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The Political Economy of Special Economic Zones: Lessons for the United States

Lotta Moberg*

INTRODUCTION

Imagine a policy change that could spur economic development without costing a dollar. A change that could increase employment in selected areas of a country through the growth of the industries of policy makers' choices. The change in question is the special economic zone ("SEZ"). This article explores the benefits and downsides of SEZs, and analyzes their economic and political impact on the United States. It argues that, though widely implemented in the country, SEZs have likely done more harm than good for the United States.

SEZs are areas where a government chooses to have different rules from the rest of the country. The zones are usually designed to attract investors in various industries with the aim to increase exports, employment, and production. SEZs are credited with promoting development in numerous countries, from the large-scale zones of China to the small industry parks scattered throughout Latin America and Asia.¹ In the past few decades, several African countries have introduced SEZ legislation, often with the hope of emulating the rapid industrialization of the Asian "Tigers."²

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¹ See, e.g., Hooshang Amirahmadi & Weiping Wu, *Export Processing Zones in Asia*, 35 ASIAN SURV. 828, 828–29 (1995); ANTOINE BASILE & DIMITRIOS A. GERMIDIS, INVESTING IN FREE EXPORT PROCESSING ZONES 11 (1984); Gokhan Akinci & James Crittle, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* 32 (World Bank Foreign Investment Advisory Service, Working Paper No. 45869, 2008); ROBERT C. HAYWOOD, *Free Zones in the Modern World*, WEPZA 3 (2000); Thomas Farole & Gokhan Akinci, *Introduction to SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS* 4–5 (Thomas Farole & Gokhan Akinci eds., 2011); Jin Wang, *The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities*, 101 J. DEV. ECON. 133, 145–46 (2013). Most of these sources also note some of the problems with the SEZ model.

² THOMAS FAROLE, SPECIAL ECONOMIC ZONES IN AFRICA: COMPARING PERFORMANCE AND LEARNING FROM GLOBAL EXPERIENCE 166–67 (2011).

SEZs are not without their controversies, and as this article argues, the United States has largely failed to implement them in a way that promotes economic growth. The World Bank proposed in the early 1990s that SEZs are inferior to “economywide” reforms.³ Some zones have failed to attract investors, despite generous incentives. Clearly, the policy does not always succeed. SEZ success, as discussed below, is also commonly misunderstood and can be defined in many different ways.

Most of the early SEZs, which focused on reshipping and warehousing, were found primarily at ports and airports, and served as spaces for tariff relief. The shipping and warehousing industries rely on importing and exporting goods. If the government imposes tariffs to protect its domestic industries, this clearly hurts the import-dependent industries. In this environment, SEZs can allow the shipping and warehousing industries to flourish. As long as they cannot buy their wares domestically, allowing them to import tariff-free causes no harm on the domestic producers that enjoy tariff protection.

SEZs have been around in their modern form at least since the 1950s. One of the first modern SEZs came about as the scope of the free zone at the Shannon Airport in Ireland was expanded. The airport had previously relied on air traffic in need of refueling airplanes on their way across the Atlantic.⁴ The introduction of the jet engine made this business model obsolete.⁵ The zone authority therefore decided to lure production to the zone as well, thus growing the town of Shannon and inducing air traffic for more reasons than mere transit.⁶

The Shannon zone represented an early version of the export processing zone, which is the form of SEZs that has prevailed ever since.⁷ Export processing zones take the form of industrial parks, which means that they only contain production facilities, as opposed to also including residential areas.⁸ They are generally small enough to fit within a few blocks. Governments often require that most or all zone investor production be exported—hence the label of the zone. Some SEZs are even smaller. So-called single factory zones⁹ may host a single company and occupy one floor in an office building.

³ THE WORLD BANK, EXPORT PROCESSING ZONES 1 (1992).

⁴ BRIAN CALLANAN, IRELAND'S SHANNON STORY: A CASE STUDY OF LOCAL AND REGIONAL DEVELOPMENT 47 (2000).

⁵ *Id.*

⁶ *Id.* at 50.

⁷ THE WORLD BANK, *supra* note 3, at 25.

⁸ *Id.* at 24.

⁹ Akinci & Crittle, *supra* note 1, at 3.

The variation, size, and form of SEZs—from the multimillion-people zones of China to one-company schemes—implies that there is no one answer to the question of whether SEZs represent good policy. Depending on their size, regulations, and institutional context, they will function very differently and come with very different problems and benefits, as this article explores.

The United States introduced free zones in 1934 in response to the Smooth-Hawley tariffs.¹⁰ This new-found protectionism threatened the U.S. warehousing and reshipping industry, and the zones isolated this segment of the American economy from much of this protectionism regime. Since then, SEZs have proliferated in the country and now amount to around 750, including smaller zones.¹¹

Despite their ubiquity, the U.S. zones have had little impact on economic development in the country.¹² This paper applies a political economy analysis to SEZs and shows that the reason for their limited influence in the United States lies both in the nature of the zones themselves and in the institutional context in which they are introduced. It also suggests how to make American zones more successful, and explains what lessons can be drawn from SEZs of the past.

The next Part explains why a political economy analysis best assesses the costs and benefits of SEZs. Part II presents a framework for comparing SEZs to the status quo. Part III discusses whether SEZs are better than their political alternative. Part IV explores how SEZs can perform at their best. The paper concludes in Part V with a discussion of the implications for the SEZs in the United States.

I. THE POLITICAL ECONOMY APPROACH TO SEZS

Most scholarly literature on SEZs applies a misleading perspective when assessing their success. Commonly stated goals of SEZs include increased exports, production, and employment in

¹⁰ Matthew Grant, *Why Special Economic Zones? Using Trade Policy to Discriminate Across Importers* 8–9 (Feb. 2018) (unpublished manuscript), https://drive.google.com/file/d/0B_4Z5rmKH1P5VE0yV1QxZ0JaZTg/view.

¹¹ See Tom W. Bell, *Special Economic Zones in the United States: From Colonial Charters, to Foreign-Trade Zones, Toward USSEZs*, 64 *BUFF. L. REV.* 959, 969–70 (2016); Grant, *supra* note 10, at 7–8; Benjamin Chris Zissimos, *Summary of the 4th InsTED / 9th EESP-FGV Workshop*, INSTED INSTITUTIONS TRADE & ECONOMIC DEVELOPMENT (May 31, 2017), <http://blogs.exeter.ac.uk/insted/2017/05/31/summary-of-the-4th-insted-9th-eesp-fgv-workshop/> [<http://perma.cc/XN2A-9V8X>]; *How many zones exist now?*, U.S. FOREIGN-TRADE ZONES BOARD, <https://enforcement.trade.gov/ftzpage/info/zonestats.html> [<http://perma.cc/6UVD-PX7G>] (last visited Nov. 11, 2017).

¹² Susan Tiefenbrun, *U.S. Foreign Trade Zones, Tax-Free Trade Zones of the World, and Their Impact on the U.S. Economy*, 12 *J. INT'L BUS. & L.*, Spring 2013, at 214.

the area of the zone. Such outcomes are fairly easy to measure, but are unfortunately quite unhelpful in determining whether a zone policy is actually beneficial.¹³

Instead of looking only at outcomes, scholars should apply a cost-benefit analysis to SEZs and focus as much attention to the costs of the policy as to the benefits. To understand the impact of SEZs, one must take a political economy perspective that looks both at the incentives they promote and their most common unintended consequences. The political economy perspective reveals that the main costs of SEZs are political, rather than economic. The most severe costs are not easy (and often impossible) to measure with macroeconomic data. This perspective also reveals that the main benefits of SEZs are political too, rather than the economic outcomes for which the zones are commonly praised.

There have been attempts to perform cost-benefit analyses of SEZs, but these are limited in scope and rely on various quantitative approximations. Scholars have attempted to count company profits, wages, and the like in an SEZ. These benefits are then compared with the costs of the resources used in the zone, which must be based on prices and wage levels in the country at large. If, for instance, 100 zone workers earn \$10 per hour, while their wage elsewhere is \$5, the zone adds \$500 of benefits per hour in wages. If the return on a piece of capital, like a machine or natural resource, is \$1 per day in the zone and eighty cents outside the zone, the daily value created by the zone through capital use is twenty cents per piece of capital. Because of the complication of such estimates, this type of cost-benefit analysis can apply only to smaller zones with simple production and no residential property. Even then, the costs can only be approximated, and any dynamic benefits, such as technological transfers from foreign investors to domestic firms, must be excluded.¹⁴

A political economy analysis considers that policy makers cannot know the ultimate outcome of a policy. The analysis also accounts for the risk of a policy being abused by both businesses and policy makers. Any policy, SEZs included, look good on paper when any such political economy problems are assumed away. When policy makers always know the exact effect of the changes they introduce and govern with the best for society in mind, most

¹³ LOTTA MOBERG, *THE POLITICAL ECONOMY OF SPECIAL ECONOMIC ZONES: CONCENTRATING ECONOMIC DEVELOPMENT* 8 (2017).

¹⁴ Peter G. Warr, *Export Processing Zones: The Economics of Enclave Manufacturing*, 4 *WORLD BANK RES. OBSERVER* 65, 77 (1989); Kankesu Jayanthakumaran, *Benefit-Cost Appraisals of Export Processing Zones: A Survey of the Literature*, 21 *DEV. POL'Y REV.* 51, 61–62 (2003).

policies are beneficial. Alas, the reality is that policy-makers inevitably have a poor understanding of the market conditions that they seek to affect. Just like businesses, they are also motivated by their own wellbeing. Under the wrong incentive structures therefore, they will take advantage of their positions to the detriment of society at large. Whether policy makers will act as if they are informed and selfless will depend on the institutional environment in which a policy is introduced.

Classical economic models generally assume away political-economy related frictions stemming either from the ignorance or distorted incentives of government officials. These models assume that policy makers aim to maximize social welfare, have perfect knowledge, and that the system is free of fraud or corruption. Alas, reality is famously fraught with such imperfections, an insight that a political economy analysis takes into account.

An assessment of SEZ success must also account for political economic benefits that standard macroeconomic studies generally overlook. Political influence can be for the better if it leads to beneficial policy changes. If these spread beyond the SEZ, they can catalyze beneficial change in the country as a whole.

SEZs should be deemed successful if they have long-term beneficial impacts on the broader host economy. Focusing only on one or a few macroeconomic variables as indicators of success is too narrow. Yet “beneficial” can have a different meaning, depending on the reference point. As such, SEZs may be seen as beneficial in three different ways:

1. Compared to the status quo:
Would the country be better off without them, assuming all else stays the same in their absence?
2. Compared to their political alternative:
Would the economy be in worse shape with the policies that would be introduced in the absence of SEZs?
3. Compared to their best possible outcome:
Are the SEZs living up to their full potential?

The following three Parts discuss these levels of SEZ success in turn.

II. COMPARING SEZS TO THE STATUS QUO

SEZs famously have many advantages. By attracting investors, they increase economic activity in the designated area

and provide employment for the local population.¹⁵ They may also increase the demand for local products. When looking only at these benefits, SEZs seem like a winning proposition for any economy.

Unfortunately, SEZs can also come at great costs that, in a bad scenario, overshadow the benefits. While it is true that market-friendly SEZ policies generally increase economic activity in the country as a whole, the investments needed to make this happen may come at too high a price to make the policy worthwhile.

The most obvious cost of SEZs is government spending on zone infrastructure.¹⁶ When planners envision an SEZ, its visible features usually come to mind most vividly. Governments commonly make sure that their visions are fulfilled by building the structures and offices that they expect investors to demand.¹⁷ While that ambition is admirable, more spending on infrastructure means that the government must either spend less on other programs, raise taxes, or borrow money. In one way or another, the people of the country pay the bill for the zone project.

While infrastructure costs are easily measured, SEZs also come with several hidden costs that are harder to estimate. One is the loss of revenue that the government incurs from granting fiscal incentives to zone investors.¹⁸ Domestic investors contribute more in taxes directly when located outside an SEZ. If they move from other parts of the country into the zones without increasing their production, the move constitutes a mere transfer of government revenue to company profits. Alas, this seems often to be the case for the U.S. zones. If domestic investors do expand and employ more people as they become SEZ investors, they can contribute to government revenue through income taxes, for instance. To account for the full impact on government finances, one must estimate how many more people domestic companies employ in the zone and what that implies in terms of increased income tax revenues.

The picture is equally as complicated for foreign SEZ investors. It is often assumed that they would not have chosen to come to the country in the absence of fiscal incentives.¹⁹ If this is the case, no tax revenue is lost as it would not have been collected without a zone either. However, that will not always be true. If they would have invested in the country anyway, the government

¹⁵ *See id.* at 63.

¹⁶ MOBERG, *supra* note 13, at 8.

¹⁷ *Id.* at 9.

¹⁸ *Id.*

¹⁹ *See id.* at 2.

is foregoing revenues by offering them tax exemptions. Yet the government can always claim that the SEZ policy is the reason for any investments that enter the country, since nobody can ever prove the counterfactual.

Another hidden cost is the alternative cost of domestic resources employed in an SEZ.²⁰ Foreign investors may bring some of their employees and capital with them, but they generally take advantage of domestic resources too, which are removed from other parts of the economy. Domestic workers benefit as foreign companies compete for their loyalty by raising their wages, but this imposes costs, both on the domestic firms they leave, and on all firms that must meet higher wage requirements.²¹ To claim that SEZs “create jobs” is therefore partially misleading. SEZs do benefit workers, but as long as not all of them were previously unemployed, SEZ investors hire people at the expense of domestic companies.

This logic applies similarly to production inputs and other forms of capital. As foreign investors bid up prices, they inevitably impose costs on other companies. In a functioning market economy, resources seldom lie idle. It is good for the producers of these production inputs that prices rise, but this is far from the full story.

The value of the alternative use of either labor or capital cannot be measured with any precision. Attempts have been made for simpler forms of SEZs, as was previously mentioned, but such analyses will always remain best guesses rather than proven costs.

Because several of these costs are difficult to measure, it is hard for a government to know whether the zones they are promoting actually benefit the economy. In their pursuit to increase growth and economic activity, they cannot ever be sure this is actually accomplished. Most analyses of SEZs presume that if a zone attracts investors and functions well, it has been a good project. However, knowing about the hidden costs of SEZs, a proper analysis must obviously be more complicated.

A. Policy Implications

A government initiating SEZs should consider how it can best lower its cost in relation to the benefit of any SEZ. Government spending on infrastructure may be necessary to attract investors to a zone, but will be profitable only in certain circumstances. For

²⁰ *Id.* at 9.

²¹ *Id.*

one, any SEZ must be placed in areas where investors want to go. Numerous SEZ projects have been poorly located, resulting in unused infrastructure and office space. Such “white elephants” present obvious examples of SEZ failure.²²

In the less obvious case of failure, SEZs attract investors, but at a price not worth paying for the people of the country. Any location might be attractive to investors when endowed with enough government resources. By choosing a proper location, the government can minimize how much it has to “compensate” investors by paying them to come.²³

Infrastructure investments must also be suitable for the kind of production that is located in the zone. In order not to waste resources, the government must choose carefully what kind of production they target with its incentives and regulations.

All of this may seem to impose an insurmountable burden on policy makers introducing SEZs. Yet, rather than requiring them to know the perfect location and policy framework for every zone, people in power are better off recognizing that they are not omniscient, and should therefore prudently set policies accordingly.

SEZs work by rearranging economic activity in a country, with the goal of increasing economic activity as a whole.²⁴ As such, there are inherent problems of assessing the cost of any changes in the current market structure. Companies in the country are located at particular spots for a reason. If they enter the SEZs, they are generally leaving a naturally optimal location for an inferior one, lured by fiscal incentives. It is also likely that international investors would not prefer the location of an SEZ, but are nevertheless incentivized to invest in the zone.

Governments may get around the problem of resource misallocation by allowing for a more market-driven process in finding an SEZ location. If a government relies on private parties for SEZ development, people with better understanding of market conditions seek out the most lucrative location to establish an SEZ.

The private zone model works as follows. The government announces the SEZ legislation, including the incentives offered and what kind of activities are permitted in the zones. Private developers must then buy or lease land and make all the necessary investments to establish the SEZs. A zone developer can then lease space to zone investors, who are willing to pay for the fiscal benefits, the infrastructure and services in the zone, and for the

²² See *id.* at 36.

²³ See *id.*

²⁴ See *id.* at 25.

proximity to peers and suppliers. The government need not be part of the location selection, but can still claim credit for the success of the policy.

In addition to zone location, it is also unlikely that the government will know what the best industries will be for its SEZs. The government may think that it is textile production if that has traditionally been a widely spread type of production in the country. In fact, the economy may be better off diversifying into other types of manufacturing, more sophisticated agriculture, or high-technology production.²⁵ The reverse is probably an even more common mistake. A government might believe that the economy should take unrealistic leaps into high-tech areas of production.²⁶ In fact, what a country is already producing likely reflects its inherent comparative advantage, implying that it should focus on those industries going forward. Targeting the wrong industry can be a costly mistake for the government.

Fortunately, private zone developers can also address the problem of finding the right kind of production. Private developers have both the incentive and expertise to assess what industries should fit for a particular location in a particular country. If potential investors are unknown, they can delay infrastructure investments until later, or work together with interested investors to provide the required business environment.²⁷ For private investors, the costs of poorly targeted infrastructure investments are more immediate. As a result, they are more prone to step carefully in finding a successful zone model.

Importantly, when private developers do make mistakes and fail to attract investors, it does not impose large costs on the country's tax payers. SEZs may thus fail by not attracting investors, but may still be neutral from a cost-benefit perspective to the host country. The reason governments are often reluctant to rely on private SEZs is that they cannot claim credit for introducing a job-creating policy if the zones fail to grow. When areas designated as SEZs are left idle, this constitutes political failure, even if the attempt to establish zones imposed costs only on private developers and not on the country's tax payers.

For this reason, a government may prefer that zone development be in the hands of a public authority. If so, it should consider decentralizing the process down to the local level. The United States has adopted this model to a large extent. American

²⁵ *See id.* at 5–6.

²⁶ *See id.* at 38.

²⁷ *See id.* at 56.

zones are often developed by county or city governments or their subdivisions, such as port authorities.²⁸ This is a politically safe model, which is less likely than a centralized model to waste resources. Yet, even with decentralization, government-developed SEZs are prone to waste if the targeted locations or SEZ activities are suboptimal. However, in some cases, U.S. zones can be privately developed as well.²⁹ In these cases, the federal government stays out of involvement in zone development and leaves this up to the local entities.

Local politicians are more knowledgeable about the immediate business environment of any given area and are thus more likely to make informed decisions. They may also perceive and react to zone failure more rapidly and adjust policies accordingly. In addition, with fiscal decentralization, it becomes harder for local politicians to conceal the costs of an SEZ. While this means costs are more concentrated and can thus do more harm locally, it also makes it less likely for those costs to rise beyond proportion. As such, while decentralization does not ameliorate the problem with SEZ failure ultimately becoming a burden on tax payers, it is at least a second-best solution after zone privatization.

B. SEZs and Rent-Seeking

Besides policy makers not having sufficient information to create the perfect SEZ policy, they may also lack the will to do so. One inherent problem with SEZs is that they offer various kinds of opportunities for rent-seeking. It is the nature of a discriminatory policy that it offers people or businesses special treatments. This inevitably creates the incentive for private-sector actors to land on the right side of the policy.³⁰ Even more destructively, policy makers have the incentive to introduce policies that make it easier for businesses to engage in policy manipulation by offering the policy makers various gifts and favors.³¹

SEZs offer beneficial tax, tariff, and regulatory conditions for the businesses granted the privilege to enter.³² As long as there is any kind of selection between investors, there is an opportunity for

²⁸ See *Who Can Apply?*, U.S. FOREIGN-TRADE ZONES BOARD, <https://enforcement.trade.gov/ftzpage/info/applicant.html> [<http://perma.cc/N85T-BU8J>] (last visited Nov. 11, 2017).

²⁹ *Id.*

³⁰ JAMES M. BUCHANAN & ROGER D. CONGLETON, *POLITICS BY PRINCIPLE, NOT INTEREST: TOWARD NONDISCRIMINATORY DEMOCRACY* 3 (1998); Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 *AM. ECON. REV.* 291, 291–92 (1974).

³¹ John Joseph Wallis, *The Concept of Systematic Corruption in American History*, in *CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY* 23, 50–51 (Edward L. Glaeser & Claudia Goldin eds., 2006).

³² *Id.*

rent-seeking.³³ Businesses may bribe policy makers outright, lobby for the rules to change in their favor, or induce policy makers to make exceptions for them if they do not fulfill the criteria.³⁴

Bribe-taking may not impose an obvious cost on the people of the country. After all, policy makers are benefiting at the expense of companies, and not directly at the expense of the people of the country. However, as businesses incur higher costs for entering the zones, they have less money for capital expenditures and for hiring people. As a result, they will produce, export, and benefit the country's workers to a lesser extent. Rent-seeking through SEZs thus transfers resources from workers and the government—which loses out on income tax revenues—to individual officials.

Even if the SEZ legislators try honestly to make the policy work, rent-seeking can occur in various levels of the government bureaucracy. The more agencies a business must pass to obtain their SEZ entrance, the larger is the risk of bureaucrats extracting rents along the way, thus diminishing the benefits of zone investing.³⁵

Rent-seeking is more likely to occur in certain kinds of SEZs. In short, the smaller and simpler the zones, the easier it is to use them as vehicles for corruption.³⁶ The smallest kind of zone is the single-factory zone, which includes only one company.³⁷ Single-factory zones make it easy for government to select particular investors for fiscal benefits. Governments often motivate these schemes with the need of certain businesses to be located in particular spots, such as in the center of cities, where one cannot set up regular SEZs. While this is a sound argument, the problem with introducing single-factory zones is that they easily serve as ways to give favors to specific companies. If a policy maker wants his uncle to benefit, for example, he can designate the uncle's business as an SEZ, prompting the government to provide a source of extra profits.

It is understandable that such a scheme would often be confused with simple government favoritism and targeting of benefits of individual companies. In practice, there is little difference. There will also be no agglomerative effects with

³³ See MOBERG, *supra* note 13, at 46.

³⁴ Krueger, *supra* note 30, at 292.

³⁵ See, e.g., WILLIAM EASTERLY, *THE ELUSIVE QUEST FOR GROWTH: ECONOMISTS' ADVENTURES AND MISADVENTURES IN THE TROPICS* 247 (2002) (arguing that low-level corruption creates a tragedy-of-the-commons problem as bureaucrats maximize their gains from implementing policies that benefit companies).

³⁶ See MOBERG, *supra* note 13, at 56–57.

³⁷ *Id.* at 6, 43.

single-factory zones, even though this is a common rationale for SEZs. Despite these drawbacks, single-factory zones are found in numerous countries with SEZ policies, the United States among them. It is certainly possible that rent-seeking in some cases drives their proliferation.

The more zone benefits that emanate from the government, the harder it will be for to rid an SEZ scheme of rent-seeking. The more opportunities for businesses to gain from lobbying and graft, the more resources will be wasted on such activities. The best a government can do in that case is to distance itself from the provision of favors, through infrastructure provisions and selection of SEZ investors. That is, it can allow for private zone development.

In addition to solving problems of finding the right location and zone production, private SEZs can also solve several problems related to rent-seeking. Private developers profit from the rents they charge investors. They have little incentive to extract additional rents illegally from private zone investors, as this diminishes the ability of those investors to pay rents the legal way. Private zone development thus means that there are fewer incentives for rent-seeking and less opportunity to trade rents for fiscal benefits.

Private developers can reap higher profits only by using their resources in more efficient ways. They can, for instance, find more cost-efficient forms of infrastructure, they can provide better services and charge higher rents, and plan for agglomerative effects that will help improve investor profits. All of these are ways to create value and thus increase the probability of a successful SEZ. By contrast, the government's main tool to attract investors is to increase fiscal incentives.³⁸ This does not necessarily imply a better way of organizing production more efficiently in a zone—which is the way private developers are incentivized to do.

The larger and more diversified the zones, the less likely rent-seeking will be a major problem. With zones the size of cities, where people work, live, and study, the government cannot possibly attract investors by providing all the buildings. It must rely on private planning and investment to make the zone function. The larger the zones, the more open they must be for people to enter and invest. This limits the government's ability to target benefits to certain sectors. Finally, larger zones make it harder to target specific companies. Because it will be difficult to benefit a specific company, fiscal incentives must be offered to

³⁸ Tiefenbrun, *supra* note 12, at 12.

everyone in the zone, which is more expensive the larger the zone is. As a result, large zones are harder for governments to use as vehicles for rent-seeking, for which single-factory zones are so suitable.³⁹

Decentralization may solve some of the problems with rent-seeking, albeit less effectively than private zone development.⁴⁰ At least in a democratic system, local policy makers are more incentivized to promote the economy through their policy-making. It is easier for the people to see the connection between their actions and social welfare. Come next election, policy makers risk losing their power if they fail to live up to expectations. Thus, when managing an SEZ scheme, they are less likely than central government officials to engage in graft at the expense of economic success of the program.

The incentive to avoid corruption does not, however, apply to less accountable officials. Bureaucrats dealing with SEZ applications, for instance, are seldom held accountable for poor economic performance and can therefore engage in graft (as long as they are not caught) without major repercussions.⁴¹ Decentralization with checks and balances, therefore, is only a partial solution to the rent-seeking problem, and will alleviate the problem only in particular circumstances.

In conclusion, SEZs do introduce some efficiencies to the economy. But because of their discriminatory nature, they also present problems related to insufficient knowledge and distorted incentives. In the worst case, these problems render SEZs worse for an economy than the status quo. That is, even a country with high barriers to trade, taxes too high even to maximize government revenue, and a prohibitive business climate may be better off keeping such policies and shunning SEZs.

The main solution to these problems is private zone development. This zone model has been recognized as producing better results than public zones and is becoming increasingly popular as a result.⁴² Yet policy makers are often reluctant to cede control over a program to the private sector. They may want to benefit a particular part of the country or take credit for introducing a particular industry in the country. As a result, government-developed zones remain common throughout the world. Any SEZ study should therefore account for the extent of

³⁹ MOBERG, *supra* note 13, at 46.

⁴⁰ *See id.* at 42.

⁴¹ *See id.* at 50.

⁴² *See* FAROLE, *supra* note 2, at 37–39; Akinci & Crittle, *supra* note 1, at 4.

privately-driven investments in the zone. This may give a first clue about whether the scheme is even better than the status quo.

C. Case Studies of Zone Failure

Throughout the history of SEZs, numerous programs have either failed to attract investors or been so infused by mismanagement, miscalculations, and inefficiencies that any benefits they generated failed to compensate for the costs. This Section explains how SEZ schemes can look successful, but nevertheless fail to benefit the country as a whole due to hidden costs. In some cases, failure is obvious as SEZs fail to take off despite government investments in infrastructure and facilities.

One vivid example of this is the Calabar zone in Nigeria. The location of the zone looked completely rational, primarily because of its proximity to the Calabar port.⁴³ The plan was to dredge the port so that it could serve ships that would export the manufactured goods of the Calabar SEZ.⁴⁴ However, for several years, the authorities tasked with the dredging failed to fulfill this mission. Goods were therefore shipped by truck to the port of Lagos at high costs. The Calabar zone is close to the Cameroonian border and not connected to any of Nigeria's highways. The government ran the zone and chose not to privatize it. Power supply to the zone was unreliable, which forced businesses to run generators for electricity.⁴⁵ It is no wonder that the number of investors was a small share of the capacity of the zone.⁴⁶ As a result, much of the SEZ infrastructure was left idle.⁴⁷

Nigeria's SEZs have seen most investments in oil-related industries.⁴⁸ Most SEZ incentives have thus been given to oil extraction and production. Because oil is a lucrative and established industry in Nigeria, these SEZ incentives may not have done much to increase production and employment in the country.⁴⁹

Another case of obvious failure is the SEZ of Bataan in the Philippines. The area was the site of a former U.S. military base, and the plan was to use the existing infrastructure to create a zone

⁴³ FAROLE, *supra* note 2, at 204.

⁴⁴ *See id.*

⁴⁵ *Id.* at 219.

⁴⁶ *See id.* at 211–12.

⁴⁷ *Id.* at 187; Martin Norman, *Have 'Special Economic Zones' Entered the 21st Century Yet? A Tale of Two Cities*, WORLD BANK (Mar. 28, 2014), <http://blogs.worldbank.org/psd/have-special-economic-zones-entered-21st-century-yet-tale-two-cities> [<http://perma.cc/ULZ9-BRUA>].

⁴⁸ FAROLE, *supra* note 2, at 78.

⁴⁹ Ebehi Iyoha, *Nigerian Free Trade Zones: As Simple as SEZ*, STEARS BUS. (June 22, 2017), <https://www.stearsng.com/article/nigerian-free-trade-zones-as-simple-as-sez> [<http://perma.cc/7GFK-H4D2>].

attractive to investors. The government invested hundreds of millions of dollars in the zone in the 1970s and 1980s.⁵⁰ The port was upgraded as the bridges and roads connecting the zone to highways and the like were inadequate.

Nevertheless, the business potential for the zone remained weak and investors stayed away. The zone was allegedly too remote. Thus, in this case, even substantial government spending in the zone did not make it grow. Sixteen years after its founding, the Bataan zone actually became a case of failure that made the international community question the zone model.⁵¹ With time, the government spent even more money on the zone. It now hosts investors, so it is considered a success. However, this remains a case where the zone benefits for the economy can hardly live up to all the public investments made throughout the years.

Because of their obvious failures, SEZs such as Nigeria's Calabar zone and Bataan of the Philippines get the worse press. Yet they are likely not as costly for a country as zone schemes that look successful enough to continue without meaningful reforms, while relying on large investments from the government coupled with generous fiscal incentives. Thus, in contrast to the Calabar and Bataan SEZs, most unsuccessful SEZs in the world are likely not recognized as such. These are the zones that attract investors, but at a cost that cannot be justified on the basis of the benefit they bring to the country as a whole.

As mentioned previously, there have been attempts at cost-benefit analyses for functional SEZs. These get to the question of whether zones are actually better than the status quo and do not just take it for granted whenever a zone attracts investors. Warr lays out a framework for cost-benefit analysis of export processing zones.⁵² Building on Warr's work, Jayanthakumaran assesses the net benefit of zones.⁵³ Their evaluations of specific SEZ schemes indicate that the zones in the Philippines were a net negative for the economy, while those in South Korea, Indonesia, Malaysia, Sri Lanka, and China were beneficial.⁵⁴

India's SEZ present a prominent example of a scheme that was maintained despite its high costs. The rest of this chapter will therefore look closer at this case. India introduced its first zone in

⁵⁰ See MOBERG, *supra* note 13, at 36.

⁵¹ See Peter G. Warr, *Export Promotion via Industrial Enclaves: The Philippines' Bataan Export Processing Zone*, 23 J. DEV. STUD. 220, 238–39 (1987); MOBERG, *supra* note 13, at 36.

⁵² Warr, *supra* note 14, at 77–81.

⁵³ Jayanthakumaran, *supra* note 14, at 53–56.

⁵⁴ *Id.* at 58.

1965, but it took another eight years to establish a second one.⁵⁵ In 2002, the country still had only seven SEZs.⁵⁶ To put this in the context of the country's development, India saw increased GDP growth in 1980, and even more so in the 1990s, after economically liberal reforms.⁵⁷ This was a turnaround period for India, which previously had seen the so-called "Hindu rate of growth" of only around 1.7% in real terms between 1950 and 1985.⁵⁸

The SEZs seem to have played no part in this success. In 1984, around the time that the economy started to take off, India had only two SEZs.⁵⁹ The share of Indian exports stemming from the zones never exceeded four percent before 1996 and reached five percent only in 1998.⁶⁰ Also, while Indian growth relied primarily on services, the SEZs were more manufacturing oriented.⁶¹

Why, then, did the scheme show such poor results? Was it a matter of poor knowledge of government officials or distorted incentives? Alas, it seems, the answer is both. It is therefore worth taking a closer look at these issues, one at the time.

Much of the knowledge problem for Indian SEZs stemmed from the centralized nature of the scheme. The zones were government funded and thus came at a cost for the Indian taxpayers.⁶² In addition, from the start of the program until 1994, only the central government could set up a zone, after which state governments, agencies, and private investors could take on SEZ projects.⁶³ SEZ policies were in the hands of a unit of the ministry of commerce. Furthermore, the task of approving investors

⁵⁵ Aradhna Aggarwal, *Export Processing Zones in India: Analysis of the Export Performance* 4 (Indian Council for Res. on Int'l Econ. Relations, Working Paper No. 148, 2004), <http://icrier.org/pdf/wp148.pdf> [<http://perma.cc/AL53-9TUM>].

⁵⁶ *Id.* at 14.

⁵⁷ *Id.* at 12.

⁵⁸ *Penn World Table: The Database*, UNIV. OF GRONINGEN, <https://www.rug.nl/ggdc/productivity/pwt/> (last visited Oct. 29, 2017). This growth increased to 4.6% between 1985 and 2010. IMF data suggests that the growth 1985–2010 was 5.3%. See *World Economic Outlook Database*, International Monetary Fund, <http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx> (last visited Nov. 3, 2017). For reference to "Hindu growth," see Dani Rodrik & Arvind Subramanian, *From "Hindu Growth" to Productivity Surge: The Mystery of the Indian Growth Transition 193–94* (International Monetary Fund, Working Paper, May 2004).

⁵⁹ Aggarwal, *supra* note 55, at 5.

⁶⁰ *Id.* at 5, 10, 13; *Penn World Table: The Database*, *supra* note 58. For discussion on the Penn World Table methodology, see Robert C. Feenstra, Robert Inklaar & Marcel P. Timmer, *The Next Generation of the Penn World Table*, 105 AM. ECON. REV. 3150, 3150 (2015).

⁶¹ Ashok Kotwal, Bharat Ramaswami & Wilima Wadhwa, *Economic Liberalization and Indian Economic Growth: What's the Evidence?*, 49 J. ECON. LIT. 1152, 1168–69 (2011).

⁶² Triyakshana Seshadri & Virgil Henry Storr, *Knowledge Problems Associated with Creating Export Zones*, 23 REV. AUSTRIAN ECON. 347, 351 (2010).

⁶³ Ram Krishna Ranjan, *Special Economic Zones: Are They Good for the Country?* 8 (Ctr. for Civil Soc'y, Working Paper No. 156, 2006).

seeking to enter the zones was given to an authority placed under this same ministry.⁶⁴

In a country the size of India, centralized policy-making is bound to suffer from the limited knowledge of government officials about the conditions on the ground in various parts of the country. For the SEZs, one result of this flaw was the poor location of the initial SEZs in Kandla, a port city, and Falta, located by the Hooghly River, not far from Kolkata.⁶⁵ Both locations allegedly lacked not only an industrial culture, but also the necessary social and economic infrastructure.⁶⁶ The government later set up some zones in areas that already showed decent industrial performance, and these SEZs fared better.⁶⁷

It certainly does not seem that the government had an insight about the potential of Kandla and Falta that private investors, which largely stayed away from these areas, were lacking. Falta, in particular, remained a small part of the SEZ scheme, providing only one percent of its exports by 2000.⁶⁸ Had the zones been privately developed, poor location choices would not have been such bad news. The companies invested in the zones would have lost money and been forced to relocate and start over. Alas, because much of the initial investments came from the central government, the poorly located zones inevitably imposed costs for the Indian economy as a whole.

In an attempt to improve the SEZ scheme, the Indian government introduced a new SEZ law that came into effect in 2005. Importantly, the law encourages privately developed zones.⁶⁹ Some of the authority of SEZ management is also transferred from the central government to the state government level.⁷⁰ The new law concentrates significant power in local-level development commissioners, who have both regulatory and administrative powers. This framework has been criticized as an “extreme

⁶⁴ Aradhna Aggarwal, *Performance of Export Processing Zones: A Comparative Analysis of India, Sri Lanka and Bangladesh* 15–16 (Indian Council for Res. on Int'l Econ. Rel., Working Paper No. 155, 2005), <http://icrier.org/pdf/wp155.pdf> [<http://perma.cc/93LY-TEQF>].

⁶⁵ ASHOK KUNDRA, *THE PERFORMANCE OF INDIA'S EXPORT ZONES: A COMPARISON WITH THE CHINESE APPROACH* 66 (2000).

⁶⁶ *Id.*

⁶⁷ Seshadri & Storr, *supra* note 62, at 361.

⁶⁸ *Id.* at 353.

⁶⁹ AMITENDU PALIT & SUBHOMOY BHATTACHARJEE, *SPECIAL ECONOMIC ZONES IN INDIA: MYTHS AND REALITIES* 174 (2008).

⁷⁰ See Shankar Gopalakrishnan, *SEZs in India: An Economic Policy or a Political Intervention?*, in *SPECIAL ECONOMIC ZONES IN ASIAN MARKET ECONOMIES* 139, 143 (Connie Carter & Andrew Harding eds., 2011); PALIT & BHATTACHARJEE, *supra* note 69, at 174; Jona Aravind Dohrmann, *Special Economic Zones in India – An Introduction*, 106 *ASIEN* 60, 66 (2008); *Introduction*, *SPECIAL ECONOMIC ZONES IN INDIA*, <http://www.sezindia.nic.in/about-introduction.asp> [<http://perma.cc/5W5D-83BX>] (last visited Nov. 12, 2017).

centralization of government institutions.”⁷¹ However, while such a concentration may be unwise, a more local authority is at least more likely to understand the local market conditions, and can better design SEZs commensurate to the development potential of any area. Still, the main authority accepting applications for approval to establish new SEZs remains a central-government function.⁷² India has thus gone only some of the way to a decentralized system for its SEZs.

Indian land policy contributes to SEZ-related misallocation of resources. In an unregulated market, land owners could sell land to prospective SEZ developers if the latter are willing to pay more than the land is worth for the land owners, many of whom are farmers. This exchange would signal that the land had a higher potential value as an SEZ than for its current use. However, in India, land prices do not reflect supply and demand because they are set by the state government. This price must, by law, reflect the value of the current use of the land, and can thus not exceed the value of the land derived from farming.⁷³ Such a system discourages land transactions from ever taking place.

The government’s solution to the potential dearth of land transactions is eminent domain. By law, the government has the right to expropriate land “for any public purpose or for a company.”⁷⁴ The opportunity to seize land for SEZ use is further enhanced as zones are designated as public utility services, which per definition, are useful for social welfare.⁷⁵

Fair or not, the system disguises the information that is embedded in market-derived prices. It thus makes it even harder for the government to determine the economic benefit of establishing an SEZ.

It is still unclear whether the new SEZ law sufficiently deals with the flaws of the previous system, but in the absence of change in the land laws, this is doubtful. The increasing number of private SEZ developers will need to turn to the state government to free up land for them, thus discouraging the investors to make the

71 Dohrmann, *supra* note 70, at 69; *see also* Gopalakrishnan, *supra* note 70, at 148.

72 *Introduction*, *supra* note 70.

73 Triyakshana Seshadri, *The Political Economy of Special Economic Zones in India* 79 (Spring Semester 2011) (unpublished Ph.D. dissertation, George Mason University), <https://search.proquest.com/docview/868552266?pq-origsite=gscholar>.

74 SHRUTI RAJAGOPALAN & ALEXANDER TABARROK, *LESSONS FROM GURGAON, INDIA’S PRIVATE CITY 203* (2014), <https://mason.gmu.edu/~atabarro/Lessons%20from%20Gurgaon.pdf> [<http://perma.cc/M3CJ-ZCV5>].

75 GOV’T OF INDIA MINISTRY OF COM. AND INDUSTRY, *SEZ RULES INCORPORATING AMENDMENTS UP TO JULY, 2010*, ch. 2 (2006), http://sezindia.nic.in/upload/uploadfiles/files/14_SEZ_Rules_July_2010.pdf [<http://perma.cc/WSU5-8NUJ>].

proper cost-benefit analysis. It is therefore worth looking into whether the new system is more likely to solve the incentive problems that plagued the SEZ policies of the past.

One prominent feature of the early SEZ scheme was the wide use of the single-factory model, which was introduced in 1981.⁷⁶ As previously discussed, such zones are potent tools for rent-seeking and lack the positive cluster-effects that are a prominent rationale for setting up SEZs. By the year 1998, 1210 single-factory zones were operational, and by 2009, as many as 2600.⁷⁷ As the selection process for companies designated as single-factory zones is not one based on competitive potential, it is not surprising that these companies seem not to live up to their export goals.⁷⁸

Encouragingly, the new SEZ law aims to create larger zones, which should steer the country away from the single-factory model. However, an initial minimum zone size of 1000 hectares was soon compromised down to 500 hectares, with exemptions for agriculture and IT companies.⁷⁹ By 2008, only six percent of the zones were larger than 300 hectares, and forty percent were smaller than twenty hectares.⁸⁰ The government even chose to set a maximum SEZ size of 5000 hectares due to land disputes.⁸¹ For perspective, the Chinese pioneering SEZ of Shenzhen covered 32,750 hectares in 1980, a year after its founding.⁸²

While smaller zones are generally more prone to incentive problems, additional problems are introduced in India because of its land laws. With suppressed land prices combined with eminent domain, SEZ developers are incentivized to lobby officials to seize land on their behalf. Land will thus be found in the hands of those with the largest political influence, rather than those able to create the most value.

⁷⁶ *Export Oriented Unit Scheme*, EOU INDIA, http://eouindia.gov.in/eou_scheme.htm [<http://perma.cc/3KXL-9JGB>] (last visited Nov. 12, 2017).

⁷⁷ *Facts and Figures*, EOU INDIA, http://eouindia.gov.in/fact_figure.htm [<http://perma.cc/56NB-H3TD>] (last visited Nov. 12, 2017).

⁷⁸ Niloptal Goswami & Pravakar Sahoo, *Why have export-oriented units in India failed to deliver?*, BRUEGEL (Oct. 22, 2016), <http://bruegel.org/2016/10/why-have-export-oriented-units-in-india-failed-to-deliver/> [<http://perma.cc/Z4BC-PAAR>].

⁷⁹ Dohrmann, *supra* note 70, at 66–67; Letter from Rajeev Arora, Joint Sec’y to the Gov’t of India, to The Chief Sec’y of States/UTs 1 (Sept. 13, 2013), <http://www.sezindia.nic.in/writereaddata/rules/Amendment%20rules.pdf> [<http://perma.cc/5GDU-VZMZ>].

⁸⁰ PARTHA MUKHOPADHYAY & KANHU CHARAN PRADHAN, LOCATION OF SEZs AND POLICY BENEFITS WHAT DOES THE DATA SAY? 70–71 (2009), https://mpr.ub.uni-muenchen.de/24333/1/MPRA_paper_24333.pdf [<http://perma.cc/Q8P2-LNDA>].

⁸¹ See Gopalakrishnan, *supra* note 70, at 144.

⁸² April A. Herlevi, What’s so Special about Special Economic Zones? China’s National and Provincial-Level Development Zones 14 (June 18, 2016) (unpublished research paper), <http://web.isanet.org/Web/Conferences/AP%20Hong%20Kong%202016/Archive/3a83092a-cbfa-4526-85d7-3ca39931b3b4.pdf> [<http://perma.cc/83F5-AM6Y>].

Another problem that has plagued India's SEZ scheme for many years is bureaucratic corruption.⁸³ Companies wanting to invest in a zone would previously have to pass through numerous authorities. This provided opportunities for rent-seeking as bureaucrats could demand unofficial payments for their services. A survey from 2004 found that sixty percent of responding SEZ companies claimed to have made "irregular payments"—payments not registered in the books—to the SEZ-related bureaucracies.⁸⁴

The aim of the new scheme is to streamline the application and approval process with a so-called "single window" facility.⁸⁵ Yet it has taken time for such an institution to be set up. Admitting as much, the central government appealed in 2010 to state governments to set up their own single window facilities.⁸⁶ By 2015, a survey found that sixty-four percent of SEZ firms reported that no such facility existed in the state.⁸⁷ SEZ investors are thus still faced with several steps through the bureaucracy to obtain approval. The bureaucratic problems with SEZs have contributed to the de-notification of SEZs. While in 2013, India had 580 approved zones, there were only 405 in late 2016 and have since risen to 424 by July 2017.⁸⁸

In conclusion, while the Indian SEZ scheme is moving in the right direction on some margins, it is yet to be seen whether this will be enough to improve it significantly. Insufficient decentralization and flawed land legislation will likely keep causing problems related to governments not having enough information to properly design an SEZ that would benefit the country as a whole. Those same land laws, combined with a burdensome SEZ bureaucracy and wide use of single-factory zones, create distorted incentives that further discredit the claim that the SEZs are meant to benefit the people.

⁸³ See, e.g., S.R. Keshava, *The Effect of FDI on India and Chinese Economy: A Comparative Analysis* 18 (Feb. 2, 2008) (unpublished manuscript), <http://ssrn.com/abstract=1089964> [<http://perma.cc/U45U-V7PL>].

⁸⁴ Aggarwal, *supra* note 55, at 32.

⁸⁵ See Dohrmann, *supra* note 70, at 66; *Introduction*, *supra* note 70.

⁸⁶ BS Reporter, *Create single-window clearance for SEZs: Govt tells states*, BUS. STANDARD (Feb. 11, 2010, 11:06 AM), http://www.business-standard.com/article/economy-policy/create-single-window-clearance-for-sezs-govt-tells-states-110021200075_1.html [<http://perma.cc/5JNL-68RV>].

⁸⁷ PROGRESS HARMONY DEV. RES. BUREAU, *SEZs IN INDIA: CRISS-CROSS CONCERNS* 43 (2015).

⁸⁸ See *Set up a single-window clearance system for speedy approvals of special economic zones: ASSOCHAM Plea to Govt.*, THE ASSOCIATED CHAMBERS OF COM. & INDUSTRY OF INDIA (Nov. 30, 2015), <http://www.assochem.org/newsdetail.php?id=5357> [<http://perma.cc/JT4Z-FU2W>]; *Approved SEZs in India*, SPECIAL ECON. ZONES IN INDIA [<http://perma.cc/N5T7-S3QU>] (last visited Nov. 12, 2017).

More private zone development should enhance the scheme. During its decades of existence, the dominance of government investment in India's SEZs has imposed high costs that are ultimately borne by the Indian taxpayer. The conclusion must therefore be that India did not live up to the lowest bar of SEZ success, in that the scheme was not even better than the political status-quo.

III. COMPARING SEZs TO THEIR POLITICAL ALTERNATIVE

Even if SEZs are better than the status quo, they might still not benefit a country if a superior set of policies could prevail in their absence. For example, policy makers might feel compelled to liberalize the economy and consider a cut in tariffs across the board. As they ponder their options, they might learn about SEZs and find them an attractive policy alternative. With SEZs, policy makers can look as though they are actively promoting trade and development for the country. A zone is a clearly-defined space where policy makers claim credit for the economic activity that they host. They can count the amount of foreign investors and employees in the zone and win praise for how much capital it attracted and how many jobs it created.⁸⁹ There will obviously be no mention of the public resources that the project consumed or how many investors simply moved within the country to enjoy the zone's fiscal benefits.

Besides the political point-scoring, SEZs have another feature that is even more attractive for protectionist-minded policy makers. SEZs allow for a dual trade system, in which the country as a whole can remain protectionist while opening up for imports only in limited spaces. Governments often protect certain sectors by limiting foreign competition.⁹⁰ In exchange for this favor, they can earn rents from the protected companies, in the form of political support, favors, or outright bribes.⁹¹ Trade liberalization

⁸⁹ See Chenggang Xu, *The Fundamental Institutions of China's Reforms and Development*, 49 J. ECON. LIT. 1076, 1093 (2011).

⁹⁰ Daron Acemoglu & James A. Robinson, *Economics Versus Politics: Pitfalls of Policy Advice*, 27 J. ECON. PERSP. 173, 189 (2013).

⁹¹ See, e.g., Acemoglu & Robinson, *supra* note 90, at 186–87; Carlos F. Díaz Alejandro, *The Argentine Tariff, 1906–1940*, 19 OXFORD ECON. PAPERS 75, 95 (1967); Krueger, *supra* note 30, at 291–92; J.J. Pincus, *Pressure Groups and the Pattern of Tariffs*, 83 J. POL. ECON. 757, 757–58 (1975); Robert E. Baldwin, *The Political Economy of Protectionism*, in IMPORT COMPETITION AND RESPONSE 263, 278 (Jagdish N. Bhagwati ed., 1982); Robert E. Baldwin, *The Political Economy of Trade Policy*, 3 J. ECON. PERSP. 119, 125, 130 (1989); Arye L. Hillman, *Declining Industries and Political-Support Protectionist Motives*, 72 AM. ECON. REV. 1180, 1181, 1185 (1982); Giulio M. Gallarotti, *Toward a Business-Cycle Model of Tariffs*, 39 INT'L ORG. 155, 166–67 (1985); James H. Cassing & Arye L. Hillman, *Shifting Comparative Advantage and Senescent Industry Collapse*, 76 AM. ECON. REV. 516, 522 (1986); Barry Eichengreen, *The Political Economy of the Smoot-Hawley Tariff*, in

threatens such relationships. If interest groups no longer receive support from the government, they will be unwilling to offer anything in return.

While this suggests that policy makers should never consider trade liberalization, they may be forced to do so in the face of pressure from other interests. Potential investors in the country can complain about the lack of opportunity and widely declare that the country is losing jobs by keeping foreign investors away. Economists may write articles and speak out about how protectionism is impoverishing the country's people. Foreign trade representatives may pressure the country to open up.

Such demands present the dilemma for the protectionist government between yielding to the pressure and siding with its protected interest groups. SEZs offer a way out of the situation. As policy makers introduce zones, they can claim to pursue liberalization. Meanwhile, they are still protecting the interest groups from threatening imports by maintaining the protectionist regime elsewhere. Foreign investors will be happy to enter the zones, where they enjoy exemptions from tariffs and taxes, and economists and foreign government representatives may accept the partial liberalization as adequate, albeit not perfect.

In this way, SEZs can be a tool to avoid trade liberalization, and thus serve a very different function from that with which they are generally associated. They may improve on the status quo. Yet they may not benefit the economy when the status quo is not the relevant comparison. In the absence of SEZs, the policy makers would likely need to liberalize the economy more broadly in the face of pressure to do so. As a result, SEZs primarily benefit policy makers and protected industries at the expense of the rest of the society.

To understand whether SEZs are better than the status quo, one must consider the political context and understand the incentives of policy makers and the policy alternatives that they face. Any counterfactual scenario will remain a hypothesis. Nevertheless, this approach to assess SEZ benefits is superior to the naïve assumption that policies will remain the same in their absence. The very fact that a government introduces SEZs

INTERNATIONAL POLITICAL ECONOMY: PERSPECTIVES ON GLOBAL POWER AND WEALTH 37, 37–38, 46 (Jeffrey A. Frieden & David A. Lake eds., 4th ed. 2000); Avinash Dixit & John Londregan, *Redistributive Politics and Economic Efficiency*, 89 AM. POL. SCI. REV. 856, 858 (1995); Dani Rodrik, *Political Economy of Trade Policy*, in 3 HANDBOOK OF INTERNATIONAL ECONOMICS 1457, 1468–69 (Gene M. Grossman & Kenneth Rogoff eds., 1995); Gene M. Grossman & Elhanan Helpman, *Electoral Competition and Special Interest Politics*, 63 REV. ECON. STUD. 265, 283–84 (1996); Jong-Wha Lee & Phillip Swagel, *Trade Barriers and Trade Flows Across Countries and Industries*, 79 REV. ECON. & STAT. 372, 372–73 (1997).

suggests that their incentives are not directly aligned with social welfare. The officials may have suddenly awoken to the benefits of economic openness. However, if the SEZs come in response to pressure to liberalize trade, they may be a mere tool to avoid any radical reforms.

A. The Case of the Dominican Republic

The Dominican Republic provides an example of SEZs introduced as a response to pressure to liberalize the economy broadly. The zones allow companies to import tariff-free and enjoy tax exemptions. Meanwhile, these SEZs remain small enough not to threaten the trade protection enjoyed by companies outside the SEZs' boundaries. As a result, while the zones promoted Dominican exports, they also helped preserve a system of protectionism which, in the absence of SEZs, might have been eroded.

In the 1960s, President Joaquín Balaguer inherited a country with a system of trade protectionism, government benefits to particular industries, and general government interventionism.⁹² The United States occupied the country for a while and helped Balaguer reach his position of power, thus putting him in a position of loyalty towards the American government.⁹³

Balaguer was no natural sympathizer of free markets and introduced new forms of trade protection in the country. On some margins, though, these barriers were made more flexible.⁹⁴ This, combined with higher prices of the crops the Dominicans exported, made the country wealthier, which increased the demand for imported goods.⁹⁵ Seeing that imports could threaten domestic businesses, Balaguer responded by establishing even more solid protectionism in the country.⁹⁶

⁹² See FRANK MOYA PONS, *THE DOMINICAN REPUBLIC: A NATIONAL HISTORY* 371 (2010).

⁹³ *Id.* at 396, 398.

⁹⁴ See Frank Moya Pons, *Import-Substitution Industrialization Policies in the Dominican Republic, 1925–61*, 70 *HISPANIC AM. HIST. REV.* 539, 561 (1990); see also EMELIO BETANCES, *STATE AND SOCIETY IN THE DOMINICAN REPUBLIC* 120–21 (1995); Andrew Schrank, *Luring, Learning, and Lobbying: The Limits to Capital Mobility in the Dominican Republic*, 37 *STUD. COMP. INT'L DEV.* 89, 95–96 (2003).

⁹⁵ See *DOMINICAN REPUBLIC: A COUNTRY STUDY* (Richard A. Haggerty ed., 1989), <http://countrystudies.us/dominican-republic/> [<http://perma.cc/AKQ5-VB3M>].

⁹⁶ See JAN KNIPPERS BLACK, *THE DOMINICAN REPUBLIC: POLITICS AND DEVELOPMENT IN AN UNSOVEREIGN STATE* 44, 63 (1986); see also PONS, *supra* note 92, at 396–97; Fabio Rafael Fiallo, *Alternativas de Política Industrial en la República Dominicana* [*Industrial Policy Alternatives in the Dominican Republic*], *EL TRIMESTRE ECONÓMICO* [ETE] 159, 162 (1973); JONATHAN HARTLYN, *THE STRUGGLE FOR DEMOCRATIC POLITICS IN THE DOMINICAN REPUBLIC* 104–05 (1998); Andrew Schrank, *Foreign Investors, “Flying Geese,” and the Limits to Export-Led Industrialization in the Dominican Republic*, 32 *THEORY & SOC'Y* 415, 422–24 (2003).

His policies soon met resistance from several corners. Importantly, the U.S. government pushed for trade liberalization in order to access the Dominican market.⁹⁷ To respond to these demands, while still protecting the important interest groups that represented domestically focused businesses opposed to foreign competition, Balaguer introduced SEZs in 1968. The new law offered companies two types of benefits: either trade protection or SEZ status that came with fiscal benefits. The law made the system of tariffs more systematic than previously, and offered attractive opportunities to monopolize the domestic market. The protectionist benefits were considered most attractive and were primarily seized by the politically connected elite in Santo Domingo. The SEZ benefits were considered less attractive and were claimed primarily by the less-connected manufacturers outside the capital.⁹⁸

While this form of liberalization was not all the United States had hoped for, the American government accepted the new rules as a partial opening of the economy.⁹⁹ Balaguer thus succeeded in preserving and even strengthening the protectionist regime while pleasing the critics asking for more liberalization. In the absence of SEZs, the president might have had to pursue broader measures of liberalization.

The Dominican zones have been praised for diversifying the country's exports and for offering employment opportunities.¹⁰⁰ Yet, it has also been noted that the SEZs function as isolated enclaves that fail to transfer their sophistication and growth to the rest of the economy.¹⁰¹ An understanding of the political purpose

⁹⁷ See generally Ved P. Nanda, *The United States Action in the 1965 Dominican Crisis: Impact on World Order – Part II*, 44 DENV. L.J. 225 (1966); see also BETANCES, *supra* note 94, at 120–21; HARTLYN, *supra* note 96, at 105; Schrank, *supra* note 94, at 95; Schrank, *supra* note 96, at 423; PONS, *supra* note 92, at 402.

⁹⁸ See DOMINICAN REPUBLIC: A COUNTRY STUDY, *supra* note 95; BETANCES, *supra* note 94, at 121; Andrew Schrank, *Entrepreneurship, Export Diversification, and Economic Reform: The Birth of a Developmental Community in the Dominican Republic*, 38 COMP. POL. 43, 46–47 (2005); Andrew Schrank, *Peasants, Planters, and the Predatory State: Export Diversification in the Dominican Republic, 1970-2000*, 10 RES. RURAL SOC. & DEV. 353, 355 (2005); Schrank, *supra* note 94, at 97.

⁹⁹ See Schrank, *supra* note 94, at 95.

¹⁰⁰ See Larry Willmore, *Export Processing in the Caribbean: Lessons from Four Case Studies* 19 (Econ. Comm'n for Latin America and the Caribbean, Working Paper No. 42, 1996), <http://archivo.cepal.org/pdfs/1996/S9600501.pdf> [<http://perma.cc/JF9W-6ZWA>]; ADOZONA, IMPACTO ECONÓMICO Y SOCIAL DE LAS ZONAS FRANCAS: UNA VISIÓN DE 360 GRADOS [ECONOMIC AND SOCIAL IMPACT OF FREE ZONES: A 360 DEGREE VIEW] 19 (2012), <https://adozona.org/wp-content/uploads/2017/01/impacto-economico.pdf> [<http://perma.cc/SMM7-BXPF>]; THOMAS FAROLE, WORLD BANK, UNLOCKING CENTRAL AMERICA'S EXPORT POTENTIAL 4 (2012).

¹⁰¹ See Raphael Kaplinsky, *Export Processing Zones in the Dominican Republic: Transforming Manufactures into Commodities*, 21 WORLD DEV. 1851, 1857 (1993); see also

of the zones explains this outcome. Because the SEZs were meant to divide the economy into the traditional protected sector and the internationally open and export-oriented sector, the latter was never supposed to integrate much with the country at large because that would have eroded the traditional system of trade protection.

The final verdict of the Dominican zones is ambiguous. They were better than the status quo of protectionism, but as tools to avoid reform, they were probably worse than the political alternative of broader economic liberalization.

IV. WHEN SEZS LIVE UP TO THEIR BEST POSSIBLE OUTCOME

So far, several flaws with SEZs have been discussed that are commonly overlooked in analyses of their success. When the political economy perspective is ignored, problems of resource misallocation, rent-seeking, and reform avoidance are overlooked. Yet ignorance of the political economy aspects of SEZs also leads to an under appreciation of what SEZs can accomplish when they are at their best. This Part will examine how SEZs can help solve the problem of rent-seeking.

One of the great problems in economic development is that destructive policies and institutions are commonly preserved because the ruling elite lacks the incentive to promote economic progress. Trade restrictions are but one example. Regulations can deter businesses from investing while doing little to protect consumers or preserve market stability. Tax systems can be too complex to comprehend, while offering too many loopholes to yield much government revenue. The list of seemingly irrational policies can be made long.

A simplistic analysis may deem such policies uninformed. Yet they often come about and remain in place due to highly rational calculations from individuals in government. Most interest groups can benefit from regulations that restrict the power of their competitors. They thus have an incentive to pressure the government to introduce seemingly irrational rules. Every burden on the business community is also an opportunity for people in government to demand favors in exchange for exemptions.

As a result, policy makers generally lack the incentive to simplify rules and make the system fairer and more transparent. This leads countries into destructive states of equilibria that

hamper their development, discourage investments, and confine people to poverty.¹⁰²

This is precisely the context in which SEZs can function at their best. By changing the incentives for policy makers, they can set countries on a gradual path towards more growth-promoting policies.

In a system where the government prefers to preserve a protectionist status quo, any initiative for a change will not come from the top, but instead from interest groups that would benefit from liberalization. Just as some groups will pressure the government to introduce growth-suppressing policies, others will seek exemptions from them. A leather manufacturer, for instance, might lobby for tariffs on leather, while a clothes manufacturer would prefer exemptions from the same. One way to obtain more general exemptions is to introduce SEZs. In contrast to specific exemptions, SEZs can create a dynamic that spreads economic liberalization throughout the country.

This dynamic starts with initiatives from people close to the SEZs who will benefit from more openness. This may be business people seeking new opportunities or local policy makers hoping to expand the local government coffers through more economic activity. Assuming most people in power are against more openness, such reformers need to offer favors or bribes in exchange for an SEZ. The zone, while not perfect, is the best they can obtain in the face of strong resistance to change.

As the SEZ grows by attracting more investors, it starts having an impact on the economy at large. Some local monopolies wither as the SEZ inflicts more competition. Other opportunities for rent-seeking weaken as businesses move from other parts of the country to the SEZ with its inviting business environment. The country starts gaining the reputation of a more open economy.

All these factors change the calculation and optimal strategy of local policy makers. They can pursue two different strategies of

¹⁰² See, e.g., Daron Acemoglu & James Robinson, *Political Losers as a Barrier to Economic Development*, 90 AM. ECON. REV. 126, 126 (2000); DARON ACEMOGLU & JAMES ROBINSON, WHY NATIONS FAIL: THE ORIGINS OF POWER, PROSPERITY, AND POVERTY 243–44 (2012); Stephen Haber, *Introduction: The Political Economy of Crony Capitalism*, in CRONY CAPITALISM AND ECONOMIC GROWTH IN LATIN AMERICA: THEORY AND EVIDENCE xi, xii, xv–xvi (Stephen Haber ed., 2002); DAVID C. KANG, CRONY CAPITALISM: CORRUPTION AND DEVELOPMENT IN SOUTH KOREA AND THE PHILIPPINES 187 (2002); Susan Rose-Ackerman, *Introduction and Overview to INTERNATIONAL HANDBOOK ON THE ECONOMICS OF CORRUPTION* xiv, xiv (Susan Rose-Ackerman ed., 2006); John V.C. Nye, *Why Do Elites Permit Reform?*, 1 ANN. PROC. WEALTH & WELL-BEING NATIONS 53, 55 (2008–2009); Fernanda Brolo, Tommaso Nannicini, Roberto Perotti & Guido Tabellini, *The Political Resource Curse*, 103 AM. ECON. REV. 1759, 1760 (2013).

enriching themselves: they can promote growth and benefit from higher tax revenue, or they can rent-seek by pursuing protectionism, giving monopoly rights to select companies. Thanks to their external effects, SEZs nudge this calculation towards more openness and reliance on tax revenue as opposed to rents from rent-seeking activities. As the first SEZ expands, more local leaders find they can benefit from more openness.

As long as most leaders are against liberalization, no local leader can possibly convince the government to pursue nationwide liberalization. That would threaten too many interest groups from which the government draws its support. Yet they can enjoy most of the fruits of openness by obtaining SEZs, which are less threatening to rent-seeking anti-reformers.

This process does not require a miscalculation of the impact of SEZs by any anti-reformist leader who accepts the zones in exchange for favors. The external effects come only after some time, perhaps several years. If the anti-reformers do not expect to be in power at that time, they are better off accepting the bribe today, at the expense of their successors who will lose out on rent-seeking opportunities.

The process requires a system of fiscal decentralization, though, which allows local leaders to benefit from local tax collection. If not, they would always be better off promoting rent-seeking at the expense of tax collection. With fiscal decentralization, local leaders face a trade-off between tax revenues and gains from rent-seeking, as they cannot promote one without diminishing the other.

The process is necessarily gradual and can take decades, depending on the size of the country. It may not seem like a great proposition for SEZs. Yet if the zones can change the equilibrium of rent-seeking in a country, they provide the solution to one of the main obstacles to economic development.

A. How SEZs Reformed China

China offers the most prominent example of a country that used SEZs to profoundly change the economic system of the country. As will be discussed, the SEZs worked to change the incentives of political leaders to promote reform in a context where broad liberalization would likely not have been possible otherwise.

In the 1970s, China was a closed economy in many ways. Rent-seeking by government officials was widespread and there was little indication that the leaders of the economy would want to disrupt the illiberal status quo. Yet the country provided a beneficial institutional setting for SEZ-driven reforms.

The most important feature was the country's decentralization, both on the political and fiscal front. After the death of Mao, the Communist party started focusing on economic development in the country, as opposed to class struggle.¹⁰³ The party leaders in Beijing pursued this through political decentralization and incentives to local leaders to produce economic growth. The central government had the power to award local leaders if they obtained their growth targets, and unseat them if not.¹⁰⁴ Yet policy-making was to a large extent left to the local levels of government. Fiscal decentralization meant that local leaders could benefit from higher tax revenues, and hence benefit in two ways from local growth.¹⁰⁵

Fiscal decentralization thus presented these officials with a trade-off. They could promote protectionism and benefit from the rent-seeking opportunities that this would provide. The down side of this approach, however, was suppressed economic growth, which lowered their tax revenues. By promoting liberalization in their municipality or province, local leaders could amass more tax revenues, albeit at the expense of limiting their rent-seeking opportunities.¹⁰⁶

The extent to which local leaders pursued growth at the expense of rent-seeking varied, as some areas were better exploited for rent-seeking and others for tax revenues. Areas close to trading spots, such as ports with more opportunities to benefit from trade and foreign investments, would offer more opportunities of real economic growth and tax revenues. However, China's closed system probably made this difficult in most cases. By contrast, areas close to Beijing would likely benefit more from central government largesse through rent-seeking schemes. Areas rich in extractive industries, like mining and other natural resources, would also incentivize officials to take the rent-seeking approach, by granting exploitation rights to friends and those offering favors in return.

The aggregate structure of China's economy at the time suggests that rent-seeking in many cases offered the most lucrative opportunities. In this context, a group of business people with connections to Hong Kong started lobbying for exemptions from protectionism, to make it easier for them to conduct business

¹⁰³ See Xu, *supra* note 89, at 1090.

¹⁰⁴ See *id.* at 1093–94.

¹⁰⁵ See Shaomin Li, Shuhe Li & Weiyang Zhang, *The Road to Capitalism: Competition and Institutional Change in China*, 28 J. COMP. ECON. 269, 283–84 (2000).

¹⁰⁶ See *id.*

in the then-British colony.¹⁰⁷ They turned to Ye Fei, Minister of Transport, who ultimately granted them a special deregulated area from which they could conduct their business from Shekou in Guangdong Province, adjacent to Hong Kong.¹⁰⁸ The Shekou Industrial zone opened in 1979, as the first SEZ of China.¹⁰⁹

Seeing the benefit of the zone, the governor of Guangdong province started to promote SEZs for China.¹¹⁰ The first three zones officially labeled SEZs were thus located in Guangdong.¹¹¹ One of them is Shenzhen, which was only a small fishing village when it was designated an SEZ.¹¹² Its special status allowed it to grow into a megacity of over ten million people. With more SEZs being introduced, more local leaders lobbied for SEZs in their areas.¹¹³

The zones thus spread gradually throughout the country. 1984 was an important year in this development, as China's fifth SEZ was introduced in Hainan, together with fourteen other zones labeled "Coastal Cities."¹¹⁴ In 1992, all provincial capitals were designated as SEZs, which meant that over half of all municipalities in China now hosted SEZs.¹¹⁵

It is important to understand the mechanism through which the SEZs proliferated. Some previous work on SEZs in China has described them as test-beds for policy-making. Government officials could see what worked in the SEZs and then implement those policies in the country at large.¹¹⁶ This theory sells the SEZs short, as it suggests that they were not instrumental in liberalizing China. The leaders had allegedly already made up

¹⁰⁷ GEORGE T. CRANE, *THE POLITICAL ECONOMY OF CHINA'S SPECIAL ECONOMIC ZONES* 26 (1990).

¹⁰⁸ *Id.*

¹⁰⁹ Victor F.S. Sit, *Specials Economic Zones in China: A New Type of Export Processing Zone?*, 23 *THE DEVELOPING ECONOMIES* 69, 75 (1985); CRANE, *supra* note 107, at 26.

¹¹⁰ See RONALD COASE & NING WANG, *HOW CHINA BECAME CAPITALIST* 61 (2012).

¹¹¹ *Id.*

¹¹² *See id.* at 59.

¹¹³ *See id.* at 60–62; see also CRANE, *supra* note 107, at 26–27.

¹¹⁴ CRANE, *supra* note 107, at 156; KAREN I. MCKENNEY, *THE INDUS. COLL. OF THE ARMED FORCES, AN ASSESSMENT OF CHINA'S SPECIAL ECONOMIC ZONES* 11 (1994).

¹¹⁵ See Wang, *supra* note 1, at 136; Payton Alexander, *Laboratories for Capitalism: Testing the Limits of the Special Economic Zones of Mainland China* 11 (2014) (unpublished M.A. dissertation, University of Edinburgh).

¹¹⁶ See Kwan-yiu Wong & David K.Y. Chu, *Export Processing Zones and Special Economic Zones as Locomotives of Export-led Economic Growth*, in *MODERNIZATION IN CHINA: THE CASE OF THE SHENZHEN SPECIAL ECONOMIC ZONE* 1, 6 (Kwan-yiu Wong & David K.Y. Chu eds., 1985); CRANE, *supra* note 107, at 96; Wei Ge, *Special Economic Zones and the Opening of the Chinese Economy: Some Lessons for Economic Liberalization*, 27 *WORLD DEV.* 1267, 1268, 1281 (1999); Jean-Pierre Cling & Gaëlle Letilly, *Export Processing Zones: A Threatened Instrument for Global Economy Insertion?* 7 (*Développement et Insertion Internationale*, Working Paper No. DT/2001/17, 2001), <http://ideas.repec.org/p/dia/wpaper/dt200117.html> [<http://perma.cc/S6TD-4XRL>]; Xu, *supra* note 89, at 1114–15.

their minds and were only looking for the right policies to promote growth. While the SEZs were tools in this pursuit, they would eventually have found the liberalizing reforms beneficial.

In this story, the SEZs were a top-down project, a notion that fits the common story about Deng Xiaoping making China an economic powerhouse through his convictions and strong leadership. In fact, Deng Xiaoping, like most leaders, did not support the SEZ policy until the mid-1980s, when they started to prove their worth.¹¹⁷ SEZs can give policy makers an idea about the effect of certain policies, but as test-beds for reform, they cannot reconstruct a system built on rent-seeking into one of openness.

Another often-told story about SEZs is that they function as showcases for reform.¹¹⁸ In the case of China, Communist Party leaders would have introduced the zones to show either other policy makers or the public that liberalization could create wealth. However, this too is a story about policy makers seeking ways to maximize the wellbeing of the citizenry. If this were indeed their goal, they would eventually understand what kind of reforms to introduce in this pursuit. As with SEZs as test-beds for reform, SEZs as showcases can benefit the country only at the margin by speeding up a process toward liberalization that is set to occur in any case.

The power of SEZs is instead that they can change the incentives of policy makers from relying on rent-seeking to promoting growth, and this is what seems to have happened in China. The new SEZs gave the country an image of newfound openness. China was, in practice, becoming capitalist.¹¹⁹ Local leaders thus saw two main changes that affected their incentives. For one, it became possible to reap the rewards of economic growth through openness. Second, it became harder to rent-seek, as businesses within the country had the opportunity to move to SEZs with more open business environments. The trade-off between rent-seeking and taxation thus tilted in the favor of the latter for more local leaders. As they lobbied for and obtained their SEZs, they made rent-seeking a decreasingly attractive strategy for other local leaders.

Eventually, a majority of the ruling elite in China could benefit more from openness and liberalization than protectionism

¹¹⁷ See CRANE, *supra* note 107, at 156.

¹¹⁸ See George T. Crane, 'Special Things in Special Ways': National Economic Identity and China's Special Economic Zones, 32 AUSTL. J. CHINESE AFF. 71, 76; see also COASE & WANG, *supra* note 110, at 160.

¹¹⁹ See COASE & WANG, *supra* note 110, at 164-66.

and rent-seeking. At that point, China truly had relieved itself from its previous destructive status quo. By 2008, ninety-two percent of all Chinese municipalities hosted SEZs.¹²⁰ China still suffers from corrupt practices throughout their official institutions, but no more so than the United States did at a similar stage of development.¹²¹

In addition to opening up the country to the world, the SEZs in China have avoided many of the problems that plagued the Indian zones. For one, political decentralization meant that decisions about the zones were taken on the local level by people who were familiar with prevailing business conditions. As a result, fewer mistakes were made regarding zone location and nature of production. Also, Chinese policy makers had little reason to use the zones for rent-seeking. They owe their seats to the elites in Beijing, who reward them for high GDP growth and can demote them if they fail to reach the growth targets.¹²² If granted an SEZ, they have the opportunity to secure their jobs and advance their careers by boosting economic growth. In many cases, the rewards that come from the top are larger than the rents they may extract by trading SEZ privileges. Similar to a democracy, China's system incentivizes local leaders to promote economic prosperity, as this rewards them politically.

China shows that SEZs can help profoundly change a country stuck in a rent-seeking disequilibrium. Still, it does not provide an example for how "governments" can use SEZs to promote growth. Had China's ruling elite wanted to reform the country, they could have done so much faster than through SEZs. The zones served instead as tools from the people at the bottom of the hierarchy to promote changes that initially were against the interest of the majority of rulers.

There may be no other policy that can promote such change so forcefully. For this to happen, though, conditions must be right, with sufficient decentralization and heterogeneity between municipalities, so that some can lead the SEZ reform while others follow. Alas, while it happened in China, it is unclear whether other countries will see a similar SEZ-led restructuring in the future.

¹²⁰ Wang, *supra* note 1, at 136.

¹²¹ See Carlos D. Ramirez, *Is Corruption in China "out of control"? A Comparison with the US in Historical Perspective*, 42 J. COMP. ECON. 76, 77–78 (2014).

¹²² See Xu, *supra* note 89, at 1093, 1102.

V. IMPLICATIONS FOR SEZs IN THE UNITED STATES

A thorough understanding of the political economy of SEZs allows for an analysis of the benefits and flaws of the SEZs of the United States. Labeled “foreign trade zones,” these were introduced in 1934 as a response to the Smoot-Hawley Tariff Act that came about as a reaction to the Great Depression.¹²³ Today, there are around 750 zones, which offer investors tariff and tax exemptions.¹²⁴

These fiscal incentives allow zone companies to be more profitable by reducing the cost of doing business and encouraging regional commerce.¹²⁵ To the extent that taxes and tariffs discourage the productive use of resources, SEZs in the United States create wealth by offsetting them. However, the zones are not without their critics, who primarily seem to focus on the limited impact the zones have on the economy as a whole. Tiefenbrun, for instance, points out that exports from the zones are only 2.6% of the total¹²⁶ (this figure was closer to 2.7% by August 2017).¹²⁷ Therefore, she concludes that the zones have done little to promote U.S. exports.¹²⁸

As was previously discussed, this is a flawed metric by which to judge SEZ success, as it tells us nothing about their net impact.¹²⁹ The U.S. zones may be small, but as long as their costs are smaller than their benefits, they still constitute a good policy for the country. However, as will be argued here, the United States relies far too much on small zones, and would be better off with larger, more diversified SEZs that include residential developments and offer investors more regulatory incentives.

There are some arguments for SEZ success in the United States. To start, the SEZs are largely decentralized. The federal government does not develop the zones, but leaves this to zone applicants. An applicant must be a “public or public-type corporation.”¹³⁰ Zone development is thus open to private development, although there is likely much governmental influence through public companies. Because these are local, they likely have an adequate understanding of the business climate in which the

¹²³ Eichengreen, *supra* note 91, at 37.

¹²⁴ See *How many zones exist now?*, *supra* note 11.

¹²⁵ See Bell, *supra* note 11, at 974; see also Tiefenbrun, *supra* note 12, at 221.

¹²⁶ Tiefenbrun, *supra* note 12, at 214.

¹²⁷ See Press Release, U.S. Census Bureau & U.S. Bureau of Econ. Analysis, U.S. International Trade in Goods and Services (Oct. 5, 2017 8:30 AM), <https://www.census.gov/foreign-trade/Press-Release/2017pr/08/ft900.pdf> [<http://perma.cc/DN2C-ESZB>].

¹²⁸ *Id.*

¹²⁹ See MOBERG, *supra* note 13 and accompanying text.

¹³⁰ *Who can apply?*, *supra* note 28.

zones are introduced. Local policy makers should also be incentivized to pursue successful zones, as they must answer to the judgment of their voters of their economic policy-making.

Public companies, on the other hand, do not face such incentives, as their positions are more akin to bureaucrats who are not exposed to the democratic process. Thus, the decentralization of U.S. SEZs go only halfway in solving the knowledge and incentive problems associated with centralization. Moreover, if public companies fail in their SEZ project, they will sometimes do so at the expense of the local government and hence, its tax payers.

While the public involvement in SEZ development is a concern, the main problem with U.S. SEZs lies in the incentives they create for the actors involved. The country has unfortunately relied to a large extent on single-factory zones for the expansion of its zone scheme. SEZ developers can apply to expand their benefits to affiliated “subzones,” which are single companies that need not be located adjacent to the main zone. There are twice as many of such “subzones” than the 250 “general-purpose zones.”¹³¹

The subzones are predominantly focused on manufacturing, and thus are likely private in most cases.¹³² The problem, though, is that such a scheme looks much like a program of targeted fiscal benefits for companies. In this respect, the United States looks much like India, with its numerous single-factory zones. This set-up contrasts sharply with China’s diverse SEZs with millions of residents. Single-factory zones incentivize companies to lobby for SEZ designation. They also prompt policy makers to make the scheme flexible enough that such lobbying is attractive. As a result, public resources are spent on a politically driven process of companies seeking benefits and officials responding to their demands.

Initially, only ports could become SEZs, which would at least have limited lobbying to that sector. In 1950, as manufacturing was allowed in the zones, the opportunities they provided became available to a much larger part of the U.S. economy.¹³³ With the introduction of single-factory zones in 1954, the field was ripe for widespread lobbying, as firms no longer had to relocate to obtain the benefits.¹³⁴ Although these zones must be affiliated with

¹³¹ *How many zones exist now?*, *supra* note 11; see also *Where can a Zone be Located?*, U.S. FOREIGN-TRADE ZONES BOARD, <https://enforcement.trade.gov/ftzpage/info/adjacency.html> [<http://perma.cc/7MQ7-SAEC>] (last visited Nov. 12, 2017).

¹³² *Who can apply?*, *supra* note 28.

¹³³ Grant, *supra* note 11, at 8, 10.

¹³⁴ *Id.* at 10.

general-purpose zones, they can potentially be located anywhere.¹³⁵ Most SEZ-based manufacturing now takes place in subzones, while general-purpose zones engage primarily in distribution and wholesaling.¹³⁶

Grant finds a significant lobbying activity surrounding the SEZs.¹³⁷ “Industry groups, individual producers, local and state governments, unions, congressmen and senators, and individual SEZ governing bodies all lobby.”¹³⁸ The board that approves SEZ applications often cites the lobbyists’ arguments for its decisions.¹³⁹ When a government offers fiscal benefits to single companies, such lobbying should be expected. The single-factory component of the SEZ scheme is therefore primarily a net waste of resources to the economy at large. Lower tariffs and taxes across the board for the county’s manufacturers would clearly be more beneficial. Thus, the zones are hardly better than such a political alternative. Yet, even compared to the status quo, the fact that the system relies on lobbying suggests that the costs of the scheme outweigh its benefits.

The general-purpose zones, too, are hardly better than an alternative policy of lowering tariffs and taxes in a less discriminatory fashion. Still, these look more like traditional zones, and thanks to the decentralized system, they may well bring prosperity to the country. While ports also must lobby to become SEZs, the benefits brought about in applying the fiscal incentives over a larger area and for more companies can override the negatives. Whether the benefits of general-purpose zones outweigh the costs of the single-factory zones is nevertheless questionable.

For SEZs to benefit the United States, they must be made larger, more inclusive, and dominated by private developers. The smaller the zones, the larger the incentive problems become. Larger and more inclusive zones can also have dynamic effects that spread prosperity beyond the zone borders. Rather than small industrial parks, the United States should allow for larger areas with residential developments that can offer not only fiscal but also regulatory exemptions. Regulatory incentives not only cost less for the government to provide but also open up new opportunities for businesses, as opposed to merely lowering their expenses.

¹³⁵ See *Where can a Zone be Located?*, *supra* note 131.

¹³⁶ Grant, *supra* note 11, at 10.

¹³⁷ *Id.*

¹³⁸ *Id.* at 12.

¹³⁹ *Id.* at 10.

The SEZ scheme in the United States came about as a response to heightened tariffs. In that light, there are three main roads that the United States can take. First, the government can reduce the fiscal burden from which companies seeking SEZ status are trying to alleviate themselves. A reversal of a mistake that caused the problem in the first place seems logical. Alas, although tariffs are not as high now as in the 1930s, recent administrations have not done much to lower them further. Second, the government can maintain the current SEZ system, which most likely will remain a burden for the economy. Third, the government can reform the SEZ scheme to make it more likely to succeed in enhancing welfare. Seeing that the program is unlikely to ever be abolished, the last option has the best chance of coming about.

CONCLUSION

There is reason to be optimistic about the future of SEZs. Decades of experience have shown which models promote prosperity and which come with too many burdensome costs. However, to understand what makes a successful SEZ, one needs a political economy perspective, which accounts for institutional contexts and recognizes the problems caused by limited knowledge and distorted incentives of the policy makers involved. Experience and logic show that an SEZ is a potent tool, which can do much good and much harm, depending on how it is used. With an increased appreciation of the political economy perspective of SEZs, more zone practitioners may promote the kinds of zone models that most likely promote welfare in any given institutional context.

The United States can also hope to learn from the rich experiences of the SEZs of the past. So far, the U.S. zones have hardly benefited the country, but that does not mean that they might not do so in the future. With large, privately developed zones, the United States can establish an SEZ policy that not only is better than the status quo, but also even better than its political alternative. In the best case, the U.S. zones may even promote countrywide reforms.

