

# SPECIAL ECONOMIC ZONES AS A TOOL FOR ECONOMIC DEVELOPMENT

Over-hyped white elephants or valuable economic enabler  
in today's increasingly globalised market place?





# Introduction

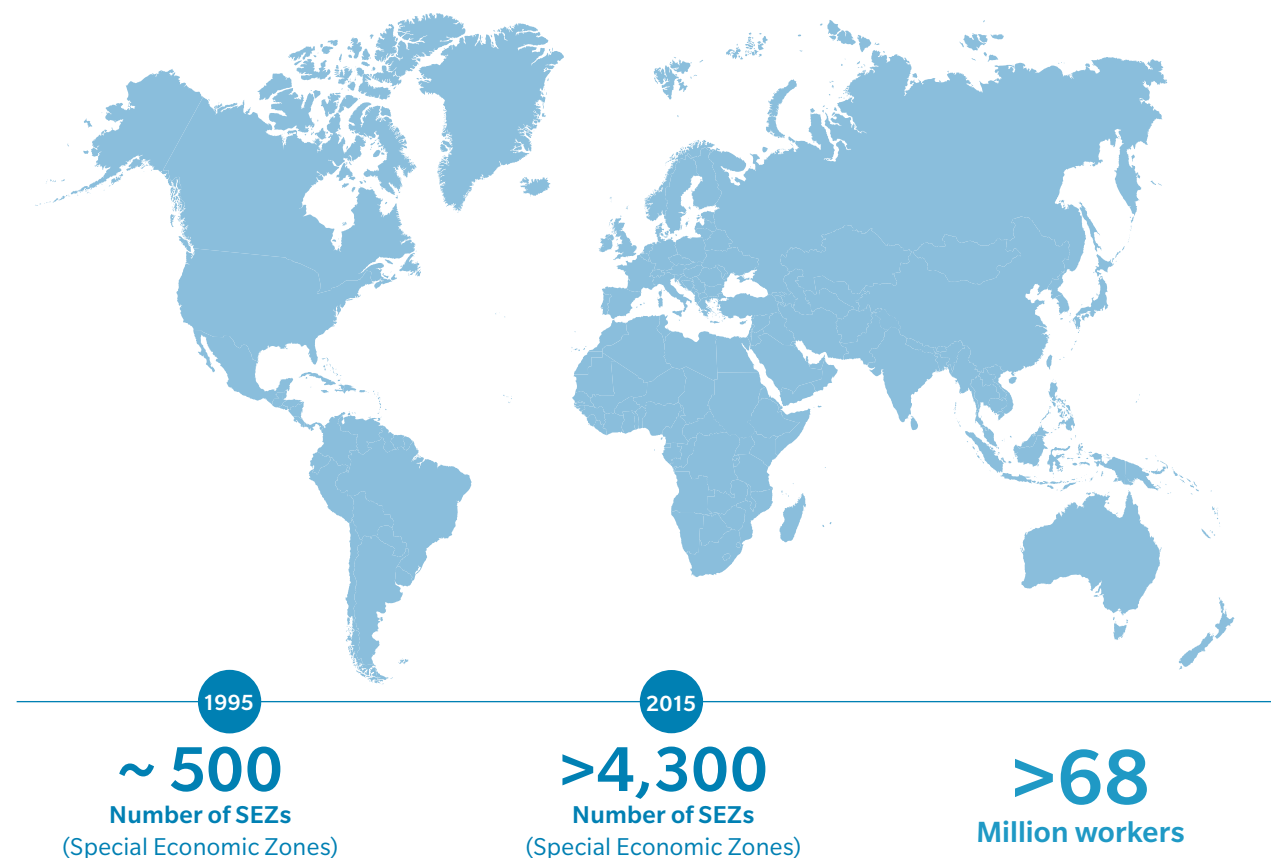
As a national development strategy, Special Economic Zones (SEZs) have become a global phenomenon. From an estimated 500 in 1995, SEZs have now grown to around 4,300 in over 130 countries and employ more than 68 million workers (ADB, 2015).

SEZs play varied roles in facilitating national, regional and local economic development, and global economic connections, with some remarkably successful in doing so. But many others (quite possibly the majority) fail to achieve a fraction of their intended objectives. The sheer number of SEZs, and their uneven success raises two critical questions:

Are SEZs still relevant and effective as a development strategy in this crowded and connected global marketplace?

What is required for a SEZ to succeed in such shifting national and global economic conditions?

**Exhibit 1: Global SEZ landscape**



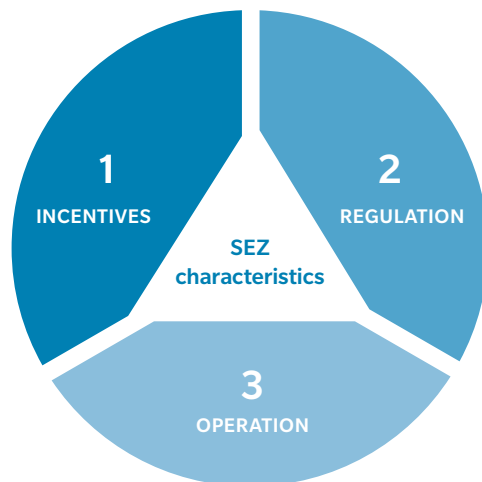
Source: Xiangming Chen, ADB 2015, Oliver Wyman

# What is a SEZ?

Special Economic Zones can be characterised as a geographically delineated area subject to differentiated regulation and administration from the host country in which it resides, for the purpose of attracting foreign direct investment in economic activity that could not otherwise be achieved.

Despite SEZs taking a multitude of forms, Exhibit 2 below summarises the most commonly seen characteristics:

**Exhibit 2: SEZ characteristics**



## 1 INCENTIVES

- Offer direct financial benefits to companies or individuals operating in the SEZ
- Attract companies and residents, rapidly growing economic activity in the SEZ
- Examples include:
  - Lowered duties, fees or taxes
  - Repatriation of profits
  - Rebates or subsidies
  - Attractive investment and financing options

## 2 REGULATION

- Offer improved regulation and administration for those in the SEZ
- Facilitate autonomy and create an attractive place to live and do business
- Examples include:
  - Dedicated regulatory authority
  - Regulatory framework based on international standards
  - Regulatory transparency and expediency
  - Government service one-stop-shops

## 3 OPERATION

- Provision of infrastructure and services for industrial, commercial and residential operations
- Attract talent by offering residents improved quality-of-life facilities
- Examples include:
  - High-quality communications infrastructure and specialised lab space
  - Onsite consultancy, marketing, networking and courier services
  - Green spaces, pedestrianised areas and integrated public transport

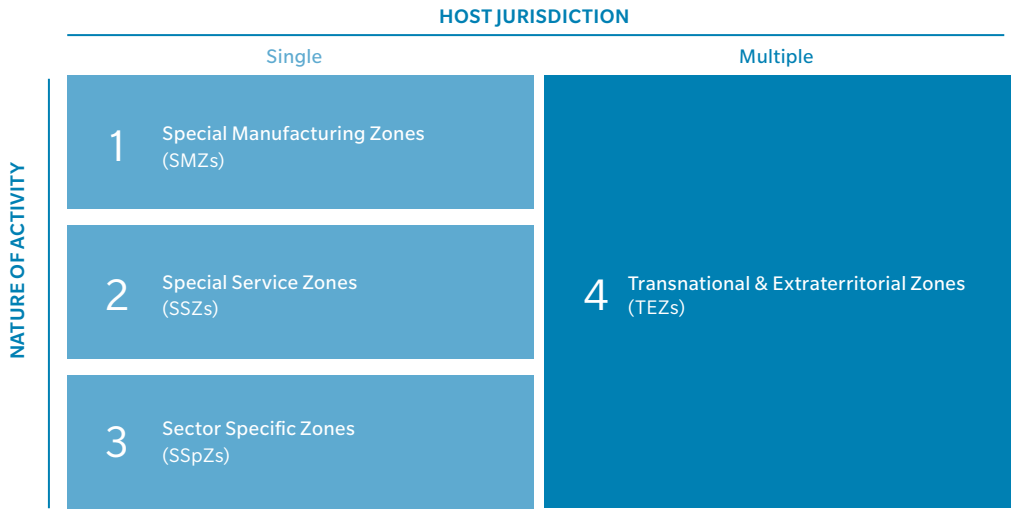
Source: Xiangming Chen, ADB 2015, Oliver Wyman

# Are SEZs still relevant and effective as a development strategy in this crowded and connected global marketplace?

## SEZs' CONTINUED BUT EVOLVING RELEVANCE

Across the decades, SEZs have evolved from a relatively simple proposition, to an increasingly diverse range of propositions, designed to achieve more specific development objectives. Despite the proliferation of SEZ variants, three (plus one) core archetypes have persisted, which largely correlate to the main stages of economic development that are typically seen across the globe.

Exhibit 3: SEZ archetypes



Source: Xiangming Chen, Oliver Wyman

**Special Manufacturing Zones** originally sought to seed manufacturing activity in a country through leveraging an abundance of low cost land and labour (and potential raw material availability) to overcome the absence of a domestic market through export. Historically, significant financial incentives were also required to attract investment. As global manufacturing has evolved, so too have SMZs – reflecting both the increasing competition and sophistication of manufacturing, and the realigned outcomes of economic development that accompanies it.

**Exhibit 4: Special Manufacturing Zones (SMZs)**



Source: Xiangming Chen

**Special Service Zones** typically started with a simple focus on trade and trade facilitation, with a number of successful examples. Whilst such trade zones will always have a place, the scope and sophistication of services has dramatically increased in absolute value, the scope of services covered, and share of the global economy underlining their relevance as an SEZ archetype.

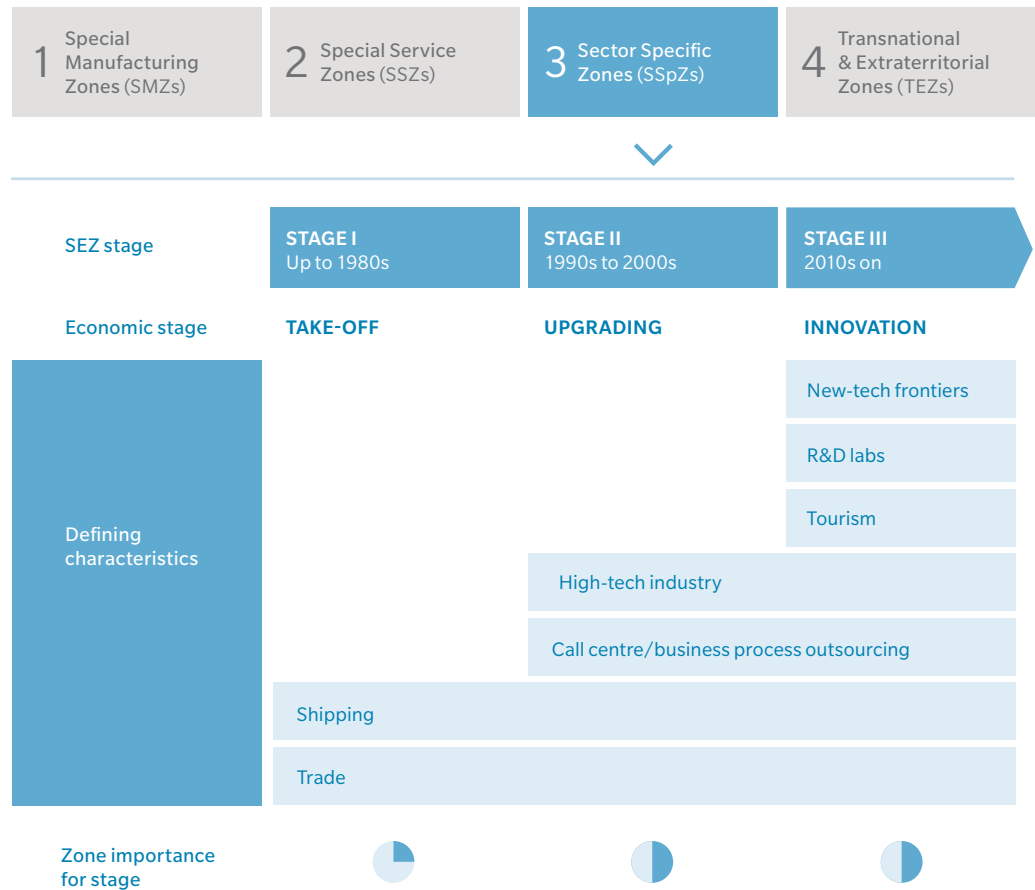
**Exhibit 5: Special Service Zones (SSZs)**



Source: Xiangming Chen

**Sector Specific Zones** could be seen as a variant of either SMZs or SSZs, where there is enhanced value deriving from increased focus on a specific sector such as e-commerce. The value typically derives from maximising the ‘cluster effects’ of that activity, for example, through knowledge or supply chain integration.

**Exhibit 6: Sector Specific Zones (SSpZs)**

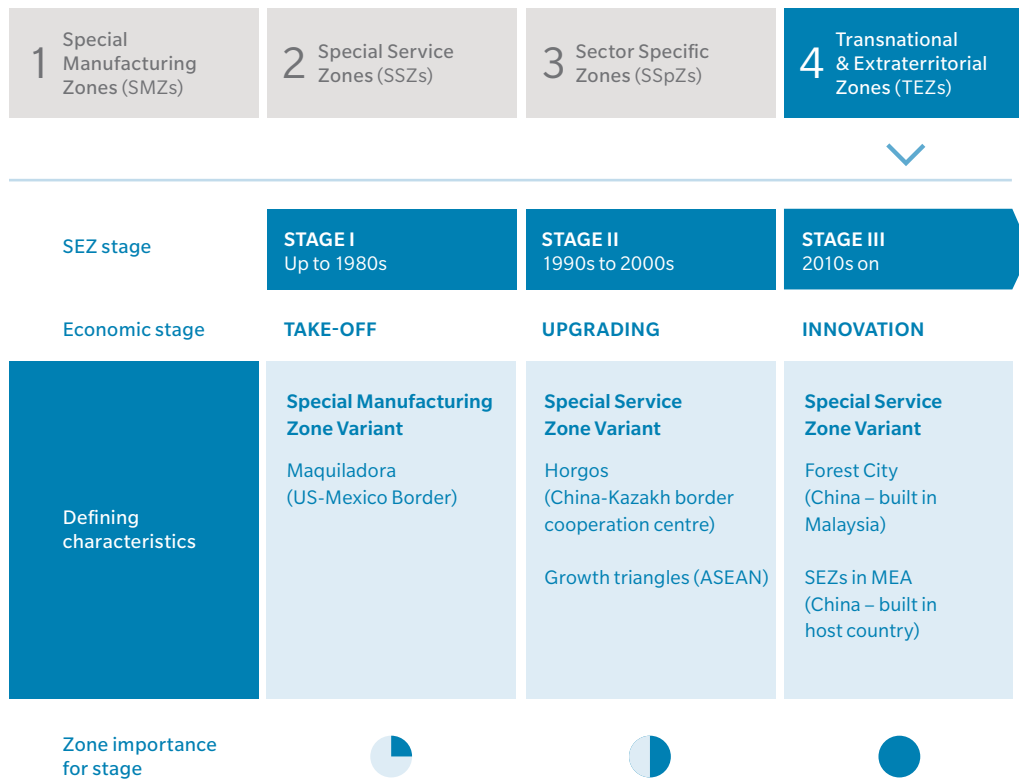


Source: Xiangming Chen



**Transnational or Extraterritorial Zones** can be based on any of the above three archetypes, with the crucial difference being their geographical or sovereign status. TEZs present the opportunity to overcome traditional border constraints between two sovereign nations, combining comparative advantages of both in a complimentary way, to the benefit of both nations.

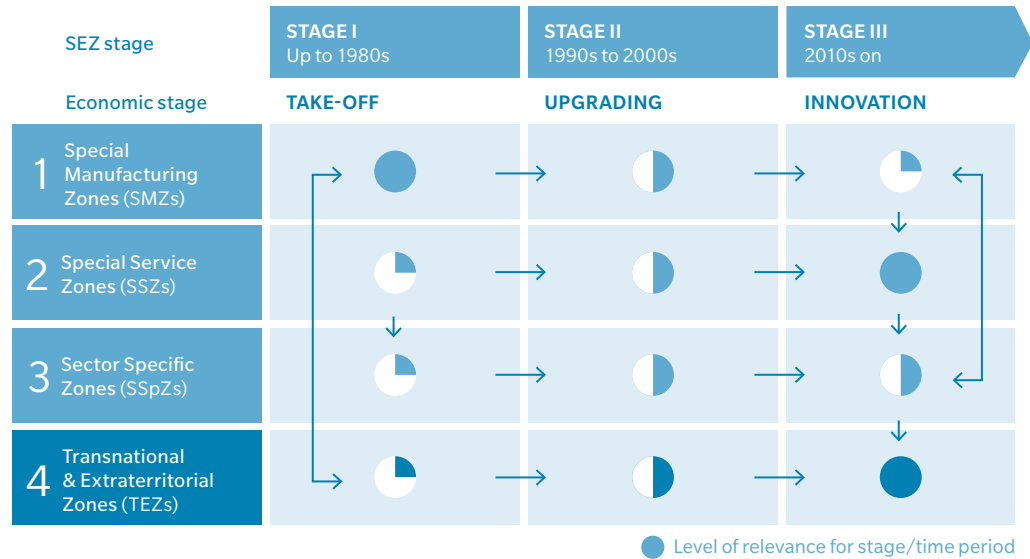
**Exhibit 7: Transnational or Extraterritorial Zones (TEZs)**



Source: Xiangming Chen

As alluded to above, Special Economic Zones are evolutionary in nature, with SEZ success typically prompting the need for modification of an SEZ to another stage, or archetype through connections or combinations, as illustrated below:

**Exhibit 8: Typical SEZ evolution paths**



Source: Xiangming Chen

Whilst important from an evolutionary perspective, two increasingly powerful trends require a re-framing of SEZs to reflect the ever more global and dynamic environment in which they exist:

- The shift of the global manufacturing landscape from (now) higher-cost domains (North America, Western Europe, East Asia) to cheaper locations elsewhere, such as Africa – coupled with increasingly global supply-chain dynamics and more fragmented distribution of advanced and innovative manufacturing; and
- The rise and fall of cities and regions achieving highly variable levels of success based on new national policies, locally niched competitive strengths, and global connectivity.

These trends, coupled with a substantial volume of competing SEZs across the globe have created a more diverse and fragmented field of ‘winners’ and ‘losers’ across the SEZ archetypes and their offshoots.

Much like any form of evolution, attempting to leap-frog evolutionary stages can result in dubious outcomes. For GCC countries, with a relatively limited foundation of successful stage I & II SEZs, there is a natural temptation to aspire to the most innovative stage III Zone types, without the underlying building blocks in place. The appeal is clear; knowledge based economic development with high economic value add. What is less clear is how they could succeed when global competition for dominance in such sectors is fierce. Selecting which sectors to bet on and designing the right value proposition as a vehicle for success is more important than ever.

# What is required for a SEZ to succeed in such shifting national and global economic conditions?

## WHAT CONSTITUTES A COMPARATIVE ADVANTAGE TODAY?

In a global arena crowded with both nationally/regionally promoted and private sector-led SEZs competing for every dollar of new business, how can a new SEZ possibly succeed?

Comparative advantages typically fall into three main groups:

### Abundance of cheap factors of production

- The value of such a proposition is largely limited to SMZs, in host countries at their earliest stage of development. Ironically, the greater the success of the zone, the faster such comparative advantages dissolve as the host country enjoys economic growth, resulting in increasing factor costs. As has been witnessed in East Asia, in a global supply chain environment, many cases of low cost, low skilled manufacturing like shoes has already moved from China (as it progresses its industrial upgrading journey) to South East Asian countries such as Cambodia.

### Incentives

- Evidence shows that the historical 'blunt' tool of straight forward fiscal incentives rarely achieves any sustainable value. They may have a place in attracting the pioneer investors during stage I type of SEZ formation, but otherwise risk simply attracting investors that leave the day after the incentives expire, or artificially sustaining unnecessary subsidies and uneconomical activities at the cost of the host economy.
- Some of the most successful incentives today focus increasingly on encouraging target investors to consume local content and employ local human capital, with the aim of deriving an economic 'return-on-investment' in the form of increased national economic activity and knowledge transfer/ labour force upskilling.

### Institutional factors

- Providing an efficient and robust institutional environment remains one of the most important success factors in any SEZ. The highest quality physical infrastructure, access to labour and cheap input factors will simply not be enough for many investors considering a new location due to their 'risk-adjusted' return calculations. In the 'global arms race', to be at the peak of 'Ease of Doing Business', many host nations simply do not have the requisite institutional apparatus to support this (the correlation between a base economy's ease of doing business ranking and its sustainable economic growth performance is no coincidence).
- SEZs represent a valuable 'low-risk' environment to provide an institutional proposition that could not otherwise be offered by the base economy for a host of reasons; whether bureaucratic inertia, political or social constraints. In some cases, the success of SEZ regulation then provides the host nation the impetus and confidence to enhance their national regulation and extend other institutional reforms, resulting in even greater economic benefit.

Reflecting on the functional and temporal evolution of SEZs highlights just how difficult it can be to create a sustainable comparative advantage.

## Special Manufacturing Zones (SMZs)

Entering the established and competitive realm of SMZs in today's mature globalised production model faces many barriers to entry, including:

- The relevance of cheap labour and basic factors of production remain predominant in many areas of manufacturing, without which a country has limited chance of (economic) success, however there is an ever-reducing number of such countries; and
- Even with comparative factors of production advantages, the ability to 'reconfigure' global supply chains requires a very compelling proposition; usually incentives that almost certainly could or might deliver negative economic return on investment but would still be dictated by competition.

Despite that, there remain specific pockets of viable opportunity under the right circumstances, including geographies where there is not yet a sufficiently broad and dense manufacturing base (for example the Middle East).

Low-cost factors have become less of a differentiating factor (typically in stage II or III of development) and the emphasis is more on access to talent, valuable domestic or regional market for consumption, and industry-spread effect opportunity;

- Intelligent design of mutually beneficial incentives (both financial and non-financial) can create a differentiated proposition; and
- The institutional environment for a specific industry or activity could become a specific differentiator (highly regulated/complex or frontier sector activity), like the institutional experimentation in China's Shenzhen Special Economic Zone in the 1980s.

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Such factors as nationalization objectives and highly educated national labour force pose significant challenges to success in this domain for GCC countries, greatly reducing chances of success. Where they have gained a level of success they remain heavily reliant on the lower cost expat labour force, ultimately reducing the net accretive economic impact of the zone

## Special Service Zones (SSZs)

Whilst many of the considerations for SMZs are relevant for all zone archetypes, there are also some important differences with regard to incentives, location and other requirements/enablers. Where late entry may limit a new SMZ to a small number of manufacturing industries, this is much less the case with respect to SSZs, with more flexible fiscal incentives and location choices.

A pertinent lesson may come from the uneven experience of Kazakhstan with its SEZs as an oil-rich and dominant economy in transition to more diverse sectors and activities. Of its 10 SEZs, Seaport Aktau and Astana account for over 83% of total goods and services produced. While Seaport Aktau is a SSZ, Astana is the Kazakhstan capital and can be compared with the PRC's city-like SEZs (see ADB, 2015 for more about the SEZs in Kazakhstan).

Trade and logistics also dominate the design and functionality of the more recently established China-Kazakhstan Horgos International Border Cooperation Center. Trade and logistics are two of the most important services supporting manufacturing in countries that feature energy industries and main ports. Consequently, emphasis is placed more on simplified customs clearance, efficient warehousing and expedient transport connections than generous upfront fiscal incentives.

With simple and fast electronic customs clearing, the China-Kazakhstan border trade zone functions efficiently to see through large numbers of Chinese and Kazakh freight trucks on a daily basis.

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Jebel Ali Freezone (JAFZA) is one such example that has increasingly sought to expand its' role from pure trade and shipping to a complete logistics and supply-chain proposition, capturing an increasing share of the value-chain of trade and logistics in the process

## Sector Specific Zones (SSpZs)

Both SMZs and SSZs can foster and benefit from the careful design and planning of true SSpZs. This archetype also reflects the most recent evolution of SEZs in general. It should and can target the kind of activities with a dual connection to both manufacturing and services. They typically include the specialised activities that differentiate or spin off from either manufacturing or service into high-value-added niches. While innovative R&D labs exemplify their connections with manufacturing, digital media has also become a distinctive segment of professional services as part of the rapidly growing digital economy.

On the other hand, activities best suited for SSpZs can forge the most innovative and mutually beneficial ties between manufacturing and services, or between any pair of an SMZ and an SSZ (Exhibit 8). The best example may be a small zone of ICT start-ups (“a bay of innovative makers”) located near a cluster of large home-grown high-tech corporate headquarters including Tencent and higher education institutions, such as Shenzhen University in Shenzhen’s tech-heavy district of Nanshan.

Having interviewed several tech entrepreneurs in this small but dense SEZ, Xiangming Chen found it to be conducive to creating indigenous innovation. In this micro environment, fiscal incentives through tax exemption and reduction are less important, although start-ups are entitled to subsidised rents. The most powerful enabler, in our view, is the combination of being right there with other innovators and a set of amenities, such as cosy restaurants and coffee shops serving as convenient spaces for brainstorming.

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From an SEZ evolutionary perspective, SSpZs are predominantly a vehicle to ‘upskill’ an industry, with its associated benefits. The presence of the relevant ‘base’ industry in critical mass is naturally a prerequisite for success. For many GCC countries, it is highly appealing to target the more knowledge-intensive activities characterized by SSpZs, however seeking to develop a SSpZ without the material presence of the base industry will greatly reduce its’ viability

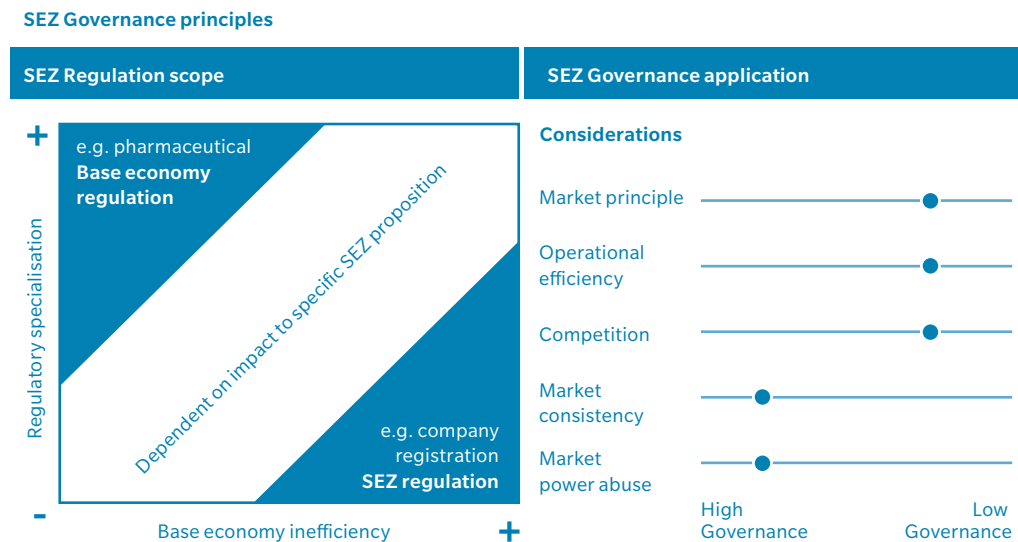
## SEZ Governance

A crucial aspect that will be closely scrutinised by any potential investor in an SEZ will be that of governance. Often, one of the primary catalysts for the creation of an SEZ is the institutional shortcomings in the host base economy, hence the governance of that zone must offer transparency, efficiency, consistency, and security to succeed.

Furthermore, governing SEZs of various types and locations within a given jurisdiction poses further challenges, including an attempt to balance naturally conflicting factors such as autonomy and oversight to create a value accretive marketplace.

One of the most cited examples of a successful governance model is the Dubai International Financial Centre (DIFC). A material ingredient to its' success can be attributed to its' governance model (most famously the independent judicial system based on English law) to provide a compelling business environment for such economic activity

### Exhibit 9: SEZ Key governance considerations



Source: Xiangming Chen, Oliver Wyman

Defining SEZ regulation scope and governance application must be sensitive to the context of the SEZ proposition, and the host economy in which it resides to achieve success. With the increasing importance of such institutional factors in SEZ propositions, a compelling governance proposition represents a valuable comparative advantage that is more important than the traditional low labour cost or a financial incentive for the early SEZs.

# Conclusion

SEZs remain a powerful development strategy in today's crowded global marketplace but in such a global and interconnected marketplace, their success will depend on a number of crucial considerations:

## Where to play

Having a clear understanding of the host economy's position in the global context, and where it could achieve comparative advantage: attempting to jump on a ship that has sailed, or being overly ambitious with the targeted goal and stage of development where the foundations do not exist, will have an almost certain outcome – failure.

## How to play

An SEZ value proposition is only as strong as its' weakest link. In such a competitive global market, many legacy elements have become mere hygiene factors – being necessary, but not sufficient to attract investment. Tailoring the proposition to target industries/sectors based on insight from those potential investors ensures maximum relevance of the offer.

Overly generous financial incentives rarely succeed – ensure that incentives generate an economic return on investment rather than artificially sustain uneconomical business activity.

Today's increasingly global political economy and its resultant uncertainty means that global investors are seeking additional assurance to commit – emphasising the increasing focus and value from institutional factors in SEZ propositions, while adjusting and recombining location and financial incentives.

## How to win: Design for change

The very purpose and nature of SEZs means that the definition of success implies redundancy of that zone's original proposition. Planning for sustainable success requires identifying the target evolutionary path of an SEZ, designing for that at inception, with constant adaptation to internal and external economic dynamics.

In a world where the only certainty is change, and the global arms race to attract international investment, any SEZ strategy must be designed with sufficient in-built agility to avoid becoming static or redundant in a very short space of time – responding to competition to remain relevant without disproportionate delay or cost. This is crucial for SEZs to remain as a powerful and viable tool for economic development.



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