Opportunities and Challenges of Special Economic Zones under CPEC for Pakistan

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The paper was presented at "The International Academic Seminar on Industrial Cooperation and Construction of Industrial Zones, CPEC", Beijing China, 5-7 January 2018, *hosted* by the Center for Pakistan Studies of Peking University, and *co-hosted* by China Three Gorges International Corporation.

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Abstract

Despite yesteryears' stimulating growth performance, the Pakistan economy lags behind its long term potential growth path mainly due to inherent structural weaknesses. Concomitantly, rapid transformation in the global economy, whereas Pakistan's economy is virtually stagnant. It has thus become absolutely necessary for Pakistan to fast reposition itself in the world market. Despite a recent slowdown, Pakistan's entrepreneurs and industries have shown resilience, which indeed is critical for sustaining a growth momentum. Pakistan's favorable demographic profile have the ability to drive the economy into a high growth path to create demographic dividends. Pakistan has the added advantage of a large diaspora residing abroad, some of them can return if conducive work and living environments are created in the country. Pakistan thus holds some essential advantages that can be harnessed to prepare its economy to secure a bigger share in global production and exports. In this regard, the launch of the Special Economic Zones (SEZs) under CPEC has become herald for fast-tracked industrial development. In this context, Pakistan aims at establishing resilient and potentially productive industries to initiate a new era of industrialization jointly or side-by-side with Chinese companies to be based in SEZs. While embarking on this phase of industrialization, Pakistan will get a number of opportunities to capitalize on, and of course, will face challenges that it will have to effectively manage for the success of SEZs. This paper aims at assessing the opportunities and challenges coming from SEZs. In the end, the paper provides some strategic policy directions as a way forward.

1. Introduction

For Pakistan, inclusive and sustained economic growth is a vital policy goal for prosperity of its citizens. After a period of slow growth (starting from 0.4% in 2008-09 to 4.1% in 2014-15), signs of a visible improvement are now quite evident. As in 2016-17, Pakistan managed to achieve a growth rate of 5.3%. All major economic sectors have experienced growth over the past three years. For instance, the manufacturing sector recorded a negative growth of 4.2% in 2008-09, it experienced a positive growth rate of 5.3% in 2016-17. Most of the macroeconomic fundamentals have also significantly improved showing a stable macroeconomic environment with low fiscal deficit (3.9% in 2016-17) and inflation (4.1% in 2016-17 above from 2.9% a year ago), and steady growth in government revenues.

International ratings agencies have also endorsed Pakistan's economic progress. They are optimistic about its economic performance and have predicted Pakistan to emerge as one of the fast growing and promising global economy. Despite the recent encouraging performance, Pakistan still lags behind its potential annual growth rate of about 7.5-8.0% mainly due to inherent structural weaknesses.

In view of the rapid transformation taking place at the global level, it is necessary for Pakistan to reposition itself in the world market. Pakistan holds some essential advantages and growth potential that can be harnessed to prepare its economy to secure a bigger share in global production and exports. Over the past four decades Pakistan’s manufacturing sector has grown at an average annual rate of over 7%, despite a slowdown in recent years. This shows resilience of the Pakistani industries and entrepreneurs, which indeed is critical for sustaining a growth momentum.

Pakistan has a favorable demographic profile with a large proportion of bright youth (60% of population), which has the potential to drive the economy into a high growth path thus creating a demographic dividend.

Pakistan has the additional advantage of a large diaspora residing abroad, some of them can return if conducive work and living environments are created in the country. Diasporas carry an added advantage of working with foreign workers and multinational companies. They can play a decisive role in providing expertise, knowhow and even investments for a new phase of industrialization in Pakistan.

In the above context, as Pakistan is preparing to take some strategic economic decisions, the launch of the landmark project of cooperation the China Pakistan Economic Corridor (CPEC) has become the precursor for fast-tracked industrial development. Pakistan aims at establishing resilient and potentially productive industries to initiate a new era of industrialization, including high-end textiles, telecom parts, engineering, knowledge-based industries, fish and marine products, and modern storage facilities for fruits and vegetables, jointly or side-by-side with Chinese companies to be based in Special Economic Zones (SEZs) under the CPEC project.

While embarking on this phase of industrialization, Pakistan faces a number of issues that have so far restricted industries to realize their growth potential. These include, low investment, dispersal of industries across country, weak institutions, low quality human resources, shallow tooling skills due to lack of depth in vocational expertise, lack of modern technology, high business cost, lax IPR protection, brain-drain, low quality hard and soft infrastructure, etc.

SEZs under CPEC will be a life-time opportunity for Pakistani companies to work together with Chinese companies for the development of export-oriented manufacturing industries, while striving to overcome the above stated issues with the assistance of reformed public sector institutions. SEZs with new business models would generate decent jobs, develop industrial and business infrastructures, and would also develop domestic value chains and their connectivity with global supply and value chains. Thus, SEZs are expected to provide much needed impetus to stimulate economic activities in Pakistan.

Given the successful record of China in establishing a very many number of SEZs, Pakistan finds a new conviction to establish China-led SEZs. Pakistan is ready to benefit from the Chinese experience in ensuring the success of its prospective SEZs.

In this new phase of industrialization under CPEC, Pakistan will get a number of opportunities to capitalize on and, of course, will face challenges that it will have to effectively manage for the success of SEZs. In this context, this paper assesses opportunities and challenges coming from SEZs. In the end, the paper gives some strategic directions as a way forward.

2. Why SEZs?

The global experience suggests that SEZs are an important source for diversification of the economy, reduction in regional disparities, clustering of economic activities for complementarity generation with local industries, skill development of local labor force, transfer of technology and dissemination of know-how, promotion of ancillary industrial activities, development of local entrepreneurship, creation of competition, attraction of local and foreign direct investment especially towards under-privileged regions, generation of employment, promotion of exports, and ease of administration and management.[1]

SEZs are generally self-contained in the procurement of raw materials (from local and international markets), power generation, mitigating pollution, sewage treatment and support services. They have practically everything from transportation to cultural and educational facilities. So, they are perceived to provide significant insulation from the uncertain external/outside environment.

[1] Also see Zafar Mahmood (2017) A Win-Win Proposal to Establish China-Pakistan Special Economic Zones. *Hilal*, October 2017.

Laws and regulations of SEZs are different from generally applicable laws & regulations in the rest of the country. SEZs are generally duty free enclaves for both trade and manufacturing. Several fiscal and regulatory incentives are offered to investors within zones by national, provincial and local governments. Nonetheless, international experience suggests that decisions to invest in SEZs are rarely based on financial incentives alone; indeed such incentives are not the key to SEZs success that may attract weaker firms. Success factors for them include; efficient and cost effective infrastructures, and good governance (or absence of over-intrusive governance) that distinguish them from other parts of the country. Success of SEZ inspires rest of the economy, encouraging more effective provision of public services and infrastructure, and forcing policy makers to introduce economic reforms to achieve what was not achieved before.

Thus, successful SEZs introduce structural change throughout the country relatively quickly through a combination of linkages and demonstration effects with local industries. As a result of leaping up value chains and triggering positive externalities, they create economic space for their entry into basic and intermediate manufacturing. Too often, SEZs generate and allocate resources for socio-economic uplift of the adjoining areas for their acceptability by the locals.

It is worth noting that despite gainful role played by SEZs worldwide, in some countries they have been criticized for being less legal and socially protective for workers, misusage of allotted land for real estate speculation and tax evasion. International experience suggests that the main reason as to why SEZs fail is “rent-seeking” by interest groups, exploitation of incentives and other fringe benefits, weak governance, bilateral disputes, regulatory issues, lack of a dispute resolution mechanism, etc. To avoid such problems and to ensure effective management, countries assign decentralized decision-making roles to private-public partnership arrangements of SEZs with inclusiveness of local communities and institutions.

SEZs are strategic locations which address structural and institutional bottlenecks, arising from infrastructural deficiencies, procedural complexities, bureaucratic hassles and other restrictive policies. They offer an enabling investment climate to attract both offshoring and outsourcing activities.

3. Existing SEZs in Pakistan

Virtually, every district headquarter of Pakistan has an industrial estate or area having infrastructures and offers incentives of various natures: Punjab has 26 industrial estates, whilst Sindh, Baluchistan and KP, have 30, 7 and 12 industrial states, respectively. Some of these are successful whilst others are unsuccessful because they are established in remote areas lacking necessary skilled work force or basic amenities for workers.

Some big cities also have industrial clusters on the basis of their strength in skilled workforce, raw materials, supporting institutions and deep historical links with local and global supply chains. These clusters include: sports and surgical clusters in the city of Sialkot, textiles cluster in Faisalabad, fan cluster in Gujrat, and engineering cluster in Gujranwala to name the major ones.

Existing SEZs in Pakistan include: (i) Karachi Export Processing Zone (Karachi); (ii) Risalpur Export Processing Zone (Risalpur); (iii) Sialkot Export Processing Zone (Sialkot); (iv) Gujranwala Export Processing Zone, Gujranwala; (v) Khairpur Special Economic Zone, Khairpur; (vi) Rashkai Economic Zone (Rashakai-Mardan, M1); (vii) Gadoon Economic Zone (Gadoon-Amazai Swabi); and (viii) Hathar Economic Zone (Hathar-Haripur).

In addition, there are some Industrial Parks in Pakistan: Rachna Industrial Park (Lahore), Marble City (Lahore), and Textile City (Port Qasim). Some of the newly established industrial estates are: Value Addition City (Sheikhupura-Faisalabad Expressway), M-3 Industrial City (Faisalabad), and Quaid-e-Azam Apparel Park (M-2 Lahore).

4. CPEC-SEZs

Keeping at front the Memorandum of Understandings signed by the governments China and Pakistan, Pakistani government has proposed following nine SEZs: (1) Rashakai Economic Zone: (M-1, Nowshera); (2) China Special Economic Zone, Dhabeji; (3) Bostan Industrial Zone (near Quetta); (4) Punjab-China Economic Zone, (M-2, Sheikhupura); (5) ICT Model Industrial Zone (Islamabad); (6) Development of Industrial Park on Pakistan Steel Mills Land (Port

Qasim); (7) Bhimber Industrial Zone; (8) Mohmand Marble City; (9) Moqpondass SEZ (Gilgit-Baltistan).

Three prioritized SEZs of the CPEC are set to take off as both governments have recently agreed to cooperate in the development of Faisalabad, Rashakai and Dhabeji industrial areas.

The whole political sphere in Pakistan is united to fast establish SEZs. All Party Conference (APC) held on 15th January 2016 provided a much needed reassurance to both governments and their private investors. Despite some reservations, stakeholders in two countries now perceive CPEC as a project that would transform Pakistan into a hub of manufacturing and trade activities in the region.

5. Governing Structure of SEZs

Governing structure for the industrial zones is provided in the SEZ Act 2012, it provides the legal and governing structure, allowing both the federal and provincial governments to set up economic zones under various administrative frameworks.[2]

The Board of Investment (BoI) has established "CPEC-SEZ" Cell for facilitating stakeholders on the matters related to CPEC and Special Economic Zones. BOI has been assigned the lead role under CPEC, for industrial cooperation. The Chairman BoI has been designated as the convener of the Pakistan-side Joint Working Group on industrial cooperation under CPEC.

[2] This section is based on "Investment Policy 2013". Board of Investment, Prime Minister's Secretariat (Public), Pakistan.

The Act evoked immense interest among investors as it provided confidence, stability and the correct incentives, however mainly focuses on domestic investors.

The requisite staff of BOI is well conversant with the issues related to CPEC/SEZs and have been deployed. The Cell has been furbished on the contemporary corporate style and is equipped with state of the art facilities.

The criteria for establishment of SEZs under CPEC stipulates a minimum area of 50-acres (with no maximum limit) and allows zone developers, private or in public-private partnership, to purchase land on ownership or lease from central/provincial/local governments.

Official documents noting other major conditions for establishing SEZ's include: (i) 10-year income tax holiday both for zone developers and zone enterprisers and one-time exemption on import of capital goods for establishment of zones and projects in the zones; (ii) maximum land that each SEZ can allocate for commercial use and other non-productive activities such as setting up retail shops, recreational areas, hospitals, etc., would be limited to 10 percent of total land area; (iii) investors must begin construction within six months and production within 24 months of project approval, the land title will not be transferred to the investors until after it has been in production for six months; (iv) the government is committed to providing infrastructure and utilities up to the gate level of the SEZ; (v) BOI would provide one window facility within the zone for facilitation of the investors; (vi) Zone developers, once approved for SEZ status, shall have authority to develop their master plans, allot land and approve individual investors in compliance with the rules; (vii) the incentives protected by law cannot be withdrawn; and (viii) the policy allows existing Zones/Industrial Estates to apply for the status of SEZ.

Documents further reveal that the government would either establish SEZs on its own or in collaboration with private parties under various modes of collaboration including public-private partnership or accord recognition to the privately established economic activity zones as SEZ to be governed under the Act. The Provincial Investment Promotion Authority would be responsible for SEZs within its jurisdiction for supervision and operation of the SEZ Authorities and be the focal entity responsible for investment promotion.

The documents envisages the qualifications and approval criteria for SEZs as follows: (i) to generate economic activity in terms of exports, employment and other performance indicators at least equal to or more than the total overall capital cost incurred over a period of 15 years; (ii) provide import substitution and generate direct and indirect exports, (iii) not to target any industry material/input which is being protected by other countries in the larger national interest; (iv) respective federal and provincial governments have to commit to correspond resources on the time line to materialize the SEZ under consideration; (v) zone Application shall be in conformity with the provisions of the Act, any applicable regulations issued under the Act and other applicable provisions of law; (vi) 70 percent of the SEZ land area will be used for the purpose of operations of zone enterprises; (vii) developer will be obliged to undertake to comply with all the environmental, labor and other applicable legislations in force in Pakistan; (viii) developer will be obliged to take all necessary approvals to start construction activities within six months of signing of development agreement; (ix) developer to be engaged for the particular SEZ shall be a body incorporated under the laws of Pakistan; (x) Articles of Association of the developer shall be approved by the Provincial/ Capital SEZ Authority; (xi) developer shall ensure that the zone enterprises start construction of facilities within six months and assumes regular production within twenty four months after receipt of all required licenses and permits; (xii) developer will be obliged to undertake that the title of land may only be registered in the name of zone enterprises after they have performed business operations in the SEZ concerned for at least six months; and (xiii) there shall be no real estate activities in the zone.

6. Opportunities from SEZs of CPEC

As Pakistan desperately needs a more developed industrial sector to lay a solid foundation for its economic revival, SEZs are to provide a number of opportunities to fast achieve a higher path of industrialization. By making industrial zones production and export hubs of high quality manufactured goods, Pakistan will be more favorably positioned in the international market. Specifically, the following opportunities will come with the establishment of SEZs:

1. SEZs will work as a strong economic incentive for Pakistan's government to introduce reforms to improve domestic business environment, style of governance, productive capacity, export base, and enhance commercial attractiveness for more foreign investments.
2. Industrialization with a new face will help creating jobs for the country's large, under-employed population, especially growing educated workforce, thus turning a social burden into an economic dividend.
3. Capacity-building efforts through vocational and technical training will help local workforce to catch up in quality skills.
4. Opportunity to attract back Pakistani diaspora with their skills and knowledge gained while working abroad along with their accumulated capital for more profitable prospects in the country.
5. SEZs will enable firms to agglomerate and get benefits of external economies and will thus provide opportunity to put domestic industries on a higher path of the learning curve.
6. Trade creation opportunities will induce both countries to further strengthen their trade relations.
7. Opportunity for domestic allied industries to expand their ancillary businesses with SEZ firms.

8. Within SEZs, Pakistani companies either competing or complementing Chinese companies will learn modern business and effective trade techniques from their Chinese counterparts.
9. Global firms that are increasingly organizing their production and trade in increasingly complex global value and supply chains and are looking for the least cost locations, SEZs would provide a platform to reap the benefits of such opportunities that are virtually missed so far in Pakistan.
10. Opportunity to strengthen technology status in Pakistan with close partnership with Chinese companies and technology institutions.
11. SEZs would provide opportunity for labor pooling thus cutting down job search costs on the part of workers and employers, and hence unemployment of skilled workers.
12. While working within a SEZ, there will be a strong possibility that innovative ideas will be disseminated across companies. Workers at their usual gatherings informally share their ideas and experiences, and offer solutions to technological problems.
13. SEZs by establishing backward linkages with the large Chinese market and Chinese SEZs in China can create a strong and sustainable business integration through trade and investment.

7. Challenges of SEZs

Above stated opportunities would indeed create challenges for Pakistani policymakers. The biggest challenge would be to transform human, financial, technology and institutional resources to benefit from the upcoming opportunities. Following challenges may be faced from SEZs:

1. Location is the key success factor for SEZs. There should be no compromise or politics on the location of SEZs. Establish them where they are most suitable and viable. The rule of thumb for site allocation should be just the competitiveness of the area.
2. Pakistan’s human resources are not attuned to the expected SEZ needs, neither they are proficient enough to operate Chinese technological tools and machines. This will be a major challenge for the government to benefit from employment opportunity of SEZs.
3. Access to finance is the single most important impediment to growth of industries. This problem especially increases in magnitude with reduction in size of the firm. So financial institutions will have to prioritize provision of financial resources to such industries working with SEZs.
4. Harmonizing SEZ policies with Chinese SEZs and effectively implementing them to cut down cost of doing business and to enhance ease of doing business. In this context, long-term

government commitment and consistency in policies are crucial for the success of the SEZs.

5. To achieve the objective of establishing export-oriented industries in SEZs, make sure they work in *laissez faire* environment and benefit from the best trade facilitation system that cut their trade-related costs and time.
6. Government agencies, do not have much experience and knowhow in industrial zones management and operations especially dealing with foreign investors. This seriously undermine their implementation capacity. So the challenge would be to develop requisite capacity of public sector institutions.
7. Creation of an environment for fast and effective dissemination of technology and knowhow.
8. Ensuring adequate number and size of allied and supplier firms and locating them in SEZs or in nearby industrial clusters to draw benefits of external economies.
9. Local connectivity and provision of utilities will be a major challenge. The success of the SEZs would depend on provision of cost effective and uninterrupted utilities as well as proximity to road, rail, and sea and air ports. It would be important to physically connect all SEZs with national and international supply chains.

10. Governance challenge includes overcoming political influence, rent-seeking and tariff-seeking activities, and coordination failures among different stakeholders.

All in all, challenges would be to ensure; consistency in economic policies and avoidance of sudden policy reversal, transparency in decision-making, expansion of financial markets to provide adequate finance to industries, availability of qualified personnel through execution of vocational training and skill development programs, and favorable business environment, including strong property rights protection and fair and speedy dispute resolution.

8. Strategic Policy Directions for SEZs: A Way Ahead

Given their importance, development of SEZs should be made part of the overall growth strategy of Pakistan. Only in this way, Pakistan will be able to achieve the objectives of pro-inclusive and sustained growth. Following strategic policy directions may be adopted to maximize benefits from opportunities that are likely to come from SEZs:

1. Once a site for SEZ is selected in consultation with all stakeholders, stay firm on it. Don’t get influence from interest groups.

2. Develop policies in close coordination with Chinese and Pakistani firms. Learn from Chinese experience for effective policy implementation. To overcome governance problems, decentralize decision making as much as is possible with involvement of the private sector. Since all the companies to be based in SEZs will be private therefore adopt a market-based approach.
3. In consultation with potential industrial leaders from China and Pakistan develop an agreed-upon set of *rules of engagement* with respect to how the SEZs should operate to ensure greater success.
4. Revise the SEZ Act 2012, which was enacted before the launch of CPEC project so that aspirations of Chinese investors are also taken into account.
5. SEZ planners should then organize roadshows to mobilize potential investors from China and Pakistan to promote SEZs. Give full media coverage based on credible information to project a positive image of the Zones.
6. Establish modern vocational and technology institutions. Chinese vocational and technology institutions are modern and elaborate, utilize their expertise by inviting Master Trainers from those institutions. Host for a longer period by appointing their retired experts. Also introduce, vocational training partnerships with the Chinese institutions. Prepare a plan and share with the Chinese government.

7. Establish incubators in SEZs with close coordination with Chinese companies so that Pakistani start-ups can closely watch and learn from their way of working, this will quickly enhance entrepreneurship.
8. Diaspora can spearhead SEZs activities and can be champions and drivers of SEZs, encourage them by giving full confidence that their investments and transfer of skills and knowledge will be absolutely secured and highly valued by the nation.
9. Train local Allied firms on how to efficiently conduct ancillary business with SEZ firms. Appoint qualified Chinese trainers for conducting short-term training courses and workshops.
10. With increase in the size of SEZs in the future, they will benefit more and more from external economies. From the beginning, government should keep an option open for expanding successful SEZs. There should be no limit on SEZ expansion.
11. Make public sector organizations efficient and productive by creating a mindset to assist and facilitate foreign private companies. Involve private sector experts for this purpose.
12. All ministries should work to ensure speedy implementation of SEZs projects to seize the upcoming opportunities. All provincial and federal governments should work together as 'one team' for the success of the SEZs.

13. Absolutely discourage rent-seeking activities, don't allow investors to exploit policies or circumvent the very objective of establishing SEZS.
14. Through information dissemination and training, create a positive attitude in local firms to work with Chinese companies.
15. Be part of global supply chain[3] and global value chain[4] by increasing the competitiveness of supplier firms with improved reliability and efficiency. For this to happen introduce business supporting policies. Moreover, modernize trade facilitation system and infrastructure. Create a special cadre of customs officials and staff who can facilitate SEZs' trade on efficient basis, especially minimizing time involved in various procedures. By cutting on delays, bureaucratic hurdles and corruption; trade costs and trade time will be cut down especially for export-oriented industries. In this context, closely coordinate with concerned Chinese institutions.

[3] Supply chain, a tool of business transformation, establishes a link between suppliers (of raw materials), manufacturers (semi- or manufactured products), wholesalers, distributors, retailers, and the end consumer—a link from the point of origin to its final destination i.e. consumption. A global supply chain refers to the network created among different global companies producing, handling, and distributing specific products.

[4] Value Chain, allows competitive advantage over a competitor, refers to the range of activities that adds value at every single stage in designing, producing, and delivering a quality product to the user. A global value chain is divided among multiple firms and geographic spaces.

16. Promote SEZs as enclaves of good practices and self-containment, supported by good infrastructure and service provider firms. Preferably government should engage a private firm to develop and manage the SEZs, while the government should be an active player in provision of transport, electricity, water, telecommunications, waste disposal, and other infrastructures to link SEZs with global and local supply chains.
17. Accord complete and secured property rights protection to ensure sustainability and attract Chinese firms.
18. Ensure that market access through efficient transportation system is available. This will guarantee *just-in-time* availability of raw materials as well as delivery of produced goods.
19. Negotiate with Chinese government to secure duty free status to exports originating from SEZs. Pakistan should promptly conclude special trade agreement for SEZs in addition to the existing bilateral free trade agreement.
20. China has successfully positioned its SEZs to establish backward linkages with allied and supplier industries. Pakistan should act fast to learn from the Chinese experience. In this regard, create a synergy/ complementarity between Pakistani and Chinese SEZs for mutual advantage and their connectivity.

21. Last but not the least, the upcoming phase of CPEC is not likely to be an easy one and may not please everyone therefore Pakistan needs to ensure that all stakeholders (Chinese and Pakistani) are on board and patiently play their positive and constructive roles for the success of SEZs.