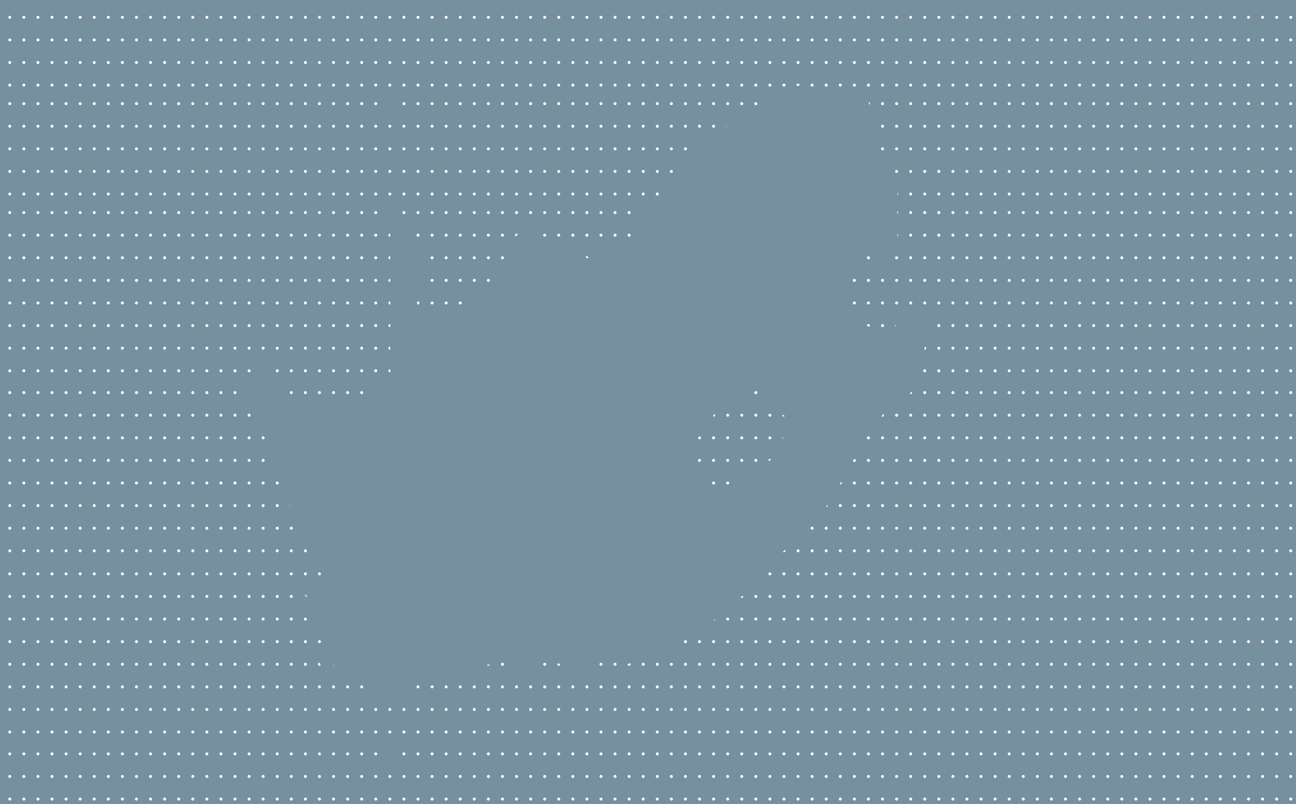
THE GROWTH AGENDA
Priorities for mass employment and inclusion

AN EPZ FOR THE NELSON MANDELA BAY METRO



GROWTH SERIES
Report 7

CDE
CENTRE FOR DEVELOPMENT AND ENTERPRISE

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About CDE

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

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

The CDE Growth Agenda Series
Series editor: Ann Bernstein

Reports in the Growth Agenda series are based on CDE's many policy initiatives, commissioned research and think pieces, as well as consultations and workshops with experts and stakeholders. They were written and edited by Ann Bernstein, Antony Altbeker and Professor Alexander Johnston. The entire project has been guided by a reference group of CDE Board members, supplemented by other senior advisers. We are grateful for the advice and assistance of many other people in helping CDE to produce this series of reports.

This report was written for CDE by David Kaplan, professor of business-government relations and professor of economics at the University of Cape Town.

This document and the six other reports in the Growth Agenda series, are available from CDE; they can be downloaded from www.cde.org.za.

The initial research was funded by The Atlantic Philanthropies. The funders do not necessarily agree with the views expressed in the report.

Published in April 2016 by The Centre for Development and Enterprise, South Africa.
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ISBN: 978-1-920653-22-4

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AN EXPORT PROCESSING ZONE FOR THE NELSON MANDELA BAY METRO

INTRODUCTION

Over the last few decades China has become the centre of global manufacturing, particularly of labour-intensive exports. However, rising wages in China mean that many firms are looking for other locations to base either existing operations or new factories. The number of jobs being relocated is potentially very large; one estimate, by the former chief economist of the World Bank, is that the number will eventually be 85 million.

"Rising wages in China mean that many firms are looking for other locations to base either existing operations or new factories."

At present, most of these relocated jobs are destined for Asian countries including Vietnam, Bangladesh and India, although some African countries, notably Ethiopia, are starting to attract some manufacturing firms.

Even a tiny share of these jobs would be enormously beneficial to South Africa. The first major benefit would be the new jobs created. These are labour-intensive (unskilled and semi-skilled) activities that South Africa desperately needs, and which its present growth path fails to deliver. The second benefit would be the increase in exports, which would enhance economic growth and hence indirectly have a further positive impact on employment. (*See the CDE Growth Agenda series Report 2, Jobs.*)

THE EPZ PROPOSAL

The objective of the export processing zone (EPZ) is to provide a competitive location for labour-intensive manufacturing activities.

Firms locating in the EPZ would enjoy the following benefits:

- Duty-free imports, rapid customs and export clearance formalities.
- Subject to certain basic safeguards on employment practices such as working conditions, plant safety etc., firms would be free to negotiate wages and working hours in-house with their employees.
- Subject to certain safeguards, firms would be able to expand and contract their workforces as market and demand conditions change and/or rely on piece-work contracts for the remuneration of their staff.

Firms locating in an EPZ would have the added advantages of easy access to the harbour and provision would be made to ensure that workers can have easy access to the EPZ. No other incentives or subsidies would be granted to firms locating in the EPZ.

There will be two restrictions on firms locating in the EPZ:

- Production would be solely for export. Firms located in the EPZ would be required to export 100 per cent of their output.
- Only new firms and/or new activities would be permitted. Firms with operations in South Africa would not be permitted to move any existing operations to the EPZ.

Why would the EPZ be a competitive location?

The major cost for labour-intensive operations is – unsurprisingly – labour. Firms in the EPZ would be free to set their wages. What wages would firms need to 'offer' to attract workers?

The Expanded Public Works Programme (EPWP) currently offers a wage of R78 per day and attracts more workers than it can accommodate. Factory work would presumably be far more attractive than these jobs for a range of reasons: there is the prospect of long-term employment; wages may increase over time; employment there invariably entails some training and skilling; working conditions are likely to be more attractive, etc. This would suggest that firms in an EPZ would be able to attract labour at wages in the vicinity of R78 per day.

"Firms in the EPZ in Port Elizabeth could draw on a very large pool of people who are long-urbanised, who have higher levels of education and who, most critically, have training in and experience of factory work."

At this wage, which at present exchange rates is about $105 a month, firms engaged in clothing-related activities in the EPZ would be very competitive with those based in other locations. At that rate, wages in the EPZ would be reasonably similar – in dollar terms – to the minimum wages of workers in garment factories in Cambodia and the Philippines in 2014. While there would be a number of countries in which minimum wages would be lower than this, most of those have business environments and infrastructural deficiencies that are considerably more challenging than South Africa's.

What about the productivity of workers? Firms relocating from China to Vietnam or Laos and other countries in Asia for the most part employ workers who are recent arrivals to the city. Education levels are very low and workers have no training or experience of factory work. By contrast, firms in the EPZ in Port Elizabeth could draw on a very large pool of people who are long-urbanised, who have higher levels of education and who, most critically, have training in and experience of factory work. In the Eastern Cape, over 60 000 jobs in manufacturing (or 35 per cent of the total) have been lost since the peak of the sector in 2008. Many of these were in labour-intensive industries such as clothing and footwear.

Firms locating in the EPZ would have low labour costs and, relative to other international locations, they would also have access to workers with better training and more experience. There are locations in other countries where labour costs would be cheaper. However, there are few locations, if any, that could offer a large pool of workers already trained and experienced in industrial work, as well as the relatively good logistics infrastructure possessed by South

Africa. Moreover, the EPZ would be especially attractive to firms who wanted to enter the export market rapidly and who therefore set a premium on employing experienced and trained workers.

Because the export market for many labour-intensive products is subject to fluctuations, it is essential to the competitiveness of firms in these industries that they are able to expand and contract employment as market demand changes. This provision would be subject to safeguards against unfair dismissal.

An EPZ located in Port Elizabeth would have additional attractions. By comparison to locations in other countries currently attracting labour-intensive export-oriented firms, the proposed EPZ would offer:

- An excellent quality of life;
- Better-developed infrastructure;
- Well-developed institutions, for example in finance and banking, as well as education and training;
- Easy access to two well-functioning ports with excess capacity; and
- Excellent market access to Africa, but also to other markets, notably the United States (US) and the European Union (EU).

"Because the export market for many labour-intensive products is subject to fluctuations, it is essential to the competitiveness of firms in these industries that they are able to expand and contract employment as market demand changes."

What are the costs of failure?

An EPZ as outlined above would be an attractive offering to export-oriented firms in labour-intensive industries. However, success is by no means guaranteed. This is an experiment – South Africa has not had an EPZ of this kind before. Unless and until we undertake the experiment, we cannot know the result.

But, let us assume that the experiment is an abject failure and no firms are attracted to the EPZ. What is lost? Costs will have been incurred in establishing the zone and developing some infrastructure. There would have been some marketing costs to attract investors. However, these costs are relatively trivial. Moreover, they are largely payments made to other South Africans, with no payments made to foreign-owned firms and investors, and no subsidies having been paid to potential investors.

The downside risk is therefore very limited; even then there is compensation. Government will have been seen to be trying a novel way to create employment– and in an area where employment is sorely needed.

What are the prospects of success?

For the EPZ to be a success, it needs to appeal to only a tiny percentage of the world's labour-intensive, export-focused firms. The EPZ has a distinctive offering – a combination of low-cost labour (but by no means the lowest cost) that is reasonably experienced and productive and which, together with good logistics infrastructure, would allow firms to get into export markets quickly. These factors, in combination with a number of other important advantages outlined above, would be attractive to many firms.

There is a further important advantage. Unlike most other countries, a South African EPZ is not solely reliant on attracting foreign firms. South Africa has a very well-developed business community who would be attracted to invest. Moreover, while there have been many firm closures in Port Elizabeth and the Eastern Cape area, particularly in labour-intensive manufacturing, there still are local firms in these sectors for whom an EPZ would be very attractive.

What is most likely to happen is that the EPZ will attract a few firms – probably initially local firms. If these firms are successful, the very strong likelihood is that many other firms would then follow. A few successes will encourage many followers.

Given the very large number of jobs relocating globally, the upside is potentially very large indeed. By contrast, the downside, the costs of failure, are very limited. In essence, the EPZ provides government with the opportunity to try something new to enhance growth and exports and employment where it is most needed – for unskilled and particularly semi-skilled workers – and in an area, Port Elizabeth, where unemployment is especially high.

Why Port Elizabeth?

The region has high levels of poverty and unemployment. For the Eastern Cape as a whole 50 per cent of households do not have a wage earner, as compared with the 37 per cent nationally, while Port Elizabeth's narrow unemployment rate, at 33.2 per cent in 2015 was nearly seven percentage points higher than the national average. In addition, 57 per cent of Eastern Cape households receive social grants, as compared to 45 per cent for South Africa.

There is clearly a major need to create employment – even more so in this region than in South Africa as a whole. However, the choice of Port Elizabeth as a location is not primarily because of need – there are other areas of the country where poverty and unemployment are higher. Port Elizabeth has been proposed because this is the location where an EPZ has the highest prospects of success. Port Elizabeth offers a combination – unique in South Africa and indeed probably in the world – of well-functioning ports geared to exports and imports of manufactured goods, combined with large numbers of unemployed people with previous training and experience of working in industry.

"As is evident from the experience of the EPWP, there is a substantial cohort of work-seekers who would strongly prefer to accept low-wage work rather than remain unemployed."

What are the arguments against?

The economic case for an EPZ in Port Elizabeth is strong. But, what of the politics? What are likely to be the arguments of those opposed to the EPZ?

The major argument against is likely to be that the EPZ offers only very low wages, wages that are not at levels that we should have in South Africa where we should aim for 'decent jobs'.

There are several strong counter arguments to this position:

- As is evident from the experience of the EPWP, there is a substantial cohort of work-seekers who would strongly prefer to accept low-wage work rather than remain unemployed.

- What is the justification for the state to employ workers at taxpayers' expense in public works programmes which pay low wages but not allow private firms to engage low-skill workers at similar low wages? Especially when private sector firms offer better jobs with some training, prospects of promotion and full time employment.
- Firms in the EPZ will have to pay workers enough to make it attractive for those workers to come to work. Since the workers would come to work in the EPZ voluntarily, they would do so because they feel better off than they would be than if they did not work. There is therefore no justification in claiming that these workers would be worse off. It is the workers' own assessment of their situation that alone counts.
- While wages will be low at the outset, the global experience is that, over time, wages in EPZs will rise. China is a clear example of how quickly wages can rise as labour markets tighten. There, according to the Economist Intelligence Unit, average labour costs have risen from $0.40 per hour in 2000 to $2.10 per hour in 2012 – an annual average increase of nearly 15 per cent.
- There is a concern that low wages in one area may undermine the higher wages – 'decent wages' – that workers have struggled so long for and have achieved elsewhere. This is a legitimate concern. However, since all the output of the EPZ is destined for the export market, firms in the area will not be competing with workers employed elsewhere in South Africa. The lower wages in the EPZ do not undermine the higher wages paid in other areas. Suppose that the EPZ were successful and that there were 10 000 people employed making shoes, clothes, electrical equipment etc. for export to markets in Europe, America and Africa. There is no way that this would generate downward pressure on wages elsewhere in the economy. Indeed, insofar as the EPZ facilitated growth and demand for locally-produced goods and services, the impact on employment and hence on wages elsewhere would be positive.

"The EPZ proposal should be seen as part of a broader discussion as to how South Africa could expand and diversify exports and simultaneously create employment for those millions of workers, who are most in need of employment opportunities."

Who might champion the EPZ?

For the EPZ to become a reality it will need strong champions – in both civil society and in government.

There is plenty of evidence that manufacturing faces many constraints in the region. Outside the heavily subsidised automotive sector, there are very few areas of growth and many areas of decline, with over a third of all manufacturing jobs in the province having been lost between October 2008 and June 2015. Arresting this decline depends not on shoring up the old, but on finding new areas of growth.

While the Port Elizabeth area is distant from major domestic markets and the roads are in poor condition, it has two significant advantages – access to the ports and access to large numbers of workers with training and experience in manufacturing activities. Any proposals for future growth will have to exploit these two advantages.

A significant number of people and organisations active in the local economy, who were interviewed for this project are of the opinion that there is very little if anything 'on the table' in the way of concrete proposals to enhance growth and develop new directions.

From the perspective of local and regional government, however, the creation of new sources of employment should be at the top of the agenda. As a result, the EPZ is likely to find support in both civil society and in government in Port Elizabeth, and more broadly in the Eastern Cape region.

Is the EPZ consistent with other government policies?

In May 2014, the Special Economic Zones Act was passed to facilitate the establishment of SEZs. The Act envisages a number of different categories of SEZs, including a free port and a free trade port, both of which have very similar characteristics to an EPZ. So an EPZ would be compatible with government policy.

EPZs are a constituent part of industrial policy in many countries. The EPZ does not appear to conflict with the aims of any of the programmes and supports offered by the Industrial Policy Action Plan (IPAP). It offers the potential for additional growth in industrial output and employment.

The National Development Plan (NDP) requires that new sources of employment should not undermine the higher wages paid elsewhere – '…expanding access to new entrants should not be undertaken in a manner that lowers the working and remuneration conditions of existing employees…' (NDP: 127). An EPZ would meet this requirement.

"Global experience is that properly incentivised private sector operators are far more likely to make a success of running an EPZ than public entities."

Who should run the EPZ?

Global experience is that properly incentivised private sector operators are far more likely to make a success of running an EPZ than public entities. Government, particularly provincial government, might underwrite some of the infrastructure in return for a share of the business. The key is that the private sector should operate the EPZ as a commercial entity in accordance with rules and regulations as laid down by government. Done effectively, the EPZ could even become a source of revenue for government.

A WORD OF CAUTION

The EPZ would be in competition with other locations globally and in Africa to attract labour-intensive exporters. Many such zones have failed. For the EPZ in Port Elizabeth to have a chance of success it is vital that:

- The key requirements outlined above are not changed. In particular, the ability of the firms investing in the EPZ to set their own labour and working conditions is essential. Also important is the proposal that a private sector operator runs the zone as a business.
- Any reduction in the incentives offered or any imposition of additional costs or administrative burdens on the EPZ will reduce its attraction and chances of success.

A BROADER DISCUSSION

South Africa is currently experiencing low growth and job destruction. All the forecasts are for this to continue, at least for the next few years. Other countries in the region are growing far more rapidly.

Clearly our current policies are not working. We need a fundamental rethink. CDE is proposing a number of reforms to key areas of policy in the reports prepared in this series. The interested reader should examine these in the reports linked to this one, particularly those that focus on jobs and labour market reform as well as our document on how to increase competitiveness generally. (*See the CDE Growth Agenda series Report 2, Jobs and Report 3, Accelerating inclusive growth.*)

Almost every country that has developed has gone through an important phase of labour-intensive export-oriented industrialisation. Many in this country have assumed that this path is not available to South Africa, largely because of our high wage rates.

An EPZ opens up the possibility that South Africa could indeed take this route, principally through the establishment of a zone where lower wage rates, in combination with relatively high productivity, would allow labour-intensive export firms to be competitive. By ensuring that all output is exported, this can be achieved without undermining higher wages prevailing elsewhere.

The EPZ proposal should be seen as part of a broader discussion as to how South Africa could expand and diversify exports and simultaneously create employment for those millions of workers, the unskilled and semi-skilled, who are most in need of employment opportunities.

The CDE Growth Agenda Series

This series consists of seven reports.

1. Summary overview: Insights and key recommendations
2. Jobs
3. Accelerating inclusive growth
4. Cities
5. Skills
6. Business and government
7. An export processing zone for the Nelson Mandela Bay Metro

These reports are available at www.cde.org.za

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