

# The plight of long-term growth in South Africa

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## 1 Introduction

As South Africa entered recession in 2008 following the housing and financial markets crisis in the United States and several European countries, the government signaled that it would engage in counter-cyclical fiscal policy to support the economy. However, instead of the proposed surge in infrastructure spending, the result was a sharp rise in the public sector wage bill. This essay will assess how successful the counter-cyclical policy the South African government enacted between 2008 and 2011 was. In addition, it will discuss the importance of infrastructure and an efficient public service and examine ways in which the government can strike a balance between both seemingly antagonistic needs. Lastly, this essay will discuss how the political dynamics in 2012 are likely to impact the government's attempt to reduce the wage bill.

## 2 How successful was the counter-cyclical fiscal policy?

### 2.1 Fiscal response to the crisis

The counter-cyclical fiscal policy enacted by the South African government was one of the most aggressive among a group of comparable countries (Selassie, 2011). In the figure below, we see that the change in structural fiscal balances of South Africa was one of the largest:

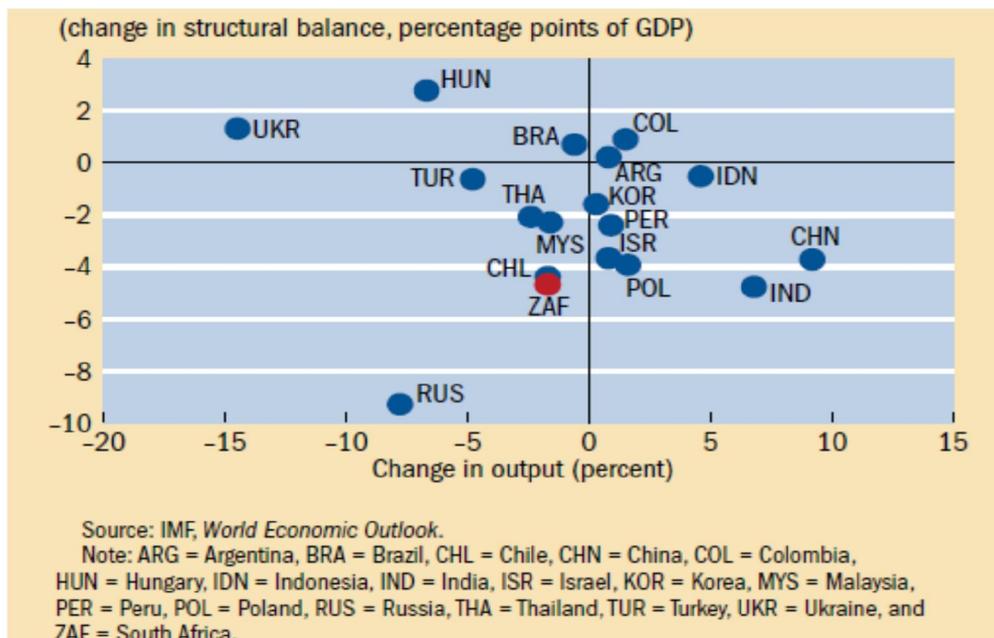


Figure 1: Supporting role of fiscal policy (Selassie, 2011)

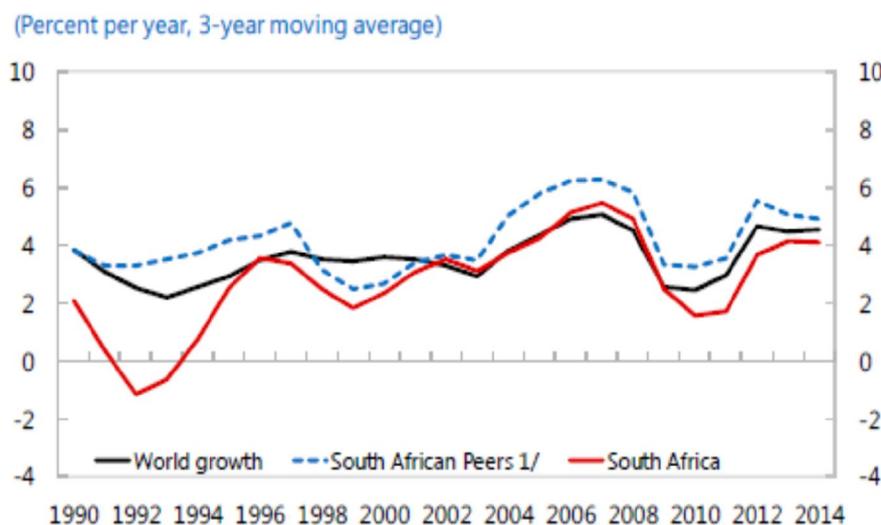
As illustrated above, the accommodating policy shielded South Africa from a worse recession: growth decelerated from about 5% in 2007 to about -2% in 2009 (OECD, 2010). On the contrary, some may argue that the counter-cyclical fiscal policy was not as aggressive as figure 1 above suggests and that the larger fiscal deficit (5.75%) as compared to the other economies was merely a result of increased infrastructure spending in the run up to the 2010 World Cup. However, it is important to note that this is not the case as this figure excludes measures that had already been planned for before the crisis.

## 2.2 An uneven recovery

In assessing whether fiscal policy was as effective in the recovery of the economy as it was in mitigating the decline in output, we examine the performance of both macroeconomic and socioeconomic indicators.

### 2.2.1 Macroeconomic indicators

Although actual Gross Domestic Product (GDP) is projected to close in on potential GDP this year, the recovery has been slow and growth of output has been below both the emerging economies' and world averages as depicted in the figure below:



Sources: WEO and IMF staff estimates.

1/ Unless otherwise indicated and depending on data availability, South Africa's peer group in this report includes Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Thailand, Turkey, and Ukraine.

Figure 2: Relative performance of South Africa's growth (IMF, 2011)

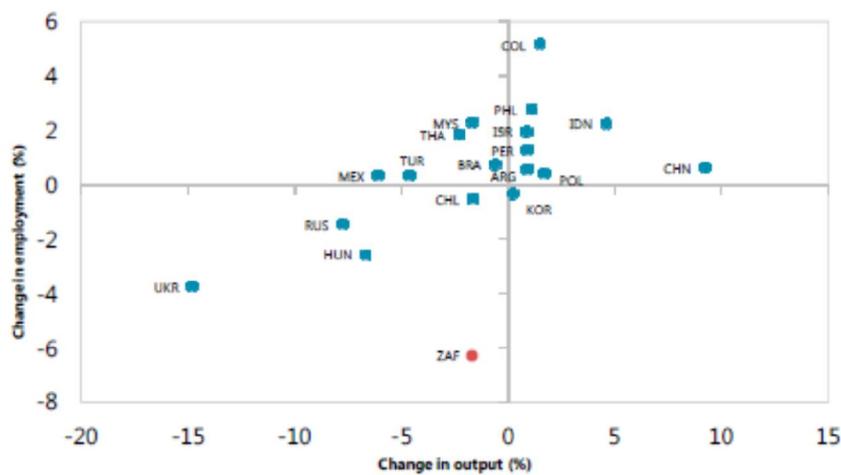
One could argue that the tepid recovery is an indication of an unsuccessful counter-cyclical policy. However, it is important to take into account that South Africa was not only confronted with the global recession but was also plagued by electricity shortages and food and fuel price hikes (Selassie, 2011). Consequently, the economy was already experiencing a downturn before

the global recession hit and growth was still below the average of comparable economies as shown in figure 2 above.

Other macroeconomic indicators show that the fiscal stimulus in concert with monetary easing has been largely successful. The current account deficit improved from 4% in 2009 to 2.75% of GDP in 2011 (IMF, 2011). In contrast, investment and exports remain below their pre-crisis levels (IMF, 2011).

### 2.2.3 Socioeconomic indicators

Although South Africa experienced one of the most modest decreases in output, the decline in employment was much more severe as shown in figure 3 below:



Sources: WEO and Stats SA.

Figure 3: Output and employment, 2008-2009 (IMF, 2011)

In addition, employment remains below the pre-crisis peak:

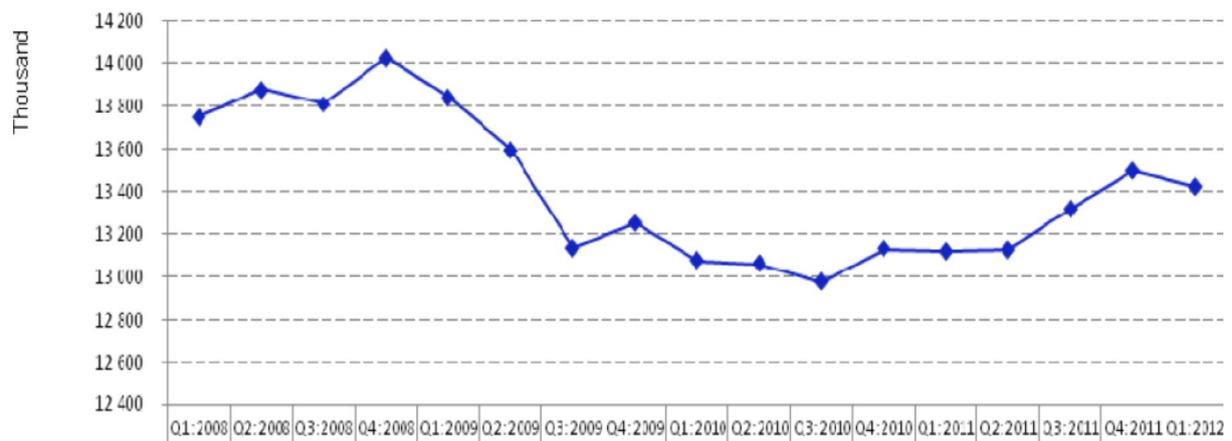


Figure 4: Total employment, quarter 1:2008 to quarter 1:2012 (Stats SA, 2012)

This sluggish recovery is detrimental to the human capital of displaced workers as they become detached from the labour force, a concept referred to as hysteresis (OECD, 2010). In addition, the proportion of the employed as a percentage of the working age population is the lowest amongst a group of comparable countries. Furthermore, this proportion has decreased from 45% in 2008 to 40% in 2011 (IMF, 2011).

However, is fiscal policy to blame for the poor performance in the reabsorption of the unemployed? Inefficient labour<sup>1</sup> and product markets are partly to blame (Selassie, 2011). Wage restraint on the part of the South African government and trade unions may have helped lessen the impact on unemployment. The associated decrease in unemployment in Korea where wages showed remarkable downward flexibility contrasted to the associated increase in unemployment in Spain where wages increased amidst the severe recession is evidence that wage restraint may have been beneficial to South Africa (IMF, 2010).

One positive aspect of the fiscal stimulus was that social security arrangements mitigated the impact on unemployment as subsidies to employers enabled them to keep workers on part-time employment (Naidoo, 2012).

### **2.3 A detour from a path of increased infrastructure spending**

In light of the fact that actual GDP is almost on par with potential GDP, does it matter that the government's fiscal stimulus was concentrated on public sector wages rather than the proposed spending on infrastructure? In any case, in line with the Keynesian theoretical framework of the aggregate demand/ aggregate supply (AD/AS) model; either would have led to an increase in aggregate demand and a return to potential output in the medium-run which was the objective of the counter-cyclical fiscal policy. Other than the issue of credibility, we take up this argument in the next two sections where we analyze the importance (or lack of) of each strategy and allude to their corresponding outcomes in the long-run.

## **3 Importance of infrastructure in South Africa**

In light of the emphasis on reducing poverty, unemployment and inequality by President Jacob Zuma, Finance Minister Pravin Gordhan and Economic Development Minister Ebrahim Patel, the role of infrastructure in promoting growth and employment cannot be undermined (Gordhan, 2012; Patel, 2010; Zuma, 2012).

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<sup>1</sup> We explore the role of excess real wages in more detail in section 4.2

Several empirical studies confirm the productivity of infrastructure. One such study was conducted by Calderón, Moral-Benito and Servén (2011) using data from 88 countries<sup>2</sup> spanning the years 1960-2000. The authors use a bounds testing approach to cointegration<sup>3</sup> to estimate a long-run aggregate production function relating GDP to human capital, non-infrastructure physical capital and infrastructure<sup>4</sup> as described in equation (1) below:

$$y_{it} = \alpha h_{it} + \beta k_{it} + \gamma z_{it} + \mu_i + \omega_t + \epsilon_{it} \quad (1)$$

Taking potential endogeneity<sup>5</sup> and heterogeneity<sup>6</sup> into account, Calderón et al (2011) find that the output elasticity of infrastructure is between 7% and 10% depending on the precise specification employed. This highly statistically and economically significant result is evidence that the growth and job creation prospects of South Africa can be significantly improved by spending on infrastructure.

In addition, this positive long-run relationship between investment in capital infrastructure is consistent with the Solow growth model. For the above reasons and in light of the fact that the public sector wage bill increased by 2% to 11.5%<sup>7</sup> of GDP since the beginning of the crisis while capital spending on infrastructure increased by only 0.5% to 2.25% of GDP, many have been against the South African government's deviation in the use of counter-cyclical fiscal policy (IMF, 2011). Thus, although the objective of steering the economy towards potential output was achieved; the major concern lies in that spending was concentrated in non-productive activities. Consequently, output growth will be on a lower trajectory in the long-run.

Moreover, central to output growth and job creation is the successful establishment of Small, Medium and Micro Enterprise (SMME) business (Tshabalala, 2012). The increase in the tax-free threshold to R63 556, the reduction in the rate of taxable income to 7% as well as the decrease in the number of payments of turnover tax from 18 to twice a year; will go a long way in promoting SMMEs (Gordhan, 2012). However, as the state of infrastructure affects the cost and ability of firms to receive inputs, complete production and deliver goods; efforts to encourage the growth of SMMEs will be futile if they are not matched by adequate expenditure on infrastructure (Fan, Reis, Jarvis, Beath & Frauscher, 2008).

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<sup>2</sup> South Africa was among the countries included in the study. Bogetic and Fedderke (2006) also conducted a similar study focusing on South Africa and obtain results similar to those of Calderón et al (2011).

<sup>3</sup> Equivalently, an autoregressive distributed lag model (ARDL)

<sup>4</sup> A synthetic measure of infrastructure given by the first principal component of infrastructure endowments in transport, power, and telecommunications is used.

<sup>5</sup> Reverse causality from output to infrastructure

<sup>6</sup> Unobservable country-specific effects

<sup>7</sup> This is well above the average of 8.75% of GDP for the other emerging markets in the G-20 (IMF, 2011).

Furthermore, the possibility that the recession in Europe (a main trading partner of South Africa) is expected to persist emphasizes the importance of South Africa creating its own growth (Gordhan, 2012). Hausmann (2008) and Rodrick (2006) advocate that momentum in the growth of the economy can be gained by promoting the non-resource tradable sector, and in particular, the manufacturing sector. A significant constraint to this development however, is the relatively low competitiveness of the tradeables sector in South Africa. Besides high unit labour costs<sup>8</sup>, high transportation costs is also to blame. Thus, expenditure on infrastructure will play an important role in alleviating bottlenecks, increasing mobility and reducing costs.

Despite the positive spin-offs of infrastructure in the economy, it is distressing that compared to a group of comparable<sup>9</sup> economies; South Africa is below average in most infrastructure sectors (Bogetić & Fedderke, 2006). Although most utilities offer decent services and at times, at competitive prices; limited access to these utilities particularly in the rural areas and less than expected quality of basic services have contributed to the low ranking. The influx of citizens from the Eastern Cape to the Western Cape is evidence of the increasing importance of these facilities in the country. To address some of these issues, it is encouraging that the government will consider 43 major projects worth R3.2 trillion over the next 20 years (Gordhan, 2012). Already, R845 billion has been budgeted and approved for infrastructure over the next three years with R262 billion in transport and logistics projects and under R300 billion in the energy sector.

The question which now arises is whether these funds will be put into use effectively. With only 68% (R178 billion of R260 billion) of planned infrastructure spent in 2010/2011, this is a valid concern (Gordhan, 2012). Consequently, among other things; project, financial and risk management need to be addressed in government departments. That is to say that the two go hand in hand: the effective implementation of the infrastructure plans requires an efficient public service. Moreover, as the executive arm of government, the public service is responsible for translating policies and legislation into practice and plays an increasingly important role in developing countries so as to ensure that citizens receive essential services and that the goals of poverty and inequality reduction are attained. In the next section, we explore the government's attempt to improve the efficiency of the public sector post-recession.

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<sup>8</sup> We allude to this in section 4.2

<sup>9</sup> Both region and income level (low income, middle income, upper middle income, and OECD countries) are used as comparator criteria. However, due to the strong positive correlation between income level and infrastructure; upper middle income countries are used as the main benchmarking group.

## 4 The public service

### 4.1 Efforts to improve the public sector

In an attempt to improve the efficiency of the public sector, the South African government has allowed the public service salary bill to increase from R156 billion to R314 billion over the past five years (Bisseker, 2012). Although a portion of this increase could be attributed to the employment of more workers in the public sector as part of the counter-cyclical fiscal policy, wage increases and entitlement accounted for 50% of the government’s budget (Klein, 2012; Tshabalala, 2012). Although the direction of causality between real wages and productivity is ambiguous, the positive correlation between them is well established in economic theory. On the one hand, higher worker productivity increases the demand for labour resulting in an increase in the compensation of workers (Klein, 2012). On the other hand<sup>10</sup> and consistent with efficiency wage theories, an increase in salaries gives workers the incentive to exert more effort.

### 4.2 Have these efforts had the intended effects?

Despite the well-intentioned motive of increasing salaries, the increase in the wage bill has been unsustainable: the delay to return to the acceptable 3% level of deficit following the recession resulted in the country’s credit rating being altered from stable to negative (Gordhan, 2012).

Moreover, high US dollar wage levels in the public sector (depicted in figure 5 below) relative to productivity has been detrimental to output and employment in particular.<sup>11</sup>

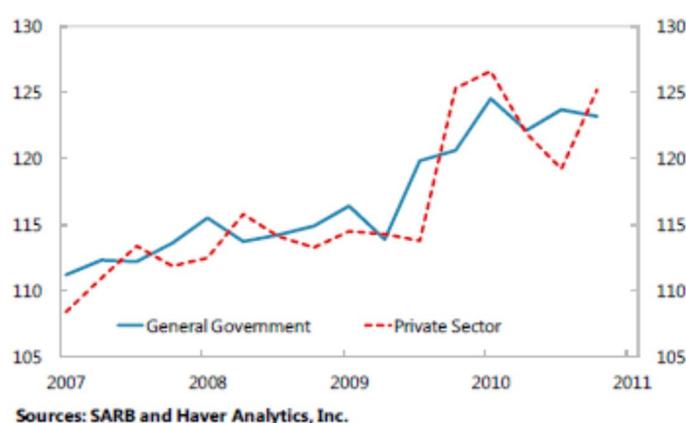


Figure 5: Net wages after all taxes in PPP USD, 2010 (Schüssler, 2012)

<sup>10</sup> This is the case we are interested in

<sup>11</sup> Borat, van der Westhuizen and Goga (2009) also found a statistically significant wage premium associated with membership in public sector councils in excess of the large and significant union wage premium particularly amongst the unskilled and semi-skilled workers.

As mentioned briefly in sections 2 and 3 above, the misalignment of real wage growth and productivity gains coupled with uncompetitive product markets<sup>12</sup> is partly to blame for the slow reabsorption of the unemployed and for low competitiveness in the tradables sector (Selassie, 2011). This is intensified by the fact that private sector wages move in tandem with public sector wages (Demekas & Kontolemis, 1999; Krishnan, 2000) As illustrated in figure 6 below, private sector wages match the movement in public sector wages after a lag of about one quarter:



**Figure 6: Real wages, 2000=100 (IMF, 2011)**

Furthermore, several empirical studies confirm that excess<sup>13</sup> real wage growth is not the solution to improving efficiency in the public sector:

Using pooled ordinary least squares (POLS), fixed effects and dynamic panel; Klein (2012) found that an increase in excess wages is associated with a significant and negative effect on formal employment. More importantly, using Engle-Granger's two-step co-integration method as well as the error correction model (ECM) to investigate the short-run dynamics; the author finds that although real wages and productivity are co-integrated, the link in South Africa is among the weakest compared to its peer group of economies. Thus, attempts by government to increase wages may not enhance efficiency.

Haurer and Kyobe (2008) use a panel<sup>14</sup> dataset encompassing 114 countries from 1980-2006 to determine the effect of increasing expenditure on efficiency. Using OLS and Generalized Method of Moments (GMM) where endogeneity was expected, they find that efficiency declines with the level of spending in the health sector and has no significant effect in

<sup>12</sup> Using industry-level panel data for more than 100 countries, Aghion, Braun and Fedderke (2006) found that the mark-up in South Africa is significantly higher than in equivalent industries world-wide.

<sup>13</sup> Real wage growth above productivity gains

<sup>14</sup> The authors obtained approximately 1800 observations for the education sector and about 900 observations for health.

education. Thus, pumping out more money does not solve problems of efficiency if not supplemented by efficiency-enhancing policies.

A third study was conducted by Kerr and Teal (2012) using a panel dataset from Kwazulu-Natal. They find that although human capital (educational attainment and individual ability) explain a significant portion of the earnings differential within the private sector, including the union premium; the same cannot be said about the large premiums for public sector workers. Consequently, low ability workers opt to work in the public sector as they are aware that they would not earn as much in the private sector as they do in the public sector: poor screening of applicants and weak firing policies may contribute to this. In addition, the authors suggest that one possible explanation for the attrition of high skilled workers in the public sector may be due to public sector earnings not being determined by ability. Thus, government's attempt to attract high skilled workers by increasing wages may be having the reverse effect!

### **4.3 If not higher real wages, then what?**

There are various ways the South African government can endeavor to improve the efficiency of the public sector. In this section, we discuss some of the key techniques as well as briefly highlight some of the areas in which the government has already taken an active stance but could do more in those spheres.

#### **1) Alignment of productivity and pay:**

A resonating theme throughout this essay particularly in section 4, is the need to align productivity and pay. As a starting point, the government needs a strong public relations campaign with clear objectives and an emphasis on re-invigorating the spirit of performance and reward. At the moment, the extravagant lifestyles of some of the political elite are not justifiable and hence to be effective, this new approach would need to be enforced at all levels of government. The concept of "quality step increases"<sup>15</sup> adopted under the National Performance Review (NPR) in the United States in the late 90s is an international experience South Africa could draw on (Shields and Gadsby, 2000). Similar programs were adopted in Chile and South Korea, two of South Africa's peer economies.

Ulleberg (2009) suggests that financial incentives are not always optimal. Moreover, the value of merit-based incentives such as career development, holidays and decision-making responsibilities are often underestimated. New Zealand, which may be hailed by many as the epitome of public service efficiency, adopted incentives and sanctions in 1987 in an attempt to improve accountability (Scott and McKenzie, 2000). One of the successful incentives was granting of managerial freedom in return for delivering results.

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<sup>15</sup> Equivalently, performance-based pay

## **2) Reevaluation of leadership and training techniques:**

Effective leadership is critical for effective public service delivery. However, the focus on managerial leadership which has been adopted from the western world and implemented in government without consideration of the multicultural context, has been largely unsuccessful (Binza, 2011; Naidoo & Xollie, 2011; Wenzel, 2007). Naidoo and Xollie (2011) suggest that an integrated leadership approach combining managerial and transformational leadership is required for public servants to deal with the complexities in government. The authors advocate that managerial approaches which focus on short-term day-to-day administration are very limited. Binza (2011) also proposes that collaboration of the government with universities is key in addressing the multicultural context. Accordingly, the government should step up research funding of public administration as well as encourage productivity in research through more support programs and awards.

In the short-term, projects independent of municipalities should be created to target infrastructure in the poorest of communities. These should be headed by competent consultants from the private sector and should report directly to the Presidency. In addition to improving basic service delivery in these communities, these projects could serve as a training tool for public servants involved in the projects.

## **3) The battle on corruption and the enforcement of accountability and transparency:**

Using a panel dataset encompassing 114 countries from 1980-2006, Hauner and Kyobe (2008) found that controlling corruption and increasing accountability play a significant role in increasing government efficiency. Although one could argue that higher wages are correlated with lower corruption particularly in developing countries, Rijckeghm and Weder (1997) found that this holds across countries but does not hold within countries over time. Thus, increasing wages is not the solution to corruption. An enhancement of methods of detection is needed coupled with a strengthening of the judicial system in which the law is enforced on all citizens including the political elite. In the recent past, lack of enforcement has been associated with individuals failing to comply with the law.

In addition, although the government is taking active steps to monitor procurement and ensure that money is used for the intended purposes<sup>16</sup>; more definitive mandates need to be put in place. Bester (2007) suggests that one such approach would be the widespread use of Public Tracking Systems (PTS). Furthermore, one of the strategies attributed to the success in New Zealand as mentioned in the preceding point was that data on performance was made readily available to the public (Scott and McKenzie, 2000).

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<sup>16</sup> For example, National Treasury will appoint a Chief Procurement Officer to carry out the task (Gordhan, 2012).

#### **4) Enhancing of inter-governmental relations:**

Strengthening inter-governmental relations (IGRs) amongst the 3 distinct, interdependent and interrelated spheres of national, provincial and local government is essential for improved service delivery. Ile (2010) advocates that delegation of responsibilities to the sphere of government most suited to carry out a specific task as well as support and constant monitoring from the other spheres is essential in improving service delivery. In addition, so-called “core” government departments should be a priority when addressing problems of service delivery as failure to deliver may render so-called “peripheral” departments unable to effectively carry out their functions. Linked to this is the importance of coordination and communication within the various spheres. Visser and Twinomurinzi (2007) propose that e-government can be of great help in improving coordination and supporting government’s service philosophy of Batho Pele. Although significant achievements have been made in this area, the authors argue that increased integration and management from a single portfolio will enhance this.

### **5. Two seemingly antagonistic needs?**

As discussed in sections 3 and 4, while South Africa is moving away from consumption-led growth towards investment-led growth and hence an emphasis on infrastructure expenditure; an effective public service is essential in ensuring the implementation of the various projects. However, as pointed out in section 4.3, adopting projects to target the poorest of communities can cater for both needs. However, emphasis should remain on developing infrastructure. In any case, the resultant creation of employment should mitigate the need for the demand of higher wages as more individuals in a given household will have access to income opportunities. Should government revenue be insufficient to fund infrastructure, Private Public Partnerships (PPPs) should be sought. However, these will require increased transparency and credibility on the part of the government in particular.<sup>17</sup>

Having said this, can the South African government be expected to abide by its goals of reducing real growth of spending on wages from 9.4% to 1% and remaining on an investment-led growth path? This is unlikely as the upcoming centenary national conference of the African National Congress (ANC) in Mangaung in December 2012 will either result in a delay in the implementation of proposed plans as politicians focus on elections, or a temporary abandonment of promises. Cahuc and Carcillo (2012) have shown that public sector wage bills increase significantly in the run-up to elections. With an increase in the voter share of unions such as Congress of South African Trade Unions (COSATU) which is capable of bringing the

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<sup>17</sup> The initial reluctance of the South African National Roads Agency (SANRAL) to disclose the names of all the 33 subcontractors involved in the collection of e-tolls on Gauteng highways is evidence of this.

economy to a standstill<sup>18</sup>, it is likely that the government will give in to demands of wage increases.

## **6. Conclusion**

This essay has shown that while counter-cyclical fiscal policy was successful in preventing a severe downturn, recovery has been weak. In particular, on average, macroeconomic indicators show that the policy was successful whereas socio-economic indicators contrast this view. Despite potential output being achieved, the problem is that the focus was on short-term rather than long-term growth. Although the government has vowed to rectify this and is taking the necessary steps to do so, the challenge of whether it will uphold these promises in the face of upcoming elections is an inevitable one. Having outlined the importance of infrastructure, it is the hope of this essay that the government will not depart from its vision of long-term growth, employment, and poverty and inequality reduction.

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<sup>18</sup> This is evident from the suspension of e-tolling in April 2012

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