



SEIFSA Position Paper: Procurement Regulations and Support for BBBEE, Job Creation and Local Production

**SEIFSA Economic Forum
Prepared by: The SEIFSA Economics Division, February 2011**

1. INTRODUCTION

The South African economy masks key structural problems associated with the inability to absorb labour, high input costs of production and a low skills base. In addition, growth has been driven by unsustainably high levels of credit by the banking sector, with consumption not underpinned by productivity in the economy. This has led to considerable structural imbalances throughout the economy, resulting in persistently high levels of unemployment and a large current account deficit.

Last year the government unveiled its new Industrial Policy Action Plan (IPAP2), aimed at shifting the economy from the current consumption-driven growth path towards industrialisation. According to its proponents, the initiative is intended to improve the labour absorption of the economy through growth and targeting labour intensive industries, whilst also rectifying structural imbalances.

The manufacturing sector has lacked sustainability over the past number of years. A number of factors are responsible for the decline in manufacturing competitiveness. These include, high costs, limited available capital, a weak skills base, unreliable and expensive logistics (including ports and rail systems). Also, the introduction of the National Credit Act, as well as the lag effects of the rising interest rates by the South African Reserve Bank since June 2006, have had a negative impact on the economy and on the manufacturing productive capacity.

Adding to the situation were the far-reaching implications of the effects of the energy crisis since early 2008. This has seriously affected production over a prolonged period as companies began to establish a new base and looked to improve their operating efficiencies. Apart from this, other serious challenges facing the industry included high electricity prices approved by the National Energy Regulator of South Africa (Nersa) and the global impact of the economic recession of 2008/09.

Sustainable employment and skills development in local manufacturing is crucial to the metal and engineering industry's longevity and competitiveness in the global economy. The new IPAP unveiled by the Department of Trade and Industry (DTI) focuses on improving growth in key manufacturing sectors, with emphasis in creating sustainable employment. IPAP is expected, over the medium to long-term, to create over 700,000 jobs through various sector strategies and policy decisions. The metal industry received attention in IPAP as being one of the key industries which government wants to use to leverage its economic development initiatives.

The metal industry is at the core of economic development as it produces products and applications that are widely used across the entire economy. By leveraging the public infrastructure programme, government can create an opportunity to stimulate the metal industry. However, the current procurement practices which are ad hoc, and with unrealistic short delivery times, often undermines local manufacturing.

Strategic leveraging of the public procurement system is therefore critical in ensuring the success of IPAP, in reducing import leakages, increasing investments, reviving lost capacity and increasing employment and exports by the metal industry.

1.1 Purpose

This document is a discussion paper aimed at taking into account SEIFSA members' views on the Draft Preferential Procurement Regulations pertaining to the Procurement Policy Framework Act (PPFA), with its implications and support for Broad-Based Black Economic Empowerment (BBBEE), local production and job creation.

1.2 Scope

This document presents the background and the legislative framework to the current preferential procurement system under the PPPFA. The main area of focus is the assessment of the role of the governmental procurement system, particularly the interim procurement regulations drafted by National Treasury, in achieving the much desired economic growth, creation of decent jobs and the promotion of BBBEE and local production.

2. MOTIVATION

In 2000, the South African government enacted the Preferential Procurement Policy Framework Act (PPPFA) which aimed to promote Historically Disadvantaged Individuals (HDIs) and Reconstruction and Development Programme (RDP) goals in determining the preference of procurement contracts. The PPPFA was subsequently found to be inconsistent with the objectives of the Broad-Based Black Economic Empowerment Act.

The PPPFA had to be completely repealed in the long-term and the recommendation by National Treasury was that this should be done through a review of the Public Finance Management Act (PFMA). However, in the short-term, the amended Preferential Procurement Regulations would be used to achieve this objective.

As part of government's consultative process, organised business (through BUSA) was given an opportunity to make its input on the draft regulations before they were gazetted. In its review of the draft regulations, Business had to take into account the effectiveness of achieving the two contending imperatives of BBBEE and local production.

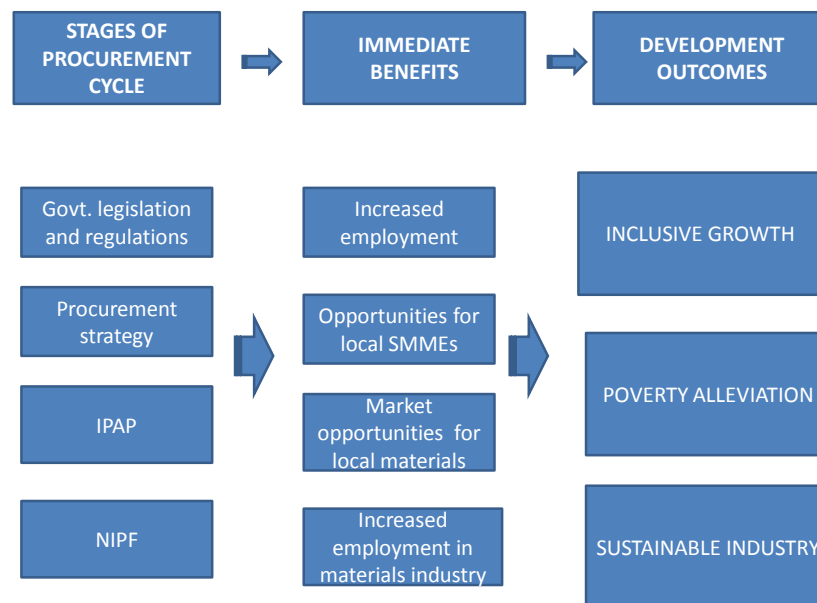
SEIFSA's view was to campaign for and further the interests of local manufacturers. SEIFSA expected government to support local industry and, with it, job creation and retention by ensuring that, wherever possible, government departments and parastatals should favour local content in fulfilling their procurement requirements.

2.1 Promoting Local Content as a Policy Objective

The need to increase local labour, goods and services – ‘local content’, through state procurement is recognized by multilateral development banks, the World Trade Organisation and major United Nations agencies. Increasing the input of local labour, goods and services in the production process can make a major contribution to economic growth.

In addition, this may open opportunities for the poor to participate in the growth process through the creation of jobs in the local manufacturing and supply industries. The long-term development outcomes are poverty reduction, inclusive economic growth and a sustainable local industry. These benefits are illustrated in Figure 1 below.

Figure 1:



Creating opportunities for local people to earn an income through employment is one of the major means of alleviating poverty in developing countries. The process of promoting local industrialisation and industrial diversification offers significant opportunities for the generation of employment and maximising these opportunities.

The use of local procurement has received international support as an instrument capable of creating sustainable outcomes and to assist in the generation of skills, income and employment. The use of government procurement to support strategic industries has been consistently and successfully pursued by a number of developed and developing countries.

Among the developing countries, India stands out as having successfully promoted, local, small and public sector enterprises in its procurement policies for a number of years now. These policies have resulted in a high local content and it is estimated that 100 per cent of the inputs to water and rural road projects and 75 per cent of inputs into power projects are local.

In China, procurement regulations require that government buys nationally unless the required goods and services are not available or cannot be acquired on reasonable commercial terms and conditions. The example of Singapore below (Box 1) also shows the importance of access to a public procurement system.

Box 1: The Role of Public Clients in Developing the Construction Industry in Singapore

Thirty years ago, the local construction industry in Singapore was seriously underdeveloped, but now local firms are now represented in all classes and are fully competitive in their own home market, as well as winning a substantial number of projects overseas.

A recent investigation of the factors that have been responsible for the development of Singaporean contractors found that public sector clients played a key role. For many years, the Housing and Development Board has offered bidding preferences to firms with good performance records, as well as a pre-financing loans scheme.

Contractors were asked to rank 10 factors in order of importance in furthering their development. Top in the overall ranking was '*government's attempt to improve the industry's operating environment*' and this was followed by '*public sector client's help*' and '*Government's financial incentives*'. In fifth place was '*private client's help*'.

This shows very clearly the importance of demand side issues for developing construction industries.

Source: George Ofori and Chan Swee Lean, Factors Influencing Development of Construction Enterprises in Singapore, Construction Management and Economics, 2001, 19, pp. 145-154

Locally in South Africa, the eThekweni municipality has used its transport fleet equipment in the best interest of domestic production and supply capacity without compromising price, quality or any other policy objectives. It is believed that this model can serve as a case study on how a carefully designed procurement system can be used to leverage local production and strengthen domestic supply chains.

According to the Department of Trade and Industry, the draft procurement regulations are currently being evaluated and, once finalised, will become the new set of regulations to the Act which, subject to Cabinet approval, will create a platform to advance the aims of the Industrial Policy Action Plan (IPAP2) in respect of state procurement.

2.2 Key Challenges

One of the objectives of the draft preferential procurement regulations is to bring the legislation governing state procurement in line with that pertaining to broad based economic empowerment. To redress the racial inequalities caused by the country's previous apartheid dispensation, the current government passed certain laws, including the Broad-Based Black Economic Empowerment Act, 2003. Hence, this resulted in the twin imperatives (i.e. BBBEE and support for local production) for incorporation into the draft regulations.

According to organised Business and SEIFSA, the draft Regulations addresses neither of these imperatives. Section 4 of the Regulations aligns the entire point allocation of the BBBEE status level of the bidding company according to the seven elements of the scorecard of the BEE Act. It is recognised that the BEE codes provide no recognition for local procurement and, in fact, make it easier for importers that add little value locally to gain advantage over local manufacturers with local value-add and employment.

When this aspect was raised by the Business and Labour representatives at Nedlac, the government representatives serving on the Trade and Industry Chamber (of Nedlac) indicated that this would be accommodated through the PPPFA. No preference points are allocated to local production and/or local procurement, a

radical change from the existing allocation to local content and seemingly no preference points will be allocated to local production through this approach.

This, according to BUSA, is problematic in that it encourages fronting and, at the same time, discourages Broad Based Economic Empowerment compliance by White Business. BBBEE and local production are inextricably linked. Severing this link, by dispensing all preference points to BEE, will encourage one or two-man importer operations aligning to BBBEE status level companies for the sake of winning tenders - and hence robbing the economy of the important benefits of local beneficiation and also the promotion of Black Industrialists.

Part of the aim of preferential procurement for local producers is the promotion of South African owned enterprises; the promotion of export orientated production; the creation of new *decent* jobs, and the intensification of labour absorption. The removal of the alignment of all preference points for local content / local production significantly undermines these objectives.

Notwithstanding this, it seems to have been the intention of the Regulator to substitute the removal of the points allocatable to local production / procurement by providing expression to this through Section 11(1) of the Regulations instead. This section of the 'Regulations' will, however, require a substantial expansion of the existing language - which will assist in achieving the local production / procurement objectives set out in both the Industrial Policy and the '*Tuynhuys Framework Agreement*'.

The Act, although well intentioned (particularly in its goals of empowerment, transformation, enhancing local procurement, growing the economy and in promoting decent job opportunities), has regrettably, due to unintended consequences, often served to create the opposite effect - i.e. de-industrialisation, local job shedding and delayed transformation. It is paradoxical therefore, that due to these unintended consequences the Act often advantages importers at the expense of local producers.

By way of example, the present preference point system, allocates a maximum of 10 points for tenders larger than R1m, distributed amongst the following three elements: Historically Disadvantaged Individuals (HDIs), SMMEs, and points for local content. The HDI component cannot apply to public listed companies, hence a public listed company that meets the 25 per cent ownership criteria and which could have undertaken a significant empowerment ownership transaction and which employs thousands of employees, is unable to score more than 0 out of 4 points. Often these listed companies score fewer preference points than four or five-person importers that derive little or no economic value-add or employment to the South African economy.

It is ironical that such importers usually enhance industrial activity in other countries at the expense of our local economy. This contradicts the primary purpose of the Act.

The anomaly of the unintended consequences, in some cases of favouring importer penetration over local production, is further exacerbated by the often uneven playing field that exists between importers who are incentivised by foreign governments, usually through fiscal and other tax breaks and subsidised finance, who enjoy a cost advantage over local producers - who are neither incentivised nor subsidised. This places local producers at a significant disadvantage and often leads to the destruction of productive local capacity.

Furthermore, many South African Industrial tariff lines have 0% applied tariffs and preferential procurement interventions are, in part, aimed at levelling the playing field against either incentivised (subsidised) importers and/or those exporters who import to South Africa under disproportionately advantageous trade conditions.

Once again, this is inconsistent with the aims of the Act in that subsidised importers are often able to score more preferential points than local producers - particularly as the funding of the cost of the fiscal incentive received by the importer is often at the expense of the South African tax payer.

2.3 Proposals by BUSA towards Achieving BBEE and Local Procurement through Preferential Framework.

According to BUSA, the central weakness of the South African Procurement Policy has been the inadequate interface and integration with industrial and BBEE policies, particularly at operational and implementation level. International experience has adequately demonstrated that where this integration between procurement and industrial policy has been achieved, a significant contribution to achieving the objectives of sustainable growth is realised.

Economies of scale are critical for the international and domestic competitiveness of local producers. Support for local production is key to achieving both economies of scale and international competitiveness for export orientation.

SEIFSA and BUSA are attempting to introduce consistency, integration and alignment between the procurement provisions contained in the PPPFA (the Act), the BBEEA, the Public Finance Management Act (PFMA), the Companies Act and the Municipal Systems Act (in the context of state and all public entities, particularly SOEs). The scope and application of the Act currently excludes certain of the SOEs and municipalities.

2.4 Proposed Intervention

The process required for the amendment of the Act or the ultimate repealing of the Act and the incorporation of the key procurement imperatives introduced into the PFMA is prioritised with utmost urgency. To this end, Business proposed that a joint working group between National Treasury and Business be established in order to agree the key principles in respect of BBEE, local procurement and industrial policy alignment, and to ensure that none of the current unintended consequences recur. Business has significant practical experience that it can contribute to such a working group.

Black Business does not find the current point allocation system the most optimal way of promoting the aims of the BEE Act with respect to procurement and is advocating

its withdrawal of this approach in the Regulations. Instead, Business is advancing the introduction of so-called '*set asides*' for key products supplied by accredited BBBEE enterprises. The principle of these *set asides* is contained in the *Tuynhuys Framework Agreement* under paragraph 3.7.

The Act presently makes no provision for *set asides* other than for specific sectors identified by the Department of Trade and Industry, and these are, in themselves, a little vague. The amendment Act or the PFMA incorporation needs to carefully consider the introduction of *set asides* within the Framework of advancing BBBEE and within the realms of affordability to the economy. This will involve understanding the premium that the fiscus is prepared to pay for these *set asides* and the possible introduction of the matching tender principle for empowerment entities bidding against other entities, should the premium be exceeded.

Notwithstanding this, there are certain interventions that can be attended to immediately, particularly given the need to boost local output and to mitigate the impact of job losses in the interim until an amendment or the repeal of the Act takes place. These short term interventions are critical and can be incorporated into the more medium-term amendment / repealing of the Act (incorporation into the PFMA) in time. It is however critical that they are not delayed until the amendment / repealing of the Act.

Section 11(1) of the Regulations makes provision for '*specific industries*' (as identified by the Department of Trade and Industry) where the award of bids to local manufacturers is of critical importance. These bids may be advertised with a specific bidding condition that only locally manufactured products will be considered. This provision enables the operational expression of the intent of Section 12 of the Act.

This is the section in the Act used in the protection of the textile industry, as identified by the Department of Trade and Industry, when it came under siege from heavily subsidised import penetration. It is an important provision in terms of attempting to ensure that local capacity is not destroyed, jobs are preserved, and social stability is strengthened.

Section 11(1), however, still remains unclear in many areas, and its scope, application and implementation requires greater clarity.

3. OTHER CONCERNS

- There is a need to align BBBEE imperatives to local content so that it does not endanger local businesses and job prospects.
- The definition of local content should go beyond simply looking at designated final products but should also encompass local raw materials and other inputs – including labour.
- The South African manufacturing sector must identify niche markets where it has a competitive advantage and thereby prevent countries such as China from entirely dominating the local manufacturing economy.
- South Africa must, in addressing the weak skills base, look beyond basic education and improve the hands-on skills of artisans, technicians and engineers.
- There is a greater need for the industry to engage trade unions beyond wage negotiations - particularly on how the industry can save jobs (for example, through the job grading system, artisan training initiatives etc.).
- Unlike China, where there are minimum / no work ethics, in South Africa, work ethics may act against increasing productivity at factory floor. In order to increase productivity there is an important need for union buy-in.
- Whilst the industry might have the capacity to increase productivity, there are not enough skills available. For instance, there is a shortage of middle managers but a large number of higher management positions.

4. CONCLUSION

Increasing local content through governmental procurement obligations and ensuring sustainability of the local manufacturing sector will generate income and enhance national employment. This will contribute to economic growth and poverty reduction. The use of local procurement to achieve these fundamental objectives is supported by international agencies and has been successfully practiced by a number of countries over many years now.

Preferential Procurement is an important instrument in achieving South Africa's socio-economic, transformational and industrial objectives.