

Export processing zones, special economic zones: Do we really need to have more of them?

Rosario G. Manasan



Export processing zones (EPZs) are considered an important economic strategy to boost export promotion, attract foreign direct investments (FDIs), and create employment opportunities for the local labor force. As of June 30, 2013, the Philippine Economic Zone Authority (PEZA) manages and operates four public ecozones: Baguio City Economic Zone, Cavite Economic Zone, Mactan Economic Zone, and Pampanga Economic Zone. These ecozones host 400 locators. In addition, PEZA facilitates business operations of and grants fiscal incentives to over 2,200 locators in 304 privately operated ecozones.

At the same time, the Bases Conversion and Development Authority administers four ecozones: Clark Freeport and Special Economic Zone, Poro Point Freeport Zone, Camp John Hay Special Economic Zone, and Bataan Technology Park. The Subic Bay Metropolitan Authority (SBMA) operates the Subic Bay Freeport Zone. Four

other ecozones were created and are being operated by government entities specifically established under special laws to manage them: Freeport Area of Bataan (formerly the Bataan Export Processing Zone), Cagayan Special Economic Zone and Freeport (CSEZF), Aurora Pacific Economic Zone and Freeport, and the Zamboanga City Special Economic Zone.

With our more than 40 years of experience in managing ecozones, it is but fitting to know if these ecozones have been successful in facilitating economic development for the Philippines. The number of ecozones has significantly increased since 1969 when the first export processing zones was established as part of the country's export promotion strategy. The question is, do we really need more of them? In answering this question, this *Policy Note* briefly reviews the performance of export processing zones and special economic zones (SEZs). Along

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The author is Senior Research Fellow at PIDS. The views expressed are those of the author and do not necessarily reflect those of PIDS or any of the study's sponsors.

the way, it provides some guidance in evaluating ecozone proposals by drawing on the lessons learned from our experience in SEZs and that of other countries so as to ensure the success of future ecozones.

Brief history

Established in 1969 in Mariveles, Bataan, the Bataan Export Processing Zone (BEPZ) is the first export processing zone in the Philippines. This was followed by the Phividec Industrial Estate (PIE) established in 1974, the Baguio City Export Processing Zone (BCEPZ) and the Cavite Export Processing Zone (CEPZ) in 1980, and the Mactan Export Processing (MEPZ) in 1986. These first-generation economic zones (or ecozones) followed the traditional model where they are essentially enclaves outside of the country's "normal customs territory"¹ with production of locator firms being meant almost entirely for the export market and with their intermediate and capital inputs being allowed to come in free of duty and exchange controls. To encourage investment, the zones were aimed at providing better on-site and off-site infrastructure, and locators were also granted fiscal incentives. As in other countries, the EPZs were created with the following objectives: (i) to promote exports, (ii) to create employment, and (iii) to encourage investments, particularly foreign investments.

Republic Act (RA) 7916 enacted in 1995 replaced the traditional model with the second-generation

¹ This meant that EPZ locators are subject to simplified import and export procedures compared to their counterparts operating outside the ecozones.

² Section 8 of RA 7916 provides that all ecozones (not just the export processing zones and the free trade zones) shall be managed and operated by PEZA as a separate customs territory.

model, the special economic zone. RA 7916 expanded the objectives for the establishment of ecozones by including the establishment of forward and backward linkages among industries in and around the ecozone, promoting greater financial/industrial linkage between the Philippines and the rest of the world through technology transfer, and broadening the geographic dispersion of industries.

The SEZ model is more liberal than the EPZ model in the sense that SEZ locators need not produce exclusively for the export market. Registered enterprises in SEZs are also allowed to engage in a wider range of activities in addition to manufacturing, such as commercial/trade services, utilities and infrastructure development, and tourism. An SEZ "may contain any or all of the following:

- industrial estate: a tract of land subdivided and developed according to a comprehensive plan under a unified continuous management and with provisions for basic infrastructure and utilities, with or without prebuilt standard factory buildings and community facilities for the use of the community of industries;²
- export processing zone: a specialized industrial estate located physically and/or administratively outside the customs territory, predominantly oriented to export production; enterprises within the export processing zones are allowed to import capital equipment and raw materials free from duties, taxes, and other import restrictions;
- free trade zone: an isolated policed area adjacent to a port of entry (such as seaport and/or airport) where imported goods may be unloaded for immediate transshipment or may be stored, repacked, sorted, mixed, or otherwise manipulated; however, movement of these

imported goods from the free trade area to a nonfree trade area in the country shall be subject to customs and internal revenue rules and regulations.”

Under RA 7916, the operation and development of privately owned SEZs is also encouraged through the provision of incentives for private zone developers and operators.³ Zone developers are allowed to supply utilities to tenants by treating them as indirect exporters.

The PEZA grants the following fiscal and nonfiscal incentives:

- to ecozone export and free trade enterprises
 - Corporate income tax holiday for four years to a maximum of eight years
 - Exemption from duties and taxes on imported capital equipment, spare parts, materials and supplies
 - After the lapse of income tax holiday, a five-percent special tax on gross income and exemption from all national and local taxes
 - Tax- and duty-free importation of raw materials, capital equipment, machineries, and spare parts
 - Exemption from wharfage dues, export tax, impost, or fee
 - Value-added tax (VAT) zero rating of local purchases
 - Exemption from any and all local taxes, impost, licenses, and fees
 - Exemption from expanded withholding tax
 - Tax credit (equivalent to 25% of duties) for import substitution of raw materials used in producing nontraditional exports
 - Additional deduction for training expenses
 - Tax credit on domestic capital equipment (equivalent to 100% of taxes and duties)

- Tax- and duty-free importation of breeding stocks and genetic materials
- Tax credit on domestic breeding stock and genetic materials (equivalent to 100% of taxes and duties)
- Additional deduction for labor expense
- Unrestricted use of consigned equipment
- Employment of foreign nationals
- Permanent residence status for foreign investors and immediate members of the family
- Simplified import-export procedures

- to ecozone domestic economic enterprises and ecozone developers
 - Exemption from all national and local taxes and in lieu thereof, payment of a special rate of five percent on gross income
 - VAT zero rating of local purchases
 - Exemption from expanded withholding tax
 - Additional deduction for training expenses
 - Incentives under the Build Operate and Transfer Law or RA 6957 as amended by RA 7718.

In addition to fiscal incentives and the infrastructure and facilities in the ecozones, ecozone enterprises enjoy streamlined customs and business registration procedures, and liberal foreign exchange policies. These are meant to reduce business entry and operating cost of ecozone enterprises and thus improve their competitiveness (FIAS 2008).

Under RA 7916, SEZs are areas that are highly developed or have the potential to be developed

³ Section 45 of RA 7916 provides that privately owned industrial estates shall be monitored by PEZA for the implementation of fiscal incentives.

into agro-industrial, industrial tourist/recreational, commercial, banking, investment, and financial centers. RA 7916 (Section 5) initially identified some 37 areas around the country as ecozones “to ensure the viability and geographic dispersal of ecozones through a system of prioritization”. The law also provides that, in addition to the specific areas identified in Section 5, other areas may be established as ecozones based on the following evaluation criteria: “(a) the proposed area must be identified as a regional growth center in the Medium-Term Philippine Development Plan; (b) the existence of required infrastructure in the proposed ecozone, such as roads, railways, telephones, ports, and airports, and the suitability of the proposed site to absorb such improvements; (c) the availability of water source and electric power supply for the use of the ecozone; (d) the extent of vacant lands available for industrial and commercial development and future expansion of the ecozone as well as lands adjacent to the ecozone available for residential areas for the ecozone workers; (e) the availability of skilled, semiskilled, and nonskilled trainable labor force in and around the ecozone; (f) the area must

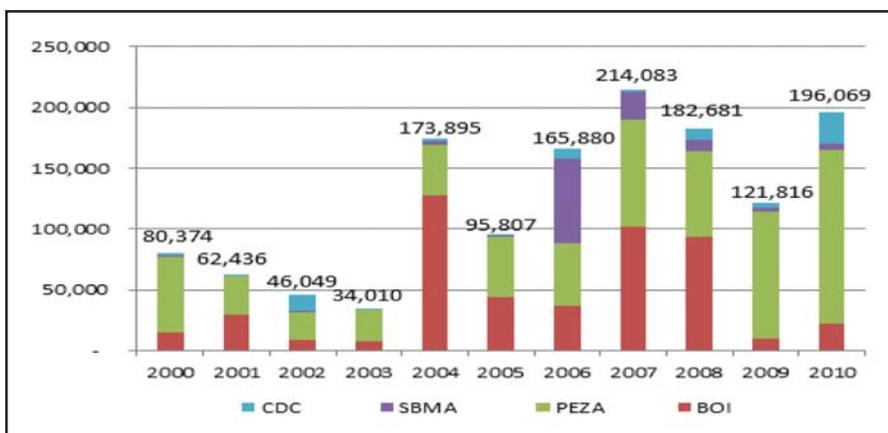
have a significant incremental advantage over the existing economic zones and its potential profitability can be established; (g) the area must be strategically located; and (h) the area must be located where controls can easily be established to curtail smuggling activities.” In line with this, a number of bills have been filed in Congress proposing to establish new SEZs, e.g., in Southern Palawan and Iloilo.

Philippine SEZ experience and assessment

Special economic zones in the Philippines have a mixed record of success to date. A number of experts have given PEZA positive reviews. For example, Akinci (2006) cited PEZA as a “shining example of successful regulatory reform improving overall investment climate in the country,” noting that its one-stop-shop model⁴ contributed to the improved competitiveness of registered enterprises by reducing the cost of doing business. He also lauded PEZA’s decision to encourage the establishment of privately operated SEZs instead of more public SEZs. Booz Allen Hamilton (2008) also noted PEZA as being “very efficient, effective, and successful”. These

positive reviews are consistent with PEZA’s significant gains in attracting

Figure 1. Approved foreign direct investment by investment promotion agency (in PHP million)



⁴ Aldaba (2013b) reported that PEZA has a Memorandum of Agreement with the Department of Environment and Natural Resources allowing the latter to issue environmental certificates to its locators. PEZA also has an agreement with the Bureau of Immigration that allows visa processing in PEZA within 20 to 30 days. PEZA also handles local government clearance requirements along with revenue payments and local government fees. Being the model of the single window system in the country, import and export permits are issued by PEZA. PEZA is a full service agency and is on call 24/7.

FDIs, boosting exports, and generating employment.

PEZA's creditable record in attracting FDI is shown in Figure 1. PEZA-approved FDIs grew by 23 percent yearly on the average in 2006–2010 compared to a 13-percent decline yearly on the average in FDIs approved by the Board of Investments (BOI) during the same period. Consequently, the share of PEZA in total approved FDI expanded from 46 percent in 2000–2004 to 52 percent in 2005–2010, while the share of BOI contracted from 48 percent to 32 percent. The share of SBMA in total approved FDI rose from 1 percent to 11 percent and that of the Clark Development Corporation was fairly steady at 5 percent.

Manufactured exports of PEZA-administered SEZs grew from USD 19.5 billion from 2001 to USD 28.9 billion in 2009, growing by 5 percent yearly on the average during the period (Figure 2). In contrast, manufactured exports from outside the PEZA's SEZs went down by 9 percent yearly on the average during the same period from USD 9.1 billion to USD 4.3 billion. As a result, the share of PEZA's SEZs in total manufactured exports increased from 68 percent to 87 percent.

On the other hand, the number of direct workers in PEZA SEZs increased by 10 percent yearly on the average in 2001–2010 from 289,548 to 735,672 (Figure 3). The share of PEZA ecozones in total employment nationwide doubled from 1 percent in 2001 to 2 percent in 2010.

Figure 2. Philippine manufactured exports (USD billion)

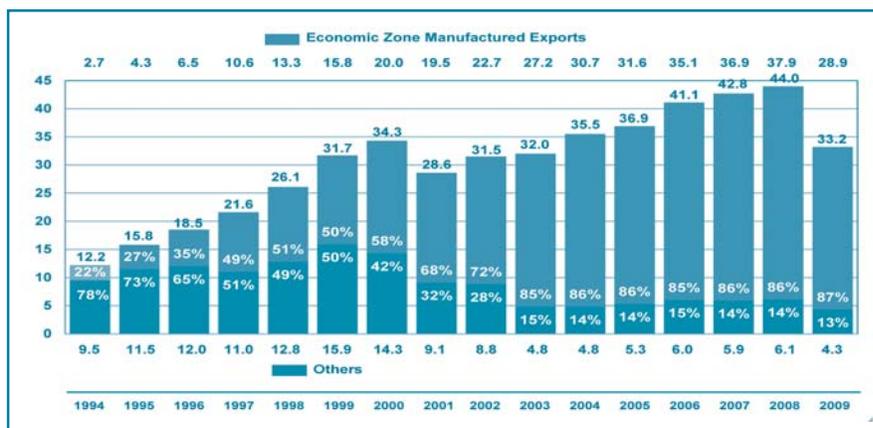
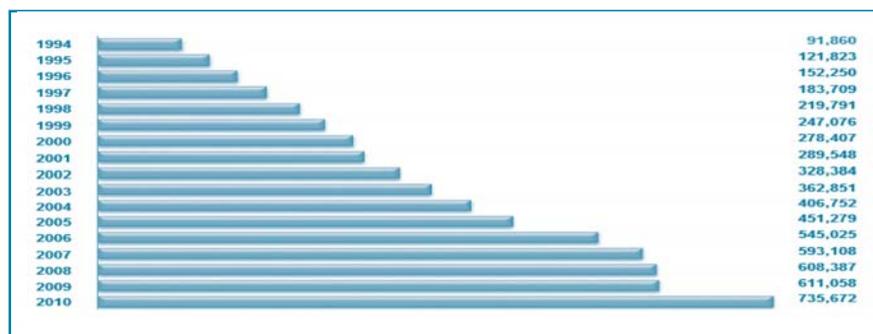


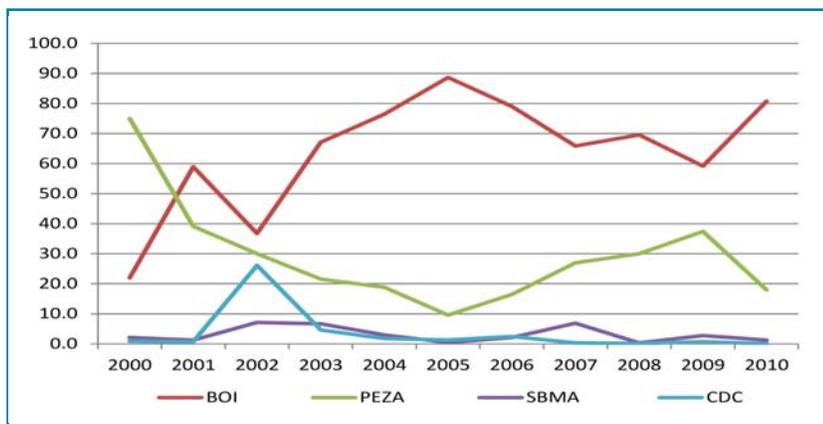
Figure 3. PEZA ecozone direct employment



In other aspects, however, the performance of SEZs is deficient. Dynamic economic benefits in terms of domestic investment in ecozones and forward and backward linkages are lacking. Nevertheless, FIAS (2008) has documented the substantial rise in skill levels in Philippine SEZs, with the increasing share of more skill-intensive design and research activities in the entire electronics sector workforce. Also, the share of domestic investments of registered ecozone enterprises exhibited a discernible upward movement from 2006 to 2009 after declining between 2000 and 2005 (Figure 4).

Backward linkages of SEZ enterprises have remained at a low level. A shift in the industrial composition of ecozone investments from

Figure 4. Share of domestic investment in total approved investments, by investment promotion agency (%)



garments/textile in favor of more capital-intensive electronics and electrical machinery sector is evident in the last 30 years. As a result, locator investment has become overly concentrated on the electrical and electrical machinery sector, increasing the country's vulnerability to external shocks. Nine out of the top 10 PEZA exporters belong to this sector. Being highly dependent on imported inputs, the value added of the electronics sector is also low as firms are mostly engaged in the assembly of electronic components, and production is limited to original equipment manufacturing which is based on processes and designs developed by the mother company abroad. At the same time, subcontracting to Filipino firms is mostly limited to low-technology and low value-added operations (Aldaba 2008).

Not all SEZs are created equal, however. A cost-benefit analysis of the operations of the BEPZ in the Philippines, Masan Export Processing Zone in South Korea, the Jakarta Export Processing Zone

⁵ The BEPZ is located four hours from Manila and the road network between the BEPZ and Manila (the nearest port) was poor when it was first established.

in Indonesia, the Penang Free Trade Zone in Malaysia, the Shenzhen Special Economic Zone in China, and all the ecozones in Sri Lanka by Warr (1989), Jayanthakumaran (2002), and Chen (1993) indicate that some ecozones have costs that outweigh their benefits. For example, the BEPZ stood out in sharp contrast to the other SEZs in the studies because its costs (consisting primarily of infrastructure development costs) exceeded the benefits (measured in terms of employment and associated wage income of workers in the

ecozone, exports and associated foreign exchange earnings, local input purchases by ecozone enterprises, and government revenues). Such an outcome can be attributed to a number of related factors, including the *remote location* of the zone⁵ that necessitated large public infrastructure investments, government-subsidized utilities, and unrealized projected demand for zone facilities as per the feasibility study. Although these studies are not recent, their findings on the poor performance of the BEPZ are still relevant today. Note that the number of BEPZ (now AFAB) locators in 2011 is still the same as that in 1989.

The BEPZ story underscores the weakness of SEZs as a tool for attracting investments in lagging regions as also experienced in other countries. Another example is the Aurora Pacific Economic Zone and Freeport Authority (APECO). The APECO was created as a special economic zone by RA 9490 of 2007. In 2010, RA 10083 expanded the area covered by APECO and converted it into a freeport. The *2012/2013 Philippine Human Development Report* noted that after government investments amounting to PHP 2.9 billion in an airstrip, port improvement, paving and

rehabilitation of the Baler-Casiguran Highway, flood control, and other on-site improvements, there were only 10 approved locators as of April 2013 and only three of them have started doing business.

Farole (2011) emphasized that “the international experience with using SEZs as a tool of regional development has been, almost without exception, a failure.” Because of the importance of agglomeration economies, “SEZs are only likely to be effective for lagging regions with economic density and those located in close proximity to leading regions, where SEZs may offer the missing ingredients to accelerate slowly developing agglomerations. SEZs are far less likely to make a difference in low-density geographically peripheral regions, where no agglomerations have emerged.”

Some SEZs and freeports have also become a channel for smuggling. Freeports (e.g., the SBMA and CSEZF) have allegedly been used as the staging points for the entry of duty-free used vehicles into the country.⁶ This claim appears to be supported by the gap between Philippine import statistics and the export statistics of countries exporting used cars to the Philippines (Aldaba 2013a). Citing automobile industry sources, Aldaba noted that used vehicles that enter the country through freeports and other special economic zone ports do not pay the correct duties and taxes. The revenue implications of this anomaly are significant. The duties, excise, and VAT that have not been collected due to smuggling of used vehicles are calculated to be equal to PHP 21 billion in 2007, PHP 16 billion in 2008, and PHP 21 billion in 2009 (Aldaba 2013a). Consequently, the domestic automobile industry faces undue stiff

competition from second-hand imported vehicles that are priced 30 percent to 50 percent lower than their unused counterparts.

Role of SEZ in liberalized, low-tariff regimes

Some analysts argue that if SEZs are really useful in providing a free trade environment to exporters, then these would have more limited relevance in the increasingly liberalized trade environment that we have today. Farole (2011), however, offers a different perspective. He said: “regional integration offers significant opportunities for economic zones in terms of expanding market access. ... There may be potential for using zones to link up regional suppliers and leverage economies of scale in production.” Also, SEZs that are successful in “reconfiguring themselves into efficient distribution, production, and trade facilitation hubs” may be helpful to firms wishing to reduce logistics cost so as to be internationally competitive (FIAS 2008).

Conclusion

FIAS (2008) provided a succinct summary of the obstacles to the success of SEZs:

- “Poor site locations, entailing heavy capital expenditures,
- Uncompetitive policies—reliance on tax holidays, rigid performance requirements, poor labor policies and practices,
- Poor zone development practices—inappropriately designed or over-designed facilities, inadequate maintenance and promotion practices,

⁶ <http://www.philippinebusiness.com.ph/archives/magazine/vol9-2002/9-6/policy.htm>

- Subsidized rent and other services,
- Cumbersome procedures and controls,
- Inadequate administrative structures or too many bodies involved in zone administration, and
- Weak coordination between private developers and governments in infrastructure provision.”

The FIAS study (2008) also emphasized that the benefits from SEZs can be maximized if they are well integrated into the local economy instead of being operated as enclaves. This implies the need to strengthen both the backward and forward linkages of the activities of SEZ enterprises by ensuring that SEZ rules are flexible enough to accommodate both exporters and nonexporters, and to allow a wide range of commercial and manufacturing activities. Finally, international experience suggests that private development of SEZs increases the chance of success. 📄

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For further information, please contact

The Research Information Staff
 Philippine Institute for Development Studies
 NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, 1229 Makati City
 Telephone Nos: (63-2) 894-2584 and 893-5705
 Fax Nos: (63-2) 893-9589 and 816-1091
 E-mail: rmanasan@mail.pids.gov.ph; publications@pids.gov.ph

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