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Special Economic Zones (SEZs) and Prospects for the Domestic Economy of Pakistan

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Abstract

Special Economic Zones (SEZs) is an important aspect of China Pakistan Economic Corridor (CPEC) besides projects with regard to infrastructure, energy, and the development of Gwadar port. SEZs as growth strategy have static and dynamic implications for the host economy. In static sense, they help in promoting investment, employment, trade and economic growth. In dynamic sense, they result in infrastructure development, technological upgradation, human resources development, institutional and economic reforms besides urbanization. All of these are essentials for successful industrial development. However, the success clearly depends on the threshold conditions that need to be met in order to reap the potential benefits associated with successful SEZs. In this regard, the organizational structure of the development and operation of SEZs is of primary importance. For instance, the structure that resolves the problems of knowledge and incentives is deemed to produce the desired benefits. Likewise, effective labor policy combined with less dependence on subsidies ensure higher employment and competitive industrial development. Moreover, secure environment, focus on the domestic priorities and close coordination between stakeholders are among the essentials that lead to success in this regard.

Key Words: CPEC, Special Economic Zones, Organizational Structure, the Problems of Incentives and Knowledge, Domestic Priorities, Coordination

JEL Classification: F21, O16, O47, R10

1. Introduction

China Pakistan Economic Corridor (CPEC) is an investment contract of around \$62 billion between the governments of Pakistan and China. It mainly comprises the construction of transportation networks, energy projects, the development of Gwadar port, investment and industrial cooperation through Special Economic Zones (SEZs).¹ Since its inception, there has

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¹ The activities with regard to Gwadar port includes the development of both the port and city and bringing improvements in the socio-economic development of the region. Likewise, energy projects are aimed at reducing shortages through different sources of energy like coal, hydel, wind, solar and LNG, and improvement in the transmission mechanism. Infrastructure focuses on the development of modern transportation networks through road, rail and aviation links. Finally, the investment and industrial cooperation would be enhanced through joint ventures, technological and human resources development under Gwadar Free Zone and other Special Economic Zones (SEZs). Accordingly, the Sector-wise distribution comprises \$34 billion for electricity, \$14 billion for Gwadar and the remaining \$14 for hard infrastructure and related activities.

been a variety of arguments on media over its possible implications for the domestic economy of Pakistan. The proponents consider CPEC as a game changer as it would result in industrial development, regional connectivity, market access, and increased trade. To put it differently, modern transportation networks combined with energy self-sufficiency, larger trade potentials and SEZs are intended to create higher investment and employment opportunities which, in turn, would result in overall growth of the economy. However, on the uncertain side, we have coordination failure among the federating units over the selection of routes, the allocation of infrastructure projects and SEZs.² Moreover, uncertainties associated with security, political, economic and cultural risks create doubts in the minds of stakeholders over the potential gains of CPEC related investments. Despite these opposing perspectives, CPEC offer both opportunities and challenges that need to be addressed in order to reap the potential benefits associated with regional connectivity, enlarged market access, and enormous infrastructure and industrial development.

Special Economic Zones (SEZs) is one of the important aspects of CEPC which is intended to serve as a strategy for industrial development and growth. SEZs are well-defined geographical areas which are specified within a country's national boundaries. In these areas, the rules of business are different as compared to those that prevail in rest of the country (Zeng, 2011). Alternatively, business environment within the zones is more efficient from the perspectives of regulation and liberal policy packages. SEZs encourage industrial development in several ways.³ First, they ensure efficiency in economic sense by offering a bundle of public services within a concentrated geographical area (He, 2002). Second, governments usually have limited funds that they can allocate for industrial development; so, if such funds are used within SEZs, they would improve efficiency by ensuring thrift in the public spending. Third, they facilitate joint ventures, domestic linkages, along with clusters development (Farole and Akinci, 2011). Fourth, SEZs are associated with technological upgradation, urbanization, human resources development besides infrastructure development (Romer, 1993; Johansson and Nilsson, 1997). Finally, SEZs may serve as an engine of institutional and economic reforms

² Alternatively, the lack of consensus may, further, aggravate political tensions and social divides and may create new sources of conflict in Pakistan.

³ According to World Investment Report (2019), there are nearly 5,400 SEZs today in 147 countries, more than 1,000 of which were established in the last five years. At least 500 more zones (approximately 10 per cent of the current total) have been announced and are expected to open in the coming years.

within the country (Weingast et al., 1995). There are also some opposing opinions in this regard. For instance, in order to attract businesses, SEZs may result in an inefficient transfer of resources to zones which may result in rent-seeking (Moberg, 2015). Likewise, according to Chaudhuri and Yabuuchi (2010), SEZs may destroy agricultural land due to government's quest for industrial development. Moreover, Lee (1999) asserts that jobs in SEZs may be comparatively insecure due to the mobile nature of multinationals within SEZs.⁴

In this study, we want to highlight the prospects of SEZs in Pakistan. In particular, given the internal and external challenges, we want to discuss how SEZs can result in employment generation, export promotion, industrial development, technological and skill upgradation, urbanization and overall growth of the economy. Also, we focus on how the issues with regard organizational structure may cause failure as far as the development and operation of SEZs are concerned. Pakistan did not have successful experience with respect to industrial estates which it did establish at provincial level in order to deal with the issue of sick industry.⁵ However, there are some success stories across the globe in terms of SEZs. For instance, China is one of the success stories in this respect. In this study, by giving a comparative touch with China and other countries, we want to put forward the threshold conditions for successful SEZs. First, we focus on the organizational structure of the SEZs. In other words, we want to see how the problems with respect to information and incentives are resolved in alternative decision-making mechanisms. Onwards, we emphasize how the focus on domestic priorities like potential exports and imports, effective labor policy and control over the rent-seeking of the industrial class are important for successful SEZs. Finally, we shed some light on the exogenous environment for the functioning of SEZs. In this way, we want to give some policy prescriptions for Pakistan by resolving these issues. Rest of the chapter is categorized into five sections. Section 2 provides the background of SEZs in Pakistan along with the current agenda of SEZs under CPEC. Section 3 highlights the corresponding facilities that are presumed to be offered in the newly established SEZs. Section 4 highlights the prospects for the domestic economy that are associated with successful SEZs. The challenges that need to be addressed in order to reap the potential benefits of SEZs are discussed in section 5. We conclude in section 6.

⁴ Usually, multinationals can easily leave SEZs when their cost of production rise.

⁵ According to Nawaz et al. (2015), Pakistan industrial estates are failure due to the governance issues and rent seeking of the industrial class.

2. Clustering of Industries in Pakistan: Background and Current Status

The performance of Pakistan's industrial sector is dichotomous in terms of growth, efficiency, competitiveness and diversification. There are a variety reasons for this failure, but the lack of coherent industrial policy is the most obvious one. In 1960s, we implemented the policies of export promotion and import substitution which were based on instruments such as imports rationing, credits at the subsidized rates, over-valued exchange rates, and discriminated tariffs.⁶ These policies had two effects on the industrial sector of Pakistan. First, in static sense, it resulted in higher growth rates of the manufacturing sector in the country. For instance, during Ayub's Regime, we experienced an industrial growth of around 10% per annum (Khan, 2013). Likewise, the share of industrial sector to GDP rose to 11.9% in 1965 from 6.9% in 1950. However, as a by-product, these policies resulted in the creation of an organized interest group in the form of industrial class. Subsequently, the nationalization of 34 industrial units in the decade ahead not only retarded the continuity of higher manufacturing growth; but, also, it resulted in inefficiency and declining incentives on part of the private sector.⁷ Thus, the dichotomous performance of the industrial sector is due to lack of continuity in policies. In addition, the behavioral rent-seeking of our industrial class along with the geopolitics might also have contributed in this regard.

The industrial failure in 1970s resulted in an increased number of sick industrial units which led the government of Pakistan to use clustering of industries as an additional strategy of industrial development. Accordingly, around 100 industrial estates were established in various parts of the country (Khan and Anwar, 2017).⁸

⁶ The base purpose of this policy was the presumption that a small group of rich industrialists usually save more for reinvestment as compared to poor peasants and underpaid workers.

⁷ These measures created a considerable amount of uncertainty, resulting in a fall in private investment and flight of capital. Moreover, these policies had long run implications for the industrialization process manifested in the reluctance of the private sector to invest, which continues to date.

⁸ An industrial estate is an area which comprises many businesses and factories in a single region. However, it is relatively small area as compared to special economic zones. Also, it has limited liberal economic policies. These estates were used as policy of regional development through fiscal incentives to investment in estates.

Subsidies only induced rent-seeking behavior and allowed efficiency-reducing free riding by recipients whose industries remained less efficient than they would otherwise have been (M. H. Khan).

of subsidies whose industries remained less efficient than they would otherwise have

In addition, Pakistan have some successful industrial clusters which constitute as groups of interconnected firms contained in single geographical region dealing with common industry.⁹ For instance, we have clusters like Gujarat Ceramic/Pottery Industrial cluster; Faisalabad Readymade Garments Manufacturing cluster; Tannery/Leather Industrial Cluster; Sialkot Surgical Goods Cluster; Gujranwala cluster; and Khyber-Pakhtunkhwa (KPK) Marble Cluster etc.

A special economic zone is a broader concept as compared to industrial estates and clusters in terms of leniency in economic and tax policies. SEZs can further be categorized as Free Ports, Industrial Estates (IE), Export Processing Zones (EPZ), Free Trade Zone (FTZ), Technology Development or High-Tech Zones, etc. Since the SEZ Act in 2012, Pakistan promoted six of its industrial estates to the status of SEZs. They are Bhawal Industrial Estate, Multan Industrial Estate Phase-II, Rahim Yar Khan and Mianwali Industrial Estates, Rawalpindi and Dera Ghazi Khan Industrial Estates. They are expected to create 1.5 million jobs under CPEC. In Punjab, three addition SEZs were approved by the Board of Investment (BOI), Pakistan. They are Industrial City located on Trade corridor and M3 near Sahiwal interchange, Quaid-e-Azam Apparel Park (QAAP) at M2 near Sheikhpura Interchange, and 225 acres Value addition City near Faisalabad on Expressway. In these, we expect a turnover of around Rs. 1 trillion along with the creation of 2 million jobs by their completion. Currently, under CPEC, the following 8 SEZs are under process.

1. In FATA, we have Mohmand Marble City
2. Mirpur Special Economic Zone which is allocated to AJK
3. Moqpondass SEZ in Gilgit-Baltistan
4. Rashakai Economic Zone (REZ) in Khyber-Pakhtunkhwa
5. Steel Mills at Port Qasim Special Economic Zone, Federal
6. China Special Economic Zone Dhabeji which is located in Thatta, Sindh
7. Bostan Special Economic Zone in Baluchistan

⁹ Alternatively, industrial clusters promote the development of related community.

8. ICT Model Industrial Zone, Islamabad, Federal

Overall, there are around 40 SEZs expected under CPEC out of which 28 have been identified so far. For instance, we would have 7 zones in Baluchistan. Khyber Pakhtunkhwa and Punjab have been assigned 8 and 7 zones, respectively. Sindh would have 3 zones while Gilgit-Baltistan, Islamabad and AJK have been allocated one zone, each. In Khyber Pakhtunkhwa, the expected zones would be Mansehra Marble and Granite Industrial Estate; Chitral Industrial Estate (food processing); Hattar Industrial Estate; D. I. Khan Industrial Estate (manufacturing); Nowshera Industrial Estate (manufacturing); Bannu Industrial Estate and Karak Oil Refinery; and Ghazi Industrial Estate (manufacturing). Likewise, in Punjab, we would have Multan Industrial Estate-II; Pind Daden Khan Industrial City; Mianwali Industrial Estate; Rahim Yar Khan Industrial Estate; Bhawal Industrial Estate; Rawalpindi Industrial Estate; and DG Khan Industrial Estate. In Baluchistan, the expected zones are: Gawadar Industrial Estate; Lasbela Industrial Estate; Turbat Industrial Estate; Dera Murad Jamali Industrial Estate; Winder Industrial and Trading Estate; Mini Industrial Estate Khusdar; and Bostan Industrial Estate. In Sindh, we would have Chinese Industrial Zone near Karachi; Textile City near Port Qasim and Marble City Karachi.

3. Special Economic Zones in Pakistan: Expected Facilities under CPEC

There is a long list of facilities that are expected to be offered to the developers of SEZs and zones enterprises. The incentives fall into five categories: fiscal incentives; general incentives; facilities in export processing zones; facilities in industrial estates; and exemptions in Gwadar port. Table 1 in the appendix gives the summary of these incentives. In terms of fiscal incentives, as far as the development of SEZs is concerned; one-time exemption is offered for all capital goods from all taxes and custom duties. It includes all capital goods which are imported into Pakistan for the operation, maintenance and development of an SEZ. With regard to income which is accrued from the operation and development of an SEZ, exemption from all taxes is offered for a period of five years. Likewise, one-time exemption is given to zone enterprises from all taxes and customs duties on capital goods which are imported for installation within the SEZs. As far as the incomes of zone enterprises are concerned; exemption from all taxes is offered on income for a period of ten years till June 30, 2020 and for five years beyond. These

facilities are expected to incentivize investors to invest within the SEZs. Similar fiscal incentives are offered in Gwadar port as can be seen in table 1 in the appendix.

In terms of general incentives, all the SEZs, industrial estates and export processing zones would be offered utilities like electricity, gas, and others at the zero-point of the zones. Likewise, one window facility and dry port facility would be provided by the Board of Investment (BOI), government of Pakistan. In addition, the development of SEZs and the enterprises within the zones would be regulated by transparent procedures and efficient regulatory mechanism. For instance, best building codes practices would be implemented. Likewise, protection to workforce and environment would be provided. The provincial government would be responsible to provide better security arrangements for the zones. There would be an efficient dispute settle mechanism within the zones. The continuity of these incentives would be ensured. For instance, incentives would not be withdrawn midway. Likewise, incentives would not be altered to the disadvantage of an enterprise. In the same way, as table 1 in the appendix shows, a detailed list of facilities would be provided to investors in industrial estates and export processing zones.

4. Special Economic Zones in Pakistan: Prospects for the Domestic Economy

There are three types of effects that Special Economic Zones (SEZs) might confer on the domestic economy of Pakistan. In static sense, SEZs encourage employment, industrialization, exports and FDI.¹⁰ For instance, firms in SEZs have connections to the local market, so they usually purchase production inputs from the local market; thereby resulting in employment generation and rising demand for the domestic raw materials. In addition to direct employment, SEZs are useful in creating indirect employment; however, it depends on the degree of forward and backward links between the local market and zones.¹¹ With respect to raw materials, Pakistan can provide cheap raw materials to investors in SEZs like those for marbles, gemstones, textile industry, leather products etc. besides cheap human resources. In this regard, the

¹⁰ SEZs in most countries are intended to incentivize Foreign Direct Investment (FDI), generate employment and to experiment with economic reforms via zone-exclusive trade and economic policies (Basile and Germidis, 1984; Litwack and Qian, 1998; Schrank, 2001).

¹¹ According to FIAS (2008), despite marginal direct employment, SEZs are successful in creating huge indirect employment, ranging from 9.6 to 77 million jobs across the globe. However, Maex (1983) points out that EPZs are not successful in creating indirect employment due their higher reliance on imported products.

development of SEZs should be based on specified products and services. Alternatively, the factors such as domestic raw materials, human resources and other inputs should provide the basis for the development of SEZs.¹² Likewise, through regional connectivity, Pakistan can find market for potential primary products like fruits, fertilizers, flour, meat, vegetables, and some other goods. The incentives offered by the cheap domestic inputs, lenient economic policies within the SEZs, and efficient regulatory mechanism incentivize both the domestic and foreign investors to invest in SEZs. Again, the result is higher FDI and exports which pushes the overall growth of the domestic economy. In China, FDI rose to \$4.1 billion by the end of 1980s with the functioning of the first four SEZs which was zero in 1980 (Khan and Anwar, 2017).¹³ Likewise, by late 1980s, the exported products through these SEZs rose up to \$10 billion. In the next decade, in year 2000, FDI to China reached to \$50 billion.¹⁴ The experiences of other countries show that the share of SEZs in exports is 78% in Philippine in 2005, 20% in Thailand in 2012, 17% in Bangladesh in 2009, 22% in India in 2009-10, and 41% of the manufacturing exports in Vietnam (FIAS, 2008).¹⁵ In terms of FDI, the share of SEZs in total FDI is 22% in Bangladesh in 2009, 81% in Philippines in 2000, 6.9% in India in 2011-12. Moreover, SEZs result in cluster development or in the agglomeration of certain industries, resulting in higher rates of specialization and economies of scale.

In dynamic sense, SEZs are associated with infrastructure development, joint ventures human resources development, and technological up-gradation. For instance, foreign investors clustered in SEZs spread their expertise about quality upgrading and technology to local firms. Alternatively, domestic firms become competitive in terms of technological development and upgradation (Romer, 1993; Johansson and Nilsson, 1997). Likewise, the interaction of domestic firms with foreign firms result in joint ventures due to the spillover effects of mutual interaction. Moreover, product diversification and innovations are encouraged within SEZs

¹² In general, the availability of raw materials (natural resources in a region) and cheap factor of production is perceived to have direct impact on regional economic development.

¹³ China started with SEZs in formal way in 1970s. They developed SEZs in four districts such as Shantou, Shen Zhen, Xiamen in province Fujian, and Zhuhai in province Guangdong on experimental basis.

¹⁴ By 2009, there were overall 1750 SEZs in China. The contribution of these SEZs to national GDP, FDI and Exports was 22%, 46%, and 60%, respectively. In addition, they are creating 30 million jobs (Zeng, 2010; Zeng, 2015).

¹⁵ See also, Farole and Akinici (2011), for details.

through joint ventures in Research and Development (R & D) activities. In case of China, investments under joint ventures expanded to \$432.74 million in 1993, which is 171 times as much as it was in 1980. It can also encourage public-private partnership, especially for technology transfer. According to Zeng (2010), SEZs have brought new technologies to China. For instance, the average technological commercialization rate in industrial parks is 60% as compared to around 10% in rest of the China. Likewise, the average technological development in agriculture is 70% in agro-tech parks; while in agriculture demonstration zones, this rate is 55.2%. Moreover, they are instrumental in the adoption of up-to-date management practices.

Given the comparative environment within SEZs, we would have competitive private sector in Pakistan which is deemed as essential for the future economic prosperity of any society. As a by-product, SEZs result in urbanization as it provides favorable living amenities to technical personnel and workers in a concentrated area. Moreover, the development of SEZs as smart cities rather than isolated from urban areas/markets result in the economies of scale, in particular, with respect the ecological services such as solid waste treatment plants and water treatment plants. Since employment within SEZs is competitive, this would incentivize the domestic workers to get skilled. Alternatively, SEZs enhance the capacity of workers by making them more productive. In order to improve the vocational and technical skills of the local workforce, the Chinese government did establish training institutes in SEZs. Similarly, SEZs in Taiwan are instrumental in skill development by arranging joint training programs between enterprises in the SEZs and colleges/schools (Aggarwal, 2007; Aggarwal et al., 2008). According to FIAS (2008), Eco-zones in the Philippines have upgraded the skill levels due to their higher focus on research and skill-intensive activities. So, for Pakistan, in this regard, vocational training institute in collaboration with China is of prime importance.

In experimental sense, SEZs may serve as experimental laboratories where we can compare the effectiveness of various policy options by taking SEZs as a treatment group while the rest of the economy as control group. For instance, in China, the purpose of SEZs in the beginning was to introduce the market-oriented economic reforms on experimental basis within these zones. The reforms included changes in laws with respect to immigration, land entitlements, financial services, regulatory mechanism, taxation and customs, and labor arrangements. After successful experience within the zones, the corresponding reforms were

steadily introduced throughout the china. Thus, SEZs can result in initiating reforms.¹⁶ In the presence of politically decentralized mechanism, SEZs can indulge the regions in competition for capital. Even, the regions can compete in terms of initiating reforms on the local level. Alternatively, more political autonomy within SEZs, more faster reforms within SEZs than the rest of the country that we can expect.¹⁷ SEZs in China introduced significant reforms with respect to the security of private property rights, labor policy and land use policy (Zeng, 2011; Moberg, 2015). For instance, before 2004, there were no rules with respect to private property rights in China outside the SEZs. Thus, entitlement of the private property rights within the zones was a radical reform as far as foreign investors are concerned. Likewise, foreign investors can lawfully acquire the land use right for the development or business purpose. They also have the rights with respect to the lease, transfer, or mortgage of the entitled land for terms of use and specified purposes.¹⁸ With respect to labor laws, foreign investors are independent from the government influence in firing or hiring their workers. Wage reforms in zones was undertaken at a time when it was unthinkable in rest of the China.¹⁹ Thus, in Pakistan, we can initiate from SEZs to experiment with the economic reforms.

5. Special Economic Zones in Pakistan: Threshold Conditions for Success

As stated earlier, SEZs offer both opportunities and challenges. In particular, we have to resolve the challenges in order to exploit the potential benefits that are associated with successful SEZs. In this section, we discuss how the issues with regard to the organizational structure, focus on the domestic priorities and security are important for successful SEZs.

5.1. Organizational Structure of SEZs

¹⁶ See, for instance, Weingast et al., (1995) and Moberg (2015) for details in this regard.

¹⁷ According to Crane (1990) and Auty (2010), SEZs may contribute to countrywide political reforms.

¹⁸ Moreover, China also offer exemption from land use fee to foreigners for five years when they invest in projects which are promoted by the state. For the next five years, they pay half of the usual fee. This exemption is given to projects which have an operational term of more than 15 years. Likewise, for technological advanced projects or projects with a total investment of at least \$10 million, the land us rights is assured to them.

¹⁹ The management of SEZs offer a social insurance to all permanent and most of the contract workers. Likewise, they also have determined an official minimum wage. These facilities were not available previously in China. Given the social protections and improved terms of employment, there is an enhanced migration from rural areas to urban areas of migrant workers.

The success in SEZs clearly depends on the organizational structure which deals with the development and maintenance of SEZs (Moberg, 2015). In the ideal world, it is presumed that policy makers are benevolent and well-informed social wealth maximizers. Accordingly, they would choose the optimal policies and pursue them without any hesitation for such maximization. In this world, the decision makers would resort to SEZs as an industrial and growth strategy when they are among the best policy options available for the development of the society. However, in real world, the assumptions of perfect knowledge and benevolence are rarely met as far as the policy makers are concerned. Once, we relax these assumptions, then successful SEZs require the right institutional context or the Hayek world.²⁰ The right institutional context would be the context which can transform the actions of badly informed and self-interested agents into activities that maximize social welfare or result in the successful development of SEZs in this case. As far as the efficiency and effectiveness of the organizational structure is concerned, we have to resolve two problems: one is the knowledge problem and other is the incentives problem.

5.1.1. The Knowledge Problem

There are different governance models with respect to the development and operation of SEZs across the globe. In some countries, zones are regulated by an autonomous government structure as is the case in Thailand, the Philippines, and Bangladesh.²¹ In India, the department of commerce under the auspices of the Ministry of Commerce and Industry regulate the SEZs. Thus, in most countries, SEZs have some types of governing regulations which are updated and amended from time to time and case to case. In most of the countries, multiple government departments at the central level are involved in regulating and organizing the SEZs. In contrast, the Chinese model of regulation is based on a decentralized mechanism where the zone management enjoy a substantial amount of economic and political autonomy.²² Such liberal regulatory mechanism is the main factor behind the China's success with SEZs. Alternatively, for successful SEZs, strong commitment from the governance structure along with sufficient

²⁰ In the words of Hayek, in a market, the individuals' pursuit of their self-interest leads them to serve one another (Hayek, 1945).

²¹ In Bangladesh, the autonomous authority is under the control of Prime Minister's office while, in the Philippines and Thailand, such authority is under the control of ministry for industry and trade.

²² See, for instance, Tantri (2012) for details.

knowledge regarding the development and operation of SEZs are essentially needed. The knowledge Problem arises when the decision makers with respect to SEZs does not have sufficient knowledge of the market mechanism (Moberg, 2015). This lack of information is the root cause of the knowledge problem as far as policy making is concerned. For instance, in centralized decision making, the policy officials cannot understand the fluctuations in the economies or in the operations of market mechanism as the private businesses do. The consequence would be badly designed and misplaced SEZs. In contrast, in the private decision making, businesses are well-informed about the mechanism of market. Consequently, they would choose better locations for zones and, also, they will select best enterprises for the zones. Overall, the organizational structure in private decision making would be somewhat efficient as compared to that of the central decision making. In the middle of these two is the decentralized decision making which involve both the officials and private agents in decision making. Such a decentralized mechanism again is relatively efficient as compared to the centralized one. Given the successful global practices, Pakistan must adopt a regulatory framework which is simple, transparent and predictable. It should not only provide protection to investors and developers but, also, should ensure the clarity of roles and responsibilities of various stakeholders. In addition, such framework should be based on clear social, environmental and business standards along with attracting the right investments within the zones. Likewise, the surety of policy continuity and adequate provision of various facilities enhance the possibilities of zones' success.

5.1.2. The Incentives Problem

The incentive problem arises when the incentives of the policy makers are not aligned to the incentives of successful SEZs or overall economic welfare. Just like other policy packages, SEZs create opportunities for rent-seeking. Policy makers will use these opportunities for their self-interest based on the assumption of non-benevolent policy makers. One solution to this problem would be the private development of SEZs. In Private SEZs, the incentives of the private developers are aligned to the success of SEZs. Alternatively, with private development, when the policy makers would not provide infrastructure and other facilities to these SEZs, there would be fewer opportunities for corruption and rent-seeking on part of the policy makers. The success of SEZs would be directly related to the benefits of the private developers. Private agents would not develop the zones where the opportunities for profit-making are bleak. Global practices show

that privately developed zones become integrated townships which offer a variety of facilities. Alternatively, in such zones, a range of commercial and non-commercial activities are undertaken where private agents not only make profits in industrial activities; but they also offer profitable residential and other commercial facilities. China is a glaring example of the government's commitment towards the development of zones (Zeng 2011). Its institutional framework, based on an incremental and decentralized approach for SEZs, comprises a management committee for each zone with significant involvement of the private sector. Each zone has a legislative mechanism which has the authority to develop regulations and municipal laws with respect to taxes and other related structures in line with the national regulations and laws. With such a system, the management enjoy substantial freedom in order to be experimental with reforms with regard to the success of zones. Thus, autonomy along with the involvement of private sector would solve the incentives problem. Our purpose for SEZs should be the development of competitive private sector which can lead to the industrial development on the principles of Schumpeterian Creative Destruction. Alternatively, zones should endeavor for the development of conducive business environment instead of just relying on fiscal and other incentives. In successful zones across the globe, the incentives like one-stop-shop services, aftercare and infrastructure are efficiently and effectively provided. For instance, these features make the zones very attractive for businesses in countries like China, Korea, Singapore, Dubai and Malaysia.

5.2. Focus on Domestic Priorities

One of the most important objectives of CPEC and the establishment of SEZs is to attract foreign capital inflows and generate employment. Likewise, the boost of domestic exports and technological upgradation are the other objectives of SEZs. In order to achieve these objectives, we must do rigorous planning. We should rigorously assess the conditions of local goods and labor markets by evaluating the demand situation. Likewise, we need to do planning for the supplies of labor and land for the zones. In addition, assessing the supply chain, industrial base and the overall business environment are of utmost importance. In this way, we can clearly identify the domestic priorities at each stage.

5.2.1. Employment and Labor Policy

SEZs are aimed at providing employment and technical skills to the domestic labor force. Alternatively, within SEZs, the domestic labor force must upgrade their skills and deepen their knowledge by specialized or customized education and training. Investors within the zones are keenly interested in the skill upgradation of the work force because it is an essential part of the overall business atmosphere. We don't have sufficient data in order to examine whether SEZs are helpful in creating new employment. However, we have some rough estimates for various countries in this regard. For instance, employment in Export Processing Zones (EPZ) in Bangladesh constituted 3% of the national industrial sector employment in 2008. In Vietnam, zones employed roughly 19% of the workforce in 2008 (Farole, 2011). In India, the growth in employment within SEZs was around nine-fold from 2005-06 to 2013-14. Likewise, SEZs have enhanced the quality of the domestic workforce through skill upgradation and training in many countries. Also, it is perceived that SEZs are helpful in providing employment to women. So far, Pakistan has not adopted any policy with regard to the protection of domestic labor in projects under CPEC. At present, the enforcement of labor laws is ineffective at both the federal and provincial levels. Inspections and regulation of labor market are almost absent due to the corrupt and biased lower-level labor courts. We need transparent and effective labor policy for CPEC and SEZs due to two reasons. First, we need framework for the employment of domestic labors within SEZs by the foreign investors. For instance, China has some labor relations with countries like Egypt, Nigeria, Mauritius etc. Egypt allow one work permit to foreign workers for every nine employed Egyptians. In Chinese zone in Suez region of Egypt, there were around 1800 Egyptians workers along with 80 staff members of China. Likewise, in Nigeria, at the development stage of zones, Chinese companies employed 80 Nigerian workers for every 20 Chinese workers. In contrast, Chinese workers face lenient policies from Mauritius as far as employment is concerned. In this regard, Pakistan should come up with clear policy. Second, policy guidelines should be established in order to protect the rights of workers employed by the foreign investors. The Industrial Relation Act (IRA) of 2011 specify the rights of workers with respect to working conditions, memberships in union, safety measures and workers' other rights. The rules in IRA should be enforced in their true spirit.

5.2.2. Focus on Potential Exports and Imports

One of main objectives of SEZs is to enhance industrial development on the basis of comparative advantages of the domestic economy. In order to ensure this objective, we must identify the right model which is based on the domestic strengths. Alternatively, we should conduct a detailed analysis in order to prioritize the areas within the SEZs. In particular, we should prioritize our imports and exports for SEZs by studying our potential exports and imports from the micro perspective. The market access that we can have to Afghanistan, Central Asian Republics (CARs), Middle East under CPEC should enhance our exports of fruits, vegetables, flour, fertilizers, meat, grocery products, textiles etc. This list must be expanded, and quality improved to indulge in healthy competition with Chinese exports under CPEC. Likewise, cheap energy products from either CARs or Iran may be our probable imports with increased access to the markets of these countries. Moreover, zones must be connected to local clusters/supplier as their value chains. For instance, in China, most of zones are well connected with the existing local clusters. Alternatively, local clusters and zones in China reinforce each other through business interactions. Also, foreign investors in Chinese zones are actively involved in joint-ventures with local businesses. In addition, the backward connections through technical assistance and other policy packages must be encouraged as is the case in China, Taiwan and South Korea. SEZs in Pakistan should exploit the domestic comparative advantages and they must encourage joint-ventures and linkages with the local clusters.

5.2.3. Controlling the Rent-Seeking of Domestic Industrial Class

We would be successful in SEZs as industrial strategy when the incentives offered create a competitive private sector within the SEZs. Alternatively, we should tie all the incentives offered within SEZs to the efficiency of the enterprises. Given the history of incentives in Pakistan, industrialists take advantage from the incentives offered; however, they wind up their businesses once the incentives are exhausted. This is one of the main reasons for the failure of industrial estates in Pakistan. In particular, many industries in Pakistan stay inefficient and small even after decades of official protection through incentives. In other words, the incentives did not result in the economies of scale and exports growth of the domestic industries. The obvious examples are the sugar, flour, car and textile industries which are still nourished on subsidies. Besides subsidies, they are awarded with land in industrial estates at subsidized rates. Likewise, in privatization, they are provided insider arrangements. The persistent protection entails three

issues. First, subsidies once provided are difficult to remove. This issue is crucial when the institutional framework is weaker, and governments are elite captured. Second, subsidies create interest groups and, consequently, these groups lobby for the extension of such subsidies. Finally, a good fraction of the subsidies is spent by the interest groups for the continuation of such protection. Thus, in weak states, subsidies result in rent-seeking because in such states it is hard to resist corruption. In short, incentives in SEZs should not result in rent-seeking on part of the industrialist in Pakistan; rather, they should result in healthy competition between the enterprises.

5.3. Conducive Exogenous Environment

In addition to the endogenous factors of concern, there must be a conducive exogenous environment for SEZs to function successfully. In this regard, coordination between stakeholders and security is of prime concern.

5.3.1. Solving Coordination Problems between relevant Stakeholders

Coordination failure is a situation when we have Pareto inferior economic outcomes due to the non-cooperative behavior of relevant stakeholders or economic agents. In this case, mutual coordination between the units of federation would have great bearing on the success of SEZs and CPEC. Alternatively, the decision-making mechanism should not be only with the central government; rather both the provincial and local governments should be given due roles in this regard. The joint decision-making or close coordination between the stakeholders would ensure the smooth functioning of the alternative programs within SEZs. Two aspects should be given due respect in this regard. First, the development of all routes should be made in a balanced way. In other words, the notion of preference for eastern route over western route by the central government should be resolved by making a balanced budgetary allocation for all the routes. Second, the distribution of zones and other infrastructure projects under CPEC should be based on the perspectives of both the efficiency and need. Also, the budgetary allocations for these projects should be made according to these criteria. For instance, finding the best locations for SEZs is essential for successful SEZs. Likewise, land procurement for SEZs is a crucial issue due to the opportunity cost of land. Alternatively, we should keep in mind the issues of food security, resettlement and loss of earnings which are associated with the large-scale land acquisition. In addition, land acquisition may also cause political and social tensions, among other issues. Accordingly, we should have close coordination between the stakeholders in order to resolve these issues. For instance, the distribution of SEZs should be based on the availability of raw materials, land and human resources. The availability of raw materials and cheap land and human resources will determine the cost of production which has been the focus of concern for most businesses. Likewise, closeness to transport connections such as airports and sea-ports has beneficial effects on the growth of zones.

5.3.2. External and Internal Security

One of the basic objective of CPEC is to obtain access to the markets of Middle East, Central Asian Republics (CARs), Africa etc. besides others. The performance of SEZs clearly depends upon the achievement of this objective. However, access to markets is rather a political issue. In order to have greater market access and, accordingly, successful SEZs, we should ensure both the external and internal security. In this regard, relationships with Iran, Afghanistan and India are of utmost importance. This is due to the fact that the principle of economics or market mechanism work only when it is supported by the right institutional mechanism. Alternatively, geo-political position combined with the supporting institutional framework would ensure the success of SEZs, market access, and the infrastructure projects under CPEC. In addition, internal security in terms of peace in FATA, Khyber-Pakhtunkhwa, Baluchistan and, even, in Afghanistan would pave the way for successful operations of SEZs. Finally, Pakistan's market access is highly vulnerable to ethnic and sectarian tensions, especially those in Karachi and other areas of the country. We have to resolve these tensions in order to be in a beneficial position with SEZs and CPEC.

6. Conclusion

The motivation for this study is given by the current debate on the effectiveness of SEZs as an industrial and growth strategy under CPEC. Global experiences show that SEZs can generate employment, attract FDI, boost industrial development and exports, result in human resources development, technological upgradation and urbanization. However, there are several factors, including both the measurable and non-measurable ones, that are considered as essential for successful SEZs. In general, the location of zones; the price and accessibility of property; infrastructure, including both within and outside the zones; market access; autonomy within the zones; regulatory mechanism; fiscal incentives and other facilities etc. are important to have successful SEZs. In this study, we highlight the prospects for the domestic economy of Pakistan as far as the SEZs under the umbrella of CPEC are concerned. Onwards, we elaborate on the threshold conditions that are needed for successful SEZs in our case. We argue that, in order to be successful with SEZs as an industrial development and growth strategy, we should focus on the organizational efficiency of the development and operation of SEZs. For instance, the structure that could resolve the problems of knowledge and incentives would boost the

performance of SEZs. In addition, control over the rent-seeking of industrial class as far as the incentives within SEZs are concerned would result in the development of competitive private sector. Likewise, effective labor policy would not only generate employment; but it would also result in skill upgradation of the domestic labor. Also, we should prioritize our potential exports and markets for those exports in order to have beneficial effects on our overall exports and growth within SEZs. Finally, coordination between the relevant stakeholders combined with the internal and external security are deemed essentials for good performance within SEZs.

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Appendix

Table 1: Expected Facilities in Special Economic Zones under CPEC

<p><u>Fiscal Incentives</u></p> <ol style="list-style-type: none"> 1. One-time exemption from all customs duties & taxes for all capital goods imported for the development, operation and maintenance of an SEZ 2. Exemption from all taxes on income accruable in relation to the development and operation of the SEZ for a period of five years 3. One-time exemption from all customs duties and taxes on imports of capital goods in to the SEZs for installation therein. 4. Exemption from all taxes on income for a period of ten years till June 30, 2025
<p><u>General Incentives</u></p> <ol style="list-style-type: none"> 1. The Board of Investment would provide One Window Facility and Dry Port Facility within SEZs. 2. Gas, Electricity and other utilities will be provided at the zero-point of the Zones 3. Captive power generation is permissible to developers of the Zones 4. Continuity of Incentives: incentives granted cannot be withdrawn midway; Incentives cannot be modified to the disadvantage of an enterprise 5. SEZ Act encourages transparent procedures for establishment of SEZs: Rules have been framed to simplify the procedures 6. Best practices for building codes, environment protection and workforce 7. Security arrangements by the respective provincial government 8. For dispute resolution, administrative and alternate dispute resolution mechanism
<p><u>Facilities in Exports Processing Zones</u></p> <ol style="list-style-type: none"> 1. Developed land on competitive rates for 30 years 2. Duty-free import of machinery, equipment and materials 3. Freedom from national import regulations/ custom duties 4. Repatriation of capital and profits 5. No sales tax on input goods including electricity/gas bills 6. Duty-free vehicles allowed under certain conditions 7. Domestic market available to the extent of 20%. (exceptions may be available under special circumstances) 8. Sales to domestic market are liable for payment of custom duties. 9. Presumptive tax at the rate of 1%. Only EPZA is authorized to collect presumptive tax at the time of export of goods which would be final tax liability. 10. Obsolete/old machines can be sold in domestic market after payment of applicable duties and taxes 11. Defective goods/waste can be sold in domestic market after payment of applicable duties, maximum up to 3% of total value.
<p><u>Facilities in Industrial Estates</u></p> <ol style="list-style-type: none"> 1. Reinforced Concrete Road Network 2. Underground Sewerage System 3. Underground Electricity Distribution System 4. Walled industrial estate with limited entry/exit points. 5. High Pressure Gas Pipelines 6. Telecommunications Systems 7. Estate Manages Electrical Distribution System 8. Fully Equipped Fire Station 9. Computerized Weigh Station 10. Technical Training Facilities 11. Estate Owned Security Arrangements 12. Hospital / Emergency Medical services (Social security) 13. Potable water.
<p><u>Exemption in Gwadar Port</u></p> <ol style="list-style-type: none"> 1. Income Tax exemption for 23 years effective from July 01, 2016 on profits and gains from business set up in the Gwadar Free Zone Area. 2. Income Tax exemption for 23 years effective February 06, 2007 for specified Chinese companies working on the Gwadar port. 3. Income Tax exemption for 20 years effective July 01, 2016 for contractors and sub-contractors of specified Chinese companies working at the Gwadar Port. 4. Concessions in terms of Sales Tax and Federal Excise duty is for 40 years on imports or supplies of materials and equipment for the operation and development of Gwadar port and is for 23 years on supplies made by the businesses to be established in the Gwadar Free Zone

Source: Khan and Anwar (2017)