PEGNet Policy Brief

KEY POINTS

- Special Economic Zones (SEZs) are an increasingly popular policy instrument aimed at attracting investment and inducing structural change.
- Today, there are over 5,000 SEZs worldwide but their economic performance varies widely.
- SEZs are particularly widespread in Asia, where they are regarded as a key engine of the export-led growth in recent decades.
- In Sub-Saharan Africa, SEZs have been less successful so far, especially due to inadequate planning and implementation of zone programs.
- Carefully designed and managed, SEZs have the potential to alleviate shortcomings in the national business climate and to contribute to private sector development.

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Special Economic Zones – An effective instrument for growth in Africa?[1]

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In recent decades, special economic zones (SEZs) have become a popular economic policy instrument aimed at creating attractive investment conditions and compensating for weaknesses in the national business environment, especially in emerging and developing countries. SEZs, also known as free zones, are geographically defined areas designated by the government in which companies are subject to laws and regulations that differ from those in the rest of the country and that are designed to be more favorable to business. Investors are, for example, granted tax breaks, duty exemptions and other financial incentives. In addition, they often benefit from simplified administrative procedures as well as high-quality infrastructure and services. SEZs usually serve to attract and facilitate foreign direct investment in order to increase and diversify exports and create job opportunities. Ideally, SEZs also help integrate local firms into global value chains, promoting technology and knowledge transfers from foreign investments that benefit the domestic economy in the long run. SEZs can further be a tool to pilot certain policy reforms that later on are extended to the rest of the country. This policy brief addresses the question of whether SEZs can live up to the expectations, with a particular focus on Africa.

Special economic zones: Types, Trends and Performance

The number of free zones worldwide has increased considerably over the past decades and they contribute substantially to global trade. According to recent estimations, there are currently more than 5,000 SEZs in over 140 countries around the globe (UNCTAD 2019), up from less than 200 in the 1980s (Figure 1). SEZs are particularly widespread in Asia, where they are regarded as a key engine of the export-oriented growth in recent decades. However, there are also SEZs in industrialized countries: the United States, for example, is host to more than 190 so called foreign trade zones (NAFTZ 2018). According to the OECD (2018), SEZs are responsible for exports worth at least 3,500 billion US dollars annually – equivalent to around 20 percent of global trade in goods. In developing countries, the trade share of SEZs is probably even higher at around 40 percent (FIAS 2008). Around 100 million people are estimated to work in SEZs (UNCTAD 2019), most of them in China.

There is a wide range of different types of SEZs and an even wider range of terminology used to describe them. Some SEZs or free zones specialize in manufacturing for export markets (Export Processing Zones) or warehousing, storage and logistics services for trade (Free Trade Zones). In some countries, including Mexico and India, SEZ-type incentives can be granted to individual firms independent of their location (Single Factory Free Zones). In recent years and especially in developing countries, there has been a growing tendency towards larger, multi-sectoral zones designed to attract investors in a wide range of manufacturing and services industries. In addition to offices and production plants, these general-purpose zones can accommodate facilities including residential areas, research centers, and start-up-hubs, as well as education and health care facilities. Moreover, Eco-Industrial or Green Zones have gained prominence. These SEZs focus on more sustainable industrial development, for example by supporting zone-based firms in improving their environmental performance (see, for example, Kechichian and Jeong 2016; Görlich 2017).

The economic success of SEZs varies widely. While some succeed in creating overall positive economic effects, others have a more mixed or even negative record, for example because public expenditure on the zone infrastructure exceeded the benefits. Somewhat surprisingly, studies on the performance and the economic effects of free zones are comparatively rare in light of their veritable boom in the emerging and developing world – not least because of the lack of data. Hachmeier and Mösle (2019) evaluate the existing literature. Overall, many SEZs generate foreign direct investment, exports and employment opportunities by creating a better-

1 This PEGNet Policy Brief is based on Hachmeier and Mösle (2019), a German study on special economic zones and industrial parks with a focus on Africa. It was funded by Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH.

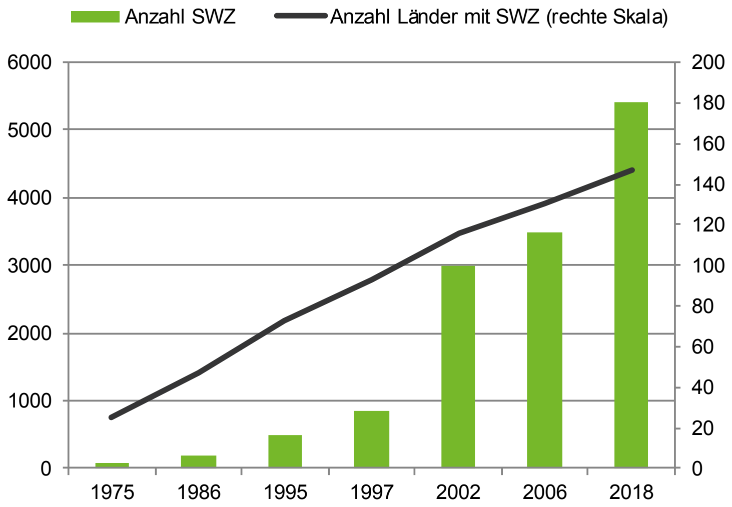

Figure 1: Development of SEZs worldwide based on estimates by the International Labor Organization
Source: ILO database on SEZs, last updated by Boyenge (2007); estimation provided by UNCTAD (2019) for the year 2018.

than-national business climate including better-quality infrastructure and streamlined administrative services and procedures. In terms of dynamic effects, however, SEZs seem to be less successful. Only a few free zones have successfully established backward linkages along the supply chain with the local economy. Especially traditional Export Processing Zones are often isolated enclaves. Technology and knowledge transfers and associated economy-wide productivity gains have thus been limited in most parts of the world. Some countries in Asia, where SEZs played a catalyst role for industrial upgrading, are an exception. Examples include China, Taiwan and South Korea where SEZs are regarded as important contributors to the structural transformation of the economies (ADB 2015).

Beyond purely economic considerations, free zones in developing and emerging countries are subject to criticism regarding labor rights, working conditions and environmental impacts. However, broad scale evidence that performance across these dimensions is systematically different inside and outside of SEZs is rare. In the majority of countries, national labor laws also apply within free zones (ILO 2017) and shortcomings such as lacking compliance with existing labor or environmental legislation, low levels of security standards or precarious work are generally not specific to SEZs. Rather, these shortcomings are widespread in many developing countries and particularly in some industries prevalent in SEZs, often due to a lack of government control and enforcement. Despite the criticism, free zones have started to increasingly compete on the basis of social and environmental standards in recent years (UNCTAD 2019). For example, Shenzen SEZ was the first place in China to introduce a minimum wage, pension insurance and other labor market reforms to protect workers (Khandelwal and Teachout 2016). Other SEZs, for example in South Africa, Turkey and Argentina, promote environmental standards and provide infrastructure and technical support to ensure their compliance (UNCTAD 2015). Good social and environmental practices could thus become a competitive advantage for SEZs and potentially induce positive change at a broader scale.

Special Economic Zones in Africa

Many countries in Africa have tried to replicate the success of Asian SEZs for economic development. In North Africa and the Middle East, SEZs played an important role in promoting diversification, for example in Egypt, Morocco and the United Arab Emirates (UNCTAD 2018). The first free zones in Sub-Saharan Africa – traditional export processing zones – were opened in the 1970s in Liberia, Mauritius and Senegal. However, it was only in the 1990s that SEZs began spreading widely throughout the continent. Today, the majority of countries in Sub-Saharan Africa already have or plan to implement SEZ programs; UNCTAD (2019) reports more than 200 zones in the region, and this trend continues to rise. Recent initiatives for SEZ programs are taken, for example, in Swaziland and Benin (Hachmeier and Mösle 2019).

Despite the increase in the number of free zones, the success of countries in Sub-Saharan Africa to replicate the SEZ-driven growth of East Asia has so far been limited. An exception is Mauritius where the Export Processing Zone Program attracted foreign investors and supported export growth, the diversification of the economy and structural reforms (Farole 2011; Farole and Moberg 2017). The initially successful performance of other SEZ was less sustainable as illustrated by the export-oriented textile sector in Madagascar. Due to political crisis, the country lost its preferential access to the US market under the African Growth and Opportunity Act in 2009, leading to a decrease in employment and the number of firms in SEZs by roughly 50 percent (Morris and Staritz 2014). Other zones, for example in Nigeria and Tanzania, failed to attract investment and promote exports and employment in the first place (Farole 2011).

Global and regional factors have contributed to the limited success of African SEZs. African countries largely initiated their SEZ programs later than Asian and Latin American states that were able to benefit from an unprecedented era of globalization including the establishment of global value chains. Competition has therefore been fiercer and more established for African SEZs, especially in light of comparatively high labor costs and low productivity in many countries in Sub-Saharan Africa (Gelb et al. 2017; Steenbergen and Javorcik 2017). Low competitiveness and absorptive capacity at the national level could also be the reason why even SEZs that successfully attracted FDI failed to establish linkages with the local economy and contribute to economic development at a broader scale. In addition, a lack of regional economic integration and the prevalence of trade barriers prevented African free zones from taking advantage of regional value chain networks (AfDB 2015).

Nevertheless, inadequate planning and implementation is regarded as the main reason for the failure of many SEZs in Africa. Deficient infrastructure, suboptimal location with poor access to markets, high regulatory uncertainty, political instability, a top-down focus on non-competitive industries, insufficient implementation capacity and coordination problems between actors involved in the development and management of the zones are among the reasons for limited success. Experiences from several countries exemplify these failures: In Tanzania, two different government agencies launched competing SEZ programs within four years in the early 2000s causing regulatory uncertainty for investors and impairing limited financial resources. A similar fight for competencies occurred among two competing free zone authorities in Nigeria (Farole and Moberg 2017). In South Africa, the lack of a clear political strategy lead to an uncompetitive design of its Industrial Development Zones: while regulatory reforms and incentives were needed, the government narrowly focused on infrastructure investment - even after ten years no SEZ had a “One-Stop-Shop” where investors could take care of numerous administrative procedures efficiently in one place (CDE 2012). Other countries, like Lesotho, aimed at expanding their SEZs program throughout the country. However, their development zones in remote areas proved unattractive for investors and, at the same time, caused the government to lack financial resources for the expansion of successful industrial areas around the capital (Farole and Moberg 2017). Overall, many SEZs in Africa failed to create an attractive business climate for investors. Even free zones successfully improving infrastructure and regulatory quality compared to the rest of the country often continued to lag behind their counterparts in Asia or Latin America (Farole 2011). Farole and Moberg (2017) emphasize that the development and implementation of SEZs is highly dependent on a country’s political and economic framework, explaining the limited success of free zones in Africa despite numerous “lessons learned” from SEZ programs around the globe. In the presence of weak institutions and misaligned incentives, rent seeking and mismanagement are prone to harm the process.

However, more recently there have also been positive signs for the development of special economic zones in Africa. The shift from traditional enclave-type export processing zones towards larger multi-sectoral zones is also visible in the region and has the potential to realize increasingly positive effects through local linkages and spillovers. It also reduces the risks from focusing on a specific sector that might prove uncompetitive. For example, the Kigali Special Economic Zone that opened in 2013 in Rwanda is host to a variety of domestic and foreign firms operating in different sectors. By 2016, it already employed around 2 percent of the country’s labor force and managed to increase and diversify its exports substantially. The zone’s regulatory and incentive system also contributes to better firm performance (Steenbergen and Javorcik 2017). Interestingly, the firms in Kigali Special Economic Zone are not eligible for any tax incentives – the main benefits stem from better infrastructure, trade facilitation and streamlined regulatory procedures. Moreover, international cooperation regarding special economic zones has intensified over the past decade. Organizations such as the World Free Zones Organization and the Africa Free Zones Organization encourage the international exchange of knowledge and experience which can positively impact on SEZs in Africa by providing valuable “best practices” for successful zone development and management.

Policy Recommendations

SEZs are complex instruments of industrial policy that have the potential to attract investment, create employment and contribute to broader economic development. However, their success critically depends on careful planning and implementation. Following Hachmeier and Mösle (2019), a series of policy recommendations for the development and implementation of SEZs can be identified:

- Planning a SEZ program is usually a long process that requires the involvement and coordination of a variety of stakeholders including ministries and other government agencies at the national and subnational level, the private sector and civil society. At the same time, SEZs are often prestige projects of policy makers that are associated with high expectations and high public investment. The responsibility should therefore lie with a central and high-level government authority. Sufficient administrative capacities and qualified staff are required throughout the development and implementation process. Additionally, the regulatory authority of a SEZ should be clearly separated from the developer and operator of the zone to avoid conflicts of interest. The implementation of SEZ programs as Public-Private-Partnerships – where the private developer and operator of the SEZ is responsible for financing the infrastructure within the zone – has proven successful in many cases.
- SEZ programs should be integrated into the national development strategy. They cannot replace necessary reforms to improve the country-wide investment and business climate, especially since development effects of SEZs at a broader scale depend on their integration into the local economy. Therefore, structural reforms that increase the competitiveness of local firms and foster linkages between SEZ and non-SEZ firms should accompany the program.
- SEZs should not narrowly focus on specific industries or sectors. Due to incomplete information, it is rarely possible to predict which industries or sectors will successfully operate in a zone, not least because comparative advantages can change over time. SEZs should therefore be sufficiently flexible and ideally open to a broad range of sectors.
- Barriers to investment and an uncompetitive incentive structure limit the success of SEZs. The incentives offered should be designed in accordance with the national business environment, tax system and regulation. It is important to note that high fiscal incentives (e.g. tax holidays) cannot fully compensate for other obstacles to investment – in fact, the literature often does not find an association between the two, suggesting that other factors such as high-quality infrastructure and efficient administrative procedures are more important drivers of the success of SEZs. Carefully analyzing the needs of potential investors can provide important insights when designing the incentive system.
- SEZ programs need to ensure their compatibility with WTO regulation and regional trade agreements. Since 2016, the WTO’s Agreement on Subsidies and Countervailing Measures prohibits the use of certain incentives and fiscal subsidies in SEZs (especially in export processing zones) located outside of least developed countries. In the presence of regional trade agreements, strong coordination of SEZ programs with partner countries is required.
- SEZs can be controversial projects for several reasons, including high public expenditures and subsidies, detrimental effects for the environment due to increased traffic and industrial activity and potential land grabbing. A thorough cost-benefit-analysis and financial plan, as well as ecological and social impact assessments are therefore essential elements of the planning process. Transparency, public outreach and appropriate compensation to affected individuals can increase acceptance by the local population.

Concluding Remarks

Providing a favorable business environment and high-quality infrastructure remains a fundamental challenge in many African countries (see, for example, Asche and Grimm 2017). Carefully planned and implemented SEZs have the potential to alleviate these shortcomings and can contribute to private sector development, sustainable growth and poverty reduction. While policy makers in Africa can draw on lessons learned and best practices from zone programs in various countries, there is no single recipe for a successful SEZ. Policy makers need to keep in mind the country-specific context throughout the planning and implementation process and the fact that SEZ cannot be a substitute for sound economic policies at the country level.

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