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Special Economic Zones (SEZs) in EAIO: An inadequate strategy for developing a veritable industrial economy

In summary...

Inspired by the success of Asian models, the region's countries have gradually incorporated the concept of special economic zones (SEZs), primarily export-oriented, into their industrial development strategies. However, these zones (mainly specialized in the textile and agri-food industries) are struggling to produce the desired effects in terms of appeal and industrialization. This is evidenced by the decline in the manufacturing sector at regional level, whose share of GDP has fallen from 12.0 % in 2000 to 7.2 % in 2022. This downward trend can be attributed to a lack of infrastructure and human capital.

In detail...

SEZs as standard-bearers for the industrial development strategies of the East Africa and Indian Ocean (EAIO) region countries...

EAIO governments have tried to emulate the Asian model, which enabled rapid and massive industrial development, thanks to advantages granted to foreign investors in priority sectors. Most countries in the region have set up legal frameworks for special economic zones. The forerunner in this field was Mauritius, with the introduction of the first SEZ legislation on the African continent in 1970. This was followed by Madagascar (1989), Kenya (1990), Seychelles (1995), Tanzania (2002), Rwanda (2006), Ethiopia (2010), Uganda (2014), Burundi (2017), Comoros (2021) and Somalia (specifically Somaliland - 2021). To date, **only four countries in the region do not have operational SEZs**: Burundi, Comoros, Eritrea and South Sudan. While the region's countries initially focused on developing export-oriented free trade zones, many of them have since amended their legislation to include the development of multi-activity industrial zones to boost their attraction.

The nature of advantages theoretically granted to investors in the SEZs within EAIO countries is relatively similar from one country to another. On the fiscal front, investors generally benefit from reduced/exempt corporate income tax, customs duties, VAT on imported and local goods and services, and preferential rates on utilities (electricity, water). **On the administrative front**, investors generally benefit from one-stop licensing, relaxed constraints on hiring foreign staff, free repatriation of capital and profits, and easier access to land. Among other unconventional benefits, Ethiopia offers relaxed labor standards and a lower minimum wage within its SEZs.

The **aim of these SEZs is first and foremost to reduce their dependence on imports of manufactured goods** by enhancing local production, at a time when the countries are structurally in deficit in terms of their trade balance. The aim is to **diversify their economies,** which are mainly based on the agricultural and service sectors (mainly tourism and transport), and thus strengthen their resilience to shocks. Added to this is a desire to **create jobs**, in a context of demographic transition where the region's economies need to absorb growing cohorts of young people entering the job market, and indirectly to **develop human capital** by upgrading the skills of employees working for foreign companies. As a reminder, the EAIO population increased 7.5-fold between 1950 and 2022, from 50 million to 410 million, and should reach 1.15 billion by 2100 according to United Nations estimates.

While the range of sectors targeted by SEZs is broad, the majority of operational SEZs in EAIO focus on the textile and agri-food industries. This sectoral specialization is in line with the region's comparative advantages: a predominantly agricultural sector and abundant, low-cost labor.

… which does not allow for a significant rise in industry

At regional level, the share of the manufacturing industry in GDP has declined overall, from 12.0 % in 2000 to 7.2 % in 2022. The countries in the region with the highest share of manufacturing in GDP are Uganda (17.2% of GDP in 2022), Mauritius (13.2%), Kenya (9.4%) and Tanzania (9.2**%). Although employment in the industrial sector has increased, it also remains low**: in 2022, at regional level, it represented 10.1 % of total employment (9.3 % in 2000), compared to 56.5 % in agriculture (64.1% in 2000). **The region's main export sectors continue to have low added value**: plant products (18.5 % of exports in 2021), precious metals (16.1 %) and transport (14.4 %). **However, Mauritius stands out from its neighbors: its manufacturing sector in GDP rose from 5.8 % in 1970 to 29.8 % in 1980**, before falling back to 12.1 % in 2019 with the rise of the financial services sector.

Beyond the legal framework, the effectiveness of SEZs is often incomplete, lagging behind government announcements and strategies. A number of companies based in the region's SEZs have complained of shortcomings in the application of the tax benefits provided for in the legislation. This is particularly the case in Uganda (delays in VAT exemptions), Kenya (lack of cooperation from the Kenyan tax authority) and Tanzania (lengthy and complex administrative procedures). In Madagascar, the law on SEZs has still not been the subject of an implementing decree, with a general framework that is subject to political changes, and advantages ultimately granted individually to free zone companies.

In addition to the small number of SEZs in operation, their limited success is due to a number of limiting factors: (i) A lack of infrastructure in the region, where the appeal of SEZs is reduced by unreliable electricity, water and internet supplies. **(ii) A lack of human capital**, both in terms of qualifications of the workforce and its availability. In Ethiopia, for example, low wages and a lack of nearby housing keep local workers away from the SEZs. **(iii) Unstrategic geographical locations**. Many SEZs in the region are located in remote areas and lack of connectivity with strategic transport routes, which are vital for the routing of imported intermediate goods and the export of finished products. This is particularly the case in Ethiopia, where the location of some of the SEZs has been defined to satisfy inter-regional political balances. **(iv) Single-factory SEZs**, which do not offer the "agglomeration" advantages of multi-business zones (economies of scale, technology transfer and learning). This is notably the case in Tanzania, where legislation allows investors to own an export processing zone (EPZ). As a result, no multi-company EPZs have been identified. **(v) Increased regional competition**. The countries in the region share similar economic structures and de facto aim to attract the same business sectors

to their SEZs. With equivalent tax incentives, countries such as Uganda struggle to stand out from more attractive economies such as Kenya (better infrastructure, more developed human capital, seafront). **(vi) Binding EAC regulations.** Under the EAC customs union protocol, only 20 % of goods produced in EPZs can be sold locally within the East African common market (they are then subject to the common external tariff, like other goods produced outside the national customs zone). While regional integration contributes to the economic development of countries in the region, it also reduces the appeal of EPZs for companies wishing to expand in the region. **(vii) Conflicts**. This is notably the case in Sudan and Ethiopia, where the conflict in Tigray has led to the closure of four SEZs representing 6 % of jobs and 9 % of exports in the country's SEZs. **(viii) Limited access to international markets, heavily dependent on trade agreements**. The African Growth and Opportunity Act (AGOA) with the United States was a driving force behind the development of certain industries: the share of Ethiopian textile exports to the United States rose from 10 % in 2014 to 70 % in 2019. Its suspension has led to the loss of 10,000 jobs nationwide.

These barriers are part of a wider context of a deteriorating business environment in the region, to which SEZs are only partially responding. According to the World Bank's Enterprise Survey, carried out among companies with over 10 % foreign ownership, **access to electricity** is the main obstacle in terms of business environment in EAIO, according to 15.2 % of companies. This is followed by **access to financing** (for 13.1 % of companies), the **tax rate** (10.7 %), **informal sector** practices (8.3 %), **customs and trade regulations** (8.2 %), **tax administration** (8.0 %), an inadequately trained workforce (6.9 %), political instability (6.4 %), corruption (5.1 %) and access to land (5.1 %). In summary, **while SEZs meet a demand from foreign investors, particularly in terms of taxation, they are no substitute for a comprehensive industrial development strategy,** including infrastructure and human capital development.

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