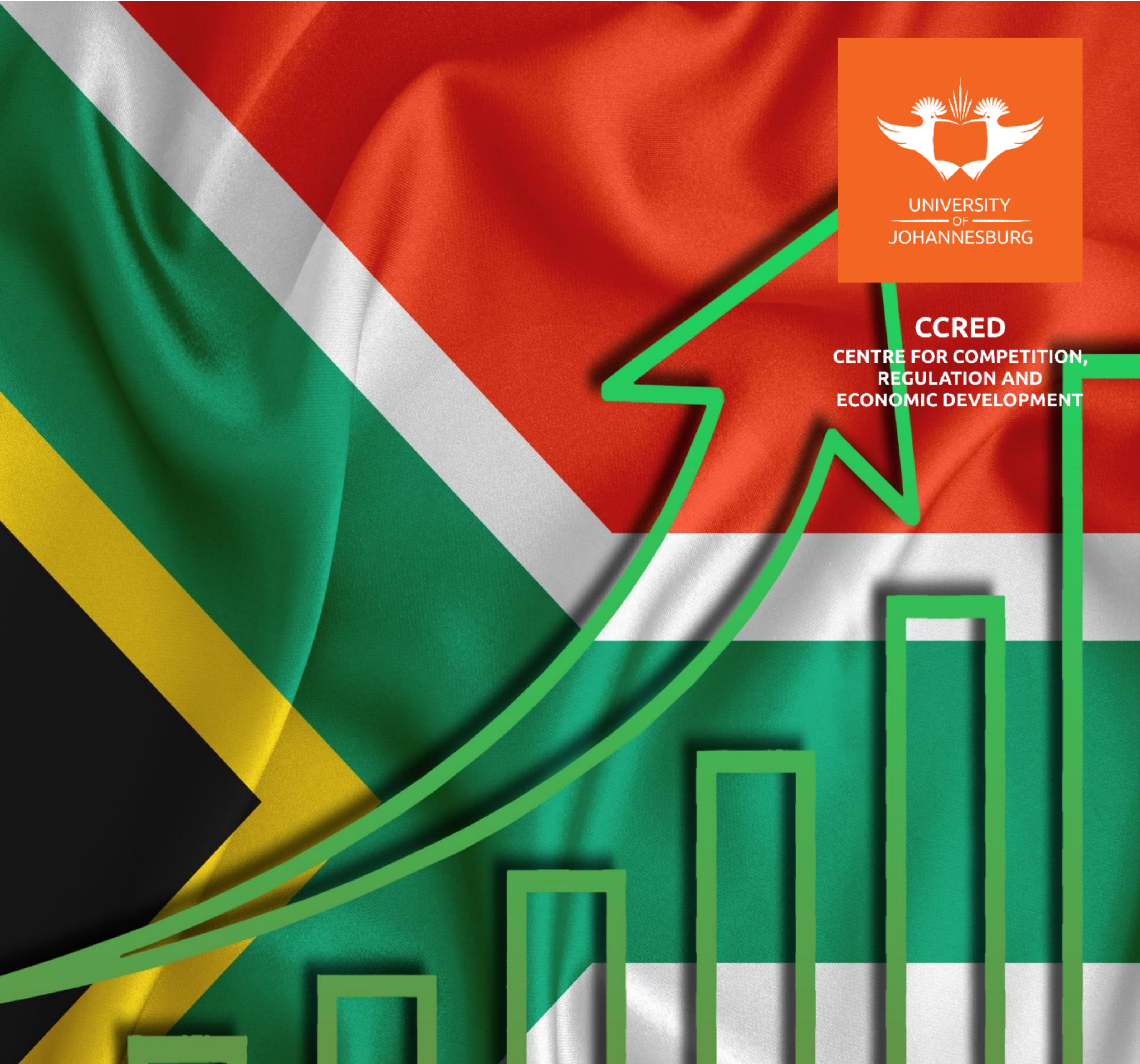

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Ingredients for a successful localisation policy in South Africa

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1. Introduction

South Africa has experienced premature deindustrialization, with the manufacturing sector performing poorly over the past three decades, particularly downstream manufacturing activities. To reverse this trend, the post-apartheid government has implemented several localization initiatives aimed at boosting the local industrial capacity. The latest of these emanates from the 2011 amendment to the Preferential Procurement Policy Framework Act (PPPFA) of 2002, which empowers the DTIC to designate specific industries/sectors for local production to meet a specified level of local content. Moreover, it empowers the DTIC to order state organs to include local content in their bid invites. This latest initiative recognizes that the previous initiatives have been piecemeal in nature with limited economy-wide reach and minimum impact on the overall industrial base of the country. This brief discusses key areas of the present localization initiative that need to be strengthened for maximum impact.

Effective use of state procurement levers to anchor the localisation process

South Africa is a democratic, small, and open market economy that rapidly liberalized and intertwined with the global economy, post-1994. Moreover, the country is a member of the World Trade Organization (WTO), meaning the State is limited in terms of its powers to dictate to economic participants what to produce in what quantities. That is, it can only indirectly incentivize private business to produce the type of goods and services it desires. In that regard, the State's powers are limited to activities of government and its entities. Essentially, the only direct tool at government's disposal to drive localization is state procurement. Public sector remains the largest consumer of goods and services in South Africa, making the promotion of localisation through public procurement even paramount.

State procurement, properly leveraged, has the potential to catalyse the process of industrial localisation, especially in the initial phases of the localization process by serving as 'offtake' that firms can rely on to increase capacities and improve competitiveness. Without increased and protected government demand, it is unlikely that firms will increase local production given competitive pressures from foreign firms and high investments requirements is some instances. Thus, powers created in the PPPFA which permit the DTIC to designate specific products that government departments must purchase from domestic manufacturers remain a strategic tool to utilise to resuscitate the local industry.

Unfortunately, the recent 2022 Constitutional Court judgment has essentially invalidated the local content regulations. The judgement followed a legal battle that was instituted by Afribusiness NCP against the Minister of Finance challenging the 2017 amended version of the Preferential Procurement Regulations, which resulted in the court setting aside the entire regulations published under the PPPFA. Subsequent to the judgement, the National Treasury has decided to halt enforcement of local content regulations until new regulations are developed. This is a regrettable setback that will certainly derail achieving the set localisation targets.

Uncoordinated activities along the supply chain. Despite National Treasury's decision to halt implementation of local content regulations, state procurement has generally not been utilised effectively. The chain from production of a product to procurement and consumption by government is disconnected and consists of multiple stakeholders whose activities are highly uncoordinated and difficult to monitor. The implementation process entails a procuring government entity issuing a tender bid for the particular product(s), with details relating to local content requirements. Bidders can be any entity registered in government's database of suppliers, regardless of whether they are actual manufacturers or just distributors.

The main challenge has been a disconnection between suppliers and the actual producers of the products they supply to government. In cases where suppliers (i.e., bidders) are not the actual producers, often they do not have detailed knowledge of the components that went into the production of the particular product. So, they would often classify the product in the tender document as being locally produced just because they bought it from a company that's based in South Africa, even as the product may have not been produced locally. Essentially, there is no relationship/agreement between bidders and actual producers that compel them (producers) to disclose detailed product information to the bidders or distributors. In other instances, bidders don't even have access to producers, or know who the producers are, and/or where they are located. This happens in cases where bidders purchase from distributors and not directly from manufacturers. Thus, the procuring entities only have sight of the information provided by the bidders, many of whom are not manufacturers.

In cases where bidders are manufacturers, some of the challenges arise when manufacturers feel uncomfortable sharing detailed manufacturing process information, they consider confidential, and feel could end up being accessible to competitors. In such cases bidders simply opt to withdraw from the bidding process, especially wherein individual transactions are of relatively low value making it unworthy for businesses to fulfil the long and detailed list of local content requirements. The implication is that procuring entities may end up not being able to procure the goods they need, and therefore impact service delivery, or that they end up awarding tenders to uncompetitive bidders. The DTIC, together with procuring entities, have tried to mitigate this by holding workshops with potential suppliers to discuss the local content related information required by government so that suppliers don't end up sharing information they consider confidential. The DTIC concedes that more of those engagements are needed.

No monitoring during transaction implementation. Further, there is little that procuring entities can do to verify the accuracy of the local content information provided by bidders, beyond the ordinary bid evaluation due diligence they would normally conduct. State procurement currently focuses on the initial stages of the transaction (i.e., tender, adjudication, and award), with no policing during the fulfilment of the transaction. Detailed verification of local content information is undertaken by the South African Bureau of Standards (SABS) only after the transaction is fulfilled. The reason for deferring verification is to avoid burdening the procurement processes of government entities which may impact on service delivery. Whilst this is justified, the implication is that procuring entities likely have awarded tenders to suppliers that do not meet local content requirements. The SABS Local Content division continuously conducts audits on awarded tenders to verify local content claims made by suppliers, and there have been instances where audits have revealed that tenders were awarded to suppliers that did not meet local content requirements. In such instances, the information is relayed to the relevant procuring entities and left with them to take necessary recourse, without the involvement of the DTIC. Furthermore, there are no reciprocal commitments that firms are required to make when being procured from under the localisation policy, even if it's just reporting back over time, or proving that access to state procurement also led to increased capacity and employment.

The nature of state demand matters. Lastly, while the public sector spends substantially on goods and services, creating important demand for local production, this demand has been difficult to utilise as offtake by firms to underpin capacity expansion. The reason is that it is highly disaggregated, uncoordinated, and dispersed across many government entities, making individual transactions insignificant and unworthy for potential suppliers to go through the long list of local content documentation required. Firms can only increase capacity when there is clear and substantial offtake demand sustained over a longer period. Thus, there needs to be a way to pool together state demand to act as an effective offtake to ensure local firms enjoy economies of scale and reduce productions, which will make them competitive to even supply to other domestic businesses. On the other hand, while aggregation of demand is critical, big bang demand that is typical with government infrastructure projects is also undesirable. Using Eskom as example, local firms are unlikely to fully benefit (and increase capacities) from large and infrequent projects, such as Medupi and Kusile, for example. Instead, government demand (especially infrastructure rollout) should be smoothed out over a longer period, thereby providing certainty and a good incentive for firms to increase capacity.

2. Enforceability of commitments and clear benefits to all parties

In addition to the nature of demand discussed above, there needs to be clear benefits expected to accrue to the localizing firms in order to show interest and commit to localizing. That is, government needs to find a proper incentive that will make firms to want to implement localization. Lessons from previous and other localization initiatives can be drawn; for instance, from the NIPP, DIPP, BIS and other sector specific cases such as REIPPP and BioVac, as discussed below.

The National Industrial Participation Programme (NIPP) was promulgated in 1996 to leverage economic benefits and increase investments into the country and was anchored on state procurement. Under NIPP, before the government concludes and finalises a procurement agreement with a foreign or local company, with an import value of more than US$10 million, the company is required to sign an obligation agreement with the DTIC pertaining development of local industry. That is, an NIPP obligation is placed on the recipient company to reinvest a portion of the costs in South Africa. The NIPP obligation is calculated as 30% of the imported portion of the purchase contract and can be fulfilled through local economic activities that have the potential to make a positive impact on developing the local industry. Similarly, the Defence Industrial Participation Programme (DIPP) requires all contracts with an import value of between US$2 million and US$10 million entered by Department of Defence and suppliers to have obligations related to local industrial capacity development.

The NIPP and DIPP have been quite successful, leading to direct investments made, for instance, into automotive components manufacturing; mineral beneficiation (use of platinum in the catalytic converters); local manufacture of military equipment/vehicles for export market; setting up of SME funding instruments in partnership with national DFIs; and establishment of production facilities for a range of manufacturing activities (including biomass pellets, railway axles for export markets, steel, etc). The success of NIPP/DIPP can be attributed to clear and legally enforceable contracts between the DTIC and companies, that is in the interest of both parties. The interest on the companies' side is generated by the size of the transaction involved. The minimum transaction value of $10 million that triggers NIPP is quite substantial, meaning the company involved is likely to concede to and implement the obligations of NIP/DIPP.

The Renewable Energy Independent Power Procurement Programme (REIPPP) is a public-procurement programme designed and implemented to introduce the supply of renewable energy into the national grid. Renewable power producers tender to provide energy to Eskom at the price agreed upon at the beginning of the contract. The tender scoring process is weighted 70% on price and 30% on other development factors. These factors include emphasis on local content and job creation. The REIPPP is lauded as one of the most successful government programmes in the past decade in terms of management and design. This success has been underpinned by a number of factors including offtake agreements, project management and access to funding. Offtake is arguably the most important factor that attracted the private sector. The potential project profitability was clearly visible from the purchase price agreements entered into with Eskom, which stimulated the initial interest in the programme and attracted larger numbers of bidders in later rounds. In addition, the 20-year contracts provide for security and sufficient time to recoup invested funds and earn profits.

Interventions in the pharmaceuticals industry aimed at establishing local industrial capacity for production of vaccines and active pharmaceutical ingredients (APIs), through extension of support to BioVac – a bio-pharmaceutical company based in Cape Town that is the result of a partnership formed with the South African government in 2003 to establish local vaccine manufacturing capability for the provision of vaccines for national health management and security. Since establishment, Biovac has built important capabilities and upgraded from packaging and labelling, to formulation, filling and finishing of vaccines locally through technology transfer agreements with international pharmaceutical corporates such as Sanofi and Pfizer.

The success of BioVac was anchored on an exclusive supply agreement with the Department of Health (DoH) for the procurement, storage, and distribution of vaccines used in government's Expanded Program on Immunisation (EPI). The offtake agreement guaranteed prices that were between 10 and 20 per cent higher than international competitors, resulting in significant growth in output and employment. Even as the exclusive supply agreement is no longer in place, BioVac continues to supply the DoH through competitive bidding processes because it has managed to build strong capabilities over time to be an effective competitor. For instance, it has successfully secured 85% of the DoH's most recent R11.4-billion tender for the supply of childhood vaccines from June 2020 through December 2023.

Nevertheless, the success of BioVac has been limited in some respects, given that South Africa still does not have capacity to produce active pharmaceutical ingredients (APIs). BioVac has only managed to develop capabilities for formulation, filling and finishing, and not the actual manufacturing of active ingredients. Although BioVac has some knowhow for APIs, it does not currently have the capacity to produce them commercially, as that would require substantial investments (in the billions of Rands), which are currently unjustified given the short-term nature of DoH tenders. The length of the DoH tenders is typically two to three years, which is insufficient to incentivise the level of investment needed to build local production capabilities.

Another initiative is the Black Industrialists Scheme (BIS) which was established in 2016 by the DTIC with the primary aim of transforming the manufacturing industry in South Africa through prioritisation and inclusion of black businesspeople (Bosiu et al, 2020). The scheme provides concessional funding to black industrialists (BIs) in the form of loans and investment grants. The qualifying criteria consists of a range of factors, including demonstration of localization. The results of a survey of black industrialists conducted by CCRED in 2019 indicated that a significant proportion of the beneficiaries have implemented measures to increase use of local materials in their production processes. The results are attributed to the fact that the localization commitments by firms are tied to their ability to access funding.

It is however important to draw the distinction that the BIS is not a localisation initiative per se, like the others discussed. It is one of the ways in which procurement from local sources has been incentivised, by making localisation one of the economic benefit criteria elements upon which an applicant for funding scores one point if they can satisfactorily demonstrate that their product will be made of a minimum proportion of local materials. Although an applicant wouldn't necessarily be denied funding if they don't score on the localisation element, as the overall decision to provide funding relies on several other factors. Moreover, successful applicants are not required to report on this element post funding award. Nonetheless, the BIS demonstrates how other programmes can be leveraged to incentivise firms to produce or procure locally.

Lastly, measures/incentives need to be developed to attract private businesses that do not necessarily transact with government to promote local procurement. For instance, national retailers are the major route to market for majority of the fast-moving consumer goods (FMCG). These can be leveraged to facilitate access to retail shelve space for locally produced products. Given that government cannot directly compel private businesses to procure locally, creative tools need to be developed to incentivise them. The approach government has adopted has been that of persuasion and consensus and has managed to develop the Local Procurement Accord (LPA).

The LPA is a non-binding agreement signed in 2011 by social partners (government, labour, business, and community) with the aim of collaborating to promote local procurement. The common aspiration across the signatories is to achieve 75% localisation in the procurement of goods and services. In particular, business committed to evaluate their supply chains and increase local procurement, especially from black-owned suppliers. Nevertheless, the main challenge remains on how best to ensure that business implement the commitments in the LPA to the fullest. The major drawback with the LPA is that it is not legally binding. Moreover, there is seemingly no mechanism in place to enforce and track implementation.

3. Selection and prioritisation of products

The amended PPPFA empowers the DTIC to identify products that government entities are compelled to procure locally. The DTIC has thus far designated 28 products. It's noteworthy that the selected products fall within the broader set of priority sectors identified to be best placed to promote value addition, growth and employment in the South African economy. However, there are a number of other products/industries that have been seemingly left out, yet there is local capacity to produce them. Apparently, the ultimate list settled on was also a result of fierce lobbying from the industry. It is important to note, though, that the current list is not exhaustive and final as the process of designation is a continuous one. In fact, the DTIC has overtime reviewed local content designations and production thresholds for some sectors.

According to the DTIC, the criteria for selection of products or sectors considers a number of factors, including, strategic positioning of the industry; government expenditure on the product; import and export trends; local production capacity; and local market structure and competition dynamics. That is, there should be demonstrable evidence that the selected product is consumed by government and presently imported in large proportions even as there is capacity to produce it locally, otherwise the use of state procurement would be ineffective. Further, competition dynamics of the value chain within which the product falls are important to consider avoiding compromising on quality of the locally produced product, unjustified price increases, and increased entrenchment given an economy that is already highly concentrated. In a concentrated economy like South Africa, protection of large and few local producers from international competition can potentially increase entrenchment in the local economy and incentivise producers to price excessively while producing low quality products. Hence it is important to conduct an in-depth analysis of the selection criteria to bring to the fore a nuanced perspective. In that regard, our analysis raises two important issues worth examining closely: determination of government expenditure on specific products; consideration of local production capacity.

Determination of government expenditure on specific products: one element of the selection criteria dictates that there must be a clear demonstration that government (through its various entities) consumes the product being designated, and that government spends substantially on the product on annual basis. This is central to the designation process since the implementation of the local content thresholds is anchored on state procurement. However, the challenge is that focus is placed on the final product, without consideration of the intermediate products (such as packaging) that make up the final product consumed by government. For example, in the case of the designated plastic products, industry representatives argue that one of the reasons for designation of only two plastic products (wheelie bins and plastic pipes) is that there are naturally few complete plastic products that government consumes, whereas there would be a substantial amount consumed in other forms, such as packaging material used on a variety of complete products consumed by government. This is not captured separately on government expenditure, and therefore missed by the product designation criteria.

Consideration of local production capacity: as highlighted above, in designating, the DTIC needs to ensure that there is some level of local capacity to produce the designated product. This is quite an important consideration given that the increased demand (through government procurement), in an environment where local production capacity of a designated product is limited, can lead to cost increases on the government side, with detrimental impacts on service delivery.

Engagements with the DTIC and analysis of its documents used to rationalise designation of some of products indicate that the DTIC has knowledge of the local production capacities for the selected products, although some sections of industry assert that there is no full knowledge of the precise production capacities for some of the products. For example, one industry association indicated that it has only recently been commissioned to determine the production capacity for the manufacture of electric cables, yet these are already designated and placed at 70% local content threshold.

Nevertheless, the important issue that has emerged is that in engaging with industry to determine the designated products, the DTIC limited the engagements to existing capacity without going further to determine the ability of industry to create new capacity in cases where there is limited or no capacity for a particular product. For example, during the engagements between government and industry regarding capacity, if the response from the industry was that there is limited/no local capacity for a particular product, government did not go further to establish the possibility of firms modifying their existing equipment so that they could produce that product (akin to processes of upgrading and attaining dynamic efficiencies in structural transformation literature). For example, in the case of injection moulding a firm may state that it presently does not have capacity to produce a particular product, however in reality it may be relatively easy for the firm to purchase the mould and utilise existing equipment to create capacity for the required product.

In some cases, firms are able to adapt their production process to accommodate new demand or alternative, related products. For example, during the COVID-19 pandemic period, the plastic industry was apparently quite flexible and agile as manufacturers responded to the increase in demand for face shields, screens and sanitizing bottles. Another example relates to EcoCasa – a black industrialist that manufactures cooler boxes. The company was also able to produce components that were needed to produce CPEP ventilators during COVID-19 when global supply was disrupted, even though this product was not its primary line of production. The incentive of guaranteed offtake created by government enabled EcoCasa to effect minor modifications to the existing equipment and quickly add new capacity for production of those components.

In essence, designation of products only (or largely) in line with current production output as the main criteria, can mean that opportunities to leverage localisation thresholds to drive processes of upgrading, adaptation, and dynamic efficiencies (precisely the processes understood in the economic complexity literature to be critical for structural transformation and manufacturing-led growth) may be missed. The above illustrations therefore also point to a key opportunity for the DTIC for subsequent rounds of designation – that is, establishing a framework for determining both present capacity and whether there are pockets of latent capacity or adaptable capabilities that can be leveraged towards new local production opportunities. It may be helpful therefore, for government to engage firms on what they could potentially produce utilising existing resources which may allow for a broadening of the pool of designated products over time that also stimulates production of 'new' products and upgrading within firms. It may be possible for government (in the short to medium term) to request firms to estimate and demonstrate potential capacity in key value chains (perhaps linked to sector master plans), with the state providing a medium to long term commitment to consider categories of 'new' products (that is, those not presently manufactured in South Africa for which local production processes could readily be manipulated to allow for future domestic production of those goods) for localisation designation in future once local production capacity is established and proven.

4. Concluding remarks

There is certainly a potential to improve South Africa's industrial capacity through the present localization initiatives. What is needed is purposefulness and ability to harvest low hanging fruits. For instance, government needs to seize the supportive prevailing political economy to drive the localization process much more aggressively. Our engagements with industry indicate that local firms appreciate the potential unlocked through state procurement and therefore are interested in the success of the localization policy. Moreover, local firms already have competitive edge over foreign companies in that they can offer shorter lead times. A number of improvements on the present initiative would need to be effected, in particular effective utilization of state procurement levers to provide the correct form of offtake that businesses can use. We synthesize the key ingredients for an effective localization policy in the table below.

Table 1: Ingredients for an effective localization policy in South Africa

Area	Ingredient
Effective use of state procurement	• Aggregate and smooth demand
	• Capacitate SABS Local Content Division for effective policing
	• Impose conditionalities (i.e., report back on capacity and employment changes overtime)
Enforceability of commitments	• Clear and legally binding commitments
	• Clear benefit to the firm(s)
	• Tie commitments/implementation to some form of benefit (i.e., funding, license, etc.)
Selection of products for designation	• Consider agility of firms to utilize existing resources to create capacity for other products
	• Consider intermediary products (i.e., packaging products)