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## It worked in China, so why not in Africa? The political economy challenge of special economic zones

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WIDER Working Paper 2014/152

## **It worked in China, so why not in Africa?**

The political economy challenge of Special Economic Zones

Thomas Farole<sup>1</sup> and Lotta Moberg<sup>2</sup>

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**Abstract:** African countries have sought to replicate the success of East Asia by implementing special economic zones. Despite decades of international experience, there remains no blueprint for successful special economic zone policies, and the majority of special economic zones fall well below expectations. We argue this is largely due to flaws in the political economy of special economic zone schemes, which prevent replication of ‘best practice’ in special economic zone development and management. We propose a ‘robust political economy’ framework that divides political economy problems into those of inadequate knowledge and distorted incentives. We use it to explain the problems with African special economic zones and to suggest possible solutions.

**Keywords:** Special Economic Zones, Sub-Saharan Africa, foreign direct investment, political economy, industrial policy

**JEL classification:** F13, F23, F59, F63, O24, P48

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## 1 Introduction

Much of the economic success of East Asia has been attributed to their use of Special Economic Zones (SEZs). This has led to a rush of countries seeking to replicate the export led growth and structural transformation in those countries by launching SEZ programmes of their own. The wave of SEZ projects in Sub-Saharan Africa (SSA) is a case in point. The scale of the expansion in recent years is unprecedented, and more zones may be developed over the next decade than during the three preceding decades combined.

The aim of SEZs is generally to attract investment, create employment, and diversify economies, traditionally with a focus on expanding the manufacturing sector. To accomplish this, governments have focused on developing modern industrial parks, providing fiscal incentives (in particular, tax breaks); and promising hassle-free business environments through efficient ‘one-stop-shops’. After decades of international experience with SEZs, it seems that governments around the world would have learned to craft these policies effectively to deliver SEZ success. Yet, despite a general understanding of the ‘technology’ of SEZs, such as their design, development, and management, the majority of SEZ projects continue to fall well below expectations. The experience in SSA has been particularly disappointing.

This paper will therefore look at the progress of African SEZs so far, analyse the obstacles for their success, and propose some potential solutions. When analysing some of the often-cited problems with African SEZs, we find that these problems can largely be attributed to the political economy of the SEZ schemes. Political economy issues are context-specific, which means that the avenues to replicate ‘best practice’ for SEZ development and management are limited. Yet they should play a critical role when governments set the initial strategic objectives and carry out strategic planning of zones. We propose a ‘robust political economy’ framework that divides political economy problems into those of *inadequate knowledge* and *distorted incentives*. The framework also helps us suggest some possible solutions to these problems.

The next section provides a brief introduction to SEZs, their objectives, and international experience in their use. Section 3 discusses the experience of SSA with SEZs and traces some of the usual explanations for their failure back to a root cause of political economy. In Section 4, the political economy framework is introduced. This framework is then applied to SEZs in Section 5, illustrated with examples from the African experience. Section 6 concludes by outlining a way to enable political economy considerations to be understood, mitigated, and taken into account in the planning and implementation stages of SEZ programmes.

## 2 Special Economic Zones – theory and experience

Export processing zones (EPZs), free trade zones, and other forms of special economic zones are demarcated geographical areas within a country’s national boundaries. In these zones, rules of business are different, and generally more liberal, from those that prevail in the national territory. We use the term special economic zone in a generic way, to encompass a broad range of regime types. Table A1 (see Appendix) summarizes the most common forms of these regimes.

SEZs have a long-established role in international trade. Entrepôts and citywide free zones that guaranteed free storage and exchange along secure trade routes, such as Gibraltar, Hamburg, and Singapore, have been operating for centuries. The first modern industrial free zone was

established in Shannon, Ireland, in 1959. Before the 1970s, most zones were found in industrial countries. Since the 1970s, however, starting with East Asia and Latin America, zones have been designed to attract investment by multinational corporations in labour-intensive manufacturing. These zones became a cornerstone of trade and investment policy in countries as they shifted away from import-substitution policies and aimed to integrate into global markets through export-led growth policies. Since the mid-1980s, the number of newly-established zones has grown rapidly in almost all corners of the world. In 1986, the International Labour Organization reported 176 zones in 47 countries. By 2006, this had risen to 3,500 zones in 130 countries (Boyenge 2007).

Around the world, SEZs have played a catalytic role in growth and structural change. This includes East Asia's 'tiger economies' such as China, which used SEZs as platforms to support the development of export-oriented manufacturing. Latin America, the Dominican Republic, El Salvador, Honduras, and others, used free zones to take advantage of preferential access to the USA market. Their zones generated large-scale manufacturing sectors in economies previously reliant on agricultural commodities. In the Middle East and North Africa, SEZs played an important role in catalyzing export-oriented diversification in countries like the Arab Republic of Egypt, Morocco, and the United Arab Emirates. In SSA, Mauritius is an example where SEZs were a central policy tool supporting a highly successful process of economic diversification and industrialization. SEZs have in several cases succeeded not only in attracting investment and generating employment, but also leveraged these inputs to support dynamic benefits of openness, technology absorption, upgrading, and structural transformation.

SEZs are designed as instruments of trade, investment, and spatial industrial policy. They are generally established with a few specific, by no means exclusive, policy goals (FIAS 2008), with export promotion and foreign direct investment (FDI) attraction central to almost all zones. Besides exports and FDI, zones may also serve to:

- Support a wider economic reform strategy. SEZs can permit a country to develop and diversify exports, while limiting trade exposure to international competition of their protected industries. SEZs are therefore sometimes more likely to be accepted by elites that oppose reform than broader changes in the trade regime. While keeping protective barriers intact, zones can reduce anti-export bias, which may lead to broader reforms down the line. The EPZs of Taiwan-China, Mauritius, and the Republic of Korea seem to follow this pattern.
- Serve as 'pressure valves' to alleviate large-scale unemployment. In the absence of political will to undertake reforms, zones can be a 'second-best' solution, as enclaves that absorb excess labour. As a result, the SEZs tend to have limited impact in the country as a whole. Tunisia and the Dominican Republic are examples of robust, job-creating SEZ programmes that confined these benefits within the walls of the SEZs.
- Pilot the application of experimental new policies and approaches. China's wide-area SEZs are examples of confined areas that introduced financial, legal, labour, and even pricing reforms. New policies first tested within the SEZs, before being extended to the rest of the economy.

What objectives a government has with its SEZ programme depends on how it views economic reform in the context of wider development and structural transformation of the country's overall economy. To meet these various objectives, SEZs must overcome barriers that hinder

investment in the wider economy. The zones create ‘special’ regimes that typically confer four specific advantages to investors relative to what they enjoy in the domestic economy:

- 1) *Infrastructure*, including serviced land, factory shells, and utilities, that is easier to access and more reliable than in the country as a whole;
- 2) *Special customs regimes*, such as efficient customs administration and access to imported inputs free of tariffs and duties;
- 3) *Improved regulatory and administrative regimes*, mainly streamlined procedures for setting up companies; and
- 4) *Attractive fiscal regimes*, often including reduction or elimination of corporate taxes, VAT, other taxes and labour contributions, such as pensions and social security, and sometimes subsidies for training or other activities.

Despite the potential of SEZs to improve economies through these channels, they have a mixed record of success. Investments in zone infrastructure have in many cases resulted in ‘white elephants’, that cost more to maintain than the benefits that they bring, or zones where investors take advantage of tax breaks without delivering substantial employment or export earnings. Many of the traditional EPZ programmes have been successful in attracting investment and creating employment in the short term, but failed to sustain competitiveness in the face of rising wages or eroding trade preferences. Empirical research shows that many SEZs have been successful in generating exports and employment, and come out marginally positive in cost-benefit assessments (Arce-Alpizar et al. 2005; Chen 1993; Jayanthakumaran 2003; Wang 2013; Warr 1989). However, as SEZs give preferences to specific sets of firms based on pre-defined criteria, economists view zones as a second-best solution to policies promoting competitiveness more generally (Hamada 1974; Madani 1999; World Bank 1992). Another concern is that zones, by and large, have failed to extend benefits outside their enclaves or to contribute to upgrading of the domestic skills and the production base (Kaplinsky 1993). The SEZs in Africa have by no means been shielded from these problems.

### **3 Special economic zones in Africa**

Several African countries, including Liberia, Mauritius, and Senegal, launched SEZ programmes in the early 1970s. However, most African countries did not operationalize their programmes until the 1990s or 2000s. As of 2014, the majority of countries in SSA have active SEZ programmes, and many others are in the process of developing them. The vast majority of African zones are traditional EPZs and industrial parks.

The African experience with SEZs over the past two decades has been less than spectacular. With the exception of Mauritius and the partial initial success of Kenya, Madagascar, and Lesotho,<sup>1</sup> most African zones have failed to attract significant investment, promote exports, and create sustainable employment. No SEZ programme except Mauritius has managed to use economic zones to support a successful process of structural transformation. Recent research

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<sup>1</sup> Lesotho does not have a zone programme per se, but it combines the same policy instruments to support export manufacturers, including a special fiscal and administrative regime along with the public provision of industrial infrastructure.

(Farole 2011) shows African SEZs have failed to generate significant improvements in investment, employment, and exports, both relative to their own internal targets and in international comparison. Even where programmes have been successful in attracting investment, creating employment, and generating exports, there are concerns over the quality of investment and employment as well as its sustainability. Indeed, the recent experience of Madagascar, which lost tens of thousands of jobs in SEZs following political turmoil and the country's subsequent suspension from African Growth and Opportunity Act (AGOA) (Staritz and Morris 2013), may highlight the fragility of the economic zones models implemented in Africa to date.

One of the reasons for the failure may simply be poor timing. In East Asia, the rapid growth of economic zones and their contribution to export-led growth were driven in part by an unprecedented era of globalization. The 1980s and 1990s saw impressive growth in international trade and cross-border investments, as well as the rise of global production networks (GPNs). African countries, which mostly launched programmes later, faced a more difficult competitive environment when they did. The emergence and entrenchment of 'factory Asia', the expiration of the Multifiber Arrangement, the consolidation of GPNs; and recently slowing demand in traditional export markets can all take some of the blame. African countries may thus have developed the wrong zone model at the wrong time.

Yet, most of the blame lies not with the global environment but with zone planning and implementation. Farole (2011) finds that while African zones in most cases established physical and regulatory environments that were more attractive than their national markets, the improvements were far from sufficient to establish investment environments that were sufficiently attractive to footloose international investors with global alternatives. African zones also failed to take off due to a lack of basic infrastructure or regulatory uncertainty. Beyond this, other problems which have plagued African SEZ programmes include: insufficient (and insufficiently rigorous) strategic planning; poor choice of location; insufficient investment in connective and social infrastructure outside the gates of the zone; weak implementation capacity and poor internal co-ordination; and lack of sustained, high-level support, and policy stability.

While it is easy to identify manifold reasons why African zones have failed to take off, it is less clear why these situations come to pass. After more than 40 years of experience in planning and implementing SEZs, there is no lack of international research on them. Legions of international consultants and development agencies have spent time and money on the matter. Asian countries with successful SEZ experiences provide technical expertise and financial support for SEZ development as part of their bilateral development assistance. Many African zone programmes have received support from these governments. For example, several of China's overseas 'Economic and Trade Co-operation Zones' are being developed in Africa.<sup>2</sup> Other private Chinese developers are active in Tanzania, Nigeria, and Sierra Leone, among others (Bräutigam and Xiaoyang 2011). The governments of Korea and Japan provide technical support to SEZ developments across the region. Olam International of Singapore has developed an SEZ with the government in Gabon.

With all this global expertise involved, and all this experience across time and space, one would expect greater success. Nevertheless, SEZs often fail to take off or generate the promised export revenues and employment expansion. Unless a country has an absolute advantage in production

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<sup>2</sup> In Ethiopia (Eastern), Mauritius (Jin Fei), Nigeria (Lekki and Ogun), and Zambia (Chambishi and Lusaka).

or a very large internal market, a number of factors must come together simultaneously to make an SEZ programme successful. These include location, policy, strategy and planning, the legal and regulatory framework, customs, administrative capacity, management, as well as political will and long-term commitment. While most of these issues are technical in nature, they are in fact reliant on a functioning political economy. Political economy shapes the initial strategic thinking and planning for zones, as well as their implementation. As such, it can either set things in proper alignment, or throw them off course. In the next section, we outline a ‘robust political economy’ framework to analyse the challenge of SEZs. We then apply it to the African experience to show how political economy factors help explain the difference between success and failure.

#### **4 Political economy – theoretical framework and its application to SEZs**

A political economy analysis takes into account the effectiveness and flaws of governments and the individual actors who constitute it. Economics has traditionally treated governments as a ‘black box’, with policies forming the rules by which economic agents act considered exogenous (Basu 2000: 5). A couple of assumptions are necessary about how governments operate for its policies to be treated as tools for fine-tuning economic outcomes. First, that policy makers have access to all relevant data and information to forecast the outcomes of different policies. Second, that policy makers and other government officials are interested in pursuing the stated objectives of government. In standard macroeconomic models, there is no room for transaction costs of policy execution. In these models, governments function by automation and based on perfect information. In the real world, of course, these assumptions never hold. And indeed they hold less in some places than others.

Political economy analyses therefore treat governments and the individual agents within them as actors with their own goals and information asymmetries, and focuses on the interaction between market and government actors. The School of Public Choice is one strand of political economy that applies the principles of incentives of economic agents to non-market actors. Much of the public choice literature explores the actions of people in politics or political institutions (DiLorenzo 1988; Buchanan 2003). Public choice extends the fundamental logic of standard microeconomic models, of rational individuals who maximize personal utility, into the individual actors within public institutions, to explain collective decision-making. The decision to adopt a policy, and the way that the policy is designed and implemented, is endogenous. They emerge from the interplay among actors in political institutions (Wagner 2007). Because this interplay will vary considerably across places, it is also highly context-specific.

Buchanan and Tullock (1962) show that even though government officials are different from businesses and households in their positions and powers, they are also rational and utility maximizing. Politicians seek to be re-elected, civil servants may seek larger offices and more staff, and bureaucrats may seek more leisure time (Niskanen 1971). As a result, the self-interest of policy makers and policy executives often conflict with assumed goal of maximizing social welfare. While assumptions of rational self-interest and perfect information may produce optimal policies when limited to market participants, they can lead to corruption and less egregious forms of rent-seeking when extended to government. Officials may for instance use trade policy for personal gains, by selling import or export quotas (Krueger 1974) or adjusting tariff rates according to the lobbying by interest groups (Grossman and Helpman 1994). Political elites may use foreign aid that they receive for their personal advantage, rather than distributing it effectively (Bauer 1971; Friedman 1958). They can even gain by depressing economic



development (Easterly 2007). In many such ways, officials may use policies to enrich themselves both financially and politically at the expense of the economy as a whole.

Another line of political economy focuses on the assumption of perfect information. Government may have the right incentives, and try honestly to improve economic conditions. Yet, it lacks the superior knowledge and understanding of market fluctuations and potential that it would need to improve on an economy's resource allocation (Lavoie 1985; Boettke 1998; Horwitz 1996). Much insight about the limited knowledge emerged from the 'calculation debate' over the feasibility of government planning in the Soviet Union (Horwitz 1998). As Hayek (1935: 157) explained, even if a central authority could calculate all prevailing prices, it would be unable to perform the multiple small adjustments in prices that constantly take place in a market regime. Not only are market participants more familiar with the details about local market conditions. They also constantly obtain and digest feed-back on their performance through their profits, which allows for regular improvement and updates (Myint 1964: 120-1). The risks of industrial policy can be explained by this same logic. Industrial policy is built on the premise that government can mitigate consequences of market failures, such as information spillovers and other externalities (see e.g. Harrison and Rodriguez-Clare 2009: 4). But government is at an inherent disadvantage to market participants when it comes to knowing what development projects are actually worthwhile (Keck 1988).

A thorough political economy analysis accounts for the absence of both government benevolence and omniscience. It considers problems that may occur due to distorted incentives in the absence of benevolence as well as problems resulting from the limited knowledge of policy makers. This forms a reality-based, positive theory of policy-making, where policies are not exogenous and not automatically in the interest of the public. It does not mean that policy makers always get things wrong, but that there will be a risk of harm from policy-making. Because rents are extracted only at the expense of others, policies also come with a systematic bias against the common good. The upside is that the right institutional environment can align the self-interest of public officials with benefiting the people, and it can allow policy makers to make the right decisions without being perfectly informed. Such institutional environment is what constitutes a 'robust political economy' (Leeson and Subrick 2006; Pennington 2011). (See Figure A1 in the Appendix.)

Instituting a robust political economy is important for the prospect of success of such policies as SEZs, which aim to improve market conditions and spur economic development. The obstacles that we have outlined to getting SEZs right such as proving a certain quantity of infrastructure, may at first look like economic problems. However, rather than being purely a matter of following 'best practices' of established SEZ models, solving political economy problems is critical to SEZ success.

SEZs need designs that work despite the limitations of distorted incentives and inadequate knowledge. The more prominent are the political economy problems, the more careful a government must be when setting up the policies and institutions regulating SEZs. In the next section, we discuss the main political economy problems with SEZs, with a specific focus on the African context. The analysis is structured to deal with the two broad lines of thought in political economy, namely that relating to distorted incentives and that relating to inadequate knowledge. If the incentives are not aligned with a successful outcome, the knowledge of proper SEZ policies, location, and so on will be irrelevant, as policy makers will choose not to act on them. In the presence of problems stemming from inadequate knowledge, on the other hand, any

amount of political will and coherent motivation of an administration will be insufficient to get an SEZ scheme right.

## **5 The political economy of African SEZs**

The political economy framework introduced in the previous section appears relevant for the recent experience of African countries with SEZs. Indeed, many programmes in the region have suffered from various manifestations of both distorted incentives and imperfect information. In this section, we discuss how such political economy factors have contributed to underperformance in African SEZ programmes.

### **5.1 Distortions from political incentives**

African SEZ investors are often limited by weak SEZ governance, inefficient bureaucracies, and/or poorly designed legal frameworks. Such problems may appear to stem from inadequate funding or weak capacity. However, at their root, these problems seem to result from the misaligned incentives of policy makers and other officials. As a result, policies and practices are far more distorted than would be ideal.

The most obvious example of destructive self-interest is when politicians use the privileges that SEZs confer, including access to cheap land and fiscal incentives, for self-enrichment. SEZs around the world are rife with examples of corrupt land deals involving government officials. There have also been many instances where members appointed to the board of the SEZ regulator have their own political and business interests in the SEZs. They thus use their influential position to affect SEZ regulations in ways that do not benefit the SEZ scheme as a whole (Farole 2011: 182).

In practice, corruption is nevertheless a small part of the story. More commonly, distorted incentives flow from more prosaic political realities. In particular, politicians motivated by electoral gains have the incentive to use SEZs as an instrument to show visible progress and results. Also, given the short-term nature of the election cycles, the emphasis tends to be on short-term gains, which is usually at odds with the long-term nature of SEZs. Politicians also have the incentive to use SEZs as an instrument to confer privileges on various domestic constituencies, and therefore to quell potential internal political dissent.

These political motivations have several implications regarding the design and delivery of SEZ programmes. First, the visible and marketable nature of the SEZ gives politicians an incentive to adopt an SEZ regime even when there are simpler, quicker, and less expensive alternatives. This causes delays in getting the right policies in place, as developing SEZ laws and regulations, and plan and implement large infrastructure projects takes a long time. This implies the risk of missing market opportunities. Bangladesh offers a positive example of the opposite. Well before setting up EPZs, Bangladesh implemented a bonded warehouse regime, which allowed exporters to import raw materials inputs duty-free and hold them 'in bond' to be used for export products. Kenya's Manufacturing-Under-Bond programme played a similar role. Such a programme, combined with an existing national investment incentive regime, delivers many of the benefits inherent in an export-focused EPZ programme. Had countries such as Tanzania implemented this approach, they could have had a value proposition available for export-oriented investors during the early days of AGOA. Instead, the legal, institutional, and financing challenges of putting in place an SEZ regime delayed implementation for close to a decade.

Second, it becomes politically attractive to concentrate government efforts on the ‘hardware’ of SEZs, such as infrastructure, which is easy to measure and show to the public as signs of progress. The ‘software’ of an SEZ, such as a good business climate, a proper legal framework, and the professional and effective execution of it, generates much less political capital. These SEZ features cannot be measured as easily, or showcased visibly with models and artists interpretations, not to mention with groundbreaking ceremonies and modern entry gates. The emphasis on the visible side of SEZs has often resulted in zones that fail to address the investment climate constraints that should have been their *raison d’être*. For example, when Senegal’s pioneering free zone programme was set up in the 1970s, administrative barriers meant that firms sometimes had to wait up to a year to get an approval on a free zone applications (Baissac 2011). South Africa, the country with by far the best industrial infrastructure in Africa, launched its industrial development zone programme with huge investment in infrastructure, but with a regulatory regime that offered virtually nothing different from what investors could get in the domestic environment (CDE 2012).

Because capital-intensive investments in industrial parks are attractive showcases for progress, policy makers also have the incentive to dismiss the value of other forms of production and usage of land. Agriculture in particular, has frequently been held in low esteem in relation to manufacturing oriented SEZs, despite most African countries having a comparative advantage in agriculture. Moreover, the very designation of a piece of land as an SEZ can raise its value substantially.

These factors have contributed to land grabbing and corrupt land deals to secure agricultural land for conversion into SEZs, often without appropriate compensation to those previously using or occupying it. Widespread land grabbing has been catalogued following India’s 2005 SEZ Act, resulting in the ‘conversion of the fertile land into cement structures’ (Mitra 2008: 13; Levien 2012; Kahn 2008: 14). Vietnam has seen around 100,000 rural villagers displaced to make way for industrial zones and complexes. A 2005 report said that more than a third of those were inadequately compensated directly or indirectly through better employment opportunities or improved technical or social infrastructure (Action Aid Vietnam 2005). Nigeria has also faced protests from local communities over land compensation and resettlement around the SEZ of Lekki. These clashes inevitably cause delays in SEZ projects. More generally, they contribute to the possible sub-optimal use of land.

The political incentive to tell the story of SEZ success as soon as possible has contributed in many cases in a misallocation of resources toward promotion over project implementation. For example, in Senegal, millions of dollars were spent on promotion of the *zone franche* programme through its investment promotion offices around the world. The reality on the ground, meanwhile, was that the zone lacked the resources, capacity, and political will to deliver a basic quality investment environment. Similarly, Nigeria’s Lekki project has been promoted for almost a decade without yet coming to fruition.

The preference for measurable results is also an incentive to attract more businesses to SEZs regardless of whether those businesses have the potential to be competitive or to fulfill their targets for investments and exports. The government may lower its standards for SEZ licenses to attract a larger quantity of firms, many of which are not competitive enough to bring a positive contribution to the zone. If SEZ authorities have quantitative goals, they inevitably have the incentive to offer zone licenses cheaply. One of the visible manifestations of this in African zone programmes is the failure of many ‘committed investors’ to convert to actual operations on the ground. Similarly, authorities often open up free zone licenses to individual firms, so-called

‘single-factory zones’, regardless of where they are located. This practice has been adopted widely in Africa, including in Ghana, Senegal, and Kenya. While single-factory zones can be effective in some circumstances, they also allow zone programmes to encompass large numbers of investors without adequate regard for the fiscal consequences of domestic firms shifting into the SEZ regime. They also lead to licensing of firms that may be questionable from the perspective of the aims of the SEZ programme. A review of zone programmes in West Africa, where free zone status is commonly granted to individual firms shows that, while the programmes aim to attract labour intensive exports, the composition of activities is substantially capital-intensive and (regionally) import-substituting in nature (Kreuzwieser 2011).

SEZs can also be an attractive instrument to manage political constituencies. This can be beneficial, if they allow for better policies than would have been feasible in the absence of the zones. In the case of Mauritius, for example, the initial SEZ programme was the result of a process of political compromise, which opened the door for a substantial political experimentation and reform. More commonly however, SEZ have been used as a token to appease regional interests, specifically with the aim of alleviating unemployment in distressed areas. The result is a fragmentation of focus and resources across a large number of SEZs across a country, most of which never get off the ground. There also tends to be poor allocations of investment to peripheral regions that are poorly positioned to attract investment with or without a zone. This is primarily seen in SEZ programmes designed to contain one zone per region, province, or state. By 2009, Tanzania announced plans for 25-30 zones, spread out around the country by 2020, before it even had its first operational SEZ. In Tanzania as in many countries, such expansion has serious fiscal implications. As a case in point, Tanzania committed to securing the land and carrying out feasibility studies across the country. Similarly, South Africa is launching a new SEZ programme with 13 identified zones,<sup>3</sup> and at least one per province. It is also committed to carrying out studies on each zone. Lesotho had serious financial constraints that prevented authorities from investing to meet demand in the central industrial areas. Nevertheless, the government invested in developing zones in remote regions. Not surprisingly, these zones went unoccupied while supply constraints in core areas worsened.

## **5.2 Co-ordination failures from institutional incentives**

Some of the biggest challenges faced in African SEZs have resulted from the failure to deliver on promises of world class infrastructure, quality investment environment, etc. This has in many cases been due to the difficulty in co-ordinating across the various government bureaucracies required to deliver on the complex package of infrastructure, regulations, and services of SEZs. While such co-ordination is a function of authority, capacity, and communications, it is ultimately shaped by the incentives of individual institutions, and of the individual bureaucrats working within them.

At its most extreme, failure of co-ordination among institutions results in the creation of multiple, overlapping SEZ regimes. Tanzania, for example, launched an EPZ programme in 2002, led by its National Development Corporation. Just four years later, and before the EPZ programme was operational, the government passed an SEZ Law setting up an SEZ regime under the purview of the Ministry of Planning, Economy, and Empowerment. This not only created internal policy confusion and competing interests (making co-ordination extremely challenging), but it diluted already limited financial resources and sent conflicting signals to the

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<sup>3</sup> Although five of these zones were already operational from the previous IDZ regime.

investment community. The EPZ Authority in Nigeria was established in 1992. Four years later, before the first zone was established, the government created the Oil & Gas Free Zone Authority (OGFZA). The two organizations were in conflict for many years over which had the authority over a number of important activities. The Attorney General was ultimately forced to mediate. Having multiple regimes is not necessarily problematic, so long as they are managed and communicated effectively. They exist in China, Vietnam, Jordan, and elsewhere. However, in the African cases, they happened in the absence of design and co-ordination, and led to significant confusion and uncertainty on the part of investors.

The most common co-ordination problems exist in the implementation of the many elements of an SEZ programme. This requires institutions with vastly different objectives and incentives to work toward a common goal. Lack of alignment in the incentives between people promoting exports and investment (usually the drivers of the SEZ programme) and those responsible for fiscal matters (Ministry of Finance and Customs) has contributed to failure of zone projects. In Nigeria, disputes between customs and the free zone programmes have been going on for some 20 years, with customs refusing to implement certain key provisions of the programme. Tinapa, in the southeast<sup>4</sup> of Nigeria, represents an extreme case of the consequences of conflicting interest. Announced in the mid-2000s Tinapa, was to become a 'duty-free shopping' destination. However, while the plan on which the investment was made called for a duty exemption of US\$5,000 per person, in the end, customs allowed only US\$330. The result was that after several hundred million dollars of sunk investment, the fundamental business case for attracting visitors to the zone was fatally undermined. In the years that followed, the zone has struggled to survive (CNN 2010; Daily Champion 2012).

So-called 'one-stop-shops' are intended to showcase the SEZs potential to deliver streamlined, efficient services. Ironically, their operations exemplify vividly the challenge of co-ordination. Because one-stop-shops are unable to align the incentives and practices across agencies with highly disparate institutional objectives, they often fail. An immigration regime that is primarily protective or security focused rather than facilitative in nature may for example administer the work permit processes in a country. Civil servants administering that regime will then be incentivized to follow protectionist policies, even if they are part of a one-stop-shop. There are in fact few African zones where the SEZ authorities have had decision-making power over the regulatory activities in the one-stop-shop. When Lesotho introduced a one-stop-shop for investors in 2007, it found that the physical co-location did little to resolve the problems of facilitation (Farole 2011: 216), because officers assigned to work in the facility still reported to individual ministries. As a result, the head of the one-stop-shop had no authority to ensure the officers worked efficiently and provided quality service. The Dakar EPZ in Senegal was similarly plagued, by an excessive bureaucracy and long delays in customs and agencies giving the necessary permits, among other problems. Such defects are by no means limited to African SEZs. A 2005 study of Indian SEZs found that companies often needed to pass through 15 different authorities before they could invest in them (Aggarwal 2005: 26).

Misaligned incentives between SEZs and local governments also create co-ordination problems in delivering on zone programmes. In Ghana, the development plans for the Tema zone assumed that provision of water would be provided by the local municipality, responsible for water provision in the area. However, the local municipality had no incentive to invest in

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<sup>4</sup> Tinapa is located just north of Calabar but is not related to the Calabar Free Zone discussed elsewhere in this paper.

delivering water to the zone, since they did not receive any share of revenues or even political 'credit' for the success of the zone. The local authorities would therefore prioritize delivery to their municipal residents and businesses. As a result, zone investors, with highly water-intensive activities like cocoa processing, were forced to bring water in by tanker truck, at a huge cost. Similar problems of access to water, although to a lesser degree, affected Kenya's Athi River zone. In Calabar, Nigeria, institutional competition and co-ordination failures led to a situation where the country's flagship zone in Calabar was ultimately unconnected to the Calabar port, which established its own free zone. National institutions then failed over many years to agree to dredge the port, so that goods shipped to and from Calabar had to go by road via Lagos.

Finally, misaligned incentives also plague co-ordination between public and private sector actors in many SEZ contexts. Design and construction of SEZs requires co-ordination between off-site (typically public) infrastructure and on-site (typically private developer) build out of the zone, in order to ensure their seamless and timely integration. Time lags or discrepancies in the infrastructure delivered can result in disagreements and credibility gaps between public and private parties, which can undermine the programmes. Given the incentives of each party, such disagreements and co-ordination failures should only be expected. A government, for instance, often wants to link their offsite investments to wider programmes, which may affect timing and alter approaches from initial plans. They are also likely to want to secure that investors will come to the zone before they invest too heavily. Meanwhile, private zone investors want to see the government commit to delivering infrastructure before they make any major commitments of their own. In Ghana's initial development of the Tema zone, misalignments in the expectations of the private developers and government led to a stalemate that stalled zone development for almost seven years. Similar problems contributed to delays in the development at the Eastern Zone in Ethiopia.

In many African zone programmes, the government is both the regulator of SEZs and their developer. As a result, its incentives tend to be in conflict with facilitating private sector zone development, regardless of the potential national benefits. In Lesotho, the public developer of industrial parks also acts as the promoter, regulator, and administrator of the licensing regime. The government's provision of land and factory shells at below-market rates has undermined private sector provision of industrial facilities. This has resulted in an acute shortage of space and acting as a major barrier to entry of new FDI. Again, the experience is not confined to Africa. In Bangladesh, where a government authority is also both the regulator and the developer/operator, it also passed a law allowing for the provision of private zones. However, the first private zone project languished for eight years on spurious grounds, awaiting approval for its operating license.

### **5.3 Inadequate knowledge**

Even with the best of intentions and fully-aligned incentives, the success of government programmes is constrained by the problem of inadequate knowledge. This is particularly acute in the case of SEZs, given their long-term nature. Government officials face knowledge gaps on several crucial features of new SEZs, including their location, their industry focus, and the combination of features that will attract investors. SEZs are often meant to open up new frontiers for a country. They can give new life to an underutilized port, revive areas with high unemployment, or establish new lines of production to transform local businesses into champions in international trade. However, the novelty that SEZs bring to an economy also implies how inherently difficult it is for the government to know the right combination of factors that will make a zone work.

Government miscalculations can lead to costly mistakes, not least in the form of misguided infrastructure projects. One example of this is the Bataan export processing zone in the Philippines. In the 1970s and 1980s, the central government invested almost US\$200 million in upgrading the port and built road, bridges, and other zone facilities. Yet, this did not suffice to attract investors to its remote location. As a result, the performance of the zone was dismal. Still 16 years after its founding, the failure of the Bataan zone was so discouraging that it made the international community question the zone model of development entirely (Warr 1987; Moran 2011: 16). Bataan shows that although poor infrastructure is a commonly cited reason for SEZ failure, more infrastructure investment is not a solution if the SEZ is poorly located to begin with. In Africa, the Calabar case (discussed previously) provides a parallel story, as does the case of COEGA in South Africa, where more than US\$300 million of infrastructure investment generated less than 3,000 operational jobs (CDE 2012).

A core co-ordination problem emerges when governments set specific goals for the type of production that an SEZ should host. SEZs are often meant to develop a country by opening up new lines of manufacturing and linking them with global supply chains. Therefore, one cannot simply mimic the production that is already taken place in a country. Governments are instead compelled to make qualified guesses about the country's potential comparative advantages. If SEZ policies end up targeting the wrong industries, they may exclude crucial investors in industries that have growth potential in the country (Farole 2011: 161). When India introduced a new SEZ Act in 2005, it designated 60 per cent of SEZs as technology zones. The Indian SEZ scheme has subsequently underperformed, and the heavy reliance on IT-only zones is seen as a burden rather than a benefit (Govardan and Srivastav 2012; Mishra 2013). In Bangladesh, the initial strategy for attracting investors was to focus only on high technology activities, an approach which would have completely failed to take advantage of the country's absolute advantage in wages. It was only when the zone authority brought in an apparel company with the fortunate name of Hi-Tech Knitting that the programme began to take off.

In the African case, many knowledge failures were predictable. They often resulted from a failure of authorities to plan properly at the outset. One serious failure of long-term planning was the failure to recognize the implications of the expiration of the Multi-Fiber Arrangement (MFA). The MFA was a system of import quotas that governed international trade in apparel since 1974. As it was dismantled gradually starting in 1995, many African zones were ramping up and focusing almost exclusively on apparel. As the MFA ended, many restrictions on Asian apparel exports to developed countries were lifted, lowering the competitiveness of African producers.

Similarly, zone programmes in East Africa reacted with surprise when they found that the East African Community Common Market meant that limitations on sales to domestic markets for SEZs extended across the region. This was not impossible to foresee, but short-term incentives discouraged the exploration of such eventualities. A similar mistake occurred in Benin, where the authorities made great efforts to attract a pasta factory to their zone programme. Only after investment was made was it recognized that the pasta was on a list of products for which imports are banned in its primary market of Nigeria.

Africa's late arrival to SEZs should have made SEZs a less risky prospect. For one, governments should be able to identify private development partners in SEZs with global experience in implementing zones. Instead, the continent has seen many low quality private developers. An early example of this was the investment in Ghana's Tema zone by the Malaysian investor Business Focus in the early 1990s. The company did not live up to its promised investments, and

later abandoned the project. More recently, several investors which came as part of China's high-level 'Trade and Co-operation' zones, including the original investors in Ethiopia and Mauritius, turned out to be inexperienced and lacking in the deep financial capabilities that were anticipated.

The problem of inadequate knowledge is expressed also in the design and implementation of fiscal incentive regimes for SEZs. The SEZ programme designers cannot know the real value of the projects costs and benefits. Unable to assess whether these investments would have come about even without the incentives, they tend to undervalue the cost of tax expenditures relative to the tangible benefits of investments and jobs. The result in many African zones is a situation where sunset clauses on tax breaks get renewed, and where firms are allowed to shut down and reopen under another name.

Many of the problems that occur due to insufficient knowledge about the location, nature of production, and strategies to attract investors are difficult for a government to solve through simple macroeconomic and market analyses. They are fraught with too much uncertainty. To make a case for the benefits of an SEZ, governments often refer to previous SEZ successes, and assume that models that worked in one country are replicable elsewhere. China is the most cited example of SEZ success, in that the country as a whole developed at a time when its SEZs served both as centers for growth and as showcases for economic reform. However, the particular circumstances of China in the 1980s have not been found anywhere else at any time. Countries introducing SEZs today have generally already taken steps to open up to foreign direct investment, to liberalize trade, and to introduce other basic components of a free market economy. The transformational potential of SEZs is, therefore less relevant in African economies, making the margin for error in SEZ programmes much narrower.

#### **5.4 Political economy implications for SEZ policy**

To understand how SEZs become successful, governments often look at the symptoms of SEZ success rather than its causes. The political economy discussion in this section implies that assets commonly described as the reasons for SEZ success, such as infrastructure, beneficial location, and a good business environment are rather symptoms of successful co-ordination and aligned incentives. Macroeconomic aggregates can only reveal these symptoms of success. Attempts to replicate 'best practice' SEZ schemes by matching their level of infrastructure investments, strategic positioning, or regulatory regimes are therefore futile. The political economy factors discussed here will always intervene, and will shape the gap between the *de jure* and *de facto* SEZ environment. The scale and nature of this gap ultimately defines the difference between success and failure.

In approaching the design and delivery of SEZs, governments must aim at creating a robust political economy, in which SEZs are successful despite the inevitable and natural flaws of both government and civil servants. Policy makers need to acknowledge these flaws, and understand the obstacles to SEZ success that they cause. Only then can remedies be found that target the root causes of SEZ failure. We conclude this paper by discussing some potential solutions to the specific political economy problems with SEZ that we have discussed here.

## **6 Conclusion: Addressing the challenges of political economy**

Acknowledging the challenge of political economy opens up the possibility to mitigate its deleterious effects, by introducing procedural, policy, and institutional solutions. In this final



section we outline some approaches that have been effective in managing the political economy challenges in SEZs, and at least alleviating its harmful effects.

Ensuring transparency in the process of deliberation over the whether to adopt SEZs, and the nature of the SEZ regime to be implemented, is a critical starting point. Governments that engage in an open and public debate over the SEZ programme are less prone to suffering from both types of political economy problems. Such debates should involve all stakeholders, including domestic business, local communities, and the media. Public debates can reveal adverse incentives that may ultimately undermine the SEZ programme, whether related to land, the industries and activities that are being promoted, or the nature of decision-making in the programme. They also alleviate the knowledge problem. By engaging in detailed debate over all aspects of the programme, issues that might not otherwise have been given consideration are likely to emerge. Moreover, experts are likely to be brought in to provide technical expertise, and the practices and experiences of other countries will normally be explored. In South Africa, following the relative failure of their industrial development zone programme, a long and intense public debate ran parallel to the process of restructuring the regime into a broader SEZ programme. This debate has been instrumental in shaping the programme to ensure greater flexibility to meet local needs, and to limit the extent to which the regime may establish an un-level playing field for local investors.

Linked to transparency is the process of carrying out rigorous market demand assessments and feasibility studies, and making these studies open to public review. Too often, feasibility studies are seen as a procedural activity that must be 'ticked off' for the investment to go ahead. They are however critical to overcoming the knowledge challenges of SEZs, as they require an in-depth assessment of likely SEZ costs as well as future demands. Feasibility studies may also help detect occasions of distorted incentives. Due diligence analyses are also important for selecting private developers and key anchor tenants, which may receive special government benefits. It is important to avoid lead developers that lack the required technical or financial capacity, or where personal and/or political considerations have shaped the selection of developers. Due diligence should apply at a minimum to legal, business operations, and financial matters.

Fundamental to addressing the knowledge problem, and indeed some of the incentive problems that arise in feasibility process, is the role of the private sector in a lead investment role. SEZs involving both public resources and private investors sometimes fail due to incentive and knowledge problems. Some of the biggest SEZ success stories are run by the government or state-owned enterprises, including China, Singapore, the UAE, and Malaysia. However, the private sector can help to overcome knowledge gaps. Private businesses tend to have better knowledge about commercial realities, and can bring technical and managerial expertise. They also have the incentive to plan for long-term development, as they do not face short-term political constraints. Moreover, the willingness of the private sector to commit funding to an SEZ project is a market signal that suggests feasibility. As such, it can serve as another check against projects that have little chance of commercial success. International experience from the Dominican Republic, Colombia, the Philippines, and other countries, shows that the private sector brings a level of credibility and a network of potential investors to locate in an industrial park. Privately developed parks therefore tend to command higher prices from end-users and attract higher value-added activities.

Bringing transparency into the institutional design is also critical. Often, this is done through the structure of the board of the SEZ authority. Such boards have traditionally been composed mainly of various government ministries and agencies. However, broader representation, including private sector representatives and other stakeholders including community groups and

representatives of labour provides a better check against distorted incentives. It can also contribute to overcoming the knowledge problem on an ongoing basis, as these groups have more insights into businesses on the ground and the condition of workers and communities affected by the SEZs. An increasingly common approach is to ensure that half or more of board members come from outside the government, and that these members are elected or appointed by their community, rather than being appointed by government.

Introducing a flexible SEZ legal regime has been critical in some countries to allow for ongoing adaptation. This can help resolve two types of political economy problems. First, the knowledge problem that results from the impossibility of knowing exactly the nature of the SEZ regime that may be needed to cope with circumstances that may change substantially in 10 or 20 years into the future. As we have discussed in this paper, countries with rigid initial legal regimes were later forced to introduce a new regime, often running in parallel with the old one. Establishing a flexible legal framework from the start avoids the serious co-ordination problems that such parallel regimes may cause. It also avoids the incentive of different ministries to introduce their own regimes as a form of ‘empire-building’. It is for instance common that a Ministry of Science and Technology introduces an entirely new regime to operate science parks. In the Panamá Pacífico SEZ, a former airforce base with a focus on the logistics sector, special fiscal incentives for civil aviation sector ‘maintenance and repair operations’ were also included in the law. Through extensive investment demand and regulatory environment surveys, it was later determined that the SEZ stood a chance to attract investment in call centers. The law then succeeded in incorporating working hour flexibility. This attracted a large investment by Dell. Jordan’s Aqaba SEZ legislative framework was designed flexibly enough to enable the subsequent adoption of implementing regulations dealing with the area’s tourism sector needs. This ultimately became Aqaba SEZ’s key investment sector.<sup>5</sup>

The institutional set-up of the SEZ programme is important to mitigate the internal co-ordination challenges that often undermine what may, on paper, look like a well-designed SEZ programme. International experience suggests that an SEZ regime should be regulated by an autonomous, powerful government authority, possibly linked to the head of state or of the government. Establishing an autonomous agency helps relieve the SEZ programme of day-to-day political considerations that may distort its incentives. Linking the agency to a central authority facilitates co-ordination across various government ministries and agencies. Where the SEZ authority comes under the responsibility of a line ministry like the Ministry of Trade and Industry, other ministries often have little incentive to co-ordinate to support its aims. This approach of a strong, centralized authority was taken, for example, by such successful zones regimes as those administered under SEZ programmes in Jordan and Dubai. In Jordan, once King Abdullah had decided to proceed with the 375 km<sup>2</sup> Aqaba SEZ project, a series of feasibility studies were commissioned, including the potential legal, regulatory and institutional frameworks for the zone. These studies involved detailed, multi-volume organizational audits of existing government bodies, including Aqaba International Industrial Estates, Aqaba Port, Aqaba Municipality, and Aqaba Governorate. It sought to determine their strengths and weaknesses, cultures of rent-seeking, and overall administrative capacity. This was done with a clear objective to merge the various bodies into a single, overarching authority. Such an authority was ultimately established in 2001. Named the Aqaban SEZ Authority (ASEZA), it reports directly to the Prime Minister’s office and is run by six commissioners who, for increased effectiveness, wield ministerial powers (Farole et al. 2013).

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<sup>5</sup> Examples in this section are gathered from (Farole et al. 2013).

This approach should however not be implemented without considering the merits of other potential approaches, given a country's specific circumstances. Following the return of the Panama Canal from the USA military in 1999, the government set up a time-bound body—the 'Autoridad Regional Interoceánica' (ARI)—to convert redundant military assets into productive economic ones within five years. There was thus an opportunity to convert the USA Howard Airforce Base into a logistics hub type of SEZ. The design and development of the zone's institutional regime, and its transitional regulatory powers, were originally vested in ARI. It was however clear from the onset that regulatory powers would be transferred rapidly to a new, SEZ-specific authority, the planned 'Autoridad del Area Económica Especial Panamá Pacífico' (AAEEPP)—later renamed the 'Agencia Panamá Pacífico' (APP). The 'sunset clause' of the ARI's mandate was instrumental in avoiding inter-agency problems. In a concession to operational realities, it became evident that an Aqaba-style 'true one-stop-shop' would not prove politically feasible in the country. The focus of the regime designers then shifted to amending the enabling legislation and re-engineering the procedures that each competent ministry would apply within the SEZ, under the overall administrative and financial co-ordination of the APP. An effective 'hybrid model' SEZ one-stop-shop was the result—it for efficient service delivery while operating within the political economy constraints of Panama.

Beyond the institutional set-up, a variety of mechanisms to overcome institutional co-ordination challenges have proven useful for SEZ programmes. While common, inter-agency memoranda of understanding and service-level agreements often break down when the political incentive for co-ordination is weak. A way to avoid gridlock in the one-stop-shops, taken in Senegal among other places, is the use of 'silence is consent' provisions in the SEZ law, which grant authorization by default if an applicant does not receive a response to its application (for a license, a work permit, etc.) within a specific time period.

Other institutional solutions are needed to solve co-ordination challenges and institutional conflict at the vertical level, especially between local and national authorities. China–Singapore Suzhou SEZ, a joint venture between the governments of China and Singapore, suffered in its early years from misaligned incentives between the SEZ authorities running the zone and the local government of Suzhou. While the SEZ authorities pursued returns on its investment, the local government was concerned about wider socioeconomic outcomes and, critically, tax revenues. Local governments in China are responsible for the provision of most public goods and services, and their main source of revenue is the value-added tax paid by industrial firms. The SEZ was however allowed to keep all collected tax revenues. The local government therefore had no incentive to support the project. It instead invested in industrial development projects that competed directly with the SEZ. The conflict was finally resolved by re-aligning the incentives of all stakeholders. National authorities rearranged the tax-sharing formula for SEZs, striking a balance between national and local government as well as the SEZ authorities. This gave the local municipality the incentive to invest in key social and economic infrastructure linked to the zone and more generally to support its development.

These are just a few of many legal, institutional, and procedural approaches to addressing the pervasive challenges of political economy in the SEZ context. They by no means guarantee success, and mostly alleviate rather than eliminate political economy problems. The pervasiveness of political economy, and the complexity of SEZs, means that there is no 'best practice' that any country can adopt that will guarantee success. Recognizing this reality is, however, an important starting point. The principles outlined in this section, of transparency, broad participation, technical expertise, and leveraging incentives for co-ordination, can help guide policy makers and technicians through the many political economy challenges for SEZs.

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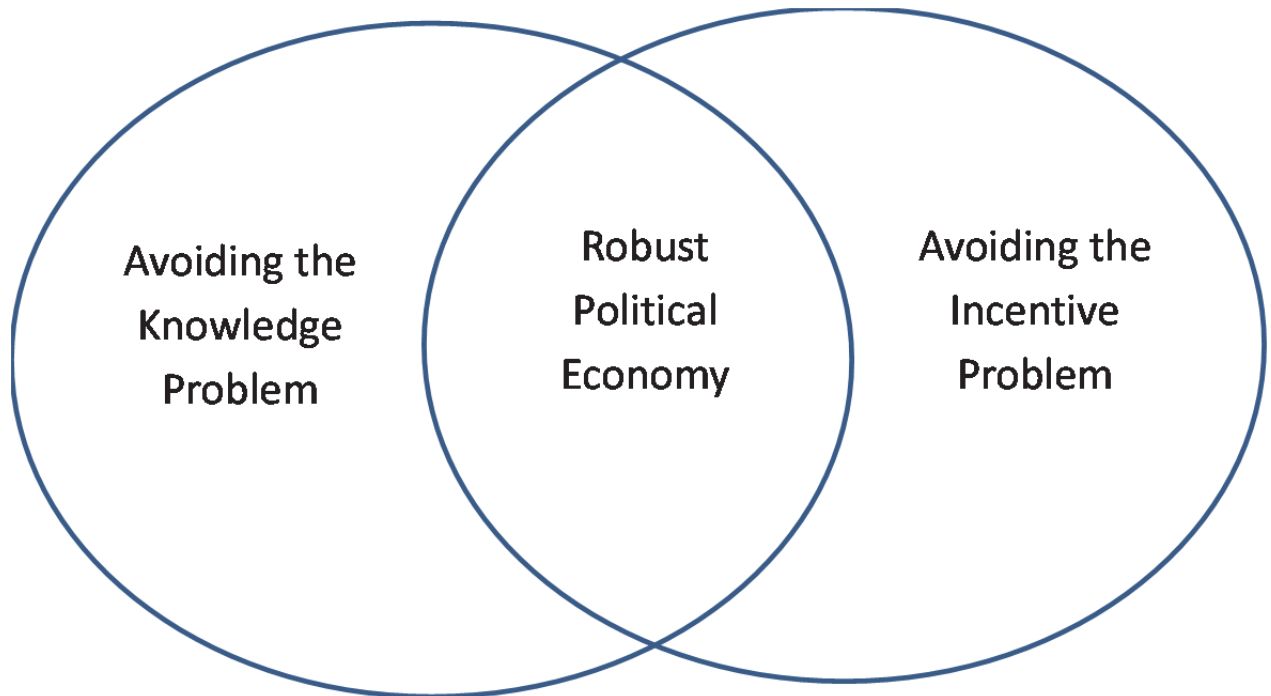
Appendix

Table A1: A typology of zones

	Trade	Manufacturing	Services			Mixed use		
	Free port	Industrial free zone/EPZ	Commercial free zone	Financial services zone	IT/Science Park	Tourism zone	Special economic zone	Enterprise zone
Physical characteristics	Entire city or jurisdiction	Enclave or industrial park	Warehouse area, often adjacent to port or airport	Business park, adjacent to city	Business park, near university	Entire jurisdiction	Entire province region or municipality	Part of city or entire city
Economic objectives	Development of trading centre and diversified economic base	Development of export manufacturing/assembly industry	Facilitation of trade and imports	Development of off-shore banking, insurance, securities hub	Development of technology-intensive industry	Integrated tourism development	Deregulation; private sector investment in restricted area	Development of SMEs in depressed areas
Typical activities	Trade, service, industry, banking, etc.	Light industry and manufacturing	Warehousing, packaging, distribution, trans-shipment	Financial services	Data processing, software development, computer graphics	Resorts and other tourism	All types of industry and services	All
Typical examples	Hong-Kong, Singapore, Batam	Ireland, Korea, Malaysia, Dominican Republic, Kenya	Jebel Ali Colon, Mauritius, Iran	Bahrain, Dubai, Mauritius, Uruguay	India – Bangalore, China-Dalian; Poland – Krakow	Colombia – Barú; Philippines - Cagayan de Oro; Jordan – Dead Sea DZ	China – Hainan and Shenzhen; Jordan – Aqaba; Philippines – Subic Bay	USA, Europe

Source: Derived from FIAS (2008).

Figure A1: Framework for robust political economy



Source: Authors' illustration.