

SPECIAL ECONOMIC ZONES: KEY LESSONS LEARNED FROM GLOBAL EXPERIENCE

Special economic zones (SEZs) are increasingly common and popular policy instrument for economic growth. They are one of the oldest economic regulators and have been in existence for several centuries. The idea of zones' establishing arose in the XII century in Europe; at those times, they were functioning in form of free ports and cities. Since then the meaning of the term has expanded significantly and now SEZs are defined 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*» [1, p. 23].

If considering the components of the term «special economic zone» apart, it can be seen that they are both sufficiently broad and precise [1, p. 26-27]:

1) «*special*» relates to the differential regulatory regime that distinguishes the zone from the national economy;

2) «*economic*» refers to a variety of activities allowed in zones, without prejudice concerning their nature and focus;

3) «*zone*» relates to the legally or physically bounded «economic space» contained in the national territory.

Nevertheless, the definition given above only partly related to the reality, because some countries do not apply taxation incentives, and others have rejected the geographic spatiality of the SEZs and have preferably made it a solely legal space which is applicable to the entire of the domestic territory or large parts of it. It is therefore not surprising that there is some confusion in the name and classification of zones.

Experts *Thomas Farole* and *Gokhan Akinci* comment on it this way [2, p. 1]: ask three people to describe the economic zone and you will get three different answers. The first person may describe a fenced-in territory offering industrial land in a developing country with tax breaks and other investment incentives. In contrast, the second person may remember the «miracle of Shenzhen» – a fishing village, which was transformed into a modern city of over 14 million inhabitants 30 years after the establishment of [3]. A third person

might think about Singapore or Dubai's ports, which operate as the foundation for a wide range of trade- and logistics-oriented activities. Notably, all three of these opinions are correct descriptions of economic zones. Table 1 shows key characteristics of SEZs' types which have become widespread in recent decades.

In addition to SEZs' types identified in table 1, economic zones are often included *specialized economic zones* – highly specialized structures adapted to the necessities of specific activities – science and technology parks, software zones, finance service zones, tourism zone, logistics parks and others [4, p. 11].

As the report [1, c. 24] points out, the multiplicity of SEZs' types is the result of several factors, including:

- the need to distinguish between types of SEZs which have significant differences in form and function;
- zone founders' desire to differentiate their product from others in a competitive environment;
- differences in terminology among countries;
- the result of multiple translations.

The definitions of zones vary with the development of their new modifications, the disappearance of old types or their adaptation in accordance with the new conditions. Experts note [1, c. 24-25] that the definition of SEZ should be broad enough to include a wide variety of «past, present, and future zones», and at the same time sufficiently accurate to exclude those that do not reflect «the essential structural features that make a zone a zone»: *specific regulatory regime, dedicated governance structure, physical and transport infrastructure*.

There is an extensive theoretical and practical studies dealing with SEZ, including Ukrainian [7-9]. However, despite decades of research, many crucial issues remain unanswered. There is still an ongoing debate over the value of special economic zones as a policy instrument. Some economists argue that SEZs can act as a catalyst for economic recovery and growth while others consider them as a «second best policy» tool, giving preference to the economy-wide liberalization of investment and trade.

The aim of the paper, therefore, is to investigate various challenges, opportunities, and perspectives that arise when countries apply SEZs by analyzing the conditions that lead to success or failure of implementation this instrument in practice. This paper also explores why in Ukraine the experience of SEZs' establishing had proved unsuccessful and what needs to be done primarily to remedy this situation.

Table 1

Key characteristics of common SEZs' types in the world *

Type of zone	Features	Goal of establishing	Size	Eligible activities	Markets	Examples
Free Trade Zone (Commercial Free Zone)	<ul style="list-style-type: none"> The oldest and one of the most ubiquitous form of SEZ; They are usually <i>in or near</i> major international transport nodes; Physically segregated from both the port's main area and the outside by fences, gates, and walls, because they lie outside the country's customs territory 	Trade supporting	< 50 hectares	Trade-related activities (warehousing, storage, sales, exhibitions, transshipment, and re-export). Light processing operations (packaging, labeling, quality control, sorting)	Domestic, re-export	Colon Free Zone (Panama)
Traditional Export Processing Zone (EPZ)	<ul style="list-style-type: none"> One of the most common form of SEZ; They appear in the 1950-1960s as a way to hasten industrialization and industry-related international trade in developing countries; Today they are a fenced-in territory offering developed industrial land for rent situated outside the country's customs territory; Provide investment and operational incentives, supported by simplified administrative procedures; The entire area within the zone is <i>for export-oriented enterprises</i> 	Export manufacturing	< 100 hectares	Manufacturing and related activities	Mostly foreign	Shannon Free Zone (Ireland), Masan Free Export Zone (Republic of Korea)
Hybrid EPZ	<ul style="list-style-type: none"> The first four features are the same as in the case of traditional EPZs; The entire area within the zone is <i>for all industries regardless of export orientation</i> 	Manufacturing, including export	< 100 hectares	Manufacturing and related activities	Domestic and foreign	Lat Krabang Industrial Estate (Thailand)
Single Factory EPZ (Free enterprises, FE)	<ul style="list-style-type: none"> Provide incentives to individual enterprises regardless of location; In some countries Single Factory EPZ and EPZ coexist; Some countries have no EPZs as such, and the EPZ status is given to individual enterprises. For instance, in Mexico enterprises that are located along the Mexico-U.S. border have the EPZ status (the so-called maquiladora status) 	Export manufacturing	Designation for individual enterprises	Manufacturing and related activities provide incentives to individual enterprises regardless of location	Domestic and foreign	Mauritius Export Processing Zone (East Africa)
Freeport	<ul style="list-style-type: none"> The largest type of SEZs as they encompass fairly large parts of the territory (urban and rural areas) and also contain large transport facilities (ports and airports); They can include entire regions (even overlap political and administrative units) with populations that live and work in these regions, and all the economic activities that take place there, and even can overlap administrative units; Provide a broader set of incentives and benefits than other zones' types 	Integrated development	> 100 km ²	Multi-use (accommodate all types of activities, including tourism and retail sales)	Domestic and foreign	Aqaba Special Economic Zone (Jordan)
Enterprise Zone	<ul style="list-style-type: none"> This zone intends to revitalize distressed urban or rural areas by the provision of tax incentives and financial grants; Most zones are in developed countries 	Revitalization, empowerment of distressed urban or rural areas	< 50 hectares	Multi-use	Domestic	Empowerment Zone (Chicago, USA) United Kingdom, France
Industrial Zone (Industrial Park)	<ul style="list-style-type: none"> Offer a broad set of incentives and benefits; Provide the qualitative physical infrastructure (real estate, roads, water, electricity, telecommunications) of modern industrial activity 	Industrial development	< 100 hectares	Industry	Domestic and foreign	Eastern Seaboard (Thailand)

* Based on sources: [1, p. 27-30; 2, p. 2; 4, p. 3, 10-11; 5, p. 3; 6, p. 2].

Since the first SEZ in its modern sense was established nearly sixty years ago in Ireland (*Shannon Free Zone*), they have become an essential feature of the world economy [3]. If in 1986, there were 176 SEZs, than in 1995 – already 500 and today more than 3,000 zones are known to exist in 135 countries, which employ more than 70 million people and new ones being added all the time (Figure).

According to *The Economist*, «three out of every four countries have at least one zone» [10]. The largest number of SEZs are found in Asia (470 items), North America (266), Central America (228) and Europa (161). Thus, there are approximately 260 SEZs in the USA, 190 – in China, 115 – in Indonesia, 30 – in Thailand [11, p. 9-10].

Their popularity should come as no surprise. The main economic and social benefits that SEZs can bring are:

- attracting foreign direct investment (FDI);
- jobs creation, especially in «smaller countries with populations of less than 5 million» [4, p. 3-4];
- boosting exports and its diversification as well;
- developing new (among them export-oriented) industries;
- raising government revenue.

These all ultimately resulting in structural transformation, industrialization, and modernization, promoting technology transfer, and innovation through industrial clusters.

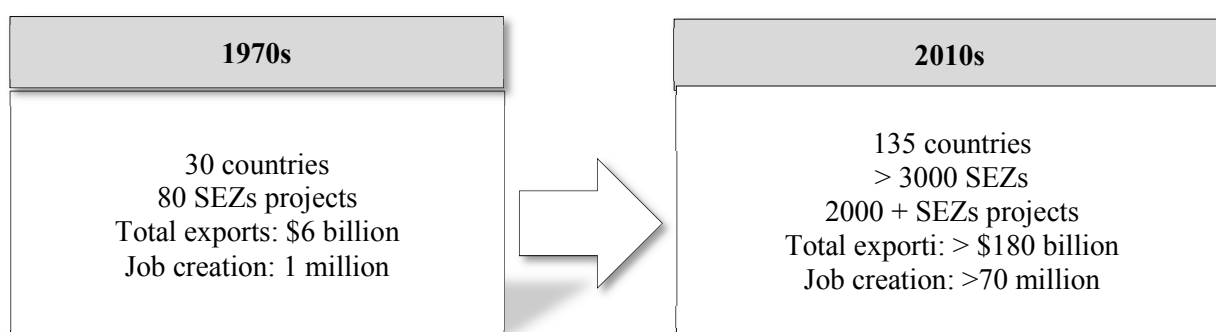


Figure. The growing popularity of SEZs in the world *

* Based on sources: [3; 11; 12].

At the same time, *SEZs are not a ready-made solution for all the economic problems*. They should be taken only as one of the instruments of economic policy. It should also be borne in mind that not all countries have demonstrated successful attempts at creating SEZs. There are both successful and failed zone schemes.

Chinese zones are a good example of success. SEZs helped China to encourage industrial development by attracting FDI, accelerating export growth and promoting technology transfer that subsequently spread to other domestic industries. The best-known example is already mentioned «*miracle of Shenzhen*».

However, the stories of successful zones, particularly Asian and Latin American, have proved difficult to replicate in other regions of the world. Many SEZs have failed or have achieved modest results. For instance, Kandla (India), Bataan (Philippines), Cartagena (Colombia), Moin (Costa Rica) fall into this category. Some experts consider [2; 11] that failed zone programs had been applied in countries such as Senegal, Namibia, Liberia, Ivory Coast, Democratic Republic of Congo (Africa), Pakistan (Asia), *Ukraine*, Moldova (Europa).

That explains why there is still no consensus in the academic and political circles have been reached on the importance of zones as a policy instrument. According to the economic literature, the possible impact of SEZs can be divided into two groups.

Representatives of the *first group* assess SEZs with the help of static economic parameters and do not take into account the potential dynamic «indirect» effects (Table 2). This is the orthodox approach, which based on neoclassical economic theory. Orthodox economists support a country-wide liberalization of trade and investment instead of promoting certain SEZs [2; 13].

Table 2

Potential «direct» and «indirect» benefits derived from SEZs *

Static «direct» benefits	Dynamic «indirect» benefits
Employment creation	Skills upgrading
Export growth	Export diversification
Foreign direct investment	Transfer of knowledge and technology
Foreign exchange earnings	Promotion of non-traditional industries
Government revenue	Regional development

* Based on sources: [1; 4; 13; 16].

Proponents of the *second approach* – the heterodox approach – hold the opinion that «zones can play a long-term dynamic role in their country’s development process» [14, p. 8], potentially generate «the longer term structural and development benefits» for the national

economy [1, p. 26]. Recent economic literature dealing with SEZs particularly highlights the dynamic benefits that zones could achieve. Modern researchers emphasize such dynamic effects as skill formation, knowledge and technology transfer, cluster effects and the integration of national firms into global value chains [4; 15].

However, even not all successful SEZs have been able to achieve equally positive results in static effects, namely boosting employment, increasing export earnings and attracting FDI. For example, in China (zones account for more than 80 percent of cumulative FDI [4, p. 35-36]), in the Philippines and Malaysia SEZs have been proven to be «a very significant contributor» to foreign direct investment [1, p. 66]. The same cannot be said of South and East Asian, Latin American and North African countries' SEZs.

The zones have played an important role in employment generation in certain countries, but on a regional scale, the rates of job creation are low. This contrasting with export performance (Table 3): in many countries, zones account for a major share of exports.

For example, in Nicaragua – 79,4% of total export, in the Dominican Republic – 77%, in Panama – 67%, in the Philippines – 78,2%, in Morocco – 61% [4, p. 35].

Nearly 60 years of SEZs' experience show that the success or failure of a particular zone is related to a multitude of factors. There are as many explanations of such situation as there are zones.

There is evidence that generous fiscal incentives are unable to compensate the weak infrastructure and bad location of SEZs'. Poor roads, no access to electricity, water, and other resources, isolation from suppliers and consumers could not be compensated by tax preferences. Moreover, sometimes tax relief form only a few percent of total cost for implementing investment project and are not the main reason for investing. The most important thing for investors is the state and local government's attitude towards them, their willingness and openness to cooperation. Tesla Motors founder and CEO Elon Musk talks about it in his interview when commenting on the decision to construct of the new factory in Nevada [17].

Table 3

The economic performance of SEZs' activities across regions and the world at large *

	Direct Employment		Zone Exports	
	US\$ millions	Percentage of National Employment	US\$ millions	Percentage of Exports
Asia and the Pacific	61089	2,30	510666	41,0
Americas	3084	1,15	72636	39,0
Western Europe	179 **
Central and East Europe and Central Asia	1590	0,001	89666	38,7
Middle East and North Africa	1458	1,59	169459	36,4
Sub-Saharan Africa	1040	0,20	8605	48,7
Global	68441	0,21	851032	40,8

* Based on source: [4, p. 34, 36]

** data are not available.

Familiarizing with experience of SEZs' functioning in different countries and regions of the world makes it possible to highlight common obstacles to zones success.

1. Mistaken priority setting and the inability to implement them, including due to lack of competent staff.

Overly ambitious and reassessment of own capacities are frequent in economies which try to use zones as an easy way to addressing the economy's structural problems.

In addition to the obvious, incompatible with reality, the desire of local authorities to transform economically weaker regions and cities into «growth poles», some problems are less noticeable. For instance, many SEZs in Asia were initially oriented on the development of new perspective sectors, such as information and communication technologies, software, new materials, including energy saving. However, in order to achieve

success in these areas, statements of local authorities should be backed by a clear strategy and appropriate programs of economic development.

Therefore, overstated state goals may not coincide with the existing economic conditions and from the very outset hinder the development of SEZs'. Take Kazakhstan, for example. In the country had been decided to develop knowledge-based zones. However, as it turned out Kazakhstan did not have enough qualified personnel, so investors had to attract foreign specialists who possessed the necessary amount of knowledge, relevant technical and marketing skills, which had experience in project management. As a result, the share of zones in the total output of goods and services in the country remains scanty – 0,003% and the number of jobs created within them is only 9,000 units (in the period from 2001 to 2013) [18].

Other countries have faced similar problems. For example, in Malaysia in the mid-1990s, the government initiated a large-scale program of economic restructuring in order to stimulate structural changes and to increase the share of high value-added products. However, by the year 2000 the production «came out on the plateau» – there was no decline and no growth. Some scientists note [19] this situation is affected not least by the imbalance in the labor market and limited of high-quality human resources. Indeed, working conditions, labor relations and the development of human potential are weaknesses in many zones of the world, and, consequently, those areas that needed to be improved.

2. *Industrial specialization.*

SEZs should not be created purely as industrial sites in isolation from consumers, suppliers, trade organizations and, most importantly, from the needs of the population. Industrial zones cannot be designed without living quarters and high-quality social infrastructure. Otherwise, the lack of normal comfortable living conditions will prevent the attraction of high-skilled personnel, as it happened, for example, in Airbus Park in Tianjin City, China.

3. *Inappropriate land use.*

As a rule, large tracts of land are allocated for SEZs at an adjusted price (at a price below market). This poses risks of using land plots not for their intended purpose, but, for example, as arable lands, or such purposes (that is use land of SEZs for farming) can be claimed initially.

In that case, SEZs become a place for easy enrichment and abuse of state support. In order to preclude such situation, it is important to highlight the priority areas for investments at the legislative level, including within the framework of zones. It could be the investment:

- in technology innovation for industrial modernization;
- in the development of priority sectors of the economy;
- in order to promote the commercialization of scientific and technical developments owned by scientific institutions and universities;
- in order to accelerate the development of economically backward areas and so forth.

4. *The risk of distortions of competition.*

Except that provision of public assistance to firms entering the SEZs (in the form of tax, customs, credit benefits and preferences) reduces tax revenues to the budget - at least in the short term - it also entails the threat of distortions to the economy and competition due to the advantages to some firm or to the production of certain types of goods. This is one of the reasons why some scientists and politicians prefer economy-wide liberalization of trade and investment instead of in limited areas of the country.

5. *Location and quality of infrastructure.*

As it was mentioned above, offering just tax and other economic benefits to SEZs' firms, the state can certainly improve the economic situation in a certain region, but it is unlikely to provide a long-term effect due to this. The most successful zones in world practice are organically built into the national economy and closely integrated with global markets, for example, the South Korean SEZs have strong links with local suppliers. This, in turn, requires quality infrastructure and substantial public expenditure for the upgrading of roads, electricity and water-supply systems, telecommunication systems, and transport.

Lack of adequate infrastructure even with the favorable economic environment can become an obstacle to the successful development of SEZs how it happened in particular in Africa: lack of reliable electricity and long distance to the port have become the reason of failures of many African zones.

An important role in SEZs' success plays their location and closeness to the transport. SEZ in Dakar (Senegal), which was located far from the port of Dakar and isolated from the main trade routes, may be used as a bad example.

Nevertheless, that does not mean that considerable investment in infrastructure will ensure SEZs' success automatically. For example, Philippine authorities have invested significantly in the infrastructure of SEZ in province Bataan: a port was upgraded, a new dam for supply power was built and new modern office buildings were built. However, despite its «infrastructure attractiveness» for a long time, the zone could not attract investors. Public resources were spent ineffectively. As a whole, it should be pointed out to a large number of similar instances in world practice.

On the other hand, there are several examples of how SEZs have dramatically reduced the number of unemployment, developed export activities, attracted investment and finally have played a catalytic role towards structural changes.

As mentioned above, *in Ukraine the experience of establishing zones was not successful*. The first Ukrainian SEZ – the North Crimean Sivash Experimental Economic Zone – was created over two decades ago (in 1996) as a pilot project with traditionally good intentions: for attracting investments and developing export potential, solving social problems and other. Nevertheless, in 2002 upon termination of the experiment and obviously not too high of its success by decree [20] SEZ «Sivash» was eliminated. Another attempts to create zones also failed.

The preferences and benefits provided by the state to firms entering the SEZs had not yielded the expected results and had led to large losses of the state budget, distortions in the economy and competitive environment. Among «national characteristics» of SEZs are

worth noting neglect of legislative requirements and existence of corruption opportunities for abuse of authority, enrichment of officials at the taxpayers' expense. Therefore, drastic criticism of the Ukrainian SEZ is quite fair. Though could such verdict be final? Obviously not. As well as SEZs, a number of instruments which worked well in numerous countries have not become successfully established in Ukraine largely owing to unqualified implementation and abuse of power.

Today according to the Ministry of Economic Development and Trade of Ukraine there are eleven special economic zones created in the late 1990s and early 2000s. In the form in which they were «locked up», Ukrainian SEZs have significant shortfalls. However, this does not mean that they should not be corrected. Quite the contrary, this instrument of «targeted» stimulating of investment activity, promotion of employment, increases in exports, etc., generally accepted in the world practice, needs to be improved and brought into line with modern conditions.

First of all, Ukrainian's legislation needs to be improved. Basic Law in force on SEZs [21], adopted in 1992, has laid only general legal foundations for zones. However, the Law was not clearly defined criteria to attract investors; it does not specify special requirements for enterprises wishing to work in the SEZs, along with investment benefits. Each SEZ was established on the basis of a separate law, that defined tax, customs and monetary regimes of economic activity, but even in these laws, there were no criteria for drawing investors. This means that enterprise of any sector of the economy (it is not even about high-tech activities as is customary in the world practice) could benefit from SEZs. As a result, the zones have become a convenient tool for abuse of power and tax avoidance, led to distortions in the economy and of the competitive environment. If we add to this the State's position of the refusal to assume responsibility and expenditures on ensuring of the SEZs with all the necessary infrastructure (roads, electricity and water supply systems, telecommunication systems, etc.), it can be stated that the authorities had done its utmost in order to this instrument did not live up to expectations.

It is now important to recognize that without of political leadership's goodwill which should put the future of the country above self-enrichment the situation will remain unchanged. The public policy toward SEZs should be well-balanced, systemic and predictable enough in order to create stable conditions for investing activities. Nevertheless, the existence of SEZ in itself should not be regarded as a self-sufficient instrument for stimulating structural transformation. In addition to supporting the implementation of SEZs' role in the economy, the state should form a common enabling environment for business that extends beyond spatial boundaries of SEZs and spread to the economy as a whole.

Conclusion. Special economic zones are widely distributed around the world. The study showed that zones can be an effective instrument to attract foreign investment, create new jobs, stimulate industrial production, increase export revenues, and promote structural transformation, as well as economic development, but only when implemented properly. SEZs are the costly risky initiative that needs careful planning. Despite this nowadays there are too many zones to ignore. The most important lessons of SEZs' world experience for new initiatives are:

The zones do not bring the positive result overnight. It takes from five to ten years before they reach high levels of employment and investment. This is even true for the most successful zones.

SEZs are offered generous tax relief to firms as well as more liberal trade, and operating rules than in the rest of the national territory. However, tax preferences as such had not deserved a broad support. Tax relief brings positive results if political and macroeconomic stability is provided, infrastructure is well-developed and reliable, there is no corruption, there is access to qualified human resources.

As a rule, SEZs' foreign firms seek to prevent disrupting well-established linkages with their sources of inputs because it is hard to develop backward linkages with local suppliers. The exceptions are China and Thailand where developed supporting industries can be identified. So the existence of zones does not necessarily imply the development of local supporting industries due to the SEZs' firms is not always interested in resources locally.

The zones are more likely to bring advantages to the host country if they are an integral part of a general economic development strategy. Zone programs must be part of a broad national or regional development program and they also must be designed to best support of countries' comparative advantages. As an example, in China, Republic of Korea, Singapore and in Dubai zones programs consider as a crucial tool of national or regional economic and industrial development program and they are supported at the very top level of the government.

In Ukraine, the potential contribution of SEZs to solve internal structural problems remains unrealized. In the country as a whole was registered eleven special economic zones, but in fact, they are not functioning. Preferences and benefits in the territory of SEZs were canceled in 2005 and have not been restored to this day. Therefore, enterprises working in zones operate under general tax rules and do not have any state privileges. For changing this situation, it is first of all necessary to amend the legislation and improve state policy towards zones by making it well-balanced, systemic and predictable enough.

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Підоричева І. Ю. Спеціальні економічні зони: головні уроки, набуті зі світового досвіду

Спеціальні економічні зони є одним із найстаріших економічних регуляторів, які поширені в усьому світі. Дослідження показало, що зони можуть бути ефективним інструментом залучення іноземних інвестицій, створення нових робочих місць, стимулювання промислового виробництва, збільшення доходів від експорту, сприяння структурним перетворенням і, в кінцевому підсумку, – забезпечити економічний розвиток країни, але тільки коли створюються з дотриманням певних умов. У даній статті основна увага приділяється дослідженню проблем і можливостей, які супроводжують процес створення спеціальних економічних зон, шляхом аналізу умов, які приводять до успіху або невдачі в

реалізації цього інструменту на практиці. Приділяється увага українському досвіду створення спеціальних економічних зон і питанню того, чому в Україні спроба використати цей інструмент економічної політики зазнала невдачі і що необхідно зробити в першу чергу для виправлення цієї ситуації.

Ключові слова: спеціальні економічні зони, економічна політика, інструмент, індустріалізація, модернізація, структурна трансформація, економічний розвиток.

Пидоричева И. Ю. Специальные экономические зоны: главные уроки, извлеченные из мирового опыта

Специальные экономические зоны являются одним из старейших экономических регуляторов, распространенных во всем мире. Исследование показало, что зоны могут быть эффективным инструментом привлечения иностранных инвестиций, создания новых рабочих мест, стимулирования промышленного производства, увеличения доходов от экспорта, содействия структурным трансформациям и, в конечном счете, – обеспечить экономическое развитие страны, но только когда создаются с соблюдением определенных условий. В данной статье основное внимание уделяется исследованию проблем и возможностей, которые сопровождают процесс создания специальных экономических зон, путем анализа условий, которые приводят к успеху или неудаче в реализации этого инструмента на практике. Уделяется внимание украинскому опыту создания специальных экономических зон и во-

просу того, почему в Украине попытка использовать этот инструмент экономической политики потерпела неудачу и что необходимо сделать в первую очередь для исправления этой ситуации.

Ключевые слова: специальные экономические зоны, экономическая политика, инструмент, индустриализация, модернизация, структурная трансформация, экономическое развитие.

Pidorycheva I. Special economic zones: key lessons learned from the global experience

Special economic zones are one of the oldest economic regulators which are widespread throughout the world. The study showed that zones can be an effective instrument to attract foreign investment, create new jobs, stimulate manufactured production, increase export revenues, promote structural transformation, and ultimately ensure country's economic development, but only when they are created in accordance with all the necessary conditions. This paper focuses on the study of various issues and opportunities that accompany the process of SEZs' creation by analyzing the conditions that lead to success or failure of implementation this instrument in practice. Attention was paid to Ukrainian experience of SEZs' establishing and to a question on why in Ukraine attempt to use this instrument of economic policy had proved unsuccessful and what needs to be done primarily to remedy this situation.

Keywords: special economic zones, economic policy, instrument, industrialization, modernization, structural transformation, economic development.

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