Policy note

International Growth Centre

Special Economic Zones

Policy considerations for Uganda

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Introduction

Attracting productive investment continues to be essential for Uganda's economic growth and job creation. Economic activity continues to be concentrated in low value-added agricultural production, non-tradeable services and manufacturing activities such as construction, that offer only a limited scope for new employment and market opportunities. Many reasons could explain this poor economic performance, including a difficult regulatory climate, poor access to production inputs (such as finance, skilled labour, and electricity), and poorly implemented public investments.

The development of Industrial Parks and Free Zones offer an opportunity for the Government of Uganda to target resources towards tackling these key challenges in a way that is less financially and politically demanding than wide scale reforms. However, the benefits of these programmes are by no means automatic, in particular given the mixed experience of many countries with Special Economic Zone (SEZ) policy. Considering the potential benefits and limitations of SEZs, this brief offers some key recommendations for Uganda:

- Define clear objectives for SEZ policy, and design programmes to avoid overlapping or unnecessary public expenditures.
- Identify the main constraints and barriers to investment that SEZ policy may be able to remove – infrastructure and trade facilitation, for example, are likely to be more effective in attracting investment than tax incentives.
- Start small and learn-by-doing: getting zone policy right in the first attempt is difficult. Experimenting and building on what works is a more promising approach and allows to better predict the costs and benefits of future SEZ programmes.
- Focus on high potential locations rather than promoting regional development – firms in SEZs often rely on their proximity to big cities to sell their products or source inputs.
- Promote spillovers to the rest of the economy - the ability of SEZs to generate wider productivity benefits for the economy crucially requires active policies to encourage and facilitate linkages
- Regional integration offers an opportunity to develop *regional* SEZ policies that avoid a race to the bottom between neighbouring countries.

A policy framework for Special Economic Zones

There is no clear consensus over the exact definition of the terms 'special economic zones', 'free zones', 'export processing zones' and 'industrial parks' and how these relate to each other. For the purposes of this policy note:

- Industrial parks are geographically delimited areas for production
- Special economic zones (SEZs) are geographically delimited areas for production, with a different regulatory, customs, or fiscal environment from the rest of the country. These include export processing zones, free zones and free ports.

SEZs are often implemented with the aim of achieving a wide range of outcomes, including attracting high productivity (often foreign) investment[1], promoting exports and generating high wage employment.

Mixed international experience with SEZs

While SEZ programmes have been implemented in a number of developing countries, evidence of the **effectiveness of SEZ policy is mixed.**[2] While in some countries, SEZs have proved to be catalytic to growth, in others, they have become expensive 'white elephant' projects with limited contribution to economic development.

The clearest success story of using special economic zones to drive growth can be found in China. In 1979, four SEZs were established as an experimental policy with the aim of spurring growth in the country. By addressing significant distortions in the economy regarding firm ownership, trade and taxation, these zones soon accounted for over 60% of FDI into the country. By 2010, there were over 2000 zones in the country, accounting for 30 million jobs, 60% of exports, and 46% of FDI.[3] Similar successes have been observed in other countries such as Korea, Malaysia, Mauritius, Dubai and Poland.

However, there have also been notable failures in the implementation of industrial parks and SEZs, in particular in India and in some countries in Latin America and sub-Saharan Africa.[4] SEZs in Kenya and Ghana have generated 10-15 less employment per capita than those in Honduras and the Dominican Republic.[5]

What does this mean for Uganda?

The mixed experience of SEZs in many countries indicate that copying the Chinese model of simply allocating land and offering tax incentives for foreign investors is unlikely to bear the same fruits for Uganda. Uganda today does not resemble China in the 1980s **- the "*build it and they will come*" approach only works when there is huge pent-up demand for investing in a country.**

[1] Many developing countries seek to attract high productivity investment through FDI given limited domestic resources for this.
[2] Rodriguez-Pose and Hardy (2014) 'Technology and Industrial Parks in Emerging Countries: Panacea or Pipedream?', Farole (2011) Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience'
[3] Wang, Jin. 2013. "The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities," Journal of Development Economics 101: 133–47, Zeng (2016) 'Special Economic Zones: Lessons from the Global Experience'
[4] Yannick Saleman and Luke Jordan (2014) 'The Implementation of Industrial Parks: Some Lessons Learned in India'
[5] Farole (2011) 'Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience'

What should SEZ policy aim to do?

Given mixed international experience with SEZs, it is important to consider how such zones can best contribute to a country's overall industrial strategy.

Developing countries are typically subject to a wide range of constraints that limit investment and business growth. These include:

- **Access to land and protecting property rights:** challenges to land registration and sale often present a significant cost of entry for investors. Similarly, the risk of direct or indirect property expropriation acts as a barrier to entry for investment.
- **Lack of infrastructure and other public goods and services:** most investments require a wide range of high-quality public infrastructure and services to operate and be profitable, such as roads, ports, and reliable electricity
- **Regulatory environment**: Overly burdensome regulations can generate significant operational costs for businesses.

SEZ policy should be seen as a powerful tool to address and remove the most **pressing obstacles to investment** that exist at the national level and to leverage **productivity-enhancing spillovers**[6]. The spillovers can take the form of technology transfers and learning between firms operating in a zone, skill upgrading of the labour force employed in SEZ firms, or supplier-buyer relationships with local firms which allow them to learn production processes or management practices from highly productive firms in zones.

Implementing reforms in **smaller and delimited geographic area** means SEZs can act as a laboratory to experiment with new policies that may be financially or politically costly to initially implement as country-wide reforms. Policies that successfully promote investment can be tested and scaled up to the rest of the economy over time.

However, implementing a different regulatory (and/or fiscal) environment in a delimited area can come at a cost. For example, providing fiscal incentives can create unfair competition between firms inside and outside the zones.

What does this mean for Uganda?

Building effective SEZs in Uganda requires a deep analysis of the main constraints to growth in the country, and *whether* and *how* SEZs specifically address these challenges or generate new opportunities for productivity growth. In other words, the objective of SEZs in Uganda should not simply be to create jobs and increase exports but rather remove the barriers that reduce the potential for private sector development.

[6] It is important to note that single factory SEZs – common in many African countries - do not offer the 'agglomeration' benefits of multi firm zones i.e. the gains in productivity that come from man firms being co-located and sharing knowledge and skills. They are therefore more limited in their potential for dynamic gains in efficiency.

What are the alternatives to SEZs?

SEZs are just one policy option available to governments in achieving goals of national industrial strategies. As such, it is important to consider:

- Whether SEZs are able to address the major constraints to investment, exports and job creation.
- Whether they are the most cost-effective way to do so.

For example, if the major constraint to firms is a lack of access to land, infrastructure and reliable utilities for production, directly addressing these constraints through industrial parks may be enough for attracting investment, without having to bear the additional cost of fiscal or regulatory incentives. Similarly, if the major issue for firms is the cost of inputs for the manufacturing sector, duty drawbacks or streamlined import procedures may be sufficient, without investing in state-of-the-art infrastructure. If the main barriers to increasing investment and business growth is access to skilled labour, then zones will not bring structural change to the economy.

Leveraging comparative advantage through SEZs

Zones are unlikely to leapfrog countries into entirely new high quality, high value-added sectors. It is only when the underlying distribution of skills, the capacity and capabilities of firms and demand for their products are high enough that these sectors emerge. As such, SEZs are likely to generate more benefits for the economy if they build on a country's comparative advantage.

Working with comparative advantage

Bangladesh's export processing zones have been particularly successful in promoting garment manufacturing – a sector in which the country's location and low wages put it at a distinct advantage even against fierce global competition[1]. By providing access to land, fiscal incentives and streamlining customs procedures (given the importance of imports and exports for garment production), the government was able to attract large scale foreign investment that boosted existing local production in the sector.

In Nigeria, attempts to use SEZs to diversify the economy towards manufacturing have proved difficult to get off the ground, while zones targeted towards boosting the country's large oil and gas sector have been much more successful in attracting investment and garnering employment[1].

Similarly, in Ghana, zones have been far more successful in attracting cocoa, wood and fish processors than the originally targeted ICT sector.

This is not to say that SEZs should not aim to promote sectoral diversification or upgrading of the economy. SEZs can contribute to the emergence of new sectors. However, that transition will need to build on the set of sectors in which the country currently has a comparative advantage in. In Malaysia, for example, the provision of fiscal incentives for worker training, R&D and technology upgrading allowed zones to play a key role in the transition towards higher value-added activities[7].

What is Uganda's comparative advantage?

Given that Uganda is a landlocked country and wages are relatively high compared to East Asian counterparts, it is unlikely that SEZs in the country will be able to replicate the models of many zones in East Asia which attracted mostly export-oriented, import-intensive 'assembly' line companies, thanks to their position in global shipment routes and their cheap labour supply. Instead, Uganda's current competitive advantage is likely to lie in:

- Natural resource-based activities e.g. agriculture, and agro-processing activities
- 'Industries without smokestacks' that require higher skilled labour such as tourism, accounting, financial services, and carpentry
- Leveraging its central location within regional markets to attract investors that want to serve the domestic economy or the region as a whole. Uganda's location in the EAC could be particularly interesting for industries that benefit from large economies of scale and as such, could serve several neighbouring markets from only one production site.

Special Economic Zones in Uganda

There are two major programmes that can be considered special economic zone policies in Uganda:

1) **Industrial Parks** managed by the Uganda Investment Authority (UIA).

27 industrial parks are being planned across the country. Of these, land has been acquired and physical plans have been designed for 9 parks, and plot allocation is underway**.**

Firms in these parks are offered renewable land leases at a discounted rate and in some cases core infrastructure is provided by government. Road, water and power infrastructure has been provided by government in the three parks closes to Kampala and in Soroti, though there continue to be concerns about the quality of this.[8] In cases where no infrastructure is provided, land is often provided free of charge to investors. UIA acts as a 'one stop shop' for firms in these industrial parks, coordinating firm activity with all other government ministries and agencies.

[7] Tom Farole, Claude Baissac, and Jean-Paul Gauthier (2013) 'Special Economic Zones: A Guidance Framework for Policymaking'
[8] Uganda Investment Authority (2016) 'Status of Industrial Parks Development and Agricultural Lands'

Figure 1: Industrial Parks in Uganda

(Base map image source: NordNordWest/ Wikipedia)

2) **Free Zones** managed by the Uganda Free Zones Authority (UFZA).

'Free zone' status firms are not subject to customs duties on imported or exported goods and are eligible for on-site customs inspection. Under the EAC Customs Union Protocol, 20% of good produced in Free Zones can be sold locally – i.e., within the East African Common market (these are then subject to the Common External Tariff like other goods produced outside the domestic customs area). Free zone status can be offered to single firms or to groups of firms located in one area. So far, there are 19 declared free zones in the country, of which the majority are single-firm zones – only 2 are multi-firm zones. Land has been acquired in Entebbe and as part of the industrial park in Jinja for the construction of publicly managed multi-firm zones.

It is important to note that **corporate income tax incentives are provided to firms in both industrial parks and in free zones.** In both, developers and operators over a certain investment threshold are given a 10-year income tax holiday[9].

[9] The fiscal incentives provided to firms in Free Zones and Industrial Parks are part of a menu of fiscal incentives used by the government to attract and promote certain kinds of investment in the country. These range from corporate income tax exemptions for aircraft operators to total tax exemptions on imports of machinery used for oil and gas exploration. Similar corporate income tax holidays are offered to all investors in particular target sectors whose capital investment exceeds $10 million and who satisfy certain thresholds of local inputs and employment.

Public and private zones

Both industrial parks and free zones can be private, public, or implemented through a public-private partnership. Public zones and parks are owned, and infrastructure developed, by the relevant government agency, while private zones are owned and developed by a private company. In public-private partnerships, there is some sharing of responsibilities between government and the private sector – for example, the government acquisition of land, but private development, master planning and selection of operators. In all cases, UIA or UFZA acts as a regulator, responsible for approving and monitoring zones.

Table 1: Government policies for industrial parks and free zones in Uganda

Scheme	Type of zone/park	Land	Infrastructure	Fiscal incentives	Non-fiscal incentives	Govt agency responsible
Industrial Parks	Public	Provided by government	Provided by government	Developers and operators over a certain investment threshold are given a 10-year income tax holiday.	UIA as 'one-stop shop' for firms	UIA
	Private	Provided by private company	Provided by private company		UIA as 'one-stop shop' for firms	UIA
Single firm Free Zones	Private	Provided by private company	Provided by private company	Developers and operators over a certain investment threshold are given a 10-year income tax holiday. No customs duties on imported or exported goods	No specific policy from government	UFZA
Multi-firm free zones	Public	Provided by government	Provided by government		One stop centre on site to ease business regulations On-site customs inspection. Warehouse facilities for goods not to be exported.	UFZA
	Private	Provided by private company	Provided by private company			UFZA

Policy recommendations for Uganda's SEZs

As Uganda undertakes an expansion of its Industrial Parks and Free Zones programmes, we make six key recommendations:

1. Define clear objectives for SEZ policy
2. Identify the main constraints to investment that zone policy could remove
3. Start small, learn, adjust and expand
4. Focus on high potential locations rather than promote regional development
5. Promote spillovers to the rest of the economy
6. Make the most of regional integration through regional SEZ policies

1. Define clear objectives for SEZ policy

In deciding how best to leverage SEZ policy for Uganda's economic development strategy, first and foremost, policymakers need to define clear objectives for this policy - keeping in mind what SEZ policy can and cannot be expected to achieve, as outlined in Section 1 above.

A potential first step in that effort is to identify key objectives from the national economic growth policy agenda and how zones may be able to help achieve these. For example:

- If a major goal is adding value to natural resources such as agricultural products, then an appropriate policy would be to build a zone to attract a few anchor agrobusinesses by providing infrastructure to source more easily from local producers.
- If instead, the objective is to generate low skilled manufacturing employment to promote structural transformation, building a zone next to a large existing city, providing streamlined customs procedures and reliable electricity supply, would be a more suited intervention.

Defining a clear purpose for zone policy is particularly important in the current Ugandan context where the exact objectives of UFZA and UIA are not clearly defined or if anything, seem to overlap, resulting in interinstitutional competition in attracting investment. One possible delimitation could be to use Free Zones to boost export-oriented activities– and should be designed keeping in mind the major constraints and incentives needed for this. Industrial Parks would instead target activities aimed at production for the domestic/EAC market that typically do not require trade-related fiscal and non-fiscal incentives. If there is a need to provide enhanced trade facilitation and infrastructure to firms importing inputs and serving the local market, this could be done through 'Special Economic Zones' as defined under EAC Customs Protocol, where firms are not limited in the amount they can export to the EAC market – while still being outside the customs area.[10]

[10] To give investors flexibility and to level the playing field as much as possible, those SEZ firms exporting into the customs territory should ideally only pay: 1) any relevant duties (e.g. if they are importing inputs duty free and that is not the case for firms located outside the zones, then they will be responsible to pay customs duties on these inputs; and 2) a flat tax for selling into the domestic customs territory (equivalent to fiscal/non-fiscal incentives in the SEZ that are not available outside the zone).

2. Identify the main constraints to investment that zone policy is trying to remove

As noted above, identifying the right instruments that will help firms overcome the **most significant constraints to investment** in Uganda is critical for successful SEZ policy.

Fiscal vs non-fiscal incentives: cross-country evidence

There is good reason to believe that fiscal incentives such as tax holidays and income tax exceptions will not be sufficient – and perhaps not necessary - to attract investment in special economic zones. Cross country analysis highlights that **fiscal incentives do not appear to play an important role in explaining either the performance of special economic zones or attracting FDI** in African countries. This is supported by investor surveys that suggest that incentives do not appear to be the most important factor in their location decisions. It is important to note the limitations of fiscal incentives given that:

- Implementing tax holidays and exemptions can easily prompt tax competition from neighboring countries[11] and encourage a 'race to the bottom' in tax rates.
- If these schemes are targeting firms which are planning to serve the local market (in Uganda, this would be through industrial parks), there is little competition from other destinations – and therefore these incentives are unlikely to be pivotal in investment decisions but may significantly distort competition in favour of firms in parks.
- These incentives come at the cost of foregone tax revenues that could otherwise be spent on infrastructure or reducing the cost of doing business for firms. Current estimates suggest that tax exemptions provided to Ugandan firms make up between UGX 900billion – 1,300 billion or 1-2% of GDP every year[12].

Instead, evidence from a number of countries highlights the importance of improving the business climate to generate investment, exports and employment in SEZs[13]. In particular, this includes:

- **(Basic) infrastructure** - according to a survey of firms in 10 African countries, competitively priced utilities were ranked as the most important consideration when making an investment – with reliable and cost-effective electricity provision at the top of the list.[14] After basic infrastructure and utilities such as water and electricity has been provided, governments can provide more attractive infrastructure packages for firms. In Sri Lanka and Ghana, for example, governments have provided specific infrastructure useful for firms engaging in apparel and wood processing.[15]
- **Trade-related infrastructure and services,** including well-functioning roads, ports and airports, as well as customs clearance and other trade logistics services.[16] This can be crucial in lowering costs of investment - in Rwanda, the cost of transport

[11] Klemm and Van Parys (2012) 'Empirical evidence on the effects of tax incentives'
[12] IMF 'Uganda: Fiscal Transparency Evaluation' International Monetary Fund, 2017
[13] Farole (2011) 'Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience', Tom Farole, Claude Baissac, and Jean-Paul Gauthier (2013) 'Special Economic Zones: A Guidance Framework for Policymaking'
[14] Farole (2011) 'Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience',
[15] Tom Farole (2018) Special Economic Zones: Lessons from Global Experience
[16] Farole (2011) 'Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience',

between Kigali and coastal ports adds roughly 50% to the cost of inputs.[17]

- **Reducing unnecessarily burdensome, expensive or lengthy regulations** for firms in zones can also help to attract investment. In many African countries, poorly administered or overly restrictive regulation - particularly around setting up businesses - raises costs and predictability of entry and reduces profitability of potential investments.

What are likely to be the most pressing constraints to investment in Uganda?

While customs duties and corporate taxes have been noted as some of the major constraints to business in Uganda, fewer firms view this as an obstacle to business than the sub-Saharan African or global average – in general, Uganda performs relatively well on indicators relating to 'regulation and taxes'.

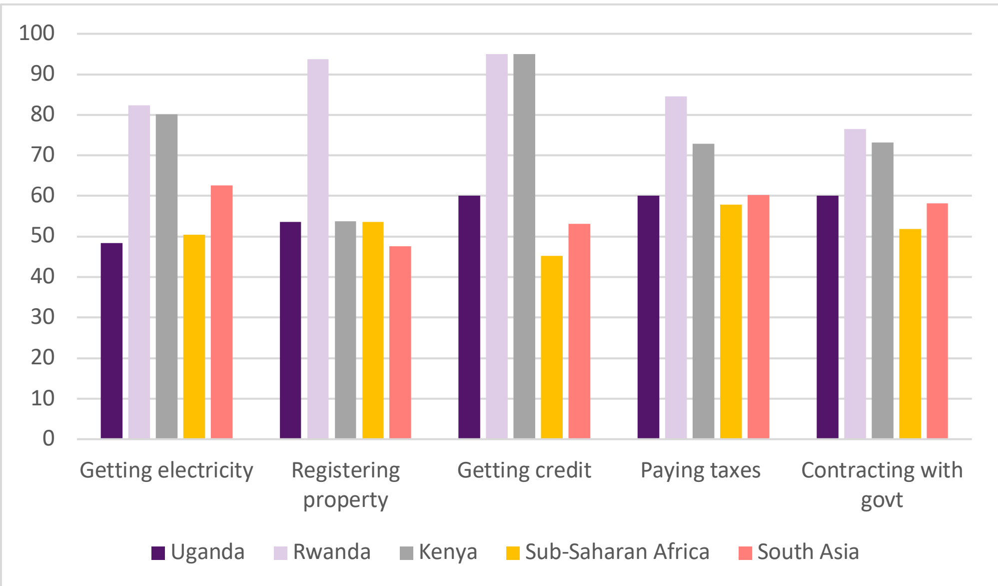
Table 2: Comparing perceptions on tax rates

Indicator	Uganda	Sub-Saharan Africa	All countries
Percent of firms identifying tax rates as a major constraint	21.6	36	32

(Source: World Bank 2013 Uganda Enterprise Survey)

By contrast, non-fiscal incentives are likely to be particularly important in Uganda, where across a number of measures, ease of doing business in the country trails behind its neighbours, and in some cases falls below the average for the continent.

Figure 2: Ease of doing business scores



(Source: Uganda's World Bank Doing Business Rankings 2020)

[17] Sutton, J., Jinhage, A., Leape, J., Newfarmer, R., and Page, J. (2016). Harnessing FDI for Job Creation and Industrialisation in Africa. IGC Growth Brief Series 006. London: International Growth Centre.

2013 Uganda World Bank Enterprise surveys, recent Doing Business indicators and data from annual Private Sector Investment Surveys in Uganda[18] highlight that key factors negatively affecting competitiveness in Uganda include:

- **Macroeconomic conditions,** including exchange rate fluctuations and inflation rates
- **Reliable electricity** – A high share of firms pay bribes for access to an electrical connection. Poor access to electricity has important consequences for firm productivity and profitability[19].
- **Trade facilitation** – the time taken to obtain import licenses and clear customs procedures is high, and Uganda ranks poorly on Doing Business Indicators for trading across borders.
- **Uncompetitive entry** - a higher number of firms are expected to pay bribes to obtain operating licenses, and Doing Business Indicators suggest relatively significant impediments to starting a business and dealing with construction permits – which may be harming competitiveness
- **High costs of capital.** We see relatively significant internal financing by firms business – reflecting high costs of finance

Addressing these constraints is a critical first step to lower the costs of investment and promoting FDI- fiscal incentives alone, are unlikely to be enough to compensate for these significant barriers to doing business.

In this context, it is particularly important to consider whether 'single firm' zones are the most effective way of overcoming major constraints to investment. If potential investors are facing challenges with land, infrastructure, trade facilitation etc., single-firm zone policies are unlikely to bring in new investment or even significantly increase exports of existing firms. Moreover, by definition, single-firm zones cannot provide any of the productivity benefits firms may enjoy from clustering near one another.

One stop shops are not enough

Effectively addressing many of the constraints above crucially requires improved coordination and communication between government agencies to streamline both support and regulations for businesses. Within UIA, there have been attempts at improving the ease of firms' interaction with government by creating a 'one stop centre' to reduce the number of places and people firms have to engage with to get various licenses and government approvals. While this may go some way to improving coordination between ministries, such centres require ministerial representatives to be effectively **empowered** to act on behalf of their ministries. If this is not the case, coordination failures between ministries will continue to hamper the effectiveness of SEZs. Improving state support and effectiveness requires reforming unnecessary regulations themselves and moving from 'one-stop' centers to 'single window' facilitators who can effectively represent and respond on behalf of government authorities.[20]

[18] Annual survey data on investor perceptions is collected on ~500 enterprises with FDI and unrelated foreign borrowing operating across a range of sectors by the Bank of Uganda/Uganda Investment Authority/Uganda Bureau of Statistics
[19] Hardy and MacCasland (2019) ; Abeberese et al (2019)
[20] Farole, Baissac, and Gauthier (2013) 'Special Economic Zones: A Guidance Framework for Policymaking'

3. Start small and learn by doing: "cross the river by feeling the stones"

Addressing investment constraints is not an easy process – it involves an iterative process of experimentation and adaptation with regular feedback from the private sector. As such, starting small, learning, and scaling over time is crucial for a successful implementation of SEZs. An effective process involves:

Conducting cost benefit analysis

It may seem obvious – but SEZs should only be implemented if the expected benefits from their establishment exceeds their costs - and do so more than an alternative policy:

- Benefits: is there significant demand for these particular programmes? What are the expected benefits in terms of investment, exports, jobs?
- Costs: what is the cost of these programmes – including foregone tax revenues?

Not only can *ex ante* cost benefit analysis prevent money from being wasted on inappropriate policy design, mapping out expected benefits and costs can be a useful benchmark against which to monitor and evaluate performance of SEZ policy. Cost benefit analysis of SEZ policies as a whole would be particularly important in Uganda, for example, given the current plans to implement a large number of industrial parks and free zones in the country targeting similar sectors and providing somewhat similar incentives to firms[21].

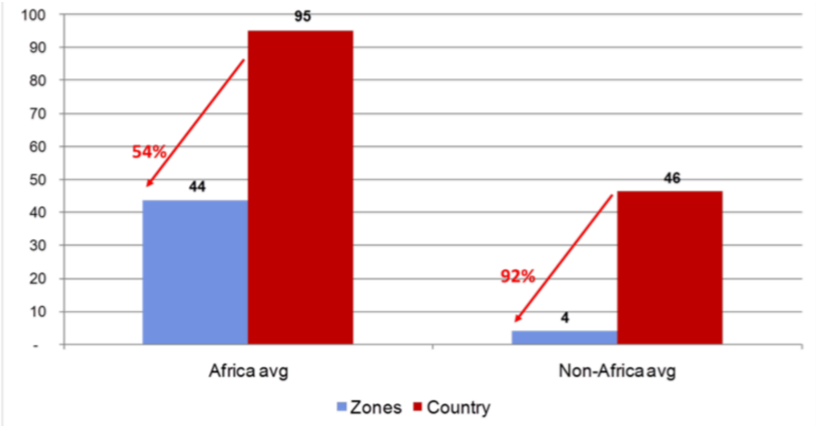
Starting with a few key zones and a few key challenges

Even if initial cost benefit analysis suggests that the potential benefits of zones outweigh their costs, there is typically a large degree of uncertainty about the magnitude of these benefits. Reducing the scale of reform to a select few zones and target anchor firms that can attract further investment can allow governments to:

1) **Test out new policies for infrastructure and regulation on a smaller scale** and see how they affect investment, without the risks involved in large scale policy experimentation.
2) **Identify key constraints for these firms and try to overcome them completely.** The graph below highlights the importance of that point. While SEZs in African countries offer significantly improved investment climates compared to the national average, this doesn't appear to be sufficient – because they still fall far below international standards.[22]

[21] While free zones offer customs exemptions to firms, industrial parks do not impose limits on the destination of outputs – other than this, incentives offered between the two schemes are very similar.
[22] Farole (2011) 'Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience'

Figure 3: Average downtime (hours) monthly resulting from power outages



(Source: Farole, 2018)

3) **Learn from experience to improve policy over time** – not only for SEZs, but for the country as a whole. Given their role in policy experimentation, there may be a valuable role for agencies such as UIA and UFZA to provide regular recommendations based on their interactions with investors for wider reform across different government agencies.

Current plans to implement 27 industrial parks and 19 free zones in the country limits the ability of policymakers in Uganda to target scarce resources to overcome investment constraints comprehensively, learn from these experiences and then scale up over time:

- Based on estimates from UFZA, the full costs of land acquisition, infrastructure provision, warehousing facilities and institutional support for one 640-acre publicly managed Free Zone in Uganda would cost roughly between UGX 340 billion (92 million USD).[23]
- In comparison, budget allocations to UIA and UFZA in 2018/19 amounted to UGX 129 billion in total.[24]

Assuming a number of these planned zones are to be publicly managed or at least require significant public support e.g. in land acquisition, it is **important to focus policy attention and limited resources on implementing 4-5 large and successful zones before any further scale up**.

Monitoring and evaluation

At the same time, crucial to the learning process is implementing **monitoring and evaluation** systems to track the costs and benefits of policies over time. In many cases, it may be difficult to predict the expected benefits of these programmes, and monitoring

[23] UFZA (2015) 'Strategic Plan (2015/16-2019/20)'
[24] Ministry of Finance (2018) 'Approved Estimates of Revenue and Expenditure (Recurrent and Development) FY 2019/20'. In FY 2018/19, the approved budget allocation to UIA was UGX 116.9 billion, of which approximately UGX 103 billion was allocated to industrial parks The estimated budget allocation to UFZA was UGX 11.964 billion, of which less than 8.5 billion went to business development activities.

outcomes can help inform cost-benefit analysis for future investments. Monitoring and evaluation also allows policymakers to identify and adjust policies that do not work as well as expected. Key to quantifying benefits is understanding what investments would have taken place in the absence of these programmes – this requires comprehensive data collection on firm behavior and outcomes before and after the implementation of SEZ policies, as well as on all firms outside of these zones, to be able to undertake effective comparisons.

Monitoring and evaluation would also allow the Ugandan government to identify which reforms work (and which do not), to inform scaling up a specific policies to the rest of the economy. Zones can be used as a laboratory to experiment with new reforms, but – as any lab – they need data collection to measure the effectiveness of interventions.

Finally, monitoring and evaluation can support the government's efforts to promote spillovers in identifying which channels have the greatest potential and should be promoted (linkages, worker trainings etc.). For example, survey collected from workers in the zones can provide a better understanding of the magnitude of skill upgrading on the job for the domestic labour force.

A cost-efficient approach to monitoring and evaluation

There are a number of data sources government agencies can rely on to monitor and evaluate the performance of SEZs. In Uganda, domestic tax and customs data can provide a clear picture of investment, value-added and exports generated from zones, as well as the level and types of supplier linkages from firms located in these zones.

It is important to ensure that any further data required from firms for evaluation does not represent an additional administrative burden. By using soft reporting systems such as text or online forms, more granular data can be collected in particular at the worker level.

4. Location, location, location

Special economic zones and parks are often used as place-based policies, to revitalize left-behind regions in a country. However, cross country evidence suggests that **SEZs are often not appropriate tools to promote regional development -** the further away these zones are from big cities and existing markets, the lower their chances of being successful[25]. Firms are attracted to the large pools of labour, suppliers, markets, ideas, and infrastructure that come with existing urban areas. Attempts at using SEZs to encourage regional development in Bangladesh, Turkey, Thailand and Russia have shown that the level of effective subsidy required to attract investment to less connected areas with weaker infrastructure and smaller markets typically exceeds what is reasonable and affordable for governments to provide.

[25] World Bank (2017) 'Special Economic Zones: An Operational Review of their impacts', Farole (2011) 'Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience'

The challenge of land acquisition

One rationale for locating zones and parks in more remote areas may be to more easily overcome the difficulties and costs associated with land acquisition in areas close to big cities. Complex and unclear rights to land in Uganda limit the ability of both government and private investors to acquire land and put it to a more productive use. In Wakiso District, UFZA has identified that land acquisition, compensation and multiple claims on land have impeded the establishment of zones. Improving systems of land administration and clarifying both public and private rights to land are therefore crucial in making better locations available for SEZ in Uganda.

5. Planning for upgrading and spillovers in the long run

In the long run, it is important to ensure that SEZs don't just become offshore assembly lines, repatriating profits and only staying in the zone until another country offers lower wages or more attractive tax breaks. Globally, even where SEZs have proved successful in boosting export growth and employment, it has often proved difficult to use zones to promote transitions to higher value-added production and to encourage linkages to the rest of the local economy.[26] Export processing zones focused on garment and textile production in the Dominical Republic, for example, played a hugely important role in boosting exports, investment and job creation between from the 1970s to 2000s, with free zone firms contributing to 7.5% of GDP in 2003. However, without additional policies to promote diversification, long term upgrading through education and skills, and backward linkages to the wider local economy, zone policies reached a natural limit in their ability to spur growth when cheaper labour supplies from East Asian countries began to draw investors away.[27]

Limited current potential for employment spillovers from Mbale's industrial park

Recent work by the International Growth Centre[28] highlights the untapped potential for job creation from the recent Sino-Uganda Mbale Industrial Park. Limited communication between local government, investors and UIA mean that local governments have little information about the types of investment being targeted and therefore how to design skill upgrading or supplier development programmes to complement this. Similarly, there are limited government programmes or incentives for encouraging local employment and local inputs for production in Industrial Park firms across the country.

Instead, active policy is needed to develop linkages between large SEZ firms and domestic suppliers and promote learning from domestic workers to ensure knowledge and technology upgrading is spread beyond firms in the zone. These spillovers are likely to be the primary driver of employment growth outside SEZs.

[26] Farole, Baissac, and Gauthier (2013) 'Special Economic Zones: A Guidance Framework for Policymaking'
[27] Farole and Akinci (2011)
[28] Sladoje et al. (2019) 'Transforming secondary urban areas for job creation: A study of Uganda'

Overcoming information asymmetries

One key obstacle to linkages between SEZ firms and domestic suppliers is information asymmetries. Large firms, and in particular foreign investors, may not have extensive knowledge of which domestic suppliers are available and what they can supply. In Uganda, given the variability in output quality across potential suppliers as well as poor contract enforcement[29], there is an obvious role here for government to reduce these information frictions.

Improving access to information can be best achieved through the development of supplier databases such as Yellow Pages, Yelp and Ali Baba, which are used across developed and developing countries to provide information on firms.[30] Supplier databases can be more or less ambitious in the information they collect and provide, ranging from contact details of businesses to information and reviews based on their previous transactions. Once this basic infrastructure is in place, governments can also play a more active role in facilitating introductions between firms. Governments can also facilitate introductions through industry specific trade fairs and conferences, as is often done in Malaysia and Singapore.

Local supplier upgrading

However, information is not enough. In many cases, large firms rely on imported inputs because domestic suppliers are unable to provide high quality and reliable goods at competitive prices. Buying companies often have particular standards and certifications they require regarding the quality of inputs, production techniques and labour standards that local suppliers struggle to meet without additional support. Providing assistance to domestic firms to raise their competitiveness can range from investments in the overall business climate such as infrastructure and access to finance, to targeted programmes that provide subsidies to large firms which promote capacity building and technology upgrading for their existing set of suppliers. The latter type of arrangement proved to be extremely successful in encouraging supplier linkages in Chile over the 1990s.[31]

Knowledge transfer within firms

Another form of spillover can be skill upgrading of the labour force employed in SEZ firms. Governments can implement active policies to encourage knowledge transfer within firms, including incentives to gradually replace the senior expats in SEZ firms by local managers or impose a fixed tenure for workers in the zones so that they can bring the knowledge acquired in SEZ firms to other domestic companies. However, boosting mobility may dampen firms' incentives to train workers, so these two countervailing effects should be weighed against each other.

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[29] World Bank, "World Bank Doing Business Indicators," 2018.

[30] Spray and Steenbergen (2017) Made in Rwanda: Establishing a publicly available supplier database for Rwanda

[31] For more information, see Arraiz, Henriquez, and Stucchi, "Supplier Development Programs and Firm Performance."

6. Making the most of regional integration through regional SEZ policies

One key question facing policymakers is how increasing regional integration affects SEZs, and how to design SEZ policy in a way that makes the most of this. This is particularly pertinent for Uganda as a member of the EAC free trade area, COMESA, and having signed the African Continental Free Trade Agreement in 2018.

As noted above, Free Zone firms in Uganda are only allowed to supply 20% of their output to local markets, which now include all EAC countries. As such, attempts to enhance regional integration as part of the African Continental Free Trade Agreement will a) limit exports of products to any countries that join the domestic customs area and b) increase market competition for the 20% of goods sold to the domestic customs area. Integration actually makes Uganda a *less* attractive place to invest in a Free Zone. While firms in 'Special Economic Zones' as defined by EAC Customs Protocol that are not limited in the amount they can export to the domestic customs territory do not experience any additional limits on market access, they would still similarly face stronger competition for domestic markets.

The effect of further regional integration on Industrial Parks, by contrast, is more ambiguous. As firms in these parks are within the domestic customs area, further regional integration offers both better access to larger markets and regional suppliers and greater competition for these markets – the net effect of this will depend on whether domestic production is able to effectively compete with entrants into the newly defined domestic market.

In order to maintain investment in SEZs in this context, policymakers can implement policies to make Free Zones and Special Economic Zones more attractive for firms (e.g. by reducing import duties on SEZ goods). This was a strategy used by Mexico in the 1990s. Until NAFTA came into force in 1994, SEZs in Mexico primarily targeted US markets. However, under NAFTA, there was a strict prohibition on the entry of goods from SEZs to member countries. To continue to promote SEZ firms, Mexico introduced a Sectoral Promotion Program that provided much lower MFN tariffs on a wide range of inputs to registered companies. Qualification for these tariffs relied not on export requirements but on the sector firms were producing in, allowing the government to adhere to NAFTA's rules on export-based incentives.[32]

Policymakers face a trade-off between making Free Zones and Special Economic Zones more attractive for investors and protecting local producers from unfair competition. If additional incentives are provided to attract investment in these zones, it will be crucial to match these with active supplier development policies and enforceable targets to ensure wider benefits to the economy of this investment.

Uneven integration in the EAC

Concerns about the impact of regional integration on Free Zones in Uganda are enhanced by the fact that there appears to be *uneven* integration across the EAC:

[32] Farole and Akinci (2011) 'Special Economic Zones: Progress, Emerging Challenges, and Future Directions'

- ‘Special Economic Zones’ with 100% access to domestic markets (subject to payment of import and export duties) have been introduced in Kenya, Tanzania, and Rwanda, but not in Uganda
- At the same time, the 20% Export Processing Zone threshold on textile and leather products in Kenya and Rwanda has been waived.[33]

With similar types of firms being offered a larger market in other EAC countries and comparable if not better infrastructure and fiscal incentives, it may be difficult for Uganda to compete in attracting FDI for its zones. While Uganda could try to introduce similar incentives, this will simply add to a race to the bottom between EAC countries on both incentives and market access. Instead, making the most of regional integration requires collaboration in implementing *regional* SEZ policies. This means moving away from intra-regional competition towards boosting regional competitiveness, by:

- Reducing search costs for firms by harmonizing requirements, market thresholds and incentives for SEZs across the region, allowing location decisions to be made based on comparative advantages of countries
- Coordination in sectoral specialization of zones in different countries, taking into account each country’s comparative advantage.
- Developing joint marketing and investment promotion strategies for the region as a whole

[33] UFZA (2017) ‘The Export Processing Zone 20 Percent Threshold: Implication on Free Zones in Uganda’

Conclusion

SEZ policy can be seen as a powerful tool with which to remove the most pressing obstacles to investment that exist in Uganda and to leverage productivity-enhancing spillovers between firms in zones and with other domestic firms. However, mixed experience with SEZ policy globally highlights the importance of carefully defining the objectives of SEZ policy, identifying key constraints to investment and private sector development, and designing policies that address them.

Enterprise surveys from Uganda and other countries suggest that tax incentives are not the main determinant of investment decisions, but that instead, zone policy aimed at improving the business environment is likely to be a more successful strategy. Crucial to learning about the effects of these policies and improving design over time is starting small, targeting a select number of firms and zones for policy experimentation, monitoring and evaluation. Cross-country evidence suggests that zones located closer to existing markets for goods and labour are more likely to succeed.

In the long run, policy attention should be paid to encouraging spillovers between zones and domestic suppliers, through transfers of technology, knowledge and labour. In doing so, the government of Uganda can ensure more widespread impact from SEZ policy.

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