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Policy Options to Reform Free Economic Zones in Belarus

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Policy Options to Reform Free Economic Zones in Belarus

Executive Summary

In Belarus, six Free Economic zones (FEZs) exist in the country, with the first one (Brest) coming into existence 20 years ago. Their main objectives are according to the Law the promotion of the socio-economic development of Belarus and its regions, the attraction of investments aimed at the creation and development of export-oriented and import-substituting industries based on new and high technologies, as well as other purposes.

A more detailed assessment of their economic performance reveals a very mixed picture, though. While their contribution to the nations FDI and employment stock is relatively limited (5% and 3%, respectively), there have been worrying growth dynamics over the last years. The number of zone residents as well as the people employed in FEZ shrank over the last couple of years. The export share in FEZ is rather poor in international comparison, and they did not really contribute to the diversification of exports from traditional CIS markets towards new markets.

Based on our analysis and on international experience, we suggest the following policy recommendations:

1. Reposition the FEZ scheme towards a cluster-oriented model with a strong focus on FDI-attraction
2. Strengthen the focus of FEZ on SME development
3. The positioning and differentiation of FEZs should be based on services and infrastructure and less on (fiscal) incentives
4. Target-group oriented investment promotion efforts should be intensified and after-care services extended
5. It should be assessed if public-private partnerships can be used for the proposed upgrading of the FEZs to increase the efficiency and to reduce the burden on public resources

In order to refine the proposed reform and to prepare a policy decision, a survey-based analysis of the needs of residents and investment potentials of FEZs should be carried out as a next step. This would help to gain a better understanding of the underlying investment patterns and potentials.

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1 Introduction

Belarus uses several economic policy instruments that set up a special legal regime for stimulating investment and business activities of enterprises and entrepreneurs. One of them are Free Economic Zones (FEZs) , whose main objectives are the promotion of the socio-economic development of Belarus and its regions, the attraction of investments aimed at the creation and development of export-oriented and import-substituting industries based on new and high technologies, as well as other purposes.

In this paper, we try to assess the performance of FEZs in the country, and give recommendations on how this specific instrument can be improved.

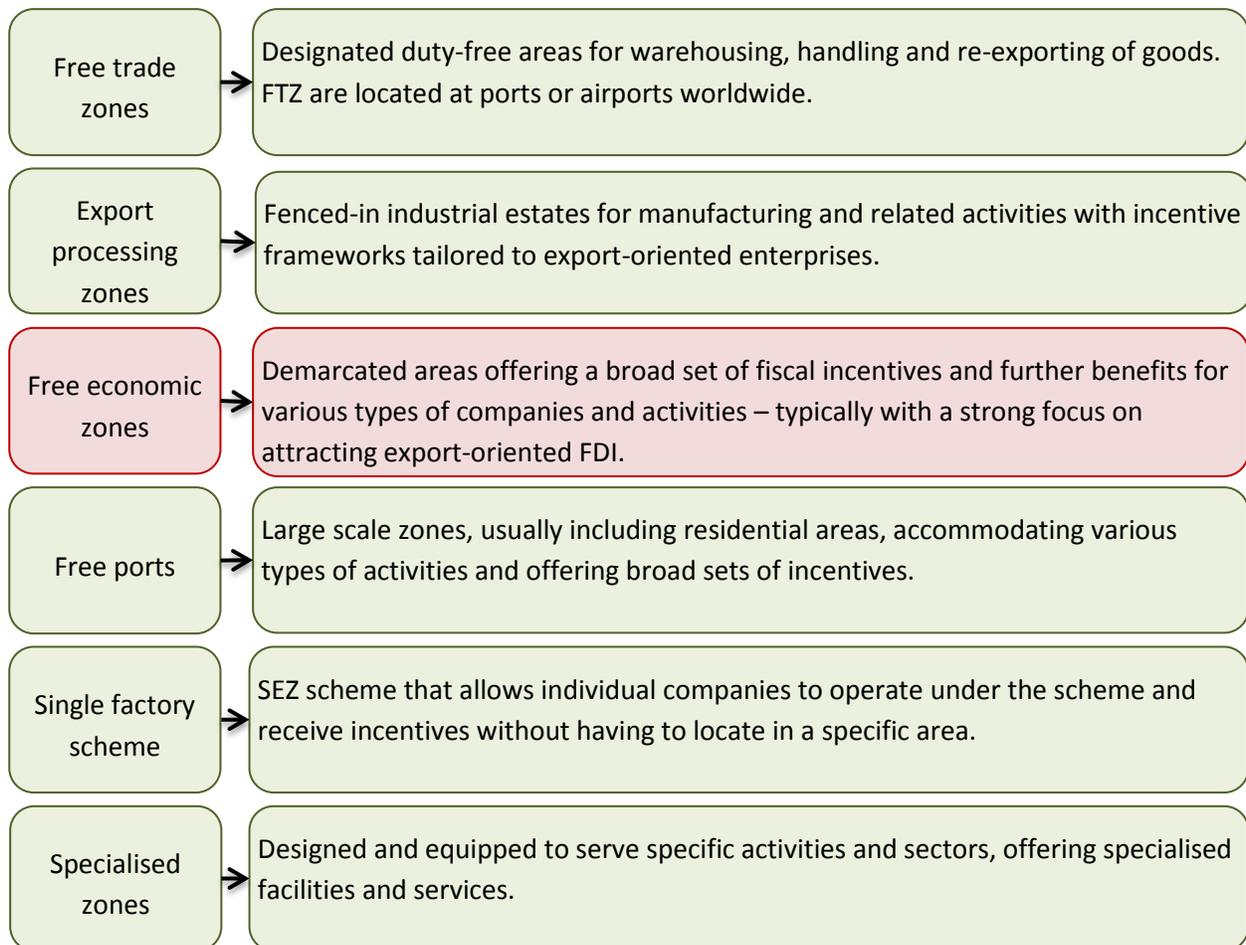
The paper is organised as follows: In Chapter 2, we provide an overview of the concept and the different types of special economic zones, of which Free Economic Zones are a part of. Chapter 3 then deals with FEZs in Belarus, their legal background and their economic performance. Lessons learnt from the international experience with FEZs are summarized in Chapter 4. The following Chapter provides policy recommendations for a reform of FEZs in Belarus. We conclude in chapter 6 with a proposal for the next steps.

2 Concept and different types of special economic zones

The free economic zones (FEZs) of Belarus are an economic policy instrument that falls into the group of special economic zones (SEZs). While there is no generic definition of what comprises an SEZ, the term usually denotes the concept of a spatially delimited area (often including industrial infrastructure) that is operated under an administrative, regulatory and fiscal regime that differs significantly from the rest of the national territory. Depending on how broad the definition and criteria are applied, there are estimations of up to 4,300 special economic zones of various types worldwide. Figure 1 provides an overview of the most common types of special economic zones.

Figure 1

Types of Special Economic Zones



Source: own research

Governments typically launch SEZ programmes with the goal of achieving one or several of the following policy objectives:

- **Attracting foreign direct investment:** SEZs can help attract FDI by offsetting an otherwise adverse investment climate in a given country and leveraging comparative advantages such as low labour cost or preferential access to foreign markets.
- **Promoting and diversifying exports:** Traditionally, SEZs have a strong export focus. Various countries have used SEZs as an integral part of export-oriented industrialization strategies focusing on attracting export-oriented firms that participate in global value chains.

- **Employment generation:** By attracting large-scale, labour-intensive manufacturing operations, SEZs can serve to alleviate local unemployment. Depending on the zone regime employment effects in the long-run can go beyond jobs created immediately with the zone, by catalysing the development of local supplier industries and services.
- **Supporting wider structural change:** Depending on the type of investments attracted and the level of forward and backward linkages the zone regime allows, SEZs can serve as a catalyst for structural transformation by creating spill-over effects (e.g. skill and technology transfer, development of a local supplier base) to the domestic economy.
- **Spatial and cluster-oriented development:** SEZs can be designed and located to facilitate or support industrial agglomeration and the development of industry clusters. In this context, specialized zones with complementary facilities and services catering to specific – often high-tech – industry sectors have evolved.
- **Testing new policies and measures:** Most notably in the Chinese context, SEZs have been used to experiment with economic and trade policy reforms. More recently, SEZs have been used as a controlled environment for the experimentation with innovations in environmental policies and standards.

A SEZ programme needs to be aligned to country-specific conditions and objectives. Typically, the following categories of key design features are used to shape the SEZ model and concept of a specific country:

- **Fiscal incentives:** This may include duty- and tax free imports of raw and intermediate inputs as well as capital equipment, export duty exemptions and tax holidays or reduced tax rates and rebates. Since SEZs are usually considered extra-territorial – meaning outside the domestic customs territory – sales to the domestic economy commonly attract duties.
- **Regulatory and administrative relief:** Simplification of regulations and increased efficiency of bureaucratic processes is a key feature of SEZs. This may include on-site customs clearance, one-stop-shops for administrative procedures, expedited permit applications and other facilitation services.
- **Infrastructure and services:** This may include a range of on-site services and facilities, warehousing, production facilities for lease, serviced land, access to and maintenance of high quality road and port infrastructure. The available services, infrastructure and other amenities are often geared towards specific target groups. In addition, stable and reliable provision of utilities is an important zone feature, especially in regions or countries where power and water supply are otherwise unreliable or limited. Depending on the size and purpose of the zone, additional specialized services may be offered.
- **Eligibility criteria and access restrictions:** Access to SEZs can be restricted by certain eligibility criteria and restrictions such as the type of activity or sector, company ownership (i.e. foreign, domestic or joint ventures), company size, production volumes or turnover.

The gains and benefits that SEZs are expected to yield for the host economy depend on the type of zone, the specifics of the zone regime and the underlying policy objectives. In general, potential benefits can be divided into static and dynamic gains. Static benefits accruing to the host economy are derived from the generation of employment for local workers, foreign-exchange earnings, the purchase of domestic raw material inputs and domestic capital equipment, taxes and other revenues, profits accruing to local shareholders and the use of utilities as well as domestic borrowing of foreign firms. Dynamic gains are longer term benefits related to structural change and development through forward and backward linkages between the zone and the host economy. Further key aspects are skills and technology transfer and the stimulation of local industries and entrepreneurial activity.

At the same time, there are a number of direct and indirect costs associated with the establishment and operation of SEZs. Often these are underestimated or overlooked when it comes to the decision of whether a certain SEZ scheme should be implemented or not. In general, the costs to government include the infrastructure cost related to setting up the zone, administrative expenditure for the operation of the zone and the implementation of the regulatory and fiscal regime – including on- and off-site administrative services rendered – as well as the forgone tax revenue related to the fiscal incentives granted. In addition, SEZs inherently create distortions in the economy, which may yield additional social and economic costs.

3 Legal framework, economic performance and impact of FEZs in Belarus

3.1 Legal framework

The Law of the Republic of Belarus “On Free Economic Zones” set up the legal framework for the creation, carrying out of activity and liquidation of free economic zones in Belarus. Article 1 of the Law stipulates that a free economic zone is part of the territory of the Republic of Belarus with defined boundaries and a special legal regime for investment and business activities of residents¹. According to Article 3, the main objectives of FEZs are the promotion of the socio-economic development of Belarus and its administrative-territorial units, the attraction of investments aimed at creation and development of export-oriented and import-substituting industries based on new and high technologies, and (or) other purposes determined at the establishment of a free economic zone.

There are six free economic zones in Belarus:

1. Brest – created in 1996;
2. Vitebsk - created in 1999;
3. Grodno-Invest – created in 2002;

¹ <http://www.pravo.by/main.aspx?guid=3871&p0=h19800213&p2=%7BNRPA%7D>

4. “Gomel-Raton” – created in 1998;
5. Minsk – created in 1998;
6. Mogilev – created in 2002.

The Edict of the President of the Republic of Belarus No. 262 “On Some Matters of Activity of Free Economic Zones on the Territory of the Republic of Belarus” stipulates that in order to be registered as a FEZ resident, a legal entity or individual entrepreneur should invest in the implementation of the investment project the amount equivalent to at least EUR 1 m. The costs of the creation of engineering and transport infrastructure required for the implementation of the investment project with the declared investment of an amount of more than EUR 10 m should be covered from the State Investment Program and local budgets on a priority basis².

Residents of FEZs are granted the following tax and customs benefits:

Tax privileges

- Profits received from the sale of goods (works, services) of own productions are exempted from corporate income tax for 5 years from the date of its declaring. After 5 years of profit declaring, residents of FEZ should pay corporate income tax at a rate reduced by 50 per cent;
- Exemption from the real estate tax on buildings and facilities (including unfinished construction), located in the territory of the respective FEZ, regardless of the direction of their use;
- Exemption from the state fee for the issuance of special work permits for foreign citizens and stateless persons;
- Exemption from a land tax on land within the boundaries of FEZ³;
- Exemption from a fee paying for a right to conclude a lease of land;
- Exemption from a compensation fee for flora objects;
- Reduced VAT (10 % instead of 20%) for goods produced and supplied to the internal market. These goods should be included in the list of import substitution goods produced by FEZ residents (this benefit will be abolished since 01/01/2017).
- Exemption from the surrender requirement of foreign exchange⁴.

² <http://www.pravo.by/main.aspx?guid=3871&p0=p30500262&p2=%7BNRPA%7D>

³ For residents registered from January 1, 2012, for the construction of facilities (for the period of design and construction of these facilities, but not exceeding five years from the date of such registration). FEZ residents registered prior to January 1, 2012 shall be entitled to use these benefits during the design and construction of facilities, construction of which provided the land, but no earlier than January 1, 2017 and no more than five years from that date.

⁴ <http://www.pravo.by/main.aspx?guid=3871&p0=P30600452>

Table 1

Customs privileges

	For residents, registered before January 1, 2012	For residents, registered after January 1, 2012
Goods placed under the customs procedure of a Free Customs Zone (FCZ)	Without import duties and taxes	Without import duties and taxes
Exports from FCZ to the territory of Customs Union goods manufactured by residents of FEZ:		
1) without use of foreign goods (raw materials) placed under the customs procedure of FCZ	Without import duties and taxes	Without import duties and taxes
2) with use of foreign goods (raw materials) placed under the customs procedure of FCZ	Without import duties and taxes till 2017	Import duties and taxes
Exports from FCZ outside the territory of the Customs Union:		
a) Foreign goods in the unchanged condition previously placed under FCZ procedures b) goods manufactured with the use of foreign goods placed under FCZ procedures	Without import duties and taxes	Without import duties and taxes

Source: own compilation

The “Treaty on the Issues of Free (Special) Economic Zones in the Customs Territory of the Customs Union and Customs Procedure of a Free Customs Zone” of June 18, 2010, that was signed by Belarus, Kazakhstan and Russia replaced the national customs legislations of the member countries, regulating customs benefits granted to residents of Free Economic Zones. This Treaty abolishes customs privileges for residents of FEZ that were registered from January 1, 2012. Residents that were registered before January 1, 2012 will be able to use such customs benefit only till 2017.

Conclusion 1: Undoubtedly, the abolishment of customs privileges negatively impacts the conditions of operations in FEZ and decrease the attractiveness of investments in free economic zones in Belarus.

3.2 Economic performance and impact

In this section, we analyse the performance of the free economic zones in Belarus and its impact on the country's economy. We structure our analysis based on the main objectives of FEZs establishment according to the law, i.e. the attraction of investments aimed at the creation and development of export-oriented and import-substituting industries based on new and high technologies.

Attraction of foreign investments

On January 1, 2016 all FEZs attracted USD 850 m of FDI stock. However, this amount is not significant and accounted for only around 5% of the total FDI stock in Belarus. The Mogilev FEZ has the highest share of FDI stock with 22.3% of the total, followed by Minsk 22.2% and Grodno-Invest 21.2%. The Brest FEZ has the lowest share (10.5%).

Table 2

FDI stock (January 1, 2016 in USD thousand)

	Total	equity capital	reinvested earnings	other capital (intercompany debt)
Brest	89 683.8	35 482.6	31 434.9	22 766.3
Vitebsk	90 044.9	14 292.2	31 605.8	39 646.1
Gomel-Raton	112 956.2	26 858.7	22 799.0	63 298.5
Grodno-Invest	179 859.0	140 117.4	15 721.0	28 521.4
Minsk	188 545.6	82 769.4	29 148.4	76 627.8
Mogilev	189 283.3	114 188.0	11 563.5	63 416.8

Source: Belstat

The share of foreign investments in total investments in fixed assets varied significantly among Belarusian FEZs and also over time (Table 3). It was lowest in Brest and highest in Mogilev over the period 2012-2015, while in Gomel-Roton it steadily increased over the last two years and accounted for 71% of total investments in fixed assets in 2015.

Table 3

Share of foreign investments in total investments in fixed assets (%)

	2012	2014	2015
Brest	10.3	3.0	8.8
Gomel-Raton	4.4	57.3	71.0
Minsk	1.1	21.2	2.5
Vitebsk	2.6	44.5	6.6
Mogilev	59.4	65.8	58.2
Grodno-Invest	1.4	6.9	32.2
National Average	3.2	3.7	3.9

Source: own calculations

The largest amount of the FDI stock in the FEZs came from Cyprus (34.1%). German investors were also very active and contributed 13.8% of the accumulated volume of foreign direct investments. Other countries that have invested heavily in Free Economic Zones are Russia (7.3% of FDI stock) Poland (6.5%), as well as Iran, UK and Switzerland (share of each is around 5%).

Conclusion 2: FEZs are not a main contributor to the FDI stock of Belarus; only 5% of FDI are located in these zones, with significant regional variation. While in some zones, FDI did play an important role for investments in 2015 (e.g. Gomel, Mogilev), in other FEZs like Minsk or Vitebsk it only played a small role. Questions could be also raised about the significant role that Cyprus plays as the most important investor country (34.1%).

Membership in FEZs and job creation

Table 4 shows that the number of registered residents and active residents constantly decreased over last four years in all FEZs, except Gomel-Roton. As a result, it dropped from 524 residents at the beginning of 2012 to 437 residents at the beginning of 2016, of which 96% were active. This may indicate a loss of investors' interest to Belarussian FEZ.

Table 4

Number of residents (beginning of year)

	Number of registered residents				Number of active residents			
	2013	2014	2015	2016	2013	2014	2015	2016
Brest	88	84	78	81	82	78	75	77
Gomel- Raton	76	73	76	81	72	71	73	76
Minsk	144	145	135	129	137	136	130	115
Vitebsk	56	51	44	40	53	48	44	40
Mogilev	55	54	48	40	48	50	44	40
Grodno -Invest	94	96	88	75	66	80	79	70

Source: Belstat

It is widely recognized that one of the main benefits of FEZ to the host country is employment creation, and large scale employment benefits reveal themselves in 5-10 years after establishment of free economic zones⁵. However, it is evident that free economic zones in Belarus have not brought about such kind of benefits, as the total number of employees at six Belarusian FEZs decreased in 2011-2015 from 143.7 thousand to 139.7 thousand, which amounted to 3.1% of the employed population. Moreover, as can be seen from Table 5, the numbers of newly created workplaces decreased sharply, e.g. in Brest, Gomel-Roton and Mogilev the decline was in the range of 70-80%.

⁵ Farole, T. (2011) *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences*. Washington, DC: The World Bank.

Table 5

Employees hired on newly created workplaces

	2013	2014	2015
Brest	1 874	1 012	466
Gomel-Raton	830	782	639
Minsk	1 459	1 568	1 040
Vitebsk	286	370	193
Mogilev	808	547	291
Grodno-Invest	936	451	216

Source: Belstat

Conclusion 3: About 3% of the total employed population in Belarus work in FEZs in the country. While this number is not very impressive, the negative dynamics over recent years give rise to concern: Both the number of FEZ residents and the total number of workers employed by them is decreasing, as is the new jobs generated by them.

Orientation towards exports, export diversification and import-substitution

A universal feature of FEZs is their export orientation, as residents typically receive tax and duty free privileges in order to produce goods and services aimed at export markets. Yet, the share of export-oriented products in revenues of Belarussian free economic zones is relatively low in international comparison. Thus, in Brest, Gomel-Raton and Grodno-Invest it was around 50-55%, while in Minsk, Vitebsk and Mogilev it was only slightly higher and amounted to 60-66%. Table 6 shows that some of the FEZs had a strong import-substitution orientation, but this constantly changed over the period 2012-2015. In 2015, only the FEZ Minsk and Gomel-Raton had a high share of import-substituting products in the total volume of production, which even increased from the level of 2012.

Table 6

Share of import-substituting and export-oriented products

	Brest	Gomel-Raton	Minsk	Vitebsk	Mogilev	Grodno-Invest
Share of import-substituting products in total volume of production						
2012	42.2	19.5	37.5	38.0	16.5	21.4
2013	47.5	32.1	42.8	35.8	14.3	15.4
2014	25.1	26.8	42.9	22.0	7.9	11.0
2015	22.2	25.5	41.1	21.4	3.1	7.5
Share of export-oriented products in revenues						
2012	53.7	43.8	66.7	49	55.3	43.2
2013	53.9	44.3	59.2	56.0	52.5	48.3
2014	52.5	49.0	56.7	61.2	51.0	47.2
2015	53.5	55.9	66.5	60.8	59.5	47.4

Source: own calculations

Table 7 shows that free economic zones in Belarus have also not contributed to export diversification; they are still aimed at CIS and mainly Russian market, share of which accounted for 92.8% in Brest FEZ, 88.2% in Grodno-Invest, 87.7% in Minsk. Only the FEZs Vitebsk and Gomel-Raton have been able to increase their presence in markets of non CIS countries.

Table 7

Share of exports to CIS and non-CIS countries

	CIS				Non-CIS			
	2012	2013	2014	2015	2012	2013	2014	2015
Brest	97.1	96.0	95.4	92.8	2.9	4.0	4.6	7.2
Gomel-Raton	81.6	85.3	77.2	73.5	18.4	14.7	22.8	26.5
Minsk	92.8	92.8	89.3	87.7	7.2	7.2	10.7	12.3
Vitebsk	78.0	78.2	58.8	60.7	22.0	21.8	41.2	39.3
Mogilev	83.4	88.3	85.0	83.4	16.6	11.7	15.0	16.6
Grodno-Invest	86.8	88.1	90.3	88.2	13.2	11.9	9.7	11.8

Source: own calculations

Conclusion 4: The share of export-oriented products fluctuates between 50-65% of production, which is in international comparison a rather low share. Also, export diversification away from traditional CIS markets has not really happened. Only the FEZs Vitebsk and Gomel-Raton have been able to increase their presence in markets of non CIS countries significantly. The share of import-substitution is very volatile both over time and between the zones: In Minsk it is above 40%, but in Mogilev only a tiny 3%.

Innovative products

FEZs in Belarus were established with the objective to serve as a platform for the creation of innovative products that can also contribute to exports diversification. However, this aim has not been reached. The data in Table 8 show that the share of innovative products in the total volume of shipped products is extremely low, and even lower than in Belarus as a whole (13.1% in 2015), with the exception of FEZs Minsk and Vitebsk. Moreover, this share has been constantly decreased over the last years.

Generally, free economic zones in Belarus do not have clearly defined specialization. In the Brest FEZ, food, textile, and chemical production have the highest share in the total volume of industrial production, in Gomel-Roton metallurgical production amounted to 17.9% followed by manufacture of rubber and plastic products (13.4%). In the Minsk FEZ, metallurgy and production of metal products and manufacture of electronic and optical equipment accounted for 18.5% and 16.5% respectively, while in Vitebsk the latter amounted to 25%. In the Grodno-Invest FEZ, the highest share has metallurgy and production of metal products, and in Mogilev it is manufacture of rubber and plastic products (14.3% and 18.2% respectively).

Table 8

Share of innovative products in total volume of shipped products

	2013	2014	2015
Brest	2.4	1.0	0.7
Gomel-Raton	9.0	4.6	4.0
Minsk	1.3	20.7	21.9
Vitebsk	16.1	13.2	18.2
Mogilev	14.2	9.8	5.2
Grodno-Invest	15.5	9.6	8.0

Source: own calculations

Conclusion 5: The objective to boost the output of innovative products in the country via FEZs has generally not been reached; in the majority of zones the share is lower than the national average and shows a downward tendency.

4 Lessons learnt from international experience

The number of zones has grown significantly since the 1980s. This popularity is largely fuelled by success stories such as the “miracle of Shenzhen” and the export-oriented growth performance of several East Asian countries. While economic zones have yielded rather mixed results overall, policy makers remain attracted to the instrument. Even though there is no one-size-fits all solution, there are a few widely applicable lessons to be learned from the more than 50 years since the first modern SEZ was established:

- **Integration into the industrial policy framework:** SEZs should be considered an integrated policy instrument rather than a stand-alone measure. Designing and implementing an SEZ scheme without regard for the objectives and priorities defined in a country’s industrial policy framework will yield suboptimal or even negative results. For example, the sectoral and SME focus defined in the industrial policy should be reflected in the target groups, incentive structure and services of the related SEZ scheme. In the same way other vertical and horizontal policy measures such as cluster promotion or skills development need to be aligned in order to capitalize on synergies.
- **Linkages with the domestic economy:** Research suggests that the long-term success of SEZs with regard to structural transformation depends on the level of integration with the domestic economy. While traditional EPZ models have allowed very little interaction between the zone and the rest of the country, it has become best practice to remove legal restrictions and other barriers. Allowing forward and backward linkages can promote skills and technology transfer, the establishment of local supplier networks and the integration into regional value chains and, thus, foster diversification and industrial upgrading. Accompanying policies and measures such as improvements in education and training or targeted cluster promotion can further accelerate the process.
- **Role of infrastructure and services as a means of differentiation:** Investor surveys indicate that the quality of target group-oriented infrastructure and services offered is crucial for the success of an SEZ, while fiscal incentives are of less relevance (see table below). This is especially the case in countries and regions where industrial and transport infrastructure is lacking, utility supply is unreliable and bureaucratic processes are cumbersome. The provision of serviced industrial land or facilities, reliable and cost-competitive utility supply, efficient road and port access as well as accompanying services and administrative efficiency can be a key means of differentiation and success. Furthermore, in order for SEZs to thrive, the choice of location – including access to quality infrastructure, (skilled) labour and local supplier and service networks – is of key importance. The attempt to alleviate regional economic disparities by setting up zones in rural or underdeveloped areas has proven inefficient.
- **Alignment of incentive framework to strategic positioning:** The incentive framework needs to be designed carefully to attract and support the types of activities that are desired with regard to the strategic positioning of the zone and the overall policy framework. In light of the global competition, excessive and broad-based fiscal incentives are a rather inefficient means of differentiation and have been associated with footloose industries seeking out new locations as

soon as tax holidays expire. As indicated above, non-fiscal incentives such as specialized services, efficient administration and high-class infrastructure appear to be the more promising approach to attracting investors to individual zones. In recent years, some countries – such as Malaysia – have successfully improved the effectiveness of their fiscal incentive regime by basing eligibility on strategic sectors and activities rather than location. This way, target companies can combine non-fiscal zone incentives with sector-oriented fiscal incentives, while the risk of deadweight effects is reduced.

- **Involvement of private sector in zone development and management:** A notable trend is the rise of private sector involvement in SEZ development and management. This shift allows government to concentrate on providing a conducive regulatory environment and key administrative services such as on-site customs. Furthermore, public resources are freed up for the development of important off-site infrastructure including utility and road connections. At the same time, privately operated zones tend to offer a broader set of facilities and services in line with the needs and demands of their tenants.

Table 9

Criteria for SEZ selections

Rank	Investment Criteria
1	Access to low-cost labour
2	Access to transport infrastructure
3	Cost and quality of infrastructure
4	Access to highly skilled labour
5	Business regulatory environment
6	Level of corporate taxes
7	Access to suppliers
8	Tariffs, duties, and rules of origin
9	Availability/cost of land and buildings
10	Access to local and regional markets
11	Access to technology

Source: International survey of SEZ firms; World Bank 2011

5 Policy options and recommendations

Overall, the mixed performance and rather moderate impact of FEZs in Belarus compared to successful schemes at the international level suggest that this policy instrument is not yet used to its full potential. One key reason seems to relate to the economic model of the FEZs and its positioning within the policy and incentive framework of Belarus. Despite similarities between the FEZs in Belarus and schemes in other countries in terms of incentives, services and the regulatory framework, the economic model applied and inconsistencies in the policy and incentive framework in Belarus pose significant obstacles for success.

According to international experience, FEZs have proven to be successful policy instruments if ...

- **Zones have a strong outward and/or cluster-orientation:**
Successful zones tend to attract firms that are export-oriented and that participate in global value chains. Zones are often also leveraged for cluster development. The outward and cluster-orientation can be combined. Often, the focus is shifted depending upon the development stage of a country. Developing countries tend to focus on FDI attraction and export promotion, while more developed countries tend to place increasing emphasis on cluster-development.
- **Zones offer investment conditions and benefits that are only available in a clearly demarcated area and are significantly different from the rest of the country:**
There needs to be a clear business opportunity and needs-oriented advantage of investing in a zone from the perspective of a company. If similar or even better conditions are available outside the zones, agglomeration effects and the overall impact are going to be limited.
- **Zones attract investment that would otherwise not have occurred in the country:**
If a zone only encourages firms that are already operating within the country to relocate to the zone, it would seem likely that the impact is rather limited. The genuine success of zones relates to attracting new investment, thereby generating new employment, new value addition, new exports, etc., which would not exist in the absence of the zone.

Those key success factors and preconditions are currently not or only partly reflected by the prevailing FEZ regime in Belarus:

- **FEZs in Belarus have a rather strong inward and no clear cluster-/sectoral orientation:**
The performance of FEZs in attracting export-oriented investment and in particular FDI has been rather moderate compared to successful zones at the international level. Import substitution plays an important role in the economic model and eligibility criteria. The import substitution focus differs from the established international model and is highly vulnerable to currency fluctuations unless the focus is on the substitution of the entire value chain. Furthermore, FEZs in Belarus do not have a clear sectoral or cluster orientation which could support the development of related value chains. This approach is now implemented as a core element of the industrial park which also entails a much stronger focus on FDI attraction than the FEZs.

- **FEZs in Belarus do not offer specific investment conditions and advantages that are significantly different from the rest of the country / other schemes available**

From the perspective of investors, the benefits offered by FEZs do not differ significantly from other schemes in Belarus – such as the industrial park, hi-tech park or the incentive scheme for small and medium-sized towns and rural areas. Furthermore, through individual investment agreements similar conditions are available throughout the entire country.

- **FEZs in Belarus seem to attract considerable investments that would have occurred also in the absence of the zones:**

The findings from the interviews and research indicate that a substantial proportion of investments consist of relocations or projects that would have also taken place without the scheme leading to deadweight effects and limiting the impact on the national economy.

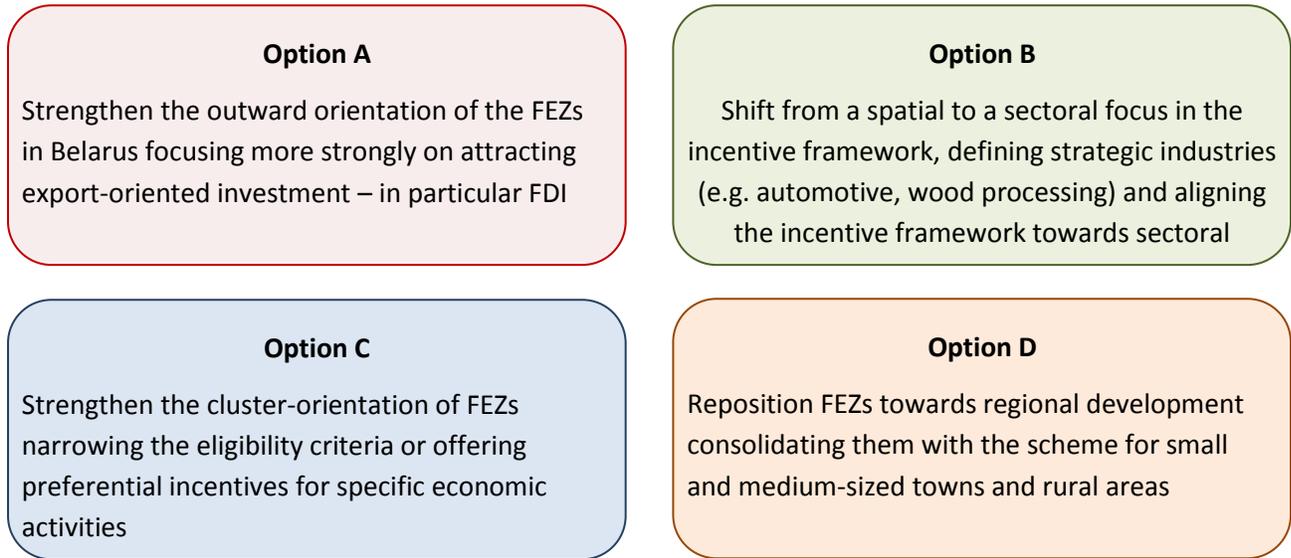
Against this background, there is a clear need to clarify and realign the rationale and economic model of FEZs in Belarus as well as the positioning of the scheme within the policy and incentive framework. FEZs in Belarus should more closely replicate the core design principles of successful schemes at the international level. At the same time, FEZs needs to be integrated into a guiding industrial policy with clear objectives regarding its horizontal, vertical and spatial focus ensuring a clear vision of the role of FEZs in this framework.

If the government of Belarus tries to improve the attractiveness of FEZs in this constellation simply by extending fiscal incentives without a fundamental repositioning of the zones and a realignment of the incentive framework, this would most likely only contribute towards a race to the bottom at the national and international level and further increase distortions, deadweight effects and fiscal losses within the economy.

Based upon the findings, the following strategic options for reforming and repositioning FEZs within the incentive framework of Belarus can be identified:

Figure 2

Strategic options for reforming and repositioning FEZs



Source: own research

Each option relates to a different set of opportunities as well as challenges and risks which are summarized in the table below.

Table 10

Strategic options for reforming FEZs and corresponding opportunities and challenges/risks

Strategic Option	Opportunities	Challenges / Risks
A. Strengthen outward orientation of FEZs	<ul style="list-style-type: none"> • Attracting more FDI projects • Integrating into global value chains • Contributing towards innovation transfer and sophistication of the economy • Increasing and diversifying exports • Increasing foreign exchange earnings 	<ul style="list-style-type: none"> • Tapping only part of investment potential • Influence of external factors (e.g. global investment trends, image of Belarus) • Risk of enclave without linkages • Upgrading of FEZs required • Competing with industrial park
B. Shift from spatial to sectoral focus	<ul style="list-style-type: none"> • Clear guidance for promoting structural change • Avoiding challenge of geographic demarcation • Integrated approach targeting domestic and foreign investors 	<ul style="list-style-type: none"> • Limited impact if concentration in selected industries is not sufficient • Fundamental reform of policy and incentive framework required (incl. substantial analysis and planning efforts)

C. Strengthen cluster-orientation of FEZs	<ul style="list-style-type: none"> • Leveraging cluster-approach for upgrading and structural change • Using zones as test-lab and catalysts • Integrated approach, combining spatial and vertical dimension of industrial policy 	<ul style="list-style-type: none"> • Limited impact of concentration in selected clusters is not sufficient • Upgrading of infrastructure and services of FEZs required
D. Reposition FEZs towards regional development	<ul style="list-style-type: none"> • Supporting broad based regional development • Reducing regional disparities • Clear differentiation between regional development schemes, industrial park and hi-tech park scheme 	<ul style="list-style-type: none"> • Tapping only part of investment potential • Limited potential to attract FDI • Neglecting vertical dimension of industrial policy • Complex consolidation / reform of incentive framework

Source: own research

Considering the strategic options and their opportunities and challenges/risks profile as well as the preconditions in Belarus, the following recommendations to reform the FEZs in Belarus can be derived. The recommendations combine elements of the identified options in order to maximize the impact and minimize the risks:

1. Reposition the FEZ scheme towards a cluster-oriented model with a strong focus on FDI-attraction:

Based upon an assessment of the cluster- and investment potential as well as of the competitive position of existing and potential further/alternative FEZs, a selection of zones should be upgraded offering incentives and conditions comparable to those in the industrial park. Infrastructures and services should be extended and aligned to the needs of the identified clusters. The zones should have a strong (but not exclusive) focus on attracting FDI. Fiscal incentives should be limited in future to investors belonging to the strategic clusters of the zones. The SEZ model in Kazakhstan follows a similar approach limiting incentives to companies in priority sectors.

Most likely, the upgrading requires significant investments in the infrastructure, services and marketing and not all zones will meet the preconditions for an international cluster-oriented positioning. As only a limited number of flagship projects will be sustainable, it would mean that probably only two or three FEZs could be upgraded. The fiscal privileges of the remaining zones should be phased out to finance the necessary investments and to reduce the burden on public budgets.

In the medium term, once a critical mass of economic activity has developed within the strategic clusters, it could be considered to shift towards a universal scheme without spatial limitations similar to the hi-tech park. The FEZs could serve as a catalyst to support the development of the critical mass benefitting from agglomeration and spill-over effects. Furthermore, individual

investment agreements could be used to promote this development path focusing on strategic investments to develop competence within the defined clusters.

Cluster / sectoral focus of SEZ in Kazakhstan

The Kazakh SEZ scheme follows a cluster / sectoral approach, setting up SEZs to foster export-oriented manufacturing and services, FDI attraction and technology transfer in specific priority sectors. Kazakhstan currently operates ten special economic zones throughout the country, all of which have been established after 2001. Priority sectors targeted – amongst others – are metallurgy and metalworking, chemical and petrochemical, logistics and transport, construction as well as the IT industry. In order to be accepted into an SEZ, companies' main activities have to be in line with the defined sector and objectives of the respective zone.

Following international best-practice, Kazakh SEZ legislation allows for private sector involvement at different stages of SEZ development and operation. Individual management companies in the form of joint-stock companies are established. Shareholders may include the government, local authorities as well as domestic or foreign private entities depending upon their experience in SEZ development and management. The management company is entrusted with all aspects of the development and operation of the zone.

2. Strengthen the focus on SME development:

As SMEs play an important role in cluster development, the reformed FEZ concept should also place particular emphasis on their needs, e.g. with respect to facilities and services offered, e.g. facilities for rent. International experience shows that FDI attraction and SME development can be successfully combined within a cluster-oriented model. The combination of the cluster-orientation and stronger focus on SME development would also support a differentiation between the reformed FEZ scheme and the industrial park. In this context, it could be considered to rename the scheme, e.g. "Cluster Development Zones".

To integrate SMEs, the minimum investment requirement should be reduced or abolished. Furthermore, it seems advisable to reform the fiscal incentives introducing a preferential treatment for SMEs. As part of a general realignment of the industrial policy and incentive framework, it could be considered to introduce such a preferential treatment for SMEs also in other schemes to support structural change, in particular within the scheme for small and medium-sized towns and rural areas. A similar approach is taken amongst others in Poland where the aid intensities of the zones are aligned to the size of the company as well as to the development stage and potential of the regions.

SME and regional development focus of the Polish SEZ Scheme

The first Polish SEZs were established 1994. Besides serving as a key instrument for FDI attraction, the SEZ scheme has been designed to off-set regional disparities in economic development. The spatial component is not only represented in the locality of the SEZs, but also in the scale of the fiscal incentives offered. Fiscal incentives are granted in the form of a tax credit based on the initial investment volume and the aid intensity defined for the region (25 – 50%).

SMEs receive preferential treatment in the form of a top up of 10 – 20 percentage points. In order to avoid deadweight effects, large companies have to demonstrate how the fiscal incentive is affecting the size, shape or location of their investment. SMEs are exempt from this requirement. In addition, SEZ incentives can be combined with other incentives available to investors including real estate tax exemption as well as cash grants from EU funds and domestic budgets.

Investor surveys indicate that besides incentives, the quality of infrastructure and access to skilled labour play an important part in the success of Polish zones. For example, the Katowice SEZ is often recommended for its excellence with regard to infrastructure, services and human resources.

3. The positioning and differentiation of FEZs should be based on services and infrastructure and less on incentives:

Worldwide, successful zones are moving from granting broad-based fiscal incentives to competing based on a target-group oriented infrastructure and quality services. Fiscal incentives are used with a more targeted approach focusing on specific types of activities and companies. Experience shows, that incentives matter as a promotional and psychological factor, demonstrating the interest of a location in attracting investment. However, incentive packages cannot offset disadvantages related to decisive location criteria such as infrastructure. They lower the investment barriers but are alone not sufficient to attract firms to invest. Nor are these efforts cost-free. The incentives offered to attract investors mean forgone tax revenues (at least in the short term) that should be reduced to the necessary minimum to relieve pressure on public budgets in Belarus. Furthermore, fiscal incentives create distortions within economies.

Also in the interviews carried out for this policy paper, firms that have invested in FEZs in Belarus considered the infrastructure (sites, utilities, electricity, water etc.) and administrative services (e.g. onsite customs services) more important than incentives. At the same time, it has been critically questioned in the interviews if and to what extent the FEZs currently offer decisive advantages regarding the infrastructure and services compared to alternative investment locations in Belarus.

Against this background, it is recommended to focus fiscal incentives more strongly on the proposed target groups. Based on an assessment of the real needs of the residents and investors, the FEZs should be encouraged to extend and upgrade their facilities and services utilizing the resources released by the strategic refocusing and realignment of the FEZ scheme.

For instance, cluster-oriented infrastructure (e.g. training or competence centres, facilities for rent) or services (e.g. supply chain development, innovation transfer services) could be offered, regulatory relief could be extended (e.g. in the areas of permits, licences or inspections).

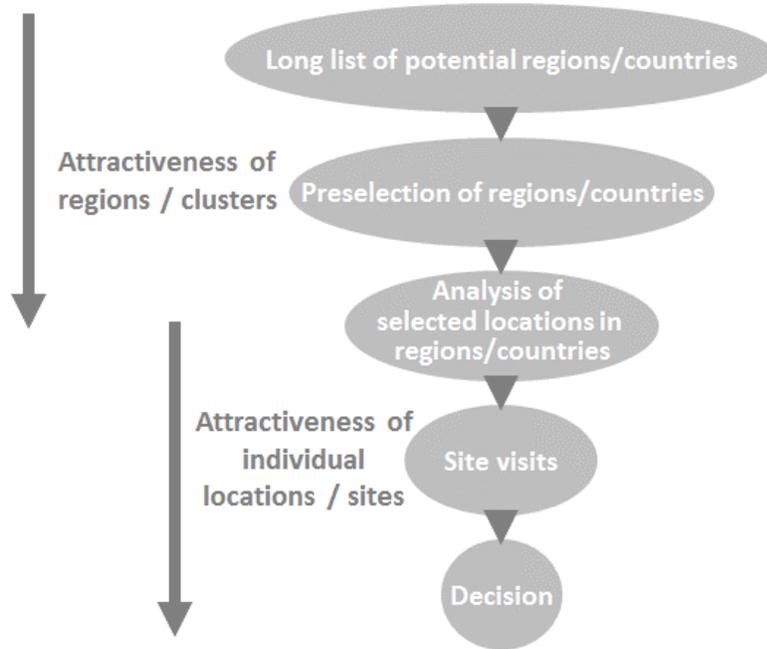
4. Target-group oriented investment promotion efforts should be intensified and after-care services extended:

Currently, investment promotion efforts are rather reactive and opportunity-driven (e.g. an invitation to a conference abroad), broad and without a clear target-group focus, and rather fragmented with uncoordinated activities by various actors. In order to unlock the investment potential for FEZs (and other locations) in Belarus, a more proactive and systematic target-group oriented approach is needed with concerted and coordinated efforts addressing the entire investment attraction cycle:

- **Target groups should be clearly defined** and regularly reviewed and updated based on an assessment of the investment and cluster potential and competitive position of the FEZs considering also opportunities to attract SMEs.
- **Target-group specific investment promotion efforts should be intensified** based on an investment promotion strategy focusing in particular on proactive lead generation campaigns – e.g. in the context of relevant trade fairs – and intermediary marketing.
- **Capacities of the National Agency of Investment and Privatization (NAIP) should be strengthened** supporting a coordinated and comprehensive promotion of investment opportunities in line with the location decision process of investors which starts at the country/regional level and not at the zone/site level (as depicted in the figure below).
- **The breadth and depth of after-care services should be extended** tapping the expansion potential of existing residents (e.g. technical and support services to encourage clustering, networking and reinvestments).
- **Monitoring should be intensified** focusing also on identifying key challenges of investors which could be taken up in zone and business environment reforms.

Figure 3

Schematic overview of investment decision processes



5. It should be assessed if public-private partnerships can be used for the proposed upgrading of the FEZs to increase the efficiency and to reduce the burden on public resources:

One of the most notable international trends over the past 20 years has been the growing number of privately owned, developed, and operated zones. Approximately 60 percent of zones in developing and transition countries are nowadays private sector developed and operated. The key factor behind the rise of private zones is the realization that private developers can make an important contribution towards increasing the efficiency and customer-orientation of the zones and that the burden the zones place on government resources can be reduced significantly. Public-private partnerships (PPP) have also become increasingly popular, with a number of different models evolving, including:

- Public provision of off-site infrastructure as an incentive for private funding of on-site infrastructure and facilities
- Provision of land for lease to private developers
- Build-operate-transfer and build-own-operate approaches combined with government guarantees and/or financial support
- Contracting private management for government-owned zones, combined with a purchase option for the private operator based on defined performance levels.

Also within the region, a number of PPP approaches have been initiated. As mentioned, Kazakh legislation allows for private sector involvement at different stages of zone development and operation. Furthermore, the industrial park in Belarus is based on a PPP model, dividing up the tasks of off-site infrastructure and providing one-stop shop administrative service and the development, management and promotion of on-site infrastructure, facilities and premises.

Building upon those experiences, it should be assessed if private developers and investors can be involved in the proposed upgrading of the FEZs to increase the efficiency and to reduce the burden on public resources.

6 Way forward

The findings of the research and in particular the review of international best-practice strongly indicate a need to realign the economic model and key design features of FEZs in Belarus as well as the positioning of the scheme within the policy and incentive framework. In order to refine the proposed reform and to prepare a policy decision, a survey-based analysis of the needs of residents and investment potentials of FEZs should be carried out.

To gain a better understanding of the underlying investment patterns and potentials, the survey-based analysis should focus – amongst others – on the following aspects:

- Main motivation to invest in the FEZs, underlying business scenario (e.g. regional markets serviced)
- Alternative locations considered
- Decisive location decision criteria
- Most important features of the FEZs (e.g. incentives, infrastructure, services)
- Key needs regarding additional services and infrastructural aspects
- Cluster potential, cooperation patterns, backward/forward linkages
- Future investment plans
- Most promising target groups for investment promotion activities.

Based on the findings, the proposed reforms could be further refined. Additional site and cluster analyses could be carried out for the most promising zones as well as corresponding implementation plans could be developed (e.g. outlining the future zone layout and service profile).

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