Submission No 15

ESTABLISHMENT OF SPECIAL ECONOMIC ZONES

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NSW GOVERNMENT | Trade & Investment

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Mr David Elliott MP
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Parliament House
Macquarie Street
SYDNEY NSW 2000

Dear Mr Elliott

Inquiry into the Establishment of Special Economic Zones

Thank you for your letter of 14 February 2012 inviting submissions to the inquiry into the establishment of special economic zones.

I appreciate your invitation to provide comments and attach the NSW Trade and Investment submission to the inquiry for the consideration of the Committee.

Should you have any further enquiries, please do not hesitate to contact Mr Scott Davenport, Chief Economist and Executive Director, [redacted]

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Legislative Assembly Committee on Economic Development Inquiry into the Establishment of Special Economic Zones

1. Introduction

The Legislative Assembly Committee on Economic Development is conducting an inquiry into the establishment of NSW Special Economic Zones (SEZ) based on State tax and financial incentives for the purposes of promoting economic growth, employment and investment in regional and rural NSW.

This paper is the NSW Trade and Investment submission to the inquiry. It briefly explains the history of the development of SEZs, considers some Australian examples and, finally, discusses the range of issues around SEZ development.

2. Background

The World Bank[1] outlines the generic characteristics of SEZ as including:

- a geographically delimited area which is usually physically fenced in;
- a single management or administration;
- businesses within the SEZ being eligible for benefits; and
- a separate customs area with duty-free benefits and streamlined procedures.

An independent study of SEZ indicates that the International Labour Organisation's database of SEZ reported that by 2006 there were 3,500 zones within 130 countries.[2] The majority of these countries appear to be "developing" countries and are concentrated in Asia, the Pacific, Latin America, and Central and Eastern Europe. The main reason for implementing SEZ in such countries appears to be the stimulation of regional economies by attracting foreign investment, which in turn facilitates exports. SEZ may also provide the opportunity to test new economic policies prior to widespread implementation. The World Bank indicates that most international SEZ focus on labour intensive industries such as clothing manufacture, textiles, and electrical and electronic goods manufacture.

Internationally, China is held as one of the most successful implementers of SEZ. Since 1978, China's economic growth has been assisted by SEZ in areas such as Shenzhen, which is close to the major port of Hong Kong. The success of Chinese zones was facilitated by the availability of cheap labour and the attraction of significant foreign investment, technology and management and trading skills.[3] However there is very mixed evidence about the success of SEZs - often it is hard to demonstrate cause and effect, and even defining what constitutes "success" is often problematic. Chinese SEZ are, for example, often characterised by the suspension of laws to aid export.

Globally there is an increase in SEZ development in developed countries such as the United States of America. Much of the car manufacturing in the US is done so under a SEZ regime.

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[1] FIAS, *Special Economic Zones, Performance, Lessons Learned, and Implications for Zone Development*, **The World Bank Group**, page 9, April 2008

[2] Farole, Thomas, *Special Economic Zones: What Have We Learned?*, **VOX**, 28 September 2011

[3] Das, Satyajit, *The China Syndrome and the Crisis*, **Business Day – Fairfax Media**, 28 December 2009

Worldwide, the private sector has also been a significant developer of SEZ either in isolation of government or through public-private partnerships.[4] The industries of these SEZs are likely to be high value electronics, software or petro-chemical based.

3. SEZ in Australia

There appear to be very few SEZ in Australia. The South Australian Government are administering a $4m Enterprise Zone Fund - Upper Spencer Gulf and Outback, which offers financial support to priority projects for economic and community development within the region.[5] The South Australian Government designed the fund to make a major economic impact in the Upper Spencer Gulf and Outback.

The public may support the notion of SEZ, as shown by a 2011 Institute of Public Affairs commissioned Galaxy poll where 60% of those surveyed stated that they were in favour of the establishment of a SEZ in Northern Australia.[6] However, generic, rather than location-specific, programs have been the preferred method of promoting regional development for both the state and Commonwealth governments to date. For instance, the Commonwealth Government response to the Galaxy poll was that the existing $1 billion five year Regional Development Australia Fund would support infrastructure projects to improve economic and community development across Australia.[7]

Such state and Commonwealth regional growth initiatives are generally focussed on increasing regional employment, investment attraction and/ or innovation by providing assistance through: grants for capital investments or infrastructure development; tax breaks; and wage subsidies[8]. Such schemes are usually available across all non-metropolitan areas of a jurisdiction rather than being confined to a defined region.

4. Rationale for implementing SEZ

Before considering the reasons for implementing SEZ, it is important to recognise that there are a number of variations to the SEZ model. The following table provides examples and characteristics of a number of different types of zones. [9]

Name of Zone	Features	Examples
Free Trade Zone	Fenced in, duty free areas offering warehousing, storage and distribution facilities	Trade, transhipment or re-export operations located at ports such as Panama
Export Processing Zone	Industrial estates primarily for foreign markets	Manufacturing and processing markets e.g. Pakistan or Thailand
Enterprise Zone	Implemented to revitalise or enhance economically depressed regions through tax incentives and financial grants	Multi-use operations e.g. Chicago or South Australia
Freeport	Large areas which accommodate many different activities	e.g. Jordan or China

[4] **The World Bank Group**, pages 2 and 3.

[5] http://www.pir.sa.gov.au/regions/programs/enterprise_zone_fund

[6] Media Release: *New Poll – Australians Want Special Economic Zone in the North*, **Institute of Public Affairs**, 20 June 2011

[7] Bateman, Daniel, *New Bid for Australia Special Economic Zone*, **cairns.com.au**, 21 June 2011.

[8] Daley, John and Lancy, Annette, *Investing in Regions: Making a Difference*, **The Grattan Institute**, page 23, May 2011

[9] **The World Bank Group**, page 11

Specialised Zone	There are many types of specialised zones which aim to promote development. They include technology or science parks, financial services, airport, tourism or petrochemical industries.	e.g. Singapore, United Arab Emirates or Malaysia

The rationale for developing SEZ in developed countries is mainly based on developing areas or regions of the country which have stagnated, or suffered the loss of a major employer or undergone some other event which has resulted in negative economic outcomes. Another key reason is the need to improve international trade and manufacturing standards by providing incentives for companies to conduct business internationally.

5. Discussion

Given that the Terms of Reference for the inquiry are broad and provide no details about the location or the type of SEZ model being considered, it is difficult to provide specific commentary on the merits of establishing SEZ in NSW. However, an examination of some basic policy principles with reference to international experience can usefully be employed to provide an indication of whether or not SEZ is likely to be an appropriate policy response.

5.1 Policy Principles

The first step in policy analysis is the identification of the problem that might need to be addressed. Government intervention is usually intended to either address social inequity (wealth distribution) or correct a market failure that is resulting in socially undesirable outcomes (see Attachment 1 - Market Failure Justifications for Government Intervention). The Committee's Terms of Reference imply that the potential objective of introducing SEZ in NSW is the promotion of "economic growth, employment and investment", all of which are interrelated in that investment is the precursor to employment and economic growth. Assuming, therefore, that the primary objective might be the attraction of investment to a specific region or regions of NSW, it follows that government would only intervene in the market to increase or redirect investment because it believes that existing investment is sub-optimal.

While there is no evidence of the types of market failure that might warrant intervention (such as negative externalities or information asymmetry), it is possible that the NSW Government may have distributional objectives, such as improving economic development in a depressed region. If so, the consequent policy question is whether the establishment of SEZs are the most appropriate way to pursue these objectives.

Businesses choose to locate their operations in regions that deliver a competitive (cost) advantage, such as ready availability of suitable labour or close proximity to port facilities that assist in the export of output. Hence, the implications of intervention designed to persuade businesses to locate their operations in relatively less competitive regions should be carefully considered, as businesses located in uncompetitive regions will either fail or require permanent subsidies. Ill-considered incentives designed to influence initial business location decisions could, therefore, embed inefficiency.

Furthermore, it is unlikely that policy makers will be in possession of all the facts relevant to business location decisions, such as the relative cost profiles of each potential location. Creation of narrowly defined SEZs, rather than offering generic incentives for any regional location, could magnify the above problem by concentrating business operations in particularly uncompetitive regions. Indeed, this may be the policy makers' intention without realising the long term consequences.

Often a policy assessment does not take into account the negative impacts felt by regional areas outside the SEZ. Typically, the areas which fare worst are those directly contiguous to the SEZ. When businesses decide to re-locate into the SEZ, they generally come from quite nearby (as opposed to metropolitan areas). Negative impacts are, therefore, often felt in other regional or rural areas that have had investment and employment redirected out of their location towards the SEZ.

The design of incentives also requires careful consideration to ensure they do not affect World Trade Organisation rules.

5.2 SEZ Incentives

If it is determined that one or more SEZ will be created in NSW in the pursuit of distributional objectives, careful incentive design will be crucial in minimising the costs to both government and society. While it might be tempting to offer ongoing 'tax breaks' to encourage relocation to the zone, they are not likely to be very effective because:

1. they are not well targeted – existing businesses in the zone will receive a windfall, unless the incentives are limited to new entrants, which increases the scheme's administrative cost;
2. they are on-going, committing the Government to open-ended subsidies, and their later removal would also diminish any regional cost advantage as the incentives do nothing to improve underlying competitiveness; and
3. NSW Government taxes do not constitute a significant proportion of the total cost of production and, consequently, any concession with respect to these taxes is unlikely to provide enough incentive to influence business location. Furthermore, payroll tax, the major NSW business tax, does not apply to most small businesses, which generally tend to be drivers of economic growth in regional/rural locations.

The long term success of a SEZ appears dependent on whether it is run on a cost recovery basis rather than reliant on ongoing Government subsidy.[10] The World Bank Group papers on SEZ indicate that, while many countries offer a range of incentives under a SEZ regime such as tax breaks, many of these have little to no effect over the long term and are simply a drain on Government resources.[11]

The suitability of the existing characteristics of an area also should be considered before creation of a SEZ. The Grattan Institute recently reported that Australian state and Commonwealth government regional assistance and regional development programs have little effect in boosting lagging regional economies where there is not a "critical mass" of a well-educated population and a good industry base.[12]

On balance, a SEZ scheme based on NSW Government tax concessions is unlikely to be effective, nor particularly costly to government, as uptake is likely to be negligible due to point 3, above.

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[10] **The World Bank Group**, page 57
[11] **The World Bank Group**, page 56
[12] **The Grattan Institute**, page 42

SEZ that are not based on tax concessions are possible and might include schemes designed to address the underlying regional cost disadvantage through either: 'public good' infrastructure improvement, which is likely to be relatively costly to government but potentially more effective in both attracting new business operations to a regional area and providing real cost improvements in the long term; and/or implementation of regionally-based concessional planning processes and other red tape reduction strategies to encourage business 'clustering' to better realise economies of scale. While such SEZ schemes are preferable to those based on tax concessions, the SEZ concept, regardless of the type of incentives offered, creates a real risk of cannibalising investment that would have occurred in any case, either within the SEZ area or elsewhere within the jurisdiction.

5.3 Alternatives

It may be that the social returns to jurisdiction-wide economic and regulatory reform exceed those associated with the SEZ framework in that such reform is more likely to generate sustainable benefits for regional businesses by cutting the regulatory burden and developing 'public good' infrastructure. Pursuing such a policy would reinforce the underlying cost advantages of regional locations, such as cheaper inputs (labour and land), to provide sustainable incentives for regional business investment.

There are also a number of existing specific initiatives relevant to regional development. The NSW Government already offers a broad-based payroll tax concession for new jobs created under the Jobs Action Plan. This concession is less likely to distort market decisions as it is offered State-wide.

NSW Trade & Investment also provides a range of special services and programs to assist the regions of NSW. The Department has programs to address both longstanding and emerging economic development issues in regional NSW. The Regional NSW program is supported by the Regional Industries Investment Fund (RIIF), which aims to encourage business growth and job creation in regional NSW by helping businesses to overcome impediments to investment projects. Support is available from the RIIF for local infrastructure projects that are linked with employment generation investments and deliver industrial projects that have the potential to benefit more than one firm in order to address infrastructure barriers impeding business investment and job creation. Assistance is directed toward offsetting the costs of specific critical infrastructure required for business establishment, expansion or relocation in regional NSW.

In relation to discrepancies in tax regimes between NSW and bordering states, the NSW Government has recently appointed a Cross Border Commissioner to:

- be an advocate for the concerns of cross-border communities;
- review existing cross-border governance & management arrangements; and
- develop strategies to optimise the delivery of services to these communities.

Other initiatives include the grants and programs available under the jointly funded Regional Development Australia. These initiatives include round three of the Regional Development Australia Fund and the Regional and Local Community Infrastructure Program which aim to assist developing regional communities.

Attachment 1: Market Failure Justifications for Government Intervention

Perfectly competitive markets can be shown to achieve socially optimal resource allocation – that is, they are efficient in that they provide a mechanism for resources to flow to their most valued use. However, most markets are not perfectly competitive and display some degree of 'market failure', with consequent implications for resource allocation. Many markets do not display sufficient market failure to warrant intervention as intervention itself involves efficiency cost, and consequently intervention should not be attempted unless its costs are outweighed by the associated benefits.

'Market failure' has a very precise meaning in economics. It does not simply mean dissatisfaction with market outcomes. It refers to a situation when a market left to itself does not allocate resources efficiently. Where market failures exist, there is a potential role for government to improve outcomes for the community, the environment, businesses and the economy.

Governments may intervene to change the behaviour of businesses or individuals to address market failure or to achieve social and environmental benefits that would otherwise not be delivered. Government intervention is not warranted in every instance of market failure; in some cases the private sector can find alternative solutions.

There are five major types of 'market failure' that may provide a justification for government intervention:

i. Public Goods

Public goods exist where provision of a good (product, service, resource) for one person means it is available to all people at no extra cost. Free-riding is a problem with public goods. Because the good is non-excludable, everyone can use it once provided. This makes it impossible to recoup the costs of provision by extracting payment from users. Public goods are therefore said to be 'non-excludable' and 'non-rival'.

The definition of a public good should not be confused with phrases such as 'good for the public', 'public interest' or 'publicly produced goods'. There are very few absolutely public goods. Examples include national defence, law enforcement, clean air, street lights and flood control dams.

There may be a role for government in providing public goods or funding private provision. However, such intervention should only take place where it is clear the market would not find a solution to this form of market failure. Government intervention should not stifle private innovation.

ii. Externalities

Externalities are costs or benefits arising from an economic transaction received by parties not involved in the transaction. Externalities can be either positive (external benefit) or negative (external cost). The existence of externalities can result in too much or too little of goods and services being produced and consumed than is economically efficient. For example, where the cost of producing a good does not include its full costs, say in relation to environmental damage, then a negative externality is said to exist. This results in the good being over-produced (and under-priced).

The government may try to address negative externalities through:

- regulation that mandates corrective measures;
- persuasion (eg an advertising campaign to 'Do the right thing' and not litter);
- establishing property rights in the externality; and
- charging for pollution generating behaviour.

Goods associated with positive externalities are sometimes termed 'merit goods'. Governments may have a role in encouraging increased consumption of merit goods through subsidisation of or public provision of such goods (e.g. free access to vaccinations). Mandating consumption is a regulatory alternative (e.g. compulsory schooling for all children).

iii. Information Asymmetry

Information asymmetry occurs when one party to a transaction has more or better information than the other party. Typically, it is the seller that knows more about the product than the buyer, however, it is possible for the reverse to be true. Information asymmetry can prevent consumers from making fully informed decisions.

Regulation requiring information disclosure or placing restrictions on dangerous goods can be used to address this type of market failure. For example, when providing financial advice, financial service providers are required to disclose information about significant benefits and risks, and the fees and charges associated with the financial products, as well as remuneration they receive in relation to the services offered.

It should be noted, however, that information disclosure alone may not be sufficient to change behaviour where there is information asymmetry. Behavioural economics suggests that individuals do not always make decisions in their best interests based on the information provided. It may be necessary to use other instruments in conjunction with providing information to overcome this market failure.

iv. Imperfect Competition and Market Power

Market power exists when one buyer or seller in a market has the ability to exert significant influence over the quantity of goods or services traded, or the price at which they are traded.

In perfectly competitive markets, market participants have no market power. The ability of an incumbent firm to raise its price above competitive levels is limited by the existence of or threat of competition.

The existence of market power can result in economic inefficiency because it may:

- allow firms to increase prices without a commensurate reduction in demand; and
- restrict competition by creating barriers to entry by other firms.

Examples of market power include monopoly (where there is a single supplier) and oligopoly (where a small number of firms control the market). Where market power exists, governments may intervene to correct the operation of the market or set prices at a competitive level.

v. **Common Pool Resources**

This is where a good is 'non excludable' but rival in consumption – that is, a depletable resource where users cannot be excluded with a consequent incentive for individuals to over-extract or over-use the resource to ensure that they receive their 'share'. For example, the exploitation of wild fisheries.

The correct identification of the type of market failure involved is crucial to efficient intervention design:

1. <u>Public Good</u> market failures are usually overcome through public (taxpayer) provision, or underwriting the provision, of the good.

2. <u>Externalities</u> can be overcome through price adjustment such that product prices incorporate their true cost to society, though direct price adjustment (such as the carbon tax) can be more complex and imprecise than simply allocating property rights and forcing producers or consumers to either accept higher costs or financially compensate those affected (for example, banning smoking in public increases the cost – in the form of inconvenience – to smokers but spares non-smokers the health and other costs of passive smoking: in effect, the right to smoke has been replaced with the right to clean air).

3. <u>Assymetric Information</u> is usually addressed by ensuring both sides of a transaction are aware of the relevant information. Interventions range from providing generic information to market participants to requiring disclosure of certain information by one party to the other.

4. <u>Imperfect Competition</u> is often addressed by attempting to balance the market power of participants, with interventions ranging from compulsory disclosure of price or other relevant information, standard contract provisions (sometimes through voluntary or compulsory codes of conduct), legalisation of otherwise anti-competitive conduct, such as collective bargaining, and even compulsory demerger of monopolies into a number of competing businesses. Approval mechanisms for takeovers and mergers are also designed to prevent the formation of monopolists / oligopolies.

5. <u>Common Pool Resources</u> are usually managed by limiting access and/or assigning property rights with respect to access, such as freehold land tenure, issuance of a limited number of grazing permits for stock reserves, and management of commercial fishing through 'total allowable catch' quotas.