

# **An Enabling Environment and Economic Zones for Private Sector Development in Bangladesh**

Free Zones: Performance, Lessons  
Learned and Implications for Zone  
Development

Dhaka, Bangladesh  
14-15 December 2004

Jean-Paul Gauthier  
Consultant, FIAS  
(Prepared while at BearingPoint, Inc.)

Foreign Investment Advisory Service  
A joint service of the International Finance  
Corporation and The World Bank



# Contents

<b>1</b>	<b>Introduction.....</b>	<b>2</b>
<b>2</b>	<b>Free Zone Definition and Development Trends.....</b>	<b>3</b>
	Free Zone Definition.....	3
	Rationale for Free Zone Development.....	5
	Major Trends in Free Zone Development: The Move toward Nationally Integrated, Non-distortionary, Model Policy Environments.....	7
<b>3</b>	<b>Economic Performance and Impacts .....</b>	<b>11</b>
	Defining Zone Benefits and Costs .....	11
	Free Zones and Countrywide Reforms .....	12
<b>4</b>	<b>Lessons Learned and Implications for Zone Development.....</b>	<b>14</b>
	Why Do Zones Fail? .....	15
	Guidelines for Free Zone Development.....	15
	Outlook for Free Zone Development.....	20

# 1 Introduction

The rapid proliferation and economic impact of Free Zones (FZs)—especially Export Processing Zones (EPZs)—has been documented in numerous studies. In 2002, there were an estimated 3,000 EPZs in 116 countries worldwide, accounting for 43 million direct jobs and over \$400 billion of total trade (ILO, 2003). The net economic impact of zone development has been undertaken in other studies, in the form of cost/benefit evaluations of specific zone programs (Warr, 1989, Jayanthakumarn, 2002, and Sinclair 2001). Still other studies have tried to examine the role and linkages of FZs in broader economic reform and trade liberalization efforts (Madani 1999, Cling and Letilly, 2001 and Schrank, 2001).

Yet, most of these studies focused on evaluating government-owned, developed and operated zones. They largely miss the fact there have been dramatic changes in the ways in which zones have been conceived, developed, managed, regulated and governed in the past decade. These include the growing prominence of private sector developed and run zones; the use of public-private partnerships for zone development; the implementation of WTO-consistent policy and incentive frameworks; and innovative regulatory frameworks.

These changes have important implications for the economic impacts of zones. They also offer significant lessons to policymakers on how to maximize zone success. The number of zones and the number of countries hosting zones, particularly OECD economies, continues to grow. What is the continuing rationale for zones in the face of global trade liberalization? And why do zones continue to expand in industrialized countries that already offer low duty and tax environments?

This paper analyzes the major trends and developments in terms of zone configuration, ownership, development, management and regulation approaches, and identifies best practices. It evaluates the overall economic performance of zones in light of these changes, and assesses the relationship of EPZs and economic reform efforts. The overall goal is to define lessons and implications to enable policymakers to design and facilitate zone development to maximize benefits to their host economies.

The analysis is based upon a review of recent studies and assessments of EPZs and free zones and a stocktaking of zone programs worldwide, including ownership patterns, legal and regulatory frameworks, institutional frameworks, ownership and management approaches, incentives, and economic impacts. To evaluate the complex linkages and impacts of zones and economy-wide policy reform efforts, a number of case studies of zone programs were undertaken and previous cost/benefit assessments analysed.

## 2 Free Zone Definition and Development Trends

### 2.1 Free Zone Definition

Free zones have existed for several centuries. They were established to encourage entrepot trade, mostly in the form of citywide zones located on international trade routes. Examples include Gibraltar (1704), Singapore (1819), Hong Kong (1848), Hamburg (1888), and Copenhagen (1891). Modern free zones are recent variants of these traditional, commercial zones. The principles underlying the basic concept of a free zone include:

- Geographically delimited area, usually physically secured
- Single management/administration
- Eligibility for benefits based upon physical location within the zone
- Separate customs area (duty-free benefits) and streamlined procedures

The core definition of a free zone, and proposed guidelines and standards are contained in the *Revised Kyoto Convention* of the World Customs Organization (WCO).<sup>1</sup> Specifically, Annex D of the Kyoto Convention and the accompanying guidelines provide standards and recommendations on the treatment of imports to and exports from free zones including territorial limits (free zones are defined as “outside the Customs territory” for purposes of the assessment of import duties and taxes); minimal documentation requirements; and issues to be covered by national legislation. Free zones typically allow for duty- and tax-free imports of raw and intermediate materials and, in many cases, capital equipment.

This generic free zone concept has evolved over time, resulting in large variety of zones with differing objectives, markets, and activities, including:

- **Free Trade Zones**, also known as commercial free zones and free commercial zones, are small, fenced-in, duty-free areas, offering warehouse and other storage facilities for trade, transshipment and re-export operations, located in most ports of entry around the world. A leading example is the Colon Free Zone in Panama.
- **Export Processing Zones** are industrial estates offering special incentives and facilities to manufacturing and related activities aimed

---

<sup>1</sup> Annex D of the International Convention on the Harmonization and Simplification of Customs (revised in 1999), defines a free zone as “part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory .....and not subject to the usual Customs control.”

mostly at export markets. The traditional, “pure” EPZ model is where the entire area within an EPZ is designated for export-oriented enterprises licensed under an EPZ regime. Hybrid EPZs in contrast are sub-divided into a general zone open to all industries regardless of export orientation and a separate EPZ area reserved for wholly export-oriented EPZ enterprises.<sup>2</sup>

- **Enterprise Zones** are intended to revitalize distressed urban or rural areas through the provision of tax incentives and financial grants. Most zones are in developed countries like the USA, France and UK, although South Africa is developing similar schemes.
- **Freeports/Special Economic Zones (SEZs)** are a much broader concept—typically encompassing much larger areas; accommodating all types of activities including tourism, retail sales; permitting people to reside on site; and provide a much broader set of incentives and benefits.
- **Single Factory EPZ** schemes offer EPZ incentives are provided to individual enterprises regardless of location; factories do not have to locate within a designated zone to receive incentives and privileges.<sup>3</sup> Leading examples of countries relying exclusively on a single factory scheme include Mauritius, Madagascar, Mexico and Fiji; countries like Costa Rica, USA and Sri Lanka allow both industrial estate-style zones and single factory designations.

It is frequently pointed out that free zones have also evolved into highly specialized facilities, configured to the needs of specific industries and activities. Examples profiled in Table 2.1 include special zones to promote high technology or science-based industries; petrochemical and heavy industry zones relying on cheap energy sources and specialized facilities; offshore financial services zones to promote offshore financial and non-financial activities; software and ICT zones accommodating software coding and other offshore IT services operations; airport-based zones, specifically support aviation and air-based activities; logistics parks, cargo villages/cities, providing specialized facilities and support services to facilitate trade, supply chain management and logistics; tourism zones to facilitate integrated resort and leisure community development, and others.

---

<sup>2</sup> In most Asian countries like Thailand and the Philippines, EPZ areas within hybrid zones are required to fenced-in. In many Latin American countries—like Costa Rica and Mexico—EPZ-registered enterprises may be located in the same area as firms registered under other regimes.

<sup>3</sup> Single factory EPZ programs are similar to Bonded Manufacturing Warehouse schemes, although typically offering a broader set of benefits and more flexible controls.

**Table 2.1: Examples of Specialized Zones**

Type of Zone	Development Objective	Size	Typical Location	Activities	Markets	Example
Technology or Science Parks	Promote high tech and science-based industries	< 50 hectares	Adjacent to universities, institutes	High technology activities	Domestic and export	Singapore Science Park, Singapore
Petrochemical Zones	Promote energy industries	100-300 hectares	Petrochemical hubs; efficient energy sources	Petrochemicals and other heavy industry	Domestic and export	Laem Chabang Industrial Estate, Thailand
Financial Services	Development of offshore financial svcs.	< 50 hectares	None	Offshore financial & non-financial services	Export	Labuan Offshore Financial Centre, Malaysia
Software and Internet	Development of software and IT services	< 20 hectares	Adjacent to universities, urban areas	Software and other IT services	Export	Dubai Internet City, UAE
Airport-based	Air cargo trade and trans	< 20 hectares	Airports	Warehousing, transshipment, sub-dividing	Re-export and domestic	Kuala Lumpur Airport Free Zone, Malaysia
Tourism	Integrated tourism development	200-1,000 hectares	Tourism areas	Resorts and other tourism	Export and domestic	Baru Island, Colombia
Logistics or Cargo Villages	Support logistics	< 50 hectares	Airports, ports, transport hubs	Warehousing, transshipment	Re-export	D1 Logistics Park, Czech Republic

Source: BearingPoint.

## 2.2 Rationale for Free Zone Development

The rationale for the development of free zones differs between developing and developed countries. For **developing countries**, free zones have traditionally had both a policy and infrastructure rationale. The typical free zone policy package of import and export duty exemptions; streamlined customs and administrative controls and procedures; liberal foreign exchange policies; income tax incentives – are meant to boost an investor’s competitiveness and reduce business entry and operating costs. Export-oriented free zones (EPZs) are intended to convey “free trade status” to export manufacturers to enable them to compete in global markets, and counterbalance the anti-export bias of trade policies.

Madani (1999) and Cling and Letilly (2002) outline four, broader policy reasons for the development of zones, especially EPZs, in developing countries:

- **To support a wider economic reform strategy.** In this view, EPZs are a simple tool permitting a country to develop exports and to diversify. Zones are a way of reducing anti-export bias while keeping protective barriers intact. The EPZs of Taiwan and South Korea follow this pattern.
- **To serve as “pressure valves” to alleviate growing unemployment.** The EPZ programs of Tunisia and Dominican Republic are frequently cited as examples of robust, job-creating programs that have remained enclaves with little linkages with the host economies.
- **To serve as experimental laboratories for the application of new policies and approaches.** China’s SEZs are classic examples of this category. Financial, legal, labor and other policies were introduced and tested first within the SEZs before being extended to the rest of the economy.
- **To attract foreign direct investment.** Most newer EPZ programs, particularly in the Middle East, were designed to attract foreign investment.

The “hardware” of free zones—fully serviced sites with purpose-built facilities for sale or lease—is aimed at enhancing the competitiveness of manufacturers and service providers, and realizing agglomeration benefits from concentrating industries in one geographical area. These include efficiencies in government supervision of enterprises and provision of off-site infrastructure facilities; improved environmental controls; and increased supply and sub-contracting relationships among industries, amongst others. This ‘infrastructure rationale’ is one of the most important driving forces behind zone development in infrastructure poor countries.

The rationale for free zone development in **industrialized countries** is more varied. The new SEZ program in South Korea and the 22 Foreign Access Zones in Japan, for example, are explicitly intended to promote foreign investment. The main rationale for the Shannon Free Zone in Ireland, in contrast, was to establish a ‘growth pole’ in the economically distressed southern part of the country. Revitalization of economically distressed urban and rural areas is the motivation behind the many enterprise zone-style programs in the UK, France and the USA. But enhancing trade efficiency and manufacturing competitiveness is the principal rationale behind free zone programs in most industrialized countries. Many companies choose a free zone location because of important advantages of operating in a flexible, duty-free environment.

Operating costs are lower as a result of reduced insurance, security and overhead costs. Cash flow is enhanced by the ability to postpone duty

payments only upon entry into the domestic customs territory. Foreign-Trade Zones in the U.S. have been critical in enabling manufacturers to operate “just-in-time” systems. The efficiency advantages provided by free zones are even more important for industrialized countries even with the advent of modern production concepts and approaches, and the reduction of tariff and non-tariff barriers.

The fact that zones are expanding in OECD countries suggests that they may be much more than tools for developing countries with bad policy environments—they may be critical to firm-level competitiveness in a globalized economic environment.

### ***2.3 Major Trends in Free Zone Development: The Move toward Nationally-integrated, Non-distortionary, Model Policy Environments***

There have been profound changes in the free zone concept and development approach since the first modern zone was established in Ireland in 1959, and even more fundamental changes are foreseen over the next decade with full implementation of the WTO Agreement. As detailed below, this is evident on many fronts —free zone policy package, physical development approach, governance structures, etc. But the most vivid example is the expansion in the types of zones in both developing and industrialized countries previously noted. Countries are facilitating the development of zones to meet specific objectives and target markets. Traditional EPZs are increasingly being augmented and sometimes supplanted by new, more flexible arrangements. Hybrid EPZs are the preferred model in most Central and East European countries, and increasingly among many Latin American countries. Commercial free zones have been the traditional development norm among most Middle East and North African countries, but are a relatively recent innovation in Asia, where zone development has emphasized export manufacturing.

Free zones were traditionally developed as isolated enclaves, both in terms of their underlying policy framework, and in terms of geographic location. Access to a generous set of incentives and privileges were tightly controlled. Qualifying firms typically had to be 80-100 percent export-oriented (for EPZs), engaged in recognized manufacturing activities, and at times only foreign-owned. Zones were physically located in relatively remote areas or near transport hubs, viewed primarily as “growth poles” for regional development. Zones were exclusively developed and operated by government bodies. This rigid concept has changed quite fundamentally over the past two decades. One of the major changes in thinking has been to permit zones development countrywide, and not restrict zones to growth poles or other designated areas. This is in response to the growing number of private zones and the increasing number of private property development groups. Applications for new zone development are increasingly treated like any large scale property development—subject to applicable, land use planning, zoning,

building and environmental permitting processes. Governments have had to develop zone designation criteria and transparent processes to govern the designation of new zones promoted by private groups. A related development has been the re-thinking of the role of zones in economic development. Sinclair (2001) correctly points out that the development objectives behind the first EPZs were viewed in relation to a trade restricted or closed economy. EPZs were intended to promote exports, create jobs and transfer technology through backward linkages. The rapid pace of globalization and trade liberalization is stimulating a much broader view of zones, their development objectives and performance expectations. Increasingly, zones are viewed as a key mechanism to promote two-way trade and facilitate liberalization and modernization of the host economy. The new emphasis is to integrate free zones with the domestic economy.

The extent to which traditional free zones have evolved is exemplified in the new generation of special economic zones or freeports. Traditionally, freeports were city-states such as Hong Kong, Macau, Singapore, or islands including Labuan (Malaysia) and Batam (Indonesia), which were viewed as more easily secured. In the past decade, led by the Chinese SEZs, freeports inside the contiguous parts of countries have increased, in part because of better customs and tax controls and technologies, but also as part of efforts to integrate zones with host economies, and have balanced development rather than dependence on single industries such as apparel or electronics.

Freeports/SEZs are fundamentally different from traditional free zones. Instead of export drivers and investment magnets, they are designed as liberalized platforms for diversified economic growth that not only could but also should spill over into the national economy. As summarized in Table 2.2, the SEZ/Freeport concept represents a major expansion over traditional approaches:

- Larger size. SEZs/Freeports tend to cover larger areas, and therefore offer greater flexibility to firms in terms of the location of their plants and the scope for inter-firm linkages.
- Broader range of permissible activities. Firms can undertake any legal activity including manufacturing, tourism, duty-free shopping, informatics, warehousing, transshipment, and re-packaging activities, among others. Individuals can reside within the zones, permanently or temporarily.
- Duty-free privileges. All types of merchandise can be introduced duty- and tax-free by registered enterprises or individual residents. Enterprises can freely import any merchandise in any quantity, and are not restricted to that is directly used in the manufacturing process as in the case of EPZs. Duty- and tax-free merchandise can be sold at the retail or wholesale level and sometimes consumed within the zone

area. This is in contrast to EPZs or even commercial free zones that do not permit retail sales or on-site consumption of duty- and tax-free products.

- Full access to the domestic market on a duty-paid basis. Unlike EPZ enterprises that are usually required to export at least 80 percent of their production, most SEZs allow enterprises to sell any amount to the export market, local market or to consumers located temporarily or permanently within the Freeport. Sales to the domestic customs territory are unrestricted so long as all applicable import duties, taxes and other charges are fully paid.

Another important development trend is the expansion and liberalization of the core set of policies and privileges of most free zone programs. In general, these have taken the form of removing many of the distortions previously associated with EPZs, in line with best practices. Typical provisions now offered by many programs include:

- Expansion of activities permitted within zones to include commercial and professional services (such as warehousing, transshipment, and informatics) in addition to all types of manufacturing and processing.
- Equal treatment of investors and investment forms. Zone legislation accords the same benefits to foreign and local investors, and to various legal forms. This reduces distortions in terms of the impact of incentives.

- Provision of incentives for private zone developers to facilitate private entry into zone development.
- Relaxation of minimum export requirements in line with the WTO framework and to accommodate the globalization of production.
- Allowing zone developers and others to supply utilities services (telecommunications water/sewerage, power) to tenants of EPZ estates by treating them as indirect exporters.

**Table 2.2—Examples of Freeports/SEZs**

<b>Zone</b>	<b>Size (km<sup>2</sup>)</b>	<b>Date Established</b>
<i>City States</i>		
Singapore	693	1819
Gibraltar	6.5	1830
Hong Kong	1,042	1841
Macau	25	1887
<i>Islands</i>		
Labuan, Malaysia	92	1990
Batam, Indonesia	416	1978
<i>Cities/Provinces</i>		
Inquique, Chile	2.4	1975
Shenzhen, China	327	1980
Subic Bay, Philippines	300	1992
Kaliningrad, Russia	15,000	1995
Aqaba, Jordan	375	2000
Howard, Panama	1,500	2004

*Source: BearingPoint.*

- Treatment of sales of goods and services from the domestic sector to zones as “constructive exports” eligible for all relevant export incentives.

- Shift towards a universal set of fiscal incentives for all promoted activities, rather than a separate regime for zones. In Malaysia, for example, free zone-based enterprises receive the same income tax incentives as promoted industries outside of the zones. This eliminates the potential for unfair competition that arises when identical operations located within an outside a free zone have different income tax treatment.

New zone legislation also increasingly incorporates features to increase the transparency and automaticity of the programs. Investment approvals have been transformed from a case-by-case evaluation process to a simple registration process, meeting explicit criteria. The use of negative lists, default mechanisms that confer automatic approvals within a predetermined time-period, and other mechanisms have greatly simplified investment approvals. Customs procedures have been simplified by the use of single forms, automated systems and other technologies.

Headway has also been made by many EPZ programs to dismantle previous anti-labor provisions of zone policies and management practices and toward greater adherence with universal labor standards as defined by the 1998 ILO Declaration on Fundamental Principles and Rights at Work and various conventions, as discussed in Section 3.

While most countries in the Asian region offer a range of small- to medium-scale traditional export processing zones to attract a range of export-oriented manufacturing and service industries, the region has taken the lead in promoting large-scale special economic zone and Freeports, Following on the phenomenal success of China's SEZs, a number of other countries in the region have followed its lead:

- Philippines, which converted a number of former US military bases into large-scale freeports—Subic Bay and Clark—with impressive results

**Box 2.1: Zones Within Zones, the Unique Case of China**

Special Economic Zones (SEZ's) were established by China to serve as 'demonstration areas' for policy reforms and to encourage foreign investment. The economic impact of these zones has been far-reaching, transforming entire regions and economies.

The Shenzhen Special Economic Zone (SSEZ) provides a snapshot of the impact of the SEZ's on China's economic development. Twenty-three years of growth has transformed Shenzhen from a small sleepy fishing village into a thriving urban metropolis. Today, Shenzhen is an export-oriented economy with an export value in 2003 of US\$48 billion or 14 percent of the country's exports, some \$30 billion in FDI, and directly employing some 3 million.

What is less well known is the fact that the SEZs host hundreds of other zones. National level zones, all with special and differing incentive regimes include:

- 14 Open Coastal Cities
- 15 Free Trade Zones
- 17 EPZs
- 54 Economic and Technological Development Zones
- 53 High Technology Development Zones
- 15 Border Economic Cooperative Areas
- Many other provincial- and city-level zones.

- Indonesia, which provided Bonded Zone status to Batam and Bintan islands, located 20 minutes away from Singapore
- India, which has launched a major SEZ development initiative—some 26 SEZs have been approved for development, 5 of which are underway, several by leading private sector consortia
- South Korea has initiated a major large-scale FEZ development program, with three large-scale zones are being implemented by private property development consortia, Korea has also designated Cheju island as a ‘Free International City’ with special benefits

A number of Asian countries have also implemented specialized zones for financial services, information technology, science-based industries and other industries required tailored infrastructure, facilities and business development services.

### 3 Economic Performance and Impacts

Many studies have evaluated the economic performance and impact of free zone programs in developing countries. But most have focused on government developed and run zones and have neglected private zone development. Critics of zone development, on the other hand, have focused on the social and environmental impacts of zones, and have been largely dismissive of economic contributions. And almost all studies have failed to evaluate zone contributions relative to the counterfactual—if zones did not exist. How do free zones and zone-based enterprises compare to local firms or those operating under other incentive regimes? This section tries to document the economic impact of zones, and where data is available, evaluates some larger socio-economic issues.

#### 3.1 *Defining Zone Benefits and Costs*

The economic benefits from zone development are both static and dynamic. The static benefits are quite straightforward and include:

- Employment creation and income generation
- Export growth and diversification
- Foreign exchange earnings
- Foreign direct investment
- Government revenues

The dynamic benefits are much harder to measure and are far more important to the long-term contributions from zone development. The most common include:

- Indirect employment creation
- Skills upgrading
- Female employment
- Technology transfer
- “Demonstration effect” arising from application of “best practices”
- Regional development

Although some critics argue that zone development has negative socio-economic impacts, particularly in relation to the role of women, labor and working conditions in zones, its positive impacts outweigh its costs and the benefits are obviously amplified in poorer countries where jobs and foreign exchange earnings and government resources are scarce.

Zone development also entails a range of financial and economic costs—e.g., salaries of government workers in the zone authority and other operating expenses, infrastructure development outlays, import duties and charges lost from leakages of duty-free goods, taxes foregone from firms relocating from the domestic customs territory to the zone. But it is important to keep in mind that the costs specifically linked to zone development to a government are those that are *incremental*—additional costs not otherwise entailed—and *not recovered* through service charges and assessments. Many studies have made the mistake of focusing on total rather than incremental costs specifically linked to zone development. Public expenditures are clearly the highest in the cases where governments develop zones and even worse, when they are not operated on a cost recovery basis, i.e., subsidized, typical of most government-run zones.

### 3.2 *Free Zones and Countrywide Reforms*

Economic theory suggests that free zones are a ‘second best solution’ to compensate for the anti-export bias of trade policies and other policy distortions. Using different hypotheses and parameters, economists have concluded that free zones lead to economic distortions (Hamada 1974) and conversely, that establishment of a zone improves a country’s well-being (Young and Miyagiwa, 1997). At a public policy level, the fundamental debate has been whether free zones promote countrywide economic policy reforms by serving as ‘demonstration areas’ or catalysts, or whether instead they act as ‘pressure valves’ for unemployment thereby reducing the incentive to reform. The World Bank cautions that EPZs may be used by developing countries to ‘muddle along without reforms,’ and therefore concludes that countrywide trade liberalization must be given priority over the establishment of isolated free market enclaves (World Bank, 1992).

In this context, the experiences of South Korea and the Dominican Republic offer an informative contrast. South Korea is an example of a country where establishment of the EPZ program in 1970 spearheaded structural transformation of the overall economy. By 1980, almost 35 percent of total

consumption of equipment and components of EPZ firms were bought locally. By the late 1980s, the Korean EPZs purchased almost US\$200 million worth of locally manufactured capital and intermediate goods per month. (UNCTC, 1991). In the Korean experience, free zones promoted countrywide economic reforms.

In contrast, thirty years after the establishment of the first industrial free zone in the Dominican Republic, the 500 free zone firms purchase no more than 0.001 percent of their material inputs from the domestic customs territory. Very free free zones co-exist with a highly protected domestic economy (Schrank, 2001).

**Table 3.1 : Zones as Catalysts**

<p><b>South Korea</b></p> <ul style="list-style-type: none"> <li>▪ Equal footing policies extended to firms in domestic customs area enhancing competitiveness</li> <li>▪ Almost \$200 million of local capital and intermediate goods purchased by zone firms per month</li> <li>▪ Liberal FDI policies tested in free zones before extended countrywide</li> </ul>
<p><b>Jordan</b></p> <ul style="list-style-type: none"> <li>▪ Automated customs systems piloted and implemented in the Aqaba SEZ prior to countrywide roll-out</li> <li>▪ Aqaba SEZ implements on-line, simple business registration</li> <li>▪ Aqaba SEZ customs forces merged with national customs to upgrade latter's capabilities</li> </ul>
<p><b>Kuwait</b></p> <ul style="list-style-type: none"> <li>▪ FTZ pilot for private infrastructure provision outside utilities</li> <li>▪ FTZ law liberalizes foreign ownership restrictions; later extended to countrywide FDI law</li> </ul>

*Source: BearingPoint.*

Why is it that some countries are able to use free zones as demonstrators of best practice and catalysts of reform and others are not? It is because some countries have consciously viewed zones as mechanisms to change their economies and others have not. In countries as diverse as South Korea, Ireland, and Malaysia—deliberate efforts were made to integrate zones into national economies at some point of their development process. Zones were used, variously, to facilitate a broader export orientation, transfer technology, and improve the broader business environment by extending best practice policy.

The process of integration was undertaken by extending 'equal footing' policies to domestic suppliers of capital and intermediate goods. Another important 'transmission and integration mechanism' in these and other countries was the extensive use of sub-contracting by zone-based firms to local producers. Zone firms provided materials, technical assistance and financing as part of the sub-contracting arrangement. These were supported by broader trade and investment reforms that exposed domestic firms to competition and enhanced competitiveness, and focused programs to establish

backward and forward linkages between zone-based firms and domestic enterprises.<sup>4</sup>

Countries like China, Malaysia and Jordan used zones as demonstration areas to test the impact of new policies and approaches to improve the business environment. The Chinese SEZs, for example, experimented with market-oriented FDI, land and tax policies before extending them to all enterprises. Costa Rica used free zones as efficient mechanisms to attract foreign investment prior to extending these approaches to enterprises more broadly. Free zones in a number of the Middle East Gulf countries are being used to prove dramatic liberalization in foreign investment ownership policies. In Kuwait, such policies were originally restricted to the Kuwait FTZ and are now being extended to FDI in the country generally. New legislation in India and Panama are using SEZs to remove labor market rigidities and promote ILO-consistent approaches. In the Aqaba SEZ in Jordan, automated business registration and customs systems first fast-tracked and proved in the zone are now applied in the country more broadly.

Schrank (2001) suggests that EPZs fail to become ‘bridges to structural reform’ in small markets or where an import-substituting industrialization approach has resulted in inefficiency and lack of competitiveness. In these cases, EPZs remain isolated enclaves and ‘grow at the expense of national industry.’ The Dominican Republic is a case in point. In larger markets, where a firm industrial foundation has already been established, backward linkages are more successful. In general, backward linkages (as measured by net exports) are stronger in larger countries with than in small economies.

## **4 Lessons Learned and Implications for Zone Development**

The previous sections reviewed the development patterns and economic impacts of zones worldwide. That review suggests that free zones have not been uniformly successful, and successful zones tend to be concentrated in East Asia and Latin America. To date, most African zones have yielded marginal results or failed completely despite significant technical assistance and funding from donors. Why do some free zones, especially EPZs fail, while

---

<sup>4</sup> In Taiwan, Korea and Ireland, local authorities promoted personnel exchanges, supported training efforts and provided technical assistance to potential suppliers. The Irish program to increase linkages included the technical departments of local universities. The program also encouraged purchasing managers of export-oriented firms to work with local suppliers to help them achieve the quality standards and delivery times required.” (Jenkins, Esquivel & Larrain, 2002). In Singapore, the Local Industry Upgrading Program created in 1986 had 30 multinational corporations, 11 large local firms and 670 domestic suppliers by 1999 (Sanchez-Ancochea, 2004).

others succeed? The discussion below identifies the major “lessons learned” from zone development, sets out the key guidelines to maximize the success of a zone development strategy, and evaluates the current and future rationale for zones.

#### **4.1 Why Do Zones Fail?**

A major reason behind the poor performance of some zones has been uncompetitive and restrictive policy frameworks. While investment incentives provided are generous, restrictive provisions and bureaucratic procedures erode their effectiveness. There are several main policy issues such as:

- Uncompetitive Fiscal Incentives. The fact that virtually the same package of incentives is offered by successful zones and failed zones suggests that they are not a key success factor
- Trade Exclusions on Free Zone Merchandise. Some bilateral and multilateral free trade agreements (such as the Arab FTA and MERCOSUR in Latin America) exclude products produced in free zones
- Weak Administrative Bodies. The weak performance of some programs can also be traced to weak government bodies established to develop and operate zones, and regulate free zone activity.

Other issues relate to the physical design, the development and the management practices of the Free Zone such as:

- Poor site locations, entailing heavy capital expenditures. The economic failure of zones such as the Bataan EPZ in the Philippines is linked to poor site location, design and development practices
- Poor zone development practices—poorly designed or over-designed facilities, poor maintenance and promotion
- Subsidized land and building lease rates rent. This is exacerbated if water, power and other utility services are also subsidized
- Cumbersome procedures and controls
- Inadequate administrative coordination between private developers and governments in infrastructure provision structures or too many bodies involved in zone administration. Most private EPZs and industrial zones in Viet Nam, for example, sat empty because local and national authorities could not provide road and other infrastructure connections to the site.

#### **4.2 Guidelines for Free Zone Development**

One of the clearest lessons learned from decades of free zone, particularly EPZ development, is that zones cannot and should not be viewed as a substitute for a country’s larger trade and investment efforts. They are one tool in a portfolio of mechanisms employed to commonly employed to create jobs, generate exports and attract foreign investment—through the provision of incentives, streamlined procedures and custom-built infrastructure. But maximizing the benefits of zones depends on the extent to which they are integrated with their host economies. The static and economic impacts of zone

development are suppressed when zones are operated as enclaves. They are multiplied when they are accompanied by countrywide economic policy and structural reforms that enhance the competitiveness of domestic enterprises and facilitate the development of backward and forward linkages.

### *Zone Concepts*

One of the critical issues that need to be addressed in the configuration of a free zone development program is the types of zones to be promoted. The recommended approach is to adopt a Hybrid EPZ model with the following features:

- Permit industrial estates to host EPZ enterprises as well as those licensed under other regimes.
- Ensure that the EPZ regime is flexible, allowing a range of commercial as well as manufacturing activities.
- Promote private rather than public development of zones. International experience suggests that private rather than public development of zones increases the chances of success.

However all types of zones should be permitted, offering customized infrastructure, facilities and services tailored to the specific needs of target industries. But as far as possible, all zones should have a common set of incentives and privileges, rather than duplicating and overlapping regimes which result in revenue loss.<sup>5</sup> There is the final and unique case of SEZs or so-called 'large format' free zones which can have significant economic impacts, particularly in terms of exports and foreign investment. The Subic and Clark Freeports in the Philippines, for example, together account for almost 10 percent of national merchandise exports. The Shenzhen SEZ in China has attracted almost US\$30 billion in FDI and generates 14 percent of Chinese exports. SEZs can also be very effective in promoting the diffusion of new policies, procedures and governance structures. But administering and regulating an SEZ regime is extremely demanding on governments thus SEZ development efforts should only be undertaken by those countries that have the institutional capabilities, expertise and commitment to make them succeed.

### *Core Policy Framework*

International experience suggests that a best practice policy and incentive framework needs to be streamlined, encouraging zones to compete on the basis of facilitation, facilities and services rather than incentives. The key elements of a best practice policy framework include the following:

- Concept of extra-territoriality—as defined in the Revised Kyoto Convention, free zones should be treated as outside the domestic customs

---

<sup>5</sup> China and Viet Nam provide particularly egregious examples where numerous zones exist each with slightly different incentive packages.

territory, but should be eligible for national certificates of origin and participate in trade and market access agreements.

- Private zone development—clear definition of private zones, benefits, obligations, rights and public-private partnerships for zone development.
- Zone designation criteria—physical development standards and clear criteria for the designation of new zones. The main issue is to guide but preserve the flexibility of individual zone development proposals, while optimizing the impact on government funding for off-site infrastructure connections.
- Eligibility criteria—the openness of an EPZ regime is defined in terms of minimum export requirements and the types of activities and ownership forms permitted.
- Labor regime—international experience strongly suggests that the long-term competitiveness of a free zone depends on the quality and productivity of its workers. To achieve this, it is important that labor regimes are fully consistent with ILO standards and obligations but they should be defined within a flexible and liberal labor market regulatory framework.

#### *Incentive Framework*

There has been a great deal of debate regarding the types of fiscal incentives and other privileges at the heart of an EPZ regime. Countries are under pressure to offer a generous package of tax and duty exemptions to equalize competition from competitors. The package of fiscal incentives has become almost standardized among zones internationally. Yet there is considerable evidence to suggest that some of these fiscal incentives are ineffective and a drain on public resources. In particular, the use of income tax holidays and other differentiated corporate income tax regimes has been widely abused.

Although EPZs and free zones do not appear in the WTO agreements, some of their provisions affect the zone incentive regime. In particular, the Agreement on Subsidies and Countervailing Measures (SCM) poses potential compliance problems for free zones. The accepted consensus is that EPZ regimes are consistent with the WTO so long as incentives are not contingent on export performance, use of local content, or maintenance of a foreign exchange balance; or primarily benefit a specific firm, industry, etc.

The following guidelines can be proposed for the design of a free zone incentive framework:

- Introduction or reform of free zones regimes should be leveraged as an opportunity to rationalize corporate income tax incentives. Best practice approach for income tax incentives is to have performance-based

incentives in a country's tax code rather than through special legislation such as EPZ regimes.

- Zone regimes should be used to advance demonopolization and deregulation of telecommunications and other utilities where applicable. Jamaica and other countries have used their free zone regime to accomplish this.
- Incentive framework should be WTO compliant. This is best done by removing any export obligation and allowing zone enterprises full access to the domestic market on a duty-paid basis.

### *Regulatory Framework*

In contrast to the attention given to incentives, the importance of regulatory relief to investors is frequently overlooked, yet a crucial aspect of successful EPZ programs is the simplification and streamlining of investment approvals, expatriate work permits, removal of required import and export licenses etc.; as well as accelerated on-site Customs inspection procedures and automatic foreign exchange access. Free zone legislation is increasingly incorporating features to increase the "transparency" and "automaticity" of the programs. A key global trend is the movement toward the establishment of "one-stop-shops" to consolidate and expedite government approvals.

The key guidelines for the development of a best practice zone regulatory framework are:

- Install streamlined procedures for business registration embodying a simple declarative investment registration system, rather than any sort of investment approval regime. Key elements would include: application to a single government office to provide the license; promulgation of a negative list of ineligible activities and other explicit criteria for approval or denial; default clause authorizing automatic approval of the application if no ruling has been issued within the review period.
- Facilitate provision of secondary permits and authorizations. Additional permits—land, buildings, labor, health and safety, etc—can be facilitated by vesting all such authorizations within the zone authority rather than other ministries and agencies. The zone authority should have offices within each zone to perform these services.
- Develop a special customs rules and regulations drawing upon WCO and WTO provisions, and fast-track implementation of automated customs systems, with proper inventory controls and audit systems, within the free zones.

### *Institutional Framework*

One of the major factors behind the success and failure of zone programs is the autonomy and effectiveness of the body charged with regulating zone operations. One element is particularly important especially in the context of the rising number of private zones. It is critical that zone authorities remain engaged in purely regulatory functions, and do not own, develop or operate zones since opportunities for perceived and actual conflict of interest are multiplied when the entity charged with guiding and monitoring zone performance is simultaneously one of the zone operators being monitored.

Best practice guidelines for the development of an effective institutional framework are the following:

- Ensure adequate autonomy of the zone authority particularly over staffing, budgets, spending and policy-making.
- Ensure adequate authority by constituting an independent Board comprised of key government ministers and private sector representatives reporting to the highest level of government. Ideally, allow private sector representatives to constitute the majority of Board membership to ensure flexibility, results-orientation and customer-focus.
- Ensure that the zone authority serves as a one-stop shop by promulgating legislation that provides the body with single-point authority over other government bodies in core areas.
- Ensure that the body delegates, outsources and privatizes as many non-core functions and services as possible to focus on core activities.

### *Physical Development and Management*

The success of zones is critically linked to the way in which they are located, developed and managed. We have argued that management of zones is enhanced when they are operated on a cost-recovery rather than subsidized basis, and are market-oriented and customer-focused. This is best done when zone development and operation is undertaken by private sector groups on a commercial basis, rather than government organizations who frequently are subject to political pressures and funding constraints. At the same time, the rapid proliferation of private zones can place significant, unanticipated costs on governments especially in terms of offsite infrastructure and facilities, as exemplified by the Dominican Republic and more recently, the Philippines and Viet Nam.

Best practice guidelines for zone development are:

- Implement land use planning and zoning efforts in core areas to zone areas for industrial and commercial development to guide the actions of private developers.
- Develop zone designation criteria in the free zone law and implementing regulations to ensure that private free zones have the best topography, are well located (near population centers and transportation hubs), and minimize offsite infrastructure development expenditures of government.
- Establish a land use planning and infrastructure development unit in zone regulatory authorities to ensure adequate planning and support of offsite infrastructure provision.

#### *4.3 Outlook for Free Zone Development*

What is the outlook for free zones in the context of global integration and trade liberalization? Some analysts argue that the rationale for zones is diminishing as average tariff rates fall around the world. Others foresee a diminished role for zones as the MFA is dismantled in January 1, 2005, given the dependence of many zones on the apparel and textiles industry.

Our analysis suggests that this is not the case. The case for free zones may actually be stronger in the context of trade liberalization. Even with the full implementation of the Uruguay Round, some tariff and non-tariff barriers will remain in most countries. Developing country exporters will need to compete with exporters in other countries who are operating in a duty- and tax-free environment. Second, even with lowered tariffs, anti-export biases will not be removed. Various policy distortions, procedural inefficiencies, and infrastructural inadequacies will deter exporters, many of which can be directly addressed only over the long-term. This places importance for the continued development of focused investment and export promotion mechanisms such as free zones.

The prevalence of free zones in industrialized countries with open economies also underscores the importance of the concept to competitiveness. The 266 U.S. foreign-trade zones are particularly prominent example. Many companies choose an FTZ location because of important advantages of operating in a flexible, duty-free environment. Operating costs are lower as a result of reduced insurance, security and overhead costs. Cash flow is enhanced by the ability to postpone duty payments only upon entry into the domestic customs territory. FTZs in the U.S. have been critical in enabling manufacturers to operate “just-in-time” systems. In fact, most vehicles manufactured in the U.S. are located in FTZs or have factories provided with FTZ status. Mechanisms such as free zones that provide efficiency advantages are even more important

even with the advent of modern production and distribution concepts and approaches, and the key to the reduction of transaction costs.

There is little doubt that free zones must re-invent themselves to response to global integration, international trading rules and the rise of regional FTAs. Zones cannot and should not compete on the basis of fiscal incentives, but rather differentiate themselves in terms of facilities, services and most importantly, streamlined procedures. Many zones, especially privately run ones, are rapidly re-configuring themselves into efficient distribution, production and trade facilitation hubs to reduce logistics costs. International manufacturers have realized that there is much greater scope to reduce logistics costs than production costs. This can be accelerated within a free zone setting, by reducing transaction processing times and paperwork requirements.

There is a continuing role for zones in many countries to incubate and accelerate policy reform. In most developing country settings, the greatest scope may lie in introducing new customs control concepts. In others, zones might be used to side-step public or private monopolies in telecommunications. In still others, like the South Korean SEZs which are 'English language-only,' zones may provide a better environment to attract foreign investment.

In conclusion, Free Zones now increasingly complete on the basis of business-enabling policy environments, rather than on the basis of fiscal and customs incentives. They are increasingly integrated into national markets from a physical, policy, and economic standpoint. They are increasingly utilized as platforms to move goods between countries in today's global marketplace. They have increased their compliance with WTO and ILO norms, as well as decreased their dependence on scarce State resources, becoming more socially responsible development tools as a result. They have, in short, evolved and adapted to a new situation, and are, in our view, unlikely to disappear. Given this finding, properly assessing the particular characteristics which have made some zones successful and others less so is a relevant proposition. It is hoped that this paper has offered a few elements for consideration in that context.