Special Economic Zones (SEZs):
Chinese, Russian, and Latin American Cases and
the Use of SEZs as an Economic Development Tool

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Executive Summary

This paper compares China’s experience using Special Economic Zones (SEZs) to promote regional export-oriented economic growth with the experiences of post-Soviet Russia, Mexico and the Dominican Republic. This analysis is used to demonstrate that Special Economic Zones will only succeed in countries with a strong central government, geographic ties and cultural ties to developed markets, and competitively low-wage labor.

Introduction

SEZs are used to stimulate private investment and economic development through preferential government policies. The benefits an SEZ offers to companies may include corporate tax reduction or elimination, tariff free trade, or deregulated labor markets.

In China, the creation of SEZs was also the first step in the transition from a planned to a market economy. As the government of China opened the economy, it was able to direct the flow of foreign investment to selected regions. This was possible because China was largely undeveloped before the reforms, and the government had complete control over commerce and industry. Furthermore, China’s highly structured economy offered a relatively stable climate for business.

Foreign investors were initially attracted to China’s SEZs because China offered cheap labor and huge potential for growth. When the SEZs were created, they represented the only opportunity for investors to utilize China’s desirable human capital. Now that foreign investment is permitted throughout China, businesses choose where to invest based on the availability of labor,
infrastructure, distribution networks and other market factors. SEZs in China are therefore no longer effective at guiding investment.

A similar regional development strategy using SEZs may be theoretically appealing to other developing countries. Each country, however, presents unique challenges that would reduce the effectiveness of the Chinese model. The post-Soviet countries in Eastern Europe cannot duplicate China’s strategy because they did not geographically limit private investment and are already highly developed. There is therefore no pent up demand for market access to focus on targeted areas. Countries in Latin America are often less developed than Russia and those in Eastern Europe, but they are also already open to trade and investment, and do not offer competitively priced labor.

The general effectiveness of SEZs in attracting investment is being diminished because of multilateral trade liberalization through the World Trade Organization (WTO). As all member countries of the WTO cut tariff levels, the marginal tariff preferences awarded in SEZs will be reduced. Moreover, many of the corporate tax breaks given to companies either sunset or are matched by competing markets.

This paper will examine China’s experience with SEZs to determine how they contributed to China’s spectacular growth. The Chinese case will then be compared to that in Russia, Mexico and the Dominican Republic. This analysis will be used to create a list of prerequisites for countries considering a regional development strategy based on the use of SEZs.
SEZs in China

China first experimented with economic reform and attracting FDI by establishing SEZs in the cities of Shenzhen, Zhuhai, Shantou, and Xiamen in 1979. Having pursued policies aimed at equal allocation of resources, the Chinese central government redirected its policy toward regional development and efficiency and the results were remarkable. China experienced an 8.2% growth rate of real GDP from 1980 to 1997; the real GDP of the Shenzhen SEZ grew at 28.5% during the same time period. The SEZs were successful at attracting FDI, which fueled the high growth rates. In order to better understand this success, it is important to consider the factors that contributed to it. We will look at the political climate in China at the time when the SEZs were established, the choice of their location, and China’s comparative advantage in labor supply.

Prerequisites: Political Climate, Geography, and Labor

The Chinese political system is a one-party Communist state. Although local governments have a measure of control in many matters, policy is set at the central level and there are not any strong competing actors at the stage of either policy formation or implementation. This is critical to understanding the formation of China’s regional development policy and establishment of the SEZs. To stimulate economic growth in the late 1970s, the Chinese government formulated a strategy of opening up certain locations to foreign investment. The goal was to increase growth and economic development in these locations.

However, economic growth was not the only motivation behind opening up certain locations to FDI. The central government was looking for a way to experiment with elements of a market (rather than planned) economy, but did not want to risk an uncontrolled process and the demands
for political liberalization that might accompany economic liberalization. The party leadership was not concerned about the prospects of regional economic inequalities in part because everyone stood to benefit from a certain level of economic growth and because there was very little expression of resistance and rebellion to government policies with which the Chinese disagreed (Wu 1999).

The central government carefully selected the locations of the first SEZs based on several criteria. The selected sites benefited from good transportation infrastructure, were already connected to other communities that might invest in them (such as Hong Kong and Taiwan), and were at a distance from the political capital of Beijing. The importance of proximity to nearby investors cannot be overstated. Much of the financial capital and technical know-how China received with the establishment of the SEZs came from the overseas Chinese community, including Chinese in Hong Kong and Taiwan.

Prior to the establishment of the SEZs China was not open to receiving FDI. China had a competitive advantage in its very large and cheap labor supply, which investors were anxious to tap into. By opening up the SEZs to investors, China not only allowed them to access a cheap labor supply, but also offered them incentives in the form of expedited processing, which would otherwise be hampered by bureaucratic red tape. The SEZs themselves received greater investment from the state, were allowed to remit smaller amounts and benefited from favorable price and financial policies granting them lower-priced goods and greater financial autonomy (Fan 426).
Future of the Chinese SEZs

The original SEZs were tremendously successful, leading to the creation of more zones meant to attract FDI. In 1984 the government opened 14 coastal cities and 7 open coastal belts. It declared the open economic zones of the Yangtze River Delta, Pearl River Delta, Xiamen-Zhangzhou-Quanzhou Triangle, and Shandong and Liaodong peninsula. In addition, 15 free trade zones, 32 state-level economic and technological development zones, and 53 new high-tech industrial development zones have been established in large and medium-sized cities.

Despite their successes, economic growth fueled by investment in the SEZs and other open zones has contributed to some negative outcomes as well. The outcome of greatest concern, noted recently in numerous publications, is the growing economic inequality in China. Whereas initially this was not of great concern to the state, there has been a rise in the number of protests, particularly amongst rural residents and farmers. In addition to the basic problems of poverty inherent in inequality, Chinese suffering from low wages may begin to call for changes to the Chinese political system, a change which the one-party state is not ready to make.

It is time to reconsider the advisability of continuing to support SEZs in China, particularly to the exclusion of other economic development strategies, for several reasons. We have considered their negative effects in terms of widening the income gap disparity. SEZs are no longer necessary or useful from the view of potential outside investors as well. China has opened up to outside investment to the degree that all of China is attractive to investors. China’s WTO membership has limited its ability to offer preferential policies to outside investors and businesses. Finally, to a certain degree China is looking toward offering the world more than the
cheapest-priced labor. The central government is investing in entrepreneurial activity on many fronts and businesses are looking for ways to market higher-priced goods, such as refrigerators, outside of the Chinese market.

**Russian SEZs: A Comparison Case**

*Russia’s lack of success*

Both China and Russia have used SEZs to help work toward economic development goals. Whereas China’s SEZs have been successful at attracting FDI, Russia’s have not. Until the recent passage of the new legislative framework, the incentives offered by SEZs such as Kaliningrad were not guaranteed by law. The lack of trust and confidence this engendered in would-be investors is indicative of the main impediment to FDI inflow into Russia. The economy and political system have been perceived to be unstable, a view which was reinforced by the financial crisis of 1998 and Putin’s centralized power. In comparison to China, Russia lacks a large investment-minded diaspora. Finally, regions in which SEZs have been established in Russia “lacked the resources needed to develop the zones so that they would be attractive to outside investors. Infrastructure for effective development of the territory was woefully inadequate, and regional resources were not mobilized for this purpose” (Mukhina 1998, in Moses 2004, 160). Lacking the prerequisites which made China’s SEZs effective and led to economic growth, as well as negotiating both economic and political crises during the 1990s, Russia did not experience economic growth driven by regional development.
Prerequisites: Political Climate, Geography, and Labor

China and Russia differ in terms of the political leadership and motivation behind the introduction of SEZs. While China’s central government strategically allowed for the establishment of carefully monitored SEZs in certain geographic locations in order to boost regional development, the Russian leadership in the early 1990’s exercised a very different style of management in terms of the SEZs. Yeltsin designated people in favor of economic liberalization and marketization as governors of regions with the expectation that they would establish more open market economies, including SEZs. In reality, however, “the procedures and institutions established for special zones seem to have been designed to meet other goals of regional leaders: to retain and expand control over regional economies, to enhance opportunities for corrupt gains, and to provide additional assets that can be mobilized for political purposes – i.e., to hold on to power” (Moses 2004, 160). The outcome of this process, however, has been that regional leaders and their networks have personally profited from the establishment of SEZs.

Particularly since the departure of Yeltsin, economic liberalization in Russia has not benefited from widespread support amongst political leadership. Experience with failed legislation on free economic zones provides further supporting evidence: despite Yeltsin’s original backing of free economic zones, subsequent leadership has resisted implementing the legal underpinnings which might actually provide for investor confidence and an increase of FDI into the Russian Federation (Moses 2004, 157).

Despite the general lack of success in terms of boosting local and regional economies and the drop in support for SEZs, new legislation has recently been introduced to create a legal
framework for their operation and in theory, to finally attract FDI. SEZ Kaliningrad is the first region in Russia to take advantage of the new law on SEZs. Given that FDI, in combination with China’s comparative advantage in low-wage labor, was critical to the success of its SEZs, it may prove useful to consider the potential for Kaliningrad to attract FDI both in terms of predicting its course of economic development and in assessing the wisdom of introducing SEZs into other transitional and developing economies.

Although SEZs were established in Russia in order to take advantage of their geographical location, they did not benefit from location in the same way as Chinese SEZs. Many Russian SEZs, including SEZ Kaliningrad, are located in coastal provinces. Theoretically this should allow them to take advantage of existing transportation infrastructure. However, these regions “lacked the resources needed to develop the zones so that they would be attractive to outside investors. Infrastructure for effective development of the territory was woefully inadequate, and regional resources were not mobilized for this purpose” (Mukhina 1998, in Moses 2004, 160).

China also located its SEZs to take advantage of investment from the large diaspora population. Russia did not have the same diaspora population, located in nearby enclaves and prepared to invest, from which to draw. Some of the investment into SEZ Kaliningrad has, indeed, come from Russians, although often moved out of Russia, into Cyprus, and back into the Kaliningrad oblast. Russia certainly has not had a diaspora with more advanced technical knowledge at its disposal.
Russia does have the advantage of proximity to both European investors and European markets. Proximity alone has not enticed this investment, which has largely been hampered by bureaucratic red tape and an uncertain political climate, particularly under President Putin.

Post-1991 Russia also differed markedly from pre-SEZ China in terms of the available labor force. When the Soviet Union was dissolved in 1991 it was an industrialized state, in which more people were employed in state-owned industry than in the agricultural sector. These employees were accustomed to social benefits. The state continued to subsidize its enterprises and provide these benefits. Employees, therefore, had no incentive to move into other jobs (Sachs and Woo 1994). In contrast, at the beginning of China’s experiment with SEZs in 1979 the country was still largely rural and agricultural and not fully supported by social benefits. The SEZs could draw from a labor pool which was willing to both migrate to the location of the SEZs and enter manufacturing jobs.

Structure and goals of the SEZ Kaliningrad

The SEZ Kaliningrad was first introduced in 1991. In 1996 a Russian Federal Law was enacted specifying its design and the SEZ regime has been extended and reformed by a law enacted in April 2006 (Special Economic Zone for Kaliningrad).

The SEZ Kaliningrad has offered the following benefits:

- Free customs zone with the usual benefit of no import taxes (Vinokurov, 2004, p.3) and hence cheaper imports for local production, lowering manufacturers’ costs, therefore promoting export sales, primarily to Russia (Vinokurov, 2004, p.4). Kaliningrad also offers an attractive location from which to export goods from mainland Russia
• System of regional import quotas under which the rights to import 35 categories of goods duty-free are auctioned off; above the quota the goods are subject to customs procedures (Vinokurov, 2004, p.4).

• Goods of entire local manufacture and with 15% value-added for electronics and household appliances and 30% value-added for other goods and changes for Tariff Nomenclature in both cases can be further transported to mainland Russia without paying customs duties (Vinokurov, 2004, p.3-4).

Up until the present all other preferences meant to attract investment have not worked in practice because they lacked legal guarantees. Unlike Chinese SEZs the customs regime of SEZ Kaliningrad has not focused on attracting foreign direct investment. In 2003 FDI in Kaliningrad was USD 300 million, 45% of which came from Cyprus (largely of Russian origin); Germany, Poland, and the Netherlands furnished the remaining amount (Liuhto, 2005, p.3).

In recent years, investors and firms have held off on entering Kaliningrad due to uncertainty of the passage of the pending legislation. This situation is predicted to change with the introduction of the new SEZ law, which provides for full income tax relief for 6 years for new companies investing a minimum of RUR 150 million (€ 4.25 million) (Vinokurov, 2004, p.14). The old and new SEZ regimes will exist simultaneously for the next 10 years. However, the new law considerably alters the existing structure of the SEZ and thus, leaves open for question the future success of SEZ Kaliningrad and possible confusion due to overlapping SEZ regimes. With its recent passage, analysts are divided as to whether the entry of these investors and firms will have
a substantial positive effect on investment and economic development in at least the short-term (Liuhto, 2005, p.16).

SEZ Kaliningrad is a useful comparison case with the Chinese SEZ experience due to:

1. **Political environment – parallels in central support of regional development**

   Establishing an SEZ in Kaliningrad was supported by the central government. Yeltsin designated Yuri Matochkin, an economic liberal in favor of free market reforms, as governor. Matochkin’s desire was to turn Kaliningrad into “‘Russian Hong Kong’” (Moses, 2004, p.153). SEZ Kaliningrad is the only Russian SEZ which has been in continuous existence since the introduction of SEZs in the early 1990s. While SEZs flourished in the years immediately following the 1991 dissolution of the Soviet Union, by 1993 “when a new law establishing tariffs was set, free economic zones with the exception of the SEZ in Kaliningrad were not given any special dispensation thus eliminating customs benefits enjoyed by SEZs” (Salimov 1995 quoted in Moses 2004, 158).

2. **Geography – parallels in strategic location for infrastructure**

   The Kaliningrad oblast (a region smaller than a republic and lacking the republic level political autonomy) is located on the Baltic Sea neighboring on Lithuania and Poland and separated from “mainland” Russia. The SEZ system takes advantage of Kaliningrad’s location by utilizing the well-developed ports (Russia’s only ice-free ports) and proximity to EU member states. Although land transit requires passage through Lithuania, Russia exports goods (primarily natural gas) to the EU via Kaliningrad.
3. **Labor – very different**

In terms of labor Kaliningrad obviously cannot replicate the large and cheap supply critical to China’s economic transformation, but very few if any other locations would parallel China’s labor supply.

**Future of the Russian SEZs**

While Russia has not seen the same increase in FDI as a result of establishing SEZs, it has, encouraged value-added manufacturing in Kaliningrad, which has served as the point of entry for imports later consumed in the Russian market as a whole, providing for a certain level of employment in Kaliningrad and lower import prices in the Russian Federation.

With the new law on SEZs, which is meant to encourage FDI, perhaps the SEZ Kaliningrad will continue to support the economic development of the Kaliningrad oblast. As labor prices in the new EU member states increase, comparatively lower labor prices in Kaliningrad may encourage the migration of some manufacturing and service industries to Kaliningrad, which is in an ideal location for the production of exports to the EU.

Despite the recent extension and expansion of SEZ Kaliningrad, the usefulness of this model for sustainable economic growth in the Kaliningrad oblast is also disputed. The customs regime largely favors exports and the only manufacturing industries with a comparative advantage in the region are woodworking and food processing. SEZ Kaliningrad may also be adversely affected by the widening of the EU, the accession of Russia to the WTO, and the creation of a Common European Economic Space (CEECs) (Liuhto 2005).
Lessons learned from the China-Russia comparison

No country will be able to establish SEZs from the same starting conditions as China did in 1979 and as such, it would be unwise to predict the same level of success in economic growth which China experienced. Russia’s experience with SEZs in the 1990s, however, points to the fact that governments, whether central or local, may encourage the establishment of SEZs for reasons other than China’s. They may be a means of encouraging market economy reforms and a means for establishing regional and local economic autonomy. The case of SEZ Kaliningrad also shows that SEZs may be used to achieve goals other than high rates of economic growth, ranging from export-promotion to import-promotion.

The other lesson of this comparison, however, is that emerging market economies need to consider a range of economic development policies in light of new economic realities. Many emerging economies are competing for FDI and are increasingly having to do so in a world economic system of trade regulated by the WTO. Emerging market economies cannot offer the same incentives to investors as China could with the advent of SEZs. Russia would be advised to employ a range of economic development policies that play to its strengths, including natural resources and a fairly well-educated work force, and to continue to improve the business environment, by ensuring that government is efficient and unobtrusive.

EPZs in Mexico and the Dominican Republic: An Alternative Model

Export Processing Zones (EPZs) have been used extensively throughout Latin America and the Caribbean to promote foreign investment and export-oriented industry. The most successful
examples are the *maquiladora* factories along Mexico’s border with the US. Caribbean nations, primarily the Dominican Republic, have also used EPZs to promote export industries. Mexico and the Dominican Republic share little directly with China, but it is important to consider these cases in order to establish whether the political, geographic and competitive factors that contribute to promotion of export-oriented development are the same across countries.

During the 1990s, Mexican production focused on the assembly of textiles and electronics. Dominican production during the same period was almost exclusively textiles and produce (Esquivel, Jenkins and Larraín, 1998). Through the North American Free Trade Agreement (NAFTA), and the US Caribbean Basin Initiative\(^1\), Mexico and the Dominican Republic enjoyed preferential, duty free, access to the US market. The Multifiber Agreement limited the textile imports from any given country into the US and European markets, thereby guaranteeing some portion of the market to countries from all regions. When the Multifiber Agreement expired in December of 2004, relatively higher labor costs in Central American and Caribbean countries meant that Mexico and the Dominican Republic could no longer compete with Chinese textile exports.

*Prerequisites: Political Climate, Geography, and Labor*

Mexico and the Dominican Republic are democracies that exhibit a high degree of political instability. Consequently, the EPZs in both countries were developed in response to market forces and international politics rather than through a central government economic development plan. The Dominican Republic, which first established an EPZ in 1965, faces a perennial unemployment level of up to 30%. With a small population base and few natural resources, the
government promoted labor-intensive export industries as the only viable alternative for increased employment (Esquivel, Jenkins and Larraín 1998). The Dominican Republic is also a former Spanish colony. As such, it has historically been awarded preferential access to markets in the EU and US. Most African, Pacific, and Caribbean nations receive some form of special market access.

Mexico promoted the development of EPZs for economic and political reasons. The passage of NAFTA made it much easier for US firms to conduct their manufacturing and assembly operations in Mexico. However, firms would still need to invest heavily in new facilities in order to make such operations possible. The government of Mexico used the EPZ model to attract the foreign direct investment necessary to build those facilities.

Mexico and the Dominican Republic benefit from their proximity to the US. Mexico, in particular, is the only developing country with a land border with the US. This is Mexico’s primary competitive advantage and the primary reason why export-oriented investment has continued despite lower labor costs in Asia and other parts of Latin America. Proximity to the US also means that there are long established ties to the financial markets and that US enterprises are familiar with the business environment in Mexico and the Dominican Republic.

Mexico and the Dominican Republic offer labor that is much cheaper than in the US, but wages are many times higher those in China. Increasing global trade has therefore shifted production of many labor-intensive goods to China. Mexican maquiladoras are now more likely to be

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1 Superseded by DR-CAFTA in 2005
assembly plants for durable goods with high transportation costs, like automobiles, than textiles or electronics.

*Lessons Learned from a comparison of China, Mexico and the Dominican Republic*

China, Mexico and the Dominican Republic all created EPZs or SEZs to foster export-oriented economic growth and foreign investment. Each country also had preexisting ties to developed financial markets and distribution channels. The primary difference is that much of the industry in Mexico and the Dominican Republic was not cost competitive in the absence of trade preferences. China’s SEZs, on the other hand, received government support and in country preference, but did not benefit from trade preferences. The result is that industry in China has developed according to China’s competitive advantages in scale and labor cost.

**Conclusion**

China is often singled out as unique among developing countries. It has the world’s largest population and a strong central government that is not directly accountable to the people. Furthermore, it is developing so rapidly, in part, because it is still extremely poor. No other country can hope to duplicate China’s success based on these characteristics. However, there are several general lessons to be drawn for any country considering the use of SEZs as a development strategy. It is not possible to create a successful export-oriented industry through the use of tax incentives and trade preferences alone. The following factors are prerequisites for establishing an SEZ that will successfully attract foreign investment, promote regional export-oriented growth, and remain competitive when preferences are eventually removed.
A Strong Central Government

The preferences awarded to foreign investors in an SEZ will only be credible if they are supported by national and international laws. Labor-intensive manufacturing facilities often require large upfront direct investment. Investors must therefore be confident that bureaucratic confusion or regional disputes will not lead to changes in the local business environment.

Geography Must Facilitate Distribution and Investment

An SEZ will only attract foreign investment if it is created in an area where distribution to desirable markets is feasible and cost effective, most frequently a coastal or border region. The region should already have connections with the industry targeted for expansion by the SEZ.

The Country Must be Sufficiently Undeveloped

In order to have competitive advantage in an export-oriented industry, developing countries must compete on labor cost. Workers in developing and middle-income countries tend to be relatively low skilled. Wages must therefore be low enough to compensate for additional distribution, training, and building costs necessary to expand modern production capacity.

The Future of SEZs

Throughout the mid-twentieth century, many developing countries implemented policies of import substitution to expand their economies. In the import substitution model, a developing country would place high tariff barriers on imports and then attempt to create a domestic industry to meet local demand. This strategy met with very limited success because no country is an efficient producer of all goods and manufacturing often requires global consumption scale in
order to offset high start-up and development costs. These problems caused many developing
countries to switch to a policy of export promotion.

SEZs and EPZs are some of the most commonly used policy tools by governments to promote
export-oriented growth. However, globalization and progress toward multilateral trade
liberalization make it much more difficult to promote development through preferential policies.
Only countries that are currently isolated from the world economy are likely to experience
substantial benefits from the creation of SEZs.
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