The Seven Sins of Localisation

Can South Africa afford this costly policy?

THE GROWTH AGENDA
Priorities for mass employment and inclusion

CDE
ROUNDTABLE

About CDE

The Centre for Development and Enterprise (CDE), an independent policy research and advocacy organisation, is South Africa's leading development think tank. Since its establishment in 1995, CDE has been consulting widely, gathering evidence and generating innovative policy recommendations on issues critical to economic growth and democratic consolidation. By examining South African and international experience, CDE formulates practical policy proposals outlining ways in which South Africa can tackle major social and economic challenges. CDE has a special focus on the role of business and markets in development.

CDE disseminates its research and proposals to a national audience of policy-makers, opinion formers and the wider public through printed and digital publications, which receive wide media coverage. Our track record of successful engagement enables CDE to bring together experts and stakeholders to debate the policy implications of research findings.

Series Editor: Ann Bernstein

This report is based on a workshop hosted by CDE with various experts on 8 June 2023. The report was written by Senior Policy Analyst Rehan Visser with assistance from Research Director Dr Stefan Schirmer.

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List of CDE localisation roundtable participants

Speakers:
Donald MacKay, CEO, XA Global Trade Advisors
Peter Attard Montalto, Head: Capital Markets Research, Intellidex
Matthew Stern, Director: Trade and Regional Integration, DNA Economics

Attendees:
Darryn Allan, Policy Officer: Trade and Economic Section, European Union Delegation to South Africa
Antony Altbeker, independent researcher
Ann Bernstein, Executive Director, Centre for Development and Enterprise
Roberto Cecutti, Head: Trade and Economic Section, European Union Delegation to South Africa
Kenneth Creamer, Senior Lecturer, University of the Witwatersrand and member of the Presidential Economic Advisory Council
Lawrence Edwards, Professor of Economics, University of Cape Town
Shawn Flatt, Minister Counsellor for Economic Affairs, Embassy of the United States of America
Shawn Hagedorn, independent analyst
David Kaplan, Emeritus Professor of Economics, University of Cape Town
Lauralyn Kaziboni, Consultant, DNA Economics
Tshegofatso Lesenyego, Intern, Centre for Development and Enterprise
David Lewis, member of the President's anti-corruption task team and former executive director of Corruption Watch
Moeletsi Mbeki, Deputy Chairman, South African Institute of International Affairs
Mike Morris, Professor of Economics, University of Cape Town
Stavros Nicolaou, Group Senior Executive, Aspen Pharmacare Holdings
Hugo Pienaar, Chief Economist, Bureau of Economic Research
Natasha Rachwal, Associate, Herbert Smith Freehills South Africa
Philippa Rodseth, Executive Director, Manufacturing Circle
Stefan Schirmer, Research Director, Centre for Development and Enterprise
Mmamose Seloane, Director: Technology Localisation Unit, Department of Science and Innovation
Wandile Sihlobo, Chief Economist, Agricultural Business Chamber and member of the Presidential Economic Advisory Council
Peter Sullivan, retired Group Editor-in-Chief of Independent Newspapers
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Jeanine van Straaten, Executive: Strategy, Stakeholder Relations and Legal, Proudly South African
Rehan Visser, Senior Policy Analyst, Centre for Development and Enterprise

Background

According to former Eskom CEO André de Ruyter, "If Eskom wants to build a transmission line, we pay a whopping two and a half times more per kilometre than NamPower does in neighbouring Namibia. It's one of the many poisonous effects of our government's insistence on local procurement."[1] This claim is difficult to verify, but if the scale of this policy's impact is anything on this order of magnitude, then the costs of localisation are hugely significant. Think of the many thousands of kilometres – possibly as much as 14,000km – of the transmission grid that need to be built in the near future. Localisation as an approach to industrial policy, it is fair to say, has major repercussions for South Africa's economy.

In November 2021, CDE published a report on South Africa's localisation policy. *The Siren Song of Localisation: Why localisation policy will not lead to industrialisation*, based on conversations with two of South Africa's leading economists, Professor Lawrence Edwards and Professor Emeritus David Kaplan, both from the University of Cape Town. In the report we detailed some of the costs that localisation imposes.

CDE's report gained significant public attention. In June 2022, President Cyril Ramaphosa responded to it in Parliament.[2] He acknowledged CDE's "contributions to the public discourse", which he said should be "encouraged and welcomed" but rejected our conclusions. He argued instead that, "Localisation is pivotal in stimulating growth and transformation... It is about creating an enabling environment for inclusive growth, deepening the country's industrialisation base and creating targeted transformation measures...The evidence suggests that our localisation efforts are *on the right path*."[3]

> **"Localisation as an approach to industrial policy, it is fair to say, has major repercussions for South Africa's economy"**

Since the publication of CDE's *Siren Song of Localisation* report in November 2021, there have been some important changes to localisation policy. In August 2022, minister of Trade, Industry and Competition (DTIC) Ebrahim Patel announced that large import duties on frozen chicken from five countries (up to 265 percent for Brazil), set to be instated for five years, and provisionally imposed for the first six months of 2022, would be suspended to ease food inflation. This was despite Patel's agreement that the countries in question were dumping their produce in the Southern African Customs Union. The move appeared to be an admission by government that imposed localisation policy drives up costs for consumers, and, at least in this case, these costs were too heavy to bear compared to the protection benefits local chicken producers receive. The moratorium expired at the end of July 2023, and anti-dumping duties were reinstated, although the DTIC indicated that "if there are price increases aimed at taking advantage of the introduction of the antidumping duties", they would again be suspended.[4]

The same month (August 2022) an even more significant policy change was announced, also by minister Patel. Under the terms of the Renewable Energy Independent Power Producers Programme (REIPPP), whereby the state procures renewable energy from private sector bidders on Eskom's behalf, certain components must be manufactured domestically. For solar photovoltaic modules (i.e., solar panels), these localisation requirements had been 100 percent for Bid Window 5 (released in April 2022). Now these have been reduced to 35 percent, given the lack of capacity within the country to manufacture these parts – South Africa only has two solar panel producers. According to Matthew Stern, director of trade and regional integration at DNA Economics, local content requirements (LCRs) in REIPPP drove up energy production costs by at least 10 percent for some producers, and up to 40 percent in some cases.

Localisation: a costly approach

In *The Siren Song of Localisation*, CDE argued that redirecting demand away from imports to locally produced goods is a beguiling proposition. However, the growing shift towards protectionism is misguided, inefficient and expensive, and unlikely to work as a development strategy. If legislation is required to compel purchases of local goods, it must be the case that imports would otherwise have been preferred, presumably because of their price or superior quality. Localisation is effectively a tax on consumption and investment, with consumers, firms and taxpayers having to foot the bill.

Apart from imposing higher costs, quantity-based localisation restrictions, which stipulate that a certain percentage of designated goods must be sourced locally, reduce incentives on firms to become more efficient and innovate new products. Their market is guaranteed, and firms can secure a share of the market without having to become more efficient or to innovate. The net effect is that policy ends up supporting very inefficient firms – a risk that is especially acute when markets are dominated by a small number of players.

Raising costs and/or lowering the quality of their goods obviously has implications for firms' ability to compete in export markets, suggesting that an entirely plausible effect of localisation policy will be a reduction, rather than an expansion, in exports. Global supply chains are complex, and exporters have to import intermediate goods, components and capital equipment in order to export their output to the next link in the supply chain. Higher levels of imports are therefore a sine qua non of higher exports. An undue focus on localisation and reducing imports will weaken our export capabilities since we will not have the intermediate goods and capital equipment needed to make competitively priced goods for global markets. Localisation should be called what it is: an anti-export strategy, one that will only further constrain our future development.

CDE, 2023

Also interesting is that the minister has denied the International Trade Administration Commission's (ITAC) recommendation that anti-dumping duties be imposed on steel chain from China. He has also rejected an application to increase duties on frozen vegetables from 10 percent to 37 percent, citing concerns about food inflation and the possible impact on the lower segment of the market. This seems to signal concern for consumers ahead of domestic producers.

Another significant development is the February 2022 Constitutional Court judgement rolling back the minister of Finance's powers to promulgate BEE pre-requirements for government tenders, as laid out in the 2017 procurement regulations. This has effectively ended LCRs in public procurement, at least for the time being. A new Public Procurement Bill, which contains preferential provisions for local producers, including "to balance the economic impacts of imported goods and services", is however, currently making its way through Parliament.[5]

Given the changing and contested nature of localisation policies in South Africa, CDE held a roundtable in June 2023 to bring together various stakeholders for a conversation on what had been changing on the local landscape and why; whether a strong case could be made for the current government approach; and what its potential pitfalls and dangers are. What follows is a thematic distillation of the key points that arose from this discussion.

What do we mean by localisation?

To begin with, it is important to set out in clear terms what is meant by 'localisation'. As CDE pointed out in our 2021 report and as the 2023 roundtable discussion made clear, there are two distinct ideas of what the term entails.

> **"Local content requirements (LCRs) in REIPPP drove up energy production costs by at least 10 percent for some producers, and up to 40 percent in some cases"**

One suggestion is that localisation is equivalent to all local value add, local production and the employment of locals. In other words, localisation simply amounts to domestic economic activity. But this is not a helpful way of separating out what we mean by 'localisation' as such, or else we could simply use the word 'growth'. This is, furthermore, something that CDE and most of the participants at the workshop strongly support.

The alternative formulation was posited by Professor Kaplan:

> I don't think any right-minded person can disagree that we want local production, local value, output growth and employment. The problem lies in how to make it happen and, specifically, what role government is able, and ought, to play in promoting it. Thus, it does not make sense to define localisation so broadly as to make it synonymous with all domestic productive capacity. Localisation is better understood as an approach to developing local industry by, in one or another respect, shielding it from foreign competition.

Government understands localisation in the same way as Kaplan. The Department of Trade, Industry and Competition (DTIC) framed the issue in the *Policy Statement on Localisation for Jobs and Industrial Growth* from May 2021 as:

> South Africa has an over-propensity to import goods which could otherwise be produced in South Africa. Every year, the South African economy spends approximately 25% of the national wealth created, on goods imported from other countries.[6] This propensity is far greater than in other similar countries and is out of line with our developmental needs and impedes the opportunity for South Africa to develop its manufacturing capacity across carefully identified selected strategic industries to take advantage of the enormous export potential.[7]

CDE believes that localisation in South Africa is most fruitfully understood not as being synonymous with 'developing local industry', but as a preference for the sourcing of domestic goods and services at the expense of foreign-based firms. It involves using instruments of the state to ensure that a greater proportion of manufacturing takes place within a country's borders *by protecting it from foreign competition*. That is why it is often equated with import substitution industrialisation.

This does not mean that localisation is a narrow policy tool. The box below indicates that localisation extends far wider than many might realise, ranging from import duties to local content requirements in public contracts to forced local discounts (e.g., selling scrap metal locally at a discount before exporting it) to aspirational commitments. The 2021 agreement with NEDLAC to reduce the value of imports by 20 percent within five years is only the latest and most visible of a long line of localisation measures or aspirations. These measures are subject to varying levels of legal obligation, enforcement and penalty.

South Africa's basket of localisation measures

- 2021 NEDLAC import substitution agreement
- Preferential Procurement Policy Framework Act of 2011 with designated local content requirements for 28 specified items
- Sale of government assets
- Industry-specific masterplans
- Local procurement commitments by the private sector
- Business-funded localisation initiatives (e.g., Localisation Support Fund)
- Employment equity
- Broad-Based Black Economic Empowerment
- Subsidies for domestic firms
- Forced local discounts
- Mineral beneficiation
- Import duties
- Conditional duty relief
- Export control and duties
- Reciprocal trade agreements

CDE, 2023

Localisation is not simply one arm of industrial policy; it is an approach to industrialisation that is deeply embedded across a range of government functions and ministerial departments, as well as South African business. It is central to how the state aims to achieve its goals, which include, as stated by the President, inclusive economic growth, a deeper industrial base and the racial transformation of ownership of and participation in economic activities. In short, the question is not whether to promote local production. The issue is whether localisation, meaning protection from foreign competition, will spur more local production. That is the question participants debated at the roundtable.

The case for localisation

The first thing to note about localisation is that it consists of government intervention to achieve certain market outcomes. This is not problematic per se – market failures abound and careful arguments for industrial policy can certainly be made. But it is important that localisation policies consist of an obligation, an inducement or an attempt at persuasion for firms to make use of parts that are produced locally or for customers to purchase locally made goods. This must mean that they are presently deciding otherwise; that is, firms and customers are deciding to purchase imported goods. Often, the reasons for this have something to do with lower prices or higher quality but may also reflect that equivalents are simply not produced locally. In other words, localisation policies are not in response to market failures, but are generally an attempt to interfere in markets that are working well.

There are several arguments made in favour of localisation. One idea appears to be that imports are a drain on economic activity, because when the national accounts are tallied, the value of imports is subtracted to arrive at the total for gross domestic product (GDP). That is because GDP is a measure of the total market or monetary value of all finished goods and services produced within a country's borders over a defined period of time.

It includes consumer spending, investment, government spending and exports after imports have been deducted. In 2022, South Africa's merchandise exports amounted to 30 percent of its GDP, a slightly lower figure (about 3 percent) than its imports.[8]

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The easy solution, then, would be to reduce goods and services from abroad (imports) and make whatever we were importing at home instead, leading to an increase in GDP.

However, this leaves out any consideration of exports, and especially the linkages between imported components that play a role in the local production of exported goods. Professor Edwards, who has done much firm-level research on how to improve exports, made this point at the workshop:

> If you want to export and compete on global markets, you have to improve productivity and competitiveness. All the empirical work we've done confirms that access to imports, especially imported technology, is a crucial factor driving productivity. Similarly, the ability to lower input costs through imports improves a company's competitiveness. In other words, there is a strong throughline from imports to enhancing productivity and competitiveness to export success – and exports are crucial for growth.

A counterargument for localisation is that establishing new domestic industries in a global market is very difficult, because local firms have far less capital and capacity to compete with established firms that are globally competitive. Thus, erecting high tariff barriers, or other similar protectionist measures, is necessary for the early stages of starting up new firms or new industries. Once established, these firms can gradually deal with more competition over time. This import substitution theory has been around for a very long time, stretching back to the 18th century and becoming very popular in postcolonial countries, especially in Latin America, in the decades after World War Two.

The reason this argument is almost never mooted in South Africa, however, is that it would not be applicable given the structure of the economy. South Africa is still characterised by strongly concentrated product markets with a few big firms dominating certain industries. For example, the country's dominant steel company, ArcelorMittal South Africa, had its roots in the parastatal Iscor, which was founded by statute in 1928. Moreover, the firms that demand protection are often older, less competitive firms, as is indicated, according to Donald MacKay, by the number of applications for tariff and trade remedies made to the International Trade Administration Commission (ITAC), the statutory body making recommendations to the minister on trade measures.[9] Thus, there are few grounds for thinking that South Africa must enforce localisation for the sake of its struggling, new firms.

A more promising economic argument is one put forth by Stavros Nicolaou, senior executive at Aspen, one of the country's largest pharmaceutical manufacturers. He uses the example of antiretrovirals (ARVs) to demonstrate the importance of the 'fiscal multiplier effect'. According to Nicolaou:

> The Industrial Development Corporation (IDC) has produced a study, which showed that for every R1 spent by the public sector on ARVs produced locally rather than imported, it multiplies an additional 32

> cents back into the economy. This means that government could entertain a cost premium of up to 32 percent before it would start affecting the fiscus. The benefit, meanwhile, is that this spending allows for companies to achieve economies of scale, lower production costs and become competitive on the global stage. Localisation can and should get industries to stand on their own two feet.

It should be noted, however, even granting that the modelling by the IDC is plausible (their research on this is not publicly available), that it is not accurate to suggest that an increase in procurement costs is 'fiscally neutral' if there is an equivalent percentage fiscal multiplier. The simple reason is that only a small proportion of that extra 32 cents per rand will be recuperated by the tax collector. For an increase in public spending to finance itself, the fiscal multiplier needs to be much higher. A study by economic modellers at the South African Reserve Bank (SARB) found that government's fiscal multiplier had declined from about 1.5 in 2010 to around zero in 2019.[10] In other words, additional government spending would not increase the national income at all. This currently makes the multiplier argument for boosting domestic production in South Africa by replacing government purchases of imports with more expensive locally manufactured items extremely weak. The April 2023 decision by the Department of Health to import pneumococcal vaccines for children from India at a third of the price offered by the state-subsidised local manufacturer Biovac should be seen in this context.[11]

"Localisation policies are not in response to market failures, but are generally an attempt to interfere in markets that are working well"

An alternative consideration Nicolaou asks us to heed is that cost premiums may be 'worth the price' if import substitution leads to improved reliability of supply, particularly in strategic industries or goods. The danger of long global supply chains is that they may become disrupted for reasons outside of the home country's control. This fact was aptly demonstrated during the Covid-19 pandemic, which closed down supply chains across all sectors at various times and across a range of geographical regions. This led to severe shortages and price spikes, including of essential items such as medication. This is an issue Proudly South African, the membership-based organisation born out of the 1998 Presidential Summit, is very concerned with, and is one of the key motivating reasons for it seeking pledges by local corporations to source more of their inputs from domestic producers.

Building resilience in the face of potential global supply chain shocks, whether from pandemics or potential policy changes in other countries, such as nationalisation or expropriation of a supplier's assets, is surely desirable. What premium a country can reasonably afford to pay for this insurance is a critical debate to have, involving important empirical work. This will vary from country to country, and from sector to sector. Food security, for example, is essential for the wellbeing of all, although as agriculture economist Wandile Sihlobo explained: "Localisation is not helpful in agriculture because we cannot produce all the products we want to consume."

Finally, even if one were to accept that secure access to medications or basic foodstuff justified the higher prices attendant on localisation policies, that is not an argument that can be easily extended to other commodities. The government's flip-flopping on the anti-dumping duties on chicken products suggests that it is struggling to decide who to prioritise: consumers facing food inflation in the double digits or local producers battling to be competitive given the difficult business environment in which they are operating.

Even among those who have argued in favour of localisation, there are disagreements about how best to carry it out. For instance, one proposal is that efforts to improve firm efficiency be aimed at the level of the firm, rather than the sector or country as a whole. Another is that government work with the private sector to identify opportunities for local value add. CEO of the Manufacturing Circle Philippa Rodseth captured this point when she argued that "We must look at this approach from a practical perspective. Where is demand coming from? Where is there an industry that can produce to meet that demand? Where do we have existing capabilities and how do we increase our capacity?"

Such an approach would be preferable to the current one, but the question remains whether it is implementable, or viable, given the state of our economy and the enormous weakness of the state. As Mmamose Seloane, Director of the Technology Localisation Unit at the Department of Science and Innovation, acknowledged: "There is a lack of coordination not just between DTIC and the Department of Mineral Resources and Energy, but in government in general. That has led to a fragmented implementation of localisation."

"South Africa is still characterised by strongly concentrated product markets with a few big firms dominating certain industries"

The seven 'sins' of localisation

Localisation, particularly as it is practised in South Africa, has several drawbacks. They may not be as obvious as the apparent benefits of a simple import replacement strategy, but they are enormously consequential for inclusive growth and economic development. If, theoretically, an industrial policy were to succeed, it should, according to a number of the participants at the workshop, avoid the following 'sins' that current localisation policies commit.

1. The policymaking process is neither transparent nor evidence based

In a study by Matthew Stern and Lauralyn Kaziboni from DNA Economics, it was found that several European firms in the renewable energy sector had to apply for local content requirement (LCR) exemptions because they were unable to source domestic inputs competitively.[12] As Stern remarked,

> Our LCRs do not always reflect South Africa's industrial base. That is why, for example, the LCR of 100 percent for solar photovoltaic modules had to be dropped to 35 percent during REIPPP Bid Window 5 – there were not enough manufacturers in South Africa to cope with the demand.

Other figures, too, are in question. The 20 percent in the NEDLAC import replacement pact is a nice round figure, but analysis by Intellidex has shown that it is, for the most part, not realistic given the timeframe.[13] Kaplan observed that "there seems to be no evidence base on which decisions are made either as to the designation of products or the levels of local content ", including for similar targets in the various masterplans. Peter Attard Montalto, head of capital markets at Intellidex, said that the IDC has conducted research to inform these targets, but this is not in the public domain.

The problem is that without transparently produced data and research, it is not possible to evaluate their accuracy and how well thought through any given policy is, localisation targets included. In any event, the IDC can hardly be thought of as independent: as an investor in local industry, it has interests in protecting the firms it has invested in.

> **"There seems to be no evidence base on which decisions are made either as to the designation of products or the levels of local content"**

There were other concerns raised by participants. With regard to the industry masterplans, it is claimed that the inclusion of some favoured businesses at the expense of those who are critical of government is deeply problematic. It suggests a highly politicised, transactional, even personal form of policymaking. Finally, the fact that strings are attached to certain applications for tariff increases or duties, by way of confidential reciprocal agreements, means that only those with the deepest pockets can afford to 'buy' protection; those who cannot afford the terms of these agreements, such as spending X rands or creating or preserving Y jobs, opt out of the process altogether. This is exemplary rent-seeking behaviour. It also has the damaging effect of further concentrating industries.

2. Conditionalities pose a threat to investment

Forcing firms to source inputs locally raises costs and can cause delays in their production schedules. This acts as a brake on investment. If a policy results in costs, delays and inefficiencies, investors take a hit to their bottom line, causing them to rethink future investment. The fact that all the firms in the DNA Economics study which requested exemptions received them could be used by proponents of localisation to suggest that it is easy to get around this obstacle, but the authors explain that exemptions were granted on a case-by-case basis and, at least in one instance, took a long time to be resolved, further raising costs. This, critically, creates investment-deterring uncertainties. That exemptions have to be granted also "undermines the credibility of the policy framework".[14] Government protects certain industries, such as local steel producers, which comes at the expense of downstream manufacturing industries, which suffer higher prices as a consequence. A policy like this is in Kaplan's view "incredibly shortsighted" and "based on an extremely limited understanding of how economies work". MacKay also noted that firms only receive relief from import duties after agreeing to invest a minimum of X locally and create Y number of jobs or train Z number of people, with the upshot that many companies find this agreement too expensive and either continue paying the import duty or exit the product market entirely. This is one of the ways investment in South Africa is experiencing death by a thousand cuts.

3. Import substitution is biased against exports

Despite rhetoric by the DTIC that "localisation is about building local industrial capacity for the domestic market *and* for export markets", the reality is that the nature and scope of South Africa's protectionist policies hampers our ability to export manufactured goods.

Local procurement rules and import replacement strategies act as a tax on exporters: the rise in costs means that they must pass on higher costs to customers, making them less competitive in the global marketplace. As Edwards argued, for firms to grow their exports, they need to lower their input costs, and often rely on imported technology. In Kaplan's words, "You can't have exports without imports. Policies to reduce imports are also policies to reduce exports." MacKay made the point that this is a problem if maximising exports is the principal goal of our industrial policy, as it plausibly should be. Instead of industry masterplans, MacKay suggested that we develop an export masterplan: "By focusing on the things we export, that will bring the jobs and growth we want."

4. Restricting imports reduces competition

Kaplan pointed out that the Competition Act was amended so that firms can collude to meet local procurement

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targets. "That is an admission that this is an anti-competitive strategy. It is contrary to the 'C' in DTIC," he said. The reality is that any kind of conditionality is *ipso facto* a reduction in competition. To levy a duty on imports is to raise the cost thereof, making it relatively more expensive than a local producer, which restricts competition and lowers competitiveness. If that has to be done to keep the domestic manufacturer in business, one is left with inefficient firms that likely would not survive if faced with greater competition. Such inefficient firms will pass on inefficiencies to consumers in the form of higher prices and/or lower quality products. The problem is that this does not address the root causes of why consumers are not buying enough locally produced goods in the first place – that may be because of higher prices, a lack of capacity for domestic demand, or any other reason. Trying to fix the problem at the endpoint by, for instance, compelling firms to secure goods locally is superficially attractive, but leaves the fundamental challenges untouched. As MacKay emphasised,

> What we are doing here is to ignore the fundamental issues affecting business and go straight to the end of the chain to fix the outcomes to what government wants them to be. Our forms of localisation are totally disconnected from any of the economic drivers that make us competitive.

5. Excluding foreign knowhow constrains innovation

A further problem with localisation as applied by the state is that it reduces incentives for firms to grow, especially to move into new markets. Producers who receive protection from foreign competitors are getting higher prices and have a captive domestic market. That makes it overly difficult and unnecessary to enter new growth areas. It also acts as a brake on innovation. Kaplan asked, rhetorically, "If you have a guaranteed market, why would you innovate? Why change your products? You don't need to learn from your competitors or to up your game." In this way, local firms are discouraged from investing in research and development that can improve technologies and goods, which is where so much growth occurs. Countries that adopt these policies are liable to lag behind more entrepreneurial regions, especially if new imports are made to be prohibitively expensive.

6. Forced localisation threatens trade relations and might be in violation of international obligations

Head of the Trade and Economic section at the European Union (EU) Delegation in Pretoria, Roberto Cecutti, also pointed to potential negative consequences of locking firms from other countries out of competition with domestic firms, by disrupting existing supply chains at regional or global level not to mention the consequence of higher costs for consumers and local businesses. Perhaps most concerning is that various aspects of South Africa's basket of localisation policies appear to be in violation of South Africa's international legal commitments, both through the World Trade Organization (WTO), the EU-SADC Economic Partnership Agreement (EPA) and also the African Continental Free Trade Agreement (AfCFTA). For example, within the framework of the WTO, Article III.4 of the General Agreement on Tariffs and Trade (GATT) establishes that imported products cannot be accorded less favourable treatment than domestic products. This is reflected in similar provisions in the WTO General Agreement on Trade in Services and in the WTO Trade-Related Investment Measures. A similar provision is also included in the EU-SADC EPA. Similar non-discrimination provisions are also in the AfCFTA framework. Of course, South Africa could always resort to some derogations aimed at fostering infant

industries or with a view of raising the general standard of living of its people (like the one foreseen in GATT Article XVIII), but the relevant process has never been triggered by South Africa, which is currently calling on WTO members to agree on carve outs from WTO rules to allow more policy space for domestic measures. The fact that no country has as yet challenged South Africa on this issue should perhaps not lull the country into a false sense of security. The EU has so far opposed and legally challenged localisation policies in the United Kingdom, Taiwan, South Korea and Turkey. The possibility of future challenges exists. This is true even for non-binding agreements such as the NEDLAC import replacement pact, since WTO case law is clear that even policies that allow for discriminatory incentives with voluntary buy-in are unlawful.

7. Localisation locks us into the wrong path

The final concern about localisation is that it will quickly start to become self-reinforcing, pushing us down a path that will be difficult to leave once we are on it. Reducing competition leads to a decline in competitiveness, which generates higher prices and can spur inflation. To cap that process, and to spare local consumers the hurt, government must introduce price controls. But if firms cannot operate as going concerns at lower prices, the state must bail them out. What can end up happening, in other words, is that government subsidises inefficient industries, all for the sake of putting a national flag on the final product. There is a further danger that once this process starts, it becomes very difficult to back out of politically. Edwards warned that more and more firms will request more and more protection because of the tough business environment wherein input costs are rising and municipal services are declining. As the ITAC data suggests, we are already seeing this phenomenon take place.

"Producers who receive protection from foreign competitors are getting higher prices and have a captive domestic market. That makes it overly difficult and unnecessary to enter new growth areas"

On the political side, Antony Altbeker contended that firms in declining industries are more likely to lobby for protection than those in rising industries, firstly, because they are incumbents, and secondly, "because they are less likely to face new firms entering that industry to compete away whatever benefits you get from additional protection". Under these circumstances, policymakers may be more likely to pay attention to the costs of lost jobs and productive capacity in declining industries than not-yet-existing potential jobs and production.

A further danger of localisation policies is that they are inherently corruptible and open to rent-seeking behaviour. This is especially treacherous in an economy like South Africa's, with large established firms dominating industries and facing little competition from small or medium growing enterprises, making it easier for them to collude or to organise as a cohesive political force for increased protection. Of course, the more inefficient industries become, the more protection they will need, pushing us further down the road to a point where will eventually be completely cut off from global markets.

Concluding thoughts

Localisation effectively uses administrative processes as a substitute for market forces to put the economy on a new development path, which its supporters claim will be more inclusive and good for the country. In MacKay's phrasing, "Government is using industrial policy to try to solve all our social and economic ills ."

However, leaders from across the political spectrum are speaking up about the costs of localisation. Transnet CEO Portia Derby called for the scrapping of preferential public procurement criteria at a Black Business Council summit on localisation in July 2023. She talked of the challenge of insufficient aggregate domestic demand, stating that "our internal markets are simply too small for demand to lead to huge gains in productivity, competitiveness and growth." [15] As an example, Derby cites

> The tender that we had for 1 064 locomotives was for a four-year period. There's no industry that's sustainable for four years. At the end of that period, there's a collapse in demand because the project's done. Local content reaches 55 to 60 percent during that time, and the minute the project ends, that percentage is dead because those companies have folded.[16]

Another place where the issue has been taken up is in the State Capture Commission of Inquiry (the Zondo Commission). In Part 1 of its final report, released in January 2022, it explicitly spoke out against the costs of localisation:

> Ultimately in the view of the Commission the primary national interest is best served when the government derives the maximum value-for-money in the procurement process and procurement officials should be so advised. The same problem is encountered when a choice must be made between the competing virtues of localisation and lower cost. Again, the view of the Commission is that the legislation should make it clear that in such a case the critical consideration is value-for-money.[17]

Preferential procurement speaks to a broader set of issues. Localisation is not an isolated, quirky and narrow government policy: it is central to how our state wants to achieve its objectives. Whether and how we implement localisation policies is therefore at the core of how we want to structure our economy. It also speaks to the appropriate role government should have. In Cecutti's opinion, the best option for a government, particularly one as weak as South Africa's, is to "play an enabling role, instead of seeking to compel industry into targets according to designated percentages".

A debate about localisation is a debate about the future of our economy. As Kaplan put it at the end of the discussion, "The question is: do we want our future to be inward-looking or do we want to be integrated with the global economy, learning from others and increasing our export footprint, growing our economy and providing the jobs and inclusion we so desperately require?"

"Government is using industrial policy to try to solve all our social and economic ills"

Rather than trying to compel local manufacture of products, government should be working to shape a business environment which facilitates competitiveness and productivity increases. In a context where foreign policy missteps may be raising the difficulties of accessing US export markets, and where the window for an export-led strategy may be narrowing thanks to automation and artificial intelligence, failure to focus on, and fix, the essentials will be devastating.

It may still be early days, but it seems that government is slowly waking up to the reality that our current localisation path will not take us where we want to be. We need a different approach to building an expanding local economy with many more growing, innovative and export-oriented firms creating employment opportunities for the whole South African labour force. That is the kind of 'localisation' we need.

Endnotes

[1]André de Ruyter, *Truth to Power: My Three Years Inside Eskom*, Cape Town: Penguin Random House (2023).
[2]Ebrahim Patel, portfolio committee meeting on trade, industry and competition (17 November 2021).
[3]Cyril Ramaphosa, 'Question NW2098 to the President of the Republic', *Parliamentary Monitoring Group* (23 June 2022).
[4]Katharine Child, 'Chicken prices set to rise as tariffs are reinstated', *Business Day* (3 August 2023).
[5]Minister of Finance, *Public Procurement Bill* (June 2023), p. 14.
[6]It is worth noting that the percentage Patel cites has increased to about a third, as of 2022, which is much higher than the minister's claimed 20 percent average for all upper middle-income countries. Own calculations from World Bank, 'GDP (current US$)' and 'Merchandise imports (current US$)' (2023).
[7]Department of Trade, Industry and Competition, 'Policy Statement on Localisation for Jobs and Industrial Growth' (18 May 2021), p. 2. Although elsewhere, the statement reads: "Localisation refers to the development of local industrial capacity to serve both the domestic and export markets." But because local industry can be developed in a variety of ways, including by *increasing* imports, this definition is not helpful. The point is that the DTIC frames the problem of depleted local manufacturing capability as an overreliance on imported goods.
[8]Own calculations from World Bank, 'GDP (current US$)' and 'Merchandise exports (current US$)' (2023).
[9]XA Global Trade Advisors have collected data on ITAC assessments on anti-dumping, anti-subsidy (i.e., countervailing) and safeguard actions requested by South African industry since 2003. These investigations require 50 percent of the industry to be applicants. (XA CEO Donald MacKay notes that working out the threshold is difficult. Where the actual number of companies making up that proportion were not known, XA assumed that five companies are a proxy for the 50 percent figure.) Of the 129 investigations since 2003, 20 (16 percent) were brought by a single company that accounts for over 50 percent of the South African production capacity in that industry. Half the cases were brought by only 18 companies. The largest user of these instruments was established in 1897, the third-largest in 1969, the fourth-largest in 1924 and the fifth-largest in 1929. In MacKay's words, "We are protecting old, inefficient companies. We are entrenching monopolies and suppressing innovation." XA will be publishing a detailed study on their findings later in 2023.
[10]Theo Janse van Rensburg, Shaun de Jager and Konstantin Makrelov, "Fiscal multipliers in South Africa after the global financial crisis", South African Reserve Bank (3 May 2021).
[11]Georgina Crouth, 'Health Department comes to Cipla's defence after Biovac claim tender was unfair', *Daily Maverick* (20 April 2023).
[12]Lauralyn Kaziboni and Matthew Stern, *The impact of local content policies on EU exports and investment, and economic transformation in South Africa* (July 2020).
[13]Intellidex, *Localisation: What is realistic?* (17 May 2021).
[14]Lauralyn Kaziboni and Matthew Stern, *The impact of local content policies on EU exports and investment, and economic transformation in South Africa* (July 2020), p. 4.
[15]Dimakatso Leshoro, 'State localisation procurement decision is irrational', City Press (9 July 2023).
[16]Dimakatso Leshoro, 'State localisation procurement decision is irrational', City Press (9 July 2023).
[17]*Judicial Commission of Inquiry into State Capture Report: Part 1*, chaired by Raymond Zondo (January 2022), p. 797.

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