# SPECIAL ECONOMIC ZONES:

# A GUIDANCE FRAMEWORK FOR POLICYMAKING

Draft

June 2013

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# Contents

# 1. INTRODUCTION

## 1.1 Context

Special economic zones (SEZs) have been credited with underpinning the some of the biggest economic success stories of recent decades, including China, Korea, Singapore, and Mauritius. As a result, the popularity of SEZs as a policy tool has grown enormously. Almost all countries in the world now have some form of SEZ, most of those who do not have one are planning or considering it, and many that do have SEZs are in the process of restructuring and / or modernizing them.

Governments typically hope to see their zones act as catalysts to attract foreign investment, promote export-oriented growth, and generate employment. But beyond these traditional objectives, many governments are looking increasingly to SEZs as an instrument to attract more diverse economic activities (beyond manufacturing, to include agriculture, tourism, and other services) and to contribute to a more rational urbanization. Less clearly articulated is the objective to contribute to improved national competitiveness and structural transformation by using SEZs to pilot broad economic reforms.

In the context of the significant increase in demand for SEZs, it is important to keep in mind they have had a mixed record. Indeed, for every China and Mauritius there are countless stories of 'white elephant' projects or of zones that failed to ever benefit more than a few opportunistic investors.

Put simply, SEZs are very difficult to get right. Unless a country has an absolute advantage in production or a very large internal market, a number of factors must come together to make a zone successful, including: location, policy, strategy and planning, the legal and regulatory framework, customs, administrative capacity, management, and – last but certainly not least – political will and long-term commitment. *Many of the important decisions that determine the success or failure of SEZ programs are made early on in the process. It is critically important, therefore, that policymakers start off on the right track.*

**Some questions that governments should consider before committing to SEZs**

The lure of SEZs as a panacea to development challenges contributes to often hasty decisions in the early stage of SEZ development that ultimately contributes to failure, for example:

- There is often unrealistic expectation that an SEZ project will turn into an immediate success and replicate the recent experience of China or Dubai. This often leads to initiating projects on far too large a scale than is realistic, putting immediate pressure on financial viability.
- Governments often see land as their primary contribution to an SEZ project, with the result that land drivers the project rather than the other way round, contributing to inappropriately-sized projects, poor location choices, and problems with existing communities living on or near the sites.
- A common objective given to SEZs is regional development, where zones are expected to accelerate local economic growth and contribute to decreasing spatial disparities. But the same factors that explain why these regions lag (e.g. geographic position, lack of skilled labor and business services, etc.) may be precisely the reason why an SEZ will fail.
- Increasingly, SEZ projects are generated by private sector entities or sovereign funds. These entities approach national governments and offer to develop 'turnkey' zones. This may be a huge opportunity for the host government, but without sufficient due diligence on whether the projects are viable and serve the national interest, failed SEZs result.

SEZ regimes must be tailored to understanding and meeting actual and potential investors' needs and behaviors. Without the well-performing 'software' of a SEZ's investment climate and policy regime, its physical 'hardware' is nothing more of it than a real estate proposition, with no 'special' attributes to support building competitive advantage. Moreover SEZ regimes do not exist in a vacuum but rather in the real world of competition with other SEZ and SEZ-type products. Understanding and owning these assumptions is fundamental to establishing the sound foundations for the SEZ regime. Experience shows that only where a government shows the necessary level of commitment will an SEZ program succeed. Failures are much more common. Accordingly, a number of questions should also be asked during the policy interrogation phase:

- Is the SEZ program a national priority (i.e., is there real government commitment to the SEZ program from a financial/public investment perspective; government commitment to take action on SEZ legal and institutional needs)?
- What will be the 'Unique Selling Proposition' of the SEZ regime relative to others in the region?
- What is the political appetite to do what is necessary, in terms of changes to the investment policy environment, to make the SEZ regime a truly 'special' one?
- Even if one makes these changes, will the SEZ have a truly credible business regulatory environment from an international business perspective? Does the proposed regime truly protect investors from the counterproductive constraints in the national investment environment?
- How competitive are neighboring countries' investment regimes relative to the proposed SEZ regime?
- Even if the answers to the previous questions support the establishment of an SEZ regime, is it realistic to assume that government institutions (whether new or existing) will be able to administer it effectively?

## 1.2 Objectives, and target audience

This *SEZ Policy Guide* is designed to support this early-stage policymaking and planning process. Its intention is to provide a non-technical overview of SEZs, the roles they play, and the key decisions and alternatives that need to be taken to make SEZ implementation (if it is the right choice) successful. Specifically, it intends to guide policymakers in taking decisions on: whether to invest in SEZs, what type of SEZ model may be most appropriate, and how to develop policy, regulatory structures, and institutions to maximize chances of success.

The *SEZ Policy Guide* is designed for policymakers as well as for advisors and development institutions that shape the policymaking process. While the *Policy Guide* will be useful for technical practitioners, including those responsible for implementing SEZ programs, it is not intended for them as a primary audience. Implementing an SEZ is a technical process that requires deep expertise across a broad range of disciplines. Other sources exist for practitioners – notably the World Bank / IFC's *SEZ Practitioner's Guide*.

Finally, it should be noted that while this *SEZ Policy Guide* is focused on planning for an SEZ program rather than for setting up one specific SEZ, in many cases, there will be overlap to these processes. Moreover, it can still be useful for countries that have an established SEZ program in place – particularly when programs have not met expectations, it is important to go back and revisit the basis for the program.

## 1.3 Structure of the SEZ Policy Guide

Section 2 provides a simple background on SEZs. It is intended to establish a common understanding of what zones are and how they are used, as well as to provide geographical and historical perspective. Section 3 is the core of the *Policy Guide*. It provides a framework for making policy decisions around 8 critical questions:

1) **Is an SEZ the right instrument to address our needs?**
2) **What is the most appropriate broad zone model in our situation?**
3) **What will be 'special' about the zone?**
4) **How do we align the incentives of all actors through the legal framework?**
5) **What is the best institutional regime to regulate, promote, and administer the SEZ program?**

6) **How do we coordinate across the ministries and agencies to deliver the SEZ program?**
7) **How do we ensure our SEZ program integrates effectively with the local economy?**
8) **How do we plan at the start to ensure social, and environmental compliance and sustainability?**

For each of these, the *Policy Guide* outlines the issue, explains the policy options and the benefits, drawbacks, and risks of each, and provides perspective from international experiences. Throughout Section 3, we provide some guidance on how the decisions may vary depending on the context of the country. In addition, within each question is a *Policy Primer* box which provides some background on a related issue relevant to the broader question.

Finally, Section 4 discusses briefly the process by which the questions discussed in Section 3 can be assessed and decisions taken. It includes discussion on the importance of having internal capacity to plan and deliver SEZs.

**While the *SEZ Policy Guide* intends to support the SEZ planning process, the crucial first decision is whether or not an SEZ is actually the most appropriate and effective instrument for the country in the context of its objectives, opportunities, and constraints. By no means should it be a foregone conclusion that the answer to this question is 'yes'. Undertaking and SEZ is a big and risky investment, and one that is probably not appropriate in many circumstances.**

**Indeed, it should be a measure of success of this *SEZ Policy Guide* if many of its users never go beyond Question #1.**

# 2. UNDERSTANDING SPECIAL ECONOMIC ZONES

## 2.1. What are SEZs?

Special Economic Zones (SEZs) are demarcated geographical areas within a country's national boundaries where the rules of business are different – generally more liberal – from those that prevail in the national territory. Specifically, most economic zones create a 'special' regime that confers four main advantages to investors relative to what they could normally receive in the domestic environment:

1) **Infrastructure** (including serviced land, factory shells, and utilities) that is easier to access and more reliable than is normally available domestically;
2) A **special customs regime** including efficient customs administration and (usually) access to imported inputs free of tariffs and duties;
3) An **improved regulatory and administrative regime**, including streamlined procedures for company set-up, licensing, and operations; and usually,
4) An **attractive fiscal regime**, including reduction or elimination of corporate taxes, VAT, other taxes, labor contributions (e.g. pension / social security), and sometimes training or other subsidies.

Economic zones take on many different forms, depending on their purpose. Table 1 summarizes the most common forms of these regimes – note that industrial parks are included for perspective, however, they are not normally considered as an 'economic zone' as such, given that they operate without any special customs, regulatory, or fiscal regime.

**Table 1: Summary of forms of economic zones**

| Type | Objective | Typical Size | Location | Eligible Activities | Markets | Examples |
|---|---|---|---|---|---|---|
| **Industrial parks** | Manufacturing | < 100 hectares | Various | Mostly manufacturing | Domestic; Export | Exist in most countries |
| **Commercial free zone** | Support trade | < 50 hectares | Ports, airports | Trade-related processing and services | Re-export; Domestic | Colon (Panama); Jebel Ali (Dubai) |
| **Export processing zone (EPZ)** | Export manufacturing | < 200 hectares | Ports, airports | Mostly manufacturing | Export | Masan (Korea); Kenya; Bangladesh; Central America |
| **Free enterprise zones ('single factory' zones** | Export manufacturing | As little as 1 hectare (one factory) | Various | Mostly manufacturing | Export | Mauritius, Mexico |
| **Wide-area SEZs and freeports** | Integrated development | > 100 km2 | Mixed | Multi-use | Domestic; Export; Internal | Shenzhen (China); Aqaba (Jordan) |

*Source: Derived from FIAS (2008). Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development. Washington, D.C.: World Bank*

**In this *SEZ Policy Guide*, we refer to 'zones', 'economic zones', and 'SEZs' interchangeably as generic terms to encompass the wide range of special regimes designed to attract investment and promote exports – these include free trade zones (FTZs), export processing zones (EPZs), special economic zones (SEZs) and other spatially defined areas that include the components and objectives discussed in this section.**

## 2.2. What role do they play?

SEZs are designed as instruments of trade, investment, and spatial industrial policy. They are generally established with four specific (although by no means exclusive) policy goals.[1] First, and foremost, SEZs are designed to ***facilitate trade and attract foreign direct investment*** **–** virtually all SEZ programs from traditional EPZs to China's large-scale SEZs have as one of their main objectives to promote trade, normally exports, and most aim to do this primarily by attracting FDI. Beyond this common theme, the objectives of SEZ programs depend very much on how the government views economic reform in the context of wider development and structural transformation of the country's overall economy. Thus zones may be used to:

- **Pilot the application of experimental new policies and approaches**: China's wide-area SEZs are classic examples—financial, legal, labor, and even pricing reforms were introduced and tested first within the SEZs before being extended to the rest of the economy.
- **Support a wider economic reform strategy**: In this approach, SEZs are a simple tool permitting a country to develop and diversify exports. Zones are a way of reducing anti-export bias while keeping protective barriers intact. The EPZs of Taiwan-China, Mauritius, and the Republic of Korea follow this pattern.
- **Serve as 'pressure valves' to alleviate large-scale unemployment**: In the absence of political will to undertake reforms, zones have still been used effectively as enclaves to absorb excess labor. Tunisia and the Dominican Republic are examples of robust, job-creating SEZ programs that had limited impact beyond the walls of the SEZs.

SEZs meet these objectives by overcoming barriers that hinder investment in the wider economy, including restrictive policies, poor governance, inadequate infrastructure, and problematic access to land.

## 2.3. Do they work?

The short answer is: 'sometimes'. As noted at the beginning of this *Guide*, there exist plenty of anecdotal examples of SEZs playing a catalytic role in growth and structural change. This includes East Asia's 'tiger economies' and of course China, which used SEZs as platform to support the development of export-oriented manufacturing. In Latin America, the Dominican Republic, El Salvador, and Honduras, among others, used free zones to take advantage of preferential access to U.S. markets and have generated large-scale manufacturing sectors in economies previously reliant on agricultural commodities. In the Middle East and North Africa, SEZs have played an important role in catalyzing export-oriented diversification in countries like the Arab Republic of Egypt, Morocco, and the United Arab Emirates. And in Sub-Saharan Africa, Mauritius is an example where SEZs were a central policy tool supporting a highly successful process of economic diversification and industrialization.

On the other hand, without naming countries, it is fair to say there are even more examples of failure. In cases where 'white elephant' infrastructure is built, the evidence is clear to see. More often, however, failure is undocumented and more subtle – in programs that fail to grow, that never deliver benefits to justify the incentives they transfer to investors, or that simply create employment at wages that are economically and socially unsustainable.

A recent study on SEZs[2] identified a number of critical success factors for SEZ programs. Most important among these was the competitiveness of the *national economy*, implying that SEZs are no shortcut for broader reforms. But the study also showed that how a zone is conceived and designed matters for attracting investment, generating exports, and creating jobs. Ensuring a high quality *investment climate* inside an SEZ – specifically high quality infrastructure and efficient trade facilitation – is critical to success. By contrast, low wages and fiscal incentives have no link with positive outcomes in SEZ programs globally.

While the factors that contribute to failure of SEZ programs are often very specific, a number of common themes emerge, including:

- Poor strategic planning and a mismatch with comparative advantage
- Poor choice of location
- Insufficient investment in infrastructure
- Poor implementation capacity and lack of authority
- Lack of high-level support and policy stability

Overall, SEZs have generally been successful in facilitating export growth and generating low skill employment, particularly for women. However, they have been less successful in growing the value-added content of exports, in facilitating linkages between SEZ based firms and in attracting investment to regions that are peripheral and/or economically lagging.

As discussed at the beginning of this *Policy Guide*, when SEZs work effectively they can be transformative. But more often than not, they fail to meet expectations. While much of the blame for failure comes down to implementation, much of it also has to do with poor planning and policymaking from the start. Indeed, many of the instances of 'implementation failure' have at their root failures in initial planning and policy.

## 3. GETTING SEZ POLICY DECISIONS RIGHT – GUIDANCE FRAMEWORK

The guidance framework is intended for use by a SEZ Working Group (see Section 4) at the outset of the process to define an SEZ program. The framework aims to provide strategic input to an SEZ program, facilitate broad institutional interest and understanding, and help avoid many of the pitfalls that have beset the numerous failed or underperforming zone programs.

Specifically, it steps through 8 critical questions that need to be considered before moving ahead with an SEZ program. Consideration of many of these issues often gets pushed off until later in the process, usually only *after* a decision has been made pursue SEZs and the feasibility studies have begun. Moreover, they are often left to be taken at a lower technocratic level, where strategic and political considerations may be underappreciated. This presents several risks. In the first case, governments may find themselves locked into an SEZ program that turns out to be inappropriate and ineffective – technical and political energies are then spent (often in vain) trying to refit the SEZ program to the country's needs. In the second case, unresolved political tensions tend to resurface in operational stages, resulting in poor coordination and gridlocked decision making.

### Question 1: Is an SEZ the right instrument for us?

*Overview*

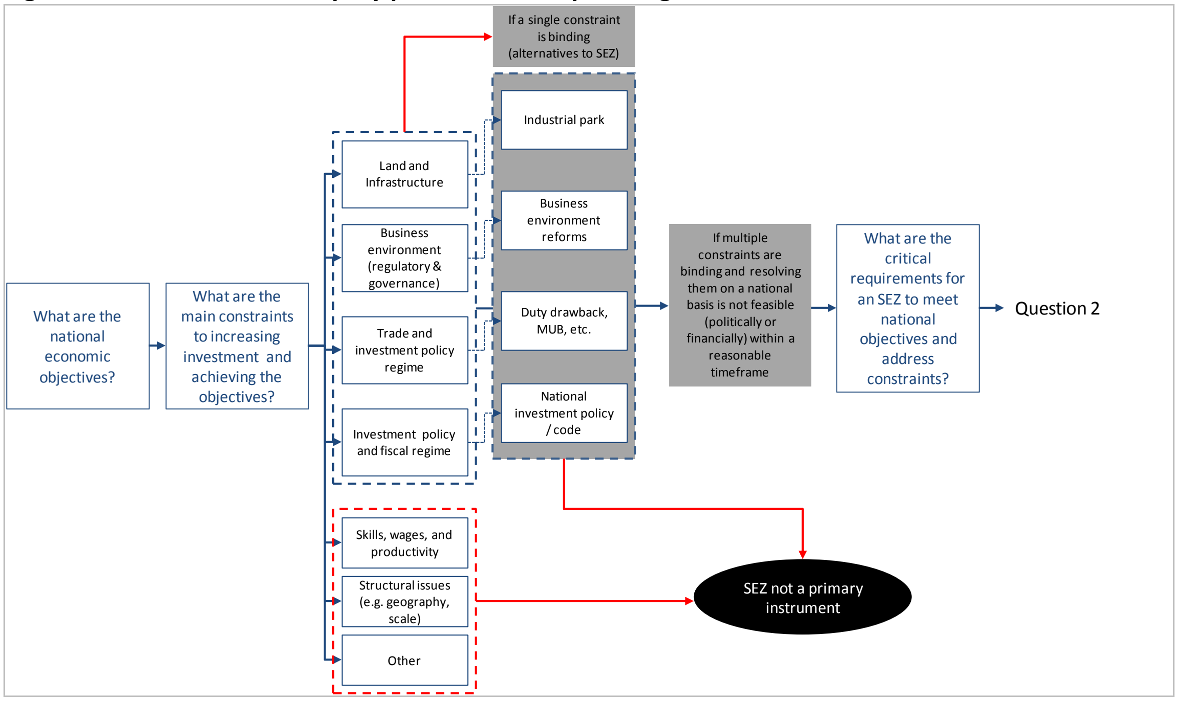
The fundamental question to answer before anything else is whether an SEZ actually represents the right solution for the kind of economic problems and/or opportunities faced by a country. More often than not, insufficient consideration is given to answering this question in a systematic, disciplined, and objective way. Yet, such an interrogation process is essential to orient planning from the start. It is also a chance to identify important constraints that need to be addressed – and opportunities to be pursued – irrespective of whether an SEZ program is ultimately established.

Figure 1 outlines a basic inquiry process for answering Question #1. It will require carrying out an extensive analysis of the country's economic performance, constraints to growth and investment, and existing development objectives and strategies. Generally, most of the research and background studies needed for this will already exist. Details on each step of the inquiry process are described below.

The first step is to go back to national objectives for economic growth, articulated, for example, in industrial and trade policies. Is the country's main challenge diversifying away (or adding value to) natural resources? is it generating low skilled manufacturing employment to transition away from agriculture? is it upgrading manufacturing quality or shifting into high value services? While an SEZ may have relevance for addressing each of these challenges, the nature of the SEZ will certainly differ for each (see Question #2). Moreover, the constraints that must be addressed to achieve these objectives are also likely to differ, which in turn will determine the appropriateness of an SEZ as the policy solution.

As part of the planning process, an analysis should be undertaken to identify the specific constraints that are most binding in meeting these objectives. As Figure 1 illustrates, if these constraints relate to structural issues like *geography or scale*, or if they relate to *skills and productivity, social or environmental problems, or macroeconomic imbalances* the most effective solution may not lie in the infrastructure and special regimes of an SEZ. Instead, solutions may need to be found in the domains of public finance, education and training, or elsewhere.

**Figure 1: Schematic of an inquiry process for SEZ planning**




If constraints to investment are the main barriers to be overcome, SEZs may have a role. But even here, it is important to understand exactly what constraints matter most. For any one individual constraint, there are alternative solutions that may be faster, cheaper, and/or more effective to implement, as summarized in Table 2. For example, if the main problem is lack of access to land and quality infrastructure, it is not obvious that it is necessary to set up an entirely new legal and regulatory regime – a basic industrial part should do the trick. If the regulatory environment for setting up and operating a business is the problem, three questions should be asked: 1) are there fundamental reasons (cost, capacity, political will) why reforms cannot be achieved on a national basis?; if not 2) are we be confident that we can establish a 'world-class' investment environment inside the SEZs?; and 3) do we know for sure that regime needed to address these constraints does not already exist and may simply need to be adjusted or enforced? It is worth noting that some of the world's most famous freeports – for example Hong Kong and Singapore – have no specific legal designation as 'freeports', and yet they clearly are, through a combination of laws implicitly implementing that vision. Indeed, in many countries the combination of existing industrial (or science or business) parks, Authorized Economic Operator programs, bonded warehousing, manufacturing-in-bond, Temporary Entry and Re-export schemes, Customs 'green channels,' Free Trade Agreements and Customs Unions, sectoral fiscal and/or labor regime carve-outs, and an investment agency one-stop-shop may also already provide the solutions than an SEZ regime typically provides. *Table 2 provides some specific examples of alternatives to SEZ regimes to solve typical investment constraints.*

It is really when several significant constraints co-exist, when the resources, capacity, and/or political economy is such that government cannot be confident it can resolve them countrywide within a reasonable time period, and when existing regimes are insufficient to the challenges at hand, that SEZs start to become a proposition worth investing in.

**Table 2: Alternatives to SEZs**

| If the problem is only… | An alternative solution is… | Benefits of the alternative | Drawbacks of the alternative |
|---|---|---|---|
| Simple access to | Industrial park | • No need to establish entirely | • More difficult when there is not |

| If the problem is only… | An alternative solution is… | Benefits of the alternative | Drawbacks of the alternative |
|---|---|---|---|
| **land and quality infrastructure** | | new legal & regulatory regime<br>• Available to domestic and foreign investors | already strong demand for investment (may need to offer more) |
| **Access to inputs for processing** | Duty drawback regime; bonded warehouse; manufacturing-in-bond | • Quick to set up and no major infrastructure or (in some cases) new laws required<br>• Well-established models<br>• Easily made available to FDI and domestic exporters | • Many countries have duty drawback or bonded warehousing schemes, but they are poorly implemented and ineffective<br>• Can be difficult to manage when not spatially defined |
| **Business regulatory environment (set up and operations)** | Business environment reforms (countrywide) | • Improves situation for all firms in the country | • Lack of capacity, funding, and/or political will may make it infeasible within a reasonable time period |
| **Fiscal incentives** | Incentives offered through existing investment policy regime | • Avoids establishment of multiple parallel regimes (avoids confusing investors)<br>• No need for new laws | • May be considered insufficient in context of competitive locations<br>• Must be open to all investors |

*Case examples*

- **Lesotho's factory shells**: As a small, landlocked, developing country, with a weak domestic private sector, Lesotho depends on FDI as a major contributor to employment and growth. Recognizing the potential to attract FDI in the apparel sector to take advantage of AGOA trade preferences, the Government of Lesotho put in place a package of measures during the 1990s (it has since evolved) designed to overcome the perceived constraints to investment. This included a low tax rate for manufacturing firms, the provision of infrastructure through government-provided 'factory shells', an in-bond treatment for imported inputs (through provisions of the Southern African Customs Union) and investor facilitation through the investment promotion agency. In short, they provided all the components that would normally be delivered through an SEZ program, without ever having to put in place a new legal and regulatory framework for SEZs. For a small country, with limited investment promotion capacity, this simplified and reduced costs.
- **Bangladesh's bonded warehouses**: While Bangladesh does SEZs, some of the success of its export garments sector can be attributed to an alternative regime that was particularly valuable for locally-owned exporters (as opposed to the SEZs, which have tended to focus on FDI). Under the central bonded warehouse (CBW) regime, exporters may import raw materials inputs duty-free to be used for export products 'in bond' – this reduces the tie up of capital of these firms, and also improves lead times, critical for the garment sector. The CBW program solved one of the critical bottlenecks to export competitiveness by focusing simply on the customs regime rather than a wider range of issues typically addressed through a full-fledged SEZ program.
- **Turkey's Organized Industrial Zones (OIZ)**: Turkey established its OIZs in the 1960s, primarily as an urban development tool. These OIZs have features of traditional SEZs, including spatial designation, infrastructure, and some 'one stop features', but were traditionally regulated and managed through individual local committees. Indeed, while more than 120 OIZs are operational with thousands of firms operating in them, no formal legal regime was put in place until 2000, nearly 40 years after their launch.

**SEZ Policy Primer #1: Using SEZs as a reform catalyst**

Very few countries have launched zone programs with the intention to use them as catalysts for economic reform. Yet, some of the programs that are held up as the biggest SEZ success stories used their economic zones precisely for the purpose of piloting reforms before rolling them out economywide. For example:

- **China**[3] famously used their SEZs, particularly Shenzhen, to as experimental 'laborotories' for economic reforms that would have been politically risky to adopt on the national level. Sweeping reforms were introduced through Shenzhen, including the abolition of price controls, the introduction of the first labor contracts along with pensions and labor insurance, the privatization of SOEs, and opening up the banking system to foreign investment. Most recently, the government is piloting full flotation of the Yuan in Shenzhen.
- **Mauritius**[4] used their SEZ regime over several decades as a bulwark for reform, introducing labor reforms and gradually shifting the economy's focus from import substitution to export promotion. Indeed, with its most recent 'duty-free island' initiative, it is clear that the reforms once started inside the SEZs have now encompassed the country.

## Question 2: What is the most appropriate broad zone model in our situation?

*Overview*

Once it appears clear that an SEZ is a valid policy option for the country, the next step is to identify the right broad model of SEZ that should be deployed. This process will outline the type(s) of zone(s) that would be suited to achieve the policy goals defined in Question 1, but also scale, geographic location and development model. While defining these attributes in detail are the purposes of the prefeasibility and feasibility studies, at this early stage of the process it is important to define broadly the attributes of the future zone(s) to ensure that the match between government policy objectives and the future zone program is solidly rooted. These broad attributes will become the value proposition that the feasibility cycle will test, validate and/or refine.

As shown in Table 1, there are four broad types of special economic zones, each with a specific set of characteristics that derive from their economic rationales. These types are not mutually exclusive, and an SEZ development strategy may rely on a complementary set of zones to be deployed over time, as has been the case in countries like China, Colombia, Dubai, Malaysia and Mauritius. Table 3 summarizes the main strategic roles and requirements of each of these types of zones.

- **Commercial free zones** are mainly trade development instruments, and tend to be located in countries and regions that already have some trade-related natural comparative advantages – such as geographic location near major trade routes, established or emerging important ports or airports, or large consumer markets. Commercial free zones are rarely very large, except when they have reached regional prominence – like Colon Free Zone in Central America, Jebel Ali Free Zone in the Middle East, or Singapore in South East Asia. These zones provide limited opportunity for value addition, as activities are mainly commercial and logistical, and processing is focused on bulk-breaking, packaging, labeling, product finalization (for rules of origin benefits), testing and quality control, and the like. They do act as trade catalysts, and as such can become part of a strategy to position a country or region within global or regional trade and logistic flows, often in tandem with a more pronounced focus on services and manufacturing – either through other SEZs or not.
- **Export processing zones** are mainly focused on manufacturing for exports. They were very popular from the 1960s to the 1990s, a product of the search cheap labor, pre-WTO trade preferences, and the dominance of Western consumer markets. EPZs have not lost their relevance, but the market

and regulatory rules they obey have changed. EPZs can no longer rely on preferential market access (except marginally as in the case of AGOA) and export subsidies (which are being phased out by WTO). They must compete globally on the basis of real factor costs, economies of scale, access to markets, and productivity of labor. This renders tax incentives relatively ineffective for marginal countries. Creating successful EPZs is significantly more difficult than it used to be.

- **Free (or single) enterprise zones** have been used in three contexts: i) small countries where distance to labor, utilities and transport infrastructure is not an issue, and where real estate is efficiently managed and is available; ii) large countries that have not managed to effectively develop the industrial and business parks component of SEZs for lack of capacity or insufficient demand; and, iii) countries that have allowed existing domestic companies obtain free zone status without having to relocate to a zone. A free enterprise zone framework can be deployed as a cost effective alternative to a full-scale SEZ, and can be useful for sectors that are turning toward export markets. But in countries that have poor infrastructure and inefficient real estate markets, they usually fail to have a meaningful economic impact.
- **Wide-area SEZs and freeports** have gained prominence with the Chinese experience. In their most developed format, these zones function as autonomous entities, managed by a dedicated government that also oversees the cities, ports, airports and the population, living within them. By definition, these zones are multi-sectoral, hosting and attracting a wide spectrum of economic activities: international trade and logistics, retail trade, tourism, property development, financial services, and so on. The focus of these 'mega-zones' is regional development, catalytic economic growth and structural reform through a demonstration effect.

These different types of zones are also highly adaptable to local requirements and contexts. The Working Group should seek to identify the most appropriate type(s) of zone(s) required to achieve the policy objectives, but should not hesitate to explore innovative configurations, provided best practice knowledge is incorporated. This could mean opting for a hybrid concept bringing elements of the different types serving the national economic objectives.

**Table 3: Overview of common zone models**

| Type | Main constraints they can help overcome | Appropriate for strategies focusing on: | What is required from the start |
|---|---|---|---|
| **Commercial free zone** | • Trade and investment policy regime<br>• Business environment<br>• Land and infrastructure | Developing commercial and logistical sectors | Existing trade-related comparative advantage – location and trade infrastructure (e.g. port) |
| **Export processing zone (EPZ)** | • Trade and investment policy regime<br>• Business environment<br>• Land and infrastructure | Low income countries focusing on labor absorption; diversifying into basic manufacturing | Significant labor force; relatively favorable location (for input / export shipping); decent national infrastructure; trade preferences to key markets |
| **Free enterprise zones ('single factory' zones)** | • Trade and investment policy environment<br>• (Limited) business environment | Middle income countries focusing on upgrading; countries focusing on exploiting natural resources for value addition | Good national infrastructure; broadly competitive existing national environment; trade preferences to key markets |
| **Wide-area SEZs** | • Trade and investment | Low and middle income | Substantial investment |

| | | | |
|---|---|---|---|
| **and freeports** | policy regime<br>• Business environment<br>• Land and infrastructure | countries focusing on undertaking radical reforms to support broad competitiveness, structural transformation, and regional development | resources; large land area; potential for significant agglomeration; willingness for substantial autonomy of governance and radical testing of reforms |

Other attributes of the zone program that should be considered in line with the broad model include:

- **Scale**: Scale is a product of the type of zone envisaged, and ultimately of final demand in the target markets for the products and services that are offered by zone users. Table 1provides some indicative sizes at maturity (15-20 years), ranging from commercial free zones at around 50 hectares to wide-area SEZs at up to 100 $km^2$. While it may not be possible to specify scale early on, the initial analytical process should aim to gather enough information on current and expected pent-up demand for serviced industrial, logistics and services land, the expected growth of the producing sectors of the economy, and their respective contribution to produce orders of magnitude of future land demand. This information would provide some sense of the sectors of activity that could be hosted, and their respective broad land uptake. Actual development is usually done in phases, and successful zones are 'right-sized' according to conservative demand forecasts that ensure they fill up rapidly and achieve rates of financial returns that justify the investment.
- **Location**: Good location is a critical attribute of effective zones. Broadly, two principles of location can be applied, serving two distinct objectives: economic decentralization (or dispersion) and economic concentration. Evidence suggests that zones are poor decentralization performers, unless the location selected already has some natural comparative advantage, significant resources are invested in promoting the zone, and government takes a 20-year view on the project. Conversely, zones have better performers when they have exploited the pre-existing advantages that are the products of concentration: comparatively skilled labor force, presence of good national infrastructure, business services, trade flows, etc. The concentration model, however, needs careful planning as it can exacerbate spatial inequalities, environmental degradation, and load an already stressed local infrastructure. Irrespective of the model chosen, location must be chosen in relation to the presence in sufficient quantity, quality and price of critical factors of production: land, labor, utilities, business services, and international connectivity. Zones need all of these – not just some – for businesses within them to operate competitively. Understanding whether reasonable conditions exist for the success of either the concentration or dispersion model requires an assessment of the country's spatial distribution of endowments in the context of strategic objective. Ideally, 3 or 4 most promising locations could be identified for validation in the feasibility cycle of the future SEZ program. However, *no specific pilot project location should be selected until after the feasibility assessment*.
- **Development model***:* Broadly, the development model refers to how the SEZ(s) will be designed, financed, constructed, marketed and operated. It must specify what the respective roles of government and the private sector will be. There are three main forms of private involvement: i) service contracts (where management contracted to a specialist firm); ii) concessions and BOTs (where government still owns the zone, but capital investment and operation are private), and; iii) full private ownership. Selection of specific development models will depend on the context of project and should only come after feasibility studies are completed. However, it an early stage it is important to evaluate the government's capacity to lead and finance both program and projects.

**SEZ Policy Primer #2: Are SEZs effective instruments for regional development?**

International experience has shown clearly that the location of an SEZ in a country – in particular, its proximity to major trade gateways (ports and airports) and the country's largest metropolitan areas – is critical to its success. This is particularly important for zones that depend on manufacturers who require access to imported inputs, business services, large pools of labor, and transport networks. But it also holds true for knowledge-based zones (e.g., IT parks), which may have less need to access ports but require proximity to population centers to access specialized labor and business services, as well as high-quality backbone services (utilities). Still, most countries continue to use SEZs to try to attract investment and create employment in remote and lagging regions. In just about every case, these efforts have failed to deliver on their objectives. Below are just two examples from countries with otherwise successful SEZ programs[5]:

- **Bangladesh**: While the first two EPZs—in the main cities of Dhaka and Chittagong—and the recently established zones along the Dhaka-Chittagong corridor have been highly successful in attracting investment, three zones in the northern (Uttara EPZ) and western (Ishwardi and Mongla EPZs) parts of the country sit almost empty, despite significant additional incentives offered to investors. These three zones are all located more than 600 kilometers from the international port[6] and hundreds of kilometers from Dhaka; the poor transport infrastructure makes it difficult to get goods in and out. In addition, availability of reliable electric and gas supplies is a major problem, and these remote locations lack manufacturing clusters, making access to supplies problematic.
- **Dominican Republic**: The Dominican government has long attempted to promote investment in the depressed regions along the Haitian border and has provided a number of investment incentives through the SEZ program, including an extension of tax holidays, preferential loans, and relaxed regulations. Yet despite these benefits, only two zones are in operation in these provinces, and both are public parks (while most of the country's industrial parks are invested in by the private sector. Together, they house only six firms provide only 3,500 jobs.

Again, with lagging and peripheral regions it is critical to understand what opportunities for investment are realistic, the specific constraints holding back investment, and whether SEZs are the most effective instruments to address these constraints.

*Case examples*

- **Leveraging trade-related comparative advantage in Subic Bay (Philippines) and Djibouti:** The Subic Bay Freeport was developed on the site of a major US navy base that was closed in the early 1990s. Taking advantage of location and this existing infrastructure, government along with private investors (including major investments from Fedex) developed a Freeport complex that has become one of the leading engines of the national economy. Together with the Clark SEZ, it accounts for some 10% of all exports from the Philippines. In Djibouti, a conflict-affected country with few sources of comparative advantage, but a highly strategic location, also leveraged it to develop a highly successful SEZ. In this case, foreign investment from the Dubai Ports Authority, which came in to manage the Djibouti Port, played a critical role in seeing and realizing the vision. With a strategic investor driving traffic to the port, the SEZ development enabled the country to attract substantial investment around logistical, commercial, and assembly activities.
- **Developing a range of zone models to fit strategic objectives in Dubai:** The development of the Jebel Ali Free Zone, a major distribution and logistics hub, is well known as being central to the economic transformation of the emirate. But the country has also used various other forms of the SEZ model to support the development of other industries. Combining a strategic location, a constrained domestic and regional regulatory environment, and substantial resources for investing, the country initiated a wide range of SEZ projects on different scales and using different models. These include specialized zones for ICT (Dubai Internet City), communications (Media City), skills and education (Knowledge Village), finance (Dubai Financial Markets), and Health (Dubai Healthcare City).

- **Getting the model and the location wrong in Nigeria:** When the decision was made to establish export processing zones in Nigeria in the early 1990s, the emphasis of the program was on manufacturing for export and the decision was made to establish a flagship EPZ run by the government in the City of Calabar in the Cross Rivers State. Calabar was neither a major manufacturing nor an important logistics location in the country. The port of Calabar (which, in the end, was separated from the Calabar EPZ and established its own free zone) was and remains insignificant within Nigeria. It is not on the main shipping lines and has never been properly dredged. Thus, attracting manufacturing investment, much less export-oriented manufacturing investment, was a major challenge from the start. For this, and a host of other design and operational, the zone failed to develop.

## Question 3: What will be 'special' about the zone?

*Overview*

In parallel with identifying a broad model, it is critical that policymakers identify clearly up front just what will be 'special' about their zone. Too often zones are developed with little that differentiates them clearly from the national environment or from regional competitors. On the other hand, resource limitations and strategic concerns will reduce the scope of what is achievable – in most countries it will not be possible to develop a zone that is truly special across all dimensions. Therefore, it is critical to go back to the initial question of '*what are the most important constraints to investment in the country*?' and focus attention on developing the environment to offer something special in that respect. The four main domains around which this can be crafted are: i) infrastructure and services; ii) the business regulatory environment; iii) the trade policy environment; and iv) the investment policy environment and fiscal regime

Below are some issues to be considered for each:

- **Infrastructure and services**: While in some middle income economies, sufficient quality infrastructure exists in the country to make this a limited source of differentiation, in almost all developing countries provision of quality infrastructure will be the single most important way in which a zone program can offer a 'special' environment to investors. This may include the provision of land and factory shells with flexible lease terms (reducing risk for investors), but most critically it means delivering an environment where utilities supplies (water, telecommunications, and most importantly, electricity) are dependable and available at a reasonable cost. It also means that infrastructure like roads, ports, and airports are invested in and well operated, and trade related services like customs are efficient. Recent research on SEZs shows a very clear relationship between SEZ program performance and the quality of hard and soft infrastructure. In middle and upper income countries, differentiation may be possible through provision of specialized, value-added infrastructure (e.g. related to services sectors or R&D activities) or by establishing a regulatory environment that reduces the cost of infrastructure and/or range of services available. *In a context of limited financial resources, concentrating investment to get this part of the SEZ equation right is a practical strategy. However, while the infrastructure of a zone is important, without the well-performing 'software' of a SEZ's investment climate and policy regime, its physical 'hardware' is nothing more of it than a real estate proposition, with no special attributes to support building competitive advantage*.
- **Business regulatory environment**: SEZs often make significant efforts to establish a licensing and operating regime that reduces steps, cost, and most importantly, time, relative to the domestic environment. This is typically achieved through the provision of some 'one-stop service' programs. However, such programs often turn out to be ineffective. One reason for this is inability to coordinate across ministries and agencies (see Question 6). Another is problems with the

underlying laws and regulations – where, for instance, an extra document or signature, an additional check, a lengthy processing timeline, an onerous form, or an expensive fee is set by law, or where criteria are too numerous and onerous yet enshrined in law, the margin of maneuverability for regulators to be 'facilitative' is limited. In the context of these two challenges, some design-related issues should also be considered, including: i) going beyond a 'one-stop' center where all government agencies are located to a true 'single window' where a single facilitator operates across all government authorities; and more importantly, ii) establishing a regime where the licensing and other requirements are actually reduced rather than simply facilitated.

- **Trade policy environment**: In traditional EPZs, one of the critical selling points of zones was the preferential environment with respect to accessing imported inputs on a duty-free basis. This, however, is no longer a major source of differentiation in most countries for two reasons: i) tariffs on most imported inputs have reduced considerably in recent decades; and ii) the use of alternative mechanisms like duty drawback and bonded manufacturing (see Table 2) has become more commonplace. Moreover, if regional markets are likely to be important for zone-based investors, zones may even be a hindrance from the perspective of trade policy, as rules or origin within some trade agreements (e.g. ECOWAS, WAEMU, and NAFTA, among others) restrict zone-based exports from benefitting from preferential market access. But in an environment where many countries are increasing protectionism, for example through anti-dumping measures and imposition of standards and other NTMs, the liberal trade policy environment of zones can remain an important source of competitive advantage for export-oriented investors.
- **The investment policy environment and fiscal regime**: Fundamentally, this is the question of fiscal incentives[7].This is the domain where most effort and resources to make a zone program 'special' tend to be focused. In the competitive environment of investment attraction, governments make a fair argument that if their neighbors are offering incentives it is difficult for them not to offer something similar. However, the arguments against fiscal incentives are pretty conclusive. Most research suggests that fiscal incentives are ineffective as a source of differentiation, with the end result merely an increasing 'race to the bottom' and transfer of rents from governments to private investors. Moreover, WTO provisions against subsidies severely the use of traditional fiscal incentives offered in SEZs in most countries. In the SEZ planning process, policymakers should at least be sure not to start with the assumption that fiscal incentives will be the main, or even an important, aspect of what is 'special' about the zone. Efforts should be made to find incentives that are more focused on the sectors and strategies that are at the heart of the zone program, and do not tie the government into long term commitments with deleterious fiscal impacts.

**Policy primer #3: Fiscal incentives and WTO compliance**

Under the WTO Agreement on Subsidies and Countervailing Measures (SCM), countries that have reached a minimum income threshold are required to eliminate all export subsidies by 2015. Among the export subsidies that are considered non-compliant are key components of the SEZ programs of all countries in the region. Any subsidy to a firm (e.g. the income tax exemption that all countries offer to SEZ investors) that is designed specifically to promote exports is non-compliant. This is likely to have a significant impact on the nature of the SEZ programs in the region, which are currently designed along the lines of traditional EPZs, with heavy reliance on fiscal incentives and restrictions against SEZ-based firms selling into domestic markets.

One way to comply is to remove the subsidies (in this case, removing tax exemptions and raising them to the levels of the domestic economy). Of course, as these subsidies are perceived to be critical to attracting export-oriented investment, this option is not particularly attractive to many policymakers. A second option is to remove the minimum export obligations of firms in the EPZs and allow them to sell in the domestic market. In this case, the subsidies are no longer linked to exporting and so do not breach the SCM Agreement. But this, too, has significant drawbacks. It will result in unfair competition for domestic producers as EPZ-based firms enjoying fiscal and other subsidies can now compete head-to-head with them. Moreover, domestic producers will of course also seek the same subsidies, and while they may have previously eschewed EPZ status due to the domestic market sales restrictions, they will no longer be held back by this. Thus the fiscal cost of subsidies could rise out of control. Instead, most countries have opted for a third approach, which is to reconfigure the fiscal incentive model in a spatial or sectoral dimension. This allows for compliance and a level playing field, while maintaining some control over the scale of subsidy costs while linking the subsidies to targeted policy objectives.

It is worth noting that removing the export requirement, as well as tax exemptions, of EPZ firms is in any case part of the more modern SEZ models that are now becoming the norm. Here, the traditional approach of setting up enclaves and giving them strong fiscal incentives is giving way to a more open model where SEZs provide a world-class infrastructure and business environment, and fiscal incentives are de-emphasized. This has the added benefit of facilitating greater integration and linkages between the zones and the domestic economy.

*Case examples*

Table 4 provides some examples of good and bad practice in relation to each of the sources of differentiation discussed in this section.

**Table 4: Case examples – easing and creating barriers to competitiveness in SEZs**

| | Good practice examples | Mistakes to avoid |
|---|---|---|
| **Infrastructure and services** | ▪ ***Dedicated customs in a landlocked environment – Suzhou Industrial Park (SIP), China***: From its inception, SIP was established with a dedicated customs sub-directorate. To extend the benefits further, SIP was later made a 'virtual port', despite being landlocked. Firms in SIP enjoy an efficient 'green lane' for import and export clearance running 24 hours a day and 7 days a week.<br>▪ ***Private investment for reliable electricity in Bangladesh***: While EPZs in the country already receive priority access to electricity, the authorities in Bangladesh went one step forward to amend the law allowing for investors to establish power plants and resell production within the zones.<br>▪ ***Delivering connective infrastructure – toll road in Honduras***: As private sector EPZs expanded in the valley around San Pedro Sula, government facilitated transport by developing a toll road from the industrial heartland in the valley, connecting to the country's main port.<br>▪ ***Value added infrastructure and services – MAS Fabric Park Sri Lanka***: Operated by a private developer, the MAS Fabric Park offers a range of sector-specific infrastructure and services to tenants, including dedicated water and effluent treatment, short-term office (incubator) space, engineering consultancy, and facilities and consultancy for business and management training. | ▪ ***Replicating national infrastructure problems inside the zones***: In a country where electricity reliability is the single biggest constraint to businesses, the flagship EPZ only replicated the misery of the national environment inside the zone. Investors noted that in one month, electricity was down for 87% of production hours, and when power was delivered, its quality is so poor (low or high voltage) that it is of little use. A survey of companies in the zone indicated that every one of them was forced to purchase generators and paid a huge premium for power.<br>▪ ***Failing to consider infrastructure constraints outside the zone gates***: In another zone, investors complained of frequent water shortages forcing them to haul water into the zone in tanker trucks. It turns out there was no problem with the zone's infrastructure, but the zone continued to rely on the local municipal water authority for supply, and this authority did not increase its capacity to take into account the huge increase in demand coming from the zone, thus leading to shortfalls and the municipality prioritizing (quite appropriately) its service delivery obligation to nearby residents. |
| **Business** | ▪ ***Promoting regulatory competition - Vietnam***: To | ▪ ***Approval delays***: After the launch of one of |

| | Good practice examples | Mistakes to avoid |
|---|---|---|
| **regulatory environment** | curb unhealthy competition among regions with SEZs, Vietnam put tighter control on the provision of local incentives. This forced zones to compete on services. For example, one zone advertises a record investment license being issued within four hours of submission; others advertise average three-day approval periods<br>▪ ***'Silence is consent'- empowering one-stop service facilities in Senegal***: To get over the problem of delays in approving SEZ licenses, Senegal adopted a law so that if the applicant receives no response within 30 days, authorization is granted by default | Africa's first free trade zones, administrative requirements quickly became a major barrier to investment – some potential investors reported having to wait nearly one year to receive approval of their initial applications. |
| **Trade policy environment** | ▪ ***Using zones as enclaves for pioneer industries – Mauritius***: Mauritius strategically aligned its diversification and industrialization strategy with the international trading regime to create a specialized, attractive investment microclimate in its EPZ. However, this trade and investment strategy has not been static. Initially, the EPZ was a liberal enclave inside a highly protected economy. Over time, with the erosion of preferential trade access, liberalization in the trade and investment regime has allowed for diversification outside the EPZ in line with the island's evolving comparative advantage, including the launch of the offshore financial sector and the free port in the early 1990s, the Cybercity/ICT initiative in the early 2000s, and the integrated tourism resort scheme in the mid-2000s. | ▪ ***Failing to take into account trade policy***: A zone in West Africa approved a major investment from a food company that began production with the intention to export to Nigeria. Only later did the firm and the government realize that under ECOWAS trade arrangements, exports from the zone would not qualify for preferential market access. Worse still, they later learned that the product the firm planned to export was on a list of products for which imports are banned in Nigeria.<br>▪ ***Failing to prepare for regional integration***: Several EPZ programs have been caught in a situation where they attract investors with fiscal incentives and strict export requirements, only to find out that the creation of a regional single market has turned former export markets into effectively domestic markets. Governments are then put in the difficult position of having to essentially remove incentives from EPZ investors (and risk the likelihood of them leaving) or open up domestic producers to potentially 'unlevel' competition from EPZ-based firms.<br>▪ ***Setting up barriers for domestic suppliers***: An EPZ program in Latin America undermined the potential for local firms to become suppliers to EPZ-based factories by maintaining VAT charges for EPZ firms on products bought from the local market while allowing imports to arrive duty-free. Another country in South Asia attempted to overcome this but required VAT to be reclaimed through a drawback system that was notoriously slow and unreliable, making it effectively useless. |
| **Investment policy and fiscal regime** | ▪ ***Evolving incentives for comparative advantage – Malaysia***: Malaysia used a wide variety of fiscal incentives combined with their SEZ program to facilitate the growth of export oriented manufacturing. During the 1990s when the country needed to shift toward higher value added activities rather than simply export volume, export incentives were phased out and replaced with incentives tied to technological deepening, R&D, training, and sourcing.<br>▪ ***Transitioning incentives for WTO compliance – China and Vietnam***: To comply with WTO and address distortions caused by the SEZ fiscal | ▪ ***Policy reversals***: Over a period of 30 years, one country changed its free zone law on four occasions, each time reversing critical aspects of the previous law, leading to serious investor uncertainty. For example, the country started with a 100% corporate tax exemption, then set a low, flat tax and later returned to the full exemption; it started with a 60% export requirement, increased it to 80% and then removed it entirely; it started with a strict spatial program, then allowed all firms in the country to participate regardless of location, then cancelled the program, then later re-started again with a strict spatial focus. |

| | Good practice examples | Mistakes to avoid |
|---|---|---|
| | incentives regime, in 2008 (after giving investors more than 5 years notice of their plans) China passed a law to substantially reduce incentives but also extend them to all firms regardless of their location inside or outside zones. They also shifted toward incentives focused on 'strategic sectors' and specific locations. Vietnam similarly shifted its SEZ fiscal incentive regime from targeting exports to targeting sectors and locations. | ▪ ***Allowing gaps between de jure and de facto regimes***: Another country passed a law to allow companies in free zones to sell into the local market, but years later the customs authorities (who opposed the decision) continued to block local sales. Similarly, a new tourism zone was announced, with its cornerstone being a large duty free allowance for visitors, yet after hundreds of millions of dollars of investment had been sunk into the project, opposition from customs authorities eventually saw the duty-free exemption reduced 0-fold, undermining the project. |

### Question 4: How do we align the incentives of all actors through the legal framework?

*<u>Overview</u>*

Once a country has made a decision to establish an SEZ program, questions should be asked as to how it should set the right incentives for private sector developers, private investors, and public regulators in order to ensure that an SEZ legal framework delivers results, success and impact. In reality, this involves three levels of inquiry and action:

- First, a country considering SEZs should pause and ask itself, whether the need for a legal framework is the same thing as the need for an SEZ Law;
- Second, it should ask itself what the political, transactional and commercial incentives are that drive effective legislative change; and
- Third, it is also important to reflect upon how the SEZ legal and regulatory framework should be structured so as to get the right kind of investment reaction from the private sector (and/or the public sector, if they are involved in the SEZ development and/or operations).

Few countries begin the process of SEZ regime design by asking themselves the following question: *What can a Law do?* As a result, the incorrect legal instrument (the increasingly ubiquitous 'Best Practice SEZ Law') is sometimes unthinkingly pushed for by the SEZ regime's framers. Only a law can change most bad policies (which usually embedded in other laws) in order to create an optimal business environment. Only a law can confer the ability to issue regulations and to regulate. Usually, only a law can create a new government institution, agency, parastatal or authority.

But the question should nevertheless be asked: *Is a Law required, or might regulations, legislative amendments, or a Contract-Law or Concession do?* Legislative amendments can be a complicated way of putting together an SEZ regime if there are many things to be dealt with, but may not take as long as a Law, which commonly takes years from start to finish. Regulations cannot change things set forth in other laws, but can if they are adopted under the right laws. A 'Contract Law' or Parliament-approved Concession can only be used for one zone, one time, but is sometimes an interesting and appropriate option.

Moreover some of the concerns which a country may be trying to address through an SEZ regime can also be dealt with through other instruments, administrative approaches, or technologies. If circumstances dictate that a law *is* required, it should be borne in mind that good legislation can only come out of a good process and a receptive climate for it, including:

- A committed technocratic champion, assisted by a dedicated team.
- Involvement and endorsement of a private sector constituency and endorsement.

- A transparent process in which the media has been involved.

In terms of structuring the legal and regulatory framework for SEZs to get the desired investor reaction, an important starting point is that all SEZ legal frameworks should be designed from a demand-driven perspective. Just as it is important to choose the right location for targeted investors and offer infrastructure and services tailored for them, legal frameworks ought to be purpose-built. Unfortunately, this is rarely the case. Some of the top mistakes in developing legal frameworks include:

- Assuming that all SEZ frameworks are more or less the same and can thus be more or less copied from 'off-the-shelf';
- Failing to link the SEZ policy to the country's real investment policy challenges, either due to:
  - a lack of understanding of the importance of what legal changes can actually deliver;
  - a lack of political will; or
  - a desire to take short cuts to get to an adopted SEZ law more quickly;
- Failing to link the SEZ policy to the targeted sectors and thus failing to address specific sectoral policy concerns (or worse yet, designing an SEZ policy with no sector/cluster targets and/or absolutely no idea which investors are likely to set up in the zones); and/or
- Assuming that fiscal incentives are the only real competitive differentiator that matters.

The country preparing an SEZ Law should therefore ask itself *what, in terms of specific sectors and regulatory challenges, is the proposed SEZ program (and thus the SEZ Law) trying to impact?* The guiding principle in thinking through this question is that an SEZ Law should not be generic. Sectorally, it should address legal/regulatory issues in the specific value chain(s) being targeted (e.g., specific licenses or competition impediments, taxes and inspections that affect the sector in question, adapted training/work-shift/productivity regimes for the sector, etc.). It also needs to be 'special' from a regulatory perspective –a good rule of thumb is that *it should address at least two (2) significant business constraints meaningfully*. If it does not, it is hardly worth the considerable required effort of its drafting and adoption.

Finally, it is critical to recognize that the job is not complete once the Law has been enacted. Required *implementing regulations* sometimes take years to be prepared, rendering the Law and SEZ regime of little or no use for extended periods.

**Policy primer #4: Beyond the SEZ Law – selecting and contracting SEZ Developers**

Many countries see the SEZ Law as an instrument to effectively 'license' SEZ developers and operators. But while the SEZ Law can establish the parameters for identifying eligible developers, the actual process of licensing developers and the ground rules for how they will operate is a complex process that goes beyond what can reasonably be considered in an SEZ Law. Two critical aspects of this process are: i) *due diligence of developers*; and ii) the *Developer Agreement*.

<u>Due Diligence</u>:

In selecting developers, it must be recognized that there is an opportunity cost to the allocation of designated SEZ land and plots to any particular party –particularly if one is allocating prime State land to parties outside of the context of a competitive bidding process and clear designation/registration criteria.[8] Indeed, in order to prevent land speculation, crowding out of private development and investment, and reputational damage, as well as ensure phased development, sound project governance, and financial viability, proper due diligence must be conducted, most importantly of potential SEZ developers, but also for anchor tenants and end-users. For developers, due diligence should apply at a minimum to legal, business operations, and financial matters.

<u>Developer Agreements</u>:

It is critical, therefore, that countries are also prepared to negotiate contractual Developer Agreements that establish an effective incentive framework around which to attract developers and ensure they deliver on their mandate. Following is a list of important elements that must be included in such an agreement:

- Objectives, summary description of proposed project
- Clear definitions of roles and responsibilities of parties
- Periodic testing/benchmarking and re-pricing mechanisms or phased development options
- Clear definition of contributions (assets, capital, payments) of the parties
- Performance standards
- Duration (commencement, critical dates, expiry/ release)
- Performance monitoring (events, acceptances, measurement methods)
- Warrantees (due diligence, latent defects…) & Exclusions
- Delivery protections (performance bonds, parent company guarantees, security, long-stop date, access, step-in rights, subrogation rights, contingency fund requirements)
- Government commitments
- Delivery of possession
- Limitations and restrictions
- Covenants of private partner (access, liability for damage and indemnity for events on site)
- Expiry (survival of obligations, and extension or renewal of contract)
- Termination (default events, cause, consequences, takeover, survival of obligations, force majeure, compensation/ relief/ prorating & valuation)
- Breach (payments, forfeiture of performance bond/security, rectification, damages & indemnities)
- General provisions
- Assignment / Change of Ownership / Subcontracting
- Intellectual property rights (IPR)
- Legal stability clause

**For a list of key issues that need to be addressed in any good SEZ law, see the *SEZ Practitioner's Guide.***

_Case examples_

In order to illustrate the points made above, it may be useful to consider a few examples of legal frameworks that were designed for very specific objectives:

- **Jordan's Aqaba SEZ** legislative framework was designed flexibly enough to enable the subsequent adoption of implementing regulations dealing with the area's tourism sector needs (e.g., its 'Marine Park Regulation' and 'Wadi Rum Regulation'), ultimately Aqaba SEZ's key investment sector.[9]
- In the **Panamá Pacífico SEZ**, a former airforce base with a focus on the logistics sector, the SEZ's One-Stop-Shop uniquely includes representatives of both the Civil Aviation Authority and the Transport & Transit Authority. Special fiscal incentives for civil aviation sector 'maintenance and repair operations' were also included in the Law. When it was determined, through extensive investment demand and regulatory environment surveys, that the SEZ stood a chance to attract ICT investment in call centers, the Law succeeded in incorporating working hour flexibility.[10] The pay-off was a huge investment by Dell.
- More recently, in the **Democratic Republic of Congo** and in **Kenya**, draft SEZ legislation currently under consideration has incorporated provisions with a dedicated sectoral focus on such areas as mining, agriculture and ICT – all areas of regulation not traditionally found in traditional export-oriented, light manufacturing focused EPZ legislation.

In contrast, examples of mistakes made in developing the SEZ legal frameworks of various countries may be also provide useful illustration (Table 5).

**Table 5: Typical mistakes related to SEZ legal frameworks**

| Mistakes | Example |
|---|---|
| **Failing to address the fundamental investment constraints** | • One of the largest developing country economies recently went through a process to shift from their existing zone legislation to adopt a new 'SEZ Law'. Despite significant effort and resources, however, political compromises meant that the final product was little more than the old regime with a new name, as failure to tackle the fundamental constraints to investment (which was responsible for the lack of success of the initial zone regime) remained. |
| **Overlapping zone regimes** | • In Tanzania, the EPZ regime was launched in 2002; in 2006 an SEZ Law was also passed. For the latter, however, no enabling regulations were ever put in place and so the EPZ authority ended up being responsible for the administration and licensing of firms wanting to invest in the SEZ program.<br>• In Nigeria, the EPZ Authority was established in 1992; just four years later (and before the first zone was established) the government created the Oil & Gas Free Zone Authority (OGFZA). The two organizations were in conflict for many years over which had authority over a number of important activities, causing significant confusion and uncertainty on the part of investors. |
| **Failing to consider the content of Developer Agreements** | • In several countries (including Ghana and Kuwait), lack of rigorous focus on the details of Developer Agreements resulted in situations where conflicts between the government and developers resulted in a stalemate, with government unable to step in and take over a failing zone. |
| **Failure to conduct proper developer due diligence** | • Similarly, in a number of countries, failure to undertake appropriate due diligence of developers resulted in government's getting locked into deals with developers who had insufficient experience or more commonly insufficient financial resources to deliver on their investment obligations. |

## Question 5: What is the best institutional regime for the SEZ program?

*Overview*

A strong SEZ governance plan will create the framework for policies and procedures that will guide the SEZ's management and establish the required authority for decisions. The special characteristics of an SEZ require that its governance framework: i) assign key functions to the appropriate institutional stakeholder; and ii) define the optimal model for the development of infrastructure and facilities and for the provision of services. These roles may be divided or shared among institutions in the public or private sectors.

**The three principal SEZ governance roles:**

- **Regulator:** Generally a government body with oversight authority, it ensures the regulatory environment is more streamlined and efficient than the national one.
- **Developer:** In best-practice scenarios, a private sector entity charged with designing, planning and managing the development of infrastructure and facilities within the SEZ.
- **Operator and Service Providers:** Specialized entities that manage the day-to-day provision of services to site investors, tenants, and resident labor. As the scale of an SEZ project expands, the depth and variety of services that must be provided expands with it.

The responsibility for designating SEZs, including their establishment from a legal perspective, is a public sector role. However, best practice demonstrates that applications for designation of zones should be a joint public-private endeavour, where the private developer first demonstrates the business case for and financial viability of a zone, and the public sector then assures itself, through rigorous studies, of the socio-economic benefits of the proposed project. Left unchecked, the incentives of each of these two parties (profits on the one hand, and politics on the other) almost invariably lead them to neglect the other's key concerns. The result is poor public policy in the form of either unsustainable 'white elephant' zones or profitable zones that fail to deliver positive socio-economic results. It is thus critical that the incentives for the public and private sectors be balanced. International experience shows that it is vitally important for the government to recognize that appropriate private sector projects should be allowed to apply and be considered for SEZ designation –which would encourage private sector-led development and growth in the country, and ensure that a maximum amount of risk associated with SEZ development and operation is borne by the private sector.

**Designation Practices Enabling Private Sector SEZs:**

- Letting the private sector take the initiative, rather than giving government the leeway to designate unprofitable zones.
- Making sure that the designation application process is not so cumbersome, unclear, or open to abusive administrative discretion to deter the private sector from applying for designation of their projects.
- Requiring that all SEZs – whether publicly or privately promoted – be able to demonstrate a return on investment derived from their on-rental income stream, taking into account market-based (or at least 'equal footing') costing of land, infrastructure, and capital.

Once SEZs have been designated, *Public-Private Partnerships (PPPs)* and joint steering committees (or *SEZ Boards*) are some of the mechanisms governments can use to ensure success in SEZ development and operations. Indeed, cooperation of public and private efforts has become the preferred institutional model for running successful industrial park programs. International experience shows that the private sector brings a level of credibility and a network of potential investors to locate in an industrial park, and their parks tend to command higher prices from end-users and attract higher value-added activities. The overarching goal is for the public sector to support industrial park development *only as much as necessary* so that private sector developers and operators are able to take the lead. Thus, in a public-private arrangement, the typical roles and responsibilities are as follows:

- **Government**: strategy and policy formulation; regulation and enforcement; coordinating the roles of various government bodies; and provision of key public goods the private sector cannot or should not provide.
- **Private sector**: development and operation of the project itself, including master planning, construction, management, and promotion.

**SEZ Policy Primer #5: Public or private SEZs?**

Up until the 1980s, almost all SEZs were built and managed by government. This changed significantly during the 1980s, with the emergence of private sector industrial parks, particularly throughout Latin America – most notably in Dominican Republic, Costa Rica, El Salvador, Honduras, Nicaragua, Guatemala, and Colombia. This model expanded in the 1990s, with countries like Turkey, Thailand, the Philippines, and Vietnam launching private zones. According to FIAS[11], while private zones represented only 25 percent of the world's total in the 1980s, by 2006–2007 they accounted for 62 percent of the vastly expanded population of zones.

While private sector developed and managed zones are becoming the norm, some of biggest SEZ success stories remain government or SOE run, including China, Singapore, the UAE, and Malaysia. And so the debate remains as to which approach is ideal. On the one hand, that government has the more strategic, long term approach that is needed for an instrument like SEZs, and can better link zones with industrial policy objectives. On the other hand, it is argued that private sector is more aligned with commercial realities, is a better manager, and can develop for the long-term precisely because they are not required to balance short-term political objectives. Moreover, at the very least, private investment reduces government exposure in what can be highly risky projects. A recent World Bank study (Farole, 2011) found no evidence that privately run SEZs were either more or less likely to be successful. Indeed, both public and private SEZs have had success in Asia; and neither model has been terribly effective in Africa. What seems to matter most is capacity to deliver – whether by the government or the private sector – something largely predicated on corporate-style management.

Recently, innovative public-private partnership (PPP) mechanisms have blurred the line between the strictly public and private. Such PPPs operate in one of three main forms: i) *service contracts*, where management of the zone is contracted to a specialist firm, while government maintains ownership; ii) *concessions and BOTs*, where government still owns the zone, but capital investment and operation are private; and iii) *full private ownership*, where government remains a partner for the provision of some infrastructure or services.

A number of considerations influence which model is likely to be effective, including: i) capacity of government to establish, fund and manage an SEZ program and individual projects; ii) economic objectives given to the SEZ program; iii) commercial viability of the specific SEZ project(s) envisaged; and, iv) presence of domestic or international commercial entities interested in participating into the program and projects. In principle, the respective roles of government and commercial entities are determined by the interaction of economic and financial returns to be expected from SEZ projects:

- *The higher the net economic benefits for the country (in terms of expected investment, economic value add, job creation, foreign exchange earnings, and demonstration effect), the greater government's role should be*. These net economic benefits will be formally measured through a cost-benefit analysis measuring the project's expected economic rate of return (ERR) via a discounted cash flow projection during the feasibility cycle. This analysis subtracts all economic costs (incurred and opportunity) from all economic benefits, and applies an appropriate discount rate.
- *The higher the net financial benefits for the zone owner/operator (in terms of expected revenues from the sale or lease of serviced land and/or buildings, the provision of services to users, and other revenues), the lower government's role should be*. These net financial benefits will be measured through a financial analysis measuring the project's expected internal rate of return (IRR) via a discounted cash flow projection. It will subtract all financial costs (land acquisition, construction, operating costs, marketing, etc.) from the expected revenues over the project's planned lifetime.

In reality, limits to capacity will have a crucial impact on government's ability to act as a developmental catalyst to projects. The least commercially viable zone projects tend to be in countries with the least governmental capacity. In such situations government will need to rely extensively on external technical and financial assistance to launch the program and support the development of one or several zone projects.

But PPP is not a panacea and is not always the most appropriate approach. PPPs popular in SEZs these days because, amongst other things, they save government resources, can produce higher returns on investment, and help prevent private sector crowding-out. But what if a country's proposed SEZs are truly developmental projects, require very high investments in terms of public goods, are expected to yield a marginal internal rate of return but a high social/economic rate of return, or will take a long time to yield a return on investment? What if the framework for establishing PPPs is developed well enough to ensure an efficient, fair, and transparent process so that the best bid emerges within a reasonable timeframe? What if a country is bringing an SEZ project to market in the context of an economic downturn?

Design and construction of SEZs requires considerable coordination between off-site (typically public) infrastructure and on-site (typically private developer) build out of the zone, in order to ensure their seamless and timely integration. Any significant time gaps, discrepancies or lags between them will result in overruns and credibility issues during SEZ development, and set the zone on the wrong foot from an investment attraction standpoint. As a result, another important governance tool for resolving offsite/onsite and other private-public coordination challenges is the institution of dedicated governmental steering committees or SEZ Boards to help oversee the development of the project, with at least some form of private sector representation (usually by the developer and/or tenants). SEZ Boards typically take on such functions as approval of the park's land-use plan, coordination of its off-site utility service delivery with existing utility providers, obtaining their commitment to supply unmet park utility requirements. To further enhance the attractiveness of the zone to a private partner, the SEZ Board can also engage in a number of other zone-enhancement activities. The goal of these activities is to shift resource/risk allocation from the private sector, to improve the terms and conditions of the transaction, and most of all, to increase the likelihood of long-term project success to the benefit of all parties.

Quite apart from issues of SEZ management, various practices must be in place for zones to deliver a world class investment and operating environment from a *regulatory* standpoint. While the management and operation can be undertaken by either a public or a private entity, or even a special purpose PPP vehicle, regulation an essentially public sector role. From an institutional perspective, *international experience suggests that the SEZ regime be regulated by an autonomous, powerful government authority*. This is for instance the approach which was taken by such successful zones regimes as those administered under **Jordan's ASEZA** or the **Dubai's JAFZA**. But such an approach should not be implemented without considering the merits of other potential approaches, given a country's specific circumstances.

The question should thus systematically be asked by every country reflecting upon SEZ institutional arrangements: *What can new institutions do for a country's SEZ program?* Many countries are reluctant to create entirely new institutions for regulating SEZs, arguing that existing institutions can handle the task. The reality, however, is that even with existing institutions, building capacity to handle the new tasks of regulating an SEZ regime will take considerable time and resources. The argument for establishing new institutions is a strong one. In addition to being able to operate from a new and especially relevant mandate, systems and procedures, new institutions can provide a new set of skills, as well as a new culture of performance, transparency, independence and energy. *New institutions represent the unique opportunity for a 'fresh start,' provided they are properly designed.*

Another, related, question that must be asked is the following one: *Should a country establish a SEZ-specific or an overarching SEZ Authority?* This very much depends on how it arrived at the decision to consider one or more SEZ opportunities and their specifics. There are countries that begin to look at the SEZ question from the perspective of 'finding a way to boost economic returns' from the countries' assets in general and others that come to the SEZ question from the perspective of *maximizing the returns of a single or limited set of particularly attractive asset(s)*. Although the first route is becoming increasingly prevalent, historically, the latter route was the more common of the two – examples include: **Ireland (Shannon Airport), the UK (Channel Islands), China (Shenzhen), the UAE (Djebel Ali), the Philippines (with the Subic Bay Naval Base and Clark Airforce Base), Jordan (Port of Aqaba), South Africa (Coega Port), Tunisia (Port of Bizerte), Panama (with the Panama Canal Port of Colón, Howard Airforce Base, Kobe Naval Base, and Fort Clayton), Egypt (Port of Ain-Sukhna), and Morocco (Port of Tangiers)**.

It is sometimes argued that if a country wishes to put in place multiple SEZs or move from the initial position of being a single-zone country to a multiple-zone country, then it should have a single SEZ Authority, responsible for regulating all of the country's zones. The arguments for taking this approach revolve around leveraging existing expertise and avoiding the potential competition and confusion that can (and indeed sometimes does) result from having multiple zones authorities (and thus regimes) to choose from. This argument has merit, although it should not be taken as universally-applicable best practice.

Zones can be sufficiently economically differentiated, far apart, financially well-endowed or in some other way unique as to make SEZ-specific authorities appropriate. Indeed, there are numerous examples of effective SEZ-specific authorities operating within multiple zone regimes, including in such geographically distant locations as China, Jordan and Panama. Experience suggests, however, that this approach has been more effective in middle and upper income than in low income countries.

Finally, there is the question of institutional complexity. A single, overarching zones authority is a deceptively complicated system. Whereas a single-zone authority is necessarily a 'one-stop-shop', almost invariably located on-site at the zone, a well-functioning overarching authority requires multiple layers of management, with functions divided between the central and zone-specific levels. As multiple layers involve more human and financial resources to administer, some countries opt to forgo the zone-specific layer of administration. Amongst other implications, one consequence of such a decision is that the zones' regulatory one-stop-shop is not on-site and thus is less convenient for investors to access, knows its investor less well, and feels less ownership over any given zone's success. Thus, while a single authority may be more efficient from a resource perspective, it runs the risk of being less effective. Indeed, *both institutional options on offer, whether the single-authority or overarching-authority, require significant investments of resources to be effective* **–** the issue is seldom one of having too many regulatory authorities, and rather more likely one of having too many zones.

_Case Examples_

Table 6 provides some examples of good and bad practice in relation to design of the institutional regime for regulating SEZs.

**Table 6: Case examples – good and bad practice in SEZ institutional regimes**

| **Good practices** | |
|---|---|
| **A tailor-made institutional regulatory regime in Aqaba, Jordan** | Once the decision had been made by King Abdullah to proceed with the 375km$^2$ Aqaba SEZ project, a series of feasibility studies were commissioned, including on the potential legal, regulatory and institutional frameworks for the zone. Amongst other subjects, these studies involved detailed, multi-volume organizational audits of existing Government bodies (including Aqaba International Industrial Estates, Aqaba Port, Aqaba Municipality, and Aqaba Governorate), with view to determining their strengths and weaknesses, cultures of rent-seeking, and overall administrative capacity. All of this was done with a clear view to finding a route to merging these various bodies into a single, overarching authority. Such an authority, reporting directly to the Prime Minister's office and run by 6 Commissioners wielding Ministerial powers for increased effectiveness, was ultimately established in 2001, and named the Aqaban SEZ Authority or 'ASEZA.'<br><br>In designing ASEZA, and in determining what it should be responsible for and how it should go about its operations, the Government of Jordan conducted an exhaustive analysis of every interface between Government and the private sector, and of considering in which part of Government they should be vested –if any. As a result, certain regulatory functions were fundamentally reengineered, while others were eliminated altogether. Partnerships were then structured with the Jordan Investment Board and Jordan Tourism Board, to ensure coordinated and collaborative investment marketing. Moreover, donor capacity-building programs were embarked upon which lasted several years, in order to strengthen ASEZA's delivery capability.<br><br>While institutional conflicts were not completely avoided (for example, problems over authority of Customs arose in the early years of the project), Jordan's ambition to create a 'true one-stop-shop' in Aqaba, beginning with a frank and thorough assessment of the situation on the ground, recognition that what was required was whatever was best for |

| | |
|---|---|
| | the economy, allowing bad institutions to fall, establishing the necessary regulatory and procedural instruments for success, and enabling the SEZ Authority through adequate budgetary capacity, stand out as exemplary SEZ institutional design and implementation practices. The results of these combined efforts, in ASEZA's first three years, included US$450M in investment, 310 land sale/lease agreements, an 800% cumulative increase in licensed construction, a 63% increase in employment, and Government revenue increases of 835% for sales tax and of 430% for income tax. |
| **Intelligent and Effective Institutional Compromise – Panama-Pacifico's AAEEPP** | After the full reversion of the Panama Canal Zone by the US military in 1999, Panama was left with considerable military base infrastructure assets which it was determined to leverage for maximum economic impact. One such asset was the Howard USAF Base, directly across the Canal from Panama City. The 'Autoridád Regional Interoceánica' (ARI), the time-bound government body set up to convert these assets into productive economic ones within 5 years (i.e., by 2004) immediately saw the potential to turn Howard into a multimodal logistics hub. A specially-tailored SEZ legal and institutional regime, for instance dealing with unique aviation-related regulatory and institutional issues, was developed to enable this vision.<br><br>While the design and development of the SEZ's institutional regime and transitional regulatory powers, were originally vested in ARI, it was from the onset clear that regulatory powers over the zone would be transferred rapidly to a new, SEZ-specific authority, the planned 'Autoridád del Area Económica Especíal Panamá Pacífico' (AAEEPP) –later renamed the 'Agencia Panamá Pacífico' (APP). The fact that ARI's mandate had a built-in 'sunset clause' was instrumental in avoiding inter-agency problems in this regard.<br><br>ARI's bold willingness to engage with the political opposition parties, labor unions, as well as ministries who stood to lose powers through the SEZ's institutional arrangements, not to mention the local Municipality of Arraiján (which stood to lose municipal tax revenues), including through strategic use of the media, was another ingredient in successfully securing the required support for APP. Finally, in a considered concession to operational realities, when it became evident that an Aqaba-style 'true one-stop-shop' would not prove politically feasible in the country, the focus of the regime designers shifted to amending the enabling legislation and reengineering the procedures that each competent ministry would apply within the SEZ, under the overall administrative and financial coordination of the APP. An effective 'hybrid model' SEZ one-stop-shop was the result. |
| **<u>Mistakes</u>** | |
| **Failing to address conflicts of interest between public and private operators** | In Lesotho, where the public developer of industrial parks also acts as the promoter, regulator and administrator of the licensing regime, provision of land and factory shells and below-market rates has undermined private sector provision of industrial facilities, resulting in an acute shortage of space and acting as a major barrier to entry of new FDI.<br><br>In Bangladesh, the same authority is responsible for zone development, management, and regulation. Despite, passing a law allowing for the provision of private zones, the first privately zone project languished for 8 years awaiting approval for its operating license. |
| **Creating confusion and inefficiency with multiple, competing SEZ regulatory authorities** | Vietnam has embraced special economic zones, creating an estimated 223 industrial and Export Processing Zones, 13 Coastal Economic Zones, 26 Bordergate Economic Zones, two High-Tech Zones and 600 small-and-medium-enterprise industrial parks since 1991. Vietnam's wide range of zone types is however governed by a complex regulatory structure that crosses a number of national ministries and agencies and includes significant roles for subnational entities.<br><br>At the highest level, the Ministry of Planning and Investment (MPI) is responsible for Export Processing Zones, Industrial Zones, and (Coastal) Economic Zones; the Ministry of Trade has primary jurisdiction over Bordergate Economic Zones; the Ministry of Science |

over High-Tech Zones; and the Ministry of Agriculture over High-Tech Agriculture Zones. In addition, the SME industrial parks / clusters are regulated at the provincial level and do not report in to any ministry. Export Processing Zones were defined at Law as being 'governed under central authority,' yet the MPI is responsible for preparing master plans in consultation with provincial People's Committees and are administered by individual EPZ Management Committees, while industrial zones are administered by Industrial Zone Management Boards. While a 2008 law aimed to simplify the network by creating single, provincial management committees for all types of SEZs, multiple exceptions were made and new complexities introduced.

In the case of Vietnam competition across government Ministries, combined with a tendency to 'decentralize the details,' contributed to unnecessary complexity. Although this decentralization was effective in some respects (creating healthy competition amongst provinces), it also contributed to a proliferation of zones models. The regulatory differences between each are often small; the important difference being who controls them (the Prime Minister directly, various Ministries, provinces, etc.). This has led to a complex array of choice (and scope for bargaining) for investors, resulting in a politicized process, with many inefficient investments getting approval.

## Question 6: How do we coordinate within government to deliver the SEZ program?

*Overview*

Given the reality that few governments ultimately establish a powerful and autonomous SEZ Authority, *effective coordination across the many ministries, departments and agencies that contribute to delivering on an SEZ is of critical importance*. More often than not effective coordination is lacking – and this is one of leading causes of SEZ failure. It is thus critical to address this coordination challenge up-front with the right institutional set up.

The best alternative to setting up a strong, autonomous SEZ agency, is probably a 'one-stop-shop'. An effective one-stop can ensure timely and efficient approvals for initial setup and ongoing operations within the SEZ, eliminating arbitrary administrative barriers and excessive paperwork, and providing timely review, feedback and approval of applications. In practice, however, many one-stop-shops serve as marketing tools more often than as fully functioning investment processing centers, and few establish the necessary procedures and decision-making authority required for such the institution to work. Indeed, often they are simply 'one more stop' for the investor.

Establishing an effective one-stop-shop requires making difficult political agreements, as ultimately it requires some ministries, department, and agencies to give up some power (or at least it will be perceived that way). As a result, *it is a common mistake to opt immediately for the easiest solutions in order to minimize political battles*. Below is a list of several of the models of one-stop-shops worth considering, outlining their approach as well as benefits and drawbacks:

- **The one-stop-shop with delegated powers**: Responding to the inevitable political obstacles facing the true one-stop-shop, some countries, such as **Indonesia**, have adopted an alternative approach. Short of providing legal powers to the investment centers, governments require various government authorities to delegate approval powers to investment centers. Agencies are thereby not required to transfer legal approval powers; instead, the relevant agency merely delegates approval power and can reclaim the authority as appropriate. With certain exceptions (such as **Senegal's APIX**), the delegation approach has a low success rate, working only when applied to relatively minor approvals. However, combined with other one-stop-shop model elements in a hybrid fashion, it represents a powerful idea.

- **The account executive one-stop investor facilitation model**: Many private and public sector organizations, investment authorities, and investment promotion agencies utilize an account executive approach –with relatively high degrees of success[12]. In terms of investor facilitation, the account executive model enables existing agencies to maintain significant authority, while aggressively simplifying procedures to create rapid turn-around times. Under this model, investment officials assign an account executive to each investor, giving them a single point of contact with the agency. The account executive works with the investor to complete all business compliance procedures with the government. For instance, the account executive will organize meetings with all relevant agencies, will collect all relevant forms and assist the investor in completing them, will explain all procedural issues, and resolve any problems. The account executive model has the obvious advantage of providing a one-stop center for information and investor support, without generating the high degrees of inter-institutional distrust or organizational problems common in other models. Nonetheless, the model requires certain conditions based on inter-agency cooperation, as approvals still take place in a number of different agencies.
- **The shortened circuit one-stop-shop[13]:** Under this model, relevant authorities are located in a single office, allowing the investor to make a single stop to meet all necessary authorities, while the various agencies coordinate permits and approvals behind the scenes. When this model works and is properly managed by a coordinating agency with sanctioning powers over the others[14], it offers a shortened bureaucratic circuit. However, the model has weaknesses in practice. First, many countries do not have sufficient enough investment to justify agency representatives seconded to a central agency. These representatives frequently have too little work, and government agencies are thereby loathe to send senior officials to the one-stop-shop, opting instead to send junior staff, However, the junior staff typically lack the authority to issue approvals, requiring requests to be dispatched back to the relevant agency, thereby creating an additional procedural step rather than eliminating one. Second, this model usually lacks a system for direct supervision of assigned representatives. As such, those seconded to the one-stop-shop often lose power and influence in their home office, which contributes to low morale and low productivity. While largely unsuccessful in practice, the shortened circuit one-stop-shop model remains attractive to policymakers, because it often appears the easiest remedy to agency turf battles, as agencies maintain the majority of their existing authority. But since agents seconded to the one-stop-shop have little real power, the result is often simply a showcase of bureaucrats.
- **The coordinated model**: Under this model, agencies attempt to coordinate their decisions, typically through a board or committee, thereby decreasing the steps the investor must complete. However, while committee structures limit the number of steps the investor must complete, they do not decrease the number of steps that the dossier must take to complete the process. While the process appears simpler to the investor; it is not necessarily quicker or more efficient.[15]

Another tried and tested international practice for improving inter-agency coordination is the use of *Inter-Agency Memoranda of Understanding (MoUs)* in order to specify the relative tasks and performance standards of the industrial park regulator and other bodies. These coordinating agreements must be established with a wide range of other Government bodies. Even if the existing public agencies have a reputation for poor service, the regulator can work with them to improve performance standards. MoUs are less flexible than regulations to reengineer processes across various authorities and Ministries. A MoU is typically used in SEZ governance, in order to define each party's roles and responsibilities, as well as areas where on-going liaison and cooperation are required and describe how this is to occur. That being said, it is may also be used to agree that one (or both) of the parties will actually change its (their) regulations or procedures in the interest of the SEZ. One should not overload a nascent SEZ regulator with too many functions. However, even if the existing public agencies have a reputation for poor service, the SEZ regulator can work with them to improve performance standards.

Under international best practices, MoUs would typically include the following elements:

- Respective roles and responsibilities of the signatory authorities/ministries;
- Agreed new procedures, including:
  - Decision-making rules;
  - Registrations, record-keeping, notifications, audits;
  - Forms;
  - Process calendars ;
  - Rights of regulated parties to amend submissions and appeal decisions;
  - Service fees and fines; and
  - Electronic means of implementation;
- Associated staffing and training of staff, including ‘contact officers’;
- Consultation prior to legislative, regulatory or procedural changes;
- Reciprocal recognition of licenses, certificates, permits, and approvals;
- Amicable resolution of disputes in MoU application, failing which binding Cabinet decisions taken;
- Mutual periodic consultations on MoU implementation, and monitoring and evaluation;
- Commitment to abide by provisions of MoU;
- MoU revision procedure; and
- Transitional provisions (Timing of transfer of functions, staff, equipment; implementation calendar; etc.)

Whichever model is selected, the following conditions facilitate a successful one-stop-shop:

- High-level political support
- Efforts to improve procedures within each relevant agency –in this regard, one can look to Chinese reforms to see an example of successfully married process reengineering and automation of business compliance burdens, resulting in significant reductions in administrative processing times. A good example of simplified SEZ business registration and incentives administration may be found in the ‘Digital Beijing Initiative’ of the **Zhongguancun e-Park in Beijing**, **China**
- Dispute resolution mechanism
- Establishment of a facilitation network
- Staff with appropriate authority and capacity to execute functions, and account executives must have the authority to represent the investor in processes
- Management powers over the various represented ministries vested in the SEZ agency
- Designation and training of account executives in standard operating procedures

Another mistake to avoid in SEZ Authority design stems from the temptation to overcrowd and thus confuse the Authority’s mandate, for reasons sometimes defended as stemming from a desire for ‘administrative efficiency’:

**SEZ Policy Primer #6: Stand-alone SEZ Authority or combined with Investment Promotion Authority?**

In some countries – for example Ireland, Sri Lanka, and Uganda among others – the Investment Promotion Agency (IPA) acts as the authority responsible for managing the SEZ program. In very small countries and where virtually all FDI enters through the SEZ regime, this certainly is sensible. However, in most countries, a separate authority is established for marketing and promotion, investor aftercare, and regulatory oversight of the SEZs, while a separate national IPA performs these roles for FDI outside the zones. The argument for this approach is that IPAs should be free to focus on promoting and supporting investment on a national basis, while the specific, independent nature of the zone regime requires a specialized regulator and promoter.

Furthermore, there is ample experience to show that the culture of these two types of institutions is quite different and potentially incompatible. As a regulator, an SEZ Authority is called upon to exercise at least some monitoring and sanctioning (e.g., 'command and control') functions over SEZ developers and tenants, in order to protect the market as well as the public purpose. IPAs on the other hand must be 100% committed to investor and business advocacy and facilitation. As soon as they become 'regulators', the relationship may be at risk. A second issue preventing a happy merger of these two roles relates to capacity and skills. The primary skill set developed by IPA officers is one of marketing and public relations; not one of economic regulation. As a result, IPA officers seldom possess a sufficient understanding of laws, regulations or their underlying technical issues to make properly informed administrative decisions. They are for instance often more concerned with meeting time benchmarks than with protecting the public purpose or with building inter-agency consensus. As a result of these differences in culture and skills, there are few examples of IPAs making good SEZAs or SEZAs making good IPAs.

On the other hand, this separation between the IPA and the SEZA is often a source of operational disconnect between the agencies, resulting in poor coordination, particularly in marketing, planning, and aftercare. Worse, it can be the cause of institutional rivalry and conflict, as the two agencies compete rather than cooperate to attract investment.

One solution adopted by some countries is to have reciprocal representation of these two institutions on each other's Boards. A second is to have a coordinating committee. A third is to have both institutions roll up to the same Ministerial or Executive Office (which can be the Prime Minister's or the President's). A fourth is to make sure all investment attraction (as opposed to regulatory) functions for both SEZs and for the nation as a whole are squarely vested in the IPA. Yet another option[16] would be to have the same CEO placed in charge of the two organizations –without either of them however losing their institutional identity. Whichever solution is adopted, countries should thus avoid falling into the 'logic' of seeing the functions of SEZAs and IPAs as somehow identical or redundant.

### Question 7: How do we ensure our SEZ program integrates with the local economy?

*Overview*

SEZs have long been criticized as 'enclaves' that operate independently from the national economy. Operating outside the regulatory environment and operating constraints of the domestic economy is fundamental to the design and appeal of SEZs. But it is also an inherent weakness, as it limits multipliers, dampens the prospects of spillovers of technology and knowledge, and prevents FDI from becoming embedded. This impacts the sustainability of SEZs by limiting upgrading possibilities and increasing the likelihood of investors operating on a footloose basis.

There are of course, many initiatives that can be taken to facilitate improved linkages. Moreover, the main barriers to linkages in most countries relate to weaknesses in the scope and quality of goods and services provided by domestic firms. So there are many policy interventions that can support improved supply side competitiveness. But it also the case that important strategic and policy decisions taken in the early stages of SEZ program design can impact significantly on the possibility of establishing linkages. These include:

- **Strategic / sectoral focus**: While SEZs based on light manufacturing (textiles, footwear, electronics) tend to have limited local supply links due to global sourcing and production strategies, sectors like agribusiness, services, and food processing make substantially greater use of local inputs.
- **Trade policy***:* Linked to the above, attracting investment is sometimes linked expressly to the fact that investors can make use of preferential trade agreements that enable them to avoid sourcing from local markets (e.g. apparel third country fabric derogations[17]). More broadly, if the SEZ regime

offers access to imported inputs on a duty-free basis but accessing supplies is not VAT free (or more of a hassle) there is an inbuilt bias away from local linkages.

- **Nature of zones – e.g. SEZ v EPZ**: Traditional EPZs tend to have much lower levels of linkages than larger, more open and flexible SEZ regimes. This is partly because EPZs are fenced-in enclaves, but more importantly because of specific policies with respect to local market links (see below).
- **Policies on domestic participation**: Countries typically establish SEZs to attract FDI and are conscious to avoid having already-established local firms simply switch into the SEZ regime (especially if there are big fiscal incentives on offer), as a result, zone regimes often make it difficult for domestic firms to establish in the SEZs. But such proximity can be critical to establishing supply relationships. So this balance needs to be considered from the start.
- **Policies on access to local market**: Similarly, generous incentives given to SEZ based investors create an unlevel playing field against domestic firms in the same sector. As a result, most countries attempt to protect these domestic firms from unfair competition from SEZ firms by restricting SEZ firms from selling in the domestic market. But this creates yet another barrier to integration and restricts important opportunities for the local economy to benefit from spillovers.

An important point here is that all of the above issues are legitimate and need to be taken into consideration when planning SEZs. It is certainly not the case that countries should focus on agriprocessing, for example, just because linkages may be higher. Nor does it mean that countries should avoid taking advantage of trade preferences or of trying to maintain a level playing field for domestic firms. What it does mean is that policymakers should be aware of the trade-offs and that reasonable expectations should be set of what level of linkages is realistic given the strategic choices that are made.

*Case examples*

Table 7 provides some examples of good and bad practice in relation to policies and operational practices that impact the ability of SEZs to link with local economies.

**Table 7: Case examples – good and bad practice in promoting linkages between SEZs and the local economy**

| Good practices | |
|---|---|
| **Opening up zone access to non-traditional (service) activities in Honduras** | Honduras was a pioneer among Central American EPZs in opening up their program to service suppliers, enabling the development of a domestic support industry and raising significantly the share of inputs acquired locally |
| **Co-location of FDI and domestic firms in Ghana** | In Ghana's main SEZ (Tema), government set aside 70 hectares as a 'Multi-Purpose Industrial Park' open to non-exporting domestic firms (without full SEZ status and benefits), to help integrated domestic firms into the supply networks of large exporters |
| **Active promotion of supply linkages in Costa Rica** | Costa Rica's *Supplier Development Project for High-Technology Multinational Companies, a program* was established in 1999 to enhance domestic value added in high-technology MNCs' production and improve domestic SMEs' competitiveness. This project had three key components: Pilot Procurement Program; Comprehensive Information System; and the creation of a domestic supplier development office ('Costa Rica *Provee*'.) Costa Rica *Provee* engages in detecting the needs of multinationals, identifying business opportunities, and recommending registered suppliers who meet the production, technical, and quality specifications. Support provided by Provee includes: i) *Technical Support:* This focuses on analyzing goods to be offered to multinational companies. This task is undertaken by *Provee's* staff, made up of professionals with relevant experience in business development, engineering, industrial chemistry, and business management; and ii) *Diagnosis*: Costa Rica *Provee* applies evaluation tools aiming at ensuring long-term business relationships, |

| | |
|---|---|
| | including comprehensive diagnostics in finance, production, marketing, business management, and environmental and quality systems, among others.<br><br>Between the 2001 and 2006, the number of backward linkages (business transactions) registered by Costa Rica Provee increased from 1 to nearly 140 (from US$0.8m to US$3.m). In the medium term, Costa Rica Provee expects that at least 25% of MNCs' goods and services needs would be supplied by domestic companies. |
| **Mistakes** | |
| **Structural and trade policy constraints to zone integration** | Lesotho's FDI attraction strategy focused on the apparel sector. But: 1) the country had no existing domestic base of subcontractors or suppliers in the sector; and 2) its proposition to attract FDI into their 'SEZ' program[18] was heavily predicated on trade policy provisions that allowed for relaxed rules of origin, enabling investors to source fabric from outside the region. In this context, it is hardly a surprise that no domestic supply links have been established in the country |
| **Restrictive fiscal policies** | At one point, SEZ-based firms in Honduras were required to pay a 12 percent VAT on all purchases from the local market but could access those same goods from international suppliers on a tax- and duty-free basis, creating a major disincentive to use local suppliers. This policy was later corrected. |

**SEZ Policy Primer #7: Are weak linkages between domestic suppliers and foreign investors an SEZ issue?**

Achieving linkages between foreign investors in SEZs and suppliers in the domestic economy has long been a major challenge in zone programs worldwide, particularly those in low-skill, labor-intensive, footloose sectors such as apparel. Empricial evaulations of SEZ programs support this[19], showing that the contribution of local intermediate inputs to SEZ firms has been limited, leaving employment as the only significant benefit of SEZ investments to their host economies.

In considering policies to promote deeper linkages, it is important to understand first what aspects of the challenge are related to SEZs as an instrument and what aspects are related to factors that may be correlated with the presence of SEZs, such as the nature of sectors, of trade policy, and of supply side characteristics. In the case of linkages, all three of these play an important role.

With regard to the first and second factor, the majority of investment in SEZs in low income countries remains in traditional labor intensive sectors like textiles & apparel, and much of this investment is driven by the trade preferences afforded through regional trade agreements or trade programs like AGOA (US) and EBA (EU). In the case of apparel, many of these preferential trade agreements create an inbuilt bias against using local supply, as the key provision of these agreements is the ability of exporters to access inputs from outside the region and maintain the preferential rates.

Another important sectoral dynamic – not only for apparel but other sectors that operate through global production network models, including electronics, automotive, and services – is the fact that sourcing decisions are typically dictated not by local plants but by head offices or directly by the buyers (global brands or retailers). Recent research on SEZs in seven countries[20] found, for example, that the use of inputs from the domestic economy was twice as high for SEZ firms in the food and beverages sectors than for those in apparel.

With regard to supply side characteristics, several issues that have little to do with SEZs hinder the development of local supply linkages. One obvious issue in many low income countries is the lack of scale of domestic production. Small market size also impacts the scope of goods and services available in the local economy. Indeed, most surveys of foreign investors point to the lack of existing local suppliers as the single biggest barrier to local sourcing. Finally, local producers often fail to meet required international standards, or are unable to provide the quality, price, and reliability required by international investors.

In summary, the challenge of FDI-local economy linkages is a global one, and one that has strong links to global value chain strategies. This type of investment tends to cluster in SEZs. Yet, as discussed in this section there are facets of the SEZ environment that may make local supply linkages even more difficult to achieve – these are both policy and administrative in nature. From a policy perspective, the trade policy disincentive to local sourcing (discussed above) is aggravated further by the incentive structure of the SEZs, which allow firms to access imports duty free, removing a potentially important source of competitive advantage for local suppliers. This is compounded in some cases by lack of a corresponding tax benefit for local purchases.

On the positive side, SEZs are often ideal places to establish formal linkage programs, for several reasons. First, they receive a wide set of special incentives and so obligating them to promote linkages actively can be reasonably expected in return. Second, they tend to have a close relationship with the investment promotion agency, which often takes the lead in running linkage programs. Third, because investors (many from the same sector) are clustered geographically, it is possible to take advantage of scale, making spillovers more likely. Finally, for these same reasons, the demonstration effects of spillovers can be more visible.

### Question 8: How do we ensure compliance and sustainability?

*Overview*

Among the most common criticisms of traditional SEZ programs is that they fail to meet social and sustainability criteria on labor and environmental grounds. There is certainly some validity to these concerns. It is also true that activities of often large foreign investors in SEZs are inherently more visible than those of the thousands of small, domestic firms operating outside the SEZ walls. Thus, SEZs attract considerably more attention. It is critical for governments considering SEZ programs to ensure they are governed properly, and that in seeking competitive advantage in attracting investment they do not sacrifice protection of workers and the environment.

Like many of the issues discussed in this *SEZ Policy Guide*, addressing compliance and sustainability involves decisions made early on in the process, particularly with the regard to the broad strategy and form of the SEZs. How can SEZ programs be forward-thinking in this regard? In the early planning stages, government can think of using SEZs as pilots to establish more sustainable practices – environmental, labor, or social. Indeed, SEZs offer an ideal environment for such policy experimentation, not only because of their enclave nature, but because they have built-in incentive and compliance mechanisms that are more difficult to enforce outside of zones (e.g. the ability to issue licenses, to monitor firms within a short timeframe and no a regular basis, and to revoke a license, terminate a lease, or impound a container). This creates an ideal context for testing innovative approaches.

Beyond this, and later in the process, the starting point for compliance is to ensure that international standards are met – for example, ensuring ILO compliance in all labor regulations. In most SEZs these days, however, this is no longer an issue. What is more important regarding labor, is to balance the rights of workers (with respect to issues like hours, working conditions, sick and maternity leave, etc) with the strategic needs of investors. This goes back to Question #1 and making sure the zone policies and strategies are in line with national objectives. The labor regime adopted for an SEZ program targeted at assembly manufacturing activity clearly needs to differ from a program targeting knowledge-intensive services.

Most importantly, governments must pay attention to governance, and ensure that whether a public or a private operator runs the zone, the regulatory responsibility of the SEZ authority is taken seriously, and rigorous monitoring *and* enforcement are established. Indeed, it is the gap between the *de jure* and *de facto* situations – and specifically, enforcement – that is most commonly the culprit in zones that fail to protect workers and the environment.

*Case examples*

- **Bangladesh Labor Counselor Program**: Bangladesh is one of the few countries where the EPZ regime still restricts the formation of trade unions. Given barriers to changing this legal restriction, the zone regulator (BEPZA) attempted to find a solution through the establishment of a program of Labor Counselors. Established in 2005, 67 counselors were recruited to work with employees and management to address issues related to wages, working conditions, food, child care, benefits, and security. These counselors worked on behalf of BEPZA but were perceived more as facilitators than as regulators or enforcers. The young recruits paid almost daily visits to their designated factories to work with management on the correct application of labor and compensation regulations, and acted as informal arbitrators between management and workers to resolve grievances. They reported existing and potential issues to BEPZA. According to an assessment by the IFC improved implementation of *existing* rules facilitated by these counselors resulted in a 32 percent increase in wages for the workers in the EPZs. As evidence of this improved relationship, in the Dhaka EPZ, grievances declined from 2,000 in 2007 to only 400 in 2009.
- **Lesotho ALAFA program**: Lesotho has also made substantial efforts to improve its labor situation through training, better relations with unions, and support for programs such as ALAFA**,** a nonprofit coalition of companies that provides education and treatment for Basotho garment workers, more than 40 percent of whom are estimated to be afflicted with HIV. The industry-wide program provides education and prevention, voluntary testing and counseling, and management through the roll-out of care and treatment for HIV-positive workers. Since 2009, the service has been extended to spouses of workers. Lesotho has used programs such as ALAFA to reposition itself as a location for sourcing high-quality clothing manufactured under ethical conditions.

**SEZ Policy Primer #8: Monitoring & Evaluation in SEZs**

One of the most critical and underappreciated roles of government as a regulator of SEZs is in monitoring and evaluating (M&E) the performance of zones. The role of M&E links back to the overall strategy and objectives of the SEZ program – it should be a fundamental component of initial program planning and a key tool for government's ongoing decision-making on the program.

The SEZ strategic plan should make it clear how success will be defined, determine how it can be measured, and establish mechanisms to collect the necessary data to monitor progress against these measures on an ongoing basis. Because of the closed and regulated nature of zone programs, authorities are in a good position to collect detailed and valuable data from the firms that operate within them. However, many zone programs around the world fail to take full advantage of this opportunity, with many programs having no systematic process for data collection, despite the fact that many of them require (at least nominally) their licensed investors to fill out relatively detailed forms on a quarterly or annual basis.

In the absence of an effective program to monitor the activities and results of companies operating under their zone regimes, regulators are (1) unable to enforce regulations effectively, which results in abuse of the system and negative externalities (e.g., environmental); (2) unable to determine whether programs have been successful; and, therefore, (3) unable to make informed decisions on future investment, participate effectively in policy dialogue, or respond appropriately to the changing needs of the investors and the government.

# 4. SETTING THE SEZ PROGRAM ON A PATH TO SUCCESS: INSTITUTIONAL PROCESS AND CAPACITY

This final section provides guidance on the process by which the analysis and decision making on the questions discussed in Section 3 – and the wider initial consideration and planning of the SEZ program – can be carried out. It focuses on the institutional process of initial SEZ planning, and also comments on the importance of building technical capacity to ensure effective outcomes from the planning process.

## 4.1. The institutional process

The process outlined below is not intended to design an SEZ policy and implement it. That process is described comprehensively in the World Bank / IFC *SEZ Practitioner's Guide*, which should be used as the reference source and model for policy design and implementation (see box below). The process here represents the very initial stage required for governments to decide whether or not to set out an SEZ policy.

Often governments conduct the initial reflection on whether or not to initiate an SEZ program either in an informal manner or leave it to the responsibility of a particular economic portfolio ministry (such as Trade and Industry, Finance, or Economic Development). If the process is informal, it will generally lack direction and political support. If it is the responsibility of a portfolio ministry, it will often be too narrowly sectoral to capture the vast set of issues and opportunities represented by such a program, and may lack the broad buy-in required to make the program a success.

**The World Bank / IFC *SEZ Practitioner's Guide***

The *SEZ Practitioner's Guide*, developed by the IFC, is a comprehensive toolkit at the disposal of government officials and the experts advising them in the establishment of an SEZ program. The *Practitioner's Guide* acts as an extensive reference tool for the process of planning and implementing an SEZ program, providing both an overview of the ideal-typical process and a detailed description of the steps required along it. The *Practitioners Guide* is meant to act as a capacity building support, to be delivered to government officials in charge of the establishment of an SEZ program. As such, it is invaluable, and should be used at the outset of new zone programs or ahead of the restructuring of poorly performing one.

The *Practitioner's Guide* breaks down the typical SEZ program along four phases: i) strategic planning; ii) framework establishment; iii) zone development; and, iv) zone operation.

The strategic planning phase covers of the creation of the program's governance structure and the conduct of the key studies that are to guide the configuration of the SEZ program, and the development of projects (i.e., specific zones). The *Practitioner's Guide* distinguishes between *program planning and project planning*. This distinction is essential:

1. The zone *program* represents the strategic orientation chosen by government, the governance structure for both program and projects, the high-level decisions stemming from key economic and sites pre-feasibility analyses, the common regulatory and governance framework for all zones, and the long-term configuration of the country's SEZ development plan.
2. Zone *projects* are the development and implementation of specific zones per the program.

The program is led by government, and projects are, to one degree or another, led by the private sector. Accordingly, the first two phases (i.e., strategic planning and framework development) are government-directed, the third phase (development) is cooperatively directed, and the fourth (operations) is private-sector led. Private sector should nonetheless be thoroughly consulted throughout the process.

**In line with the process recommended here, the *SEZ Practitioner's Guide* defines first step in the development of any SEZ program is the establishment of the economic development priorities of the future zone program. This is followed by the creation of the Inter-Agency Committee** – the high level program governance institution, which then establishes the terms of reference for the strategic planning process. It is out of this strategic planning that key attributes of the program will emerge.

It is during the strategic planning phase that the key characteristics of the SEZ program and first project(s) will be defined. This is the prefeasibility and feasibility studies cycle.

The SEZ question thus needs to be formally asked well before the establishment of an implementation Steering Committee, so as to validate it or invalidate it, provide critical input into the broad socio-economic objectives that will be given to any resulting program, and develop the capacity for program success.

Early formalization will give government the opportunity to register rapid conceptual progress, to frame the conversation about SEZs and economic development policy, and to move forward rapidly on if required – either toward another policy or in the establishment of an SEZ program. It will also 'jump-start' the capacity building and skills acquisition that are so critical to any SEZ program's success. Finally, it will ensure government meaningful strategic control of the program without compromising the need for truly independent and objective feasibility analysis.

The process is not envisaged to generate new analyses and studies, but rather to summarize relevant national and sector economic and institutional diagnoses, as well as policies and development programs, around a coherent problem-statement. The ultimate purpose of the process is to help government decide whether or not to deploy an SEZ policy in a formal, disciplined fashion.

*The SEZ Working Group*

Establishing a *SEZ Working Group* will provide the formality, resources and seniority necessary to conduct the SEZ inquiry in a way that maximizes the quality of the process. Making SEZ planning decisions through the establishment of a temporary *Working Group* has several additional benefits for the process. First, it saves time over attempting to establish a more formal authority or body. But most importantly, it helps remove institutional incentives to move forward with a zones program regardless of its strategic value. Often the process of SEZ inquiry is led by the ministry or agency that would eventually manage the SEZ program – this creates an in-built bias to support zone development.

This group should be composed of highly experienced government technocrats with deep knowledge of the country's economic challenges, policies, legislation and economic development projects. However, there should be balance in the composition of the Working Group to increase the independence of its findings. The combination of persons best positioned to provide the necessary input into the process might include:

- At least one political and policy 'power-broker' or 'insider,' for instance (but not necessarily) from the office of the Head-of-State or Head-of-Government;
- At least one relatively successful representative of the private sector, actually engaged in business as opposed to simply on the executive of a chamber of commerce, and engaged in a competitive market (as opposed to a monopolistic or oligarchic one);
- At least one senior, seasoned Civil Service technocrat (ideally at the Cabinet or Permanent Secretary level), in (or retired from) a Ministry interacting with business, accustomed to confronting the limits of what Government actually can and cannot accomplish;
- At least one representative member of civil society or labor, capable of speaking of and presenting the interests of labor and civil society in a cogent and objective way.

The Working Group should be aided by international experts as required to facilitate the process. Ideally, this would include one expert experienced in economic growth and strategy in order to frame the inquiry within the broader national context and government policies. Another should be an SEZ specialist with broad understanding of the economic, regulatory, institutional and operational attributes of zones.

The Working Group should be attached to the Presidency or the Office of the Prime Minister in order to maintain its independence from individual ministerial portfolios and ensure more effective cross-ministerial coordination. Otherwise there is a risk that specific ministerial agendas may preempt or condition the findings of the inquiry or create barriers to successful conclusions and decision making.

The Working Group should be equipped with the resources necessary for the proper inventorying, review and summary of the required documentation. Its task should be conducted intensively, in order to generate a critical mass of knowledge and policy guidance in a short time – *three to six months should be sufficient*.

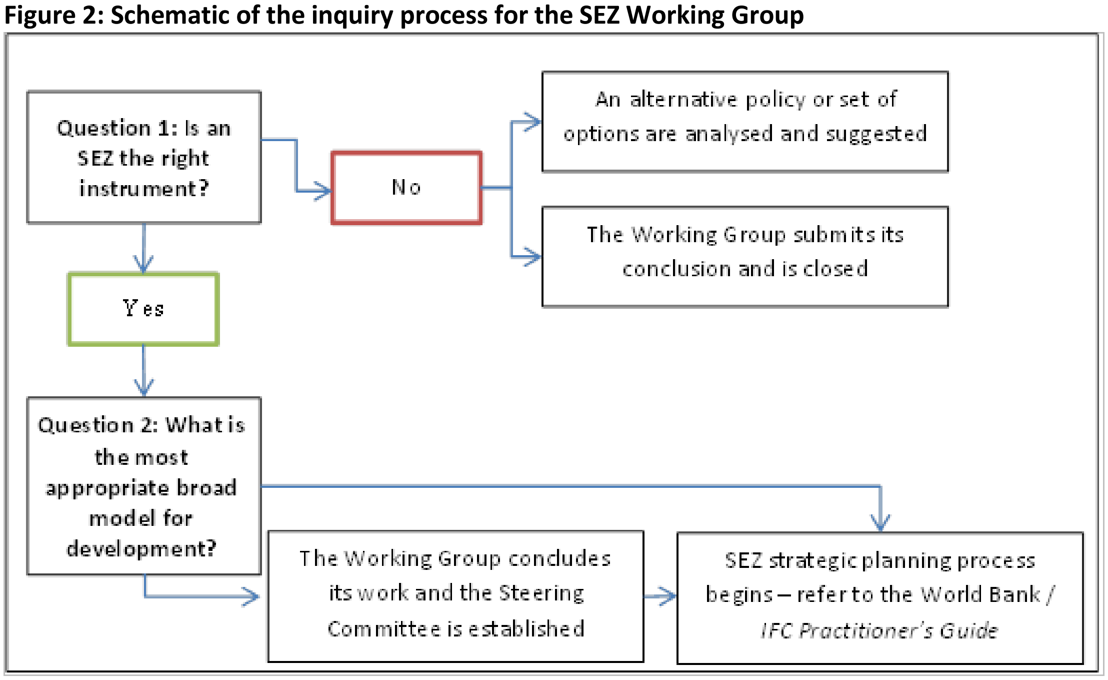
*The process*

The goal of the SEZ Working Group is to answer comprehensively the first question outlined in Figure 2, in a step-by-step process. As discussed in Section 3, question 1 (is an SEZ the right instrument to address the country's economic needs?) is the primordial one to answer. Much of this *Policy Guide* focuses on what happens if the Working Group's analysis deliberates that an SEZ or SEZs are a valid option for the country.

If the answer is negative, the Working Group must decide whether to recommend an alternative policy or to simply provide its answer to government. In this case, government will need to decide what to do next.

If the answer is positive, the Working Group's task is completed, although as part of the assessment they are likely also to take a position on what broad model of zone is most appropriate given the development priorities, strategies, and existing constraints. Government formally establishes its SEZ program, and creates the Steering Committee, which launches the strategic planning and feasibility analysis cycles. This process is described comprehensively in the *IFC Practitioner's Guide*.

**Figure 2: Schematic of the inquiry process for the SEZ Working Group**



The process followed by the Working Group should include the following phases:

1. *Phase 1 – Problem statement, to be led by a growth/strategy expert*

   - A high level review of all critical socio-economic diagnostic documents, and their summary in a 'country diagnostics'. This must specifically highlight:
     i. Key constraints to investment, growth, diversification, employment generation, poverty reduction, etc.
     ii. Key sources of demonstrated comparative advantage, in terms of location, factor costs, sectors, skills, etc.
   - A high level review of all key relevant government policies, programs and strategies, and their summary in a 'policy and strategy review', notably around: investment generation and FDI, diversification, employment creation, private sector development, infrastructure provision, export growth, technology transfers, investment climate reform, trade policy reform, etc.
   - An analysis designed to identify whether there are or will be in the future significant *gaps between policy and the socio-economic environment. This gap analysis represents the Working Group's problem statement.*

2. *Phase 2 – SEZ familiarization, to be led by a SEZ expert*

   - An introduction to SEZs to encompass all key features and attributes, including: brief history and developments, key economic attributes, structural features, social, economic and environment impacts, regulatory and governance attributes, and so on.
   - An exploration of a few relevant SEZs through case studies, successes and failures.

3. *Phase 3 – Match analysis and recommendation*

   - An analysis of the fit between the SEZ approach and the challenges identified in the gap analysis, informed by the policy objectives of government, using the inquiry model outlined below. The analysis should essentially seek to provide an *a priori* answer to the following question:

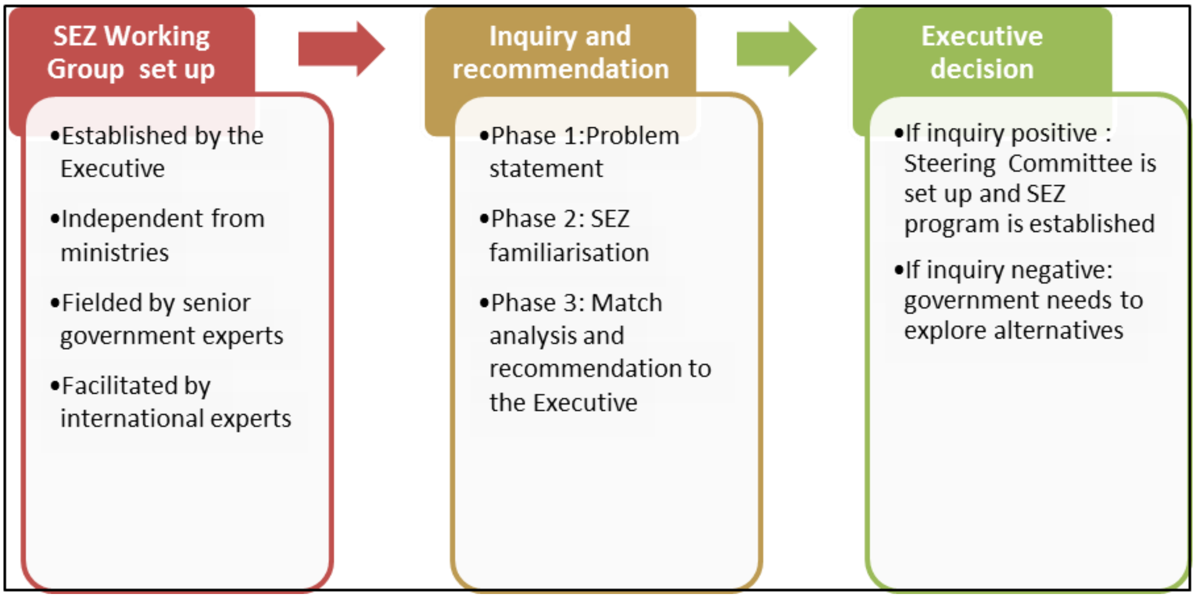
     *Considering the government's principal policy objectives as regards XYZ (growth, investment climate, employment creation, diversification, etc.), given the country's principal constraints (123) as regards achieving these goals, informed by the country's experience with similar/related policy instruments (industrial zones, free trade zones, growth poles, etc.), and taking cognizance of the experience of relevant countries (ABC) – both positive and negative – it is our view that an SEZ program would/would not advance the policy goals of this government.*

     If the analysis invalidates the SEZ approach, an outline of the preferred alternative approaches that are at the disposal of government should be prepared.

     If the analysis validates the SEZ approach, an outline of the strategic key potential objectives of the recommended SEZ program should be proposed: economic objectives, type(s) of zone(s), development and operational model (e.g., public, private, PPP), and roadmap for the establishment of the program (including the creation of the Steering Committee, its mission and membership, and its initial funding and technical assistance requirements).

   - Recommendation on whether or not the SEZ approach is relevant and may be effective, and proposed timeline for the establishment of the Steering Committee.

**Figure 3: Schematic of the guidance framework process**




## 4.2. Technical capacity for SEZ planning

Aside from the many risks, a principal contributor to the failure of many SEZ programs is having insufficient technocratic and administrative capacity to define SEZ strategies, design zone programs, and implement them effectively. This is particularly problematic in low income countries, which then tend to become over reliant on international experts. And given the ongoing global expansion of SEZ projects, this risk rises significantly, as the already limited pool of global technical expertise on SEZs is spread increasingly thin.

One result of failing to build the capacity to develop zone concepts and to invest in the research necessary to plan and design them is a lack of competitive differentiation. Ultimately, many zone programs end up being based on the same limited set of models and experiences, the same economic formats, and competing to attract the same limited set of investors and even more limited pool of developers. Failure to develop zones based on differentiable attributes then leads to a zero-sum competition, which can undermine the prospects for zone success, and certainly sustainability.

Nowhere is capacity more central than at the early stages of programs, during strategy and program planning. These stages represent the foundation and the blueprint of SEZ programs that may, if implemented, be in existence for a generation or more – some of the world's most successful zone programs are well into their third or fourth decade (China, Colombia, Korea), and in some cases older (Ireland, Mexico).

Compounding these capacity shortfalls – or perhaps because of them – often is a critical lack of emphasis over these early stages. Indeed, in an obviously competitive environment and pressured by political considerations, governments tend to fast forward projects to the pre-feasibility and feasibility stages. These are usually perceived to be tangible steps toward the creation of brick-and-mortar zones – the ultimate expression of policy delivery. Feasibility studies represent the promise of zones, as they propose in a packaged format, often convincingly presented, all the attributes of 'best practice' zone programs: i) often flattering competitive positioning; ii) a regulatory and governance regime that promises significant private sector participation under some PPP arrangement; iii) a set of promising demand, financial and economic scenarios (invariably positive); iv) an enticing master plan, with detailed graphic representation of the future ‘look and feel’ of the zone. Yet, more often than not, these attributes are insufficiently differentiated from already existing zones; and whether they can ever be realized is questionable.

Indisputably, the feasibility cycle is an essential step in the establishment of zone programs. But that cycle is more often than not undertaken in a strategic and programmatic vacuum that leaves essential preliminary questions unanswered and essential domestic capabilities undeveloped or underdeveloped. Because technical expertise in the conduct of the studies is usually contracted out, this often means that experts are provided with insufficient strategic guidance, and are given tacit decision making on some of the key attributes of zone programs and the zones envisaged. But, as noted above, this can result in replication of ‘best practice models’, often with insufficient consideration given to domestic economic and social objectives and context.

There is a fundamental relationship between outcome and capacity. The notion of ‘capacity gap’ is central to this report, and is attached to four dimensions of capacity: ownership, strategy, process and skills. All four are essential to effectiveness. All too often they are treated as distinct variables. At worst, strategy and process are designed irrespective of the skills available to take them forward. Mostly, they are designed with the expectation that the underlining skills will be developed along implementation. Rarely, however, are they seen as being four related constituents of capacity, that are either mutually reinforcing or mutually weakening, and that a strategic and process ‘plug and play’ approach rarely works. Experience clearly shows that strategy and process must be internally rooted through a process that seeks to also develop skills, and where emerging skills make a critical contribution to strategy and process design. Ownership is generally considered as an attribute on its own, and the extent to which it depends on the others is underestimated: weak strategy, absence of an effective process and lack of skills almost unavoidably degrades ownership.

Filling the capacity gap is a prerequisite for the success of current zone projects, whether these projects are for new zones or for restructuring existing zones. Linking strategy, process and skills potential provides a foundation for an improved approach to the development of zone programs. This approach seeks to complement the linear, best practice, ‘tick box’ approach with one that makes the deficit in initial capacity a central element in the development of the program.

The Working Group is intended to act as an initial catalyst for this capacity building, which will be institutionalized and reinforced in the Steering Committee.

# ENDNOTES

[1] FIAS (2008). *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development*. Washington, D.C.: World Bank

[2] See chapter 4 in Farole, T. (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from International Experience*. Washington, D.C.: World Bank.

[3] See Zeng, D. (2010). Building Engines for Growth and Competitiveness in China. Washington, D.C.: World Bank.

[4] See Baissac, C. (2011). 'Planned Obsolescence? Export Processing Zones and Structural Reform in Mauritius'. in Farole, T. and Akinci, G. (eds.) *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*. pages 227-244. Washington, D.C: World Bank.

[5] See chapter 7 in Farole, T. (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from International Experience*. Washington, D.C.: World Bank.

[6] Mongla is located next to the country's second main seaport, but the port is not of international standard and no international shipping lines call there. In December 2009, the government signed an MOU for a US$3b PPP to modernize the port (http://bangladesheconomy.wordpress.com/2009/12/03/govt-plans-3-billion-ppp-project-to-develop-mongla-port).

[7] A 'special' investment policy – specifically allowing foreign investment in sectors that are otherwise protected – is also common in SEZs. Again, however, with liberalization of the investment environment globally, it is in most cases no longer a source of differentiation. However, for certain countries and in certain strategic situations, it may still represent a valuable way in which a zone can offer something 'special' to investors.

[8] Developer Financial Designation criteria, typically found in a national SEZ Law, would normally include requirements related to: The Financial and technical track record of Developer; Minimum Developer equity requirements; Project profitability as determined by internal rate of return analysis; and Developer financial commitments.

[9] http://www.aqabazone.com/?q=node/109

[10] http://www.panamapacifico.com/area-economica-especial/ and http://aaeepp.gob.pa/index.php?content=content_body.php&section=regimenes.php

[11] FIAS (2008). *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development*. Washington, D.C.: World Bank

[12] For example, many US state and regional economic development agencies, Great Britain, Costa Rica, Singapore and the Dominican Republic.

[13] This model is used, for example, in Tunisia, Egypt and the Philippines.

[14] As is the case in Tunisia. See: USAID, *Etude des attentes des entreprises nord-américaines en Tunisie quant aux formalités d'investissement* (March 2000)

[15] The French established the CFE system in 1981. CFEs shepherd the investor's file through the various agencies involved in business regulation: The Trade Court; Revenue Services; etc. While the French system facilitates business regulatory interfaces with government, it does not eliminate steps and therefore the process remains cumbersome and bureaucratic. While the CFE system provides a single individual with whom the investor must interact, the investor must still submit 22 distinct documents and forms, requiring considerable preparation and processing time.

[16] Although we are not aware of any country where this has been tried.

[17] Derogations in apparel preferential agreements allow investors to source fabrics and other inputs from anywhere in the world. This is an important part of AGOA and helps attract investment into many African SEZ programs, but it also restricts the level of value addition that is likely to take place in the zones.

[18] As noted previously, although Lesotho has many of the components that make up an SEZ program, it does not have a formal SEZ regime.

[19] see, for example, Warr, P. (1989). 'Export Processing Zones: The Economics of Enclave Manufacturing'. *World Bank Research Observer.* 9(1):65-88.

[20] Farole, T. (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences*. Washington, DC: World Bank.