MBA Thesis

THE ROLE OF SPECIAL ECONOMIC ZONES IN ATTRACTING FOREIGN DIRECT INVESTMENT AND EXPANDING SOUTH AFRICAN EXPORTS: THE CASE OF THE COEGA INDUSTRIAL DEVELOPMENT ZONE.

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Declaration

I certify that the work contained within the report is my own. I have used a recognised convention for citation and referencing. Each significant contribution and quotation from the works of other people has been attributed, cited and referenced. I know that plagiarism is wrong.

Signed:

Donald Gardner 8 December 2011
Abstract

Special Economic Zones have become a popular tool internationally in order to promote national economic growth through the production of goods for the export market. The zones attract foreign direct investment by building high quality infrastructure, offering tax incentives and subsidising services. South Africa created four industrial development zones in the late 1990s but these have not been as successful as expected, despite huge government investment in projects. This report specifically analyses South Africa’s largest zone, Coega, and focuses on the role that the zone should play in promoting economic development. Interviews were conducted with key stakeholders to determine the major goals of the zone as well as determining the major causes for its underperformance. Comparisons with world leading zones were done in order to determine what is necessary to make a zone successful.

The main role for SEZs is to create an investment climate that is superior to the national business climate, which encourages investment, job creation and social upliftment. The zones should then be a spearhead for policy change within the broader market to make the country as a whole a better investment proposition.

The main findings of the report are that Coega hasn’t managed to separate itself from the national business climate and the incentives offered in the zone are not sufficient to overcome the issues with the country. The investor promotion agency for Coega has not been able to operate as a one stop shop for potential investors looking to enter the South African economy because of bureaucracy and delays in critical decisions. Major issues currently facing the zone include the national electricity shortage, the Eastern Cape’s water shortage, and the distance from market.
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<tr>
<td>BPO</td>
<td>Business Process Outsourcing</td>
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<td>CCA</td>
<td>Customs Controlled Area</td>
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<td>CDC</td>
<td>Coega Development Corporation</td>
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<td>CDE</td>
<td>Centre for Development and Enterprise</td>
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<td>DTI</td>
<td>Department of Trade and Industry</td>
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<td>ECDC</td>
<td>Eastern Cape Development Council</td>
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<td>ELG</td>
<td>Export Led Growth</td>
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<td>EPZ</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FTZ</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GSP</td>
<td>Generalised System of Preferences</td>
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<td>IPAP</td>
<td>Industrial Policy Action Plan</td>
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<td>NERSA</td>
<td>National Energy Regulator of South Africa</td>
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<tr>
<td>NMBM</td>
<td>Nelson Mandela Bay Municipality</td>
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<tr>
<td>OEM</td>
<td>Original Equipment Manufacturers</td>
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<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
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<tr>
<td>REFIT</td>
<td>Renewable Energy Feed in Tariff</td>
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<td>SARS</td>
<td>South African Revenue Service</td>
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<td>SEZ</td>
<td>Special Economic Zone</td>
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1. Chapter 1: Introduction

Special Economic Zones (SEZs) have received significant international attention in the last three decades, coming off the dramatic success that China has had with its SEZ programme. A SEZ is defined as a designated area that offers benefits to investors such as income tax incentives and/or lower import and export tariffs with the aim of attracting foreign direct investment (FDI) in the SEZ (Firoz & Murry, 2003). The zones are expected to create job opportunities, promote regional development and boost exports for the nation. Over the past few decades SEZs have been created in over 100 countries and have been used as vehicles to facilitate investment, boost exports and create jobs, especially in developing economies.

Faced with stagnant manufacturing output and high unemployment rates throughout the country, the South African government embarked on a new industrialisation policy in the late 1990s. Part of the policy was the development of four Industrial Development Zones (IDZs), one of which was the Coega IDZ\(^1\), located near Port Elizabeth in the Eastern Cape. Directly linked to the IDZ development was the development of a new deep water port, named the Port of Ngqura. To date, the government has invested an estimated R30 billion in creating the port and the Coega IDZ (Munshi, 2011b). Despite this massive government investment, private investment in the zone has been well below the anticipated levels.

Given such large investments from government, and the apparent potential of IDZs to create sustainable jobs in disadvantaged sectors of South Africa, it is of national importance that the opportunities that such developments can make are well investigated and thoroughly evaluated. If the mechanisms that attract determine investment levels into zones such as Coega are properly understood, this knowledge could be used to develop a framework that could be applied by government and other stakeholders to undertake similar projects in other parts of South Africa.

1.1. Research Question and Scope

In light of the challenges currently facing Coega, this study seeks to tackle the following research question:

*How effective have SEZs been in attracting foreign direct investment into South Africa and what future roles should they play in increasing South African exports?*

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1 See section 3.1 for the distinction between the different types of zones.
Coega has been used as a case study for this research report and the emphasis has been on how to create a sustainable growth hub using the SEZ concept. The following sub questions are being proposed:

- What have been the major determinants of the success or failure of SEZs in other parts of the world?
- Why has Coega failed to attract the desired levels of investment?
- What challenges is Coega currently facing in attracting investment and how are they being addressed?
- What kinds of incentives are currently being provided at Coega and are they adequate?
- What is Coega lacking that could potentially make it more successful?
- What incentives can viably be instituted to attract development to Coega?
- What issues and problems should government and its partners be addressing to attract FDI?

Interviews were conducted with experts and stakeholders to understand the underlying issues affecting Coega. Using literature and interviews, comparisons were then done with successful zones internationally in order to uncover which instruments are critical to make a zone successful. The thesis specifically looked at Coega and the pitfalls it is currently facing, but many of the problems are national in nature and many of the leanings from this case could be applied in a broader context.
2. Chapter 2: Methodology of Research

2.1. Research Approach

The research took the form of a qualitative research report. A qualitative research method allows the research to take place in the “real world” and allows the study of the phenomena in all its complexity (Leedy & Ormrod, 2005). As the role of a SEZ is a highly complex subject with many influencing factors, the research took the form of a case study with the Coega IDZ as the principle focus. Contributing factors that may influence the success of the zone were investigated in depth. Inductive reasoning was then used so that recommendations could be made for the Coega IDZ.

A case study has the advantage of only requiring a single subject to be analysed and extensive data relating to the subject can be collected. This enabled the researcher to investigate the issues at play which have determined the performance of Coega. Comparatives have been made using available literature as well as other sources found during the course of the research. To prevent bias from sources, multiple sources of evidence have been used in order to create a balanced argument (Yin, 2003). This has enabled the researcher to make recommendations as to what changes could be made to further incentivise investment in the zone.

2.2. Data Collection

Data was gathered from a number of sources. Primary sources were government policies, relevant data sources and interviews with key stakeholders. Further secondary sources such as academic literature, reports and news articles have also be used to ensure that balanced and accurate data has been collected.

Data gathering primarily consisted of semi-structured elite interviews, undertaken for the collection of data directly from key stakeholders in all aspects of Coega and other IDZs. The stakeholders include the Coega Development Corporation (CDC), South African businesses, national and provincial government institutions and SEZs experts. A round table forum focusing on SEZs in South Africa was also attended by the researcher. According to Holloway (1997) an elite interview is defined as an interview with powerful or high status stakeholder in the subject being researched.

Prior to conducting interviews, the researcher familiarised himself with relevant background information in preparation for the interview, so as much pertinent information as possible was
obtained from each interview. The sources of background information included literature, policies and press articles. Most interviews took place in person so that a rapport with the interviewee could be more easily created. Only one interview took place over the phone.

The interviews were conducted in a semi-structured manner. Specific target topics were used as a guide for the questions to ensure that relevant questions were posed to the interviewee. This allowed for both facts and relevant opinions to be obtained. The method also provided latitude for the interviewee to answer questions, so that a comprehensive story could be obtained.

The value of the data obtained was largely dependent on the qualifications and experience of the person being interviewed. Therefore careful consideration was used to determine which candidates would provide accurate and meaningful information on SEZs, government policies, company positions or the standing of Coega. Another determinant of the usefulness of the interview was the preparation for the interview from both the researcher and interviewee. Specific questions were asked by the researcher relevant to both the interviewee and the research topic.

The protocol that was followed in the interview was an opening introductory statement, including background information and the desired research direction, followed by specific research questions, probing questions and a discussion around the topic of interest, where issues and observations were raised (Creswell, 2003). In most cases the interviews were recorded, in instances where the interviewee agreed to this procedure.

Interviews were conducted with four different groups: – business representatives, South African government agencies, SEZ experts and Coega Stakeholders. The people interviewed and the title that they hold in their respective organisations is listed in Appendix 2.

As part of the research process the researcher also attended a round table forum hosted by the Centre for Development and Enterprise (CDE). The subject of the forum was the “The role of Special Economic Zones” and it specifically looked at the challenges facing South African IDZs. The forum was a round table event with specialists in various fields presenting on selected relevant topics, followed by an open questions and answer session. During the discussion periods the specialists answered the questions posed to them. Attendees included various industry stakeholders in SEZs as well as those representing various industries that
could potentially invest in IDZs. A list of the presenters and their affiliations are also listed in Appendix 2.

Questions posed during interviews were mainly based on the literature discussed in Chapter 3 as well as information provided by the different interviewees. In the case of government departments and foreign representatives questions were posed to determine the following, where applicable:

- Their key interests in the development of Coega or SEZs
- The long term goals of creating a SEZ as perceived by them
- What incentives they are willing to offer in order to improve the attractiveness of these zones (Current and future proposed incentives)
- Support infrastructure that needs to be in place before SEZs gain private investment interest.
- How they plan to ensure that the developments in the SEZs don’t crowd out businesses already operating in the local market.
- The measures, other than policy changes and capital spending, that governments are taking to attract FDI to SEZs.

For businesses groups and stakeholders directly involved in the operation of Coega:

- Their key interests in developing a site in a specific region
- The attractiveness or problems currently in place with the Coega development that is encouraging / discouraging investment
- The incentives that they would require in order to make Coega their industrial investment destination of choice. Research Criteria

According to Yin (2003), four tests of validity can be used to determine the quality of the research performed. These are construct validity, internal validity, external validity and reliability.

Construct validity establishes the correct operational measures for the subject being studied. This means that multiple sources need to be used, there needs to be a chain of evidence and the draft of the report needs to be reviewed to ensure that it is valid. With this in mind the researcher has taken care to utilise a variety of sources to prevent subjectivity playing a role in the research. The research supervisor has reviewed the document to determine the validity.
Interviewees were questioned in a way that their measures of development success are taken into account.

Internal validity determines whether causal relationship error has occurred or that unjustified inferences are being used. Pattern matching, explanation building, addressing rival explanations and using logic models are tools that have been applied to ensure that internal validity is obtained.

External validity determines whether findings from a study can be generalised beyond the case being studied. As the research is on a single case, the ability to generalise beyond the scope of the project is limited. Theory and other research has been combined with the case study to ensure that replication of findings has taken place, so that broader generalisations can be made.

Reliability tests whether similar outcomes would be found if the same methodology was followed. A case study protocol has been followed and a database of information has been created to ensure that information and findings obtained are of a reliable nature.

These four tests were kept in mind when compiling the research report to ensure that research of the project in valid on all four criteria.

2.3. The Role of the Researcher

The researcher is a Chemical Engineer who has experience working for a large multinational industrial company. His four years of work experience in a heavy industrial production environment enables him to understand the requirements of industrials which operate in the large scale manufacturing sector. As an MBA student at the UCT Graduate School of Business the researcher has become familiar with the role of government policies, business needs and general society interests. The researcher is enthusiastic about industrialisation, economic development and the need for social upliftment to achieve a better South Africa for all in the future. Under the guidance of Assoc. Prof Mills Soko, who is specialist in regional economic integration and government-business relations, the researcher received invaluable guidance in the pursuit of his research goals.

2.4. Limitations

The case being investigated for the research is specific to the Coega IDZ and not all IDZs in South Africa, although there are commonalities between the zones, which have been
highlighted. Time limits imposed on the research have meant that it was only be possible to interview a portion of groups that had interests in the Coega IDZ. This was why only elite interviews were conducted. Findings have relied heavily on interviews with key stakeholders and may be subject to bias based on the limited number of interviews that have been conducted. This was overcome by the fact that a variety stakeholders were interviewed, who should have varying interests, objectives and opinions.

When reviewing which businesses could be incentivized to invest in Coega it was difficult to draw conclusions that would be applicable to an entire sector, as each business has specific needs and there is only a degree of commonality between businesses. As Coega is a development to encourage industrial investment, only certain sectors of the economy were reviewed as part of the investigation.

Comparisons cannot easily be made as there is no similar project within South Africa and only broad generalisations can be made regarding factors assumed to be common amongst SEZs around the world. The IDZs in South Africa are all different in nature, at different locations, and Coega is by far the largest SEZ project undertaken by the government to date. Like any study conducted by a single individual the study could be flawed by subjectivity. The researcher has tried to remain conscious of this danger and attempt to minimise its impact.
3. Chapter 3: Literature Review

3.1. The role and impact of SEZs

SEZs can be categorised under a multitude of different names depending on the purpose they serve and the host country. In many instances the zones are called Free or Foreign Trade Zones (FTZ), Economic Development Zones (EDZ), Export Processing Zones (EPZ) or Economic Trading and Development Zones (ETDZ) (Firoz & Murry, 2003). Essentially all of these zones are similar in that they offer incentives for direct investment that will result in the production of goods for export. The zones often cluster similar industries, or least aim to. By clustering, the industries are expected to benefit from synergies, interact and collaborate. It is hoped that such clusters will encourage innovation and thereby improve national competitive advantages.

Generally, one of the core benefits of the zones is that they are considered as foreign territory for imported goods, and therefore no customs, taxes or levies are collected on goods that are imported (Firoz, Rezvani, Ramin, & Abdallah, 2003). Taxes are only levied on goods if they leave the zone and enter the domestic market. If finished goods are exported then no levies are collected. As a result of this, the zones are normally located at or near a port of entry, either a harbour or an airport.

Farole of the World Bank states that “SEZs are typically established with the aim of achieving one or more of the following four policy objectives:

- Attracting FDI;
- Serving as “pressure valves” to alleviate large-scale unemployment;
- Supporting a wider economic reform strategy; and
- Acting as experimental laboratories for the application of new policies and approaches.” (2011b, p1)

The concept of an SEZ is that it confers economic benefits on both the host country and the businesses that locate there. For the host country the SEZs generate foreign income, create jobs and attract businesses that might have otherwise chosen to locate in another country. It should be noted that companies tend to invest in EPZs in an attempt to improve business efficiency and international competitiveness (through reduced costs) rather than joining an EPZ to gain access to the host country’s market. Most traditional EPZs competitiveness is determined by labour skills, productivity and costs and reduced tariffs. The principal
advantage for businesses is that manufacturing inputs and raw materials can be imported into the zone free of customs duty. The goods can then be enhanced and levies will only be imposed on the finished goods if they enter the domestic market. Depending on the industry that the company operates within, there can be a variety of benefits (Firoz et al, 2003), which include:

- **Cutting and Packaging** – where a product is imported in bulk and then repackaged to smaller sizes. Any spoilage of goods that don’t make it to market would not be subject to tax.
- **Testing** – products can be imported and tested before they are sent through to the domestic market. Any product that does not pass the testing process can be returned to the originator country without attracting customs duty.
- **Assembling parts and intermediate goods** – These can be brought into the zone, assembled and exported without attracting any duties. If the assembled goods are sold in the local economy, levies are only charged on the final goods, not the intermediates. Rejected intermediate goods would therefore not be levied.
- **Taking advantage in discrepancies in taxes levied** – finished items might have a lower tax rate than their components, so assembly could take place in the zone and import duties are only paid on the finished goods.
- **Insuring** – insurance is only paid on the cost of the goods, not the cost of the goods plus the levies.
- **Displaying and exhibiting** – if the goods don’t leave the zone, no levies will be charged for an unlimited period of time, so items can be displayed and exhibited in the zones indefinitely.
- **Taking advantage of other government dispensation for the zones**, which could include lower corporate tax rates, tax holidays and variations in depreciation costs for tax purposes.

Despite the advantages of SEZs for both government and businesses, there are concerns that producers in the SEZ may clash with domestic manufacturers (Schweinberger, 2003). Companies operating in the zone could be more cost competitive, in both local and international markets, due to the incentives they enjoy, and thus erode existing production capacity in the domestic economy. However Schweinberger (2003, p627) asserts that “by imposing appropriate employment taxes and/or subsidies in conjunction with the creation of the special economic zone, the special economic zone: (a) results in an increase in
government revenue, (b) is not conflict generating between households, and (c) brings about structural change only in the geographic entity declared a special economic zone.”

3.2. Determining a successful SEZ

Determining the success of a zone is critical in order to determine whether the investment is worth the return. Farole (2011a) states that the zones should be assessed in terms of the static economic benefits, the dynamic economic benefits and the social effects of the SEZs. The static economic benefits would include measures such as:

- Employment creation of direct jobs within the SEZ and indirect jobs created in other sectors of the economy;
- FDI capital inflows into the SEZ;
- Generation of foreign exchange through exports;
- The creation of economic value added;

Measures of dynamic economic benefits would include:

- Promotion of non-traditional economic activities (diversification of the economy);
- Hard and soft technology transfer;
- Vocational skill development;
- The encouragement of domestic entrepreneurism;
- Promotion of economic openness;

The measures of social effects of SEZs would include:

- Quality of employment generated;
- Extent to which workers’ right are protected in the zones;
- The gender differentiated impacts on zones (given that the large majority of workers in most zone programs are female);

Assessments must be done on the cost benefit of such zones (internal rate of return and economic rate of return). Alignment must be achieved between the objectives of the zones as economic projects and their objects as instruments of trade and industrial policy. However it should be noted that the return on such investments is often long term. Governments generally need to front the cost of development in the zone with the expectation that private enterprise will make the zone self-sustaining later. Most zones start slowly, growing linearly in the initial stages, before hitting a growth inflection point which normally occurs somewhere between the 5th and 10th year of operation.
Although FDI plays a crucial role in the success of a SEZ, domestic investment is also critical. Generally, FDI plays a more significant role in the initial phases of development because FDI brings with it knowledge and technology which is an important aspect of making an SEZ a success. Foreign firms can also place pressure on governments that can lead to structural economic reform. Despite this, most zones that start with substantial FDI are eventually dominated by locally based firms (Farole, 2011).

3.3. History of SEZs in China

China is often cited as an example of a country with a successful SEZ policy. Much of the country’s growth over the last 30 years can be attributed to the SEZs that were created as a spearhead for economic policy change within the country. As a result, the Chinese example has been closely studied and attempts have been made to replicate the success of China around the world.

In 1979 China began opening up its economy and one of its first steps was the creation of the SEZs (Shenzhen, Zhuhai, Shantou, Xiamen, & Hainan), which allowed for free flow of imported and exported goods through the zones. This immediately attracted international investment, especially from Hong Kong, Macau and Taiwan, which were located near the zones. By 2002 30 million people were employed in five SEZs as well as numerous FTZs in the country (Morris, 2007). The opening up of the Chinese economy, through the SEZ program, is thought to have been one of the primary drivers of Chinese economic growth, and particularly the improvement in the Chinese current account through export growth.
Initially the zones were used as a test bed for the development of international policies for foreign investors and as a method for China to generate foreign exchange. China utilised the zones as mechanism to industrialise the economy and begin trading with the developed world. The zones offered the government an opportunity to test free market trade, while still upholding the principles of its political regime. Initially the zones were regarded by the Chinese government as a public investment, with large amounts spent on infrastructure development to make the zones attractive. For example, in the case of Shenzhen it took 8 years before the tax generated from the zone exceeded government spending in the zone.
However between 1980 and 2004 Shenzhen’s Gross Domestic Product (GDP) grew at a spectacular annual rate of 28% and 14% per capita (Lai, 2006).

Mainland China is controlled by tight customs measures and high trade barriers that prevent companies from importing freely into the country. Due to this protectionism, international investors need to set up joint ventures (JVs) in the many economic zones, in order to import and export freely from China (Firoz & Murry, 2003).

Shenzhen was initially confronted by a shortage of skills as the area was largely rural when the zone was formed. To counteract this, the government set up generous incentives to encourage people to move to the city by, for example, providing larger apartments and paying higher wages. Active recruitment campaigns were also undertaken to bring people to the area (Lai, 2006).

When the zone was formed there was an electricity shortage in China, with regular supply outages affecting many regions. To allay foreign investors’ fears about this, the government guaranteed electricity supply to Shenzhen and even subsidised the cost (Chen, 1995). This was part of larger efforts by the Chinese government to provide infrastructure and services which met international standards and allay the fears of potential foreign investors.

One of the major attractions of investing in China was and still is low labour costs. There is no minimum wage in the country and this factor combined with the undervaluation of the Chinese Yuan makes labour costs extremely attractive to foreign investors. The zones provide a large dedicated non-unionised working class, who are generally well trained and willing to work for foreign companies (Morris, 2007).

China has largely used SEZs to drive its Export Led Growth (ELG) strategy. By fundamentally undervaluing the exchange rate of the Yuan when compared to its Purchasing Power Parity (PPP) value, China has managed to keep the costs of its exports down, making the country extremely competitive internationally (Morris, 2007). The undervalued currency favoured import substitution, tradable goods production and export promotion.
Firms from Hong Kong and Macao played a significant role in the success of the initial SEZs because they were looking for a cheaper place to produce goods and the country also provided a large market for finished goods. The most attractive element for these firms was the cost and work ethic of local labour. The Chinese government also adhered to its commitment to supply infrastructure, labour, and freedom to import, insulated from local controls (Morris, 2007). Little or no unionisation meant that real wages could only rise once the pool of available labour had become limited, but many firms made use of migrant labour so that the local labour pool was expanded.

According to Firoz and Murry (2003) there are numerous corporate incentives offered to companies who take part in Chinese SEZs. First is a low corporate tax rate of 15% and a two year tax exemption for enterprises guaranteeing fixed investments exceeding 10 years. There is also a 50% tax reduction in the ensuing three years once the business starts producing, in order to reduce the payback period for investments. Another advantage for the companies is that all imported equipment, vehicles, building material and consumer goods are exempt from customs duty. Projects that are in the energy and transportation sectors receive a 5year tax holiday.

In Shenzhen the focus is on industrialising the economy and generating exports for China to earn foreign exchange. Therefore certain industries are not tax exempt in the zone, such as
wholesaling, retailing, eating establishments, photographic industries, repair shops, training, passenger transportation and near shore fishing (Firoz & Murry, 2003).

Generally the Chinese system has been a model of success, with rapid growth, large scale FDI and the generation of large amounts of foreign exchange. However not all developments have been as successful as the initial projects. A good example is Hainan, which to date has only had limited success (Aggarwal, 2005).

3.4 SEZs outside of China

Following on the success of SEZ’s in China, similar industrial and export processing zones have been developed in other parts of the world, in both developed and developing countries, in the hope that they will replicate the huge achievements of the Chinese model. However the success of these endeavours has been variable. Morris (2007) has claimed that the success of the SEZs in China and East Asia are as a direct result of the favourable macroeconomic policies and strategies, in the pursuit of ELG.

Aggarwal (2005), while comparing the performance of various ELG initiatives in South Asia, noted the significant incentives that businesses are offered in order to encourage investment in EPZs.

| Table 1: Incentives and facilities: India, Bangladesh and Sri Lanka Fiscal Incentives |
|-------------------------------------------------|---------------------------------|---------------------------------|---------------------------------|
| **Income tax holiday**                           | **India**                       | **Bangladesh**                  | **Sri Lanka**                   |
| 100% exemption for 5 years. 50% exemption in the next two years | 10 years followed by 50% rates for 5 years | 3-5 years (3 for the backward regions), concessory rate of 10% for two years and 15% thereafter |
| **Exemption on dividends**                       | NA                              | 10 years complete exemption     | During tax exempt period and 1 year thereafter |
| **Exemption of income tax on interest on borrowed capital.** | NA                              | Yes                            | Yes                             |
| **Exemption of income tax on salaries of foreign technicians** | NA                              | Yes, up to 3 years (subject to certain conditions) | Yes, concessory rate of 15% for first 5 years |
By providing strong incentives and access to low cost labour, the zones in all three countries have enjoyed substantial growth and attracted considerable investment, despite infrastructure generally being considered to be of a relatively poor standard. In India the EPZs captured almost 39% of FDI, while in Sri Lanka the EPZs attracted 59% of the country’s FDI during 2003. No official figures are available for Bangladesh, but it is thought that their figures are higher than India’s (Aggarwal, 2005). Although the EPZs have generally been successful, some zones have not flourished as expected and it appears that the better developed zones have performed better.

International clusters, which lack the monetary incentives of SEZs, have also been successful in various places around the world. Some of the most well-known are Hsinchu Science Park in Taiwan, the Casablanca Technopark in Morocco and Technolopolist Innovation Park in Delft in the Netherlands (Saunders, 2010). These clusters have allowed for the sharing of facilities, fostered innovation and knowledge sharing. The benefits of these clusters have been significant enough to give the regions a competitive advantage in the sectors in which they operate.

Aggarwal (2005) states that the access to low cost labour attracts labour intensive businesses to a country. Some countries have discounted their own labour laws, including worker health and safety requirements, in the establishment of EPZs (Jauch, 1997). Sikaka (2007) argues that many EPZs can attribute their success to the use of cheap labour in the production of labour intensive goods such as clothing. The benefits then flow to foreign firms who further benefit from the customs and tax exemptions.

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>Bangladesh</th>
<th>Sri Lanka</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty free importation of</td>
<td>No</td>
<td>Yes (Up to 3)</td>
<td>No</td>
</tr>
<tr>
<td>motor vehicles for use of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>the enterprises in EPZs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>under certain conditions.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exemption from regional</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash subsidies</td>
<td>None</td>
<td>30% on agro based industries</td>
<td>None</td>
</tr>
</tbody>
</table>

(Source: Aggarwal, 2005)

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16
According to Goswami et al (2002) a good investment climate may also be crucial for attracting FDI to an EPZ. Quality of infrastructure, location, incentive packages on offer and the quality of governance all appear to be directly related to a zone’s success.

Not all zones have developed according to plan and Nam & Radulescu (2003) identify some of the causes as:

- Poor road and air communications linking the zone to developed regions.
- Failure of other basic infrastructure such as telecommunications and electricity.
- Poor international accessibility to the region.
- A mismatch of the skills required to run operations and those provided by local communities.

Aggarwal (2005, p59) backs this up by stating that “international experience suggests that if EPZs are located in backward areas with poor social and economic infrastructure and lack of industrial culture their performance is likely to be below expectation”

Successful zones may have also encountered the above problems to varying degrees, but it was the ability of the zone authorities to skilfully manage the challenges faced. The management of these EPZs continually evaluated the policies and situation in the zone and adapted their offerings accordingly.

The Philippines is cited as a good example of an early adopter of a SEZ that did not achieve large scale benefits for the host country (Morris, 2007). After some initial success, the zone never expanded much beyond its initial phase. The policies in the zone favoured import substitution, rather than export orientated businesses. Targeting import substitution rather than export growth limited the potential of the zone; investors did not reinvest their profits but rather issued dividends and repatriated their investments.

The zones that have been setup in Africa have generally been created to take advantage of preferential tariff treatment created during the Lome Convention of Generalised System of Preferences (GSP). Mauritius in particular has successfully capitalised on the GSP. The zones created there have attracted large investments from Taiwan, Korea and Thailand in the clothing and textile industries. The countries invested mainly to circumvent quota restrictions that the Multi-Fibre Agreement (MFA) imposed on them when exporting to rich countries such as the United States and European Union (Morris, 2007). In 2003 up to 70% of Mauritian exports were originating from the country’s EPZs (Aggarwal, 2005).
Mauritius however has some unique attributes that would be difficult for South Africa to replicate. Firstly the country is a relatively small island; therefore extending infrastructure to cover an underserved area is much easier. All areas on the island are within 30 minutes of a port, therefore access to an international logistics hub is much simpler when compared to a large country like South Africa. Critical to the Mauritian FTZs was the fact that private companies were allowed to operate within their ‘own premises’ if they wanted to – each factory in effect became its own EPZ. The zones were not restricted to a physical location, but rather certain activities were deemed approved as part of an EPZ (Makoond, 2004).

3.5. Government Policies and Initiatives in South Africa

The South African government has embarked on a policy to industrialise the nation in order to increase employment, generate foreign income and increase the skills levels of the general population. The strategy applied at Coega is directly aligned with these national goals. This is best described by Jacob Zuma in his State of the Nation Address in June 2009, where he said “The creation of decent work will be at the centre of economic policies and will influence our investment attraction and job creation initiatives. In line with our undertakings, we have to forge ahead to promote a more inclusive economy.” (The New Growth Path, 2011).

Within South Africa the IDZs are conceived to be designated areas where value is added to commodities, goods are manufactured for export and foreign exchange is earned for the country. Focus is placed on manufacturing tradable, labour intensive goods in order to create employment.

Efforts to improve South African exports have been hampered by local factors highlighted in the 2010 World Bank Report on the South African Investment Climate Assessment. The report states that South Africa is struggling to attract FDI due to the following reasons:

- The cost and impact of crime on the domestic economy.
- The high prevalence of HIV/AIDS in the country, which has already dramatically affected the working population.
- The high degree of labour regulation and the influence of politically powerful trade unions, when compared to the nation’s peer group.
- Lack of access to financing for small and medium enterprises, which prevent them from growing their businesses.
- Poor skills that do not adequately match the requirements of the productive sector.
• The recent shortage of electricity generating capacity and the negative shocks of dramatic electricity price increases.
• An unreliable, expensive and aging railway and port system.

An analysis performed in the Industrial Policy Action Plan (IPAP) report stated that South Africa’s cost of capital is high relative to its major trading partners. The report also asserted that private credit extension has been in the form of debt-driven consumption, rather than in capital and energy intensive industries. This has resulted in a low rate of investment in productive industries. To rectify this situation the report states that the Industrial Development Bank (IDC) should play a bigger role in lowering the cost of investment, as it is currently only able to offer financing at commercial rates. The report uses the example of the Korean Development Bank (KDB) and Brazil’s BNDES which have played a successful role in channelling finance towards productive activities. However, increasing the role of the IDC would require a substantial capital injection to enable them to provide financing at discount rates.

The IPAP and industrial policy are just aspects of a number of interrelated policies that are meant to align the country to towards the New Growth Path, which is targeting an economy which is relatively more labour-intensive and value-adding.

Corporate tax is a motivating factor for any company looking to invest internationally. In South Africa the corporate tax rate is 28%, along with a 10% tax on dividends issued. When compared to China (25% national, 15% in SEZs), Brazil (34%), Chile (17%), Indonesia (25%) and Taiwan (17%) (oecd.org database, 2010), it appears as if South Africa sits within the upper end of international corporate tax rates for emerging economies. Therefore it could be argued that there is an opportunity to further incentivise investment in the IDZs through the relaxation of corporate taxes.

Since the end of apartheid South Africa has embarked on a policy of trade linearization. The expected benefit of such a policy is to improve export performance because immediate input costs are reduced and there is a lower incentive to produce for the domestic market (Harding & Rattsø, 2005).

The IDZs developed in South Africa offer limited incentives, when compared to those in other parts of the world. The main incentive is that the IDZs form part of Customs Controlled Areas (CCAs), which allow goods to be imported, without any customs duties (SARS, 2011).
Only if the goods enter the local economy will duties be paid. Other incentives are in place for capital equipment such as machinery and infrastructure (See Appendix 1 for full list of incentives from SARS). There are also non-financial incentives in the zones such as streamlined and simplified customs clearing processes.

According to Rustomjee and Hanival (2008), in September 2006 the IDZ unit made proposals to the National Treasury to consider the following proposals:

- Providing a tax holiday scheme that applies to all firms setting up within the IDZ,
- Giving relief from customs duty for imported plant, machinery and equipment (although this partly exists for goods destined for export under the 470.03 schedule).
- Training tax allowances.
- Providing operating companies in the IDZ some form tax relief or reductions.
- Creating a range of more technical proposals relating to the treatment of VAT and tax deductibility of various operations within the IDZ.

Some aspects of the IDZs status and proposals are contradictory to general government objectives. The proposal that importation of plant and equipment to the IDZ be tax exempt is contrary to the objective to encourage the production of capital goods domestically. Rustomjee and Hanival (2008) also recommend that the spatially-defined tax holiday, “needs to be reconciled with proposals that other parts of the Department of Trade and Industry (DTI) are also making to National Treasury for the re-implementation of strategically sectorally-targeted tax-based incentives” (2008, p45). However Morris (2007) states that even in China, liberalisation of import restrictions were required for entry into certain markets. He argues that inputs for light engineering, textiles and electronics assembly were required in the setup of those industries in China.

3.6. Other Government Incentives and Policies

A report by Walwyn (2008) found that spending on Research and Development (R&D) in the South African manufacturing sector is on average just 20% of the benchmark set by competitor countries. Taking this into account, Walwyn suggests that manufacturing R&D expenditure in South Africa should be boosted to 0.9% (85% higher) of GDP, should South Africa want to advance to a more knowledge based economy. Tax incentives, which have changed in the last two years, allow for a tax credit for 150% of incurred operational expenses relating to R&D and an accelerated depreciation timeline for capital goods.
Although the incentive system is generous, it does create some ambiguity as it does not define what is research and development, and there is uncertainty as to what costs can be claimed under the act (Price, 2010). The incentive system however is comparable to other nations in the world, so it is hoped that it will have the effect of accelerating spending in R&D in South Africa.,

Incentives are already applied in the automotive sector. According to Mills (2011), The National Treasury allocated incentives worth R17.8billion to the industry, comprising of tax allowances, preferential financing from the IDC, cash grants and import tariff reductions. An estimated 36 000 people work directly in this sector, which means the annual incentive cost per direct job is R585 000.

Hausmann and Klinger (2008, p634) propose that “interventions should be justified on their expected impact on increasing productivity, rather than take the form of subsidies or interventions that compensate activities for their lack of productivity.” In the light of this recommendation and the high cost of some other incentives already in place in the country, one should be looking for incentives that have the maximum benefit for the economy at the lowest cost.

Every product has specific inputs such as intermediate inputs, equipment, knowledge and labour. A nation will therefore find it significantly easier to gain a competitive advantage when moving towards similar ‘products’ with regards to inputs than for something in which they do not have an historical skills base (Hausmann & Klinger, 2008). Therefore government should be actively looking at sectors where any existing competitive advantage of the country can be levered.

The unemployment rate of 18 to 25-year olds is estimated to be 51% (Bulletin of Statistics, 2011), which is usually attributed to their poor level of skills and experience. Countries such as Columbia offer tax incentives to businesses that hire first time employees (Mills, 2011). It is thought offering incentives to firms to hire these employees would allow them to more easily serve apprenticeships and acquire job specific skills. Such an incentive is currently under consideration at the National Treasury (Mothabi, 2010).

In order to address the problems facing the country, President Zuma created the National Planning Commission (NPC), which is meant to advise the president on issues impacting long term development. The NPC released its national development plan report on the 11th of
November 2011 and has suggested strategic shifts in policy in order to reduce the jobless rate to 6% by 2030. The report identified nine main challenges facing South Africa, which included:

- Too few people work;
- The standard of education for most black learners is of poor quality;
- Infrastructure is poorly distributed, under-maintained and insufficient to foster higher growth;
- Spatial patterns exclude the poor from the fruits of development;
- The economy is overly and unsustainably resource intensive;
- A widespread disease burden is compounded by a failing public health system;
- Public services are uneven and often of poor quality;
- Corruption is widespread;
- South Africa remains a divided society;

The report argues that that “failure to address these challenges is likely to result in economic decline, falling living standards, rising competition for resources and social tension” (2011, p4).

Within the report there are recommendations to best address these needs, some of which would be of interest to foreign investors. The NPC has suggested mechanisms that lower the cost of doing business in South Africa. This includes developing infrastructure networks, and lowering tariff and non-tariff barriers that exist in the economy. The government has however acknowledged that drivers of growth are not necessarily the same drivers of job creation. In order to get a better alignment with this, the NPC recommends a high focus be placed on the labour intensive manufacturing sector. The report states that South Africa is not competitive in the labour intensive manufacturing sector because of high cost structures emerging from labour costs, logistics and low levels of management acumen. One of the reforms that would likely have the largest impact for business would be changes in the functioning of the labour market. The report suggests that reforms should be made regarding dispute resolution and discipline, and recommends the simplification of the current process to remove underperforming staff.

In order to improve business conditions in the country the NPC recommends that the government boosts its own investment spending. This has been in steady decline over the last
few decades dropping from 30% of GDP in the 1980s to a low of 16% in the early 2000s. Public sector investment draws in investment from the private sector and as such the government should commit to boosting capital investments in roads, rail, ports, electricity, water sanitation, public transport, information and communications technology and housing. The host of plans put forward highlight the government’s desire to improve the business conditions in the country. Some of the proposals, especially those relating to labour force regulation are likely to face stiff political opposition, but if the country is to address the core issues, hard decisions and sacrifices will need to be made.

3.7. Reasons for the development of IDZs in South Africa

Growth in manufacturing in South Africa has significantly lagged other sectors of the economy. According to International Monetary Fund statistics, South Africa’s manufacturing output per capita is lower today than it was in the 1970s (Hausmann & Klinger, 2008). Hausmann, Hwang and Rodrik (2007) have argued that the improvement/sophistication in the export basket of a country is a strong determinant of the country’s growth.

![Figure 4: South African Annual Manufacturing Growth](Source: World Bank, 2011)

South Africa is also experiencing high unemployment, low investment in labour intensive industries and a ballooning current account deficit.
With these problems in mind the government has been focusing on policies and initiatives that will contribute to rectifying the imbalances, grow the economy and boost exports.

When analysing what countries should do to enhance their growth Porter (1998) recommends specialisation according to historical strength. However, Hausmann and Klinger argue that South Africa’s export growth is stymied by the fact that it “is specialized in sectors intensive in highly specific factors of production that cannot be easily redeployed to other activities” (2008, p609). This has prevented the diversification of South Africa’s economy and export led growth.

Porter (1998) believes that industrial clusters improve productivity, stimulate innovation and boost national competitiveness. Porter uses a diamond model to highlight the four forces that will determine the success of an industrial cluster. These forces are: factor input conditions; related and supported industries; local demand conditions and firm strategy, structure and rivalry.

Porter (2000) has also contended that global competition and technology have reduced the traditional role of location. However he argues that clusters are still an important factor in many economies, because they determine the competitive advantage of a nation. He states that “clusters represent a new way of thinking about national, state, and local economies, and they necessitate new roles for companies, government, and other institutions in enhancing competitiveness” (2000, p175).
This type of thinking influenced the IDZ initiatives that the government embarked upon 12 years ago. At inception two IDZs were created in the Eastern Cape Province. The province has an unemployment rate of 24.7% (Bulletin of Statistics, 2011), with an estimated 57.9% of households dependent on social grants (General Household Survey 2010, 2011). This explains why the government is trying to attract direct investment into this province in particular. The recent development of the Port of Ngqura and its associated infrastructure has improved the area’s export capability, making it a more attractive proposition for companies interested in investing in export businesses. There are a number other incentives available to businesses in the area, which combined should make the region more attractive to investors compared with other areas in the country and hopefully internationally as well.
4. Chapter 4: Research Findings, Analysis and Discussion

4.1. Justification and history of Coega

The primary reason that the Coega IDZ was conceived was to address the social inequality in the Eastern Cape and was originally conceived by a team of private sector companies which included Gencor (now part of BHP Billiton) and Pretoria Portland Cement. These companies wanted to establish large production facilities in close proximity to a port, so that their products could be easily exported.

The province is the second poorest in the country, with an unemployment rate of 24.7% (General Household Survey 2010, 2011b). Compounding the unemployment problem are poor levels of literacy and a huge number of unskilled workers, who continue to be marginalised in the economy (Tuswa et. al, 2011). The Eastern Cape is also heavily reliant on the automotive sector which accounts for almost half of the manufacturing value-add in the province. Given the difficulties facing the province, the concept was enthusiastically embraced by the Port Elizabeth municipality at the time and the municipality supported a feasibility study in 1997.

The development of the Coega IDZ therefore provided an opportunity to diversify the manufacturing sector of the province. Given the fact that an estimated 57.9% of households in the Eastern Cape are dependent on social grants (General Household Survey 2010, 2011), the province is in dire need of job creation opportunities that will lead to social upliftment. Coega was and is seen as a critical mechanism to improve the overall Eastern Cape economy.

Moran (2011) highlighted a number of benefits that can potentially be achieved from successful SEZs. His research, which correlates highly with the findings with other reports reviewed, states that benefits from a successful SEZ can include the following:

- Macroeconomic reform;
- Improvement in the doing business indicators; (Starting a Business, Dealing with Construction Permits, Getting Electricity, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Trading Across Borders, Enforcing Contracts, Resolving Insolvency);
- Skills development;
- The fostering of a close relationship with investors;
- The expansion of formal employment;
• Greater job security compared to the normal economy, even in areas where there is little employee protectionism;
• Poverty reduction;
• Better working conditions;
• Higher educational attainment;
• Better equality between men and women in the workplace;
• Economic advancement from low skill industries to medium skills and finally through to high skills industries.

Based on the potential benefits of a SEZ, the government wanted to create an industrial zone with an orientation towards production for export, rather than import substitution, which had been a policy of the apartheid regime.

Based on the findings of a feasibility study, cabinet approved the establishment of IDZs in South Africa and the DTI set out a framework for the rules governing the zones. With high expectations, the Coega IDZ was established in 1999, co-owned by the DTI and the Eastern Cape Development Corporation (ECDC), while being operated by the CDC.

Covering an area of 110 km² and located near the city of Port Elizabeth, the automotive hub of South Africa, the zone was expected to be attractive to both foreign and local investors. In 1999 a major infrastructure plan was drawn up, which included the development of the port, road and rail links as well as water and electricity supply.

The purpose of the zone was to create a complex customised for heavy, medium and light industries. The zone would have superior international logistical links through the development of the deep-water harbour called the Port of Ngqura adjacent to the IDZ.

In the Nelson Mandela Bay Municipality (NMBM) there is a strong presence of automotive manufactures and associated original equipment manufacturers (OEM). It was hoped that the presence of these industries, along with the development of the industrial complex would be sufficient to attract to new investors in these and associated fields. International companies such as Volkswagen, General Motors, Goodyear and Johnson Controls had already created a high technical skills pool in the region, so it was thought that there would be a good balance of skilled and unskilled labour resources to effectively operate businesses in the targeted industries. The vision for the zone is that it would be able to accommodate low as well as
medium and high skill-based industries because of the nature of the South African population.

The establishment of the port was a contentious issue at the time because the new deep water port was built within 20km of the operational harbour in Port Elizabeth. The expected benefit of building a new port outside of the city was that all industrial activities in the centre of the city could be moved out to the vicinity of the new port, thus allowing for the restructuring and renewal of the Port Elizabeth port area. Analysis of 2001 municipal data by Krugell and Matthee found that Port Elizabeth had high export performance and high export capability. This was prior to the development of Coega, therefore reasonable grounds existed for questioning the development of the port and the substantial spending by government for infrastructure development in the area. One could argue that the capital could have been better spent in an area that had large export capability but low export performance. One should perhaps consider the opportunity cost of setting up a large industrial zone by comparison to other potential projects in the country.

Despite the criticism of the IDZ and its dedicated new port, the physical development of the area has largely been completed. At the port there are two berths for containers, two berths for dry bulk handling (mineral ores) and one for liquid bulk handling (oil products). Some of the industrial activities that were taking place in Port Elizabeth are now in the process of being moved over to the new port, providing the opportunity for land rehabilitation to take place in the city centre.

Interest in the area was initially good as a number of potential companies were looking at setting up mineral beneficiation plants for manganese, zinc and steel. However certain companies were reluctant to invest initially because they were unsure whether the plans for the area would be carried out. Many companies expressed interest in the zone but wanted to see infrastructure in place before building their plants and establishing businesses.

The first major commitment for the IDZ was from Pechiney (a French aluminium company) to build a US$2.7 billion aluminium smelter, which would act as the anchor tenant for the zone. However the establishment of the smelter was drastically delayed when Alcan purchased Pechiney in 2003. The project was still on the cards after the purchase, but was terminated in the wake of South Africa's unplanned power outages in early 2008. This was because Eskom could not commit to supply the smelter with the necessary electricity to run
the refinery (*Rio Tinto-Alcan*, 2009). With the loss of this potential anchor tenant Coega has since struggled to encourage large scale investment in the area.

4.2. Current Status of the Coega IDZ

To date government and its various entities have spent in excess of R30 billion in the creation of Coega (Munshi, 2011b). The bulk of the spending went into the construction of the port, which became operational in 2008, as well as roads and other hard infrastructure. There are 14 zones within the access controlled complex. The area is set up to attract investment from the following sectors:

- Automotive manufacturing and assembly
- Agro processing
- Chemical Manufacturing
- Business Process Outsourcing
- Energy
- Metals Beneficiation

The benefits of the distinct zones is that similar industries can be grouped together to get the advantages of clustering. The physical infrastructure has been built according to the original plans and at the moment there are 24 operational companies that have invested R1.14 billion in the zone. According to Matchett (2011), the port is currently operating at about 70% capacity and has positioned itself as a trans-shipment hub for goods travelling from the East for final delivery into other parts of Africa. Discount rates are being offered to shipping companies so that the capacity of the port is utilised as much as possible.

Excluding the port, 2082 permanent jobs have been created within the IDZ; while an estimated 20 000 temporary jobs were also created during the various construction phases of the zone. According to Pepi Selinga (CDC CEO) a further 25963 indirect and induced jobs have also been created (Jack, 2011). Considering the massive amount of public money that has been spent on the zone, the amount of private capital committed to the zone has been discouraging. Many critics are now calling the zone a white elephant, the result of misguided flawed strategy on the part of the government.

There are however numerous other projects in the pipeline for Coega. The largest of which is Kalagadi Manganese, a state owned firm. The company has announced that it will be investing R4.2 billion in a ferromanganese smelter located in the IDZ. It is expected to create
1000 jobs during the construction phase and 400 permanent jobs when it is completed (CDC website, 2011).

An estimated R13 billion has been committed for investments in Coega. The projects with various companies are outlined below. The table details the amount committed, as well as highlighting the potential hurdles that need to be overcome before the businesses can become operational.

<table>
<thead>
<tr>
<th>Company</th>
<th>Project Description</th>
<th>Amount Committed</th>
<th>Hurdles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innowind</td>
<td>Innowind is a renewable energy company from France which plans to build 16 wind turbines, which have the capacity to generate 3MW of electricity each. The viability of the project is dependent on a successful bid to the National Energy Regulator of South Africa (NERSA) which will determine the feed in tariff rate for the electricity produced by the turbines.</td>
<td>R500 million</td>
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<tr>
<td>Cape Concentrates</td>
<td>Cape Concentrate has built a new factory that will produce tomato paste. The factory is in the final stages of completion and should be fully operational in the near future. The facility boasts state-of-the-art technology for processing tomato paste. Situated on 33,000 square metres of land, it will be the largest plant of its nature in Southern Africa. 180 direct jobs are expected to be created, but the plant has significant spill over effects because large amounts of tomatoes will need to be grown by the surrounding communities.</td>
<td>R100 million</td>
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<tr>
<td>Universal Wind</td>
<td>Universal Wind is proposing the establishment of a wind energy project comprising of approximately 20 wind turbines that produce approximately 2 to 4 megawatts (MW) each and a combined generation capacity of up to 80 megawatts (MW). 6 permanent jobs will be created by the project. The viability of the project is dependent on a successful bid to NERSA which will determine the Renewable Energy Feed in Tariff (REFIT) for the electricity produced by the turbines.</td>
<td>R850 million</td>
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<tr>
<td>GDF Suez</td>
<td>GDF Suez, a French based company has been approved to build a peaking power plant that produces 330-megawatts of electricity. The project has been approved by NERSA</td>
<td>R2-3 billion</td>
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</table>
already and is moving forward. The plant is expected to operate mainly during peak electricity demand periods to stabilise electricity supply. The plant may also be used during periods when other power plants on the national grid are undergoing maintenance, or when security of supply from the national grid is threatened.

<table>
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<tr>
<th>Coega Dairy</th>
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<tr>
<td>Coega Dairy (Pty) will invest in building a state of the art dairy processing plant. The dairy will be owned by a cooperative of 13 commercial dairy farmers. The project will create 754 indirect jobs, 200 farm jobs, 70 operational jobs and 50 construction jobs. By the end of 2013, the investment is expected to have grown to R150 million.</td>
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<th>EAB</th>
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<tr>
<td>EAB, a German company plans to construct a solar power plant that will potentially generate 12MW of electricity. 200 hectares of land have been set aside for the project. The project, like the other renewable energy projects in Coega is dependent on an agreement being reached on the feed in tariff to the national grid with NERSA.</td>
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<th>Rainbow Nation Renewable fuels</th>
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<tr>
<td>Australian-owned firm Rainbow Nation Renewable Fuels plans to build a plant that produces 288-million litres a year of biodiesel. The plant will also supply the local market with soybean meal and soybean oil. The plant will be the biggest in Africa, using one-million tons of soybeans to produce 250 000 tons of soybean oil and 800 000 tons of animal feed. According to the company, the operation will generate over R4.5-billion in turnover for the local economy and will provide 350 new permanent full-time jobs, 725 additional jobs in related industries and a further 800 jobs in the construction of the facility. The project was meant to have been competed in 2009, but has been beset by delays.</td>
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<th>AGNI-Steels (SA)</th>
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<td>AGNI-Steels commenced construction of a steel plant in the Coega IDZ on the 1st of June 2011. The plant will create 800 jobs once fully operational. Instead of the scrap metal being exported it will be locally beneficiated thereby adding value to locally available resources.</td>
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<th>Electrawinds</th>
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<tr>
<td>Electrawinds, a Belgium, company plans to invest R1,2-billion in a project to build 25 wind turbines that will have a capacity of 1,8 MW each, which translates into an annual yield of 5,7-million kilowatt hours. This is enough energy to power about 1 700</td>
</tr>
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</table>
households. The original completion was scheduled for 2011, but has been delayed by the REFIT process. Once completed the wind farm would supply the NMBM with about 45 MW of green energy. Overall, 133 indirect construction jobs, 55 construction jobs and 12 permanent jobs will be created during the building of the wind farm.

**FAW**
FAW SA, a Chinese owned vehicle manufacturer, plans to open a truck assembly plant next year with the aim of producing 5000 units a year. The truck plant will create 400-500 new jobs. It is also hoped that the second phase to build a passenger car assembly line will be completed by 2014, which could assemble up to 30,000 cars a year.

**Kalagadi Manganese**
Kalagadi Manganese, a state backed company, is planning the construction of a high-carbon ferromanganese smelter, which will be one of the largest of its kind in the world. The smelter is expected to create 1000 construction jobs and 400 permanent ones. The 320 000 tons a year smelter plans to use the deep-water port of Ngqura adjacent to Coega, to export the beneficiated minerals.

**Business Processing Outsourcing (BPO) Park**
The BPO Park is a project that was driven and owned by the CDC. The major targets for the Coega BPO Park are companies that require contact centres and outsourcing services. There are 1500 seats in the centre. ABSA currently employs 102 staff for its needs, and Discovery have recently employed 130 people to meet their call centre needs.

Despite the fact that Coega has world class infrastructure in many respects, it still lacks critical elements that would make it an attractive investment proposition. Electricity security, which is a national problem, has been a major stumbling block for many investors. The logistical links inland are also a hindrance as most cargo has to be transported by road to inland regions like Gauteng, the country’s largest market. According to a CDC representative, only 30% of containerized cargo from the port which is destined to Gauteng makes use of rail because of the inefficiencies of Transnet.

South Africa nationally lags its developing country peer group significantly in terms of the number of days that it takes import and export goods to clear customs. This increases the transport time lag on goods produced, reducing the nation’s competitiveness for internationally traded goods (World Bank Investment Climate Assessment, 2010). An advantage for businesses investing in an IDZ is that customs clearing should be simpler and
quicker for imported and exported goods. However most of the administration challenges that occur at other ports within South Africa also occur at the Port of Ngqura. The port however is known for its superior efficiency with regards to offloading and dispatching of goods.

Although Coega is meant to form part of a CCA, the benefits are limited. When goods land in South Africa there are procedures that both Portnet and the Department of Customs need to follow. As a result, goods are booked and cleared out of the port and customs much in the same way as other non-IDZ import and export goods, even if they are destined for Coega. This means that the IDZ does not to enjoy any major exceptions. This could be one a major pitfall for companies looking to invest in an EPZ as time lost on customs clearing can be crucial. Paying duties on landed goods is harmful to company’s cash flow and locating in a zone that isn’t part of a CCA, when they are looking to export goods would be detrimental to many businesses.

Despite the poor levels of investment, some of the companies that have invested in the zone have also done well with regards to backwards linkages and social upliftment in areas outside of the zone. The best example is an agro-processing business called Dynamic Commodities, which produces sorbets mainly for export. The company relocated to the zone in 2007 and has expanded rapidly since their move. The company employs 1095 permanent workers, most of whom are low skilled, working in the labour intensive factory, which was purpose built to be labour absorbing. The factory has also created a huge number of indirect jobs in the rural communities of the Eastern Cape, where farmers produce the fruit required for the factory. Other agro-processing plants like Cape Concentrates, which is about to start operating, and the Coega Dairy are also expected to have good backward linkages into the surrounding communities.

4.3. Expectations of the Coega IDZ

Based on the amount of money that has been invested in IDZs in South Africa and especially the vast sums that have been invested in Coega, the public have been critical of the lack of return. However such large scale investments have a long term strategic role to play in the development of the economy. Zones in other parts of the world have taken at least 10 years before they have yielded any tangible return on public investment. Shenzhen in China was cited in the literature review as having a long period before it offered a return on investment, even though it was hugely successful from the start. In all SEZs around the world, host governments have had to take the lead in fronting the investment on infrastructure
in order to make a zone attractive. Given the size of Coega, setting up world class infrastructure has taken time. The port only became operational in 2008 and up until then the zone did not have a critical logistical link to international markets to make it viable.

The zone was also not located in an area that had the necessary infrastructure so inevitably significant amounts of money had to be spent in order to develop it as an industrial hub. According to representatives from the CDC, for many years Coega was regarded as just a concept in the eyes of investors and many businesses were reluctant to invest on the expectation that the infrastructure would eventually be developed. According to Moran (2011), an international expert on SEZs, multinational companies are “risk adverse” to making large capital investments. On capital projects there is often a first mover disadvantage for many companies when moving into a new country, because the support structures are not automatically in place. Therefore these types of companies prefer to see physical infrastructure in place rather than invest on a commitment that the necessary infrastructure will be built. As Coega has only been operations for a few years, this has been an obstacle to attracting investment.

Today much of the necessary infrastructure is in place and one can consider Coega to have been operational for three years (since the port opened). Companies interested in investing in the IDZ can now send investigative teams and can physically see the infrastructure in place. As a result it should now be easier to generate investor interest than when Coega was still in the planning and development stage.

4.4. Problems currently facing the Coega IDZ

Despite the fact that the zone has world class infrastructure, it has little that makes it a compelling investment opportunity for international businesses. There are virtually no financial incentives, except for the fact that superior financing deals can be achieved by using the IDC or the ECDC. Unlike other SEZs around the world the IDZs in South Africa do not offer tax holidays or other fiscal incentives. This has hindered investment from multinationals that have the option to establish manufacturing hubs anywhere in the world.

Electricity, which is critical to most large scale manufacturing operations, is in short supply nationally. The metropolitan area is also a water stressed area, with limited capacity. This limits the feasibility of a number of potential projects. The zone is also dependant on other government departments to get project approval for new initiatives. Many interviewees stated
that the departments are not necessarily aligned with the CDC’s strategic intent and many of them delay project approval or hinder the progress of projects. Problems such as these have increased the risk and therefore the attractiveness of investing in the zone.

Perhaps the biggest issue for the IDZ is the fact that it is difficult to distinguish what benefits the zone offers, when compared to any other private industrial park in the country. A study performed by the World Bank found that the performance of any SEZ is strongly related to the national investment environment and competitiveness of the nation (Farole, 2011a). South Africa has often been criticised for its business climate which makes operating a business far more difficult than is the case in other locations around the world.

When the zone was established, the legislation governing the zone fell under the Manufacturing Development Act, which limited the power of the operators, according to the CDC interviewees and Simphiwe Khondlo, the CEO of the East London IDZ. The initial legislation that governed the IDZs has limited the authority of the zones to demand the assistance of other entities of government, such as Eskom, municipalities and Transnet. This is in stark contrast to the most successful SEZs internationally, which have been able to demand the services that are required from other government institutions in order ensure that the SEZs are connected and serviced to the best international standards.

This lack of wide scale support for the zone initially undermined and delayed the development of the necessary infrastructure. Certain people from the CDC stated that government at the time did not have a single minded approach to the establishment of the zone and as a result strategic alignment between various departments did not occur. This was echoed by the participants at the CDE round table event. The net result of this is that the CDC has struggled to get the cooperation or prioritisation from some government agencies and departments, a factor which has undermined their efforts to attract investors. This is in stark contrast to highly successful SEZs, which had high levels government support and prioritisation of business interests in the zones.

According the CDC interviewees, when different government departments did get involved with specific projects their response times on critical issues has tended to be sluggish. Slow approval times for projects can mean that business conditions in the market have changed substantially between the initiation and required implementation dates for a specific project.
A good example of the slow response of government has been with regards to the REFIT\(^2\) process, which will be a critical determinate of which renewable energy projects at Coega will be feasible. In this case, the Department of Energy had to develop an integrated resource plan. This involved discussion with the National Treasury with regards to power purchase agreements, direct agreements and transmission connection agreements (Khanyile, 2010). Only once this whole process was complete did the request for proposals from renewable energy producers go out. This process took almost two years to complete, significantly delaying the implementation of this type of project at Coega.

When the IDZ was established, the incentives to invest in Coega were limited. The infrastructure had not been built to support the area and critically none of the financial incentives that normally attract investors to a SEZ were in place, specifically tax holidays and tax breaks. The main advantage the zone had to offer international investors up until 2008 was the fact that South Africa had the cheapest electricity in the world. However, this competitive advantage was quickly eroded by the national electricity crisis that began in 2008. Although much of the necessary infrastructure exists today there is still uncertainty with regards to electricity and water supply for energy and water intensive industries.

According to some CDC representatives, there are also other entrenched and conflicting interests within government structures as the various departments lobby for additional funds and projects, which at times has undermined the development of Coega.

Gauthier (2011), who has advised governments on SEZ legislation, stated that his impression of the South Africa’s IDZ legislation was that it was “cumbersome” for companies that want to participate. This was echoed by Baissac (2011), who stated that the “red tape” in South Africa is discouraging investment. Coega seems unable to separate itself from national business conditions, which are not conducive to attracting international investors. Baissac highlighted national problems that the IDZs should be trying to address. These include addressing the skills shortage; reducing the oversupply of unskilled labour; improving the country’s poor infrastructure and international linkages and changing the inflexible labour regulations of the country.

\(^2\) The REFIT process has been undertaken to install grid connected renewable energy supply from private companies. The national grid is controlled by Eskom, a parastatal, therefore the legislation regarding electricity generation from private companies, needed to be put in place. Part of the process was to determine Feed-in Tariffs, in essence, guaranteed prices for electricity supply to ensure that costs and a reasonable profit can be made from the investment.
The Port of Ngqura is operated by Portnet, which operates as a separate entity to the CDC. Although the port operations at Coega are known to be more efficient than others in the country the operations are not as seamlessly integrated into the zone as they could be. Customs clearing for goods going into the zone still takes place in the same manner as if the goods were entering the country. Therefore the time and administration processes are no simpler than conventional imports or exports. This should not be the case considering that the zone is considered a CCA.

Although the zone is designed to cluster similar industrial activities together there is currently little benefit for the initial investors, because the limited number of industries that have invested and operate in the zone are in unrelated fields. There is no anchor tenant within the zone to justify the existence of the other downstream businesses. Many companies base their investment decision on whether a large international firm has committed to base operations in the zone. For example, many investors followed Intel’s lead after the company committed to invest in the SEZ in Costa Rica, according to Moran, Graham, and Blomström (2005). These investors stated they would not have invested in Costa Rica if Intel had not committed itself to the zone.

The only benefit that the IDZs can offer to potential investors is superior financing for their capital investments. According to Kaplan (2011), this is a misguided incentive offer by the government, because it incentivises businesses to invest in capital intensive businesses, rather than labour absorbing businesses, thus undermining the objectives of the New Growth Path. Incentives should rather be offered for businesses to employ more low skilled people, something that does not occur in industries that are capital intensive. If the government’s primary goal with the New Growth Path is to create jobs which would lead to social upliftment then policies should be changed to make it less onerous to hire new employees. Also the productivity of employees relative to their wages should be internationally comparable, which is not the case currently in South Africa. This view is contrary to many interviewees, who feel that, the superior capital financing costs are critical to attracting investment into these zones, because obtaining funding for projects is often a determining factor in selecting where to locate Greenfield investments. Internationally, companies are normally offered superior financing deals for new investments in a SEZ, therefore removing this incentive could undermine investment in Coega.
4.5. Actions that are being taken to address the underlying problems with the Coega IDZ

A number of actions initiated by the CDC and other government entities are in progress, which should improve the attractiveness of Coega to potential investors. First of these is that the IDZs have submitted proposals for changes in the IDZ legislation to the DTI, which would give them more authority. The zones have also proposed a better incentive package be offered to potential investors that would include tax breaks and tax holidays. This would make the IDZs fit the SEZ mould better. The proposals are currently under review by the department.

Infrastructure development has also been a major stumbling block for the zone and as such numerous actions are being taken to address this. The availability of reliable electricity has been one of the major concerns for industrial developments in South Africa and the IDZ has committed to guaranteeing supply in the zone. In the early years of the IDZ, the area was only connected by one transmission line to the national grid. Although the country at the time had excess electricity, the area itself did not have any excess capacity and was at risk of a single point of failure regarding supply. Since then another major transmission line has been installed, but this has occurred simultaneously with a national shortage of generating capacity. As a result of these problems Coega itself has initiated projects that are expected to guarantee electricity supply to the area. The CDC has reached an agreement with the NMBM which should ensure that in the case of supply shortages to the area, the Coega zone will receive the highest priority.

In the wake of the national rolling blackouts in 2008 it became apparent that the country cannot supply the entire grid during periods of peak demand when other generating factors come into play. As a result a peaking power plant is being built in the IDZ. The open cycle gas turbine will have a generation capacity of 335MW and be operational for 400hrs per year during periods of peak electricity demand. The turbine, which has already been approved, is expected to be operational by the end of July 2013 (Creamer, 2011a).

Coega has also committed itself to becoming the renewable energy hub in South Africa and current estimates are that the zone could generate 480MW of power from renewable energy sources. It has recently managed to attract a R270 million investment to build a solar power plant, along with other investments in wind energy (Munshi, 2011b). However the alternative energy providers have yet to successfully negotiate a power purchase agreement, with the
energy regulator. Most of the suppliers have submitted their REFIT proposals to NERSA and are awaiting feedback. If the bids by the various companies are approved then progress to become operational should happen fairly quickly.

In order to improve links with inland regions of the country, Transnet has tentatively backed the development of a heavy haul railway line from Hotazel in the Northern Cape to Coega. The line will transport manganese ore to supply the port and proposed smelter (Creamer, 2011b). This comes in the wake of the announcement of the proposed Kalagadi Manganese Smelter and the commitment to move the manganese handling facility from the Port Elizabeth harbour to the Port of Ngqura. The new line is estimated to cost between R12 to R15 billion and will further boost the region’s infrastructure and further commit the government to the success of the IDZ. The line would also ease the traffic on the current inland link, which should allow more efficient transport of container cargo to inland regions.

In order to alleviate the water scarcity problem for the NMBM, a new water pipeline is being built to supply the area. At a cost of R500 million, the Orange River Project will supply the municipality with 270 mega litres of water a day and should become operational in 2013 (Drought Relief, 2010). This project will go a long way to ensuring water security in the area as a whole but also allow Coega to target industries that are water intensive.

It is hoped that the large investment from Kalagadi Manganese will serve as a catalyst for other investment in the zone. The smelter could potentially encourage other businesses that make use of manganese alloy to locate in the IDZ. Coega has also pinned much of its future success on the proposed PetroSA Project Mthombo. PetroSA plans to build a 360 000 barrel per day crude oil refinery at a cost of $10billion in the IDZ. The mega project is meant to address the national 180 000-barrel-a-day shortfall of refined petroleum products by 2020. If the project goes ahead it is expected to create 18 500 direct and indirect permanent jobs because it will be able to provide raw material for a number of other large industries such as plastics and chemicals (Project Mthombo, 2009).

4.6. Actions that could be taken

The current IDZ legislation is currently being reviewed by the DTI. Submissions of the various IDZs in the country have been made and are being considered as part of an anticipated overhaul of current legislation. Based on a presentation by Molefane (2011) (Director of Spatial Planning and Economic Research within the DTI), the legislation is going be a full SEZs proposal, rather than exclusively IDZs.
Under the current legislation there is confusion over who should administer the IDZ as the responsibility is currently shared between the DTI and provincial governments. The IDZ are also considering shifting the IDZ board to report directly to the director of the DTI, rather than through the Manufacturing Development Board.

The IDZ should be used as a mechanism to spearhead economic change as has been the case with many SEZ internationally. As there are distinct boundaries to the zones, effectively making them separate entities in the national mix, therefore opportunity exists for the government to test policy. This might include policies that are not politically popular but might be economically beneficial. One of the options discussed at the CDE forum was applying exemptions to aspects of South Africa’s labour legislation. The rigidity of labour market legislation coupled with low productivity relative to the wages paid to workers is seen as a major stumbling block for business in South Africa by many business leaders. It was therefore suggested that the IDZ be offered dispensations from the current legislation that reduces the amount of job security given to South African workers so that the labour force in the zone can become more flexible. This will enable workers to be laid off or retrenched more easily when there is a global slump in demand and encourage companies to hire rapidly when there is an upswing in demand. Moran (2011) presented evidence showing that IDZs that worked in this fashion boosted formal employment in the area of the zone significantly.

Having a flexible labour force is seen as attractive to international investors because it makes it much easier for them to rapidly adjust their cost base in times when demand for their products is low.

Amongst many of the CDE forum presenters there was an opinion that lowering the wage rate in the IDZs would also go a long way towards increasing employment in South Africa as a whole. Areas such as the Eastern Cape suffer huge unemployment, with an estimated 25.8% of the population unemployed according to the official definition of unemployed people, which excludes discouraged workers (General Household Survey 2010, 2011). For the low skilled unemployed any type of wage would be beneficial to them and assist in alleviating poverty in their area. A lower wage rate relative to productivity would automatically boost the attractiveness on the zone internationally, especially in low skills, labour intensive industries such as clothing and textiles. On this point, there already seems to be a willingness from certain sectors of the economy to accept below minimum wage salaries. This is best highlighted by the recent agreement between the Clothing and Textiles worker union and the bargaining council, where compliant employers are allowed to pay new employees 30%
below the minimum wage for two years, as this is considered to be a training period for them (Payne, 2011). This is expected to make the clothing and textile industry more competitive internationally and stem the flow of job losses or even help job creation in the sector.

Adjustment of labour policies and legislation would not be politically popular if implemented in the broader economy, especially when considering the alliance between the labour union Cosatu and the ruling party, the ANC. However testing such policies in the IDZs might be possible and could be used to demonstrate the potential of broader policy change. Having a different set of employment policies within the zone compared to the rest of the domestic economy could present some challenges. The producers in the zone would have a significant cost advantage over other local producers and this could undermine the viability of existing businesses operating in the normal economy. Problems such as these could be overcome by requiring a certain portion of the goods to be destined for export (e.g. 80% for export, 20% for local economy) before the producer is allowed such a minimum wage exemption. The government could also introduce a separate tariff on goods produced in the zones destined for the local economy so that competitor goods produced in the normal economy are not at a disadvantage.

A subject that was emphasised at the CDE forum was the fact that the IDZs need to be a “one-stop shop” with regards to establishing an operational business in the zones. The investment promotion agencies should be able to approve investments in projects as rapidly and transparently as possible. Moran (2011) cited four different types of investment promotion agencies:

- The ineffective: these agencies don’t return phone calls and don’t readily respond with critical information for potential investors.
- The effective agencies: these are true “one-stop shops”. The example that was consistently cited by the panel was the Costa Rican Investment Promotion Agency, called CINDE. This agency is aligned with all the government stakeholders in the country and has had high level government support to achieve its objectives.
- The investment screening agencies: The agencies test the suitability of the project for the zone, but don’t actively support the potential investor by walking them through the regulatory process in the country.
- The investment prevention agencies: These agencies screen projects and prevent new businesses from setting up if they could potentially conflict with existing
businesses in the country. These agencies are controlled by vested interests groups that may not have the best overall interests of the county at heart.

Moran (2011) warns that if a SEZ is to be truly successful then it has to have an effective investment agency that attracts investors to the country and makes the approval process for the projects as simple as possible. Some limitations on these agencies might exist, but government should ensure that the agencies have sufficient capacity and authority to execute approval rapidly.

This was backed up by Mohamed (2011), the director of the Corporate Strategy and Industrial Research Programme at Wits University, who said that investment promotion agencies must create a respectable “brand”. The brand created should portray the SEZ as an attractive investment destination, where the necessary authorisation to do business is a seamless process.

It is difficult to determine the effectiveness of CDC’s investor relations agency. The time frame of this thesis did not afford the opportunity to talk to enough investors and potential investors about their experience with the CDC. However one would hope that they are doing everything within their power to make the process of taking a project through from concept to completion as seamless as possible. However, the impression was created that the CDC is constrained by the regulations in other government departments. As the CDC takes on the responsibility of dealing with these departments, the inefficiencies of the departments might cause the CDC to appear to be performing poorly at times.

Based on the information provided by the DTI on the upcoming legislation proposals, the government seems reluctant to provide fiscal incentives for investors in the IDZs. It appears that such incentives have been stalled by the National Treasury and SARS, the state agencies that could approve tax holidays and other tax incentives. Many of the people interviewed felt it was critical that investments be afforded such incentives as this would give the zones a competitive advantage, which they currently don’t have. As the zones currently stand they have no investment incentive other than being an exclusive industrial zone that offers direct access to a port and some limited clustering benefits. The zones need to compete internationally and a number of other zones around the world are offering large incentives, which the local IDZs feel that they are unable to compete against.
However SEZ experts at the CDE conference stated that pure tax incentives are not absolutely necessity. They stated that the ease of doing business in the zone was a far bigger determinate in the success of a zone. They felt that the zones should be about overcoming the constraints within the normal economy with respect to the business climate. This could include relaxed labour regulations, better logistical links internationally and streamlined business approval processes. An entire package needs to be offered to potential investors so that the overall attractiveness of investing in the country is substantially improved. An example of this, cited by Moran (2011), is that of the Philippines. The country ranks significantly worse than South Africa in the Ease of Doing Business index, yet it has managed to establish 225 SEZs of varying types that employ 726 thousand people.

Given the huge amount of capital already spent on IDZ projects and the amounts still expected to be spent, the government needs to be cautious that it isn’t diverting funds that could have a higher yield somewhere else in the economy. It could be argued that spending the money in other areas of the economy might create more jobs although it seems unlikely that the jobs would be created in the Eastern Cape, which is in desperate need of them.

If incentives such as tax breaks are implemented in IDZs, then the controlling IDZ body should ensure that the new businesses established in the zone do not simply substitute businesses in the local economy that do not receive the same incentives. Therefore it would be a wise policy to ensure that the businesses that receive the incentives are export orientated. In this case government revenues would still increase even if a full tax holiday is given, because income tax on new employees would be generated and foreign exchange inflows from exports would have a positive effect on the country’s balance of payments. Effective tax holidays or other fiscal incentives should be enough to encourage businesses to locate in the country. The companies should then be encouraged to anchor their investments in the country so that they don’t leave as soon as the tax holiday expires. A good way of ensuring this is to make sure that business conditions in the country are good enough not to warrant the investor to look elsewhere.

4.7. The role that the Coega IDZ should play in South African economic development

South Africa should not view the IDZs as the only mechanism to bolster export earnings and attract FDI. South Africa has a fantastic array of raw materials, skilled people and a huge pool of untapped labour resources. With the slowdown of growth in the developed world,
developing countries are being viewed as a major potential avenue for growth by many international businesses. South Africa, as the largest African economy with a well-developed business infrastructure, is an attractive gateway to the rest of Africa, which in turn offers many rapidly growing markets. South Africa should position itself to become a beneficiary from this shift in global wealth and trading patterns.

The IDZs can play an important role by improving the ease of doing business in the country and by building the brand of South Africa as a desirable investment destination. The zones alone will not solve the high unemployment problem in the country. They are also not a single solution to improve the skills of unskilled people in the country, because this needs a comprehensive solution in which the country’s education system plays the central role. However the zones can be an important piece in a far larger puzzle in the dynamics of the country that will hopefully lead to economic success. A successful SEZ will have a number of positive spill over effects into the local economy, benefiting service businesses, such as banking, insurance and accounting as well as a number of downstream industries that supply the inputs to businesses operating within the SEZs. Therefore the number of indirect jobs created by the SEZ will always be a multiple of the direct jobs created in the SEZ.

A strong political will is needed to execute a long term strategic plan for SEZs in South Africa as the benefits will not be felt in the short term, which are what many populists would like to see. The IDZs do have long term benefits for the economy as a whole, but tangible gains may take years to emerge.

It is clear is that South Africa needs to improve its business environment before it becomes an investment destination of choice for international companies. In labour absorbing, low skill industries, the nation compares poorly with other developing nations, especially those in Asia. The wage rates relative to productivity, rigid labour laws, distance from international markets and poor logistical connectivity are all factors that reduce the country’s attractiveness as an FDI location. The effects of these factors have already been seen in South Africa’s clothing and textile industry, which has shrunk significantly over the last 20 years. However the fact that English is widely spoken and that South Africa is in a similar time zone to Europe is an advantage that cannot be replicated by many other nations. Many economists argue that the SA Rand is overvalued, which undermines the country’s export potential. Although South Africa generally runs at a trade deficit the currency is strengthened mainly as a result of monetary inflows to the financial markets. Given the recent Euro zone debt crisis,
this has led to a substantial depreciation of the currency, which should make exporting more attractive to South African based companies. If the currency holds at the current levels then there could be further investment in manufacturing capacity to serve the export market.

4.8. Scenarios for Coega in the future

4.8.1. Government pulls out support

With over R30 billion having been spent on Coega by the various agencies of government over the last twelve years, there are some people in the country who have argued that the state should cut its losses and withdraw its support.

In this case two scenarios could potentially play out. The first would be the worst case scenario, where the withdrawal of government support would leave Coega to a slow and painful death. The expensive world class infrastructure would deteriorate because it would be left underutilised. Coega would then have to be seen as a social initiative that created temporary jobs during the construction phase but left no long lasting benefit for the local community.

The second scenario is one where it could be argued that the CDC is now a strong enough entity to attract new investment and enable projects that are already in the pipeline to come to fruition. Today Coega is an appealing investment destination, despite the flaws of the zone already discussed. There are a small number of existing investors from which the business base can grow, although without large scale government support, one would think that the pace of development would slow even further.

If South Africa as a whole became a more attractive destination for FDI then Coega would be well positioned to reap some of the benefits. Electricity supply is a national problem, from which Coega is not exempt, so any national improvement will also benefit Coega. Water security is an issue for NMBM as a whole, so costs relating to improving the water supply should not be attributed solely to Coega, although it would be a beneficiary.

4.8.2. Government invests further to make the area more attractive, but does not introduce incentives

Government has committed itself to invest an additional R25 billion in IDZs and the other potential SEZs in the country over the next six years (A commitment announced by Finance Minister Pravin Gordhan during his medium-term budget policy statement, 2011). This contribution will mainly be in the form of further improving infrastructure in existing IDZs
but also in creating new zones. Despite the capital commitment to IDZ, there is unlikely to
new commitments from the Treasury in the form of tax incentives.

Securing the commitment of parastatal companies to Coega would likely be a significant
contributor in helping the Coega IDZ becoming more successful. Large infrastructure
additions are unlikely to happen at the Coega IDZ without further investment in the zone.
Portnet has committed to moving the manganese handling operations from Port Elizabeth to
the Port of Ngqura as well as the tank farm, which handles petroleum products for the city.
These by themselves are unlikely to cause any additional major investments.

Transnet are also in the final discussion stage regarding the building of a heavy haul railway
line for the transport of manganese from the mines to the port. This would relieve pressure on
the existing railway line, which could incentivise logistics companies to make more use of
rail than road for container haulage. This could offset some of the cost advantage that Durban
has over Coega in terms of distance/cost to market. Depending on a feasibility study, Portnet
could also add an additional dry bulk handling terminal in order to cater for the new Kalagadi
Manganese refinery and the additional manganese ore coming through the port.

The influence of government could also be pivotal in setting up the proposed PetroSA mega
refinery. As this is such a huge project, one would expect it to have major downstream
implications for the zone. One would hope that the refinery would act as an anchor tenant to
which other industries would be attracted. South Africa has seen the success of entire towns
around energy systems in the form of Secunda and Sasolburg. Both towns owe their existence
to the Sasol operations that are built there. The industrial plants in these towns also serve as
major training grounds for many of the country’s artisans and engineers which could serve as
a good model for the PetroSA plant to follow.

Most of these projects by parastatal companies could, if properly implemented and
managed, be beneficial to the country as a whole as well as Coega. The addition of the heavy
haul railway line superficially appears to make business sense and the feasibility study which
will come out next year will determine whether the line is needed. One could argue that it
would be wiser to locate the PetroSA plant on the KwaZulu Natal coast because of the
proximity to market and better distribution centres, but this would go against government’s
goals of developing areas that need it most. The additional developments by the state owned
enterprises should improve the investment attractiveness of the zone from its current status.
However it is unlikely to cause rapid development in the Coega IDZ, which is what many critics would like to see.

4.8.3. Government introduces incentives

Many of the people interviewed considered government incentives as the only way to make the zone internationally attractive. This would include tax holidays, reduced tax burdens on corporations, subsidised labour cost or subsidised services costs. One of the initial attractions to the Coega IDZ was that the zone could offer the cheapest electricity in the world at the time.

Discounted services would likely be the most difficult incentive for government to offer. The country is already struggling with large scale service delivery and offering services at a discount to major corporations would attract condemnation from much of the population. Electricity is already in short supply in the country, so subsidising its use would be foolish. As would the subsidising water usage in the NMBM as this is a water constrained area.

Subsidised labour cost could be of interest to the national government and appears to be popular amongst the business groups consulted. This is already being considered on a national level for first time workers in all sectors of the economy. The concept is to provide a subsidy to companies that take on new additional workers. This proposal has been widely criticised by the labour union Cosatu, which claims the subsidy would create a two-tier labour market and encourage employers to get rid of workers as soon as their subsidy falls away (Vecchiatto, 2011). However the idea of a subsidy for all workers in the zone could be a possibility for new businesses that create entirely new jobs in the economy.

The subsidy would be beneficial mainly for labour intensive industries, which would create the largest number of jobs. This is directly aligned with the New Growth Path, which is trying to address the issue of high unemployment for unskilled workers. This would increase the productivity rate relative to wages paid by employers and this could boost the international competitiveness of labour intensive industries located in South Africa. Such a subsidy however could be undermined by South Africa’s rigid labour laws and the high protectionism given to employees. International companies want a flexible labour force and the high costs of dismissal of employees could prove to be a hindrance for them to invest in the country.

Tax holidays might be the magic pill that is needed to solve the lack of take-up in the Coega IDZ. Low or no corporate taxes are offered to many international companies who invest in
SEZs around the world. However in many cases the lack of taxes is the icing on the cake in what should already be an attractive business destination. If the National Treasury were to introduce incentives, it would need a mechanism to ensure that it achieves a net gain on tax revenue generated. It would not want to offer incentives that undermine local businesses serving the local market. In this case businesses would shift their local operations to the zone in order to remain competitive and there would be a net loss for SARS. Therefore careful overseeing of the zone and business practices would need to take place.

The reduction of corporate taxes would make the zone attractive to a number of investors. A mechanism such as a tax holiday could be used as a catalyst to get investment into a zone. The value of the tax holiday should be enough to reduce the cost of setting up a business, helping to offset the flaws in the country’s general business climate. While the tax holiday is in place, the country should try to improve its business climate to the extent that the tax incentive is no longer required to successfully run the business. Should the tax holiday expire and the cost of doing business in the country is untenable, a company will likely withdraw its investment and move its operations to another country that has a more favourable business climate. In this case, the incentive offered by the government would have been a waste. Minimal or no additional income would have been earned by the government after the incentive expired and a number of people’s livelihoods would have been left in tatters. The benefits of tax incentives are obvious to potential investors. Government agencies offering these incentives should however be sure that they are not selling the country short. The last thing the government would want to happen is to invite a company into the country that proceeds to exploit local resources for its own benefit, undermine existing local and contributing businesses and then disinvest once the incentivised period has ended. Countries that have successful IDZ policies seem to have managed this process well to the extent that new businesses have thrived under the incentives and have led to large scale development of the local economy.

Reduced corporate tax rates or tax holidays would probably have the most immediate impact of any other incentive offered in the IDZ. The reduced taxes would immediately give the zone a significant and tangible competitive advantage over other areas in South Africa and the region. Given that Coega already has world class hard infrastructure and South Africa has a number of existing preferential trade agreements with many developed nations, it would immediately make Coega more attractive as an EPZ. The tax incentives along with Coega’s further development plans would likely be sufficient to tip the scale for many investors who
already had an interest in building a facility in Africa. The tax incentive would make it much easier for the CDC to attract investment to the zone and as a result the growth of the IDZ would likely happen at a far faster pace than has been the case.

Hurdles would have to be overcome in the National Treasury to cater for such incentivised businesses but similar incentives have been put in place for the automotive industry to good effect. Overall tax incentives could offer a win-win scenario for all parties involved. Businesses would have reduced cost, Coega would develop at a much faster pace, boosting jobs in the Eastern Cape and revenue collection for SARS would increase because only new job creating businesses would be eligible for such incentives. SARS may argue that they are forfeiting revenue, but overall the amount of tax revenue collected by them would likely increase because of increased income tax by new workers and VAT collections on increased consumption spending. Spending on social grants in the local community would also likely decline because of increased employment.
5. Chapter 5: Conclusion

The South African public has perhaps been unreasonable in expecting rapid economic benefits from the IDZ at Coega. The zone has done well in respect of the infrastructure has been developed so that any new industries can more easily establish themselves. However as the zone currently stands, it offers limited benefits over other industrial complexes within South Africa. These benefits have to be weighed up against the fact that Coega is not currently located near any large market. The zone is still hindered by the national difficulties in doing business in the country.

Coega should been seen as a strategic investment for the country, with a long term payback plan. The legacy of apartheid has meant that certain areas of the country, such as the Eastern Cape, were badly neglected and now the cost of repairing the damage is something that needs to be taken on by the current government if it wants to deliver to its citizens. In this case the development of Coega is justified and critics should take heed of the country’s history.

However for an SEZ to be a success there needs to be an unwavering national commitment together with policy coherence, which does not appear to currently be the case at Coega. However the expectations of the economy should not rely entirely on SEZs to advance development. Gauthier (2001) stated that high performing countries can expect a maximum of 2% of national employment to be in SEZs. Therefore the zones should be seen as a mechanism to boost the national economy, not as a replacement for improvement in the national economy as a whole.

Large strategic investments necessarily entail benefits that may take considerable time to emerge. A classic South African example was one cited by Matchett (2011) is that of Richards Bay. Matchett stated that the port took 17 years before it turned its first operating profit and 25 years before it covered its losses and was widely criticised at the time. Today, Richards Bay is a major manufacturing hub in the country and its port services are a critical link in earning the country foreign exchange.

The IDZs should continue to focus on medium skilled industries, even though they are relatively capital intensive and not as labour absorbing as low skilled industries. However they can foster extensive skills development and can fund the formation of vocational training facilities. South Africa is in desperate need of improving the skills of its labour force and this is why the CDC is targeting industries such as manufacturing, engineering and
assembly plants. Moran (2011) also claims that it is much easier to attract medium skilled industries to invest internationally in SEZs. This is supported by his statement that medium skilled industries have attracted ten times more investment capital than low skilled industries in recent years.

Traditionally, countries have to move from a low skills base through to a medium skills base and then into a high skills economy. South Africa, because it is dual in nature, might be able to shorten the amount of time spent as a low skill economy, but it does still need to have low skill industries to cater for its large unskilled population. It is not ready to move into high skilled or high technology industries at the moment because the people who possess such skills in the country are already fully employed and there is limited capacity to expand.

People in South Africa often talk about the opportunities that are available in the country, but one must take heed of a statement by Spicer (2011), who said “South Africa needs to work with the people it has, not the people it wishes it has.” Businesses in South Africa have to work within the constraints that currently exist in order to make a better future for all. Some policies exist because they are politically popular but may not be in the best long term interest of the country. As a result of this government needs to review some of its policies to see how business conditions can be improved so that it is easier to attract new business and put more of the population to work.

The work at Coega is not complete and further commitments to the zone will have to be made. Direct financial incentives should be put in place so that Coega can compete on an international basis. Also the limitations of the zone, such as electricity and water supply need to be corrected before investment can be considered by many large scale industrial corporations. It needs to be acknowledged that Coega has to compete on a global basis for investment and the benefits of investing in the zone need to be comparable with the best in the world. Strategic alignment between the various stakeholders of Coega needs to take place so that a full investment solution can be provided to potential businesses.

Currently it looks as if a number of initiatives are moving in the correct direction, but until definitive changes are implemented, the zone will continue to have its growth stymied. Focus is being placed on a number of critical areas and as the zone is now fully operational so it should be an easier investment offering to sell. The next five years are likely to determine the viability of the zone in the long term and one would hope that the huge amounts of money spent to date have not been wasted.
6. Recommendations for future research

This paper has taken the form of qualitative research and many of the recommendations are based on underlying assumptions on which incentives could be best suited for an IDZ such as Coega. A quantitative analysis that calculates the opportunity cost for government and private enterprises for items such as tax incentives could be worthwhile. An estimate on the cost-benefit analysis for the various incentives and scenarios could go a long way in determining which incentives could result in the best yield for job creation and FDI.

Government also has limited resources in order to achieve its goals. To date government has invested large amounts of money and effort in creating the IDZ in order to meet its mandates. However it could be argued that there are better programs that could be pursued by the government which would yield better long term benefits for the country if they were fully supported. Therefore there is an opportunity to investigate potential government programs to find out which of them would have the maximum benefit on the nation as a whole.

When doing this research there appeared to be a large gap between what policies exist and what policies business would like enacted. There is an opportunity to research how this divide could be bridged by enacting policies that would both achieve government mandates and make business conditions better in the country.

The newly released NPC report has a number of recommendations to government in order to improve the lives of the general population. The recommendations are at times thin on methods on how the objectives of the country will be achieved. Therefore there is opportunity to research aspects of that report and investigate how best certain recommendations can be implemented, given the constraints under which the current government operates.

Internally there should be research done on the CDC’s investor relations agency and what the major hurdles are that it has to clear in order to get business licensing approvals, and also the extent to which delays are undermining private investment in the zone. Practical recommendations could then be made to various government departments, which would hopefully make the business approval process occur more seamlessly with fewer delays.
7. References


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http://www.oecd.org/document/60/0,3746,en_2649_34897_1942460_1_1_1_1,00.html#


8. Appendix 1: full list of incentives offered by SARS for investing in CCAs

In order to incentivise development in IDZs and giving them a strategic economic advantage, the following is offered to the zones, which form part of Customs Controlled Areas (CCAs):

- Relief from customs duties at time of importation into a CCA
  - any goods for storage;
  - raw material for manufacture; and
  - Machinery used in the manufacturing process.
- Simplified customs procedures
  - Clearance of goods – importation, exportation and transit
  - Application for designation, licensing and registration
  - Release of cargo
  - Consideration of stage consignments if the requirements are met
  - Consideration of release under embargo
  - Lesser amounts for security – licensing, registration and movement of bonded goods
- Fiscal incentives on goods when
  - Goods are imported for storage,
  - Raw material imported for manufacture,
  - Machinery imported for used in the manufacturing process; or
  - Any material imported for use in the construction of the CCA infrastructure.
  - Goods are exported from the CCA to a foreign country.
  - Any services are rendered to a CCAE or in the CCA
- Subsidised infrastructure
  - No import duties payable on goods imported for use in the construction and maintenance of the infrastructure of a CCA in an IDZ (rebate item 498.02).
  - No Value-Added Tax shall be payable when:
    - Goods imported for use in the construction and maintenance of the infrastructure of a customs controlled area
    - Land supplied to a CCAE in the CCA for sale, letting or any other agreement
    - Electricity or water supplied to the IDZ Operator or CCA Enterprise located in the CCA.

*(Information taken directly from South African Revenue Service (SARS) website)*
9. Appendix 2: List of people consulted for thesis

List of interviewees

<table>
<thead>
<tr>
<th>Name</th>
<th>Position Held</th>
<th>Date interviewed</th>
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<tbody>
<tr>
<td>Idriss Mouchili</td>
<td>Quantitative Analyst for the CDC</td>
<td>4 October 2011</td>
</tr>
<tr>
<td>Dr Siyabonga Simayi</td>
<td>Manager at CDC</td>
<td>4 October 2011</td>
</tr>
<tr>
<td>Dr Peter Inman</td>
<td>Senior Manager - Energy &amp; Mega Projects at the CDC</td>
<td>4 October 2011</td>
</tr>
<tr>
<td>Luvuyo Mkontwana</td>
<td>Senior Manager - Energy &amp; Mega Projects at the CDC</td>
<td>4 October 2011</td>
</tr>
<tr>
<td>Vijay Makanjee</td>
<td>International Trade and Development Professional at the Eastern Cape Socio</td>
<td>6 October 2011</td>
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<td></td>
<td>Economic Consultative Council (ECSECC)</td>
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<tr>
<td>Russell Grinker</td>
<td>Specialist at ECSECC</td>
<td>6 October 2011</td>
</tr>
<tr>
<td>Lesley Govender</td>
<td>Eastern Cape Development Corporation</td>
<td>6 October 2011</td>
</tr>
<tr>
<td>Gerard Cairncross</td>
<td>Quality Coordinator for General Motors South Africa operating in Coega</td>
<td>4 October 2011</td>
</tr>
<tr>
<td>Janine De Kock</td>
<td>Manager at UTI Sun Logistics in Port Elizabeth</td>
<td>4 October 2011</td>
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<tr>
<td>Chris Matchett</td>
<td>Transnet National Ports Authority Executive Head of Infrastructure</td>
<td>10 November 2011</td>
</tr>
<tr>
<td>Simphiwe Khondlo</td>
<td>CEO East London IDZ</td>
<td>7 November 2011</td>
</tr>
<tr>
<td>Kevin Hustler</td>
<td>CEO of Nelson Mandela Bay Business Chamber</td>
<td>5 October 2011</td>
</tr>
<tr>
<td>Tumelo Chipfupa*</td>
<td>Deputy Director-General of Enterprise within the DTI</td>
<td>22 November 2011</td>
</tr>
<tr>
<td>Nils Flaatten</td>
<td>CEO of WESGRO (The Western Cape Investment and Trade Promotion Agency)</td>
<td>14 November 2011</td>
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</table>

*Interview was conducted over the telephone*

CDE Conference Presenters on 7 November 2011

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
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<tbody>
<tr>
<td>Ann Bernstein</td>
<td>Executive Director of the CDE</td>
</tr>
<tr>
<td>Prof Theodore Moran</td>
<td>Marcus Wallenberg Chair in International Business and Finance, Georgetown University</td>
</tr>
<tr>
<td>Name</td>
<td>Title</td>
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<tr>
<td>H.E. Hector Valezzi</td>
<td>Ambassador of Mexico</td>
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<tr>
<td>Dr Greg Mills</td>
<td>Director of the Brenthurst Foundation</td>
</tr>
<tr>
<td>Nimrod Zalk</td>
<td>Deputy Director General of the Industrial Development Division at the DTI</td>
</tr>
<tr>
<td>Prof Seeraj Mohamed</td>
<td>Director of the Corporate Strategy and Industrial Research Programme at the University of the Witwatersrand (Wits)</td>
</tr>
<tr>
<td>Prof David Kaplan</td>
<td>Professor of Economics at UCT</td>
</tr>
<tr>
<td>Dennis Dykes</td>
<td>Chief Economist for the Nedbank Group</td>
</tr>
<tr>
<td>Crispem Chinguno</td>
<td>PhD Fellow at the Society, Work and Development Institute at Wits University</td>
</tr>
<tr>
<td>Maoto Molefane</td>
<td>Director of Spatial Planning and Economic Research at the DTI</td>
</tr>
<tr>
<td>Simphiwe Kondlo</td>
<td>CEO of the East London IDZ</td>
</tr>
<tr>
<td>Claude Baissac</td>
<td>Secretary General of the World Economic Processing Zones Associations (WEPZA) and Executive Director of Eunomix</td>
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<tr>
<td>Lourens Mare</td>
<td>CEO of the Jewellery Council of South Africa</td>
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<tr>
<td>Jean-Paul Gauthier</td>
<td>Deputy Secretary General of WEPZA and Managing Director of Locus Economica</td>
</tr>
<tr>
<td>Amanda Nair</td>
<td>CEO of Blue IQ Investment Holdings and CEO of OR Tambo IDZ Development Company</td>
</tr>
<tr>
<td>Prof Neil Rankin</td>
<td>Director of the African Microeconomics Research Umbrella in the School of Economic and Business Sciences at Wits University</td>
</tr>
<tr>
<td>Michele de Bruyn</td>
<td>Managing Director of Kaiser Associates Economic Development Practice, South Africa</td>
</tr>
<tr>
<td>Mike Spicer</td>
<td>Former CEO of Business Leadership South Africa</td>
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