# Establishment of an EPZ in Nelson Mandela Bay

## 1 Problem statement

SA's crisis of unemployment is much more pronounced among unskilled workers than skilled workers. There are many reasons for this, not least the collapse in employment in once-large sectors like agriculture and mining that have become increasingly capital-intensive. SA also lacks significant employment in low-skill manufacturing, as a result of:

- The high price of unskilled workers when employers cannot know how productive they are or how easy it will be to replace them relative to skilled workers and relative to capital equipment;
- The low cost of imported goods, many of which use unskilled labour; and
- The limited number of local entrepreneurs with direct experience of global supply chains producing labour-intensive goods.

The result of the above is that SA is uncompetitive in the production of manufactured goods which generate significant employment for unskilled workers. Given that a very large proportion of the working-age population is unskilled, this lack of competitiveness has compounded the challenge of reducing unemployment.

While the difficulties of addressing these challenges are formidable, a special economic zone specifically designed to address some of these challenges might go some way to reducing SA's competitiveness gap and increase employment. For this to work, a number of conditions must be met:

- The cost to employers of taking on unskilled workers must reflect their expected productivity, and the relationship between productivity and costs must be close to international levels so that SA's superior levels of productivity and logistics compared to many developing countries can offset any remaining differential; and
- The reforms cannot be too politically contentious, or they will never be implemented (or will be quickly rolled back).

To achieve this, we propose the establishment of an export processing zone (EPZ) in Nelson Mandela Bay designed to attract international firms/entrepreneurs who specialise in the manufacture of goods that are intensive in the use of unskilled labour, 100% of the output of which would be for export. Although no capital subsidies would be provided, the EPZ would offer investors the following benefits:

- All labour would qualify for the ETI;
- Wages would be agreed at factory level and would not be subject to the national minimum wage;

- Minimum health and safety rules would pertain, but employers would be free to negotiate other conditions of employment (e.g. piece-work, output-based pay, shift times, etc.); and
- All imports would be duty-free.

In order to ensure additionality, the EPZ would be open only to new firms or expansions of existing firms. Firms would not be able to relocate to the EPZ from elsewhere in SA. In order to protect existing firms supplying the local market, all output would have to be exported.

## 2 Jobs impact

It is not possible to anticipate the jobs impact of an initiative of this kind. However, the global market for labour-intensive goods is enormous, and that, as wages rise in China, some estimates suggest that as many as 80 million jobs might move to other countries. Most of these will go to ultra-low wage economies that are also geographically close to China, but attracting even a small fraction of these jobs to SA could make a material difference to employment prospects of unskilled workers.

Apart from the employment gains (and all the associated social and political benefits), a successful EPZ would:

- Increase export earnings;
- Facilitate the learning-by-doing of local firms' engaging with global supply chains; and
- Put SA on the map as a destination for foreign investment in light manufacturing activities.

## 3 Theory of change

*Please provide no more than half a page that indicates in practical terms, how the proposal would work – what has to be done, what the outputs would be, how that would lead to the desired outcomes.*

The essence of the proposal derives from two insights. The first is that the only way to expand labour-intensive activities is on the basis of the cost of labour's being competitive after taking account of both productivity levels and of the employer's risk-adjusted costs of employment: these are highly competitive industries where profit levels are low, and, in the nature of things, the more labour-intensive an activity, the more important the cost of labour in determining competitiveness.

The second insight is that entry into a new industry generally requires a high level of knowhow, and that this knowhow, built up through experience, is more easily and often acquired through the relocation of entrepreneurs who already have it.

It follows from the above that, in order to attract investors and entrepreneurs in labour-intensive export-oriented manufacturing activities, SA would have to create a policy environment conducive to those activities.

Attracting investment of this kind necessitates the creation of a labour market regime that is globally competitive. That means:

- Protecting health and safety standards, but providing firms with exemptions from a range of provisions of the BCEA and LRA that reduce firms' flexibility in staffing up and reducing payrolls in response to order flows;
- Permit more flexibility in wages by exempting firms from the outcomes of collective bargaining and national minimum wages; and
- Provide the equivalent of the YETI to all workers.

Importantly, no workers would see a diminution of existing rights, and only those who chose to opt in to the labour market regime in the EPZ would be employed there. Foreign owners and managers in these firms would be entitled to work visas.

The EPZ itself, which could be established within the boundaries of Coega, would be fenced in and would enjoy duty-free imports. Firms would pay market-related rents for their premises and would not qualify for subsidies for building factories or purchasing machinery and equipment.

EPZ-based firms would pay corporate income tax at the standard rate, and all employees would pay personal income tax. EPZ-based firms would be entitled to VAT refunds for goods and serviced purchased from domestic firms.

Much of the requisite infrastructure already exists at Coega (which also enjoys access to a port). In addition, Nelson Mandela Bay offers a potentially attractive environment for immigrant investors/entrepreneurs , has an established business community that might take advantage of the scheme, and, because it is in the heart of the Eastern Cape's industrial belt, offers access to a workforce that has some workplace experience.

From the above, it is clear that the principal differentiator between the EPZ and the rest of the economy lies in the labour-market regime, though the disqualification of firms for capital subsidies and the qualification of all employees for the ETI are also important. These differences would change the relative price of unskilled labour relative to skilled labour and to capital equipment, and would create the basis for establishing labour-intensive, export-oriented firms, many of which could be owned and managed by foreign entrepreneurs. This would help expand SA's FDI as prioritised by the president.

## 4 Existing initiatives/experience

*Indicate if the proposal has been attempted or piloted, and broadly what was learned.*

SA has considerable experience of industrial development zones (IDZs), but the rules governing commercial activities in these zones have tended to be all but identical to those operating in the rest of the economy, reducing the IDZs to glorified office/industrial parks. This has meant that they have achieved little by way of additionality in employment creation: firms that were established in the IDZs would almost certainly have been established elsewhere if the IDZs did not exist.

The EPZ proposed here would be sufficiently different from the rest of the economy to justify the establishment of new, labour-intensive operations.

## 5 Constituency participation in implementation

*What is the potential for constituencies to participate in the implementation of the proposal.*

The critical challenge with this proposal is that it will meet with resistance from organised labour (for obvious reasons) and from local business (who might fear unfair competition in the domestic market from firms based in the EPZ) – see below. Given that Coega is geographically close to Motherwell, and given the strength of organised labour in the region, it might be possible to engage both the local community and the relevant unions in the design of the EPZ, overseeing how it is implemented, and assessing what lessons can be learnt from it. It might even be possible for the EPZ, should it be successful, to help secure resources for local training institutions linked to the needs of firms in the EPZ.

## 6 Benefits

*What social/economic groups would benefit from the proposal directly and indirectly? Please use the following table, and do not list more than 5 groups. Please describe the benefits as precisely as possible.*

| Group | Job creation | Other benefits | Time frame for success |
|---|---|---|---|
| Local community | Jobs – uncertain how many | Training opportunities | Factories being established within two years of reforms' passage |
| Local business | | Development of knowhow in relation to global supply chains | |
| SA as a whole | | Export earnings and FDI | |

## 7 Cost and potential sources of funding

*What social/economic groups would bear the cost of implementing the proposal directly or indirectly? Please use the following table, and do not list more than 5 groups. Please* *describe the costs as precisely as possible. In the case of financial costs, who would pay them?*

The project is designed to minimise out-of-pocket costs, and to avoid doing harm to constituencies that might oppose it. Apart from the expanded ETI, there are no subsidies on offer to EPZ firms, and the infrastructure needed at Coega is largely in place.

| Group | Anticipated costs | Potential sources of funding to implement the project | Time frame for impact |
|---|---|---|---|
| Taxpayers | Modest increase in tax expenditures associated with expanded ETI | | Immediate |
| Taxpayers | Modest provision for expanded capacity, security at Coega, and for marketing the EPZ | | Immediate and some ongoing |

## 8 Risks

*What are the main risks that would prevent the proposal from achieving the anticipated outcomes? Describe at least two.*

Because there are no out-of-pocket costs, the principal risks associated with the project are political: will organised labour and domestic business oppose it? Organised labour might do so because it might be seen as rolling back hard-won rights or undermining their conviction that SA business should not engage in these kinds of poorly paid activities. Local business might oppose it if they fear that EPZ firms will be able to undercut their prices in local markets.

Another political risk is that potential investors might doubt that the commitment that government might make to allowing a more flexible labour market regime to govern employment in the EPZ will survive opposition that may emerge at some later point, increasing their perceived risk and reducing their willingness to invest.

A final risk is that, having expended the political capital needed to effect the reforms described above, slow uptake in the EPZ offering might undermine the general argument that risk-adjusted costs of employment matter for job creation.

## 9 Risk mitigation

*What should be done to mitigate the identified risks? Which stakeholder would be responsible for the risk mitigation activity?*

Risk of opposition from unions and business

Business, working with government, will have to persuade unions that the parameters of the project pose little threat to the interests of workers in firms outside the EPZ, that the jobs created could not have been created elsewhere, and that the workers who took those jobs were doing so willingly, knowing that there were few plausible alternatives.

Business and unions would also have to be persuaded that the controls put in place at the EPZ would ensure that goods produced within its boundaries would not be sold in SA. Plausibly, the possibility of increased training opportunities around the EPZ would also help both organised labour and local business up-skill workers outside the EPZ.

Investors' risk perceptions

It is not possible to address these completely, but clear commitments from government at local, provincial and national level would be needed that the exemptions put in place at the EPZ would remain in force. In addition, were it necessary, it might be worth exploring the possibility of government's providing political-risk insurance to investors.

The risk of limited uptake

In order to minimise the risk that the expenditure of political capital is not wasted, a dedicated team would have to be appointed by business to secure investment commitments from potential investors conditional on the passage of reforms and exemptions identified above. This team should begin working immediately so as to minimise the risk of delay in the uptake of the EPZ offering.

## 10 Additional comments

Industrialisation is the most efficient route to social and economic development, and every country that has seen a substantial rise in incomes and welfare has achieved this through rapidly growing manufacturing output. SA has substantial industrial capacity, but a vast population of relatively unskilled workers in search of employment. Given the scale of the global market, seeking to attract some of the jobs available in global supply chains is an obvious strategy for developing countries, and one that countries like Japan, South Korea and China have pursued, and which  Malaysia, Mexico, Phillipines and Costa Rica are pursuing successfully.

In this regard, it is critical to understand the benefits of creating this kind of employment is not just that unemployed people find work, but that these operations can become the foundations for different kinds of activities that are more productive and which are able to pay higher wages. This has been the experience across the world, and there is no reason to think that it would not apply in SA, too.