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Joachim Ahrens, Astrid Meyer-Baudeck*

Special Economic Zones: Shortcut or Roundabout Way Towards Capitalism?

The experiences of developing countries suggest that special economic zones (SEZs) might be appropriate instruments for accelerating the economic restructuring of Central and Eastern Europe. What functions could SEZs fulfil in the transformation process? What conditions must be met if they are to be successful?

The transformation processes in Central and Eastern Europe (CEE) are characterized by highly sensitive interrelations between the political, economic and cultural subsystems. From the very beginning of the systemic change, this interdependence has challenged the entire fabric of society. Therefore, the transition towards democracy and a market economy is a unique challenge without any precedent in history. Although political and economic realities outpace scientific findings, there is a substantial pragmatic need for politicians to act and to manage the transformation.

Transforming formerly socialist societies not only requires the implementation of a new political and economic order, but also the finding of new effective instruments of economic policy-making. In this context, the experiences of developing countries suggest that special economic zones (SEZs) might be appropriate instruments for accelerating the economic restructuring of CEE, all the more as SEZs have proved to be driving forces of the systemic change in socialist China. Protagonists of SEZs point out that this instrument positively affects both the economic performance of individual regions and the transformation of the national economy. Hence, they expect SEZs to become catalysts for sustainable economic development. However, in view of the numerous failures of that concept in various developing countries, the presumed positive effects are far from being generally accepted.

In all CEE countries, economic transformation has been accompanied by considerable political changes, in some cases even endangering the political system

per se. There are interdependencies between all the subsystems of society, which restrains rational policy-making. Transformation measures have to address the implementation of a new economic order and a new political order simultaneously. If cultural changes and social adjustment processes are also taken into consideration, which occur in any development process, it is quite evident that the political authorities are hardly capable of planning and controlling the transition towards the new system, the more so as an economic recession is inevitable in the early phase of transformation.¹

Typically, the "transformational recession"² is essentially caused by distortions in the industrial structure and the system of relative prices, the financial system's backwardness, deficient market-oriented institutions, a lack of horizontal and vertical mechanisms for coordination and conflict resolution, and weak state authorities allowing massive rent-seeking. Usually, the recession is temporarily worsened by certain necessary transformation measures, especially by the introduction of hard budget constraints.³ Wrong economic policies and the inconsistent assignment of competences can lead to further distortions and delays in restructuring. In some countries, such as the successor states of the USSR and former Yugoslavia, the recession has been aggravated by political upheaval and even warfare.

In view of the nature of the systemic change as well as the recent experiences of CEE countries, three

* University of Göttingen, Germany. The authors are grateful to Dr. Johann Graf Lambsdorff for critical comments.

¹ J. Ahrens: Der russische Systemwandel. Reform und Transformation des (post)sowjetischen Wirtschaftssystems, Frankfurt/Main 1994, chapter 5.

² J. Kornai: Transformational Recession: The Main Causes, in: Journal of Comparative Economics, Vol. 19, No. 1, 1994, p. 39.

³ Ibid., pp. 41-52.

factors can be identified which are crucial for a successful transformation policy. First of all, political authorities need to enforce a bold and comprehensive transformation strategy in order to stabilize the political system and to implement a market-oriented economic and legal order as a framework for economic agents to act independently of political institutions. In this respect, a stabilization-cum-adjustment programme is to be regarded as a *sine qua non*, even for countries like Hungary and China in which a more gradual approach seems to be manageable. At the same time, political and economic competences must be properly assigned in order to maintain the ability of political institutions at all federal levels to act, and to have private economic agents act independently within a stable and enduring institutional framework.

Second, opening up the economy at an early stage of the transformation is of utmost importance in order to strengthen domestic policies and benefit from welfare gains from the international division of labour. That way, competitive structures can be created, inducing adjustment pressures on domestic enterprises and accelerating the necessary structural change. Also, a rational price structure for tradables can be imported, diminishing the persistent misallocation of resources. Furthermore, liberalizing imports and making the economy attractive to foreign direct investment (FDI) eases access to modern technology and know-how and increases domestic quality competition as well as the economy's export potential.⁴ Hence, opening up the economy is an essential step to compensating domestic transformational deficiencies and to strengthening and complementing a rational domestic restructuring programme.

Third, in view of the enormous burden of adjustment and the limited resources in CEE, external assistance must be regarded as a necessary complement to CEE's own transformation efforts. Supporting the economies in transition not only includes financial and technical assistance, but also political cooperation and suitable measures to

integrate the countries into the world market and to enhance their attractiveness to foreign investors. In this context, expertise and guidance from international institutions, Western governments, and non-governmental organizations (NGOs) are important in order to create an appropriate framework for FDI.⁵

SEZs: Concepts and Experiences

Since the 1950s, beginning with the success of the Irish Shannon Airport Free Zone, the pragmatic rather than theoretically grounded concept of SEZs has attracted the growing attention of politicians and economists in industrial and, particularly, in developing countries. In view of the nature of the systemic change in CEE, one might also expect SEZs to contribute to the overcoming of specific problems of economies in transition. In this regard, the experiences of developing and newly industrialized countries with export processing zones are of special interest because this kind of SEZ became an integral part of their national development strategies. Besides theoretical considerations, those experiences reveal the determinants of the effective application of that instrument.

SEZs (including offshore enterprises) are geographically or functionally limited parts of an economy in which rules and other institutions concerning the production and the distribution of goods and services differ from those in the rest of the economy. These special institutions are realized in order to promote and favour economic activities in a specific area.⁶ Generally, they offer both financial incentives, such as lower taxes and tariffs, and subsidies as well as the substantial deregulation of the legal and administrative framework or the provision of legal privileges.

The primary goals pursued by the establishment of SEZs determine their design. In general, SEZs are aimed at promoting foreign trade, diversifying the production of exportables and overcoming structural balance of payments pressures, importing modern technology and know-how, and improving supply conditions on the domestic market. Furthermore, positive employment effects as well as positive spill-overs to the rest of the economy evolving backward and forward linkages are expected. Actually, SEZs are implemented to improve the performance of economically underdeveloped regions as well as of those regions which show a considerable growth potential inducing a stimulation of the national economy via linkage and multiplier effects. Hence, SEZs can basically serve as a regional-specific or growth-promoting instrument.

⁴ D. Lösch: Der Weg zur Marktwirtschaft. Grundzüge einer Theorie der Transformationspolitik, Baden-Baden 1994, p. 98.

⁵ J. Ahrens: Die Rolle westlicher Industriestaaten bei der Transformation sozialistischer Volkswirtschaften – Einige grundsätzliche Anmerkungen zu den Umgestaltungsprozessen in Polen, Ungarn und der CSFR, in: LIST FORUM für Wirtschafts- und Finanzpolitik, Vol. 19, 1993, No. 1.

⁶ B. Busch: Sonderwirtschaftszonen als Instrument der Systemtransformation, in: Beiträge zur Wirtschafts- und Sozialpolitik 198, 3/1992, Cologne 1992, p. 8.

The various theoretical and practical SEZ concepts are essentially:⁷

- a tax-free zone and free ports, which are implemented in order to facilitate (foreign) trade turnover, to improve the refinancing possibilities of enterprises, and to make these areas attractive to foreign and domestic investment;
- import or export processing zones, which favour the production and processing of importables and exportables;
- enterprise zones (zones of free economic activities), primarily established in industrial countries as an instrument of regional policy;
- free banking and insurance zones and technology parks, implemented to increase the international competitiveness of domestic banks and insurance companies and to improve, respectively, the transfer of know-how and the diffusion of technical knowledge.

Export Processing Zones

In developing countries, export processing zones (EPZs) have played the most important role. Especially in the newly industrialized countries (NICs), they significantly supported the development process by integrating the economies into the world economy and by making use of their comparative advantages. The main characteristics of EPZs are the duty-free import of raw materials and other inputs, the reduction or elimination of profit taxes, efficient and flexible administrative structures, provision of an appropriate material and legal infrastructure and of subsidized public utilities.⁸

The implementation of numerous EPZs during the last three decades essentially reflected two tendencies of economic development in the world: the changing investment pattern of enterprises and the developing countries' search for new strategies to overcome underdevelopment and poverty. In the course of technological change and increasing competition in the world market in the 1970s, enterprises in industrial countries started world-wide sourcing in order to break down production processes and to find production locations that allowed a

minimization of costs and a high degree of entrepreneurial flexibility.⁹ On the other hand, many developing countries realized the deficiencies of an import-substitution strategy and started to pursue a strategy of opening up. Diversifying exports and acquiring FDI were regarded as unalterable prerequisites of economic growth. Another incentive to implement EPZs was the need to react to the growing international competition for foreign investors, the more so as the share of FDI going to developing countries significantly declined since the mid-1970s.¹⁰

In developing countries, the first EPZs were founded in Puerto Rico (1962), Mexico (1964), and India (1965). Taiwan (1966), South Korea (1971) and the Philippines as well as Malaysia (1972) followed those examples.¹¹ In subsequent years, the number of SEZs increased rapidly, which does not mean, however, that SEZs proved to be effective instruments of development policy in all cases.

With respect to the employment situation, experience shows that only a few countries succeeded in increasing the number of jobs significantly due to the establishment of labour-intensive production processes which took advantage of relatively low wages. However, the absolute number of unemployed did not decrease as expected because most new jobs were given to women who had not been employed before. Improvements in human capital via the transfer of know-how could hardly be realized.¹²

The effects on the balance of payments differed substantially among countries, depending on the amount of imported inputs and the degree of value added produced in the host country. The biased orientation towards the production of exportables often induced substantial imports because domestic production could not provide competitive inputs to meet the quality standards of the world market. Balance of payments pressures continued to exist

⁷ K.-W. Schatz, D. Spinanger: Zonen freier Wirtschaftsaktivität, Kieler Diskussionsbeiträge 105, Kiel 1984, pp. 4-13; P. G. Warr: Export Processing Zones and Trade Policy, in: Finance & Development, June 1989, p. 35. With respect to notional variety see United Nations Centre on Transnational Corporations (UNCTC): The Challenge of Free Economic Zones in Central and Eastern Europe. International Perspectives, New York 1991, p. 3.

⁸ P. G. Warr, op. cit., p. 35.

⁹ E. Liebau, P. Wahnschaffe: Freie Produktionszonen als Instrument der Wirtschaftspolitik in Entwicklungsländern, in: Mehrwert, Beiträge zur Kritik der politischen Ökonomie, No. 32, Bremen 1990, p. 17.

¹⁰ W. Lütkenhorst: Challenges from New Trends in Foreign Direct Investment, in: INTERECONOMICS, Vol. 23, September/October 1988, p. 221; K. Merforth: Das entwicklungspolitische Instrument der Freihandelszone. Eine Analyse im Rahmen einer exportorientierten Industrialisierungsstrategie unter besonderer Berücksichtigung der Erfahrungen Sri Lankas, in: Fortschritt-Berichte VDI, Reihe 16: Technik und Wirtschaft, No. 39, Düsseldorf 1987, pp. 25-30.

¹¹ Ibid., p. 15.

¹² E. Liebau, P. Wahnschaffe, op. cit., p. 6; and H. Dörrenbächer: Sonderwirtschaftszonen – Ein Beitrag zur wirtschaftlichen Entwicklung der UdSSR?, in: Osteuropa-Wirtschaft, Vol. 36, 1991, No. 2, pp. 83. ff.

especially in (very) low-income countries, because the setting up of the SEZs, especially the creation of an appropriate infrastructure, required substantial resources that could not be provided by the domestic economy. Additional state revenues induced by economic activities in the SEZs could hardly be realized due to tax reductions and omissions, the elimination of tariffs, and the fact that multinational zone enterprises redistributed their profits in order to minimize their tax bills.¹³

Regarding the goal of transferring modern technology and know-how, the outcome was often disappointing. The main reasons included the substantial protection of patents, the low technological level of labour-intensive production, and a lack of skilled labour. Furthermore, neither forward nor backward linkages connecting the SEZ with the rest of the economy could be sufficiently realized in many cases. These deficiencies were mainly caused by the production of exportables and the inability of the host country to provide high-quality inputs in due time. UNIDO and OECD studies also emphasized that the subsidiaries' degree of dependence on their parent companies played an important role. The more independent a subsidiary, the more likely was its integration into the host country's economy and, hence, the realization of forward and backward linkages.¹⁴

Individual Country Experiences

South Korea implemented two EPZs in the early 1970s, which proved to be successful instruments of an export-oriented industrialization strategy. From the very beginning, the establishment of the EPZs Masan and Iri was regarded as an integral part of an overall development strategy. Both zones primarily served to acquire foreign capital. Masan as well as Iri were provided with an efficient administration in the form of one-stop investment offices and with other legal and administrative privileges. Both zones were located in rural regions, equipped with favourable transport facilities and a surplus of cheap labour. Thus, these EPZs also served as an instrument of regional policy. Also, they proved to be particularly successful examples of the generation of market-induced backward linkages.

Moreover, the South Korean EPZs revealed that SEZs are subject to a certain life cycle. Initiated in an early phase of economic development but with a minimal industrial basis, they show a substantial potential for attracting foreign capital, inducing an increasing value-added in domestic production and

positive spillovers, and improving the country's export performance. In the process of increasing industrialization and international integration, SEZs become more and more obsolete as an instrument of growth-oriented policy because the overall economy increasingly catches up with international competitors. At the end of the EPZs' life cycle, the authorities must either eliminate special regulations and integrate the zones into the national economy or design a new internationally competitive concept, such as the transition from labour-intensive production towards a more capital-intensive one. The South Korean SEZs policy was successfully accompanied and supplemented by administrative guidance, stability-oriented macroeconomic policies meeting the challenges of the world market, a strong commitment to structural change, and an educational system that met the needs of a growing and changing economy.¹⁵

Mauritius was the first African country to implement an EPZ at the beginning of the 1970s, after having replaced its import-substitution strategy by an export-oriented one. The primary goals of that SEZ consisted of supporting the structural change of the economy, improving the transfer of technology and know-how and, above all, reducing unemployment. The EPZ was not a geographical but a functional concept and included most of the country's export-oriented companies. This procedure was feasible due to the country's suitable infrastructure and promised the rapid integration of the privileged enterprises into the national economy. The EPZ was quite successful despite some temporary drawbacks. Due to substantial investment activities, both employment and exports (especially of textiles) could be significantly increased. Overall economic policies complemented the EPZ's activities appropriately. Besides various multilateral and bilateral economic agreements promoting the country's international integration, crucial factors responsible for the economic success of the EPZ included the availability of capital and cheap but skilled labour, and a democratic, multi-party system that provided effective mechanisms for conflict resolution and generated a climate encouraging individual creativeness, flexibility, and innovation.¹⁶

¹³ P. G. Warr, *op. cit.*, p. 35; and H. Dörrenbächer, *op. cit.*, p. 86.

¹⁴ H. Dörrenbächer, *op. cit.*, p. 84; and A. Basile, D. Germidis: *Investing in Free Export Processing Zones*, OECD Development Centre Study, Paris 1984, pp. 50-53.

¹⁵ UNCTC, *op. cit.*, pp. 333-343; United Nations Industrial Development Organization (UNIDO): *Export Processing Zones in Transition. The Case of the Republic of Korea*, New York 1988.

Mexico initiated an EPZ at its border to the United States in 1964. The primary goal was to create new jobs in the border region. Duty-free imports of inputs and relatively low wages were the most important incentives to investors. At the beginning, the total production had to be exported, and only since the 1980s have companies been allowed to sell their goods on the domestic market. Due to a massive depreciation of the peso, the attractiveness of the EPZ to foreign investors increased substantially in the 1980s. Until 1990, 1,800 enterprises (maquiladoras) had started their business in the EPZ, employing half a million people and producing 12% of Mexico's total exports. However, neither significant forward nor backward linkages evolved due to the limited involvement of domestic investors, the regulated isolation of the EPZ vis-à-vis the national economy, the insufficient competitiveness of domestic enterprises as a result of protectionism, and the lack of skilled labour.¹⁷

India implemented two EPZs, Kandla and Santa Cruz, in 1965 and 1973 respectively. Their performance, however, was disappointing and they supported neither national nor regional economic development noticeably. Regarding Kandla, the authorities chose a location with unfavourable transport facilities and infrastructure as well as an inflexible bureaucratic treatment of investors. Despite the more suitable location of Santa Cruz, even that EPZ disappointed because it was embedded in a strongly regimented and highly protected environment that had created internationally hardly competitive economic structures.¹⁸

Key Factors

The experiences of developing countries and NICs allow the identification of an attractiveness portfolio emphasizing the importance of FDI and showing key factors which are crucial for SEZs to become successful instruments of regional policy and particularly of growth-oriented development strategies. These determinants refer to both the concrete design of the SEZ and to the national framework in which the SEZ is embedded. Central factors concerning the design of an SEZ comprise:

- ☐ an appropriate infrastructure and favourable transport facilities;
- ☐ incentives to invest such as duty-free imports of inputs, tax reductions and omissions, as well as other privileges;
- ☐ an effective and flexible administration, based on a transparent and consistent legal framework;

- ☐ relatively low factor costs as well as the availability of (skilled) labour.

Measures regarding the design of SEZs have to be complemented by a favorable national framework including

- ☐ political stability;
- ☐ the guarantee of private property rights as well as a critical number of private enterprises;
- ☐ a low degree of protection (no quantity restrictions on imports and exports, low tariffs);
- ☐ convertibility of the domestic currency, including capital-account convertibility for foreign investors;
- ☐ a well-designed educational system;
- ☐ a transparent and stable legal and administrative framework;
- ☐ a strong commitment by political authorities to establish an open market economy.

Besides these preconditions, the host country should have reached a certain stage of development in order to be prepared for the formation of sustainable forward and backward linkages. Moreover, the effectiveness of SEZs can be enhanced and the overall development process accelerated if the host country enters into international trade agreements and signs suitable agreements on the protection of investment.

Catalysts of Systemic Change?

The experiences of developing countries and NICs suggest that SEZs can basically serve as instruments for accelerating economic development and supporting an overall strategy of economic restructuring. Whether or not they can also be regarded as useful instruments of the systemic change in CEE not only depends on the commitment of the political authorities towards economic restructuring and on country-specific characteristics, but also on the functions SEZs are supposed to fulfil within the process of transformation.

- ☐ *SEZs as a test laboratories for implementing the market economy.* In view of the complexity of the

¹⁶ U. Leffler: Mauritius. Abhängigkeit und Entwicklung einer Inselökonomie. Determinanten einer exportorientierten Industrialisierung durch Freie Produktionszonen, in: Hamburger Beiträge zur Afrika-Kunde, No. 33, Hamburg 1988; R. Alter: Lessons from the Export Processing Zone in Mauritius. Success involves more than just a well-designed policy package, in: Finance & Development, December 1991.

¹⁷ J. Grunwald: Assembly Industries, Technology Transfer, and Enterprise Zones, in: R. E. Green (ed.): Enterprise Zones. New Directions in Economic Development, Newbury Park 1991, pp. 192-206.

¹⁸ K. Merforth, op. cit., pp. 89-90.

systemic change, the lack of experience and know-how in economic policy-making, and the substantial controversies concerning the appropriate design of restructuring programme, transformation policies might evolve to a trial-and-error policy inducing substantial (maybe even prohibitive) economic costs. This would imply widespread political disorientation, which is likely to endanger the whole transformation process. In this context, SEZs might offer the opportunity to establish a geographically constrained market economy and to use those experiences in the design of an overall transformation programme.¹⁹ However, political constraints usually do not allow the postponing of transformation efforts until first economic results have been reached in an SEZ. Moreover, areas which are suitable for implementing an SEZ should be representative for the rest of the economy; a precondition unlikely to be fulfilled due to the geographical heterogeneity of any economy with respect to branches of industry, availability of resources, cultural background etc. Also, it cannot be effective to implement a market-oriented SEZ as part of a planned economy if competitive structures are to develop in the SEZ. Being an open system, an SEZ needs to establish relations with its environment. If this environment is a planned economy, market-oriented adjustments in the SEZ can hardly evolve. Hence, SEZs cannot effectively adopt the role of a test laboratory.

□ *SEZs as an instrument to enhance the acceptability and credibility of transformation policies.* Since private economic agents play a crucial role for the success of any transformation policy, acceptability and credibility represent central conditions and prerequisites of a successful transformation strategy. If the enforcement of a bold transformation programme (e.g. due to political constraints) is not feasible in the short run, building up functioning competitive structures in SEZs might serve as a step to increase people's confidence in the authorities' policies. That way, an SEZ becomes a leading example, showing a long-term economic perspective and explaining the mechanisms and characteristics of a market economy to the people. Learning effects will evolve that reduce eventual resistance to the systemic change. In this regard, the possible location of an SEZ does not need to be a representative region, but rather an area with a high

probability of becoming a successful SEZ. Furthermore, the external support of international and other organizations can be enhanced if the SEZ reflects a strong commitment by policy-makers to sustainably promote the transformation process. Basically, SEZs represent an instrument which is appropriate for strengthening confidence in the ability of political authorities to act, domestically as well as abroad.

□ *SEZs as an instrument to attract domestic and foreign investment.* The implementation of SEZs is a promising means of making certain locations attractive for private investment. This is of particular importance if the possibilities for creating a positive climate for investment in the economy as a whole are limited. Despite the strong growth potential of CEE markets, substantial reserves of natural resources, relatively cheap but skilled labour, and a generally successful trade liberalization, private (foreign) investment has stagnated in many CEE countries.²⁰ Political instability, the inconsistent and intransparent assignment of competences, contradictory laws, the unclear regulation of property rights, and an unstable macroeconomic environment have increased the option value of waiting for potential private investors. Also, an inadequate institutional and material infrastructure, the lack of functioning capital markets, trade restrictions, and convertibility constraints discourage investment. Implementing SEZs might contribute to the elimination of some of the persistent barriers to investment, at least in certain areas and in the short run. This reduces transaction costs, increases the number of feasible alternatives, and reduces the uncertainty of investment decisions. With respect to domestic enterprises, investing in SEZs not only implies favourable economic conditions and better world-market access. It might also be an opportunity for faster adjustment towards market-oriented production and management structures due to closer formal and informal relations with the foreign companies operating in the SEZ. In order to support domestic enterprises in catching up with the foreign competitors, the authorities should actively promote enterprise restructuring by providing suitable incentives and administrative guidance.

□ *Using regional transformation potentials.* Especially in large countries, the regional preconditions for a successful transformation might differ significantly due to particular ethnic, cultural and geographic characteristics and regional political priorities. Using regional transformation potentials by establishing SEZs may accelerate regional structural change, induce positive spillovers, and imply a

¹⁹ B. Busch, *op. cit.*, pp. 29 ff.

²⁰ A. Inotai: Foreign Direct Investment in Reforming CMEA Countries: Facts, Lessons and Perspectives, in: M. W. Klein, P. J. J. Welfens (eds.): *Multinationals in the New Europe and the Global Trade*, Berlin, Heidelberg 1992, p. 130.

regional competition of transformation supporting the overall systemic change. This concept requires a new orientation of regional policies towards a growth-oriented regional policy. In addition, decentralizing political decision-making, implementing federal structures and the devolution of competences represent necessary measures to establish regional economic independence. Using regional transformation potentials should be regarded as a central function of SEZs during the systemic change, especially in those countries where an overall bold transformation programme cannot be carried out for political reasons.

□ *SEZs as an instrument for opening up the economy.* Trade liberalization is one of the transformation's core elements. However, a rapid external liberalization might result in the bankruptcy of those domestic enterprises which produce a negative value-added under a regime of world-market prices and need some time for adjustment. In this regard, SEZs can serve as an instrument of foreign trade policy, specifically directed at increasing the country's export performance. This approach implies the rapid external opening of the SEZ, while the rest of the economy remains temporarily protected via a network of tariffs. Even in that case, forward and backward linkages might evolve over time if the overall transformation strategy pursues a more gradual, but single-minded policy of macroeconomic stabilization and microeconomic restructuring. Competitive pressures should spill over to the rest of the economy in a more moderate way.²¹

Second-best Approach

Analyzing possible functions of SEZs suggests that this instrument can basically become a catalyst of the systemic change if it is embedded in an overall, single-minded transformation strategy. The most important contributions of SEZs are the creation of attractive conditions for private investment and the use of regional transformation potentials. In addition, they might serve as an instrument of external opening and increasing acceptability and credibility of the transformation policies. However, solutions for central problems of transformation such as its sequencing and timing can hardly be expected. Moreover, decision-makers in CEE should be aware of the fact

that the potential positive effects of SEZs must not be overestimated. The experiences of developing countries and NICs clearly show that basic economic problems cannot be overcome by setting up SEZs. They induce positive spillovers only if an adequate economic and political framework exists which manifests competitive structures in both the SEZ and the rest of the economy. Basically, it has to be considered that SEZs always represent a second-best approach to accelerating economic development. Only if a bold and radical transformation strategy cannot be carried out due to political, social or other reasons, should the authorities try to promote economic development by implementing SEZs.

A suitable concept for SEZs should aim at establishing a zone of free economic activity. In contrast to zones focused on special goals such as export promotion these are more flexible and meet the requirements of an overall strategy. Moreover, they allow the use of regional and national comparative advantages more efficiently, promote the development of a balanced regional economic structure, and give regional authorities the opportunity of pursuing their own economic priorities and transformation strategies.

However, past experiences in CEE with SEZs have not been very promising, although these economies in transition have a relatively high degree of industrialization as well as a comparatively skilled labour force. Particularly in Poland, Hungary, Bulgaria and the (successor states of the) USSR, initiatives were taken to implement SEZs. In all cases, these zones were founded or planned before the beginning of the transformation, and they tended to be regarded as instruments of reform within the old system rather than as accelerators of a possible transformation. All past attempts turned out to be failures.²²

Failures in Central and Eastern Europe

In Poland, seven SEZs were implemented in 1989, all of which were regarded as instruments of regional development only. Hence, they were not suitable catalysts of the systemic change. Moreover, they were confronted with difficulties with regard to adequate financing and finding appropriate locations. In Hungary, SEZs have existed as single offshore enterprises (joint ventures and foreign companies) since 1982. However, the Hungarian government has not shown great interest in using that instrument because the country is relatively small and the transformation has already made substantial progress. Therefore, SEZs are regarded as a

²¹ In this context, however, it must be guaranteed that transactions between zone enterprises and other domestic companies are settled in convertible currencies.

²² UNCTC, op. cit., pp. 344-408; K. Bolz, D. Lösch, P. Pissulla: *Freihandels- und Sonderwirtschaftszonen in Osteuropa und in der VR China*, Hamburg 1990, pp. 23-45.

roundabout way towards capitalism. In Bulgaria, EPZs were implemented in 1988 as locations of production for foreign enterprises and joint ventures. They essentially failed as instruments of transformation, because domestic companies were not allowed to invest, the zones were isolated from the domestic economy, and the institutional and material infrastructures were intransparent and unfavourable respectively. In the former USSR, discussions on SEZs began in the era of perestroika following an initiative by the political centre. In 1990, the central authorities decided to implement several SEZs throughout the country. However, the development of SEZs in the USSR and Russia has mainly reflected the political topsy-turvy which has dominated economic transformation and Russian society during recent years. Zone concepts were neither embedded in overall policy programmes, nor coordinated between local and central authorities, nor based on a clear and consistent legal framework.

At present, progress in transformation differs substantially among CEE countries. Especially in Poland, Hungary, and the Czech Republic, considerable progress has been made towards implementing a functioning market economy. Furthermore, these countries are emphatically pursuing the goal of becoming members of the European Union (EU) in the medium term. Therefore, implementing SEZs as catalysts of the systemic change seems to be redundant. Rather, such an approach would negatively affect the credibility of policy-making in these countries and cause new structural distortions. However, narrow SEZ concepts such as free ports or small duty-free zones might be useful to facilitate foreign trade.

In the Russian Federation (and other successor states of the USSR), however, the economic and social situation has continued to deteriorate, and the overall depression has been accompanied by substantial political conflicts and disorientation, hampering any transformation. The political centre, still trying to control the systemic change, has lost most of its authority. Furthermore, the transition towards a functioning capitalist system is particularly hindered by the prevailing conflicts between the central government and the regional authorities struggling for competences and political power. These

conflicts threaten not only the country's economic unity but also its political unity. The only way to overcome the current crisis and to make sustainable progress in transformation is to reorganize the political-administrative structure of the country by implementing strict federalism based on the principle of subsidiarity.²³

Need for Devolution

Since the overall transformation cannot be actively planned, managed, and controlled by central political authorities, a comprehensive devolution of competences must be realized. On the one hand, this would facilitate the elaboration and implementation of an overall strategy based on the remaining political tasks assigned to the centre. On the other hand, such an approach enables the regions to act independently and to pursue their own goals of economic development. Hence, political conflicts could be overcome, and competition between the regions could evolve, making the overall transformation more efficient.

Institutions particularly matter during the period of transformation. Old institutions have to be eliminated, and new ones must be implemented in order to build up a functioning market economy. That is not only true regarding economic institutions, but also with respect to political ones. As long as Russia maintains its centralized policy-making, severe coordination problems continue to exist which cause inefficiencies and inconsistencies in transformation policies and threaten to paralyze any effective change. The political centre, which is responsible for implementing a certain transformation programme, strongly depends on the regions, which are responsible for enforcing the political decisions of the centre. In view of the different preferences and priorities of the various political organs, it is not surprising that a consistent and effective transformation policy has not been implemented in Russia. Building up true federal structures and the devolution of competences regarding policy-making and tax collection would not only contribute to solving the coordination problem, but also imply a considerable reduction of the transaction and information costs of private economic agents and foreign investors. Realizing the principle of subsidiarity facilitates the enforcement of political decisions, creates proper incentives to private investors and regional politicians, and increases the acceptability and the credibility of the transformation. Furthermore, the heterogeneity of the country and the different stages of development of the regions is explicitly taken into consideration.²⁴

²³ J. Ahrens, *Der russische Systemwandel ...*, op. cit., pp. 356-366.

²⁴ The recent experience of the city of Nizhniy Novgorod proves that the devolution of competences can imply substantial regional initiatives which are suitable for accelerating economic restructuring on the regional and local level.

Based on the restructuring of the political-administrative order, it might prove to be helpful for some regions to implement SEZs in order to promote their international integration and to accelerate the regional transformation. In this context, especially Russia's Far East and the districts of St. Petersburg and Kaliningrad seem to be promising candidates for SEZs. Particularly the port at Nakhodka and the oil and container terminals at Vostochni in the Far East represent suitable locations for SEZs. They can serve as an instrument to tie the markets of Northern Europe, North Asia, America and Russia together. Moving goods between these markets through Russia rather than by sea could be much quicker. Therefore, Russia might become an important and competitive transit country. The same argument holds for the St. Petersburg region as a location for an SEZ, which represents Russia's window towards the West. However, shipping goods between Europe and Asia via Russia reliably and at competitive costs requires the implementation of an efficient transport system as well as the reduction of transit time within the SEZs. In this regard, setting up joint ventures with Western shipping companies could accelerate the restructuring process.²⁵ Kaliningrad as an SEZ might also serve to link the European and the Asian markets, and the status of an SEZ could help to overcome that region's problems as a Russian exclave.

The experiences of China show that, even in large countries, SEZs not only accelerate regional development, but also support the transformation of the whole economy by serving as examples and inducing positive spillover effects. In order to implement SEZs successfully in Russia, it is, however, not sufficient to stabilize the political system and to reshape the political-administrative order; overall economic policy also has to complement the implementation of SEZs by opening up the domestic economy, pursuing sound macroeconomic policies, restructuring the educational system, and encouraging domestic enterprises to invest in SEZs.

Benefits of SEZs

Subsequently, we conclude that SEZs are hardly useful as catalysts of systemic change in those CEE countries which have already made substantial progress in transformation and which intend to join the EU soon. However, in those transforming

countries which do not have the option of becoming EU members or in which a direct way to capitalism via a bold transformation programme is not feasible because of political or social constraints, SEZs might prove to be catalysts of systemic change if they are embedded in an overall market-oriented strategy that emphasizes macroeconomic stability and external liberalization. However, these countries should have reached a certain stage of industrialization and should be endowed with a skilled labour force. In this context, Russia particularly seems to be a country which could benefit from SEZs; the more so as this country has huge reserves of natural resources.

If the radical enforcement of widespread economic deregulation is not feasible at the beginning of the transformation process due to the resistance of strong pressure groups, partial deregulation by establishing SEZs represents a political compromise not only allowing new local or regional interest groups to evolve, but also implying the possibility of a more flexible, selective and single-minded policy that is directed at structural adjustment needs. Hence, static and dynamic efficiency gains can be expected, including increasing specialization, cost reductions and a more efficient allocation of the factors of production, as well as promoting competition by a more effective diffusion of know-how and the elimination of barriers to innovative and flexible behaviour by private entrepreneurs.²⁶ Thus, SEZs might serve as models for a general economic deregulation.

Since the establishment of SEZs generally implies additional benefits primarily on the regional level, whereas the corresponding costs strain the budget of superior federal institutions, redistributive effects evolve. On the one hand, this explains why initiatives to create SEZs are usually undertaken by local and regional authorities; on the other hand these asymmetric effects can cause political conflicts that can only be prevented by the clear assignment of competences between different federal levels.

SEZs can basically serve as catalysts of systemic change, especially in large and heterogeneous countries such as Russia. If the overall transformation proves to be successful, they will lose their special status over time and will be completely integrated into the economy of the host country. However, if central transformation problems remain unsolved and if the authorities do not show a strong commitment to implementing a market economy even SEZs cannot be expected to become a worthwhile instrument of economic transformation.

²⁵ The Economist, November 19th, 1994.

²⁶ Of course, possible welfare gains depend on the costs resulting from redirecting trade flows and possible externalities.