

Discussion Paper – July 1, 2020

# Special Economic Zones and Urbanization



Factory workers producing masks for protection against viruses. [Shutterstock/ Pgallery]

## 1. Introduction – objective of the paper

Special Economic Zones (SEZs) continue to be widely used across all regions and seek to achieve different economic policy objectives, with significantly varying degrees of impact. Experience has shown that proximity to urban centers is a key determinant of success for SEZs. At the same time, as policymakers seek to achieve objectives related to the Sustainable Development Goals, the success of SEZs will be increasingly defined in terms of how they can contribute to them and to sustainable urbanization in particular.

The COVID-19 pandemic has brought to light some of the challenges associated with increased urbanization, including densely populated and poorly planned areas. Urban centres have not only been epicenters for the transmission of the COVID-19 virus, but also proved to be particularly challenging

settings within which to respond effectively to the pandemic. Existing inter-urban inequalities are likely to be exacerbated, with the most vulnerable sectors of society, including urban informal sectors, being the hardest hit by the negative economic consequences of the crisis. In a post-pandemic context with a weak global economy and strained government resources, the role of SEZs to contribute to sustainable urbanization will be increasingly challenging but also more critical.

This paper seeks to address the link between SEZs and urbanization and builds on an earlier exchange between experts on this subject in February 2020 at the Tenth Session of the World Urban Forum (WUF10) in Abu Dhabi.<sup>1</sup>

<sup>1</sup> Speakers at the UNCTAD-WUF10 meeting Urbanization and the Role of SEZs on 11 February 2020 in Abu Dhabi included: Mr. Marwan Abou Dib, Co-Founder and Partner, Tekuma Frenchman; Mr. Abdulla Balalaa, Director, Sustainable Real Estate and Design, Masdar; Mr. Marco Kamiya, Senior Economist, Knowledge & Innovation Branch, UN-Habitat; and, Mr. Paul Wessendorp, Chief, Investment Promotion Section, DIAE, UNCTAD.

## 2. Brief background on SEZs

**SEZs are widely used across most developing and many developed economies.** SEZs go by many different names (including free zones, export processing zones and industrial parks), and come in many varieties. In its *World Investment Report 2019: Special Economic Zones*, UNCTAD has defined SEZs as geographically delimited areas within which governments facilitate industrial activity through fiscal and regulatory incentives and infrastructure support (UNCTAD, 2019).

**Policy objectives of SEZs differ substantially among economies at different levels of development.** In developed economies, most SEZs are custom-free zones to provide relief from tariffs, and more importantly, from the administrative burden of customs procedures, in order to support complex cross-border supply chains. Developing economies often have different objectives for establishing SEZs, notably to attract foreign direct investment (FDI) in order to build, diversify and upgrade industries. A country's level of economic development is likely to influence the types of SEZ that it embraces. For example, many lower income economies, including in Africa, are using SEZs to kick start manufacturing, industrialization and exports. More advanced countries are focusing on industrial upgrading of certain sectors through SEZs. Zones are also increasingly centered around technology sectors. This is the case in many transition economies (UNCTAD, 2019).

**The rationale behind SEZs lies in the economic foundations of agglomeration economies.** Economists and geographers have argued that economies benefit from the clustering of industries either as firms in the same sector (localization economies) or as diverse firms in the same location (urbanization economies). Agglomerated economies have been shown to provide many benefits such as gains from positive spillovers, economies of scale, and it promotes cost-efficiency in the provision of public goods. The concentration of economic activity enables easier transfers of knowledge and technology through mutual learning, and also plays a key role in the creation of forward and backward linkages (UN Habitat and FAO, 2020). It is important to note, however, that spillovers from clustering are in part determined by the organizational structure of firms and their industry. The type and degree of positive spillovers can therefore vary greatly and may be less than has been assumed.

**The planning and development of SEZs involves a range of strategic partners.** While coordination with different stakeholders is often an important challenge, it is critical in order to ensure that SEZs are aligned with national and local objectives, planning strategies as well as to maximize synergies and promote cooperation that can contribute to their success. At the national level, relevant actors can include ministries responsible for urban planning, economic development and fiscal matters, in addition to sectoral ministries and specialized agencies, including in charge of public-private partnerships. In addition, investment promotion agencies (IPAs) at the national, sub-national and city-level are strategic partners, as they can play a role in attracting and facilitating investment towards the zones. SEZs

can also engage with local and city-level public actors, such as city managers and mayors as well as local urban planning authorities. Finally, SEZs also build strategic relations with the local private sector including with business associations.

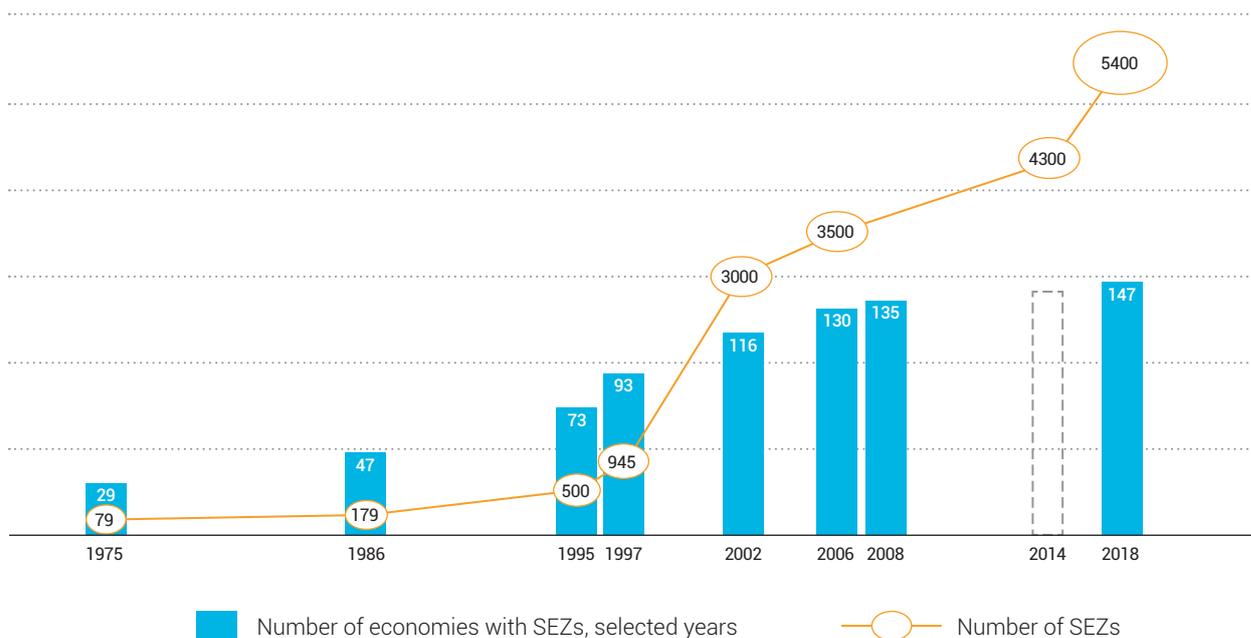
**The continued enthusiasm for SEZs among governments around the world stands in contrast to their impact, which is often mixed.** While SEZs can give a boost to investment, exports and jobs, they are not a guarantee. Although SEZs have been around for decades, there is relatively little systematic research on their performance or economic impact. Recent UNCTAD research shows that although the performance of SEZs remains below expectations, new zones continue to be developed, as governments increasingly compete for international mobile industrial activity. Today there are around 5,400 SEZs, more than 1,000 of which were established in the last five years (UNCTAD, 2019).

**Beyond facing the traditional challenges of making SEZs succeed, policymakers are now facing new SEZ objectives related to the sustainable development imperative.** With growing evidence of the materiality of many SDG issues, the strategic decisions and operations of multinational enterprises (MNEs) are increasingly being influenced by the sustainable development agenda. This is being reflected in the value propositions that SEZs and IPAs market to investors. Laxer social and environmental rules or controls are not a viable long-term competitive advantage to attract investment in zones. On the contrary, they can lead to zone failure when the SEZ becomes associated with labor or human rights abuses. UNCTAD has provided a Framework for Sustainable Economic Zones to help SEZs enhance their competitiveness by switching from a narrow focus on cost advantages and lower standards to championing sustainable business (UNCTAD, 2019).

**The COVID-19 pandemic and its impact on the global FDI landscape is testing the resilience of SEZs...** A recent survey among SEZs revealed that the majority have been significantly affected as many operate in sectors and activities where working from home is not an option. In addition, they have been affected by global supply chains disruptions, decreased global demand and a deterioration of global financial conditions (World Free Zones Organization, 2020). The pandemic will cause a dramatic drop in FDI flows. The top 5000 MNEs have seen expected earnings for 2020 revised down by 40% due to the crisis (UNCTAD, 2020a). Beyond that, there will also be lasting effects, with MNEs reshoring part of their business to make supply chains more resilient. Other trends will also be reinforced including the importance of the digital economy. Finally, as fiscal revenues are strained across countries, this will put pressure on tax incentives. These trends will force countries, their IPAs and SEZs to find new and innovative ways to attract investment.

**...while also bringing to light their capacity to innovate and react quickly to challenges.** In many countries, SEZs are supporting the role of IPAs in not only keeping investors abreast of COVID-related policy measures targeted at businesses, but also in investment facilitation and aftercare services to help existing investors continue to operate during these challenging times. Together with IPAs, SEZs – particularly those that focus on health and bio-tech sectors – have had an important role

Figure 1. Historical Trends in SEZs: (Number of countries and SEZs)



Source: (UNCTAD, 2019)

in contributing to national efforts to source equipment and materials in support of combatting the pandemic. As SEZs are increasingly oriented towards fostering innovation and promoting high-value activities, including in digital sectors, they may be catalyzers for innovative solutions to the new challenges of a post-pandemic economy. This can support change in cities that have already shown their capacities to tap into pools of entrepreneurial talent, networks and resources to provide creative and innovative mechanisms to mitigate crisis effects. There are global initiatives working on the tracking of response mechanisms to the COVID-19 pandemic led by organizations such as UN-Habitat, ThinkCity, CitiIQ, and Mansueto Institute, working with city authorities.

### 3. The links between SEZs and sustainable urbanization

**The relationship between SEZs and urbanization can be bidirectional.** The existence of SEZs significantly impacts the urbanization landscape, and the urbanization process simultaneously creates a mix of factors that influences the location decision of SEZs. China's famous Shenzhen zone is an example of how SEZs can evolve together with the country's level of development as well as the urban landscape of the Shenzhen region (box 1).

#### Box 1. Shenzhen Special Economic Zone, China

The Shenzhen Special Economic Zone is one of the largest SEZs in the world. Locational advantages were crucial on the decision-making of this SEZ, together with three other ones that were established in China during the 1980s, all near coastal areas. Shenzhen is close to Hong Kong, China, one of the most important industrial, financial and commercial hubs in the world. China's success with its early SEZs, including the one in Shenzhen, stems from a developmental approach where SEZ objectives are aligned with national development priorities and integrated into long term urban planning frameworks. In addition, the strategic focus and objectives of the SEZ take into consideration the country's existing level of development and evolve with it.

In 1979, Shenzhen was a poor fishing village with a relatively low level of education and poor standard of living. Since the establishment of the SEZ, Shenzhen's GDP grew from \$4 million in 1980 to \$114.47 billion in 2008 (Zeng, 2010) and \$338 billion in 2017 (UN-Habitat, 2019). Export volume ballooned and successfully provided meaningful jobs to the growing urban population. Shenzhen's impressive growth over a forty-year span was influenced by targeted development strategies that planned Shenzhen's future growth. These evolved from a focus on labor intensive industries, to capital intensive development and in turn to a focus on innovation-driven companies. Today, the zone continues to attract innovative talent and produces more than 40% of China's national patents.

Source: (UN-Habitat, 2019).

**A strategic location close to key infrastructure hubs, large markets and labor pools is fundamental to attracting investors into a zone.** Several studies have shown that closeness to ports of large cities is more likely to spur zone dynamism than locating SEZs in more remote areas. Likewise, SEZs that are located in urban centers that are densely populated tend to be successful in the achievement of their objectives (White, 2011). In developing countries with one or very few major urban agglomerations, the distance to the largest city is negatively correlated with zone performance (UNCTAD, 2019). Cities and urban centers offer a host of benefits crucial for the development of industrial zones, including skilled labor, diverse markets, capital, and an easier access to other firms (UN-Habitat, 2016). They also offer upgraded transport networks and communication infrastructure, facilitating easier movement of people, goods, and information. Furthermore, SEZs are able to benefit from the connectivity and integration that urban areas have within global supply chains. The example of Morocco's Tanger Med is illustrative of an SEZ that is strategically located close to a major port, has access to supporting infrastructure to ensure connectivity as well as a pool of skilled labor (box 2).

**The role of cities and urban areas as hubs for creativity and innovation could underpin the success of SEZs in the vicinity.** Creative systems, technological innovation, and the development of knowledge mechanisms, have primarily occurred in cities. Innovation will continue to be an imperative for successful SEZ development, with benefits from scientific research and commercialization, improved project design, and higher efficiency contributing to the development of higher value-added industries (UN-Habitat, 2012).

**SEZs can encourage the development of nearby urban areas.** The establishment of SEZs can catalyze investment in supporting infrastructure, including transport, water and sewerage, electricity and housing, not only within the zones but also in its periphery, including urban areas. This could prevent the mushrooming of slums around SEZs which

can have a negative impact on foreign investment and the achievement of SEZ objectives (Akinci and Crittle, 2008). In addition, as infrastructure – particularly for information communication technologies (ICT) – mounts as a critical determinant for attracting FDI in the zones, the deployment of ICT technologies within and around zones can have positive spillovers in the surrounding urban environment.

**SEZs also have the potential to contribute to sustainable development.** Shared services related to sustainability, such as common health and safety services, waste management installations and renewable energy sources will become increasingly important. SEZs that market their environmental performance (ecozones) are already emerging (UNCTAD, 2016) and active promotion of high environmental, social and governance (ESG) standards will increasingly become a feature of SEZs. This is the case of Masdar City SEZ in United Arab Emirates, whose value proposition is strongly based on high environmental standards (box 3).

**But mutual benefits are not automatic.** The impact of SEZs on the wider economy, including on sustainable urban development, is not guaranteed. Even in successful cases of SEZs that have managed to generate investment, jobs and exports, the benefits outside of the zones have often been hard to detect. It is not uncommon for SEZs to operate as enclaves, with few linkages with local suppliers, few spillovers and consequently, limited impact on the broader urban environment in which they are situated. At the same time, while proximity to urban centers is key for the success of SEZs, it is by no means a guarantee. SEZs that are ill placed or that grow without proper urban planning may actually have a negative impact on a city's sustainable urban development. For instance, if companies inside the zones are polluting residential areas, if ill designed entries to an SEZ are contributing to a city's congestion or if informal urban industries instead of formal SMEs develop in the zones periphery.

### Box 2. Tanger Med SEZ, Morocco

The Tanger Med Zones (TMZ) is an ecosystem of diverse economic and industrial activities. In total, TMZ extend over a land area of 3,000 hectare and constitute a platform for regional competitiveness in the industrial, logistics, services and trade sectors. The zones are located at 14 kilometers from Spain and situated on the Strait of Gibraltar which provides access to African, Asian, European, North American and South American shipping routes.

One of the success factors of TMZ was a strong long-term vision and political will. The different zones within TMZ, and their supporting infrastructure, were developed quickly and in line with the overall vision to create an integrated cluster supported by world class infrastructure and services. The individual industrial zones were simultaneously developed with the Tanger Port, as well as road and rail infrastructure linking the different hubs of the region (COMCEC, 2017). In addition to comprehensive and long-term urban planning that accompanied the development of the SEZ, there was also significant investment in skills and training to ensure a qualified labor pool to service the companies in the zones. Twenty-seven training centers were established and developed by government funding, with training costs also subsidized by central government funding. Private companies were consulted to identify skills requirements and needs in the zones. In addition, training courses were developed for specific industries and in collaboration with the private sector.

Source: (COMCEC, 2017)

### Box 3. Masdar City SEZ, United Arab Emirates (UAE)

Established in 2006, Masdar City is a global leader in renewable energy and sustainable urban development. Its strategic focus is to support the country's objective to remain a leader in the global energy sector, while supporting diversification of both its economy and energy sources. The SEZ seeks to attract and develop commercially viable renewable energy projects, advance innovation in clean technologies and become the world's most sustainable city.

Masdar City seeks to serve as a testing, development and innovation hub that will contribute to the generation of new revenue streams for the UAE in the long term, including in the knowledge and industry sectors and help contribute to the growth of the country's renewable energy sector. The water and energy demand of the city's buildings is 40 per cent lower than that of the average building in Abu Dhabi, and each building must meet a minimum green building certification (Balalaa, 2020). In this way, the SEZ is demonstrating how an urban environment can accommodate denser populations more efficiently and in a manner that is aligned with sustainable development.

Source: UNCTAD event "Urbanization and the Role of SEZs" at WUF10, Abu Dhabi, UAE.

## 4. Maximizing mutual benefits between SEZs and sustainable urban development

### i. Ensure SEZs are integrated into urban planning frameworks

**The choice of location of SEZs is a key feature that is determined or can be influenced by government policy.** The overall value proposition of individual SEZs includes a host of locational advantages, only some of which are determined or can be influenced by government policy. External factors include high competition for international mobile investment, sudden changes in industries with respect to offshoring, including as a result of economic shocks or a crisis like the COVID-19 pandemic, and amendments to the policy environment, such as shifting trade preferences.

**Urban planning is crucial for the development and success of SEZs.** Spatial planning policies, which define the areas of residential, industrial and commercial development, are imperative to ensuring efficient land use and contribute to planned urbanization and spatial growth. By integrating urban patterns, spatial planning policies can also transform connectivity and accessibility to jobs, while reducing environmental pressure, travel times, and congestion (UN-Habitat, 2017). Well-designed urban planning therefore can provide many benefits to SEZs, contributing to its success.

**Alternatively, when SEZs are not integrated into well designed and long-term urban development plans, they may exacerbate some of the negative aspects of urbanization,** including the development of urban slums in its periphery and traffic congestion around the zones. In addition, when the growth of SEZs is not taken into consideration and integrated into broader urban plans, this often leads to the sporadic and sometimes uncontrollable development of zones. A poorly planned urban social infrastructure, including a city's health apparatus, can also be significant for nearby SEZs. The COVID-19 pandemic has surfaced the vulnerabilities of urban centers, which can have a knock-on effect on nearby SEZs (UN-Habitat, 2016).

### ii. Develop SEZs that contribute to the SDGs as part of their value proposition to investors

**As a response to the global COVID-19 pandemic, SEZs will need to re-evaluate their strategic focus...** In the face of the changing FDI landscape, as well as new industrial policies that will arise as a result of the pandemic, SEZs will be forced to re-evaluate their strategic focus and value propositions. SEZs should work closely with IPAs to set strategic targets in line with new national investment priorities.

**...which may present an opportunity to focus more deliberately on SDG-related sectors and objectives.** Governments should consider the development of *Model SDG zones*, as proposed by UNCTAD. These would be built around three key elements: (i) a strategic focus on attracting investment in SDG-relevant activities; (ii) the highest level of environmental, social and governance (ESG) standards and compliance; and (iii) promoting inclusive growth through linkages and spillovers (UNCTAD, 2019). ESG compliance, as well as linkages and spillovers are of course among the objectives of most existing zones. However, much more can be done, including in many areas related to sustainable urbanization such as renewable energy, sustainable supply chains and environmental policy, among others.

**If SEZs adopt the highest international standards and deliberately contribute to the SDGs, they can not only facilitate sustainable models by SEZ enterprises but also act as catalysts for replicable SDG business models outside.** For example, such "Model SDG zones" could provide services to control and support the ESG performance of firms operating in the zone and ultimately also outside the zone. Such services could include inspection services on health and safety standards, as well as training and financial support to facilitate improvements, implement best practices and obtain third-party certifications in SDG-related areas including the environment (UNCTAD, 2019).

**In addition, SDG model zones could offer facilities with benefits for the urban community.** For example, renewable energy installations can serve the zone but also feed the grid (or supply outside the zone), waste management plants with additional capacity or other utilities with benefits beyond

the zone, such as water treatment plants. They could also offer amenities and health care and education services that would benefit nearby urban areas. Operating on such high standards, SDG model zones would effectively transform the race to the bottom into a race to the top – making sustainable development impact a new locational advantage.

### **iii. Facilitate linkages between SEZs and the domestic private sector**

**Linkages prevent SEZs from remaining enclaves and can optimize the benefits to the development of cities and urban centers in the proximity.** These include backward linkages with suppliers, which occur when enterprises in the zones buy parts, components, materials and services from local suppliers, forming either arm's-length transaction or close inter-firm cooperation, depending on the types of advantages offered by local firms (UNCTAD, 2010).

**Linkages can be facilitated when they are considered in the design phase of the SEZ.** This includes the choice of location of the SEZ, to ensure access to housing, schools and health services. Beyond that, it also includes the planning of the SEZ itself, its design. For example, this can be the case when multi-service spaces are included in the design of the zones that serve the many needs of the SEZ companies and their employees, while providing opportunities for local enterprises, such as restaurants and day-care services, among many others.

**IPAs can be strategic partners for investment facilitation and aftercare, including optimizing linkages with the local economy.** FDI is expected to decrease dramatically as a result of the COVID-19 pandemic. The immediate response by IPAs across the world has been to reallocate resources towards aftercare and investment facilitation, helping existing investors (UNCTAD, 2020b). Many have been on the frontline of supporting investors and have taken on an important communication role by keeping them abreast of government emergency and economic relief measures. In collaboration with IPAs and other entities, SEZs should strive to understand the evolving needs of investors in the zones, in order to provide targeted company support, minimize layoffs and importantly, sustain linkages with the local economy. Many local SMEs have suffered in the crisis, which puts at risk linkages with SEZ investors.

**The absorptive capacity of the local economy, including local pools of skilled labor, is essential to develop beneficial and sustainable linkages between SEZs and the domestic private sector.** Projects to strengthen the local absorptive capacity should therefore be included in the planning of SEZs. When deciding on the strategic focus of SEZs and identifying what business sectors will be targeted, it is important to identify, together with the private sector, the skills that will be needed in companies inside and outside the zones. In some cases, private investors in the SEZ can be involved in either the financing of such project or in the training. In turn, this will allow to identify mechanisms to ensure a qualified labor force and identify key linkages with local research centers, universities and vocational training bodies as well as with other local partners.

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