CAN EARLY SEZS BE DRIVERS OF ECONOMIC GROWTH IN TRANSITION ECONOMIES? 
COMPARATIVE ANALYSIS: CHINA, RUSSIA, VIETNAM

by
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**Abstract**

This research began with questions arising from disparate economic performance of early special economic zones (SEZs) in transitional economies at the initial phase of reform and market opening, specifically in China, Russia, and Vietnam despite their shared legacy of command economy as socialist states. Having a focus on the political economic dynamics of SEZ development, this comparative analysis examines how institutional governance structure of the respective countries impacted economic growth. It employs six key elements for SEZ development in the context of transition economies, chosen for their heuristic value: 1) state capacity for effective governance, 2) legal framework, 3) political stability, 4) infrastructure, 5) location, and 6) global networks, all of which are grouped into categories of internal foundation and external connectivity. Findings indicate that SEZs can serve as drivers of economic growth in the early stages of a socialist country’s transition to a market-oriented-economy when a host country with political stability and strong institutional capacity grants adequate autonomy and incentives to local authorities for effective governance of SEZs in strategic locations. Adequate infrastructure along with functioning state agencies that enable and promote coherent economic activities by both domestic and international actors with trust in the political commitments and stability of the host country were quintessential for SEZ development. Failure or success of a zone was linked to the efficacy of an institutional and incentive framework, whether it was strategically located both domestically and internationally, and the level of coordination between the central and local governments.

**Primary Reader and Advisor**: Kent Calder

**Secondary Readers**: Ling Chen, Peter Raymond
Preface

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Chapter 1: Introduction

From a humble fishing village of 30,000 residents with no industrial base more than four decades ago, Shenzhen has sprouted as a thriving metropolis of 17 million with the third largest GDP in China in 2022 (China Daily 2023). Designated as one of China’s first Special Economic Zones in 1979, Shenzhen has attracted nearly $300 billion in Foreign Direct Investment, and over 90,000 foreign enterprises have set up businesses in the zone since its opening (Kawase 2020; Figure 1). Labeling Shenzhen's Special Economic Zone (SEZ) a success story, the World Economic Forum (Santosdiaz 2022) states that SEZs, if done well, are a great vehicle for international trade and FDI to propel economic development because they provide investors and businesses mitigated risk in a market under a jurisdiction usually associated with high uncertainties and unfavorable market conditions.

Figure 1. Shenzhen SEZ’s GDP in 1979 and 2019
Sources: Local statistics bureaus. (cited in Nikkei Asia 2020).

SEZs are geographically demarcated areas within a country that provide infrastructure and streamlined administration with fiscal incentives under more liberal economic and juridical regulations than those in the rest of the country (Zeng 2010, 4). Widely adopted in many developing countries, SEZs have been a powerful development strategy to attract foreign direct investment and facilitate national and regional economic growth, especially for emerging markets or those undergoing transition from command to market-oriented economies.
Over the past four decades, the number of SEZs skyrocketed from less than 100 in 29 countries to some 5,400 in 147 countries, according to findings by UNCTAD (2019, 129). While there has been a boom in SEZs, especially in the past decade with more than 1,000 new zones opening up, the performance of many zones in developing countries have had varied results in achieving the intended outcome of accelerated economic development. The varied performance of SEZs is particularly pronounced in transition economies; that is, those without a functional market economy in place, for they are often restrained in terms of economic tools as well as flexibility for political reasons, especially if under authoritarian regimes.

Notwithstanding such constraints as a single-party communist state and a non-market-oriented economy in 1979, China successfully leveraged SEZs as important engines for economic growth since its first opening of SEZs, almost concurrent with the launch of the country’s open-door policy in 1978 by Deng Xiaoping. Considering that the country was still under the spell of old political interests in the post-Mao era, opening SEZs as testbeds for first foreign-funded companies, labor and foreign-exchange markets, banks, and large-scale project was among boldest measures undertaken by Beijing at the time (Chen et al. 2003, 1-2). In 1981, two years after China opened its first four SEZs, these zones accounted for nearly 60 percent of the nation’s total FDI, with Shenzhen taking up the lion’s share at nearly 51 percent, as illustrated in the World Bank Report (Zeng 2010). Moreover, when China’s national annual GDP grew at about 10 percent from 1980 to 1984 (Figure 2), Shenzhen developed at a remarkable 58 percent (Table 3). By 1992, SEZs extended beyond the coastal region, stretching to all capital cities of
provinces as well as the interior regions with various types of special zones springing up throughout the nation (Figure 8).

Early SEZs in the Russian Federation, on the other hand, did not experience the kind of economic growth and development witnessed in China at all due to a lack of efficient SEZ policies and direction for a decade and a half since Russia’s dissolution in 1991 until it managed to introduce a federal law for a more workable system of SEZs under President Vladimir Putin in 2005 (Sosnovskikh 2017, 183). Such inefficiency was not unusual for post-socialist countries and transition economies (Table 19), and the early SEZs in Russia failed to deliver on their intended objectives, attracting much less investment, thus resulting in a dearth of available public information or research (Kuznetsov and Kuznetsova 2019, 118). This situation reflects classic selection bias in research: much attention is drawn on success and very little on failures, which consequently leads to a biased base of information.

Vietnam had a mixed experience. Its first SEZ opened in Con Dao Islands in 1979 but was terminated in 1991 upon the conclusion that it failed to produce a tangible economic effect. Following the initiation of economic reforms in 1986 dubbed “Doi Moi,” aimed at creating a "socialist-oriented market economy," Vietnam’s new secretary-general of the Workers Party, Nguyen Van Linh, called for policy changes designed to expand opportunities for private initiatives and to relax barriers to commerce, as well as to encourage foreign investment and trade (Scalapino 1989, 89). Although Vietnam’s ambitious plans to open two SEZs fell through due to budget and political constraints, following full normalization of relations with China in 1991, it was able to set up national-level key economic regions and over a dozen coastal economic zones subject to
a range of fiscal and administrative incentives. While these special zones in Vietnam brought about “factory-driven” economic growth, they did not trigger the kind of economic development with extensive spillover effects for the country as had been the case in China (Nguyen 2018; Appendix).

What made a marked difference in their SEZ performance was the host country’s institutional capacity and political stability with a cohesive infrastructural base, not only in terms of the physical constructs of the SEZ, but an effective bureaucracy with an adequate blend of autonomy that allows for regional-central government coordination as well as an incentive mechanism that mobilizes its personnel to become agents of economic development. The notion of a cohesive state that enables coherent agents acting in a dense network of ties to facilitate developmental transformation (Evans 1995) and the importance of interaction, connectivity, and networks among parts of a broader system in political-economic transitions (Calder 2019), are pertinent to understanding the transitional economies’ SEZ introduction and development.

My research examines the crucial elements and conditions for successful SEZ development from the perspective of governance and political economy—not macroeconomics—in the “initial” phase of market-opening and reform, specifically those that transitioned from command economies of communism, in a comparative analysis of three countries: China, Russia, and Vietnam. While several Eastern European countries also underwent transitions from centrally planned to market-oriented economies, they were satellite states of Soviet Union for over four decades, aligned militarily, politically, economically, and culturally until its collapse. Such conditions further complicate the
conduct of comparative analysis with its former controlling state, which is different for
more independent and autonomous countries like China and Vietnam.

A host of factors, including infrastructure, logistically and legally, as well as
economic and fiscal reforms accompanied by capital and human investment are necessary
for economic development. However, beneath the surface of economic indices and data
to illustrate economic performance in numbers, lie political economy dynamics, the basis
of which determines whether an SEZ scheme can be successful and serve its intended
purpose as development policy.

To focus on the political economic dynamics of SEZs, this paper takes a
qualitative approach to gauge what contributed to different economic outcomes in SEZ
programs in the three countries by examining institutional changes in governance that
enabled economic growth of the nation’s SEZ to trigger regional, and possibly national,
economic development. My research is important in two aspects. First, the paper provides
a comparative perspective on how different initial conditions and approaches—one, like
China, that retained a strong political regime and institution despite economic reforms,
and another one that pursued a dramatic shift in its economic and political regimes
simultaneously—produced quite different results in SEZ performance in the initial phase
of market opening. Second, the paper would provide some useful directives for policy
planning and governance as well as SEZ strategies for other developing countries and
transition economies’ aspiring economic development before they are able to commit to
or can execute full-fledged market opening.

My research generates a comparative hypothesis: SEZs can serve as drivers of
economic growth in the initial stage of a socialist country’s transition to a market-
oriented economy when enabled by coherent state and institutional capacity to permit adequate autonomy for effective decentralized governance on the back of political stability and resourceful external networks. Mere introduction of SEZ programs to a transitioning economy unaccompanied by relevant changes in state institutions and incentive mechanisms will not automatically translate to successful economic performance: differences in SEZ performance, as in developmental performance, depend heavily on the efficacy of state governance grounded on agency, connectivity, and coordination to accomplish common transformational goals.
Chapter 2: Literature Review

Special Economic Zones

Three quarters of developing countries and almost all transition economies have introduced SEZs according to a United Nations World Investment Report (UNCTAD 2019, 137, 140). Yet, no country has been as successful as China in terms of absolute number, scope, and outcome, with much of the literature and study on SEZs involving a heavy focus on that country. A good examination of China’s SEZs, therefore, would serve as a kind of basis that can provide a comparative perspective, especially on other former communist countries or command economies that underwent market openings such as had Russia and Vietnam about a decade later in time, inspired by aspirations to emulate China’s development path.

Various studies on China’s development often point to policy experimentation via SEZs as well as gradualism and decentralization as key elements for success (Shirk 1996; Naughton 2018). Heilman (2008) attributes the capacity of the Chinese-party-state to find innovative solutions to learning facilitated by “experimentation under hierarchy.” He contends that the combination of decentralized experiments with ad hoc central interference, which resulted in selective integration of local experiences into national policymaking was critical to the emergence of adaptive authoritarianism in China. Here, the challenge is how to “smuggle” change into uninviting and resistant political economies. For a state with the desire to introduce new ideas and methods with potential beneficial economic effects without knowing how much political resistance such experimentation or change would provoke within its political circles, SEZs were useful test labs not only for economic experimentation, but also political resistance (Moberg
2017, 75). If the SEZs do not cause defiance, that is, if the introduction of foreign and capitalistic economic activities produces positive economic performance without causing much insecurity and turmoil, then SEZs could serve as a showcase for reform with less resistance for broader spread and adoption throughout the country.

In the absence of a universal definition for Special Economic Zones, SEZ is widely used as a generic term to describe different types of such districts, including free trade zones, free economic zones, export processing zones, and industrial parks, which can be classified according to their objective, industrial focus, or the type of regulatory regime applied (UNCTAD 2019, 2, 136). Despite differences and variations in definition and name, there are three common key criteria that characterize SEZs: 1) a clearly demarcated geographic area, 2) a regulatory regime distinct from the rest of the economy, often customs and fiscal rules, and 3) infrastructure support (UNCTAD 2019, 133).

While SEZs in developed countries focus primarily on logistics, for developing countries, SEZs serve as development venues to facilitate national and regional economic growth by attracting foreign direct investment, which explains why three quarters of developing countries and almost all transition economies have introduced SEZs. In the case of formerly planned economies, SEZs can be more attractive because they allow for economic experiments and relatively rapid business practice reforms (UNCTAD 2019, 137, 140).

In essence, SEZs epitomize the concept of free zones that are free from tariffs, taxes, and red tape. So, the basic components of incentive packages are rather similar across most types of zones and locations (UNCTAD 2019, 131), even though the rates and details may vary. SEZs typically have a policy and an infrastructure rationale. In
terms of policy, SEZs often offer various incentives including import and export duty exemptions, streamlined customs and administrative controls and procedures, liberal foreign exchange policies, and tax concessions such as holidays on income tax for several years and reduced rates thereafter. All are designed to enhance investment competitiveness by reducing business entry and operating costs (WB-FIAS 2008, 12). Another key feature of SEZs involves provision of infrastructure or the “hardware,” with fully serviced sites and purpose-built facilities for lease or sale. In some cases, host countries or governments go so far as to provide cheap land and subsidized utility rates to attract desirable foreign investment enterprises, which are expected to contribute to enhanced local output and employment (Naughton 2018, 430).

Operating under more liberal economic and fiscal conditions and fewer regulations than those governing in the host country, SEZs deliver direct and indirect economic benefits. Direct economic benefits, including foreign exchange earnings, exports growth, employment generation, and government revenue are salient, while indirect economic benefits are more elusive, ranging from skills upgrade, testing field for wider economic reform, and demonstration effect (Zeng 2010). Indirect benefits, such as the influx of advanced technology, skills, and business practices through these special zones are significant in that they could lead to spillover effects beyond limited areas (Naughton 2018, 432). The spillover effects, however, are not a given and would not necessarily take place were it not for the host country’s willingness to actively embrace and introduce zones to regions outside the SEZs. In that sense, the mere presence of SEZs per se does not translate into spillover effects that enable emulations outside the zone and across the country.
In general, some key dimensions driving SEZ success are strategic focus, regulatory framework and governance, and value proposition for investors (UNCTAD 2019, 131). Performance and success in its most explicit form are reflected in hard numbers in categories such as FDI, contributions to GDP growth, and employment size (Zeng 2010) as can be seen in Table 1. Yet, it is noteworthy that even though the components of incentives packages are important in attracting investors, findings indicate that incentives by themselves do not play a significant role in explaining zone performance and that the correlation between the incentives and performance is limited (WB 2017, 74).

Table 1. Performance of Initial SEZs and ETDZs in China, 2006

<table>
<thead>
<tr>
<th>Indicator</th>
<th>SEZs</th>
<th>National ETDZs</th>
<th>China</th>
</tr>
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<tr>
<td>Total employment (millions)</td>
<td>15</td>
<td>4</td>
<td>758</td>
</tr>
<tr>
<td>as % of China total</td>
<td>2.0</td>
<td>0.5</td>
<td>100</td>
</tr>
<tr>
<td>Real GDP (RMB 100 millions)</td>
<td>9,101</td>
<td>8,195</td>
<td>183,085</td>
</tr>
<tr>
<td>as % of China total</td>
<td>5.0</td>
<td>4.5</td>
<td>100</td>
</tr>
<tr>
<td>Utilized FDI (US$100 millions)</td>
<td>55</td>
<td>130</td>
<td>603</td>
</tr>
<tr>
<td>as % of China total</td>
<td>9.1</td>
<td>21.6</td>
<td>100</td>
</tr>
<tr>
<td>Merchandise exports (US$100 millions)</td>
<td>1,686</td>
<td>1,138</td>
<td>7,620</td>
</tr>
<tr>
<td>as % of China total</td>
<td>22.1</td>
<td>14.9</td>
<td>100</td>
</tr>
<tr>
<td>Total population (millions)</td>
<td>25</td>
<td>—</td>
<td>1,308</td>
</tr>
<tr>
<td>as % of China total</td>
<td>1.9</td>
<td>—</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: — = not available.

Source: Cited in Zeng (2010, 13)

For developing countries, factors driving SEZ performance were identified as successful system experimentation, institutional reforms within SEZs, and increased openness for the entry of capital, technology, and talent from around the world. As such, the success of a zone and its impact typically depend on factors both within and outside the zone—the program and its characteristics, its structure and layout, as well as regional
and country contexts (WB 2017). Similarly, others contend that important criteria for successful SEZs depend on the capacity to address key constraints raised by investors to improve their competitive performance relative to the rest of the economy and to establish effective linkages with the rest of the economy to improve overall competitiveness through transfers of knowledge, technology, and spur policy reform (Warr et al. 2016, 286).

The location of SEZs, both in terms of geography and politics within the country as well as on the global map of commerce and market demand, plays no small part. Traditionally, SEZs were created as enclaves, restricted to relatively remote areas or near transport hubs, exclusively developed and operated by government bodies. This concept, however, has changed over the past few decades. Instead of restricting SEZs to secluded areas and their roles in economic growth, many governments increasingly view these special zones as a key mechanism to promote two-way trade and facilitate liberalization and modernization of the host economy. That is, there has been renewed emphasis on integrating zones into the domestic economy (WB-FIAS 2008, 14).

Relatedly, a unique aspect of SEZ development distinctive to China is the role of diaspora investors. Mostly from Hong Kong, diaspora entrepreneurs' contributions as early entrants to SEZs were pivotal (Ye 2014, 59) accounting for more than 90 percent of FDI in the case of Shenzhen (Yearbook 1985). During the first five years of SEZs, more than 85 percent of infrastructure investment in Shenzhen came from FDI, while domestic funds, including national and government allocations and bank loans, amounted to less than 15 percent. The existence of diasporas not only contributed to initial infrastructure building for SEZs, but more importantly helped China overcome domestic resistance
among conservative forces over losing control with market opening and liberalization, as
diasporas, many of them serving as advisors to the State Council and members of the
People’s Congress, were in close contact at local and national levels (Ye 2014, 60).
Although originally envisioned as small experiments, the national leaders were convinced
of SEZs’ remarkable success by the end of the decade (Vogel 1989).

**Making the Transition From Command to a Market-Oriented Economy**

However, in transition economies where “free” markets barely exist and need to
be built from the ground up by institutions quite different from those of market
economies, mere implanting of such foreign methods, which had existed in other
countries for more than two decades already, would not ensure economic performance. In
a late-developing, communist context, “how basic inputs are mobilized and distributed by
the state is critical to the rise and shape of markets” because goals, constraints, and
resources for the development vary and the selections that fit these different contexts
must also be different (Ang 2016, 7). Instead of attempting to copy identical actions taken
by other countries, what is necessary for development are conditions that spur a
productive and sustained quest for solutions that fit one’s environment (Ang 2016, 17).

To use North’s terms, an essential goal of economic policy is to create “the
necessary artifactual structure” that enables economic and political agents to confront
new problems successfully (2005, 70). Describing development as a mutually
coevolutionary process, Ang points to the “paradoxical mixture of top-down direction and
bottom-up improvisation” as underlying forces that lay the foundation for China’s
process of radical change, especially in terms of SEZ operations. And this process of state
and market coevolution and conditions enabled the “adaptive efficiency” (Ang 2016, 17)
for SEZs in the initial phase of market opening in China. Such economic transition is described as “a process of institutional change, a process of building new institutions required by capitalist economy,” which was “above all, a problem of coordination” (Redek and Susjan 2005, 996).

Some common processes involved in transition to a market economy include liberalization, decentralization, deconcentration, demonopolization, and diversification. Liberalization of price controls is among the most symbolic and significant steps taken by transition economies that often result in soaring prices of goods, jacking up the nation’s inflation rate. In what is mainly a vertical process, decentralization of decision-making authority takes place with much responsibility and accountability transferred from central to local levels of government. Deconcentration of lines of cooperation and supervision in the state hierarchy makes for a more horizontal division of responsibility between state agencies. The monopoly of specific areas of work is increasingly distributed to various agencies and organizations while functions and productions in general enterprises and SOEs become more diversified (Jerneck 1995, 66).

There is no universal recipe or fixed paradigm for successful economic transition or development. Yet this lack of “optimal” pattern or scenario of success need not be disappointing because by definition, according to Korani (1998), transition does not require a paradigm or theory—only the beginning and end-point systems do (Havrylyshyn 2001, 54). Hence, acquiring knowledge about a range of factors and conditions of relative success—as opposed to failure—can lead to emulation of similar practices in different settings (Dinello and Popov 2007, 15). As Rodrik (2000) emphasizes, every well-functioning market economy is a mix of state intervention and
laissez-faire. What is crucial is the efficiency of this mix. But even in mature industrial societies, the roles of state and market in fostering economic efficiency are challenging and complex with the two being intricately intertwined. Hence, to create and maintain institutional conditions necessary for economic growth in transition economies become even more difficult as the issue of broader development is distinct from economic growth within a given framework of institutions (Puttermann and Rueschemeyer 1992, 2).

**Reform, Institutions, and Governance for Economic Development**

It is change, or discontinuity, that is the source of increased productivity according to Schumpeter’s (2005) analysis of economic development. The Schumpeterian concept of change termed “creative destruction” entails, among other concepts, the introduction of a new method of production, the opening of a new market, and the execution of the new organization of industry (Schumpeter 2005, 110).

Simultaneous application of deregulation and trade reform can take an economy from a slow-growth trap toward accelerated growth, which in turn develops its own dynamics. Even though such a model does not have a basis for sustained growth, it implicates the acceleration of growth that will already have pushed the economy to a higher growth track (Dornbush 1992, 76). While SEZs do provide a new growth environment in which institutions introduce and execute new methods of production, the rise and fall of numerous SEZs in many developing countries demonstrate that the drivers of economic outcomes depend on effective and strategic approach toward and governance of the SEZs. That is, the success of SEZs requires a very capable institution and effective governance, at least inside the zone (Zeng 2011, 7). Although the boundaries of its economic experimentation were clearly set within the limits of designated areas of SEZs,
China adopted bold measures, unlike other SEZ countries of the time that drove unprecedented and unparalleled economic outcomes, quite contrary to the overall gradual and piecemeal steps introduced outside the zones (Chen et al. 2003).

**Speed of Reform**

Political considerations aside, literature on reform strategies of transition economies often compare the different approaches taken in China and the former Soviet Union, in what is widely described as incrementalism as opposed to a radical “big bang” approach. While one school of thought advocates a quick, comprehensive, and early implementation of structural economic reforms for market liberalization, others argue that transitions occurring too precipitously could prove more costly than beneficial, undermining the state’s will to continue restructuring (Rodrik 2000).

The speed of reform was a major point of contention in earlier studies of economic transition of former communist states. The rapid and comprehensive approach, also referred to as shock therapy, involved major changes in a short period of time for immediate liberalization of markets, including removing price controls and subsidies as well as rapid privatization of state-owned enterprises. Widely known as the “Washington Consensus,” such was conventional advice recommended by international institutions like IMF when counseling governments undergoing transition (IMF et al., 1990). Many East European countries as well as the former Soviet Union implemented the “big bang” approach for economic reform. Poland, despite a sharp increase in inflation and unemployment initially, succeeded eventually in creating a more market-oriented economy, whereas the former Soviet Union and Russia thereafter experienced major
economic and social problems, including prolonged hyperinflation, degradation of people’s living standards, and social unrest.

In contrast to the wholesale adoption of market liberalization measures in the “big bang” approach, China began to introduce market-oriented reforms in a step-by-step manner since the announcement of its open-door policy in 1978. A proponent of partial and incremental reforms, Rodrik (2000) contends that gradual reform programs that reflect and are tailored to initial conditions and pre-existing institutions are more likely to succeed than those that assume new institutions can be established wholesale overnight (87, 98). Put differently, China’s gradual reform strategy worked because it economized on institution-building. However, while some underscore China’s incrementalism for minimizing the kind of economic and social disruptions witnessed in Russia, others note that the sustained entry and expansion of the non-state sector in China during the reforms were also rather rapid and forceful, emerging as an important engine of growth in less than a decade of reform efforts (Qian 2017).

Vietnam, another regime that transitioned from a command to market-oriented economy, had a mixed experience. Because its initial efforts for gradual reform between 1985 and 1988 resulted in an accelerated inflation and diminished growth without repairing serious macroeconomic imbalances, Vietnam reversed its course and enacted a radical “big bang” liberalization measure in 1989, which triggered a boost in economic performance (Woo 1999). Sachs et al. (1994) argue that rather than incrementalism per se, structural conditions and reform were what account for successful economic performance, and gradual reform cannot be considered a superior approach to that of shock therapy.
Moreover, the radical transition in Eastern Europe should be viewed in context with its historic background, for it came after long and serious failures of continued attempts at gradual reform, first initiated in 1968 with some success but encountering major difficulties in 1980s. Hence, the speed of reform cannot sufficiently explain, much less determine, the success of a regime’s economic transition or performance. Rather than being an intentional choice of strategy, the speed of reform in each state is more a product of numerous factors, including the existing economic and political conditions as well as level of public support for reform (Qian 2017).

Level of Industrialization

Gerschenkron’s (1962) theory of economic backwardness holds that less developed countries enjoy higher growth potential and rate of economic growth compared with the more developed ones. The logic is that latecomers in industrialization have the advantage of bypassing traditional stages of development by adopting and adapting advanced technologies and institutions to shorten the time of change. Moreover, the lower levels of existing capital and technology in less developed countries also translate to a higher marginal return on investment, which can further expedite the rate of economic growth. Conversely, the more developed countries with a larger stock of capital and technology are likely to experience lower marginal return on investment and slower rates of growth.

Sachs et al. (1994) point to Gerschenkron’s concept of economic backwardness to explain China’s rapid growth compared with other former communist countries undergoing transition despite their shared common legacy of central planning. Sachs et al. contrast China’s predominantly peasant agricultural society on the eve of its spurt with
that of urban and overindustrialized East European countries and the former Soviet Union, attributing China’s successful reform and growth to its backwardness (104).

Characterizing China’s underdevelopment as that of a classic problem of normal economic development in which workers transfer from low-productivity agriculture to higher-productivity industry, Sachs et al. argue that normal economic development is “easier than structural adjustment” (103).

Such economic backwardness in transition economies, however, is not necessarily always advantageous to fast growth. According to Qian (2017, 25), the immediate effects of the initial institutional conditions are generally not optimal for growth in many transition and developing countries because they may not be able to undertake necessary changes in a short span of time. For the same reason, however, once institutions are changed to address economic inefficiencies, latecomers can enjoy great growth potential. That is, if institutions can fix these distortions, former centrally planned economies whose reform began from very inefficient status quo with poor incentives as well as vast allocative distortions, have a much bigger room to generate efficiency and growth.

In addition to the initial level of economic development or industrialization, the differences in economic performance in post-communist countries during transition are also associated with the magnitude of initial distortions in their industrial structure (De Melo et al. 2001; Popov 2004, 105). Over-industrialization, which translates into industrial distortion, was common in socialist countries as trade, financial services, business, and consumer services were severely repressed, with high industrial share accounting for as much as 50 percent in Russia and Eastern European countries. Market-oriented adjustment would require downsizing the industrial output and employment as
resources are reallocated to the service sector. In this respect, considering that state enterprises accounted for most workers in Russia and Eastern European countries because of the deeper penetration of central planning and industrialization, China’s smaller share of an industrial labor force at about 15 percent meant less structural distortions in comparison (De Melo et al. 2001, 4). Yet, Russia and the East European countries—albeit their common high level of industrial distortions initially—went on different paths during transition with a contrasting outcome in economic performance and growth. As many aspects of the initial conditions are country- and context-specific, which require special arrangements to fix, transitional institutions display a variety of nonstandard forms (Qian 2017, 26). Hence, the success of reforms cannot be explained by the initial low level of development or industrialization alone.

Institutions and Institutional Change

The focus on institutions and the process of institutional change is the diagnostic characteristic of institutional economics. Departing from previous mainstream neoclassical economic analysis that focused primarily on the relationship between macroeconomic policies and economic performance, the role of institutions gained greater attention and emphasis, particularly in the decade following the collapse of former communist states in Eastern Europe and the Soviet Union (Redek and Susjan 2005). Evolutionary institutionalists underscore the importance of institutions for reform and development. Although economic stabilization and liberalization are needed, they cannot be achieved without adequately developed institutions for market operations (Havrylyshyn 2001, 55).
Veblen, considered a forefather of institutional economics, explains that economics is a “theory of process, of an unfolding sequence,” and that sound macroeconomic policies alone do not necessarily yield the intended outcome, or economic development (Veblen [1898], 376; 1998, 404). Whether theoretically sound macroeconomic policies generate positive economic performance also depends largely on the state of the given economy, or institutions, at the time of reform. According to Veblen ([1899] 1975), institutions are “products of past process, are adapted to past circumstances, and are therefore never in full accordance with the requirements of the present” (cited in Tool and Bush 2003, 17).

Similarly, North (1990) states that change in institutions usually takes place incrementally rather than discontinuously, and contends that even discontinuous changes, such as revolutions, are not completely discontinuous due to the “embeddedness of informal constraints in societies” (6). That is, even when political or judicial decisions may drastically alter formal rules, informal constraints embodied in codes of conduct are much more impervious to deliberate polices, connecting the past with the present and future. In this respect, transitions may be viewed as a “path-dependent evolutionary process” (Qian 2017, 318) in which the initial conditions of institutions, in addition to the macroeconomic policies, prove pivotal to economic development. As such, institutions are not just another variable, but “structure political situations” where decisions made at one point in history can continue to shape present and future possibilities by “sending policy off onto particular tracks, along which ideas and interest develop and institutions and strategies adapt” (Goldstein 1996, 149).
Despite their common legacy of central planning, transition economies had notable differences in their initial levels of development, macroeconomic distortions, integration into the trading system of the socialist countries, and the extent of reforms (De Melo et al. 2001, 3) depending on the duration, rigidity, and severity of the central planning system (Sachs et al. 1994). Such differences in initial conditions, in addition to policy choices and historic backdrop, were significant elements that influenced the trajectory of the transition economies. For example, the beginning of transition in Central and Eastern Europe was prompted by a wave of popular political revolutions in 1989, which were later accompanied by economic shock from the collapse of the Council of Mutual Economic Assistance (CMEA) trading arrangements.

The transitions to market economies for the republics of the former Soviet Union, on the other hand, began with the gaining of independence at the fall of the Soviet Union in 1991 (De Melo et al. 2001, 3). As such, studying transitional economies and their institutions requires careful examination of the many dimensions and conditions—initial and evolving—of a society which are country- and context-specific (Qian 2017, 26). Hence, specific organizations and institutions need to be understood as parts of larger, historically derived social structures (Polanyi (1957 [1944]). In other words, institutional changes cannot be understood detached from their social, historic, political, and economic conditions. And because all such conditions are fundamentally products of behaviors and interactions among those inhibiting in society, engendering institutional change entails altering the processes of interactions and decision-making by those governing the institutions.
Effective Governance, Bureaucracy, and Industrial Transformation

Sustaining or regaining the institutional integrity of state bureaucracies enhances the possibility of carrying out social transformation as deterioration of state institutions is strongly associated with the disorganization of civil society (Evans 1995, 249). Evans (1995) contends that uniformly treating bureaucracies with dismissal is a mistake, for when used imaginatively, a state apparatus can also involve being a home to creative entrepreneurial initiatives and spark new sources of social energy contributing to industrial transformation (40, 250). According to economic anthropologist Polanyi (1957 [1944]), the life of the market from the outset has been associated with the structures and policies of the state, and that effective state was integral to the formation of market relations (140). This notion can be traced to Max Weber’s (1968[1904-1911] statement that “capitalism and bureaucracy have found each other and belong intimately together” (1395). Put differently, states bureaucracies with effective governance can be agents of industrial transformation. However, whereas developmental states need capable bureaucracy, they are often in short supply because building or maintaining effective bureaucratic organizations is a formidable task, especially in countries undergoing reform or transition.

Evans (1995) argues that industrial transformation is possible and that states make a difference, in that state apparatus are potential sites for agency. That is accurate if states can act as coherent entities with a cohesive bureaucracy accompanied by a certain degree of autonomy vis-à-vis society, such as the competence-enhancing structures as postulated by Weber (Evans 1995, 30, 40-41). In what is termed “embedded autonomy” Evans proposes that bureaucratic structures can create a set of incentives for state officials by
designing an affinity between the incentives for officeholders and the policies required for economic growth. The concept combines seemingly contradictory characteristics of Weberian bureaucracy’s insulation from manipulation of social groups and state-society relations that connect them to the surrounding social structure. A bureaucracy’s ability to effect transformation thus depends both on its autonomy and immersion in dense social networks with which it shares a project. Because connectedness is perceived to enhance bureaucratic competence, it becomes as important as coherence and cohesion, for even the most bureaucratically coherent state cannot carry out transformation without an intense network of ties to social groups and classes (Evans 1995, 50, 249).

Besides the emphasis on connectedness for social networks in the context of efficacy of state governance, connectedness for global networks is even more important from the perspective of trade and market expansion to enable economic development and to achieve transformational goals. As Calder points out, it is the interaction among the parts of the broader system that often gives concrete developments in any one location their broader importance (2019, 9). The concept of connectivity from an international political economy perspective will be discussed in the next chapter.
Chapter 3: Comparative Analysis

To make analytical sense of the early SEZs introduced in three different countries during the initial phase of their respective market opening, this research employs six organizational elements for SEZ development in the context of transitional economies, chosen for their heuristic value: 1) state capacity for effective governance, 2) legal framework, 3) political stability, 4) infrastructure, 5) strategic location, and 6) global networks. These attributes are grouped into two categories of internal foundation and external connectivity.

While different in size, level of industrialization, and reform period for a more market-oriented approach as well as the introduction of the concept of SEZs, China, Russia (the former Soviet Union), and Vietnam share a common thread: they all sought economic growth and development with a partial market opening at the time of transition without full-fledged economic reform, still under the banner of communism. Comparative case analysis of SEZs in the three countries would be useful to understand how different approaches in the initial stages of economic opening in their respective countries resulted in disparate outcomes and trajectories, not just for the SEZs themselves but also for the country. Given the relatively weak literature on Russia and Vietnam’s SEZs compared with that of China, it would be hard to determine what all the important institutional, political, and economic differences were between these states. Yet, meaningful comparative analysis would be possible by examining how institutional governance structure of respective countries with capacity for policy making and enforcement with embedded incentive matrices that foster productivity among institutional agents impacted economic growth and development via SEZs.
A successful SEZ in this research is defined by both the *growth* of the SEZ itself and economic *development* generated by the SEZ, which contributed to the host country’s overall economic development, manifested in economic indicators such as the GDP growth rate. Here, the terms economic growth and economic development are not synonymous. In *The Economics of Development*, Hagen (1986) defines economic growth of a country as an increase in its real per capita income through continuing improvement in its means of production, whereas economic development includes the “many other economic changes that accompany economic growth” (4). Though often qualitative in nature, the “many other economic changes” are reflected in macroeconomic indices, such as GDP, GDP growth rate, employment rate, foreign investment, and trade balance.

To determine the impact and contribution of the SEZ to the host nation’s economic development in the initial phases of market opening, this research will primarily examine 1) the economic performance of the SEZ in the first several to ten years of the first decade of its establishment, 2) the economic contribution of the SEZ to the national GDP not just by the dollar amount but in proportion to the total volume (on the basis that official statistics are available), and 3) subsequent widespread adoption of SEZ policies outside the zone, or introduction of additional SEZs in other parts of the country in an attempt to emulate similar economic growth witnessed in the nation’s first SEZs. (Widespread SEZ policy adoption will be assessed not only by the number of additional SEZs introduced across the nation, but also in proportion to the total number of municipalities and provinces, to better reflect the differences in the absolute size and scale of the three countries.) Among the macroeconomic indices to be examined, the GDP growth *rate* of the SEZ draws particular attention as a useful indication of its future
growth trajectory for the purpose of this research. As Hagen (1986) noted, when one looks farther into the future, the greater the degree of a country’s growth rate rather than its current income level determines its prospective level of income (10).

The goal of this comparative analysis is to gain a more comprehensive understanding of the political economic role and dynamics of institutions and governance in the context of SEZs as well as SEZs’ contribution to economic development in China, Russia, and Vietnam, manifest in macroeconomic indices serving as objective bases for comparison, taking into account their many substantial differences in size, time, and context.

**Internal Foundation**

**State and Institutional Capacity**

An essential question for many developing and transitional countries is how to make institutional changes to materialize their growth potential, which requires not only recognizing the importance of institutions but having the capacity to devise and implement the needed changes in their institutions. As Qian (2017) contends, it is important not to confuse the goal with the process— “building best-practice institutions is a desirable goal, but getting institutions right is a process involving incessant changes interacting with initial conditions” (24-25). Here, the focus is on transition paths connecting the starting point and the goal, or on transitional institutions that can come in a variety of nonstandard forms reflecting country- and context-specific conditions. Instead of a binary framework advocating either state or market as principal agent, the goal and emphasis are placed on more effective government, which for centrally planned economies undergoing transition translates to states capable of managing development.
This goal requires sufficient institutional strength and capacity to control the course of reform—both the content and speed—and to enable interaction of state and market as well as the adjustment of state actions (Oi 1996, 130, 185).

As such, developing a market-based economy “requires a heavy dose of institution building” (Rodrik 2007, 182). According to Rodrik (1998), institutional strength is what makes some countries achieve higher economic growth than others and high-quality institutions contribute to growth regardless of the government’s stance on policy interventions (25, 28). Institutional quality is measured as a function of four variables: 1) the quality of bureaucracy, 2) the rule of law, 3) risk appropriation, 4) repudiation of contracts of government, or postponement of payment obligations (Rodrik 1997).

A key dilemma for states undergoing economic reform and transition, however, lies in the inter-related nature of economic system requiring major changes and the political institutions that make such change unlikely (Goldstein 1996, 145). In other words, to execute institutional reform requires autonomous power outside the existing political structure, for those extant institutions could not underpin economic reform. The nature and scope of “what within system reform can achieve is not dependent just on reform strategy, but also on what is within the system” (Goldstein 1996, 159). Some transition states attempted to avoid the policy gridlock by quickly overhauling its system altogether to enable economic reform, as was the case in the former Soviet Union under Mikhail Gorbachev. Yet even “advanced” political institutions that may have worked well in developed countries often fail to produce the intended changes for economic growth and stability in developing countries (Dinello and Popov 2007, 3). Because transitions
require delicate adjusting of formal institutions to given context and conditions, some argue that rather than to spend political capital on abrupt and extensive system overhauls, it is sometimes more effective to work within the context of imperfect existing institutions (Fukuyama 2007, 39).

The formation of coalitions between economic and political elites is also instrumental to establishing effective government, for it has powerful impact on government performance in the initial stages of political and economic transitions (Stoner-Weiss 1977, 27). When these coalitions promote higher levels of institutional performance instead of becoming extractive institutions, states can attain the needed institutional strength and capacity to carry out the envisioned economic transition and growth (Acemoglu and Robinson 2012, 442-443). Hence, ensuring institutional strength and capacity are the bedrocks for economic growth, particularly for those making the shift from centrally planned to market-oriented economies, for even the best policies could not be implemented without an enabling and effective government, whether interventionist or not.

Organizational Structure

Initial institutional conditions in terms of organizational structures play a big part in transition paths for economic development. The terms “U-form” referring to the unitary organizational structure and “M-form,” the multi-divisional structure, had first been used by Williamson (1975) to describe different organizational structures of business firms in the United States. Qian (2017) applies this concept to compare different organizational structures of transitional economies, contrasting those based on unitary form in the former Soviet Union (and East European countries) with the Chinese hierarchy of multi-layer-regional form primarily based on territorial principle. The
unitary state and their governments are mostly organized along functional lines in which specialized ministries exercise concentrated power and regional governments little authority, while governments organized in multi-divisional structure were further decentralized with increased authority and incentives endowed to regional governments (Qian 2017, 288-289). The US government, known for federalism, is one example that has the “M-form” organizational structure in which fifty states have the constitutional rights and responsibilities to coordinate government activities within their jurisdictions, generating an environment that encourages them to try innovative policies.

The perception that “federalism enables people to try experiments which could not safely be tried in a large, centralized country” (Bryce 1901) further gained affirmation in 1932 when the US Supreme Court Justice Louis Brandeis characterized American federalism as a “laboratory of the states,” saying that “it is one of the happy incidents of the federal system that a single courageous state may… serve as a laboratory; and try novel societal and economic experiments without risk to the rest of the country” (Osborne 1988). In fact, US President Franklin D. Roosevelt acknowledged that many of New Deal policies originated from experiments first initiated by individual states, when he said that “practically all the things we’ve done [about the New Deal] in the federal government are like things Al Smith did as governor of New York” (Osborne 1988; cited in Qian 2017, 368). When programs such as Social Security and massive public projects implemented by state governments proved successful, many were institutionalized at the federal level, speeding up the adoption of the policies nationwide.

The costs and benefits of the respective forms of organizations are determined by the integral traits of their structures, which can be summarized as follows. The unitary
form of hierarchies in the former Soviet Union and East European countries are “1) organized mainly by functional or specialization principles; 2) regional governments’ roles are limited and supplementary; 3) interdependence between regions is strong and coordination at the top is critical; and 4) the size of enterprises is generally large, and industries are very concentrated.” On the other hand, the multi-layer-multi-regional form of hierarchy in China is characterized as follows: “1) organized mainly by territorial principle in addition to functional or specialization principles; 2) each region is relatively self-contained and interdependence between regions is relatively weak; 3) coordination at all levels is important but at the top is not particularly critical; 4) the size of enterprises is generally small and industries are less concentrated; and 5) the above features extend many levels down to the very bottom” (Qian 2017, 304).

*Centralization & Decentralization*

Because the structure of organizations influence not only the evolutionary processes of the system, but also state capacity and efficiency for governance, it is useful to examine how the differences in organizational forms affected transition economies’ reform paths and produced heterogeneous outcomes, particularly in the form of political and fiscal decentralization.

Similar to the comparison between unitary and multi-divisional structures, Franz Schurmann (1968) distinguished two forms of organization (in Soviet-type systems): the ‘branch system’ organized by function and governed by ministries under vertical command from the center, and the ‘committee system’ operating under horizontal coordination across functional areas at a regional level (Goldstein 1996, 149). Whatever the different organizational forms of government are called, differences in their structure led to political and economic centralization or decentralization of the state and
consequently, its governance. For instance, the strong ministerial system in the former Soviet Union resulted in the bypassing of local governments and transmission of plans and policies directly to its enterprises. On the other hand, in China under the Maoist system of decentralization, much economic and administrative power was allocated to the localities (Oi 1996, 171-2). In his study of economic development and “market-preserving federalism,” Weingast (1995) emphasizes the crucial role that decentralized political institutions play to not only limit the central government’s authority to unilaterally make economic policy but to leave much in the hands of local governments. Decentralization of economic policies is considered crucial to demonstrate a state’s credible commitment to the market and is key to solving the “fundamental political dilemma of an economic system” because “a government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens” (Weingast 1995, 1).

**Market-Preserving Federalism**

The market-preserving federalism approach addresses issues related to the federal system in which the central government is granted enough power to police provinces to ensure common rules of the game but not having so much power that it can subdue the sub-units at will. Market-preserving federalists argue that elites limit themselves independently of externally imposed norms and laws when the system provides them with benefits for doing so and punishes those who fail to take social optima into account (Weingast 1995). This approach applies the principles of federalism to unitary states whose economic structures create de facto decentralization, such as in China and Vietnam where deconcentration of decision-making authority over investment decisions took place. Studies show that when an economy consists of competing jurisdictions, and if
these units permit the free flow of goods, capital, and labor, competition will provide a credible commitment device against arbitrary predation, which in turn makes non-elites or investors feel safe enough to invest in the economy despite the absence of a constitutionally federal system and independent courts (Weingast 1995, 18). This situation is only possible, however, when the state is strong enough and willing to establish and enforce widely acceptable rules of the game and uphold contracts reliably against all potential violators (Weingast 1995, 19).

The intricate interplay or tension between the need to decentralize and the deteriorating effect it can have on the need for a strong central state is a frequent problem in late industrializing countries (Oi 1996). The question and major concern then become whether the localities can continue to flourish without fatally damaging the strength of the center that can diminish state capacity. Hence, to retain institutional strength as a state, the government not only needs to strike a fine balance between centralization and decentralization but ensure that this strong capacity exists at both the local and central levels (Oi 1996, 185). In Federalism, Riker (1964) singled out two political fixtures that promoted political centralization: strong national political parties and administrative subordination by way of appointing local governments. Similarly, Enikolopov and Zhuravskaya (2007) also found that a strong national party system is an effective means of aligning national objectives with local political incentives, which is necessary for efficient decentralization. They contend that in developing and transition countries, older and more stable party systems along with lower fractionalization of government parties facilitate better fiscal decentralization on economic growth, government quality, and public goods (101). Scholars remain divided without a consensus on the overall effect of
decentralization in developing and transition economies, with stark examples of how decentralization in one country promoted economic growth while it proved to be an obstacle in another, specifically in China and Russia, as will be discussed in ensuing chapters.

**Incentives Mechanism**

Individual initiative is what ultimately accounts for all economic progress (Rodrik 2000, 98). Rodrik (2007) contends that one of the most important lessons past decades of comparative experience with economic growth has taught us is the need for private initiatives and incentives because “all instances of successful economic development are the collective result of decisions by entrepreneurs [individuals] to invest in risky new ventures and try out new things” (153). In the case of former communist states entrenched in decades of central planning, an apparent missing link for economic development was the absence of market-oriented incentives for individuals, be they bureaucrats, laborers, or farmers. If there was one principle that economists could universally agree upon despite their divergent perspectives on the role of state and market, not to mention economic policies, it would probably be the market system’s efficacy in directing individual effort towards the goal of material advancement of society (Rodrik 2000, 98).

So, the challenge is not just to permit but to institutionalize incentives for individuals to pursue innovative ways toward economic development that benefit both the individual and society because incentives in the absence of adequately devised and operating institutions could prompt perverted results such as corruption and rent-seeking, which have plagued many developing countries.
While incentives are apparently necessary and need to be institutionalized to foster sound economic development, the key here is to craft incentives in a way that turn those in bureaucracy and in the frontlines of policy execution from mere administrative-service providers to full-fledged economic actors who enable innovation and progress (Oi 1996, 174-5). To achieve this goal, Oi emphasizes the importance of endowing the local government greater autonomy with injection of strong economic incentives to be entrepreneurial. Fiscal decentralization, or devolution of authority over public revenue and expenditure to lower levels of government arouses interjurisdictional competition and can encourage the provision of public goods if government officials have the proper political incentives (Enikolopov and Zhuravskaya 2007, 101).

However, creating effective fiscal and political incentives that enable simultaneous innovation and progress in a strong centralized system may be something of a self-contradiction. Because states with strong centralization typically have a “U-form” or unitary structural organization in which specialized ministries exercise concentrated power and coordination with the center carries the highest priority, incentives of regional government officials are designed to ensure implementation of commands from above (Qian 2017, 307). Subject to strong and arbitrary control by their superiors in a unitary hierarchy, bureaucrats at regional governments tend to avoid changes and risks rather than to attempt new things for innovation and development (Ericson 1991). On the other hand, the M-form, or multi-divisional structure of government that already espouses decentralization, is much more optimized for increased autonomy and incentives for regional governments that allow more flexibility and opportunities for experiment and innovation (Qian 2017, 288).
Yet, governments with strong political centralization are not without merit because authority over personnel and promotions that directly affect the career prospects of bureaucrats serve as powerful incentives under a meritocratic principle, if done right. The logic is that fiscal decentralization can motivate local governments and officials to take the initiative to develop the local economy, while a meritocratic promotion system of personnel can provide political incentives for career advances that help remediate the ill effects of decentralization such as regionalism and corruption (Yao 2018, 84). For such incentives to generate the intended effect, however, depends largely on whether the government is able to make a credible commitment not to expropriate promised benefits and subsidize loss makers, the absence of which had been a legacy of centralized economies, resulting in the “ratchet effect” (where excess profits are constantly siphoned away) and the “soft budget constraint” (when loss-makers are continually bailed out). The lack of credible commitment hence becomes an intrinsic problem in centralized economies as the state gets too powerful to constrain itself (Qian 2017, 308).

Legal Framework

Among the most visible and effective ways to demonstrate state commitment against expropriation and corruption, and to investor protection is the introduction of a series of laws. These laws include property rights and price liberalization, which are considered prerequisites for transition to a successful market-oriented economy, as prescribed by the Washington Consensus and often imposed by international development institutions like the IMF and its donor states. The “pluralist” view, on the other hand, rejects the notion that there are clear universal rules for economic development, as displayed by the success of the Chinese gradualist approach without
political reform. In fact, mere plantation of the best practices or foreign models of legal framework in developing countries may not be the solution to economic development because they may prove ill-suited to country conditions and create heightened risks of inefficacy (deLisle 2011, 148). Moreover, unless accompanied by strong political leadership and efforts to enforce the established regulatory framework, simply adopting a series of laws would be little more than an empty piece of paper in transitional economies with firmly rooted old political forces (Chin and Guan 1996, 67).

While the absence, ignorance, disregard of, and limited role of the law in developing countries are suboptimal for national economic development goals, introduction of relevant laws can nevertheless serve local economic progress. In the case of China, much of the law’s practical effect was largely in policy signaling, and its impact was often expressed through invocation of officially sanctioned, law-embedded norms in extralegal contexts (deLisle 2011, 154). Economic development-promoting laws convey political commitments and solicit adherence—albeit by informal and oftentimes political means—rather than reliance on feeble legal institutions in progress. Relatedly, the introduction of such laws also impacted local officials’ behavior as direct agents who conduct economic policies and advance the interests of their business clients. Moreover, in an environment lacking the rule of law and protection of private property rights, local governments assume a vital role of orchestrating market production, selectively providing subsidies, and coordinating relations among enterprises (Chen 2018, 4, 6).

Although no ideal means of stable and sustained growth for prolonged periods, deLisle (2011) explains that this may fit a viable pro-growth equilibrium for transitional economies based on the example of China’s legacy of a strategy that unleashed growth
through political decentralization and the high costs of transition to a more law-governed system (151). Therefore, examining and understanding the law’s place in national economic development is useful to evaluate the trajectory and sustainability of economic success in states undergoing transition and reform both in terms of content and implications for other developing countries.

Political Stability

Just as indispensable to successful introduction and enforcement of laws in transitional economies are the will and commitment of the political leadership to follow through. As political and economic objectives are often at odds with each other, a pressing challenge for transitional economies is whether they can and how to strike a balance between the need for political control and pursuit of economic freedom to maintain political, economic, and social order (Chin and Guan 1996, 1). Rodrik (2007) argues that an attitudinal change on the part of the top political leadership often plays as large a role as the scope of reform itself (191). Similarly, longtime World Bank official and head of China desk Bottelier (2007) testifies that although the Bank contributed immensely to China’s institution building from the development of rules, systems, and organizations for managing projects, “long-term vision on the part of the government, political stability, pragmatism, and trust between local and foreign partners are essential” (251, 258). Bottelier insists that the best assistance programs with good intentions can reinforce, but not substitute for the drive and commitment necessary on the part of political leadership for reform and development to succeed. For instance, China’s leadership, initially interested in the experience of East European countries, where efforts for market mechanisms had started in 1960s, began to look beyond Eastern Europe for
their reform strategy after learning that the reforms in Eastern Europe were more price adjustments than actual market reforms (Bottelier 2007, 256). Moreover, to implement envisioned reforms means breaking the status quo by freeing the market from inefficient controls that often requires authorities to relinquish some political power. To actually follow through with the introduced laws and reforms requires unwavering will and commitment from those in possession of the authority and power, which cannot be easily found nor expected from the privileged, particularly in more authoritarian states in which the leaders often wield unrestrained power.

Along with clear strong government leadership in the direction of a country’s development, political stability is a key factor that enhances a state’s credibility for successful reform initiatives and implementation, often directly affecting investment decisions by foreign actors and enterprises (Du Pont 2000, 244). In this aspect, China is among few countries to carry out successful economic reform with the introduction of relevant laws under political stability. deLisle (2011) describes that while sustaining stability and party rule, laws in China played important roles in promoting development in that 1) law has been relied upon to help establish frameworks for increasingly market-oriented economy and international openness, 2) served development-sustaining monitoring and controlling functions, and 3) helped avoid and co-opt demands for political change by fulfilling one side of implicit social contract—the delivery of material well-being (155-160).

However, sustaining political stability while undergoing reform with implementation of a new legal framework is no easy feat, especially in large developing countries. Under such circumstances, a strong national party system is conducive to
effectively aligning the political incentives of (local) politicians with national objectives because of its older and more stable party system with lower fractionalization, according to findings by Enikolopov and Zhuravskaya (2007, 126).

**External Connectivity**

Infrastructure

Quality of infrastructure is regularly ranked as a top decision-making factor for selecting an investment location in surveys of investors (Jandl 2013, 89). While a favorable business environment with quality infrastructure is necessary for many investors, it gains greater significance for those considering business in under-industrialized countries, in which even basic architecture for industrial activities, let alone integrated road, rail, air, and maritime transportation is often not readily available. As a poor country lacks the means to develop the necessary infrastructure, establishing SEZs as joint venture projects is encouraged to help scale down bureaucratic and facility construction problems (Gates and Truong 1995, 90).

Due to high costs involved in comprehensive infrastructure building for SEZ development, especially when host countries like Vietnam require private partners to shoulder most of the expenses, SEZ development plans often flounder or experience delays in construction. Compounding the problem further, many investors encounter problems of corruption and overpricing in infrastructure investment projects, which Vietnam became known for and experienced serious undersupply of quality infrastructure (Jandl 2013, 89). Besides the construction of logistical facilities for production and transportation of goods, provision of various utilities such as power, communications, and other services and technology are also necessary infrastructure for SEZ operations.
Location

The recognition that location makes a much greater difference in shaping political-economic outcomes than often appreciated (Calder 2019, 11) could not be truer for SEZs, for the geographic position—both on the domestic and global map—is paramount to its successful development. In countries making a transition from a centrally planned to market-oriented economy with a limited market opening, SEZs were often intentionally set up in isolated and backward areas to minimize the possible negative impact on the rest of the economy should the experimentation fail (Ge 1999, 47). However, to use SEZ as a policy instrument facilitating economic transition and development, Ge (1999) argues that rather than operating it in isolation from the rest of the economy, a strong backward linkage with good flows of commodities, resources, and information between the SEZ and other parts of the country is encouraged (173). Surveys on primary motivational and locational forces for foreign direct investment also indicate that market factors are oriented solely towards the local host country market, that is, “to access and supply the local market and the growth potential of the local market” (Du Pont 2000, 244).

Agglomeration, or the development of clusters to foster economies of scale, is another rationale that encourages governments to concentrate businesses and industries to particular areas, similar to how the location of an SEZ is vital for successful business. However, agglomeration is considered more the result of a successful industry than its cause (Moberg 2017), which makes its utility as a policy instrument for national economic development quite a different matter. Vietnam’s designation of multiple industrial zones in Ho Chi Minh City is described as an example of misguided cluster
policy because despite the government’s endeavor to promote business constellations in the region, investment for industrial cluster development was dampened due to a rising demand for residential constructs, which resulted in shrinking of the zones (Xuan 2015). Misjudgment in designations is often a result of centralized decision-making, and Moberg (2017) argues that one way to help mitigate this problem is through some form of decentralization by delegating much authority regarding the SEZ location, the nature of industry, and production to officials with close access to and knowledge of local markets (41-2).

SEZs run the risk of causing unfavorable distortions in the economy and a net cost for the country. Along with the government’s distribution of resources to provide various fiscal incentives such as tax reductions or exemptions at the SEZ to attract foreign investment, the government also reallocates capital directly to establishing the SEZ infrastructure, such as buildings, roads, and ports (Moberg 2017, 36). Designation of SEZs in poor locations not only fails to attract investment but incurs a serious waste of public resources for host countries, especially for developing countries already suffering from a poor economy. When the government spending poured into building the necessary facilities exceeds revenues generated by the SEZ, the government-financed infrastructure can turn into the so-called white elephant that requires much expense for maintenance with little or no profit yield. The Bataan EPZ, the first official economic zone in the Philippines, is considered a failed SEZ due to its poor location in a cove and misguided resource allocation. Following the closure of the US military base at Bataan in 1992, the Philippine government transformed the former base into an export processing zone and invested over $200 million for infrastructure upgrades. Despite the zone’s generous fiscal
incentives and renewed infrastructure, its location proved too secluded to attract much global investment and lackluster performance resulted in its shutdown as an economic zone (Warr 1987; Moran 2011). The Bataan case illustrates the importance of SEZ location and accessibility for sustained and long-term investment for businesses.

On the other hand, a strategically located SEZ, not only in terms of domestic needs and purposes but in vicinity to centers of international commerce and market, can be a useful catalyst for economic development. As explicated in detail by Calder’s (2019) Super Continent, geographic location is important, determining not only resource endowments but latent connectivity potential that can have far-reaching ramifications in a country’s economic development via interactions with neighboring states. Location is also crucial to understanding regional political-economic interactions, their complementarities and broader global significance (Calder 2019, 6). As such, the decision to establish China’s first SEZ in Shenzhen near a vibrant economic hub of Hong Kong was instrumental to its extraordinary success. Physical proximity to Hong Kong—among the top five busiest container ports in the world at the time—proved extremely advantageous in terms of access and transport of goods but also because it allowed for the Chinese to witness and learn from a nearby thriving model of economic development, which served as an invaluable resource base for advances in technology, business management, and personnel training, not to mention large inflows of foreign investment (Ge 1999, 45-46).

Global Networks

Besides the construction of SEZs in a strategic location equipped with necessary infrastructure in and outside the zones, the host country’s openness and extensive
networks are compelling attributes for SEZs to develop as more competitive venues for investment and business in the international market. Contrary to the SEZ’s stated conceptual definition as geographically “delimited” area, a high degree of openness for good flow of resources and information as well as goods and investment, are crucial for SEZ development and its subsequent expansion (Pan and Ngo 2016, 120). For instance, Vietnam’s proactive efforts to improve and expand its external relations, including with former archenemies China and the United States, were pivotal to its turnaround from a heavily sanctioned and isolated country to an emerging nation that traded extensively with a much more diverse group of nations, which contributed to its rapid economic growth. Vietnam’s exports and trade saw an expedited growth in the mid-1990s after forging much expanded global networks through normalization of relations and joining of regional cooperation bodies such as ASEAN.

Just as the emphasis was placed on the need for bureaucracy’s connectedness with dense network of ties to social groups and business partners for effective governance and economic development (Evans 1995), from an international perspective, sustained efforts at enhancing connectivity can yield global implications, increasing its economic weight as well as geopolitical and geo-economic leverage (Calder 2019). Calder (2019) contends that interaction as part of a broader system often leads to concrete developments in a location and turns it into an increasingly interactive political-economic player. China is a prime example that changed profoundly from a static socialist economy to a growing juggernaut in the 1980s and 1990s, changing its political-economic course to provoke a quantum leap in the country’s economic magnitude (Calder 2019, 101).
Chapter 4: Case Study

China

Overview of SEZ and Economic Development

China’s first SEZs played a vital role in driving the country’s national economic growth during the initial phase of opening and reform under Deng Xiaoping’s pronounced open-door policy in 1978. Introduced in the following two years as experimental areas where the government implemented market-oriented policies and provided various incentives to attract foreign investment and promote trade, the first SEZs contributed significantly to the country’s economic growth from the onset of its transition from a centrally planned to a market-oriented economy. The success of the SEZs in China provided a model for economic development that other regions in the country aspired to emulate and laid the foundation for China’s rapid economic transformation in the ensuing decades.

As shown in Table 2, following the launch of all four SEZs in 1980, the growth rates of both the GDP and industrial production in the provinces with SEZs—Guangdong and Fujian Provinces—soared well above the national average. While China’s national GDP grew at more than 9 percent in a span of fifteen years since its open-door policy, that of Guangdong Province rose more than 14 percent, and even higher in Fujian Province at over 23 percent in that period (Table 2).
Table 2. GDP and Industrial Production: China and Provinces with SEZ (100 million yuan)

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1985</th>
<th>1990</th>
<th>1995</th>
<th>Annual average growth rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>4,518</td>
<td>8,964</td>
<td>18,531</td>
<td>58,261</td>
<td>9.8 (1979-94)</td>
</tr>
<tr>
<td>Industrial production</td>
<td>5,154</td>
<td>9,716</td>
<td>23,924</td>
<td>91,894</td>
<td>14.9 (1979-94)</td>
</tr>
<tr>
<td>Guangdong</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>250</td>
<td>577</td>
<td>1,559</td>
<td>5,734</td>
<td>14.4 (1979-96)</td>
</tr>
<tr>
<td>Industrial production</td>
<td>234</td>
<td>505</td>
<td>1,907</td>
<td>7,458</td>
<td>21.7 (1980-95)</td>
</tr>
<tr>
<td>Fujian</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>87</td>
<td>200</td>
<td>523</td>
<td>2,160</td>
<td>23.9 (1979-96)</td>
</tr>
<tr>
<td>Industrial production</td>
<td>81</td>
<td>173</td>
<td>531</td>
<td>2,881</td>
<td>26.9 (1980-95)</td>
</tr>
</tbody>
</table>

Note: Average growth rates of Fujian were computed based on current price, whereas National and Guangdong growth rates were official figures from the yearbook. Current price figures tend to be much higher.


Figure 2. China’s GDP growth, 1978-1994 (annual %)


More remarkable was the Shenzhen SEZ whose GDP grew at 40 percent per annum from 1979 to 1993, a rate more than 30 percentage points higher than the national average (Tables 3 and 4)).
### Table 3. Shenzhen’s GDP and GDP Growth Rate, 1979-1993

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP (100 million, current year=100)</th>
<th>GDP growth rate (% current year=100)</th>
<th>Per Capita GDP (Yuan, current year=100)</th>
<th>GDP growth rate (% 1979=100)</th>
<th>Per capita GDP (Yuan, 1979=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>1.96</td>
<td>-</td>
<td>606</td>
<td>-</td>
<td>606</td>
</tr>
<tr>
<td>1980</td>
<td>2.70</td>
<td>37.55</td>
<td>835</td>
<td>62.70</td>
<td>988</td>
</tr>
<tr>
<td>1981</td>
<td>4.96</td>
<td>83.53</td>
<td>1417</td>
<td>53.78</td>
<td>1405</td>
</tr>
<tr>
<td>1982</td>
<td>8.26</td>
<td>66.56</td>
<td>2023</td>
<td>58.43</td>
<td>1907</td>
</tr>
<tr>
<td>1983</td>
<td>13.12</td>
<td>58.90</td>
<td>2512</td>
<td>58.30</td>
<td>2359</td>
</tr>
<tr>
<td>1984</td>
<td>23.42</td>
<td>78.46</td>
<td>3504</td>
<td>59.89</td>
<td>2949</td>
</tr>
<tr>
<td>1985</td>
<td>39.02</td>
<td>66.65</td>
<td>4809</td>
<td>24.53</td>
<td>3025</td>
</tr>
<tr>
<td>1986</td>
<td>41.65</td>
<td>6.72</td>
<td>4584</td>
<td>2.70</td>
<td>2774</td>
</tr>
<tr>
<td>1987</td>
<td>55.90</td>
<td>34.23</td>
<td>5349</td>
<td>25.40</td>
<td>3024</td>
</tr>
<tr>
<td>1988</td>
<td>86.98</td>
<td>55.60</td>
<td>6477</td>
<td>35.90</td>
<td>3198</td>
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<tr>
<td>1989</td>
<td>115.66</td>
<td>32.97</td>
<td>6710</td>
<td>18.70</td>
<td>2957</td>
</tr>
<tr>
<td>1990</td>
<td>171.67</td>
<td>48.43</td>
<td>8724</td>
<td>32.50</td>
<td>3432</td>
</tr>
<tr>
<td>1991</td>
<td>236.66</td>
<td>37.86</td>
<td>11997</td>
<td>36.00</td>
<td>4170</td>
</tr>
<tr>
<td>1992</td>
<td>317.32</td>
<td>34.08</td>
<td>12827</td>
<td>33.20</td>
<td>4430</td>
</tr>
<tr>
<td>1993</td>
<td>453.14</td>
<td>42.80</td>
<td>15005</td>
<td>30.91</td>
<td>4750</td>
</tr>
</tbody>
</table>

Source: the data of GDP, per capita GDP of 1979 to 2008 calculated by the current prices was from the Shenzhen Statistical Yearbook (2009); the data of GDP, per capita GDP of 1979 to 2008 calculated by the constant prices of 1979 were reckoned basing on the local GDP index of the corresponding year from the Shenzhen Statistical Yearbook (2009); the GDP, per capita GDP of 2009 calculated by the current prices was reckoned basing on the related statistics of Shenzhen Statistics Web site (http://www.szj.gov.cn/pub/szjsjzzb/default.htm); the data of 2009 GDP calculated by the constant prices of 1979 was from Steady and healthy development of National economy, Shenzhen 2009, released by the Shenzhen Development Committee and Shenzhen Bureau of Statistics.


### Table 4. China’s Per Capita GDP, 1978-1993

<table>
<thead>
<tr>
<th>Year</th>
<th>Per Capita GDP (Yuan) (1978 Price)</th>
<th>Per Capita GDP (% (1978 = 100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>379</td>
<td>100.00</td>
</tr>
<tr>
<td>1979</td>
<td>402</td>
<td>106.10</td>
</tr>
<tr>
<td>1980</td>
<td>428</td>
<td>113.00</td>
</tr>
<tr>
<td>1981</td>
<td>445</td>
<td>117.50</td>
</tr>
<tr>
<td>1982</td>
<td>478</td>
<td>126.20</td>
</tr>
<tr>
<td>1983</td>
<td>523</td>
<td>137.90</td>
</tr>
<tr>
<td>1984</td>
<td>594</td>
<td>156.80</td>
</tr>
<tr>
<td>1985</td>
<td>665</td>
<td>175.50</td>
</tr>
<tr>
<td>1986</td>
<td>713</td>
<td>188.20</td>
</tr>
<tr>
<td>1987</td>
<td>783</td>
<td>206.60</td>
</tr>
<tr>
<td>1988</td>
<td>858</td>
<td>226.30</td>
</tr>
<tr>
<td>1989</td>
<td>879</td>
<td>231.90</td>
</tr>
<tr>
<td>1990</td>
<td>899</td>
<td>237.30</td>
</tr>
<tr>
<td>1991</td>
<td>969</td>
<td>255.60</td>
</tr>
<tr>
<td>1992</td>
<td>1093</td>
<td>288.40</td>
</tr>
<tr>
<td>1993</td>
<td>1226</td>
<td>323.60</td>
</tr>
</tbody>
</table>

A bar graph (Figure 3) comparing the real GDP growth rate of the Shenzhen SEZ and China clearly illustrates the substantial margin between the two. Since its launch, Shenzhen SEZ’s real GDP growth exceeded that of China for over a dozen years; that is, except for a single year in 1986, one year after the Chinese government decided to diminish the SEZ preferential status in 1985 amid mounting criticism and opposition to its SEZ policy regarding problems exposed in SEZ performance and strategy (Ye 2014, 64). However, China promptly restored a modified SEZ policy and its preferential status in 1986 following a heated debate and realization that the policy retraction scared away foreign capital, holding up its modernization program (Crane 1990, 108; Ge 1999, 68).

![Figure 3. Shenzhen SEZ and China: real GDP growth rate, 1981-1993 (preceding year=100)](image)

As shown in Table 5, all four SEZs saw a much higher economic growth compared with other localities in China in terms of FDI inflow, industrial output, and exports in the first decade of opening. The average annual growth of real NMP (Net Material Product, the main macroeconomic indicator used by socialist countries during
the Soviet era to monitor growth in national accounts; a conceptual equivalent of GDP)

for SEZs hovered over 16 percent compared with that of 4.4 percent for other major cities
during the latter half of 1980s. Reflecting their exponential growth in stature, some SEZs
underwent as much as a fifty-fold physical expansion by 1990 (Table 6).

Table 5. Economic Performance of Regions by Size of their FDI in China

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SEZ average</strong></td>
<td>21.1</td>
<td>16.1</td>
<td>0.31</td>
<td>23.7</td>
<td>33.5</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>30.5</td>
<td>20.8</td>
<td>0.27</td>
<td>16.5</td>
<td>44.5</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>19.4</td>
<td>18.9</td>
<td>0.29</td>
<td>27.0</td>
<td>45.9</td>
</tr>
<tr>
<td>Shantou</td>
<td>11.5</td>
<td>9.5</td>
<td>0.35</td>
<td>16.2</td>
<td>16.3</td>
</tr>
<tr>
<td>Xiamen</td>
<td>22.8</td>
<td>15.2</td>
<td>0.31</td>
<td>35.1</td>
<td>27.3</td>
</tr>
<tr>
<td><strong>Special provinces average</strong></td>
<td>11.4</td>
<td>11.0</td>
<td>0.32</td>
<td>26.4</td>
<td>14.2</td>
</tr>
<tr>
<td>Guangdong</td>
<td>14.1</td>
<td>11.2</td>
<td>0.30</td>
<td>22.2</td>
<td>17.6</td>
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<tr>
<td>Fujian</td>
<td>8.6</td>
<td>10.7</td>
<td>0.35</td>
<td>30.6</td>
<td>10.7</td>
</tr>
<tr>
<td><strong>Other localities average</strong></td>
<td>5.9</td>
<td>4.4</td>
<td>0.12</td>
<td>13.0</td>
<td>6.9</td>
</tr>
<tr>
<td>Shanghai</td>
<td>4.2</td>
<td>1.1</td>
<td>0.03</td>
<td>7.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Tianjin</td>
<td>2.6</td>
<td>2.5</td>
<td>0.06</td>
<td>0.8</td>
<td>5.7</td>
</tr>
<tr>
<td>Beijing</td>
<td>6.6</td>
<td>5.8</td>
<td>0.12</td>
<td>10.2</td>
<td>7.7</td>
</tr>
<tr>
<td>Dalian</td>
<td>10.1</td>
<td>8.3</td>
<td>0.28</td>
<td>33.3</td>
<td>9.6</td>
</tr>
</tbody>
</table>


Table 6. Size of China’s SEZ and Asian EPZs (square kilometers)

<table>
<thead>
<tr>
<th></th>
<th>Initial 1980 size</th>
<th>Size in 1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shenzhen</td>
<td>327.5</td>
<td>327.5</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>6.8</td>
<td>121.0</td>
</tr>
<tr>
<td>Shantou</td>
<td>1.6</td>
<td>52.6</td>
</tr>
<tr>
<td>Xiamen</td>
<td>2.5</td>
<td>131.1</td>
</tr>
<tr>
<td>Kaohsiung, Taiwan</td>
<td>0.7</td>
<td></td>
</tr>
<tr>
<td>Penang, Malaysia</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Batam Island, Indonesia</td>
<td>36.6</td>
<td></td>
</tr>
<tr>
<td>Bataan, Philippines</td>
<td>3.4</td>
<td></td>
</tr>
</tbody>
</table>

Shenzhen SEZ, however, was by far the largest and most consequential in terms of economic performance—from FDI, GDP, and contribution to the national GDP and the transformation of its local economy as demonstrated in Tables 6 and 7. Since 1979, the city of Shenzhen’s Gross Value of Industrial and Agricultural Output (GVIAO) skyrocketed from 175 million to 2.862 billion yuan in just six years, recording more than a 16-fold increase. During that period, the SEZ’s share in the GVIAO of the Shenzhen city rose from 29 percent to 83 percent, indicating that the SEZ not only helped generate much economic growth but actually carried most of the city’s gross value output.

The Shenzhen SEZ also transformed the industrial structure of the city’s economy. The Gross Value of Industrial Output in Shenzhen, which was 61 million yuan in 1979, roughly half that of its Agricultural Output, increased exponentially to 2.67 billion yuan over the six-year-period, not only completely reversing the industrial structure, but accounting for over 93 percent of the city’s 2.86-billion-yuan Gross Value of Output altogether (Table 7).

The Shenzhen SEZ’s rapid growth impacted not only the city of Shenzhen, but the entire province of Guangdong. The Shenzhen SEZ, which accounted for a mere 0.2 percent population of the Guangdong Province with a contribution of 0.6 percent in GDP and 0.5 percent in exports, respectively, in 1980, grew to account for more than 5 percent of the GDP and a quarter of total exports of the entire Province in 1988, as indicated in Table 8.

Table 8. Shenzhen SEZ: Shares of Population, GDP, and exports in Guangdong Province, 1980-1993 (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Population</th>
<th>GDP</th>
<th>Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>0.2</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>1985</td>
<td>0.8</td>
<td>4.9</td>
<td>19.1</td>
</tr>
<tr>
<td>1988</td>
<td>1.3</td>
<td>5.2</td>
<td>24.7</td>
</tr>
<tr>
<td>1989</td>
<td>1.7</td>
<td>5.8</td>
<td>27.1</td>
</tr>
<tr>
<td>1990</td>
<td>1.6</td>
<td>8.3</td>
<td>28.4</td>
</tr>
<tr>
<td>1991</td>
<td>1.9</td>
<td>9.5</td>
<td>25.2</td>
</tr>
<tr>
<td>1992</td>
<td>1.9</td>
<td>10.1</td>
<td>27.6</td>
</tr>
<tr>
<td>1993</td>
<td>1.8</td>
<td>10.2</td>
<td>22.3</td>
</tr>
</tbody>
</table>

At the core of Shenzhen SEZ’s rapid rise in economic contribution to the city of Shenzhen and the Province of Guangdong were its booming exports. On the back of growing industrial output in the Shenzhen SEZ, exports soared from 9.3 million to 18.3 billion US dollars from 1979 to 1994, an increase of nearly 197,000 percent in a span of 15 years (Table 9). Such an exponential boost in exports was also reflected in exports at the national level (Figure 4).
Table 9. Shenzhen SEZ: Exports and Growth, 1979-1994

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of Exports (millions of U.S. dollars)</th>
<th>Growth of Exports (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1979 = 100</td>
</tr>
<tr>
<td>1979</td>
<td>9.3</td>
<td>100.0</td>
</tr>
<tr>
<td>1980</td>
<td>11.2</td>
<td>120.8</td>
</tr>
<tr>
<td>1981</td>
<td>17.5</td>
<td>187.6</td>
</tr>
<tr>
<td>1982</td>
<td>16.0</td>
<td>171.7</td>
</tr>
<tr>
<td>1983</td>
<td>62.3</td>
<td>669.6</td>
</tr>
<tr>
<td>1984</td>
<td>265.4</td>
<td>2,852.4</td>
</tr>
<tr>
<td>1985</td>
<td>563.4</td>
<td>6,055.5</td>
</tr>
<tr>
<td>1986</td>
<td>725.5</td>
<td>7,797.9</td>
</tr>
<tr>
<td>1987</td>
<td>1,413.5</td>
<td>15,192.8</td>
</tr>
<tr>
<td>1988</td>
<td>1,849.5</td>
<td>19,878.4</td>
</tr>
<tr>
<td>1989</td>
<td>2,174.3</td>
<td>23,369.3</td>
</tr>
<tr>
<td>1990</td>
<td>2,995.8</td>
<td>32,199.2</td>
</tr>
<tr>
<td>1991</td>
<td>3,446.1</td>
<td>37,038.4</td>
</tr>
<tr>
<td>1992</td>
<td>5,097.0</td>
<td>54,782.4</td>
</tr>
<tr>
<td>1993</td>
<td>8,335.3</td>
<td>89,587.8</td>
</tr>
<tr>
<td>1994</td>
<td>18,309.0</td>
<td>196,786.3</td>
</tr>
</tbody>
</table>


Figure 4. China: exports, imports, and trade balance, 1980-1996 (billions of US$)

The ascending trend in China’s exports from 1980 to 1996 is replicated in its ascending GDP trend during that same period, as shown in Figure 5.

Figure 5. China’s GDP, 1980-1996 (current, billions of US$)

Among the necessary external and economic conditions for SEZs’ rapid growth both in industrial production and exports was a reliable inflow of FDI. For an underdeveloped nation without much financial means to build the needed infrastructure for SEZs, attracting ample foreign investment was essential, especially in the initial stages to set the foundation for stable economic and industrial performance.
Albeit gradual in the initial phase, FDI inflow into China saw a steady rise in the 1980s, then making a steep jump in the 1990s, a full decade since the launch of SEZs, as illustrated in Figure 6. The influx of FDI rose from 44 million to 3.49 billion US dollars in a span of 10 years from 1980 to 1990, and total value of FDI firms’ trade grew from four million to 20 billion US dollars during the same period. Then in the next five years from 1990 to 1995, the influx of FDI multiplied over ten times from 3.49 to 37 billion US dollars and total value of FDI firms’ trade over five-fold from 20 to nearly 110 billion US dollars (Table 10).
As trade by FDI firms in China grew, so did their share in China’s total trade.

From about one-tenth of a percent of China’s total trade in 1980, FDI firms’ trade amplified to account for 17 percent in 1990, and then 39 percent of China’s total trade in 1995 as shown in Table 10. The gushing inflow of FDI into China played a critical part in the nation’s economic rise and development.

Besides providing the needed capital investment in SEZs, which helped boost China’s total trade, the influx of FDI also resulted in higher employment. As Figure 7 illustrates, increase in overall foreign investment in Shenzhen SEZ is accompanied by a corresponding increase in employment. A rise in the level of FDI tends to move closely in tandem with employment in non-state-owned units, for most FDI firms created jobs outside the limited employment market largely predominated by the state sector in a socialist country like China.

### Table 10. FDI Firms’ International Trade Performance in China, 1980-2008

<table>
<thead>
<tr>
<th>Year</th>
<th>FDI inflows (US$ billion)</th>
<th>Value of FDI firms’ trade (US$ billion)</th>
<th>FDI firms’ trade as % of China’s total trade</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total trade</td>
<td>Exports</td>
</tr>
<tr>
<td>1980</td>
<td>0.44</td>
<td>0.04</td>
<td>0.01</td>
</tr>
<tr>
<td>1985</td>
<td>1.66</td>
<td>2.36</td>
<td>0.29</td>
</tr>
<tr>
<td>1990</td>
<td>3.49</td>
<td>20.12</td>
<td>7.81</td>
</tr>
<tr>
<td>1995</td>
<td>37.52</td>
<td>109.82</td>
<td>46.88</td>
</tr>
</tbody>
</table>

As shown in Table 1, employment in non-state-owned units, which was virtually non-existent before 1982, exceeded 100,000 by 1988, and in 1993 became on par with employment in state-owned units, accounting for some 334,000 out of total employment of 683,000 workers in Shenzhen SEZ. As the SEZ transformed the industrial structure of Shenzhen region on the back of a rapid boost in industrial production and exports, it also transformed the employment landscape with a precipitous increase in total employment, posting a 26-fold growth in 1993 since its launch in 1980.
Table 11. Shenzhen SEZ: Employment by State- and Non-state-owned Units, 1980-1993 (Thousands of Workers, % Change)

<table>
<thead>
<tr>
<th></th>
<th>Employment</th>
<th>Annual Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State-owned Units</td>
<td>Non-state-owned Units</td>
</tr>
<tr>
<td>1980</td>
<td>26.5</td>
<td>26.5</td>
</tr>
<tr>
<td>1981</td>
<td>38.5</td>
<td>38.5</td>
</tr>
<tr>
<td>1982</td>
<td>66.8</td>
<td>60.8</td>
</tr>
<tr>
<td>1983</td>
<td>106.7</td>
<td>87.0</td>
</tr>
<tr>
<td>1984</td>
<td>154.5</td>
<td>117.8</td>
</tr>
<tr>
<td>1985</td>
<td>193.1</td>
<td>140.0</td>
</tr>
<tr>
<td>1986</td>
<td>221.3</td>
<td>156.4</td>
</tr>
<tr>
<td>1987</td>
<td>273.5</td>
<td>177.2</td>
</tr>
<tr>
<td>1988</td>
<td>357.9</td>
<td>229.4</td>
</tr>
<tr>
<td>1989</td>
<td>412.0</td>
<td>243.7</td>
</tr>
<tr>
<td>1990</td>
<td>475.9</td>
<td>271.0</td>
</tr>
<tr>
<td>1991</td>
<td>554.7</td>
<td>302.9</td>
</tr>
<tr>
<td>1992</td>
<td>600.6</td>
<td>330.4</td>
</tr>
<tr>
<td>1993</td>
<td>683.2</td>
<td>349.3</td>
</tr>
</tbody>
</table>


A growing presence of the non-state sector in China, at least in SEZ operations, is also evident in the composition of investment funds for the Shenzhen SEZ. Although foreign investment took up the lion’s share of total funds at the beginning of the Shenzhen SEZ, state appropriation was also quite substantial, accounting for nearly a quarter of the total investment in 1980 (Table 12). The share of state appropriation dropped to a single digit the following year and then below one percent by 1988, and finally to zero by 1993. While foreign investment continues to take up a significant portion of funds infused into the SEZ, what is notable is the steady increase in self-raised funds, accounting for 51 percent of total investment in 1993. In the meantime, the share of foreign investment dropped to below 13 percent, about a quarter of self-raised funds. Rather than pouring in state subsidies, China veered toward using non-state funds as well...
as foreign investment in SEZ operations, indicating a shift in its practice of economic and business operations closer to that of a market economy.

Table 12. Shenzhen SEZ: Source of Investment Funds, 1980-1993 (Percentage Share of Total Investment)

<table>
<thead>
<tr>
<th>Year</th>
<th>State Appropriation</th>
<th>Domestic Loan</th>
<th>Foreign Investment</th>
<th>Self-Raised Funds</th>
<th>Other Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>23.9</td>
<td>6.2</td>
<td>43.9</td>
<td>26.1</td>
<td>—</td>
</tr>
<tr>
<td>1981</td>
<td>7.6</td>
<td>11.6</td>
<td>51.1</td>
<td>28.7</td>
<td>1.1</td>
</tr>
<tr>
<td>1982</td>
<td>7.3</td>
<td>33.2</td>
<td>28.6</td>
<td>27.6</td>
<td>3.2</td>
</tr>
<tr>
<td>1983</td>
<td>5.2</td>
<td>37.3</td>
<td>26.6</td>
<td>26.6</td>
<td>4.4</td>
</tr>
<tr>
<td>1984</td>
<td>1.4</td>
<td>40.1</td>
<td>18.0</td>
<td>38.2</td>
<td>2.3</td>
</tr>
<tr>
<td>1985</td>
<td>1.7</td>
<td>18.6</td>
<td>13.7</td>
<td>57.7</td>
<td>8.4</td>
</tr>
<tr>
<td>1986</td>
<td>2.7</td>
<td>13.9</td>
<td>18.6</td>
<td>50.1</td>
<td>14.8</td>
</tr>
<tr>
<td>1987</td>
<td>1.3</td>
<td>17.5</td>
<td>16.7</td>
<td>55.5</td>
<td>8.9</td>
</tr>
<tr>
<td>1988</td>
<td>0.8</td>
<td>15.8</td>
<td>15.3</td>
<td>49.0</td>
<td>19.1</td>
</tr>
<tr>
<td>1989</td>
<td>0.3</td>
<td>11.8</td>
<td>32.0</td>
<td>45.3</td>
<td>10.6</td>
</tr>
<tr>
<td>1990</td>
<td>0.5</td>
<td>22.5</td>
<td>34.0</td>
<td>34.3</td>
<td>8.7</td>
</tr>
<tr>
<td>1991</td>
<td>0.3</td>
<td>29.9</td>
<td>23.6</td>
<td>36.0</td>
<td>10.2</td>
</tr>
<tr>
<td>1992</td>
<td>0.0</td>
<td>30.7</td>
<td>11.8</td>
<td>43.6</td>
<td>13.9</td>
</tr>
<tr>
<td>1993</td>
<td>—</td>
<td>19.8</td>
<td>12.9</td>
<td>51.2</td>
<td>16.1</td>
</tr>
</tbody>
</table>


In its experiment of market-oriented policies in the initial phase of opening and reform, China had an invaluable resource it could count on—Hong Kong. Even when other advanced countries were not quite ready or confident to make hefty investments in China, affluent Hong Kong, with ample capital and diaspora entrepreneurs, welcomed China’s market opening and made inroads to mainland China, especially to the nearby Shenzhen SEZ. Naturally, Hong Kong was the number one source of FDI in China, accounting for nearly 73 percent of total FDI from 1978 to 1993, as shown in Table 13. The combined Chinese diaspora, including those from Taiwan, Macao, and Singapore accounted for 88 percent of the total FDI in China during that period. The Chinese diaspora FDI played a pivotal part in the relatively steadfast and rapid sail of China’s first SEZs.
Table 13. Sources of FDI in China, 1978-1993 Combined

<table>
<thead>
<tr>
<th></th>
<th>No. of FIFs*</th>
<th>%</th>
<th>Registered capital ($billion)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong**</td>
<td>106,914</td>
<td>63.8</td>
<td>103.9</td>
<td>72.7</td>
</tr>
<tr>
<td>Taiwan</td>
<td>20,612</td>
<td>12.3</td>
<td>13.2</td>
<td>9.3</td>
</tr>
<tr>
<td>Macao</td>
<td>4,116</td>
<td>2.5</td>
<td>4.1</td>
<td>2.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>3,037</td>
<td>1.8</td>
<td>3.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Thailand</td>
<td>1,361</td>
<td>0.8</td>
<td>1.6</td>
<td>1.1</td>
</tr>
<tr>
<td>U.S. United States</td>
<td>1,1554</td>
<td>6.9</td>
<td>8.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Japan</td>
<td>7,096</td>
<td>4.2</td>
<td>5.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Total Diaspora (%)</td>
<td>81.2</td>
<td></td>
<td></td>
<td>88.3</td>
</tr>
</tbody>
</table>

*FIFs refer to foreign-invested firms.
**Hong Kong’s shares do not include investment made by Hong Kong subsidiaries of other nations.
(cited in Ye 2014, 47).

On the back of strong economic performance in China’s first SEZs, most notably in Shenzhen, other regions in the country aspired to emulate their economic success by introducing their own SEZs. By 1984, Beijing granted its “open policy” to additional 14 cities along China’s coast from north to south with greater autonomy for economic policies, liberalization, and generous tax incentives for FDI. Soon thereafter, other zones were established with a more specific focus such as “Economic and Technological Development Zones” (ETDZ; Chen 2011, 38). Various types of special zones quickly spread across China in all provinces and most municipalities (Figure 8).

Figure 8. Percentage of Chinese municipalities with SEZs, 1978-2008
Rise of Deng Xiaoping and China’s 1978 Open-Door Policy

Since the foundation of the People’s Republic of China in 1949, the Chinese economy became highly isolated internationally. Led by its founder Mao Zedong’s doctrine to preserve communism and to “delink” from the capitalist world economy, China took a heavy-industry-priority development strategy or Big Push strategy, taking after the industrialization path of the Soviet Union. Decades of a command economy with an inward-directed strategy emphasizing national self-reliance left China’s economy in a dire state of severe poverty (Naughton 2018, 65-69), particularly in the aftermath of a decade-long Cultural Revolution that lasted until 1976. The proportion of people living in poverty in China on less than $1.90 per day, the international poverty line as defined by the World Bank, reached 97.5 percent of the rural population with a poverty headcount of 770 million in 1978 (World Bank 2022). The threat of economic crisis created pressure for China’s elites to re-examine and change their policies to redirect the country toward a more viable and stable economy—like Schumpeter’s notion of creative destruction (Heady et al. 2009). Following Mao’s death, China’s new leader Deng Xiaoping seized the opportunity to make a major pivot—to pull China out of economic backwardness and to improve the standard of living for its populace. At the third plenum of the Eleventh Central Committee in December 1978, Deng declared the Chinese Communist Party’s primary objective as China’s modernization and development, replacing that of class struggle from Mao’s era. The ambitious program termed “Socialism with Chinese Characteristics,” aimed to “actively expand economic co-operation with other countries” and to “strive to adopt the world’s advanced technologies and equipment” (Peking Review 1978, 6-16). Its announcement of an open-door policy in 1978 marked the
beginning of China’s shift and reform from a command to a market-oriented economy, from ideological to material incentives, and from isolated self-reliance to a more open economy, engaging with the outside world.

However, despite Deng’s pronounced new national direction of pro-economic growth, China did not have a clear blueprint for a successful economic reform (Naughton 2018; Lieberthal 2004); that is, how to carry out economic reform without invoking major changes to its political regime ruled by a single party, the Chinese Communist Party. As such, China’s basic approach to reform and opening in the face of uncertainty, risk, and political opposition is captured in Deng’s famous metaphoric expression, “crossing the river by feeling the stones”—pioneering and experimental, yet cautious and gradual in nature. According to Denzau and North’s (1994) notions of shared mental models, people, in times of uncertainty, do not easily disassociate themselves from their existing mental models, such as those based on Maoist and socialist principles in China’s insulated, ideology-driven, and single-party society in 1978, without overwhelming evidence to prove otherwise (Heady et al. 2009, 6). A wrong choice at as large a scale as China may not only have weakened its reform program but would likely have irreversible and detrimental consequences to the credibility and stability of the political leadership. Thus, a reasonable solution was to opt for strategies involving minimized political opposition: that of experimentation and marginal reform. China’s gradualist approach, whether by design or not, served a dual purpose: to simultaneously promote learning by experience and to overcome potential political resistance to reform.
China’s first SEZs

*Economic and Political Experimentation*

According to Naughton (2018), reform in China is often induced or conducted as experiments by “creating a new system alongside, or in the interstices of, the existing one,” a pattern of Chinese policymaking during the first era of reform (427). So came about two significant experiments, the dual-track price system and the development of SEZs. While both were instrumental in China’s successful transition to a market-oriented economy, this research will focus on the latter.

China studied economic reform efforts in other socialist states such as Hungary and former Yugoslavia for reference, but it was unable to derive an applicable configuration for itself. Instead, what appeared more encouraging were the development models in non-socialist states, namely the East Asian countries of Singapore, Taiwan, and South Korea. As noted by Heady et al. (2009), without a readily available transition model to replicate nor the talent pool to formulate sound market-based policies because few bureaucrats in China had formal training or substantial experience in market economies, China was compelled to resort to “learning by doing,” another famous expression of Deng Xiaoping underscoring progress through trial-and-error, to discover a viable development path for itself. Among the six main features of Beijing’s new growth strategies, the development of SEZs would be an experiment for an economic liberalization process through which collective learning would take place without disrupting the rest of the country.

The subsequent introduction of SEZs and the Equity Joint Venture Law in 1979 immediately after Deng Xiaoping’s announcement of an open-door policy, was a striking signal of China’s strong commitment to economic opening and initiative to promote rapid
progress within the confines of its socialist system (Chai 1997; Naughton 2018). Although China’s economic reform is widely known to have proceeded in a step-by-step gradual manner—as opposed to a big bang or shock therapy of drastic overhaul of the entire system—the launch of SEZs and relevant laws for SEZ operations were introduced rather speedily.

Deng Xiaoping in his April 1979 meetings with Guangdong Provincial secretary and governor Xi Zhongxun, who called for economic liberalization in the region, finalized the experimental district’s name as a “special zone” and gave the green light to permit favorable policies, though without extending financial support from the central government (Li 2008, 73). In July 1979, the CCP and the State Council approved Xi’s formal proposal on the creation of special zones—later renamed Special Economic Zones—with economic liberalization. The following year, the National People’s Congress passed the bill permitting SEZ autonomy on foreign trade policy decisions and incentives to invite foreign investment projects (Sina News 2010; Ye 2014, 57-8).

China’s first SEZs opened in four locations: Shenzhen, Zhuhai, Shantou, and Xiamen in Guangdong and Fujian provinces. The two neighboring provinces along China’s southern coast were selected to house SEZs not necessarily because they were better equipped for the economic venture, but rather for their backwardness and distance from key cities such as Beijing and Shanghai, to minimize possible negative impacts on the rest of the economy should the economic experiment falter (Ge 1999, 47). Because resources during the Mao era were concentrated on building up the internal economy

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1 Xi was instrumental in initiating economic liberalization in Guangdong Province in the 1980s. He proposed to Beijing to authorize the introduction of SEZs. Three of China’s first four SEZs, Shenzhen, Zhuhai, and Shantou were located in his jurisdiction. Coincidentally, his second son Xi Jinping became the general secretary of CCP and president of China in 2012.
away from the coast for fear of external attacks, the coastal region—despite geographic
advantages with access to major ports as well as previous history of flourishing trade—
suffered from little industrial development (Yegrin 1998, 200). So, at the time of the SEZ
bill’s passage, the Chinese leadership, including Deng, viewed SEZs as “laboratories”
circumscribed to a small, remote, and politically inconsequential areas in the country’s
southern tip. Such a perception, which underscores the experimental nature of the
proposed SEZs, is also reflected in the July 15, 1979 document, “Approval by the Central
Committee of the Chinese Communist Party and the State Council Concerning the
Adaptation of Special Policies and Flexible Measures in External Economic Activities”
and the May 16, 1980 "Written Instructions of the Central Committee of the Chinese
Communist Party Provincial Authorities” (Lu 2005; Ye 2014, 58).

Although economic liberalization measures were only permitted inside the
designated areas—a kind of mini economy within the country—the process of economic
transition can be said to have begun in essence with the launch of SEZs in China. As
such, China used SEZs not just to pioneer the economic liberalization process per se, but
to test whether drastic adoption and facilitation of favorable market economy conditions
could result in accelerated progress. Interestingly, China’s generally incremental
approach to reform may have, ironically, prompted the need for a calculated and bold
experimentation, albeit within limits, for radical reform at the national level was not
feasible nor desirable for a country the size of China, especially considering the political
circumstances at the time amid major leadership change.

Contrary to the common notion, a gradualist approach does not imply the progress
of transition and development is necessarily slow-moving, but is rather a carefully
watched and managed process that eventually contributes to reaching the destination more quickly and smoothly (Ge 1998, 180). By swiftly adopting visible liberalization measures first in the SEZs with the backing of the CCP and its top leader Deng, China successfully demonstrated its commitment to a market opening and enhanced credibility of its reform process to outside investors, while also cultivating the grounds to showcase the fruits of a market opening to the conservatives resistant to reform inside China.

Another unique element of China’s first SEZs was its comprehensiveness. The special zones in China were not simply factory sites but played a bigger role in a “much larger geographical areas with broader functions—political, cultural, educational, and technological, as well as economic” (Vogel 1989, 127). Compared with special zones elsewhere specializing in one or few types of export-oriented activities from simple bonded warehouses to product assembly or manufacturing electronics goods, the range of economic programs and services at Chinese SEZs were much more extensive with multiple functions. In addition to the general trade related activities, China’s SEZs, particularly in Shenzhen, developed as comprehensive sites to cover a variety of industries, including tourism, housing, and financial services with a sizable demand from nearby Hong Kong. Such a diversified structure covering a wide range of industries and multiple functions enabled the Shenzhen SEZ to provide a greater allowance for experimentation with various reform policies while at the same time serving as windows to the world to absorb advanced technological, administrative, business, and personnel training practices (Ge 1999, 7, 171; Chen 2011, 37). Considering their multiple roles and greater importance to the domestic economy, it is understandable why China’s SEZs are
much bigger than those in other countries, especially those in other Asian developing
countries that were mostly focused on more simple activities related to export-processing.

China’s first SEZs were also quite distinct from the perspective of experimenta-
tion in development economics literature. Whereas contemporary randomized experiments are confined to microeconomic experiments in the context of development economics (Duflo 2005; Rodrik 2008), the first SEZs in China were an example of deliberate experimentation with elements in macroeconomic reform (Heady et al. 2009, 9). With a much wider scope and serving more diverse functions than would average free trade or export processing zones in other developing countries, the first SEZs in China were a critical and integral component of China’s economic development with a profound impact on the nation’s trajectory and transition to a market-oriented economy. In the words of vice-president Fang Shen of Shenzhen University,

Chinese SEZs are more than an effort to build up a processing industry for exporting goods. The most important point is to “open up a window to the outside world – a window of technology, a window of knowledge and a window of management.” The Chinese economic structural experiment in the Special Zone is an experiment to train new people, to extend, if successful, to the rest of the nation this advanced new success. Many new experiments are carried out without any prior knowledge. (Chang 1988, 188)

Shenzhen SEZ – Complementarity with Hong Kong

China’s first four SEZs, albeit small towns without much industry at the time of the designation, were built near Hong Kong, Macau, or across from Taiwan, all destinations already driven by market economy. By far the biggest in size and most important among the four was the Shenzhen SEZ (Naughton 2018, 429) as shown in Table 13 in the preceding section. Its proximity to Hong Kong, the world’s top three ports
by container volume from 1982 to 2012 (Nightingale 2022), was critical and conducive to economic development. Located just across the border and about 27 km, or 16 miles north of Hong Kong, Shenzhen was an ideal location to take advantage of, and learn from, a burgeoning center of commerce and enterprise. Since its 1892 separation from Chinese mainland following the Opium War, Hong Kong had gone a different path from China under a liberal capitalist economic system and emerged as a global hub of business, finance, and logistics in the 1970s.

Keenly aware of Hong Kong’s economic success in sharp contrast with its own backwardness, the local government in Guangdong Province was eager to gain a special status from Beijing for greater autonomy and economic liberalization (Ye 2009, 407-408). In fact, Guangdong officials, even prior to Deng’s announcement of open-door policy in 1978, lobbied national leaders and suggested an openness strategy with FDI liberalization at the 1977 Military Commission Meeting held in Guangzhou, the capital city of Guangdong Province (Yanhuang Chungqiu 1998, as cited in Ye 2014, 56). In subsequent meetings, local government officials in Guangdong made proposals to make small towns of Bao’an (later integrated into the Shenzhen district) near Hong Kong and Zhuhai next to Macao as export zones, and even made specific suggestions for operations, including a 15 percent corporate tax rate to match that in Hong Kong to attract investment (Sung 1991, 13).

Another paramount and indispensable element in China’s first SEZs was the diaspora networks, particularly those based in Hong Kong. They played important roles, initially as informants in their correspondence with Guangdong local officials, as ardent supporters for SEZs who lobbied to the Beijing government for the designation of the
zones, and as early entrants to the SEZs providing most of the investment for infrastructure building and jumpstarting operations. The business community in Hong Kong had fostered diverse and vibrant communication channels with Beijing through ties to representatives posted in Hong Kong.

With generous contributions, prominent diaspora entrepreneurs cultivated long-term relationship with Beijing, and it was during anti-capitalistic and post-Mao power struggles in early 1977 that the diaspora networks voiced their support for reform-leaning central leaders and persuaded them to experiment with FDI in select areas with positive investment prospects from them (Ye 2014). In fact, more than 85 percent of investment in infrastructure between 1979 and 1984 in Shenzhen came from FDI, and more than 90 percent of that FDI was from Hong Kong. The figure is similar in nearby Zhuhai SEZ with 92 percent of FDI coming from Hong Kong (The Yearbook of China’s SEZs 1985, 198, 231, 202). As avid entrepreneurs, they lost no time to exploit new business prospects in the SEZs. Even before the official passage of the Joint Venture Law in 1979 to permit foreign business entry and operation in China, the diaspora business in Hong Kong contracted merchandise assembly orders worth more than $30 million with the Guangdong government for investment (Ye 2014, 56).

While ethnic and cultural ties were clearly a plus, the diaspora investors at the core were entrepreneurs, driven primarily by anticipated business prospects for profit. Amid rising production costs in Hong Kong where the average wage was 20 to 30 times higher than in mainland China, the newly launched SEZs, particularly the massive Shenzhen SEZ nearby, were ideal destinations for offshore outsourcing with an abundant supply of cheap labor and land (Ye 2009, 408). Moreover, the Shenzhen SEZ was among
the first to introduce both a flexible wage system with no ceiling on incentive payments, and tender bidding for construction projects.

Shenzhen SEZ’s experiments with development of land markets through leasehold were also attractive to Hong Kong investors, for land in Hong Kong was a scarce commodity (Chen 2011, 37). For Hong Kong’s entrepreneurs who were confined to a small territorial boundary, the opening of the mainland China via Shenzhen SEZ was like a newfound land for business expansion at a lower cost than at home, but in the vicinity of the home backyard. And Shenzhen was ready to absorb the explosive demand not only in business and production facilities, but also housing, tourism and hospitality, as well as other services in short supply for residents in Hong Kong. Having a large diaspora community ready to make inroads into mainland China, Hong Kong was a solid and reliable source of capital, investment, and personnel training for early SEZs, particularly in Shenzhen.

*Preferred Policies and the Spillover Effect*

Because China placed a high priority on economic development, unprecedented freedom and autonomy were granted to its first SEZs to be run on a market basis, in contradiction of the “socialist” ideology and existing institutions. To attract the much needed capital essential to their takeoff, the SEZs offered many preferential policies for foreign investors: income tax reduction of at least 15 percent on all FDI companies (Table 14). FDI firms involved in production with plans to operate for a minimum of ten years were exempt from income tax altogether in the first and second profit-making years with a 50 percent reduction in the subsequent three years; full exemption from income tax on the remitted share of profits; exemption from export and import duties for equipment
used for export products as well as entry and exit formalities (Liu et al. 1993; Chen 2011, 37).

**Table 14. Income Tax Rate Incentives for FDI Firms in China**

<table>
<thead>
<tr>
<th>FDI firms</th>
<th>National Business Income Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Productive FDI firms located in SEZs and ETDZs</td>
<td>15%</td>
</tr>
<tr>
<td>2. Productive FDI firms located in the old urban areas of the cities in the coastal economically opened areas, SEZs and ETDZs</td>
<td>15%</td>
</tr>
<tr>
<td>3. Productive FDI firms located in the old urban areas of the cities in the coastal economically opened areas, SEZs and ETDZs, but engaged in projects with technology-intensive and knowledge-intensive investment over US$30 million with a low profit margin, and energy, transportation and port construction</td>
<td>15%</td>
</tr>
<tr>
<td>4. Joint ventures engaged in port construction</td>
<td>15%</td>
</tr>
<tr>
<td>5. Wholly foreign-owned banks and joint-venture banks located in SEZs and government-permitted areas with investment over US$10 million scheduled to operate ten years or more</td>
<td>15%</td>
</tr>
<tr>
<td>6. Productive FDI firms and FDI firms located in Shanghai Pudong New ETDZ engaged in development and construction of airport, ports, railway, energy and transportation</td>
<td>15%</td>
</tr>
<tr>
<td>7. High and new technology FDI firms located in government-designated national high and new technology development zones and in Beijing New Technology Development Zone (TDZ)</td>
<td>15%</td>
</tr>
<tr>
<td>8. FDI firms engaged in business activities classified as encouraged categories</td>
<td>15%</td>
</tr>
</tbody>
</table>


In addition to the permission to use concessionary tax policies for foreign investors, the four SEZs, and their home provinces of Guangdong and Fujian, were subject to financial subsidies in the form of fiscal and foreign revenue contracts. The two provinces, beginning in 1980, were awarded five-year fiscal contracts that allowed them to retain nearly all the taxes and industrial profits generated by companies in their jurisdiction, which was in contrast to the three provincial-level cities of Beijing, Tianjin, and Shanghai. Those cities had to hand over between 63 and 88 percent of their revenues.
As for the special policy on foreign exchange retention, the SEZs were allowed to retain all hard currency from their trade earnings, whereas only an average of 25 percent retention was permitted for other localities. Similarly, Guangdong and Fujian provinces that housed the four SEZs were also granted higher special foreign exchange retention rates compared with those for other provinces (Shirk 1994). The special financial incentives for the SEZs and their two home provinces not only motivated local officials to develop their economies with a profit orientation but facilitated a major boost in exports and overall rapid economic growth of the SEZs and the two provinces housing them (Chen 2011).

What is noteworthy is how the preferential policies granted to the SEZs also created new incentives for Chinese domestic enterprises to invest in the SEZs. By opening their own subsidiaries in the zones, even if not in the form of joint ventures with foreign firms, the domestic enterprises were subject to administrative flexibility and lower tax rates of 15 percent instead of 30 percent, along with less complicated access to the outside world (Chen 2011, 37). Other municipalities in China also joined the trend to gain a foothold in the SEZs. By 1987, all but two of 29 provinces in China established offices in Shenzhen and some 25 different central ministries created over 2,000 “domestic link” ventures under their Shenzhen offices (Vogel 1989, 141; Ye 2014, 63).

These domestic linkages contributed to a wave of burgeoning FDI entrepreneurship and broadened pro-FDI coalitions within China. Drawing from the successful experiences in the SEZs, private entrepreneurship began to mushroom from 1978 to 1983 using the hometown networks and diaspora investment beyond the designated zones in southern China. For instance, local cadres in small towns like
Dongguan in Guangdong province endeavored to entice investment from its considerable emigrant population to Hong Kong and Taiwan to promote development of their own localities (Renmin Ribao 1983; as cited in Ye 2014, 59).

The regional approach was a distinctive feature of China’s open-door policy. By opening its southern areas first with the SEZs and taking advantage of thriving Hong Kong as a dependable source of investment and demand for business, China’s regional orientation played out quite well for a relatively smooth yet rapid economic development with FDI liberalization measures (Sung 1990). Most remarkable was the transformation of Shenzhen, a small border town surrounded by farmland, whose share of population, GDP, and exports in Guangdong Province in 1980 stood at meager 0.2, 0.6, and 0.5 percent, soared to 1.6, 8.3, and 28.4 percent, respectively, a whopping 80 to 550 percent increase in a span of ten years (Statistical Yearbook of Shenzhen, various years; cited in Ge 1999, 47; Tao and Lu 2012, 78) as illustrated in Table 8.

Shenzhen’s stellar growth becomes more evident when compared with China’s traditional economic stronghold Shanghai, which had been way ahead of Guangdong Province in terms of exports and GDP growth before 1979, as shown in Table 15. In just three years after the introduction of liberalization measures in 1979, GDP growth in Guangdong Province, home to three of the four SEZs, surpassed that of Shanghai in 1982. The GDP growth rate of Guangdong jumped from 1 percent in 1978 to 12 percent in 1982, whereas that of Shanghai halved from 15.8 percent to 7.2 percent during that same period. Though not as dramatic as the GDP growth rate, exports in Guangdong increased from US$ 1,387 million to US$ 2,256 million, while that of Shanghai rose from
US$ 2,893 million to US$ 3,605 million over the four years, gradually catching up with Shanghai by 1986.

Table 15. Guangdong and Shanghai Compared, 1978-1983

<table>
<thead>
<tr>
<th>Years</th>
<th>FDI US$ Million</th>
<th>Exports US$ Million</th>
<th>GDP Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Guangdong</td>
<td>Shanghai</td>
<td>Guangdong</td>
</tr>
<tr>
<td>1978</td>
<td>1,387.6</td>
<td>2,893.0</td>
<td>1.0</td>
</tr>
<tr>
<td>1979</td>
<td>1,702.0</td>
<td>3,675.0</td>
<td>8.5</td>
</tr>
<tr>
<td>1980</td>
<td>2,194.1</td>
<td>4,266.0</td>
<td>16.5</td>
</tr>
<tr>
<td>1981</td>
<td>2,372.5</td>
<td>3,807.0</td>
<td>9.0</td>
</tr>
<tr>
<td>1982</td>
<td>2,256.5</td>
<td>3,605.0</td>
<td>12.0</td>
</tr>
<tr>
<td>1983</td>
<td>2,385.2</td>
<td>3,648.0</td>
<td>7.3</td>
</tr>
</tbody>
</table>

Source: All China Data Center, *China Yearly Macroeconomic Statistics*, China Data Online. (cited in Ye 2014, 413)

On the back of impressive economic performance of the SEZs and the Guangdong Province, the national leaders became convinced by the success of what was originally envisioned as small economic experiments (Vogel 1989). What made it more appealing was that such an outstanding outcome was possible with minimal allocation of domestic funds—be they from the central or local governments—of less than 15 percent of total investment in SEZ infrastructure for the first three to four years (The Yearbook of China’s SEZs 1985, 198). Deng Xiaoping’s 1984 statement, “Shenzhen’s development and experience prove that the policy of establishing SEZs is correct” was an unambiguous endorsement of its operations.

In witness to the striking economic growth of the SEZs that were geographically limited to four areas in two provinces, the pressure from other provinces demanding the granting of the same special policies began to grow (Chen 2011, 38). As a prelude to further wave of liberalization, Deng Xiaoping, following his visit to the SEZs in January 1984 said,
Our guiding ideology of establishing SEZs and implementing open door policy is not to close some, but to open more. The SEZs are the windows of technology, management, knowledge, and foreign policy. In addition to the existing SEZs, we might consider opening several port cities such as Dalian and Qingdao. Let parts of China get richer first. Egalitarianism is not going to work. (The Selected Works of Deng Xiaoping, n.d.)

Soon thereafter in April 1984, Beijing granted its “open policy” to an additional 14 cities along China’s coast from north to south (Ministry of Foreign Economic Relations and Trade, 1984).

Though instructing the coastal cities not to be named SEZs or given the same preferential benefits, they were granted greater autonomy for economic policies and liberalization with permission to provide some tax incentives for FDI companies. For the tax benefits to be granted to FDI firms, zone development for advanced technology was encouraged, with the first Economic and Technological Development Zones (ETDZ) opening in Dalian (Chen 2011, 38). Rather than being a reformulation of SEZs, however, the primary goals of ETDZ development were to “break a new era by taking advantage of foreign investment and introducing advanced technology,” according to major conference documents of 1984 Central Committee of the CCP and the State Council that jointly started the initiative (Chen 2018, 24-25).

The opening of ETDZs in the coastal region following the launch of first four SEZs invited much FDI and triggered rapid development as entrepreneurs made inroads to China. To capitalize on the country’s vast pool of cheap labor and resources, manufacturers, particularly from land and labor-stripped Hong Kong, began to shift their
most labor-intensive production procedures to nearby SEZs, which eventually led to economic and technological development of the Pearl River Delta in Guangdong. The Shenzhen development, as one China scholar noted, represents a Chinese multi-purpose innovative regional experiment with the Shenzhen SEZ as the “transmission belt for technology in the development of China’s hinterland” (Chang 1988, 163). China’s first SEZs, besides serving as catalysts for economic development and setting off further economic liberalization in the country, engendered China’s expanded and intense engagement with the world economy.

Incentives for Competition and Effective Governance

_Fiscal Decentralization with a Contracting System_

In China, the spillover effect of the SEZs was possible not only because Beijing permitted greater economic autonomy and liberalization measures beyond the zones, but as other regions were keen on emulating the economic success of the SEZs. The granting of autonomy and preferential policies by the center per se did not necessarily lead to active pro-growth and pro-market activities in the provinces, especially in a communist country where everyone from bureaucrats to managers had become coddled by the state and indifferent to the notion of competition (Shirk 1993). However, with relatively short decades under communism and the experience of flourishing trade in coastal cities not too long ago, the issue was not whether its bureaucracy was capable of generating economic growth, but whether it had the incentives to do so (Oi 1996, 174). The incentive that activated and motivated local governments can be found in the fiscal decentralization system.

Starting in 1980, China implemented a new fiscal system known as “eating from separate kitchens,” a contracting system between any two adjoining levels of
governments, designed to create incentives for provinces to expand their economies without emptying state coffers (Lieberthal 2004; Garnaut 2018). Despite variations across regions and in time, the idea was that a lower-level regional government could enter a contract with the upper-level regional government on the total amount or share of taxes, or profit remittances for the next several years and keep the rest of the revenues to itself. This fiscal contracting system meant reduced planning for the central government and greater autonomy for regional governments to determine prices, set up new firms, and make investments with funds drawn from the local revenues not subject to sharing with the central government. Because burdens of fiscal expenditure were also decentralized, local governments assumed greater responsibility for providing education, health, housing, and local infrastructure needs in the region, which meant that regional governments had to maximize their revenues on their own.

As the local government budget became increasingly dependent on tax revenues from local enterprises, they were motivated to set up more firms by capitalizing on the newly granted autonomy and authority by the central government. The more enterprises they helped start and thrive in business, the greater the revenue, which could be used as resources for regional development. In other words, high revenue retention for local governments resulted in distribution of reform benefits to all those involved—the local populace, the local government, and the officials. Hence, fiscal decentralization gave rise to intensified competition for growth and an increasingly pro-market economy (Qian and Weingast 1997; Jin et al. 2005). What started as experimentation with reform within the confines of SEZs turned into a competitive race for growth-oriented reforms across the nation with contemporaneous implementation of fiscal decentralization in China.
Although the fiscal contracting system was introduced upon reforms initiated by Deng’s open-door policy, the multi-regional hierarchy was inherited in Mao’s era and played an important part in China’s reform strategy and outcome. In an M-form organization and economy, each region at each layer is regarded as an operating unit, which makes regions relatively self-contained and more self-sufficient, which in turn enables efficient coordination of activities as well as effective local governance (Qian 2017, 298, 379). Historically, China’s organizational structure along regional lines—the M-form organization—dates back to centuries of Chinese empires. Nevertheless, when China formulated its first Five-Year Plan (1953-1957) at the beginning of the nation’s founding by Mao, it took after the Soviet model—a U-form organization based on principles of function—for political and ideological reasons. Toward the end of the 1953-1957 Five-Year Plan, however, Mao became dissatisfied with the over-centralization and bureaucratization of the Soviet model and advocated “mobilizing two initiatives of both central and the local governments” and “walking on two feet,” in his famous 1956 speech on the ten major relationships (Mao 1997).

Since then, China began to deviate from the Soviet model and shifted to ‘administrative decentralization’ of the hierarchal system by trimming the central government’s bureaucracy and encouraging local government’s initiatives for regional development. Mao’s legacy reshaped the organizational structure of the Chinese economy, which had a major impact on China’s transition path and performance. The M-form economy based on regional organization created favorable initial conditions for effective implementation of future economic reforms because many reasonably self-
sufficient regions were better suited for inducing incentives and yardstick competition for performance evaluation (Qian 2017).

Another important aspect of China’s fiscal decentralization is that it altered the nature of local governments and their relationship with the center. Incentives via fiscal decentralization not only turned local governments and officials into active agents of economic growth from that of a passive “extension of the central government,” but in some instances, as “interest groups” with a negotiating relationship with the upper-level government (Goldstein 1996; Huang 1996, 121). Competition among local governments also functioned as a kind of check on central government power in the absence of formal controls, while the entrepreneurial role of local government officials compensated for the lack of formal institutions of a market economy and ensured the alignment of investors and local officials’ interest (Hofman 2018, 59).

The enabling measures of fiscal decentralization invited bureaucrats and governments at all levels to become active participants, followers, and leaders of pro-growth by taking the matter into their own hands. Local bureaucrats developed their own ways of attracting foreign capital and seeking domestic upgrading by adapting and tailoring state policies, with their interests and developmental strategies embedded in the norms and institutions of local capitalism that had been developing in China (Chen 2018, 4).

A new dynamic between a more enabling central government and a more empowered local government created an economic momentum with a “virtuous circle of a cumulative and mutually reinforcing process of interaction among market-leaning institutional change and economizing behavior” (Rawski 1996, 190). Moreover, the
behavior of local governments, particularly with direct regulatory authority over new entry enterprises, had a decisive impact on the economic growth of the jurisdiction. Whether the local governments became corrupt “grabbing hands,” or “helping hands” to foster growth, relied to some extent, on incentives (Qian 2017). Compared with many developing countries mired in rampant rent-seeking and corruption that disrupted sound economic activities, let alone growth (Ang 2020), China’s fiscal decentralization system helped curb pervasive rent-seeking from impeding its economic growth. While fiscal decentralization was an effective development strategy in China, whether it works in other countries depends on the institutional structure and development objective of a given state (Oi 1996).

Besides providing incentives for local governments via fiscal decentralization, individual officials and cadres also had a strong incentive to pursue economic growth because promotions were conducted based largely on economic performance of their jurisdictions. In addition to achieving central mandates, yardstick competition in key economic indicators became increasingly important for cadre promotion, reflecting China’s strong drive and emphasis on the pursuit of market-seeking reforms suited to its purpose and circumstances (Hofman 2018, 62).

Political Centralization

Clearly, China’s primary goal in the early years of reform, also described as years of “market-seeking reforms,” was to promote economic growth (Hofman 2018). Yet, the underlying and uncompromising condition for the single party state, which to this day remains unchanged, was to ensure political and regime stability. Hence the need for political centralization despite its experimentation or tinkering with pro-market economy and market liberalization measures, and Beijing continued to retain control over the
provinces via its personnel promotion system. The dominant benchmark for promotion of government and party officials was economic growth, attraction of FDI, creation of employment, containing social unrest, and achieving birth control targets. By prescribing four of the five criteria to align with GDP growth, China effectively provided incentives for pro-growth activities at individual as well as collective levels of its government while maintaining firm political control (Huang 2001; Chen et al., 2005; Li and Zhao 2005, Heady et al. 2009, 5; Landry et al. 2018; Hofman 2018, 59; Chen and Zhang 2021).

As promotions to higher-level party posts also highly valued the officials’ experience in the provinces and regional government, the most talented and ambitious were incentivized to demonstrate their capacity to reform and spur growth. Political centralization, Chen and Zhang (2021) contend, affected the orientation and actions of local officials in two significant ways: local officials remain agents of the central government regardless of fiscal resources they control, and the center could set up political and bureaucratic incentives so that local officials take into account the full benefits of providing public goods rather than narrowly focusing on provincial benefits to their regions. Taken together, all these conditions and incentives for local governments and officials led to rapid economic growth with competition serving as the disciplinary mechanism by which local governments provided de facto protection of investors’ property rights in the absence of a well-defined property right protection in China’s de jure legal system until 2007 (Zhang 2007; Heady et al. 2009, 5; Hofman 2018, 59). Such a phenomenon also implies that governing issues in China’s transitional phase involved more than conflicting ideologies of economic systems between capitalism and socialism but that of a centralized vs. decentralized economy.
What makes China’s reform experience intriguing, however, is that economic and fiscal reforms since 1978 have not fundamentally affected its political system. It has remained a centralized and unitary state politically, even as it developed a kind of economic federalism (Huang 2001). To describe these elements and characteristics in the Chinese polity, the term “federalism, Chinese style” (Montinola et al. 1995; Qian and Weingast 1997; Jin et al. 2005) is often used, as is ‘market-preserving federalism’ to explain success of China’s reforms in the early 1980s. Referring to the fundamental dilemma facing a government that seeks to build and protect markets, this special type of federalism focuses on how federalism can be structured to promote market development and productive enterprises by limiting the power of the central government, allowing local governments to have authority over markets and thereby foster local economic prosperity.

Competition among local governments seeking development of their own economies was the major force driving robust economic growth, and a crucial factor in explaining China’s economic success. Yet, such competition is a delicate and difficult balancing act, and challenges the conventional thinking on the relationship between political and economic reform; decentralization and limits on central government intervention might “distort markets.” Even so, more than a simple unleashing of the localities via decentralization is necessary, for there remains a need to ensure the central government’s capacity to oversee local growth and market preservation without stifling them (Goldstein 1996; Qian and Weingast 1997).

China’s experience of economic growth in the early years of reforms can be attributed to its successful experimentation of the SEZs with spillover effect nationwide,
driven largely by incentivized local governments and officials to develop their own economies using their newly permitted financial empowerment. Fiscal decentralization in tandem with political centralization—enabled by fiscal contracting system and meritocratic promotion scheme by the central government—were two vital and effective incentives to motivate actors at all levels in the provinces and regional governments to take the initiative for economic growth and a pro-market economy into their own hands, in alignment with development goals of the center.

*Chinese Diaspora: Catalyst for Increased Interaction and Connectivity*

The importance of the Chinese diaspora in jumpstarting China’s first SEZs as the provider of much of the initial capital investment is well recognized and established in China’s SEZ development literature. Yet, their role and impact were not just in the supply of palpable resources necessary for the SEZs’ takeoff. Just as paramount was their role as an accessible and useful link to connect with the world. The Chinese diaspora and its networks served as an apt and opportune facilitator for a socialist state carefully testing the waters and contemplating possible pathways for the transition to a market economy in a less cataclysmic way.

The economic success and thriving business of the compatriot entrepreneurs in Hong Kong stimulated observers just miles away from the flourishing commercial hub, first generating an increased interest to emulate their accomplishments, and then serving as a bridge to set out from and to extend and advance China’s own business, trade, and presence in the global market. By taking full advantage of the established, stable, and resourceful diaspora networks, China was able to broaden its interaction and connectivity with market economies of the world, which enabled its inchoate transitional economy to amass the economic scale and capacity to emerge as a competent and avid player in the
international market. Perhaps its role as a facilitator and catalyst for China’s engagement with the world beyond its boundaries was no less pivotal to China’s accelerated economic growth and expanded global presence. The diaspora networks helped China to chart its course from the very beginning of its transition to a market economy.

**Russia**

Overview of SEZ and Economic Development

The official transition from a socialist planned economy to a capitalist market economy occurred with the emergence of the Russian Federation, but reform efforts to remedy the ailing economy with some liberalization measures had begun in the final years of the Soviet Union under Mikhail Gorbachev’s leadership in 1985. The Soviet budget deficit increased by 8 percent of GDP between 1985 and 1990, due to deteriorating overall output coupled with failing export earnings—mostly from lower international oil prices—that resulted in reduced government revenue by about 3 percent of GDP (Figure 9).

![Figure 9. USSR Budget deficit and export earnings (% GDP)](image)

While differences exist between official Soviet data and figures released by international institutions such as the IMF, the general trend reflecting the Soviet economic performance coincided in both the GNP and NMP (Net Material Product, the main macroeconomic indicator used by socialist countries during the Soviet era to monitor growth in national accounts) show a clear drop to negative territory from 1990 (Table 16; Figure 10).

Table 16. Growth Rates for Soviet Economy During 1980-1991 (Percent Per Year)

<table>
<thead>
<tr>
<th>Year</th>
<th>Western estimates</th>
<th>Official Soviet data</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1) GNP (2) Consumption</td>
<td>(3) NMP (4) Consumption</td>
</tr>
<tr>
<td>1980–85</td>
<td>1.8 1.9</td>
<td>3.2 3.2</td>
</tr>
<tr>
<td>1986</td>
<td>4.1 1.5</td>
<td>2.3 3.5</td>
</tr>
<tr>
<td>1987</td>
<td>1.3 2.2</td>
<td>1.6 3.5</td>
</tr>
<tr>
<td>1988</td>
<td>2.1 3.5</td>
<td>4.4 4.2</td>
</tr>
<tr>
<td>1989</td>
<td>1.5 2.3</td>
<td>2.5 5.1</td>
</tr>
<tr>
<td>1990</td>
<td>−2.4 1.5</td>
<td>−3.9 2</td>
</tr>
</tbody>
</table>
| 1991  | −12.8<sup>a,b</sup> [N.A.] | −15<sup>b</sup> [−13<sup>b</sub>]


*Notes:* a GNP for 1991 is the average of two different estimates (−8.5 per cent and −17 per cent); b Estimate excluding Georgia and the Baltic republics.

The negative trend continued its downward spiral in industrial production, agricultural output, and investment as well as in GDP well into the first half of the 1990s (Figure 11) following the collapse of the Soviet Union in December 1991.
Although the precipitous negative growth rate in various economic indices (Table 17) as well as in real GDP (Table 18) attenuated somewhat in the latter half of the 1990s, Russia’s economic performance and transition could not be described as successful when compared with other former communist states in Eastern Europe (Table 20), not to mention that of China.

Table 17. Select Economic Indicators for Russia, 1992-1998

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product (GDP, %)</td>
<td>-14.5</td>
<td>-8.7</td>
<td>-12.6</td>
<td>-4.2</td>
<td>-3.5</td>
<td>0.8</td>
<td>-4.6</td>
</tr>
<tr>
<td>General government balance (% GDP)</td>
<td>-18.8</td>
<td>-7.3</td>
<td>-10.4</td>
<td>-6.0</td>
<td>-8.9</td>
<td>-7.9</td>
<td>-8.0</td>
</tr>
<tr>
<td>Industrial production (%)</td>
<td>-18.2</td>
<td>-14.2</td>
<td>-20.9</td>
<td>-3.0</td>
<td>-4.0</td>
<td>1.9</td>
<td>-5.2</td>
</tr>
<tr>
<td>Fixed investments (%)</td>
<td>-40.0</td>
<td>-12.0</td>
<td>-27.0</td>
<td>-13.0</td>
<td>-18.0</td>
<td>-5.0</td>
<td>-6.7</td>
</tr>
<tr>
<td>Trade surplus (U.S.$ billions)</td>
<td>10.6</td>
<td>15.4</td>
<td>17.9</td>
<td>20.4</td>
<td>26.9</td>
<td>19.8</td>
<td>14.4</td>
</tr>
<tr>
<td>Metals, metal products, fuels, and precious stones (% of total exports)</td>
<td>68.5</td>
<td>69.9</td>
<td>71.6</td>
<td>68.0</td>
<td>71.1</td>
<td>71.8</td>
<td>69.7</td>
</tr>
</tbody>
</table>

Table 18. Russia’s Annual Growth in Real GDP, 1993–1998 (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-8.7</td>
<td>-12.7</td>
<td>-4.1</td>
<td>-3.6</td>
<td>1.4</td>
<td>-5.3</td>
</tr>
</tbody>
</table>


Table 19. Real GDP Percentage Changes in Post-Transition Years

<table>
<thead>
<tr>
<th>Country</th>
<th>Yr. 1</th>
<th>Yr. 2</th>
<th>Yr. 3</th>
<th>Yr. 4</th>
<th>Yr. 5</th>
<th>Yr. 6</th>
<th>Yr. 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1.83</td>
<td>-6.6</td>
<td>7.32</td>
<td>2.58</td>
<td>-1.88</td>
<td>-6.22</td>
<td>0.06</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-7.25</td>
<td>-1.6</td>
<td>1.86</td>
<td>2.56</td>
<td>-10.9</td>
<td>-0.9</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>3.26</td>
<td>7.3</td>
<td>10.7</td>
<td>6.64</td>
<td>4.24</td>
<td>8.5</td>
<td>7.2</td>
</tr>
<tr>
<td>Czech R.</td>
<td>-11.5</td>
<td>-3.3</td>
<td>0.57</td>
<td>2.7</td>
<td>5.95</td>
<td>4.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Estonia</td>
<td>-12.4</td>
<td>-7.8</td>
<td>-1.8</td>
<td>4.3</td>
<td>4</td>
<td>7</td>
<td>5.4</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>-3.11</td>
<td>-3.3</td>
<td>12</td>
<td>1.69</td>
<td>10.6</td>
<td>5.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Haiti</td>
<td>-2.02</td>
<td>-14.3</td>
<td>-3.41</td>
<td>-6.41</td>
<td>3.77</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>-11.9</td>
<td>-3.1</td>
<td>-0.59</td>
<td>2.83</td>
<td>1.49</td>
<td>1.35</td>
<td>4.12</td>
</tr>
<tr>
<td>Iran</td>
<td>-14.1</td>
<td>-1.9</td>
<td>7.42</td>
<td>0.91</td>
<td>0.24</td>
<td>-15.1</td>
<td>1.16</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-30.4</td>
<td>0.99</td>
<td>2.65</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philipp.</td>
<td>4.31</td>
<td>6.76</td>
<td>6.2</td>
<td>2.96</td>
<td>-0.51</td>
<td>0.34</td>
<td>2.1</td>
</tr>
<tr>
<td>Poland</td>
<td>-7.04</td>
<td>2.63</td>
<td>3.85</td>
<td>5.15</td>
<td>7.05</td>
<td>6.04</td>
<td>6.6</td>
</tr>
<tr>
<td>Romania</td>
<td>-7.34</td>
<td>-12.9</td>
<td>-13.5</td>
<td>1.41</td>
<td>3.97</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>-1.3</td>
<td>-4.05</td>
<td>1.37</td>
<td>-4.6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovak</td>
<td>5.28</td>
<td>5.86</td>
<td>7.81</td>
<td>5.69</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


While the steep decline in national GDP and industrial production had mitigated somewhat by 1997 (Table 18), albeit gradually on the back of Russia’s existing industrial centers as well as major cities such as Moscow and St. Petersburg, most regions lagged far behind the national average in terms of gross regional product and industrial output (Table 20). For as vast a country as Russia, concentration of resources and investment to major industrial centers already equipped with basic infrastructure rather than underpopulated and underdeveloped areas is natural and inevitable. What is notable, however, is the mediocre, if not less than average performance in provinces such as Primorskiy Kray and Kaliningrad, among the more renowned early SEZs Russia had...
established for the specific purpose of enhancing investment, production, and economic growth (Table 20).

Table 20. Russia’s Gross Regional Product (Per Capita) and Industrial Output, 1994-1997

<table>
<thead>
<tr>
<th></th>
<th>Gross regional product (per capita)</th>
<th>Industrial output (change %)</th>
<th>Industrial labour productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>1.00 1.00 1.00 1.00</td>
<td>-51</td>
<td>1.00</td>
</tr>
<tr>
<td>St Petersburg</td>
<td>1.05 1.16 1.15 1.17</td>
<td>-66</td>
<td>0.59</td>
</tr>
<tr>
<td>Kostroma</td>
<td>0.85 0.88 0.76 0.81</td>
<td>-67</td>
<td>0.68</td>
</tr>
<tr>
<td>Samara</td>
<td>1.55 1.63 1.58 1.62</td>
<td>-38</td>
<td>2.14</td>
</tr>
<tr>
<td>Krasnodar</td>
<td>0.68 0.74 0.77 0.71</td>
<td>-55</td>
<td>0.31</td>
</tr>
<tr>
<td>Irkutsk</td>
<td>1.31 1.47 1.41 1.49</td>
<td>-53</td>
<td>1.29</td>
</tr>
<tr>
<td>Sakhalin</td>
<td>1.39 1.23 1.26 1.56</td>
<td>-52</td>
<td>1.34</td>
</tr>
<tr>
<td>Primorskiy kray</td>
<td>0.98 1.02 0.94 1.01</td>
<td>-52</td>
<td>0.70</td>
</tr>
<tr>
<td>Kaliningrad</td>
<td>0.76 0.68 0.67 0.67</td>
<td>-69</td>
<td>0.42</td>
</tr>
</tbody>
</table>

Notes: All normalization is based on the Russian regional average. The reported gross regional product excludes measures of non-market collective services provided by the state to the population as a whole; certain non-market services financed by the federal budget; services of financial intermediaries; and services for foreign trade operations.

Though granted special status and tax incentives to attract more foreign investment and business, these regions garnered about 0.6 level of Russia’s average cumulative total foreign investment (1.0) despite an outstanding total number of joint ventures (over 300) created in their districts compared with other regions in 1997 (Table 21). Exports in these SEZ regions were also well below the average, between 0.51 and 0.63 levels, though exports exclusively by the joint ventures in Kaliningrad posted 1.86, far surpassing the Russian average (Table 21).

Table 21. Foreign Economic Activity by Region in Russia, 1997
Table 2 provides a direct comparison of the two SEZ regions, Primorskiy Kray and Kaliningrad with the regional average in Russian Federation: per capita real income, for Primorskiy Kray (1.17) and Kaliningrad (0.96) are below the Russian Federation average (1.39) in 1999. The percentage change in industrial output from 1990 to 1999 for Primorskiy Kray (-55%) and Kaliningrad (-61%) are also below the Russian Federation average (-54%); however, per capita foreign exchange inflow in Primorskiy Kray ($438) was slightly higher than the Russian average ($435) whereas that of Kaliningrad ($392) was about 10 percent below the Russian Federation average, though both regions had a significantly higher foreign exchange influx when compared with the Russian Federation average excluding Moscow city ($300). The situation is similar for per capita real income when using the average for Russian Federation minus Moscow city because Primorskiy Kray (1.17) is relatively on par with the average (1.15) while Kaliningrad (0.96) lags behind regardless (Figure 12). Figure 13 illustrates Kaliningrad region’s GDP per capita in comparison with the bordering states of Lithuania and Poland.
Table 22. Indicators of Outcomes in Regional Regimes, Primorskiy and Kaliningrad oblast, late 1990s

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Primorskiy</th>
<th>Kaliningrad</th>
<th>RF&lt;sup&gt;a&lt;/sup&gt;</th>
<th>RF – M&lt;sup&gt;b&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per capita real income, January 1999&lt;sup&gt;c&lt;/sup&gt;</td>
<td>1.17</td>
<td>0.96</td>
<td>1.39</td>
<td>1.15</td>
</tr>
<tr>
<td>Change in industrial output, 1990–98 (%)&lt;sup&gt;d&lt;/sup&gt;</td>
<td>-55</td>
<td>-61</td>
<td>-54</td>
<td></td>
</tr>
<tr>
<td>Unemployment, December 1998 (%)&lt;sup&gt;e&lt;/sup&gt;</td>
<td>3.8</td>
<td>3.5</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>Employment in foreign firms, 1998 (%)&lt;sup&gt;f&lt;/sup&gt;</td>
<td>0.7</td>
<td>1.2</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Employment in small firms, 1998 (%)&lt;sup&gt;g&lt;/sup&gt;</td>
<td>10.5</td>
<td>13.7</td>
<td>9.6</td>
<td>8.5</td>
</tr>
<tr>
<td>Per capita forex inflow, 1995 ($)&lt;sup&gt;h&lt;/sup&gt;</td>
<td>438.0</td>
<td>392.0</td>
<td>435.0</td>
<td>300.0</td>
</tr>
</tbody>
</table>

Notes and sources:

<sup>a</sup> RF denotes average for Russian Federation. RF figures in brackets are unweighted averages of data for all regions.

<sup>b</sup> RF – M denotes Russian Federation less Moscow city.

<sup>c</sup> Per capita real income is monetary income per head of population divided by the regional cost of the subsistence minimum. Derived from Goskomstat Rossi (1999a and 1999b).


<sup>e</sup> The unemployment figure is especially approximate. It is the officially recorded ‘unemployed and seeking work’ figure for December 1998 as a percentage of average 1997 employment plus December 1998 unemployment. Derived from Goskomstat Rossi (1996, 1997d and 1999c, pp. 337–8).

<sup>f</sup> Employment in foreign firms (as defined in the text above) in 1998 is given as a percentage of the average 1997 total employment. Derived from Goskomstat Rossi (1998d, table 7.3, and 1999c, pp. 252–3).

<sup>g</sup> Small-firm employment in 1998 is shown as % of all employment in 1997. Derived from Goskomstat Rossi (1998d, table 7.3, and 1999c, pp. 248–9).

<sup>h</sup> Per cap forex inflow is valyutnye postupleniya (see Chapter 7) per head of population. Derived from Goskomstat (1996).

Source: Cited in Hanson and Bradshaw (2000, 233-234).
Figure 12. Average per capita GDP, 1990-2000: Kaliningrad region, the Russian Federation, the North-Western Federal District of the Russian Federation, (thousand USD)

Source: Cited in Zhdanov et al. (2000, 9).

Figure 13. GRP/GDP per capita: Kaliningrad region, Lithuania, Poland (thousand USD)

Source: Cited in Zhdanov et al. (2000, 10).
As indicated by lackluster performance of SEZ-hosting-provinces located far from the gravity of the country’s major centers of industry, early SEZs in Russia were not successful in using foreign investment and boosting output for exports and consequently, their per capita income (Tables 21 and 22). Perhaps that was not feasible in the first place when the nation was suffering from a comprehensive fallout in the aftermath of disintegration. Indeed, Russia’s annual GDP growth rate remained in the negative territory for 7 consecutive years with a cumulative decline of 40 percent since 1990 (World Bank 2002) until finally emerging to positive territory in 1997, only to plunge again in the face of the 1998 financial crisis (Figure 14).

Figure 14. Annual GDP growth (%) in Russian Federation, 1990-1998
Source: World Bank, data.worldbank.org

A rapid increase in exports in SEZs can trigger export-driven economic growth in regional and even national economies, as was the case in China and some East Asian countries. Conversely, SEZs in Russia may be a counter example in which exports suffered rather than thrived despite its policy of SEZ promotions: Russia’s net exports as
a percentage of GDP remained in the single digits for most of the 1990s owing to poor
domestic industrial production as well as low global oil prices (Figure 15).

![Graph showing Russia's Net exports as percentage of GDP, 1995-2002]

Figure 15. Russia’s Net exports as percentage of GDP, 1995-2002

While macroeconomic indices reflect a nation’s economic performance
quantitatively, governance indicators provide a qualitative dimension to the
circumstances affecting economic performance. Poor governance, as described by the
IMF (1997) offers more incentives and opportunities for corruption—the abuse of public
office for private gain—which undermines the public’s trust in its government and
threatens market integrity, distorts competition, and endangers economic development.
The Worldwide Governance Indicators developed by the World Bank capture six key
dimensions of governance and provide a country’s rank among 214 countries since 1996.
Available data for Russia during its transition and reform period (1990s) locate all six
dimensions of Worldwide Governance Indicators between 10 and 45 percentiles, mostly
on a downward trend apart from a slightly improved control of corruption from 15 to 20
percentile during the 1996-2000 period (Figure 16). In 2002, four dimensions of the governance indicators—regulatory quality, government effectiveness, and political stability—show a significant uptick following President Putin’s leadership.

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Voice and Accountability: %</td>
<td>43.5</td>
<td>36.8</td>
<td>37.8</td>
<td>36.3</td>
</tr>
<tr>
<td>Regulatory Quality: %</td>
<td>32.6</td>
<td>28.8</td>
<td>28.8</td>
<td>45.4</td>
</tr>
<tr>
<td>Government Effectiveness: %</td>
<td>37.7</td>
<td>26.2</td>
<td>27.9</td>
<td>44.3</td>
</tr>
<tr>
<td>Control of Corruption: %</td>
<td>15.1</td>
<td>21.4</td>
<td>20.2</td>
<td>20.6</td>
</tr>
<tr>
<td>Rule of Law: %</td>
<td>24.6</td>
<td>23.5</td>
<td>16.9</td>
<td>22.9</td>
</tr>
<tr>
<td>Political Stability: %</td>
<td>12.2</td>
<td>16.0</td>
<td>10.6</td>
<td>24.9</td>
</tr>
</tbody>
</table>

Figure 16. Governance indicators, Russian Federation, 1996-2004

Note: 1) Years available only from 1996; 2) Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to lowest rank, and 100 to highest rank.

Source: Worldwide Governance Indicators.
Figure 17 provides another relative perspective on Russia’s standing in terms of governance in comparison with different groups of countries—that of the OECD, large developing mixed economy, and former Soviet Union (FSU). Russia is located significantly lower than the OECD group, near the bottom of the graph: below the -0.5 mark just above the FSU, still notably beneath other large developing countries such as China, India, and Brazil.

![Graph showing comparative governance indicators 1996-2008](image)

Figure 17. Comparative Governance indicators 1996-2008 (average of all)

Note: Scores run from 2.5 to -2.5 with higher scores signaling better governance.

Mikhail Gorbachev’s Perestroika (1985) and the Dissolution of the Soviet Union (1991)

*Perestroika*, meaning “restructuring,” was economic and government reform initiated by Mikhail Gorbachev, who became the General Secretary of the Communist Party of the Soviet Union in 1985. Gorbachev came to power on a platform of reform after a period of economic stagnation that gave rise to frustration among its population confronted with a contradiction between the country’s sense of greatness and their poor standard of living. The reform program was intended to revitalize the ailing economy by incorporating
elements of liberal economics, including loosening price controls, encouraging more entrepreneurism, and forging business partnerships with the West to replace the country’s highly centralized and inefficient economic mechanism. An important aspect within the framework of perestroika was glasnost, or “openness” policy, which sought increased transparency in government allowing freedom of information and public discussion as well as the democratization of its political institutions (Kotz and Weir 2007, 59).

No major changes occurred in the Soviet economy until June 1987 when the Central Committee approved “Basic Provisions for Fundamental Perestroika of Economic Management,” and the Supreme Soviet adopted a series of decrees designed to implement the new policy. Among them was the Law on State Enterprise, the first real attempt at economic restructuring scheduled to take effect the following year in 1988 (Politizdat 1987; Pravda, 1 July 1987). While this package of measures was devised to retain the fundamental economic system, it allowed for decentralization and a significant role for market forces to help transform a highly centralized form of planning.

The focus of Gosplan, the central planning agency, would shift to long-term goals and the day-to-day management of production by economic ministries would end with enterprises exercising substantial autonomy over decision-making. In line with the leadership’s idea of decentralizing the economy within the framework of public ownership and economic planning, republican, regional, and local governments in the Soviet Union would be granted a larger role in managing the economy of their respective areas. Although the 1987 reform did not remove central controls over the economy, it allowed for phased loosening of them with the intent to gradually replace the strict central
controls by a new system of decentralized and democratized planning in tandem with a greater role for market relations (Kotz and Weir 2007, 75-76).

The introduction of the Law on State Enterprises, however, would soon create serious economic problems—erosion of the state’s power to obtain revenues that resulted in a growing budget deficit. At the same time, the freeing of state enterprises led to a rise in incomes of the population and a greater consumer demand that far outpaced production, which gave way to product shortages and soaring inflation. The process of carrying out the bold venture of perestroika not only exacerbated existing shortages and budget deficits but also created added economic, political, and social tensions within the Soviet Union. As the reforms gradually diminished the relative power of the highest echelon of leadership in the hierarchical Soviet system, the success of Gorbachev’s perestroika depended not only on the soundness and feasibility of the reform policies, but largely on mustering necessary political support with the broader party-state elite to implement the reforms (Kotz and Weir 2007, 5, 75-6, 80, 292).

Delayed and Abortive Development of Free Economic Zones (FEZs)

Before the announcement of the first reform measures in June 1987, also underway were discussions on free economic zones (FEZs), a popular, yet controversial device for a more open economic policy. China’s impressive economic success stimulated the Soviet Union to consider establishing FEZs themselves (Slider 2003, 157; Miller 2016, 110, 112-3). The regulation on “joint ventures with the participation of Soviet organizations and companies from capitalist and developing countries” was introduced in the “Resolution of the Council of Ministers of the USSR” and “Decree by the Presidium of the Supreme Soviet of the USSR” in January 1987. It soon became
evident though that to draw FDI to its economy, more incentives were necessary (Manezhev 1993, 609). Gorbachev made the first official statement in September 1988 on the Soviet Union’s intention to open special zones for joint entrepreneurship with favorable customs and tax regulations in border regions to give “new dynamism to foreign economic ties” during a speech in a Siberian city of Krasnoyarsk, where he mentioned possibilities for trilateral economic activities with China and Japan. The speech, coming on the eve of the 1988 Seoul Olympics, also included remarks on Soviet Union’s interest in developing economic relations with South Korea with reference to Seoul’s July 7 declaration of its new “northward policy” to expand economic and other ties with socialist countries by its first directly elected president Roh Tae-woo the previous year (Meyer 1992, 759).

Based on the recommendations by the United Nations analysts that Special Economic Zones would be especially appropriate in the more outward-oriented regions of the Soviet Union, such as the Baltic republics or the Far Eastern region, the Soviet Council of Ministers in December 1988 issued a decree that provided the framework for establishing such zones. The decree provided tax incentives for Soviet enterprises that established joint ventures with foreign firms: profit taxes were cut from 70 percent to 30 percent in addition to exemption from profit taxes for three years after the venture first declared a profit in addition to subsidies on rent and credit (Miller 2016, 115). Convinced that the more advanced and industrialized nature of the Soviet economy over China would make them more capable of attracting foreign investment, many local leaders were enthusiastic about the idea of establishing FEZs. Mayor Anatoly Sobchak of Leningrad
said, “There is a light at the end of the tunnel, and I would describe it as quite bright. There is a solution… the creation of a free economic zone” (Miller 2016, 113).

The FEZ idea, however, exposed a deep conflict of interest between the central government and local authorities at different levels as well as conservatives during Gorbachev’s ongoing economic and political reform. Because many conservatives within the government considered foreign investment incompatible with self-sustained national growth, preparations for implementation of the FEZ were mired in controversy from the start and influenced how the zone policy would evolve. Even among proponents of the special zone, a “unified state concept” of FEZ needed to be worked out to encompass the excessively diverse and contradictory objectives the related parties had set out—a combination of both inward and outward orientations to fulfill domestic demands for consumer goods, to accelerate local development with technology transfer and management modernization as well as to boost exports and foreign earnings (Slider 2003; Miller 2016; Kuznetsov and Kuznetsova 2019).

Permitting full administrative and economic autonomy to the zones proved another major obstacle under the still vertical centralized structure of the Soviet administrative system, in which the central government in Moscow determined spending priorities as well as policymaking. When regional governments were rendered little more than administrative organs within the multi-institutional subordination under a high degree of centralization, FEZ authorities who were subject to the local government, had virtually no independent authority (Stoner-Weiss 2006, 47). Not only would the role of FEZ authorities be limited to mainly providing special incentives and administrative services to foreign investors, but the autonomy of enterprises in the zones would also be
undermined because their decision making was restricted to the amount of their above-quota production. As such, organizers of the special zones underwent continuous struggle with federal ministries, first Soviet and then Russian, to be granted “special” rights and autonomy, for without stable long-term administrative arrangements, repatriation of profits and continued tax and customs benefits could not be guaranteed (Slider 2003, 157). From its inception stage, limited flexibility and sluggish speed in decision making within the rigid Soviet centralized bureaucratic management system constrained the potential efficiency of FEZ policy, complicating and delaying the development of its first economic zones (Manezhev 1993, 610-611).

*Regional Initiative – FEZs in the Periphery (Primorskiy Krai, Kaliningrad, and Elsewhere)*

Many economic projects and initiatives by the regions, albeit their broad variety, fundamentally deviated from Moscow’s idea of a unified state concept—close to the traditional structure of hierarchy—because the regions all pressed for greater local economic and administrative autonomy as well as broader liberalization measures essential for free entrepreneurship by both domestic and foreign firms. The continued political and central-regional conflict of interest further postponed development of FEZs for nearly two years. Nevertheless, *Voprosy Ekonomiki*, Soviet Union’s flagship economics journal, continued to publish a host of articles on the topic (Miller 2016, 112) and the authorities in Soviet Union confirmed its intention to establish FEZs by introducing new legislation, including the Law on Basic Principles of Economic Relationships between the USSR, Union and Autonomous Republics, and the Law on Enterprises in the USSR, in April and June of 1990 (Manezhev 1993, 612-613). The overall unfavorable investment conditions in the Soviet Union in the late 1980s—poor
infrastructure facilities, general financial disorder, and complicated administrative hierarchical structure—resulted in its foreign joint ventures (JVs) being concentrated mostly in a few major cities with the lion’s share of 45 percent located in its capital, Moscow. Hence was the expectation that setting up FEZs in the country’s periphery would provide a competitive edge to attract foreign investment (Manezhev 1993, 611-612).

Between 1990 and 1991, when resolutions were signed on the creation of “zone of free enterprises” and the Law on Free Economic Zones as well as Law on Foreign Investment, many regional leaders sought to gain FEZ status, which would grant them exemption from the national tax laws for the expressed purpose of attracting foreign investment. Eight regions, including Nakhodka in Primorskiy Krai, Kaliningrad, Leningrad, Sakhalin, Novgorod, Kemerovo, and Chita, comprised the first group of Soviet FEZs. The selection of locations for FEZs were not strategic decisions by the state but instead were based on local or regional initiatives that garnered support from the center (Slider 2003, 153). Among them, however, Primorskiy Krai and Kaliningrad had some unique traits—both are maritime gateways at opposite ends of the country under pressure to reorient their economies to foreign transactions: Primorskiy, due to its immense distance from Moscow, the center of the gravity of the Russian economy, and its proximity to the Northeast Asian countries; Kaliningrad because it was physically separated from the rest of Russia as an exclave and surrounded by soon to be an enlarged EU (Hanson and Bradshaw 2000, 15-16).

In 1990, even before the Russian legislature’s formal proclamation of FEZs granting their special status with autonomy in 1992, the republic-level government
Primorskiy Krai—also informally called Primorye region—proclaimed the creation of the country’s first special zone in the port city of Nakhodka, fifty miles southeast of the region’s capital Vladivostok. Home to four ice-free ports in the Soviet far east and several hundred miles from South Korea and Japan, Nakhodka processed 25 million tons of trade each year even before the zone was created. On the back of strong support from the local government, which under the new legislation was granted authority to determine the zone’s fiscal system and tax privileges, profit taxes were to be lowered to 10 percent for foreign investors with other incentives such as rights to invest in banks and to lease land. State-run enterprises in the zone were also set to become independent from the controls of the ministries. Construction of facilities including an airport and international hotel, as well as trade and exhibition centers were planned to be completed within two years by 1992, in hopes to secure foreign investment in various sectors ranging from engineering, transport infrastructure, and building facilities to tourism and agriculture in the subsequent five years.

The launch of the zone, however, came belatedly as the Soviet Union soon began disintegrating. Amid disarray, many investors shied away. As Miller (2016, 116-117) contends, no matter how well Nakhodka’s SEZ was designed with good incentives, it could not function in a vacuum because investment relied on the overall stability of the Soviet economy and the efficacy of its government. Even though Nakhodka eventually managed to attract foreign investors from 29 countries to finance over 270 local businesses over the next few years, the collapse of the Soviet Union significantly hampered and delayed Nakhodka SEZ’s takeoff. Albeit a new wave of foreign investment
that arrived in the end helped Nakhodka secure much needed projects, it fell far short of the envisioned FEZ in the likes of Shenzhen in China.

Kaliningrad oblast, host to the other one of the two most widely publicized FEZs in Russia, is reported to have had success with over 400 enterprises attracting FDI by April 1993, according to the organizers of the zone (Klimanov 2000, 142-51). Located in the westernmost part of Russia, Kaliningrad established its FEZ at the Yantar shipyard, the only ice-free port on the Baltic Sea, to be developed into an export zone with product assembly plants while allowing in duty-free imports to compensate for the relatively high costs in the exclave. Duty-free consumer goods were to apply only to the products sold within the region, and not in other parts of Russia, unless imports were processed with value added in Kaliningrad (Hanson et al. 2000, 242-243). In practice, however, the Yantar FEZ in Kaliningrad became more a center for imports, if not smuggling, among the Baltic states, Poland, West Europe, and the rest of Russia. Because there were no general law governing all zones in Russia, laws on individual FEZs were passed by the Russian legislative body Duma and signed into law by the president. To reduce the number of duty-free imports passing through the Kaliningrad zone, the Russian government began to set quotas on the quantity of certain goods to be permitted (Slider 2003, 154, 158).

Despite the initially optimistic reports, there is little substantiated evidence of any positive impact the Yantar FEZ had on Kaliningrad’s economy, for it suffered from poor legal provisions on tax benefits as well as uncertainty about the status of the zone with changes in federal law in a matter of a few years (Hanson and Bradshaw 2000, 240). In fact, its industrial output plummeted by about 70 percent from 1991 and 1998—or 69
percent from 1990-97 period (Table 20), among the worst performances of any region in Russia whose national average saw about a 50 percent decline during the same period—or 51 percent from the 1990-1997 period (Slider 2003, 154). Kaliningrad was not so successful in attracting significant outside investment either as its per-capita level of FDI stood only half that of the average Russian region by the late 1990s (Smirnov 2001).

Yet, Kaliningrad is said to have had moderate success—compared with the utter failure of many FEZs across Russia—perhaps because its economy remained more open than other regions (Hanson et al. 2000, 249). However, there was no massive influx of foreign capital to the Soviet Union nor its successor, the Russian Federation, to invigorate the economy with foreign investment and trade throughout the 1990s. This trend is also evident in the overall Russian economy as it underwent consecutive seven years of decline, which resulted in a cumulative drop of GDP by more than 40 percent from 1989 to 1996 (UNCTAD 1998). Instead of becoming a productive manufacturing base or venue for exports and trade as well as having economic reconstruction, the special zones were associated, ironically, more with tax evasion in the early 1990s.

*Internal “Offshores” for Tax Evasion*

Amid continued disintegration of the central government in the ensuing years since the collapse of the Soviet Union at the end of 1991, regional and local governments increasingly used FEZs for reduced tax benefits. What was created for the avowed purpose of attracting capital investment, companies and individuals exploited the special zones as internal “offshores,” similar to some island nations serving as offshore banking sites for multinational corporations (Miller 2016, 117). The number of regions with the special status in Russia reached 19 by 1995 and then 25 by 1998 (Finansovye izvestiia, 20 April 1995; Izvestiia, 10 July 1998). The problem was that many of the designated
special zones, with no ostensible logic to their location as enclaves deep inside Russia, were granted by government resolutions or presidential decrees. Although Yeltsin actively supported the creation of special zones initially when he first signed resolutions to allow creation and development of FEZs in 1990 and 1992, he did not take much initiative on setting up the zones thereafter and conceded to lobbying pressure from regional leaders, often without review by relevant officials from the Tax and Finance Ministry (Slider 2003, 157). Their designation as SEZs reflected the relative success of lobbying efforts by regional leaders, drawing a parallel with the Soviet-era practice in which regional leaders lobbied the central planning agency Gosplan to attain scarce raw materials for local industry (Slider 2003, 153).

Among a new set of regions with the special status to provide economic privileges to its registered enterprises were referred to as “offshore zones” because they offered tax incentives to enterprises in exchange for a registration fee much lower than the amount saved in taxes. Three such zones, established in Russia’s poorest republics of Ingushetia, Kalmykia, and Altai, were the most controversial. An audit of 1302 enterprises registered in Ingushetia in 1995 revealed that only 19 had an actual physical presence in the republic, illustrating how the zones were transformed into massive tax evasion vehicles (Slider 2003, 155). Even the corporation established to operate the special zone misused the money taken in from registered enterprises, receiving only 42 percent of the receipts for the development fund with much of the remainder making their way for corrupt gains by officials there. A deputy minister of Finance complained that the resolution to create the Ingushetia zone bypassed the relevant agencies and that the “interested party” continued to lobby the government for the extension of the Ingushetia zone even after a
decision had been made to cease its activities (Noskov 1995; Slider 2003, 157). Estimated to have cost the Russian government US $ 5 billion in lost tax revenue in 1994, a Russian government resolution in July 1997 ended the special privileged status of the Ingushetia zone (Gadaborshev 1998).

In Kalmykia—described as a “tax oasis” by the republic officials—the number of its registered enterprises exceeded 5000, coming from 81 regions in Russia by 1998 (Kucherenko 1998). At the behest of the neighboring regions losing much tax revenue, the Russian Security Council dispatched an investigation team that discovered 1200 enterprises, nearly a quarter of those registered in the zone, had not filed any activity report or paid taxes, while the collected registration fees had been liquidated and all relevant documents destroyed. The lead investigator described that "in Kalmykia what we have is an economic bespredel [chaos]… they have legalized the laundering of underground money (teneyye den'gi)" (Nizhegorodtseva 1999; Kornev 1999; Zhuravlev 1999).

Such was not the economic rejuvenation anticipated from the introduction of SEZs. Instead of creating favorable conditions to attract much needed outside investment, the procedures and institutions established for the special zones were often used by regional leaders to retain and strengthen control over regional economies, thereby increasing opportunities for corrupt gains to enhance their political power. This scheme was possible, for the interests of regional leaders coincided with those of Russian enterprise managers who sought ways to avoid taxes and other government-imposed business expenses via in-country capital flight. The purported goal of seeking outside investment became a handy cover to facilitate lobbying to federal authorities for special
status and privileges (Slider 2003, 160). These abuses, as Miller contends, were more evidence of the central government’s inability to enforce basic rules than sheer ineffectiveness of the strategy intended to promote foreign investment and trade via FEZs (2016, 117).

*Political Instrument and Comprehensive Misgovernment*

Under such dynamics, the special zones often fell prey to political goals and needs of regional leaders. In theory, they welcomed international investment, but many regional leaders were cautious, if not suspicious, of accepting foreign investment, viewing it as potential threat to their ability to direct the region’s economy. While they tried to ensure no loss of control in accepting foreign ventures, when foreign investors managed to gain notable command over important assets, regional leaders often tried to undermine their ownership rights, which created a hostile environment for investors (Slider 2003). Also noteworthy was that political leaders in the country’s gateway regions were quite protectionist and even xenophobic. In fact, many regional leaders deployed common refrains that an outside investor was primarily interested in establishing control over a local enterprise to eventually close it down and remove competition (Hanson et al. 2000, 248).

This trend became more pronounced in the mid-1990s when President Yeltsin cancelled the status of FEZs in 1995 and then instated them under a new name, Special Economic Zones (SEZs) the following year with stricter guidelines and quotas on duty-free imports. The SEZ rules required firms to pay 14 federal, 4 regional, and 23 local taxes for duty-free arrangements, which did not improve the business environment for investors (Hanson et al. 2000, 243). Alterations in the special zones coincided with a new set of governors who emerged through popular election, and not by the president’s
appointment. During the initial period of Russian independence when governors were designated by the president, Yeltsin appointed economic liberals who favored market reforms and opening to outside investment. Few market reformers, however, were able to garner broad support to win popular election in later years because xenophobic nationalism proved more effective on campaign platforms, particularly in border regions that would be the natural and advantageous location for SEZs. As the local population in border regions often put the blame for their economic difficulties on competition with neighboring countries and the influx of overseas traders, aspiring politicians portrayed outside investment as a threat to their region’s economy and campaigned on populist appeals hostile to foreign investment (Slider 2003, 153).

Yuri Matochkin, a reformer with an advanced degree in economics, was named governor of Kaliningrad in 1991 after becoming a member of the Congress of People’s Deputies of Russia with a proposal to turn exclave Kaliningrad into a “Russian Hong Kong” (Slider 2003, 153). Following the comprehensive federal cancellation of FEZs in 1995, Matochkin worked to restore the advantages of the newly instated SEZ status and succeeded in securing the zone’s first major investment: a car assembly plant by Kia-Baltika, a company established in Moscow with the Korean automobile maker KIA’s technology. In 1996, however, Matochkin lost his election to economic nationalist Leonid Gorbenki, who soon after taking office sabotaged a previously settled investment plan. In breach of the terms of agreement with the joint venture as well as SEZ arrangements, Kaliningrad’s regional customs imposed standard duties on car parts, which put a major brake on the envisioned assembly project. The Kia-Baltika fiasco sent sounding alarms to
potential investors to avoid business in the region, reportedly putting off Volkswagen, which was also reviewing investment in Kaliningrad (Popov 1998).

Resolving the problem of “state predation” to the extent that the state was bound by commitments that it would not use its coercive power to increase uncertainty or confiscate assets, was key to enhancing credibility of the state, which critically influenced the evolution of capital markets and institutional transformation (North 1990, 129). The inimical business climate in Kaliningrad, however, was antithetical to attracting foreign investment, let alone fostering sound growth of regional economy. Such were the circumstances in Russia’s two most widely publicized SEZs in Kaliningrad and Primorskiy Krai (Hanson et al. 2000, 247; Slider 2003, 154, 160).

In Primorskiy Krai, which housed the Nakhodka FEZ, economic reform measures from 1991 to early 1993 moved relatively speedily under its first governor, Vladimir Kuznetsov. However, the Russian Far East business center soon became notorious for corruption after Yevgenii Nazdratenko, known for his economic nationalism with a populist, xenophobic stance—mostly directed at bordering China—entered office. Nazdratenko’s leadership sought to strengthen the monopoly power of the local business structure by creating exceptionally large barriers to market entry. Also, several firms whose investors had begun to establish operating influence, such as the Far Eastern Shipping Company, were expropriated (Hanson et al. 2000, 235, 249). Massive corruption and high rates of economic crime in the region prompted the Russian Ministry of Internal Affairs in 1999 to investigate several enterprises in the zone, where 18 major criminal cases were filed, including theft of federal budget money lent to the region. In both Primorskiy Krai and Kaliningrad, the governors’ affiliates were accused of
corruption, embezzlement, and intimidation of political opponents (Shekhovtsov et al. 2000, 113; Hanson et al. 2000, 249; Slider 2003, 154).

Regional governments under political leaders who were unfavorable toward market opening and foreign investment negatively affected the central government’s drive for economic development and transition to a market economy. Empirical studies on efforts to open the economy show that changes in macro-level policy are not sufficient to draw major outside investment, especially when policies that liberalized the investment climate were undercut by regional or sectoral “second tier” administrative barriers (Emery et al. 2000). Such barriers were rampant in Russia, carefully preserved and expanded by regional leaders and bureaucracies, usually in the form of red tape-induced delays and administrative disturbances. According to Russian Minister for Anti-Monopoly Policy, II’ya Yuzhanov, an average investment project involving construction activity required visits to 42 different offices and obtaining about 70 signatures (Voloshin 2001). Reports indicated that paying bribes were routine for business undertakings from export licensing and customs duties to privatization deals and tax transfers, with 90 percent of all bribes in Russia paid by businessmen (Vedomosti 2002, as cited in Ledeneva 2006, 2). While bribes may help businesses to overcome delays and administrative hindrances, the more detrimental impact was to turn off foreign investors from setting up shop in the first place (Slider 2003, 152).

Overall, FEZs in Russia were malfunctioning and breeding increasing skepticism about their utility not only among foreign investors, but also the central government and President Yeltsin. Many special zones, including the Nakhodka FEZ, were increasingly operating under their own economic policies and investment incentives independent from
the influence of the central government, often in plain conflict with federal Finance and Tax agencies’ directives that declared not all commercial activities in FEZs are subject to federal tax exemptions (Kim 1993, 48). Eventually, federal benefits of all types there diminished by 1996 and by the end of the 1990s, most had ceased to operate as special zones (Salimov 1995; Neimysheva 1999; Slider 2003, 158) until the next president Vladimir Putin in 2005 sought an overhaul of SEZs with a comprehensive legal framework.

Misuse of SEZs and Institutional Degeneration

The essence and purpose of reforms in transition and developing countries have been to supply institutions that support markets, protect property and contracts, and ensure accountable governance in the private and public sectors as well as efficient delivery of social services (Polischchuk 2012, 172). While such an emphasis on institutions is in line with the literature providing evidence of their key role in economic development and welfare (Acemoglu et al. 2012; Kaufman et al. 2023), there is also strong evidence that affirms extensive failure of newly introduced institutions to deliver the expected results with many economies demonstrating “institutional variance” (Acemoglu and Robinson 2008). That is, in some cases, reforms do not alter the pre-existing social, economic, and political orders because newly introduced institutions have little or no impact on the status quo ante. As Popov (2012) contends, among critical reasons why Russia’s transition did not fare well can be found in institutional degeneration that led to a lower state capacity as existing institutions were destroyed while imported new ones did not yet take root.  

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The administrative, legal, and social environment ruling the economic game in Russia in the aftermath of the Soviet implosion in the 1990s were unsuited for a successful transition and output recovery: weak state governance suffering from increasing deficit, unclear property rights and tax arrears, pervasive embezzlement and corruption impeding market entry and growth of new firms, a lack of trust in institutions and a lack of confidence in the country’s economic future were all considered pathologies for Russia’s decrepit state and performance (Polishchuk 2012). Additionally, and perhaps integral to this problem was the clout of regional business and political elites.

Hanson and Bradshaw likened a Russian governor who pursued rigorous free market policies to someone going against the present Russian grain—of distributional coalitions inherited in the older order; of a general disregard for the law; and of pervasive patron-client relations (2000, 253-254). Put differently, it was conducive for regional actors to operate, that is, misuse and manipulate institutions in accordance with extant circumstances—imprecision of the rules, lax controls of rules compliance or malfunctioning enforcement mechanisms—allowing behavior that Polishchuk (2012) described as “conforming to the letter of the institutions but violating its intent” (174). As the number of violators increases, confidence in the institution steadily deteriorates, leading to loss of its reputation—an asset vital to the institution’s ability to serve as a credible signaling authority because the credible threat of sanction for those who do not comply with state authority rather than the actual use of force—is at the core of state capacity (Jackman 1993). Without the underpinning of the rule of law, Russia was doomed to have low institutional capacities (Popov 2012).
Among well-known patterns of misused institutions are capture and subversion. Capture places an institution under the control of a small group that manages the institution or is affected by its performance. The beneficiaries of such a regime, besides a corrupt bureaucracy, are the economic elite who are capable of clearing the high entry barriers and reaping higher returns on their assets under curtailed competition.

Subversion is another example of misuse via capture of subnational governance in a federal system. The advantages of a decentralized system of government, including flexibility of fiscal policies and performance incentives in the public sector, are not achieved automatically by merely introducing decentralization with local autonomy, as seen in many failed instances, quite notably in Russia (Polishchuk 2012, 176-177).

*Decentralization in Decapacitated State*

Finding a balance between central authority and local autonomy, that is, to attain the golden mean between over-centralization and excessive decentralization, captures the challenge of (government) reform in early Russia. Young (2009) argues that hyper-centralization may lead to soulless uniformity and lack of interest by its constituents as had been the case during the Soviet era, while inordinate decentralization leads to chaos, witnessed in early years of newly established Russian Federation (248). Strong and early resistance to the new central state in Russia was both a reaction to previous hyper-centralization and a result of clashes between central authorities and regional political leaders on appropriate distribution of power between levels of government, which stemmed and intensified in part from the institutional vacuum in the wake of Soviet disintegration (Stoner-Weiss 2006, 49).

The tide toward decentralizing government authority in the last years of the Soviet system continued in the early 1990s of the Russian Federation under President Yeltsin
with the devolution of power to the regions and other “subjects of the federation” (Evans Jr. 2003, 103-104). Yeltsin granted more independence to the regions and republics of the Russian Federation, but more authority for regional governments did not mean greater autonomy for local administration. Reports of how municipal leaders “refer to the oblast” officials as part of the central apparatus illustrate perceptions consistent with the distinction made in the new Constitution of Russia (Mitchneck 1995). Adopted in 1993, the Russian Constitution categorizes regional governments along with the central government as part of “state power,” and executive and legislative bodies at city and district level as organs of “local self-government” (Evans Jr. 2003, 103-104). The central government had to ensure sufficient control throughout the Federation to weather the strong centrifugal storm that threatened vigor of the new Russian state while also satisfying the interests of local governments as potential allies in the center-regional dynamic: a challenging task universally, but far more difficult to accomplish amid simultaneous destruction of old and building of new institutions in a country undergoing political and economic transition and reform (Young 2009, 250).

Although some regions performed less poorly than others, the drawbacks of weak government and social capital were constant conditions of the Russian state in the 1990s. One reason for the failure of decentralization in the federal system is attributed to the capture of devolved government prerogatives at regional and local levels. Such risks are amplified by a higher probability of emergence of a dominant interest group in smaller jurisdictions (Bardhan and Mookherjee 2000; Blanchard and Shleifer 2001). Even though the 1993 Constitution provided the initial structure for federalism in Russia, boundaries between central and regional prerogatives remained rather indistinct as each federal
subject negotiated so-called power-sharing arrangements with the central government for their perimeters of authority. The problem with such a practice lay in that legal representatives did not sign these treaties, but personally between leaders of single regions and federal authorities, determined by the different nature of regional bargaining power depending on its economic clout and electoral performance with the introduction of popular elections. Regions with better political bargaining leverage were able to negotiate special tax breaks and additional subsidies of soft credits. Consequently, increasing personalization of center-region relations resulted in strengthening of governors and leaders in their respective regions, where they coalesced with strong business players (Zimmer 2007, 114-115).

Institutions are particularly prone to misuse when they have not emerged endogenously evolving as self-enforcing equilibria supported by norms, efficient enforcement mechanisms and various constituencies of users and beneficiaries (North 1990; Aoki 2001). Hence, expeditiously planted exogenous institutions—in the context of this paper, decentralized system of government as well as SEZs in Russia—during economic reform that are not incentive-compatible could often be misused and require an effective enforcement mechanism to ensure decent performance (Roland 2004). The 1990s’ “war of laws” between the central government and nearly all of Russia’s then 89 provinces—in which regions passed laws that directly contradicted federal law, not to mention chronic noncompliance with existing federal law—illustrate the country’s center-region strife and the predicament of the Russian state. Patterns of regional noncompliance with the federal law and constitution during that decade show an especially strong resistance to central authority in areas of economic policy (Stoner-Weiss
2006, 49, 51). The extensive capture of regional governments in Russia in the 1990s deprived the country of the economic benefits of federalism and contributed to the protracted recession and political instability throughout most of the decade (Polishchuk 2004; 2012).

Decentralization, as Stoner-Weiss (2004) emphasizes, is not good in and of itself because in the face of a central state lacking the authority to regulate economic policies at the subnational level could just as easily lead to stalled economic reform as to economic success. A key component to successful market reform in post-communist countries is to ensure that it maintains the capacity to regulate the national economy and exert some minimal level of control over other political and socioeconomic actors (132). When a new institution fails to deliver from the onset, and initial positive expectations are foiled—due largely to early misuse while the institution has yet to gain ground—general support of the institution will likely be withdrawn thereafter, and misuse tends to persist unhampered (Polishchuk 1999). Such was the case for newly introduced SEZs in Russia. An environment conducive for SEZ development requires provision of adequate regional economic autonomy as well as sufficient central backing under a well-functioning decentralized system of government with a strong state capacity for effective rules enforcement.

However, for a country with a long history of a centralized government system under a rigid vertical organizational form (U-form), decentralization in Russian federal system had no solid basis in the national political culture nor in strong social capital to guard against misuse. It was more a product of a counter-reaction to the flagrant failures of Soviet era hyper-centralization and a political compromise by a weak state to co-opt
balky regional elites amid an intense executive-legislative power struggle. Even though President Yeltsin had managed to retain power after the constitutional revision in 1993, federalism Russian-style was susceptible to disarray and intemperance with a practically debilitating federal center lacking cohesive social, cultural, and strong political anchors (Polishchuk 2012, 178-179).

While some misuse is bound to take place, the scale and scope of institutional misuse in Russia indicate an utter lack of an adequate enforcement mechanism. Consequently, perpetrators of misuse gain to the detriment of bona fide users who are withheld or disallowed the benefits of the institutions (Polishchuk 2012, 177). In the face of mounting problems from misuse of the special zones by regional governments such as tax evasions and inconsistent and discretionary administrative barriers to and expropriation of enterprises, the central government began to curb regional leaders’ powers in the latter half of Yeltsin’s presidency by retracting some of the control of fiscal levers and laws passed at the regional level (Zimmer 2007, 114-115). The central government’s initial response to misuse of the special zones was to invariably restrict access, first by suspending FEZs in 1995 and then reinstating a new version under a new name—SEZ—the following year with heavier constraints, which suppressed overall development of the zones.

Federal policy changes on special zones can be viewed as part of an effort to block regions’ attempts to operate unconstrained by the center, even if the outcome of the autonomy may prove useful to the regional and the national economy in the long-term. Shifting from earlier political calculations and determination to consolidate power and to keep the country from disintegrating by according greater authority to the regions, the
primary concern for leadership in the center changed to the immediate impact the proliferation of special zones would have in terms of the federal budget through lost taxes and customs duties—even if successful SEZs could eventually lead to an increased overall level of foreign investment and potential economic development for the country as a whole (Slider 2003, 158). Instead of adequately addressing and fixing problems in SEZ operations in the regions, the federal government approach switched from that of lax rules and enforcement to blunt regulatory measures across the board with stringent and increased mandatory procedures, which further discouraged an appetite for business and investment in Russia’s special zones.

Besides dysfunctional decentralization and ill-performing SEZs during Russia’s transition to a market economy, what aggravated the already unfavorable conditions for economic reform was the behavior of important players in positions of power and policy execution. Insufficiently qualified personnel in bureaucracy with lack of training and susceptibility to corruption proved detrimental to Russia’s transition without the necessary state capacity for envisioned economic development (Young 2009, 252).

*Lack of Adequate Incentives Structures and the Fall of Bureaucracy*

Poor performance by institutions is ascribed to various factors: cultural rejection and “bad fit” (Cooter 1997; Rodrik 2000; Polterovich 2001); inconsistency of a specific institution with the rest of the institutional design, such as an imbalance between newly adopted “fast-moving” and previously “slow-moving” institutions (Roland 2004); insufficient reform in which the absence of integral institutions negatively affects those that have already been introduced (Hellman 1998); and formation of “institutional traps,” or inefficient yet stable norms of behavior which become one of the main obstacles to successful economic development (Polterovich 2007; Polishchuk 2012, 173).
Notwithstanding all these elements that help explain the underperformance of SEZs in Russia, it is noteworthy that low institutional performance is characteristic of low-trust societies (Popov 2012). As Polishchuk (2012) contends, low government performance is a product of two concurrent elements: incompetent and poor traits of public servants coupled with weak government accountability to a society that is disorganized and lacks civic culture (i.e., with low social capital; 180).

While much focus of post-communist economic transition has been on institutional reform—following earlier neoliberal economists’ utmost priority on macroeconomic and market liberalization measures—how a dearth of social capital can impede reform process was often overlooked. Because institutions, values, and behavior co-evolve in an activated dynamics already in place, the likely outcome of sweeping institutional reform lacking necessary social capital is low-level equilibria in which social capital remains meager and discredited institutions are misused without constraint (Polishchuk 2012). Put differently, misuse of institutions and incomplete reform feed on each other. Rent can often be extracted through misuse of earlier institutions in half-reformed economies by political and business elites who not only exploit the situation but actively impede further reform and development, protracting an institutional hiatus (Hellman 1998). Then, the institution becomes a source of private gains for opportunistic agents at the expense of the rest of society, which is what transpired in Russia during its transition and reform (Polishchuk 2012, 173); hence, the argument that any sustained improvement in the Russian economy requires changes in the incentives and constraints to business and administrations in the regions (Hanson and Bradshaw 2000, 254)
Yet, as the central government in Russia was feeble with its federal system at an embryonic stage of development, decentralization served as an obstacle to implementing strong and effective incentives, contrary to how decentralization encouraged economic growth in China (Zhuravskaya 2000; Jin et al. 2005). Some attribute this divergence to the difference in the political centralization levels of the two countries (Blanchard and Shleifer 2001)—China under competent administrative control of the center albeit economic decentralization, whereas Russia underwent turbulent political decentralization in tandem with economic decentralization. While the launch of simultaneous decentralization in its economic and political system may have affected Russia’s performance, a more significant difference was in the existence of an embedded incentive structure that linked collective and personal advancement, both financially and career wise, within China’s system of economic decentralization and political centralization.

The critical question, as Evans (1995) contends, is what kind of state intervention—not how much—is necessary for development, which can only be addressed adequately through relevant institutional analysis of specific state-society relations. Because different types of state structures generate different capacities, these structures define the range of roles that states can take. More importantly, developmental outcomes depend on whether these roles fit the surrounding social context and how well political elites execute them. For instance, “predatory states” lack the bureaucratic institutions—meritocratic recruitment, professionalism, esprit de corps—necessary to ensure political elites enough autonomy to resist corruption and capture by actors whose rent-seeking behavior would otherwise thwart the state’s efforts to promote development and formulate policy in the national interest. The comparison between transitions in
China and Russia highlights the importance of ensuring a compatible incentive structure that reflects career concerns of local politicians and bureaucrats with economic policies (Enikolopov and Zhuravskaya 2007, 107). As people respond to the incentives that exist at their time and place, it was necessary for Russia to recognize that not only were incentives important, but to create incentive structures in its system in accordance with the conditions prevailing in Russia at the time to ensure that they were not counterproductive to national objectives (Hough 2001, 12).

Instead of establishing impersonal rules and incentives to induce behavior beneficial to society, and institutionalizing these incentives to help economic actors take a long-term view with confidence that the incentives have meaning in the present and in the future, the conditions and incentives created, or lack thereof, in Russia worked against public good and economic growth. The bureaucrats and the members of the nomenklatura, who executed the country’s reform and transition beginning with the destruction of the Soviet state, did not defend the presumed interests of the state and their institutions, but took advantage of vague legislation and lax compliance controls by persistently following their individual interests. They attempted to maximize personal gains by “privatizing” taxation of those making private profit legally or illegally as well as by acting as independent agents who acquired and defended their own property while in government positions. Hough (2001) suggests that it was perhaps a natural and rational course of behavior for normal economic actors given no tangible incentives for long-term interests nor prospects for career advances within the existing system of Russian federalism in the 1990s. Despite the serious fall of civil service essential to carrying out reform and promoting economic growth, the central leadership failed to address the
matter properly and in a timely way, perhaps out of a greater political need to stay in power (Hough 2001, 232, 242). If anything, the continued strong support for Yeltsin’s presidency from the West and international organizations throughout Russia’s transition period only helped to nurture unchecked clientelism to take firm root.

Clientelism arises when businesses try to achieve their economic goals with the help of powerful political leaders, in the process of which business-political clans are created, usually in less transparent political regimes. Russia’s ruling elite comprising the old nomenklatura, new economists, and new businessmen soon created clientelist relationships: state officials became patrons usually in regions with more stable and powerful elites holding their positions from Soviet times. For profit-seeking business groups, friendly relations with politically influential regional authorities proved useful to overcoming administrative barriers and to reducing political risks. The empirics indicate that these business groups, often in cooperation with regional officials, tried to stall central regulation of their activities either through law or administrative edict by actively undermining what the central state could accomplish in the periphery and hindered Russia’s efforts for economic reform and development (Stoner-Weiss 2006, 99). More fundamentally, the ruling elites at all levels had already set and led the privatization process in which they could determine the outcome of the privatization deals and auctions, or cheat competitors to rule them out of the game altogether (Turovsky, 2007, 139). In Russia, the development of clientelism in place of institutionalized incentives not only fostered rent seeking but extensive corruption to thwart state affairs, hardly a sound foundation on which to build a state capable of fostering sustained socio-economic development.
Patron-client relations in public administration are not unique to Russia, for opportunistic behavior and rent-seeking often take place amid general disorganization in the economy and society in states undergoing transition, but such deviations became habitual and subsequently reinforced in the post-Soviet context—and eventually produced behemoth oligarchs who became a staple feature of Russia today. In the absence of clearly established administrative norms of civil service behavior, political loyalties and personal ties as opposed to productivity and efficiency became primary to career advances for bureaucrats in Russia (Stoner-Weiss 2006, 82-3, 99; Polterovich 2007; Polishchuk 2012, 188). As Russia’s changing political landscape via newly introduced popular elections defined the degree and form in which the authorities and business players interacted, the joint interests of regional government or municipal officials and business owners or managers became powerful incentives for the clan to retain its power relatively free from constraints of the center (Turovsky 2007, 159). This corruption resulted in a repeated and chronic cycle of weak institutions in 1990s as public officials, lacking the autonomy from emergent financial interests as well as the benefit of coherent incentives and legitimate rewards within Russia’s administrative system, subordinated their public service role to private interests. The Russian state became further debilitated as it continued to be, in the words of Stoner-Weiss (2006), “highjacked” for personal gain in the course of the country’s elites actively “resisting the state” (146).

While the creation of a proper set of rules, laws, and incentives comprise the epitome of institutions (North 1990), seldom can states undergoing transition and reform achieve them all and at once. Evans (1995) contends that as developmental states are also
embedded in a network of social ties that enable political elites to negotiate goals as well as policies and implementation strategies with business actors, successful economic activity and outcome actually depends heavily on political elites being accessible to and working closely with entrepreneurs. What is crucial, however, is that the social ties be connections between constituencies and the state as an organization, and not personal or clientelist, as revealed in a marked difference in the nature of the ties between economic actors and government officials in Russia and China.

Besides the provision of investment incentives, assurance from the government—not as a single actor, but on the whole, including from the top leadership and local individual officials with whom entrepreneurs developed close ties—were important in building the trust necessary for investment, particularly when adequate legal and financial institutions were normally absent in economies undergoing transition (Hough 2001). Indeed, such relations—involving some “corruption” often in the form of bribes in developing countries—can actually work to enhance trust when done right, according to Hough (2001) who argues that corruption is associated with growth in early stages of market opening and capitalism (17-18). For instance, in addition to the strong commitment demonstrated by Deng Xiaoping in support of SEZs in China, local cadres’ close relations with foreign investors on the ground contributed to building the necessary trust to fill the gap in the country’s fledgling legal framework (deLisle 2011; Chen 2018).

The governments can provide the necessary guarantees, but individual government officials who share the fruit of the investment have a better incentive to seek out the most profitable business than does a faraway state leader concerned more about political support. Hough (2001) contends that arrangements in which specific government
officials and specific entrepreneurs cooperate for projects they deem economically optimal are likely to be more advantageous for growth (250). Hence, what economic reform in Russia lacked was not only a government that recognized and incorporated incentives in its political and economic system, but a government that filled the gap of trust in lieu of dearth of legal restraints and juridical foundation on which trust is based. The core of the corruption problem in Russia was not in corruption per se, but that the kind of social ties that gave way to corruption led to promoting only the individual interests of those in client-patron relations rather than collective economic growth.

In summary, early SEZs in Russia—conceived during the Soviet era and implemented in the post-Soviet Russian Federation—failed to deliver on their intended goal of economic growth and development in the regions during the nation’s transition to a market economy in the 1990s. An overwhelming majority of the early zones did not really operate, much less function as proper SEZs, for the following reasons: 1) there was no adequate budget to invest in SEZ infrastructure nor government bandwidth for concerted SEZ policy formulation; 2) there was lack of trust by investors as relevant government authorities failed to administer consistent SEZ policy and provide promised tax benefits and incentives due in part to dysfunctional administrative system and weakened state capacity amid political instability; and 3) the majority of early SEZs were created in regions with low investment attractiveness, making investment even less feasible in the absence of working institutions with necessary social capital nor legal framework, particularly during economic crisis (Kuznetsov and Kuznetsova 2019).

As the prevailing evaluations of Russia’s early SEZ efficacy were usually negative (Shekhovstsov et al. 2000; Kutnetsova 2002) with some recognizing only the
SEZ in Kaliningrad region as such in the 1990s (Zhdanov et al., 2002; Gareev 2013), the evolution of early SEZs during the 1990s remain at best contradictory, which according to Kuznetsov and Kuznetsova (2019) resulted in the early SEZs being rather unaddressed and understudied. There is a consensus among researchers that before 2005—when Putin conducted a comprehensive overhaul of Russia’s SEZ with the introduction of federal laws on SEZs—Russian SEZs were “mere shells” and had meager influence on the regional distribution of FDI in the country (Iwasaki and Suganuma, 2005).

**Vietnam**

*Doi Moi, Policy of Economic Renovation Since 1986*

Vietnam is one of the world’s few remaining socialist states today, with the term explicitly included in its official name the “Socialist Republic of Vietnam.” Despite its relatively late industrialization, Vietnam quickly moved from an impoverished state to that of a middle-income country today, which the World Bank has credited as one of the most spectacular success stories in economic development (Nguyen et al. 2021, 11).

Vietnam underwent prolonged warfare in the 20th century. Following a century-long French colonial rule until 1954, Vietnam fought against the United States (1955-1975) before achieving national reunification under the communist party in 1976. A military clash with the Khmer Rouge leadership in 1978 and subsequent occupation of Cambodia triggered China’s offensive in 1979, seriously deteriorating its relations with Beijing. Decades of continued warfare not only left Vietnam in ruins but in increasing international isolation. In addition to the trade embargo the United States had imposed at the end of the Vietnam War in 1975, sanctions on Vietnam for its involvement in Cambodia resulted in severed international assistance on post-war reconstruction and
development efforts throughout most of the 1980s. Shortage of inputs, material, and foreign currency in Vietnam were further exacerbated due to diminished trade with the socialist bloc as COMECON, formed under the aegis of the Soviet Union for mutual economic assistance, eventually disintegrated in 1991 following their own reform movements in Eastern European countries.

Besides plummeting trade and aid, the Soviet-based centrally planned economic model unilaterally enforced by the CPV not only led to a severe imbalance of growth across the nation but to the point of crisis that brought about shortages of food and resources. Recurring famines in the predominantly agricultural country further added to the already dire situation and over 70 percent of the population were considered living in poverty by already low Vietnamese standards (Dollar et al. 1998, 17). In spite of poverty, inflation skyrocketed to over 700 percent in 1986 (Table 23). The confluence of these conditions—declining production, imbalance in supply and demand, soaring inflation rates, and rising debt among others—resulted in unprecedented economic difficulties for Vietnam and prompted a change of course. It was imperative for the Communist Party of Vietnam (CPV) to improve the material conditions it had promised the people upon reunification of North and South Vietnam, without forsaking control of power (Jandl 2013, 45, 57).

**Bold Shift Toward Market and Price Deregulation**

It was not until 1986 when Vietnam’s top leader Le Duan passed away, however, that the CPV was able to admit serious errors in its economic policies. This period of economic renovation dubbed Doi Moi is commonly dated from the Sixth Party Congress convened in December 1986, when radical economic liberalization measures gained momentum in Vietnam with a marked shift from central planning to a “socialist-oriented
market economy” (Than and Tan 1993; McCarty 1993, 100; Anh 1994). True to the literal meaning of Doi Moi, “change to something new,” the rise of a new party leadership under a more liberal southern reformer Nguyen Van Linh not only led to questions about mistakes in policy implementation but also about the party doctrine itself (van Arkadie and Mallon 2003, 49). Twelve ministers were dismissed with the cabinet members held to account, and wholesale reforms were written into law to welcome foreign investment and to officially allow a multi-sectoral economy with both private and state-owned branches (Jandl 2013, 68). The political decision to recognize the market as an efficient allocator of resources marked the beginning of a substantial transformation of Vietnam’s economy and created space for non-state and foreign economic agents (Jerneck and Ha 1995, 159).

While Vietnam’s poor macro-economic and external conditions under international isolation and pressure spurred the state to revamp its economic policy and system, at the micro-level, the growing practice of “fence-breaking” (pha’rao) by firms as a kind of survival strategy in “unplanned” transactions within the state sector also played into changing Vietnam’s trajectory. The spontaneous activities that deviated from the rules of a command economy were a deliberate process of testing the boundaries to get things done, for which Vietnam’s most successful provinces became known (Fforde and de Vylder 1988; Jandl 2013, 56).

Two-Directional Reform Process

Characterized as “bottom-up” activity, fence-breaking bore symbolic value as it induced entrepreneurial skills into the system, put the subsidized sector of the economy under pressure, and triggered state response with Decree 217-HDBT on autonomy of state enterprises (Jerneck 1995, 123). Although conservatives continued to be a faction within the CPV, provincial leaders came to the forefront of the new policies, which were
modeled after such “fence breaking” activities as well as authorized experiments in the provinces that led to improved SOE performance. These “bottom-up” dynamics illustrate an important aspect of Vietnam’s reform process: the state not only re-acted to rein in enterprise behavior unpermitted by the boundaries of the planned economy, but it actively reflected and incorporated such practices to its policy if considered effective and necessary to improved economic performance and outcome (Jerneck 1995, 120).

Vietnam’s economic reforms, which began during a period of adaptation from war to peace, have helped to shape the overall reform process that can be characterized as two-directional: a grassroots upwards process and a central leadership downwards process (Anh 1995). As Anh (1995) contends, this two-directional process of economic reform stimulated by economic conditions rather than political upheaval, contributed to increasing the people’s understanding of the new conditions and lowering the “shock” element of macro-economic stabilization. The end of the war-time economy gave rise to an awareness for the need to remove institutional obstacles to change the economic management organization and to establish new relationships between the political and economic systems both at the top and the bottom. Such a perception was key to Vietnam’s economic reform process: the leadership sought to establish a modified system by eliminating inappropriate traits and incorporating new and more suitable elements, rather than clinging to dogmatic theories or seeking a destruction of the old system to implement a completely foreign model (Anh 1995, 17-18).

*Introduction of Liberal Foreign Investment Law and New Constitution*

Using an intensified political commitment for a more fundamental and integrated economic reform, Vietnam carried out a series of measures focusing on stabilization, structural change, and deregulation. In November 1987, Decree no. 217 governing the
liberalized and decentralized system of factory management, was promulgated and gave the directors greater authority on management issues at the enterprise level. A month thereafter, a highly liberal foreign investment law was passed to attract international capital with an announcement to introduce Export Processing Zones (EPZs) in Vietnam.

Since 1989, the state liberalized prices for most goods, leaving only electricity under its control. Within a few years, many of the basic elements of a market economy were in place: commercial relations were established through economic transactions, not administrative means; wage incentives were permitted in SOEs; domestic and foreign trade became “commercialized”; central banking functions were separated from commercial banking; new policies of high interest rates and tightened credit were initiated to tackle hyper-inflationary pressures; legislation kept abreast of economic reform with the promulgation of the law on private business, taxation, and shareholding companies; and the institutional framework also underwent reform as all levels of bureaucracy were re-organized with a reduced number of administrative units and employees (Nørlund et al. 1995, 2; Nørlund, 1995, 138-9; Anh 1995, 24; Chin and Guan 1996, 29).

*Outward-Oriented Policy in Pursuit of Export and FDI-Led Economic Growth*

An important component of Vietnam’s transitional development strategy was to move out of insulation and seek integration with the world economy. Having witnessed neighboring socialist state China’s development path following Deng Xiaoping’s open-door policy in 1978—a decade before Vietnam’s Doi Moi—and how opening to foreign investment and trade could help expedite economic growth, Vietnam’s strategic goal was to facilitate more exports and foreign investment for modernization and industrialization (Jerneck 1995; Mai 2004; Jandl 2014; Hiep 2020). In tandem with the open-door policy
on economy, trade, and investment, the decision to completely withdraw forces from Cambodia in 1989 helped Vietnam improve and diversify external relations. Ending its longstanding isolation, Vietnam normalized relations with China in 1991, the United States in 1995, and gained membership in the regional organization ASEAN that same year.

Between 1988 and 1992 an array of policies, laws, and measures were instituted to improve Vietnam’s macro-economic environment, specifically to encourage export production and attract FDI. The introduction of a one-price system in 1989 that linked the Vietnamese dong to the US dollar, followed by a periodic devaluation based on the inflation rate, brought the exchange rate to a level that not only aligned with the street market—or black market—rate but better reflected international market conditions. A realistic exchange rate replacing the previous dual exchange rates made Vietnam’s exports more competitive in the world market. Export promotion and incentive schemes such as preferential tax and financial measures on productions for exports and incentives for foreign-owned export-oriented industries were adopted. Major Asian and European banks were also permitted to open official commercial branches in Hanoi and Ho Chi Minh City (Gates and Truong 1995, 90). Also in 1989, the State Committee for Cooperation and Investment (SCCI) was established and a stock exchange market in 1991, followed by the introduction of a new Constitution in 1992. The Vietnam government’s commitment to a market-oriented, multi-sectoral, and outward-looking economy was reflected in the legal framework because the new Constitution recognizes the rights of the state, cooperatives, individuals, and private capitalists to engage in
economic activities and provides assurances against nationalization (Jerneck and Ha 1995, 163).

Improved Macro-Economic Indices

Within a few years of rigorous adjustment to the concentrated reform process, major indicators of Vietnam’s macroeconomic performance—albeit with slight variations in the figure by organizations—improved: GDP rose from below 4 percent per annum until 1987 to a steady average of 8-9 percent per annum between 1992 and 1997 (before the Asian financial crisis in late 1997; Table 23, Figure 18); hyper-inflation was tamed dramatically from several hundred percent per annum to two-digit figures by 1989, then to below 5 percent after 1996 (Table 23, Figure 19); in just four years since Doi Moi, exports jumped 3.5 times (Ebashi 1997; Figure 20; Jandl 2013, 74); and a steady increase in exports throughout the 1990s (Figure 21) contributed significantly to Vietnam’s GDP growth (Figure 20), accounting for more than 75 percent of national GDP in 1997 (Table 24).

Table 23. Vietnam: Major Indicators of Macroeconomic Performance, 1986-97

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth rate (%)</th>
<th>GDP per capita ($)</th>
<th>Export growth (%)</th>
<th>Import growth (%)</th>
<th>Inflation rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>0.3</td>
<td>n.a.</td>
<td>23.5</td>
<td>5.6</td>
<td>775.0</td>
</tr>
<tr>
<td>1987</td>
<td>3.7</td>
<td>n.a.</td>
<td>20.2</td>
<td>19.3</td>
<td>232.0</td>
</tr>
<tr>
<td>1988</td>
<td>5.9</td>
<td>n.a.</td>
<td>80.1</td>
<td>18.3</td>
<td>394.0</td>
</tr>
<tr>
<td>1989</td>
<td>8.0</td>
<td>n.a.</td>
<td>31.1</td>
<td>18.3</td>
<td>280.0</td>
</tr>
<tr>
<td>1990</td>
<td>5.1</td>
<td>n.a.</td>
<td>18.0</td>
<td>6.3</td>
<td>67.5</td>
</tr>
<tr>
<td>1991</td>
<td>6.0</td>
<td>n.a.</td>
<td>21.2</td>
<td>18.7</td>
<td>67.6</td>
</tr>
<tr>
<td>1992</td>
<td>8.6</td>
<td>n.a.</td>
<td>20.6</td>
<td>20.3</td>
<td>17.6</td>
</tr>
<tr>
<td>1993</td>
<td>8.1</td>
<td>n.a.</td>
<td>35.8</td>
<td>39.3</td>
<td>5.2</td>
</tr>
<tr>
<td>1994</td>
<td>8.8</td>
<td>n.a.</td>
<td>28.2</td>
<td>48.6</td>
<td>14.4</td>
</tr>
<tr>
<td>1995</td>
<td>9.5</td>
<td>n.a.</td>
<td>41.0</td>
<td>43.7</td>
<td>12.7</td>
</tr>
<tr>
<td>1996</td>
<td>9.3</td>
<td>n.a.</td>
<td>24.8</td>
<td>39.0</td>
<td>4.5</td>
</tr>
<tr>
<td>1997</td>
<td>8.2</td>
<td>n.a.</td>
<td>2.4</td>
<td>-0.2</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Figure 18. Vietnam’s GDP growth rate (%), 1985-1997
Source: World Bank Data

Figure 19. Vietnam’s Inflation rate (%), 1985-1998
Source: World Bank Data

Figure 20. Vietnam’s Exports (% of GDP), 1986-98
Source: World Bank Data
Figure 21. Vietnam’s GDP (US$ billion), 1985-1998
Source: World Bank Data

Table 24. Vietnam’s Total Foreign Trade as Percent of GDP

<table>
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<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Trade</td>
<td>25%</td>
<td>50.9</td>
<td>51.9</td>
<td>65.5</td>
<td>77.4</td>
<td>80.5</td>
</tr>
</tbody>
</table>


Turning from famine conditions and dependence on food aid in the mid-1980s, Vietnam’s agricultural industry improved significantly and became the world’s second largest rice exporter by 1997 (Jandl 1998, 15; Phong 2004, 21-25). On the back of improved agricultural production and economic performance, Vietnam’s poverty rate nearly halved in a span of five years from 45 percent in 1992 to 24 percent in 1997 (Figure 22), a significant drop from an estimated 70 percent just a decade prior (Dollar et al. 1998).
Influx of FDI and Early SEZs: Wholesale Opening to Foreign Investment

As economic reforms began to take effect and material conditions gradually improved with increasing trade and a subdued inflation rate, Vietnam’s main priority was to boost non-farm output, with emphasis on basic manufacturing of domestic goods and export processing for hard currency earnings as well as job creation (Jandl 2013, 68). Shifting its focus from heavy industry, preferential treatment was given to investment in the food, consumer items, and export sector (Phong 2004, 36-37). To encourage foreign investment, Vietnam amended its already liberal foreign investment law in 1990 and 1992 (and again after 1997) and made it increasingly investor friendly. Unlike in China, Vietnam allowed fully foreign-owned companies with no shareholding ceiling for foreign partners and granted unlimited profit repatriation as well as authorized private firms to enter joint ventures (Van Thuyet 1999, 769; Beresford 2004, 64; Jandl 2013, 68).

In line with Vietnam’s aim to promote foreign investment and business, direct investment was favored over portfolio investment on the assumption that foreign
ownership and investment would bring with it expertise, technology, and foreign market access. In 1989, over a third of SOEs in Vietnam—4,600 out of 12,000—posted losses. Viewing SOEs as a major problem, the government decided to reduce protection for these firms and saw the need for them to be shaken up by foreign competition, management, and production methods. Even though SOEs accounted for 75 percent of the nation’s assets, they produced about 26 percent of the GDP and employed 30 percent of the labor force (Rondinelli and Litvack 1999, 21).

The new leadership decided to not only open up SOEs to foreign partners but disband 7000 of them en masse. While bold and dramatic moves on the part of the government considering the significant role SOEs had in communist states traditionally, the proportion of Vietnam’s workforce in SOEs was relatively small, especially when compared with that of 77 percent in Russia during its period of reform (Rondinelli and Litvack 1999, 3, 22). According to a 1991 survey in Hanoi, the stronghold of the state economy, 60 percent of all households obtained income from the private sector, and the figure was estimated to reach 85 percent across the country (Dollar 1999, 38; Dollar and Litvack 1998, 9), which indicated a rather diversified source of income in Vietnam as a communist state.

*Rapid Rise in FDI And Number of FDI Projects*

On the back of favorable investment measures to usher in foreign capital, Vietnam saw a rapid rise in FDI inflow for a decade since Doi Moi reforms began (till it suddenly dropped amid the 1997 Asian financial crisis). The total amount of FDI and the number of FDI projects grew several-fold in a matter of years since Vietnam’s foreign investment law went into effect in 1988 (Table 25; Figure 23).
Table 25. Foreign Investments Approved in Vietnam, 1988-1996

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of projects</th>
<th>Investment Amount (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>37</td>
<td>366</td>
</tr>
<tr>
<td>1989</td>
<td>70</td>
<td>539</td>
</tr>
<tr>
<td>1990</td>
<td>111</td>
<td>596</td>
</tr>
<tr>
<td>1991</td>
<td>155</td>
<td>1,388</td>
</tr>
<tr>
<td>1992</td>
<td>193</td>
<td>2,271</td>
</tr>
<tr>
<td>1993</td>
<td>272</td>
<td>2,987</td>
</tr>
<tr>
<td>1994</td>
<td>362</td>
<td>4,071</td>
</tr>
<tr>
<td>1995</td>
<td>404</td>
<td>6,616</td>
</tr>
<tr>
<td>1996</td>
<td>326</td>
<td>8,538 (38% approved in the final week of December, from 5,260 million)</td>
</tr>
</tbody>
</table>


Figure 23. FDI inflows in Vietnam (US$ million, number of projects), 1988-2001

As the absolute volume of FDI inflows to Vietnam increased, its percentage share relative to GDP also grew to reach its peak at more than 10 percent in 1993, and then fluctuated between 8 and 10 percent level until 1997 (Table 26).


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</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>8.1</td>
<td>9.8</td>
<td>15.1</td>
<td>15.1</td>
<td>17.6</td>
<td>25.7</td>
<td>29.3</td>
<td>29.7</td>
<td>29.2</td>
<td>30.9</td>
<td>26.7</td>
</tr>
<tr>
<td>Public sector</td>
<td>3.9</td>
<td>6.3</td>
<td>5.1</td>
<td>2.8</td>
<td>5.8</td>
<td>7.0</td>
<td>5.4</td>
<td>11.4</td>
<td>13.2</td>
<td>14.8</td>
<td>14.3</td>
</tr>
<tr>
<td>Private sector</td>
<td>3.7</td>
<td>2.3</td>
<td>8.6</td>
<td>9.7</td>
<td>3.9</td>
<td>8.6</td>
<td>15.1</td>
<td>8.7</td>
<td>7.6</td>
<td>6.4</td>
<td>5.7</td>
</tr>
<tr>
<td>FDI sector</td>
<td>0.5</td>
<td>1.2</td>
<td>1.5</td>
<td>2.6</td>
<td>7.9</td>
<td>10.1</td>
<td>8.8</td>
<td>9.6</td>
<td>8.3</td>
<td>9.7</td>
<td>6.7</td>
</tr>
<tr>
<td>Memo items</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP*</td>
<td>15.4</td>
<td>28.1</td>
<td>42.0</td>
<td>76.7</td>
<td>110.5</td>
<td>136.6</td>
<td>170.3</td>
<td>228.9</td>
<td>272.0</td>
<td>313.6</td>
<td>361.0</td>
</tr>
<tr>
<td>Exchange rate (000, VND/ $)</td>
<td>n.a.</td>
<td>n.a.</td>
<td>5.13</td>
<td>9.27</td>
<td>11.15</td>
<td>10.64</td>
<td>10.98</td>
<td>11.10</td>
<td>11.50</td>
<td>12.94</td>
<td>13.98</td>
</tr>
<tr>
<td>Change in GDP deflators</td>
<td>n.a.</td>
<td>n.a.</td>
<td>42.1</td>
<td>72.5</td>
<td>32.6</td>
<td>14.3</td>
<td>14.5</td>
<td>19.5</td>
<td>6.1</td>
<td>6.6</td>
<td>8.9</td>
</tr>
</tbody>
</table>

*: GDP is at current price, VND ‘000 billion.


Also, an influx of FDI played a key role in Vietnam’s capital formation between 1922 and 1997, accounting for one-third or as much as two-thirds of gross national investment (Figure 24). After 1995, however, as normalization of relations with the United States paved the way for reconstruction and cooperation projects with international organizations, the public investment amount surpassed that of FDI as the leading investment source with a significant increase in ODA disbursement poured into large-scale public investment projects (Mai 2004, 39).
Figure 24. Vietnam’s Capital Formation*, FDI as percentage of GDP, 1988-98

Notes: World Bank Databank glossary defines gross capital formation* (formerly gross domestic investment) as consisting of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements; plant, machinery, and equipment purchases; and the construction of roads, railways, schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings.

Expanded Trade Market And Shift In Investment Sources

Besides the increase in volume, expansion and diversification of countries making capital investment were crucial in expediting Vietnam’s economic transition progress as well as to offset the precipitous dip in trade and foreign aid from the former communist bloc. Reflecting a dramatic shift from a decade prior, Asia became the region where the largest amount of foreign currency flowed into Vietnam (Table 27). In 1991, more than half of all foreign capital investment in Vietnam were made by Asian companies (Tuoi Tre 1991; Gates and Truong 1995, 95). Particularly important were Japan and the newly industrialized economies (NIEs) in Asia, namely Singapore, Taiwan, and Hong Kong, whose average annual growth rate exceeded 7 percent during the 1990s. They were among the first and top countries to make inroads with the largest amount of investment and number of joint venture projects in Vietnam (Table 27).
Table 27. Vietnam: Foreign Investments by Countries (Cumulative as of October 1998)

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Country</th>
<th>Number of Projects</th>
<th>Investment Amount (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Singapore</td>
<td>181</td>
<td>6,447</td>
</tr>
<tr>
<td>2</td>
<td>Taiwan</td>
<td>309</td>
<td>4,268</td>
</tr>
<tr>
<td>3</td>
<td>Hong Kong</td>
<td>184</td>
<td>3,734</td>
</tr>
<tr>
<td>4</td>
<td>Japan</td>
<td>213</td>
<td>3,500</td>
</tr>
<tr>
<td>5</td>
<td>South Korea</td>
<td>191</td>
<td>3,154</td>
</tr>
<tr>
<td>6</td>
<td>France</td>
<td>89</td>
<td>1,465</td>
</tr>
<tr>
<td>7</td>
<td>Malaysia</td>
<td>59</td>
<td>1,370</td>
</tr>
<tr>
<td>8</td>
<td>US</td>
<td>70</td>
<td>1,230</td>
</tr>
<tr>
<td>9</td>
<td>Thailand</td>
<td>78</td>
<td>1,109</td>
</tr>
<tr>
<td>10</td>
<td>British Virgin Island</td>
<td>55</td>
<td>1,089</td>
</tr>
</tbody>
</table>


Also noteworthy is that Vietnam was the first developing country that had its main trade and investment partners guiding it through reforms in East Asia, not in the West (Jandl 2013, 77). *The Economist* (1995) described Vietnam as “the first economy to reach the point of take-off without help from the West.” In 1992, nearly 80 percent of Vietnam’s exports and 78 percent of its imports were with Asian countries, whereas those with the European market stood at below 10 percent and 15 percent, respectively, and in single digit figures with the former communist bloc (Anh 1994, 40). The United States came later in the game with official trade beginning in 1997 upon restoration of diplomatic relations in 1995 and lifting of its embargo on Vietnam in 1994.

**Designation of First SEPZs**

In 1991, inspired by China’s successful use of SEZs as both a platform to attract FDI and an engine for accelerated economic growth, Vietnam introduced its own version, Special Export Processing Zone (SEPZ), often simply referred to as EPZ. The first to be
granted the special status in Vietnam was Tan Thuan SEPZ, located just 4 km south of Ho Chi Minh City. It opened as a joint venture with a US $90 million investment from Taiwan’s two major companies on 300 hectares of land in the heart of Vietnam’s commercial capital (Tan Thuan Corporation 2023; Chin and Guan 1996, 29; Luong et al. 1996). Taiwan had been a top investor in Vietnam since the early stages of Doi Moi for several reasons: the geographical proximity for timely inputs to the production chain, traditional and cultural affinity with the existence of a Chinese minority there, as well as abundant and cheap labor. Additionally, for Taiwanese firms, Vietnam was a good alternative investment destination, for the then popular new manufacturing hubs along China’s southern coast could become politically problematic (Jandl 2013, 76; Gates and Truong 1995, 95; Ebashi 1997, 52). Besides, Vietnam met important conditions that foreign investors deemed most critical for investment: the macro-environment of the host country (World Bank 1989, 34).

Economic and political stability is the single most important factor in attracting investors, stemming capital flows, and encouraging reflows. Stable growth in domestic incomes, strong domestic investment, and relative political stability have been the cornerstone of East Asia’s success in attracting FDI. Conversely, high inflation, threats of nationalization or currency devaluation, and frequent policy changes quickly dampen investors’ enthusiasm. (World Bank 1990, 44)

By 1993, Vietnam granted a total of six licenses for SEPZs to be established in various regions: two in Ho Chi Minh City (Tan Thuan and Linh Trung), one each in Haiphong City, Da Nang, Can Tho, and Hanoi. All the SEPZs were to be established as joint-ventures—Can Tho being the only exception—with foreign partners, who contributed 65-70 percent capital and the Vietnamese partner 30-35 percent, usually in the form of land use rights. (The Vietnamese partner for all EPZ projects—whether
already licensed or not—was usually the local People’s Committee or a state-owned construction company.) By the middle of 1994, licensed SEPZs comprised about 14 percent of officially approved investment commitments in Vietnam, according to SCCI sources (Luong et al. 1996, 43). While approved foreign investment commitments increased rapidly (Table 28), the investment implementation rate was rather low, hovering around 30 percent range until 1997 (when the sudden drop in total investment commitments led to an arithmetic increase in implementation rate).


<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment (Approved)</td>
<td>2,889</td>
<td>2,271</td>
<td>2,987</td>
<td>4,071</td>
<td>6,616</td>
<td>8,500</td>
<td>4,500</td>
</tr>
<tr>
<td>Implementation</td>
<td>620</td>
<td>463</td>
<td>1,002</td>
<td>1,500</td>
<td>2,000</td>
<td>1,800</td>
<td>2,600</td>
</tr>
<tr>
<td>Implementation as percent of approvals (%)</td>
<td>21.5</td>
<td>20.4</td>
<td>33.5</td>
<td>36.8</td>
<td>30.2</td>
<td>21.0</td>
<td>58.0</td>
</tr>
</tbody>
</table>

Source: Ministry of Planning and Investment (MPI), Data 1996-1997 from the World Bank, which used the same source of MPI.

Delayed SEPZ Construction and Operations

All of the SEPZs in Vietnam experienced significant delays in infrastructure building, hence, in subsequent opening and operations. Even Tan Thuan SEPZ, first to acquire its license in September 1991 saw its first plant production more than two years later in November 1993 (Tan Thuan website). The other SEPZs experienced even longer delays in infrastructure construction, if at all. Among them, Haiphong SEPZ, the largest in terms of planned investment capital (US$ 150 million) had its license revoked and the joint venture ordered to disband in October 1995 because the foreign partner faced bankruptcy in its home country, Hong Kong (Luong et al. 1996, 44). That same month, SCCI announced that it would no longer issue licenses for SEPZs, stating that “only one
of the six licensed zones [Tan Thuan] … was a feasible project that had attracted [secured] foreign investment,” as reported by Bangkok Post (12 Oct 1995, 19; Luong et al. 1996, 44). As the government acknowledged in its own statement, prospects for the remaining four zones were not so bright as the SEPZ development in Vietnam—despite the hype and expectations—appeared largely a failure in execution as well as planning. Indeed, a WSJ article covering news on Tan Thuan SEPZ’s first profit-making in 1996 after three years of operations, wrote that “other export processing zones and industrial parks may find the going a little tougher” (WSJ 1996).

*Designation of Additional Special Zones*

What is noteworthy, however, is that while licensing six locations to establish SEPZs, several additional zones for investment of similar magnitude—though not exclusively for exports or export-processing—were also being considered in various locations as early as 1993 (Luong et al. 1996, 43). That is, even before Vietnam’s first EPZs had been properly built, let alone become operational—with the exception of Tan Thuan beginning operations in 1993—industrial zones and estates had emerged as the new name of the game in attracting foreign investment, which was in part due to changed regulations that permitted the same incentives as those initially offered exclusively for SEPZs, that is, for exporting manufacturers (Table 29). Because the government allowed operation of non-EPZs under similar favorable conditions with just as high tax breaks and incentives, foreign investors saw no special merit in the SEPZs, especially when they could engage in a wider scope of industrial activity (Kwon 1933, 88).
Table 29. Tax Benefits and Incentives for Investment Firms in Various Special Zones

<table>
<thead>
<tr>
<th>Type of zone</th>
<th>Type of firms subject to tax benefits</th>
<th>Tax rate (%)</th>
<th>Tax exemption period (years)</th>
<th>50% tax reduction period (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPZ</td>
<td>Manufacturing firms inside EPZ</td>
<td>10</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Service providing firms inside EPZ</td>
<td>15</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Less than 50% production for exports</td>
<td>15</td>
<td>2</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>50% - 80% production for exports</td>
<td>15</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>More than 80% production for exports</td>
<td>10</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Service providing firms inside IZ</td>
<td>20</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>IZ</td>
<td>Firms inside High-tech zones</td>
<td>10</td>
<td>10</td>
<td>--</td>
</tr>
<tr>
<td>High-tech</td>
<td>Also applicable to firms outside zones</td>
<td>10</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>New-tech</td>
<td>firms</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Based on Vietnam’s Foreign Investment Law. (cited in Kwon 2003).

By October 1995—the same month that SCCI announced that it would no longer issue licenses for SEPZs due to feasibility concerns following the collapse of joint venture for Haiphong SEPZ—six new areas had been officially licensed as Industrial Zones (IZs; Table 30). Surpassing the initial investment commitment of $300 million for the country’s first six SEPZs, a total of $400 million in planned infrastructure commitments for IZs were made by foreign investors, including those from Taiwan, Singapore, and Thailand (Luong et al. 1996, 45). To oversee Vietnam’s overall investment planning, SCCI was merged into the Ministry of Planning, which was then renamed the Ministry of Planning and Investment (MPI) in 1995 (Van Thuyet 1999, 780).
Table 30. Licensed SEPZs and IZs in Vietnam, 1991-1995

<table>
<thead>
<tr>
<th>Name of zones</th>
<th>Location</th>
<th>Source of investment</th>
<th>Investment (US$ mil.)</th>
<th># of firms</th>
<th>Date of license</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noi Bai</td>
<td>Hanoi</td>
<td>Malaysia + Vietnam</td>
<td>30</td>
<td>-</td>
<td>1994. 4</td>
</tr>
<tr>
<td>Dai Tu</td>
<td>Hanoi</td>
<td>Taiwan (100%)</td>
<td>12</td>
<td>-</td>
<td>1995. 8</td>
</tr>
<tr>
<td>Nomura</td>
<td>Haiphong</td>
<td>Singapore + Japan +</td>
<td>120.5</td>
<td>-</td>
<td>1994.12</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vietnam</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Da Nang</td>
<td>Da Nang</td>
<td>Malaysia + Vietnam</td>
<td>24</td>
<td>1</td>
<td>1993.10</td>
</tr>
<tr>
<td>Tan Thuan</td>
<td>HCMC</td>
<td>Taiwan + Vietnam</td>
<td>89</td>
<td>61</td>
<td>1991. 9</td>
</tr>
<tr>
<td>LinhTrung</td>
<td>HCMC</td>
<td>China + Vietnam</td>
<td>14</td>
<td>7</td>
<td>1992. 8</td>
</tr>
<tr>
<td>Amata</td>
<td>Dong Nai</td>
<td>Japan + Thailand</td>
<td>46</td>
<td>-</td>
<td>1994.12</td>
</tr>
<tr>
<td>Bien Hoa</td>
<td>Dong Nai</td>
<td>Vietnam</td>
<td>18</td>
<td>51</td>
<td>1995. 6</td>
</tr>
<tr>
<td>Tuy Hoa</td>
<td>Dong Nai</td>
<td>Vietnam</td>
<td>12</td>
<td>1</td>
<td>1995. 3</td>
</tr>
<tr>
<td>Go Dau</td>
<td>Dong Nai</td>
<td>Vietnam</td>
<td>18</td>
<td>6</td>
<td>1995</td>
</tr>
<tr>
<td>Song Be</td>
<td>Song Be</td>
<td>Vietnam</td>
<td>25</td>
<td>7</td>
<td>1995</td>
</tr>
<tr>
<td>Can Tho</td>
<td>Can Tho</td>
<td>Vietnam</td>
<td>8</td>
<td>2</td>
<td>1993.11</td>
</tr>
</tbody>
</table>


_Proliferation of Special Zones Under Many Names_

Both local and central governments were keen to attract foreign investment, but their concerns and reactions on EPZs were somewhat different. While the local government planning committees’ primary concern was to invigorate their communities by securing foreign partners and investment via joint ventures, the bigger concern for the central government was on the type of foreign investment, i.e., whether the accompanying technologies would be “obsolete,” to fulfill expectations from the perspective of national development. While the first designated SEZPs had not yet begun running, local governments already shifted gears to create industrial zones and estates despite provision of a clear policy framework, and consequently little guidance from central authorities on the new zones (Luong et al. 1996, 42-3).
What was clear, however, was Vietnam’s continued focus on expediting national economic development as it embarked on preparations for its first market-based Five-Year Plan (1996-2000) following the introduction of a new Constitution in 1992, which institutionalized “market economy” (albeit the qualifier “socialist-oriented”; Luong et al. 1996, 43). During the five years from 1995 to 2000, the number of EPZs and IZs in Vietnam rose more than five-fold from 12 to 65 (Figure 25). During that same period, the total number of FDI projects in these zones also grew nearly five-fold from 155 to 746; the total amount of FDI in these zones also increased 5.5 times from US$ 1.5 billion to US$ 8.7 billion (Figure 26). Figure 27 illustrates the expansion of special zones across Vietnam during that period.

![Figure 25. Vietnam: Number of EPZs and IZs, 1995-2005](image)

Figure 26. FDI projects in Vietnam’s IZs & EPZs (number of projects, capital)

Figure 27. Spread of SEZs across Vietnam, 1994-2000

The special zones were divided into two categories, economic zones (EZs) and industrial zones (IZs); IZs are further classified into different types of zones, such as export processing zones (EPZs) and supporting industrial zones; the EZs into coastal EZs
and border-gate EZs. The government encouraged investment in designated economic and industrial zones with each zone serving its own agenda and providing special incentives, but a key component to their success was having a good infrastructure that enabled efficient transportation and trading of products. As such, proximity to major cities, highways, seaports, and borders became a critical consideration for investors in making large sums of investment commitments.

**Regional Distribution of Special Economic Zone Development**

Vietnam’s focal economic areas, or growth triangles, were categorized by three administrative regions: North Key Economic Zone (NKEZ), Central Key Economic Zone (CKEZ), and Southern Key Economic Zone (SKEZ; Figure 28).

![Figure 28. Map of Vietnam’s regions](image)

Source: Government of Vietnam, the World Bank, 1999
Among the three areas, the SKEZ, home to Ho Chi Minh City (HCMC), which also housed the nation’s first licensed and operational SEPZ, had the most robust economic activities. Known for its history of strong entrepreneurial and liberal market practices prior to Vietnam’s reunification, the southeastern region surrounding HCMC was considered the leading hub in terms of industrial development, commerce, and services, attracting the majority of FDI in Vietnam (Table 31).

Table 31. Provincial Allocation of FDI in Vietnam, 1988-98 (Percent)

<table>
<thead>
<tr>
<th>Province/Region</th>
<th>Committed FDI 1988-95</th>
<th>Implemented FDI 1991-98</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Red River Delta</td>
<td>30.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Ha Noi</td>
<td>22.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Hai Phong</td>
<td>4.3</td>
<td>100.0</td>
</tr>
<tr>
<td>Ha Tay</td>
<td>1.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Hai Duong</td>
<td>0.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Northern Uplands</td>
<td>4.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Quang Ninh</td>
<td>2.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Vinh Phu</td>
<td>1.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Ha Bac</td>
<td>0.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Ten other provinces</td>
<td>0.5</td>
<td>100.0</td>
</tr>
<tr>
<td>North Central</td>
<td>2.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Thanh Hoa</td>
<td>1.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Nghe An</td>
<td>0.6</td>
<td>100.0</td>
</tr>
<tr>
<td>Thua Thien-Hue</td>
<td>0.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Three other provinces</td>
<td>0.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Central Coast</td>
<td>7.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Quang Nam-Da Nang</td>
<td>3.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Quang Ngai</td>
<td>3.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Three other provinces</td>
<td>1.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Central Highlands</td>
<td>0.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Kontum</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Gia Lai</td>
<td>0.1</td>
<td>100.0</td>
</tr>
<tr>
<td>Dak Lac</td>
<td>0.1</td>
<td>100.0</td>
</tr>
<tr>
<td>Southeast</td>
<td>52.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Ho Chi Minh City</td>
<td>28.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Song Be</td>
<td>4.1</td>
<td>100.0</td>
</tr>
<tr>
<td>Tay Ninh</td>
<td>0.6</td>
<td>100.0</td>
</tr>
<tr>
<td>Dong Nai</td>
<td>9.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Ba Ria-Vung Tau</td>
<td>6.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Three other provinces</td>
<td>2.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Mekong River Delta</td>
<td>2.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Can Tho</td>
<td>0.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Long An</td>
<td>0.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Kien Giang</td>
<td>0.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Eight other provinces</td>
<td>0.6</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: The data do not include FDI flows to the oil and gas industries. Source: GSO 1995; 1996a; 1997; 1998a; 1999a and several World Bank Country reports. (cited in Mai 2004).

From 1988 to 1998, about 55 percent of FDI in Vietnam was in the southern region, the Southeast (52.4%) and the Mekong River Delta (2.5%) combined (Table 31). Consequently, a similar pattern is reflected in the distribution of industrial zones with a
combined 55 percent located in the Southeast (43%) and Mekong Delta (12%) area (Figure 29). Although the government promoted a more balanced development and encouraged investment in the northern regions, which included the nation’s capital Hanoi and third largest city Haiphong, foreign investors preferred to locate their projects and business in the southern region. Compared with the northern region, the relatively more developed infrastructure lessened the burden for investors and more availability of labor force with better understanding of business practices with management skills—though still far below the desired level and short in overall supply—made foreign investors flock more to the southern region (Van Thuyet 1999, 769).

![Figure 29. Distribution of industrial zones by region in Vietnam](image)

Source: Jandl (2013, 121).
“Race-to-the-Bottom” Competition

The special economic zones, first established in select few areas with deregulation and incentives as tools for economic development, had expanded to more than 60 locations nationwide since Vietnam’s first SEPZ began running in 1993. Many of the special zones—whether EPZs, IZs or the newer high technology zones—were mostly driven by local governments with approvals from the central government, which highly promoted such zones for national economic development. Competition between the regions to create such zones resulted in excessive supply beyond their economic demand and feasibility (Luong et al. 1996). As Jeong and Zeng (2016, 90) point out, special zones introduced by local governments not based on economic feasibility but largely on political needs typically fail, and what made matters worse was that local governments continue to request the approval of various new zones. This phenomenon not only results in an overlap and overdevelopment of different types of SEZs but in inefficient use of resources, which was the case in Vietnam. The rapid proliferation of private zones placed a significant cost burden on the government, especially in terms of offsite infrastructure and facilities (WB-FIAS 2009, 57).

Reliance on Private Developers to Install External Infrastructure

As findings indicated, duplicate and overlapping zone regimes often result in revenue loss and indeed, Vietnam experienced difficulties with tax regulation for its numerous zone regimes featuring varied incentive packages (WB-FIAs 2008, 52). Such was the risk facing countries that had encouraged private zones based on zone development agreements, as the terms and conditions of each zone concession could vary widely in the absence of an appropriate and firm legal foundation set in place. From the onset of its SEZ program in 1991 with the establishment of Tan Thuan EZP in HCMC,
Vietnam relied mostly on private zone developers requiring them to install external infrastructures, including access roads and utility connections as well as financing on-site facilities such as factory buildings and internal roads (WB-FIAs 2008, 18, 28). Though this practice gradually changed with the advent of formal public-private partnership approaches in the later phase of SEZ development, designation of numerous zones in the mid-1990s led to unproductive “race-to-the-bottom” competition in Vietnam, not only among regions but even within regions among various cities (Luong et al. 1996; Tang 2022).

*Over-Supply of Zones and Under-Supply of Quality Infrastructure*

For instance, when the central government approves special tax and tariff regimes on local government’s proposed SEZ development, the provinces try to produce a more accommodating business climate, sometimes through “fence breaking,” such as Binh Duong’s support for migrant worker housing, to outcompete neighboring regions and attract investment commitments for special zones in their jurisdictions (Jandl 2013, 72). Such practices occurred as quality of infrastructure is regularly ranked as a top determining factor for choosing investment location. As provision of quality infrastructure is costly and competes with rent-seeking opportunities for elites, infrastructure projects often involve corruption and cronyism in the contracting process, which then lead to bad infrastructure building because a portion of the allocated budget gets used elsewhere, resulting in under-supply of quality infrastructure (Jandl 2013, 89).

This vicious cycle of malpractice can be traced in part to the existence of an infrastructure index known as the Provincial Competitiveness Index (PCI), which contains four categories: industrial zones, road and transportation network, utilities, and communication technology. Based on Vietnam’s fiscal arrangement, however, the
provision of these facilities cannot be attributed directly to provincial officials, for many capital projects are still decided and funded by the central government. Yet, increased fiscal decentralization has, in theory, created opportunities for provinces to raise their own resources for infrastructure improvements (VCCI 2009, xv), particularly for industrial zones as they are commonly decided, planned, and implemented at the provincial level (Jandl 2013, 89)

As such, fierce competition between local governments to attract foreign investment without sufficient planning and feasibility assessment under close central-regional government coordination gave rise to many problems in Vietnam’s SEZ development, often resulting in either half-finished zones or large vacancies in zones that were constructed (WB-FIAS 2008, 50). While Vietnam’s more decentralized government system since Doi Moi allowed more flexibility for local officials to experiment with and implement policies better suited to local conditions, overheated regional competition was not conducive to desired performance nor creation of SEZs in the true sense. “Too much competition, not enough coordination,” a commonly heard slogan when talking about special zones in Vietnam, reflected the sentiment prevalent in the country (Jandl 2013, 61).

Low Labor Cost the Main Motivation for Many Foreign Investors in Vietnam

Cheap labor costs were found to have been among the main motivations for many foreign investors in Vietnam as wage levels remained lower than those in other countries in the region, including Indonesia, Malaysia, Thailand, and the Philippines, not to mention those in the newly industrialized economies such as Taiwan and Singapore (Mai 2004, 30). A 1996 survey of Japanese companies operating overseas also indicated that more than 60 percent of those investing in Vietnam did so to secure low-cost labor.
According to findings by the World Bank, wages in Vietnam in 1996 were in fact the lowest in the region for all categories of labor—from unskilled to skilled and middle managers as well as the minimum daily wage, which was $0.78, a miniscule amount when compared with $28.50 in Taiwan and still less than one-fifth that of $5 in Thailand (1998, 7). Vietnam’s comparative advantage of cheap labor continued even after other countries in the region had significantly depreciated their currencies against the US dollar in the wake of the 1997 Asian financial crisis (Mai 2004, 30).

Limited Growth Beyond Exports Without Adequate Infrastructure & Governance

*Early SEZs Contribute to Growth in Industrial Output, Exports, and Trade*

Despite some early problems in infrastructure building, once the facilities were set up and began running in the mid-1990s, production at SEZs posted increases and contributed to Vietnam’s trade (Figure 30). Tan Thuan EPZ in HCMC, the first to be established and operate in Vietnam in 1993, was particularly successful, whose import-export value took up the lion’s share in trade contributions among IZ and EPZs in the country (Figure 31). Rapidly rising trade volume (Figure 32) and exports as percentage of GDP helped boost Vietnam’s GDP growth (Figure 33), which soared to account for more than 80 percent of the national GDP in 1999 from a mere 25 percent in 1986 (Table 24).

![Figure 30](image). Vietnam: IZs & EPZs’ trade contribution (in US$ billion), 1995-2005
Vietnam’s accelerated growth in the mid-1990s was led mainly by manufacturing and exports increasing by an average of over 22 percent annually to reach about 47 percent of GDP by the end of the decade (Figure 33; WBR 2001, 2).
Changes in Vietnam’s GDP and Output Structure

In light of galloping exports and trade, Vietnam’s GDP and output structure saw dramatic changes in a span of a decade, transforming Vietnam from a predominantly agricultural country to one driven by industrial output and growth (Table 32): the industry share of the national GDP at below 19 percent—less than half the agriculture share of 40 percent in 1990—rose to nearly 26 percent, surpassing the 23 percent agriculture share in 1998. The industry share in terms of output structure also increased from 33 percent to nearly 41 percent from 1990 to 1998, while the share of agriculture decreased from 35 percent to 26 percent during the same period. Most notable was the industrial growth rate, which jumped from 2.5 percent to 12 percent when agricultural growth rate grew a tad from 1.5 percent to 3.4 percent during the 1990-1998 period.
Overall, Vietnam’s economy fared rather well throughout the 1990s, continuing its upward trend since reforms began in 1986, as shown in various indicators of economic development (Table 33).

Table 32. Vietnam’s GDP and Output Structure, 1990-1998 (Percent)

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<td>GDP structure</td>
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<tr>
<td>Industry share</td>
<td>18.6</td>
<td>19.3</td>
<td>20.4</td>
<td>21.2</td>
<td>21.9</td>
<td>22.5</td>
<td>23.4</td>
<td>24.5</td>
<td>25.9</td>
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<tr>
<td>Agriculture share</td>
<td>40.7</td>
<td>39.2</td>
<td>38.6</td>
<td>37.1</td>
<td>35.5</td>
<td>26.2</td>
<td>25.1</td>
<td>24.2</td>
<td>23.6</td>
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<tr>
<td>Service share</td>
<td>40.7</td>
<td>41.5</td>
<td>41.0</td>
<td>41.7</td>
<td>42.6</td>
<td>51.3</td>
<td>51.5</td>
<td>51.3</td>
<td>50.5</td>
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<td>Output structure</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Industry share</td>
<td>33.2</td>
<td>34.9</td>
<td>36.0</td>
<td>36.4</td>
<td>36.5</td>
<td>35.8</td>
<td>37.1</td>
<td>39.0</td>
<td>40.8</td>
</tr>
<tr>
<td>Agriculture share</td>
<td>35.0</td>
<td>34.3</td>
<td>32.7</td>
<td>31.3</td>
<td>28.9</td>
<td>28.5</td>
<td>27.2</td>
<td>26.8</td>
<td>26.0</td>
</tr>
<tr>
<td>Service share</td>
<td>31.8</td>
<td>30.8</td>
<td>31.3</td>
<td>32.3</td>
<td>34.6</td>
<td>35.7</td>
<td>35.7</td>
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<tr>
<td>Industrial growth rate</td>
<td>2.5</td>
<td>9.9</td>
<td>14.6</td>
<td>12.1</td>
<td>12.9</td>
<td>13.2</td>
<td>14.2</td>
<td>13.8</td>
<td>12.1</td>
</tr>
<tr>
<td>Agricultural growth rate</td>
<td>1.5</td>
<td>2.2</td>
<td>7.3</td>
<td>3.8</td>
<td>3.9</td>
<td>4.4</td>
<td>4.4</td>
<td>4.7</td>
<td>3.4</td>
</tr>
<tr>
<td>Service growth rate</td>
<td>10.2</td>
<td>7.6</td>
<td>7.1</td>
<td>10.1</td>
<td>11.1</td>
<td>19.6</td>
<td>9.9</td>
<td>7.8</td>
<td>4.0</td>
</tr>
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</table>


Table 33. Indicators of Economic Development in Vietnam

<table>
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<tr>
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<tbody>
<tr>
<td>Economic growth (%)</td>
<td>3.4</td>
<td>6.0</td>
<td>9.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Illiteracy rate (%)</td>
<td>10.7</td>
<td>9.2</td>
<td>7.7</td>
<td>6.5</td>
</tr>
<tr>
<td>Income/cap ($)</td>
<td>180</td>
<td>228</td>
<td>339</td>
<td>410</td>
</tr>
<tr>
<td>Food grain production (kg/cap)</td>
<td>301</td>
<td>323</td>
<td>385</td>
<td>433</td>
</tr>
<tr>
<td>Budget surplus (% of GDP)</td>
<td>-6.2</td>
<td>-3.8</td>
<td>-0.7</td>
<td>-3.5</td>
</tr>
<tr>
<td>Budget revenue (% of GDP)</td>
<td>14.0</td>
<td>13.5</td>
<td>23.6</td>
<td>21.8</td>
</tr>
<tr>
<td>Gross dom. savings (% of GDP)</td>
<td>n.a.</td>
<td>13.2</td>
<td>16.7</td>
<td>24.0</td>
</tr>
<tr>
<td>Current account (% of GDP)</td>
<td>-2.7</td>
<td>-2.0</td>
<td>-11.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Gross dom. invest. (% of GDP)</td>
<td>n.a.</td>
<td>15.1</td>
<td>27.9</td>
<td>26.1</td>
</tr>
<tr>
<td>FDI inflows ($ million)</td>
<td>—</td>
<td>229</td>
<td>1,838</td>
<td>1,200</td>
</tr>
<tr>
<td>ODA inflows ($ million)</td>
<td>147</td>
<td>229</td>
<td>939</td>
<td>1,700</td>
</tr>
<tr>
<td>Exports ($ million)</td>
<td>494</td>
<td>2,042</td>
<td>7,330</td>
<td>15,027</td>
</tr>
<tr>
<td>Imports ($ million)</td>
<td>1,121</td>
<td>2,1059</td>
<td>10,481</td>
<td>16,162</td>
</tr>
</tbody>
</table>

The development of SEZs was useful in boosting Vietnam’s industrial production and trade volume, which helped shape its growth trajectory as a fast-industrializing nation. In that regard, Vietnam’s early SEZs delivered on their primary function and goal—attract FDI for joint ventures and projects to help expand the nation’s industrial production and trade, which in turn contributed to increasing the national GDP. Yet, considering how Vietnam’s early SEZs were inspired by and sought to emulate the kind of national economic transformation enabled by SEZs during China’s transition to a market economy, they appeared to have fallen short of such expectations; that is, to trigger extensive development beyond growth in exports to advance the country’s overall business and industry with spillover effects nationwide. While simple comparisons cannot be made with China, considering the vast difference in size and stature both as country and market as well as in the period the reforms and market-opening had begun, there are some distinct traits in terms of efficacy in SEZ planning, execution, and oversight by the government.

Dearth of Coordination for Selective and Concentrated SEZ Development

Establishing a large industrial zone is a costly proposition that requires careful planning and assessment of relevant circumstances, including market demand, labor supplies and connectivity (Jeong and Zeng 2016, 300). As such, designating few select locations with most advantageous conditions for concentrated SEZ development was especially important in countries like Vietnam for effective use of its already limited resources and capital. By giving the green light to six different locations across the country from the start, however, Vietnam was stretched thin, so to speak, to ensure construction of basic infrastructure for all the SEZs’ timely opening and operation. Because Vietnam relied mostly on foreign investment and investors, often private, to
establish the early SEZs, close partnership with private partners based on circumspect planning among central-local governments was particularly important for a successful launch of its SEZ development program (WB-FIAS, 2008). Moreover, while sound contests between regions can help stimulate and promote growth, too fierce a competition can be counterproductive without relevant regulations and oversight body in place. In the absence of an empowered coordinating agency or mechanism to oversee the entire process with a holistic rather than a provincial view, overheated competition between regions can lead to creation of too many similar zones beyond the market demand and consequently, insufficient resources to delay zone construction and development (Jeong and Zeng 2016, 91). Vietnam’s early zones, including many SEPZs, suffered from this problem along with high vacancies in the zones that had already been established (Kwon 1993).

Vietnam’s ambitious wholesale opening of a dozen special zones—either as SEPZs or IZs (Table 30)—across the entire country in a span of a few years since the introduction of its SEZ program can be contrasted with China’s selection of four SEZs along its southern coast first before widespread expansion nationwide. By choosing only strategic locations near flourishing commercial regions such as Hong Kong, Taiwan, and Macau, China’s early SEZs were able to take advantage of those markets both for market demand and as a dependable source of investment. Also, despite growing appeals by different regions within the country to establish SEZs, China authorized only Hainan and Shanghai as SEZs in 1988 and 1989, respectively, nearly a decade after successful operation of the first four SEZs. Instead of creating many additional SEZs too soon, China granted greater autonomy for economic policies and liberalization in 14 coastal
cities, which enabled them to provide tax incentives for FDI companies, though they were less generous than those offered in the SEZ.

**Bureaucratic Impediments With Overlapping Authority**

The delayed development of SEZs was also largely due to impediments in bureaucracy and regulatory procedures in Vietnam. The administrative process—from the initial stage of investment approval to the actual implementation once the project had been approved—required authorization from a total of eight central agencies upon review by provincial governments. A foreign investment project proposal in HCMC must typically pass through three layers of review for final authorization: 1) City People’s Committee and its Committee for Cooperation and Investment Evaluation, 2) local SCCI, and 3) Central SCCI in the nation’s capital Hanoi, which will either approve or reject the project based on a recommendation of the Central Project Evaluation Committee chaired by the Minister of Planning and Investment (Van Thuyet 1999, 780).

Besides multiple layers of administrative procedures, the overlapping authority of the local government—mainly at the provincial level—and the central government was problematic. Many of the criteria on which the central agency (Project Evaluation Committee) in Hanoi evaluated the proposed projects, had already undergone assessment by provincial governments, creating unnecessary paperwork, lags in decision making and consequently, delays in the implementation of projects (Van Thuyet 1999, 781).

Cumbersome procedures and controls with too many bodies involved in zone administration were detrimental to Vietnam’s SEZ development as administrative complexity and weak institutional mechanisms to coordinate and implement development policies were cited as greater impediments to foreign investment than the absence of a detailed legal framework (Luong et al. 1996; WB-FIAS 2008). Making long-term
investments in a country without coherent bureaucratic institutions and a predictable
environment of political rules and decisions was not very compelling (Evans 1995, 247).
A streamlined procedure without superimposed evaluations by various authorities would
not only reduce the burdensome lengthy administrative process for a more expedited SEZ
development but also enhance Vietnam’s overall business environment for investors.

*Inapt Institutions for Adequate Regional Autonomy, Incentives, and Enforcement*

A major component contributing to the performance of the zone program is the
autonomy and effectiveness of the agency in charge of regulating zone operations over
other government ministries (WB-FIAS 2008, 56). The shift from a command economy
suggests that the state’s previous monitoring instruments and enforcement mechanisms
are weakened or subjected to comprehensive change, which undermined many
government agencies at both central and provincial levels (Jerneck and Ha 1995, 163;

Although Vietnam is a centralized state, Jandl (2013) argues that provinces have
gained considerable autonomy to implement central regulations locally, so much so that
the provinces conducted business as if they were in a federal system of competing
economic units putting the interest of the province over that of the state, for a number of
reasons: to save face in front of their constituents or to maintain social peace, which is
essential for political promotion in Vietnam, as it is in China; but more pragmatically, for
larger amounts of rent to be gained, especially with land transfer fees as a major source of
legitimate and illicit funds for local governments and their officials (21, 234). Malesky
(2004) describes the asymmetric distribution of the benefits of reform that changed the
bargaining power among provinces in Vietnam in a cycle of pull, push, and reinforcement
forces. That is, investors are attracted to provinces with better infrastructure, human
capital, and supportive local government; investors enhance the fortunes of the local economy as well as the political clout of the local officials, who in turn engage in fence breaking to better business conditions further; as more money flows into central treasury with the surplus income from investment-rich provinces, the bargaining power shifts from the center to the successful provinces. This dynamic is reinforced as the economically successful provinces push the legal envelope by engaging in fence-breaking activities to become more business-friendly to attract bigger investments, which consequently further increases their leverage with the central government (Jandl 2013, 121).

Vietnam attempted to emulate China’s model in allowing local officials to experiment with entrepreneurialism, but it fast lost control over the process as those in Vietnam rapidly engaged in fence breaking beyond the boundaries set by the center. Unlike in China where its enforcement mechanism worked with a strong centralized system of political promotion, when Hanoi prohibited licensing of foreign investment by local officials, they did so regardless of the consequences (Jandl 2013, 62). In Vietnam, the more economically successful a province was, the more brazenly and frequently it engaged in fence breaking (Malesky 2004), for those economically successful provincial leaders were promoted to positions of power in the center precisely because of their success (i.e., as result of much fence breaking) in the province (Jandl 2013, 58). As the provincial leaders played at the margins of law with increasing entrepreneurialism and audacity, the center appeared to have given up on authority with its capacity to curb over-the-board fence breaking paralyzed (Jerneck and Ha 1995, 163; Jandl 2013, 61). Decentralization and deconcentration in the absence of an accompanying necessary
device for effective central enforcement often leads to frequent and brazen fence-breaking, debilitating a state’s overall governance. As the market-preserving federalism approach espouses, all interest groups must have incentives to fulfill their obligations and when the cost of defection becomes lower than the benefit of cooperation, defection becomes the norm (de Figueiredo and Weingast 2005).

*In Need of Multi-Level Framework For Effective Coordination Among State Agencies and Levels*

Vietnam traditionally has a strong governing party, which assures that regional interests cannot override national prerogatives entirely, but central careers have come to depend increasingly on local success in terms of paying into the state treasury as well as maintaining social peace and order. As such, even though each provincial Department of Planning and Investment is subordinated to both the line ministry (central government) as well as the governor, officials showcase a strong sense of rivalry toward competing provinces and seek ways that will bring investors to their province because both monetary gains and career advances hinge on the success of the province and not that of the national economy (Jandl 2013, 262-263).

With a dramatic shift toward market economy and intensifying competition between the provinces, Rodrik argues that as much as Vietnam needs a multi-sector economy, it needs a multi-level framework for decision-making based on interactions among various government agencies as well as between state levels, rather than one based on bureaucratic regulations and barriers (Rodrik 1992, 199; Jerneck 1995, 62). Indeed, such a scheme founded on inter-regional and intra-governmental interaction at multiple levels is required for effective governance in Vietnam with a sound regional
autonomy—not rampant freewheeling by eager provincial officials for political advances and extra pockets of rent-money—and an enforcement mechanism conducive to economic development for the provinces and the country as a whole. Designing an incentive system that stimulates its personnel to promote regional improvements that is also conducive to national development will be another important structure Vietnam must institutionalize to better mobilize provincial officials.
Chapter 5: Conclusion

This research began with questions arising from disparate economic performance of early SEZs in transitional economies at the initial phase of reform and market opening despite a shared legacy of command economy as socialist states, specifically in China, Russia, and Vietnam. Through a comparative analysis, I tested the hypothesis that “SEZs can serve as drivers of economic growth in the initial stages of a socialist country’s transition to a market-oriented-economy when a host country with political stability and strong institutional capacity grants adequate autonomy and incentives to local authorities for effective governance of SEZs in strategic locations.”

Findings indicate that in countries undergoing economic reform and transition, solid internal foundation and external infrastructures are critical pillars for SEZ creation and operations. Constrained in terms of available economic tools and institutions as well as flexibility as de jure socialist states, SEZ development amid an ongoing reform process depends heavily on the capacity of the state to arrange conditions and structures conducive to developmental objectives from the onset of SEZ programs.

Of the three countries, China had the most successful SEZ program on the back of strong state and institutional capacity with a cohesive infrastructural base—not only in terms of the constructs of facilities and preferential benefits but also an effective governance system with an adequate blend of regional autonomy that enabled local officials to become potent agents of economic growth for improved regional and national economic performance. Decentralized fiscal incentives and centralized meritocratic promotions were effectual in mobilizing China’s bureaucracy for concerted efforts toward SEZ development, producing an unprecedented growth in exports and trade,
which significantly contributed to a rapid increase in national GDP. Strategic designation of its first SEZs, particularly that of Shenzhen next to Hong Kong, to capitalize on the resources, capital, and market demand from the thriving commercial hub as well as the eager and extensive networks of the Chinese diaspora, were vital in jumpstarting China’s fledgling SEZs.

Russia’s early SEZ program, which first began in the former Soviet Union can be described as abortive at best, as turbulent political environment amid ongoing exhaustive reforms and then the dissolution of the state created adverse conditions to attract large investments for costly undertakings like SEZ development. Yet, even when some foreign investors had ventured to partake in Russia’s early SEZs such as those in Kaliningrad and Nakhodka, the absence of the necessary legal framework to protect businesses and the decrepit institutions to administer consistent zone policies had made SEZs in Russia precarious projects. The lack of a cohesive government and disintegrating bureaucracy—as officials had neither the incentives nor the will to uphold development of SEZs in their true sense—rendered the special zones as domestic tax havens or political instruments for regional politicians. Designating SEZs in remote regions with low social capital and investment attractiveness made their development even less feasible.

SEZs in Vietnam were a useful industrial policy tool that delivered on their main objectives of attracting FDI, increasing industrial production, enhancing exports, trade, and national GDP. On the back of an all-out government effort determined to pull itself from poverty and international isolation, Vietnam was successful in achieving its developmental goal in less than a decade since the launch of its reform and SEZ programs. While macroeconomic indices indicate notable progress, including growth in
its trade and GDP thanks to increasing contributions from its many and various zones, Vietnam’s SEZ program experienced poor infrastructure and over-supply problems due to inefficacy in governance and lack of central-regional government coordination. The absence of a cohesive institutional structure for a streamlined bureaucracy and adequate practice of regional autonomy resulted in excessive competition between the provinces and defection of many regional government officials engaging in far-reaching fence-breaking activities.

Adequate infrastructure with a functioning state agency that enables and promotes coherent economic activities by both domestic and international actors with trust in the political commitment and stability of the host country were quintessential for development of early SEZs in transitional economies. Failure or success of a zone was linked to the efficacy of institutional and incentive framework, whether it was strategically located both domestically and internationally, and the level of coordination between the central and local governments for SEZ development and management.

My research is significant because it provides a comparative perspective on the political economic dynamics of SEZ development in transitional economies, helps bring to light what attributes and practices constituted successful SEZ programs in delivering on the intended objective of economic development, if not a transformed state as a market economy. It would provide some useful bearings to guide future transitional economies aspiring economic development, yet not fully equipped with the tools and resources to make the bold leap. Findings from this research could also provide insights for developing countries in that they, too, are seeking venues for economic development, despite and because of their dearth of the needed means and assets to that end.
As aptly stated in the many World Bank reports, SEZs can be conduits for transition to a stable and open economy when done right. Yet, as every country has varying initial conditions and constraints, and even more so if undergoing an economic reform, there is no fixed formula for guaranteed success. The very notion in a “transition” economy implies that only those capable of engaging in an adaptive and evolutionary process best tailored to its specific conditions would have a chance at making a successful economic transformation.
Chapter 6: Implications

While there is no “one-size-fits-all” SEZ paradigm for transitional economies, findings from this research point to some common qualities beneficial to facilitating SEZ development in the early stages of reform and market opening. Besides having the institutional capacity and incentive framework in place from the onset to provide adequate autonomy for regional governments to effectively develop and manage SEZs designated in strategic locations, adaptability and connectedness to the changing circumstances and global environment appear to be integral traits leading to superior performance down the road.

Adaptability is especially important for economies undergoing transition, for this very process requires continuous balancing and adjustment to an entirely new system, comparable to a tectonic shift. Successful transitions require highly adaptive and adaptable institutions to address the challenges and changes in surrounding political economic dynamics. Notwithstanding differences in the ability and aptitude of the constituents of an institution, its adaptability hinges largely on the competency of the political leadership to steer the institutions in the right direction with appropriate and opportune calls befitting the unique conditions and circumstances facing the country. For instance, had the Chinese leadership not made the bold and timely decision to quickly correct itself following the 1985 retraction of preferential benefits to foreign investors due to domestic criticism and opposition to the SEZ policy, damage to China’s credibility would likely have caused lasting negative impact on its early SEZ performance.

Connectedness is perhaps a requisite condition for transitional economies aspiring to economic development via SEZs. Were China and Vietnam not connected to the
international market—and subsequently international organizations that facilitated systematic integration to the global economy—there would have been few avenues for exports and trade of the products manufactured at the SEZs, without which their growth and expansion would have been rather limited. However, albeit essential, simply being connected with the international market—especially under systematic support of international organizations such as the IMF—does not necessarily translate to a boost in exports and trade, as was the case in Russia, which had enjoyed much assistance and backing from the West and their institutes during the first decade of reform and transition.

As such, a preliminary and significant step for aspiring transitional economies would be to cultivate external networks for greater connectedness to the international market in tandem with institutional readiness and capacity to make necessary and timely adaptations to take full advantage of SEZs as a useful and potent platform for economic growth.

**Limitations**

Implications made in this research may not be relevant to SEZ development during a later phase of reform in transitional economies as such would likely require a different approach due to the maturing of the SEZs as well as a wider range of available economic tools and institutions with ongoing market opening and reform. For instance, China and Vietnam needed to modify and revise their early SEZ development and management approach as they became middle-income countries following a successful initial economic transition to a stable mixed economy.
This research is also limited in that its focus was within the purview of economic development enabled by SEZ programs in transitional states without considerations for potential political changes. As the three countries in this research have not undertaken political reform in earnest despite introduction of various market economy practices and traits, exploring what affects a country’s political reform following economic development would be a topic of useful research to illuminate different dynamics of political economy, which gave way to divergent paths to former Soviet states and many Eastern European countries.

**Issues for Further Research**

Because two of the three countries’ SEZ programs examined in this research were geographically located in, and largely influenced by the emerging economies of East Asia, SEZ programs outside the region would merit further research to investigate regional differences as well as the general utility of SEZs for economic growth in developing countries. Future studies in specialized entrepôt or service oriented SEZs at strategic locations in smaller developing countries beyond the periphery of China would also be useful with the growing importance of the service sector compared with the previous emphasis placed on cultivation of the manufacturing industry for developing countries in the past century.
Appendix: Economic Performance at a Glance

Figure 34. China’s GDP growth (%), 1978-1988
Data Source: World Bank (https://www.macrotrends.net/countries/CHN/china/gdp-gross-domestic-product)

Figure 35. China’s GDP, GDP per capita (US $), 1978-88
Data Source: World Bank (https://www.macrotrends.net/countries/CHN/china/gdp-gross-domestic-product)
Figure 36. China’s exports (US $, % of GDP), 1978-1988
Data Source: World Bank (https://www.macrotrends.net/countries/CHN/china/gdp-gross-domestic-product)

Figure 37. Russia’s GDP growth (%), 1990-2000
Figure 38. Russia’s GDP, GDP per capita (US $), 1990-2000

Figure 39. Russia’s exports (US $, % of GDP), 1990-2000
Figure 40. Vietnam’s GDP growth, 1986-1996

Figure 41. Vietnam’s GDP, per capita (US $), 1986-96
Figure 42. Vietnam’s exports (US $, % of GDP), 1986-1996

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