# Are Special Economic Zones a Panacea for Developing Countries? Lessons for Developing Countries

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A special economic zone (SEZ) is an area of a country regulated specifically to attract foreign investment and spur economic development. It is separate from the rest of the country in the sense that the business activities it hosts are free from requirements such as commodity taxes, foreign currency exchanges and customs limitations. In addition, SEZs offer business incentives such as rent discounts and preferential tax structures. Both developing and advanced countries [1] have established and utilized such zones to attract outsourced activities in industries such as manufacturing, distribution, logistics and trade.

Over three thousand special economic zones now exist worldwide, and more countries have begun implementing or shown interest in using SEZs for their industrial development. The results so far have been quite mixed; SEZs have succeeded in countries such as China, Singapore and South Korea, while others are still struggling. Many scholars maintain the view that SEZs are not a panacea, and must be implemented properly and carefully aligned with a country's specific circumstances.

[1] Including the United States, which has established hundreds of export processing zones.

Establishing a business-friendly environment is the chief policy objective of every successful SEZ. To this end, useful lessons that could be relevant to developing economies include, but are not limited to, the following:

1. **The SEZ should maximize guaranteed freedom for business activities, removing impediments to foreign investment.**

Successful SEZs and other jurisdictions have visibly sharp differences in their living conditions, levels of economic freedom, currency exchange practices and taxation. In other words, an SEZ should not be subject to regular laws. Greater economic freedom in SEZs can be achieved through several conditions: guarantees of independence, antitrust regulations, anti-corruption measures, a stable currency and consistency of policy. Loosening or eliminating tax requirements and restrictions on foreigners will further streamline business processes.

Governments should scrutinize every SEZ regulation to ensure that it favors foreign investors. This practice must extend to laws on environmental protection, construction, the business environment and living conditions. It must also cover labor laws: minimum wage restrictions, unemployment benefits and hiring and firing practices. Strict regulations in these areas may hinder the execution of SEZ development plans, and any delays in development will further discourage investment from abroad.

In addition to guaranteeing flexibility for business activities in SEZs, governments should provide foreign firms with stable currency exchange to further encourage foreign investment. Volatile exchange rates make foreign firms hesitate to invest in emerging nations, and many international companies with operations in SEZs identify the availability of liquid capital and currency conversion as the most important prerequisite legal conditions for a stable investment environment. Foreign firms should consistently be able to convert the domestic currency of an emerging market to the currency of an investing nation, without obstacles.

Thus, governments should establish policies to expedite currency exchange. Developing nations should apply a floating exchange rate in their SEZs rather than a fixed rate, because they may be unable to hold the value of their currencies within an appropriate range. International banks must be stationed in SEZs to ensure stable financial transactions; with their large reserves of money, such institutions can guarantee that businesses will have their currency demands met.

Also, governments should institute preferential tax schemes that differentiate the business environment of an SEZ from that of surrounding areas. To minimize the transaction cost of business activities in SEZs, the administration system, financial system and corporate structure should be organized in accordance with international standards.

Finally, comfortable living conditions are essential to help foreign investors settle down and concentrate on business. The longer governments take to create such conditions, the more time they will need to attract foreign capital. Convenient transportation and guaranteed security are basic elements; in addition, housing, schools and medical institutes should be built to facilitate resettlement. To attract foreign schools and medical institutes, governments should prioritize the elimination of regulatory obstacles.

2. **Expediting the development of essential infrastructure, such as transportation facilities, is essential to improving the flow of business.**

To expedite the buildup of infrastructure, a vertical system of regulation, direction, approval and supervision must be replaced with an integrated authority capable of executing these functions with the goal of supporting investments. In addition, the central government should guarantee the independence and autonomy of the regional SEZ authority by granting it discretionary power over employment, organization and budget. The national budget should provide sufficient funds for infrastructure development. Eliminating or loosening construction laws, including requirements for environmental impact assessments, can simplify the process of infrastructure development.

3. **The regional SEZ authority's legal status and characteristics should be clearly defined prior to the SEZ's development.**

A regional SEZ authority's special purpose requires it to have more control within the SEZ than the municipal government. To prevent conflicts between the regional SEZ authority and the municipal government from potentially undermining an SEZ's efficiency, the host country should enact a law establishing the regional SEZ administration's processes and authority. The regional SEZ authority's role consists of finding potential investors, marketing the benefits of operating in the zone, offering administrative services and attracting world-renowned education and medical institutions. It is especially important that early-stage SEZs have official institutions and organizations capable of properly executing laws, to support the establishment and operation of foreign firms.

4. **The central government should set the direction of industrial and economic policies to drive economic growth.**

Although successful SEZs possess independent decision-making authority, that autonomy does not extend to policy-making. The central government can maximize the potential of its SEZs by proposing a development plan and specific role for each one. Without central supervision, multiple SEZs may compete for foreign investment and establish redundant projects, reducing efficiency. To stipulate the growth of successful SEZs, the central government should develop clear communications that reflect its vision. Lack of communication can disrupt the central government's collaboration with regional SEZ agencies. In addition, the country should set the vision and goal of its SEZs in accordance with its national economic situation; the objectives of its SEZs should reflect long-term national economic goals. National economic policy, in turn, should maximize benefits and gains from the country's SEZs. For example, local companies can develop their technological capabilities through active business with foreign firms in an SEZ. Eventually, this process will help upgrade the national economy's industrial structure. Separately, governments can expect foreign firms in SEZs to demand a large number of laborers, potentially easing broader unemployment problems.

5. **To attract foreign investment, it is essential to supply a sufficient labor force and sustain competitive wage levels.**

The cheap labor of emerging markets can be an early-stage SEZ's greatest source of appeal to foreign companies, so it is prudent to sustain wages at a competitive level. It is advisable to legally guarantee the differentiation of salaries and to leave salary determinations to the discretion of companies. In addition, SEZ regulations should simplify hiring and firing processes to guarantee labor market flexibility.

To secure a stable supply of skilled labor, educational institutions should be established in SEZs as part of a well-designed employee training program. Educational institutions can also collaborate with foreign firms on research.

Research institutes can produce powerful ripple effects in industry by introducing more advanced technology for domestic use. Governmental support, such as material incentives and subsidies, can attract foreign research institutes to SEZs. As an alternative to bringing in foreign institutes, the government can hire domestic research professionals to improve collaboration between academia and industry.

**6. Socio-political factors are critical to the attractiveness of SEZs.**

Relevant socio-political factors include consistency of policies, deregulation, corruption rate, economic freedom and property rights. The stability of legislature can guarantee the safety of investments in SEZs. Since political instability in emerging nations or social instability during political transitions can threaten investments, foreign firms must be assured that their assets are safe in SEZs.

Regulations can be seen as impediments to business activities. Corruption rates can be interpreted as reflections of a supporting system's efficiency; lower levels of corruption indicate a fair competitive environment, while higher levels of corruption reflect a business environment of deteriorating stability. KIEP