

ICPS newsletter

Special economic zones: Worldwide and Ukrainian experience

The aim of creating special economic zones (SEZ) is to promote economic development in depressed regions. SEZ can be used to facilitate the process of attracting modern technologies into the national economy, promote competitiveness of goods and services, expand exports, and create new job opportunities. The usefulness of SEZ in Ukraine is being widely discussed. ICPS economists have performed a comparative analysis of special (free) economic zones in Ukraine and other countries and assert that, with proper planning, SEZ can give positive results

Creation and operation of SEZ in the world

SEZ are established through granting privileges to companies investing in particular activities in specific regions. Investors usually receive custom and tax privileges, rights for simplified registration and customs procedures, and right for priority use of the SEZ infrastructure. Commonly, SEZ are divided into the following groups, according to their economic specialization:

- **Free-trade zones.** Such SEZ are established to ensure free goods turnover and develop customs-free trade. These areas are used for storing and primary processing of imported commodities (packaging, marking, assembling, etc.). Such zones include both international and free (e.g., Porto-Franco) ports.
- **Technological zones.** These SEZ include areas where domestic or foreign firms conducting research and development or innovative activities are concentrated (techno parks, business incubators).
- **Service zones.** These SEZ are located in areas with preferential treatment of companies providing financial or non-financial services (zones for banking and insurance services, offshore, and recreation zones).
- **Industrial zones.** These SEZ include areas where customs and tax privileges are granted to industrial companies producing export or import-substituting products.
- **Combination zones.** These zones, with broad specialisation, combine the features of the previous types of SEZ (common in China, Brazil, Eastern European countries, and CIS).

In creating SEZ, governments usually seek to attract foreign investment. One sector of specialisation is chosen in each zone (except for combination zones). Mostly, investments are channelled into electronics, light, food, and wood-processing industries, where output is oriented at the final consumer and has high added value.

In order to evaluate SEZ performance, experts use economic, social, environmental, and other criteria, particularly:

- ROI;
- the amounts of investment attracted;
- production capacity, and potential increase in the competitiveness of the products;
- application of high technologies;
- export volumes and changes in its structure;
- level of employment in the region;
- living standards of the population in the region;
- level of environmental pollution in the region.

International experience indicates that SEZ are not always effective. This is mainly caused by incoherent government policy, namely:

1. unstable and non-transparent legislative regulation of SEZ, resulting in low levels of investment, corruption, and privilege abuse for money-laundering purposes;
2. lack of strict requirements concerning SEZ specialisation, leading to unjustified expansion of privileges for practically all activities in the zone;
3. improper planning of SEZ, namely:
 - poor selection of SEZ location (area with

underdeveloped infrastructure, insufficient amounts of natural and labour resources, or insufficiently large market); in this case, SEZ is not attractive for investors;

- improperly determined zone size—for instance, in China, Malaysia, and Singapore large areas of SEZ turned to be the main source of industrial development; however, large zones require enormous initial investment into developing their infrastructure. Moreover, organisation of proper management in these zones is quite complicated; this factor is very important for countries establishing SEZ for the first time and having no experience in their management.

Operation of SEZ can give positive results, if it is properly planned. For example, in China 5 combination zones, 14 open cities, and 10 research and development zones were established. These zones generate almost 40% of total exports and show an annual industrial production growth of 70%. In the Philippines, 19 SEZ were introduced (including industrial, export-oriented, tourist-recreation, and free-trade zones). During 1994–1999, these zones achieved almost 5.8 times increase in exports, and 2.7 times increase in employment (388,000 jobs).

In Mauritius, improper planning was the source of the SEZ not accomplishing its predetermined objectives. Thus, SEZ performance was poor. In India, the SEZ were given too many objectives, consequently privileges were extended to almost all activities in the zones. In Liberia, expenditures on the development of SEZ infrastructure (\$15 million) significantly exceeded the amount of investment attracted (\$60 thousand).

SEZ in Ukraine

Currently, Ukraine has 11 free economic zones and more than 20 priority development areas (PDA). In creating SEZ in Ukraine, depressed regions with high unemployment were selected. Above-average levels of unemployment are recorded in almost all small cities, where city-founding enterprises are in deep crisis.

The large number of SEZ and APD in Ukraine indicates the lack of effective regional policy for promoting economic development in small cities.

The common feature of the majority of Ukrainian SEZ (PDA) is the requirement of large-scale investment and existence of numerous priority activities. Every SEZ (PDA) includes several big enterprises conducting different activities. There is almost no competition among SEZ entities. Thus, businesses have no incentives to improve. Moreover, SEZ (PDA) functioning ensures only temporary improvements. Later, those SEZ businesses that are not able to supply new products or technologies will have to quit.

In worldwide practice, SEZ entities are usually granted income or real estate (land and/or constructions) tax concessions. Instead, in Ukraine SEZ (PDA) entities are granted VAT concessions. Targeted use of products imported into Ukraine without VAT

payments is difficult to trace. Thus, SEZ (PDA) entities have an opportunity to receive additional profits from illegal sales of the products, and controlling bodies require more funds for administration and control of SEZ entities.

Among the Ukrainian SEZ, the most successful are those with narrow specialization, such as "Kurortpolis Truskavets", "Yavoriv", "Porto-Franco", "Reni", and "Interport Kovel". The "Kurortpolis Truskavets" SEZ is traditionally specialised in providing tourist and medical services. Competition among SEZ entities reduces the possibility of failure. Business activities in the "Porto-Franco", "Reni", and "Interport Kovel" zones mainly include minor processing of freight and packaging of goods.

Positive effects of the SEZ include increased legal imports and reduced consumer prices.

At other Ukrainian SEZ, competition is distorted due to improper planning of the

zones. Functioning of such zones leads to significant budget losses resulting from numerous privileges granted to SEZ entities. Prior to the creation of the zones, alternative methods ensuring support for big and city-founding enterprises were not properly analysed. Those methods include privatisation, alternative management approaches, restructuring, etc.

However, in making the decision to cancel inefficient SEZ (PDA), the government should retain all privileges already granted to economic entities. This step is needed in order to preserve Ukraine's reputation among foreign investors and ensure protection of their rights. ■

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ICPS project titled "Public-sector capacity building to accelerate reforms in Ukraine" announces a competition for participation in its internship programs

The project "Public-sector capacity building to accelerate reforms in Ukraine"—conducted by the Initiative for Reform of Local Self-government, the country service of the Open Society Institute, the Ukrainian Academy of Public Administration, Office of the President of Ukraine, and the International Centre for Policy Studies in the framework of the "Poland–America–Ukraine" cooperation initiative—announces a competition for participation in its week-long internship program.

The goal of the project is to facilitate administrative reform, consolidate democracy, and empower local governments through training, exchange of expertise, and establishing and strengthening contacts between Ukrainian and Polish colleagues.

In the framework of the project, week-long internships will be arranged in the following fields:

Malopolska Local Government and Administration Institute (MISTiA), Krakow

- regional administration: structure, functions, delegation of authorities, finances and budget;
- municipal development: infrastructure, reforming municipal services, privatisation, and promoting investment, entrepreneurship, and economic development;
- local authorities: democracy formation at a local level, social relations, public participation in decision making, and cooperation between the state and the public;

National School of Public Administration (Warsaw):

- administrative reform of 1998–1999: divisions of powers and authorities among central, regional, and local bodies;
- pension system reform;
- health care system reform: objectives, achievements, lessons learned.

Prospective participants must be:

- deputies of oblast, raion, or municipal councils;
- government employees working in central bodies or oblast/raion/municipal state administrations; as well as employees of oblast/raion/municipal/village self-governments;
- representatives of NGOs and small businesses engaged in community development and providing services to the public;
- journalists from central and regional press working on democratisation, anti-corruption, civil society building, local and regional development issues.

The deadline for applications to the program "Regional administration: structure, functions, delegation of authorities, finances and budget" is September 5; for other programs – September 20.

During July, for detailed information and application forms for the internship programs, please contact Olha Shumylo, project coordinator. Tel. (380-44) 463-5967, e-mail: OShumylo@icps.kiev.ua.

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