# CDE ROUND TABLE

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# SPECIAL ECONOMIC ZONES

## Lessons for South Africa from international evidence and local experience

Edited proceedings of a Round Table convened by the Centre for Development and Enterprise

The Centre for Development and Enterprise is a leading South African development think tank, focusing on vital national development issues and their relationship to economic growth and democratic consolidation. Through examining South African realities and international experience, CDE formulates practical policy proposals for addressing major social and economic challenges. It has a special interest in the role of business and markets in development.

Series editor: Ann Bernstein

This report summarises the proceedings of a Round Table hosted by CDE in November 2011.
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# EXECUTIVE SUMMARY

In November 2011, CDE hosted a Round Table on the role that special economic zones (SEZs) could play in accelerating economic and employment growth in South Africa. The Round Table was supported by Blue IQ (the investment arm of the Gauteng Provincial Government) and Business Leadership South Africa, and was instigated in response to government's plans to revise the law governing the country's industrial development zones (IDZs). Official recognition that the IDZs have failed to achieve their goals of employment creation and accelerated industrial development creates an important opportunity to learn from South Africa's experience as well as that of countries around the world.

Three pieces of research were commissioned for presentation at the Round Table. These were:

- A review of international experience with SEZs, commissioned from Professor Ted Moran, a leading authority on the relationship between trade, foreign investment and industrial development based at Georgetown University and the Petersen Institute of International Economics;
- A review of South Africa's IDZs commissioned from Crispen Chinguno of Wits University; and
- An analysis of changes being proposed to South Africa's legislation in the light of best international practice in the establishment and operation of SEZs, commissioned from Jean-Paul Gauthier, deputy secretary-general of the World Economic Processing Zones Association and a leading international expert in the field.

Since the Round Table, the Department of Trade and Industry (DTI) has released for public comment a draft of the law it hopes to take to parliament after consultations in Nedlac later in 2012. This, together with an allocation of some R2,3 billion over three years for SEZs in the 2012 budget, suggests that government is serious about trying to find a formula for more successful zones. But South Africa needs to learn the right lessons from its own experience and that of other countries.

## Local experience

Special economic zones are defined as specially-demarcated geographic areas in which some aspect of the business environment, whether the quality of the infrastructure or the regulatory regime, differs from the norms prevailing in the rest of the country. SEZs have been used as instruments for attracting foreign direct investment, alleviating large-scale unemployment, developing and diversifying exports, and experimenting with new policies. There are now about 3 000 SEZs in 135 countries, accounting in 2008 for more than 68 million direct jobs and $500 billion of trade-related value-add.

Impressive as the aggregate performance of SEZs has been, the international experience with them has varied. There have been some spectacularly successful zones that transformed the economies of their host countries, and there have been many zones which have failed to set themselves apart from the rest of the economy, create a sufficiently attractive business environment, or compete internationally. This has been the experience in South Africa, where the establishment of IDZs has not contributed significantly to economic growth or the transformation of the country's economic prospects.

South Africa's IDZs are defined as 'purpose-built industrial estates, linked to an international port or airport, specifically designated for new investment in export-oriented industries and related services'. To date, four of these zones have been designated and licensed – at Coega, East London, Richards Bay, and OR Tambo International Airport outside Johannesburg.

Government has recently joined the consensus that the IDZs have not delivered. Investment levels have been relatively low, the number of permanent jobs created has been small, and many of the businesses that located in the zones simply moved there from elsewhere.

There are a number of reasons for this lack of success. Unlike many SEZs around the world, investors in South Africa's IDZs receive no special incentives. And, despite initial promises that businesses in the zones would be treated expeditiously in the management of VAT and tax obligations relating to imports and exports, in practice there has been little variation on the usual treatment afforded to all businesses. Regulations in the zones also do not deviate from the social, labour and environmental rules in force elsewhere. The main justification for failing to introduce additional measures was an unwillingness to introduce distortions into the economy, but this has meant that IDZs have not been able to offer investors a compelling reason to be there.

From their conception, the IDZs have lacked a comprehensive policy framework. This has led to weaknesses in governance, planning, implementation, management and operations. A lack of inter-agency coordination has resulted in serious deficiencies. For example, ten years after the policy's inception, none of the IDZs offers a customs secured area or a one-stop shop for customs duties and VAT regulatory requirements or business registration. In contrast, international best practice has shown that consistent high-level political commitment is vital if SEZs are to succeed because these interventions require considerable inter-departmental coordination and cooperation.

South Africa's IDZs are all exclusively government-owned, promoted and financed. The management and delivery of services to firms is the responsibility of a zone operator, all of which are owned by provincial and local governments. This contrasts with the global trend which is shifting towards greater private sector involvement in SEZ ownership and management.

It is impossible to argue that South Africa's IDZs are special economic zones because there is little that distinguishes them from other industrial parks. It is, therefore, not surprising that the return on the investment of public funds – whether measured in jobs, exports or industrial development – has been low.

## Lessons from international evidence

If South Africa is to use SEZs to transform the country's economic prospects, we will have to approach their development quite differently from the ineffective IDZ strategy. Successful SEZs must do more than offer an investment proposition that is marginally better than what is available outside the zone – success requires that SEZs be globally competitive. If South Africa is to deliver on the promise of SEZs, the country's new approach will need to embrace some key lessons from international experience:

1. *Special economic zones must be special*

Successful SEZs offer investors something significantly different from what is available in the rest of the economy. Precisely what an SEZ offers, and how this differs from conditions elsewhere, depends on the goals of the country's SEZ programme. International evidence indicates that SEZs are most successful when they are targeted toward particular industries and offer concrete solutions to the challenges faced by those industries.

2. *Global competitiveness is what counts – it's not enough just to be better than the host economy*

Our SEZs need to be globally competitive. Investors, particularly foreign investors, choose SEZs for different reasons. Most consider their location, market access and logistics; others consider wage levels and labour market practices; yet others place a premium on access to skilled labour or a favourable regulatory environment.

Many SEZs offer investors particular fiscal incentives – tax breaks, subsidies, etc. International evidence shows that few investment decisions are made on the basis of these incentives alone, and that ensuring the zone's overall competitiveness is critical. Nevertheless, government should retain the capacity to provide fiscal incentives. This can help ensure that the tax burden in an SEZ is not out of line with the tax rates paid in the investor's home country or other potential investment locations. Tax incentives may also help to attract first movers who may be uncertain of the area's competitiveness.

3. *The rest of the host economy also has to work*

Although typical SEZs are demarcated spatial enclaves, the extent to which they can function effectively and benefit the host economy as a whole depends on wider economic conditions. The more business-friendly the surrounding environment, the more potential an SEZ has to stimulate economic activity both within and outside of the zone.

An important factor in this regard is the exchange rate. If the local currency is overvalued, competitiveness will be reduced. This is less true when the products being manufactured are themselves import-intensive. However, when local inputs and labour costs make up a significant proportion of total costs, an overvalued currency will undermine competitiveness.

Another factor that affects the competitiveness of SEZs is the availability of skilled workers. Successful SEZ programmes must ensure that businesses have access to the skills they need. In some countries, this has been achieved by locating SEZs in regions where the population is better educated or by aligning interventions in secondary and tertiary education with the skills needs of SEZs.

There is some evidence that SEZs can help to create skills, and firms in SEZs around the world have seen rapid productivity gains through on-the-job training.

4. *SEZs should offer tailored solutions to problems faced by local businesses*

Although it is widely believed that multinationals invest in SEZs in order to take advantage of cheap local labour, most FDI (including investments in SEZs) is in medium-skill industries. SEZs can tailor their offerings to specific sectors and subsectors across the industrial spectrum. The key is to ensure that the zones help address whatever constraints limit the growth of those sectors elsewhere in the economy. Where mass unemployment is a problem, SEZs should focus on addressing the needs of labour-intensive industries.

5. *The costs and flexibility of employment matter*

Businesses in SEZs are most likely to create large numbers of jobs if the package of benefits derived from locating in the SEZ meets the needs of labour-intensive industries. Flexible labour markets are essential if SEZs are to be globally competitive in labour-intensive manufacture. Wage levels are important. So too are rigid overtime rules, legal conditions governing temporary employment and/or piece-work, shift systems, rules of dismissal, etc. Flexibility of this kind is most important for labour-intensive industries, many of which operate in conditions in which order-flows from customers are erratic. Employers' ability to adjust the size of their workforce and their shift systems in response to these variations is an important determinant of their competitiveness.

6. *SEZs are badly suited to uplifting poor regions*

Some of the least successful SEZs have been set up as vehicles for developing poorer regions of a country. The weakness of this model is that there are often good reasons why some areas are less developed than others: a lack of infrastructure, limited access to skilled labour, distances from markets, etc. To overcome all these disadvantages, SEZs would have to offer extensive subsidies or require levels of investment in public infrastructure that are not economically viable, if costs are to be recovered.

7. *SEZs require political commitment from the highest levels of government*

Effective SEZ policies and operations require the coordination of a number of government departments. Generally, the highest levels of government must be committed to making SEZs work, if only because the zones will require government entities to do some things differently from how they do them everywhere else. Achieving this requires strong leadership and high levels of political oversight, often for a sustained period.

International best practice suggests that SEZ regimes should be administered by an autonomous but powerful government authority which: oversees the administration of dedicated laws, regulations and practices inside the SEZs; provides regulatory oversight for the SEZs' developers, operators and occupants; ensures the efficient delivery of various services (including regulatory services); and regulates economic activity, controls land use, and acts as the principal interface with private developers and operators.

8. *The most successful SEZs are public-private partnerships*

The approach where zones are regulated, developed and operated exclusively by government has been discredited by international experience. Today, the preferred institutional model for successful SEZs involves a division of labour and cooperation between the public and private sectors.

Government should formulate policy and strategy, make laws and regulations and enforce them, and provide key public goods. The private sector should develop and operate SEZs, including undertaking the master planning, investing in core real estate and services, undertaking construction, managing the zones, and promoting investment. The private sector is better placed to perform these functions because it has a profit incentive, business networks and contacts with potential tenants, and experience in development and construction.

9. *Effective investment promotion agencies are a vital part of the SEZ strategy*

SEZs work best when their host countries have effective investment promotion agencies which actively seek to attract FDI. But many countries' investment promotion agencies are not good at this. Some actually screen investment, acting like investment prevention agencies by imposing informal performance requirements on foreign corporations as a condition of entry. Moreover, the term 'one-stop shop' seems to imply that such bodies can provide authoritative commitments across a wide range of regulatory and licensing requirements. However, these bodies are often involved in turf battles with various government departments. In the process, they cease to be one-stop shops and become one-more-stop shops.

## SEZs and the challenge of unemployment in South Africa

Many SEZs have been spectacularly successful and have transformed the economies of their host countries. But many others have failed to set themselves apart from the rest of the economy, to create sufficiently attractive business environments, or to compete internationally. These diverse experiences should not obscure the fact that SEZs are a key platform for export-oriented industries, contributing significantly to global trade, attracting vast flows of FDI, and employing millions of people.

If South Africa is to exploit this potential, it will have to change the approach used with the IDZs. Government has to be clear about precisely what role SEZs should play, what industries should be targeted, and how the specific challenges faced by those industries should be addressed.

The top priority for South Africa's SEZ programme should be to establish zones in which it is considerably easier to establish and run globally competitive businesses – particularly labour-intensive businesses – than it is elsewhere in the economy. These 'zones of exception' may always be distinct from the rest of the economy, and the economic rules may always differ from those outside the zone. This approach should be coupled with using SEZs as a testing ground for new policy options. Locating such experiments in separate enclaves would allow government to reduce or avoid confrontations with entrenched interest groups opposed to wider reforms. Should these experiments succeed, these approaches could be rolled out to the rest of the economy.

International experience shows that the 'demonstration effect' of successful SEZs facilitates wider economic reform. This has certainly been the case in China, where Deng Xiaoping's initiatives in the 1980s and 1990s to attract FDI and expand exports through SEZs led to accelerated nationwide economic reform. The same is true of

Mauritius, Costa Rica, the Philippines and elsewhere. This potential for positive policy spill-overs into the rest of the economy is the greatest promise held by SEZs.

## What should South Africa aim to achieve with its SEZs?

Given the scale of the country's crisis of unemployment, South Africa should view SEZs as a platform for experimenting with reforms that might induce the emergence and growth of industries that employ large numbers of low-skilled workers. South Africa's industrial structure is characterised by the relative absence of these kind of industries – one of the key reasons why our employment rates are so low. Appropriately conceptualized, SEZs could play a key role in creating conditions needed for the emergence and growth of low-skill, labour-intensive industries. To achieve this, South Africa would have to address a range of inter-related priorities.

- *Labour costs would have to be low*. Although labour costs are rising in China's manufacturing sector, they are still lower than those in South Africa. This is true of other developing countries, too. South African businesses that pay higher wages can only be competitive if productivity is also higher. Achieving this usually implies mechanisation, a strategy that reduces labour-intensity. If South Africa is to create large labour-intensive industries, an environment has to be created in which labour costs can compete globally.
- *Conditions of employment would have to be more flexible*. Labour-intensive companies, especially in light manufacturing, often have to deal with fluctuating demand. Employers who are unable to hire and lay off temporary staff and structure shift systems in line with demand struggle to compete internationally.
- *Other input costs would also have to be competitive*. Even the most labour-intensive businesses require more than just unskilled workers. Firms also need cheap and reliable infrastructure and services as well as physical inputs. Production costs are also driven up by the shortage of skilled workers, who therefore have to be paid more. Labour-intensive firms ought to be less affected by this than other firms, but the scarcity of skills could still hamper their emergence and growth. South Africa needs to manage two processes simultaneously: improve education and training, which will begin to address the problem in the medium to long term; and recruit foreign skills much more aggressively in the short term.
- *Firms would need access to global markets*. This is essential to reach effective economies of scale. Light manufacturing firms could only employ large numbers of unskilled workers if they were substantial exporters. This requires cheap and reliable transport systems and appropriate trade policies.
- *A more competitive exchange rate would help*. The level of the exchange rate and its volatility has hurt exporters. Managing this is complicated, and it is not clear what can be done to depreciate the currency without inducing inflation. If the exchange rate is not easily depreciated, other aspects of South Africa's competitiveness equation would have to be improved even more.
- *Governance and regulatory frameworks must be clear and inviolable.* Investors are reluctant to invest in areas where they believe their property may be taken from them, unless returns are exceptionally high. This applies to government expropriation as well as to risks associated with crime and with a judicial system perceived to be unable to act against defaulting creditors. Some issues surrounding black economic empowerment codes also deter some investors. Fundamentally, investors need to know that policy commitments made in one period will be complied with in the next.

## Concluding remarks and recommendations

Taking the steps outlined above would benefit the entire South African economy. Achieving them everywhere at once may be difficult. Problems include technical and logistical challenges as well as administrative deficits. Some of these measures would probably be opposed by organised labour, companies whose profits might be threatened, and skilled workers earning wage premiums. Progress is likely to be slow, difficult and politically disruptive. This is one reason to experiment with reform in SEZs.

If South Africa is to create jobs for millions of unskilled and inexperienced workers, the country need to create the right conditions for these kind of investors. SEZs could play a useful role, particularly if they are used strategically to address the constraints faced by potential employers of unskilled labour.

For this reason, South Africa should establish at least two large SEZs designed to meet the needs of low-skill, labour-intensive businesses. This means paying attention to ten policy areas that:

1. Ensure that production costs (including the costs of labour) are as low as possible;
2. Create more flexible employment relationships;
3. Provide efficient access to international markets;
4. Ensure easy access to skills (including foreign skills); and
5. Offer credible guarantees that policies in the zones will be sustained in the medium and long term.

The international evidence suggests other factors will also be important:

6. The SEZ programme needs to be a presidential priority, thus ensuring that the DTI is supported by all other relevant departments;
7. SEZs should be run largely by the private sector;
8. The zones must be effectively promoted;
9. The red tape hampering start-ups has to be dramatically reduced by government through the establishment of genuine one-stop shops (rather than the ineffective one-more-stop shops that so many investment promotion agencies have become); and
10. Local education and training institutions need to be geared towards providing the skills these firms will need.

The proposed labour intensive zones need to be large. They will need road, rail, and shipping linkages; electricity, water, other major services; and professional and technical services. Effectively, this means they need to be in or near urban centres. These are the essential ingredients of a globally competitive SEZ programme aimed at the rapid expansion of labour-intensive industry.

If the country has the capacity beyond establishing these priority large experimental labour intensive zones, South Africa could also establish zones for more sophisticated businesses. However, these sorts of companies may not need, or be attracted by, SEZs. It is not clear, for example, why businesses serving offshore oil and gas operations require an SEZ (as is being contemplated in Saldanha). There may be good answers to this question, but the establishment of medium- or high-skill SEZs should be decided on a case-by-case basis.

Any new SEZs in South Africa will need to be globally competitive if they are to succeed. They must offer a business proposition that encourages investment and expansion. Exactly how this should be done will depend on the targeted industry or sector.

Current economic policy is skewed towards high-skill and high-wage methods of production, which do not address the core of South Africa's unemployment crisis. A paradigm shift is required, and this may best be facilitated through a new policy instrument and experimentation.

The Special Economic Zones Bill has not been finalised, and much of the detail has been left open to interpretation in later regulations or through the decisions of the proposed SEZ Board.

The international experience is clear, and our past experience with IDZs is a lesson in what not to do. SEZs represent a major opportunity to do things differently.

South Africa needs to address the factors hindering its competitiveness. Potential investors – in Asia, South Africa and elsewhere – need to be consulted and their views taken into account by government. This is the only way to make sure that the special nature of the proposed zones actually addresses the obstacles faced by labour-intensive industries.

Well-designed SEZs have proven to be a remarkable tool for growth and job creation around the world. Costs in Asia, especially China, are rising and there is much talk of millions of labour-intensive firms looking for new regional locations. South Africa should seize this new opportunity. This will require bold leadership and engagement with difficult choices that must be made. The alternative is to waste resources and energy yet again on a policy that fails.

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‘Well-designed SEZs have proven to be a remarkable tool for growth and job creation around the world. Costs in Asia, especially China, are rising and there is much talk of millions of labour intensive firms looking for new regional locations.

‘South Africa should seize this new opportunity. This will require bold leadership and engagement with difficult choices that must be made. The alternative is to waste resources and energy yet again on a policy that fails.’

# Introduction

South Africa began to establish Industrial Development Zones (IDZs) in 2000. The stated goal of these enclaves – established at Coega, East London, Richards Bay, and OR Tambo International Airport outside Johannesburg – was to encourage export industries and attract foreign direct investment. This was to be achieved by creating investor-friendly environments situated close to international ports and airports that would be characterized by less red tape and better infrastructure.

A review by the Department of Trade and Industry (DTI) summarises the situation today. From 2002 to 2010, a total of 40 investors were attracted into the three IDZs that are actually operational – Coega, East London and Richards Bay – and have spent about R11,8 billion.[1] The DTI has itself spent about R5,3 billion on the programme.[2] In total some 33 000 jobs have been created, most of which were short-term construction jobs.

No one involved believes that this performance represents success.

South Africa's IDZs are a form of Special Economic Zone (SEZ), a broad international concept denoting demarcated geographic areas where rules governing investment, employment, customs, taxation, planning, etc. differ from those prevailing in the rest of the country.[3] Various types of zones have evolved to meet a range of objectives in specific economic contexts (see box on page 12). Successful SEZs have been widely used as instruments for attracting foreign direct investment, creating large numbers of jobs, developing and diversifying exports, and experimenting with new policies.[4] There are now about 3 000 SEZs in 135 countries. In 2008 they accounted for more than 68 million direct jobs and $500 billion of trade-related value-added.[5]

There are now about 3 000 SEZs in 135 countries, accounting for more than 68 million direct jobs

In 2007 the DTI began a review of South Africa's IDZs, and the ensuing report noted the following challenges:

- the programme design excluded certain regions that might benefit from different types of SEZs;
- the programme lacked strategic planning and financing;
- guidance on governance arrangements was poor; and
- government agencies involved were poorly coordinated.

The result was that the IDZs did not offer potential investors a unique value proposition.

This review resulted in new draft legislation aimed at redesigning and expanding the IDZ programme 'in order to enable the development of diverse types of SEZs in accordance with the changing national economic development priorities, as well as regional development needs and contexts'.[6] The draft bill and policy were released for public comment in January 2012, and are due to be tabled in parliament later this year.

Government expectations for the new programme are high, and it has already been earmarked for funding in this year's budget. The Minister of Trade and Industry, Rob Davies, has described it as 'one of the most critical instruments to advance government's strategic objectives of industrialisation, regional development and job creation.' The hope is that SEZs will serve to attract foreign direct investment.[7] In his 2012 budget speech, the Minister of Finance, Pravin Gordhan, allocated R2,3 billion for industrial development and special economic zones, in the process describing SEZs as 'levers of economic change'.[8]

Aware of the pending changes to the IDZ programme, CDE, with support from Blue IQ, the investment arm of the Gauteng provincial government, and Business Leadership

South Africa, hosted a Round Table discussion in November 2011 on some of the key issues surrounding a revamped SEZ policy. Participants included business leaders, policy-makers, senior public servants, and academic economists (see participants list on page 7).

Before the Round Table, CDE commissioned research from two international experts, who presented their findings to the Round Table. Prof Theodore Moran of Georgetown University reviewed the international experience of SEZs, and Jean-Paul Gauthier, managing director of Locus Economica and deputy secretary-general of the World Economic Processing Zones Association, summarised best international practice in establishing and operating SEZs. In addition, Crispen Chinguno of Wits University summarised what is known about the performance of South Africa's IDZs. In addition, a panel of experts were asked to assess the country's existing industrial policy initiatives in order to derive lessons from this experience for the new SEZ programme.

This report summarises the Round Table proceedings, and concludes with key insights and policy recommendations.

# Opening remarks

## Ann Bernstein

*Executive director, Centre for Development and Enterprise*

Special economic zones really have to be special

This discussion about the potential of SEZs to act as catalysts for growth and development is a timely one. In last week's medium-term budget statement, the Minister of Finance announced that R25 billion would be spent over the next six years on a number of initiatives aimed at boosting industrial development. This will include support for invigorating South Africa's IDZs. The DTI is currently reviewing a draft bill on the development of SEZs which will be gazetted early in the new year and would expand the country's existing IDZ programme.

In assessing the potential benefits of SEZs for South Africa, it is important to consider what specific problems they are meant to address and what distinguishes them from the economy in which they are located. In this regard, the key point to make is that Special Economic Zones really have to be special.

International experience shows that successful SEZs create an investment climate that is significantly more business-friendly than those in their host countries. Whether they offer more favourable investment opportunities, better infrastructure or fewer regulations, something has to set an SEZ apart from the surrounding economy. This must be incorporated into South Africa's new policy framework.

The purpose of today's gathering is to think about and debate the key questions that an SEZ policy must address. These include questions about the performance of our existing industrial policies, and particularly the performance of our IDZs. Why has this been so unimpressive? What can we learn from the international experience of SEZs? What do SEZs offer that other industrial policies do not? And can SEZs that learn from the successes and failures here and abroad be established to help drive growth, exports, and job creation?

## INTERNATIONAL PARTICIPANTS

**Professor Theodore Moran**

Ted Moran is Marcus Wallenberg professor of international business and finance at Georgetown University, specialising in international economics, business, foreign affairs, and public policy. His books include *Harnessing Foreign Direct Investment for Development: Policies for developed and developing countries* and *Does Foreign Direct Investment Promote Development?* Prof Moran consults to the United Nations, governments in Asia and Latin America, and the international business and financial communities. In 2000 he was appointed as counselor to the Multilateral Investment Guarantee Agency of the World Bank. In 2002 he was named chairman of the Committee on Monitoring International Labour Standards of the National Academy of Sciences, and in 2007 he served on the Director of National Intelligence Advisory Panel on foreign investment. He is a non-resident senior fellow of the Peterson Institute for International Economics.

**Jean-Paul Gauthier**

Jean-Paul Gauthier is deputy secretary-general of the World Economic Processing Zones Association and managing director of Locus Economica, a business advisory service focused on geo-economic development projects, including SEZs. He previously worked for Deloitte Consulting as a senior manager of its Emerging Markets Practice, KPMG Consulting, and at the World Bank. He has worked in or with more than 80 countries as an attorney and economist specialising in trade and investment, SEZs and competitiveness, and has led teams for a number of international donor agencies. He also dealt with SEZ legal issues at the International Finance Corporation's Foreign Investment Advisory Service and served on its Administrative Barriers to Investment Reform Committee. He is currently a Member of the World Bank's Investing Across Borders Expert Consultative Group (advising on SEZs), a Trustee of the Flagstaff Institute, and an Alternate Member of the Christchurch (New Zealand) Redevelopment Committee. He has worked on more than 60 SEZ projects, mostly with the World Bank. He is based in the United Kingdom.

Success isn't guaranteed, and there have been many examples of failure, so it's important to recognise what makes these strategies effective

# Using special economic zones to drive economic development

## Professor Theodore Moran
*Marcus Wallenberg professor of international business and finance, Georgetown University*

Since the 1970s, SEZs have been designed as places into which foreign investors could import duty-free inputs and assemble final goods for sale in international markets. The term is sometimes used interchangeably with Free Trade Zones (FTZs) and Export Processing Zones (EPZs), partly because of the emphasis on duty-free access to inputs.

### TYPES OF SPECIAL ECONOMIC ZONES

**Free trade zones** (or commercial free zones) are fenced-in, duty-free areas located in or near major international ports. They offer warehousing, storage, and sales facilities for trade-related operations as well as some light processing.

**Export processing zones** are industrial estates offering special investment and operational incentives, mainly for export-oriented manufacturing. Since the 1990s, their scope has broadened significantly to include a diverse array of activities.

**Single factory EPZs** (or free enterprises) are a variation on EPZs or free zones, where incentives and privileges are offered to individual enterprises, which can locate anywhere in the country. Mauritius, Madagascar, Mexico, and Fiji use this model exclusively. Other countries such as Costa Rica and the United States allow both industrial estate-style zones and single factory EPZs.

**Free ports** typically encompass much larger areas (>1 000 hectares) but overlap with the generic SEZ model. They also accommodate other types of activities (including tourism and retail sales), often provide a much broader set of incentives and benefits, and can include entire economic regions. The large-scale Chinese SEZs are an example.

Sources: T Farole, *Special Economic Zones in Africa*, World Bank, 2011 and T Farole and G Akinci (eds), *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*, World Bank, 2011.

The evidence shows that successful zones in which large numbers of unskilled jobs have been created have an extremely beneficial impact on the labour force

The growth of SEZs has been impressive: from 845 zones in 93 countries employing 22,5 million workers in 1997, to 3 000 zones in 116 countries employing 43 million workers in 2002, to 3 500 zones in 130 countries employing 66 million workers in 2006.[9] Success isn't guaranteed, however, and there have been many examples of failure, so it's important to recognise what makes these strategies effective. The most important factors include:

- supporting SEZs with effective investment promotion agencies;
- using SEZs to diversify and upgrade the host country's export base;
- developing appropriate vocational training partnerships
- creating backward linkages from foreign investors in SEZs to local firms; and
- safeguarding and improving the treatment of workers in SEZs.

## Maximising the benefits of SEZs

Some of the ingredients for SEZ success include macroeconomic reform, steady improvements of business environments (both within the SEZs and outside them), and access to both reliable infrastructure and semi-skilled labour. Success stories often feature private SEZ developers (who are incentivised to find investors for their SEZs) and investor-developers, while some SEZs' success was spurred by the attraction of an important anchor tenant which had a powerful signalling effect on other investors.

Some SEZs have been criticised for failing to abide by national labour regulations and and other workplace regulations. But here there are wide variations in performance and, more importantly, the expansion of low-wage employment in SEZs has often significantly reduced poverty. In fact, the evidence shows that successful zones in which large numbers of unskilled jobs have been created have an extremely beneficial impact on the labour force, including expanded formal employment opportunities, better working conditions, and greater job security compared to workers' actual alternatives. Survey data shows, for example, that a considerable amount of on-the-job training occurs in these zones when compared to surrounding areas. This is especially true in respect of women in developing economies who have gained greater economic independence and social status as a result of their employment in SEZs.[10]

International experience also shows that productivity gains from learning-by-doing and on-the-job-training in SEZ firms lead to rising wages. In fact, workers in SEZs are often paid significantly more than those in surrounding areas. In 1995, foreign investors in Madagascar's SEZs paid their workers 15 to 20 per cent more than what workers with similar qualifications received elsewhere in the economy.[11] Other examples of wage premiums in SEZs include El Salvador (19 per cent in 2000), Honduras (22 per cent in 2004), Indonesia (7 per cent in 2004), and Cambodia (80 per cent in 2008).[12]

The idea that firms in SEZs underpay their workers is linked to another popular misconception which is that relatively unsophisticated activities – like the production of garments, footwear, toys, and so on – are the thrust of multinational manufacturing operations in the developing world. On the contrary, the annual flow of manufacturing FDI to medium-skill activities – industrial machinery, electronics and electrical products, auto parts and other transportation equipment, scientific instruments, medical devices, chemicals, rubber, and plastic products – is nearly ten times larger than the flow to low-skill, labour-intensive operations like garments and footwear. And this gap has been widening.

> The reality for many investment promotion agencies has been weak institutional structures, inexperienced staff, and a passive strategy of waiting for investors to show up

This is important because higher levels of domestic productivity and rising standards of living do not come from producing and exporting more of the same goods and services; they come from upgrading and diversifying the production and export base. It's here that an SEZ strategy, if it helps to attract FDI, can play a central role in recasting a country's development trajectory.

To tap into the vast flows of medium and high-skill FDI operations, developing countries have to combine the creation of attractive SEZs with effective foreign investment promotion. In place of cumbersome, highly discretionary screening of investment proposals, the best investment promotion agencies (IPAs) are 'one-stop-shops', empowered to approve investment projects rapidly and transparently. In some cases, project approval is automatic unless there are good reasons not to do so.

Often, a central element of attracting medium and high-skill FDI is to set up partnerships between foreign investors, local universities, and vocational training institutes. These skill-building partnerships are an important magnet for anchor investors. In turn, these stimulate follow-the-leader behaviour by other companies.

At the same time, an aggressive FDI–SEZ–export strategy helps to link foreign investors and local companies. Surveys show that foreign investors in SEZs tend to help indigenous suppliers set up production lines, train them in quality control, and coach them in management, strategy and financial planning. They also provide advance payments and others kinds of financing and introduce their suppliers to export markets.

But, the spread of backward linkages depends upon a host country having a business-friendly climate that allows local firms to grow and prosper.

If they are to become certified as suppliers to foreign exporters in the SEZs, indigenous companies also need contract enforcement, reliable infrastructure, efficient ports, intellectual property rights protection, reduced red tape, and access to duty-free inputs.

## Factors contributing to SEZ success or failure

Here are a few of the key lessons from international experiences of SEZs:

- Early SEZs were used primarily for reducing poverty and creating jobs in the poorest regions of a host country, often with very poor infrastructure. This hindered SEZ development and meant that governments had to invest heavily in building the infrastructure necessary to make the zones viable, raising costs significantly.
- An overvalued exchange rate can make low-skill intensive products uncompetitive and deter investment. For example, in the 1990s the provision of generous incentives to SEZ investors by Kenyan and Egyptian authorities failed to compensate for an overvalued exchange rate, thus lowering their zones' economic prospects.
- Ineffective IPAs have significantly hampered SEZ success. The reality for many IPAs has been weak institutional structures, inexperienced staff, and a passive strategy of waiting for investors to show up. Making matters worse, many act as a screening agency, imposing informal performance requirements on foreign corporations as a condition of entry. The key point here is that IPAs cannot make much headway in marketing a given country if they don't have a good product.[13] A poor business environment – ranging from red tape to regulatory uncertainty, from poor contract enforcement to poor intellectual property protection, from delays at ports and airports to pervasive corruption across the host economy – strongly deters foreign investment.

Women in developing economies have gained greater economic independence and social status as a result of their employment in Special Economic Zones

### LEARNING FROM A FAILED SEZ: BATAAN IN THE PHILIPPINES

A textbook example of a problematic early SEZ is the Bataan EPZ in the Philippines.[14] Launched in 1972, the site lacked adequate transport, communications, water, sewerage and power. Nevertheless, the government of Ferdinand Marcos hoped that a combination of expensive, publicly funded infrastructure and access to extremely cheap labour would attract foreign investors and showcase manufactured exports. Foreign investment arrived slowly, but by 1980 the value of exports had reached only $134 million, and consisted entirely of low-skill manufacturing. Working conditions were poor, environmental standards lagged, and very few linkages were made with the surrounding economy. Despite public expenditure of nearly $200 million to improve infrastructure, the zone failed to pass even a lenient cost–benefit assessment published in 1987.[15] This study gained widespread attention within development circles, leaving many with the impression that SEZs were undesirable policy interventions.

Source: T Moran, International Experience with Special Economic Zones, paper commissioned by CDE, 2011.

## Implications for South Africa

My impression is that South Africa is relatively well-positioned to use an FDI–SEZ–export strategy as a central component of its development policy. It seems to have the required resources, labour, industrial base and educational institutions. But success will require high-level national commitment and policy coherence.

An FDI–SEZ–export approach will not solve all South Africa's development problems. Most notably, it will not cure the unemployment crisis. SEZs are only one piece of a bigger package. However, when job creation is measured in an appropriate way against a counterfactual of what national employment would look like in the absence of SEZs, net new jobs can easily reach 100 000 or more. This has been the case in a mere two of the 250 SEZs in the Philippines (in which a totatl of over 700 000 people are now employed).

A genuine FDI–SEZ–export strategy for South Africa should have two thrusts. The first should target advanced manufacturing and medium technology sectors, including automotive assembly and components, chemicals, plastic fabrication, ITC products and services, advanced materials, aerospace, and pharmaceuticals. The country should also focus on labour-intensive sectors, including clothing, textiles, standardised electronics assembly, and agriculture/agro-processing. South Africa is in the rare position of being able to benefit from this dual approach of pursuing both low-skill and medium- to high-skill investment.

A sophisticated FDI–SEZ–export strategy does not require abandoning concerns about workers' rights or environmental damage. Nor is it advisable or possible to rely exclusively on markets without public sector involvement. A successful SEZ strategy requires strong and focused government regulations and interventions. However, labour regulations will have to allow compensation to be closely related to productivity levels, and not be bound by excessive minimum wages. This may require SEZs to have a carve-out for sub-minimum wages and more labour flexibility. In turn, this could generate employment and help raise living standards quite rapidly.

It was possible to create substantial numbers of jobs in SEZs, even when the business climate is less favourable than South Africa's

## DISCUSSANTS

### H E Mr Héctor Valezzi

*Mexican Ambassador to South Africa*

In the 1960s the Mexican economy was one of the most closed in the world. However, we share a 3 000 kilometre border with the United States, and people who lived near that border would move easily across it, comparing the economies of both countries. It was suggested that an SEZ, in this case a 'Free Zone', should be created 200 kilometres into Mexico, allowing the free passage of goods in and out of the two countries.

In 1988 President Carlos Salinas established a legal framework for this. His industrial policy started to convert the free zone along the border to an SEZ which allowed *maquiladoras* [assembly or manufacturing operations benefiting from duty-free access to the US market under the US Tax Code] to bring in machinery and other inputs without paying duty, and to export their products easily and cheaply. Under NAFTA, access to the US market was expanded to other Mexican manufacturers.

Although the *maquiladoras* have had some negative environmental impacts, they have also had many positive social ones, including raising the social status and power of women.

An entire industrial policy cannot be based on the creation of SEZs, however. If you build these all over the country, the zones will not be special. And this is what happened in Mexico, which now has free trade agreements with 43 countries. When these agreements were introduced, some industrial sectors declined, but others appeared. The toy industry, for example, almost disappeared. Bicycles and sports equipment are now imported from China. But now we focus on other exports.

An SEZ must have special attributes in terms of its location and how it's promoted. It should also be 'special' because it has to be a temporary measure. It's also not enough just to focus on exports, especially if there is a strong internal market.

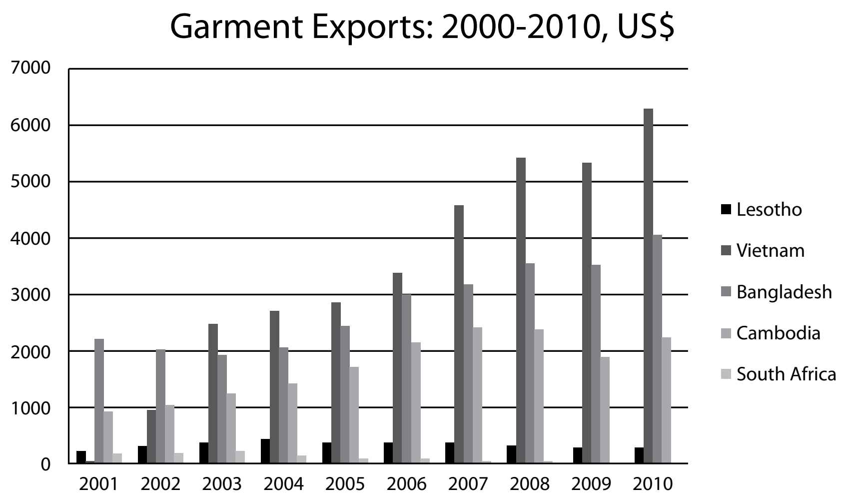
## Dr Greg Mills

*Executive director, The Brenthurst Foundation*

If we're talking about using SEZs to create jobs in South Africa, we are probably looking mainly at business process outsourcing (BPO) and apparel. In Bangladesh, for example, SEZs were used to grow the garment industry. Other than India, the Philippines is the best country to look at for growing jobs in BPO, where this sector has grown to nearly 600 000 jobs in a decade.

Creating a competitive SEZ programme means focusing on productivity and wage levels, as well as other costs of doing business

**Figure 1: Garment exports, 2000-2010 (US dollars)**




Source: Brenthurst Foundation data and analysis.

Creating a competitive SEZ programme means focusing on productivity and wage levels. But it's not just about wages; it's also about the other costs of doing business. Our competitors in the apparel sector in central America have minimum wages of around \$200 per month, which is higher than those paid by much of our textile sector. So having a competitive SEZ programme also depends on other costs in the economy. Consider, for example, the difference in the price of a 50 kilogram bag of cement. In Vietnam this costs \$3,50, but in Johannesburg it costs more than \$12.

The costs of doing business are far higher in South Africa than in many other developing countries, including Vietnam. Like them, we need to work on keeping wage levels low, maximising efficiencies, and effecting general policy improvements. SEZs can achieve a great deal, but a country can and should also achieve this cost-competitiveness without SEZs.

The ideological response you often get to the SEZ concept is that it will precipitate a 'race to the bottom'. In reality, the differentiators are things like location, security costs, infrastructure, an English-speaking workforce, and the receptiveness of government to business needs. There is also no point in having a one-stop shop for investment promotion and approval if it doesn't function as such. Creating the conditions for innovation, which hinge on education and the institutional setting (including the rule of law, protection of ideas and property), would boost the prospects of SEZs.

## GENERAL DISCUSSION

Discussion focused on two distinct but related issues: the extent to which SEZs in South Africa might absorb unemployed people, and the relationship between the establishment of SEZs and the transformation of the economy as a whole.

Several participants emphasised that SEZs could not be thought of as a panacea for South Africa's employment crisis. While SEZs in some countries have markedly improved the employment prospects of the poor, it is a mistake to see SEZs as having the capacity to create millions of jobs here. However, others argued that the fact that the Philippines had created more than 700 000 jobs suggested that it was possible to create substantial numbers of jobs in SEZs, even when the business climate – as measured by the World Bank's ease of doing business indicators – is less favourable than South Africa's. However, SEZs are only likely to help improve the employment performance of the economy if they address key factors inhibiting the growth of employment.

A key question about SEZs was whether they would aim to attract low-skill, labour-intensive manufacturing or medium- and high-skill operations. The most successful SEZs often focused on medium- and high-skill industries, which attract up to ten times more FDI than low-skill firms. Some participants insisted that SEZs could create medium- and high-skill jobs, but only if there were complementary investment in the development of appropriate skills for firms that invest in the SEZ, as has been done in Costa Rica and elsewhere.

Some participants disagreed, pointing out that South Africa's skilled workers did not face an unemployment problem, and that, if anything, vacancies existed for them in both the public and private sectors. For this reason, SEZs ought to focus on attracting firms producing low-skill export products. This would require labour market reforms, which would lower the costs of employment and introduce more flexible work practices, such as flexible shift and piece work systems.

It was pointed out that the degree to which SEZs could help to create jobs depends in part on the extent to which firms located outside them can sell their goods and services to firms within them. This would depend, in turn, on the quality of the business environment outside the SEZ: the more business-friendly this is, the more likely it is that firms located outside the SEZ will respond appropriately. This raised the question of the relationship between SEZs and the broader transformation of an economy in order to make it more competitive and productive.

One participant argued that SEZs could either be seen as alternatives to serious economic reform or as laboratories for testing particular economic reforms before they are extended to the rest of the economy. The choice of approach would greatly affect their impact over time. Furthermore, the external business environment plays such a large role in the potential impact of SEZs on economic performance that it may be more important to improve this than it is to offer investment incentives.

Should firms receive incentives to invest in SEZs? One participant argued that if firms invested in SEZs on the basis of the quality of infrastructure, the costs of doing business, and the availability of appropriately trained staff, it would be unnecessary to offer tax or other incentives. Another disagreed, noting that firms were often reluctant to be the first to move into an SEZ, and that SEZs in some countries offered incentives in order to overcome this. It is, therefore,

Although the *maquiladoras* have had some negative environmental impacts, they have also had many positive social ones, including raising the social status and power of women

important to at least have the authority to offer incentives (whether they be tax breaks, training subsidies, subsidised housing, transport, or anything else) should these be required to tip the balance in negotiation with potential investors.

Firms were often reluctant to be the first to move into an SEZ. SEZs in some countries offered incentives in order to overcome this

### EFFECTIVE INVESTMENT TARGETING AND PROMOTION: COSTA RICA

Costa Rica initially had little luck in attracting foreign investors until the government implemented sound macroeconomic policies in the mid-1980s, bringing inflation under control, adopting a realistic exchange rate, and undertaking a series of reforms to improve the business climate. A change of policy also allowed for the establishment of SEZs near the capital, where infrastructure was better. As a result, by the late 1980s Costa Rica had managed to attract some $368 million in investment, generating 37 000 jobs concentrated in the garment industry.

Fearing that rising domestic wages would erode the country's ability to compete in labour-intensive manufacturing, the country restructured its investment promotion agency, the CINDE, in 1992, with the objective of diversifying the foreign investor base toward higher-skill operations.[16] CINDE also advertised the extent to which Costa Rica was directing the country's national educational programmes toward the basic technical skills needed in industries like semiconductors, pharmaceuticals and medical equipment.

In 1996 CINDE got Costa Rica onto Intel's short-list for a new semiconductor plant on the basis of the reliable infrastructure at its SEZs and the ability to supply appropriately trained workers. To meet Intel's infrastructure requirements, CINDE obtained presidential approval both to accelerate construction of a new cargo terminal at the national airport and to dedicate a new substation of the state-owned electricity utility. CINDE also facilitated the establishment of a joint programme between Intel's human resource division, the Ministry of Education, and the country's vocational training institutes to prepare workers with skills needed at a semiconductor plant. To close the deal, Intel demanded tax treatment equal to that offered by other short-list contestants.[17] CINDE complied, agreeing to full exemption from income taxes for the first eight years of operation, and a 50 per cent exemption for the next four.

Costa Rica has become the most widely used example of the importance of the demonstration effect in attracting high-profile investors. In the three years after the arrival of Intel, Costa Rica tripled its stock of foreign investment and increase exports dramatically. In a later survey of 61 multinationals with plants in Costa Rica, 72 per cent said Intel's decision to invest had influenced theirs.[18] These firms included Western Union, which chose Costa Rica as its technical support centre, and Proctor & Gamble, which chose the country for its back office services. Before the financial crisis of 2008 the country's exports of SEZ-based goods and services exceeded $5 billion a year.

Source: T Moran, International Experience of Special Economic Zones, paper commissioned by CDE, 2011.

# Have South Africa's industrial policies delivered?

In this session, four experts were asked to assess the efficacy of South Africa's overall industrial policy as the context within which any policy discussion on SEZ development should take place.

## Nimrod Zalk

*Deputy director-general: industrial development division, DTI*

One of the key observations of the report of the International Growth Commission (headed by economist Michael Spence) was that virtually every post-war episode of high and sustained economic growth was led by manufacturing sectors. Rapid industrialisation has never occurred without policy support for key industries and the alignment of supporting policies around the industrialisation effort.

Industrial policy is never primarily about employment creation. However, along with other policy drivers (such as macro policies, skills policies, policies for SMEs, labour market and other sectoral policies, particularly in agriculture and mining), industrial policy can play a critical role in driving employment growth.

Many of you will also be familiar with the report of the Harvard-based economists who advised the National Treasury. A key finding of their work was that the skill-intensity of the tradable sectors of the economy is higher than that of non-tradable sectors, so there are important gains to be made from developing those sectors relative to developing non-tradable sectors, including services. The manufacturing sector also has the highest growth multipliers in the economy, and many manufacturing sectors have high employment multipliers. So manufacturing is a key driver of employment, both in its own right, and because of its linkages with the rest of the economy.

The Harvard Group's main finding was that the most important precondition for manufacturing growth is a stable and competitive exchange rate. In fact, one of the key contributors – Professor Dani Rodrik – has written that a bias towards currency undervaluation may be vital for industrialisation. One of the challenges that South Africa has, however, is that the rand is overvalued, creating a bias against tradables and towards capital and skills.

One of the challenges that South Africa has is that the rand is overvalued, creating a bias against tradables and towards capital and skills

### Recent achievements of our industrial policy

South Africa's industrial policy aims to address a combination of market and regulatory failures in order to foster the growth of manufacturing and related sectors. For example, the government is helping to create a biofuels market in part by requiring (soon to be implemented) that a minimum amount of biofuels be blended into conventional petroleum fuel stock. This has the potential to create tens of thousands of jobs. Work is also being done on creating an industrial base for renewable energy (to be partly funded by global climate change funding pools). We have also strengthened energy efficiency standards for buildings, which will require solar water heating or equivalent systems to be installed in all new buildings.

We have driven new public procurement regulations that will leverage public procurement in a range of sectors including road and railway investment, pylons and transmission lines, buses, and pharmaceuticals.

On the industrial financing side, we have been working with the IDC, which has identified R102 billion for investment in strategic sectors, including R10 billion set aside at prime less 3 per cent for labour-intensive projects.

In clothing and textiles, a new incentive costing about R600 million has replaced the old and ineffective duty credit system. It supports upgrading at the firm and value chain level, and has helped stem job losses in the sector. Three major retailers – Foschini, Truworths and Edcon – are participating in this initiative, with Foschini now procuring more than

70 per cent of its merchandise domestically. The footwear sector aims to increase annual production from 52 million shoes to 100 million over the next three years. Under the pragmatic new wage agreements struck in this sector, new entrants will be treated as trainees. This could provide a model for other sectors.

In automotives, incentives have helped to boost production by 59 per cent between 2000 and 2011, compared to average global growth during this period of 35 per cent. Over the same period, exports grew by 343 per cent compared with average global growth of 186 per cent. Similarly, in business process outsourcing and call centres, we have generated about 25 000 jobs.

Our industrial policy has also engaged with some of the issues related to the skills system. We are looking, for example, to boost the production of hard skills, through investments in skills centres that no individual firm (especially smaller ones) would make.

### How to make industrial policy more effective and create more jobs

The first thing we need to do is get the two most important prices in the economy right: interest rates and exchange rates.

In the automotive industry, incentives have helped to boost production by 59 per cent between 2000 and 2011, compared to average global growth of 35 per cent

A comparison of South Africa's real interest rates over the last 15 years with those of 41 major developed and developing countries shows that, for most of that time, our real interest rates have been amongst the very highest in the world. So, we have very restrictive monetary policies. In addition, a critical obstacle to manufacturing growth is an overvalued and volatile currency – a problem related to our high interest rates and the resulting short-term flows into the JSE. This is a serious constraint on business.

We also need to look at the 'user pays' approach to public infrastructure which loads investment costs directly onto the tradable sectors over periods so short that businesses are unable to offset these against productivity gains. This amounts to a direct tax on exporters, and reversing it will require strengthening the effectiveness of parastatal regulation.

There are major market failures in the private provision of finance to manufacturing firms, especially small and medium-sized firms. Reasons for this include a mismatch between the time horizons of those who supply the funds and those who need them. To solve this, we need to use development banks more effectively. A good example is KFW of Germany which extends almost all industrial financing lines in the German economy.

The skills system needs to open up to industry and its needs. We need to reorient black economic empowerment towards expansive investment in the real economy, especially in manufacturing and the procurement of local goods. Competition policy has a critical role to play in addressing the monopolistic provision of key inputs such as steel and polymers.

SEZs could play an important role in all of this. We would need to ensure significant improvements in the IDZs including establishing sustainable funding models and improving governance arrangements. At the same time, export-oriented SEZs won't be very effective in the context of an overvalued and volatile exchange rate.

## Dr Seeraj Mohamed

*Director, Corporate Strategy and Industrial Research Programme, Wits University*

In some respects, government should be commended for its management of industrial policy, but we all know that it has been really hard. It's easy for critics to say, 'You people have been talking about industrial policy since 1994 and we have had job losses, we have had de-industrialisation, and we still sit with a huge unemployment problem.' It's easy to blame the DTI. But there is a history to this.

It was in the 1980s when the apartheid government started adopting a Washington Consensus-style approach and began abandoning activist industrial policy. This was reinforced in the 1990s, during a period of free market triumphalism. We are reaping many of the consequences now, especially the liberalisation of financial markets. Nevertheless, we still have politicians and technocrats who have largely bought into this paradigm and who aren't supportive of industrial policy.

We have expended a lot of energy on trade liberalisation, which, for many academics, became the be-all and end-all of industrial policy. Liberalisation was a good thing, but it meant that we haven't addressed problems like industrial financing, exchange rates, and interest rates.

Another factor we have not dealt with is the 'financialisation' of the global economy, which has had a huge impact on global corporate structures. While value chains have been globalised, financialisation has changed the way in which those value chains have been governed and how the benefits are distributed. What we have seen is the strengthening of the global division of labour, with developed countries controlling the brands, product design, and technology, and developing countries basically selling cheap labour or resources. This has made it harder to get industrial policy going in those countries.

## Professor David Kaplan

*Professor of economics, University of Cape Town, and former chief economist, DTI*

I am very critical of our industrial policy. We're on the wrong track in a number of ways.

One of the objectives of the Industrial Policy Action Plan (IPAP) is to create 2,447 million direct and indirect jobs over ten years. Public presentation of the plan has also emphasised the intention to create millions of jobs. The difficulty is that employment growth requires a whole range of policies which focus on everything that might promote economic growth, whether it's maintaining sound macroeconomic policies, promoting access to markets, setting labour market policies and labour standards, developing skills, and so on. The same is true of the New Growth Path – it emphasises job creation, but is also not a comprehensive employment policy.

The basic problem here is that if you put job creation, especially those jobs created directly through one or other intervention, at the forefront of your industrial policy, you may make a range of mistakes that lead you in the wrong direction. South Africa does need policies to help promote private sector growth. But focusing on jobs leads to policies that won't necessarily do that most efficiently. First, we need some background.

Our manufacturing sector has become excessively capital-intensive and we under-perform in sectors which use a lot of labour

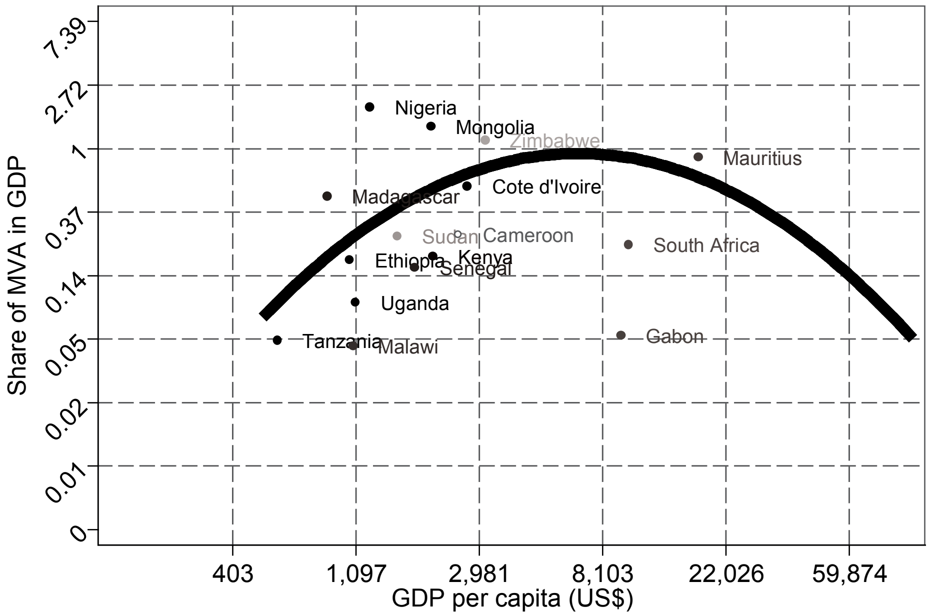
### The myth of deindustrialisation

One of the issues that keeps coming up is the idea that we are in the midst of de-industrialisation. We are told that we have no overall manufacturing output growth and that manufacturing's share of GDP has declined. We conclude that we are deindustrialising. But this is a myth.

De-industrialisation would mean that there is a very low share of manufacturing to GDP, lower than might be expected for our level of GDP per capita. But this is not the case. The data show that in most areas we are actually above the international curve in respect of a range of products and industries and within the normal range for a few more. Where we are below the norm, however, and often by a large margin, is precisely in those sectors that are labour-intensive, especially clothing and footwear.

What is really happening is that our manufacturing sector has become excessively capital-intensive and we under-perform in sectors which use a lot of labour. For our level of per capita GDP, for example, textile output should be three times higher than it is. The same is true for footwear. So we are not failing in industrialisation as such. Nor are we de-industrialising: the decline of manufacturing as a share of GDP is exactly what happens as countries get richer. The big challenge lies in our labour-intensive sectors.

**Figure 2: Share of textile manufacturing value-added in GDP, most recent year available**




Source: UNIDO database, as supplied by M Z Farooki

If you have a well-functioning business sector, and growing exports, your chances of creating more jobs will improve significantly

If we are below the curve in all the labour-intensive sectors and, in output terms, performing well everywhere else, what has driven that underperformance? The answer is not an absence of protection. Some of those sectors enjoy high levels of tariff protection, and have also enjoyed substantial export support. The answer, then, doesn't lie in the supposed failings of industrial policy. In fact, the correct answer lies in issues relating to our labour market policies, especially wage policy and labour practices.

With the advent of AGOA in 2002, while I was working at the DTI, we engaged an international consultant to approach the big clothing firms in the United States and ask them under what circumstances they would be prepared to buy clothing from South Africa. One of the responses was that our manufacturers would have to be able to employ people when there were orders, and let them go when there weren't. The buyers didn't want their suppliers to have to cover wage costs when factories were not working. They wanted flexible shift systems and piece work practices. Their responses underline that if we want to enter those markets, we need new labour market policies and new working practices. This is not an issue that can be addressed by industrial policy. So what should industrial policy focus on?

## Reframing industrial policy

Industrial policy has only two appropriate objectives. The first is to create a well-functioning industrial sector in general. To achieve this, you need policies that help everyone. The second is to grow your export sectors, which has been critical in the Far East.

If you keep industrial policy to those two objectives, and if you're successful, you should see high levels of investment, high levels of productivity growth, and growing exports. Note that we've said nothing about employment. If you have a well-functioning business sector, as well as growing exports, your chances of creating more jobs will improve significantly. To achieve this you have to address the key constraints that affect the whole business sector (including exporters). The most obvious candidates for our key constraints currently are physical infrastructure and skills. We must get the railways moving, increase power generation, make the ports more efficient, and so on. This should be the first set of tasks of industrial policy. The good news is that the government is doing exactly this. It has a massive infrastructure programme. However, that programme is loaded with a number of additional objectives, namely to limit imports, increase new capacity of domestic firms, and increase employment.

An example is the local content programme. In practice, what this means is that the government designates some products that cannot be imported. But this means infrastructure providers may end up not choosing the most appropriate inputs or the cheapest ones. This can lead to delays and to having to reconfigure planned infrastructure away from what is optimal. Since leveraging public procurement in this way negatively impacts on all users of the infrastructure, it is actually like a tax on business in general. It tightens one of the key constraints that business faces – expensive and limited infrastructure. It conflicts with what should be the key objective of industrial policy – overall business expansion. It's all very well to support firms, but it is inappropriate to do so at the point at which the binding constraint on business expansion operates. This is not good industrial policy.

Moreover, there is no indication that this kind of support (which is always temporary) actually creates sustainable, competitive businesses that continue to be profitable when government orders fall away.

If you put employment at the forefront of your policy, you're also going to make other mistakes. Take the call in the IPAP for 'developmental tariffs'. This encourages firms to lobby government for tariffs on the basis of their supposed employment effects. The correct question to ask about a tariff is not whether it will increase employment, but what impact it will have on exports. Otherwise, you get into the wrong policy. To some extent at least, all tariffs are a tax on exports. Moreover, we have seen very weak manufacturing export performance. So we should be very wary of increasing tariffs.

Another problematic policy area is industrial financing. The DTI is frequently asking for new incentive schemes to promote investment. But this is the wrong way to go. We are already providing lots of investment incentives (such as preferential credit for firms that create employment). But, the major result of such incentives is simply cheaper capital. And if a firm's capital is cheapened, the firm is going to substitute capital for labour. This is true even in labour-intensive sectors: if you lower the cost of capital, you encourage firms to buy equipment rather than employ people, thereby raising the average capital intensity of our industries. Growing capital intensity has been the major factor limiting unskilled and semi-skilled employment gain. Inadvertently, many of the DTI's policies exacerbate this problem.

If you lower the cost of capital, you encourage firms to buy equipment rather than employ people

Finally, the idea that industrial policy must create lots of jobs leads the DTI to try and cover as many sectors as possible. In effect, there's no targeting. The DTI has developed plans covering 95 per cent of manufacturing. They can't possibly do all of this well.

Creating an environment in which business can thrive is the first legitimate objective of industrial policy. The second is to grow exports. Unlike the first objective, the second requires targeting, which is very difficult. Currently there are three major problems:

- we don't focus nearly enough, so almost every sector has a programme;
- the international evidence suggests that some of the targets that the IPAP has selected – like increased beneficiation – are unlikely to be realised; and
- in practice, most of our industrial support favours capital-intensive activities — for example, two thirds of our industrial policy support goes to the automotive industry, which is not at all labour-intensive.

The bottom line is that it is very difficult to see how industrial policy can work effectively along the lines currently being planned or how it can serve to create employment.

Neither industrial policy nor the New Growth Path can function as employment policies, but both currently have employment as their principal stated objective. An economy that grows its manufacturing sector and expands its exports will create more jobs, as manufacturing growth and growth in general demand employment. A growth strategy should therefore be concerned with increasing growth, and an industrial policy with enhancing business and exports, contributing substantially to job creation in the process. If we want to talk about overall employment, though, we need a different conversation, one that a debate about industrial policy cannot do justice to. Given all of this, is there a role for SEZs, and if so, what should it be?

We must not extend capital or investment subsidies to SEZs, but should try to use zones to create jobs in labour-intensive industries

## Special economic zones and industrial policy

If we're going to have SEZs, they need to be export-oriented. That's the only way in which they will not compete with existing businesses and workers.

Imagine we set up an SEZ in Kwazulu-Natal, and it is exporting clothing and employing 30 000 people. That would be great – we would have achieved more employment, and that's fine. But, the key gain will be the increase in exports. Increased exports will have a knock-on effect for non-traded sectors like construction and retail. This is where most of the jobs will be created. So you don't have to look at your export sectors as the main source of employment growth – this happens on the back of a successful business sector and increased exports. The real advantage of SEZs is the broader economic possibilities which they open up for employment creation elsewhere.

Existing IDZs are very ineffective. The temptation is to try to improve their performance via subsidies, especially capital subsidies. There are many reasons why this would be a mistake, notably that this would once again cheapen capital and hence increase capital intensity at the expense of employment. Also, there are large deadweight costs – in one survey, about 75 per cent of businesses that received incentives said that they would have made the investement even if the incentives had not existed.

We must not extend capital or investment subsidies to SEZs. Instead, we should try to use them to create jobs in labour-intensive industries and to get those firms to export their goods. To do that, we probably need SEZs in which a key differentiator is the labour market regime – not just in respect of wages, but also in respect of productivity, hiring and firing regulations, working conditions, and shift work.

## Dennis Dykes

*Chief economist, Nedbank Group*

Government policy as set out in the New Growth Path and other policy documents seems conceptually sound. The essence is the idea that we must diversify away from our reliance on resources, which shapes an energy- and capital-intensive economy, and establish energy-efficient, labour-intensive industries instead. The aim is also to reduce inequality and build trading relations with other emerging economies. All this is sensible.

More specifically, there is much talk about growth and about preserving manufacturing capabilities through incentives, 'developmental trade policy', concessionary finance, procurement policy, skills development, and so on. Much of this is protectionist in character in that it looks to protect local industry from foreign competition. An exception to this approach is the desire to use competition policy aggressively. Obviously, more competition is desirable, and monopolistic practices should be tackled. But the reality is that where South Africa needs more competition most is in government-dominated sectors like energy and transport. Inefficiencies here have demonstrably held back economic growth and development.

One of the challenges we have is that, between all the various policies, we're either already targeting (or will soon have plans for) a range of industries that cover most of what South African businesses do. This is too broad. And it's not really working: manufacturing is still under pressure, and we're not changing the structure of the economy to be more energy-efficient. Nor are we absorbing more labour. So we're not really making progress towards achieving those objectives. Why not?

The government provides three answers: the policies haven't been given enough time to work; industrial policy is under-resourced; and the rand is too strong. By contrast, I believe the reason why industrial policy hasn't worked is that it doesn't address the overall business environment. One area frequently mentioned is the labour market. Labour isn't necessarily too expensive, but the businesses we talk to are often looking to minimise their use of labour simply because it involves a huge amount of hassle. Many of them prefer to minimise the use of labour, and will mechanise to do so.

There are other issues as well. There's already a lot of intervention, and business is constantly being battered by new requirements to which it has to adapt. It's very confusing, and not conducive to new investment and employing people. Business also faces high transport and energy costs, which relate to weaknesses in parastatals and the lack of competition.

To my mind, industrial policy should be about revealing comparative advantage. It should try to get new sectors to operate that don't currently exist. It must be very targeted. We can debate how good the state is at identifying new opportunities, but our current approach is too broad – it covers about 80 per cent of existing employment. That's much too wide and does nothing to change the structure of the economy. We're protecting what's there already.

Another problem with our industrial policy is that it often raises costs of goods that businesses need or consumers buy. One example is the idea of local procurement in infrastructure development, which could lead to delays and raise the cost of energy. The longer we wait for energy infrastructure to come on stream, the longer it will take to raise growth rates. We also need to think about what it will mean for corruption and patronage if we create new bodies and bureaucratic processes. Won't that create new opportunities to extract rents?

We need SEZs in which a key differentiator is the labour market regime – not just in respect of wages, but also in respect of productivity, hiring and firing regulations, working conditions, and shift work

A final thought: in formulating industrial policy, I think we don't see enough co-operation between business and government. If anything, the government talks much more to labour about the business environment than to business itself.

## GENERAL DISCUSSION

The discussion focused primarily on the extent to which South Africa's industrial policies have succeeded, or could succeed. This discussion was provoked by a participant who argued that, in practice, South Africa's industrial policies tended to result in less industry, and that, in response to policy failure, government frequently enacted more policies of a similar kind. Citing the example of the mining industry, the speaker noted that South Africa was about to miss out on the global resources boom (for the second time) because of existing policy and further doubts created by talk of nationalisation.

In response, DTI officials noted that mining policy was not their preserve, and that to argue that all government policies had failed was as false a generalisation as the accusation that all businesses were engaged in anti-competitive behaviour.

Two thirds of our industrial policy support goes to the automotive industry, which is not at all labour-intensive

Participants pointed to a range of factors that undermined competitiveness and resulted in a struggling manufacturing sector. These included the exchange rate, high input costs, poor infrastructure, and inefficiencies in the labour market. Some of these issues were contested. One economist said that South Africa's manufacturing businesses tended to do better when the currency was strong rather than when it was weak. He also disputed the suggestion that businesses struggled to access financing, noting that when financing was a constraint for firms with plausible business plans, it was often because of obstacles created by policies such as the National Credit Act.

High input costs originating in sectors dominated by state-owned enterprises – especially energy and transport – were repeatedly emphasised. One commentator noted that civil servants' high salaries relative to workers in the private sector and in comparison to small business owners created an important distortion in the labour market. It also reduced entrepreneurialism.

Officials from the DTI contested some criticisms of the way procurement policy is being designed and implemented, arguing that it is nowhere near as interventionist and obstructive as had been suggested by presenters. They argued that reform was needed because current policy gives South Africa the worst of both worlds: not only were local businesses not benefiting from infrastructure spending, but government was also not getting value for money.

In response, Prof Kaplan said the DTI was designating products that had to be purchased from local suppliers. This could only mean either that domestic suppliers were not price competitive or that the infrastructure would have to be reconfigured to match the specifications of the products that could be purchased competitively from local firms. This, would result in delays or increased costs, and, in the process, would tighten one of the key constraints on business – poor physical infrastructure.

**SEZS IN THE PHILIPPINES: GETTING THE MODEL RIGHT**

The next two major SEZ initiatives launched after the Bataan experience (described on page 14), – Mactan (established in 1979) and Baguio City (established in 1980) – presented important contrasts to the early failings of Bataan. Both were established near urban industrial centres, with better infrastructure and access to higher skilled workers. These attributes have helped to attract foreign investors in both medium-skill and lower-skill plants.

The Philippine Economic Zone Authority employed private companies to develop and operate the Mactan SEZ for the land owner, the Mactan-Cebu International Airport Authority.

Mactan started with a large concentration of investors in garments, shoes and toys. Over time the composition has shifted from low-skill to medium-skill companies, so that by 2000 some 72 per cent of the 151 firms were engaged in metal fabrication, or produced electronics, chemicals, machinery, optical equipment, medical equipment or software.

The Baguio City SEZ demonstrates the role that an anchor investor can play in the development of a special industrial park. Texas Instruments played a key role in lobbying for an SEZ in the mountains, away from the corrosiveness of coastal air. Like Mactan, it included many garment firms, but TI's commitment to build an electronics plant induced other American and Japanese firms to see the area's potential. They sought out semi-skilled labour from the above-average educational resources in the area, and set up co-operative training programmes for electronics workers and engineers.

Taken together, the companies in these two SEZs have generated some 126 000 jobs, and exported almost $4 billion worth of goods in 2010.

Source: T. Moran, International Experience with Special Economic Zones, paper commissioned by CDE, 2011.

# An evaluation of South Africa's Industrial Development Zones


Crispen Chinguno

*PhD Fellow, University of the Witwatersrand*


In 1997 the South African government adopted a policy allowing for the establishment of SEZs. It was aimed at creating industrial enclaves that would help shift the country from an inward-looking industrial strategy to export-led growth, promote investment in less developed areas, boost job creation, enhance the manufacturing sector, and facilitate integration into the global economy. Due to negative perceptions of export processing zones and SEZs in Asia and elsewhere, the government chose to name these enclaves industrial development zones (IDZs). They were defined as 'purpose-built industrial estates, linked to an international port or airport, specifically designated for new investment in export-oriented industries and related services'. To date four of these zones have been designated and licensed, and others are in the pipeline.

The IDZs were aimed at creating industrial enclaves that would help shift the country from an inward-looking industrial strategy to export-led growth

**Designated Industrial Development Zones since 2001**


Coega has attracted a total of 21 investments valued at R9,2 billion, which have generated 2 837 operational jobs. Most of these investments are not new, but have instead relocated from elsewhere

## Coega

The first zone to be designated (in 2001) was at Coega, about 20 kilometres from Port Elizabeth. At 11 000 hectares it is by far the largest IDZ and was designed around industrial clusters linked to the deep water port of Ngqura. It is operated by the Coega Development Corporation, which is owned by the provincial and national government.

By 2010, government had spent more than R3 billion on infrastructure, including factories, roads, warehouses, a logistics park, a commercial centre and accommodation. The zone seeks to attract a wide range of businesses and industries and aims to have clusters ranging from ICT and logistics to automotive manufacturing and mariculture. To date, Coega has attracted a total of 21 investments (17 of which are currently operational) valued at R9,2 billion. These have generated 2 837 operational jobs. However, most of these investments are not new, but have instead relocated from other industrial parks.

## East London IDZ

The East London IDZ (designated in 2002) is owned by the Eastern Cape Development Corporation on behalf of the provincial and local government. Over 90 per cent of investors are original equipment manufacturers (OEM) supplying the adjacent Mercedes Benz plant. This is because Mercedes Benz asked all its suppliers to move into it to facilitate its logistics and exports.

OEM investments are very capital-intensive and have a limited impact on employment. As of July 2011, some 1 450 people work in the zone. Each job created required almost R1 million in investment spending.

## Richards Bay IDZ

The Richards Bay IDZ (designated in 2002) is operated by the Richards Bay Industrial Development Corporation, which is owned by the municipality and the provincial government. In principle, it seeks to attract firms involved in beneficiating minerals, targeting aluminium, heavy metals, building products, dry docks, renewable energy, agro-processing, rubber recycling, and granite processing.

Tata Steel, which moved in before the zone was operational, is the only current investor on the ground. It was attracted by the then availability of cheap electricity and low logistic costs. Since the 2007 power shortfall, the zone has struggled to attract investors – a sign that IDZ competitiveness is often tied to the national context. As of October 2011, the investment was valued at R850 million, and 269 operational jobs had been created.

The zone faces a number of logistical constraints which are undermining its viability. Although it targets mineral beneficiation and manufacturing, the port is only designed to handle unpackaged bulk cargo such as iron ore or coal rather than container shipping. There are no current plans to address this, whilst there are plans to expand the Durban container terminal. This impacts negatively on the zone's ability to attract manufacturing investments.

## OR Tambo IDZ

Located near Johannesburg's international airport, the OR Tambo IDZ was designated and granted its operating permit in 2010. It is operated by the Gauteng Industrial Development Company, a subsidiary of Blue IQ, the Gauteng provincial government's infrastructure development arm. The OR Tambo IDZ aims to support strategic industries linked to air transport, including precious mineral beneficiation and high-technology industries. While plans are being developed, no concrete investments have yet been made.

## Lessons learnt from SA's IDZs

For the most part, South Africa's IDZs have failed to meet their intended objectives. In particular, they seem to have had little impact on expanding or diversifying South Africa's manufacturing sector or export performance. Limited new investment suggests that the programme has failed to create investor-friendly environments. Moreover, most of the investments thus far are capital-intensive and have therefore generated relatively few jobs.

Unlike many SEZs around the world, investors in South Africa's IDZs receive no special incentives. The zones also do not deviate from the social, labour, and environmental legislation in force elsewhere in the country. The stated reason for this was an unwillingness to distort the economy, but it has meant that IDZs have not been able to offer investors a more attractive environment.

International best practice has shown that consistent high-level political commitment is vital if SEZs are to succeed. South Africa's IDZs have not received this. Instead, they have faced ideological contestation within government and amongst stakeholders.

Unlike many SEZs in other countries, investors in South Africa's IDZs receive no special incentives. The zones also do not deviate from the social, labour, and environmental legislation in force elsewhere in the country

All South Africa's IDZs are exclusively government-owned, promoted and financed. The management and delivery of services to firms is the responsibility of a zone operator, all of which are owned by provincial and local governments. This runs counter to the global trend, which is shifting towards greater private sector involvement in owning, operating, and promoting SEZs.

From their conception, the IDZs have lacked a comprehensive policy framework. This has led to deficiencies in governance, planning, implementation, management, and operation. A lack of inter-agency coordination has resulted in serious inefficiencies. For example, ten years after the policy's inception, none of the IDZs offers a customs secured area or a one-stop centre for customs duties and VAT regulatory requirements.

South Africa's current IDZs do not really qualify as SEZs, offering nothing extraordinary to investors when compared to other industrial parks. Their primary aim is to offer world class infrastructure. This could attract some investors, but much of the infrastructure in question is really not very different from what can be found elsewhere in the country.

The IDZs do not really qualify as SEZs, offering nothing extraordinary to investors

**Table 1: South Africa's IDZs compared with leading international SEZs**

| Leading SEZs worldwide | South African IDZs |
|---|---|
| Corporate tax exemptions and discount rates over specific time frames | Full corporate tax for enterprises in customs-controlled area (CCA) of the IDZ |
| Discounted personal tax for zone enterprise employees | Full personal tax for IDZs and CCA enterprises employees |
| Conditional exemptions from import duties | Conditional exemptions from import duties |
| Zero rated value added tax | Zero rated value added tax |
| Consistent dedicated investment incentives for capital goods, HRD, imported capital goods, R&D, and other needs | Inconsistent investment incentives and no zone-specific incentives |
| Automatic qualification and speedy incentive approvals, lending certainty and investor confidence | Stringent admission criteria and requirements. Up to 6 months turnaround time reduces certainty and investor confidence |
| Discounted and competitive land and property prices, as well as rental rates | Market-related property prices and rental rates |
| Customs control delegated to zone operator by internal revenue authorities. Zone operator allowed autonomy. | Authority reserved and controlled by SARS |
| Liberal interpretation of customs control regime. Zone operator allowed autonomy | Cumbersome customs procedures compounded by excessive monitoring and reporting requirements |

Source: Richards Bay Industrial Development Zone Annual Report, 2009

## DISCUSSANTS

### Maoto Molefane

*Director, spatial planning and economic research, DTI*

The DTI has developed a new SEZ policy proposal, which is mostly based on the challenges that have been identified in existing IDZ policy and management. We acknowledge that the new proposal is not a panacea for all the bottlenecks that are currently limiting industrialisation, but we think it is a useful tool.

At the strategic level, we've observed weak linkages with our national, regional, and local economic strategies. As a result, SEZ legislation will include aspects of regional development among its objectives, rather than just industrial development and jobs.

IDZs can't focus only on production for export; production for the domestic market is important for industrialisation. One implication is that IDZs should not be limited to coastal provinces.

In terms of design and management, there are significant challenges around the governance and administration of the IDZs. It is not clear, for example, which level of government should own, manage, and administer IDZs. There is also inadequate coordination amongst key stakeholders, including national and provincial government, the DTI, the National Treasury, SARS, Eskom, and the infrastructure departments. At the moment, it's also possible for different IDZs to approach the same investors and compete among themselves.

Financial support for IDZs has been too inconsistent for long-term planning. Too much emphasis has been placed on hard infrastructure at the expense of soft infrastructure, such as providing adequate skills for targeted industries. At present, there are no dedicated incentives for IDZs.

Our strategy is to redefine and expand the IDZ model to serve as a tool for creating regionally diversified manufacturing industries both in existing regional hubs and elsewhere. We will also allow for different types of SEZ to cater for different needs and contexts. This requires improved planning, implementation, monitoring, financing and governance, as well as comprehensive government support. We intend to improve the specialisation and complementarity of SEZs in order to avoid or minimise competition between them.

The development of SEZs is not a DTI strategy; it's a government strategy. When an SEZ is established, we expect all government departments to put relevant resources in place. For example, if an SEZ is created in the Eastern Cape, the Department of Education must ensure it can provide the relevant inputs. Provincial governments, metros and district municipalities must begin to take charge of SEZs.

We have learnt some important lessons from international best practice and our own IDZs that have informed our new SEZ policy. The participation of municipal government from the outset makes the development and operationalisation of an SEZ much more efficient. Moreover, SEZs are not only about investing money in infrastructure and new jobs, but also about improving the competitiveness of the entire economy, economic diversification, technology and skills transfer, and the strengthening of co-operation among the three spheres of government.

SEZ legislation will include aspects of regional development among its objectives, rather than just industrial development and jobs

International experience shows that both the public sector and private sector have roles to play in SEZ development

## SOUTH AFRICA'S DRAFT SEZ LEGISLATION: A MISSED OPPORTUNITY

*In preparation for the Round Table, CDE commissioned Jean-Paul Gauthier, one of the world's leading authorities on the governance of SEZs to assess South Africa's draft SEZ legislation and to compare it to best practice internationally. This is a summary of his analysis, updated to reflect the most recent version of the draft Special Economic Zones Bill. His paper is available in its entirety on request from CDE.*

### Special Economic Zone Board

A key difference between the SEZ Bill and the IDZ Regulations relates to governance of the programme, with an SEZ Board to be established that consists of 13 members appointed by the Minister of Trade and Industry.[19] Its role will be 'to advise the Minister on policy and strategy to promote, develop,operate and manage Special Economic Zones'.[20]

It is unclear whether the SEZ Board represents an improvement over current practices. The proposed Board is dominated by representatives of the public sector, with even the 'independent' members being appointed by the Minister. The low frequency of required meetings (only four a year) is a potential source of regulatory bottlenecks. It is unclear whether the Board's secretariat (which DTI will establish) will be able to alleviate these bottlenecks.

### Designation of Special Economic Zones

The Bill vests the authority to propose areas for designation in a wide range of government agencies. In so doing, the Bill arguably implies a shift away from the IDZ Regulations' implicit strategy of approving projects presumed to have private sector (i.e. corporate sector) backing and support. Zones driven by government tend to be less successful than private-sector led zones. On the whole, it appears that the draft bill represents a missed opportunity to improve upon the current designation process and, arguably, enshrines the Government's failure to attract sufficient private sector interest in IDZ development.

### Developing Special Economic Zones

International experience shows that both the public sector and private sector have roles to play in the SEZ development phase. The design and construction of SEZs requires considerable coordination between off-site (typically public) infrastructure and on-site (typically private developer) construction, in order to ensure their seamless and timely integration. Private sector developers may be unable to access funding if they perceive difficulties in integrating public and private efforts. To help address this, government sometimes needs to fund both off-site infrastructure and provide guarantees or direct funding for on-site facilities. Neither South Africa's current IDZ Regulations nor its proposed new SEZ frameworks make government's intentions sufficiently clear with regard to the public and private roles in SEZ development in the country. From a best practice standpoint, clarifications in this regard would be helpful.

### Operation of Special Economic Zones

Typically, it is international practice to define developers and operators of SEZs differently from one another legally. This permits specialised developers to focus on their business, and specialised operators to focus on theirs. Once a zone has been developed, the SEZ owner, or developer, contracts with the operator to run the SEZ for a certain period. Under the current IDZ Regulations, the operator's role is quite extensive and includes the responsibility of acting as the interface between government and IDZ enterprises. Under the proposed SEZ Bill, the SEZ must appoint a board that is 'responsible for the efficient… management of the… affairs of the Special Economic Zone'.[21] Given that each zone would seem to already have an operator performing this function, the intent here is unclear. Furthermore, the Minister's proposed powers extend to approving the annual business and financial plans of the SEZs.[22] Between the zone boards and the Minister's powers, the operator appears to have little or no authority to run its business, and will, in addition, be required to report on activities to the Minister, SARS, the South African Reserve Bank, Statistics SA or other relevant authorities.[23] This implies too heavy a regulatory hand, and, taken as a whole, the draft Bill shows a failure to capitalise on the experience of private sector operators to manage SEZs.

### Incentives for Special Economic Zones

The overall impression given by the incentives administration scheme in the current IDZs is one of administrative confusion, with overlapping delivery mechanisms and poor coordination. An important gap for SEZs is in improving business registration processes, and, while SEZ regimes around the world differ significantly in the way in which they regulate the entry of new businesses, most try to improve upon the ordinary national regime. The SEZ Bill does not do this. Furthermore, to be a success, an SEZ law would need to provide clarity on the legal regime and incentives to be provided, which this draft bill has not done. This is particularly important in a country like South Africa that suffers from competitiveness issues related to labour legislation and costs, corporate tax, exchange controls, and transport costs.

CDE 2012

## Simphiwe Kondlo

*Chief executive officer, East London IDZ*

Operators of IDZs have found the experience very challenging, partly because many people see IDZs as having been established by government without involving the key players whose support the programme needs. A prime example of this is the failure to establish customs-controlled areas. The provision of duty-free raw material and other inputs for export manufacturing is supposed to be at the heart of the IDZ programme, but the DTI had to rewrite its IDZ regulations around 2004 because customs policies fall outside its remit, and SARS was not properly involved. Thus, the foundation for IDZs was not firm enough to provide for a comprehensive programme in South Africa.

We are starting to see the first indication that government is committed to strengthening the IDZs. But we must not make the same mistakes – including making promises that won't be delivered. Government shouldn't market our IDZs as if they are the same as the EPZs and SEZs established in other countries because we do not offer investors anything close to what they offer. In fact, our IDZs offer nothing. They are no different from private industrial parks because there are no government incentives whatsoever.

The East London IDZ has attracted 25 investors through specific partnerships. In our experience, there are three types of investors who might come to an IDZ: resource-seeking investors, market-seeking investors, and incentive-seeking investors. In East London, we were able to attract market-seeking investors because we have Mercedes-Benz on our doorstep, and they were looking to expand their local content. We built a very specialised automotive supplier park with everything timed and synchronised to act as an extension of their plant.

We have also developed an aquaculture cluster utilising our natural advantage of being located close to the sea, and about 30 hectares will be used for fish farming and processing.

Beyond the advantages of our location, we have not been able to offer investors any specific incentives that they would expect from a typical EPZ. I am hopeful that the DTI's new initiative will put something concrete on the table.

Operators of IDZs have found the experience very challenging, partly because many people see IDZs as having been established by government without involving the key players whose support the programme needs

## Claude Baissac

*Secretary-general, World Export Processing Zones Association*

The IDZs have underperformed in attracting investment, especially FDI. They have also tended to attract capital-intensive rather than labour-intensive firms. The balance of public and private investment is poor, with too much of the former and too little of the latter. If the opportunity costs of public spending are added, the contribution of the IDZs to the country's economy may well have been negative. Therefore, new SEZ legislation should be based on a diagnosis of what hasn't worked, and recognise existing constraints on businesses that create jobs, add value, and export manufactured goods.

So what should SEZs do? They are not necessarily about incentives, but about putting together a package that can solve the problems that constrain economic growth. They should enhance the business climate and allow investors to invest profitably. In the process, they can be used to generate benefits like employment, tax revenues, export growth, economic diversification, and backward and forward linkages to the domestic economy.

Economically, we are a country with bipolar personality disorder. We are a wealthy middle-income country as well as a poor low-income country. To date, we've been trying to create jobs in capital-intensive, well-endowed parts of the country or to create artificial capital-intensive industry in decentralised, poorly-endowed regions. We have skills shortages as well as an oversupply of uneducated and unemployed labour. We have escalating electricity prices which are now making us uncompetitive. We have a poor investment climate, including restrictive labour legislation and unnecessary red tape.

If the opportunity costs of public spending are added, the contribution of the IDZs to the country's economy may well have been negative

In this context, SEZs should not be seen as tools for decentralisation because that is costly and often fails. They should focus on bringing jobs to people in some parts of the country, and bringing people good jobs in others. They could focus on high-technology industries, but should try to attract low-skill, labour-intensive industries which would create more jobs. Most importantly, they should be seen as tools for experimenting with reforms that we are unable or unwilling to introduce in the current political environment. They should try to demonstrate what the private sector can do if it is less constrained by government.

## Lourens Maré

*Chief executive officer, Jewellery Council of South Africa*

I've been asked to talk here today because the Jewellery Council has been in discussion with Blue IQ about establishing a jewellery manufacturing cluster in the OR Tambo IDZ. The issues are complicated.

There is a competitive global market for jewellery manufacture, and South Africa's sector is relatively small. In 2009 we manufactured 3,6 tons of jewellery, while the United States purchased 300 tons.

Small as it is, our industry is in decline. Since 2006 jewellery exports are down 24 per cent, gold consumption is down 50 per cent, and our manufacturing employment is down 48 per cent. There are very few large gold jewellery manufacturers, and 75 per cent of jewellery manufacturers use less than 1,5 kilograms of fine gold a year.

The key challenge facing the industry is gold financing. Gold lease rates in South Africa are about 5 per cent, considerably higher than the 1 per cent or less paid in other countries. A more significant impact on manufacturing capacity is the rapid rise in the price of gold, because manufacturers must supply collateral for any gold they borrow for the manufacturing process. As the price rises, so the amount of collateral needed increases. All of this makes us uncompetitive, and it is the reason why a new gold loan scheme has been included in the DTI's Industrial Policy Action Plan 2. We hope this will attract investment.

We don't really have a gold culture in South Africa. VAT is levied on all inputs except Kruger rands. We have security issues related to our manufacturing industry. Over-regulation, which pushes up the costs of entry and raises barriers to new entrepreneurs, is another challenge for jewellery manufacturing. We also have a rapidly ageing labour force.

Key challenges surrounding participation in the OR Tambo IDZ include relocation costs, the cost of creating customs facilities, and ensuring access to necessary labour. Small to medium factories have already formed very successful clusters throughout South Africa and may be reluctant to move.

The areas where IDZ participation could benefit the sector are through relief on import and export duties, and relief on VAT on inputs. We should build on current initiatives, such as the clusters that are already forming at the Rand Refinery's Gold Zone, and link those to IDZs. Zones should be benchmarked to ensure that they offer competitive advantages. IDZs should also take active steps to create competitive business climates, such as attracting large anchor tenants who will create opportunities for smaller entrepreneurs, creating training and labour support facilities, and incorporating materials financing.

The DTI did not listen to potential investors and therefore misunderstood their needs

## GENERAL DISCUSSION

The discussion revolved around the performance of South Africa's IDZs, and the lessons that could be learnt from this in crafting new policy. Participants argued that IDZs had performed badly, and identified incoherent policy as the main reason. One participant noted that, while the government had spent 'hundreds of millions of rands' on the Richards Bay IDZ, it had been hamstrung from the outset by a failure to align its goal of attracting investors, who would export beneficiated minerals, with the need for a container port. Similarly, its location made it hard to attract investors simply because environmental impact assessments were hard to pass so near a wetland. Besides, it had taken 18 months to obtain an operator's permit after the IDZ had been gazetted.

Another participant said the DTI did not listen to potential investors and therefore misunderstood their needs. Little thought was also given to the specific needs of small business.

Another kind of problem related to the choice of sectoral targets. One participant found it surprising that government was focusing so much energy on jewellery manufacture, for example, because, given its small size, even quadrupling employment would add only 15 000 new jobs.

A number of lessons from international experience were underlined:

- SEZs are a poor tool for regional development and are almost always more successful when they are linked to ports or located on a country's borders.
- It is more important to involve the private sector in developing and operating SEZs than involving provincial government.

- Although the DTI intends to improve coordination between zone operators and local government, some of the most successful SEZs in the world are successful, in part, because they are their own local governments.
- Government should allow zones to fail if they are not delivering.
- Competition among zones is not a problem but rather an important way to improve performance.
- Zones must begin to operate efficiently as quickly as possible. They often fail if they do not achieve high levels of efficiency and competitiveness from the start, and so fail to generate adequate momentum.

# Successful zones: Getting governance right

## Jean-Paul Gauthier

*Deputy secretary general, World Economic Processing Zones Association, and managing director, Locus Economica*

Some of the most successful SEZs in the world are successful in part because they are their own local governments

I want to talk about the lessons South Africa should draw from the experience of the thousands of SEZs around the world, many of which have failed. This failure is due to a variety of factors, including a lack of strategic focus, the establishment of SEZs in the wrong locations, weak regulatory authorities, poor coordination amongst stakeholders, and an over-reliance on tax incentives.

The first lesson is fairly unambiguous: the approach where zones are regulated, developed and operated exclusively by government has been discredited. Today, the preferred institutional model for successful SEZs is predicated upon a division of labour and co-operation between the public and private sectors. Government should formulate policy and strategy, make laws and regulations and enforce them, and provide key public goods. The private sector should develop and operate SEZs, including undertaking the master planning, investing in core real estate and services, undertaking construction, managing the zones, and promoting investment. The private sector is better placed to perform these functions because it has a profit incentive, business networks and contacts with potential tenants, and experience in development and construction.

The overarching goal is for the public sector to support SEZ development only as much as necessary, and to allow private sector developers and operators to take the lead.

### Commissioning and establishing SEZs

Inevitably, the responsibility for commissioning or designating SEZs – including their legal establishment – is the public sector's job. SEZs are meant to differ in some way from the rest of the economy, and only government has the authority to determine where this will happen and what the distinctions will be. How this is done, as opposed to by whom, is informed by important lessons drawn from international best practice.

The first of these is that applications for the designation of zones should be a joint public–private endeavour, where the private zone developer demonstrates the business case for a zone, and the public sector assures itself of the socioeconomic benefits of the proposal.

Left unchecked, the incentives of each of these two parties (profits on the one hand and politics on the other) almost invariably lead them to neglect the other's key concerns. No zone should be designated unless it can show a potential return on investment as well as positive socioeconomic benefits.

Some key good practices learnt from international experience include:

- letting the private sector take the initiative, rather than giving government the leeway to designate unattractive and unprofitable zones;
- making sure that the designation application process is not unduly cumbersome, unclear, or open to abusive administrative discretion; and
- requiring that all SEZs demonstrate a return on investment derived from their rental income stream, taking into account market-based (or at least 'equal footing') costing of land, infrastructure and capital.

## Funding and developing SEZs

The real work of developing an SEZ begins after it is designated. International experience shows that both the public sector and private sector have roles to play in this process, and that public–private partnership driven development is now almost a *sine qua non* of SEZ development worldwide.

The private sector developer takes on the main financial risks of the project and orchestrates its various components. However, the private sector may not always be willing to do this if returns are uncertain. Indeed, if the project or the investment climate do not suggest a reasonable return on investment, a private sector developer will be unable to secure long-term financing. Government can do a number of things to reduce risk, improve the terms and conditions of the transaction, and increase the project's chances of success. These include discounting the cost of land, undertaking some of the master planning functions, developing off-site infrastructure, and identifying anchor tenants. This need not be a budgetary strain, as it could be funded by donor financing, infrastructure development funds, soft loans, or private equity.

Once financing is in place, the private sector should be principally responsible for the bricks and mortar construction of the SEZ, as well as marketing it and leasing space. The overarching goal is to provide an attractive physical and services environment to prospective investors.

The design and construction of SEZs requires considerable coordination between off-site (often public) infrastructure and on-site construction in order to ensure appropriate integration and avoid delays, which would detract from the project's credibility.

Dedicated government steering committees with some private sector representation (usually the developer and/or tenants) are an important governance tool for resolving coordination challenges between public and private partners.

SEZs are meant to differ in some way from the rest of the economy, and only government has the authority to determine what the distinctions will be

Most of the risk of SEZ operations should be borne by a private sector operator who earns revenues from rental income and the provision of other services

**Table 2: The roles of the government and the private sector in establishing and operating SEZs**

| Government (SEZ Unit) | Developer/Operator (PPP or Private Sector) |
|---|---|
| • Undertake strategic planning<br>• Identify role of private developer<br>• Select and package, or approve sites<br>• Select and enter developer agreement with developer<br>• Coordinate preparation of land use master plan with developer<br>• Provide off-site infrastructure and utilities<br>• Approve developer's plans for construction<br>• Monitor construction against building code standards and agreed construction schedule<br>• License tenants<br>• Issue building and environmental permits<br>• Co-operate with revenue authority on the administration of customs operations<br>• Monitor developer for compliance with concession agreement<br>• Monitor tenants for compliance with regulations<br>• Enforce compliance<br>• Support marketing efforts<br>• Develop workforce and other social services | • Undertake detailed feasibility analysis<br>• Develop final land use master plan<br>• Develop on-site infrastructure and utilities<br>• Secure financing and other resources<br>• Develop and implement security measures/system<br>• Undertake construction<br>• Market the SEZ to prospective tenants<br>• Lease plots to tenants<br>• Provide agreed core and ancillary services to tenants, or sell utility and other shared services<br>• Maintain infrastructure and common areas |

Source: International Finance Corporation, SEZ Toolkit, unpublished draft, 2011.

## SEZ operation and management

When an SEZ opens for business, the owner either operates the zone itself or contracts a specialised zone operator. Most of the risk of SEZ operations should be borne by a private sector operator who earns revenues from rental income and the provision of other services such as security, waste management, conference centres, and dormitories. The public sector should facilitate government services, coordinate various state bodies to ensure effective service delivery (potentially through a one-stop shop or inter-agency agreements), and monitor compliance with SEZ laws and regulations.

## SEZ regulation

Without the well-performing 'software' of an SEZ's investment climate and policy regime, its physical 'hardware' is no more than a real estate proposition with no 'special' attributes and no comparative advantage relative to other industrial locations. The unique draw of an SEZ lies in these policy-based elements, particularly when an SEZ offers investors and users a simple business environment by minimising red tape.

There is no single set of policies that characterises SEZs globally. Each country introduces incentives and/or policy measures that reflect (and alleviate) constraints in the rest of its economy so that they meet investors' needs.

From the institutional perspective, international best practice suggests that the SEZ regime should be administered by an autonomous and powerful government authority which oversees the administration of dedicated laws, regulations, and practices inside the SEZs; provides regulatory oversight of developers, operators and end-users; and ensures the efficient delivery of services (including regulatory services). It regulates economic activities within SEZs and acts as the principal government interface for private SEZ developers and operators.

The 'SEZ Authority' should have:

- broad powers and authority;
- access to the highest levels of government;
- autonomy with respect to decision-making and budgeting;
- employment flexibility and exemption from civil service rules for salaries and procurement;
- autonomous income streams; and
- private sector representation on its board.

One-stop shops are often a good solution for streamlining cumbersome and complicated business regulatory processes. When the decisions are accepted by other agencies, administrative processes can be made considerably less burdensome. Chinese reforms (such as the Digital Beijing Initiative of the Zhongguancun e-Park) are an example of successful process re-engineering and the automation of business compliance, resulting in significant streamlining of administrative processes. Incentives, if they're used, should be targeted to the industries that are being supported in the SEZ or associated industrial policy.

Globally, 32 per cent of all manufacturing FDI invested in 2004 was invested in SEZs, while 41 per cent of the world's manufacturing exports came out of SEZs

## SEZs as a vehicle for economic reform

SEZs are good at helping an economy take advantage of international trade and investment: about 32 per cent of all manufacturing FDI invested in 2004 was invested in SEZs, while 41 per cent of the world's manufacturing exports came out of SEZs. So if the principal objective of an SEZ programme is to increase trade and exports, it could be a good policy tool.

In other areas, results are more ambiguous. Using SEZs for economic diversification, for example, has produced mixed results. You can argue that SEZs foster industrialisation, which seems to have been the South African DTI's original premise. The Dominican Republic, the People's Republic of China and Taiwan were able to use SEZs to create higher value-added manufacturing sectors, but these were exclusively in export-oriented light industry rather than heavy industry. Other countries have used SEZs as a base for more high-tech industries. But creating new industries is difficult, and there have been many failures too.

Above all, I would say that SEZs are a tool for economic rationalisation and for reducing obstacles faced by investors.

## DISCUSSANTS

### Nigel Gwynne-Evans

*Acting chief director: trade and sector development, Western Cape Department of Economic Development*

The Government of the Western Cape has just completed a feasibility study for the Saldanha Industrial Development Zone. Saldanha is a deep water port with an iron ore terminal and two smelters. It exports 50 million tons of ore a year, and is aiming to double that. While it's an environmentally sensitive area, there is considerable unrealised opportunity.

Saldanha is not yet an IDZ, largely because of coordination failures revolving around the re-zoning of land, as well as infrastructural challenges relating to ports, transport and logistics. One of the main challenges we are grappling with is a high rate of government changeover. The municipality has had four political changeovers in five years, and its capacity is very limited. For this reason I would endorse the need for oversight from the provincial level.

Above all, SEZs are a tool for economic rationalisation and for reducing obstacles faced by investors

We have found two main areas of opportunity for the Saldanha IDZ. These are mineral beneficiation (of the sands and ores being transported through Saldanha), and building an industry to service offshore oil and gas infrastructure. This is really starting to move ahead, and we've had approval for the first phase of the oil and gas supplier hub. Spin-offs from this will also create jobs.

One challenge is managing local expectations. Local residents have developed exaggerated expectations of the business and job opportunities the IDZ will create. This has attracted speculative and often inappropriate investors, which can put the overall project at risk.

### Professor Neil Rankin

*Director, African Microeconomics Research Umbrella, School of Economic and Business Sciences, Wits University*

If South Africa is to create SEZs, we need to ask some critical questions. We need to figure out how SEZs fit in with industrial policies generally. Do we want them to create jobs, increase exports, or serve as test beds for policies that can't be enacted nationally?

Successful SEZ programmes require a stable policy framework. Investors anticipating a future stream of profit need to know that the relevant policies are certain and that the government will remain committed to them. In the recent example of Walmart moving into South Africa, we've seen four different government departments responding in different ways. This affects perceptions of policy continuity.

We also need to think about the role of regulations, particularly those that are politically contentious, such as labour regulations. What possibility is there for experimenting in SEZs with changes to these rules? If one of the objectives is to create jobs in these zones, this may have to be considered.

Another issue relates to infrastructure. In South Africa, a single state-owned operator controls all the ports and another dominates telecommunications. It is worth considering whether SEZs can be successful in contexts where key infrastructure services are run by monopolies – and whether they could play a role in introducing competition in those sectors.

## Michelle de Bruyn

*Managing director, Kaiser Associates Economic Development Practice, South Africa*

SEZs present an opportunity to build more effective partnerships and new ways for stakeholders to work together.

One of the key obstacles to effective partnership is mutual distrust between key constituencies. Globally, one can see a correlation between inequality and distrust, so it is not surprising that a lack of trust is a feature of our politics. Historical factors and ideological differences amplify the lack of mutual understanding needed to get programmes like this moving forward.

In our work, we've found that the way to tackle mutual distrust and increase co-operation is not through regulation or top-down structures, but by building long-term relationships. The parties don't need to agree on everything, but must agree that they will try new tactics together. Vital areas include the ways in which state-owned enterprises interact with business, how national government deals with provincial and local governments and vice versa, and the way investment promotion agencies go about their work. Perhaps SEZs offer a vehicle to try new things together?

It is worth considering whether SEZs can be successful in contexts where key infrastructure services are run by monopolies

## GENERAL DISCUSSION

A number of issues were raised, notably what an SEZ programme should try to achieve. Some participants suggested that this was the creation of labour-intensive export industries. For this to happen, the key differentiator between the SEZ and the rest of the economy would not be the quality of physical infrastructure or the delivery of services, but the regulation of the labour market.

An economist suggested that workers should be allowed to opt out of existing labour market regulations and offer their labour to employers on whatever terms they could negotiate (though minimum safety regulations should remain). Firms in the SEZ would have to export their products and should not be allowed to compete with domestic producers outside the zones. One advantage of this would be that any SEZ employment would by definition be a net addition to employment in South Africa.

Responding to this suggestion, Jean-Paul Gauthier noted that the key factor for SEZ success was that it deals effectively with constraints on business in a given economy. Some governments (such as Panama's) had identified labour regulations as such a constraint, and had designed SEZ policies for easing this. This might even be negotiated trilaterally, with organised labour and employers, but politicians would have to be strongly committed to achieving this and be willing to pursue this goal over a period of years. The question was whether South African leaders would have the resolve required for this kind of labour market reform.

Gauthier disputed the value of insisting that firms in an SEZ should be allowed to produce only for export. Imposing such limits means turning away investors who might want to use their base in the SEZ to penetrate South Africa's markets. It would also preclude organic cluster formation and backward linkages within SEZs. According to Gauthier, restrictions like these reduce the attractiveness and viability of SEZs, and run counter to integrated global production and supply chain logic, and the WTO.

Other participants insisted there were legitimate reasons to limit the access of firms operating from SEZs to domestic markets, since these might compete directly against firms operating under different regulatory rules. Similarly, allowing firms in SEZs to import skilled workers more easily than firms in the rest of the economy would amount to unfair competition. Reluctant constituencies (including local business and the unions) might be more likely to support the establishment of alternative regulatory arrangements in SEZs if the goods produced in SEZs did not enter domestic markets. Participants differed on whether this would comply with WTO rules, with some thinking it might, others saying it would so long as no explicit subsidies were paid, and a third group insisting that even if it did not comply, parties to the WTO would be unlikely to act.

Reluctant constituencies might be more likely to support the establishment of alternative regulatory arrangements in SEZs if the goods produced in SEZs did not enter domestic markets

The possibility of establishing 'single factory zones' (where individual factories receive the benefits that normally accrue only in designated zones) was discussed. Opinions were divided on this subject, with some suggesting that this option would eliminate some of the logistical difficulties surrounding the establishment of SEZs (such as finding appropriate land and building new infrastructure). Others felt single factory zones would not differ from existing 'bonded warehouses', and would add no value. Others pointed out that this model worked best in places like Mauritius or Singapore – small island economies where all factories were reasonably close to ports.

### PRIVATE SECTOR DEVELOPMENT AND PRODUCTIVITY GAINS: THE DOMINICAN REPUBLIC

After macroeconomic reforms were introduced in the first half of the 1980s, Dominican authorities changed direction in two ways. First they shifted SEZ locations to sites near the capital, where infrastructure was better. Second, they permitted SEZ management to be carried out by private sector firms, and invited international companies to act as both investors and promoters.

Now, private sector developers offer assistance with (and charge fees for) worker recruitment, worker transportation, and worker health services. They also provide business services and round-the-clock customs administration. The average rents charged rose rapidly to more than three times the rates charged in publicly owned zones. Despite the higher cost, surveys indicate that foreign firms were willing to pay the premium because of the better working environment.

Surveys also provide an unusually detailed look at the impact of on-the-job training and learning by doing in SEZ plants. Some 85 per cent of the workforce in early EPZs came directly from the country's unskilled labour pool. Within 33 American firms and 11 Dominican firms, productivity increased 44 per cent in the second year after the start of operations, and 10 per cent in the third. In 12 Korean, Taiwanese, and Hong Kong firms, productivity increased by 67 per cent in the second year after start-up, and 13 per cent in the third.[25]

Achieving these productivity increases did not require heroic measures on the part of zone employers. The typical pattern involved two to three months of on-the-job training for unskilled workers, followed by a period of learning by doing. By the end of the first five years of operation employees in the American affiliates had reached

76 per cent of best-practice labour productivity in the company. At the end of the first six years of operation, Dominican employees in the Korean, Taiwanese, and Hong Kong affiliates had reached 62 per cent of best-practice labour productivity.

Over 80 per cent of workers who became skilled said they had obtained their skills from the company that employed them. Without the opportunity to develop those skills, these zone workers would probably have been unemployed, or earned about 60 per cent of their current wages.

While textile and garment firms have retained a significant presence in Dominican zones, their proportion has been steadily falling as other industries have expanded. In 2010, SEZs in the Dominican Republic accounted for 62 per cent of total DR exports (just more than $4 billion), and employed some 160 000 workers.[26]

Source: T Moran, International Experience with Special Economic Zones, paper commissioned by CDE, 2011.

# Key insights from the round table

Industrial development zones have existed in South Africa since the establishment of Coega in 2001. The programme has been expensive. And — as the government has acknowledged — it has largely failed to deliver more jobs, industrial development, or exports.

In January 2012, government released for public comment a draft Special Economic Zones Bill, aimed at improving the country's SEZ model. This is, therefore an important time to examine international experiences of SEZs and assess what has gone wrong with the local programme.

SEZs can play a major role in transforming the economies of developing countries

Two key points emerged from the Round Table discussion and research that CDE commissioned. The first is that SEZs can play a major role in transforming the economies of developing countries. Today, there are some 3 000 SEZs in 135 countries which collectively account for over 68 million direct jobs, and $500 billion of trade-related value add. In 2004 they accounted for about 32 per cent of global manufacturing FDI and 41 per cent of global manufacturing exports. The second lesson, however, is that not all SEZs succeed. Many SEZs – including most in Africa – perform poorly.

Merely adjusting South Africa's existing IDZ model will not be sufficient. A radical rethink is necessary if the country is to use SEZs as productive economic instruments. CDE's research and Round Table produced important insights relevant to the development of a new SEZ programme, which are summarised in the nine lessons below.

### 1. *Special economic zones must be special*

If South Africa's SEZs are to succeed, they need to offer investors something significantly different from what is available in the rest of the economy. Precisely what an SEZ offers, and how this differs from conditions elsewhere, depends on the goals of the SEZ programme. These, in turn, depend on national priorities. The very successful SEZs established on China's east coast in the 1980s, for example, were aimed at attracting foreign investors who could not penetrate China's closed economy. Apart from superior infrastructure, the Chinese zones offered a radically different investment regime, including strong property rights and the freedom to repatriate profits. This encouraged investors to build factories and draw on China's huge labour force. Few SEZs offer such a dramatically different set of institutional rules relative to the host economy as did those of China's east coast, and few are as big or as well-located. Nevertheless, the Chinese zones illustrate that SEZs need to offer investors something different if they are to markedly improve a country's economic prospects.

Importantly, international evidence suggests that SEZs are most successful when they are targeted toward particular industries and offer concrete solutions to the challenges faced by those industries.

### *2. Global competitiveness is what counts – it's not enough just to be better than the host economy*

SEZs must do more than offer better conditions than those in their host economies; they also need to be globally competitive. Investors, particularly foreign investors, choose SEZs for different reasons. Most consider their location, market access, and logistics. Others consider wage levels and labour market practices. Yet others place a premium on access to skilled labour or a favourable regulatory environment.

Many SEZs offer investors particular fiscal incentives – tax breaks, subsidies, etc. International evidence shows that few investment decisions are made on the basis of these incentives alone, and that ensuring the zone's overall competitiveness is much more important. Nevertheless, governments should retain the capacity to provide fiscal incentives. One reason for this is to ensure that the tax burden in SEZs is not out of line with the tax rates paid in the investors' home countries or other potential investment locations. Tax incentives may also help to attract first movers who may be uncertain of the area's competitiveness and cannot be sure that they will benefit from the arrival of more businesses. Incentives for first movers – especially if they are anchor tenants – may also improve the commercial viability of the zone itself, as was the case when Intel opened factories in Costa Rica.

The Chinese zones illustrate that SEZs need to offer investors something different if they are to markedly improve a country's economic prospects

### *3. The rest of the host economy also has to work*

Although SEZs are usually spatial enclaves, the extent to which they can function effectively and benefit the host economy as a whole depends on wider economic conditions. External factors that matter include the exchange rate, the availability of skilled workers, the quality of surrounding infrastructure, trade and regulatory obstacles, input costs, the size of the domestic market, and so on. The more business-friendly the surrounding economy, the more potential an SEZ has to stimulate economic activity. However, if key input costs are high or the business environment is poor, it will be harder for entrepreneurs to take advantage of successful businesses in the SEZ.

An important factor that affects all businesses producing goods for export or competing with imports is the exchange rate. If the local currency is overvalued (or the currencies of competing countries are undervalued), competitiveness will be reduced. This is obviously less true of products that are themselves import-intensive, but when local inputs and labour costs make up a significant proportion of total costs, an overvalued currency undermines competitiveness.

Another factor that affects the competitiveness of SEZs is the availability of skilled workers. A skills shortage (which constrains business growth and raises the costs of skilled labour) is a challenging gap for any economy to fill: education reform is slow, and it takes a long time before more skilled people start emerging from the system. Successful SEZ programmes must ensure that employers have access to the skills they need. In some countries, this has been achieved by locating SEZs in regions where the population is better educated or by aligning interventions in secondary and tertiary education with skills needs in te SEZs. Sometimes specialised skills development centres are built to ensure access to skills or knowledge institutions are brought into an economic zone. There is some evidence that SEZs can help to create skills. Large productivity gains in SEZs have occurred through on-the-job training. International experience shows that local workers employed by foreign companies quickly become as productive as workers in the same firm's plants anywhere else in the world.

### IMPROVING THE BUSINESS ENVIRONMENT: MAURITIUS

Until the 1970s, the Mauritian economy was dominated by agriculture. Education was poor, and employment in domestic industry was limited to heavily protected sectors. It then liberalised trade, adopted a realistic exchange rate, and opened the economy to foreign investors via an SEZ programme.

Unlike many other programmes, companies with SEZ status were allowed to locate wherever they wished, and were exempted from labour regulations applying in the domestic economy. Many of the companies attracted were active in the garment sector.

Initially, wages reflected low levels of productivity. But rapid growth in exports and consequent demand for labour forced real wages in duty-free manufacturing to rise by 57 per cent between 1985 and 1996. In addition, labour regulations applicable to firms with SEZ status have become more stringent over time.

Thanks to the performance of firms with SEZ status, between 1970 and 1996 Mauritius ranked seventh among middle-income exporters of manufactured products.[28] By 2000, export earnings from SEZ firms had reached about 70 per cent of total exports. By 2008, exports had reached more than $1,2 billion, involving 413 companies employing some 65 000 workers.

In Mauritius, SEZs facilitated the development of a policy environment that improved the business climate for all firms. Initially, foreign investors owned nearly 100 per cent of firms with SEZ status. However, indigenous workers and managers began to use know-how and experience gained in foreign-owned SEZ plants to set up their own companies.[29] By 2000, indigenous investors accounted for 50 per cent of the total equity capital in SEZ firms.

Source: T Moran, International Experience with Special Economic Zones, paper commissioned by CDE, 2011.

Businesses in SEZs are most likely to create large numbers of jobs if the package of benefits derived from locating there meets the needs of labour-intensive industries

*4. SEZs should offer tailored solutions to problems faced by local businesses*

Although it is widely believed that multinationals invest in SEZs in order to take advantage of cheap local labour, most FDI (including investments in SEZs) is in medium-skilled industries. SEZs can tailor their offerings to specific sectors and subsectors across the industrial spectrum. The key, however, is to ensure that the zones help address whatever constraints limit the growth of those sectors elsewhere in the economy.

A contested issue is whether firms located in SEZs should be allowed to sell their goods domestically or be required to export everything they produce. It could be argued that allowing these firms to sell their goods locally would give them an unfair advantage over domestic firms which do not benefit from the concessions available in the zone. However, barring firms in SEZs from participating in local markets could make those zones less attractive to investors. In this regard, practices vary across the world. Businesses located in SEZs in China, India, Brazil, among others, are treated as if they were located in foreign countries.

Another consideration is that restricting SEZ-based firms to export markets might make SEZs more politically palatable to unions and local business because they would have no adverse impact on employment in local firms supplying the domestic market.

### 5. The costs and flexibility of employment matter

Businesses in SEZs are most likely to create large numbers of jobs if the package of benefits derived from locating in the SEZ meets the needs of labour-intensive industries. This could be controversial as the major constraint on such firms is usually the labour market regime, which typically enjoys the support of key constituencies and interest groups. Nevertheless, flexible labour markets are essential if SEZs are to be globally competitive and attract labour-intensive industries.

In this context, the degree to which a labour market may be thought of as flexible is only partly related to the existence and level of minimum wages. Other important aspects of the regulatory regime are overtime rules, legal conditions governing temporary employment and/or piece-work, shift systems, rules of dismissal, and so on. Flexibility is most important for labour-intensive industries, many of which operate in conditions in which order-flows from customers are erratic. Employers' ability to adjust the size of their workforce in response to these variations is an important determinant of their competitiveness, and may be more important than wage levels.

### 6. SEZs are badly suited to uplifting poor regions

In Mauritius, SEZs facilitated the development of a policy environment that improved the business climate for all firms

Some of the least successful SEZs have been set up as vehicles for developing poorer regions of a country. The weakness of this model is that there are often good reasons why some areas are less developed than others: a lack of infrastructure, limited access to skilled labour, distance from markets, etc. To overcome all these disadvantages, SEZs would have to offer extensive subsidies or require levels of investment in public infrastructure that are not economically viable.

### 7. SEZs don't work unless government gets behind them

Effective SEZ policies and operations require the coordination of a number of government departments. Generally, the highest levels of government must be committed to making SEZs work, if only because the zones will require government entities to do some things differently from how they do them elsewhere. Achieving this requires strong leadership and high levels of political oversight, often for a sustained period.

International best practice suggests that SEZ regimes should be administered by an autonomous but powerful government authority which:

- oversees the administration of dedicated laws, regulations and practices inside the SEZs;
- provides regulatory oversight for the SEZs' developers, operators and occupants;
- ensures the efficient delivery of various services (including regulatory services); and
- regulates economic activity, controls land use, and acts as the principal interface with private developers and operators.

### 8. The most successful SEZs are public-private partnerships

The model of SEZs that are regulated, developed and operated exclusively by government has largely been discredited. Analysts and planners agree that there has to be a strong business case for SEZs to be successful.

Given this, it follows that they should be run by businesses that also bear the risk of failure. In many cases governments will need to provide various forms of support in order to ensure that each SEZ generates attractive levels of risk and reward. Typically, private sector players should take on the financial risk of developing, promoting and operating SEZs, but governments may need to provide appropriate infrastructure and, in some cases, commercial or financial guarantees.

*9. Effective investment promotion agencies are a vital part of the SEZ strategy*

SEZs work best when their host countries have effective investment promotion agencies which actively seek to attract FDI. Many countries have weak investment promotion agencies with poor institutional structures, inexperienced staff, and a passive 'strategy' of waiting for investors to show up. Many then seek to screen investment, acting like investment *prevention* agencies by, for example, imposing informal performance requirements on foreign corporations as a condition of entry.[27] Moreover, the term 'one-stop shop' seems to imply that such bodies can provide authoritative commitments across a wide range of regulatory and licensing requirements. However, these bodies are often involved in turf battles with various government departments. In the process, they cease to be one-stop shops and become one-*more*-stop shops.

The model of SEZs that are regulated, developed and operated exclusively by government has largely been discredited

In summary, a significant number of SEZs have been spectacularly successful, and have transformed the economies of their host countries. Many others have failed to set themselves apart from the rest of the economy, create sufficiently attractive business environments, or compete internationally. They are, therefore, not an automatic or universal panacea to a country's growth or employment challenge.

That said, SEZs are a key platform for export-oriented industries, contributing significantly to global trade, attracting vast flows of FDI, and employing millions of people.

If South Africa is to exploit these opportunities, it will have to change its approach significantly. The country has to be far clearer about precisely what role SEZs should play, what industries should be targeted, and how the specific challenges faced by those industries should be addressed. One key issue is the degree to which SEZs should be used as a vehicle for promoting labour-intensive economic activity. Key constraints on labour-intensive economic sectors in South Africa are the high costs of labour and inflexible employment rules. If SEZs are to become platforms for large-scale job creation, these will have to be addressed.

# Concluding remarks and recommendations

Special economic zones are policy tools. They are well-suited to some policy goals, and less appropriate for others. When well-designed and implemented, they have helped countries around the world to grow their economies, create millions of jobs, develop and diversify their industrial sectors, and compete in global markets. However, they cannot solve every challenge that confronts business. To be most effective, SEZs must form part of a broader national development strategy that includes infrastructure, good governance, flexible labour markets and skills-building.

Given all this, how should South Africa set about redesigning its SEZ programme? Before answering this question, we need to ask what South Africa wants to achieve with this programme.

## Why have special economic zones in South Africa?

One way to frame the issue is to ask whether SEZs are best thought of as stand-alone interventions or as vehicles for addressing broader policy challenges. In principal, they could play either role or both of them.

In very poor countries where a wide range of institutional and policy failures make doing business exceptionally difficult (such as Bangladesh), SEZs can be places where government concentrates its limited regulatory, infrastructural and fiscal resources in order to attract foreign investors. In other countries (like China), SEZs have been used as enclaves for implementing policies which differ radically from those governing the rest of the national economy. This allows government to assess the impact of various policy reforms and create a constituency that will support and drive further reform.

South Africa's SEZ programme should seek to achieve both goals. On the one hand, government should create areas where it is considerably easier to establish and run globally competitive businesses – particularly labour-intensive businesses – than it is elsewhere in the economy. These 'zones of exception' may always be distinct from the rest of the economy, and the economic rules may always differ from those governing the rest of the economy. However, government should also use SEZs as a testing ground for new policy options. Locating those experiments in separate enclaves will allow government to reduce or avoid confrontations with entrenched interest groups opposed to wider reforms.

Without its SEZs, China (and the world) would look very different today

SEZs, then, could be distinct, productive economic areas in need of no other justification than their contribution to the economy. But they could also be policy laboratories in which government tests new ways of creating investor- and business-friendly environments. Should these experiments succeed, these approaches could be rolled out to the rest of the economy. International experience shows that the 'demonstration effect' of successful SEZs facilitates wider economic reform. This has certainly been the case in China, where Deng Xiaoping's initiatives in the 1980s and 1990s to attract FDI and expand exports through SEZs led to accelerated economic reform. The same is true of Mauritius, Costa Rica, the Philippines and elsewhere. This potential for positive policy spill-overs into the rest of the economy is the greatest promise held by SEZs. But precisely what policy reforms does South Africa need?

## South Africa's priorities

South Africa's unemployment crisis is one of the most severe in the world. Even using the narrow official definition, a quarter of all adults are unemployed, and the figures are far worse for younger people, women, and people with limited education. Some six million people who could and should be working are out of work. Addressing this is widely recognised to be the county's overriding political and economic priority.

Although government has acknowledged the scale of the challenge, and although many of its policy proposals are justified by their supposed role in addressing it, the rate of job creation is far too low. There are many reasons for this, but one of them is that many of government's policies are aimed at expanding industrial sectors that are unlikely to absorb more than a fraction of the unemployed. For the most part, this is because the sectors in question are relatively capital-intensive and rely heavily on skilled labour. South Africa has a serious shortage of skilled workers, so, with few exceptions, skilled people do not appear to have much trouble finding work. For this reason, the proposed solutions to the general crisis of unemployment are often ill-suited to the nature of the country's challenge.

The challenge is so large that a number of initiatives are needed to address it. SEZs could play an important role. In other countries where business conditions were less than ideal, governments used SEZs to create enclaves in which investors could more easily set up new firms and employ large numbers of people. When well-designed and implemented, such zones have achieved impressive results, not just in boosting economic activity, employment and exports, but eventually transforming the host economy as well. Without China's SEZs, it (and the world) would look very different today. The same is true of many other developing countries, including Mauritius, Costa Rica, Malaysia and the Philippines.

At the same time, many – perhaps most – SEZs have failed. Thus a recent World Bank report concluded that, except for Mauritius and perhaps Kenya, almost every SEZ programme in Africa has failed to meet its objectives.[30] This is because they lack strategic focus, they are in the wrong places, the authorities overseeing them are weak, stakeholders are poorly coordinated, and their host countries rely too heavily on tax incentives to support the programme. As a result, these zones have not offered real solutions to the problems faced by businesses. Little wonder, then, that they have failed to attract investors.

This, too, is the nub of the case against South Africa's existing IDZs, which have failed to attract new investors largely because, impressive as some of the infrastructure may be, they do too little to address the other challenges faced by businesses.

If South Africa's revised programme is to avoid this fate, the government will have to create a business environment that addresses key challenges faced by firms trying to compete globally. While addressing any of these challenges individually should, in principle, improve competitiveness, expanding some kinds of industry – particularly labour-intensive industries – requires substantial progress on various fronts.

We have to make sure that the country does not – once again – fail to capitalize on the opportunities that can be delivered by successful SEZ programmes, which have proven their worth around the globe

## Existing industrial policies reinforce a bias against employing unskilled labour

South Africa's existing industrial policies, as well as the policies embodied in many new proposals, tend to reinforce biases in the economy that privilege skilled workers and capital-intensive production techniques. The Round Table was presented with evidence that South Africa is not (as is often claimed) de-industrialising, and that levels of capital-intensive manufacture are not unusually low. At the same time, levels of labour-intensive manufacturing are much lower than they ought to be for a country at our level of development.

A number of implications flow from this. The first is that South Africa's capital-intensive products are reasonably competitive and comparative advantages in some sectors are being exploited. The second is that capital-intensive manufacturing may not be able to play a much larger role than it does now. These sectors could be encouraged to grow further in various ways. However, if their share of the economy is already at or near the global norm, it is unlikely that their share of national output will be doubled or tripled. Under what circumstances would South Africa succeed in building a disproportionately large capital-intensive manufacturing sector? And if it did, would the effort to achieve this not introduce significant new distortions into the economy?

This is a key issue because some government officials appear to believe SEZs should primarily be used to expand capital- and skills-intensive manufacturing, either by attracting businesses in sectors that are already skills- and capital-intensive or by offering subsidies based on the value of investment. While there is nothing wrong with trying to expand these economic sectors, the hard truth is that they will not absorb a large proportion of the unemployed. Given the profile of unemployed people, pursuing a strategy aiming at creating and expanding high-productivity, high-wage jobs fails to address the reality of the country's unemployed population. South Africa desperately needs to create jobs for unskilled workers with little or no work experience. The only plausible way of doing so is in low-skill, labour-intensive industries.

Jobs in these sorts of industries are far from ideal: wages are low, working conditions are poor, and job security is not what many would wish for. This is why South Africa's policy-makers have rejected policy options that would encourage the emergence of these types of industries. Indeed, they have sometimes sought to close down industries and firms that offer this kind of work, as demonstrated by the aggressive pursuit of employers in Newcastle's garment industry who have sought to bypass statutory minimum wages in order to save jobs.

If the exchange rate cannot be easily depreciated, other aspects of South Africa's competitiveness will have to be improved even more

However, the alternatives faced by these would-be workers are even worse: unemployment, poverty, and permanent exclusion from the main currents of social and economic life. Besides the human costs, the political consequences of millions of unemployed people having no jobs and having little prospect of ever finding work are also serious.

## Competing in labour-intensive manufacturing means cutting costs to a minimum

What could be done to promote the emergence of firms employing large numbers of unskilled workers? The key issue here is what could be done to make them globally competitive.

- *Labour costs would have to be low*. Although labour costs are rising in China's manufacturing sector, they are still lower than those in South Africa. This is true of other developing countries, too. South African businesses paying higher wages can only be competitive if productivity levels are also higher. Achieving this, however, usually implies mechanisation, a strategy that reduces labour-intensity and results in less employment growth per unit of economic growth. If South Africa is to create large labour-intensive industries, an environment has to be created in which labour costs can compete globally.

- *Conditions of employment would have to be more flexible*. Labour-intensive companies, especially light manufacturing plants, often have to deal with fluctuating demand. Employers who are unable to hire and lay off temporary staff or structure shift systems in line with demand, will struggle to compete with rivals in countries where this is easier to do.

- *Other input costs would also have to be competitive*. Even the most labour-intensive businesses require more than just unskilled workers to succeed. Firms also need cheap and reliable infrastructure and services, as well as physical inputs. This presents many challenges, including improving services currently provided by inefficient and monopolistic parastatals. Durban's port, for example, is said to be the most expensive in the world.[31]

Production costs are also driven up by the shortage of skilled workers. Labour-intensive firms ought to be less affected by this than other firms, but the scarcity of skills would still hamper their emergence and growth. South Africa needs to manage two processes simultaneously: improve education and training, which will begin to address the problem in the medium to long term; and recruit foreign skills much more aggressively to plug the gap in the short term.

- *Firms would need access to global markets.* This is essential to reach effective economies of scale. Light manufacturing firms could only employ large numbers of unskilled workers if they were substantial exporters. This requires cheap and reliable transport systems and appropriate trade policies.

- *A more competitive exchange rate would help.* The exchange rate plays an important role in determining the competitiveness of export industries. While exports that are themselves import-intensive can benefit from a strong currency, the more labour-intensive a product, the greater the impact of the exchange rate on its global prospects. There is no doubt that the level and volatility of the exchange rate has hurt exporters. Managing the exchange rate is complicated, and it is not clear what (if anything) can be done to depreciate the currency without encouraging inflation. If the exchange rate cannot be easily depreciated, other aspects of South Africa's competitiveness may have to be improved even more.

- *Governance policies and regulatory frameworks must be clear and inviolable.* Investors are reluctant to invest in areas where they believe their property may be taken from them. This applies to government expropriation as well as risks associated with crime and with weak judicial systems unable to act against defaulting creditors. Some issues surrounding black economic empowerment codes and changing goalposts may also deter investors. The recent e-tolling debacle provides another source of uncertainty for investors. Fundamentally, investors need to know that policy commitments made in one period will be complied with in the next.

Current economic policy is skewed towards high-skills and high-wage methods of production, which do not address the core of South Africa's unemployment crisis

Taking all these steps would benefit the entire South African economy. Achieving them everywhere at once may be difficult. Problems include technical and logistical challenges as well as administrative deficits. Moreover, some of these measures would probably be opposed by organised labour, some companies whose profits might be threatened, and skilled workers earning a wage premium. Progress is likely to be slow, difficult and politically disruptive. This is one reason to experiment with reform in SEZs. Another is that doing so could help overcome one of the arguments made against wholesale labour market reform, namely that the government does not have a mandate to embark on this, having been elected on a platform that included high levels of worker protection.

Because one of the properties of an SEZ is that those who find work in it are 'opting in' to its labour market regime, it would be far harder to make the case that hard-won worker rights were being undermined through labour market reform. Instead, it could be argued that SEZs are aimed at providing jobs for people who can't find jobs elsewhere and who are willing to accept a different labour regime. This principle is already reflected in the Expanded Public Works Programme, which permits lower wages than the statutory minimum wages in the agricultural sector, for example, so that it does not draw labour out of that sector. As a result, those who accept EPWP jobs are, in effect, opting into a different labour market regime.

## The way forward

If South Africa is to create jobs for millions of unskilled and inexperienced workers, it needs to create the right conditions. SEZs could play a useful role, particularly if they are used strategically to address the constraints faced by potential employers of unskilled labour. For this reason, South Africa should establish at least two large SEZs designed to meet the needs of low-skill, labour-intensive businesses. This strategy will require policies that:

- reduce the costs of producing goods and services;
- create more flexible employment relationships;
- provide access to international markets;
- ensure easy access to skills (including foreign skills); and
- offer credible guarantees that policies in the zones will be sustained in the medium and long term.

South Africa should establish at least two large SEZs designed to meet the needs of low-skill, labour-intensive businesses

These zones will have to be large enough to allow labour-intensive businesses to emerge. They will also need major road, rail, and shipping linkages; electricity, water, and other major services; and professional and technical services. Effectively, this means they need to be in or near large urban centres. These are the key ingredients of an SEZ programme aimed at the rapid expansion of labour-intensive industry. However, the international evidence suggests that five other factors will also be important:

- the SEZ programme needs to be a presidential priority, thus ensuring that the DTI is supported by all other relevant departments;
- SEZs must largely be run by the private sector who are taking the investment risk;
- government must actively promote SEZs which means that the country needs a 'best in class' and competitive approach to investment promotion;
- government must reduce the red tape hampering start-ups by establishing genuine one-stop shops; and
- local education and training institutions need to be geared towards providing relevant skills, while the country also makes it easier to access foreign skills.

South Africa could also establish zones for more sophisticated businesses. However, these sorts of companies may not need, or be attracted by, SEZs. It is not clear, for example, why businesses serving offshore oil and gas operations require an SEZ (as is being contemplated in Saldanha). There may be good answers to this question, but the establishment of medium- to high-skill SEZs should be decided on a case-by-case basis after careful assessment of the needs of particular industries and the constraints they face.

In any event, whether targeting labour- or skills-intensive industries, SEZs would need to be globally competitive if they are to succeed. They need to offer business propositions that encourage investment and expansion. Exactly how this should be done will depend on each industry or sector. However, it is clear that current economic policy is skewed towards high-skills and high-wage methods of production, which do not address the core of South Africa's unemployment crisis. A paradigm shift is required, which may best be facilitated through a new policy instrument and experimentation.

More of the same will fail to do anything more than nibble at the margins of the problem. SEZs represent a major opportunity to do things differently.

The Special Economic Zones Bill has not been finalised, and much of the detail has been left open to interpretation in later regulations or through the decisions of the proposed SEZ Board.

The international experience is clear, and our past experience with IDZs is a lesson in what not to do. SEZs represent a major opportunity to do things differently.South Africa needs to address the factors hindering its competitiveness. Potential investors – in Asia, South Africa and elsewhere – need to be consulted and their views taken into account by government. This is the only way to make sure that the special nature of the proposed zones, actually addresses the obstacles faced by labour-intensive industries.

Well-designed SEZs have proven to be a remarkable tool for growth and job creation around the world. Costs in Asia, especially China, are rising and there is much talk of millions of labour intensive firms looking for new regional locations. South Africa should seize this new opportunity. This will require bold leadership and engagement with difficult choices that must be made. The alternative is to waste resources and energy yet again on a policy that fails.

SEZs represent a major opportunity to do things differently

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