Special Economic Zones as a Tool for Accelerating Economic Growth: A Literature Review

Concept and definition

Special economic zones (SEZs) have long existed in various forms, but it was not until the mid-1900s that they were used as a deliberate policy tool. The US built its first SEZ in New York in 1937, then in 1942 constructed SEZs in Puerto Rico (Pakdeenurit, Suthikarnnarunai and Rattanawong 2014). However, the first modern industrial free zone was introduced and constructed in Shannon, Ireland, in 1959 (Farole and Akinci 2011). Since the 1960s, SEZs have become critical components of national industrial and economic strategies around the world, especially in East Asia and Latin America. Colombia, for instance, established its first zone called Barranquilla in 1964. A year later, the Dominican Republic followed Colombia by creating La Romana zone in 1965 (Farole 2011). In Asia, India set up its first SEZ in 1965, Taiwan in 1966, South Korea in 1970 and China in 1980 (Aggarwal 2012). Although the US was the pioneer of modern SEZs, India has the largest number and China's SEZs, especially Shenzhen, are considered the most successful. The success of China's SEZs has attracted much interest among academia, policymakers and industrial developers around the world. So far, SEZs, such as free trade zones, export-processing zones, industrial parks, freeports and enterprise zones, have been used by developing countries to expedite exports, attract foreign direct investment (FDI) and industrialise the economy.

The notion of an SEZ can conjure up very different images: an industrial enclave in a developing country, filled with footloose multinational companies; the economic "miracle of Shenzhen", the remote fishing village that grew into one of the world's most dynamic metropolises and China's capital of innovation; and the world-class trade and logistics hubs of Dubai and Singapore (Farole and Akinci 2011). In general, most SEZs share the following features: (1) a secured demarcated area, (2) managed by a single management or administrative body, (3) providing advantages depending on their location, (4) under special customs regimes and streamlined procedures (Shakya 2009). Among the four features, the last one is the most important determining feature of an SEZ (Farole 2011), because other SEZ features are very heterogeneous. In contrast, the Chinese SEZ model has been conceptualised as a complex of related economic activities and services rather than a single-function entity. Thus, China's SEZs are larger and cover a wider range of functions than SEZs elsewhere (Wong 1987; Zeng 2010).

Shah (2008, 4) defines SEZs as "contained geographic regions within countries—a demarcated area of land used to encourage industry, manufacturing, and services for export—typically characterized by liberal tax laws and economic policies". Similarly, but more comprehensively, Farole (2011, 23) defines SEZs as:

> ... demarcated geographic areas contained within a country's national boundaries where the rules of business are different from those that prevail in the national territory. These differential rules principally deal with investment conditions, international trade and customs, taxation, and the regulatory environment; whereby the zone is given a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective than that of the national territory.

Modality of SEZs

A wide variety of SEZ modalities exists due to each country's policy objectives, conceptualisation of SEZs, and competitive differentiation strategy. This makes classifying SEZs a difficult task. Building on the classifications suggested by Akinci and Crittle (2008) and Farole (2011), Farole and Akinci (2011) categorise SEZs into five modalities based on their development objectives, size, location, activities

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and markets: free trade/commercial-free zone (FTZ), traditional export processing zone (EPZ), free enterprise (FE)/single-unit EPZ, hybrid EPZ, and freeport, as summarised in Table 1.

SEZs as a policy tool

The rationale for establishing SEZs is that they are expected to accelerate economic development by accomplishing policy goals faster than would otherwise be possible. They have typically been used to attract FDI, reduce unemployment, support economic reforms and test new policy approaches and mechanisms (Akinci and Crittle 2008; Farole 2011; Farole and Akinci 2011).

Attracting FDI: The primary objective of SEZs is to attract FDI. This is especially the case in developing countries, where almost all SEZs are set up to attract investment in labour-intensive, export-oriented sectors such as garment and shoe manufacturing and electronics and automotive component assembly.

Reducing unemployment: Many developing countries have a large reserve of low-wage, low-skilled workers. SEZs are able to absorb this abundant workforce, which would otherwise be underused or unemployed. The SEZs of Tunisia and the Dominican Republic are often cited as examples of SEZ models that have continued to create jobs.

Supporting a wider economic reform strategy: SEZs are easy mechanisms that allow countries to diversify exports and lower export barriers while retaining protective measures elsewhere in the country. The SEZs of China, South Korea, Mauritius and Taiwan follow this pattern.

Testing new policy approaches and mechanisms: China used SEZs as laboratories for its Open Policy and economic reforms in the 1980s while the country was still a closed economy. This experimental approach, coupled with a reform-oriented mindset, proved very successful.

Development and contribution of SEZs

SEZs have contributed significantly to national development in ways that go beyond their primary policy purposes. The contributions can be categorised as static and dynamic. Static contributions are FDI, employment and export growth. Dynamic contributions include skills upgrading, technology transfer, export diversification, improved trade efficiency of domestic firms, industrial cluster formation and global value chain integration. However, evidence shows that the contributions

Table 1: Characteristics of SEZ modalities

	FTZ	EPZ	FE	Hybrid EPZ	Freeport
Objective	support trade	accelerate exports of manufactured products	accelerate exports of manufactured products	accelerate exports of manufactured products	promote integrated development by pooling economic resources
Size	<50 ha	<100 ha	no demarcated zone	- part designated as traditional EPZ - part open to all types of firms	vast (largest type), with residential areas and transport hubs (e.g. ports and airports)
Location	seaports and airports	no common location	anywhere or in designated areas	N/A	N/A
Activities	- trans-shipment - trade	- manufacturing and processing mainly for export - some modified to cover many other activities	export-oriented manufacturing and processing activities	- manufacturing and processing mainly for export - some modified to cover many other activities	all economic activities
Markets	domestic, re-export	export	export	export, domestic	within the zone domestic, export
Exemplars	Panama's Colón FTZ (opened in 1948)	South Korea's Masan FTZ (opened in 1970)	Mauritius and Mexico	Thailand's Lat Krabang	Jordan's Aqaba China's SEZs

Sources: Akinci and Crittle 2008; Farole 2011; Farole and Akinci 2011

Table 2: SEZs' characteristics and impacts at different stages of host country development

Development stage		Expected contributions	
SEZ catalyst	Host country	Static	Dynamic
Enclave	Agriculture-based economy Low income Low-cost, unskilled labour	FDI Employment Export growth	
Linkage to local economy	Middle-income status Well-established domestic firms/ value chains Increasing labour cost Semiskilled or skilled labour		Skills upgrading Technology transfer Export diversification Enhancing trade efficiency of domestic firms Industrial cluster formation Global value chain integration
Facilitate formation of industrial clusters, innovation and specialised SEZs	Industrialised economy		Industrial cluster formation Innovation

Source: adopted from Warr and Menon 2015

of SEZs vary across countries, depending on the development stage of the host country. Warr and Menon (2015) have categorised the characteristics and impacts of SEZs according to the host country's development stage, as presented in Table 2.

Performance and challenges of SEZs

Many SEZs are successful, yet many others fail to achieve their policy purposes. SEZs in India, for example, have experienced both failure and success. Empirical research shows that many SEZs have been successful in creating employment and increasing exports, and have proved marginally positive in cost-benefit analyses (Chen 1993; Jayanthakumaran 2004; Monge-González, Rosales-Tijerino and Arce-Alpízar 2005; Warr 1989 cited in Farole and Akinci 2011).

Global experiences with SEZs indicate that SEZs play an important role in economic growth, industrialisation and economic diversification. The four Asian tigers (Hong Kong, Singapore, South Korea and Taiwan) have maintained very high growth rates since the early 1960s, followed by the rise of China since the mid-1980s. SEZs played a vital role in their industrial upgrading and modernisation and rapid economic restructuring. In the Middle East and North Africa, SEZs have been instrumental in catalysing export growth and diversification. In Sub-Saharan Africa, SEZs have contributed significantly to successful economic diversification and industrialisation. And in Latin America, the Dominican Republic, El Salvador and Honduras have used SEZs to transition from reliance on agricultural commodities to large-scale manufacturing and exploit preferential access to US markets (Farole and Akinci 2011).

SEZs also have a downside, however. Evidence shows that investment in SEZ infrastructure has often outweighed the benefits; firms exploited the incentives and privileges available in SEZs even as many schemes failed to meet their objectives (Farole and Akinci 2011). Many SEZs achieved the static benefits only and not the dynamic benefits (Kaplinsky 1993). Some scholars view SEZs as a second- or third-best policy instrument for improving competitiveness, arguing that SEZs only prosper in certain situations over a restricted period (Hamada 1974; Madani 1999; World Bank 1992). SEZs will not be successful unless sufficient supporting infrastructure is in place and their development effects will depend on the stage of the host country's economic development.

Key success factors of SEZs

Many factors contribute to the success of SEZs, including rapid customs clearance, lax regulation, high global connectivity, highly developed infrastructure, abundant skilled and semiskilled workforce, lucrative incentives, minimal red tape, open macroeconomic regime, and sound monetary and fiscal policies for financial stability. The domestic investment environment also influences SEZ performance; fast expansion of internal trade attracts trade and more FDI (Aggarwal 2012).

Lessons learned from China's SEZs

China set up its first SEZs as laboratories for experimenting with market-oriented reform in the 1980s while the centrally planned economy was still effective. The important objective was to test new policies and institutions for the market economy. Shenzhen SEZ has been very successful and SEZs have sprung up all over the country. Many factors contributed to the success of China's SEZs, as highlighted by Zeng (2010):

- Strong commitment, practicality, flexibility and independence of the top leaders provided a high degree of policy stability and assured investors in the SEZ incubation sites.
- The practical step-by-step approach, as opposed to rapid reform, avoided unfavourable economic, social and political consequences; as Deng Xiaoping in his reform philosophy said, "Crossing the river by touching the stones".
- The SEZs had in place essential infrastructure and services. This laid the foundation for emerging specialised markets, technological innovation platforms and R&D centres. SEZs also had authority to establish their own regulations, contributing to efficient business management. The government made strong efforts to upgrade technology and innovation by escalating investment in R&D infrastructure and providing special incentives to attract high-tech companies and highly qualified scientists and engineers. Public-private partnerships, including in building infrastructure and R&D centres, also played an important role.
- The Chinese diaspora contributed significantly, especially through knowledge transfer in the forms of skills and technologies, capital investment and entrepreneurship in the 1980s. At that time, Hong Kong, Macao and Taiwan were poised to relocate their labour-intensive manufacturing production bases. Because of the similar culture and language and proximity, FDI flowed from these regions into China's SEZs.
- China's SEZs have clear development plans and objectives to contribute to GDP growth, generate employment, accelerate exports and attract FDI, as well as earn tax revenues. They are fiercely competitive among themselves, which encourages firms to be efficient and enhances productivity. The government controls and monitors the development plans, objectives and competition closely.

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