The Pakistan Development Review
42 : 4 Part II (Winter 2003) pp. 927–940

An Evaluation of Karachi Export Processing Zone: A Preliminary Investigation

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1. INTRODUCTION

The literature on EPZs shows that these are a second-best solution compared with generalised countrywide reforms, but that, where countrywide reforms are difficult to implement, they can be a useful weapon in the development arsenal [World Bank (2001)]. EPZs have been instrumental not only in increasing exports but also attracting export-oriented foreign direct investment (FDI). China is a classic example to be mentioned here where the levels of FDI have gone up massively over the last ten years. Added up with exports increase are also the benefits of employment generation, development of backward and forward linkages and strengthening the industrial base.

The phenomenon of export-processing zones (EPZs) is a part of broader context of structural changes in global economic development. During the last few decades, there has been a tremendous increase in exports of manufactured goods especially from developing countries. EPZs have emerged as an important channel of export generation, especially of manufactured goods, from most of the developing countries e.g. East Asia, Mexico, Morocco etc. Their significance cannot be undermined because of the location-specific advantages and infrastructure facilities possessed by them.

The concept of EPZs covers various types of zones e.g. free trade zones, duty-free zones, free-investment zones, offshore zones representing various types of activities being performed over there. The activities include bonded warehousing, export processing, assembling, trade through borders or by sea and financial services. The EPZs are defined as "fenced-in industrial estates specialising in manufacturing for export and offering their resident firms free-trade conditions and a liberal regulatory environment [World Bank (1992)].

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Since the establishment of KEPZ, there appears to be no study in Pakistan, highlighting the performance and evaluation of KEPZ in terms of its achievements and contribution in the economy as well as problems being faced by the firms operating over there. This study is an attempt to fill this gap and explore the implications of establishment of Karachi Export Processing Zone in Pakistan.

The section that follows highlights the significance of EPZs and efforts by Pakistan economy in this context. Section 3 draws on research methodology employed for the survey while results are presented in Section 4. The study leads to certain policy implications mentioned at Section 5 while the final part concludes.

2. THE ECONOMICS OF EXPORT PROCESSING ZONES (EPZS) AND PAKISTAN

EPZs are created with the primary objective of exports generation/ augmentation resulting into increase in foreign exchange earnings, labour absorption and competitiveness development in the export market. These can also attract FDI engendering technology transfer, knowledge spillover, demonstration effects and backward linkages. EPZs inherently possess a positive welfare effect for the host economy since wages paid to the local labour tend to be much higher than their local counterparts, thus, raising the living standards as well. These are described as industrial zones with special incentives set up to attract foreign investors in which imported materials undergo some degree of processing before being re-exported [ILO (1998)]. These are clearly delimited and enclosed areas of a national customs territory often at an advantageous geographical location with an infrastructure appropriate for carrying out trade and industrial operations and subject to the principle of customs and fiscal segregation [Madani (1999)]. Data on EPZs during the last two decades, from various countries, reveals the fact that expansion in manufactured exports is mainly attributed to these sorts of zones. Examples of Taiwan, China and Malaysia can be quoted here where almost 55 percent to 75 percent of the exports are reported to originate from these zones [Sivalingam (1994)]. Same is the case with Mauritius, Kenya and Mexico where around 50 percent to 95 percent of exports are generated from such areas [Warden (1999, 1999a)].

Pakistan, being one of the staunch followers of import substitution industrialisation (ISI), tried to reverse the trend by tilting towards export-oriented policy of industrialisation and development. Pakistan started liberalisation of its trade regime during the Eighties. The first export-processing zone was established in 1981 at Karachi. The purpose of the zone was to attract investment both from internal and the external sources. The zone was believed to be useful in attracting the export-oriented FDI from abroad. It allows for investment both in warehousing/trade sectors as well as industrial sector. It also provides both the physical and fiscal incentives at par with world standards (Table 2). The establishment of KEPZ can be considered as one of the tools to offset the phenomenon of *anti-export bias* inherent in Pakistan's trade policies based on the ISI strategy.

Measures to boost up export performance of Pakistan e.g. exchange rate devaluations, export incentives and the establishment of EPZs and other economic zones in the country have always been at work since the early Eighties. The 1997 Industrial Policy also provided assurances about the development of industrial, trade and export processing zones in various cities of the country like Multan, Gujranwala, Sialkot, Faisalabad, Peshawar and Quetta. The aim is to develop a vibrant trade sector to expand exports and attract larger FDI inflows. A range of fiscal, trade and other incentives are offered to investors at the zone, along with the development and modernisation of infrastructures facilities (Table 2). In continuation of this policy, the government is actively seeking to improve the physical infrastructure of the national economy. Some examples of this gesture are the construction of a motorway linking the industrial region of Punjab with the capital city of Islamabad (with eight industrial zones planned along it); plans for the construction of further motorways; and attracting foreign investors into power generation and improvements in the telecommunications networks. Presently, Pakistan lags behind many countries in terms of number of export processing zones (Table 1), that may allow producing for international markets. This undoubtedly limits the economy's attractiveness towards export-augmenting type of FDI.

Table 1

Export Processing Zones in Some Selected Asian Countries

Country	No. of Zones
Bangladesh	2
China	124*
India	4
Indonesia	26*
Malaysia	11
Pakistan	**2**
Sri Lanka	2
Thailand	1

Source: UNCTC (1988); United Nations (1992); World Bank (1997b); BoI (1998); IIC (1997); MIDA (1996); Global (1998); Cyber Market (1998); Ernst and Young (1992, 1994); BoI (1997).

Notes: * The figures include both the EPZs and Free Zones.

Table 2

A Comparative Profile of the Major Fiscal, Physical, and Administrative Incentives Being Offered by EPZs Across the Globe

Countries/Incentives	Malaysia	Korea	Philippines	Sri Lanka	Pakistan	China
Tax Exemption	Yes	Yes	Yes	Yes	Yes	Yes
Tax Holiday Period	8–10 Years	5 Years	4–6 Years	5–15 Years	N.A.	1–5 Years
Duty Free on Imports						
Equipment	Yes	Yes	Yes	Yes	Yes	Yes
Machinery	Yes	Yes	Yes	Yes	Yes	Yes
Parts/Spares	Yes	Yes	Yes	Yes	Yes	Yes
Raw Materials	Yes	Yes	Yes	Yes	Yes	Yes
Duty Free on Exports	Yes	Yes	Yes	Yes	Yes	Yes
100% Repatriation of Profits	–	–	Yes	–	Yes	Yes
Reduction Red Tape						
(i) Simple Procedure	Yes	–	Yes	–	Yes	Yes
(ii) One-stop Shop	–	Yes	–	–	Yes	–
Others			VAT Exemption		No Limit on Investments; freedom from import and Exchange Controls	

Source: 1. Kusago and Tzannatos (1998); 2. KEPZA (2002).
Notes: Information not available.

Exports of Pakistan are mainly concentrated in primary goods sector like cotton and rice which has not been able to generate the required level of earnings to support the process of economic growth. Given the persistent levels of deficits in balance of payments of Pakistan, there stands a dire need for diversification of exports both in terms of products as well as destinations. Given the strategic position of Pakistan of being close to the economies of Central Asia (CA) and Gulf, there exists an immense potential to integrate with the world through trade.

Pakistan merits for comparison, across the countries like Malaysia, Korea, China and Philippines as exhibited by Table 2 above and stands at par with them along the parameters discussed over there. Whether it is tax exemption, duty free imports/exports or the repatriation of profits, Pakistan offers the same fiscal, physical and administrative incentives as being offered by EPZs across the globe. Besides having same grounds, the total investment at KEPZ does not seem to be impressive. One of the obvious reasons might be the number of such zones (only one) in Pakistan compared with those in countries like Malaysia, Indonesia and China (Table 1).

The inability of KEPZ towards employment generation is manifested through Table 3. Where in absolute terms, the number of people employed at the zone is 2000 while this number is the lowest across other countries. In relative terms, KEPZ also stands low performer on employment front as only 0.048 percent of the labour is absorbed by the KEPZ out of the total industrial employment in the economy whereas this employment percentage appears to be high for rest of the South Asian counties as reflected by Table 3.

Table 3

A Comparison of EPZ Employment and Industrial Employment for 12 Countries (Year 1990)

Country	EPZ Employment	Industrial Employment	Country	EPZ Employment	Industrial Employment
India	30,000	6,245,000	Sri Lanka	55,000	236,760
Indonesia	50,000	2,259,200	Taiwan	70,700	3,420,000
Pakistan	**2,000**	**4,100,000**	Jamaica	15,000	136,100
Bangladesh	7,000	13,100,000	Dom. Rep.	115,000	157,576
S. Korea	20,300	4,198,000	Philippines	35,400	1,580,000
Malaysia	98,900	841,800	Thailand	12,000	2,191,800

Source: Schrank (2001).

3. RESEARCH METHODOLOGY

The purpose of the research was both analytical and exploratory. Primary data was collected to examine various aspects of KEPZ in Pakistan. The cross-sectional data was collected through a questionnaire-based survey of companies, both foreign and local, at the zone through interviews with managers of the firms. The questionnaire was pre-tested by piloting among four of the firms at KEPZ and after discussion with some of the academics at universities. The whole population of firms at the zone was intended to be the probable target for the survey. Initial survey revealed that there were 90 firms in total operating at KEPZ, 31 being local and 38 as foreign with a total investment of $ 81.041 million. Out of the total of 90 firms, only 50 responded to the request to participate in the survey to provide the required information. However, Interviews were conducted for 40 of the firms while questionnaires were left with 10 numbers of firms whose managers were not available for an interview, due to their prior commitments. Despite the consistent follow up of these firms, the questionnaires could not be received back even through mail. Managers of 25 of the firms declined to participate in the survey as it was against their policy to participate in such study while 15 of the firms were found to have closed down their businesses. Some of the features of the firms surveyed are produced below (Table 4).

Table 4

Features of the Sample Surveyed

Period of Entry	No. of Firms	Total Investment (Million US Dollars)	Nature of Business	Country of Origin
1981-85	04	$ 2.9	Electronics (1), Precision Mechanics (1), Garments (2)	UAE, Hong Kong, France, USA
1986-90	07	$ 7.032	Electronics (1), Garments (1), Leather (1), Miscellaneous (4)	South Korea, USA, Sri Lanka, Pakistan, UAE, Tanzania
1991-95	13	$ 13.375	Electronics (1), Light Chemical (1), Garments (5), Food Processing (1), Paper / Printing (1), Packaging (2) Misc. (2)	Taiwan, Pakistan, Switzerland, Germany, U.K, UAE, USA
1996-00	14	$ 5.695	Electronics (2), Engineering (1), Specialised Fabrics (1), Yarn Processing (2), Garments (2), Paper/Printing (1), Packaging (1), Misc.(4)	UK, USA, Australia, Pakistan, UAE
2001-02	02	$ 1.815	Light Chemicals (1), Garments (1)	USA, UK, Canada, Pakistan

Source: Based on this author's survey.

4. RESULTS OF THE SURVEY

The survey results are produced below where answers to the desired questions are sought. The results of the survey need to be viewed with caution mainly on account of the following reasons. Firstly, an interview *bias*, resulting from the on-site visits and; secondly, an eventual *bias* by non-response of some of the firms at KEPZ, affecting the overall response in a more positive or negative way.

4.1. Ownership Pattern

The nature of ownership patterns of firms is affected by various factors e.g. availability of incentives, scope for alliance with local partners to acquire the local market's knowledge, legislative requirements and market opportunities. Such factors can encourage or discourage a specific pattern of ownership. In most cases, company's strategy seems to be important that could, in turn, be determined by many other factors like maintaining quality, control, profits and confidentiality of technological information[1] [Lecraw (1977)]. The ownership pattern of foreign firms is also found to be significant in determining their success in business [Buckley, *et al*. (1988), p. 71]. Hence, ownership pattern gives signals towards locational features at EPZs, degree of competitiveness of firms and their success in business.

Out of the 21 foreign firms surveyed, 50 percent were wholly owned foreign companies while 40 percent had a joint venture with foreign firms. This gives the impression that foreign firms have a tendency to share the ownership with their foreign counterparts. This might be due to the fact that local firms are not competitive enough to be partner with the foreign firms. This result is reinforced by the findings on local partnership advantages where 90 percent of the firms affirmed that such advantage were not available in Pakistan.

Foreign firms included in the survey were asked to rate the major factors in developing the ownership type in Pakistan. The respondents were asked to rank on a scale of 1–4, with 1 as most important while 4 as unimportant, out of the given factors like legislation in Pakistan, policy of the company, pre-existing competition and local partnership advantages or any other factor(s) perceived to be relevant by the firms.

The response towards legislation in Pakistan, as being an important factor, was mixed as 37 percent of the firms ranked it important and an equal percentage ranked it as unimportant. Majority (89 percent) of the firms ranked policy of the company as the most important factor and local partnership advantages as the unimportant one. Pre-existing competition was ranked as important by 47 percent of firms and as average by 37 percent of them.

4.2. Production Activity

The production activity of firms at EPZs needs to be facilitated through various types of complementary amenities. These include; availability of sub-contracting facilities, necessary raw materials, availability of the required labour at cheap rates and the minimal degree of labour disputes. Such factors serve as locational advantages and enhance competitiveness and profitability of firms, especially the efficiency-seeking ones. Competitive pressures resulting from higher costs force the firms to produce beyond their original location [Wells (1983)].

[1]Especially for the high-technology firms.

Significance of some of these factors (e.g. availability of cheap inputs, labour and land) is also supported by the studies of Chen (1983); Kumar and Kim (1984); Wells (1983) and Artisien *et al*. (1991).

Firms at KEPZ were mainly involved in the business of producing finished goods as revealed by 75 percent of the firms which participated in this study. This alludes to the fact that KEPZ has the potential for value addition in GDP originating from exports of these goods. This value addition can go higher if high value added goods are produced at the zone and exported abroad.

Regarding the availability of raw materials at the zone, a majority of firms (80 percent) expressed that such requirements were not fulfilled in Pakistan. Non-competitiveness of local supplies and poor quality supplies were the main reasons that surfaced as important in this regard. The quality of labour force available in the zone was found to be consistent with the demands of firms over there. This is reinforced by the fact that 70 percent of the firms rated the quality of labour as good while 25 percent of them rated it as excellent.

4.3. Marketing Strategies

The question of exploring the issue of marketing strategy of firms at KEPZ resulted from the need to determine the degree of competitiveness of firms at the zone and the nature of objectives of firms like profitability, growth or both. Such considerations are greatly linked with the nature of market being served, as choice of the right market is considered to be important for sales generation [Buckley, *et al*. (1988), p. 99]. Factors like price and quality controls have been found to be important in the strategy of international firms [Rabino (1984); Dunning (1986) and Dunning and Norman (1987)].

Firms at the zone were found to be generating sales at varying levels. For 33 percent of the firms surveyed, sales were reported to be in the range of Rs 1 to 25 million. For 25 percent of the firms, sales were between Rs 5 to 100 million. Export Markets trends were found to be consistent with the purpose of EPZs establishment as 80 percent of firms were found to be exporting abroad in the international markets. Countries of UAE and Gulf appeared to be the major export markets (48 percent firms) followed by the Europe (18 percent) and America (15 percent).

4.4. Human Resource Profile

EPZs are believed to be instrumental in solving the problems of unemployment inherent in most of the developing countries. An EPZ can facilitate the development of an effective labour pool, create both competition and synergies between firms, and facilitate the marketing of a country to foreign direct investors [World Bank (2001)]. The survey results reveal that there appeared to be a relative concentration of production workers as compared to technical workers. This reveals that demand for production workers is greater for firms at the zone.

EPZs have the potential to contribute towards human capital development if foreign investors engage in substantial training and create the environment of learning by doing. This is expected to make local labour force more productive and can foster managerial and technical skills among local workers and entrepreneurs. Transfer of know how aspect can not be ignored as 83 percent of the firms surveyed were found to be providing on job training to workers at KEPZ.

Regarding demand for labour by the firms at KEPZ, it was revealed that 85 percent of firms were after the skilled or semi-skilled labour force. For majority of the firms surveyed, their demand for labour was equally matched by the supply of labour. This alludes to the fact that Pakistan needs to sustain the availability of such types of labor force at the zone to attract more and more firms over there. This result is further supported and strengthened as 70 percent of the firms rated the quality of labour as good while 25 percent of them rated as excellent.

4.5. Investment Climate

This part of the questionnaire was related only to foreign firms. They were required to rate the investment climate in Pakistan through some of the locational factors provided in the questionnaires as highlighted by the literature on location factors. This was of considerable importance to be known as investment climate at KEPZ, in particular and the economy in general, indicates the degree of support provided to foreign investors for their operations. EPZs are considered to be sensitive to national economic environment and perform better when sound macroeconomic and realistic exchange rate policies are performed [Madani (1999)]. Various factors are found to be relevant to firms at EPZs in context of the investment climate at such zones. These include; attractive political climate and host country's alluring attitude towards FDI [Ajami and Ricks (1981)], good infrastructure, tax concessions and absence of exchange controls [Chen (1983)], general business environment and incentives [Kumar and Kim (1984)], political stability [Bürgenmeier (1991)] and availability of financial assistance [Hood and Taggart (1997)]. Hence, the study was intended to investigate and analyse the investment climate at KEPZ proxied through some of the relevant parameters. This also helped in finding out the positive and negative features of business environment at the zone. The firms included in the survey were required to rate some of the locational variables in Pakistan with regard to investment climate. A scale of 1 to 5 was designed for this, rating 1 as high and 5 as very poor.

EPZs are more likely to be successful when there exists the lowest amount of risk, a liberal foreign exchange regime, stability in currency, transparency in regulatory regime and good institutional response. Most of the firms at KEPZ were of the opinion that legal framework in Pakistan was either moderately defined or vague as for only 25 percent of the firms it was found to be clearly defined. Pakistan was considered to be a high risk country with respect to investment as reported by 50 percent of firms in the survey. The same is confirmed by the fact that currency stability was rated as low by 80 percent of the firms and political stability was rated as very poor by 76 percent of the firms. Most of the firms (85 percent) also revealed that foreign exchange regime was partially liberal in Pakistan. For 62 percent of the foreign firms operating at KEPZ, response of the institutions dealing with investment and export process in Pakistan was considered as adequate while by only 29 percent of firms, it was considered as good.

Investment incentives at the zone were not considered to be very favourable or high by majority of the firms. Only 40 percent of the firms ranked them as moderate and the rest were below this. Almost half of the firms were of the opinion that state encouragement and local partnership advantages were poor. This presents a bleak gesture of government policies towards export augmentation and industrial development in Pakistan. As far as Business and Industrial linkages were concerned, the response was in middle of the continuum as 35 percent of the firms ranked these as moderate while the same percentage of firms ranked such linkages as low. Regarding infrastructure facilities in Pakistan, they are not considered very well by the foreign firms. The response was more on the low side (Table 5). Foreign firms do not really seem to be satisfied by export facilities and export concessions. Such facilities were rated as moderate by 65 percent to 70 percent of firms respectively. Only 15 percent of firms rated the export facilities as high while 20 percent of the same rated export concessions as high. Likewise, no special privileges, like one window operation, export rebates and concessions, were mentioned to be available to firms at KEPZ as majority of firms denied the availability of such facilities. Most of these findings are consistent with those by Akhtar (1999).

Table 5

Ratings of Investment Climate (Locational Variables)

Variables	Rating in Percentage (%)				
	High	Moderate	Low	Poor	Very Poor
Investment Incentives	5.00	40.00	35.00	15.00	5.00
State Encouragement	0.00	15.00	30.00	50.00	5.00
Local Partnership Advantages	0.00	10.00	0.00	50.00	40.00
Business and Industrial Linkages	0.00	20.00	35.00	35.00	10.00
Infrastructural Facilities	10.00	40.00	35.00	10.00	5.00
Export Facilities	15.00	70.00	5.00	0.00	10.00
Export Concessions	20.00	65.00	5.00	5.00	5.00
Political Stability	0.00	0.00	5.00	20.00	75.00

Source: Based on this author's survey.

4.6. Industrial Linkages and Infrastructure

Linkages foster growth in the economies which are industrially sound and developed e.g. Korea and Taiwan [Madani (1999)]. Promotion of backward industrial linkages is one of the essential outcomes of EPZs. Growth and development of these linkages is expected to be inconsistent in the countries where quality of inputs or raw materials has been poor. There did not appear to be a promising result in context of availability of linkages at KEPZ. The existence of business and industrial linkages was rated as poor by 50 percent of the firms while very poor by 40 percent of them.

Infrastructure is one of the critical factors in determining the size of investment in any of the EPZs. Adequate and good quality infrastructure would strengthen the position of an economy towards attracting export-oriented multinational companies (MNCs). The firms in the study were not found to be satisfied with the level and quality of infrastructure available at KEPZ. The areas where most of the firms showed dissatisfaction were the facilities like fire-brigades, water supply and electricity. The quality of infrastructure was rated to be moderate by 40 percent of the firms and low by 35 percent of them. Only 10 percent of the firms rated it as high.

5. POLICY IMPLICATIONS

Pakistan is mainly dependent upon exports of primary goods of which cotton group captures a major share. There is a need to diversify the exports both in terms of export markets and products. Pakistan needs to penetrate into those markets, which have largely remained untapped. There also needs to be a shift in composition of exports. This would assist in repairing the balance of payments by generating extra cash inflows. Pakistan can manage the diversification of its exports into non-traditional ones typically fruits, flowers and vegetables and value addition in local raw materials and semi-finished goods through these zones as done by some the economies in Africa.

Pakistan needs to adopt a clear, targeted and well-defined export-oriented strategy in order to promote the philosophy of export promotion through EPZs. There is also a need for consistent support both by the governments and policy-makers. The government, along with its agencies and related departments, needs to maintain the support extended to investors in EPZs. This needs to be shown through continuity of fiscal incentives, infrastructure services and business environment.

The EPZs need to be designed in a way that these do not result into a need for government subsidies leading to deterioration in fiscal discipline. To reduce the distortionary impact on the host economy differential fiscal incentives need to be rationalised. It would be justified to give affordable incentives consistent with the WTO regime.

The establishment of a successful EPZ programme does not require removing one or two or some of the obstacles; it requires removing most if not all of them-simultaneously [World Bank (2001a)]. Trade integration through ECO and SAARC can augment the benefits of KEPZ at Pakistan as these markets can be targeted, based on attractive market size and liberal entry conditions.

6. CONCLUSIONS

The study needs to be considered as an exploratory investigation into the performance of KEPZ on various fronts. Nevertheless, the export processing zone's contribution to the process of economic reform is notoriously difficult to assess, for the individual analyst will never know what would have happened without EPZs [World Bank (1992)].

Given the fact that EPZs are believed to be instrumental in employment creation and revenue generation. But these owe certain limitations as they are unable to transform feeble manufacturers into world market-oriented firms, and they are therefore unlikely to draw the small country on to a large country growth trajectory [Schrank (2001), p. 236]. It would be difficult to make a comprehensive cost-benefit analysis of KEPZ in Pakistan. The benefits, coming out of such zones, depend upon the dynamic gains overtime, stemming from structural contributions to national economy like Pakistan. These also depend upon the efforts towards learning and absorbing foreign technologies and shifting the growth pattern of Pakistan to an outward looking economy traditionally from an inward one.

There exists a great potential in Pakistan to achieve success and growth through export-oriented strategy activated through EPZs. The success in this requires the coordinated efforts of various agencies, sustainability of incentives, and provision of internationally competitive levels of infrastructure.

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