

What if South Africa had a
special economic zone
that was actually special?



GROWTH AGENDA
Priorities for mass employment and inclusion



About CDE

The Centre for Development and Enterprise (CDE), an independent policy research and advocacy organisation, is South Africa's leading development think tank. Since its establishment in 1995, CDE has been consulting widely, gathering evidence and generating innovative policy recommendations on issues critical to economic growth and democratic consolidation. By examining South African and international experience, CDE formulates practical policy proposals outlining ways in which South Africa can tackle major social and economic challenges. CDE has a special focus on the role of business and markets in development.

CDE disseminates its research and proposals to a national audience of policy-makers, opinion formers and the wider public through printed and digital publications, which receive wide media coverage. Our track record of successful engagement enables CDE to bring together experts and stakeholders to debate the policy implications of research findings.

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Photo credit: Textile factory machinist working in production line, Hongqi Zhang, Alamy

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Introduction

In November 2019, CDE, in partnership with the International Growth Centre (IGC), hosted a roundtable involving some of the world's leading experts on special economic zones (SEZs). This included Thomas Farole (Lead Economist in the World Bank's Social Protection and Jobs Global Practice), Stefan Dercon (Professor of Economic Policy at the Blavatnik School of Government and the Economics Department at Oxford University), Rocco Macchiavello (Associate Professor in Management at the London School of Economics), and other experts from London School of Economics' IGC. The event was also attended by managers of SEZs around the world, including those in Uganda, Ghana, Zambia, and Myanmar.

CDE's past publications on SEZs

CDE has written several reports on SEZs in recent years, some of them written by or in collaboration with David Kaplan, Professor of Business and Government Relations at the University of Cape Town and a former chief economist of the Department of Trade, Industry and Competition (DTIC). Our reports include **The Growth Agenda: An EPZ for Nelson Mandela Bay** in 2016, which was preceded by a 2012 review of international experience, **Special Economic Zones: Lessons for South Africa from international evidence and local experience**. This first report arose from a CDE roundtable funded by Blue IQ, the Gauteng provincial government, and Business Leadership South Africa. In addition to a number of op-eds and opinion pieces for a range of local publications accompanying these reports, we prepared a submission on the desirability of establishing an SEZ for the 2018 Presidential Jobs Summit.

This followed considerable work on SEZs by CDE over the past decade (see box). The current report is intended as a summation of what we have learnt in that time. It is intended as a clear statement of what SEZs could offer South Africa in the country's ongoing, but tragically delayed, quest to achieve faster employment growth. We make the case for SEZs again, in part, because our argument has been enriched and sharpened, but also because South Africa's debate about SEZs has changed, with new voices – including many in or close to the upper reaches of the ruling party – increasingly expressing interest in implementing an SEZ of the kind we describe below: one that is focused on attracting firms engaged in the production of labour-intensive goods and services intended for export.

(see box on page 15), the High Level Panel, chaired by former President Kgalema Motlanthe (see box on page 13), and the National Treasury (see box on page 5). In addition, influential voices such as Joel Netshitenzhe, Executive Director of MISTRA and ANC NEC member, international SEZ expert Claude Baissac, and former CEO of Goldman Sachs for Sub-Saharan Africa Colin Coleman have all also identified themselves with recommendations for the establishment of such a zone.

The most important of these new voices include the African National Congress

To be clear, not all of these proposals are identical, and there are important differentiators between our proposals and some of the others on the table. It is, nevertheless, encouraging that there are more voices calling for the use of SEZs, and we will have something to say about some of these proposals in the pages that follow.

Joel Netshitenzhe on SEZs

"In my view through appropriately designed and located SEZs, we can take advantage of the off-shoring that is currently happening from China as it climbs up the manufacturing sophistication ladder.

"Now as China's wages are increasing and this manufactured output is becoming more sophisticated, the estimation is that 85 million jobs would be off-shored from China. The question is how can South Africa take advantage of that, but with the qualification that doing that should not result in subtracting from the rights that workers who are already in decent jobs are enjoying because attracting low end manufacturing should not result in lowering the standards of those who are already in decent jobs."

Joel Netshitenzhe, Executive Director, MISTRA, March 2017

The final reason for this report is that, while South Africa has a number of SEZs, these are not likely to achieve what we think is necessary: the creation of a significant number of low-skill jobs in export-oriented activities. The need for this has never been clearer.

South Africa's economic woes are deeper now than they have ever been. Average annual growth has been falling more or less continuously since the 1950s, but it is now well below the rate of population growth. Under those circumstances, it is all but inevitable that unemployment will surge to catastrophic levels – as it had done even before Covid-19 knocked the wind out of the sails of an already-distressed economy. And it is this context – a massive unemployment crisis followed by a once-in-a-century economic crisis – that reinforces the need for sensible growth and employment-friendly policy

responses. Especially helpful would be initiatives that do not require the outlay of scarce tax revenues.

This is why it is so important to revisit the discussion of SEZs and to think as clearly as possible about what they can and cannot achieve, and how South Africa might sensibly use one or more SEZs to address some of the manifold challenges we face in recovering from Covid-19 and building a more inclusive economy.

Why SEZs?

A practical definition of an SEZ is that it is a geographically defined area in which government provides specific services or benefits to firms so that they are able to grow more rapidly. Precisely what benefits are provided varies considerably, and much depends on what role is ascribed to the SEZ (and the firms located in it) in the state's industrial and economic policies.

Thus, while most SEZs offer fiscal incentives (especially tax breaks) of some form, these are by no means the only kind of incentive for SEZ-located firms. In some SEZs, it is subsidised provision of basic infrastructure (factories/buildings); in others, it is improved, preferential, or subsidised access to certain kinds of bulk infrastructure (electricity, ports, sanitation services) or public services (customs control); in yet others, it is exemption from legal provisions governing economic activities in the rest of the economy (permitting the private ownership of businesses, the participation of foreign-owned companies, and/or the repatriation of profits).

To the extent that an SEZ is a success, in other words, the key issue is the degree to which the business environment in the zone differs from that of the rest of the economy. It is, of course, possible for SEZs to appear to succeed without their being particularly different from the rest of the economy, as would be the case, for example, if the whole economy were growing quickly. And this is one of the challenges of assessing SEZ policies: how much of an SEZ's apparent success is attributable to the SEZ and how much to the effects of dynamics pulling the rest of the economy? This is another way of asking an important question that is not always addressed with sufficient rigour in discussions about SEZs (particularly in South Africa): how much value is created from the resources devoted to an SEZ that would not have been created in the absence of the SEZ and its particular policy regime? This is the vexed question of an SEZ's additionality: what does it actually add to the economy?

This is a question to which we will return below. Before we get there, we should ask another: what would justify a decision to offer some firms special advantages merely because they are located in a particular place? What, to state it bluntly, is an SEZ for?

On the definition of 'SEZ'

"In order to design an SEZ policy, we must first agree on the definition of 'SEZ'. An SEZ must have a special characteristic; it must be distinguished from the rest of the economy by being more liberal and flexible with regards to policy; and it must also be more effective from an administrative perspective. So, a good definition of 'SEZ' is a formally incorporated geographic area with a single administration bureau, as well as specially provided infrastructure and incentives, fiscal and non-fiscal, such as a one-stop service shop or custom procedures. This definition is important because SEZs must be differentiated and flexible to respond to the specific requirements of a local context."

Shwe Hein, Secretary of the Thilawa SEZ (Myanmar), CDE, November 2019

The rationale for SEZs

In practice, the most successful SEZs in the world are those that have been instruments for supporting industrialisation and integration into global trade flows. Zones that have achieved this – whether in Mauritius or China, Thailand or Malaysia – have transcended their establishment as spatially distinct enclaves, and have helped drive economic transformation in their host economies. Of course many – perhaps most – SEZs do not do this (or, to be more generous, have not yet done so). But, as Professor Rocco Macchiavello highlighted in his presentation to CDE, to the extent that SEZs have been part of a process of driving major improvements in a country's economic performance, they have generally achieved this because they have been able to address significant market failures or policy deficiencies.

SEZs and market failures

There are a number of different kinds of market failure that an SEZ might conceivably help address. One is that there may be potential productivity spill-overs that an economy could capture if only there were economic agents willing to engage in a particular kind of economic activity.

This is one of the key arguments for industrial policy generally, as it is premised on the idea that some kinds of activities produce benefits that extend beyond those participating in them directly – the firms and workers and customers of the industry. They may, for example, raise the productivity of other agents in the economy

through the transfer of knowhow and technology, initially at least, by raising productivity up- and down-stream from a particular point in the value chain. When positive externalities of this kind exist, society would benefit if there were more firms engaged in the activity that is the target of industrial policy intervention than would be the result purely of market forces. In these cases, the state's incentivising of that activity is justified if it can ensure that more of it takes place. One way to do this is by establishing an SEZ in which the business environment is tailored to the needs of firms engaged in activities of that kind. An SEZ, in other words, might be developed in which firms of the right kind would grow to a size that they would not reach if they were located elsewhere in the economy.

“The most successful SEZs in the world are those that have been instruments for supporting industrialisation and integration into global trade flows.”

Caution needs to be applied when this kind of argument is made, however, since policymakers have had, at best, mixed results in designing policies that actually capture the externalities that the proponents of these policies claim are there to be captured. Such interventions may also cost more than the benefits accruing from them. Given this, and as a general rule, we think the burden of proof should fall on those making the case that there are positive externalities ready to be captured, and that we should set a much higher bar for evaluating those arguments than has generally been the case in the debate about industrial policy in general, and SEZs in particular, in South Africa. Happily, however, this is not the case that CDE is making for SEZs, which

we think offer a different kind of benefit: they may be a way around the vexed political challenges that slow the pace of economic reforms, often to a standstill.

SEZs as a tool for reducing policy constraints

A qualitatively different motivation for the establishment of an SEZ relates to their potential as solutions to policy constraints of various kinds. This argument relies less on the existence of supposed economic externalities that may supposedly be captured, and more on the idea that it might be easier to address some kinds of policy deficiencies piecemeal, or in geographically defined zones, than it would be to implement those reforms nationally. It is quite common, for example, for policy-makers and reformers to believe that a particular set of policies could be advantageously pursued, but find themselves unable to muster the political capital needed to overcome the resistance of those who believe that their interests will be compromised by those reforms. In these cases, an SEZ might become a kind of policy laboratory-cum-shop-window in which the impact of proposed reforms can be tested and their benefits demonstrated to sceptics. By confining the reform to a spatially defined enclave, so the thinking goes, it may be possible to minimise resistance that might otherwise prove to be insurmountable.

Understood in this way, an SEZ is sometimes seen as a policy of the second best: the optimal approach, from the point of view of proponents of the desired reforms, would be to implement those reforms in the economy as a whole and to reap the full rewards for the accelerated growth that would follow. By contrast, an SEZ may make it possible to effect the reforms, but at the price of delaying the full-blown reforms that are actually needed. Worse, they may make the full reforms less likely: if, for example, the SEZ is perceived to have failed – perhaps it lacked the scale to achieve take-off velocity or perhaps its second-best character meant that business did not respond as enthusiastically as they might have done to economy-wide reforms – reformers may find that the energy put into establishing an SEZ has backfired and has made it even harder to achieve their true goal.

National Treasury on SEZs in South Africa

"There is a need for more experimentation and piloting of industrial policy options... Special economic zones (SEZs) can be effective tools in this regard. SEZs allow the scope to experiment with policies on a small scale before rolling them out to the wider economy (if it makes sense to do so). In China, the Shanghai Free Trade Zone piloted reforms before they were implemented nationally.

In South Africa, broader questions need to be asked about the efficacy of how SEZs are currently being used as industrial policy instruments. It is unclear whether the incentives put in place to encourage firms to locate in SEZs, such as lower corporate income tax rates, are effective at crowding in the desired private investment. We need to develop a more nuanced understanding of the circumstances under which SEZs are most effective by understanding which SEZs are successful, what makes them effective, and whether they are appropriate tools for clustering industrial activity and addressing unequal spatial development. Answering these questions will enable a process to improve the design, functioning, and ultimately the impact of SEZs as a key industrial policy tool."

National Treasury (2019), Economic transformation, inclusive growth, and competitiveness: A contribution towards a growth agenda for the South African economy, p. 68

While all of this is true, it is also true that the world is complex and that the impact of policy reforms is hard to predict. As importantly, their impact is hard to predict in a way that is credible to all role-players. An SEZ, therefore, can be used to test the potential impact of new policy ideas. As a vehicle for experimentation, an SEZ loses its 'second best' status, and becomes something quite different: an acknowledgement that change is needed and that the effects of one or other kind of change need to be assessed before being rolled out. This, in fact, is one of the central arguments made for the establishment of an SEZ by the National Treasury (see box), although they also question whether the impact of South Africa's existing SEZ programme and incentives is sufficiently well understood, an issue to which we return below.

When SEZs succeed

No one thinks that SEZs are fail-proof panaceas: many have failed; some are white elephants. The most successful SEZs are those that have become instruments for the accelerated integration of domestic economic activities into global trade, and that have made possible the combining of foreign companies' technology and knowhow with local labour in such a way as to open

up new markets for the host economy. Much of the benefit here is simply that of scale: the vastly larger size of the addressable market for goods when firms are able to tap into global demand means that one of the most critical constraints on domestic firms' growth – the size of the domestic market – is alleviated. And, because the number of people a firm employs depends on how much of its output it can sell, access to a global market vastly increases the potential for employment growth.

Using SEZs to bring local firms together with foreign managers/investors (who know global markets and who also know how to run the relevant production processes optimally) is also a special case of the more general goal of capturing productivity spill-overs described above, because it facilitates the transfer of relevant knowhow, which, in turn, leads to faster and wider industrialisation across the whole economy.

This, roughly speaking, is the story of successful Chinese SEZs. Other zones have not been as transformative on so world-historical a scale, but there are plenty examples of zones that have made meaningful contributions

On SEZs and white elephants

"Many countries look to China and the classic story of Shenzhen, which was a little fishing village that within 20 or 30 years became a massive city. And then, on the opposite end of the spectrum, you have a place like Tinapa Resort in the Calabar Free Trade Zone, which was set up to become a commercial hub for West Africa. At least that was the vision. But it was done in an environment in Nigeria where there's very bad coordination among different parts of government. \$450 million was invested into this zone. The initial plan was that they were going to attract plenty of people from all over West Africa who go duty-free shopping in London and Dubai. But they put in the investment before they got an agreement with customs, and in the end customs gave a deferment of only \$300, which effectively killed off the zone. This is a classic white elephant story."

Thomas Farole, Lead Economist in the World Bank's Social Protection and Jobs Global Practice, CDE, November 2019

to the development of their host economies, including in Mauritius, Costa Rica, Malaysia, Myanmar, and elsewhere, largely by facilitating the more rapid insertion of local workers and firms into global trade flows. Much of this has been achieved by creating the conditions needed for firms to participate efficiently in the partial manufacture or assembly of mass consumer goods.

When SEZs fail

But zones often fail to reach their – sometimes over-ambitious – targets. And, when they fail, it is usually for one of a handful of reasons. One of the reasons for an SEZ's failure is that the problem the zone's designers hoped to solve was not actually amenable to solution through a zone. The zone was the wrong instrument, when others might have been more appropriate. This is the case, for example, when zones are created in order to address some kind of spatial differentiation in the pace of domestic

industrialisation; when they are established, for example, in the hope that they will become the lynchpin for local development in an underdeveloped area.

Zones are usually unable to achieve this because the underlying dynamics that drive the unequal spatial distribution of economic activity are so exceptionally powerful that the improvements in the local business climate that a zone can deliver – assuming it does deliver them at all – are too small to meaningfully change that trajectory. There are, for example, few if any SEZs that have helped insert host economies into global trade that are themselves not based near a major port. The ambition for South Africa to have one or two zones in each province is therefore unlikely to work: not only are zones' prospects maximised when they are near a port, but there is simply no good reason to think that the optimal number of SEZs in South Africa must be some multiple of the number of provinces.

Another key reason zones might fail is that they are established in defiance of local comparative advantages and resource endowments. Or, as Thomas Farole, one of the World Bank's leading experts on SEZs, told CDE's workshop in November 2019, "Too many places with an abundance of low-skilled labour are trying to use zones to become the next Silicon Valley."

One partial exception to the rule that zones should be aligned to local comparative advantages and be located on a port if they are to succeed is Ethiopia. There, Ethiopia SEZs are aimed at fostering rapid industrialisation in a very poor country whose economy is composed largely of subsistence farming. Yet these zones have

succeeded in attracting significant investment from global textile and footwear manufacturers and now employ tens of thousands of people. Their long-term success is uncertain, however, as CDE learnt from Professor Stefan Dercon, who has worked closely with the Ethiopian state in setting up their zones. He told our workshop that "Ethiopian exports from industrial parks are still 10 per cent of the country's total; they are costing a fortune and the country is now at high risk of debt distress." Dercon suggested, however, that given Ethiopia's limited options, the zones were a gamble that the state may be prepared to back even for an extended period.

SEZs in which the targeted economic activity is not aligned to local comparative advantages and endowments fail because the forces they seek to channel are not easily amenable to redirection, and, as the Ethiopian example shows, overcoming the comparative disadvantages may mean taking big fiscal risks – something South Africa literally cannot afford to do. Even zones that are aligned with the domestic economy's endowments and comparative advantages can fail. This happens when the characteristics of a zone that are intended to differentiate it from the rest of the economy do not do so adequately. These zones fail, in other words, because they are insufficiently special.

"Higher wages paid to those who are employed could actually increase both poverty and inequality if jobs are lost"

This appears to be the fundamental failing of South Africa's industrial development zones (IDZs), the precursors to the SEZs. It is also one possible future for the current SEZs. Consider, in this regard, that the core offering to firms locating themselves in IDZs was a degree of subsidisation in the provision of infrastructure and other services, the costs of which were not fully reflected in the rents charged to IDZs' tenants. The fact that this was insufficient incentive to ensure success is evidenced by the limited success most of the IDZs had in attracting tenants.

To date, some R25 billion has been spent by government on its IDZs and SEZs, although only three of the 11 proclaimed zones have attracted meaningful commercial activity: Coega, East London, and Dube Tradeport. According to the DTIC, these three zones contribute more than 90 per cent of the total rand value of investments and jobs generated by all the SEZs to date. Reviews of the performance of the IDZs, including those used by the DTIC to motivate for the passage of the SEZ Act, have been uniformly critical of the relationship between costs and benefits of the programme. To the best of our knowledge, all the current SEZs are loss-making in that rental income does not cover operational costs, let alone capital investment; none would survive were it not for on-going government subsidies.

The incentives offered by South Africa's new SEZs are somewhat more generous: all employees of firms in the zones qualify for the employment tax incentive and corporate taxes are supposed to be levied at a lower rate, although there are indications that the latter benefit may be withdrawn before it is ever implemented. (If this happens, it should be noted, it will undermine the credibility of the SEZ programme, since SEZ operators have been promising this benefit to potential tenants.)

It is possible that these incentives are sufficiently attractive to generate at least some interest from firms that are starting up or that may be interested in relocating in the quest for lower rents or improved infrastructural

services. It is very doubtful, however, that they are adequate to drive meaningful economic transformation, because the incentives, especially in the absence of the lower corporate tax rate, are unlikely to render these zones sufficiently "special" for them to create new industries or generate very significant new economic activities.

On SEZs and deindustrialisation

The introduction of SEZs, when you already have an existing industrial base, creates the risk of introducing significant distortions. These distortions could accelerate, for example, the phenomenon of deindustrialisation, which is a very real issue in South Africa, where our existing industrial areas – the Vaal Triangle, Mobeni in Durban, and Epping in Cape Town – are turning into rust belts, despite the country investing in their infrastructure. There are roads, railways, pipelines, water, and electricity already set up there. So, why duplicate that in a new zone when there is already capacity to service investors elsewhere?

André de Ruyter, then CEO of Nampak, CDE, November 2019

While our economic environment is far from optimal, it is not clear that subsidising infrastructure provision has ever been the most plausible response to the challenges firms face. This is not to say that firms face no infrastructure-related constraints (or no constraints related to the cost of infrastructure), just that these constraints are on a long list of challenges, many of which are more significant, and it is not obvious that merely alleviating those constraints would fundamentally shift an investment decision. Besides, a legitimate question to ask of the strategy is one framed by André de Ruyter, the current CEO of Eskom but who was at the time the deputy chairperson of the Manufacturing Circle at the CDE workshop in November 2019. What, he asked, is the justification

for investing in new infrastructure at SEZs when the infrastructure in some of South Africa's most developed industrial areas has been allowed to fall apart?

Framed more generally, de Ruyter's point is that you cannot measure the success of a zone merely by looking at the activities taking place in the SEZ and measuring these against the fiscal costs of providing the zone's infrastructure. Instead, a full accounting of the impact needs to assess also the opportunity cost of the subsidies provided to the SEZ. What might have been done elsewhere in the economy with the resources invested in the SEZ? What is the impact on economic performance of the rest of the economy of any additional taxes levied to pay for the SEZs? Which budgets might have been supplemented with the resources deployed in SEZs, and what might have been the effect of that spending?

One way to think about this question is by contemplating a counterfactual. Suppose, for the purposes of illustration, that Alec Erwin, Minister of Trade and Industry from 1996 to 2004, had been successful in pursuing an aluminium smelter as an anchor tenant for Coega when it was being constructed in the late 1990s. A smelter is an enormously capital and energy-intensive business, and, while increased capacity to produce aluminium might have generated thousands of jobs, no international firm would have located a major facility there without enforceable guarantees about energy availability and costs. Had such guarantees been provided at the time – a few years before the start of load shedding and the rapid rise in energy costs – the cost of fulfilling those guarantees would have been felt in much increased load shedding in the rest of the economy and/or very significant energy subsidies for a sustained period.

The failure to secure an aluminium smelter as an anchor tenant, in other words, has turned out to be a bullet dodged. But thinking about what might have happened had the Minister been successful demonstrates just how fallacious it is to define an SEZ's success merely by its being full of tenants. Difficult questions must be asked not just about what is present in the SEZs, but about what its presence has cost the rest of the economy.

These are demanding questions. As far as we can tell, they have never even been asked in relation to South Africa's IDZs and SEZs. Thus, even though it is true that most of the IDZs/SEZs have tenants and employ people, we think the key question to ask of the SEZ strategy is one of additionality: how much economic activity stimulated by the zones would not exist but for the zones?

The case for SEZs in South Africa

The starting point of any discussion about SEZs in South Africa should be the question of what problem they should seek to solve. The current model for our SEZ programme boils down to an industrial park in which the principal incentive for tenants is that rents are lower than they might otherwise be (because the state lays out much of the infrastructure at its own cost while also picking up some of the running costs of SEZs). The theory of the case, in other words, is that new industries can be created – or old industries can be moved to places where they were not previously engaged – if infrastructure costs are subsidised. (Note that other benefits of locating in SEZs have not been delivered: as far as we can tell, no zone has been declared a customs controlled area. In addition, although there were promises that firms located in the zones would pay a lower rate of corporate income tax, this appears never to have been implemented and Treasury appears to be in the process of revoking the commitment altogether.) In the absence of other benefits, subsidising the rents paid by zone tenants is unlikely to be sufficient to drive meaningful changes in South Africa's economic trajectory, if only because the reasons for poor economic growth and even poorer employment growth are too broad and too deep to be addressed so easily. To put it another way, South Africa's recent economic performance – the steep decline in average annual growth reflected in Figure 1 – has not been driven by any deficiency in the supply of the kind of physical infrastructure that can be delivered in a zone, so providing more infrastructure of that kind cannot plausibly generate a marked economic recovery.

This is one of the critical takeaways from the experience of SEZs around the world: they simply cannot solve the deepest problems that an economy confronts, and to think of them in that light is to set them up for failure. To the extent that an economy (whether national or local) is declining – or, indeed, merely stagnating – across a broad range of activities, an SEZ is unlikely to be the right solution to the problem; in these cases, it is not even a second-best solution when compared to a programme of meaningful nationwide economic reform. An implication of this argument is that the case for an 11-strong SEZ programme in South Africa is weak, and that proponents of economic growth and increased industrialisation might be better served by advocacy of broader and deeper nationwide reforms. CDE believes that is a legitimate and serious concern. However, we nevertheless believe that SEZs have a key role to play.

“While our economic environment is far from optimal, it is not clear that subsidising infrastructure provision has ever been the most plausible response to the challenges firms face.”

“South Africa's recent economic performance has not been driven by any deficiency in the supply of the kind of physical infrastructure that can be delivered in a zone.”

The case for an SEZ focused on labour-intensive exports

CDE's case for an SEZ is underpinned by two key facts. The first is that the greatest challenge we face is creating jobs for millions of young, unskilled, inexperienced work-seekers; the second is that the policy reforms needed to provide a platform for growth in labour-intensive industries are likely to be rejected by a significant fraction of the ruling party and its alliance partners.

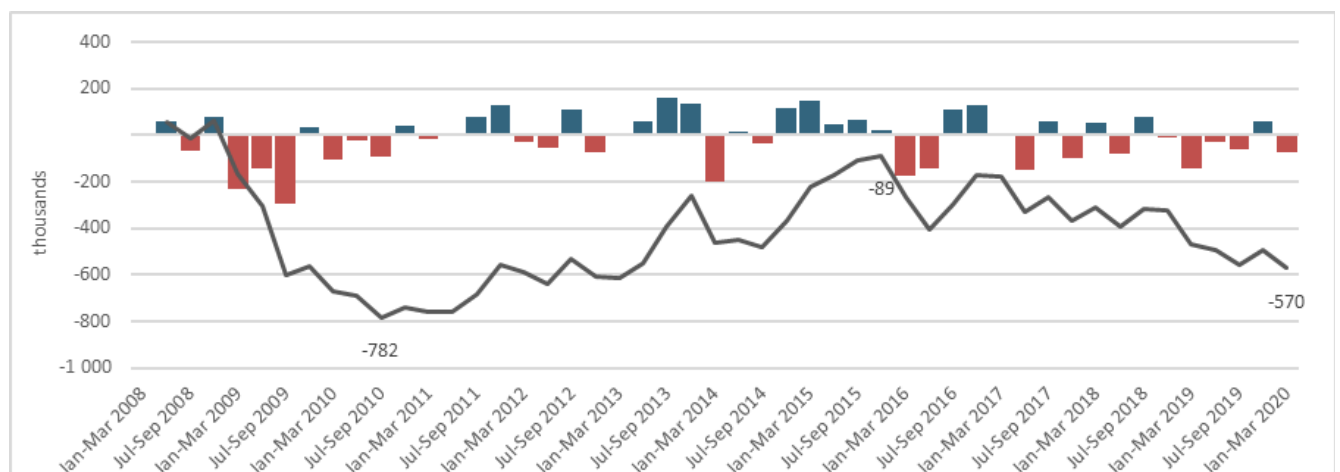
The core of our argument is that we think that an SEZ could be designed in such a way as to test whether and to what extent South Africa could create labour-intensive manufacturing

activities that might absorb unskilled and inexperienced workers while minimising the political costs of implementing the reforms that are needed to make this possible.

The SEZ we propose would be, in effect, a policy experiment designed to test whether it is possible to do better in the creation of low-skilled work in labour-intensive industries. This is essential if South Africa is ever to deal with a labour market catastrophe that sees only two adults in five having any kind of job, and in which the number of young people (15-34) who had jobs in 2020 (before Covid-19) was 570 000 lower than the corresponding number in 2008 (Figure 1).

To be sure, the economy has other problems, and this is not the only reason for the failure to create jobs. Nevertheless, the demands that our labour market regime imposes on these firms will have to be addressed if we are to absorb unskilled workers and build a more inclusive, employment-intensive economy. In this regard, the key reforms that are needed include exemption from agreements reached at collective bargaining councils for small and newly formed firms that are not party to the agreement (a recommendation that is also contained in former President Kgalema Motlanthe's High Level Panel report to Parliament – see box), as well as changes to some provisions of the Labour Relations Act (LRA) governing the dismissal of workers, particularly during probationary periods. We would not expect firms to be exempt from paying the national minimum wage, but we would expect that they qualify for an expanded employment tax incentive.

Figure 1: Quarter-on-quarter (and cumulative) change in number of employed young people (2008Q1 to 2020Q1)



Source: Stats SA, Quarterly Labour Force Survey

Our view, which we have set out in a range of publications, is that a key reason for this abominable performance is that the labour market regime is particularly unaccommodating of the needs of small, newly established labour-intensive firms that might use a disproportionately large share of unskilled labour. The result is that South Africa creates far too few of these jobs. (See CDE's reports, **Ten Million And Rising: What It Would Take To Address South Africa's Jobs Bloodbath** and **No Country For Young People: The Crisis Of Youth Unemployment And What To Do About It.**)

Few people think that there is much likelihood of these reforms' being implemented nationally. Ideological opposition to them in the ruling alliance is very strong and, in the absence of clear and convincing evidence that the reforms would generate a significant employment response, it is unlikely that those views can be shifted. And it is here that an SEZ could play a critical role as a laboratory to test what would happen if the labour market regime governing firms was to be modified along the lines described above in one spatially distinct area. What kind of response would there be? The short answer is that we do not know. What we think is that, precisely because it would be a spatially distinct zone of exception, the political challenges of shepherding these reforms through our veto-laden political system might be considerably enhanced.

So what would our SEZ look like? Essentially, it would be one in which the labour market was governed by a modified set of rules, that would make possible the emergence of labour-intensive activities (like clothing manufacturing and basic assembly work) that are rendered commercially unviable in the rest of the economy because existing rules make the employment of unskilled labour too costly.

List of current SEZs in South Africa

1. Atlantis SEZ

The Atlantis SEZ is Africa's only greentech hub, focusing on renewable energy and green technology. Situated on the West Coast, 40km from Cape Town, the SEZ was launched in December 2018 and has reportedly attracted investments worth more than R680 million.

2. Nkomazi SEZ

The Nkomazi SEZ is set to be located approximately 65km from Nelspruit. It will be linked to Swaziland by two national roads and to Mozambique by the Maputo Corridor (via rail and road). The zone will focus on agro-processing and logistics, and is expected to create more than 700 jobs per year. In November 2016, investors had reportedly committed R770 million in investments. However, due to delays and the impact of Covid-19 most of that has been withdrawn and the zone is still not established.

3. Coega IDZ

The Coega IDZ is located in Nelson Mandela Bay and is adjacent to a deep-water port. Established in 1999, Coega has attracted investments in the agro-processing, automotive, aquaculture, energy, metals, logistics, and business process services sectors worth more than R2 billion.

4. Richards Bay IDZ

The Richards Bay IDZ is an industrial estate linked to the Richards Bay port. It was created for manufacturing and storage of minerals and products to boost beneficiation, opening in 2002. According to annual reports, by the end of 2019 the IDZ had attracted investments worth R5 billion.

5. East London IDZ

Established in 2003, the ELIDZ is an industrial park in Buffalo City focusing on the automotive, agro-processing, and aquaculture industries. By December 2019, it reportedly had 42 investors with an investment value of over R8 billion.

6. Saldanha Bay IDZ

The Saldanha Bay IDZ was launched in 2013. It is expected to serve as the primary oil, gas, and marine repair engineering and logistics services complex in Africa. The annual report published in February 2019 showed that the IDZ had eight signed investors with a commitment to invest over R3 billion.

7. Dube TradePort

Located 30km north of Durban at the King Shaka International Airport, Dube TradePort brings together an international airport, a cargo terminal, warehousing, offices, a retail sector, hotels, and an agriculture zone. Two areas inside Dube TradePort have been designated IDZs: the Dube TradeZone and the Dube AgriZone. Founded in 2003, by 2018 it held assets worth R4.66 billion and its annual revenue was R476 million.

8. Maluti-A-Phofung SEZ

The Maluti-A-Phofung SEZ in Harrismith lies at the mid-point of the Durban-Johannesburg logistics route. Launched in 2001, it is intended as a production base for light and medium manufacturing with logistics links by road or rail to Gauteng, the Durban Port, and the Bloemfontein-Cape Town route. No information on investments or revenue could be located.

9. OR Tambo IDZ

The OR Tambo IDZ, also known as the Gauteng IDZ, aims to develop land around the airport. It supports the growth of the beneficiation of precious metals and minerals sector, with a focus on light, high-margin, export-oriented manufacturing of metals. Established in 2009, the IDZ multi-site development consists of industry-specific precincts that will be developed in phases over 10 to 15 years.

10. Musina/Makhado SEZ

The Musina/Makhado SEZ comprises two geographical locations close to the border with Zimbabwe. The SEZ intends to support value chains for mineral beneficiation, agro-processing, and light industrial manufacturing. R4.4 billion worth of investment has reportedly been secured into the region as a result of this SEZ.

11. Tshwane Automotive SEZ

The Tshwane Automotive SEZ in Silverton was launched on 5 November 2019. 18 investors, ready to invest R3.6 billion, were secured to set up operations, with nine planning to establish factories by January 2021. The SEZ will support the development of a Ford incubation centre established adjacent to the SEZ.

On the effect of bargaining councils on SMMEs

"In terms of the Labour Relations Act, small companies in the same bargaining council as large companies are compelled to abide by the terms of the collective bargaining agreement reached by these employers and representative unions. In essence, the LRA calls for the 'extension to non-parties' noting that all agreements reached by representative parties during the bargaining process be extended to those parties not represented at the bargaining council. In practice, what this clause in the LRA has done, unintentionally, is to force the terms of an agreement reached by large employers and large unions onto SMEs. The result is higher than manageable wages for SMEs, arising out of agreements reached by larger firms and employers – with negative consequences for the growth of, and employment generation among, SMEs in the relevant sectors. The Panel recommends that Parliament amend the Labour Relations Act to remove the 'extension to non-parties' clause or to prescribe that the extension to non-parties will not be applicable to small and medium enterprises (SMEs)."

Report of the High Level Panel on the Assessment of Key Legislation and the Acceleration of Fundamental Change (2018), p. 43.

The key exemptions from existing rules that we would want to see would be:

- Wages and working conditions would be negotiated at factory level and would not have to comply with norms set at the bargaining council that were not explicitly agreed to by firms located in zones.
- Firms would be bound by the national minimum wage and basic health and safety rules, but would be entitled to negotiate other conditions such as piecework, productivity bonuses, and shift hours.
- As is currently the case, the employment tax incentive would apply to all workers earning below the incentive's income threshold, not just young workers and for an extended period.

If these changes were implemented firms in the zone would be at a competitive advantage vis-à-vis firms in the rest of the economy. Therefore, one of the constraints we would impose on the zone would be that goods made in it could not be sold in South Africa, but would have to be produced exclusively for export. This achieves two purposes. The first is that it helps reduce the risk that any success achieved by firms in a zone is at the

expense of firms outside it. This is a real danger and is a concern that almost certainly applies to the existing IDZs/SEZs. The second advantage of insisting that firms in the zone export all their output is that it helps prevent opposition to the creation of the zone from organised labour and local businesses who, in the absence of this requirement, would face competition from zone-based firms on terms that are not level.

In line with the zone's producing exclusively for export, all imports would be duty-free (rather than subject to rebates); apart from this, however, there would be no special privileges accorded to zone-located firms, which would pay market-related rents to SEZs that would no longer receive operational subsidies, along with standard rates of personal and corporate income tax. Firms in the zone would have to be engaged in new activities, and it would not be permissible for them to simply relocate activities from elsewhere in South Africa.

We would hope for one further reform to facilitate the pursuit of opportunities in global markets: a relaxation of the rules governing the movement and employment of skilled foreign workers so that firms operating in the zone might attract staff who know and understand the relevant international markets, and whose skills and knowhow could not be easily provided by local staff. This is needed, we think, because low-skilled,

Paul Romer on SEZs as reform zones

"I came to my ideas on SEZs partly because of my familiarity with the Mauritian experience, where a Free Trade Zone turned out to be an effective way to reform the economy. By creating a Free Trade Zone, they could bring in firms that were willing to hire local workers to work in garment assembly, which is one of the most mobile and flexible source of employment around the world. You should think of these zones as a transitional measure in a broader movement for change in society. The problem we see with most zones is that they don't have the effect of creating systemic change, but become protected enclaves. In fact, they can create an entrenched elite by virtue of the special treatment the firms get. This typically happens when special concessions are given to a few.

We shouldn't do concession zones; we should do reform zones. If there is genuine opportunity to create a reform zone, then it is worth pursuing. It would be well worth trying some more experiments."

Paul Romer, winner of the Nobel Memorial Prize of Economic Sciences, CDE, November 2020

labour-intensive manufacturing is one of the most competitive, lowest-margin industrial sectors in the world. South Africa's firms and managers have little experience in these industries and markets, so they will need to import staff who do.

Finally, management of the zone must be incentivised to succeed. In light of South Africa's capacity constraints in the state, SEZs must be operated either by the private sector or as a public-private partnership. We would hope and expect that, in these circumstances, local and international firms would respond eagerly to the opportunities created by a zone of this sort. An important feature of the proposal that CDE has made is that the first such experimental reform zone would be located in Coega, which has the virtue of having already been built. While its establishment absorbed – and continues to absorb – resources from the rest of the economy, these are now sunk costs, and, apart from costs incurred through the employment tax incentive, creating an export-focused SEZ of the kind contemplated here at Coega would

not expose the South African tax base to further erosion or expense. There are other advantages, too. Coega has access to a port. There is a large workforce on its doorstep in Motherwell. The region has an existing industrial base and all the amenities that might be needed to attract foreign investors. And, critically, the region also has a significant number of people who have at least some experience in industrial work. These are all enormous advantages, all of which have the potential to place Coega in a highly competitive position relative to other export-processing zones.

Will this work?

Although we think that an SEZ of the kind described above has a reasonable chance of stimulating a meaningful response from firms, a couple of cautions are warranted. The first is that, to the extent that low-skilled manufacturing has been the principal entrée for developing countries' industrialisation, the power of this appears to be diminishing: automation and digitisation mean that manufacturing is less and less reliant on human labour. Just as importantly, manufacturing accounts for a smaller and smaller share of the global economy.

The ANC on low-end manufacturing

"With the disruption of global value chains developed in the process of off-shoring that had been under way before COVID-19, South Africa needs to identify opportunities in low-end manufacturing that it can exploit to the full. These opportunities include clothing and textiles, components for or complete ICT gadgets that the state is providing to schools and hospitals and PPE that will outlive the COVID-19 pandemic. This will require massive expansion of the SEZ and industrial park programmes. Underpinning the approach to low-end manufacturing is not only the creation of jobs for low- and semi-skilled workers, but also the opportunity to become part of African and global value chains."

ANC Economic Transformation Committee (2020), Reconstruction, Growth and Transformation: Building a New, Inclusive Economy, p. 17.

Both trends are enormously powerful and irreversible, with the result that the scope for successful adoption of a strategy such as this is narrowing all the time.

Nevertheless, while automation will impact on all manufacturing jobs, many of the most labour-intensive manufacturing sectors are least vulnerable to this, at least in the short and medium terms.

In our view, this means that action is urgent: the millions of jobs that are likely to depart from China over the next decade will not all disappear immediately, and this may be the last opportunity for developing countries to develop meaningful numbers of industrial jobs. There are no guarantees, therefore, that an SEZ of the kind we describe will work; it is all but certain that if we wait too long, South Africa will miss the last opportunity to do this.

Conclusion

South Africa's decades-long crisis of unemployment was the deepest in the world even before Covid-19 struck. We are a country with millions of unskilled, inexperienced workers looking for work in a labour market that drives firms to minimise low-skilled employment and emphasise skill- and capital-intensive activities. Ideological commitment to this model is extremely strong and, although not universal, few people in government or organised labour seem to believe that there is much prospect of expanding low-wage employment. Of those who think it is possible, most think that doing so would have to compromise the living standards of existing workers.

One of the great merits of the scheme CDE is proposing is that it would test whether more jobs could be created in low-wage, low-skilled sectors, and it would do so in a way that did not diminish the rights or incomes of any existing employee of any existing firm. To all intents and purposes, the SEZ would be the functional equivalent of an island off the South African coast. However, it could serve as a laboratory to test whether South Africa has any hope of ever creating the kind of labour-intensive manufacturing jobs that have been the lynchpin of industrialisation throughout the world since the 19th century. We think that this is an experiment well worth trying. Perhaps that is why some parts – at least – of the ANC appear keen to run it, too.

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