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Post-COVID-19: Revisiting South Asia's SEZs

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Summary

Special Economic Zones (SEZs) are back in vogue in South Asia, recovering from the impact of the COVID-19 pandemic. But these have had a mixed performance. Under certain conditions, SEZs can be useful for attracting investment and supporting South Asia's recovery.

With South Asia's expected recovery from the COVID-19 pandemic in 2021-2022, policy attention is focusing on measures to facilitate investment and trade-led growth. It has long been recognised that efficient and seamless infrastructure is the backbone of Asia's trade-led growth. It powers the movement of goods, services, technology and people across borders. Furthermore, it contributes to reducing trade costs, encourages business competitiveness as well as promotes the spread of global value chains (GVCs) and digital trade. Within the broad spectrum of trade-related infrastructure, special economic zones (SEZs) stand out for their potential impact on trade-led growth in South Asia.

SEZs are geographical locations which are used by states to encourage manufacturing for export using fiscal incentives and modern infrastructure. It is thought that the first SEZs located near seaports were established in the 1960s and proliferated in the 1980s and 1990s in the developing world with the adoption of outward-oriented development strategies emphasising attracting export-oriented foreign direct investment (FDI). The multiplication of SEZs can be attributed to the relative ease of providing attractive investment climates though SEZs in countries where implementing trade and investment reforms has been difficult, the perceived low cost of setting up SEZs and heighted competition to attract export oriented FDI.

UNCTAD (2019) estimates that there are nearly 5,400 SEZs globally with over two-thirds located in Asia. East Asia – which makes up about half the global total – is reputed to have some of the world's most successful SEZs in China, Korea and Singapore. SEZs in these countries have played an important role in East Asia becoming the world's factory through attracting FDI, spreading sophisticated GVCs, fostering domestic linkages and supporting a dense network of trade in parts and components. A recent study on Asian economies suggests that the number and presence of SEZs is positively related to the overall export performance and volume of inward FDI. On average, a 10 per cent increase in the number of SEZs increases manufacturing exports by 1.1 per cent.

A relative latecomer, South Asia has somewhere between 456 to 645 SEZs (or 8.5 to 12 per cent of SEZs globally). Recent examples of SEZs focussing on manufacturing include the Cochin SEZ in India, Gwadar Free Zone in Pakistan, the Mirsarai Economic Zone in Bangladesh and the Hambantota Industrial Zone in Sri Lanka. Dedicated SEZs for services, like the Colombo Port City SEZ, are somewhat less common. Available data suggests that the performance of SEZs in South Asia has been mixed. They have typically failed to attract significant FDI inflows and create large numbers of jobs. FDI inflows, as a percentage of the gross domestic product, ranged from 0.5 per cent in Bangladesh to 1.7 per cent in India. They only created four per cent of employment in India and six per cent in Sri Lanka. Nonetheless, SEZs have made a notable contribution to exports in some South Asian economies, particularly in the development of the garment industry, accounting for 69 per cent, 26 per cent and 17 per cent of Sri Lanka, India Bangladesh's total exports respectively.

One can speculate on the reasons why SEZs in South Asia have not performed as well as expected. They mainly operate as public sector entities which means it becomes expensive for South Asian economies to bear the full costs of establishing and running them particularly while offering generous fiscal incentives. In addition, with the exception of India, SEZs in South Asia function as enclaves with few domestic economic linkages such as those with local suppliers, small and medium enterprises and the domestic goods market. A negative image problem linked to long running civil conflicts also repels actual investment in SEZs as Nepal and Sri Lanka have discovered to great cost. Furthermore, the odds are stacked against SEZs in small South Asian economies with difficult geographical circumstances. For instance, land-locked Nepal and Bhutan are hampered by a lack of sea connectivity, high transit costs involved in international border crossings, gaps in domestic infrastructure and cumbersome bureaucratic approvals. Although Nepal's first SEZ in Bhairahawa was inaugurated in 2014 at considerable state expense, only three factories had started operations by 2020.

More generally, some South Asian economies suffer from gaps in their investment climate as indicated by the World Bank's Doing Business Index 2020 which adversely affects their attractiveness to FDI in SEZs. India, in 63rd place in the World Bank's rankings, was South Asia's best ranked economy while Afghanistan in 173rd place, was the worst. In between stood Sri Lanka at 99th place, Pakistan (108th) and Bangladesh (168th).

Drawing on East Asia's successful experience, some policy lessons may be gleaned for South Asian SEZs. First, SEZs are an important development policy tool not only for promoting inward investment but also for facilitating industrial clustering. Notable spillovers can be gained from sharing resources and costs by locating related industrial activities in given geographical locations. Second, regulatory and governance frameworks should be adaptable. The role of the government is to set regulatory frameworks for SEZs, but their development and ownership could be through public, private or a public-private partnership. Third, competitive fiscal incentives are important to initial investments in industrial ventures along with institutional factors (like an efficient SEZ governing authority, a supporting legal framework and a flexible labour market). But there is an on-going debate on the economic costs and benefits of certain fiscal incentives like long tax holidays. Fourth, improving the incentive climate by implementing behind the border regulatory reforms are necessary condition to exploit gains from investments in SEZs. Finally, political stability is essential to attract foreign investors into SEZs. Investing overseas is a long-term activity and risks of domestic conflicts and violence of any kind tends to deter investments in SEZs.

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