical assistance and training for local staff.
- Integrate projects for infrastructure, stations, parking, and adjacent infrastructure.

high cost, the lack of integration with other passenger transportation modes, and insecurity (poor maintenance of vehicles, accidents, robberies). Addressing the challenges requires a multidimensional approach implemented through a close partnership between the private and public sectors, as in the following three proposed actions.

Action 4: Reduce the cost of transportation for poor customers

Subsidizing MBT trips for the poorest segment of the population through vouchers is a step that can be taken immediately. A traveler using MBTs spends an average of R960 a month, well above the average cost of buses (R745) and trains (R581). The subsidy would enable low-income workers to retain more of their earnings. The government could distribute vouchers to the poorest households through a mobile application or an electronic card, using the same distribution system as for other income grants. The subsidy should be given to customers rather than operators to avoid capture of the benefit. The subsidy could be financed by reallocating funds from consolidating or cutting other programs (see policy note 1 for details).

Residents of South Africa's largest cities face long and expensive commutes in part because of the poor integration of different modes of transport

Action 5: Foster the integration of minibus taxis into the public transit system

Residents of South Africa's largest cities face long and expensive commutes in part because of the poor integration of different modes of transport. As a result, passengers often have to pay multiple times to move from one place to another, increasing congestion and travel times. To deal with the problems created by inadequate regulation and legislation, the MBT companies have organized themselves into route-based associations affiliated with national representative bodies such as the South African National Taxi Council and the National Taxi Alliance. While these structures impose some order, they have also led to uneven spatial coverage and limited integration between MBTs and other transit modes. Integration—of payment systems, routing, scheduling, service quality standards, and planning and investment—is challenging without some consolidation in the industry.

Several steps can be taken to integrate urban transit modes:

- ***Establishing a dialogue between the government and the MBT industry to identify the reforms and supports needed to expedite industry development and consolidation.*** Since the National Taxi Task Team reports of 1996, both industry and government have signaled their intentions to pursue this agenda, but intentions have not been followed up by actions.[16]
- ***Supporting municipalities with initiatives and technical support to better integrate MBTs into public transit networks.*** Municipalities are already pursuing measures to integrate MBTs into their planning for rapid transit.
- ***Streamlining, updating, modernizing, and strengthening regulatory structures to improve performance and responsiveness to a restructured MBT sector.*** The current structure of provincial regulatory entities interfacing with municipal planning authorities on licensing and management, coupled with outdated regulations and under-resourcing, has led to severe licensing backlogs. This undermines the objectives of regulation and enforcement. In addition, the regulatory system is not fully prepared for MBT consolidation and will need some adjustments to support this transition.

Action 6: Incentivize individual minibus taxi operators to cooperate and organize themselves

The lack of an organizing structure in the MBT industry creates perverse incentives, with individual drivers/operators competing recklessly with one another to maximize profits. With earnings based on the number of passengers served, competition among drivers for passengers, especially during peak periods, leads to speeding and other forms of reckless driving. It also results in long working hours for drivers. The combination of reckless driving and fatigue leads to high accident rates.

Shifting to a more collaborative approach could benefit drivers and customers. Greater cooperation and consolidation would bring scale, organizational capacity, and resources that would enable drivers to maintain their vehicle or invest in newer ones. The high cost and difficult access to financing and insurance are binding constraints on the sector's development.[17]

To accelerate cooperation, consolidation, and corporatization of the MBT industry, the authorities can build on the lessons from local cost-effective models, including pilot projects in Cape Town and Gauteng Province.[18] The program of Cape Town's Transport Operating Company envisages developing a joint plan for the MBT industry and public transit. The Gauteng Provincial Government's Smart Mobility initiative plans to merge MBT services with conventional public transit offerings by including MBTs in bus service contracting processes and allocating a portion of subsidized contracts to MBTs. The Gautrain Management Agency already has agreements in place with Gauteng taxi associations to provide contracted feeder services to their Gautrain stations. Moreover, several bus rapid transit companies, formed mainly by MBT stakeholders, have been operating for nearly a decade.

Government intervention, including technical and financial support to MBT owners, is crucial for creating a more efficient MBT market. The industry lacks the ability to transition to a more efficient market on its own. That requires new operating models, technologies, and financing plans, along with legal and change management support. More critically, the transition requires access to affordable capital for fleet and support facilities. Mobilizing private capital for these transitions is very challenging without state support. Incentives similar to those in the bounce-back credit schemes offered to businesses purchasing solar equipment could be considered for operators that agree to consolidate and work in partnership with the government.[19]

The government can support private operators in organizing themselves by helping them develop the tools needed for better coordination. Improved data collection on the MBT system's operation using just-in-time digital platforms could facilitate the assessment of performance metrics and passenger preferences, which in turn can enable the more timely and efficient allocation of vehicles.

Priority area 3: Redirecting urban planning policies and regulations toward higher densification

Urban development initiatives have not significantly reduced the spatial divide in South Africa, which is a major constraint to creating market linkages that integrate excluded areas. At least three factors explain urban planning's lack of progress in reducing major spatial inefficiencies and inequalities:

- ***Overly restrictive land and zoning regulations.*** While considerable progress has been made in enabling higher density formal development in urban areas, municipal zoning schemes and the National Building Regulations do not make sufficient provision for less formal development. Not enough is being done to rezone, acquire, or release land for new affordable development close to urban centers. As a result, the urban poor often opt to live in dangerous, informal settlements closer to economic opportunities rather than in formal developments far from the center. Amending the Spatial Planning and Land Use Management Act and increasing the flexibility of municipal zoning and land use management schemes are critical to enabling safe, less formal development.
- ***Few incentives for investors to develop projects in strategic locations or underserved areas.*** Post-Apartheid housing policies have inadvertently supported the development of residential areas far from economic centers, often because land and construction costs are cheaper. One of the most visible failures is the dearth of housing developments around transit stations, reflecting a lack of coordinated planning and development between government departments and agencies responsible for land use and transport. Additionally, land speculation and gentrification around prime urban transit hubs have driven up property prices in these strategic locations, making them unaffordable for lower-income residents and small businesses. These residential patterns exacerbate social and economic inequality and limit the potential economic benefits of mixed-use station hubs.
- ***Missing or incomplete information and data challenges.*** The lack of necessary data contributes to poor management by urban planners, coordination failures across agencies, and inadequate investment decisions.

Addressing these three challenges requires substantial investments in buildings and infrastructure. However, in the short term, policymakers could implement four key actions to enable increased urban density and connectivity.

Government intervention is crucial for creating a more efficient minibus taxi market, as the industry cannot do so on its own

Building codes should enable development in central areas, while the construction of foundational infrastructure to create future capacity can incentivize development near employment opportunities

Action 7: Adjust zoning and land use regulations to encourage land and building development closer to business areas

Strategically amending municipal zoning codes to reduce costs, along with tightening enforcement, can go a long way in incentivizing affordable, centrally located housing. Green or brownfield development in central, well-located nodes is often expensive because of higher land costs relative to the periphery. Building codes should be reformed to enable development in central areas. Reducing parking requirements for properties adjacent to public transit corridors, for example, can reduce building costs. Another important challenge is weak code enforcement. Corruption in the construction industry is estimated to cost the state about R10 billion a year.

Proactive land acquisition strategies are easing constraints to land ownership, which have long hindered urban development and inclusive growth in many cities. Land acquisition strategies, such as those being implemented under Johannesburg's Corridors of Freedom and Inner-City Rejuvenation Programs, are demonstrating effectiveness. The approach starts with identifying and acquiring strategically located land parcels using municipal funds to purchase plots in the open market. Subsequently, the authority allocates capital funds to develop the infrastructure necessary to support future developments in these targeted areas. Through a formal request for proposal process, the local authority then seeks private sector partners for long-term lease agreements, typically spanning 50 years, that lay out specific development guidelines and social objectives. This approach has yielded positive results in increasing high-density developments and inclusive housing opportunities in the identified corridors. By taking the initiative on land acquisition, Johannesburg is tackling land ownership issues while promoting sustainable urban development and socioeconomic growth.

Similarly, constructing foundational infrastructure to create future capacity plays a crucial role in incentivizing development closer to employment opportunities. This strategic approach by local authorities creates a valuable incentive for developers to establish projects close to job hubs. When local authorities offer ready-to-use infrastructure capacity, such as electricity, roads, stormwater management, clean water, and sanitation, developers are able to significantly reduce project timelines, resulting in cost savings and increased efficiency in the construction processes.

In the short term, the authorities could consider the following measures:

- ***Relaxing the National Building Regulations*** to allow cheaper, alternative building materials and reduce accessibility restrictions.
- ***Relaxing municipal zoning regulations*** to allow for higher densities by increasing floor area ratios, building coverage ratios, and height restrictions; by allowing greater density and mixed-use multifamily housing; and by reducing parking and elevator requirements.
- ***Amending the Spatial Planning and Land Use Management Act*** to enable safe, less formal development.
- ***Developing form-based guidelines that complement conventional zoning for development within strategic transport corridors,*** including street fronts, building typologies, ground floor activities, public spaces, and private-public boundaries.

Action 8: Adjust pricing mechanisms to encourage land development in strategic areas

Land prices are high in business areas, mainly because of limited supply. Another factor is land speculation based on anticipated future price increases. Local governments can navigate this obstacle by auctioning public land or directly releasing land for specific projects, such as the Johannesburg Inner-City Rejuvenation Program. Since 2017, this initiative has released city-owned properties to the private sector for redevelopment through long-term leases with strict development conditions. Development projects now include mixed-use affordable housing, student accommodations, and affordable space for small and medium enterprises. The initial group of developments generated about 10,000 jobs within the city and built approximately 6,500 housing units rented at more affordable rates.

In addition, public land allocation, local municipalities can reduce the price of land in dense areas in other ways:

- ***Introducing financial bonuses for social housing projects in high-density areas close to business centers.*** One option is conditional grants for

housing and related infrastructure that include a location criterion.

- *Implementing mechanism to capture land values,* sponsored by municipalities, to fund infrastructure improvements and public amenities around strategic locations, including around transit stations.
- *Strengthening regulatory mechanisms, such as taxes, to discourage private land from laying idle, vacant, or underutilized and to consolidate fragmented ownership of land around strategic locations* (e.g., transit stations). As it stands, the tariff rates imposed under municipal rate policies on various categories of land use, including vacant land, are uniform regardless of the land's strategic importance. Local authorities could explore the use of a grading system within the vacant land use category, which could ensure that properties are fairly assessed and taxed in accordance with their strategic value within a neighborhood.

Action 9: Facilitate access to finance for projects in strategic areas

Another constraint to land development in strategic areas is the cost of financing for developers. The following options could be considered by the authorities:

- *Developing financial incentives for public-private partnerships to create affordable housing and commercial spaces* close to vibrant mixed-use transit station hubs.
- *Collaborating with the financial sector to expand mortgages/lending to projects close to businesses and transit centers,* including through the bounce-back credit schemes advocated in priority note 4.
- *Encouraging investments from private and institutional funds.* Several labor and trade unions in South Africa have substantial resources that

Another constraint to land development in strategic areas is the cost of financing for developers

Box 3 Opportunity zones in the United States

Opportunity zones (OZs) were designed in the United States with a simple premise: the tax code should encourage private investment in communities that are struggling to attract capital, create jobs, and lift residents out of poverty. OZs were first proposed in the bipartisan Investing in Opportunity Act, introduced in Congress in 2016. OZs provide federal incentives for certain types of long-term, productive investments in low-income urban and rural communities nationwide.

- OZs are low-income census tracts nominated by state governors and certified by the U.S. Department of the Treasury on which investors can make qualifying investments in new projects and enterprises in exchange for certain federal capital gains tax reductions. There are more than 8,700 OZs in the country, including in every state and territory. At the time of designation, 97.4% of the OZ communities qualified for OZ status under the Treasury Department's "low-income community" standard, and 2.6% qualified under the law's provision allowing tracts adjacent to a low-income community to receive designation under certain circumstances. Fully 71% of OZ communities met Treasury's "severely distressed" definition.
- All eligible investments must be made through a Qualified Opportunity Fund (QOF) to be eligible for the tax incentive. A QOF is any private investment vehicle organized as a corporation or partnership for the purpose of investing in OZs. QOFs must register with the Internal Revenue Service and invest at least 90% of their capital in qualifying investments within OZ communities.
- OZs offer investors three incentives for cashing out of these investments and putting their capital gains to work supporting the economic development of low-income communities.
  - The taxes due on any capital gains placed into a QOF may be deferred until December 31, 2026.
  - Investors who keep their money in a QOF for five years receive a 10% step-up in basis on that original investment and an additional 5% after seven years.
  - Investors who hold their investments in OZs for at least 10 years face no capital gains taxes on the investments when they sell them.

could be used for local economic development. For example, the United States created opportunity zones in poor urban communities to attract capital, create jobs, and lift residents out of poverty (box 3).

As cities expand and evolve, planners must continually update and reconcile their data sets to accurately reflect the current state of land use and development

Action 10: Use digital tools to improve urban planning and coordination

The rapid growth and changing dynamics of urban areas make it challenging for urban planners to keep pace with the evolving data landscape. As cities expand and evolve, planners must continually update and reconcile their data sets to accurately reflect the current state of land use and development. Failure to do so can result in outdated and inaccurate information, leading to poor land management decisions.

Additionally, the fragmentation of data collection across different government agencies and private organizations makes it difficult to obtain a comprehensive view of a city's land and resources. This lack of cohesive data can lead to inefficiencies and oversights in land management. Inaccurate or incomplete data can also exacerbate issues such as urban sprawl, inefficient land use, and environmental degradation. Without a clear understanding of the current state of urban land, planners struggle to develop effective strategies for sustainable and equitable land management.

The authorities could consider the following options for improving data collection and sharing and the use of digital tools:

- ***Accelerating the development and use of digital spatial planning platforms to boost information collection and sharing.*** Building on the successes of several modern cities around the world, the authorities could use spatial planning platforms to lay the foundation for smarter urban planning and management (box 4).
- ***Ensuring the efficient collection and sharing of data needed to inform decisionmaking in numerous applications,*** including urban planning, disaster risk management, public financial management, transport, and citizen and business services. Spatial planning platforms also reduce fragmentation and information asymmetries, which can improve institutional coordination and implementation efficiency.
- ***Supporting local governments in developing integrated urban land use, housing, and transportation plans that identify high-priority infrastructure investments*** in electricity distribution, public transit, road network expansion, and water supply and sanitation. Clear capital investment plans can then form the basis for a coherent financing strategy based on potential revenues.

Box 4 How smart cities around the world have used spatial planning platforms

Improved urban planning. In Dhaka, Bangladesh, the World Bank supported the development of GeoDASH, a public geospatial data sharing, management, and visualization platform that promotes interagency coordination of urban planning and disaster risk management by facilitating the sharing of data, resources, and infrastructure between agencies. The platform has been used to assess the current conditions of schools—their infrastructure, water and sanitation facilities, access to roads, and disaster resilience. Geospatial layers have also been used to generate cyclone risk maps to guide investment plans for cyclone shelters in urban and rural areas, as well as a coastal embankment improvement project focused on arresting erosion of vulnerable coastal polders. The World Bank is also supporting the development of a spatial planning platform in Can Tho, Vietnam, that will integrate spatial and nonspatial data on a publicly accessible web portal, allowing governments, businesses, and citizens to access geospatial information for urban planning, business services, mass transit and traffic management, disaster risk management, and other applications.

Improved infrastructure asset management. Yunnan Province in China wanted to expand its highway network to boost economic development, but it lacked asset management systems and integrated databases so that it could monitor road conditions and natural disasters and optimize road maintenance strategies. An integrated management information system was established with support from the World Bank to collect data on vehicular traffic and the performance of large infrastructure projects. The data were used in decisionmaking and performance evaluation of highway assets.

Increased resilience to climate change. In Sri Lanka, the World Bank helped develop RiskInfo, a public web-based disaster risk information platform for collecting, storing, processing, sharing, and analyzing geospatial data, including high-quality aerial imagery, risk exposure data, historical flood maps, and land-use maps. The platform is used to develop local multi-hazard risk maps that enhance understanding of disaster exposure, support disaster planning and preparedness and emergency response operations, and guide prioritization of resources for recovery and financial assistance. Timely and reliable data that allow for near real-time disaster monitoring have enabled more effective institutional coordination in Sri Lanka, especially during emergency responses.

Annex table A1 Ranking of measures through the "FIT" filter of feasibility, impact, and timing

		Feasible	Impactful	Timely	Total
Priority 1: Enhancing the performance of passenger railways					
Action 1: Incentivize PRASA to perform better	1. Using a results-based approach for allocating grants	3	3	2	8
Action 2: Leverage information technologies to increase management efficiency	2. Using digital dashboards to improve municipal management of urban transit systems	3	2	3	8
	3. Introducing digital ticketing for customers without digital bank accounts	3	2	3	8
	4. Tightening security and reducing thefts of rail infrastructure through real-time monitoring of crime areas	1	3	2	6
Action 3: Consider alternative models for passenger rail investment and operations	5. Opening the passenger railway sector to private operators	1	3	2	6
	6. Seeking partnerships with the private sector, especially on urban corridors with commercial prospects	1	3	2	6
Priority 2: Improving the efficiency and affordability of minibus taxis and integrating them into the urban transit system					
Action 4: Reduce the cost of transportation for poor customers	7. Distributing vouchers to poor customers	3	3	3	9
Action 5: Foster the integration of minibus taxis into the public transit system	8. Establishing a dialogue between the government and the minibus taxi industry to identify the reforms and supports needed to expedite industry development and consolidation	2	2	2	6
	9. Supporting municipalities with initiatives and technical support to better integrate minibus taxis into public transit networks	2	3	1	6
	10. Streamlining, updating, modernizing, and strengthening regulatory structures to improve performance and responsiveness to a restructured minibus taxi sector	2	2	2	6
Action 6: Incentivize individual minibus taxi operators to cooperate and organize themselves	11. Building on the lessons from pilot projects in Cape Town and Gauteng Province to accelerate cooperation, consolidation, and corporatization of the minibus taxi sector	2	3	2	7
	12. Providing technical and financial support to minibus taxi owners to create a more efficient market	2	2	2	6
	13. Supporting private operators in organizing themselves by helping them develop the data and digital tools needed for better coordination	3	2	2	7

		Feasible	Impactful	Timely	Total
Priority 3: Redirecting urban planning policies and regulations toward higher densification					
Action 7: Adjust zoning and land use regulations to encourage land and building development closer to business areas	14. Relaxing National Building Regulations and municipal zoning regulations and amending the Spatial Planning and Land Use Management Act	3	3	2	8
	15. Developing form-based guidelines for development in strategic transport corridors	2	2	2	6
Action 8: Adjust pricing mechanisms to encourage land development in strategic areas	16. Introducing financial bonuses for social housing projects in high-density areas close to business centers	3	3	2	8
	17. Implementing mechanisms to capture land values	2	2	2	6
	18. Strengthening regulatory mechanisms to discourage private land from laying idle and to consolidate fragmented land around strategic locations	2	3	1	6
Action 9: Facilitate access to finance for projects in strategic areas	19. Developing financial incentives for public-private partnerships to create affordable housing and commercial spaces close to transit hubs	2	3	2	7
	20. Collaborating with the financial sector to expand mortgages/lending to projects close to business and transit centers	3	2	1	6
	21. Encouraging investments from private and institutional funds	2	3	1	6
Action 10: Use digital tools to improve urban planning and coordination	22. Accelerating the development and use of digital spatial planning platforms to boost information collection and sharing	3	2	3	8
	23. Ensuring the efficient collection and sharing of data needed to inform decisionmaking in numerous applications	2	2	2	6
	24. Supporting local governments in developing integrated land use, housing, and transportation plans that identify high-priority infrastructure investments	2	3	3	8

Source: Authors.

Note: The scores range from 1 to 3, with 1 being the lowest. The actions with the highest score are highlighted in yellow.

Notes

1. Car ownership is 90% for White households but just 20% for black households (South Africa Statistics Office).
2. J. Baez and V. Kshirsagar, 2024, "Spatial Impediments to Economic Inclusion: An Analysis of South Africa's Local Labor Markets." World Bank, unpublished manuscript.
3. Virtual connectivity, which is becoming increasingly important for urban mobility, is not covered in this note (see box 1 later in the text for some explanations).
4. There is a large literature on this topic, including World Bank, 2009, *World Development Report 2009: Reshaping Economic Geography;* V. Henderson, 2003, "The Urbanization Process and Economic Growth: The So-What Question," *Journal of Urban Economics;* M. Greenstone, R. Hornbeck, and E. Moretti, 2010, "Identifying Agglomeration Spillovers: Evidence from Winners and Losers of Large Plant Openings," *Journal of Political Economy* 118 (3), 536–598.
5. This is partly explained by faster population growth in the main urban settlements, which continue to attract local migrants from the poorest, more rural provinces.
6. The latest household survey available is for 2014.
7. For example, Johannesburg's population expanded more rapidly than the national average, reinforcing the decline in income per capita in this city.
8. https://www.statssa.gov.za/publications/P0320/P03202020.pdf.
9. M. Shah and F. Sturzenegger, 2022, "Search, Transport Costs, and Labor Markets in South Africa." CID Research Fellow and Graduate Student Working Paper Series 2022.142, Harvard University, Cambridge, MA, October.
10. J. Morisset, 2023, *To reduce South Africa's unemployment, make work more attractive*, Brookings.
11. https://www.gov.za/documents/white-papers/national-transport-policy-white-paper-20-aug-1996. See also, for example, the 2007 Public Transport Strategy and Action Plan (DoT 2007) (PTSAP), which was followed by the integrated rapid public transit network program that was launched in 12 urban centers.
12. Implementation was supported with substantial funding through a dedicated capital grants to participating cities for integrated rapid public transit networks (more than $4 billion has been allocated to date) along with capital funding to PRASA for its modernization program (targeting rolling stock, station renewal, and signaling system upgrades).
13. Another reason that businesses have not been attracted to poor areas is the low purchasing power of residents, explaining why the density of formal jobs is three times lower in poor than in affluent urban areas and why spatial exclusion is still prevalent in all big cities. World Bank, 2014, "The Economics of South African Townships."
14. J. Baez and V. Kshirsagar, 2024, "Spatial Impediments to Economic Inclusion: An Analysis of South Africa's Local Labor Markets." World Bank, unpublished manuscript.
15. This principle is in line with the 1996 white paper on the National Transport Policy and National Land Transport Act (https://www.gov.za/documents/white-papers/national-transport-policy-white-paper-20-aug-1996) and the 2009 National Land Transport Act (updated in 2021). The rationale was twofold: bringing the decision process closer to customers (the well-known subsidiary principle in public finance) and addressing some of the coordination failures between central and local authorities.
16. https://documents1.worldbank.org/curated/en/594051468781195258/pdf/multi0page.pdf.
17. The World Bank, 2023, "Transforming Transit in South Africa: Formalizing Minibus Taxi Services in South Africa," December draft.
18. This is one of the lessons of the pilot project supported by the World Bank and the Development Bank of Southern Africa in Gauteng Province.
19. See policy note 2 for more details on this scheme.



Priority 4

Injecting dynamism into the private sector

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SOUTH AFRICA POLICY PACKAGE

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Priority 4

Injecting dynamism into the private sector



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SOUTH AFRICA POLICY PACKAGE

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Determine what is stifling private sector growth and unleash its potential

Private sector growth is the key to rapid and inclusive economic development. When firms expand, they invest in capital and technology, hiring more people and fostering virtuous circles between product and input markets, crucial for inclusive growth. This model has not yielded the desired outcomes in South Africa for many years, however. On average, firms have lost about 8%–10% of their productivity since 2011, meaning that they are becoming less efficient at using resources. These productivity losses, unprecedented globally over such an extended period, undermine competitiveness and inhibit the ability of the country's initiatives to alleviate some of the highest unemployment, poverty, and inequality rates globally.

To end this stagnation, policymakers need to confront the stultifying presence of the state, which has increasingly curbed the growth potential of the private sector. Complicated and restrictive regulations, along with direct market interventions such as those of state-owned enterprises (SOEs) with quasi-monopolistic control, have created market distortions. Creative destruction, the natural process of new firms entering the market and moribund ones exiting, which is vital for a vibrant private sector, has been largely absent. This stagnation has stifled innovation and diverted human and financial resources from future technologies and industries, disadvantaging both workers and customers.

Decisive reforms are essential to foster dynamism in the private sector. The government needs to focus on establishing an enabling environment that supports firms with the greatest growth potential. Attention needs to focus on two connected areas: promoting competition and foreign direct investment (FDI), particularly in digital finance and green industries, where the country already possesses strategic assets and has the potential to generate numerous direct and indirect employment opportunities, and supporting the emergence of dynamic and high-growth small and medium start-ups. In each of these areas, emphasis should go first to short-term actions that create momentum for longer term reforms. To guide policymakers, this note presents a menu of seven actions under two key priority areas, along with suggested reforms.

Swiftly changing global dynamics make it even more imperative that South Africa act rapidly to facilitate private sector dynamism.[1] The rapid emergence of megatrends, including fast-moving technological advances, presents both opportunities for innovation and growth and challenges such as digital exclusion and job displacement. Climate change compounds the challenges, manifesting particularly as extreme weather events and shifts in agricultural patterns within the country. Additionally, geopolitical shifts and the emergence of new regional trade agreements, notably the African Continental Free Trade Area, are altering trade, investment, and geopolitical alliances. Successfully navigating these global megatrends to increase the country's resilience and enable sustainable development necessitates strategies that capitalize on opportunities and address challenges. A robust and thriving private sector is critical to this effort.

Swiftly changing global dynamics make it imperative that South Africa act rapidly to facilitate private sector dynamism

South Africa's story of low productivity and the imposing presence of the state

Productivity improvements are the foundation for the dynamic firm behavior that is so crucial for economic growth and job creation. As Nobel Laureate Paul Krugman argued, "productivity isn't

everything, but in the long run it's almost everything." Productivity rises when firms boost their internal capabilities (within-firm productivity gains through innovation or adoption of new technologies or better management techniques) or when resources move from low- to high-productivity firms (between-firm productivity gains) as less efficient firms exit the market and new, more efficient firms enter it. Each of these components has a positive impact on aggregate productivity growth and economic transformation.

Understanding South Africa's productivity challenge is crucial because of the effects on economic growth and inclusion, accumulation of physical and human capital, and competitiveness in international markets

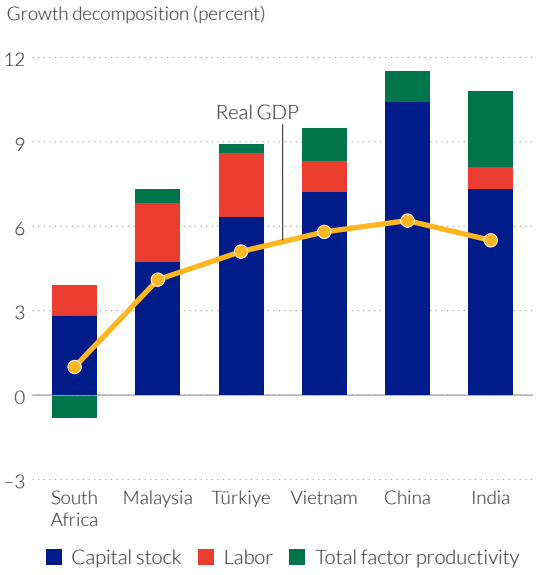
South Africa's productivity losses are costly

South Africa's productivity declined 0.8% a year over the past decade, explaining to a large extent the limited expansion of the economy. Contrast this weak performance with the rapid annual productivity growth in successful economies like India (+2.7%), Vietnam (+1.2%), China (+1.1%), and Malaysia (+0.5%) (figure 1). Had South Africa's productivity remained the same as it was in 2011 instead of declining, its GDP would have expanded by 3.9% a year between 2011 and 2022. And had its productivity growth over that period been the same as India's, its GDP would have grown by 6.6% a year.

South Africa's declining productivity has affected the entire economy but has been especially evident in labor. The gap in labor productivity between South Africa and the global average has widened in all sectors, with the biggest declines in agriculture and manufacturing (figure 2). World Bank enterprise surveys find even wider gaps between South Africa and other emerging market economies (figure 3).[2] While there have been "niches of excellence" in South Africa, such as in communication, they are rare.

Understanding South Africa's productivity challenge is crucial because of the direct effects on economic growth and inclusion and the indirect effects on the accumulation of physical and human capital and the country's competitiveness in international markets. Empirical evidence shows that low-productivity firms struggle to invest adequately in physical and human capital and to develop new technologies, and those investment deficits exacerbate their productivity woes.[3] This vicious circle explains why South Africa's employment, exports, and

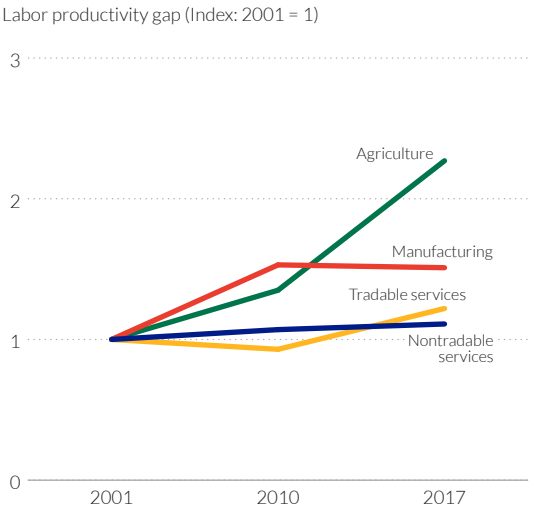
Figure 1 South Africa is on the wrong side of productivity growth, 2011–2022



Source: Authors using data from World Development Indicators database.

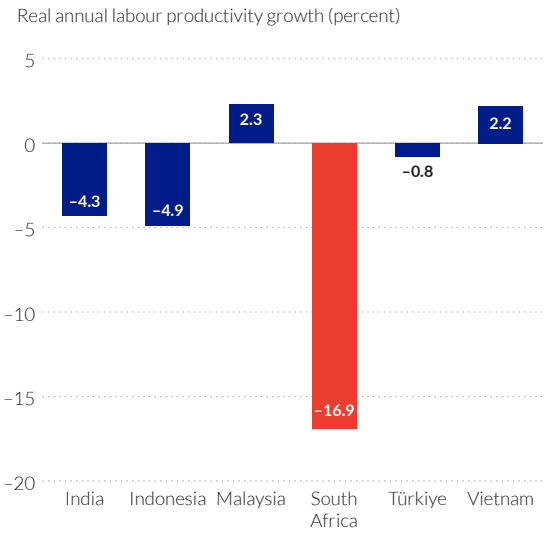
Note: Solow growth decomposition.

Figure 2 The gap in labor productivity between South Africa and the world is widening in all sectors, 2001–2017



Source: Authors using data from World Development Indicators database.

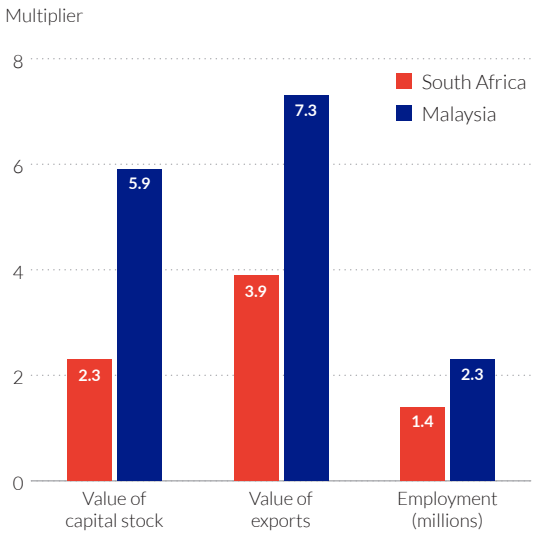
Figure 3 Drastic declines in labor productivity in South Africa relative to peers



Source: World Bank Enterprise Surveys (https://www.enterprisesurveys.org/).

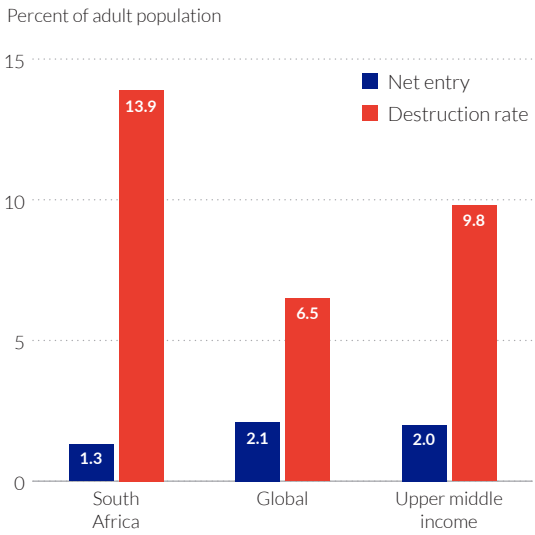
Note: The enterprise survey was conducted in different years in different countries. It was conducted in India in 2022, Indonesia in 2023, Malaysia in 2019, South Africa in 2020, Türkiye in 2019, and Vietnam in 2023.

Figure 4 South Africa has lost its development edge compared with Malaysia, 1990–2019



Source: IMF and World Bank databases.

Figure 5 Entry and exit of firms, 2021



Source: Global Entrepreneurship Monitor.

physical capital (as measured by the value of capital stock) expanded much slower than Malaysia's, for example, between 1990 and 2019 (figure 4).[4]

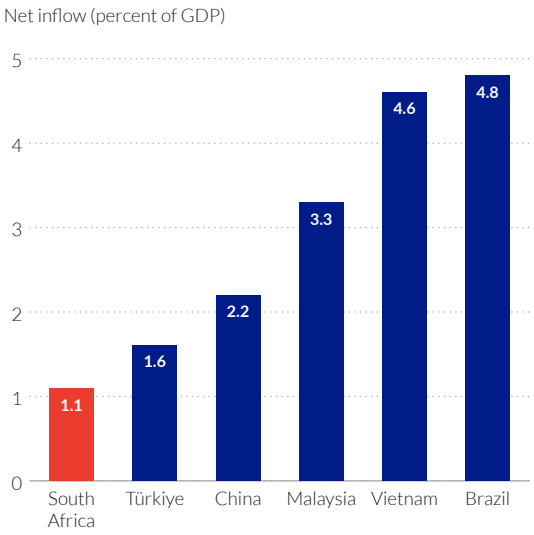
Low competition, low productivity

South Africa's productivity decline is, to a large extent, caused by the lack of competition in most economic sectors, which allows incumbents to remain unchallenged, sapping their drive to innovate. Lack of competition weakens the creative destruction process, whereby obsolete firms are replaced by innovate ones, and results in the lack of dynamism that has characterized the private sector in South Africa for years:

- Large firms have changed little over time. Of the 10 largest companies (by capitalization) in South Africa, 8 were also among the top 10 in 2000. Most of these firms are in traditional sectors like finance and mining, with two exceptions in the communication sector.
- Small and medium enterprises (SMEs) have grown more slowly in South Africa than in other middle-income countries. The net rate of new firm entry is notably sluggish, at approximately 60 percent of that in countries at similar income levels (figure 5).

South Africa's productivity decline is, to a large extent, caused by the lack of competition in most economic sectors, which allows incumbents to remain unchallenged

Figure 6 Foreign direct investment lags that in peer economies, 2011–19



Source: Authors using World Bank data. https://data.worldbank.org.

Firms in South Africa face elevated entry and operational costs

- The private sector's lack of dynamism makes it harder to attract high-value FDI. While South Africa is host to several multinationals, they tend to be heavily concentrated in natural resources sectors. The country's attractiveness to FDI lags economies like Türkiye, China, Malaysia, Vietnam, and Brazil (figure 6).

Table 1 Large firm dominance in South Africa compared with peers and the European Union, 2019

Country or group	Share of labor force (%)	Share of national GDP (%)
South Africa	74	61
Middle-income countries	35	54
European Union	32	43

Source: McKinsey, 2020, "How South African SMEs can survive and thrive post COVID-19," https://www.mckinsey.com/featured-insights/middle-east-and-africa/how-south-african-smes-can-survive-and-thrive-post-covid-19.

Note: Large firms are defined as firms with a turnover of more than $22 million a year.

So, the dominance of large incumbent firms has been only weakly challenged. Large incumbents continue to hold disproportionately high shares of revenue and employment in South Africa compared with other middle-income countries and counterparts in the European Union (table 1). The dominance of large incumbent firms makes it difficult for new firms to enter the market and allows incumbents to benefit from high markups. In concentrated markets, where firm entry and exit are limited, markups exceed global standards.[5] Markups by publicly listed firms increased 25% in South Africa from 2000 to 2016, more than four times the average global increase (6%).[6]

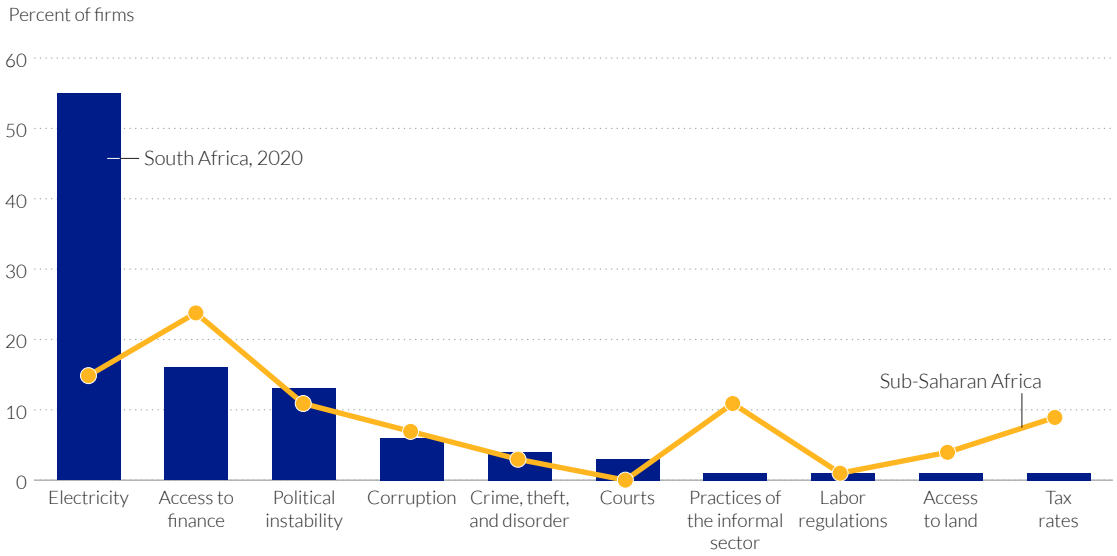
Market concentration has substantial costs for the economy, and these have risen over time.[7] When market power is concentrated in a few dominant firms, markets are unlikely to innovate and find solutions that will allow them to remain competitive over time. The International Monetary Fund estimates that South Africa could boost GDP per capita growth by 1 percentage point in the short term and up to 2.5 percentage points in the long-term by improving contestability in key markets.[8]

Excessive government intervention reinforces private sector inertia

Numerous studies have concluded that firms in South Africa face elevated entry and operational costs (figure 7).[9] Some costs, such as those associated with crime, corruption, and access to electricity, were as high as or higher than the average for Sub-Saharan Africa in 2020, and some have likely risen since then due to breakdowns in infrastructure services, especially electricity, transport, and water. Other costs are related to factors within firms, such as limited skills, poor internal organization, and outdated technology and equipment. And still others are related to serious failures by key stakeholders, such as the government, banks, and skill developers. Government failure is evident in the top constraint reported by firms, which is the poor quality of electricity services (the sector is dominated by the public utility Eskom; see policy note 2) and other public goods such as transport, water, safety, and justice.

Excessive and poorly designed public interventions have stifled private sector dynamism. The

Figure 7 The top-10 constraints reported by South African and Sub-Saharan African firms, 2020



Source: World Bank Enterprise Survey 2020.

South African government has employed various industrial and labor policies to tackle historical exclusion, but in the process has created market distortions and raised entry costs. Two undesirable outcomes have been market dominance by SOEs and poorly designed regulations that suppress firm growth and competition:[10]

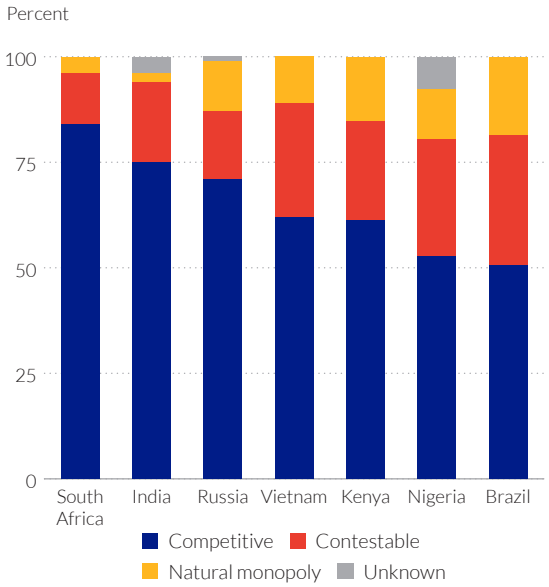
- ***Dominance of SOEs in several strategic sectors that deliver basic goods and services.*** During Apartheid, large SOEs or "national champions" were established to provide subsidized resources for industrial production, leading to concentrated ownership and anticompetitive practices. International trade restrictions further strengthened incumbents' market power. Building on the initial success of this model (for example, the public electricity utility Eskom was considered a global leader in the early 2000s), 22 primary SOEs and 82 subsidiaries are now operating in around 180 business segments along 47 supply chains.[11] The World Bank's Global Businesses of the State database records at least 725 active businesses linked to the government through direct and indirect full, partial, and minority ownership.[12] Shielded by protective policies, they wield quasi-monopolistic power in network industries (energy and transport) and dominate in commercial activities such as manufacturing, finance, and agriculture (figure 8).[13] Several SOEs have been found to have breached competition laws in trying to consolidate their market power.[14]

  Further, due to weak sectoral regulations and corporate governance, many SOEs deliver poor quality services, while facing huge financial and technical challenges. In addition to the electricity sector, such deterioration is evident in the water and transport sectors (see policy notes 2 and 3). These inefficiencies in network industries create substantial costs for businesses, lowering their productivity and depressing domestic demand.[15]
- ***Well-intended but poorly designed regulations to correct market failures.*** South Africa's SMEs spend an average of 202 working days (3.7% of the total workforce for the average SME) and $39,000 (R532,801) annually on administrative tasks.[16] Additionally, labor regulations to protect workers disproportionately burden small firms by impeding their ability to hire and thus exacerbate unemployment, especially among youth. Furthermore, industrial and affirmative action policies like the Broad-Based Black Economic Empowerment Act (B-BBEE), which are intended to extend shareholding to historically marginalized groups, have not been evaluated for effectiveness and forgone public revenue, while creating additional market distortions.[17] Finally, there are

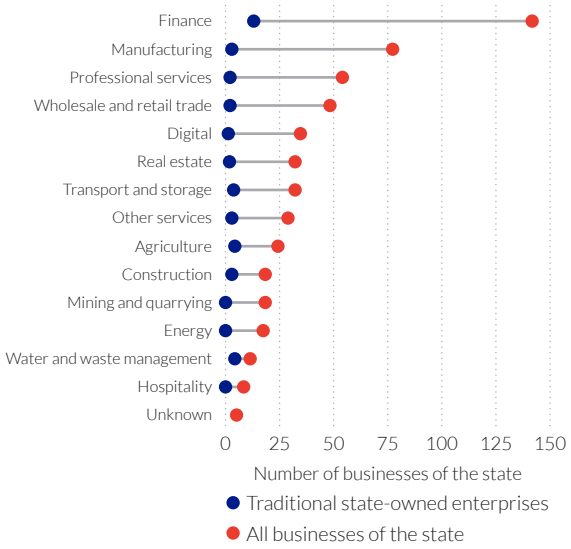
Productivity needs to grow 1%–2% a year to move South Africa toward high-income country status and significantly reduce poverty by 2050

Figure 8 **A majority of South African state enterprises operate in competitive sectors of the domestic economy, and they operate across an unusually wide range of sectors**

Nearly all state enterprises operate in competitive or contestable economic segments



The broad sectoral reach of South African state enterprises



Source: World Bank Global Businesses of the State database 2019.

severe regulatory limitations to competition in key sectors of South Africa's economy: the level of restrictiveness is close to three times higher than that in the top-performing countries.[18]

Unleashing the potential of high-growth firms, with a focus on two priority areas

For the private sector to drive growth and employment in South Africa, productivity will need to rise 1%–2% a year. This is the rate of productivity growth required to move South Africa toward high-income country status and significantly reduce poverty by 2050, according to the long-term growth model developed by the World Bank.[19] While fast-growing economies in Asia have attained this rate of productivity growth (see figure 1), it would represent a substantial turnaround for South Africa.

To achieve this goal, South African policymakers could apply two key lessons from successful economies. First, focus on creating a conducive environment that fosters the development of high-growth firms and industries that could in turn provide wide economic benefits. Second, minimize interventions by liberalizing markets to increase contestability and competition, which are the main forces propelling a creative and dynamic economy. Other countries have derived substantial gains from following these practices , not only creating a dynamic private sector, but also reducing pressure on the public budget, creating new jobs, and producing more, better quality, and less expensive products.

Sustained productivity growth does not necessarily stem from improvements across all businesses simultaneously but is typically driven by advances in a small set of high-growth firms.[20] A recent World Bank study found that high-growth firms are powerful drivers of job creation and output growth.[21] While making up 20% or less of firms in manufacturing and services, high-growth firms generate as much as 80% of all new sales and job opportunities in these sectors. Apart from their pivotal contribution to job creation and output growth, high-growth firms also produce positive spillovers to the economy by transferring knowledge, creating networks, and fostering competition, leading to price reductions.

High-growth firms are powerful drivers of job creation and output growth by transferring knowledge, creating networks, and fostering competition

Most high-growth firms in rapidly growing economies emerge from two transformational processes. First, many high-tech startups experience rapid and sustained growth due to qualities intrinsic to the firm. Examples include Flipkart in India, Airbnb in the United States, and Bolt in Estonia. The policy objective is to provide such firms with access to financial and technical resources that allow them to realize their potential. Second, some high-growth firms emerge in strategic sectors in which the country possesses or is cultivating a strong comparative advantage. Examples include apparel and electronics in Vietnam, green industry in China, and call center services in the Philippines.

Targeting high-growth firms—by aiming to boost policy selectivity and efficiency—has become increasingly appealing to policymakers in both high-income and developing countries. However, for venture capitalists as well as policymakers, it is more an art than a science to identify businesses with high potential and implement measures to expedite their growth.

Drawing from these lessons, this note advocates a targeted strategy to support the creation and scaling up of high-growth firms in South Africa by focusing on two priority areas:

- ***Fostering competitiveness in industries of the future.*** Firms operating in these sectors need to adapt to shifts in technology and consumer demand. Recent successes in the telecommunication and aviation sectors demonstrate that South Africa can increase contestability by reducing barriers to entry and aligning incentives to market needs. Today, after liberalization measures in the early 2000s, the telecommunication sector in South Africa is one of the most advanced in the region, connecting more than 203 million people in 22 countries across Africa and the Middle East. The sector undoubtedly benefited from global forces and the technological revolution, but the results would likely not have been as impressive had the authorities not fostered greater contestability. This lesson could be replicated in other sectors, such as digital finance and green industries.
- ***Upgrading the capabilities of high-growth SMEs.*** A combination of steps to facilitate firm entry and expansion can unleash their potential. The emergence of a vibrant SME startup and expansion ecosystem will not only generate productivity gains but also gradually erode the dominance of incumbent firms, increasing competition, creating jobs, boosting innovation, and further elevating productivity over time.

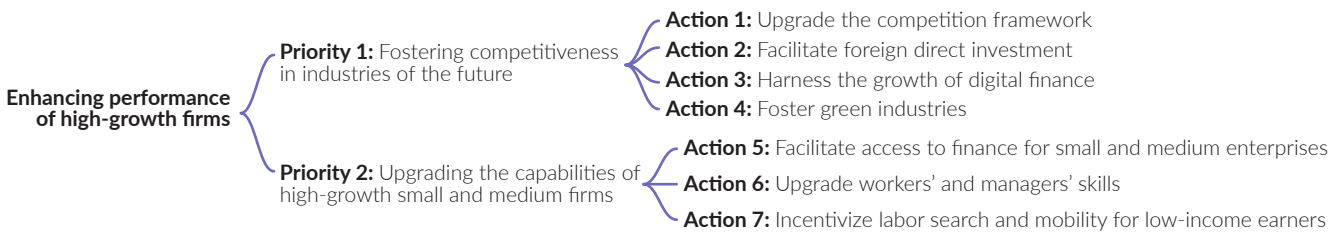
These two priorities could be supported by a set of seven actions and 18 proposed reforms. These actions and proposed reforms were selected for technical and political feasibility, ability to make a difference (impact), and the feasibility of their implementation in the short term. While the most desirable actions would ideally meet all three criteria, tradeoffs are likely to arise (see table A1 in the annex).

Of the 18 reforms, 5 have been assessed as the most technically and politically feasible, impactful, and timely:

1. ***Strengthening oversight of SOEs and liberalizing the markets in which they operate*** to improve their performance and make room for private sector investments.
2. ***Streamlining firm entry and operational prerequisites for foreign investors related to the 2013 B-BBEE Act*** by making systematic use of Equity Equivalence Investment Programs when investors commit to train Black workers and develop supply chains with local businesses.
3. ***Authorizing nonbank institutions to issue mobile money*** to reduce transaction costs and

A strategy to support the creation and scaling up of high-growth firms in South Africa could focus on upgrading SME capabilities and fostering competitiveness in industries of the future

Figure 9 A guiding framework for prioritizing policies to enhance the development of high-growth firms



improve the financial inclusion of small and informal businesses.

4. ***Increasing liquidity in carbon credit markets*** to incentivize the shift to green sectors.
5. ***Increasing the provision of venture capital for high growth startups*** to improve their access to external financing.

Priority area 1: Fostering competitiveness in industries of the future

While promoting market openness is a fundamental principle underlying the recommendations in this note, implementing it universally may prove challenging, for two main reasons. First, strategic sectors, particularly infrastructure, may require direct state intervention due to their inherent public goods nature. Second, introducing measures to promote competition and contestability could face opposition from incumbent firms and interest groups that could lose privileges during the transition.

South Africa's financial market is the most developed on the continent, but small firms face the same challenges in getting access to financial products as they do in other countries

These challenges suggest the need to achieve short-term results and demonstrate successes. Prioritizing knowledge industries has been a successful strategy in several fast-growing economies, such as Chile, Korea, and Malaysia, with productivity increasing twice as fast in these industries as in others and contributing substantially to job creation in both developed and developing countries over the past decade.[22]

South African policymakers could focus on two future-directed knowledge- and technology-intensive sectors: digital finance and the green economy—activities that are just emerging in the country. This approach would align with South Africa's emerging strengths in these two sectors, where investor interest is already evident, including that of foreign investors. Prioritizing digital finance and the green economy would require developing the skill and technology capabilities needed to meet current and future demand from local and international consumers, driven by technological advances and climate considerations.

Four policy actions are proposed to maximize the competitiveness of strategic, forward-looking sectors. Two are cross-sectoral and aim to improve the competition framework and ease the barriers to entry for FDI, and two are specific to digital finance and the green economy.

Action 1: Upgrade the competition framework

Promoting competition and creating a level playing field for firms will entail comprehensive reforms to prevent market dominance by a few firms, including SOEs. Sustained efforts will be required to bring about significant change. In the meantime, immediate attention could be given to:

- ***Enhancing the competition policy framework.*** Eliminating regulations that restrict competition is an important first step, as Australia, Chile, Colombia, and other countries have done to great effect. Systematic assessments of current regulations and incentives are needed to evaluate their design appropriateness and impacts, including direct and indirect effects on markets, and to identify gaps requiring attention. Enforcement could be strengthened by incorporating the perspectives of the Competition Commission of South Africa into sectoral reforms aimed at promoting competition and mitigating the risks of abuse of dominance.
- ***Strengthening oversight of SOEs, and liberalizing the markets in which they operate*** in order to attract private investments. In the short to medium terms, this will require systematizing information on the real economic footprint of the state, including the government's indirect and minority shareholdings. In the medium term, the government could clearly delineate the different economic rationales for state ownership in commercial and noncommercial sectors, thus separating their mandate. This would introduce checks and balances for SOE expansion and state ownership of businesses, while identifying less distortive mechanisms to achieve policy objectives. Additionally, oversight mechanisms should be restructured to strengthen the governance frameworks and practices of SOEs by incorporating good governance principles into SOE management to enhance their performance. Systematically evaluating SOEs' attainment of public policy goals is also essential, as is identifying the risks SOEs pose.

Action 2: Facilitate foreign direct investment

FDI has been crucial to the success of East Asian economies, allowing them to catch up with more advanced

economies, which own most of the new technologies. This channel has become even more important as the pace of innovation has accelerated. Attracting foreign investors is an explicit element of South Africa's development strategy, supported by significant reductions in entry barriers[23] and by top officials promoting South Africa at international trade events.

Despite these efforts, South Africa has fallen short of its goal of attracting more and higher quality FDI (see figure 6). One factor behind this underwhelming performance has been the confusing signals sent by the authorities to investors. On the one hand, the authorities have lowered barriers and offered cash grants, tax allowances, concessional funding, and preferential infrastructure access through a complex targeting system to attract FDI.[24] On the other hand, various industrial policies (such as the B-BBEE, local content requirements, and public procurement), though not explicitly targeting foreign companies, have significantly increased the cost of doing business in South Africa. These policies often discourage foreign firms, which typically operate on a global scale and can easily opt for locations with fewer economic obstacles.

A better approach for South Africa is to streamline entry and operational requirements for foreign investors. Both economic theory and real-world evidence show that clear and stable regulations do more to attract FDI than complex benefit arrangements. Malaysia and Mauritius, two of the most successful countries in attracting FDI, began to show results as they lowered standard tax rates while eliminating most of their incentives during the past 10 years. This policy change enabled them to lower both investment costs for foreign firms and the associated monitoring expenses for public administrators.

The first-best option would be to replace most incentives with a more investor-friendly common regime that is easy to navigate for investors, as Malaysia and Mauritius have done. However, given the complex social and political context in South Africa, the government could consider the simpler and more practical approach of focusing on the most binding constraints:

- ***Streamlining firm entry and operational prerequisites related to the 2013 B-BBEE for foreign investors*** by making systematic use of Equity Equivalence Investment Programs when investors commit to train Black workers and develop supply chains with local businesses. The B-BBEE requires companies to meet specific thresholds of Black ownership and management control to participate in government tenders and contracts. While the B-BBEE is well intentioned, managing required scorecards places a heavy burden on public administration and foreign companies. The government has taken actions to reduce this burden by adopting the Equity Equivalence Investment Program, which has been applied to IT companies (Microsoft and Amazon Web Services) and banks (J.P. Morgan) since 2021. This revised approach replaces B-BBEE requirements with local worker training and supply chain development with local companies. The government's next step could be to extend these programs more broadly by clearly outlining eligibility criteria for investors interested in participating.
- ***Exempting investment projects in strategic sectors in export processing zones from national regulations.*** In China and Vietnam, where national laws and regulations impose substantial burdens on enterprises, as in South Africa, governments established "geographic islands" where exporters dealing with foreign competition can apply extraterritorial laws and regulations. For instance, labor laws in these geographic islands offer greater flexibility in hiring and firing workers than do national laws and regulations, which is balanced by higher salaries or additional benefits in areas such as housing, schooling, and training.
- ***Accelerating the issuance of work permits for qualified workers.*** Foreign investors often encounter barriers in the form of complex work permit requirements to bringing in expatriate staff with specialized skills. Simplifying the work permit process for skilled professionals through streamlined visa procedures, as in Malaysia and the United States, could go far in attracting and retaining high-value investments and facilitating knowledge transfers to South Africa. Expediting the proposal to streamline business visa procedures would be instrumental in achieving this goal. For example, professionals who earn above a certain high salary (say, R40,000 a month) and have a contract with a recognized tax-paying

Promoting market openness may prove challenging—so there is a need to achieve short-term results and demonstrate successes

firm in good standing could be granted a limited-time visa (say, three years), subject only to the usual health and criminal background checks.

Action 3: Harness the growth of digital finance

Foreign direct investment has been crucial to the success of East Asian economies; attracting foreign investors is an explicit element of South Africa's development strategy

South Africa's financial sector is by far the most developed on the continent, but costs are high, making access to financial services difficult for smaller firms and poor households. The transition to digital banking and the emergence of financial technologies (fintech) offer an opportunity to lower access barriers through a diverse range of new products and services, including online banking, mobile payments, peer-to-peer lending, digital wallets, and financial management tools. Fintech is intensifying competition for banks, which are under pressure to upgrade their services.

To leverage the development of digital finance, South Africa could adopt a series of simple-to-implement measures in the short-term, as Kenya, Nigeria, and several other countries in Africa have done:

- ***Adjusting South African Reserve Bank (SARB) regulations to ease administrative process for the entry of fintech providers.*** Key hurdles include unclear application of regulations and lengthy licensing processes for new fintechs. While regulations are vital for quality assurance and consumer protection, a balance is needed that also seeks to minimize entry barriers. For instance, the SARB can improve and streamline the current sandbox process,[25] expanding its scope in the medium term and establishing a fintech roadmap for post-sandbox engagement. The framework developed in the European Union can serve as reference.
- ***Authorizing nonbank institutions to issue mobile money.*** While mobile money was introduced in South Africa as early as 2010, nonbank institutions, such as mobile network operators and fintechs, have not been authorized by the monetary authorities to issue e-money or access the national clearinghouse and settlements system. This precautionary measure may be excessive now that e-money has proved to be a secure and innovative payment solution in many countries. E-money has evolved to support electronic payments and serve as a platform for distributing financial services. The South African authorities, led by SARB and the National Treasury, are amending the National Payments Act to allow nonbanks to access the payments systems and participate in the Payments Association of South Africa. This move aims to enhance competition in the banking sector, reduce costs for customers, and promote financial inclusion. Integrated universal QR codes and interoperability between payment providers, as in the Quick Response services in Ghana and Nigeria, will be crucial for enabling this transition.
- ***Developing a framework for open finance.*** Many countries have implemented a framework for open finance, a multilateral and open data-sharing regime that enables all parties that meet defined requirements to exchange data, including customer data. The policy motivations for open finance include increasing competition in concentrated financial markets by allowing new entrants to engage with consumers and their financial data more easily, simplifying the know-your-customer process, encouraging product innovation through better consumer data and enabling payment initiation, and deepening financial access and inclusion for consumers. Less than two years after its launch, Brazil's open finance system reported serving more than 27 million customers with 41 million accounts as of September 2023.

Action 4: Build a platform for developing a green economy using catalytic market instruments

South Africa should move gradually but decisively from a strategy based on its historical advantage in coal to leveraging its assets in the green economy. Not only does the country have abundant natural green energy resources, such as sunlight, wind, vast land areas, and valuable minerals like platinum and chromium, but it also boasts one of the most robust mining and industrial bases. These resources can be used to produce products like batteries and electric vehicles, which will be in high demand in global markets in coming decades.[26] The government has recognized this opportunity, understanding that the transition to a green economy can provide a new impetus for the country's development and address

the urgent need for more jobs.[27] The transformation to a low-carbon economy could generate up to half a million jobs by 2050.[28]

The transition to a green economy is a shared objective of most countries, and South Africa needs to act swiftly to leverage its advantages and establish itself as a regional leader.[29] While large investments in physical and human capital will be necessary to manage this transition efficiently, the process can be fast-tracked by introducing a series of market instruments that will incentivize both the government and the private sector to move in this direction:[30]

- *Accelerating implementation of the carbon tax.* The government is following a phased approach to implementing a carbon tax. Introduced in 2019, the carbon tax combines a low tax rate and numerous exemptions until 2026 to allow firms to adjust to the new conditions. However, the carbon price remains effectively zero for exempted activities, at $8.20 per ton of carbon dioxide in 2023 and increasing to about $16 by 2026. This rate is too low to induce significant behavioral change, given that the estimated damage from climate change resulting from a ton of carbon dioxide emissions is $35.

  The recommendation is to streamline the list of exempted activities and accelerate the carbon tax rate increase. Another reason to expedite the carbon tax is that, when entering industrial country markets, South African exports will increasingly face a carbon tax on carbon-intensive products, like the EU's Carbon Border Adjustment Mechanism. From a fiscal perspective, it would be more advantageous to collect this tax domestically rather than paying foreign governments. If the concern is to maintain firms' competitiveness during the transition, the government could consider reducing other taxes, such as those on labor, to stimulate job creation by easing labor costs and incentivizing firms to increase energy efficiency and invest in cleaner energy sources.
- *Increasing liquidity in carbon credit markets.* Carbon credit markets have already been quite successful in South Africa, but the markets have essentially been dominated by one company (Sasol). Developing domestic standards for local service providers to issue and validate carbon credits could broaden the market. Such standards could prioritize offsets that generate sustainable development co-benefits and employment opportunities within South Africa, while simultaneously increasing the number of credits available on the market and fostering cost-effective mitigation of greenhouse gas emissions.
- *Reorienting incentives and support programs from fossil fuels toward new green activities.* Under its G20 commitments, the South African government attests that it does not provide fossil fuel subsidies that encourage wasteful consumption. In practice, however, Sasol, which supplies roughly 30% of the country's fuel and is the largest contributor to the country's carbon emissions, benefits from preferential arrangements, such as the fuel pricing mechanism and a recent carbon tax exemption. These preferential benefits are costly for taxpayers and slow the transition to a low-carbon economy. Additionally, support to the coal industry, including debt relief packages provided to Eskom by the National Treasury over the past decade, incurs substantial costs to the state.

  While such interventions may be partially justified for energy security reasons, the government can gradually shift its support toward green activities, for example, by financing a temporary value-added tax exemption and subsidizing credit lines on the purchase of renewable energy equipment by small businesses and households (see policy note 2). These resources could also be used to finance the exploration of new mineral deposits and the development of green industrial parks. Encouraging development of the battery industry in South Africa could also yield substantial benefits, considering the country's potential to be a major player in this industry (box 1).

Priority area 2: Upgrading the capabilities of high-growth small and medium enterprises

In recent years, the government has started to emphasize promoting agile and innovative small firms.[31] The Department of Small Business Development is deploying a one-stop shop to streamline business registration and has proposed a series of support programs to facilitate access to cheaper credit and

South Africa's financial sector is by far the most developed on the continent, but costs are high, making access to financial services difficult for smaller firms and poor households

Box 1 South Africa's strong potential in the battery market

South Africa has the opportunity to play a significant role in the global battery value chain, which is likely to grow by more than 3,000 gigawatt hours (GWh) by 2030. The country's domestic battery storage market is expected to reach 10 GWh by 2030, driven primarily by the electric vehicle sector. Integrating renewable energy sources into the grid, particularly solar photovoltaic and wind, necessitates adequate storage solutions, such as battery energy storage systems, to balance the grid. South Africa has already released grid-scale energy storage tenders in response to this need. The projected expansion could potentially create 25,000–55,000 direct and indirect jobs, depending on various factors.

South Africa is well-endowed with many of the minerals needed to produce lithium-ion batteries. It has benefited from early-stage activities in this value chain as well as from a diversified automotive industry that is strongly dependent on exports and will need to transition to the manufacturing of electric vehicles. Battery pack assembling and battery energy storage system integration opportunities also exist. Battery cell manufacturing at the estimated needed market scale is feasible. More challenging for South Africa is producing cathode active–material, lithium salts, and separators. Achieving the required manufacturing scale (15–20 GWh equivalent) and overcoming technological barriers require working at a larger scale than the domestic market. Additionally, local companies would require technological support from entities with a substantial market presence.

The government plays a crucial role in directing industrial policy toward developing the local battery value chain, prioritizing the production of minerals, battery materials, and energy storage systems for stationary and industrial use. Despite the region's abundant stores of battery minerals, mineral beneficiation has declined in South Africa. To help South Africa enter the global battery value chain, the government could:

- Explore policies and incentives for the beneficiation of battery minerals.
- Foster regional collaboration through bilateral trade talks with neighboring countries Democratic Republic of Congo, Mozambique, Tanzania, and Zimbabwe.
- Establish a research program on energy storage systems, with a focus on engineering, manufacturing technologies, and systems integration.
- Establish a competitive battery testing and certification facility.
- Facilitate the establishment of a training program for the battery industry by the Energy and Water Sector Education Training Authority in collaboration with universities and the battery industry.
- Improve access to finance, possibly with subsidized credit through public-private sharing instruments.
- Consider tax incentives for investments in this sector, such as accelerated depreciation of credits.
- Introduce regulations to encourage the use of electric vehicles, which will increase domestic demand for batteries.
- Streamline and accelerate the application process for projects.

Some of these actions will incur fiscal costs. To make them budget neutral, the authorities will have to reallocate some existing energy subsidies to the battery industry.

Source: World Bank, 2023, *Battery Storage Market and Value Chain Assessment in South Africa—Synthesis Report (English).* Washington, DC: World Bank. http://documents.worldbank.org/curated/en/099155502102332395/P17268201ebc89050b1960f40c8377523a.

to upgrade skills.[32] Yet, a 2020 McKinsey survey reveals that only 36% of small firm owners acknowledged receiving any kind of government support, either because of lack of awareness or because of procedures that are perceived to be complex and uncertain.[33] Closing the information gap and streamlining procedures could help, but more actions are needed. SMEs face deep structural constraints that require fundamental changes, including removing obstacles in addition to simplifying processes.

A menu of three actions is proposed to accelerate the development of SMEs. These actions aim to facilitate their access to finance, to upgrade their skills, and to incentivize low-earning workers to join the labor force or become entrepreneurs.

Action 5: Facilitate access to finance for small and medium enterprises

South Africa's financial market is the most developed on the continent, but small firms face the same challenges in getting access to financial products as they do in other countries. The World Bank estimates that only one in three SMEs in South Africa, including just 15% of startups, benefit from external financing, which is similar to the regional average but lower than in Ghana and Kenya.[34] This is disproportionately low given the size of the domestic credit market (equivalent to 120% of GDP) and the availability of more than $600 billion in private wealth, including funds accumulated by pension funds, and reflects both supply and demand weaknesses.

Nonetheless, several short-term improvements are feasible:

- ***Increasing the provision of venture capital for high-growth startups.*** Encouraging the development of venture capital can reduce the financing challenges faced by SMEs. Scaling up private–public initiatives such as the South Africa SA SME Fund has considerable potential. Established as a collaboration between government and business, this initiative has raised funds from the Public Investment Corporation and some 50 publicly listed firms, channeling more than $65 million (R3.61 million) in risk-based capital to small and innovative firms in less than two years. This risk-sharing model, in which government assumes the first loss, could be extended to

domestic institutional investors (such as pension funds, which own assets equivalent to 100% of GDP). In several Organization for Economic Co-operation and Development (OECD) countries, such funds are authorized, under strict regulations and supervision, to invest in small businesses and funds. They contribute to two-thirds of venture capital funds in the United States and one-fifth in Europe.

- ***Reviewing and redesigning public credit support programs, phasing out direct lending, upscaling partial credit guarantees, and introducing monitoring and evaluation frameworks.*** South Africa has more than 50 government credit programs, including direct lending, guarantees, and wholesale lending, totaling 0.36% of GDP, or 2.8% of SME credit in 2020. Despite initiatives like Khula Credit Guarantee (KCG), underutilization persists due to eligibility and risk criteria barriers. KCG guaranteed R248 million in loans to 87 SMEs in 2020, a mere 0.005% of GDP, compared with 0.03% of GDP in Mexico and 4% in Korea. The impact of these programs remains uncertain, however, because data on nonperforming loans and robust impact studies are lacking. Improved coordination and consolidation, along with fintech integration, are vital for enhancing SME credit delivery.
- ***Reforming policies and regulations to upgrade the credit information environment and the secured transaction framework.*** Steps to strengthen the credit information environment include mandating reporting of commercial credit information by SMEs and commercial credit institutions to credit bureaus, enhancing use of alternative data for assessing credit risk, and establishing a legal framework for a central credit registry. Other steps include establishing a movable asset registry, which could reduce collateral requirement barriers and enable lenders to claim assets in case of default, in alignment with the Department of Small Business Development's strategic plan.[35] Countries including Ghana, Nigeria, and Zambia have adopted a movable asset registry.

Action 6: Upgrade workers' and managers' skills

The skills deficit in South Africa is exacerbated by deficiencies in the education system that particularly affect disadvantaged groups. To address this, the authorities could consider:

- ***Scaling up workplace-based learning programs in SMEs.*** These programs are currently highly concentrated in large firms. This measure is further detailed in policy note 1.
- ***Improving training in digital skills, which are critical for most SMEs.*** Digital technologies present an opportunity for SMEs in South Africa to expand their reach and lower the cost of increasing their efficiency. Around half of South Africa's SMEs have embraced digital technologies, but adoption rates are behind those of countries including Brazil, Malaysia, and Türkiye, where adoption rates reach 70%. Data from the Department of Higher Education and Training and LinkedIn show that 10 of the top 11 in-demand skills are in the information and communication technology sector, with many job vacancies.

  The government could partner with private information technology (IT) companies, following the Philippine model, to foster early acquisition of IT skills and improve tertiary IT education. This approach created more than 1.5 million IT/business process outsourcing jobs in the Philippines, including through innovative local start-ups. South Africa could also emulate Malaysia's national commercialization platform, PlaTCOM Ventures, which supports students and young entrepreneurs in transforming ideas into digital products and services.

Action 7: Incentivize labor search and mobility for low-income earners

Increasing returns for low-income earners would boost employment and small enterprise creation. Low labor demand, high income taxes, and steep transportation costs discourage workers from entering the labor market or starting businesses. A worker in South Africa typically receives only half the income of a worker in Vietnam with the same base earnings (see policy note 3).[36] Reducing these costs would enhance firms' ability to hire workers and incentivize individuals to establish their own businesses, particularly as many low-income workers enter the labor market through self-employment.

South Africa should move gradually but decisively from a strategy based on its historical advantage in coal to leveraging its assets in the green economy

The government can act quickly to reduce costs to low-income workers and make employment a more attractive option:

- ***Lowering transportation costs for low-income workers to improve job search.*** Transportation costs absorb on average 80% of the earnings of low-income workers. Several solutions are discussed in policy note 3, including subsidizing trips in minibus taxis, which are by far the most frequently used mode of transportation by low-income workers.
- ***Reducing the entry tax rate of the personal income tax*** from 18% to, say, 5%, or increasing the threshold for paying the personal income tax, an approach used in many East Asian economies. The benefit is clear for low-income workers (who will take home more money), and the costs to the government will be low, as South Africa's top income decile contributes almost 80% of personal income tax revenue.

Annex table A1 Ranking of measures through the "FIT" filter of feasibility, impact, and timing

		Feasibility	Impact	Timing	Total
Priority area 1: Upgrading the capabilities of high-growth small and medium enterprises					
Action 1: Facilitate access to finance for small and medium enterprises	1. Increasing the provision of venture capital for high growth start-ups	3	3	2	8
	2. Reviewing and redesigning public credit support programs, phasing out direct lending and introducing monitoring and evaluation frameworks	2	2	1	5
	3. Reforming policies and regulations to upgrade the credit information environment and the secured transaction framework	3	2	1	6
Action 2: Upgrade workers' and managers' skills	4. Scaling up workplace-based learning programs in small and medium enterprises	2	2	2	6
	5. Improving training in digital skills, which are critical for most small and medium enterprises	2	2	1	5
Action 3: Incentivize labor search and mobility for low-income earners	6. Reducing the entry tax rate of the personal income tax	2	2	1	5
	7. Lowering transportation costs for low-income workers and job searchers	1	3	2	6
Priority area 2: Fostering competitiveness in industries of the future					
Action 4: Upgrade the competition framework	1. Enhancing the competition policy framework	1	2	2	5
	2. Strengthening oversight of state enterprises and liberalizing the markets in which they operate	2	3	2	7
Action 5: Facilitate foreign direct investment	3. Streamlining firm entry and operational prerequisites for foreign investors related to the 2013 Broad-Based Black Economic Empowerment Act	1	3	3	7
	4. Exempting investment projects in strategic sectors in export processing zones from national regulations	1	2	1	4
	5. Accelerating the issuance of work permits for qualified workers	1	2	1	4
Action 6: Harness the growth of digital finance	6. Adjusting South African Reserve Bank regulations to ease administrative processes for entry of fintech providers	2	3	1	6
	7. Authorizing nonbank institutions to issue mobile money	3	3	3	9
	8. Developing a framework for open finance	2	2	1	5
Action 7: Build a platform for developing a green economy using catalytic market instruments	9. Accelerating implementation of the carbon tax	1	2	1	4
	10. Increasing liquidity in carbon credit markets	3	2	2	7
	11. Reorienting incentives and support programs away from fossil fuels and toward new green activities	1	3	1	5

Source: Authors.

Note: The scores range from 1 to 3, with 1 being the lowest. The actions with the highest score are highlighted in yellow.

Notes

1. N. Stern and M. Romani, 2023, "The Global Growth Story of 21st Century, Driven by Investment and Innovation in Green Technologies and Artificial Intelligence," Grantham Research Institute on Climate Change and the Environment, January.
2. These surveys were conducted in different years: 2022 in India, 2023 in Indonesia, 2019 in Malaysia, 2020 in South Africa, 2019 in Türkiye, and 2023 in Vietnam. For India and Indonesia, the surveys were conducted during or right after the Covid-19 pandemic, which could explain the declines.
3. For example, McKinsey (2020) estimates that a productive firm in South Africa is 2.6 time more likely to invest in research and capital accumulation than an unproductive one. "How South African SMEs can survive and thrive post COVID-19," https://www.mckinsey.com/featured-insights/middle-east-and-africa/how-south-african-smes-can-survive-and-thrive-post-covid-19.
4. Contrary to common perception, productivity growth and employment growth are not mutually exclusive goals. Recent empirical research shows that businesses with rising productivity contribute significantly to investments in capital and technology and, critically, exhibit the highest increases in employment. R. Hornbeck and E. Moretti, 2019, "Who Benefits from Productivity Growth? Direct and Indirect Effects of Local TFP Growth on Wages, Rents, and Inequality," NBER, Working Paper 24661, January, http://www.nber.org/papers/w24661.
5. See, for example, J. Fedderke et al., 2018, "Markups and Concentration in South African Manufacturing Sectors: An Analysis with Administrative Data," *South African Journal of Economics*, vol. 86 (January).
6. International Monetary Fund, 2020, IMF Working Paper "African Department Market Power, Growth, and Inclusion: The South African Experience," https://www.imf.org/-/media/Files/Publications/WP/2020/English/wpiea2020206-print-pdf.ashx.
7. See P. Aghion and P. Howitt, 1998, "A Schumpeterian Perspective on Growth and Competition," in F. Coricelli, M.D. Matteo, and F. Hahn, eds, *New Theories in Growth and Development*, London: Palgrave Macmillan, https://doi.org/10.1007/978-1-349-26270-0_2.
8. International Monetary Fund, 2020. IMF Working Paper "African Department Market Power, Growth, and Inclusion: The South African Experience," https://www.imf.org/-/media/Files/Publications/WP/2020/English /wpiea2020206-print-pdf.ashx.
9. For a summary, see, World Bank, 2018, "An Incomplete Transition," Systematic Country Diagnostic; and World Bank, 2022, "Diagnosing South Africa's High Unemployment and Low Informality."
10. International Monetary Fund, 2020. IMF Working Paper "African Department Market Power, Growth, and Inclusion: The South African Experience," https://www.imf.org/-/media/Files/Publications/WP/2020/English /wpiea2020206-print-pdf.ashx.
11. Considering direct and indirect shareholdings of the state above 10 percent, the business of the state extends to 80 percent of the sectors (NACE-4 digit) of the South African economy. World Bank, 2023, "The Business of the State" (Overview). https://openknowledge.worldbank.org/handle/10986/4034303.
12. Data are from the World Bank Global Businesses of the State (BOS) database, which tracks business entities with a government stake of at least 10%, whether directly or indirectly owned by the national or subnational government. However, there was special treatment for the subsidiaries of two SOEs in South Africa, the Public Investment Corporation and the Industrial Development Corporation. These two SOEs had large portfolios of subsidiaries with ownership stakes of less than 50%. To help deal with all these subsidiaries in the data gathering stage, only subsidiaries in which the two SOEs had ownership stakes of at least 50% were included in the BOS database for South Africa.
13. IMF 2020.
14. Of 21 abuses of dominance referred to the Competition Tribunal between 1999 and 2016, 13 involved former or current SOEs. D. Healey, 2018, "Competition Law and State-Owned Enterprises: Enforcement," OECD Global Forum on Competition, DAF/COMP/GF.
15. SOEs receive direct and indirect budgetary support, which entails a fiscal drain and risks. Direct budgetary support via bailouts to SOEs over the past five

years have averaged around R46 billion a year, and dividend payments have been nearly zero. When viewed from the perspective of opportunity costs, such budgetary support to SOEs is very costly. For example, the bailouts are equivalent to 18% of the annual health budget and could have funded basic education for more than 2 million students.

16. For more information, see https://www.smallbusinessinstitute.co.za/wp-content/uploads/2019/12/ILO-Cost-of-Red-Tape.pdf.
17. C. Loewald and M. Stern M. (eds), 2023, *Unlocking Growth Prospects in Post-pandemic South Africa*, South African Reserve Bank. https://www.resbank.co.za/content/dam/sarb/what-we-do/research/UNLOCKING%20GROWTH%20PROSPECTS%20FINAL%20050423.pdf.
18. According to the 2018 Product Market Regulation (PMR) indicators of the OECD calculated for more than 50 countries, South Africa's regulatory frameworks are more limiting to competition in key product markets than those of most countries covered by the PMR data, including every OECD country and even peer countries such as Russia and Vietnam (https://data-explorer.oecd.org/vis?tenant=archive&df[ds]=DisseminateArchiveDMZ&df[id]=DF_PMR2018&df[ag]=OECD&dq=.&lom=LASTNPERIODS&lo=5&to[TIME_PERIOD]=false).
19. https://www.worldbank.org/en/research/brief/the-long-term-growth-model-fundamentals-extensions-and-applications.
20. They are often referred to as stars, superstars, gazelles, or unicorns.
21. See A. Grover Goswami, D. Medvedev, and E. Olafsen, 2019, *High-Growth Firms: Facts, Fiction, and Policy Options for Emerging Economies*, World Bank.
22. International Monetary Fund, 2015, "The Level of Productivity in Traded and Non-Traded Sectors for a Large Panel of Countries," https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-Level-of-Productivity-in-Traded-and-Non-Traded-Sectors-for-a-Large-Panel-of-Countries-42750 .
23. South Africa (with a score of 0.034 on the OECD FDI Regulatory Restrictiveness index) scores below the global average (0.10), placing it as one of the most competitive performers. (World Bank, 2024, "SADC Investment Climate Scorecard"). See, for example, "Investing in South Africa," https://www.thedtic.gov.za/wp-content/uploads/Investor-Roadmap-2020.pdf.
24. https://www.thedtic.gov.za/wp-content/uploads/the-dti-incentive-schemes-guide-2021.pdf. Most of the incentives proposed by South Africa are based on a complex set of criteria, including location, size of the enterprise, sector, and the size and race of the investor. To illustrate, to qualify for a cost-sharing grant in agribusiness, projects have to have a minimum investment of R1 million; have a B-BBEE level of 1–4; demonstrate that at least 50% of raw materials will be sourced from South African suppliers, 30% of which must be Black South African suppliers; can commence the project or activities applied for within 90 calendar days after the application has been approved; and must create additional jobs and pay at least the minimum wage. The benefits also depend on the type of investment (building, equipment, vehicles). See http://www.investsa.gov.za/wp-content/uploads/2021/03/PRINT-Incentives_compressed.pdf and https://www.thedtic.gov.za/wp-content/uploads/the-dti-incentive-schemes-guide-2021.pdf.
25. In a regulatory sandbox, a financial sector regulator allows small-scale testing of innovations by private firms in a controlled environment under the regulator's supervision.
26. Platinum and platinum-group metals are essential for hydrogen production, while chromium is used as a catalyst in lithium-ion battery production.
27. See, for example, http://www.investsa.gov.za/wp-content/uploads/2023/05/South-Africa-Investment-Conference-2023_Case-Booklet_on.
28. World Bank, 2022, *Country Climate and Development Report for South Africa*, https://www.worldbank.org/en/news/infographic/2022/11/01/south-africa-country-climate-and-development-report.
29. The cost of not transitioning to a green economy can be large, as South Africa's highly carbon-intensive exports will be increasingly penalized by the restrictions imposed by importing countries, such as the Carbon Border Adjustment Mechanism and the Deforestation Act recently implemented by the European Union.
30. In other words, the objective is to incentivize new projects in the green economy by increasing their expected rate of return by changing the relative prices between high- and low-carbon energy sources rather than subsidizing particular projects.
31. For clarity, a SME is defined as a "separate and distinct business entity, together with its branches or

subsidiaries, if any, including cooperative enterprises, managed by one owner, or more predominantly carried on in any sector or subsector." Specifically, the focus is on businesses with a turnover of less than R500 million ($22 million) per year and so includes a relatively wide range of businesses from very small (self or household entrepreneurs) to medium size with several employees.

32. http://www.dsbd.gov.za/programmes.
33. For more details, see McKinsey, 2021, "How South African SMEs can survive and thrive post COVID-19," https://www.mckinsey.com/featured-insights/middle-east-and-africa/how-south-african-smes-can-survive-and-thrive-post-covid-19.
34. Data from the South African Reserve Bank indicate that the collective credit exposure of SMEs to banks in 2020 was R631 billion, constituting just 25% of business loans facilitated by the banking sector. Government programs provide R18 billion, which amounts to 0.36 percent of GDP or 2.8 percent of the total credit exposure to SMEs.
35. Department of Small Business Development, 2023, "SMME and Cooperative Funding Policy 2023."
36. See J. Morisset, 2023, "To reduce South Africa's unemployment, make work more attractive," Brookings. https://www.brookings.edu/articles/to-reduce-south-africas-unemployment-make-work-more-attractive/.