

# The Siren Song of Localisation

Why localisation policy will not lead to industrialisation



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Series Editor: Ann Bernstein

This report was written by Antony Altbeker based on discussions with Lawrence Edwards, Professor, School of Economics, University of Cape Town and David Kaplan, Professor Emeritus, School of Economics, University of Cape Town.

Photo credit: The national flag of South Africa on a large number of metal containers for storing goods stacked in rows on top of each other, February 2019, by Vitalij Sova.

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## Introduction

While doctorates will one day be written about the differences between the various economic recovery strategies published during the COVID-19 pandemic, about one issue there appears to have been significant common ground – localisation. It is a word that appears in each of the economic recovery strategies published by the Presidency, Nedlac, the ANC, the SACP, the Tripartite Alliance, and Business for SA. The only recovery strategy from a major “social partner” that does not use the word is the one published by organised labour, but, since it speaks of “local procurement”, a phrasing that covers much of the same ground, the absence of the specific word ought not to be understood as labour’s not being part of the pro-localisation consensus.

Superficially, the idea of localisation is an attractive one, and it emerges from a chain of reasoning that proceeds as follows: (i) South Africa is a country in desperate need of industrial jobs, but (ii) despite that need, a significant fraction of industrial inputs, intermediate goods and consumer products are imported from manufacturers beyond our borders, creating jobs in other countries, so (iii) we should channel demand currently being diverted to imported goods back towards goods that are made here. Since GDP is made up of the sum of Consumption, Investment and Exports less the cost of Imports, anything that reduces imports raises GDP if nothing else changes. Framed in this way, localisation promotes growth, industrialisation and employment. What is not to like?

It is easy to see why this kind of reasoning is attractive to a range of interest groups: for importing businesses and their employees, it offers protection from foreign trade; for government, it offers an approach to industrial policy that is ideologically comfortable and which also reinforces other policy instincts and priorities including transformation and the creation of black industrialists. For all, it implicitly lays part of the blame for South Africa’s poor employment outcomes at the door of low-wage producers in jurisdictions that are less worker-friendly and on our own fickle consumers. All of this is deemed to absolve government from responsibility for the country’s poor economic outcomes.

**“Superficially, the idea of localisation is an attractive one”**

This report argues that the case that has been made for localisation is defective and unconvincing, that it is economically myopic, and that it ignores the large-but-diffuse costs that must be paid by society even as it creates small-but-highly-concentrated benefits for those businesses whose output will expand in response to effective localisation policies.

### About this report

This report is a reflection on and summary of a discussion about localisation involving Professors David Kaplan and Lawrence Edwards, Ann Bernstein and Antony Altbeker. That took place in March 2021, by which point the idea of localisation had begun to feature more and more in discussions of economic policy. Indeed, it was an issue that CDE had raised in its immediate response to the economic recovery strategies released in 2020. By the time of the conversation, the issue had attracted more public attention, reflected in a number of columns by Peter Bruce who had staked out an anti-localisation view in the Business Day. Those columns had also attracted responses from a number of people involved in the development of sector masterplans on behalf of

the Department of Trade, Industry and Competition (DTIC), many of whom had forgotten oft-repeated advice never to enter a dispute with people who buy printer's ink by the barrel.

Our concern in the conversation was to seek to understand the arguments for and against localisation as we understood them at the time. Subsequently, discussion has moved on, and commitment to the idea in government, organised labour and organised business has deepened. Two substantial interventions – one commissioned by organised business from Intellidex (Intellidex: 2021), the other a statement of the DTIC's policy vision on localisation (DTIC, 2021)– have been published in the weeks since our original discussion, and both have received considerable attention. As a result, this report engages with these documents.

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**“Localisation can refer to different kinds of policy. In this report, we focus essentially on the idea of localisation that seeks to divert demand away from imported goods.”**

### **What is localisation?**

One of the challenges with discussing the pros and cons of localisation is that it can be difficult to be sure precisely what is being talked about as the term is used in different ways and can refer to different kinds of policy. Sometimes, for example, it is used narrowly to refer to the designation by government of certain specific products which it will procure solely (or principally) from local suppliers. On other occasions, it is used to refer to a wider policy programme aimed at reducing imports across a broad range of product categories purchased not just by government, but by businesses and households too. Finally, it is used sometimes to refer to policies that would seek to

ensure that retailers stock the output of firms that happen to be located in their immediate vicinity and in the communities that those retailers serve. This latter usage will not be discussed in this report, where we focus essentially on the idea of localisation that seeks to divert demand away from imported goods.

### **Localisation for designated products procured by government**

Defined most narrowly, a policy of localisation refers to the use made by the DTIC of powers created in the Preferential Procurement Policy Framework Act of 2000 that permit it to designate specific products that government departments must purchase from domestic manufacturers. To date, these powers have been

used to designate 27 or 28 products (the table presented by DTIC to Parliament is unclear since it includes solar water heaters twice) for local procurement, though there have been repeated indications that this list will soon be expanded to 42 items each of which will be championed by a senior figure from the private sector. As can be seen in Table 1, the products range from bus bodies (for which 80 per cent of government procurement must come from local manufacturers) and rail rolling stock (65 per cent) to wheelie bins (100 per cent), plastic pipes and fittings (100 per cent), industrial lead acid batteries (50 per cent) and two-way radios (60 per cent). Cement has also recently been designated for 100 per cent local procurement.

**Table 1: Products designated for local procurement by the DTIC in terms of the PPPFA**

PRODUCTS DESIGNATED FOR LOCAL PRODUCTION		
Designated Products	LC Threshold	Date
1.Rail Rolling Stock	65%	16-07-2012
2.Power Pylons	100%	16-07-2012
3.Bus Bodies	80%	16-07-2012
4.Canned/Processed Vegetables	80%	16-07-2012
5.Textile, Clothing, Leather and Footwear Sector	100%	16-07-2012
6.Solar Water Heaters	70%	19-07-2012
7.Set-top Boxes	30%	26-09-2012
8.Certain Pharmaceutical Products	Per Tender	07-11-2012
9.Furniture Products	85%	15-11-2012
10.Electrical and Telecom Cables	90%	08-05-2013
11.Solar Water Heaters	70%	19-07-2013
12.Valves Products and Actuators	70%	06-02-2014
13.Working Vessels	60%	01-08-2014
14.Residential Electricity and Water Meters	70%	01-08-2014
15.Transformers and Shunt Reactors	90%	28-09-2015
16.Two Way Radio Terminals	60%	30-06-2016
17.Solar PV Components	70%	30-06-2016
18.Rail Signalling System	65%	30-06-2016
19.Wheelie Bins	100%	30-06-2016
20.Fire Fighting Vehicles	30%	21-11-2016
21.Steel Products and Components for Construction	100%	13-01-2017
22.Rail Perway (Track) infrastructure	90%	13-11-2017
23.Pumps & Medium Voltage Motors	70%	12-12-2017
24.Plastics Pipes & Fittings	100%	16-08-2019
25.Air insulated MV Switchgear	50%	20-12-2019
26.Bulk Material Handling	85%	20-12-2019
27.Industrial Lead Acid Batteries	50%	20-12-2019

Source: DTIC, 2020

The products designated for local procurement are diverse, and it is hard to discern a set of guiding principles. Nor, indeed, does there appear to be one: in a 2020 presentation on the process of enforcing compliance with the list in government, the DTIC said that the basis for designation, was "evidence indicating that the government buys product which is under distress caused by imports which displace local production and jobs."<sup>1</sup> If this is

<sup>1</sup> March 2020, "Local Content Policy & Designation: Measures to ensure compliance and verification", presentation by DTI to Portfolio Committee on Trade and Industry.

**“Import substitution industrialisation was first articulated by Alexander Hamilton in the 18th century.”**

an accurate account of the principles applied in the designation process, then all that unites the 27 products is the existence of some competitive pressure from lower cost imports. Whether or not this is a coherent basis for industrial policy is a serious question which policy-makers ought to think about.

#### **Localisation as import substitution**

If the localisation of some of government procurement is one (narrow) conception of localisation, a broader one is captured in policy documents under the rubric of “industrialisation through localisation”. This is a barely modified articulation of an older approach to development called “import substitution

industrialisation” which many developing countries – including South Africa – embraced with varying success during the 20th century but which was first articulated by Alexander Hamilton in the 18th century.

As with the narrower use of the term, in which localisation connotes the requirement that public institutions purchase a limited number of specifically designated products from local manufacturers, the idea of industrialisation through localisation presumes that demand for imported goods can be redirected to domestic firms, promoting expansions in output, employment and knowhow in local manufacturing. Although the designation of a limited number of specific products for local procurement is described as being part of this process, industrialisation through localisation casts the net much more widely, and seeks to redirect demand by all economic agents, including businesses and households, from imports to exports.

The current goal, articulated in an agreement at Nedlac, is that 20 per cent of non-petroleum imports should be replaced by locally manufactured goods within five years. According to the DTIC, “if executed successfully”, this would “return” over R200 billion in domestic demand to South African produced goods, and would raise GDP by over 5 percentage points relative to its present trajectory (DTIC, 2021:8).

#### **Similarities and differences**

There are obvious similarities between narrow localisation, which focuses on public procurement choices, and industrialisation-through-localisation, the most critical being that the chain of logic is that demand (whether public or public and private) is redirected on the basis of policy-driven decisions relating to procurement choices, leading to expansions in output of local firms. To the extent that there is any consideration that there might be costs associated with implementing these policies, these are deemed temporary. This is, in our view, the critical issue, and it is one we return to below.

Another kind of similarity between these policies is that all are compatible with a range of policy goals associated with the transformation of the South African economy, not “just” its expansion and industrialisation. Thus, localisation policies can be shaped by and aligned with policies such as the DTICs “black industrialists” programme, the provision of support to black-owned and/or township-based businesses, and with black empowerment more generally.

The compatibility of localisation with these pre-existing policy commitments is not a coincidence. Indeed, it is possible to understand and conceive of black economic empowerment as itself a form of localisation policy in that it seeks to provide an advantage to local firms that happen to be owned by historically disadvantaged individuals.

Notwithstanding these commonalities, it is important to understand that there are meaningful differences between narrow and broad localisation policies. The most critical of these is that the DTIC's powers to compel the procurement of some kinds of goods exclusively from local providers are restricted to organs of state, and cannot be imposed on businesses and households. If government sought to restrict the range of choices available to firms and households to local producers, it would violate world trade rules and South Africa's treaty commitments, and would be actionable through the World Trade Organisation (WTO). The absence of a statutory basis on which government might act to require firms to shift purchases to local suppliers is so under-appreciated, however, that it is not mentioned in the DTIC's policy framework, the agreement between the "social partners", or even the Intellidex report on localisation. The result is that the appearance of agreement on this issue seems divorced from the fact that government cannot, in fact, do anything meaningful to compel compliance. Business's reticence on this is peculiar, given that, in the absence of any plausible enforcement mechanism, it is inevitable that when the agreed target of replacing 20 per cent of non-petroleum imports with local products is missed, it will be blamed for its failure to deliver.

**"The principal problem with any version of localisation policy is the assumption that it is something of a free lunch."**

### **What's so bad about localisation, anyway?**

The principal problem with any version of localisation policy is the assumption that it is something of a free lunch: demand is transferred from imported to locally produced products to the benefit of the local firm, its employees (actual and prospective) and its owners. To the extent that there are positive externalities associated with local production (for example, the acquisition of knowhow that might spill over to other firms), this will also accrue straightforwardly to the national economy. But the supposed costlessness of the switch from imports to local products demands some interrogation.

### **Costs of localisation driven through public procurement rules**

As noted above, the DTIC has already used its powers to designate 27 products that government agencies must procure solely or principally from local suppliers (see Table 1). What is wrong with that?

"When products are designated for local procurement," Prof David Kaplan pointed out when we met in March 2021, "it means that those products were not the buyer's first choice because, if they had been the first choice, there would be no need for the policy. But if the local products are not the first choice, then there must be a reason for that. Are they more expensive? Are they inferior in some way? There must be a cost to choosing the local product over the imported product, otherwise there would be no point to the localisation policy."

In fact, matters are even worse than that, because the structure of localisation policy gives local suppliers the power to raise prices. "What you are talking about when you talk about localisation," Prof Edwards said, "is a quantity restriction: you are saying that some pre-determined percentage of a particular product has to be procured from local suppliers. This is very inefficient because if you are going to fulfil the requirement set by the policy, you are going to have to buy it from a limited number of local sources. Inevitably, those sources can then charge you more than they would have been able to if there was foreign competition."

The key problem here is that the policy provides support to local producers by imposing what is, in effect, a quota on government which must buy some percentage of a particular product from local firms. Unlike other potential approaches (such as allowing local firms to charge up to 20 per cent more than imports, for example), this kind of quantity restriction creates no upper-bound on the price local firms can set. Because the buyer has no choice about where to procure goods, she is subject to potentially extortionary pricing strategies.

There are other costs to consider, too. Costs that emerge over time and which, contrary to the claims made on behalf of localisation policy, can actually result in a decline in local firms' competitiveness.

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#### **Reducing firms' incentives to increase efficiency**

To the extent that localisation works to shift demand, it means that consumers – in this case, government – must pay higher prices than they otherwise would or they must accept a product that is of inferior quality or for some other reason inappropriate. But the effect is dynamic: by divorcing the domestic firm from competitive pressures, the localisation policy reduces the incentive for domestic firms to improve efficiency and the quality of their products.

“The very large downside risk,” Prof. Edwards said, “is that you end up supporting very inefficient firms. This is especially true in South Africa where industries tend to be highly concentrated, so there is limited competition between local firms to supply products that government agencies are not allowed to purchase elsewhere.” Worse still, because prices for goods are inflated by the requirement that only local firms can compete for goods, firms may choose to increase their margins by lowering the quality of their product: if government can't go elsewhere for the specified goods, and if there are only a limited number of local suppliers, what prevents those suppliers from producing goods that are cheaper to produce?

Designating some products as having to be purchased from local manufacturers, in other words, means paying a higher price for those products or obtaining goods of an inferior quality. It also creates the distinct possibility that the price and quality differential between local products and imports will grow because local firms are no longer subjected to the discipline of foreign competition while any innovations and quality improvements made by foreign manufacturers become inaccessible to government. If this dynamic were to set in, local firms would fall further and further behind their international competitors and there would be no chance of their ever being able to compete on international markets. Inevitably, their need for protection would continually increase.

Nor, finally, is that the last of the malign effects of localisation policies on firms' incentives to increase efficiency. Firms, knowing that government is amenable to arguments about the benefits of localisation, will invest some of their time, energy and resources in lobbying government for designation rather than in increasing their output. This increase in investment of resources in lobbying for protection is already evident in the applications for tariff protection, and is a deadweight loss to society, something that Jagdish Bhagwati described as “directly unproductive activities”.

### Indirect costs of localisation

A requirement that government purchase some items solely from local firms imposes costs on government, however those requirements also impose costs on the rest of society.

One such cost is realised if localisation policy leads to higher costs of infrastructure. If that is the case, then the costs are borne not just by the public agency responsible for building the infrastructure, but by every user of that infrastructure. If Prasa or Transnet's locally procured rolling stock costs more or is less efficient, for example, the additional cost will be reflected in a combination of less efficient services and higher ticket prices and freight costs, with cascading effects across the economy that raise the cost of doing business and reduce competitiveness.

Another consideration to which Prof Kaplan pointed, relates to the designation of intermediate and capital goods for local procurement, which might require the procuring agency having to make changes to the design (and functionality) of infrastructure for which it is responsible. If you were building a power station, for example, and you had to source a range of specific components such as valves, pumps, plastic piping (all of which are designated products) from local producers, you may have to redesign your plant to accommodate the differences between the local product and the imported product that might be better suited to the project's design. When that is the case, the cost of using local products is not only the difference between its price and the price of the lowest-cost imported alternative, but the added cost and reduced efficiency of the power station that results from the need to reconfigure plans around the specs of the local product.

**“You end up supporting very inefficient firms especially where industries tend to be highly concentrated.”**

Given all of the above, it is highly likely that the imposition of local procurement rules will raise costs in the economy, with particularly marked effects for exporters. “Essentially, this is a cost-raising strategy,” said Kaplan. “It is going to raise costs, and, in doing so, it is going to make the whole economy less efficient. Not only that, but it is a tax on exporters: the rise in costs and lower efficiency of infrastructure harms exporters most because they have less capacity to pass higher costs on to customers. In effect, localisation is an anti-export strategy, certainly for firms that do not obtain any direct benefit from the local procurement rules.”

### Can localisation drive growth?

It is, of course, no secret that localisation means higher costs, and this is accepted by even its proponents. They argue, however, that those higher costs are either (i) justified, because they generate employment growth or, at least, limit employment losses, or (ii) temporary, because firms that benefit from the protection afforded by localisation policies will become more efficient and productive over time. How plausible are these arguments?

### Under what circumstances might localisation increase competitiveness?

Let us take the arguments in reverse order and ask whether there is good evidence that the higher costs

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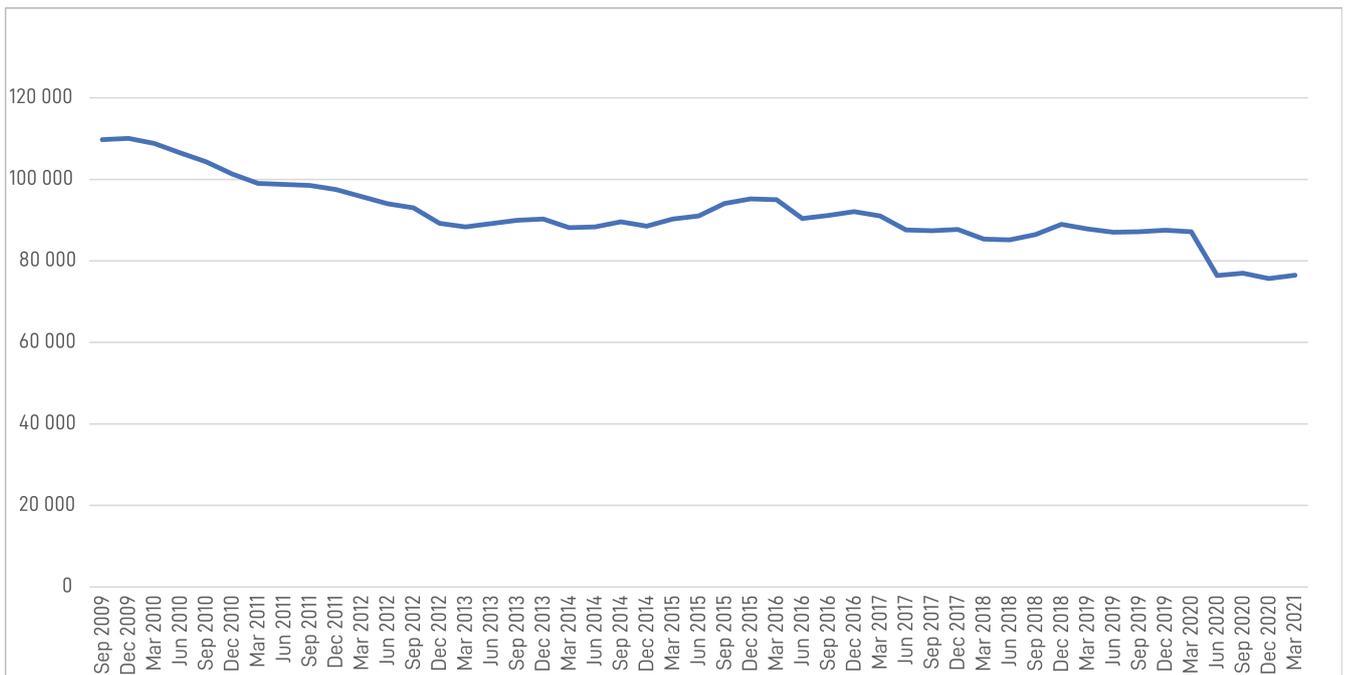
associated with localisation are temporary. This claim is made explicitly by way of example in the DTIC's policy statement on localisation which asserts that, “while a number of localisation initiatives were not initially able to compete only on price, as scale and knowhow improved, the price-premium declined and products became more competitive” (DTIC, 2021:3). The relevant firms have, the DTIC goes on to argue, now also begun to export their goods. Later in the document, it makes a similar point: “The lesson from the production of Covid-19 medical supplies is that, whilst prices were initially higher than equivalent imported products, with the benefit of clear off-take commitments, over time local firms have been able to match and beat imported prices” (op cit: 4).

The first thing to notice about these claims is that they are not very strong: while the wording is somewhat ambiguous, it seems clear that the strongest version of the claim is that some firms that benefited from localisation policies have been able to lower prices to levels that are comparable with those of foreign suppliers. How many firms achieved this? Over what period? At what net cost? These questions are not entertained. Nor is the claim supported by any independently verifiable evidence. Indeed, there is no indication that processes will be put in place that might generate the data needed to assess the benefits and the costs of localisation, nor their respective distributional effects.

The absence of supporting evidence does not mean that the DTIC is wrong and that there is no case to be made to the effect that localisation policies allow benefiting firms to develop the capabilities needed to become competitive. Indeed, it would be implausible to argue that this could never happen or that it had never happened: it would be hard to understand the emergence of some of South Africa's largest industrial firms – in steel production, vehicles and chemicals, for example – without some recognition of the role that trade protection played in their initial growth. Though there are doubts – articulated often at the Competition Commission – that these firms are truly globally competitive and that South African consumers benefit from local production of their goods, it is clear that very significant industrial capabilities and knowhow have been created over the past decades. Still, an argument for the benefits of infant industry protection of this sort can sometimes be made, though such arguments can also be exaggerated.

Even if one accepts that there are net benefits that have accrued to the South African economy from the protectionism that made possible the growth of firms like Sasol and Iscor/Arcelor-Mittal), the real question is whether this is the most likely outcome of localisation policies in general or of the indiscriminate localisation policies that are being proposed. This seems unlikely, and one way to see this is to consider trends in the clothing industry, which receives support through high import tariffs and direct subsidies from government. Within the industry there are a number of firms that have prospered in response to these policies. Nevertheless, it is evident from the steep decline in output and employment over the past 15 years that most firms have not been able to become more competitive even while protected from foreign competition. Indeed, employment in the sector has fallen continuously since at least 2009, when tariffs on imported clothes were raised to 40 per cent and when a dollar cost about R8.30. Even if one discounts the effects of Covid-19 on employment in 2020 (Figure 1), it is clear that neither the tariff nor the 60 per cent depreciation of the rand has resulted in the sector's growth.

**Figure 1: Employment in textile, clothing and leather manufacturing (2009 to 2021)**



Source: StatsSA, QES

Evidence of the ineffectiveness of localisation as a means to increase competitiveness was identified by Prof. Kaplan, who pointed to the divergent outcomes of two pharmaceutical companies that have received considerable government support since the mid-2000s: BioVac, which is effectively a public-private partnership, and Ketlaphela, a state-owned company. BioVac has seen significant growth in output and employment (it now employs over 300 people and turns over about R2 billion a year), with its capabilities having been built on the back of support provided in the form of a public sector offtake agreement that guaranteed prices that were between 10 and 20 per cent higher than international competitors. That support is estimated to have been worth nearly \$90 million between 2010 and 2014. Ketlaphela, by contrast, was established by state owned Pelchem in 2011 in order to manufacture active pharmaceutical ingredients (APIs) for antiretroviral medication. Several years later, its revenues are insignificant.

**“The kind of support the DTIC envisages providing to local companies could work for some kinds of firms, but it will do so only when the circumstances are right.”**

It is possible, as Kaplan argued, that the kind of support the DTIC envisages providing to local companies could work for some kinds of firms, but it will do so only when the circumstances are right. At minimum, you would need an offtake agreement that supports investment in plant, machinery and knowhow for a significant period of time. You would also need to make sure that the business uses the surplus profits it accumulates to invest in expanding its capabilities. Critically, you need to ensure that the firm is already reasonably “effective”, in the sense that it is well-managed and capable of taking advantage of the opportunities being provided. These circumstances apply only infrequently, however, and only to particular firms. It is very unlikely that the DTIC has the capacity to identify these select firms. Across the board support to all local producers of any particular product will result in a range of mediocre firms receiving protection, and it is unlikely that the

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support will translate into greater productivity, efficiency and competitiveness. Indeed, as pointed out earlier, the protections offered by localisation policies could easily make beneficiary firms less competitive as the walls erected to protect them allow firms to generate “unearned” gains by weakening the disciplinary effect of competition.

### **Will localisation lead to more output and jobs?**

The key argument made by proponents of localisation is that, by promoting local procurement and production, whole value

chains can develop, making possible (a) the replacement of some imports with local substitutes and (b) the entry of firms in that industry into export markets as they increase their capacity and competitiveness through economies of scale. This logic underpins much of the work on industry masterplans that has been spearheaded by the DTIC over the past decade.

Five sectoral masterplans – sugar, poultry, clothing and textiles, automotive, and steel fabrication – have been completed so far, while a number are currently in preparation. The basic structure of the plans involves reciprocal commitments from all industry stakeholders around investment, local procurement, incentives, protection from imports through higher tariffs and/or the combatting of illegal imports, commitments to protecting jobs, and transformation along the value chain. The DTIC presents these masterplans as key to more rapid industrialisation, but there are good reasons to think that their benefits are oversold and, critically, that their costs are underappreciated.

Obviously, it can be a good thing when government talks to industry role-players in an effort to understand the constraints businesses face in seeking to grow. This is something CDE and organised business has long advocated, and it would be churlish to suggest that the process of developing masterplans does not offer the prospect of better policy. Indeed, as Prof Edwards pointed out, masterplans can be effective in facilitating co-ordination between businesses along the supply chains, and, critically, the process of drafting the plans can help identify and resolve supply constraints (including the provision of services from a range of state-owned entities such as Eskom and Transnet), thus inducing investment and growth in the industry.

Having said that, there are some real dangers, and masterplans can also cause harm, if not to the sector for which the plan is developed, then for others. The most obvious channel through which plans to strengthen a sector can create costs for others is by erecting, raising or reinforcing various forms of protection from foreign competition, especially tariffs. These are, in effect, a tax on consumers of protected goods, whether those users are households (who pay higher prices for clothes and cars and chickens) or downstream manufacturers (whose input costs may rise when steel tariffs are raised).

These are not insignificant concerns: clothing accounts for about 4 per cent of household spending, so a 40 per cent import tariff directly reduces consumers' purchasing power. Similarly, the considerable protection enjoyed by the automotive industry means that the cost of vehicles (and, therefore, of transport) is higher than it might otherwise be, and has an adverse impact on every household and every industry in the economy. It is no coincidence, of course, that masterplans include proposals to protect local firms from foreign competition, even at the expense of local consumers and downstream producers, as this is often the most straightforward way for a government to provide assistance to an industry, especially in the short term. This outcome is made more likely by the fact that the stakeholders with whom government consults are dominant industry insiders,

rather than consumers and downstream users – i.e. the people who will pay the price for higher levels of protection. Nor is there any obvious way in which new entrants to an industry, much less potential entrants, can be consulted.

All of which means that there are generally costs imposed on society associated with the protection of firms in industry masterplans. Moreover, and as a general rule, those costs are greater than the benefits that accrue to the protected industry, though their impact may be dispersed widely across the economy. One reason for this is that, while there is a great deal of uncertainty about the value (and distribution) of the benefits of masterplans, there is no uncertainty about whether costs will be incurred. It is inevitable, for example, that downstream manufacturing firms for which steel is a significant input will

**“The structure of these masterplans has an inherent pro-incumbent bias.”**

face higher costs and will lose at least some custom, whether at home or in export markets, from the imposition of tariffs to protect steel manufacturers from foreign competition. It is much less certain how much benefit such manufacturers will derive from the tariff especially since higher steel costs will impact on downstream users' prosperity, prospects and choices over the medium and long term.

Nor is that the end of the matter: the structure of these masterplans has an inherent pro-incumbent bias because, for obvious reasons, the only stake-holders with whom government can engage are those that currently exist. Inevitably, that means the plans focus on making existing firms more profitable, not making the markets in which they operate more open to competition from new firms. An example of this is apparent in the structure of incentives offered to clothing manufacturers, where the value of the principal subsidy is calculated at a fixed percentage of the manufacturing value-add of the firm. Because manufacturing value-add is the sum of a firm's wages and profits, the subsidy is greater for larger firms than for smaller ones. Add to that the fact that subsidies can be paid only to firms that are compliant with all relevant labour laws, and it is easy to see how support of this kind benefits larger incumbents, and would tend, therefore, to increase concentration, rather than competition, in the industry.

As was the case with localisation policies premised on public sector procurement, the argument that masterplans will, over time, lead to firms and industries becoming more efficient and competitive is far from established, despite some claims made by DTIC to this effect. Pointing to the clothing and textiles industry, for example, Prof Kaplan noted that, while there was some evidence that individual firms had improved their productivity and competitiveness as a result of the support received from the DTIC, this had to be seen in the context of an industry that was in steep decline. As importantly, very few firms in the industry had shown the capacity to expand exports dramatically. “We know that successful clothing manufacture requires scale. Firms must produce at volume, which should show up as exports. But at the moment, even with 40 per cent tariff protection, they can't compete on the local market, much less foreign markets, so there are real limitations to these strategies.” One supposed exception to the rule that masterplans have not been able to drive the productivity gains needed to expand exports successfully is in the automotive sector, where South Africa has seen a very dramatic increase in exports over the past two decades. And, measured solely by the volume and value of exports, the plans in this sector appear to have been clear successes.

**“The average respondent expected increases in the costs of the relevant inputs of about 20 per cent as demand for local goods began to exceed their supply.”**

The problem is that the growth in volume and value of exports has come at a significant cost. These costs include direct subsidies from government and tariffs that raise vehicle prices, imposing significant additional costs on everyone. As far as we can tell there are no independent estimates of the full economic costs of this support. It is also important to note that the rise in automotive exports is indissolubly linked with a rise in imports: South Africa's success in motor vehicle manufacturing has been a consequence of the industry's integration into global value chains which means that every car we export contains a vast array of parts that are imported. Far from demonstrating the power of masterplans to drive exports, in other words, the motor vehicle plan actually shows how critical imports are for industrialisation.

Ultimately, however, the core challenge that masterplans create is that, even when they are effective in protecting and promoting the expansion of a particular sector, it is likely to be at the expense of some other sector, of consumers and/or of government. Consider, in this regard, that, while there are fewer than 90 000 people employed in the manufacture of cars and car parts in South Africa, there are nearly four times as many employed in downstream activities in the motor trade – selling and service cars, staffing petrol stations. It is, therefore, entirely plausible that more jobs would be created by making cars more affordable by lowering import tariffs, and, as a result, getting more people behind the wheel, than can ever be created by protecting jobs in vehicle manufacturing. That might also help lower the cost of transport, the high costs of which is a by-product of protecting the industry from imports.

### Industrialisation through import substitution

The most ambitious articulation of localisation policy is embodied in an agreement between business, labour and government at Nedlac that commits the parties “to work together to reduce South Africa's non-oil import bill by 20 per cent over the next five years.” This, it is claimed by the DTIC, would “return more than R200 billion in domestic demand for South African produced goods” and “increase GDP over the baseline by 5 percentage points by 2025”. This calculation presumes that no other changes to the components of GDP is affected by localisation policies so that Consumption, Investment and Exports are entirely unaffected by the switch of demand from foreign to domestic suppliers. This assumption is, we believe, at best heroic, made more so by the DTIC blithe characterisation of the five year timeframe for achieving this goal as an “extended” one (DTIC, 2021: 8).

These commitments are an extrapolation and extension of the logic of the process of drawing up masterplans for a specific industry to the economy as a whole: business, labour and government agree that supporting local industry is important and commit to working together to put in place the instruments needed to ensure it happens. Responses to the commitment should be conditional, and depend on what is the mechanism through which these goals are to be achieved. To the extent that this is through initiatives that boost productivity enabling local forms to compete against imports more effectively, the target ought to be welcomed. To the extent that it is to be achieved on the basis of expanded levels of protection from trade, however, any gains are likely to be achieved at high cost to downstream users and consumers, so enthusiasm is much less warranted.

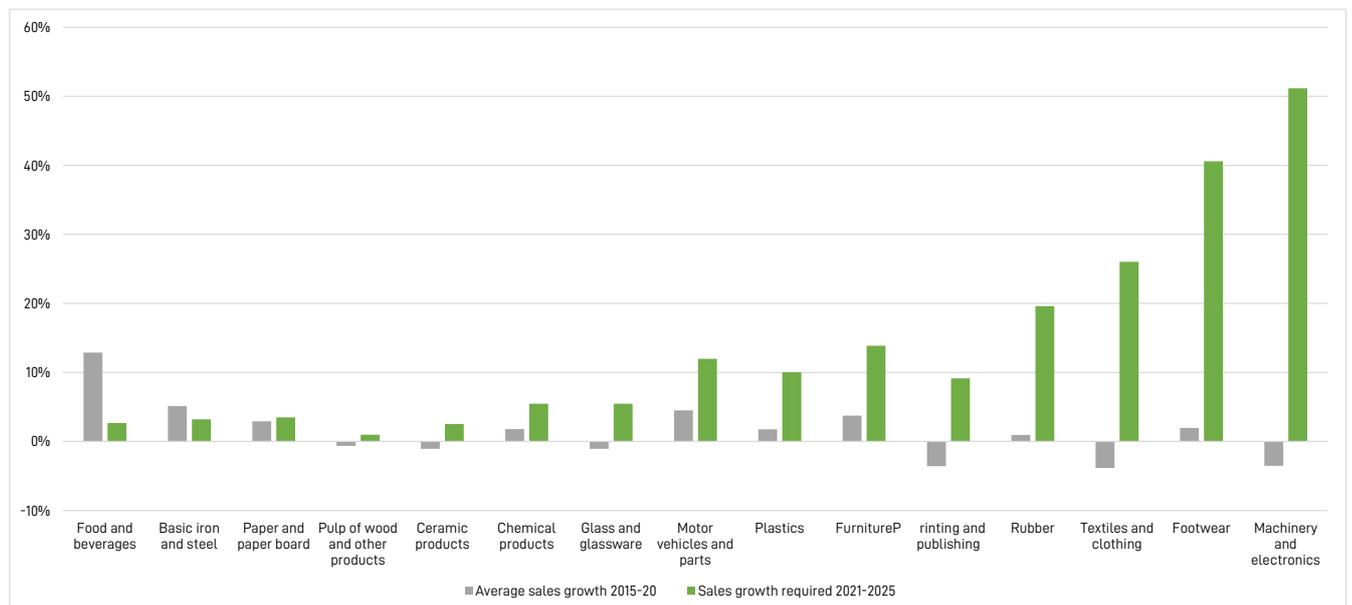
**“South Africa, could not possibly reduce its dependence on imported cell phones through a strategy of localisation.”**

Given the lack of detail about the measures to be taken, it is not possible to begin to assess these costs. It is, however, possible to do a basic plausibility assessment, which is something the consultancy, Intellidex, has done on behalf of organised business (Intellidex, 2021). Intellidex’s report examines existing trends in output and imports in different sectors of the economy, and finds wide differences in the potential to achieve the goal of replacing 20 per cent of imports in the near future. They argue that under the right conditions, localisation targets could be met within five years in sectors like paper, wood, motor vehicles, ceramic products, glass, basic iron and steel, and food and beverages. At the same time, they find that other sectors – printing and publishing, textiles, clothing, footwear, rubber and machinery and electronic equipment – were “highly unlikely to meet localisation targets without significant policy support and macroeconomic tailwinds” (emphasis added).

rubber and machinery and electronic equipment – were “highly unlikely to meet localisation targets without significant policy support and macroeconomic tailwinds” (emphasis added).

These conclusions reflect calculations of how fast local production would have to ramp up if it were to replace imports, and then comparing those rates of required growth to existing growth rates of local output. They show that the rate of sales growth between now and 2025 that would be needed if South African firms are to replace 20 per cent of imports is unrealistically high in many key industries. In electronics and machinery, to cite the most extreme example, sales growth of over 50 per cent a year would be required. This would be unrealistic even before you factor in the fact that in the last five years, sales growth has declined by 4 per cent per year. It is even more unrealistic when you realise that the Intellidex calculation implicitly assumes that the additional production from local suppliers would itself contain no imported components, which would, of course, raise imports, necessitating even more rapid increases in local production to achieve the 20 per cent target. Similar, but less extreme challenges exist in other sectors, though there are some areas (such as food and beverages and basic iron and steel) where the required growth may not be inordinately high (Figure 2).

**Figure 2: Average annual sales growth (2015-20) versus average annual sales growth required (2021-25) to achieve localisation targets**



Source: Intellidex, 2021

**“The DTIC appears to be cherry-picking data.”**

Apart from the objective difficulty associated with achieving growth rates of this kind, respondents to Intellidex’s survey reported that they would expect to see significant increases in prices of goods should they be required to source their inputs locally rather than from foreign firms. In this regard, the average respondent expected increases in the costs of the relevant inputs of about 20 per cent as demand for local goods began to exceed their supply. Given these findings, the report

concludes that the replacement of 20 per cent of imports through localisation is not achievable in the short and medium term. All of which is almost certainly true. Apart from these issues, there are other reasons to doubt the desirability and feasibility of deliberately targeting a reduction in imports of 20 per cent over a five year period, or, indeed, over any period.

### Thinking clearly about imports

Consider the DTIC’s argument for localisation, which it frames as follows:

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. 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, particularly in the context of the African Continental Free Trade Area (DTIC, 2021: 2).

The claim that South Africa’s industrial policy is crafted to support “carefully identified selected strategic industries” is surprising given the sheer breadth of the sectors and sub-sectors for which masterplans exist or are being developed. Just as surprising is the claim that South Africa has an “over-propensity” to import, which is supported by a table that presents the proportion of GDP spent on merchandise imports for a number of countries and regions. The data are attributed to “DTIC calculation from World Bank; Trade Map data (2019)”, but it is difficult to replicate the numbers presented.

**Table 2: Merchandise imports as a % of GDP per the DTIC and CDE calculations from World Bank data**

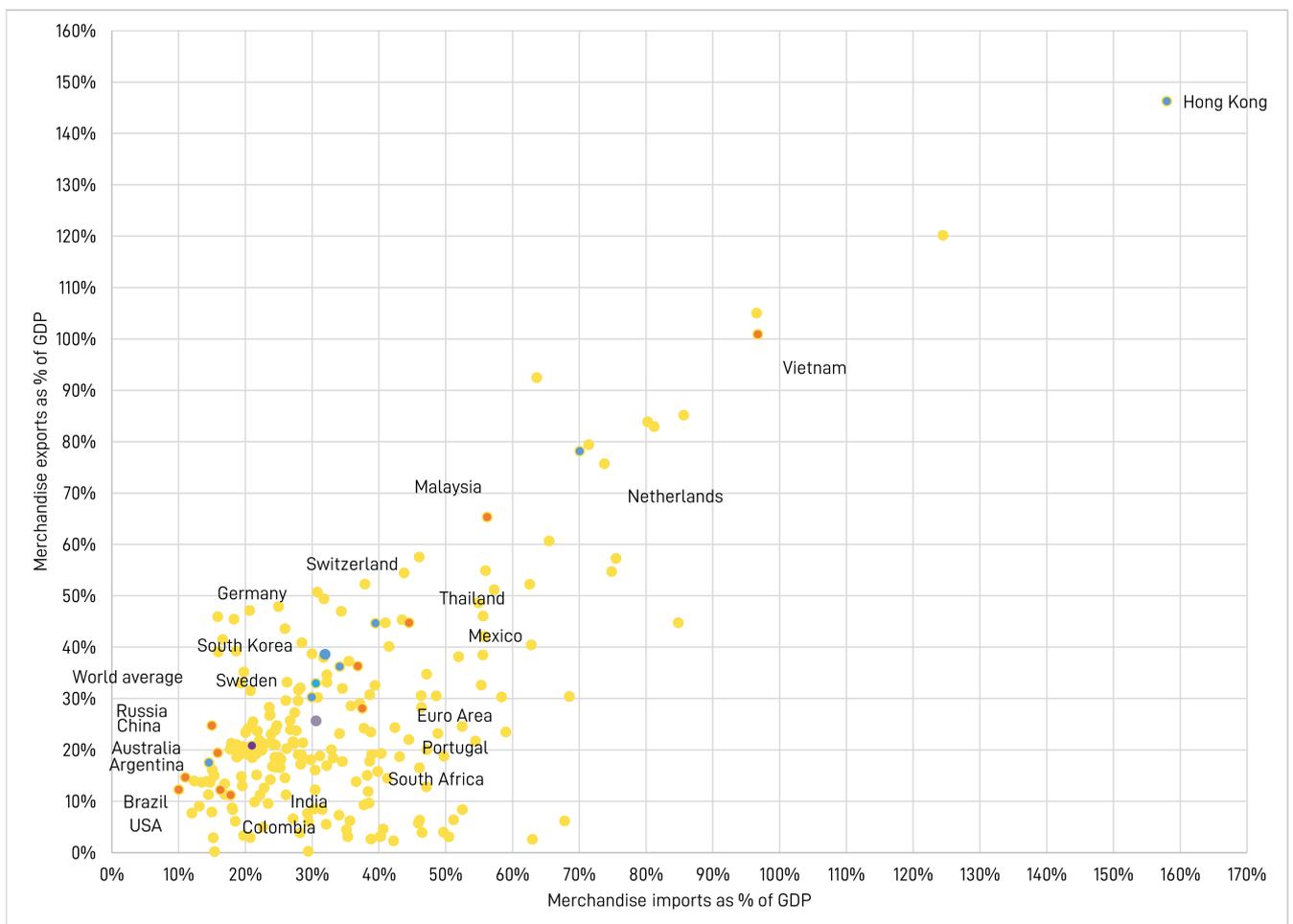
Country/region	Value as reported in DTIC	Value as calculated from World Bank data
Brazil	10%	10%
United States	12%	12%
Colombia	13%	16%
European Union	14%	35%
Japan	14%	14%
Russia	14%	15%
China	14%	15%
Indonesia	15%	15%
India	17%	17%
Turkey	18%	28%
Global average	22%	22%
South Africa	25%	31%
Egypt	26%	23%

Source: DTIC (2021) and CDE calculations from World Bank data

In the table above we reproduce the DTIC table, as well as the values for merchandise imports for those countries and regions as set out in the World Bank's data for 2019.

As is evident, we have been able to match the DTIC's figures for most of the countries they use in their sample, with the notable exceptions of the EU and Turkey (where our calculations are substantially higher than those reported by the DTIC) and South Africa (where the figure reported by the DTIC is actually lower than the figure we calculate from the World Bank's data). It is not clear why these differences are present, and, in particular, why they are different in only a minority of cases, albeit that the differences in those instances are substantial. What is notable is that the countries whose data are presented by the DTIC are exceptional for their very low levels of merchandise imports. The DTIC, in other words, appears to be cherry-picking data. This is actually made obvious in the DTIC's own table, where the global average for imports as a share of GDP (22 per cent) is more than 50 per cent higher than the median value for the sample of countries presented (China, at 14 per cent).

**Figure 3: Merchandise imports and exports as a % of GDP, 2019**



Source: World Bank database

In fact, when data for every country and region in the world is presented, as in Figure 3, it is evident that, as a percentage of its GDP, South Africa's imports is not unusual in the least (as is the value of our merchandise

exports as a percentage of GDP ). It is, to repeat, simply not true, as the DTIC avers, that South Africa's trade statistics reveal a country with an "over-propensity" to import manufactured goods. More important than that, however, is that it is evident from the data that there is actually very little relationship between the value of merchandise imports as a proportion of GDP and a country's level of development. Countries who are more developed than us may import more merchandise than we do (Netherlands) or less than we do (USA). Similarly, countries that are less developed may import more (Vietnam) or less (India) than we do. The factor determining the value of merchandise imports as a share of GDP is not, it turns out, the level of development, but the extent to which a country is an exporter of merchandise goods.

### **Importing manufactured goods is not a bad thing**

Another reason to question DTIC's rationale for reducing the value of imports as a share of GDP is that it is premised on an assumption that imports are always and everywhere a substitute for domestic products. The reality is much more nuanced. Imports replace local goods because they are cheaper, of better quality or offer something that local products cannot provide. In other words, substitution is, in the first instance, a reflection of the lack of competitiveness of local alternatives or of their non-availability.

Consider, in this regard, the parameters of the target agreed at Nedlac: South Africa will seek to reduce its non-petroleum import bill by 20 per cent. The obvious reason for excluding oil from the calculation is that oil makes up a very substantial fraction of the country's imports and cannot be replaced from local oil wells because we simply don't have oil wells. In the face of this reality, the DTIC accepts that oil imports cannot be replaced.

But is the case of cell phones any different? South Africa has precisely the same number of cell phone factories as it has oil wells – none. Obviously, there is no physical impediment to locating cell phone factories in South Africa. But is it conceivable that cell phone factories producing competitively priced cell phones with all the technological wizardry of the imported phones South Africans obviously like could be located in South Africa? That is much less likely, but, if it did happen, it would be possible if and only if (a) the vast majority of phones produced in South Africa were exported and (b) the vast majority of components used in the phones produced in South Africa were imported. South Africa, in other words, could not possibly reduce its dependence on imported cell phones through a strategy of localisation; it could do so if and only if it were fully integrated into global supply chains.

**“South Africa's poor economic performance over the last 13 years has nothing to do with any supposed 'over-propensity' to import.”**

This is actually obvious from the data presented in Figure 3, which show that, across the world, there is a very strong relationship between the value of goods a country imports and the value of goods it exports, and that in the vast majority of countries, the value of manufactured exports is closely correlated to the value of manufactured imports. The most extreme example of this is Hong Kong, which imports and exports goods worth 150 per cent of its GDP each year.

The strong relationship between imports and exports is not a coincidence: it is the nature of modern manufacturing that the supply chains of complex products are themselves complex, and inputs are sourced from a range of diverse sources. Manufacturing exports have increasingly been driven by participation by firms in global value chains, where ability to import intermediate inputs is a core part of the process of exporting. This is evident both at the aggregate level and at the level of individual firms. Lawrence Edwards and his collaborators (Edwards, et al.: 2017) have shown that firms who are the most successful exporters are also the most likely to be importing a significant fraction of their inputs. This is certainly true in the case of motor vehicle manufacture, the sector that dominates South Africa's manufacturing export statistics.

Given the strong link between imports and exports and given that there are no examples of successful industrialisers who have not exported a very large proportion of their output, it is very hard to see how a deliberate strategy of reducing imports is appropriate for South Africa.

### Concluding remarks

Perhaps the most important thing to say about localisation policy (in either of its variants) is that South Africa's poor economic performance over the last 13 years has nothing to do with any supposed "over-propensity" to import, and everything to do with a range of self-inflicted policy and governance injuries.

These injuries are well known, and include our inability to keep the lights on, our decaying infrastructure, the fact that the container terminals at our ports are both very expensive and every inefficient, the deepening fiscal crisis, rising levels of lawlessness, and our education systems' inability to produce adequate numbers of skilled workers. In this context, any policies that seek to strengthen local industry are likely to appeal to a range of stakeholders. Nevertheless, the claims made on localisation's behalf are simply not credible. It is important to recognise that the DTIC has sought to justify the localisation policy by a focus on the occasional success story, and its approach will be loudly supported by the firms that benefit. The broader costs of the policy, to be borne by government, by South African consumers and by exporters, will be ignored.

One of the ironies of all of this, of course, is that localisation, precisely because it raises costs, runs in diametric contradiction to both the President's repeatedly stated commitment to bring down the costs of doing business and the national goal – embodied in the Reserve Bank's mandate – of moderating inflation. Policy-induced cost increases is exactly the wrong medicine for a country with our policy challenges.

Protection, import-substitution and industrialisation-through-localisation all have very spotty records as vehicles for promoting development, with many more misses than hits. By contrast, exports have been integral to successful development everywhere.

South Africa's future growth will similarly be heavily dependent on growing exports – particularly of non-traditional exports. Seeking to replace imports is no substitute for building the capabilities for exporting. Indeed, an undue focus on localisation and on prohibiting 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 for what it is: an anti-export strategy, one that will only further constrain our future development.

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