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Special Economic Zones: What Have We Learned?

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It has been more than 50 years since the establishment of the first modern special economic zones (SEZs). During this time, SEZs have been credited with underpinning the dramatic export-oriented growth of China and other East Asian countries. While they remain a controversial instrument, policy makers appear to be increasingly attracted to economic zones. Since the mid-1980s, the number of new zones has grown rapidly, with significant expansion in developing countries. But in this postcrisis environment, the context in which zones operate is changing; increasingly, the effectiveness with which they are designed, implemented, and managed will determine their success. This note outlines key lessons that have emerged from the experiences of zone programs in developing countries over recent decades.

Ask three people to describe an SEZ and three very different images may emerge. The first person may describe a fenced-in industrial estate in a developing country, populated by footloose multinational companies enjoying tax breaks, with laborers in garment factories working in less than optimal conditions. In contrast, the second person may recount the "miracle of Shenzhen," a fishing village transformed into a cosmopolitan city of 14 million, with per capita gross domestic product (GDP) growing 100-fold in the 30 years since it was designated as an SEZ. A third person may think about places like Dubai or Singapore, whose ports serve as the basis for a wide range of trade- and logistics-oriented activities.

In fact, all three of these descriptions are appropriate. These descriptions highlight the diverse ways in which the concept of "special" economic zones has been operationalized and underscore the challenge of attempting to say anything specific about such a heterogeneous instrument. SEZs are typically established with the aim of achieving one or more of the following four policy objectives (FIAS 2008):

(i) Attracting foreign direct investment (FDI);
(ii) Serving as "pressure valves" to alleviate large-scale unemployment;
(iii) Supporting a wider economic reform strategy; and
(iv) Acting as experimental laboratories for the application of new policies and approaches.

Since the 1970s, starting in East Asia and Latin America, zones have been designed to attract investment in labor-intensive manufacturing from multinational corporations. SEZs became a cornerstone of trade and investment policy in countries shifting away from import-substitution policies and aiming to integrate into global markets through export-led growth policies.

Economic zones have had a mixed record of success to date, and they have remained controversial, both on economic and social grounds. In any case, since the mid-1980s, the number of new zones has increased rapidly, with dramatic growth in developing countries. For example, in 1986, the International Labour Organization's (ILO) database of SEZs reported 176 zones in 47 countries; by 2006 this rose to 3,500 zones in 130 coun-

tries (Boyenge 2007). The rise of traditional export processing zones (EPZs), and their success in contributing to export-led growth in regions like East Asia, is partially attributable to an unprecedented era of trade and investment globalization that started in the 1970s and accelerated during the 1990s and 2000s, driven by the fragmentation of manufacturing into geographically dispersed global production networks.

Traditional EPZs were designed to attract investment by enabling countries to better exploit a key source of comparative advantage—low-cost labor—that was otherwise underutilized because of low levels of domestic investment and barriers (regulatory, infrastructure, and so forth) preventing FDI. These EPZs have operated under simple principles: allow investors to import and export free of duties and exchange controls; facilitate licensing and other regulatory processes; and (usually) reduce or eliminate these firms from obligations to pay corporate taxes, value-added taxes (VAT), or other local fees. To maintain control, EPZs have normally been fenced-in estates with strict customs controls at entry, and sales are typically restricted mainly to export markets.

The model has been extremely successful in many countries. For example, it allowed the Dominican Republic to create more than 100,000 manufacturing jobs and shift dramatically away from reliance on agriculture. Similar stories of industrialization and job creation can be seen in Mauritius, the Republic of Korea, Taiwan, Honduras, El Salvador, Madagascar, and more recently in Bangladesh and Vietnam. However, it is clear that this model is now increasingly running up against its limitations. Indeed, it is perhaps no longer fit-for-purpose, given the changing macroeconomic and regulatory environment in the global economy. This creates significant challenges for developing countries that are still in the early stages of their zone programs. Some of the basic principles at the heart of traditional EPZs are no longer (or perhaps never were) sustainable sources of competitiveness.

In the postcrisis environment, in which competition for FDI is likely to remain much more intense than it was in the past, SEZs are likely to continue to grow in importance. But it is not the existence of an SEZ regime, a compelling master plan, or even a fully built-out infrastructure that will make the difference in attracting investment, creating jobs, and generating spillovers to the local economy. Rather, it is the relevance of the SEZ programs in the specific context in which they are introduced, and the effectiveness with which they are designed, implemented, and managed on an ongoing basis that will determine success or failure.

The remainder of this note outlines key lessons that have emerged from the experiences of zone programs in developing countries and is organized around three main issues of critical interest to policy makers:

(i) Making economic zones successful in attracting firms that create jobs,
(ii) Ensuring zones are economically sustainable and deliver positive externalities, including facilitating upgrading and structural transformation, and catalyzing economic reforms, and
(iii) Ensuring the sustainability of economic zones from an institutional, social, and environmental perspective.

Attracting Investment and Creating Jobs: Old Models and New Challenges

Regardless of the model, it is clear that some countries have been more successful than others in using zones to attract FDI, encourage export-oriented production, and create jobs. Indeed, after reviewing the experiences of economic zones across many countries over the past three decades, some clear principles emerge regarding the policies and practices that are associated with "static" success.

The case of Bangladesh emphasizes the importance of positioning the zone program to leverage the country's comparative advantage. Indeed, while the program in Bangladesh initially aimed to attract high-technology investment, it only took off when it made a concerted effort to focus on the garment sector, which allowed it to leverage its comparative advantage in low-wage labor. It also highlights another observation about SEZs—their incubation period. Even the biggest SEZ success stories like China and Malaysia started slowly and took at least 5 to 10 years to build momentum. In Bangladesh, the program started in the early 1980s, but only began to attract investment on a large scale in the early 1990s. From a policy perspective, this means that governments need to be patient and to provide consistent support to zone programs over long time periods, a particular challenge in countries whose political cycles are shorter. Beyond the wage-based advantages of Bangladesh, the critical contribution of the zone program was not in fact incentives, which are relatively modest in global terms, but instead the provision of serviced industrial land infrastructure and relatively reliable supply of power. Indeed, recent research (Farole 2011) shows that on a global basis, infrastructure reliability has a significant impact on SEZ success, while incentives have had no measurable effect.

Another example is Honduras, which has also been highly successful in attracting investment in the garment sector, but has faced challenges in maintaining competitiveness. While the Honduran free zone program was built on trade preferences, labor cost arbitrage and a certain amount of "good timing," this was just the starting point. Key to success was the role of dynamic, local entrepreneurs in catalyzing foreign investment. While it is too simplistic to say that private sector development of zones is better than public sector development (bearing in mind the success of many East Asian countries and of Mauritius with public sector–led models), in many countries the private sector can be much more dynamic in implementing zones, and is in any case an important source

of expertise and risk management. In the case of Honduras, a stagnant government-run zone program was transformed when the law was changed to allow for private development of zones. Government then focused on providing not only the regulatory framework in which the private sector thrived, but also critical infrastructure and services, most notably a high quality port, road connections to the zones, and on-site customs services that provide investors with efficient import and export procedures.

In contrast, the generally unsuccessful experience of zones in Africa to date highlights some important lessons in zone development. First, it is important to separate political support from political objectives in zone projects. While strong commitment from government is needed, projects must be carefully designed based on clear strategic plans—the commercial case must be there. Moreover, that commercial case must be based on sustainable sources of competitiveness. Second, despite the concept of zones as enclaves, in practice their success is almost fully entwined with the competitiveness of the national economy and the national investment environment. Many zones in Africa are operating in an environment of poor national competitiveness. And regardless of what is done inside the zones, they face challenges in linking the zones and global markets, including critical infrastructure challenges regarding ports, roads, and electricity. Third, putting in place a clear and transparent legal and regulatory framework codifies the program strategy and establishes the "rules of the game" for all stakeholders involved in the process, but de facto implementation is of equal importance. In many SEZs, the authority responsible for developing, promoting, and regulating the program lacks resources and capacity as well as the institutional authority to carry out its mandate.

Economic zones also face changing regulatory environments. One example of this is the growth of regional trade agreements and of regional integration more broadly. If a zone-based firm is prohibited from selling to the domestic market, but suddenly the regional trade agreement makes its neighboring countries "domestic" from a customs perspective, this will have an enormous impact on investors' business models and on the attractiveness of zones. From an institutional perspective, it will be increasingly critical for zone programs to look beyond their borders and develop integrated or at least harmonized approaches to SEZ legal and regulatory frameworks, particularly on the treatment of exports, rules of origin, and fiscal incentives. Regional integration offers significant opportunities for economic zones in terms of expanding market access. Perhaps more interestingly, particularly for small countries, there may be potential for using zones to link up regional suppliers and leverage economies of scale in production. Linking regional SEZs to infrastructure investments to create "growth corridors" may be a powerful new route to competitiveness.

Moving from Static to Dynamic Gains: Can SEZs Deliver Structural Change?

For economic zones to be a success in the long term, they should contribute to structural transformation of the economy, including diversification, upgrading, and increased openness. This requires leveraging *dynamic economic benefits* from investment and employment. Countries that have been successful in deriving long-term economic benefits from their SEZ programs have established the conditions for ongoing exchange and the accompanying hard and soft technology transfer between the domestic economy and investors based on the zones. This includes investment by domestic firms into the zones, forward and backward links, business support, and the seamless movement of skilled labor and entrepreneurs between the zones and the domestic economy.

From a policy perspective, this suggests shifting from a traditional fenced-in EPZ model to an SEZ model that eliminates legal restrictions on forward and backward links and domestic participation. But it will also require implementation of much broader policies beyond the scope of any SEZ program, including: promoting skills development, training, and knowledge sharing; promoting industry clusters and targeting links with zone-based firms at the cluster level; supporting the integration of regional value chains; supporting public-private institutions, both industry specific and transversal; and ensuring labor markets are free to facilitate skilled labor moving across firms.

The case of the Dominican Republic, for example, highlights that while low labor costs, trade preferences, and fiscal incentives can each play a role in catalyzing a zone program, they are almost never sustainable. Indeed, they create pressure for further distortions and "race-to-the-bottom" policies, including extending and increasing incentives (rather than addressing more difficult factors of the investment environment) and granting exemptions on minimum wage and labor rights (rather than addressing productivity or labor market rigidities).

For the Dominican Republic, and many other lower-middle-income countries whose zone programs have focused on basic assembly, manufacturing and trade, the main growth opportunities are now in services sectors, especially information and communication technology (ICT), business services, and more knowledge- and research and development– (R&D) intensive sectors. This requires fostering innovation, which emphasizes the need for zones to avoid becoming enclaves, as well as the importance of skills development and training.

But facilitating structural transformation through SEZs is not a mechanical process that simply requires the right policies. The principal factors explaining why many countries have distorted economic structures and lack sufficient dynamism are political in nature. It is in this context that SEZs can perhaps be most effective in catalyzing processes of economic reform. In-

deed, this is the classic case of China's SEZs, which were used as a vehicle to test liberal economic reforms and introduce them to the wider economy in a gradual way. Thus, while the idea of integration between SEZs and the domestic economy is ultimately the key to structural transformation, where economic reforms are politically sensitive to implement, it is *precisely* the enclave nature of zones that can be their key to success.

Several important lessons can be drawn from the Mauritius case, which represents another example of how SEZs can catalyze structural change through economic and political reform. First, it highlights the importance of the political process and of having a specific political champion behind the zone program, a lesson that was also learned from experiences in China and Malaysia (especially Penang). Second, not only does the Mauritius case again emphasize the importance of domestic investment in the zone program, it shows that integration of the zone program must go beyond the physical and financial—it must also be integrated strategically. Indeed, one of the main differences between zone programs that have been successful and sustainable and those that have either failed to take off or have become stagnant enclaves is the degree to which they have been integrated into the broader economic policy framework of the country. In Mauritius, the EPZ program was a pillar of the country's development strategy. Unlocking the potential of zones requires clear strategic integration of the program, with government playing a leading, active role in facilitating their growth and development vis-à-vis the local economy.

Sustainability: Emerging Issues for SEZs

SEZ impacts on host societies go well beyond economic efficiency. Zone programs that fail to offer opportunities for quality employment and upward mobility for trained staff, derive their competitive advantage from exploiting low-wage workers, and neglect to ensure environmental sustainability are unlikely to be successful in achieving the possible dynamic benefits, and are likely to be forced into a "race to the bottom." By contrast, zone programs that recognize the value of skilled workers and seek to provide the social infrastructure and working environment in which such workers thrive will be in a position to facilitate upgrading.

One example in which sustainability is getting attention in economic zones is in the area of gender. Firms located in economic zones are known to have much more female-intensive employment than firms in the rest of the economy (Milberg and Amengual 2008). In this regard, zones have created an important avenue for young women to enter the formal economy. On the other hand, zones have long been criticized for failing to meet labor standards, particularly for not appropriately considering the specific needs of female workers. Moreover, as firms and zones upgrade—both into new, higher value-added sectors and to higher value-added within existing sectors—the share of females in the labor force tends to decline. Thus, countries that remain wed to traditional labor-intensive, low-skill EPZ activities will be forced in time to adjust, and it will be critical to consider the economic and social implications some of these adjustments may have.

Ensuring that the rights of workers are upheld and, beyond this, that efforts are made to provide the training and social infrastructure needed to enable individual workers to thrive, will ultimately be critical to ensuring the sustainability of zone programs so they can deliver the dynamic economic benefits discussed in this note. Thus, zone programs will need to strengthen their approach to social and environmental compliance issues, establish clear standards, and put in place effective monitoring and evaluation (M&E) programs. At the national policy level, economic zones should be seen as an opportunity to experiment with policy innovations.

These same principles—of policy experimentation, clear standards, and robust M&E—are also applicable in the environmental field. Some EPZs have been criticized in the past for promoting "dirty" industries and failing to meet environmental standards. SEZs, however, offer an ideal environment for environmental policy experimentation, not only because of their enclave nature, but also because they have built-in compliance mechanisms that do not typically exist outside the zones, such as issuing of licenses, the ability to monitor firms in a short time frame, and ultimately the ability to revoke a license, terminate a lease, or impound goods. This context could offer interesting opportunities, particularly for innovations in both social and environmental policy. Indeed, while the concept of developing low-carbon zones is still in its infancy, it is already being adopted in several SEZs around the world.

Conclusions

As SEZ programs continue to proliferate, particularly in developing countries, it is critical for policy makers to learn from past experiences and anticipate the implications of the emerging and potential issues discussed in this note. Future SEZ program success will require adopting a more flexible approach to use SEZ instruments effectively to leverage a country's comparative advantage and ensure flexibility so that the zone program can evolve over time. Fundamentally, this approach will require a shift in mindset away from the traditional reliance on fiscal incentives and wage restraint to instead focus on facilitating a more effective business environment that fosters firm-level competitiveness, local economic integration, innovation, and social and environmental sustainability. This approach will also require proactive, flexible, and innovative policy approaches to address the significant macroeconomic challenges that will impact SEZs in the near future, in addition to the many unanticipated challenges that will undoubtedly also shape the environment in the years to come.

About the Author

Thomas Farole is a Senior Economist in the International Trade Department at the World Bank. This note is based on chapter 1 of *Special Economic Zones: Progress, Emerging Challenges, and Future Directions* (http://issuu.com/World.Bank.Publications/docs/9780821387634).

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