Policy Brief

SENATE ECONOMIC PLANNING OFFICE

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Creation of Economic Zones: A Need for Review

I. Introduction

The policy of creating ecozones as an instrument of promoting development must be reviewed as the benefits alluded to these economic enclaves may only be realized given certain conditions that enhance locator productivity.

During the past three decades, there has been a paradigm shift from import substitution strategies towards export-oriented industrialization. It is in this context that countries saw the need to create special economic zones (SEZs) and export processing zones (EPZs), so-called *ecozones*, to cope with the increasingly competitive environment of the global market.

These ecozones are viewed as special enclaves, wherein firms, usually foreign ones, are supervised outside the normal customs barriers and thus enjoy favored treatment with respect to imports of intermediate goods, taxation, and infrastructure. In addition, these firms are generally free from industrial regulations applying elsewhere in the country. These privileges are subject to the conditions that almost all output is exported and that all imported intermediate goods are used within the zones or else re-exported (World Bank, 1998).

As a policy instrument, the creation of ecozones has three goals. First, they are to provide a country with foreign exchange earnings by promoting non-traditional exports. Second, they are to create jobs, provide for a standard quality of management and facilities, and thus generate income. Lastly, they are to attract foreign direct investment, engendering technology transfer/knowledge spillover, demonstration effects, and backward linkages (Balasubramanyam, 1988).

Republic Act (RA) 7916, otherwise known as the Special Economic Zone Act of 1995, authorizes the establishment of ecozones in strategic locations and introduces mechanisms that would attract foreign investments into these areas. Under this legislation, firms (so-called *locators*) are no longer required to be either wholly export-oriented or engaged only in industries being promoted. That is, firms can choose to locate in these ecozones regardless of market orientation, while a distinct group of EPZs will continue to be predominantly oriented

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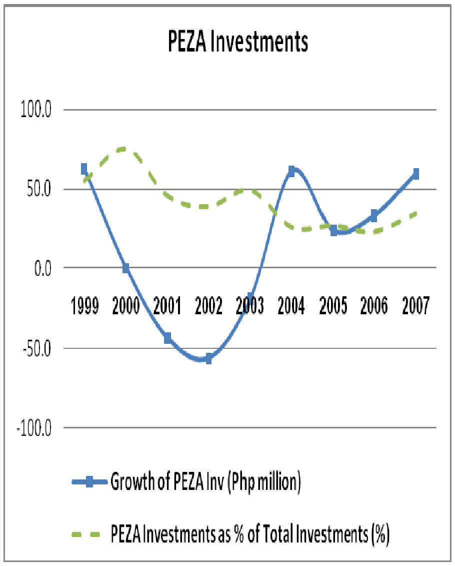

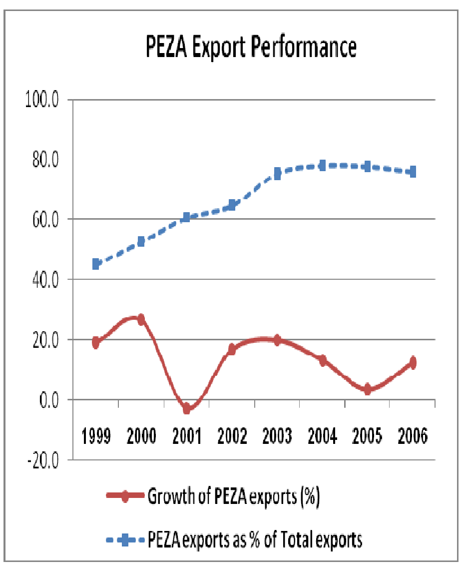

towards export production. All locators shall be considered virtually located outside customs territory.[1]

Moreover, RA 7916 provides for the creation of the Philippine Economic Zone Authority (PEZA), which is tasked to evaluate and recommend to the President of the Philippines areas that may be established as ecozones. The administration of created ecozones rests with the PEZA.

This policy brief takes a look into the factors that merit the creation of ecozones and the issues that must be addressed to reap the benefits of economic agglomeration.

II. Performance Indicators of Ecozones

As of 2007, there are four public economic zones with 423 operating firms; 45 private economic zones (mostly in Laguna and Cavite) with 528 operating firms; 70 IT parks/centers/buildings (mostly in Metro Manila) with 265 operating firms; and five tourism economic zones with five operating firms. There are two major economic zones: Subic Bay Freeport Zone managed by the Subic Bay Metropolitan Authority (SBMA) and Clark Freeport Zone managed by Clark Development Corporation (CDC).

After a sluggish performance during the previous years, ecozone investments started to pick up again in 2004. Most of these investments were expansions or re-investments of existing locators averaging PhP82.7 million annually. In 2006, nine out of the top 10 investors were existing companies. Although increasing, the amount of PEZA investments accounts for a smaller percentage of total investments. Indeed, PEZA investments accounted for 50.4 percent of total investments on the average during 1999 to 2002, dropping to 27.9 percent during 2004 to 2007.

Total export is increasingly accounted for by PEZA exports, which have been recording a lackluster performance since 2002. PEZA export has been growing at an average rate of 13.2 percent in 2002 to 2006, a slowdown compared to its average growth rate of 26.3 percent in 1997 to 2001. The expected increase in net exports from ecozones has not been impressive mainly because of their high import content.

PEZA employment only accounts for an average of 3 percent of the total number of employed. A United Nations report published in 2004 asserts that 80 percent of those employed in ecozones are women who cited low pay, excessive salary deductions, forced overtime, high production quota and lack of incentives as their most serious problems.

[1] The fiscal consequences of which must be reviewed periodically in light of the ever-changing economic environment.

Other labor issues involved 'no union policy', unpaid overtime work, non-remittance of SSS payments, non-regularization (contractualization) of workers, as well as sexual harassment, and gender bias in promotion.

III. Comments on the proposed measures

There are a number of bills filed in the Senate that seek to create additional SEZs (ecozones) and free ports in various locations in the country.[2] These are:

Senate Bill No.	Title	Author
127	Northern Samar Special Economic Zone Act of 2007 – Region 8	Sen. Enrile
128	Surigao del Sur Special Economic Zone and Free Port Act of 2007 –Region 13 CARAGA	Sen. Enrile
1228	Southern Palawan Special Economic Zone and Free Port Act of 2007 – Region 4B	Sen. Enrile
1082	Sulu Special Economic Zone and Free Port Act of 2007 – ARMM	Sen. Legarda
1091	General Santos Special Economic Zone and Free Port Act of 2007 – Region 12	Sen. Legarda
1605	Southern Palawan Special Economic Zone and Free Port Act of 2007 – Region 4B	Sen. Legarda
2118	Bataan Special Economic Zone and Free Port Act of 2007 – Region 3	Sen. Legarda
1982	Ilocos Sur Economic Zone and Free Port Act of 2007 – Region 1	Sen. Zubiri

In the case of Senate Bill No. 2118, the author seeks to convert the Bataan Economic Zone into the Bataan Special Economic Zone and Free Port and to create the Bataan Special Economic Zone and Free Port Authority.

As in previous legislation creating ecozones, the aforementioned bills call for the treatment of the proposed ecozones and free ports as separate customs territories where free movement of goods and capital will be ensured. Moreover, the following incentives will be provided to firms within the ecozones:

- *Tax and duty-free importations* of raw materials, capital and equipment;
- *Fiscal incentives* as provided for under RA No. 7916, otherwise known as the "Special Economic Zone Act of 1995", as amended, or those provided under Book VI of EO No. 226, as amended, otherwise known as the Omnibus Investments Code of 1987; and
- *Exemption from local and national taxes*, except real property taxes on land owned by developers.

[2] A free port is an area that is free from all import duties and taxes, and where all types of goods specified in the enabling national legislation can enter and remain indefinitely. Goods entering into and residing in a free port are not subject to usual Customs control and practices (1979 Kyoto Convention on the Simplification and Harmonization of Customs Procedures).

In lieu thereof, the firms shall pay and remit 5 percent of their gross income earned as follows:

- *Three percent (3%)* to the national government;
- *One percent (1%)* to the local government unit where the ecozone is located; and
- *One percent (1%)* for the establishment of a development fund for the municipalities outside and contiguous to each ecozone.

The creation of additional ecozones are well intended and founded on the idea that industrial agglomeration initiated by the government attracts investments and tourists, generates employment, and facilitates the development of these zones into self-sustaining industrial/commercial centers and free ports. In turn, increased economic activity in these zones is expected to raise the quality of life of the local residents.

Given the assertions that thriving ecozones have the potential to drive national and regional economic growth, it becomes imperative that the policy environment where they are situated are supportive and conducive for their growth.

Precautions, however, must be observed as the benefits alluded to the creation of ecozones and free ports may only be realized given certain conditions that enhance locator productivity. Also, given the assertion that thriving ecozones have the potential to drive national and regional economic growth, it becomes imperative that the policy environment where they are situated are supportive and conducive for their growth and effectivity.[3]

A. Fiscal Implications

The broad coverage of exemption from all taxes, fees, licenses, duties, imposts and other charges should be reconsidered. A broadly worded provision of exemption is likely to create opportunities for abuses/leakages, as well as arbitrary interpretation and implementation of the law.

The granting of income tax exemption by various ecozone authorities runs counter to the intent of Section 27(C) of the National Internal Revenue Code of 1997, which limits the exemption from income tax to a short list of government corporations to make the income tax a more revenue productive and an effective fiscal policy tool.

Moreover, granting of exemption from local taxes, particularly realty taxes, seems inconsistent with the principle of enhancing local fiscal autonomy. It should be noted that Section 234 of the Local Government Code withdrew most of the exemption from real property tax to make LGUs more self-reliant and capable of financing their own development

[3] Pragmatic examples of which are the booming IT concentration in Bangalore that contributed to the positive growth of the Indian economy and the well-touted automobile industry in Thailand that is considered as a driver of national and consequently, regional economic growth.

projects and initiatives. For some LGUs, real property tax is one of the biggest sources of revenues. A better alternative then is to allow the local government concerned to decide on matters pertaining to granting of exemptions from local taxes. Section 192 of RA No. 7160 allows LGUs -- through ordinances duly approved by their respective provincial, city or municipal councils -- to grant tax exemptions, incentives or reliefs under terms and conditions that may be deemed necessary.

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Also, the provision of a 20-year Income Tax Holiday (ITH) under SB Nos. 128, 1982 and 2118, is too generous and is more than what the PEZA and the BOI are currently granting. At present, non-pioneering locators are granted four to six years of ITH, while pioneering locators enjoy six to eight years of ITH. The authors of the aforementioned bills must hence explain the basis for providing a seemingly overly generous ITH as such provisions may result in substantial revenue losses on the part of the government. It is important to note that many prominent economists have argued that the ITH is one of the most redundant fiscal incentives. Medalla (2007) argues that ITH primarily benefits investments that are already quite profitable (and thus, are likely to be redundant). Moreover, ITH cannot attract investments that have long-gestation periods. That is, it is not effective in cases where the initial years of operation result in a loss. In addition, freeing all profits from tax for 20 years compromises the equity principle of taxation.

Furthermore, it must be noted that while the benefits of creating a public ecozone mainly accrues to the LGU, it is mostly the NG who bears the cost of creating it. The Department of Finance (DOF) approximates that on the average, PhP2 billlion is expended for the creation of an ecozone. To address this, the creation of ecozones endorsed by Congress must provide for a co-financing scheme between the NG and the LGU to encourage partnership in the creation and development of an ecozone.[4] Furthermore, a feasibility study to be prepared by PEZA, in coordination with the concerned LGU, must be attached to the application for the creation of an ecozone to justify its establishment in the area.[5] Such measures ensure accountability and transparency, and diffuse any financial risks.

[4] Public ecozones may be created through a presidential decree or congressional act. The expenditure associated with the creation of an ecozone through a presidential decree generally provides for a co-financing scheme, while expenditure associated with the creation of an ecozone through a congressional act is generally shouldered by the NG.

[5] In committee hearings, for instance, the Zamboanga Economic Zone is often cited as one which continues to receive budgetary allocation despite the fact that it has failed to attract the necessary investments.

B. Considerations for Productivity-Enhancing Conditions and Administrative Capacity

As cited in RA 7916, creating ecozones entails strict adherence to the following requisites:

a. The proposed area must be identified as a regional growth center in the Medium-Term Philippine Development Plan or by the Regional Development Council;
b. The existence of required infrastructure in the proposed ecozone, such as roads, railways, telephones, ports, airports, etc., and the suitability and capacity of the proposed site to absorb such improvements;
c. The availability of water source and electric power supply for 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 development of residential areas for the ecozone workers;
e. The availability of skilled, semi-skilled and non-skilled 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 situated where controls can easily be established to curtail smuggling activities.

Given the aforementioned requisites and in light of the fiscal bind that the government is facing, proposals to create additional ecozones must be subjected to careful scrutiny.

First, the required infrastructure that serves to support industrial agglomeration may not be on hand. For instance, Region 4B and the ARMM, wherein the proposed southern Palawan and Sulu ecozones are to be located, both have a small road density ratio of 0.3 km./sq. km. area.[6] Also, the regions of SOCCSKSARGEN and ARMM have low telephone densities, with 2.12 telephones per 100 population and 1.03 telephones per 100 population, respectively. Power also plays a significant supportive role. Access to electricity in the regions where the proposed ecozones are to be located leaves much to be desired. In terms of access to power, measured by the percentage of families with electricity at home, both SOCCSKSARGEN and CARAGA register 64 percent; Eastern Visayas, 60 percent; MIMAROPA, 53.8 percent; and ARMM, a significantly low 35 percent. It cannot be overemphasized that the creation of an ecozone by itself does not guarantee a surge in

[6] Compared to the road density of the NCR at 7.5km./sq.km area and region 3 at 0.8km/sq.km. area.

investment, rather, it is infrastructure spending that is key to the improvement of the investment climate in these remote areas.

Second, the creation of ecozones necessitates the creation of additional institutions to operate them. In a recent Senate hearing, local government officials lamented that the PEZA has neglected the SEZs in their respective provinces. This, perhaps, has brought about the proposals to establish administrating institutions other than the PEZA to operate SEZs. SB 2118, for instance, cites the ineffectual PEZA management of the Bataan Economic Zone as the basis for the proposal to create the Bataan Special Economic Zone and Free Port Authority. Such proposals, however, may create functional redundancy and may run contrary to the government's current policy of streamlining and rationalizing the bureaucracy. This, of course, must also be viewed in the context of its budgetary implications. Moreover, establishing another administrative agency does not ensure effective and competent management of the concerned ecozone.

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Third, ecozones are hard to manage and secure. For example, the administration of duty drawback procedures is costly and cumbersome. They are accordingly highly susceptible to revenue leakages. Also, the free port inside the Subic Special Economic Zone has often been reported as a site where rampant smuggling of used cars and petroleum products allegedly occurs. Since freeports need to be secured at all time, they require substantial resources and pose a heavy toll on tax and port entry administration.

Fourth, trading agreements introduce a host of dynamic regional/global forces that affect ecozone performance and effectivity. For instance, fiscal incentives provided to EPZs on a preferential basis can be construed as export subsidies and lead to cost subsidization for the EPZ firms' exported goods.[7] In addition, incentives like income tax holidays granted to ecozone locators do not address the need to reduce the anti-export bias brought by the existing structure of protection (Aldaba, 2006).[8] Thus, incentive schemes must be reviewed, and realigned if necessary, to avoid potential disciplinary actions or countervailing measures from trading partners. A more liberal trade and investment policy may serve as an impetus for the inflow of goods and/or services more than the building of free ports that do not fall under customs jurisdiction.

[7] WTO agreement on subsidies and countervailing measures specifies three categories of subsidies: prohibited, actionable, and non-actionable. The first two are subject to discipline. Prohibited subsidies are "those contingent, in law or fact, whether solely or as one of several conditions, upon export performance; and those contingent, whether solely or as one of other conditions, upon the use of domestic over imported goods." The provision on actionable subsidies, on the other hand, reads, "no member should cause, through the use of subsidies, adverse effect to the interests of other signatories, injury to the domestic industry of other signatory, nullification or impairment of benefits accruing to other members directly or indirectly to the other signatories of the GATT, and serious prejudice to the interests of another member."

[8] Anti-export bias is created by relatively high tariffs on intermediate and capital goods and can be addressed by incentive mechanisms that allow duty free importation of intermediate goods for export-oriented firms.

Fifth, the argument that links the creation of ecozones with positive spillovers -- particularly with regard to technology transfer, demonstration effect, and backward linkages -- may not be as valid today as it was a decade ago. If advances in information technology and increasing regional integration provide alternative sources for the "knowledge package" that ecozones are said to bring to host countries, then gains from the demonstration effect lose some relevance. Technology transfer fosters a backward linkage with local firms, allowing them to step in as suppliers of ecozone locators. However, the magnitude of such positive spillover has been variable and zone (and country) specific. The tendency of local firms to depend on their own effort for innovation mirrors the weak link between science and technology activities and industrial policy. Measures must be introduced to strengthen this link to ensure that research and knowledge creation can be accessed by the appropriate users for their pragmatic application.

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Sixth, there must be some concern over environmental damages caused by ecozone activities. Diluted concerns result in weak and non-binding environmental standards imposed on industrial/manufacturing firms. Studies have pointed out, for example, that industrial discharges mostly contaminate local water resources thereby adversely affecting local communities. Ecozones located in an urban area or within its periphery may prompt undesirable in-migration from rural areas, which may aggravate resource degradation. The conversion of agricultural lands into industrial/ commercial estates may also pose considerable risks to food security.

Lastly, RA 7916 encourages the private sector to initiate the creation of ecozones. Through the provision of incentives, the private sector is called to actively participate in the development and management of these ecozones. This may be a better alternative to the creation of public (i.e national government-initiated) ecozones for a number of reasons. First, it frees the national government from any financial exposure and liability. Second, if private zone developers see sufficient reason, i.e. profitable prospects to create ecozones, then it is likely that other private firms would try to seize the same opportunity and choose to locate in these economic enclaves. Third, since LGUs are persuaded to focus in the maintenance of specially designated economic zones, this affords them the chance to forge cooperative relationships with industries located in their provinces (PIDS, 2008).

The policy of creating ecozones must not be viewed as a single means to an end. Rather, such policy should be used in the context of a broader trade policy reform, in tandem with the provision of adequate productivity-enhancing infrastructure, and a favorable legal and regulatory framework.

IV. Conclusion

Economic zones have been known to create new employment, generate foreign exchange, expand national revenues, and increase export flows. While there have been benefits alluded to the creation of economic zones, the experience with such benefits have not been a universal phenomenon. Indeed, economic zones are known to present high infrastructure, administrative/regulatory costs; employ low-wage, unskilled (female) labor; generate small domestic value added; transfer little technology; and pose environmental risks. Moreover, the creation of these ecozones may run counter to the current efforts to rationalize fiscal incentives. Unless measures are introduced to address these factors, successful utilization of economic zones as instruments of economic development may not be fully realized.

The creation of economic zones must not be viewed as a single means to an end. Rather, such policy should be used in the context of a broader trade policy reform, in tandem with the provision of adequate productivity-enhancing infrastructure, and a favorable legal and regulatory framework.

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