

FOREIGN DIRECT INVESTMENT AND SPECIAL ECONOMIC ZONES IN LATVIA

Ivo GULBIS

Riga Technical University, Riga, Latvia
Corresponding author's e-mail: ivo.gulbis@edu.rtu.lv

Abstract. The paper aims at providing insight into the effectiveness of Latvian special economic zones (SEZ) as a tool to attract foreign direct investment (FDI). The goal is accomplished through the statistical analysis of relevant data and the comparison with international examples to establish a point of reference. Countries of comparison are chosen by merit, in the form of widely acknowledged success stories regarding SEZ policy, and relative statistical similarity. The wider the pool of examples, the more conclusions can be drawn about the effectiveness of SEZ in various metrics. Based on the results, Latvian special economic zones have significantly underperformed when compared to every single example on the list. Research has been approbated in the Riga Technical University 58th International Scientific Conference “Scientific Conference on Economics and Entrepreneurship” (SCEE’2017).

Keywords: *Foreign direct investment (FDI), special economic zones (SEZ).*

INTRODUCTION

When we think about countries with strong, developing economies, we often think of foreign direct investment (FDI) as one of the top indicators of it. FDI attracts attention from the side of foreign partners in the local economy. Any investment is proof of belief in the economic situation and the promise it holds in the future. This holds especially true for FDI, where investors need to decide on cross-border investments in places that often are far away from their home countries and the familiar institutions and practices within them. The more unfamiliar the place, the higher the chances that something about the investment will go badly. In order to accept a high risk, there must be great rewards at the end of it. As such, we can surmise that the more FDI a specific place receives, the higher the confidence from the investor side that it will have a thriving economy in the future (Gulbis, 2017).

FDI also adds to regional development by addressing the factors most responsible for the lack of growth – lack of capital and expertise. It could even be argued that because of this reason, the presence of FDI is what ultimately helps the region to have a thriving economy in the future. Therefore, attracting more FDI is always high on the priority lists of governments and regional managers (Gulbis, 2017).

One of the most popular tools in attracting FDI is the special economic zone (SEZ). The exact specifics of the zones may vary, but they always offer a better business environment within their territory than what is available in the rest of the

country. That is usually accomplished by offering tax incentives, a simplified legal framework, access to better financial solutions and other benefits. The aim is to encourage potential investors in investing in the specific territory and creating new employment possibilities with everything that comes with it.

Latvia is not an exception; it has created five SEZs with the last one being added at the beginning of 2017. All of them exist for developing the regions they are in.

The present paper aims at providing insight into the effectiveness of Latvian SEZs as a tool to attract foreign direct investment. The object of the research is the Latvian special economic zones. The subject of the research is the ability of special economic zones to attract foreign direct investment. To achieve the aim of the research, a number of research methods have been used: statistical analysis, deduction, comparative, logical access and literature review methods.

The research has mainly been carried out using the statistical analysis of gathered data in cases where it was possible to find it. Due to certain data sets being very hard to acquire regarding the functioning of SEZs, a multi-faceted approach has been adopted, and cases considered holistically in comparison with relevant international examples. Among the examples there have been two main categories: countries that are known for creating widely acclaimed and cited examples of successful SEZs and countries that have been chosen for their relative statistical similarity to Latvia. The first group is to provide an example of what it means to be truly exceptional, while the second one is to show how other countries in the same range are doing. Latvia's success, failure or parity with its SEZs, if any, should be obvious.

As an additional metric, the authors have employed a simple profitability model where the gain of investment and workplaces is considered in comparison with the total area of the SEZs. This aims at showing which zones have managed to fill their space with businesses that have the potential of bringing prosperity through the increased economic activity.

The research has been restricted due to unforeseen problems in data gathering both internationally and domestically. Many countries advertise the benefits they offer in their SEZs, but a very few provide any public records of the results of the problems they have had. During the data gathering phase, it has been found out that many administrations do not gather any detailed data at all, leading to a major problem for researchers. Unfortunately, in Latvia there was one such case. Only two of five Latvian SEZs have any publicly available data about them – Rezeknes and Liepajas SEZs. Therefore, the research will mainly focus on them. At the same time, it is expected that conclusions about the SEZ situation in Latvia as a whole can be made due to the fact that all the established SEZs are roughly the same size and have been operating for the same period of time, except for the very newest one that has not had the chance to attract any investment as of 2017.

The article consists of three sections. In Section 1, the authors review scientific literature to analyse the importance of both SEZ and FDI. Special attention is paid to important lessons learned from successful SEZ examples around the world, with the greatest consideration given to examples that are roughly similar to Latvia in terms of size and/or development in order to be able to translate the lessons learned as directly as possible. In Section 2, the analysis of Rezekne and Liepaja SEZs is

conducted based on the theoretical findings in earlier sections. Section 3 presents the conclusions and recommendations for further research.

Research has been approbated in the Riga Technical University 58th International Scientific Conference “Scientific Conference on Economics and Entrepreneurship” (SCEE’2017) (Gulbis, 2017).

1. SCIENTIFIC LITERATURE REVIEW

When policy planners are thinking about FDI, they hope to accelerate economic development by attracting the much-needed foreign capital for the development of new technologies, increasing employment and competitiveness of the local economy. However, it is not so straightforward. Often FDI is not willing to create wealth out of nothing. Capital flows to the most productive enterprises only enhance the capabilities that are already there in the form of infrastructure, knowledge and labour. It means that FDI is not a miracle cure that can help struggling regions recover economically without the host country doing anything. In order to see truly great results in the local economy, host country needs to be prepared to make some major investments of its own.

There is another issue with FDI. Invested capital seeks to make profit and then return to the country that invested it instead of staying at the host country. Therefore, there is a rather tenuous link between FDI and economic growth. There is a very large gap between core, or investor countries, and host or peripheral countries in terms of gaining benefit from FDI (Akkermans, 2017). Akkermans’ research proved that the core countries, and the capital owners from them in particular, were the ones who benefitted most from the profits made by FDI. The benefit to developing countries was smaller, suggesting that FDI could by no means be called a panacea.

The host country must also possess a certain level of financial development to gain the full benefit from FDI (Desbordes & Wei, 2017). It has been found out that FDI is very sensitive to the level of availability of external finance. Moreover, if large multinational investors have been attracted to a country with a weak financial base, then the local companies might find that their ability to borrow external credit decreases as the borrowing of multinationals increases. In this situation, the country has succeeded in attracting FDI, but the net benefit might just end up being a loss due to the difficult life of the local companies.

It is very possible that the aforementioned reasons have contributed heavily to the relatively low efficiency of FDI performance between various Eastern and Western European countries (Stack, Ravishankar, & Pentecost, 2017).

Much like previous research proved that there were differences between FDI flows depending on the countries involved, there were also differences in SEZ application. China is often lauded as the premier success story in the world when it comes to SEZ. In the Chinese example, SEZ increased FDI per capita by 58 %, mainly in the form of foreign-invested and export oriented industrial enterprises and increased the total factor productivity growth rate by 0.6 percentage points (Wang, 2010).

There is much to learn from the Chinese example. First, SEZs perform best when established in a locale that already possesses attractive attributes to foreign investors, such that these investors might be expected to come to that locale if the government policy were more favourable to FDI (Graham, 2005). Graham's findings confirm the above-mentioned considerations, i.e., FDI only enhances the capabilities that are already present in the area it is put to work at. Graham also found out that the most useful part of SEZ was to serve as a demonstration for country wide economic reforms. In the Chinese case, the earliest SEZs were located in coastal provinces, near cities with plentiful workforce and a great potential in terms of market access. Such areas are already very attractive to investors. After initial success, the SEZs provided motivation for policy changes both at the provincial and national level, thus opening the economy and making China an ever more attractive destination for FDI.

However, Graham urges to be careful with adopting the Chinese example without serious consideration. While China shares many characteristics with other developing countries, it has some areas where it is unmatched. For example, its massive size both in terms of area occupied and population grants any investors access to a very large and diverse market. China also has very high literacy rates and percentage of university graduates. It has few equals in terms of developing new infrastructure, an area that is traditionally a sore spot for many nations, especially developing ones. The crime rate is low and while corruption can be an issue, it is being dealt with aggressively wherever it becomes a serious problem.

The major finding to take away from Graham's research is that while China is being lauded as the most successful example of SEZ implementation in the world, the reasons for its success are many and SEZs themselves may just be a small part of it. Any example should be viewed holistically, without any baseless optimism. SEZs can succeed in places other than China, but in China's case they might just be a catalyst that opened up the doors at the very beginning. It was the government's policy that kept them open for decades since.

Results from the world's second most populous country also show promise. Within India, FDI inflows are higher in states with higher per capita income (market size), coastal infrastructure (nearness to ports) and urbanisation (Chakraborty, Gundimeda, & Kathuria, 2017). Their research shows that the most successful Indian SEZs are located in cities or nearby areas where there is ample access to road networks, seaports and airports for easy cargo transportation.

Another interesting case is Panama. The country operates a very successful SEZ programme that has generated more than 30 000 jobs and hosting some 3500 companies, both foreign and domestic (Hausmann, Obach, Angel Santos, & Angel, 2016a). It is relevant to the discussion as both a successful example and a similar one. Located in Central America, having a relatively small population and few natural resources, its economy leverages the country's geography and thrives on the services and transportation sectors. Latvia is in a similar position, where its main advantage is its location between Russia and Europe. Panama has managed to take its main strength and make it even better with the help of its SEZs.

Not all is well in the country, however. Panama suffers from social development issues that the existing SEZs could not only fail to fix, but actually exacerbate

(Sigler, 2014). According to Sigler, the existing SEZs erect a barrier of entry (both physical and social) to the majority of Panamanian society because high quality labour is cheaper to import rather than train locally; the generous tax breaks that entice foreign investors enrich them at the expense of the state and the state's own weak commitment to use its resources for social development. The paper focuses on the need to analyse SEZs from a holistic point of view rather than a static one.

Closer to Europe we have the example of Western Balkan economies – Albania, Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia. These countries have emerged from a turbulent past mired in conflict and the breakup of a unifying sovereign state in the 1990s, Yugoslavia. This left the countries in a recession characterised by negative growth rates, rampant inflation and lack of investments. This situation somewhat mirrors the situation in which the Baltic States found themselves in after the breakup of the Soviet Union. As a part of their development strategy, the countries embarked on an incentive policy agenda that included the introduction of SEZs (OECD, 2017).

According to the OECD, the FDI that the region has managed to attract has undergone almost entirely to the automotive industry with Serbia being by far the largest recipient and receiving roughly 88 % of the entire region's FDI within the SEZs. It is the most successful example in the region that all others are trying to emulate. On the other hand, the Former Yugoslav Republic of Macedonia has come to rely on SEZs the most of all the countries in the region. Despite the relatively low FDI amounts compared to Serbia, Macedonia's SEZs accounted for 31 % of all exports compared to Serbia's 16 %. Macedonia also had a very impressive 20 % of the entire country's FDI concentrated within their SEZs (Andonova, Nikolov, Dimovska, & Mitevski, 2016).

If we are looking for a regional leader in attracting FDI in Central and Eastern Europe, that country would be Poland. In Poland, SEZs are important parts of a policy intended to prevent discrepancies in regional development and to contribute to the overall economic growth (Dorożyński, Świerkocki, & Urbaniak, 2016). Every region in the country has a SEZ that receives various levels of state aid. In terms of attracting FDI, the zones can be considered a success by having more than 80 % of all investment coming from abroad. Their study also found that it was not a tax break that enticed investors, but the offer of quality infrastructure. This conclusion essentially means that SEZs only work as a true regional development tool if the region is already developed, which seems to confirm the thoughts expressed earlier in this paper and collaborated by findings gathered from other research.

2. RESULTS AND DISCUSSION

Latvia has established 5 economic zones at the time of writing of the paper. Three of them are free ports – Riga, Liepāja, and Ventspils. Two are SEZs – Rzekne and Latgale. The main challenge during the research has been acquiring relevant data sets regarding FDI for all economic zones. Each of the economic zones is free to decide what kind of information they publish, if any at all. The free ports have presented the major obstacle related to the data provided, while Latgale SEZ

is less than a year old at the time of writing of the paper (in 2017) and thus has no data to provide.

According to the Investment and Development Agency of Latvia, Latvia has received a grand total of 13.5 billion EUR of cumulative FDI by 2016. The stock of FDI accounted for 54 % of GDP at the end of 2016, which was slightly lower than that of several other countries in the region. FDI is an important source of investment in the country and accounts for close to 15 % of total investment. That is a higher ratio than the global and EU average. Danger lies in the fact that as a member state of the European Union (EU), Latvia has access to the EU's structural funds that count as FDI when used for various purposes. The timeline for using said funds is running out and as such the country is liable to lose a very important source of funding unless alternatives are found.

That is where SEZs should come in. Only two Latvian SEZs (Liepaja Freeport and Rezekne SEZ) had enough publicly available data to be used in the present paper. All the data used in the authors' calculations regarding Latvia was obtained from the Latvian Central Bureau of Statistics.

Rezekne SEZ is located in one of the most important junctions of the major international transport corridors in Latvia. The main value comes from the closeness to the Russian border and being a major railroad hub, it makes it the perfect place for development of logistics and transport. It is a relatively large SEZ by Latvian standards, taking up 1155 hectares; it hosts 19 companies, employing 811 workers while also accounting for 75.5 % of all FDI in Rezekne (Rezekne Special Economic Zone Authority, 2017).

Liepaja Freeport is larger than Rezekne SEZ. It takes up 3979 hectares, employs 2025 people, 1200 of them in manufacturing and hosts 41 businesses. It is a port city, with one of a few ports that stay open all year round in the often-freezing Baltic Sea. The handled cargo volumes are increasing year on year, with bulk freight dominating the overall picture (Liepaja Special Economic Zone Authority, 2017). The city also has access to a newly reopened international airport, one of the three in the country that mainly handles flights to neighbouring countries.

Several different international examples have been chosen to compare against Latvian SEZ in terms of operational data. Problems in obtaining enough data for statistically similar countries and the lack of universally accepted metrics by which to compare countries made the authors take a different, merit-based approach. The countries that have been chosen are either world leaders in certain areas at one point, like Dominican Republic with a number of people employed and China with possibly the most well-known SEZ success story in the world. Jordan is a country located in a volatile region that has succeeded in creating a self-sustaining SEZ despite all the adversity surrounding it. Panama, Serbia and Poland are similar in terms of education levels, GDP per capita, placement in World Bank's "Ease of Doing Business" index and in the case of the latter two, geographically close enough to be considered effective examples of comparison.

In order for a SEZ to serve as a regional development tool, it has to comply with these basic prerequisites:

- employ a significant number of people;
- attract a large amount of investments;

- provide the region with a knowledge spill-over effect;
 - promote a clustering effect within the relevant industries.
- The number of people employed by the SEZs is shown in Fig. 1.

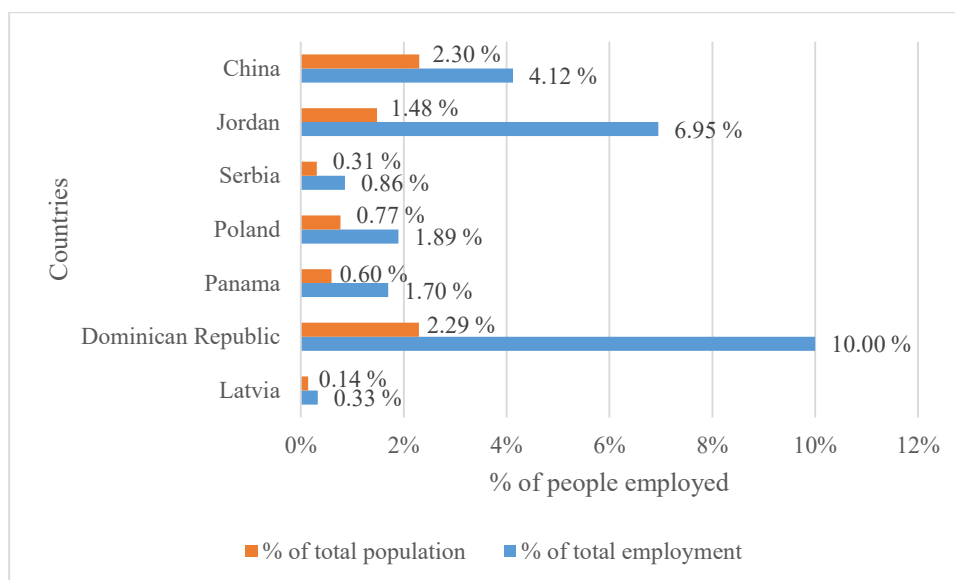


Fig. 1. The number of people employed by the SEZs, %.

When it comes to employing people, the results can be seen in Fig. 1. Rezekne SEZ employs 2.7 % of total inhabitants of the city and merely 0.29 % of Latgale region inhabitants. Meanwhile Liepaja SEZ employs 2.6 % of total inhabitants of the city and merely 0.80 % of Kurzeme region inhabitants. When combined, the two zones employ 0.14 % of Latvia's total population and 0.33 % of the total employed within the country (Central Bureau of Statistics of Latvia, 2017). It should be mentioned that since other SEZs exist in Latvia besides the two mentioned, the total percentage point is slightly higher, but not by much, since none of the remaining zones excel in this regard more than the two examined ones.

In order to understand numbers, it is important to view them in context. One of the most successful examples in SEZs comes from Dominican Republic, where they were used to kickstart a very successful textile and apparel industry. At the peak of its programme in the 2000s, the zones employed up to 10 % of the country's total employment or roughly 2.29 % of the country's total population at that time (Farole & Akinci, 2011). Jordan follows up closely with nearly 7 % of total employment and 1.48 % of the total population (World Bank, 2017). At the time of writing of the paper, Jordan has been grappling with a high level of unemployment that breached 18 %, making the Aqaba SEZ a much-needed success story. It is followed by the highly praised Chinese model, which has seen to the creation of a SEZ economic model that has ensured the employment of more than 30 million people, a number that stands out even among its huge population as a very significant one (Zeng, 2016a). The overall successful, but less employment intensive example of Panama employs around 1.7 % of the total employed people in the country or roughly 0.6 % of the total population (Hausmann, Obach, Angel Santos, & Angel,

2016b). For example, closer to home, Poland's successful SEZ programmes employ 0.77 % of the country's total population and 1.89 % of the total employed people (World Bank, 2017). At the same time, Serbia employs 0.31 % of the total population and 0.86 % of the total employed people (World Bank, 2017). In this light, Latvia's example is nowhere near one of the top examples in the world and is underperforming when viewed regionally. Amount of FDI attracted by SEZs from the country's cumulative total is shown in Fig. 2.

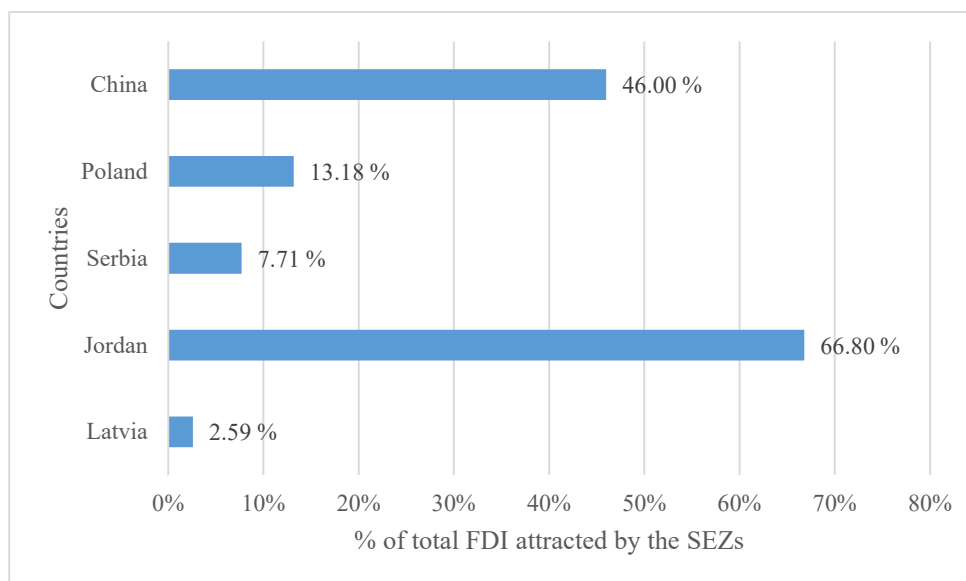


Fig. 2. The amount of FDI attracted by SEZs from the country's cumulative total, %.

In terms of attracted FDI (see Fig. 2), the two Latvian zones have received 2.59 % of Latvia's total cumulative FDI through the years (Investment and Development Agency of Latvia, 2017). While the total is likely higher, it is not by much since the remaining SEZs are not likely to significantly outperform the examined ones. Some very successful international examples include Jordan with its Aqaba Special Economic Zone that alone has attracted 66.8 % of the country's total stock FDI (Zeng, 2016b). Other examples include China with 46 % (Wang, 2010), Serbia with 7.71 % (OECD, 2017) and Poland with 13.18 % (Dorożyński, Świerkocki, & Urbaniak, 2016). China's numbers are showing why the model was considered a success for them. When development levels are considered, Serbia and Poland are closer matches and Latvian SEZs have underperformed in comparison with them.

Knowledge spill-over effect is always difficult to ascertain even in the best of times. Currently we can tell only two things. First, the SEZs in question employ 0.14 % of the total population and even less of that in manufacturing within the SEZs. Second, 48 % of businesses registered within the SEZs are in the manufacturing sector (Rezekne & Liepāja Special Economic Zone Authorities, 2017). At the same time, a lot of them are working within spheres that Latvia already has a lot of experience in, such as woodworking and metalworking.

Businesses dealing with traditionally high-tech manufacturing, like the assembly and manufacturing of electronic components, are few and far between. Due to the already small number of people employed and the rarity of businesses operating in domains where knowledge spill-over is desired most, we can conclude that the spill-over effect from Latvian SEZs is minimal.

The potential for clustering effect occurs from the involvement of businesses both within and outside of SEZs with each other and establishing mutual supply, labour and knowledge networks. Early research conducted in this area has revealed that there is very little obvious involvement between the businesses in SEZs and members of the various Latvian business associations and their members (Gulbis & Geipele, 2016).

One more metric can be used when discussing SEZs: productivity. Traditionally measured by the ratio of outputs to inputs, the productivity of SEZ can be determined by measuring the gain of jobs and FDI per hectare. At the same time, it should be noted that this measure can vary wildly due to the type of industrial activity that is happening. High technology and automation levels can lead to a relatively low number of jobs, but high amounts of investments in technologically demanding fields. Low amount of FDI and high number of jobs usually means that it is low wages that have attracted employers to fulfil their demand for manually intensive labour. High amount of FDI and high number of jobs is the ideal situation, signifying a bustling enterprise that fulfils all sorts of requirements. Low FDI and low number of jobs is the exact opposite and shows that the level of economic activity is low. Jobs created per hectare within the SEZs are shown in Fig. 3.

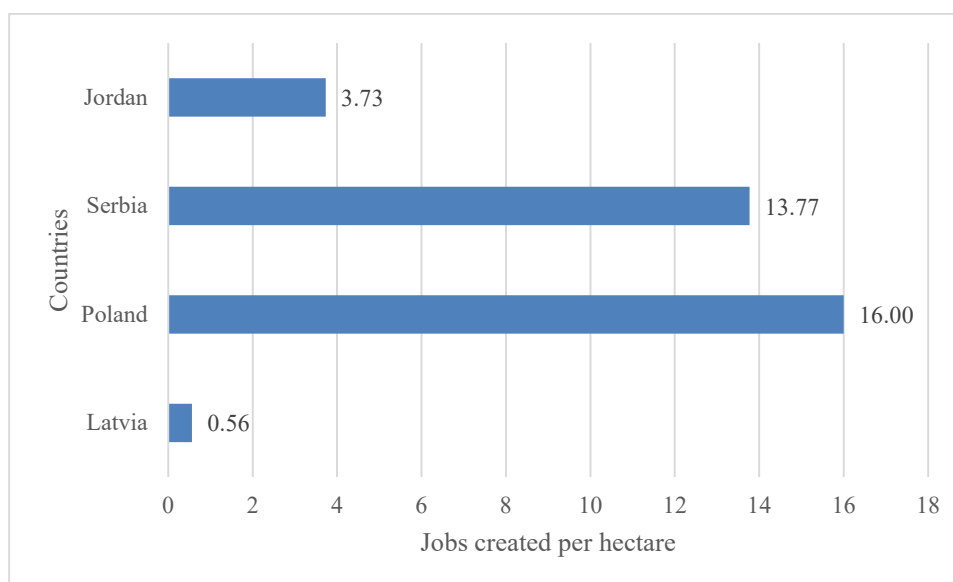


Fig. 3. Jobs created per hectare within the SEZs.

In this metric (see Fig. 3), Poland does by far the best from the reviewed examples with 16 jobs per hectare. Serbia follows it with almost 14 jobs, the vast majority in the automotive industry. Jordan's score can be deceptive, its Aqaba SEZ takes up 375 m², more than three times the rest of the examples combined. With a

vast land area, the result it has speaks of a very active economy. Latvia underperforms in this metric by a significant degree. At 5134 total hectares between Liepaja and Rezekne SEZs they are three times the size of Serbia's SEZ, but have created merely 4 % jobs compared to Serbia. Poland's SEZs are more than 3 times the size of Latvia's yet they managed to lead in terms of jobs created among all the examples analysed. It should be noted that China is missing from the final two tables because the area given to SEZ and their variants is constantly changing and no up-to-date data is available, making such calculations impossible. FDI attracted by the SEZs per hectare (thousand EUR) is shown in Fig. 4.

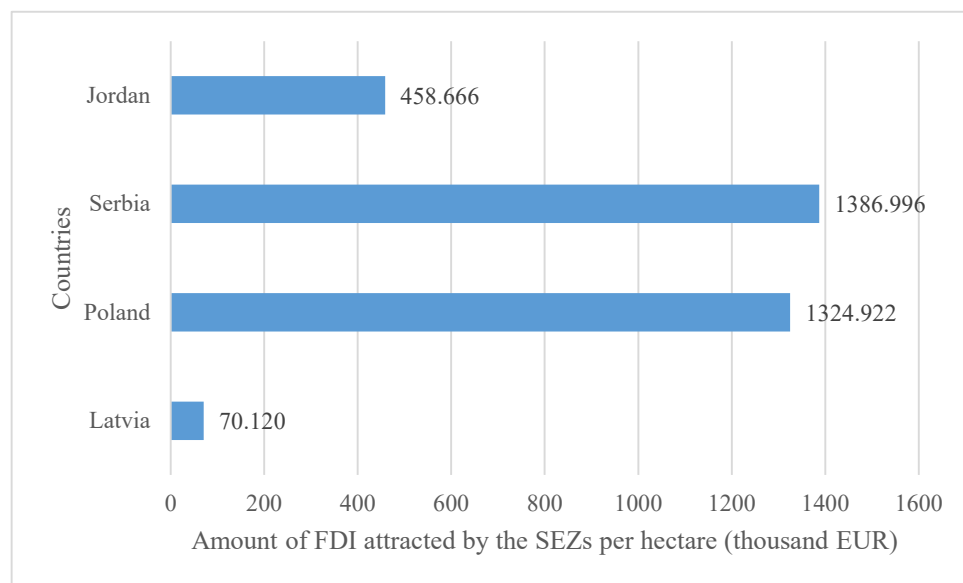


Fig. 4. FDI attracted by the SEZs per hectare, thousand EUR (Source: Relevant SEZ authorities, 2017).

Figure 4 shows the success of various SEZs in attracting FDI. Serbia slightly leads the list of examples. It is facilitated by a large investment by Fiat Automobiles Serbia's investment worth 1 billion in one of the SEZs, which makes up 45 % of the total investment received by Serbian SEZs (OECD, 2017). Poland has a more diversified investment profile, but we can see that it keeps close with Serbia both when it comes to FDI attracted and jobs created. The two countries have managed to attract both technologically and labour-intensive industries and have only gained from that. Latvia underperforms in the FDI department by a rather significant margin. Given that it has underperformed in the job creation as well, the only conclusion that can be made is that Latvian SEZs cannot achieve their intended goal of regional development as long as the economic impact they have is so miniscule.

CONCLUSION

The issue that struck out immediately was the lack of publicly available data regarding SEZ performance, both local and international. There is no unified metric

as to what data should be gathered about SEZs, each country and administration does as much or as little as they see fit, assuming they do anything at all. If all data is scrambled and inconsistent, it makes it extremely challenging to find similar SEZs for comparison. Examples that would be close in terms of size, economic development, geographic location and other metrics can become unusable due to simply not having similar data gathered about them. More research can and should be conducted about what kind of data metrics can be best used to gauge the effectiveness of SEZs and their gathering should be encouraged by administrations and researchers everywhere. Without data it is extremely challenging to have any sort of conversation about SEZ and foreign direct investment, despite the importance it has for countries.

Its importance can be seen from how every country in the world seeks to attract FDI and use it as a tool for growth. However, FDI is not a magical solution for economic growth from nothing, it merely enhances what is already there. For that reason, it is always attracted towards already established regions where it can achieve optimum return. Special economic zones can be an effective tool for attracting FDI and achieving economic growth, provided they are used right.

The example of Chinese SEZs teaches that they should not exist in a vacuum but should be supported by a purposeful governmental policy. They should be used as test beds for economic policy and things that work should be implemented in the rest of the economy. Should SEZs be viewed through a narrow point of view, there is a danger that it exacerbates economic inequality between regions.

The current situation in Latvian SEZs in terms of their ability to promote regional development and FDI accumulation is not promising. The existing zones are not very open with their operational data, which complicates the research. When their performance is compared to several international examples, it is obvious that they have underperformed in every metric. While countries like China, Dominican Republic and Jordan have achieved something great and not easily replicable, their example can be used as a goal that Latvia is currently far from reaching.

The situation did not improve when comparisons were made with statistically similar countries in Panama, Serbia and Poland. Their SEZs can be considered success stories within their respective regions. Although impressive, they have done it within a similar timeline and resources that Latvia has. Unfortunately, Latvian SEZs could not reasonably compete in any metric that was reviewed as a part of this paper with any of the countries that they were compared to. This paints a bleak outlook for the future as it shows that in the decades in which the SEZs have been established, they have achieved little to show for it and there is little reason to expect significant improvement anytime soon.

As of 2017, there is little available information in the public space about the effectiveness of Latvian SEZs. There is little public oversight of such important economic tools that have been intended as an important tool to revitalize the struggling regional economies. The first step to remedy the situation would be to start an open dialogue about the actual performance of the SEZs within the country and metrics by which to judge them. As the situation stands currently, there is suspicion that Latvian SEZs are treated as simple solutions to complex problems. Unless there is a significant change on the policy level, it is unlikely that Latvia will be able to join the list of countries that can be cited as positive examples for SEZ implementation.

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AUTHOR'S SHORT BIOGRAPHY

Ivo Gulbis, *Mg. oec.*, is an Assistant Researcher and a PhD student at Riga Technical University, Latvia. He obtained the Master's and Bachelor's degrees in Customs and Tax Administration from RTU. His PhD studies are in Management and Economics at Riga Technical University. He has work experience as an Assistant to a Member of the Parliament of Latvia and as a participant in multiple studies about the business environment of Latvia. Since 2015, he has participated in scientific conferences, congresses and workshops. His current research interests are special economic zones and industrial clusters.

ORCID iD: <http://orcid.org/0000-0001-9274-3466>