EXPORT PROMOTION IN THE INDUSTRIAL DEVELOPMENT ZONES

1 Introduction

Industrial development zones (IDZs) or special economic zones (SEZs) are specific geographical areas in a country where certain economic activities are promoted through a set of policy measures not generally applicable to the rest of the country. Using policies and programmes to create favourable conditions for foreign investment, IDZs seek to overcome obstacles to the development of a competitive, export-oriented economy. The success of SEZs in East Asia, particularly China, led the South African government to pursue the development of such zones as part of its industrial policy. The IDZ programme was formalised in 2000, and three IDZs are currently in operation: Coega, East London and Richards Bay. Since inception, these have cost government R8.8 billion.

The IDZs have been unable to attract sufficient investment to be financially self-sustainable. Some of the contributory factors, identified in the Coega Development Corporation's 2013/14 annual performance plan, include: the lingering effects of the 2008 global economic crisis, exchange rate volatility, the small domestic market, long distances to other markets, rising labour costs, negative perceptions of South Africa, and a lack of supporting industries, skills and infrastructure. Other constraints identified by the Department of Trade and Industry (DTI) include weak governance of the IDZs, inadequate incentives, deficient integrated planning, and poor stakeholder coordination. These concerns, along with the changing priorities articulated in the National Development Plan and the New Growth Path, prompted the DTI to review and repackage its approach to industrial development in its new SEZ policy.

Lessons learnt about the effectiveness and efficiency of the IDZ programme will inform policy choices about the design and funding of IDZs and SEZs in future, to ensure that successes are replicated and shortcomings remedied. Accordingly, a performance and expenditure review (PER) of the IDZ programme was commissioned to describe the structure of the programme, identify its main cost drivers, and assess its contribution to growth and employment outcomes. The PER was conducted between August and December 2013 by DNA Economics. Some of its key outputs, insights and recommendations are summarised here. The full report and the costing model are available at www.gtac.gov.za/programmes-and-services/public-expenditure-and-policy-analysis.

2 Institutional context

The three operational IDZs were established in terms of the Manufacturing Development Act of 1997. The IDZs, all of which are located near a port or an airport, aimed to:

- Facilitate the creation of an industrial complex that has a strategic economic advantage.
- Provide the location for the establishment of strategic investments.
- Enable the exploitation of resource-intensive industries.
- Take advantage of existing industrial capacity and promote integration with local industry.
- Create employment and other economic and social benefits.

All three spheres of government are involved in establishing and operating IDZs, as shown in Figure 1. A dedicated DTI unit is responsible for policy development around IDZs, including their designation, oversight, monitoring and evaluation. It is supported by units that provide services such as export promotion assistance and investment marketing services.

Figure 1: IDZ outputs, outcome and impacts

IMPACT							
Impact statement	Accelerated sustainable growth and poverty reduction						
OUTCOMES							
Long term (> than 5 years)	Decent employment through inclusive growth (Outcome 4) An efficient, competitive and responsive economic infrastructure network (Outcome 6)						
Medium term (3 - 5 years)	Increased investment		Increased value added exports			Efficient, competitive and responsive industrial zones	
OUTPUTS							
National Government - DTI							
IDZ/SEZ Governing policy and legislation	Designation of IDZ		Regulatory compliance and M&E	Investment marketing services		Export promotion schemes and assistance	
Provincial Government		Local Government				SARS	
Approved operational plans and budgets	General economic infrastructure	Provision of utilities and general Infrastructure		IDZ aligned with IDP		Reduction in trade facilitation costs	
Operating Entities							
IDZ capital and operational plans	General economic Infrastructure	Specialist infrastructure and technology	Shared infrastructure	Investment marketing services	Export promotion facilitation	Compliance support and aftercare	Incubation programme

Provincial governments are the custodians of the IDZs and provide operational funding. Their economic development departments generally oversee the IDZ as an instrument for achieving provincial objectives for infrastructure development, economic growth and job creation.

The Coega IDZ falls within the jurisdiction of the Nelson Mandela Bay Municipality; the East London IDZ is in Buffalo City Municipality, and the Richards Bay IDZ is in uMhlathuze Local Municipality and uThungulu District Municipality. Municipalities either donated land for the establishment of the IDZ or offered it at a discounted rate. They provide utilities, such as water and electricity (sometimes at preferential rates, negotiated on a case-by-case basis), as well as specialised waste services. They are also responsible for constructing, maintaining and upgrading access roads to the IDZ.

The IDZs are expected to provide a customs-controlled area, offering resident firms:

- Relief from customs duties for equipment used in the construction and maintenance of their production processes;
- Simplified customs procedures (e.g. release of cargo); and
- An exemption from VAT on the importation of goods to be used in exports.

By 2013, however, none of the IDZs had a fully fledged customs-controlled area. At the time, a factory in an IDZ had to apply and register with the South African Revenue Service and would subsequently be designated a customs-controlled area, a procedure no different from that already available to firms outside the IDZs.

While the Minister of Trade and Industry is the executive authority of the IDZ programme, individual IDZ operating entities are listed as provincial government business enterprises in terms of the Public Finance Management Act of 1999. Their primary functions are:

- Developing and operating the IDZ;
- Assisting investors (e.g. with registration, tax matters, liaison, and permits and licences);

- Marketing and developing the brand; and
- Providing specialised products and services, such as training or incubation facilities.

3 Performance analysis

Ultimately, the effectiveness of the IDZ programme hinges on the number of investments attracted to these zones (which would not otherwise have materialised), the jobs they create, and the export earnings they generate. While it is beyond the scope of this study to assess whether the investment projects secured to date would have occurred in the absence of an IDZ, it is possible to evaluate the cost of attracting the investments and compare these with the recorded gains.

The high level of up-front public investment has not been matched by a corresponding flow of new investment from the private sector. By 2012/13, the private sector had invested only R3.2 billion in the three IDZs, while national and provincial government had spent around R8.8 billion. Just over 5 000 jobs were directly created, at an average cost to government of around R2 million per job. (This figure excludes temporary construction jobs.)

Government capital expenditure comprises the provision of infrastructure (roads, electricity and water) and the superstructure (warehouses, factory shells, canteens and other facilities). Private sector contributions to infrastructure development depend on the agreement between the IDZ and individual investors. From data provided by the Coega Development Corporation, it is apparent that a high level of co-funding is offered (and may be required) to attract and retain investors within the IDZ. On average, for every R1 million invested by the private sector, the corporation also contributes R1 million (over and above the general infrastructure already provided).

In the period under review, the outcomes of the IDZ programmes were measured through two categories of indicators:

- *Increased investment:* The number of signed investors, the value of the investment, the number of new investment agreements, and the number of investment opportunities; and
- *Increased value-added exports:* The value of exports generated and the establishment of new exporters.

While these indicators are useful, the outcomes are not entirely attributable to the IDZ programme. Thus the indicators do not measure the IDZ’s contribution to the reported increases in economic activity. Potential additional efficiency indicators could include:

- The ratio of total public capital investment to private investment;
- The ratio of total government funding (capital and operating expenditure) to private investment;
- The ratio of staff costs to total operational costs; and
- The ratio of total operational cost to total operational income.

The values of these indicators were calculated in the costing model described below. The ratio of public capital investment to private investment provides an indication whether public investment is attracting private investment into the IDZ. However, because government currently covers most of the operational costs of the IDZs, it is also important to consider the ratio of total government spending (capital plus operating expenditure) to the amount of private sector investment secured.

4 Expenditure analysis

Historically, the IDZs have been directly funded by transfers from national (DTI) and provincial governments. The funding from the DTI was appropriated exclusively for capital expenditure, whilst funding from the provincial governments was intended for operational expenditure.

It was anticipated that, by the end of 2013/14, a total of R10 billion would have been transferred from government to the IDZ programme over a 13-year period, including R6.4 billion from the DTI (primarily for capital expenditure) and R3.6 billion from provincial governments (primarily for operational expenditure).

The IDZs report annually on their capital spending and plans, but there is no consolidated record of the exact share of the R6.4 billion spent on roads, bulk electricity, waste management and treatment, and storm water drainage. Although it is impossible to disaggregate total capital spending, it is clear that about 70% of this investment has been made into the Coega IDZ.

As Table 1 shows, none of the IDZs appeared close to generating an operational surplus by 2012/13. The Richards Bay IDZ had just one tenant, Tata Steel, and was not reporting any rental income from it. The East London IDZ had seen a strong increase in rental income over the five years under review, but its operating costs had increased much faster, resulting in the doubling of its operating deficit. At Coega, rental income kept pace with rising operating costs, and the net deficit remained fairly constant. Overall, it appears that the operational costs of all three IDZs escalated over the period under review: at Richards Bay, operational costs increased by an average of 51% a year since 2008/09; at East London by 20%; and at Coega by 17%. In all three cases, the single largest cost driver of operating expenses was staff costs.

Table 1: Total operating costs and revenues per IDZ, 2008/09 to 2012/13

R million	2008/09	2009/10	2010/11	2011/12	2012/13
Richards Bay IDZ					
Rental income					
Operating expenses	R 8.3	R 10.1	R 21.3	R 30.1	R 39.1
Net operating deficit	**-R 8.3**	**-R 10.1**	**-R 21.3**	**-R 30.1**	**-R 39.1**
East London IDZ					
Rental income	R 10.5	R 13.2	R 19.6	R 32.6	R 33.6
Operating expenses	R 83.6	R 91.3	R 114.0	R 134.6	R 170.2
Net operating deficit	**-R 73.1**	**-R 78.1**	**-R 94.4**	**-R 102.1**	**-R 136.7**
Coega IDZ					
Rental income	R 50.7	R 70.6	R 124.7	R 223.1	R 306.4
Operating expenses	R 308.3	R 436.5	R 400.2	R 395	R 531
Net operating deficit	**-R 257.6**	**-R 365.9**	**-R 275.4**	**-R 171.9**	**-R 224.5**

Note: Only rental income is reported, not any other income that the operating entity might have received though investments and non-core activities, such as income earned by the CDC travel agency.
Source: Annual Reports

From 2012/13 to 2016/17, it was anticipated that funding from the DTI would be been channelled through the new SEZ programme, with R5 billion made available over five years from national government alone. At the time of the PER, the contribution of the provinces to the SEZ programme was unknown, but it could increase significantly in line with the high number of new SEZs expected.

Among the proposed changes are the establishment of an SEZ fund, which will replace the current transfers to the IDZ. The fund will finance capital expenditure, while customised top structures will be funded by developers and investors. Operating expenditure is expected to be funded by the shareholder(s) of the SEZ, usually the provincial government. From 2013/14, current IDZs and prospective SEZs will be funded from the SEZ fund, with no baseline allocation for individual IDZs over the next medium-term expenditure framework period.

5 Costing model

IDZ rental income falls far short of operational costs, and the significant shortfall is currently funded by government. This raises two questions: How much additional investment would be required for these IDZs to become sustainable? What else could be done to reduce the net cost to the state? To address these questions, a costing model was developed to help policymakers create scenarios against which to test SEZ business plans. The tool seeks to determine at what stage the IDZs would achieve operational breakeven under different investment and expenditure assumptions. (In the model, breakeven could be achieved through either higher revenue or lower operating costs.)

The scenario analysis tool assesses existing IDZs based on actual and forecasted information. In the model, the years 1–5 show actual expenditure and revenue data, based on information from the annual reports of the IDZs for the period 2008/09–2012/13, and include the cumulative amount of all public and private investment acquired by the IDZ at that time. Years 6–20 provide a forecast based on a number of assumptions:

- Rental income for all future investments is collected at R100/m^2.
- No further bulk infrastructure is added to the IDZ beyond the initial package of land.
- Three direct jobs are created for every R1 million in private sector investment.
- The IDZ operator continues to provide co-funding in the form of ‘superstructure’ investment in line with the historical data received from Coega.
- At year 5, 95% of operational costs are assumed to be ‘fixed’, based on the size of the IDZ and the lettable area available.
- From year 6, the remaining 5% of operational costs increase in line with the projected increase in private sector investment.

The tool enables the user to generate various scenarios. The report, however, focuses on three scenarios for each of the three IDZs:

- *Status quo scenario:* The IDZ attracts no further private investment during the next 15 years.
- *Optimistic scenario:* The IDZ attracts sufficient private sector investment to fill all remaining lettable space over the next 15 years.
- *Pragmatic scenario:* The IDZ attracts sufficient private sector investment to fill 50% of the remaining lettable space over the next 15 years.

In each scenario, the change in operational expenditure or revenue that would be required for the IDZ to achieve financial breakeven by year 20 is calculated. Critically, this breakeven point considers only the cost of operational expenditure and not the capital investment provided by government, although the required ratio of government to private sector investment is calculated.

Should the historical spending trend (of national and provincial governments spending R10 billion over the last 13 years) continue, the model suggests that government may need to invest a further R20 billion over the next 15 years in these three IDZs alone to prepare the IDZ space to be let out.

6 Findings

The format and comprehensiveness of financial reporting by IDZ entities differ significantly, making it difficult to assess their financial performance. The available information suggests that the IDZs are far from achieving financial sustainability. By 2012/13, their combined operational costs exceeded rental income by around R400 million per year, and had been increasing at an annual average rate of 18% for the previous four years.

Unless these IDZs can quickly secure substantial new investors or significantly reduce their running cost, the overall efficiency and effectiveness of these interventions are in question. Rolling out the new SEZ programme requires rigorous analysis to assess the need for new industrial land in the proposed areas and to justify government investment in its provision (as opposed to facilitating private development).

Moreover, given the experience of the existing IDZ programme, it is crucial that the new SEZ policy manage costs and risks better, with a clearer value proposition. Any upfront infrastructure expenditure must be scaled to match business interest. Great care should be taken to minimise the initial government investment in new IDZs or SEZs and to ensure that capital and operational costs remain proportional to the number of tenants in place (or that can realistically be expected). Proposals that might lead to the unnecessary or excessive supply of industrial land by government should be strongly opposed, and any new SEZs should begin small and be scaled up to meet demand only as and when it arises.

The indicators used to measure the impact of the IDZ programme are inadequate, focusing exclusively on the economic outcomes. Greater attention needs to be given to measuring and reporting on the efficiency and effectiveness of the IDZs. This should include the ratio of total government investment to private sector investment, and measures of operational costs to total costs and income. Moreover, common and comprehensive financial reporting standards should be agreed and enforced.

7 Postscript

In the new SEZs, operating entities will no longer be permanent and new operating entities will be appointed on a five-year contract. This will require the performance of the new operating entities to be closely monitored, with even tighter oversight than in the case of the existing IDZs.

In addition, the co-funding regime has been replaced with investment incentives. In 2013, a special tax incentive regime for the new SEZs was introduced in the Income Tax Act. Qualifying companies can benefit from an accelerated depreciation allowance on buildings and other capital structures. Under certain circumstances, they may also benefit from a reduced corporate tax rate of 15%, instead of the current 28%. To qualify for these income tax incentives, companies should be tax resident in South Africa, operate within a designated SEZ, carry on business through a fixed place of business situated within that SEZ, and derive at least 90% of their income from one or more SEZs. While this moves some of the costs off the DTI budget, the tax implications need to be monitored and transparently reported.