



WORKING PAPER

# The geographic designation of Special Economic Zones

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**Abstract:** Special economic zones (SEZs) emerged internationally as a policy to support industrial development in particular by providing for the introduction of targeted incentives and infrastructure. Internationally, despite their name, they are often effectively delinked from specific geographic areas in order to achieve these aims. This is especially useful where government wants to extend incentives to specific activities that lie outside designated zones, and where – as in South Africa – neither the provision of infrastructure nor spatial re-organisation of the economy are central aims of the SEZ programme.

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## Introduction

After 1994, South Africa was confronted with a serious challenge of increasing the levels of domestic and foreign direct investments which were necessary to accelerate economic growth (the dti, 2012, p.9). Moreover, economy comprised of a narrow range of exports and an over-dependency on primary production. These challenges hampered growth within the country as well as the continent.

South Africa through the Industrial Policy Action Plan (IPAP) is determined to grow the competitiveness and labour-absorbing capacity of the manufacturing sector, particularly in the traditional and non-traditional tradable and value adding sector in the economy. In this context, considerable emphasis has been placed on reducing the current account deficit, through a combination of expanding exports and replacing imports, in these value-adding and labour-intensive sectors (IPAP, 2014, p.6). It is clear that government has started implementing policies for the purpose of diversifying and expanding its export markets.

A specific policy instrument used in this regard is the implementation of special economic zones (SEZs). SEZs are generally defined as geographically designated areas of a country that are set aside for specially targeted economic activities, and supported through special arrangements and systems that are often different from those that apply to the rest of the country. In different countries SEZ operate through a variety of forms with different functions. They include free ports, free trade zones, industrial development zones (IDZs) and sector development zones. The benefits SEZs offer to private companies include corporate tax reduction or elimination, tariff free trade as well as deregulated labour markets (Curtis. *et al.*, 2006, p.2).

In South Africa, the Special Economic Zone Act (2012) defines SEZs as an economic development tool to promote national economic growth and export through the use of support measures in order to attract targeted foreign and domestic investments and technology. According to IPAP, SEZs are used to stimulate foreign and domestic investment; increase production output leading to increased exports of value added manufacturing goods; employment creation; transfer of technology and skills development; creation of economic linkages through supplier development and regionally spread industrial development (IPAP, 2014, p.63).

This paper reviews the role of SEZs and in particular whether they require a geographic limitation. Given South Africa's substantial infrastructure base, it finds that less emphasis should be placed on spatial demarcation, and more on attracting investments and technology as well as skills transfer. This implies that SEZs in South Africa should be able to cover multiple locations, including private land. This kind of approach has been introduced successfully in other countries, notably in Mauritius.

The paper consists of three parts. The first part explains the purpose of SEZs and how countries benefit from them. This is followed by an overview of the SEZ program in South Africa reviewing the SEZ Act and Policy, and tracking the transition from the IDZ to the SEZ program, including an assessment of the main reasons for their implementation and the types of SEZs. The second part focuses on highlighting the benefits derived from SEZs by the South African economy and private companies. The third part looks at the concept of "mini- SEZs" a modification of the common SEZ policy to extend export benefits to individual productive facilities as opposed to geographical conglomerations of enterprises. Finally, the fourth part provides conclusions and policy recommendations.

## Purpose of Special Economic Zones and how they benefit a country

Since the establishment of the first SEZ internationally, approximately fifty years ago, there has been a rapid increase in their use as development instruments, particularly in developing economies. According to the International Labour Organisation (ILO), there existed 176 zones in 46 different countries in 1986, and today, more than 3 000 SEZs exist in about 135 countries. Collectively, it has been estimated that these SEZs account for over US\$500 billion in global trade, employing in excess of 70 million people (Kituyi, 2013).<sup>1</sup>

The popularity of SEZs as tool for economic transformation comes as no surprise, because of their purpose and the significant potential benefit they can bring to the host country in the form of increasing foreign direct investment (FDI), generating employment opportunities, enhancing foreign exchange earnings, developing export-oriented industries, and boosting export growth, as well as expanding government revenue and economic growth (Kituyi, 2013). In addition, SEZs also support the development of industrial clusters, which are mainly beneficial in fostering technology transfer and innovation. Finally, SEZs act as experimental laboratories, allowing governments to test out new policies and approaches while maintaining the status quo for the rest of the country (Farole, 2012, pp.25-26).

According to Farole, SEZs as a policy instrument confer two main types of benefits to a country, namely static and dynamic benefits. Static economic benefits are those that are derived in the short term and involve the use of SEZs as trade and investment policy tools (Farole, 2012, p.26). So static benefits include direct employment creation; FDI inflows; creation of economic value added; and foreign exchange generated through exports (Woolfrey, 2013, p.4). The dynamic economic benefits, in contrast, are the longer term structural and developmental benefits. These include the promotion of non-traditional economic activities and domestic entrepreneurialism; indirect employment creation; hard and soft technology transfer through forward and backward linkages. The above mentioned benefits can generally have a positive impact on the competitiveness of a region or country (Farole, 2012, p.26).

Foreign direct investment is a significant growth enabler in developing economies, and SEZs are utilised as instruments that can provide a stable and favourable investment climate in order to attract FDI which is then used as productive capital. SEZs through the creation of backward and forward linkages help stimulate the domestic economy directly or indirectly when the zone sources industrial inputs from domestic producers or provides consumer services and other non-zone activities to the community (Cheesman, 2012, pp.10-11). Consumer welfare is enhanced from the variety of new high-value products which become available in the market.

With increased growth in global value chains, success in participating in global production not only requires the capacity to import or produce high quality inputs, but also the capacity to export. SEZs can be used to facilitate the inclusion of developing economies in global value chains, allowing them to also access new markets (Kituyi, 2013). SEZs also work as information centres which provide foreign investors with easy access to information about investment conditions in the host country, thereby reducing search costs for prospective investors (von Claus Knoth & März, 2000, p.37).

Moreover, there is an expectation of the transfer of several kinds of technology from the foreign investors, in the form of production technologies; modern management know-how as well as

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<sup>1</sup> Statement by Mr. Mukhisa Kituyi, Secretary-General of UNCTAD at the 3rd Global Free Trade & Special Economic Zones Summit in Dubai, 20 October 2013

marketing strategies (von Claus Knoth & März, 2000, p.81). Such information can then be applied to domestic firms, supporting faster upgrading of the domestic economy. Accordingly, foreign investors speed up the introduction of new technologies, but in order for the host country to benefit, a proper regulatory framework must be in place (von Claus Knoth & März, 2000, p.81). Firms in SEZs are also expected to develop human capital by training their staff.

SEZs present significant benefits that have spill over effects to the rest of the economy. Their value to host countries is evident from the increase in their use as tools of economic development by developing economies. South Africa recognised the positive impact of SEZs and began a process of reviewing its IDZ program in order to maximise benefits derived from the use of SEZ.

## **Overview of the Special Economic Zone Programme in South Africa**

Preceding the drafting of the SEZ Bill, the Department of Trade and Industry (the dti) established the Industrial Development Zone (IDZ) programme under the Manufacturing Development Act (MDA) in 2000. The main aim of the IDZ programme was to attract foreign direct investment, increase exportation of value added manufactured products and creates linkages between domestic and zone based industries (the dti, 2014, p.8). This resulted in the designation of six IDZs to date, namely Coega; East London, Richards Bay, OR Tambo, Saldanha Bay and the most recent Dube Trade Port which was designated in July 2014.

There were some successes in the first three IDZ, with 42 operational investments worth R4 billion and approximately over 5,000 direct jobs and 43,000 construction jobs created.<sup>2</sup> Regardless of these achievements, the government believed more could be achieved and identified constraints and weaknesses that needed to be addressed in order to optimise benefits to the economy.

A policy review process was initiated and weaknesses on the implementation of the IDZ programme were identified. The major flaw of the IDZ programme was in the way the policy was designed and implemented. According to the Minister of trade and industry Dr Rob Davies, the IDZ policy review showed that weak governance, lack of IDZ incentives, poor stakeholder coordination and lack of integrated planning hindered the success of the programme (the dti, 2014).

## **Weaknesses of the Industrial Development Zones Programme**

In terms of the design of the IDZ programme, the weakness lay in the fact that the policy solely focused on one type of SEZ, and this resulted in limited success as benefits from other types of SEZ could not be derived (Scheepers, 2012, pp.32-33). The criteria used to designate IDZs was also biased towards regions with access to sea or airports and this restricted the programme from harnessing the long term development potential of all the regions, therefore perpetuating economic marginalisation and spatial inequalities (the dti, 2014, p.8).

In contrast with international practice, South African IDZs did not offer any fiscal incentives to investors at any stage (Chinguno, 2011, p.5). The Director General of the dti, Lionel October noted that

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<sup>2</sup> Minister of Trade and Industry, Dr Rob Davies speaking notes on the special economic zones bill, <http://www.gov.za/speeches/view.php?sid=43721&tid=140342>

“Our IDZ programme has been restrictive and it has no special incentive to compete with IDZs in Tanzania, China, Singapore and South Korea”<sup>3</sup>

This resulted in the failure to create industrial enclaves where the environment was conducive for investors, and therefore highlighted the importance of fiscal and other special incentives in creating a more efficient and effective setting for investors. Limited new investment suggested that the programme had failed to create investor-friendly environments. Moreover, most of the investments were capital-intensive and therefore generated relatively few jobs (CDE, 2012).

Additionally, a lack of targeted investment promotion resulted in poor performance in attracting foreign direct investment, which was one of the main objectives of the programme. More clarity was therefore needed to specify the role of national marketing agencies in identifying, targeting and interacting with potential investors (the dti, 2012, p.11).

Ad hoc funding arrangements resulted in IDZs relying on a single stream of on-budget funding from the National Treasury. This model presented a weakness in that it restricted the flexibility to cover costs of unexpected projects that needed to be established in the zones. Furthermore, this funding model excluded Development Finance Institutions (DFIs) as well as private sector financing, resulting in inadequate funding (the dti, 2012, p.11).

Poor stakeholder coordination and collaboration was a major stumbling block of the IDZ programme. The lack of coordination was evident in a number of cases such as the delays caused by the land question with regards to the progress of the Richards Bay and OR Tambo IDZs (Chinguno, 2011, p.22). With better coordination and collaboration in planning, implementation and management, such areas of contention could have been easily resolved leading to more efficient delivery of such programmes.

It is essential that integration of fundamental strategies at national, provincial and regional level exist in order to harness benefits from industrial policy instruments such as IDZs. The lack of integrated planning between the different spheres of government also limited the success of the IDZ programme (the dti, 2014, p.21).

Confronted with a situation where IDZs as the proposed policy instrument presented limited impact in expanding or diversifying South Africa’s manufacturing sector or export performance, the dti took measures to strengthen them. The government believed that more versatile policy instruments were key to unlock the domestic economy, focusing on innovation and productivity rooted in skills, infrastructure and efficient, responsive state action (Davies, 2014). The SEZ programme was identified as a mechanism that would propel the government’s strategic objectives of industrialisation, regional development and employment creation in line with the policy objective of NDP, NGP and IPAP.

## **Implementation of Special Economic Zones as a Development Tool in South Africa**

SEZs were identified as instruments for advancing South Africa into a higher industrialisation path not only because of their success in other economies, but based on assessment of the potential gains to South Africa due to the country’s positioning. South Africa is endowed with mineral and natural resources, ample land availability, prudent economic policies and a good regulatory

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<sup>3</sup> <http://www.citypress.co.za/business/idzs-programme-has-missed-the-mark-october-20120121/>

environment, and is a potential gateway to Africa (the dti, 2012, p.17). This therefore provides the necessary backdrop against which SEZs, if properly planned, funded, developed, managed and marketed, can be growth engines supporting industrialisation, regional development, export promotion and job creation as well as enhance the attractiveness of South Africa for foreign direct investments (Davies, 2012).

The draft SEZ Bill was released for public comment by government in January 2012. The signing of the SEZ Act into law by President Jacob Zuma in May 2014 reinforced the government's commitment to strengthen and expand the manufacturing industry as a basis for long term economic growth and development. The purposes of the SEZ, according to the SEZ Act, include<sup>4</sup>:

- Facilitating the creation of an industrial complex having a strategic economic advantage for targeted investments and industries in the manufacturing and tradable services sectors; within the framework of the IPAP, NGP and NDP
- Promoting beneficiation and value addition to the country's mineral and other natural resources
- Developing infrastructure required to support the development of the targeted industrial activities
- Attracting relevant foreign and domestic direct investment
- Providing the location for the establishment of targeted investments
- Taking advantage of existing industrial and technology capacity, promoting integration with local industry and increasing value-added production
- Promoting regional development
- Creating decent work and other economic and social benefits in the region in which it is located including the broadening of economic participation by promoting small, micro and medium enterprises and co-operatives, and promoting skills and technology transfer
- The generation of new and innovative economic activities.

There are various types of SEZs which can either be sector specific or multi product depending on working conditions, country infrastructure, government oversight and geography. It is therefore essential that the right type of SEZ should be established within the right geographical area. The following categories of SEZs have been defined according to the SEZ Act No. 16 of 2014:

- **"Industrial Development Zone"** means a purpose built industrial estate that leverages domestic and foreign fixed direct investment in value-added and export-oriented manufacturing industries and services;
- **"Free Port"** means a duty free area adjacent to a port of entry where imported goods may be unloaded for value-adding activities within the Special Economic Zone for storage, repackaging or processing, subject to customs import procedures;
- **"Free Trade Zone"** means a duty free area offering storage and distribution facilities for value-adding activities within the Special Economic Zone for subsequent export; and
- **"Sector Development Zone"** means a zone focused on the development of a specific sector or industry through the facilitation of general or specific industrial infrastructure, incentives, technical and business services primarily for the export market

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<sup>4</sup> the dti, Special Economic Zone Act, 2012

Lessons learnt in the implementation of IDZs and the review of SEZs strongly exposed the fact that benefits of SEZs will not just be automatic but will depend on whether the necessary conditions are created in terms of political and technical leadership (the dti, 2012, p.17). Therefore in an effort to create this conducive environment key aspects of the SEZs policy were established institutional frameworks; governance arrangements; SEZs strategy; financing of SEZs; SEZs incentives; clarity on eligible activities; support systems; planning of SEZs; and one stop-shop facilities (the dti, 2012, pp.20-24). An SEZ Advisory board<sup>5</sup> and SEZ Fund were therefore established to ensure proper designation, operation, promotion, development and management of SEZs.

## The benefits of SEZs in South Africa

The main goal of the South African government is to achieve significant economic growth, industrial development and employment creation. SEZs are strategic and effective instruments for industrial and economic development, and if well used and managed the South African economy stands to benefit significantly. Through an effective SEZ programme, South Africa can benefit from increased foreign direct investments (FDI); enhanced industrial capabilities and increased level of exports; sustainable infrastructure development; skills development; integrated logistics systems; technology innovation and increased research and development. These factors will consequently contribute to general economic growth, creation of quality and sustainable jobs as well as balanced regional development (the dti, 2012, p.9). Table 1 below shows the transition of these benefits to the economy from the initial effect, intermediary and structural change.

Table 1: SEZ Effects on the Economy

SEZ effect	Intermediary	Effect on Structural Change
New activity/employment	Increased income	Increased demand for higher-level goods and services
Knowledge Spillover	Skills formation, human capital upgrading	Increased supply of higher-level labor
Technology Spillover	Capital upgrading	Increased productivity, especially in higher-level activities
Backward Linkages	Increased income, demand for higher-level production	Diversification; productivity increase; skill upgrading
Forward Linkages	Access to higher-level goods and services	Productivity increase; support for diversified activity in both production and consumption

Source: Cheesman, 2012, p.26

To date, approximately 73 000 jobs have been created in the SEZs, of which 6 898 (9.6%) were direct and 65 637 (90.4%) indirect. The World Bank emphasises that: "Zone programmes that fail to offer opportunities for quality employment and upward mobility for trained staff, that derive their competitive advantage from exploiting low-wage workers, and that neglect to ensure environmental sustainability, are unlikely to be successful in achieving the possible dynamic benefits, and are likely to be forced into a 'race to the bottom'." In this view, ensuring that South African SEZs emphasise quality of jobs, skills development and technology enhancement will result in higher benefits to the economy.

<sup>5</sup> The composition of the Advisory Board includes all critical departments and agencies in the planning development and management of zones; independent experts on the development of special economic zones; special skills such as the management of industrial estates, industrial financing.

<http://www.thedti.gov.za/DownloadFileAction?id=830>

In another key component of SEZ, that of exports, there has been some impact in the IDZ programme; and although export sales generally performed below expectations, combined export sales of two enterprises in Coega and one in Richards Bay totalled over R2.7 billion. Table 2 below shows the investment performance analysis of IDZs for the period 2002 to 2014.

Table 2: SEZ Investment Analysis

IDZ	Pipeline Investors			Signed Investors not operational			Operational Investor					Export (R'000)	Import (R'000)
	No. of pipeline investors	Estimated value of investment (R'000)	Estimated number of jobs to be created by the investors	Number of signed investors	Value of Investment signed not operational (R'000)	Estimated number of jobs to be created	Number of operational investors	Value of investment (R'000)	Direct employment created	Indirect and construction jobs created	Total employment created		
COEGA	5	122,300,000	1,840	21	9,429,000	1,106	25	2,372,450	5,011	52,655	57,666	721,457	-
ELIDZ	55	23,715,000	5881	5	2,373,000	728	25	1,651,700	1,711	11,274	12,985	-	-
RBIDZ	18	14,209,000	5,048	3	4,555,000	360	1	800,000	174	1708	1882	1,941,023	-
SBIDZ	8	-	-	6	-	-	0	0	0	0	0	-	0
ORTIDZ	0	0	0	0	-	-	0	0	0	0	0	-	0
<b>TOTAL</b>	<b>86</b>	<b>160,224,000</b>	<b>12,769</b>	<b>35</b>	<b>16,357,000</b>	<b>2,194</b>	<b>51</b>	<b>4,824,150</b>	<b>6,896</b>	<b>65,637</b>	<b>72,533</b>	<b>2,662,480</b>	<b>0</b>

Source: the dti, 2014, p.2

Between 2002 and 2014, three IDZ were operational namely Coega, East London and Richards Bay IDZ which collectively attracted a total of 51 investors with an estimated value of R4.8 billion.

According to international experience, the most successful SEZs are public-private partnerships. The SEZs policy makes provision for the partnership of local as well as international private sector in the management and operation of zones (the dti, 2012, p.20). This is essential because there are limited skills within the public sector since SEZs are a relatively new concept to the country and foreign direct investment is locked in certain international networks and access to these networks is an important factor in securing foreign direct investment. Therefore public-private sector partnerships are essential for the success of SEZs in South Africa. Companies that operate in SEZs derive benefits in the form of incentives. These incentives are available to ensure that SEZs attract FDI, increase international competitiveness, create jobs and generate revenue. The suite of incentives includes: preferential 15% corporate tax; building allowance; employment incentives; customs controlled area; and 12I tax allowance. Annexure 1 provides details of the above mentioned incentives.

## “Mini-SEZ” – A potential viable subset for SEZ implementation in South Africa

Export Oriented Units (EOU) which are viewed as “mini-SEZs” are a modification of the common SEZ policy. They involve the extension of export benefits to individual productive facilities as opposed to geographically-isolated agglomerations of enterprises. Furthermore, export and import restrictions are relaxed allowing for EOU to be integrated in the economy as they can share their output with and source inputs from the domestic economy (Cheesman, 2012, p.7).

Traditional SEZs are associated with benefit-eligible activities being based on geographical location, which are carefully selected at a national level. Therefore companies that do not fall within the SEZ do not benefit. However the EOU scheme in India modified the SEZ model by doing away with such restrictions, as a result allowing enterprises to benefit from some incentives regardless of location (Cheesman, 2012, p.12). This de-spatialised framework was first successfully implemented in Mauritius, where productive activities functioned as export districts regardless of location with the country.



Given that South Africa already has basic infrastructure in terms of urban centres and trade infrastructure such as ports, SEZs do not have to be linked to spatial issues. Moreover, the SEZ programme currently is not an integral part of the rural development strategy. Rather, it seeks principally to provide a framework for promoting exports and job creation.

In these circumstances, South Africa could shift more explicitly from a geographic approach to a re-industrialisation approach. That would mean applying more of an industry and firm focus rather than a geographic restriction when it comes to implementing strategies to achieve growth and development objectives. A combination of the SEZ and EOU models could achieve greater impact as it is a more flexible approach.

In such a model, selection criteria for beneficiaries could be based on the firm or industry's potential to:

1. Expand exports and replace imports
2. Create backward and forward linkages (demand for intermediate inputs from domestic economy and supply of intermediate inputs for domestic enterprise)
3. Industrial spill overs, via training of and demonstration, to lead to upgrading of practices and technology as well as new production system in domestic activities
4. Create employment both directly and indirectly
5. Develop the community

With the increase in the incentives that are available to firms operating from the SEZ and the limited success of aspects of the earlier IDZ programme, there is a need to ensure that firms are measured against the above criteria in order to continue participating in the SEZ programme.

## Conclusion

The SEZ programme is an important government instrument to propel industrialisation, regional development, export promotion, job creation as well as enhance South Africa's attractiveness as a potential destination for FDI (Davies, 2014). Industrial policy suggests that long term economic success lies in the strengthening and expansion of the manufacturing industry which will potentially lead to increased production and exports. This will in turn lead to job creation both directly and indirectly.

South Africa can achieve success with its SEZ program by avoiding common mistakes made by developing economies when implementing SEZs. The decision to establish an SEZ in a particular location must not be driven by political objectives or an abstract set of limitations, but by economic drivers. Government must choose companies that will generate the greatest national benefits from incentives, without an artificial geographic limitation.

Although SEZs have been a successful industrial policy tool globally, benefits derived from them are not automatic but depend on whether the necessary conditions for success are created. In the South African case, a combination of SEZ and EOU as a supplementary policy could be highly beneficial since South Africa has the basic infrastructure support and does not necessarily have to be restricted by geographical location. If companies meeting the above mentioned criteria could benefit from the incentives regardless of their location, development objectives could be propelled significantly.

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## Legislation

1. The Manufacturing Development Act No. 187 of 1993
2. Special Economic Zone Bill
3. Policy on the Development of Special Economic Zones in South Africa, 2012

## Annexure 1: South Africa's SEZ incentives

- **Preferential 15% Corporate Tax**  
Businesses (as prescribed in section 24(4) of the SEZ Act) that are located in a Special Economic Zone may be eligible for a tax relief, including the reduced rate of corporate income taxation. In addition to satisfying the requirement of the SEZ Act, further criteria for some of the available tax incentives are stipulated in the Income Tax Act, 1962 (Act No.58 of 1962)
- **Business Allowance**  
Businesses and Operations (prescribed in section 1 of the SEZ Act) operating within a Special Economic Zone may be eligible for tax relief, including the building allowance, subject to requirements contained in the Income Tax Act
- **Employment Incentive**  
Businesses and Operations operating within a Special Economic Zone may be eligible for tax relief, including employment tax incentives subject to requirements contained in the Employment Tax Incentive Act, 2013 (Act No. 26 of 2013)
- **Customs Controlled Area**  
Businesses and Operations located within a customs controlled area of a Special Economic Zone will be eligible for tax relief as per the Value-Added Tax Act, 1991 (Act No. 89 of 1991), the Customs and Excise Act, 1964 (Act No. 91 of 1964), the Customs Duty Act 2014 (Act No. 30 of 2014) and the Customs Control Act, 2014 (Act No.31 of 2014)
- **12I Tax Allowance**  
The 12I Tax Incentive is designed to support Greenfield Investments (i.e. new industrial projects that utilise only new and unused manufacturing assets), as well as Brownfields investments (i.e. expansion or upgrades of existing industrial projects). The new incentive offers support for both capital investment and training.

*Source: Department of Trade and Industry, 2014*