BUSINESSDAY
NEWS WORTH KNOWING
Tuesday, 03 April 2007

close window

BUSINESSDAY MINING NEWS

Posted to the web on: 02 April 2007

GEEKONOMICS

Frank Flatters and Matthew Stern

FEW governments can resist the temptation to use their procurement policy to support domestic industries. The costs and economic effects, however, are seldom considered.

SA has made extensive use of offset arrangements, also known as industrial participation (IP) agreements with foreign suppliers. All purchases or contracts with an import content exceeding $10m are subject to offset obligations.

The national industrial participation programme (NIPP) claims it is managing obligations totalling $15bn. Most of these arise from the government’s R40bn defence procurement package. The trade and industry department (DTI) claims that the programme has created 12000 jobs and has resulted in R7,5bn in investment, sales and exports since 1996. But what do these numbers mean?

The government has designed a convoluted scorecard to determine and monitor the required contribution of foreign suppliers to the domestic economy. The value of the obligation arising from a tender is calculated at 30% (50% for defence purchases) of the import content and IP credits can be earned by achieving various predefined objectives.

To qualify for credits, IP projects must satisfy some core principles: the IP obligation must not increase the purchase price; projects must be profitable for the seller, beneficial for the domestic economy and sustainable; all proposals must reflect new business (additionality); and projects must result directly from the purchase contract (causality).

In fact, these principles are almost impossible to test beforehand. Moreover, it is widely accepted that IP raises the price of government procurement, but government cannot compare prices of tenders that include complex offset arrangements. As a result, causality and additionality are central to the evaluation of new tender proposals and are the only principles considered in defence-related offsets.

Causality is easy to claim but difficult to prove or disprove. Unless the DTI can show that the seller was not in any way responsible for an investment or export deal, an almost impossible task, any obligor’s claim, no matter how outrageous, is generally accepted. Local beneficiaries have nothing to lose in attributing causality to a foreign IP obligor, and much to gain. No matter how small an obligor’s contribution to a project, it can claim credits up to the full value of the total investment or sales.

Consider some of the department’s “success stories”. Ferrostaal will provide “a secured loan at a preferential rate” to a polyester recycling plant in Gauteng. For this it will gain credit for €2m in investment and €12,5m in sales. BAE/Saab have put in place "guarantees" to the value of $11,2m in support of a jewellery manufacturing scheme, in return for $15m in investment credits and $588m in sales.

Additionality requires that a project contribute new capital or new exports. In practice, a simple shift in exports from one market to another meets the requirements of defence procurement contracts.

Acerinox, a Spanish company, owns 76% of Columbus Steel. Volvo, as a large buyer of stainless steel, has persuaded Acerinox (Scandinavia) to favour Columbus Steel as their sourcing partner. The net gain in South African steel exports is probably nil. But for this, Volvo stands to reap R1,8bn in export credits.

In 2002 the DTI published a review of the NIPP which uses a few examples to demonstrate the "benefits" of IP. It combines export and investment values to provide grossly inflated estimates of the contribution of each obligor to the South African economy. It makes no attempt to strip out the actual contribution of the obligors to total investment or exports. In all cases, this is significantly less than the value of the project, and in most cases the IP obligors are minority investors.

The review provides no substantive analysis to back its claims for the "success" of the NIPP. And its examples actually illustrate its absurdity. We have BAE/Saab "spearheading" tourism in Port Elizabeth and manufacturing oral tobacco in Boksburg; Ferrostaal testing and sealing condoms in East London; Rolls Royce financing the exports of rock drills; Augusta (an Italian aeronautical company) spinning, dyeing and knitting mohair; Thyssen producing wheat beer; Thales managing a medical waste facility; and an unnamed defence company overseeing clinical trials for diabetes, depression and childhood infections. This kind of behaviour would only make sense if the price paid to these firms exceeds the obvious economic cost of these small and unstrategic "investments".

The benefits of the NIPP are overstated; the costs are never mentioned; and the government's ability to manage and monitor offset programmes is weak. The DTI claims that the NIPP "allows government to go where no private business has gone before". In fact, it defers industrial policy decisions to private and foreign companies and enables them to exploit existing and profitable business opportunities while charging the government a premium for goods and services.

Negotiating and monitoring industrial offsets require significant time and resources, which could be better applied to procuring the best equipment from the best supplier at the best price.

llMatthew Stern and Frank Flatters are from Development Network Africa, a private economic and development consulting firm. (geeks@dnafrica.com)