



TRADE & INDUSTRIAL POLICY STRATEGIES

LOCALISATION AND INDUSTRIAL POLICY: SCOPES, DEBATES AND INSTRUMENTS

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TIPS supports policy development through research and dialogue. Its areas of focus are trade and inclusive industrial policy, and sustainable development

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1 PROBLEM STATEMENT

Localisation has become an increasingly important part of South Africa's industrial policy as articulated by the Department of Trade, Industry and Competition (the dtic). At its core, it is a strategy to identify and support sectoral priorities for industrialisation. Those functions are also central to the well-known import-substitution and export-oriented models. The localisation approach remains relatively under-theorised, however, and is often wrongly equated to import-substitution industrialisation as conventionally conceptualised.

This paper aims to deepen understanding of South Africa's localisation strategy by identifying:

- Its economic logic;
- How it differs from the import-substitution and export-oriented approaches adopted over the past century; and
- The main obstacles to implementation.

On that basis, the paper indicates reforms that would strengthen the contribution of localisation to inclusive industrialisation in South Africa.

The following section defines localisation and outlines its economic logic, which centres on using local and domestic demand to incubate infant industries into competitive producers. It then explores how the localisation approach differs from the classic import-substitution and export-oriented models, although it incorporates some of their elements. Section 3 outlines the main blockages to successful implementation, which arise from both inappropriate procurement systems and supply-side constraints. In that context, it presents a simple theory of change for local procurement that points to the main prerequisites and risks for success. The final section points to interventions to secure more consistent implementation of measures supporting localisation in ways that foster more inclusive and equitable growth.

2 THE ECONOMIC LOGIC BEHIND LOCALISATION

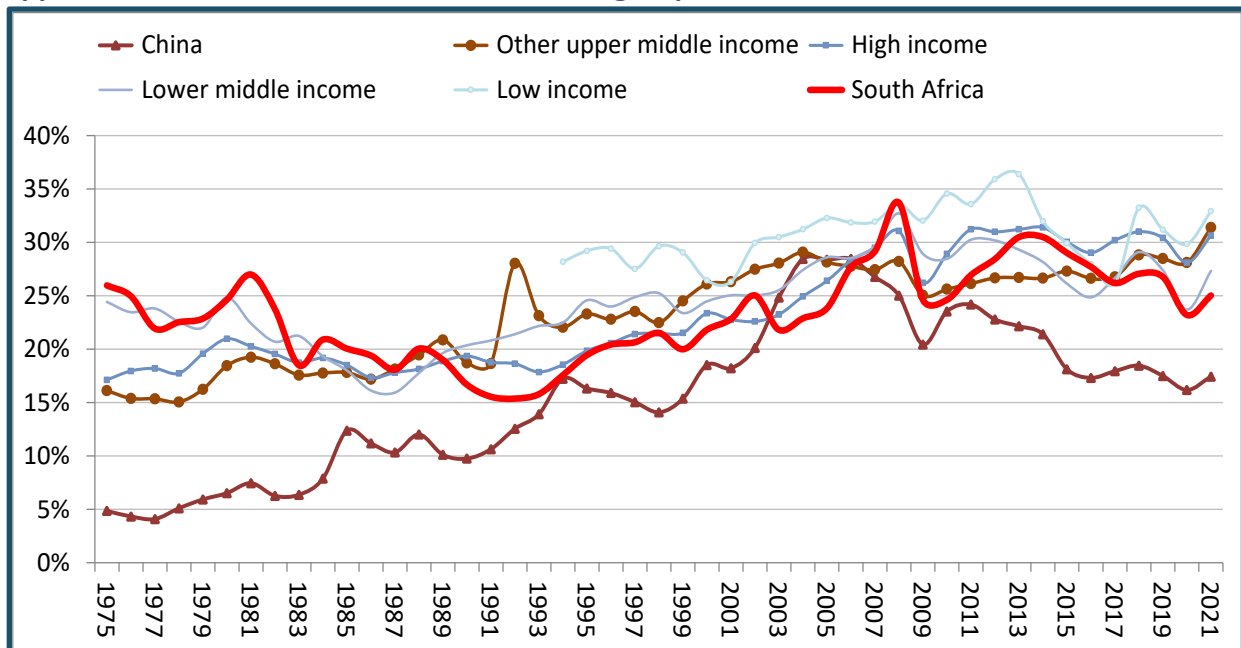
At a theoretical level, localisation – like virtually all industrial policy measures – is rooted in the infant industry argument. That argument holds that local producers, whether existing or only prospective, can become nationally and even globally competitive if given initial support. Moreover, local production can cut delivery times and provide goods and services tailored to local needs. Given this approach, the challenge is to identify which industries can grow substantially in ways that achieve national socio-economic aims in the long run, even if they require significant state support before taking off.

To understand the answer proposed by the localisation approach, this section first outlines the core elements of the strategy; then evaluates it compared to other models designed to identify what industries to support; and finally outlines its likely costs and benefits to different stakeholders, including government departments, employers and working-class communities.

2.1 Defining localisation

In practice, localisation has been associated with efforts to get government agencies and large formal businesses to buy more goods and services locally, whether for use in South Africa or for export. The challenge is to distinguish it from industrial policy as a whole. In a 2020 policy statement on localisation, the dtic defined localisation as “building local industrial capacity for the domestic market and for export markets”. (the dtic 2021:1) The department’s 2023 Annual Performance Plan was more targeted. It argued that South Africa was more import dependent than other upper-middle-income countries (see Graph 1). It concluded that industrialisation would require both greater local production of currently imported goods, including inputs for export industries as well as consumer goods, and increased beneficiation of commodities for export. (the dtic 2023:19)

Graph 1. Imports as a percentage of GDP for South Africa compared to China and to other upper-middle-income economies and income groups, 1975 to 2021

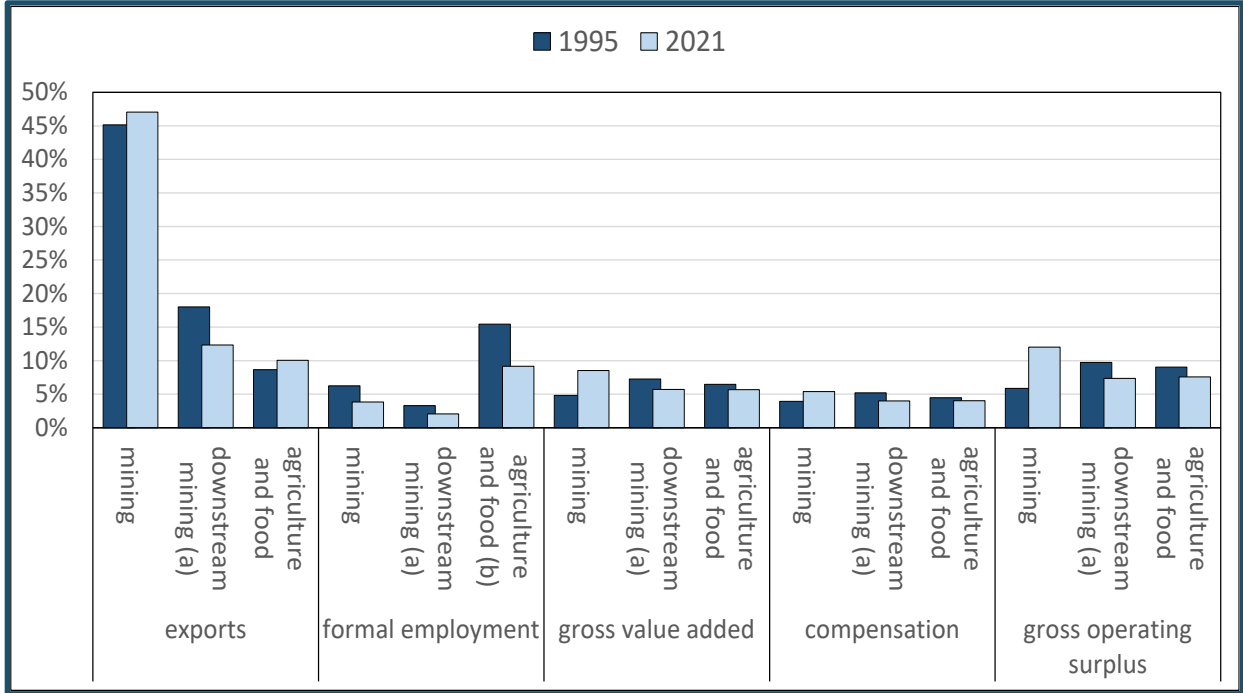


Source: Calculated from World Bank. World Development Indicators. Interactive dataset. Accessed at www.worldbank.org in June 2023.

The challenge of defining localisation reflected both practical and theoretical challenges. On the one hand, South Africa’s overall industrial policy aims to diversify away from commodity dependency. In this context, import demand provides a signal that local production might be possible. In itself, however, it is not a guarantee of viability or desirability. On the other hand, since the 1990s, import-substitution industrialisation has been subject to a broad theoretical (often near-ideological) attack on the grounds that it promotes inefficient local producers. In response, the concept of localisation aims to use the pattern of imports to identify spaces for infant industries while addressing the shortcomings identified in the classic import-substitution model.

In post-colonial economies, industrial policy starts with the argument that absent government support for new activities, dependency on exports of commodities and imports of manufactures will persist, ultimately slowing growth. From this standpoint, a core factor behind the stagnant economy and unusually profound inequality in South Africa is persistent dependence on mining and commercial farming. Half of exports are metals and minerals, while agriculture generates another tenth. In contrast, oil and refined oil products account for a seventh of imports and manufactures for nine tenths. A third comprises capital equipment, metals and basic chemicals. Yet taken together, mining and agriculture generate only 15% of formal employment and a quarter of the GDP. Mining's share in the GDP and exports spiked from 2020 as a result of soaring global prices. (Graph 2)

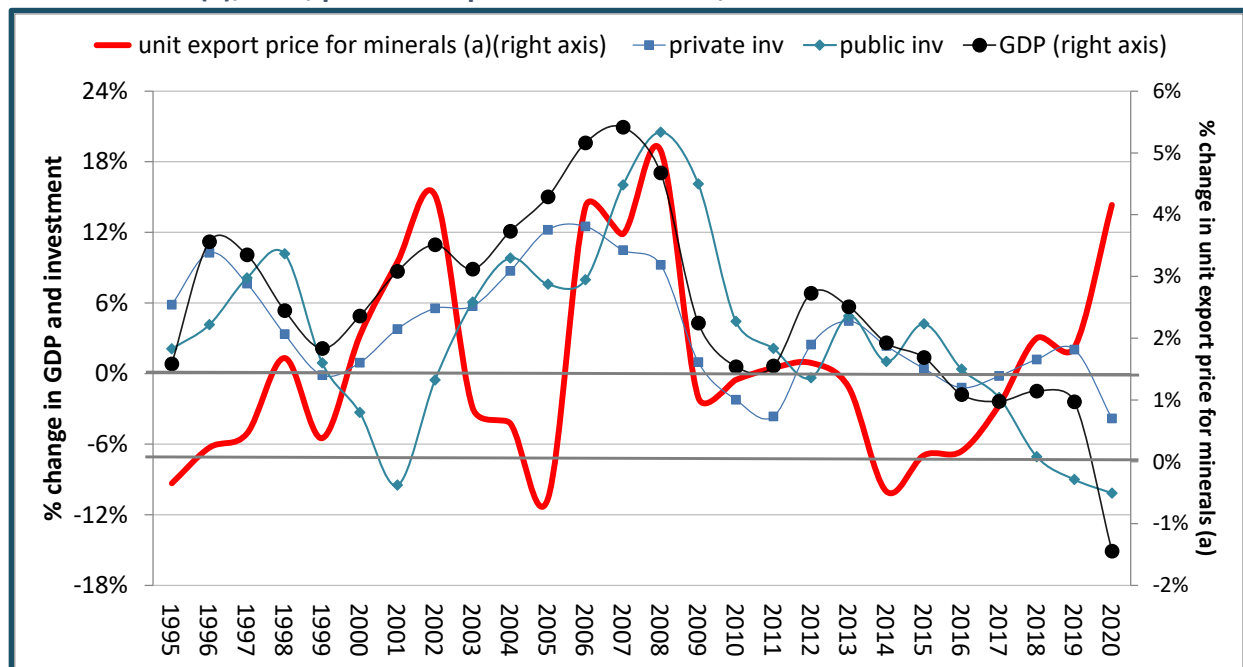
Graph 2. Exports, formal employment, gross value added, compensation of employees and gross operating surplus in the mining and agricultural value chains as percentage of total, 1995 and 2021



Note: (a) Includes raw metals and basic metal products such as structural steel; plastics and petroleum, which are produced by Sasol from coal; and electricity. *Source:* Quantec. EasyData. RSA Trade SIC and BEC and Standardised Industry Series. Interactive datasets. Accessed at www.quantec.co.za in June 2023.

Industrial-policy proponents argue that depending on commodities is problematic because they experience extreme price swings. Over the past 30 years, these fluctuations have heavily influenced growth in the GDP and investment in South Africa, as Graph 3 shows. Before the pandemic, when world metals prices spiked, economic growth and job creation accelerated; when they stagnated, so did the economy. The pandemic was an exception, as mining exports soared in 2020 but the GDP crashed as the world economy locked down. High minerals prices supported the recovery in the GDP thereafter, but began to moderate from late 2022.

Graph 3. Percentage change in three year rolling averages of unit export prices for minerals in constant rand (a), GDP, public and private investment, 1995 to 2020



Note: (a) Weighted average of the actual unit export price in rand (that is, export revenues divided by weight) for coal, gold, iron ore and platinum, reflatd with CPI. Source: Quantec. EasyData. RSA Trade SIC and BEC and Macroeconomic series. Interactive datasets. Accessed at www.quantec.co.za in June 2023.

If policymakers want to diversify away from commodities, they have to identify what clusters, industries or value chains government should support. In South Africa’s case, this project is aggravated by the need to overcome the extraordinarily high levels of inequality and joblessness entrenched under apartheid. As a result, industrial policy initiatives must support at least some activities that generate employment and raise living standards on a mass scale as well as promoting more advanced manufacturing and services industries.

Since the 1990s, theoretical engagements on what industries to prioritise have centred on stylised views of import-substitution industrialisation and export-oriented growth. In this context, localisation emerges as an effort

- to build on the strengths of import substitution in identifying viable opportunities for local production, but
- to eliminate its two main perceived weaknesses – an emphasis on tariffs as the main policy instrument, and an excessive focus on final consumer goods production for domestic consumers.

Specifically, the localisation strategy seeks to replace imports of intermediate and capital goods used for export production and infrastructure as well as final consumer products; to change public and private procurement systems to promote local producers rather than relying primarily on tariffs; and to address supply-side constraints. The approach took off in the mid-2010s as Eskom and Transnet embarked on huge infrastructure projects that required new equipment on

a huge scale. As discussed below, it also built on long-standing efforts to encourage local production of inputs for auto exports.

Table 1 compares the aims and instruments proposed by localisation to import substitution and export promotion, as well as two further strategies – increased local beneficiation, and continued dependence on commodity exports. The table also indicates the experiences commonly cited as successes for each strategy.

Table 1. Stylised representation of strategies to identify priorities for economic diversification

STRATEGY	IDENTIFICATION STRATEGY	MAIN INSTRUMENTS	PARADIGMS
Import substitution	Import demand points to opportunities for local production.	Tariffs on final products. Investment incentives for private producers of the identified products. Investment by state-owned companies (especially in post-colonial Africa). Provision of serviced sites and other infrastructure.	Latin America from 1930s; post-colonial Africa from 1950s. Also United States and Europe in 19th Century; East Asia from the early 20th Century.
Export-oriented growth	Industries that meet international demand, especially providing inputs for value chains managed by global manufacturing brands.	Incentivise foreign and domestic investment in export manufacturing, among others through finance, tax breaks, tariff rebates for imported inputs, dedicated export infrastructure, and/or low wages. Engage with global brands to contract local suppliers.	East Asia (Japan and South Korea from the 1950s; China from the 1980s; most recently Vietnam).
Localisation	Areas of high or increasing import demand, including for new infrastructure investment and inputs for export industries (auto, mining) as well as consumer goods.	Restructure public and private procurement systems, including retailers, to favour local suppliers. Link to supply-side measures (infrastructure, financing, other incentives).	Not conceptualised as a separate strategy in the global theoretical discourse, but in practice part of virtually every industrial policy.

STRATEGY	IDENTIFICATION STRATEGY	MAIN INSTRUMENTS	PARADIGMS
Beneficiation	Commodities that are currently exported in unprocessed form (as ores or agricultural products) for which there is global demand.	State provides affordable and reliable infrastructure (in South Africa, especially cheap electricity, rail transport and ports). Tax incentives (royalties and/or export taxes on unprocessed products). Licensing requirements for mining companies. Government investment in processing facilities.	Australia, Canada, Finland, Zambia.
Maintain commodity exports	Trends in global demand and South African advantages for individual commodities.	Provision of reliable and affordable infrastructure (water, electricity, transport). Protection of ownership rights to support long-term investments in mining and farming.	Chile, Australia, Canada.

In short, localisation is defined in practice by:

- The use of actual or anticipated imports to indicate when demand would warrant local production,
- An explicit emphasis on local production of inputs for export industries and infrastructure as well as final consumer goods, and
- A focus on restructuring public and private procurement to promote local production, rather than relying primarily on tariff protection.

Any strategy that involves government measures to replace imports with local products builds in a key presumption: that, at least in some cases, the market is not inducing investments that would ultimately prove both economically sustainable and socially beneficial. The following section explores when this would be the case.

2.2 The economic logic

Localisation policies rest on three interlinked economic arguments.

1. Local procurement would generate significant benefits, as meeting domestic demand boosts production, investment, technological capacity and employment. Local procurement may also reduce the transaction costs inherent in imports and encourage production of goods and services to meet specific local and regional requirements, rather than reflecting overseas conditions.
2. Despite these benefits, local producers face blockages that prevent them from competing effectively with imports on price and quality, at least in the short run.

3. For at least some products, local producers can overcome the blockages, although it may take some time – how much depends on the specific circumstances.

This logic means that the actual outcomes of localisation depend heavily on the nature of the obstacles to domestic production, which vary substantially by industry, as well as the potential benefits if successful. The obstacles take three main forms:

1. Procurement systems may effectively favour imports even where they are not significantly better on price or quality. This may occur because
 - government departments, retailers and large formal companies have long-standing relationships with importers or foreign suppliers;
 - their communications systems do not reach potential domestic producers or give them time to gear up to meet specific needs;
 - they include unnecessarily restrictive specifications that effectively exclude local suppliers; and/or
 - in some cases, their supply-chain managers get pay offs.
2. Local producers may be able to meet requirements for products that are now imported but need a few months' notice to adapt designs or get up to scale. As a result, they cannot meet short timelines for tenders.
3. New and existing local producers may need time – even years – to build new capacity and then to develop competitive technological and management systems. These “infant industries” may become competitive, and in some cases even global players. But that may take years, even decades, of production for local users that is higher cost, worse quality and/or unable to ensure a reliable supply. The Indian and Chinese pharmaceutical companies illustrate the long road required by some ultimately successful infant industries.

The economic logic of localisation means that every opportunity to replace imported products must be evaluated on a case-by-case basis. The critical questions around economic and social viability become:

1. What are the benefits of local production of a specific good or service in meeting local and regional needs; job creation; economic growth; technological advances; and other externalities? The benefits will naturally vary substantially by product, but taken together the supported activities should contribute to both more dynamic and more inclusive growth.
2. If local production requires a price premium, for how long would that be the case, and what could be done to minimise the costs? In these cases, would the benefits still outweigh the costs?

Local procurement is easy to justify when there is no price premium relative to imports. In these cases, the dependence on foreign products effectively results from shortcomings in the procurement system, usually around long-standing relationships with suppliers; prioritisation of importers over local producers, for instance because they are township enterprises or historically

disadvantaged individuals; and unnecessarily exclusionary specifications. When local products will cost more than foreign goods and services, however, it becomes important to evaluate the benefits of local procurement to ensure that they justify the higher price. The dimensions that such an evaluation should consider are discussed in Section 3. First, however, the following section explores how localisation fits into the broader debates around industrialisation models.

2.3 Localisation and debates on industrialisation

This section compares localisation to the five strategies included in Table 1. For each, it first outlines the main success stories. It then notes the leading theoretical criticisms as well as the counter-arguments. Ultimately, the analysis finds that, in practice, every industrial policy, including those in successful industrialisers in the global North and East Asia, combines all five strategies to some extent.

2.3.1 Import-substitution industrialisation

The import-substitutional industrialisation strategy, as portrayed in most theoretical debates, centres on using tariffs to secure domestic demand for local producers. In most countries, it has succeeded in promoting production of some goods that were previously imported. In larger countries in East Asia, very high tariffs over decades in the 20th Century laid the basis for strong export industries (such as auto and electronics in Japan, South Korea and China; steel and solar panels in China). In contrast, in Latin America and post-colonial Africa, tariffs to promote import substitution have not had nearly as much success in promoting competitive production.

From the 1990s, import-substitution industrialisation came under strong criticism on the grounds that it entrenched uncompetitive producers behind tariff walls. Moreover, in smaller countries, the new industries generally could not reach economies of scale, or even grow very much, as a result of limited domestic markets. Often they retained obsolete technologies and poor management systems because they were not compelled to compete with world leaders. The risk is that becomes a “protectionist, inward-looking strategy that ends up promoting rent-seeking and stifling efficiency and innovation.” (De la Torre and Ize 2022:4)

Critics also argued that import substitution policies enabled investors to benefit by setting up last-stage processing plants, without developing upstream suppliers. As a result, the production and employment multipliers from these projects remained relatively small. Moreover, in this view, because the new industries depend heavily on imported capital goods and intermediate inputs without promoting exports, they build in strains on the balance of payments.

Deciding where to invest based on existing import demand inherently means that the projects follow the market, even if its outcomes are undesirable. In very unequal economies, like South Africa and most of Latin America, they will not produce goods for working class communities unless government pays for them, as for instance with housing and school lunches. Moreover, if new producers seek only to replicate existing import patterns, they are unlikely to develop or even keep up with cutting-edge product or process technologies.

Last but not least, since the early 1990s World Trade Organization (WTO) rules have effectively banned tariffs to support new clusters and industries. The WTO does not, however, prevent governments and large local companies from privileging local suppliers, or ban supply-side measures to assist producers to become more competitive.

Arguments in support of import substitution strategies start by pointing to the use of high tariffs in the early phases of industrialisation in virtually every industrialised country. Protective tariffs were widespread when the global North industrialised in the 19th Century. Moreover, all industrialised countries in East Asia, from Japan to China, initially established competitive industries behind high tariff barriers. By extension, when tariffs fail to encourage competitiveness, the causes lie in their specific design; domestic markets that cannot support efficient production due to small populations or deep inequality; or inadequate measures to address supply-side constraints to competitiveness.

2.3.2 Export-led growth

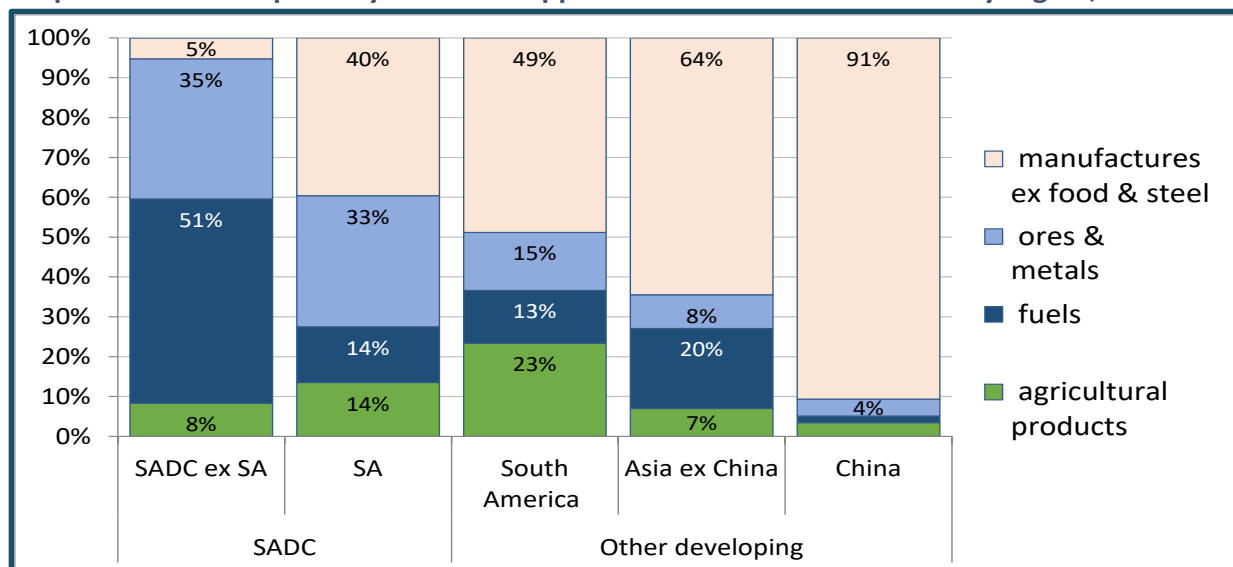
The main promise of export-oriented growth is that world markets, especially in high-income economies in the Global North, promise almost unlimited demand. That means they can support much more rapid growth in production than a focus on limited domestic demand. Moreover, proponents contend that competing abroad compels local producers to improve efficiency and quality. Finally, when local enterprises work with global brands, from sports shoe producers to retail chains to car companies, they can gain access to new production technologies, higher product standards, and international markets.

The classic models for export-oriented industrialisation are all in East Asia, starting with Japan, then South Korea and Taiwan, followed by China and most recently Vietnam. After they joined the European Union, exports became an important source of growth for Eastern European countries as well.

Critics argue that a focus on the desirability of export-led growth underplays the significant obstacles to its success in most of the world. As Graph 4 shows, no other region in the Global South has come close to catching up with East Asian success in exporting manufactures.

Critics also argue that other regions can no longer break into global value chains on a significant scale for three main reasons. First, East Asian producers now dominate most manufacturing trade outside of high-tech products and capital goods, which are still controlled by the global North. Competing with these established suppliers is difficult for latecomers. Second, through the 2010s, global trade in manufactures barely grew. From 1980 to 2010, in constant US dollar terms, East Asian exports of manufactures climbed 6,7% a year; in the rest of the world, they rose 3,5% annually. From 2010 to 2020, in contrast, East Asian exports of manufactures expanded just 1,5% a year in constant US dollars, and the rest of the world saw manufactured exports fall by 0,4% annually. Finally, over the past half century, East Asian countries as a region have built up efficient trade routes to the global North. Replicating such large-scale infrastructure is, again, inherently difficult for latecomers like South Africa.

Graph 4. Share in exports by sector for upper middle income economies by region, 2018



Source: Calculated from UNCTAD. UNCTADStat. Merchandise trade matrix. Interactive database. Accessed at www.unctad.org in October 2019.

A second critique is that East Asian countries never relied exclusively on export-oriented measures. Virtually all industrialised countries in the region started with tariffs – some extraordinarily high – to promote import substitution for decades before they became dominant exporters. From this standpoint, their main advantages in industrialisation were relatively large domestic markets in terms of both population and relative equality and, for latecomers, their proximity to earlier industrialisers (Japan, then South Korea and Taiwan). These countries became critical sources of investment across Asia in both production and logistics infrastructure.

Finally, critics argue that the hope of export-led growth can lead countries into a race to the bottom in an effort to attract foreign brands. The dominant companies in global value chains typically demand cheap labour and low taxes. Often, however, they generate limited production and employment multipliers because they import virtually all advanced inputs from foreign affiliates. China managed to avoid this by threatening to restrict access to its enormous domestic market – it holds almost a fifth of the global population – unless there was a degree of technology transfer. Smaller economies, however, have much less leverage.

The counterargument holds that there is simply no alternative to export-led growth. In this view, reaching modern economies of scale requires taking advantage of foreign markets, especially in the Global North and China. Moreover, where export-oriented strategies have worked, they have fuelled extraordinarily rapid growth – far faster than other options. For proponents, the East Asian experience demonstrates that export-led growth is the first-best option. Other countries should therefore pursue it even though success may be a long shot for most.

2.3.3 Localisation

As noted, in practice localisation forms part of almost every industrial policy. It has been part of government efforts to promote industrialisation for over a century.

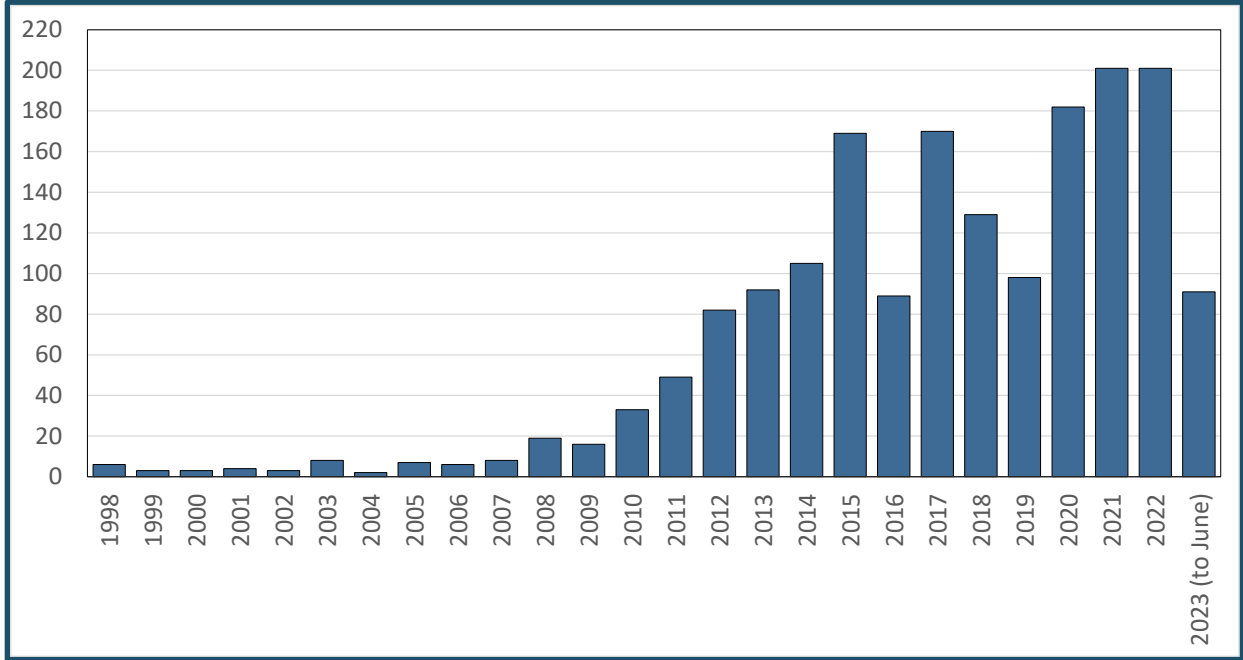
In South Africa, the first efforts at localisation emerged in the colonial Boer Republics, which aimed to replace imported inputs for mining and agriculture. In the 1940s, the state initiated a large-scale programme to promote local manufacturing of components for the auto industry. It continues to this day. From the 1950s, the state also supported production of armaments, clothing and refined petrol, among others through a combination of tariffs, public procurement policies, and supply-side support, including financing by the Industrial Development Corporation.

With the transition to democracy, starting in 1989, the economy opened up abruptly. The process brought new-found interest from foreign companies as well as accession to the WTO. In response, the democratic state initially placed its hopes in export-led growth combined with soaring domestic demand for housing, infrastructure and basic consumer goods as the economy became more inclusive.

Around 2005, the government re-committed to increased investment in bulk infrastructure, and localisation policies returned to prominence. The government called on state-owned companies, led by Eskom and Transnet, to increase their procurement of locally produced equipment, notably trains and power-plant machinery. In the late 2010s, it engaged with retailers to promote sales of local goods, especially clothing. Later, in 2020, the COVID-19 pandemic fuelled efforts to expand domestic production of critical medical inputs, mostly personal protection equipment, sanitisers and respirators.

Discussions in Parliament from 1998 reflected the evolution of interest in localisation as a driver for industrialisation, as Graph 5 shows.

Graph 5. Number of references to localisation in Parliament, by year, 1998 to June 2023 (a)



Note: (a) Before 2008, mentions referred to localisation of municipal functions, not to economic localisation. *Source:* PMG. Interactive website. Search for “localisation”. Accessed in June 2022 at <https://pmg.org.za/search/?via=homepage-s-top&q=localisation>.

Opponents of localisation programmes generally argue that it is just a form of import-substitution industrialisation, and therefore promotes inefficiency while limiting producers to the relatively small domestic market. They effectively argue that if local suppliers are not competitive, paying them a price premium only props up high costs and inefficiency. In its most extreme form, this argument implies that procurement decisions are invariably rational, so any policy intervention must impose net costs (see CDE 2021:5). Moreover, critics contend that a focus on the domestic market necessarily deprioritises efforts to promote integration into global value chains.

In South Africa, some opponents of localisation link it to state capture. Like all industrial policies, localisation necessarily substitutes political and managerial decisions for market signals. That makes it easier for corrupt businesspeople to influence procurement decisions.

The counterarguments centre on the belief that once local production is initiated, at least in some cases it can become competitive over time. Moreover, in some cases local production brings external benefits, mostly direct and indirect job creation; technological spillovers; products tailored to local needs, such as medicines for HIV; and reduced supply times and transport costs. In theoretical terms, as suggested in Section 2.2 and discussed in more detail in Section 3, pervasive market imperfections mean that market outcomes are not necessarily efficient from the standpoint of the procuring agency, much less society.

Proponents argue that localisation programmes can identify projects where the benefits outweigh the cost of a price premium in the short to medium term. By extension, decisions have to be made on a case-by-case basis, taking into account the costs to public and private consumers, domestic capacity and the longer-term scope for regional and overseas exports. Even then, not every project will work out as planned. It follows that successful localisation requires strong risk management systems.

Finally, proponents of localisation argue that localisation forms a component of export-oriented growth rather than a competing priority. In practice, everywhere in the world efforts to promote production for global value chains include localisation of inputs as a medium to long-run objective.

2.3.4 Beneficiation

Beneficiation strategies centre on increasing the value added from commodity value chains. In the case of mining, a core aim is to maximise national returns from finite assets. Mineral wealth is not renewable, the argument goes, so countries should gain as much benefit as possible while it lasts. Moreover, if governments can ensure that downstream manufacturing pays only competitive (cost-plus) prices on refined raw materials, they will effectively get a share in the mining rents through local beneficiation. That is important for inclusive industrialisation because the downstream industries generate much greater employment and technological spillovers than mining or first-stage refining.

Beneficiation has a long history in South Africa. Eskom effectively bought local coal at below global prices to process into low-cost electricity from the turn of the 20th Century until 2008.

After that, the coal rents moved back upstream as the coal mines raised their domestic prices nearer to export parity while Eskom more than doubled tariffs for its business customers. A similar process emerged in the steel value chain, as the privatisation of Iscor ultimately led to higher prices for iron ore and domestic steel, moving the rents away from downstream fabricators to the upstream steel and ore producers (AMSA and Kumba).

Critics argue that first-stage beneficiation does not usually lead to downstream manufacturing of capital or consumer goods. The bulk of the raw materials are still exported with limited processing, in South Africa's case as steel and other metals, basic chemicals and electricity. Moreover, the new refineries typically charge import-parity prices to local customers. As a result, they add only limited value, do not promote significant technological spillovers, and generate little employment either directly or indirectly.

Critics also point out that metals refineries typically need lots of reliable, cheap electricity, which became a problem for South Africa from the late 2010s. Moreover, South Africa's refineries have historically depended on coal-fuelled electricity. That means they will likely run into escalating trade barriers as other countries seek to reduce emissions.

Finally, refineries are capital intensive in terms of both production and infrastructure. Critics contend that supporting them necessarily diverts resources from more labour-intensive and dynamic industries.

As noted, proponents of beneficiation argue that because minerals are a wasting asset, countries should make every effort to add value to them before export. The alternative would be to export unrefined ores, leaving South Africa with only minimal benefits from its mineral riches. The rents can stimulate downstream production if the government intervenes to ensure cost-plus rather than import-parity pricing on refined products such as steel, basic plastics and crushed soya for animal feed.

Proponents also argue that refineries can develop their own renewable energy supplies, which would reduce the pressure from the national grid. In this view, beneficiation can benefit as much from South Africa's abundant solar and wind power as it did from coal.

2.3.5 Continued commodity dependence

While few observers argue explicitly against economic diversification, in practice many government officials and businesses lobby for government to continue to prioritise support for mining and agriculture. Over the past 30 years, South Africa has greatly diversified exports of mining and agricultural products. As a result, although production and employment on the maturing gold mines plummeted, mineral exports as a whole continued to grow.

The standard criticism of commodity dependency is that it subjects the economy to global market cycles rather than maintaining steady and rapid growth. (See Graph 3). Furthermore, mining dependency brings deep inequalities in ownership with limited employment and significant income inequalities. In South Africa, there are 400 mines registered for iron ore, coal, platinum

or gold, with the largest controlled by a handful of mining conglomerates. Moreover, export agriculture depends on around 30 000 commercial farms. Both industries still have a high level of functional inequality. The share of labour in value added averages 40%, compared to 55% in the rest of the economy. Moreover, while they account for over half of total exports, they generate just 15% of total employment. These inequalities result in significant socio-economic tensions and pressure for fiscal redistribution as well as changes in property rights to broaden ownership.

The counterargument is that South Africa cannot simply walk away from mining and agriculture, which are its core economic strengths. When commodity prices are high, as during the pandemic and the first year of the Russian invasion of Ukraine, their production generates huge benefits in terms of incomes, employment and tax revenues. During global downturns, increasing and diversifying commodity exports can alleviate some of the pain.

Supporters of continued development of commodity exports also argue that there is no necessary trade-off against growth in manufacturing and services. In this view, as mining and agriculture generate rents on global markets, they can help finance other activities that do more to generate opportunities for historically excluded communities.

2.4 Conclusions: Localisation in industrial policy

Debates on the relative benefits of import-substitution and export-oriented growth – often posed as inward vs outward looking strategies – tend to oversimplify. In practice, every industrial policy incorporates some elements of localisation, both for final products for domestic use and for intermediate inputs into export value chains. The challenge, as always in industrial policy, is to determine the relative costs and benefits of specific projects, taking into account national socio-economic aims. Even more important is to manage the inevitable risks of working outside of short-run market imperatives. Success requires monitoring projects carefully, and finding ways to minimise the costs of failure.

From this standpoint, the problem with localisation – and indeed with the other strategies evaluated here - is not its benefits or costs in the abstract. Rather, it is to find ways to identify viable projects on a much larger scale. To do that, the government has to analyse and address the main blockages to localisation both overall and for specific products. That is the subject of the next section.

3 ADDRESSING THE BLOCKAGES TO LOCALISATION

An effective localisation strategy has to address why local suppliers do not emerge even where, from a national standpoint, the benefits apparently outweigh the disadvantages. Three kinds of blockages have emerged. To start with, inadequate demand is usually not the sole constraint on local production. Typically, new producers face a host of supply-side challenges as well, ranging from the cost of initial investment to access to skills and technologies to licencing and infrastructure shortfalls. Second, procurement systems in both the public and private sector have not been designed to foster localisation. In consequence, they effectively build in a series of

unnecessary hurdles and risks for domestic suppliers. Finally, most procurement offices do not have the capacity required to manage localisation efficiently and effectively.

This section explores each category of blockages in turn. It then provides a simple theory of change that effectively summarises the main obstacles to local procurement and indicates way to mitigate them.

3.1 Economic realities

From the standpoint of government departments and agencies, the economic challenges to localisation take three main forms.

- Domestic producers might require significant time to catch up with foreign suppliers. If they are true infant industries – that is by definition, if they really have potential to become competitive over time – emerging producers should ultimately see their costs fall at least to import-parity levels. How long that takes varies by product and sector, however, ranging from years to decades. The Japanese and Korean auto industries enjoyed extraordinarily high tariff protection for over 50 years before they became dominant global players. In cases when local producers are not immediately competitive, the state has to decide how long it will support them. Private companies must similarly estimate the long-term costs and benefits of encouraging a local supplier. Their decisions may be influenced by government incentives to procure from domestic producers and to discourage imports.
- Economic decisions on local procurement suffer from systemic information asymmetries. Government agencies and departments experience the costs of local procurement directly and immediately, in the form of disrupted procurement processes and sometimes price premiums. The benefits, in contrast, are externalised, delayed and often diffuse, in the form of a faster-growing and more inclusive economy that ultimately reduces demands on government services and increases revenues. Government agencies generally only perceive the benefits directly in cases where local producers can provide more appropriate goods or supply products faster than importers.
- The benefits of localisation are contingent on success in establishing sustainable and competitive local industries. Emerging industries, however, invariably face a host of unexpected obstacles. By extension, a successful buy-local programme entails unavoidable risks. Even if the project as a whole succeeds in boosting inclusive industrialisation, some new production lines will fail. Government systems for managing risk are, however, notoriously weak. Departments tend either to avoid any risks altogether, or to cling to projects long after it becomes clear that they will never succeed.

Evaluating the economic benefits and costs of localisation is complicated because they vary in their impact on the various stakeholders. Where local producers can overcome supply-side challenges, they will displace the current suppliers, both local import handlers and the actual exporters. Moreover, government departments that are not mandated to promote

industrialisation may see any price premium as an unnecessary cost that undermines their ability to deliver core services.

Table 2 outlines the dimensions of the benefits, costs and risks of effective local procurement programmes for key stakeholders, from government to businesses to working people and their communities. It draws on the Socio-Economic Impact System (SEIAS) methodology.

Table 2. Benefits, costs and risks of local procurement programmes

STAKE-HOLDER	BENEFITS	COSTS	RISKS
Government departments and agencies	<p>Improved economic growth leads to higher tax revenues and consequently larger budgets in the medium to long run.</p> <p>Higher employment levels reduce the need for public services, alleviating pressure on budgets and employees.</p> <p>Local products permit shorter delivery times and more responsive suppliers.</p>	<p>Need for fundamental restructuring of procurement systems, including to distinguish imports from local products; plan tender processes to maximise opportunities for local suppliers; and coordinate with the dtic to support local producers.</p> <p>In some cases, prices may be higher for local goods and services, although the extent is not clear (capped by current preferential procurement regulations at 25%).</p> <p>Supply-side support for local producers may also impose costs.</p>	<p>Treasury does not meet price premiums, placing a burden on departmental budgets and potentially limiting delivery on their core mandate.</p> <p>Local production proves uncompetitive or unsustainable in the long run, wasting the effort and funds used to support it.</p> <p>The time needed to develop local suppliers may delay critical projects, which in some cases would more than offset the benefits of domestic production.</p>
Treasury	<p>Growth in the economy and employment improve tax revenues and reduce demand for government services.</p>	<p>Need to restructure procurement systems and monitor enforcement.</p> <p>Somewhat higher prices for goods and services, although the extent depends on how localisation is managed.</p>	<p>Higher prices for goods and services are not adequately offset by benefits of local production.</p> <p>Local procurement requirements delay critical infrastructure projects.</p>

the dtic	Increased domestic demand for goods and services promotes inclusive industrialisation and lays the basis for new and more competitive industries.	Cost of supply-side constraints on local producers. Time and resources to engage with Treasury and other departments to encourage and monitor local procurement. Assistance in evaluating viability and requirements of individual projects.	Local production proves uncompetitive or unsustainable in the long run, wasting the effort and funds used to support it. Local procurement rules delay critical infrastructure projects, blocking industrialisation. If a project fails, the dtic bears the blame and not anonymous market forces.
Local business	Increased demand for goods and services, and support in dealing with supply-side constraints. Reduced need for government services enables improved quality of services over time and/or lower taxes.	Importers would see reduced demand, even if owned by historically disadvantaged individuals or small businesses. Local companies need more capacity to engage in tender process and to get certification of local content.	Companies may invest to supply government and then the tender goes to a foreign company anyway, because of a large price differential or poorly designed procurement processes. If price premiums emerge, they could reduce competitiveness and growth at least in the short run.
Working people	Increased employment opportunities. Reduced need for government services enables improved quality of services over time and/or lower taxes.	Higher input costs for government departments and agencies lead to worse service delivery. Loss of employment for workers in importing enterprises.	Promised jobs do not materialise because local producers cannot get tenders due to higher prices or other blockages. Higher cost inputs and consumer goods put a brake on job creation.

Analysis of the economic obstacles to localisation point to the importance of evaluating the costs and benefits for each project. Effective measures also have to manage resistance from businesses

that depend on importing, which may take the form of lobbying, pay-offs or lying about product origins. Finally, procurement systems have to mitigate the risks associated with localisation. Even if the programme as a whole succeeds and the benefits outweigh the costs, some projects will fail. It is likely that the blame will be placed on policymakers rather than diffuse market forces or the imperatives of economic development. In these circumstances, the policy has to minimise failures rather than avoid risks altogether. In part, that necessitates careful analysis of the blockages to competitiveness in each case. In part, it requires that govt agencies design tender processes as far as possible to support local suppliers without guaranteeing them sales at any price.

3.2 The procurement system

3.2.1 The regulatory framework

The public procurement system is not geared to promoting localisation. It neither makes it easier for local producers to meet government requirements, nor helps them to overcome economic challenges. Critical issues include the following:

1. The prioritisation of local procurement relative to other socio-economic objectives is left entirely to individual departments and agencies. Past and current preferential procurement regulations as well as the proposed new procurement legislation (the Public Procurement Bill that was gazetted for comment in 2020) set no explicit performance indicators around local procurement. Both the existing and the proposed procurement systems provide 20% of points for a broad grouping of developmental aims, ranging from broad-based black economic empowerment (BBBEE) to technological advances to industrial and community development. The allocation of preferential points between these diverse objectives is entirely up to the individual department or agency. The government provides no guidance on how to manage trade-offs. In 2022, the Treasury ended a system under which the dtic could designate selected products for local procurement. Since 1995, the Budget Reviews as a whole have not used the term “local procurement” at all. They refer to “localisation” just seven times (five in the past three years and twice in 2012).
2. Trade-offs between socio-economic objectives are particularly hard when black-owned, small or township enterprises sell imported products while the local producers are large and less empowered. Efforts to prioritise local procurement in this context have largely failed. In the 2010s, the dti drafted but suspended sections in the BBBEE Code that would elevate local production above black ownership and other empowerment criteria.
3. Procurement regulations do not require supply-chain managers to track the share of imports in their purchases. That makes it impossible to consistently identify opportunities for local production. Moreover, government cannot measure success in shifting toward domestic suppliers.
4. Tender specifications often include narrow standards that unnecessarily exclude local producers. Typically, these standards reflect historic requirements and sometimes

management biases, for instance specifying foreign brands or materials that are not produced locally but could easily be substituted.

5. Although the national government has centralised procurement of some products, such as medicines, most goods and services are divided across agencies. Often, each contract is too small to incentivise investment in local production. Moreover, larger procurement processes often happen only at irregular intervals. Emerging local producers may not have sufficient scale to weather the resulting fluctuations in demand.
6. Tender processes often set tight deadlines, making it impossible for new local producers to gear up to meet requirements.
7. The regulations generally bar supply-chain managers from working with local suppliers to identify and help address challenges. In these circumstances, South African companies have in some cases invested heavily to meet emerging demand, only to miss out on the anticipated contracts and incur significant losses.
8. There are no dedicated platforms for supply-chain managers to coordinate with the dtic to support local suppliers, or even to inform the dtic of major procurement programmes. As a result, the dtic often does not know about large-scale purchases in time to help potential local suppliers upgrade production so as to take advantage of the new opportunities.
9. Where government agencies require local content, the certification process is cumbersome, overly detailed, and often expensive.
10. When local products cost more than imports, the procuring department or agency has to pay the difference out of its own budget, rather than drawing on funds set aside for industrial policy. For departments with direct service delivery mandates, for instance providing health, education or infrastructure, this system imposes concrete trade-offs. For instance, if local medications cost more than imports, the Department of Health would effectively have to curtail healthcare to promote industrial development. The regulations effectively allow a price premium of up to 25%, but that applies only if a supply-chain manager allocated all the points for local procurement, with no other aims given any weight at all.
11. The regulations do not provide a consistent methodology for analysing the costs and benefits of local procurement in the short and long run. By extension, supply-chain managers do not have a common, transparent basis for deciding when it is worth paying a premium for local products.

3.2.2 Managers' capacity and perspectives

Even if the regulations were more supportive, supply-chain managers generally do not have the capacity or in some cases the will to promote local procurement.

Few supply-chain managers have the systems or skills required to promote new local suppliers. They cannot easily identify local suppliers, and it is not always obvious where trivial changes in specifications would permit local production.

Treasury has not instituted either rewards or sanctions for supply-chain managers to incentivise local procurement, for instance through the annual performance system. Procurement regulations and systems are suffused with the aim of ensuring value for money, which is prioritised far more than socio-economic aims. In this context, government procurement systems overall incentivise BBBEE far more than local procurement. Notably, BBBEE enjoys far better defined and more specific aims and weights in decision-making processes around procurement.

3.2.3 A theory of change for local procurement

We can develop a holistic understanding of the blockages to localisation by developing a simple theory of change for local procurement, which is a critical instrument for localisation. The theory of change methodology first lays out the steps required to achieve a desired policy outcome. It then evaluates the preconditions for success as well as the main obstacles and risks.

In terms of this approach, increasing local procurement as a way to promote industrialisation essentially involves four steps.

1. Agreement that local procurement should be a priority for supply-chain managers.
2. Gazetting of regulations that both require and enable supply-chain managers to pursue local procurement where the benefits will ultimately outweigh the costs.
3. Supply-chain managers increase the share of local products in their procurement for consumption and investment, even if total spending grows slowly or even declines, without an excessive long-run increase in costs or deterioration in service delivery.
4. As a result, domestic aggregate demand rises, boosting economic growth, employment and investment, and fostering improved technological capacity.

Table 3 analyses the preconditions, obstacles and risks for each step. It also summarises relevant experiences in South Africa over the past 15 years or so.

Table 3. Evaluating the steps required to strengthen local procurement

STEP	PRECONDITIONS	OBSTACLES/RISKS	EXPERIENCE IN PAST 15 YEARS
Local procurement set as priority in procurement process	Agreement within government, and especially within Treasury, that the benefits of local procurement outweigh potential costs. That agreement requires an explicit consensus at least in broad terms around how much the costs will be, the offsetting benefits, and the risks.	Resistance from key partner departments because of concerns around the costs, including both the potential need for a price premium and the disruption of existing procurement systems and relationships. Lobbying to prioritise BBBEE as the only socio-economic aim for government procurement	The prioritisation of local procurement relative to other socio-economic aims for procurement remains highly ambiguous and contested. The BBBEE Codes, in particular, have never made local production the top priority. Available information systems do not permit analysis of either the

		outside of value for money.	extent of imports or the cost of local suppliers relative to foreign producers. That makes it virtually impossible to cost stronger local-procurement targets.
Regulations effectively require and enable supply-chain managers to reduce purchases of imported goods and services	<p>Treasury publishes regulations that explicitly prioritise local procurement.</p> <p>Regulations define:</p> <ol style="list-style-type: none"> 1. How much of a premium supply-chain managers should accept for local products, with a well-defined methodology for evaluating costs and benefits; 2. How such a premium should be paid for; 3. How specifications should be set to avoid unnecessary exclusion of domestic producers; 4. How tenders should be communicated to enable domestic producers to gear up; 5. How procuring departments should coordinate with the dtic around other measures to promote local suppliers; and 6. KPIs for local procurement and how they should be monitored. 	<p>Treasury does not agree to regulations.</p> <p>Supply chain managers cannot easily tell if they are buying local products or imports.</p> <p>Local producers have much higher costs than foreign suppliers.</p> <p>Regulations do not define clear targets and procedures, and do not prioritise local procurement relative to other goals.</p> <p>Affected producers and their workers have no obvious way to raise issues around unnecessarily restrictive tenders or communication methods.</p> <p>Because supply-chain managers have discretion to support suppliers on grounds other than price, there is greater space for corruption.</p>	<p>Regulations have been extraordinarily vague on how to manage trade-offs, particularly around (a) the relative price of local products (although no-one has tracked the actual price premiums, if any) and (b) black-owned and small importers relative to large, unempowered domestic producers.</p> <p>Where local procurement has been required, certification of local producers has often proven slow, expensive and in some cases fraudulent.</p> <p>Corruption has been a major issue in procurement, often leading to higher than expected imports or inadequate quality. It is not clear, however, if projects that promote local procurement have been more afflicted than other government spending.</p> <p>There is no obvious or responsive route for producers and their workers to complain if unnecessarily rigid specifications rule out local suppliers, especially in the case of</p>

			<p>municipalities and autonomous institutions like universities and state-owned companies.</p> <p>Government departments and agencies must pay any price premium, if one arises, even if industrialisation is not part of their main mandate. They do not usually align their procurement practices with other measures to unblock domestic production or promote inclusive industrialisation. Major procuring departments rarely inform the dtic about procurement processes in advance. They often avoid involvement in programmes to promote local production of the inputs they require.</p>
Government increases purchases of domestic goods and services	Regulations effectively promote local production of goods and services in place of imports.	Regulations are vague or easily circumvented, and therefore ineffective.	Current procurement systems do not track imports relative to domestic products, so it is impossible to evaluate the overall impact of measures to promote local procurement.
Increased demand supports domestic production, investment, employment and technological sophistication	Government procurement of locally produced goods and services increases faster than total expenditure, while households and businesses at least maintain their purchases of domestic products.	The share of local products in government procurement remains almost unchanged. Government pays an excessive premium to producers that can never become competitive, squeezing service delivery and ultimately leading to	There is not enough evidence on the impact of localisation on imports by government to evaluate its impact. That said, real non-interest expenditure declined in the past two years and seems set to grow only very slowly in the next few years. A

		higher costs and slower growth.	shift away from import dependence would mitigate the negative impact on aggregate demand.
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Ultimately, effective, large-scale localisation requires fundamental reforms to public and private procurement systems. The theory-of-change analysis underscores the importance of:

- Clarity around the prioritisation of localisation relative to other socio-economic aims in government procurement;
- Improved monitoring of imports in government purchases;
- Changes to procurement regulations to support local producers both to get into the supply chain and to become more competitive;
- Evaluation templates and procedures that make it easier for procurement officials to analyse whether a cost premium is warranted; and
- Budget allocations that ensure the cost of localisation is borne by industrial policy programmes rather than other services.

4 RECOMMENDATIONS

In theory, procuring domestic products rather than imports is worthwhile as long as the benefits from increased aggregate demand outweigh possibly higher prices for government purchases. In practice, the current procurement system militates against localisation even when it would impose no price premium at all. Critical blockages include the failure to meaningfully prioritise local procurement; the lack of incentives and capacity for supply-change managers in many cases to include local suppliers; the need to deal more coherently and strongly with supply-side blockages; and the requirement that purchasing departments alone bear the price premium if one emerges.

By extension, key reforms to existing procurement systems include the following:

1. Requiring that for major government purchases, departments and agencies inform the dtic as far as possible in advance and engage on whether and how best to support local suppliers. Regular engagement on procurement plans, for instance every quarter, between the dtic, Treasury and major departments would make this kind of alignment easier. In addition, the dtic could establish platforms to facilitate regular communication with supply-chain managers in key departments such as Health and Education as well as the provinces and metros.
2. Requiring that tenders exclude specifications that unnecessarily block local suppliers, such as specific brands and materials, with a responsive and effective system for stakeholders to

complain when tenders seem unfair to local producers. A well-staffed unit at the dtic, for instance, could respond when unions and businesses identify problematic tenders including by municipalities and public institutions such as state-owned companies and universities.

3. Clarifying the prioritisation of local production relative to other socio-economic aims pursued through the procurement strategy, especially black ownership as well as township and small business. One way would be to require that all departments and agencies adopt performance indicators for local procurement. As a first step, government agencies should have to track and report on the share of imports in their total procurement as well as on their efforts to increase the share of local products. This measure would necessitate extensive new information systems.
4. Developing a common approach to the analysis of the costs, benefits and risks of local procurement in individual cases, as well as the simplest possible rules of origin for tenders to distinguish and monitor imports compared to local products. In both cases, the methodologies would have to be very easy and fast to use, even if that would make them somewhat less precise and rigorous. If they are incomprehensible to most public servants or take too much time, the system will likely prove excessively costly to all concerned, and often be simply ignored.
5. Setting up a separate fund at the Treasury or the dtic to meet justified price premiums for domestic producers, since these expenditures support national economic development rather than the mandates of the procuring department or agency. This approach means that the economic authorities have to decide on key trade-offs around economic development, rather than externalising them to departments that have no mandate or budget to promote industrialisation.

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