

Value Chains and Institutional Imperatives in Regional Industrial Development: A Consideration of the Implementation and Impact of Defence Offsets in the Western Cape.

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Abstract

The paper explores select experiences within the Western Cape province regarding the implementation and impact of the defence offsets associated with the Strategic Defence Programme (SDP) with reference to both DIP (Defence Industrial Participation) and the NIP (National Industrial Participation) aspects. The research builds on earlier provisional research findings, is primarily qualitative in nature, and utilizes a range of in-depth interviews to explore the dynamics of the offset negotiations and decisions.

The examination of the select NIP projects includes:

- ✍ A short overall assessment of the NIP programme within the province;*
- ✍ An examination of the seeming lack of offset investment in emerging high-tech knowledge industrial sector in the region;*
- ✍ A short comparative study of the experiences of the Cape Town boat-building industry in regard to accessing NIP and other IP investments; and*
- ✍ The contribution of offset initiatives and investments in the jewelry and gold-beneficiation clusters in the Western Cape.*

The DIP offsets are considered via short analyses of selected defence firms in the region. The complex and mixed response to the SDP offsets are discussed. The question of the linkages between the NIP and DIP initiatives is raised. More broadly, the NIP and DIP projects, especially the former, are contextualized and considered within a discussion of new strategy and policy emphases on value chain integration on local, national and international levels as specified by the DTI's new IMS (Integrated Manufacturing Strategy). The question of the institutional coordination of and support for Industrial Participation and defence offsets at sub-national/provincial level is also discussed.

Although focussing on the SDP, certain of the core findings and insights of this paper have relevance for the Industrial Participation programme in general.

Introduction

This paper examines the Western Cape experience of offsets associated with South Africa's controversial R57bn arms acquisition package, the Strategic Defence Programme (SDP), in both the defence and non-defence sectors. It builds on maturing research on the impact of the offsets on the national space economy of South Africa (Dunne and Lamb 2004), as well as an early study of the regional economic effects (Haines 2004).

While the SDP was expressly aimed at kick-starting and diversifying South Africa's industrial economy, it is a conceptually overloaded programme in terms of the motives, agendas and expectations it carries. For one, it is very directly linked with the post-1994 accumulation strategies of the new political elite and of segments of the older white establishment (Auditor General 2001; CAAT 2003; Dunne and Lamb 2004; Crawford Brown 2000; Hosking and Haines 2003). The current defence offset package constitutes one of the pillars of the government's expanding set of Industrial Participation (IP) projects which are predicated on international state procurement exercises in which facilitation services by local and international agents and agencies offer possibilities are an underestimated and under-analyzed factor. The shift to a greater use of IP in South Africa's industrial policy is part of a broader shift within government since the later 1990s, to utilize partnerships and leveraged private sector investment to offset and to reduce the costs to the state for the support and subsidization of domestic industrial activity (Bond 2002; Haines 2000).

The SDP in terms of its prescriptions for the four relevant international defence consortia, has guaranteed some degree of investment into and the fostering of links with the local private and public defence firms, thereby helping secure the survival of the domestic defence industry albeit in a somewhat truncated and under-developed form. The SDP includes both defence-related counter-trade investment, namely the Defence Industrial Participation (DIP) scheme, and non-defence related investment, namely the National Industrial Participation Scheme (NIP) scheme. The DIP scheme can be further broken down into direct and indirect DIP.

The conceptualization, targeting and implementation of the ongoing defence offset obligations, and IP more generally, has occurred in the context of new policy shifts and emphases in economic and industrial strategy in South Africa. Most notable is the prominence given to a 'value-chain' approach as manifested *inter alia*. in DTI Integrated Manufacturing Strategy (DTI 2002c and 2003c). This implies some commitment to the grouping and consolidation of the various Industrial Participation projects and investments be aligned to the 'value chain' methodology in modest and sometimes retrospective ways.

However, as recent research has suggested, the defence offsets and the IP programme more generally, constitute a somewhat chaotic intervention of growing proportions in the South African space economy (Haines 2004). And while it is probably unrealistic to

expect the IP strategy to contribute in distinct ways to more equitable and balanced regional development processes, it should also be borne in mind that the IP interventions can have deforming impact as well as unanticipated effects on the national space economy. To mesh the value chain approach, with the IP programme with any degree of success, would seem to require a sophisticated set of state-directed interventions, as well as networking and partnership building, with due attention to the institutional underpinnings.

The paper comprises five sections. The first section provides a contextual discussion of the defence offsets and Industrial Participation more generally, and notes an apparent shift from more static, traditional and incremental notions of regional development to more dynamic inter-regional and trans-regional value-adding chains in approaches to industrial development. The second section profiles the Western Cape economy and its competitive advantages for offset and Industrial Participation investment and counter-trade. The third section examines the certain of the province's experience with the NIP component of the SDP. The fourth section considers the differing experiences of selected defence firms in the Western Cape in regard to the DIP offsets. The final section puts forward policy implications and conclusions.

1. THE SDP, INDUSTRIAL PARTICIPATION AND REGIONAL INDUSTRIAL POLICY

Although Armscor had conducted an in-house offsets programme during the 1980s¹ and after, these offsets were relatively modest and located essentially within the defence industry. Both defence and non-defence related industrial participation and counter trade became formal and integral components of a reshaped industrial policy, which was part of the restructuring of South Africa's macro economic strategy (Haines 1996).

Under guidelines that took effect from September 1996, all government and parastatal contracts with an import content exceeding US \$10m, must include an Industrial Participation (IP) component. The value of the offsets was to comprise a minimum 30% of a bid's imported component for civilian contracts. For defence contracts the offsets should comprise 50% of a bid's imported components (DTI 1997).

In regard to the current defence procurement exercise (SDP – Strategic Defence Programme) under scrutiny, all contracts with a value of greater than US\$10m will be subject to National Industrial Participation Policy, administered jointly by the Department of Trade and Industry and the Department of Defence. [AS STATED ABOVE] There is a Department of Defence (DoD) Industrial Participation Policy (DIP) and the DTI's national Industrial Participation Policy (NIP). The NIP programme is managed and administered by the Department of Trade and Industry (DTI), while the DIP obligations are jointly managed and administered by Armscor and the DoD Acquisition Division. In practice the relevant directorate in Armscor is playing the lead role in the management of the DIP obligations, with the DoD and the DENEL central office playing

¹ Interview with Mr Johan van Dyk, DENEL, Pretoria, 13 December 2001.

supportive roles. The Armscor directorate responsible for the management of the offsets is currently in relatively close cooperation with a specialist IP section in the DTI office.² The DIP and NIP offsets, especially the former, have been promoted by their public and private sector protagonists as constituting a significant stimulus to industrial and developmental investment. The job creation element is still emphasized though less vigorously than during the inception of the programme³.

A challenge for the relevant policy actors is to ensure that the IP scheme – which includes other large procurement exercises apart from the R57bn defence procurement – reinforces or contributes to efforts to achieve integrated development on a national and sub-national level within the South African space economy. Such an undertaking demands considerable coordination from the participating agencies and a coherent understanding of how potential projects and investments should be selected, spatially allocated and embedded. The IP interventions should ideally provide added impetus to the reshaped industrial strategy (Hirsch 2000; and DTI 2001; DTI 2003c).

An Integrated Manufacturing Strategy (DTI 2002c) built on debate around earlier policy documents (e.g. Hirsch 2000, and DTI 2001) which stressed the importance of shifting the national economy onto a knowledge-intensive development path, expanding the parameters of conventional industrial policy to take more cognizance of the increased importance of the service sector in economic development, and facilitating a partial shift of manufacturing and industrial activity to the coast. Briefly, the new IMS stresses the centrality of knowledge-intensive production processes in manufacturing and the need to construct integrated supply or value chains with a national and often an international reach. Particular emphasis is placed on five sectors of the economy for increased outputs and exports, namely agriculture and food production; tourism, ICTs, cultural industries and exports sectors, including minerals and metals, clothing and textiles, automobiles, agro-processing, and chemicals (ibid. 30). These emphases are echoed in the National Industrial Participation Programme (see DTI 2003a).

The IMS document tends though to view the cluster approach, an important current in DTI thinking in the mid- and later-1990s, as the philosophical inferior to a value chain approach which is less spatially confined. However, as recent UNIDO-sponsored research (e.g. Nadvi and Barrientos 2004) argues that clusters are important vehicles for access to global value chains for new and under-funded enterprises. Working more closely with emerging cluster initiatives might well help obligors in locating and/or conceptualizing suitable projects.

While models and methodologies were designed and/or modified to evaluate the projects and associated credits in the SDP, the allocation and integration of the various projects and investments to specific regions and centres has been less prescriptive and

² Interview, Ms Brentia Potgieter, Armscor, Erasmusrand, Pretoria, 7 June 2002.

³ The initial estimate of 65 000 jobs and earnings of R110bn for the original R31bn were downscaled early in the programme. The estimate of earnings was subsequently reduced to R70bn over a period of 11 years (Defence Systems Daily 15 September 1999, RSA 1999).

systematic⁴. Most obvious means of targeting especially in the earlier phases were the SDIs (Spatial Development Initiatives). But the allocation of specific projects has almost inevitably involved a degree of horse trading, than systematic targeting. There were distinct limitations on the range of viable investments and projects the main contractors and consortia could or would offer (Haines 2004).

The allocation has entailed a compromise between the spatial/regional considerations of the DTI, and the willingness of the obligors and their partners and agents to identify, conceptualize and implement projects in particular areas. Though on paper there is a reasonable geographic spread of projects and investments, there has not been undue pressure on obligors to direct their investments to more marginal and less desirable locations. This approach is conditioned by the realization/ perception that obligors would be more able to find reasons for not pursuing a particular project in a marginal location than in a more established and prosperous destination.

At present only seven provinces have projects up and running, in regard to both the SDP and IP more generally, with two of the more peripheral and poorest provinces, namely Mapumulanga and Limpopo failing to benefit in the shorter term. This is indicated in Table 1 below.

Table 1

**Regional Data: Industrial Participation Programme
(Projected values from Portfolio Committee Report
Credits Awarded from October 2003 Credits Information)**

	Projected Value (\$) up to 2011 – Investments, exports and local sales	Direct jobs up to 2011	Percentage allocation of performance per region
Western Cape	4,141,415,920	3,314	37.20%
KwaZulu-Natal	4,886,190,048	1,201	4.51%
Eastern Cape	3,177,770,461	2,435	1.60%
Free State	1,651,400,000	2,100	1.33%
Gauteng	5,621,256,713	3,216	42.59%

⁴ Interview, Mr R Pershad, Durban, 20 September 2002.

Mpumalanga	762,500,000	230	6.76%
North Province	909,990,000	880	6.01%
TOTAL	21,150,523,142	13,376	100%

Projected values include projections for investments, local sales and exports
Performance percentages include, but are not limited to, investments, local sales and exports.

Source: DTI 2003

As the DTI's Integrated Manufacturing Strategy (IMS) document notes: '[i]n terms of geographic patterns, the dominance of metropolises has continued, with limited economic opportunities in smaller settlements and rural areas, particularly in those areas that were homelands' (DTI 2002c: 19) If anything, despite government's avowed intention of facilitating the partial shift of industrial, and more specifically economic activity to the coast, the hegemony of the industrial metropolitan complex in Gauteng has strengthened. There is also a shift in part of certain higher-end tertiary and secondary industrial production away from Durban to Johannesburg and environs, and, though to a lesser extent, to Cape Town (Thomas 2002).

And government openly acknowledges 'that it needs to do more to improve the coherence of existing strategies to improve the coherence of existing strategies to promote a more equitable **geographic spread** of investment and economic activities'. (ibid. 28) A core element in such an exercise is to develop appropriate value chains within and beyond the national space economy, and to utilize vehicles such as the SDIs.

Bloch's 1999 argument still appears to have relevance. He maintains that the problem lies mainly with a deeply entrenched core-periphery system in terms of industrial location. A national industrial core is dominated by a 'parallelogram' bounded by Rustenburg-Free State Goldfields, Newcastle-Middleburg. It includes the industrial components of Gauteng, the adjacent mineral-rich areas, and the iron and steel, electrical and chemical-based centres in the North West, Free State, and Mpumalanga provinces. It is the heartland of the 'Mineral-Energy-Complex' that has dominated South African economic development in the post-war period (Bloch 1999). The Cape Town and Durban metropolitan areas are subordinate but integral parts of the core; as are Port Elizabeth and East London, although in a more subordinate sense. Attempts by the DTI to attract investment and support business, argues Bloch, will not alter the South African space economy, in the short, medium, or even the long-term. Nor will it create new growth centres.

2. PROFILE OF WESTERN CAPE ECONOMY

There are current nine provinces in post-apartheid South Africa⁵. Each has a provincial government with certain budgetary powers and funds allocated by central government. The dominant province in terms of economic activity and hegemony is Gauteng, incorporating both Johannesburg (the spiritual core of the mining industry) and the capital Pretoria. The Johannesburg-Pretoria axis is the largest concentration of manufacturing industry followed by Durban and Cape Town, which are the major metropolitan centres of the respective provinces of the Western Cape and Kwa-Zulu Natal (KZN). As shown by Table 2 below, the Western Cape is the second most productive province in RSA with Gauteng occupying the top position.

Table 2:

Gross Geographic Product
Gross geographic product^a and GGP per head by province, 2001

Province	<i>GGP Rbn^b</i>	GGP per head
Eastern Cape	40.4	R8 917
Free State	29.5	R15 196
Gauteng	221.9	R39 089
KwaZulu-Natal	75.7	R11 924
Limpopo	22.9	R6 869
Mpumalanga	47.1	R21 331
North West	31.9	R15 508
Northern Cape	10.9	R18 242
Western Cape	102.9	R34 986
South Africa	583.4	R19 508

a At constant prices

b Figures should add up vertically but may not, owing to rounding

Source: South African Institute of Race Relations, 2002/3 Survey

⁵ For more comparative information see the RSA Government's 'Provincial Overview' available at <http://www.gov.za/province/overview.htm> 11/08/03.

The Western Cape's GRP has increased at rates just above the South African average for the best part of 20 years, leading to its share of the RSA-GRP rising to 15% if not higher. Unemployment rates, despite substantial in-migration from other provinces, are significantly below the national average. See Tables 3 below.

Table 3:

Economically Active Population by Province, 2002^a

<i>Province</i>	<i>Employed</i>	<i>Unemployed (strict)</i>	<i>Unemployed (expanded)</i>	<i>Unemployed (strict) as proportion of provincial EAP^b</i>	<i>Unemployed (expanded) as proportion of provincial EAP^b</i>
Eastern Cape	1,628,000	638,000	1,052,000	28.1%	39.2%
Free State	767,000	386,000	531,000	35.5%	40.9%
Gauteng	2,776,000	1,027,000	1,532,000	27.0%	35.6%
KwaZulu-Natal	2,002,000	1,047,000	1,757,000	34.3%	46.7%
Limpopo	870,000	505,000	1,069,000	36.7%	55.1%
Mpumalanga	753,000	320,000	539,000	29.8%	41.7%
North West	822,000	364,000	708,000	30.7%	46.3%
Northern Cape	233,000	100,000	162,000	30.0%	41.0%
Western Cape	1,542,000	352,000	528,000	18.6%	25.5%
South Africa	11,393,000	4,738,000	7,876,000^a	29.4%	40.9%
(2001)	11,837,000	4,240,000	6,961,000	26.4%	37.0%
Change: 2002 vs 2001	-3.8%	11.7%	13.1%	11.4%	10.5%

a Figures should add up vertically but may not, owing to rounding, and owing to the fact that Stats SA disregarded sample sizes smaller than 10,000 as unreliable

b Economically active population

Source: South African Institute of Race Relations, 2002/3 Survey

While agriculture, fishing and manufacturing have remained as important sectors, the service sectors (including tourism) have become more dominant. Also, the sub-sector (niche) composition of most of the sectors have changed, with export-oriented, high value-adding niches rapidly gaining in prominence. (Wesgro 2002; 2003a)

In terms of its exports in recent years the Western Cape has performed well with a significant upswing in recent years (Wesgro 2003a). Table 5 depicts the totals for Western Cape and RSA results for the years 1996-2002 as well as the percentage share of the Cape. The ratio is significantly stable for the bulk of the period, rising from an average of 7,2% for 1996-98 to 7,9% for the next 3 years. Thereafter it moves to 9,1% in 2002 – a 48,4% increase in documented Western Cape exports compared to a 24,4% increase in the country's exports as a whole.

Table 4: Western Cape Exports as % of RSA Total Exports

	Western Cape Rmio	RSA Rmio	Western Cape Share %
1996	9 256	125 722	7,4
1997	9 407	131 360	7,2
1998	10 279	147 547	7,0
1999	13 683	163 181	8,4
2000	15 996	208 474	7,7
2001	19 146	251 542	7,6
2002	28 418	312 894	9,1
& ? 02/01	48,4	24,4	

Source: Wesgro 2003a

The larger traditional sectors with increased export growth are shown in Table 5.

Table 5: Significant Western Cape Export Sectors, with Increased Export Shares (Western Cape/RSA)

Sector	Average Share % 1996-1998	Average Share % 1999-2001	Average Share % 2002
1. Animals & Fish	51,8	64,7	65,7
2. Vegetable & Fruit	37,7	45,2	48,1
3. Animal/Vegetable Fats & Oils	17,8	19,3	23,0
4. Prepared Food & Beverages	34,0	38,0	49,2
5. Wood Articles	5,5	8,1	10,9
6. Clothing & Textiles	18,5	25,2	28,8

7. Footwear & Headgear	16,7	27,3	24,1
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Source: Wesgro 2003a

The following table provides a more detailed breakdown of the main (Top 10) export products:

Table 6: Top 10 Western Cape Export Products

Product Category	Exports 2002 Rmio (1)	% of WC Total 2002 (2)	% Increase 2002/ 1996-8 (3)	Col (3) less R- Depreciation (4)
1. Fruit (incl. Processed)	6 337,7	22,3	135,6	49,0
2. Wine, Beer & Spirits	3 187,4	11,2	323,8	237,2 (3)
3. Fish	2 418,4	8,5	246,6	160,0 (6)
4. Iron & Steel & Ores/Slag/Ash	2 381,4	8,4	335,6	249,0 (2)
5. Machinery & Appliances	1 311,0	4,6	222,5	135,9 (7)
6. Textile Products	1 216,1	4,3	307,4	220,8 (4)
7. (Semi-)Precious Stones & Jewellery	1 169,3	4,1	411,5	324,9 (1)
8. Clothing	755,8	2,7	217,0	130,4 (8)
9. Plastic Products	682,7	2,4	300,6	214,0 (5)
10. Hides, Skins & Leather	640,5	2,3	88,9	2,3 (0)
Total Exports	28 418,0	100,0	194,6	108,0

Source: Wesgro 2003a

More significant increases are evident in product categories with a smaller traditional share of the export market are revealed in the following table (Table zzz).

Table 7: Secondary Exports with significant increases 1996-2002

Product Category	Exports in Rmio		
	1996	2001	2002
1. Electrical & Telecommunications Machinery & Equipment	226,7	400,8	594,7
2. Ships & Boats	37,4	217,1	569,2
3. Furniture, Lamps & Soft Furnishings	86,5	293,6	472,3
4. (Other) Chemical Products	87,3	110,8	412,9
5. Wood (Products)	34,6	244,9	410,4
6. Vehicle Parts/Accessories	37,6	281,6	378,9
7. Tobacco (Products)	47,8	205,6	352,1
8. Meat	32,5	260,1	309,8
9. Cosmetics & Essential Oils	12,4	103,4	204,4
10. Organic Chemicals	55,1	153,2	183,9
11. Paper & Paperboard (incl. Articles)	58,6	140,2	174,7
12. Stones, Lime & Cement	52,5	216,5	173,7
13. Seeds, Fruit & Medicinal Plants	17,1	129,1	154,8
14. Dairy Products	11,8	28,8	130,4
15. Plants, Flowers, Bulbs	45,6	84,8	127,0
16. Animal Feed	4,9	31,1	119,9
Subtotal	848,4	2 901,6	4 769,1

Source: Wesgro 2003a

For some observers, this diversification and increased share of relatively ‘new’ exports symbolizes a sea-change in Western Cape exports. In addition to the above there are further categories (below the R100m mark) where exports showed dramatic increases over the six-year period. These include products such as photographic equipment; ceramics and glassware; toys and sports equipment; antiques and art; paints and dyes; footwear; artificial flowers; soaps and washing material; processed cereals; tea and spices; pharmaceutical products; and printed books and printware (Thomas 2002; WCPG 2003).

Two key niche areas which in terms of their export sales and their cluster characteristics would seem particularly useful for offset investment are the boat building and IT clusters. The IT industry in the Western Cape has grown rapidly since 1994. This sub-sector consists of about 1200 companies of which 83% are small and medium sized firms with a turnover of less than R50m in 2001. 68% of the companies had a turnover of less than R10m. There is a thickening network of IT firms facilitated in part by the formation of the Cape IT Initiative (CITI) in 1998 which is acting as inter alia as a cluster agent, and by small scale supportive efforts by Wesgro. CITI has set up the BandWidth Barn, an IT-incubator providing affordable facilities including substantial bandwidth facilities to 25-30 start-ups at a time (Aero 2004: 8)

The growth of this IT sub-sector is conditioned by the lifestyle and relatively high standard of living of Cape Town and the Western Cape more generally, diverse sets of

cultural capital networks, and booming multi-media industries. The presence of a large pool of IT-skilled people through a competitive high school, and FET and HE environment is a further important factor. A third factor is the presence of a number of large IT units within the pension funds located in Cape Town. These IT units have led to a number of small spin-off ventures (Aero 2004: 3-4) with a strong degree of entrepreneurial independence.

This sector employs over 27 000 people, with growth largely fuelled by domestic investments (2004: 2). Development and venture finance from state and private sector sources is relatively meager, with start-up IT entrepreneurs bearing the bulk of their costs. This sector would appear to be ripe for IP investment, and satisfies DTI criteria both with respect to the latter's emphasis on the desirability of investment into ITC industries, and constituting a developing and significant value chain. In addition, given the high proportion of imported IT hardware and software in South Africa, the significance of this sector in regard to modest import substitution, and expanded domestic production possibilities should not be under-rated⁶.

Boat building is another sector which appears to have considerable prospects. Centred in the Western Cape this industry comprises 'a dynamically growing set of diverse production chains' and is also 'an important employer and skills development institution'. Clustering and value chain development has been reinforced by the creation in 2000 of the South African Boatbuilders' Business Council (SABBC). Employment generation in the industry and associated sub-sectors has been significant. Growth has more than doubled since 1994, despite fluctuating markets locally and internationally, with exports in the region of 85% of total sales (Wesgro 2003b). The largest producers forecasting in December 2003 a 20-50% growth in value terms in the short term and most of the firms expected at least 10% growth in revenue. However, funding is an important issue particularly for smaller and new ventures and potential entrants to the industry. Presently government incentive schemes and support are not reaching all relevant agents, and banks are insufficiently informed about the industry to undertake appropriate risk assessments. While some progress has been made with an export incentive programme (EMIA) much of the funds are raised through indirect financial arrangements by individuals and firms⁷

In addition to the above sectors, there are other emerging manufacturing sectors such as jewelry, biotech products, electronics including security and surveillance systems (Aeroe 2004b: 8). In the services sector there is a growing export role in sectors such as tourism and leisure, transport services, professional services, engineering services, film and multi-media, BPO including call centres. While there is some degree of local and national state support for such emerging industries there is ample scope for leveraged offset investments. The rapidly expanding oil and gas exploration services niche, which includes the repair and construction projects in regard to oil/gas rig and a range of

⁶ Interview with Dr Anders Aero, Senior Manager, Trade Promotion, Wesgro, Cape Town, 15 June 2004.

⁷ Interview with Dr Anders Aero, Wesgro.

peripheral machinery is also seen as a significant growth sector⁸. A Sectoral Development Trajectory Map (Appendix B) charts these emerging sectors.

3. SELECTED NIP PROJECTS IN THE WESTERN CAPE

Early research in 2001-2002 during the early phases of the conceptualization and allocation of project in the Western Cape has revealed a not dissimilar perception among local private and public sector policy agents that the allocation of project within the provinces was conditioned in part by political imperatives. Westgro's experience tends to confirm the view that the selection of initiatives occurs more on a project-by-project basis with relevant consortia, than in a more integrated and systematic process. In such a process the deployment and potential effects are assessed and contractors informed by the kinds of offsets they can arrange, and the knowledge of local requirements.⁹.

The NIP projects in the Western Cape formally comprise the following:

- ? investment into a facility for the manufacture and export of solar panels,
- ? investment into Evertrade for the manufacture of medical bins and the treatment of medical waste
- ? expansion of a manufacturing facility for electrical components at Electrolux
- ? Supplying locally manufactured electrical switch gear products and associated services into the industrial utility markets
- ? The facilitation of the export of raw tobacco and the development of other value-added tobacco products suitable for export from South Africa
- ? A joint venture for the manufacture and export of gold jewelry
- ? A proposed stainless steel precision strip mill
- ? And the purchase of the Longridge winery and brand, and associated farm Nooitgedacht. (DTI 2003)

Current research has indicated that there has been little effective correction of these perceptions by the main obligors and the DTI and DOD/Armscor as national state agencies in the SDP process. In regard to the NIP process, the Cape Town Chamber of Commerce has not been consulted by either the DTI or relevant obligor. There has been some indirect contact with Ferrostaal regarding potential projects and investments in the emerging oil and gas exploration and repair industry. Wesgro has had some informal discussions but little in the way of a concrete involvement in the process. Overall the marketing in the Western Cape of the conceptualization, identification, and implementation of the projects by the DTI and the obligors has been disappointing, and for the most part top down. There has been little attempt to tap into local knowledge regarding sectors for investment and other offset projects, nor efforts to help create and/or reinforce infrastructural supports for value chains in the province.

⁸ Interviews with Mr Albert C Schuitmaker, Executive Director, Cape Town Regional Chamber of Commerce and Industry; and Mr Colin Boyes, Deputy Director, Cape Town Regional Chamber of Commerce and Industry, 18 June 2004.

⁹ Interview with Mr Wolfgang Thomas, Executive Director, Westgro, Cape Town, 16 November 2001.

While the SDP NIP projects in the Western Cape seem to have diversity and creativity, closer examination of selected ones suggests that the net impact of these ventures and investments is not as substantive as is claimed.

The investment by the Thales group into Evertrade Medical Waste Facility in Cape Town, appears to be a formal financial investment made via the head office in Johannesburg. The CEO of the Cape Town company was not aware of the investment¹⁰.

The supposed buy-out from Winecorp of the Longridge Winery and the Longridge brand, as well as the farm Nooitgedacht by the BAE Systems/SAAB group, as reported in the DTI 2003 Report released in June 2003 is also puzzling. This investment is *inter alia* said to have created 200 jobs, but according to a letter to the firm in March 2003 by SANIP the project was rejected on the grounds that

...your project is not sufficiently attractive from a NIP credit ratio perspective to justify a potential co-operation between SANIP and Winecorp SA (Pty) Ltd.. Given our current portfolio of projects, our risk profile employed and the time frame of your project, we feel that we have to develop and focus on the project in which we are currently involved or those in which we are about to engage.¹¹

There has been no follow-up communication to correct the mis-reporting in the DTI 2003 Report on the Industrial Participation initiatives¹²

Further research needs to be conducted into the Swedish Match and Electrolux divisions in Cape Town. Both projects were set up in 1999, and have come in for international and local press criticism for their lack of evident economic multipliers and productive economic activity¹³.

A more focused and promising project is Augusta's brokered joint venture with Filk Italy and local producer Oro Africa. This project indicates some of the dynamics and contradictions of the process. The company consists of Trigold and Filk South Africa – divisions that have overlapping interests. Fortunately, Filk entered into the joint venture in 1997, somewhat before the finalization of the IP arrangements with Augusta and the other obligors during 1997-1998. This joint venture has contributed to the improved fortunes of Oro Africa, and a 25% buy-in of Anglo Gold in 2000, helped raise sufficient capital for the company to move from Johannesburg to Cape Town.

The technology transfer appears to be modest at this stage, with state-of-the-art machinery remaining the preserve of the Italian parent. Some degree of training is provided for selected staff at the Italian plant, and is combined with training by Anglo Gold in Cape Town as part of on-the-job training.

¹⁰ Telephonic discussion with CEO of Evertrade, Cape Town, 14 June 2004.

¹¹ Letter from Mr Emile du Toit, Project Manager SANIP, to Mr Frans Bicard-Carton, Spier Holdings, 1 April 2004.

¹² Interview, Financial Director, Winecorp, Stellenbosch, 18 June 2004.

¹³ The RSA defence offset programme has received extensive investigative coverage in the UK press most notably the Guardian, and in South Africa in the Mail and Guardian, and Noseweek.

While growth of the firms has increased the staff complement, the job creation estimates of 115 appear to be on the optimistic side. The overlapping production of OraAfrica and Filk South Africa may well complicate the estimation of export credits and job creation figures (Wellman 2003). Through a technical anomaly in regard to gold beneficiation, the value added portion is not calculated separately, and the whole value of the product can be claimed as an export credit (ibid).

BAE Systems have found a similarly profitable investment in Virginia, Free State, with gold producer Harmony Gold. They are involved in two related projects. Firstly, a gold beneficiation project in conjunction with the IDC and Harmony (a gold mining firm) with a three-fold thrust: the creation of a manufacturing facility for the production of value-added gold products, the establishment of a gold technology industrialization fund, and sponsorship for students at a jewelry school. BAE/SAAB with the same two local partners have established SARM Gold Chain, which manufactures new gold rope chain, to produce high volume carat rope chain for export.¹⁴ While such efforts constitute modest but distinct contributions to the aim of developing beneficiation of minerals and other raw materials, critics of the offset package such as journalist Sam Sole have raised questions regarding the beneficial access (for US \$1m) of BAE Systems to Mintek technology, and the potential technology credits it could claim, and the long-term intellectual property implications of such a deal. The substantial export credits which could be claimed through relative modest investment by the obligor have also been problematized (See Haines 2004).

Both the Cape-Town and Virginia gold beneficiation projects are essentially firm-to-firm deals, and are not conceived of as specific spatial developmental interventions. Both initiatives could be seen as modest but distinct contributions to the local beneficiation of precious metals. Whether these can be seen as evidence of an emerging value chain is a moot point. The linkages between the Augusta and the BAE SAAB projects in the beneficiation of gold have yet to be established. Indeed, within the SDP project portfolio, contact between the main obligors (and their respective agents) appears at best rudimentary with the DTI mostly dealing with the obligors on an individual basis.

While such investments in the beneficiation of luxury raw materials such as gold and precious metals, are welcome, one would like to see more in the way of substantive sectoral support, and consideration of the issue of regional concentration and specialization in the establishment and extension of the requisite value chains. There are indications that the relevant industry associations and government and parastatal departments are considering the more coordinated local effort in regard to the beneficiation of gold and jewelry but no specific plans have been publicized at the time of writing.

It is also important to bear in mind, as Riaan Coetzee of the IDC points out, that the gold industry projects have a long developmental history in South Africa dating back to the 1980s. Their development has been on the cards for some time, and cynics might well ask

¹⁴ Interview with Mr Sipho Zikode, Chief Director, Industrial Participation Secretariate, DTI, Pretoria, 20 November 2003.

whether their export promotion has come about as a result of the SDP, or whether it fitted conveniently.¹⁵

While there is small investment in the jewelry beneficiation, the relevant cluster and value chain development and extension is not substantial at this stage, and links with related project of other obligors is more formal than real. Significant investment and project opportunities in key emerging niche sectors such as boat-building and IT with relatively impressive value chain and cluster features have been mostly overlooked to date. This is particularly surprising in regard to the latter sector as the DTI has seen the broad ITC sector as one of its priority areas. Such investments would also help address in a modest way the ‘brain drain’ problem facing Western Cape ITC companies, as a result of relatively low salaries being paid in comparison to the rest of the country (WCG 2003: ii).

The boat-building industry, which at its top end (occupied by several medium to large companies), overlaps with the small ship-building segment in Cape Town and Durban (see Haines 2004) offers both strategic investment possibilities and substantive export sales. There are also overlaps with the large boat/small shipbuilding infrastructure in Cape Town with the emerging offshore gas and oil exploration equipment and service industry. Sensible investment in these areas would enhance the relevant value chains, and help sustain more broadly the engineering sector in the region.

4. DIP OFFSETS AND WESTERN CAPE DEFENCE FIRMS: SELECT TRENDS AND ISSUES

The DIP component of the defence procurement deal is informed by essentially by strategic considerations of the DOD and Armscor, of maintaining defence capability and ensuring the longer-term existence of the private and public sectors of the South African defence industry.¹⁶ There has been solid progress in regard to the DIP programme, which is more advanced in its implementation and seemingly more focused than the related NIP programme.

Table 4: DIP Expenditure

Defence Industrial Participation DIP credits awarded to date: Strategic Defence Package

<i>Programme</i>	<i>Sales (local and export) R million</i>	<i>Technology transfer R million</i>	<i>Investments R million</i>	<i>Other R million</i>	<i>Total R million</i>
Corvettes	1,036	175	6	8	1,225

¹⁵ Interview by Gillian McEwan with Mr Riaan Coetzee, Research Director of the IDC, 27 July 2001.

¹⁶ Interview with Ms Brenzia Potgieter, Armscor, Pretoria, 7 June 2002.

Submarines	423	-	-	-	423
Light utility					
Helicopter	141	86	4	1	231
Hawk	588	193	1	88	871
Gripen	282	457	1	229	969
Total	2,470	911	12	326	3719
Conversion rates:					
	US \$	6,25			
	Euro	6,4			

Source: Armscor Annual Report 2002 - 2003

The defence offsets, especially the DIP components, have certainly provided a substantial lifeline to the South African defence industry, while at same time undercutting any remaining aspirations for South Africa to maintain its own defence industrial base. The impact has been to provide orders to domestic companies and opportunities for companies to develop niches in the international market through links with the foreign companies. Denel and private companies have been drawn into the international circuits of defence production both in terms of indirect DIP and direct DIP. There is an increasing participation of European defence groupings and investors in the SA industry, at prime contractor and sub-contractor levels. This participation is part of ongoing restructuring and expansion of international defence groups such as EADS and Thales. Local divisions can influence government-to-government dealings to the benefit of the parent company and local subsidiary (Dunne and Haines 2001; Dunne 2003).

In general, the current DIP scheme seems likely to confirm the current space economy and existing inequalities (Haines 2004 forthcoming). Much of the contracts and/or investment are being channelled to DENEL companies or sub-contractors, who are largely situated in Gauteng. There are smaller concentrations in Cape Town and Durban. In line with national trends in terms of the locus of industrial and economic production, almost 90% of the DIP business has been channelled to Gauteng.¹⁷

While the industry response overall to the DIP and IDIP components of the SDP is on balance favourable, the responses are more complex and mixed than research in 2002 suggested.

¹⁷ Telephonic interview with Ms Brentzia Potgieter, Armscor, Pretoria, 19 November 2003.

At one end of the spectrum there is the case of C2I2, which is involved in an extended court case with Thales and government, in regard to having their combat suite system for the corvettes sidelined for what seems to be an 'off the shelf' product from one of Thales sub-contractors. Also the sums and amounts of formally contracted work were apparently unilaterally reduced and payments delayed¹⁸. The efforts by C2I2 to attain redress through the courts appears have contributed to its marginalization in the defence industry, with no new contracts awarded to the firm since 2001.

Avitronics, Maritime, a Cape-based subsidiary of Grintek (one of the larger private sector defence firms in South Africa), are particularly enthusiastic about their contracts under DIP and IDIP. The company specializes in electronic warfare systems. The executive manager points out that they were proactive in chasing work, and did not wait for obligors and prime sub-contractors to get in touch with them as was apparently the case with certain defence companies. Their relationship with SAAB Tech – a joint venture arrangement set up by Avitronics helped provide access to certain overseas markets which were hitherto closed. And in areas where the SAAB-Tech has met with adverse reactions, Avitronics has been able to utilize its independent credentials to try to gain new markets¹⁹.

Tellumat, also a subsidiary of Grintek, with a particular expertise in transponders, have a more tepid response to DIP. The company had large expectations of large contracts which have mostly not materialized²⁰. While they have had steady orders in regard to the corvettes, submarines, and the LIFT, Hawk and LUH parts of the aircraft components of the SDP, the sums have been modest. Larger commencing contracts have been reduced dramatically. Also, contracts have been confined to Direct DIP work, and despite various visits by representatives of the obligors no Indirect DIP work has materialized. In addition, one of the offset contracts intended for Tellumat was swapped for another contract with another company. There is a sense that the 'tide has gone out' on DIP contracts. Given the initial expectations regarding DIP and IDIP work the company put a great deal of effort into the new potential business. Among other things, a new division was set up and two mechanical engineers recruited. Also, a promising independent international export drive begun in the mid-1990s was halted²¹.

RRS (Reutech Radar Systems) like Avitronics and Tellumat are linked in directly to sub-contracting DIP networks through their parent company. However, as their CEO points out most of their relatively modest amount of contractual work under DIP was non-core business. They anticipated more business. In their experience, the R&D and engineering staff of the obligors were reluctant to relinquish projects and technology, and tended to under-price these components in tendering and contracting processes. With South African

¹⁸ Of a R200million contract only R6.4 million of work materialized, and of this latter amount there is apparently a sum outstanding. Interview with Mr Richard Young, CEO, C2 I2, Struisbaai, Western Cape, 16 June 2004.

¹⁹ Interview with Mr Eddie Noble, Chief Executive Manager, Avitronics (Maritime), Cape Town, 17 June 2004.

²⁰ Interview with Mr Marc Anderson, General Manager, Tellumat, Cape Town, 15 June 2004.

²¹ Interview with Mr Brian Ferguson, Marketing and Sales Manager, Tellumat, Cape Town, 15 June 2004.

companies facing a range of add-on costs and general discounting of their bid offers, the South African firms had to be significantly lower on their pricing than their international counterparts²².

RRS question the lack of support accorded the defence industry by the DTI, with exception of some small-scale funding for R&D work and some export trade promotion costs (often not cost-effective for the administration side). Radar is a Category 3 defensive weapon with significant civilian and conversion possibilities. The CEO points out that the company is currently the second highest employer in the province of university degreed engineers, and the spin-off effects for the provincial economy and the manufacturing sector especially are not insubstantial.

Delkon, a small firm on the outskirts of Cape Town, specializing in refitting and upgrading the diesel engines and drive packs of armoured vehicles and tanks for the SANDF, have had contracts from other procurement programmes of Armscor, and not the SDP. These programmes are being wound down, but the company has managed to keep operational by running a parallel 'civilian' operation in turbo diesel engineering, and by retaining a core staff along with a network of sub-contractors, who are part of the mechanical engineering sub-sector of the provincial economy. The company has an export profile and useful in-house technology for non-military and military purposes.²³ Given that one of the projects in non-defence IP procurement exercises is the partial revival of the Atlantis diesel plant and subsidiary production, it is somewhat surprising that this firm has not been included in the relevant value matrix for the Western Cape, or approached by one of the obligors.

Among the general and strategic points and issues which emerged during the discussion were the following:

- ? There was some dissatisfaction with the administration of the DIP scheme by Armscor. One of the respondents referred to the bureaucratic approach to credit allocation and investment targeting.
- ? There was a general perception, whether implicit or explicitly stated, that insufficient concern was being shown by the DTI in providing state incentives to domestic defence industrial work.
- ? Several of the firms drew attention to the significant amounts of DIP work and credits which were unallocated
- ? There is some degree of swapping NIP and DIP credits and contracts. Indeed, in the words of one of the respondents, DIP/NIP credits were 'monopoly money'.
- ? There are indications that obligors at times prefer to set up a new 'sweetheart' subsidiary in South Africa for some of their DIP obligations rather than work through an existing firm.
- ? There are insufficient linkages between DIP and NIP initiatives in the province.

²² Interview with Mr James Verster, CEO, RRS, Stellenbosch, 17 June 2004.

²³ Interview with Mr Johan Delport, Delkon, Brackenfell, Western Cape, 18 June 2004.

- ? Neither the relevant national, provincial or local agencies concerned with industrial development and promotion has examined the Western Cape defence industry with a view to identify possibilities for conversion projects.

5. POLICY IMPLICATIONS AND CONCLUSIONS

This paper has considered the relation between the defence offsets and regional industrial development in the Western Cape province. The nature and spatial deployment of the NIP and DIP offsets is found to confirm rather than challenge existing spatial patterns and inequalities in the South African economy. The employment creation possibilities, offered by the offset projects seems limited, with a several of the projects not creating any additional employment. There is a tendency for obligors in the NIP scheme to opt for piggybacking and financial leveraging in several of the projects. The financial reporting via the DTI is not as accurate as it could be with the Winecorp project being listed as an active and employment creating project when it was in fact rejected by SANIP. a number of instances. There was little or no information at local level as to the nature and scope of the projects. Indeed, one of the main findings of the current research is the relative lack of contact between the obligors and their agents, the DTI and Armscor, on the one side, and organized business and local and provincial government on the other. This needs to be addressed both in terms of improved marketing of the offset programmes in various centres, and in the improved utilization of local knowledge in the process. In the Western Cape, available evidence tends to confirm the view that the selection of initiatives occurs more on a project-by-project basis with relevant consortia, than in a more integrated and systematic process.

While certain of the NIP projects conform to the sectoral priorities in DTI's push for the creation/expansion of value chains within and without the national space economy, the current crop of projects is disappointing in their size and ambition, and in the short term at least will have little tangible benefits for the Western Cape economy. The paper has demonstrated ample opportunities for investment in and trade with emerging networks and clusters in such areas as boat-building and shipbuilding. In such strategic interventions IP-related funding can play a cost-effective but vital role in sustaining start-up and promising but vulnerable enterprises. The relative lack of real input into emerging and existing value chains will need to be addressed more directly by the DTI, in liaison with Armscor. It represents one of the key institutional challenges in implementing the value-chain methodology.

The DIP scheme in the Western Cape seems more focused, but there is little attempt to look at linkages between the DIP and NIP projects and densify linkages, especially in regard to potential conversion possibilities, and the retention of indigenous technology where appropriate. The unused DIP and NIP obligations appear more extensive than is commonly assumed, which suggests that some of the obligors are considering defaulting on portions of their commitments, or exploring ways of negotiating new and more advantageous conditions.

The focus on offsets to utilize international inputs to diversify industry has diverted some attention away in part to more indigenous means of achieving this. Government have tended to take too negative a view on the possibilities of qualified import substitution (Bruton 1998), and of ensuring that the underpinnings of strategic industrial sectors and sub-sectors. This is not to advocate the retention of obsolete and vulnerable emerging niche industries, but rather to stress the importance of addressing the problems of unemployment and globalization,

The DIP and NIP schemes need to be planned and evaluated in a more coordinated fashion. This entails a more deliberate linking of top-down and bottom-up initiatives, and a concerted attempt to address the institutional capacity shortcomings and improve policy communication structures at national, provincial and local levels. More creative partnerships with non-state agencies should also be explored. In general the relevant policy makers should be more reflexive in their evaluation of and response to the implementation of NIP and DIP projects, and to take note of unanticipated outcomes and issues of transparency.

While the enthusiasm for a value matrix approach is a useful touchstone, it would be inadvisable to downplay the need for considered targeting and more balanced and sustainable inward development. Value chain development should proceed alongside parallel processes such as greater institutional finance and support for cluster initiatives (e.g. Nadvi and Schmitz 1999) and the promotion of social and cultural capital.

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Interview with Mr Brian Ferguson, Marketing and Sales Manager, Tellumat, Cape Town, 14 June 2004.

Interview with Mr Gerhard de Kock, Financial Director, Winecorp, Stellenbosch, 18 June 2004.

Appendix A

**SOUTH AFRICAN BOAT BUILDING BY CONTRIBUTION AND SALES
FOREIGN AND LOCAL**

