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Localisation and Industrialisation Nexus: Lessons for South Africa

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1. Introduction

The role of the state in the development and social advancement of the economy remains a contested issue in the economic literature and among economists. Two schools of thought have dominated this literature, the normative and positive roles of the state.[1] The normative role prescribes how the state should respond to market imperfections and complement the market in the pursuit of promoting and maximising social welfare whereas the positive role describes and analyses what the government is doing.[2] In a perfect world, these two roles would converge because the state would be implementing and practicing the dual roles and citizens would benefit. However, evidence in the real world suggests that the two roles tend to diverge greatly.[3]

Recent global crises such as the 2008-2009 financial crisis and the 2020-2021 COVID-19 pandemic, revealed the susceptibility of the global economy to various economic conditions and external shocks. As a result, there has been increased calls for more state interventions to protect domestic economies from market failure and external shocks. State interventions are underpinned by the need to address the imbalances in the economic structures of underdeveloped economies. In most cases, these state-led interventions have contributed to the turnaround of many industrialised economies in achieving rapid industrial revolution and ameliorating economic structural challenges.[4] In fact, the economic history literature highlights that after the Second World War, many independent new nations embraced state-led development strategies.[5]

Today, South Africa remains a country confronted with several structural challenges including premature deindustrialisation and a lack of diversification. The manufacturing sector continues to underperform resulting in the imports of products that could otherwise be locally produced.[6] To reverse these, the Government of South Africa has placed emphasis on localisation as one of the policy tools to leverage and develop local industrial capacity, create jobs, drive economic inclusion, and improve the overall competitiveness of the economy.[7]

This policy brief draws from our current research that examined localisation in South Africa, and explores the sectoral opportunities and implications of South Africa's localisation policy (Avenyo, Bosiu & Nyamwena, 2023). The policy brief examines the link between localisation and industrialisation and provides lessons by drawing from the literature and other countries' experiences.

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[1] Musgrave, R.A. 1959. The theory of public finance; a study in public economy. Kogakusha Co.
[2] Arrow, K.J.1964. The role of securities in the optimal allocation of risk-bearing. *The review of economic studies*. 31(2), pp.91-96.
[3] Tanzi, V. 1997. The Changing Role of the State in the Economy. International Monetary Fund: Fiscal Affairs Department Working Paper.
[4] Chang, H.J. & Rowthorn, R. 1995. The role of the state in economic change.
[5] Menocal, A.R.2006. The State They're in: An Agenda for International Action on Poverty in Africa.
[6] Andreoni, A., Mondliwa, P., Roberts, S. & Tregenna, F. 2021.Structural Transformation in South Africa: The challenges of inclusive Industrial development in a middle-income country. Oxford University Press
[7] See Department of Trade, Industry, and Competition (DTIC), 2021. Policy Statement on Localisation for Jobs and Industrial Growth. Available here: http://www.thedtic.gov.za/wp-content/uploads/Policy_Statement.pdf

2. The Import Substitution, Localisation and Industrialisation nexus

The inward-looking development strategies have roots in the statist development theory that prescribes radical transformation for backward economies with limited industrial base.[8] This involves a shift from the free-market approach which advocated for limited state intervention and represents the recognition that economies needed more state intervention than they had previously received in the past. The move to greater state intervention is also a response to market failures that are inherent features of unfettered markets.[9] Inward-looking development strategies are aimed at prioritising and protecting domestic manufacturing industries through import substitution and use of local quotas and tariffs.[10]

Localisation implies the moral, political, and practical support for locally owned businesses (including co-operatives, community enterprises etc.) which use local resources, employ locals, and serve primarily local consumers.[11] Furthermore, localisation entails the "decentralisation of settlement, government and production, and communal ownership of capital".[12] The adoption of localisation policies is a form state intervention approach to support and protect the domestic industry.

The objectives under a localisation regime include i) **reducing imports** and **supporting the local industry,** ii) **creating jobs** and **protecting the domestic industry** and iii) **reducing the vulnerability** of the domestic economy to import dependence and shocks. The latter has become more important, especially in the aftermath of the COVID-19 pandemic and has led many governments to embrace inward-looking industrial policies such as the promotion of the local manufacturing base.[13]

At the core of the development of local industrial capacity is import substitution Industrialisation (ISI) approach. The ISI is anchored on the protection of local infant industries through protective tariffs, import quotas, exchange rate controls, special preferential licensing for capital goods imports, subsidised loans to local infant industries and local content policies.[14] The underlying presumption is that demand for imported goods can be redirected to domestic firms, promoting expansions in output, employment, and knowhow in local manufacturing.[15] This promotion of local manufacturing through ISI is hence linked to the concept of localisation.

Evidence from countries such as Brazil, Japan, and South Korea highlights that inward-looking industrial policies are instrumental in the path towards industrialisation. For example, these countries were able to accelerate industrial development by prioritising and

[8] Rapley, J. 2007. End of development or age of development? *Progress in Development Studies*. 8(2), pp.177-182.
[9] Chang, H.J. & Rowthorn, R. 1995. The role of the state in economic change.
[10] Westphal, L.E. 1990. Industrial policy in an export-propelled economy: lessons from South Korea's experience. *Journal of Economic perspectives*. 4(3), pp.41-59.
[11] Frankova, E. & Johanisova, N. 2012. Economic Localization Revisited. Environmental Policy and Governance. 22, pp. 307-321.
[12] Hines C. 2000. Localization: A global manifesto. Earthscan: London.
[13] Lall, S. 2013. Reinventing Industrial Strategy: The Role of Government Policy in Building Industrial Competitiveness. Green College, Oxford University.
[14] Balassa, B. 1970. Growth strategies in semi-industrial countries. *The Quarterly Journal of Economics*. 84(1), pp.24-47.
[15] Baer, W. 1972. Import substitution and industrialization in Latin America: Experiences and interpretations. *Latin American Research Review*. 7(1), pp.95-122.

protecting domestic manufacturing industries through import substitution and use of local quotas and tariffs.[16] The development of local industrial capacity and capabilities is typically expected to support economic self-sustenance and to reduce vulnerability from external shocks.[17]

For instance, Brazil implemented the ISI in the 1950s and its experience reveal that the interventions introduced focused on promoting domestic production of goods that were previously imported. The successful industrialisation of Brazil was attributed to the central role played by the government in driving industry development.[18] This active role of the state included encouraging and protecting development of infant industries. For example, the government established state-owned companies in the secondary sector with particular focus on industries such as steel, minerals, petroleum, and chemicals. These industries are root industries since these products are intermediate products and have strong linkages to much of the manufacturing sector. The strong linkages offered by these industries enabled the ISI a substantial scope for capacity-building of the domestic economy, including transfer of accumulated expertise.[19] Furthermore, the Brazil government provided cheap loans through state development banks to support these root 'favoured' industries. This was critical in offsetting the heavy financial requirements faced alleviated the financial burden. Government direct participation in Brazil also involved the construction of supporting infrastructure designed to complement the specific industries identified by the state.

The active government role is also evident in the rapid growth witnessed in South Korea, where state intervention shaped the economic development trajectory of the country.[20] Korea adopted import substitution to develop the building of both the human and physical infrastructure which facilitated the rapid industrialisation.

Both Brazil and Korea exhibit a similar feature of the ISI with bias towards the industrial sector and promotion of vertical integration. However, in some countries like Argentina, Chile and Venezuela, the ISI had a focus on consumer goods industries (backward integration). The rationale for targeting consumer goods industries was that these industries have relatively lower capital requirements and mostly used simple technology.

Another feature of the ISI especially in Latin American countries was the use of foreign capital though less than 10% of the total savings. It was able to play an instrumental role in setting up key manufacturing industries through providing the expertise and organisational capabilities.[21] However, the foreign capital presented challenges as countries became reliant to it. For instance, in Brazil, the policy resulted in insufficiency of capital which resulted in

[16] Pack, H. & Westphal, L.E. 1986. Industrial strategy and technological change: Theory versus reality. *Journal of development economics*. 22(1), pp.87-128.
[17] Baer, W., da Fonseca, M.A. & Guilhoto, J.J. 1987. Structural changes in Brazil's industrial economy, 1960–1980. *World Development*. 15(2), pp.275-286.
[18] Singer, H.W. & Alizadeh, P. 1988. Import substitution revisited in a darkening external environment. pp. 60-86). Palgrave Macmillan UK.
[19] Dell, S. ed., 1988. *Policies for development: essays in honour of Gamani Corea*. Springer.
[20] Kim, K.S. 1991. The Korean miracle (1962-1980) revisited: myths and realities in strategy and development. Notre Dame, IN: Helen Kellogg Institute for International Studies, University of Notre Dame.
[21] Bruton, H.J.1970. The import-substitution strategy of economic development: A survey. *The Pakistan Development Review*. 10(2), pp.123-146.

the country failing to produce and export enough goods due to the shortage of imported inputs to be used in the production process.[22]

The foregoing suggests that ISI and localisation can be a springboard for facilitating industrialisation, particularly in late industrialising countries like South Africa.

3. Lessons and emerging issues for South Africa

South Africa's economy continues to suffer from several pervasive and long-standing problems, namely a significant barrier to entry, premature de-industrialisation, and lack of meaningful participation and inclusion.[23] To reverse these, the Government of South Africa has developed a localisation policy that aims to develop local industrial capacity, create jobs, drive economic inclusion, and improve the overall competitiveness of the economy.

This policy brief provides evidence on the nexus between localisation and industrialisation through import substitution industrialisation and discusses the key experiences of comparator countries. Based on the synthesis of the literature and country experiences, we found that localisation policies have been critical in setting the industrial development trajectory of countries.

The following are emerging as important elements for the success of localisation policies from comparator countries, with significant implications and lessons for South Africa.

- The government has an important role in driving the industrial development strategy. For example, governments in both Brazil and South Korea were instrumental in shaping the development courses of their nations. Therefore, the South African government needs to **adopt appropriate structures and controls** to drive structural transformation in South Africa.
- B**usiness climate constraints** must be addressed to ensure that the business climate is conducive for investments and private sector development; basic soft and hard infrastructure are available, dependable, and competitive. The Brazil case reveals how the government was intentional in ensuring that the supporting infrastructure was available for the specified industrial sectors which lessened the burden on the firms. In addition, the Brazil case also shows how the state addressed lack of capital by providing cheap loans through the state development banks. Therefore, the South African government and policy makers should be intentional in addressing some of the hurdles that constrains firms such as infrastructure and access to finance. country
- Before designing a mandatory requirement (in the form of a percentage; a list of goods or services to be sourced locally; or a procurement plan). Evidence form countries that have implemented local content requirement suggest that this must be informed by a **detailed analysis** of the capacity and potential capacity of local suppliers to fill in the gap.
- Measures must be combined with **investments in a local business capacity**. Building capabilities of local businesses and suppliers is necessary to ensure they can take up

[22] Teitel, S. & Thoumi, F.E. 1986. From import substitution to exports: the manufacturing exports experience of Argentina and Brazil. *Economic Development and Cultural Change*, 34(3), pp.455-490.
[23] Nyamwena, J & Bell, J. 2021. South Africa's economic recovery plans: What are the missing pieces for a sustainable and inclusive drive towards industrialisation? CCRED-IIDTT Policy Brief

opportunities unlocked through local procurement regulations and that companies have viable local suppliers from whom they can buy, in compliance with regulations. These can include training, skills development, access to innovation centres, and technical support to improve product quality.

- Measures should preferably be **time-bound**. If governments decide to design mandatory targets, it is important to set clear parameters and conditionalities for support and the expected outcomes of the firm and the industry as a whole.