

Special economic zones for South Africa

Lessons from experience



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About us

- Claude Baissac has nearly 20 years of experience in special economic zones, having devoted his academic career and part of his professional life to studying them, understanding their benefits and costs, creating the conditions for their optimal utilisation, and contributing to their implementation – both as policies and individual projects.
- He has worked on SEZs in many countries, including: Azerbaijan, Botswana, the DRC, Georgia, Jamaica, Jordan, Kuwait, Lesotho, Mauritius, Mexico, Senegal and South Africa.
- He is published SEZ expert, and extensively works for the World Bank and the IFC on SEZs, economic growth, diversification and investment climate reform.

Background

- Special economic zones have been in existence as tools of economic diversification, accelerated growth and liberalisation since the 1950s.
- Under various formulation and sectoral focus (as free trade zones, export processing zones, freeports, and so on) they have come to represent a well-established and often privileged solution for governments pressed to solve complex economic challenges.
- From a few dozens in 1950, zones number well over 3,000 nowadays, are a being adopted almost everywhere. Where they exist, they are being restructured to face the challenges of the day, from Costa Rica to Japan – who is the latest and most prominent country to join.

The fundamental proposition

- The SEZ's fundamental proposition is the creation by government of an environment where it is easier and cheaper for the private sector to engage into economic processes – the product of combination of capital with factors of production and knowledge (technology and access to market) – to serve their markets.
- The premise of SEZs is therefore that the prevalent policy environment is not conducive, qualitative or quantitatively, for these processes to occur easily and cost-effectively, because of a combination of regulatory, institutional and spatial-infrastructure constraints/barriers.
- SEZs are, essentially, a policy instrument designed to alleviate these constraints.

The fundamental proposition – 2

- SEZs point to one of the key insights of economic policy, an insight that governments as widely different as those of China, Dubai or Mexico have adhered to, at least partly:
 - ▶ Socioeconomic benefits like employment, wages, value added, profits, tax revenues, export earnings and FDI are the positive consequences of facilitated and properly regulated private sector activity.
 - ▶ At its most basic, the function of government is to generate the conditions for these attendant benefits to manifest.
- SEZs represent an instrument where this most basic can occur, usually concurrently with other policies that for a number of reasons do not intend or fail to generate these conditions.

Why SEZs?

- SEZs are generally understood to be tools of transition, whether political, policy, political economic, or economic.
- They usually are deployed in countries that are heavily regulated and taxed, that lack adequate infrastructure, where factors are poorly productive, scarce or misallocated (labour, capital, etc.).
- SEZs have been deployed to :
 - ▶ Transit in a controlled way from collectivist to market economy – China
 - ▶ Transit from a protectionist to a more open economy – Malaysia
 - ▶ Operate a dual-track economy where reforms are too difficult – oil-rich countries
 - ▶ Target reform the investment climate in burdened market economies – SA

Definition

- SEZs are: *“demarcated geographic areas contained within a country’s national boundaries where the rules of business are different from those that prevail in the national territory. These differential rules principally deal with investment conditions, international trade and customs, taxation, and the regulatory environment; whereby the zone is given a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective than that of the national territory”.* (Claude Baissac, in Farole, 2011)

The basics are in the term

- The terminology identify the three key features of the policy instrument called SEZ:
 - ▶ Special: refers to the differential regulatory regime that distinguishes the zone(s) from those prevalent in the domestic economy.
 - ▶ Economic: refers to the fact that, ultimately, SEZs are about economic activities – and essentially the conduct of value adding activities that generate a stream of resultant benefits: economic growth, employment, export earnings, tax revenues, etc.
 - ▶ Zone: refers either to the physically or legally bounded “economic space” within the national territory in which the SEZ regime applies.

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Necessary attributes

- Stated differently, zones have to have three key structural constituents that are both essential and interdependent:
 - ▶ A dedicated regulatory regime: zones are distinct “legal spaces” where the rules of investment, exchange and business operation are clearly and specifically separate from those prevailing in the national territory.

The purpose of that regulatory regime is to: i) guarantee the safety of investment against expropriation, restrictions or discrimination; ii) lower the barriers to entry that are directly attributable to regulation and administrative rules and practices; and, iii) significantly decrease delays and costs that are directly and indirectly caused by these rules and practices.

This regulatory regime must therefore provide a transparent, streamlined and cost-saving set of rules that creates investment and operating conditions that compare advantageously to regional or international standards.

As a rule, the more challenges exist in a country’s overall investment and business operating climate, the more critical it is to provide a decisively differential regulatory regime.

Necessary attributes – 2

- ▶ A dedicated physical infrastructure: this infrastructure usually consists of industrial or activity parks with the requisite endowment in services plots, building shells (warehouses, factories, offices, incubators, training facilities, etc.), utilities (internal roads, green spaces, electricity, water, waste water and treatment plants, etc.) and key transport infrastructure connecting the zone to its suppliers, markets and economic hinterland (either through access to existing external infrastructure or through the development of zone-specific transport infrastructure like ports, airports and railroads).

This physical infrastructure is the most visible and often most attended attribute of SEZs.

In most cases, they are the easiest constituent to deliver, both because they are perceived as being the most tangible and the one least likely to be resisted – notably by the public administration itself.

Necessary attributes – 3

- ▶ A dedicated governance structure: regulatory regimes, no matter how comprehensive, are rarely sufficient to generate the improved investment and operating climate necessary to generate the kind of diversification and accelerated growth needed.

Their implementation and administration usually requires a dedicated governance structure, notably in countries where administrative capacity is limited and/or resistance to liberalization is expected to be significant. Indeed, more often than not, zone programs fail because of the inability or unwillingness of the public administration to enforce the regulatory regime developed by government. As a rule, the lower the capacity and the greater the expected resistance, the more critical it is to provide a separate governance structure that is equipped with the mandate and resources necessary to implement the regulatory regime.

Just as the regulatory regime requires dedicated governance, so does the infrastructure, and notably at the point of interface between zone users and that infrastructure. Increasingly, this governance is done by the private sector through the provision of serviced land and real estate on commercial terms, as well as value added services. The frontier between public service and commercial service in SEZs is a product of capacity and economics.

Implications

- SEZs that do not have ALL these attributes do not qualify as SEZs:
 - ▶ Zones that do not have a meaningfully differentiated investment regime (no duties, lower taxes, no exchange controls, simplified licencing at a minimum) are economic zones – industrial or otherwise – but NOT SPECIAL
 - ▶ Zones that do not offer a clearly delineated area with dedicated infrastructure and serviced land, at a minimum
 - ▶ Zones that do not have an institutional component (effective one stop shop at a minimum)

Typology

- The World Bank's FIAS (now ICAS) provides a comprehensive typology of SEZs, the main one being:
 - ▶ *Commercial free zones*, or simply *free zones (FZs)* are the oldest form of SEZs and are the most ubiquitous, notably under the *bonded warehouse* format found in the vast majority of seaports, and in some airports. Free zones are usually in or near major international transport nodes. Generally under the administration of ports they are physically segregated from both the port's main area and the outside – fences, walls, gates – because they lie outside of the custom territory. The processes allowed in free zones are usually limited: warehousing, aggregation and disaggregation, light processing (packaging, break-bulk, labeling, testing, etc.) and sales.
 - ▶ *Export processing zones (EPZs)* first appeared in the late 1950s-early 1960s as a way to accelerate industrialization and industry-related international trade in peripheral countries – initially in South Korea and Ireland. The basic 'grammar' of EPZs includes: a fenced-in territory of several hectares, offering developed industrial land for rental/lease, situated outside of the country's custom territory, benefiting from investment and operational incentives, and supported by simplified administrative procedures.

Typology - 2

- ▶ *Free enterprises (FEs) or single company zones* are a variation of the EPZ theme, where the EPZ status is afforded to single enterprises outside the zone. Certain countries have operated or did operate both regimes in parallel, granting FE status to enterprises too large to be located in the industrial park, or dependent on some factor not available in the park.
- ▶ *Freeports*, as defined by FIAS, introduces confusion into the typology as they are also known as special economic zones, *per se*. Freeports encompass wide areas of a territory, and may include urban and rural territories, and incorporate large transport facilities like ports and airports. Freeports thus incorporate entire economic regions, the population that live and work in these regions, and the entirety of the economic activities that take place there. China's SEZs are the archetypical freeports. So is the Aqaba Special Economic Zone. This report refers to them either as freeports or wide-area SEZs (WASEZ).
- ▶ *Enterprise zones (EZs)* have been created for economic revitalization in older industrial and urban centers of advanced economies. They have sought to bring regeneration and economic diversification to once striving regions, notably in the northeast of the United States (the so-called rust belt) and in the old textile, coal mining, steel and shipbuilding regions of Western Europe.

Lessons from experience – Exogenous factors

- Farole (2011) has convincingly argued on the basis of significant case study work that SEZ programs are more likely to succeed where three factors are present: i) the market accessible to zone users is large; ii) the national economy is competitive; and, iii) government capacity is strong:
 - ▶ Insofar as the first factor is concerned, it has been proven that opening the domestic market – with the appropriate safeguards on competition – has a positive impact, notably in countries endowed with a large domestic market.
 - ▶ For the second factor, zones have shown limited capacity to fundamentally alter the competitiveness equation. Conditions that are prevalent in the domestic economy tend to be reproduced inside SEZs.
 - ▶ As for the third, there is a direct correlation between the success of a zone program and the capacity of the State to formulate and implement it effectively over the long term.

Endogenous factors – 1

- Experience shows that while these exogenous factors are determinant, it also shows that good design and implementation – by Government, its partners and the private sector whose role it is to ultimately make a zone program a success – can compensate for vulnerabilities. The following have been shown to be important in this:
 - ▶ There must be clear and sustained political support for a program based on the right design attributes and correct implementation. The greater the vulnerabilities to the above endogenous factors, the greater the requirement for such support. Zones are costly programs to initiate, notably where there is a lack of infrastructure and the initial comparative advantage is low.
 - ▶ The program must be an integral part of the national development strategy, rather than an alternative to it or an afterthought. It must have adequate support, but must also be evaluated against the objectives it has been given and against standard benchmarks of economic, fiscal, social and environmental impact. Appropriate time scales must be taken into considerations.

Endogenous factors – 2

- ▶ Sustained administrative support is required, from inception and design to implementation. It is essential that the relevant administrations (tax, customs, immigration, labor, commerce, energy, ports and airports, etc.) be engaged and provided with the resources needed to support operation. The role and capacity of the regulator and of the zone administrators (be they public or private) are of critical importance. The regulators/operators need to be empowered with most licensing powers of the state.
- ▶ Design of a coherent set of investment support measures, which must be directly derived from the competitiveness of the country, and its weaknesses. The lower this is the more important these measures become. The entire set of attributes of must be taken into consideration: i) comprehensive set of investment conditions (incentives, licensing, regulation and business operation); ii) quality and relevance of infrastructure and business services offering, including location and cost profile; iii) and, professionalism and effectiveness of institutions involved in the regulation, development and operation of the zone program. In total, the resulting overall investment climate and business operating environment must represent a major improvement from the domestic one.

Endogenous factors – 3

- ▶ The infrastructure offering is an essential component of success. This must be vastly superior to what exists outside, and must be on par with international standards. Infrastructure includes internal as well as near-external infrastructure: serviced land, utilities, connectivity. It must be priced competitively.
- ▶ The zone program must be based on a rigorous analysis of the sources of comparative advantage, the vulnerabilities around it and the identification of the most promising sectoral opportunities. A *laissez faire* approach will rarely succeed, at least at the initial stages of operation. Similarly, selecting champions and enforcing a strict sectoral development strategy will also be unlikely to succeed.
- ▶ Private sector participation to zone programs is essential. In some cases, private sector involvement should be comprehensive, and include strategy, development, financing, operation and administration of key aspects of the regulatory regime. In others, it should be limited to management of the zone. What determines this should be dictated by the strength of the economic and financial cases, government and private sector experience and capacity. Pragmatism, rather than ideological preferences, should dictate roles.

Endogenous factors – 4

- ▶ Design, location and regulation must ensure that the zone does not function as an enclave from an economic standpoint, while it may be necessary to insulate it from counterproductive economic and administrative behaviors, but foster exchanges between the zone and the domestic economy: i) encourage legitimate investment from the domestic economy; ii) foster supply relations between them; iii) cultivate technology transfers from the zone to the domestic economy, and so on. This has been a proven source of economic success, with zones acting as catalysts for national private sector development, skills acquisition, technology development, market access, etc. Zones can act as significant incentivizers in the process of self-discovery.

The South African experience – 1

- SA has nearly 20 years of experience with trying to develop SEZs, first with the IDZ program and now with the SEZ program.
- From a strictly definitional standpoint, the IDZs imperfectly fit the SEZ framework:
 - ▶ The zones do not provide a duty free environment, and the Customs Controlled Area system has never really functioned
 - ▶ There are no dedicated investment support measures, but rather a garrison of sector-specific incentives that apply nationwide
 - ▶ The national regulatory regime applies in its entirety, and this is no simplified licencing regime and administration

The South African experience – 2

- The IDZ program's performance has been problematic:
 - ▶ The programme was designed in a bureaucratic fashion with insufficient consultations and lack of relevant international benchmarks/ best practice.
 - ▶ There has been uncertainty over the programme's adequacy in terms of its strategy and configuration.
 - ▶ In this regard, the choice of locations near ports has in fact turned the programme into a regional development scheme, thus diminishing its efficacy as a tool for national competitiveness-enhancement.
 - ▶ The incentives structure and application processes are complicated, difficult to understand for both operators and investors, and burdensome in terms of administration.
 - ▶ The governance structure is complex and insufficiently responsive
 - ▶ There is a lack of consensus, buy-in and support for the IDZ programme in South African society as a whole, and in the labour and business communities in particular.
 - ▶ The programme has generated large capital investments for infrastructure development, and provides incentives that are costly to the treasury. However, the economic benefits stream so far is not clearly evident.

The South African experience – 3

- The SEZ program has been designed to compensate for the IDZs lack of performance.
- However, analysis of the SEZ law and the strategy currently deployed highlight some important weaknesses in light of international experience:
 - ▶ Clear and sustained political support: there is no broad policy consensus on what the SEZs should be about, and therefore what investment support measures are needed. As a result, the current law leaves most of these out, to be resolved at a later stage. The outcome is uncertainty and muddle through.
 - ▶ Integral part of the national development strategy: in theory, the SEZs are connected to the IPAP and the NGP, but there are serious questions about coordination, including with the NDP. The result is confusion over goals – is it about FDI, exports, industrialisation, decentralised development, jobs, experimental liberalisation, infrastructure, beneficiation, all the above?

The South African experience – 4

- ▶ Sustained administrative support is required: there is no evidence that inter-departmental coordination, and the creation of meaningful delegation of authority or one stop shops exists and will exist, because of the lack of consensus on what SEZs are to be, and what rules need to apply. There again, muddle through seems to apply.
- ▶ Coherent set of investment support measures: precious little is known about what the ultimate investment regime will be, and available information suggests that the usual measures seen in SEZs will be absent: effective and simple tax rules, customs free zone in at least sections of SEZs, simplified licensing procedures, simplified business operating rules – it is unfortunate that SA's cumbersome labour legislation remains unfettered. The package, whatever it ends up being, is not likely to be designed to significantly improve competitiveness.
- ▶ Infrastructure offering: this is likely to be the program's strong point, given SA's fiscal and technical capacity to deploy world class infrastructure. Because the other key attributes are weak, the country is likely to try to compensate through this. The IDZ experience should act as a cautionary tale. Costs must be weighed against benefits.

The South African experience – 5

- ▶ Rigorous analysis of the sources of comparative advantage: the program seems to be based on very detailed sectoral identification/targeting work, and the pre-selection by government of locations for SEZs. There is no evidence that the fundamental constraints on SA's competitiveness have been identified, and are targeted. Champions are seemingly being picked.
- ▶ Private sector participation: in keeping with the above, private sector participation is so far nominal, and there is a very limited institutional role given to the private sector in the cumbersome governance and institutional framework set out by the law. The market has played no role in identifying what locations and what sectors will ultimately be the focus of the program. This is likely to lead to continuous subsidisation.
- ▶ Zones must not function as enclaves: while it is too early to assess how zones will integrate into their local and regional economies, evidence from the IDZ program suggests that heavy industrialisation removed from a region's comparative advantage leads to the enclave phenomena, where local businesses do not integrate supply chains, and employment remains limited to low/medium skills.

Conclusions

- *In fine*, SEZs are about reducing uncertainty, creating clear and easy rules, and decreasing the cost of doing business.
- It seems that the key lessons from the IDZs and from international experience have been sufficiently incorporated.
- What the program requires is :
 - ▶ A clear set of investment support measures embodied in law that convincingly resolve barriers to investment and economic activities, and where there are no sacred cows. That's what successful SEZ policies do.
 - ▶ A simple institutional structure that gives the regulator the powers to regulate and enforce regulation, with a meaningful simplification of licencing.
 - ▶ A greater role for the private sector in setting up SEZs and managing them, choosing locations and sectors according to market demand and not top-down policy.

Thank you!

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