

## South Africa's local content policies: challenges and lessons to consider

### SUMMARY

South Africa through its Industrial Policy Action Plan (IPAP) identifies local content as a strategic industrial policy instrument, which can be used to leverage the power of public procurement; reduce the country's trade deficit; address market failures; foster infant industries; and increase the government's tax base (the dti, 2016). Although local content is a commonly used industrial policy lever, and much has been done in South Africa to use this policy instrument, a number of constraints hamper its effective use, including the lack of a common definition, procurement processes, effective monitoring and information sharing. This policy brief paper draws on a recent research project undertaken by TIPS to model the economic multipliers of local content and the maximum price premium the state should consider paying in evaluating the benefits of buying local versus buying imported products. It assesses the key challenges and lessons of local content policies in South Africa. In particular, it analyses the economic rationale driving the argument for the use of local content policies. Furthermore, the brief highlights the reasons why local content policies are not resulting in the desired level of local procurement, and suggests possible measures that could be implemented.

### INTRODUCTION

Ineffective approaches to local content that do not achieve the desired level of procurement from local manufacturers result in less industrialisation and job creation. Without active interventions to address the constraints on low levels of local content, local producers will be disadvantaged and not given the opportunity to improve their capabilities and capacity.

The benefits of a local content framework are clear; for example, while local producers may not initially be able to compete against foreign suppliers on both quality and price, with an assurance of domestic demand and clear procurement timelines and standards they would be in a position to increase, improve and modify their capacity and capabilities to suit specifications and compete more effectively. However, the current procurement regulations are not enabling of local content as they provide no space for negotiations between procurers and suppliers, leading to non-compliance by many local suppliers or total exclusion from the process altogether. Moreover, for small batch runs, the transaction costs (of locally manufactured goods) are usually higher than mass produced foreign-sourced goods

and this hinders the procurement of local products; local producers would require a signal to scale up production. However, even if the state does pay more for locally manufactured products there are significant multiplier effects on the domestic economy. The relevant systems required to measure and monitor imports and compliance for local content and procurement are insufficient, compounding the monitoring and evaluation of the effectiveness of the policy.

A recent research project by TIPS to model the benefits and economic multipliers of local procurement revealed that there is no overarching cost and quality data on local content. As such, monitoring systems and information sharing programmes should be established that provide suppliers with timely information on specifications, price and quality such that local producers can comply (with sufficient forewarning and upgrading support). The lack of systems to monitor imports and compliance needs to be addressed, and this includes providing a clear regulatory and legislative framework that provides a simple and concise definition of local content. Effective use of monitoring systems would allow the state to determine the price premium for which it is more beneficial to buy local than import.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

info@tips.org.za  
+27 12 433 9340  
www.tips.org.za

Policy Brief by  
Wendy Nyakabawo  
TIPS Economist

## ECONOMIC RATIONALE FOR LOCAL CONTENT POLICIES

The definition of the concept of local content often lacks clarity, as it differs across countries in laws and policies (Gwayaka, 2014). Although there is no agreed definition of what the term “local” or “content” means, this concept is generally understood as a set of policy measures implemented by government that typically require a certain percentage of factors of production such as labour, supplies of intermediate goods, services, knowledge and technology used in various stages of the production process be sourced from the domestic economy (Silva, 2014; Ramdoo, 2016). Local content policies ensure that within strategic sectors, domestic goods and services are used such that imported inputs are substituted by domestic value addition (Silva, 2014).

It is important to understand what motivates countries such as South Africa to design and implement local content policies. The rationale behind these policies is linked to economic and socio-political considerations. On the economic front, the primary rationale in South Africa is for developing new industries and strengthening the domestic industrial base in an attempt to stimulate job creation and economic development. A secondary aim is to stimulate the development of competencies, necessary for the functionality of an industry. In South Africa, the required expertise may not be available because of skills shortage or mismatch. In cases when multinationals use expatriate labour, local content policies are used to encourage the development and transfer of skills and knowledge (Ramdoo, 2016). Over time, companies can then use more local labour and less foreign labour in strategically selected positions. Therefore, governments can use regulatory

instruments to set minimum quantitative targets for the hiring of local labour or for the training of staff. For example, in the mining sector in South Africa, government through the Mining Charter imposed compulsory requirements to employ at least 40% local labour at all levels including senior management and board levels. Local content approaches also have the potential to stimulate spillover effects and support the creation of new more sophisticated industries; equally there may be benefits in local firms in a supply chain responding to local challenges such as deep level mining or the unique electricity current in South Africa.

Furthermore, local content policies can be used to achieve socio-political objectives as economic transformation or redistribute rents arising from economic activities (Silva, 2104). Government can carefully tailor policies in terms of which industries to focus on and the level of local content targets to set to re-direct rents arising from economic activities away from foreign entities towards specific groups, firms or regions within the host country.

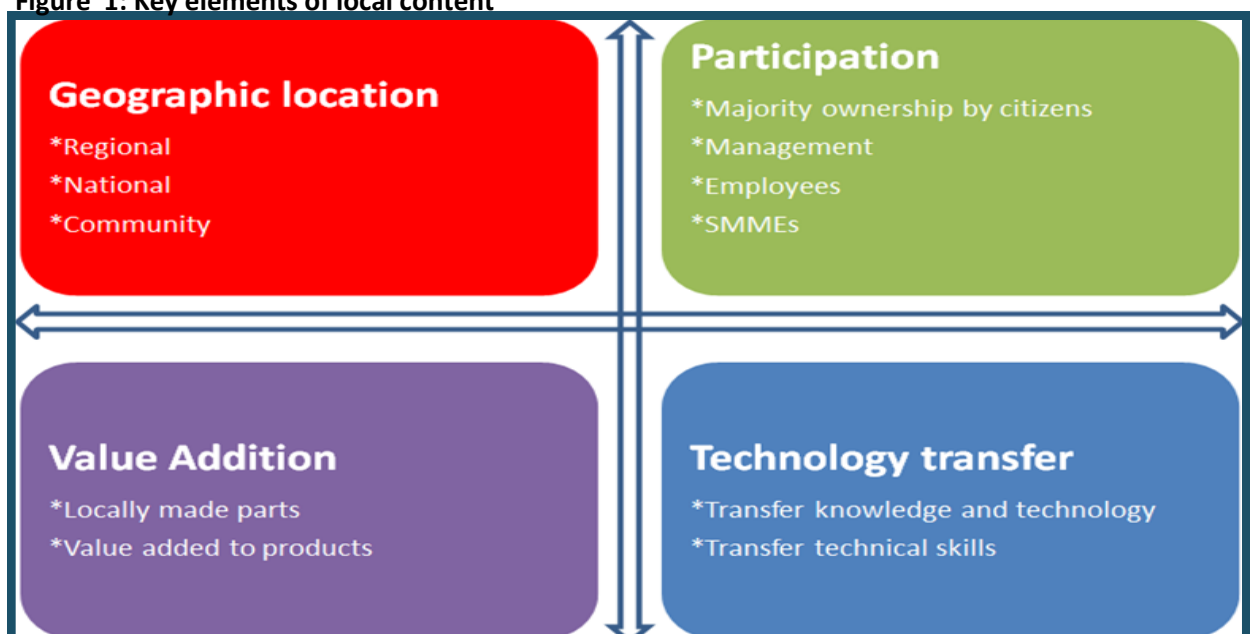
The motivation and key elements of local content can be summarised as shown in Figure 1 in terms of geographic location, participation, value addition from the development of local industries, and technology transfer from labour market development through knowledge and technical skills transfer.

## OPTIONS OF LOCAL CONTENT

Local content can be implemented in different forms for virtually any sector, goods or services. It usually takes the form of the following:

- Minimum thresholds on the amount of locally sourced materials to produce goods. This is usually expressed as a percentage of volume, length, or number.

Figure 1: Key elements of local content



Source: Department of Trade and Industry, 2016

- Minimum thresholds on the amount of locally sourced expenditure or man-hours for the use of services, such as engineering and transport, financial services, and insurance.
- Explicit or implicit requirements that companies take local content development into account in their projects and strategic planning, or when undertaking feasibility studies.
- Requirements for companies, operators or investors to establish facilities, factories, production units or other operations locally to carry out any production, manufacturing or service provision being imported.

In the South African context, local content is defined as the proportion of the tender price which is not included in the imported content, provided that local manufacturing does take place within the borders of South Africa (the dti, 2016). Under the Preferential Procurement Policy Framework Act and Regulation (latest revision released in December 2015), the government designated certain sectors in which all suppliers have to meet the set minimum local content requirements if they are tendering for goods, works and service contracts within the public sector. The regulations require all organs of state to buy only locally produced services, works or goods from the designated sectors. Those sectors or products that have been designated for local procurement have stipulated minimum thresholds of local content and Table 1 (on pages 3 and 4) shows the minimum thresholds applied to the different designated sectors.

Although the government has implemented its local content policy and the stipulated minimum thresholds for the designated sectors, the policies have not

resulted to the desired level of local procurement. It is important to understand, and address, why this problem persists.

### WHY LOCAL CONTENT POLICIES ARE NOT TRANSLATING TO DESIRED LEVELS OF LOCAL PROCUREMENT

Local content policies have not resulted in the desired levels of local procurement in South Africa because of a variety of factors. In some instances, local producers may not be competitive on quality and price against foreign suppliers and not meet the required specifications, unless they are given more time and adequate access to finance (Gwayaka, 2014). However, procurement regulations give no space to negotiate and therefore many local suppliers fall in the non-compliance category and in some cases total exclusion from the process when they may be able to match imported quality and price given the opportunity. Another problem lies with transaction costs of some locally manufactured goods being too high, i.e. local producers may struggle to compete with cheaper imports. Transaction costs can be reduced by ensuring that cost-effective practices are implemented in the procurement system, such as avoiding unnecessary costs and delays for a department and its suppliers; sending a clear signal to firms on the quantities that will be procured over an extended period; and having clear standard specifications that will be used.

It is important to note that it is difficult to analyse the degree of some of these challenges because of the lack of overarching data, particularly on cost and quality. Additionally, the systems to implement, measure and monitor compliance regarding local content are not in place.

**Table 1: Minimum threshold for local content for designated sectors in South Africa**

INDUSTRY/SECTOR/SUB-SECTOR	MINIMUM THRESHOLD FOR LOCAL CONTENT
Buses (Bus Body)	80%
Textile, Clothing, Leather and Footwear	100%
Steel Power Pylons Monopole Pylons Steel Substation Structures Powerline Hardware Street Light Steel Poles Steel Lattice Towers	100%
Canned / Processed Vegetables	80%
PHARMACEUTICAL PRODUCTS Oral Solid Dosage (OSD) Tender Family Planning Tender	70% (volumes) 50% value
Rail Rolling Stock	65%
Set Top Boxes	30%
FURNITURE PRODUCTS Office Furniture School Furniture Base and Mattress	85% 100% 90%
Solar Water Heater Components	70%
Electrical and Telecom Cables	90%
Valves Products and Actuators	70%

*Table 1 continues on page 4*

INDUSTRY/SECTOR/SUB-SECTOR	MINIMUM THRESHOLD FOR LOCAL CONTENT
<b>RESIDENTIAL ELECTRICITY METER</b>	
Prepaid Electricity Meters	70%
Post Paid Electricity Meters	70%
SMART Meters	50%
<b>WORKING VESSELS/BOATS (ALL TYPES)</b>	60%
Components	10% - 100%
Conveyance Pipes	80% - 100%
<b>TRANSFORMERS AND SHUNT REACTORS</b>	
Class 0	90%
Class 1	70%
Class 2	70%
Class 3	45%
Class 4	10%
Components and conversion activities	50% - 100%
<b>SOLAR PV COMPONENTS</b>	
Laminated PV Modules	15%
Module Frame	65%
DC Combiner Boxes	65%
Mounting Structure	90%
Inverter	40%
<b>TWO WAY RADIO TERMINALS &amp; ASSOCIATED EQUIPMENT</b>	
Portable Radio	60%
Mobile Radio	60%
Repeater	60%
Components	20% - 100%
<b>RAIL SIGNALLING</b>	65%
Components	40% - 100%
Wheely Bins	100%
<b>FIRE FIGHTING VEHICLE</b>	30%
Crew Cabin	100%
Super Structure	100%
Assembly	100%
<b>STEEL PRODUCTS AND COMPONENTS FOR CONSTRUCTION</b>	
Steel Value-added Products:	
Fabricated Structural Steel	100%
Joining/Connecting Components	100%
Frames	100%
Roof and Cladding	100%
Fasteners	100%
Wire Products	100%
Ducting and Structural pipework	100%
Gutters, downpipes & lauders	100%
Plates	100%
Sheets	100%
Galvanised and Colour Coated Coils	100%
Wire Rod and Drawn Wire	100%
Sections	100%
Reinforcing bars	100%

Source: Department of Trade and Industry, 2016

TIPS attempted to analyse the price premium on government when implementing public procurement, but data on contract prices is not available for researchers to conduct quantitative analysis on the cost of procurement. Furthermore, with the lack of clarity with definitions of local content, and without clear and simple definitions, it becomes hard to monitor implementation of the policy and ensure that implementation is being undertaken across government. (Additional challenges include: lack of underlying industrial capacity; inadequate qualified technical level human resources to meet the criteria

of local content policies; and local content being susceptible to corruption and favouritism.)

### KEY ISSUES, DEBATES AND LESSONS

Several key issues, debates and lessons shape the discussions on successfully implementing local content policies. While some view local content policies as a necessary tool for developing linkages within the manufacturing sector, others view them as protectionist (Ramdoo, 2016). Critics view these policies as doomed to fail, or at best designed to provide sub-optimal outcomes, because it is not the

role of government to “pick winners” (Hufbauer et al, 2013). Poorly designed local content policies can create perverse outcomes and can easily create a politically powerful lobby of short-lived and inefficient companies that thrive on the imperative for local content (Silva, 2014). A lesson from designing local content policies is that the formulation process must be open, transparent and backed by strong and accountable institutions.

Another crucial lesson in implementing local content policies is that the targets must be realistic and based on plausible economic assumptions (Silva, 2014). Policies must be designed to ensure that realism governs target-setting and compliance monitoring. This would ensure that firms have the space to build up their capacity and capability to meet increasing local demand.

A country’s capacity and capability are not static, but evolve over time and local content policies need to change in line with those capabilities and capacities (Gwayaka, 2014). Therefore, a gradual phasing in of local content policies will allow for industrial development and adjustment to accommodate new information (Silva, 2014).

Tracking and monitoring price information of both winning and losing bids, their country of origin and percent of local content is a priority if the state wants to effectively use procurement as an industrial policy tool.

## CONCLUSION

The primary economic rationale for the use of local content policies is to ensure that the taxes collected by the state are used not only to provide citizens with public goods but also as a tool for development of new industries and/or for strengthening of the domestic industrial base. South Africa identifies local content as an important tool that can help leverage the power of public procurement and lead to the development of industrial capabilities and capacities. However, achieving the desired levels of local procurement using local content policies has been a challenge for South Africa.

This is mainly because local producers struggle to compete in quality and price compared to foreign suppliers; transaction costs of locally manufactured products are too high; there is a lack of systems to monitor local content procurement and compliance, and the definition of local content is not very clear.

South Africa can draw from the key lessons and debates to overcome some of the challenges hindering the successful use of local content. First, the definition of local content must be clear and simple. Second, it is important that the policy is carefully calibrated and realistic. Third, there are systems in place to monitor and record pricing information on tenders. Last, the procurement processes by the state must be designed with local content and industrialisation of the South African economy as their priority.

This approach would require:

- Policy synergy between local content legislation and other policies.
- Establishing a strong institutional framework to support implementation of local content.
- Effective monitoring and evaluation of compliance with local content requirements and price information.

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[info@tips.org.za](mailto:info@tips.org.za)

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