

Aggarwal, Aradhna

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## Towards An Integrated Framework for Special Economic Zones (SEZs): A Dynamic Institutional Approach

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**Editor of the Copenhagen Discussion Papers:**

Associate Professor Michael Jakobsen

**Asia Research Centre**

Copenhagen Business School  
Porcelænshaven 24  
DK-2000 Frederiksberg  
Denmark

Tel.: (+45) 3815 3396

Email: [mj.int@cbs.dk](mailto:mj.int@cbs.dk)

[www.cbs.dk/arc](http://www.cbs.dk/arc)

# **Towards An Integrated Framework for Special Economic Zones (SEZs): A Dynamic Institutional Approach**

**Aradhna Aggarwal<sup>1</sup>**

Professor, Asia Research Centre  
Copenhagen Business School  
Denmark  
aa.int@cbs.dk

## **Abstract**

This paper presents a comprehensive conceptual framework for the rationale, success factors and development outcomes of Special Economic Zones (SEZs), and analyses their performance in selected Asian countries within that framework. It draws on the tenets of the literature on 'dynamics of institutional changes' to introduce basic assumptions and generates a series of propositions as building blocks of the framework. It argues that SEZs are a safety valve that can address inefficiencies within a given institutional context. If used strategically, the SEZ policy can be an exceedingly versatile tool to achieve a variety of goals. The drivers of success and economic outcomes of SEZs depend on the strategic approach adopted by policy makers towards SEZs. There is no single recipe of their success or development outcomes. Finally, institutions evolve in the process of development. So must strategic approaches towards SEZs. New genres of SEZs need to emerge and the existing ones must upgrade to address new institutional challenges, and achieve new goals. It argues that is the SEZ policy and not SEZs *per se* that need to be the focal point of the SEZ debate.

**Keywords;** *Special economic zones, Dynamic institutional Framework, Asian countries, Development outcomes, Success factors*

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## 1. Introduction

Special economic zones (SEZs) first emerged in the 12<sup>th</sup> century Europe in the form of free ports, free cities and free zones, and flourished in the Middle Ages when mercantilism ruled the Continent. The objective was to foster re-export or *entrepôt* trade by overcoming high tariff barriers pervasive in the then mercantilist era without opening the domestic market to foreign goods. Mercantilism declined in the mid 18<sup>th</sup> century but SEZs persisted. Not only did they persist but also evolved into new forms. They remained concentrated in the developed world until the mid 20<sup>th</sup> Century when several developing countries which became independent from their colonial rulers and adopted import-substituting policies as the cornerstone of their development strategies found them useful in promoting trade by overcoming high tariff barriers. The first wave of SEZs, which took place between the mid-1960s and 1980s witnessed a surge in their number across the developing world . In the late 1980s and early 1990s when most countries abandoned protected regimes and embraced trade reforms, SEZs were expected to lose their relevance. Contrary to the expectations however, their number continued to surge. Different types of SEZs characterized by different designs and objectives have emerged in different types of macroeconomic settings, and have become instrumental in attracting economic activities linked with the multinational enterprise (MNE) coordinated global value chains (GVCs) (Aggarwal 2012a; Basile and Germidis, 1984; Baissac, 2011; FIAS, 2008; Haywood, 2004; Meng, 2005; Omar and Stoeber, 2008). Despite their long history, continuity and adaptive dynamism, however, their relevance and development outcomes remain a highly contentious issue (Aggarwal, 2012a; Bassiac, 2011; Engman et al, 2007; Farole, 2011; FIAS,

2008; Gibbon et al; Kusago and Tzannots, 1998; Madani, 1999; 2008; Milberg and Amengual, 2008). They have been instrumental in driving employment, FDI and exports in a number of countries but their success in promoting economic development remains limited to a few countries posing a critical question: Why are success stories few despite there being almost consensus among policy makers on their usefulness as a tool for sustained growth? The present study argues that this could essentially be attributed to a lack of clear understanding of the conditions and justification for setting up SEZs, and the factors driving their success. The existing dominant literature provides limited guidance on the mechanisms through which SEZs can drive growth and development. The surge in the number of SEZs has essentially been prompted by the success of a few countries. Most countries have set up/ expanded their SEZs in the expectation of emulating their success, ignoring the framework conditions that allow SEZs to become successful (Pfister, 2017). For a better understanding of the potential of SEZs as a development tool, therefore, there is a need to move to a cohesive, coherent and integrated framework, which can explain the rationale, critical success factors and development outcomes of SEZs. The present study is a step in this direction. The theoretical paradigm developed in this paper is termed 'A new dynamic institutional (NDI) framework for SEZs'. The paper explains the basic tenets of this framework and analyses the SEZ experience of three countries namely Taiwan, South Korea, and China within this framework.

There is no single universally accepted definition of SEZs. Nor is there a universally accepted terminology for them (Farole, 2011; FIAS, 2008). The paper focuses on well-defined geographically delineated economic spaces where

economic activities are primarily export oriented and are carried out under special regulatory and institutional frameworks that are different from the rest of the economy. The main argument is threefold. First, SEZs are a 'safety valve', which allows the government to address institutional impediments to growth without giving a shock to the institutional set up in the wider economy. This makes them a highly potent policy tool. Second, there is no generic list of success factors and outcomes of SEZs. There are multiple strategic approaches towards SEZs. The drivers of success and economic outcomes of SEZs depend on the strategic approach adopted by policy makers in the SEZ implementation, and its effectiveness. Finally, institutions evolve in the process of growth; so must strategic approaches towards SEZs. New genres of SEZs need to emerge and the existing ones must upgrade to address new institutional challenges.

Section 2 reviews the existing theoretical literature on SEZs. Section 3 focuses on developing a conceptual framework, which is used to analyse the experience of three most successful countries namely China, South Korea and Taiwan in Section 4. Finally, Section 5 concludes the analysis.

## **2. Existing theoretical approaches to SEZs: A brief review**

There are three *dominant* approaches to explain the rationale, success factors and development outcomes of SEZs: the orthodox (neo-classical), the neo Marxist, and the heterodox. While the former two emerged in the early stages of SEZ evolution, the last approach came about in the mid 1980s.

### ***The neo-classical approach***

The neo-classical school adopts a trade centered approach and views SEZs as enclaves offering open and freer trade policies to promote GVC-linked foreign capital and trade in import substituting regimes by overcoming anti-export bias inherent in the regime. It means that ensuring a free trade regime within SEZs is critical for their success. In addition, the attractiveness of SEZs is directly linked with their cost competitiveness. Other critical success factors therefore include: abundant labor supply, relaxations in labor standards, cheap factory sites and utilities, strategic location near the sea/airports, and an investor friendly custom regime. The underlying assumption is that MNEs relocate essentially labor-intensive segments of their production processes in these countries where the latter enjoy comparative advantages.

The majority of studies associated with this school use the formal international trade modeling approach to assess the development outcomes of SEZs and find them to be either directly welfare-reducing or resulting in the creation of a dual economic structure that harms long-term efficiency in the allocation of resources. They may generate trade and trade related benefits in particular foreign exchange and employment but these benefits come at a huge cost to the economy and state exchequer. Hamada (1974) dismisses FDI-induced benefits by showing that the technology accompanied with FDI in the zones has little relevance for the host country and can distort its production structure.

Warr (1989) in his seminal work used a 'cost-benefit' approach to assess the net benefits generated by SEZs. He observes that by using domestic capital,



workers, and public utilities, SEZs can have an induced-consumption (multiplier) effect on the economy (Baissac, 2003; Jayanthakumaran, 2003). But, the effect is not substantial when compared with the cost that is incurred in setting them up. Backward linkages through local sourcing are also found to be negligible because the local firms are generally not in a position to meet the cost, quality and commitment standards required by the SEZ firms (Warr, 1989,1990; Madani, 1999).

A group of political economists emerged in the 1960s within the neo-classical school (Buchanan and Tullock, 1962; Arrow, 1963; Krueger, 1974) argue that there is no rationale for SEZs except that they are a rent seeking instrument set up by bureaucrats to show favors to the business community. They view SEZs as 'tax shelters', which induce relocation or diversion of economic activity from domestic areas to SEZs causing huge cost to the state exchequer with no net addition to investment and economic activity.

Following the success of Chinese SEZs, it was proposed that SEZs might be set up as 'testing labs' for facilitating the process of economic transition and liberalization (World Bank, 1992: 18). But, there is ambiguity in SEZs' role in the transition from an inward- to an outward oriented development strategy. The possibility that they permit the continuation of highly protective trade and investment regimes can not be ruled out (Schrack, 2001; World Bank, 1992).

The conclusion is that neo classical theoretical approaches to SEZs are rather pessimistic. This school views the problem of underdevelopment as being a

problem of inefficient resource allocation at the national level. Protectionist trade policies affect different sectors asymmetrically and worsen the allocation of resources. Introduction of SEZs in this regime can distort an already distorted economy and significantly reduce national welfare.

### ***The neo Marxists approach***

It avers that the primary rationale of setting up SEZs is to offer cheap labor with low labor standards rather than tax, tariff or any other privileges. SEZs are thus designed with an overarching focus on labor institutions. The development outcomes include: labor exploitation within the zones, declining employment opportunities outside them due to diversion of resources from the mainland, and dependency on foreign capital. For the Neo Marxists, SEZs are world factories with dramatically lower wages, performing assembly line work, which is the least sophisticated segment of the production process (Fröbel et al., 1978; Frank, 1967). SEZ companies are typically more integrated with the foreign countries than the rest of the domestic economy and generate few backward and forward linkages. This perpetuates dependency ties of the host countries with the developed ones.

### ***Heterodox approach***

Until the mid 1980s, SEZs were almost entirely explained by the trade centered approaches which regarded SEZs relevant because they offered free trade conditions and cheap labor in the import substituting regime. Apparently, in the mid-1980s, when developing countries started shifting from import substituting to export oriented regimes, they were expected to lose relevance. But, contrary to

these expectations SEZs continued to flourish. They even entered into an accelerated wave of expansion in the 1990s when the era of globalization set in. This period coincided with the rise of Endogenous Growth theories, which highlight the role of learning, technology and innovations in promoting economic growth. Heterodox economists used the basic premise of these theories to explain the rationale of SEZs in a liberal regime. They argue that the developing countries that have adopted the model of 'export oriented regime' as the lynchpin of their developmental strategy heavily rely on FDI for technology transfers required for rapid industrialization. However, the numerous production failures and bottlenecks that characterize these economies hamper the inflows of FDI. The rationale of setting up SEZs is to offer strategic locations with enabling investment climate to MNEs for attracting FDI. According to this approach, SEZs are enclaves of FDI and their success is not influenced so much by cost competitiveness as by enabling business environment which includes besides fiscal incentives, good infrastructure, transparent and simplified governance, a range of specialized administrative services and good locations (FIAS, 2008; Madani, 1999; Yuan and Lorrain, 1992; Sit, 1988). This may therefore be termed as the 'investment-centered approach'.

This approach focuses on the role of SEZs in generating FDI-induced benefits on economic development in an export-oriented regime. The argument is that the presence of foreign firms generates important spillovers through demonstration effects, on-the-job training, learning by doing and copying, and contributes to the diffusion of technology and knowledge (Johansson and Nilsson, 1997). These spillovers fill gaps in technical, marketing and managerial

know-how that the developing countries' firms face. The heterodox approach counters the pessimism of the neo classical and dependency theories. But, a general expectation is that FDI attracted to SEZs would automatically generate spillovers. This expectation is contentious, is somewhat contradictory to the underlying assumption of SEZs being enclaves, and is not supported by empirical evidence (Johansson and Nilsson, 1997; Johansson, 1994).

While the heterodox approach is based on export oriented FDI which arises when MNCs disintegrate their production processes and locate different processes in different countries for *offshore processing*, according to factor costs and capabilities in their pursuit to lower costs of production (UNCTAD 1998, p.11), the 'newer- international division of labour' approach (Aggarwal, 2012a) perceives the role of SEZs in promoting *offshore outsourcing* through contract manufacturing, as well. Contract manufacturing is increasingly being used by large MNCs as an alternative to operating and maintaining their own offshore facility. In this framework, SEZs are instrumental in promoting not only FDI but also outward oriented domestic investment. Entry into global chains promises domestic firms access to a global pool of new technologies, skills, capital, and markets, upgradation of firm-level capabilities from 'learning' through technology diffusion and exposure to international best practice systems of corporate governance.

Overall, the three dominant approaches represent three different contexts in which SEZs are created. They offer different rationales, CSFs and development outcomes of SEZs underlining the importance of macroeconomic contexts in

which SEZs are set up. There is however, no overarching framework that can accommodate all these theoretical explanations, and generalize and widen the basis for theoretical justification for setting up SEZs, their success factors and development outcomes. The existing explanations are in need of generalization. They present a narrow and context-specific view of SEZs

Further, while these perspectives differ in their assessment of SEZs, they have a common understanding of the basic design and characteristics of SEZs. They are grounded in three common premises, which have maneuvered the SEZ debate over the past many years. First, SEZs are 'economic enclaves' of special policy regimes, which are typically set up as attractive geographic spaces segmented from the wider economy to attract foreign investors. An economic enclave is a physical territory administratively and legally bound, which is set up for a particular type of activity. It has weak integration into the local economy and therefore its usefulness as a development tool is highly ambiguous (Phelps et al, 2015). From the perspective of this definition, it is a foregone conclusion that the development effects of SEZs on the wider economy are rather limited. But, this is inconsistent with the observed phenomenon. SEZs have been the crucial drivers of China's unprecedented and unparalleled economic growth at an incredibly accelerated rate. South Korea, Taiwan, Malaysia, Mauritius and Mexico (in the initial stages) are other success stories challenging the basic premise of the existing approaches. Second, SEZs are transitory; they lose their significance as countrywide systemic trade (trade centered approach), and macroeconomic and exchange rate reforms (investment centered approach) are implemented. In most successful countries, however there has been continuous evolution of SEZs

with new forms of zones emerging and the existing ones getting updated. Finally, SEZs are the second best solution, the first being the economy wide reforms. But there is no justification offered as to why the first best solutions are not adopted by policy makers. The concept of 'first best solutions' itself needs clarification. Policy-making does not occur in a vacuum. Rather, it takes place in culturally and historically conditioned complex political and social settings. The policy solutions are thus strongly contextual and their ordering as the 'first or second best' based on other contexts may hurt their implementation and prospects.

The upshot is that the existing theoretical literature needs to evolve. There is a need to have a comprehensive framework that can provide guidance to policy makers regarding the rationale and usefulness of SEZs.

### **3. A New Dynamic Institutional Framework of SEZs**

The model presented here draws on the tenets of the 'dynamics of institutional changes' to answer three key questions: First, what is the rationale of SEZs? Two, what are the critical success factors and development outcomes of SEZs? Three, what are the evolutionary dynamics of SEZs?

#### ***Why SEZs?***

The basic premise of this framework is that institutions are sticky, path dependent and complementary. They are deeply intertwined with each other and tend to lock in particular institutional arrangements (Boettke et al. 2008). Formal institutions, which are under the direct purview of the state can be changed rapidly by authoritative orders. But they are both underlined and supplemented

by informal institutions (North, 1990) and are locked in the overall institutional arrangement with them (Roland, 2004). They are the outcomes of informal interactions between different economic, social and political actors pursuing conflicting interests (Coleman, 1986; Putnam, 1993; Woolcock and Narayan, 2000; Helmke and Levitsky, 2004; Williamson 2009), and represent “a compromise resulting from the social conflict originating in the heterogeneity of interests among agents” (Amable, 2004:10); are politically acceptable; and may yield the highest economic returns due to direct synergies (Deeg, 2001; Kang, 2006). Any attempt to radically transform the formal institutions therefore can disturb the institutional equilibrium, creating frictions within society and producing unexpected outcomes. But the locked-in institutional arrangement may be associated with suboptimal growth outcomes. It may impede the effective implementation of the overarching development strategy which itself is locked in this arrangement. One way to overcome these impediments and put the economy on the path of growth therefore is to create ‘SEZs’ as a safety valve, which can absorb the undesirable shock to the lock-in institutional arrangement in the wider economy, and can foster the process of investment and growth over a shorter period of time.

It means that the relevance of SEZs is strongly context-specific. The setting up of SEZs can be justified only if they are designed to effectively target the growth impeding institutions in a given context. This requires policy makers to have a clear understanding of the country specific macro economic context, the development strategy and the role that SEZs can play in it.

### ***What are the critical success factors and development outcomes of SEZs?***

There is no one to one relationship between a policy institution and the purposes that it can serve. Each policy serves more than one objective, be it budgetary policy, monetary policy, labor policy or any other policy for that matter (Chang, 2011). Budgetary policy for instance can be used to build productive assets (e.g., physical infrastructure, R&D facilities), social protection (the welfare state), or macroeconomic stability. Similarly, monetary policy can target growth, stability or social justice, and so on.

The SEZ policy is no exception. SEZs can be used to achieve a variety of economic and economic diplomacy goals. They can thus serve to promote trade and FDI, industrial growth and diversification, spatial rejuvenation and urbanization, border development, regional integration or international relations. But, this does not happen automatically. It requires strategic approach and strategic planning around them. The strategic approach outlines what policy makers expect to achieve with it and how they plan to achieve that. The former specifies the positioning of SEZs within a given development strategy with vision, mission, objectives of their establishment; and the latter is the roadmap to achieve them. The strategic approach influences the strategic principles regarding the SEZ design, location, incentive structure, management processes, services to be provided, governance, their linkages with other actors, action plan, and so on and so forth. The strategic approach adopted is thus directly related with the broader development strategy and institutional impediments to implement it.



Different strategic approaches are associated with different sets of CSFs, and different outcomes. There is no generic list of their success factors and outcomes. A country, which clearly identifies the institutional impediments in its development process and assigns a well-defined strategic role for SEZs in its broader development strategy with a clear understanding of its CSFs, tends to perform better than others.

### ***What are the evolutionary dynamics of SEZs?***

Institutions have a two-way relationship with economic development wherein the former both influence and are influenced by the latter (Chang, 2006, 2011). As SEZ-induced development takes place and domestic conditions change, new agents of change emerge in the economy. At the same time, there are shifts in power, interests, perceptions and positioning of the existing actors; and there is demand for new institutions to adapt to new realities. The changing institutional dynamics pose new demands, new goals, and new institutional challenges. In line with these dynamics, policy makers must assign new roles to SEZs; and continuously upgrade the existing ones and set up the new ones. There are thus evolutionary changes in the justification, strategic approaches and designs of SEZs, which in turn further impinge on their development outcomes and success factors.

The 'new dynamic institution' framework of SEZs thus avers that SEZs are like a safety valve. They release institutional pressures on growth without giving a shock to the lock-in institutional arrangement in the wider economy and foster the process of growth. In so far as they can effectively overcome the institutional

impediments to growth, they can be set up at any level of development. Further, the performance of SEZs crucially depends on the strategic approach towards them and its execution. SEZ success stories are few because there is little understanding of the rationale of setting up SEZs and the role that they can play in the development process. Finally, SEZs must evolve with evolutionary changes in the institutional set up in the process of growth; different genres of SEZs need to be set up and the existing ones should be upgraded to address different challenges and achieve different goals.

#### **4. Assessing the experience of selected Asian countries**

Using the framework discussed above, I assess the experience of 3 most successful countries from Asia and draw policy implications for policy makers. These countries are: China, South Korea and Taiwan.

##### ***China***

*Rationale.* SEZs in China were launched in 1979 as part of Deng Xiaoping's modernization program to turn the country into a relatively advanced industrialized nation by the year 2000 with a unique approach of introducing successful elements of liberal economic policy into the socialist political regime (McKenney, 1993). SEZs were created as a safety valve for opening up the economy to foreign investment, allowing labor flexibility, and keeping regulatory burden low within the overall framework of authoritarian political regime.

*Strategic approach.* Unlike other SEZ countries of that time, China adopted an ambitious SEZ program, which was motivated by its old treaty ports in design.

China set up four SEZs: Shenzhen, Zhuhai, Xiamen and Shantou. These were open industrial mega towns spread over several square kms. Shenzhen, for instance, spans over nearly 2,000 square km; Shanghai's Pudong district is 522 square km; and Hainan, 34,000 square km. All of them were located in coastal areas. These areas were not merely ideal locations for trade (as is generally believed) but were also endowed with cheap land, active participation by officials, long tradition of trade and entrepreneurship; and had a greater likelihood of attracting non-resident Chinese investment (Lai 2006). China thus aimed at creating large clusters of exporting firms (MNEs especially) in the locations where investment climate was already conducive for a large-scale activity and spin-offs ( Aggarwal, 2011, 2012a). The strategic approach was to create trade based agglomerations of internationally competitive MNEs using SEZs, which could create a pool of skilled labor; external economies in the form of lower costs; increasing returns to scale and knowledge spillovers. It was expected that the clusters would further expand by the tendency of spin-offs and suppliers of both the clustered industry and related industries to locate near the zone. More specifically, China adopted the agglomeration-based industrialization with SEZs as the centerpiece. The critical success factors for this strategic approach were identified and addressed effectively.

*Critical mass of activity.* To generate a critical mass of activity, an attractive package of good infrastructure, cheap land, cheap labor, fiscal incentives and single window clearances was offered to foreign investors in SEZs. Huge money was pumped into infrastructure, and lucrative offers were made to skilled labor with spacious apartments within the zone. Investment in infrastructure grew from

50 million Yuan in 1979 to 2,760 million Yuan in 1985. Wages were lowered to raise the profits of foreign enterprises to lure them. Above all, the SEZ administration was given powers of provincial government, facilitating approval procedures, reducing administrative fees, and enhancing the service function of government organs. They can develop their own regulations that can be applied in their jurisdiction. They have a Congress.

During the mid-1980s, Shenzhen SEZ began to show signs of economic progress with 60 establishments employing 15,000 workers accounting for 69 % of the industrial value and 82 % of actual FDI of the city in 1983 (McKenny, 1993). Inspired by the initial success of Shenzhen, government extended the SEZ sector by designating Hainan Province and the new Pudong districts in Shanghai as the fifth and Sixth SEZs in 1988 and 1990 respectively.

These six large *national* SEZs were reinforced by a myriad of smaller zones. As early as in 1984, China introduced Economic and Technological Development Zones (ETDZs). They are provincial level SEZs with a focus on promoting high-tech industries by offering attractive hard and soft investment environment. They are set up in and around existing industrial clusters with good industrial foundation and convenient communication. To offer single window governance, the government awards economic managing right, which is equal to that of the local government, to management committee of Economic-Technological Development Area also. From 1984 to 1988, 14 ETDZs were established, all in the coastal cities. By 2014, the number had increased to 190. Several other types of zones followed soon. These include provincial and municipality level

SEZs, private SEZs, export processing zones, free trade zones, logistics parks and so on. China thus continuously expanded its SEZ sector, as a key element of its strategic approach. According to one estimates, by 2007, 300 of 326 municipalities had 1346 zones (Wang, 2009).

*Synergies with local actors.* The value of a cluster depends not on the proximity of firms but on synergies and networks that they establish with the local economy. From the perspective of the literature on clusters, SEZs are satellite clusters attracting multinational/ multi-plant firms, which locate their subsidiaries there to benefit from government facilities and incentives with little linkages with local production systems. China turned these satellite clusters into growth poles by adopting a distinct approach of clustering SEZs with each other and with inward looking industrial clusters (for instance, High Investment and Industrial zones). This was done by promoting clusters of domestic companies in the areas surrounding SEZs or by locating different SEZs in the proximity of existing clusters or other SEZs or near university areas. The objective was to generate synergies between them. The SEZ sector was also expanded vertically by locating smaller SEZs such as sector specific SEZs, EPZs and FTZs, within larger SEZs to augment them further by creating local value chain within the SEZs so that the benefits could flow within the SEZs also.

To incentivize foreign firms to forge linkages with domestic firms, government allowed SEZ investors to sell in the domestic markets without paying additional duties if they procured 100% raw materials and components from the domestic markets or produced high tech products. Besides, until recently, the Chinese

authorities made it compulsory for foreign investors to form joint ventures with Chinese firms to enter China, in order to obtain exposure to advanced technology and new management skills. In return they were offered SEZ benefits. These policies paid off.

*Successful cluster development strategy.* In addition to the above, government directly played a catalyst role in the development of SEZ-induced clusters by promoting a network of R&D facilities; promoting higher education institutions; creating conditions for private entrepreneurship to thrive; and developing good infrastructure outside SEZs.

Agglomeration economies generated in the process facilitated further entrants, in particular foreign investors. Wang (2009) shows that increasing investment in SEZs affects domestic investment also positively in the process. China thus succeeded in developing 'growth poles' around its large SEZs (Mathews, 2010). Two of the most powerful growth poles are: the Pearl River Delta (PRD) in the south with Shenzhen at the core and the Yangtze River Delta (YRD) in the east, with Shanghai as its principal cosmopolis. According to the official statistics, the Yangtze economic zone (with 11 provinces) constituted 46% of the total exports of the country in 2014 (GOC, 2015)

The upshot is that China succeeded in transforming its satellite clusters (i.e. SEZs) into growth poles with the former at the center. China's success with SEZs remains unparalleled and unprecedented. As of 2007, SEZs (including all types of industrial parks and zones) in China accounted for about 22% of

national GDP, about 46% of FDI, about 60% of exports, and generated more than 30 million jobs (Zhang 2010). However, the role of SEZs in China cannot be gauged from the direct effects generated by SEZs. It needs to be assessed from the fact that they are at the core of Chinese economic, industrial and political prowess. Today China is the largest economy of the World in terms of purchasing power parity.

*Evolutionary dynamics.* Over time, the increasing economic disparities at regional level within China have posed new challenges to develop strategies with a strong spatial focus. The government is using SEZs as the centerpiece of regional development strategy. It set up 77 ETDZs in inner parts of the country between 2010 and 2014 and paired them with successful SEZs in the East to provide them a wide range of support in their development under the dyadic support network program. Kashgar and Horgos development zones in Xinjiang province for instance have been paired with Shenzhen SEZ. Since 2010, China has set up 135 additional ETDZs across the country with only 58 being in the East and 77 are in inner parts of China. Fu and Gao (2007) found a positive correlation between the number of provincial Development Zones and GDP per capita concluding that the provincial development zones are also engines of the regional economy of China.

Evidence suggests that SEZs have also moved up the value chains. In 1991, only 2.8 % of the Shenzhen's manufactured exports were high-tech. By 2004 they amounted to \$30.6 billion and accounted for 51.2 % of the manufactured exports (Li, 2006). By 2007, in all large SEZs taken together, over 40 % of the

total industrial output was from high tech industries (Zheng, 2012). The ETDZs also accounted for one third of total high tech exports. Shenzhen remains the largest SEZ, which accounted for over 77 % of the total exports of 218 billion produced by 5 city- SEZs. It was transformed first from a fishing town to become the epicenter of China's manufacturing miracle, and now it is reinventing itself as an innovation city, a new frontier for technology. To encourage high tech activity, SEZs still maintain attractive tax preferences for high-tech enterprises, and provide highly efficient and specialized 24 hours services to investors along with world-class soft and hard infrastructure in all types of SEZs. Fu and Gao (2007) have shown that the ETDZs have been playing an important role in human capital formation, as well. They have been incurring large expenditures to support education and training. In 2005, the ETDZs used 6.69 % of all their expenditure to support related education and training; this was 4.24 billion Yuan per year.

Finally, China's SEZs have also evolved from being a tool of economic policy to that of economic diplomacy. In the 1990s, China initiated the development of Border Economic Zones in cooperation with Myanmar, Vietnam and Lao and mooted the idea of cross border zones to promote regional integration and exploit the cheap cost advantage through integration, overcoming the border area based institutional impediments. In the mid 2000s, the government adopted a policy of 'going out' to encourage Chinese companies to promote the establishment of overseas industrial and trade zones. According to a press release of the Ministry of Commerce (January 18, 2016), up to the end of December 2015, 75 cooperation zones were being promoted by Chinese



enterprises, half of which were the processing and manufacturing zones with a total investment of US\$ 7.05 billion and 1,209 enterprises operating in them. The total value of output of the cooperation zones were US\$ 42.09 billion with the tax of US\$ 1.42 billion paid to the host countries. They are expected to not only help increase demand for Chinese-made machinery and equipment and reduce costs, but also assist China's efforts to boost industrial restructuring at home and nurture companies to move up the value chain.

### ***South Korea***

*Rationale* South Korea launched a state driven highly ambitious industrialization program in 1962. In the initial phase of growth, the government adopted a two-pronged strategy of industrialization. It followed rigorous export-oriented policies in mature industries where it already had developed comparative advantage (food and textiles, in the 1960s, and metal, shipbuilding and chemicals, in the 1970s) and an import-substituting strategy in heavy consumer goods industries (fertilizers, cements, steel, machinery and oil refinery). Chaebols, the large conglomerates were assigned the key role in the development of both export and import substituting industries. Highly restrictive policies were adopted towards FDI to shield these firms from foreign competition. FDI was encouraged only in export-oriented sectors to promote exports of the manufacturing goods. Since the country's own technological capabilities were limited, the government encouraged the transfer of foreign technology embodied in capital goods and turnkey plants.

The policy led to massive imports of foreign capital goods. This raised the

problem of foreign exchange reserves drain. It was against this backdrop that the government planned to build its first free export zone (FEZ) in 1970, in Masan, with the objective of encouraging FDI in export-oriented sectors to facilitate technology transfers, promote competitiveness of the manufacturing sector, generate employment, and release pressure on foreign exchange reserves to support its dual policy of industrialization (Ying 1995, Lee 2008). It allowed only foreign firms to operate in 'free export zones' (FEZs). By 1972, 26 foreign companies had moved into the zone. In 1973, Iksan FEZ was also constructed on Korea's west coast.

*Strategic approach.* Korea introduced FEZs as 'enclaves' to address the impediments posed by its restrictive FDI regime in the manufacturing sector and generate both investment (FDI and technology transfers) and trade related (employment and foreign exchange) benefits. In the initial phases, FEZs served as safety valves for its development strategy and became instrumental in promoting employment, foreign exchange and FDI inflows to support its industrialization process (Aggawal 2012b). Over the next few years, the country grew miraculously fast to achieve the GNI per capita of US\$1,000 in 1977 from a mere US\$291 in 1971, with exports reaching US\$10 billion. As growth progressed, economic restructuring became inevitable. In the 1970s, Korea initiated the process of transforming its industrial structure with a focus on heavy and chemical industries. This required technological upgrading of domestic producers in newer sectors. The government recognized the role of FEZs in technology transfers to the domestic mainland to strengthen the competitiveness of the manufacturing sector. For this, first it lowered the

transaction barriers between FEZ and non-FEZ firms. In the late 1970s, the law was amended to allow outsourcing of production processes outside the zones. Second, for catalyzing the process, Korean firms were also allowed to invest in these zones in the 1980s. Third, the government run industrialization program ensured that domestic capabilities in production and technological development were promoted through well-targeted industrial and R&D policies (Aggarwal, 2001).

In 1987, when labor struggles (Maruyama and Yokota, 2008) led to increased wages and the government took to restructuring the economic activity in favor of capital intensive industries, FEZs were also restructured to focus only on capital and technology intensive products so as to attract more sophisticated technologies thorough FDI (Ying, 1995: Ch. 5). The direct role of FEZs in employment creation and exports declined, but many SEZ companies started outsourcing their labor-intensive processes to non-FEZ firms. In 1988, 56 out of the 73 zone firms had engaged 525 domestic firms for outsourcing processes (Madani, 1999). This permitted increased employment and exports as well as spillover of technology in the wider economy. Post 1987, SEZs were however marginalized in the growth process of Korea, which was essentially driven by large conglomerates.

*Evolutionary dynamics: Post 1997.* In the aftermath of the East Asian crisis in the late 1990s, Korea committed itself to restructure, reform and rebuild the economy and put it back on a high growth trajectory. It adopted advancement in industrial structure, enhancement of competitiveness, and the promotion of new

industry creation as the major pillars of the strategy. The policy of prioritizing manufacturing industries was shelved. The Industrial development Act 1999 contained a provision to target both manufacturing and non-manufacturing industries. With a change in the development strategy, the country focused on SEZs to overcome the restrictions imposed on FDI in the service sector and other growth restrictive institutions. In the late 1990s, it targeted the development of the logistics industry to position itself as a logistic hub in the region. But relatively higher rates and complex tariff system, which involved a multiplicity of rates were seen as the major impediments in promoting transshipment trade. To address this impediment, Korea upgraded its manufacturing zones with logistics facilities (Aggarwal, 2012b) to well equip them with the necessary software and hardware to augment them to serve as the logistics-oriented free trade zones as well<sup>2</sup>. In 2000, it initiated new logistics-oriented free trade zones. Under this policy, 6 logistics-oriented zones are currently operational. Between 2008 and 2010, the FTZs (of both manufacturing and logistics variety) generated US\$ 8.3 billion of imports and US\$14.6 billion of exports; with 13,676 persons employed in the firms in these FTZs (WTO, 2012). Inspired by the success of its policy, government introduced foreign investment zones also with attractive incentive packages.

In 2002, the Korean strategy of economic restructuring and balanced regional development placed SEZs as the center, when it initiated 'free economic zones' (FEZs) program as part of its efforts to attract foreign investment, particularly in

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<sup>2</sup> The term free export zones was dropped in favor of free trade zones. FEZs came to be called 'manufacturing oriented FTZs' and were distinguished from the 'logistics-oriented FTZs'.

services, and ultra high tech and R&D sectors to transform itself into a knowledge economy, serve as the financial, logistics and business hub of Northeast Asia and achieve balanced regional development. The FEZs offer not only a highly relaxed FDI regime in services but also carry attractive incentive packages for them. They are regarded as the main axis of the FDI policy (Lee, 2008, Jeong, 2008). FEZs are conceptualized as world-class cities and are equipped with cutting-edge infrastructure and services, and mark a major shift in the strategic approach towards SEZs, which were until then used as a supporting tool to plug in gaps in the development strategy. FEZs are based on the agglomeration approach with a focus on scale and competitiveness and are at the center of the ambitious goals of its development strategy. As of end-2015, there were 98 FIZs, 13 FTZs and 8 FEZs in South Korea. Total FDI in these zones, where 682 companies employing 149,000 persons operated, amounted to US\$14 billion (WTO, 2016)<sup>3</sup>. These zones also appear to have made a significant contribution to the resilience of the Korean economy to crises by providing significant foreign exchange reserves and broad-basing its economy. In 1997, South Korea was one of the worst hit countries by the crisis, and its IMF-led emergency bailout program cost around US\$60bn. The 2008 shock was much milder with no IMF bailout, and GDP turned to positive growth in the first quarter of 2009 itself (Sakong and Koh, 2010).

## ***Taiwan***

*Rationale.* Taiwan introduced its first four-year plan in 1952 with an objective of

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<sup>3</sup> The Official website of FEZs however indicates the presence of 2235 companies with FDI of \$10 billion in FEZs alone.

promoting labor-intensive manufactured products under import substituting regime. These industries developed quite fast and by 1956, the domestic market was almost saturated. The government therefore sought to encourage exports (Ying, 1995). In 1966, the first export-processing zone (EPZ) was set up in Kaohsiung (KEPZ) as part of the government policy of expanding exports of the labor-intensive products in the import-substituting regime (EDEPZ, 1987; as quoted in Ying, 1995) and generating trade related benefits. A highly attractive incentive package was offered to EPZs to attract investment both from domestic and foreign investors. Soon, there was pressure to expand the area and two more zones emerged, one in Nantze, just outside of Kaohsiung; and another smaller zone near Taichung. These EPZs became instrumental in attracting FDI. By 1990, 88 enterprises existed in Kaohsiung EPZ with a total investment of \$ 170.38 million. Of this, foreign investment accounted for \$140 million (82%); only 18% was local investment (as informed in Aggarwal 2012b).

*Strategic approach:* SMEs have been the main vehicle of Taiwan's industrialization strategy. Taiwan recognized the role of EPZs in providing platform for small firms to get inserted into global value chains through subcontracting and upgrade themselves technologically, at an early stage of its development. Government adopted both reactive and proactive policy approaches to encourage subcontracting between the EPZ and non-EPZ firms. As part of its reactive policy, it lowered transaction barriers between the two; and using a proactive approach, government supported them to help build their productive capacities to participate in these transactions. The state played a crucial role in targeting industries and strengthening production capabilities of

domestic firms through the use of targeted credit, subsidies, incentives packages, and import protection to expand output, productivity, export competitiveness, and economic growth (Amsden, 1989; Evans, 1995; Wade, 1990). Integration with the global value chains strengthened the technological competitiveness of SMEs by giving them access to a global pool of new technologies, skills, capital, and markets. As a consequence, they could target more sophisticated market segments such as design, marketing and branding and move up the value chains. According to Wang (1990), 1000 Taiwanese firms were subcontracted by EPZ firms to the tune of US \$392 million in 1988. Of them 250 domestic firms carried out partial processing. Over time they moved up from being second tier to first tier subcontractors; from low to high value added activities; and finally, from 'original equipment manufacturers' to 'original brand manufacturers'. This approach is akin to the vertically specialized industrialization (VSI) approach proposed by Milberg et al (2014).

*Evolutionary dynamics.* Industrial structure in Taiwan underwent several transformations during the process of development; EPZs were also upgraded along with that. Initially they were dominated by labor-intensive industries. These industries were sloughed off in the 1970s to upgrade EPZs by attracting capital-intensive industries. In the 1980s, the focus was directed to high tech industries. Restructuring was achieved by a careful maneuvering of fiscal incentive schemes specified in the 'Statute for the Encouragement of Investment (SEI). The 'Statute' was amended five times during this period to steer EPZs towards changing economic roles. The share of electronics and precision instruments increased from 58 % in 1975 to 67 % by 1990.

The availability of domestic capabilities made it possible for zone enterprises to establish linkages with domestic producers and further augment their capabilities. Over time, a two-way relationship has developed between EPZ and non-EPZ firms. EPZ investors have become important customers for Taiwanese companies outside the zones. In 2015, domestic inputs shipped into the Kaohsiung zone equaled 48% of the zones' total export value (Crook, 2016).

In the late 1990s, against the backdrop of the East Asian crisis (1997-99), the government committed itself to the development of the logistics industry and decided to use EPZs as the vehicle to promote the industry (Aggarwal, 2012b for reference). Under the policy, in 2001, the Warehouse Trans-Shipment Special Zone Plan was launched with emphasis on logistic firms. Under the plan, all export-processing zones were designated as customs bonded zones and were equipped with logistics facilities to drive the growth of the industry. In 2003, the government enacted the 'Act for the Establishment and Management of Free-trade Ports' aiming at promoting the development of global logistics and management systems; making possible vigorous promotion of trade liberalization and internationalization; facilitating the smooth flow of personnel, goods, funds, and technology; and upgrading Taiwan's national competitiveness. Since then six Free Trade zones have been set up.

There has been continuous growth in the EPZ sector *albeit* weakly, despite the fact that the administrative regime is simplified in the wider economy as well. They still enjoy immunity from institutional rigidities in the labor market and FDI



regime. Taiwan has currently ten export processing zones (EPZs) and 6 free trade zones. These zones are clustered together to form two growth poles, one each in Kaohsiung and Taichung Cities, which are reinforced by science parks and industrial parks of various types. Thus the strategic positioning of small EPZs close to each other has generated a mutually supporting whole with benefits flowing forward, backward, vertically and horizontally; international technology inflows and foreign competition act as the driving force of their dynamism.

The upshot is that all three countries introduced zones as a safety valve to overcome institutional impediments to growth in the wider economy to foster growth. Given their socio-economic and political compulsions, this was viewed as the best policy option. SEZs allowed the governments to practice liberal trade policy (as in Taiwan), a relaxed FDI regime (as in S.Korea), and capitalist policies (as in China). All three of them offered a highly lucrative and comprehensive package of incentives to investors with a comprehensive administrative and institutional framework, fiscal incentives, and relaxed labor conditions to attract FDI and generate trade and investment related benefits in their respective countries. But they did not view trade and investment as the ultimate outcomes of their SEZ endeavors. All three adopted a development oriented evolutionary approach towards them. There were strong parallels in their development strategies with developmental state, focus on manufacturing, and prioritization of industries being the major pillars of the policy. Yet, there were differences in the approaches towards the process of development, which could be attributed to differences in their macro-economic contexts. Therefore,

each adopted a distinct strategic approach towards its SEZs to drive its development goals.

Korea adopted a dual policy regime and its strategic focus was on the development of light industry based export-led growth to ensure foreign exchange inflows to support its heavy industrialization program and generate employment. It used its SEZs initially as enclaves of trade and FDI to meet these development goals and focused on mere attracting FDI. Gradually, it introduced reforms in the law and lowered transaction barriers between SEZs and the wider economy. It upgraded its FEZs in line with the industrial restructuring in the wider economy to facilitate linkages between the FEZ and non-FEZ firms. However, since the development strategy focused on large conglomerates as drivers of growth, FEZs essentially remained enclaves of low value added activities. Their role declined sharply in the late 1980s (as enclaves) with rapid growth taking place outside them. But, the 1997 crisis revealed longstanding structural weaknesses in Korea's development model. After this crisis, Korea started to build a knowledge economy with balanced regional development and steered its SEZ policy to overcome the institutional impediments besetting the economy and achieve its development goals. While the SEZ policy was used to plug in the gaps in the development strategy in the initial phases, in the post 1997 period, it occupies the center stage with FEZs becoming the axis of its FDI policy. The role of its traditional EPZs has however declined sharply.

Taiwan followed a relatively less aggressive industrialization plans. It progressed slowly from light to capital to knowledge intensive industries with essentially small

and medium enterprises driving the economy. Taiwan used EPZs as the platform for strengthening the small and medium enterprises by integrating them with GVCs. This approach was a variant of the vertically specialized industrialization strategy proposed by Milberg et al (2014). Once integrated with GVCs, enterprises moved from the assembly of imported inputs to increased local production and sourcing (OEMs) and then finally to the sale of their own branded merchandise (OBMs) targeting more sophisticated market segments such as design, marketing and branding both in and outside of SEZs. They developed a mutually reinforcing relationship with EPZs with each augmenting the other. Taiwan has expanded its SEZ sector in the post 1997 period to address the regulatory constraints that had affected its competitiveness. However, over time the zones' contribution as a proportion of the island's exports has declined to around 4.7% in 2014. But, it has maneuvered its location policy such that it has created two growth poles at Kaohsiung and Taichung cities to generate agglomeration economies with science and industrial parks in vicinity.

China traversed a trajectory which is distinctly different from that followed by Taiwan and Korea. It viewed SEZs as the key element of its cluster-based industrialization strategy. The institutional structure of SEZs, which provided considerable economic incentives and leeway to local authorities; large city-size; and open-ness facilitated domestic linkages with SEZs in the initial stages itself. Subsequently, smaller zones were created in the proximity of the existing zones or near industrially developed locations or clusters to generate synergies between them and promote a critical size of economic activity. At the same time synergies were created with the regional economies using appropriate policy

packages, reaping the benefits of increasing returns, external economies and complementarities. Agglomeration economies generated in the process has accelerated the growth of these zones and has immensely benefitted the economy as a whole. While Korea and Taiwan identified the role of SEZs in their development strategy and were benefitted by them in the effective implementation of their respective development strategy, China's growth strategy itself place them at the center (in addition to state owned enterprises) and the growth process was largely driven by them.

## **5. Policy Implications**

The major policy implications are threefold. First, SEZs are a safety valve that can address institutional inefficiencies by overcoming growth constraining institutions within a given locked-in institutional arrangement. Policy makers implementing the SEZ policy must have a clear understanding of the macroeconomic context, development challenges, and the role that SEZs can play in a given context. Second, if used strategically, the SEZ policy can be an exceedingly versatile tool to achieve a variety of goals. Crucial to a successful SEZ policy is selecting a strategic approach to produce the desired outcomes. This requires a clear understanding of the goals to be achieved and the mechanisms that underpin the links between SEZs and these goals. The drivers of success and economic outcomes of SEZs depend on the strategic approach adopted by policy makers towards SEZs. There is no single recipe of their success or development outcomes. An enclave SEZ, which is not designed for development cannot be expected to yield development benefits by policy makers. Thus, it is the SEZ policy and not SEZs *per se* that need to be evaluated. Finally,

institutions evolve in the process of development. So must strategic approaches towards SEZs. New genres of SEZs need to emerge and the existing ones must upgrade to address new institutional challenges, and achieve new goals. This evolution is key for a successful SEZ strategy.

A serious risk with SEZs as development tools arises when they remain 'enclaves' of trade and FDI with little linkages with the wider economy. This can delay the process of industrialization in an economy by diverting resources and the attention of policy makers away from building industrial capabilities within the wider economy. A well-endowed enclave SEZ can be instrumental in attracting FDI and promoting trade but it starts losing relevance as the macro contexts change. Any effort to sustain cost advantages of SEZs at the low end of activities over time is not sustainable and can harm the process of industrialization in the wider economy. The experience of the selected Asian countries presented here indicates that a strong focus on the development goals, sound understanding of the role that SEZs can play in given institutional context and continuous evaluation and evolution of the policy have been the major pre-requisites to achieve phenomenal outcomes using SEZs.

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