Protocol Design for Opportunity Zones

We sit down with Bob Haywood, the "policy entrepreneur" who may have done more than any living person to pull humanity out of poverty. This is our second installment.

EDITOR
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This is the second installment of an extended interview with Robert Haywood, who, arguably, has done more to lift more people out of poverty than any other living person. That's because, *for decades, Haywood has quietly advised on the development of Opportunity Zones around the world. From special economic zones (SEZs) to mega-cities like Shenzen, Haywood has been an effective force for change. If you're keen first to read Part One "The Invisible Hand Behind a Hundred City-States," please feel free. Otherwise, you can jump right in to this and read the first part later.*

Max Borders: You have been dispatched to war zones, not just developing countries. What can you say about institution building amid violence?

Bob Haywood: One of my more challenging projects was in 2008 becoming the Senior Economic Advisor to the British Commander in Iraq during part of Operation Iraqi Freedom (OIF) (Every time I use that acronym, I recall the original name for the operation was Operation Iraqi Liberation until one bright officer at the Pentagon realized the acronym would be OIL, which might have unfortunate public relation consequence. Not all of my responsibilities had to do with zones.

In violent environments, institution building can be hard, but violence is an indication of failed institutions, so it may also be necessary. I have always held that politics should be the art of settling differences without violence. Politics can only achieve that if there are functioning, creditable institutions.

It is also important to recognize that zones are only one of many tools that can be applied to help to create greater stability. I originally went to Iraq to help write a report on how zones might be used to create" islands of stability" within the conflict zone. I was somewhat naïve. We ended up proposing 12 different zone types.

I ought to mention that most countries have multiple zone programs. There can be zones for tourism, light industry, high technology, free ports, and even single factory zones where special incentives are given by industry rather than geography. Each of these programs may have a different set of laws and regulations.

Zones can be used for a wide variety of purposes, so suggesting 12 different zone types was not unusual. It's important to ask three questions. 1) What's the goal? 2) Is the goal being achieved? And 3) How can we eliminate any impediments to growth for the country or for some defined zone in the country?

One of the proposals in Iraq was to increase land productivity. It turned out that about 80 percent of the farmland was "dead land". This was land where for a variety of reasons there were hundreds of known owners each owning a fractional percent of a large piece of land. Unfortunately, the addresses of more than half the owners were not known. Without a majority of owners, it was not possible to use the land as collateral for a loan, to sign leases and collect rents, or to sell the land. Nobody had the interest to invest in the land since the owners did not receive lease income and the tenants had no enforceable tenure. I proposed creating a land reform zone in which 5 percent of the owners could petition the government to form a land corporation covering the entire parcel. After a supervised process of notifying all the tenants who could be found, title to the land would be vested in the corporation and shares would be issued to individuals in proportion to their ownership interest. Shares that belong to the owners who couldn't be found would be retained by the corporation and be available to be issued if another owner was found in the future. The existing shareholders could elect officers who could exercise corporate ownership rights for the entire parcel. There were some other issues managed in the proposal but in the end, the land was resurrected as an operating economic entity. Profits could be distributed to shareholders, and dividends from the undistributed shares could be invested in the property. Both tenants and owners had the incentive to invest in the property, and the company had the capital to do so.

This was proposed as a zone because some local authorities were not interested in land reform or believed land reform was always violent. In this case, the owners were petitioning for the reform not getting expropriated, so the prospect of violence was greatly diminished. In addition, having regained their ownership rights, the owners had the incentive to support the government, and the program respected the integrity had the incentive to support the government, and the program respected the integrity of the traditional land registry. By creating a land reform zone in a limited area where the local governments and residents were receptive to the idea, necessary security could be maintained even in a war zone. The program could be expanded when other areas saw success with the first zone.

A land reform zone is very different from what is generally considered a SEZ. It did not offer tax holidays. What it offered was an ability for landowners to get effective possession of their assets, a significant economic benefit. It demonstrates the great flexibility one has in zones to solve significant impediments to prosperity. Importantly, it converts a dysfunctional land tenure system into a modern legal structure without alienating the landowners.

Another proposal was the creation of an integrated regional rehabilitation hospital, college, medical industry, and entertainment zone in one of Saddam Hussein's old palaces. After lengthy wars, there were a great number of disabled veterans who needed care and reintegration into Iraqi society. Thousands of doctors, nurses, and therapists needed to be trained, and prosthetic devices needed to be manufactured. As part of this Zone, the development of an entertainment zone could provide jobs during rehabilitation. A patient with a leg amputation might run a water taxi carrying customers between restaurants and other attractions located around the palace's large lakes.

Most of my job focused on forecasting future problems and mitigating their impact. In many cases, the existing institutions had to be used, but with some effort, their performance and credibility could be enhanced. That served the purpose of the coalition and strengthened support for the Iraqi government. Surprisingly, I felt there were some advantages in conflict zones. In the turmoil, some Iraqi institutions were more receptive to change and more open to new ideas.

Max Borders: Dubai is a fascinating example of what I refer to as "institutional gene splicing." What pitfalls did they avoid and what sort of law did they import to ensure success?

success?

Bob Haywood: The development of Dubai is a fascinating story. I was first there in 1977 before the port of Jebel Ali opened in 1979 and eight years before the opening of the Jebel Ali Free Zone. It was a poor, small dusty town with about 7 percent of its current population and unreliable infrastructure.

Dubai is a part of the United Arab Emirates which is not an old state. It did not come together until 1972. At the time Abu Dhabi, the largest and richest of the seven Emirates that made up the UAE, promised to build a new capital city on the Abu Dhabi-Dubai border. Dubai, being the commercial hub of the UAE determined that it could maintain its position only by building a port on its side of the border to serve the new capital city. It borrowed money from Kuwait and dug a large hole in the desert and let it fill with water. There was no natural feature that contributed to the location of the port. The port was ready by 1979, but by then Abu Dhabi had decided not to build the new city and the costly port suddenly had no reason to exist. It was only 24 miles to the center of Dubai, but with the dirt roads of the time it was well over an hour's drive. Dubai was in trouble.

Shaikh Mohammed, son of the ruler of Dubai, suggested that they needed to make it a free zone, but Dubai had no taxes and no tariffs. From the traditional view of free zones at the time all Dubai was already a free zone. But it was not getting the levels of investment that would dig it out of its debt for the port. The obstacle was the requirement for all businesses to have majority UAE ownership. We suggested the concept of the Freezone Corporation. It allowed foreign investors to have 100 percent ownership if the investment was located within the Freezone. It was the first place in the Middle East to allow a foreign firm to establish a wholly-owned subsidiary. The Freezone opened in 1985 with less than two dozen investors. It now has over 9,000 investors and contributes almost 1/3 of Dubai's total gross domestic product. The output of the Jebel Ali Free Zone is approximately equal to that of Delaware.

I tell you that story because the start of free zone development in Dubai was not some brilliant grand strategy, it was an act of desperation that proved very successful. Dubai learned to appreciate the flexibility zones provided and how to use their sovereign powers creatively. They created zones for media production, humanitarian organizations, and other specific purposes with focused incentives. Humanitarian organizations for example could form wholly-owned subsidiaries in which they could pre-position supplies needed to respond to natural disasters and other emergencies.

An interesting development was Dubai's International Financial Center Zone. From about 1976 until 2000, Bahrain was the primary international banking center in the Middle East. It took over from Beirut because of the growing civil war in Lebanon. Unwisely, during the Gulf War, Bahrain implemented currency restrictions to slow the outflow of international banking assets. This was completely unacceptable to the international banking community who continued to shrink their operations after the war. Dubai took notice and recognized that one thing the Arabs had was money, but the Arab world did not have a large international financial center that catered to various types of financial companies. They observed that all major financial centers operated under some form of British common law. Islamic law was out of step with modern banking and insurance practices. Using their powers of sovereignty, they created an area of their country with its own civil and commercial laws including trusts that were based on British common law. In the event of ambiguities, British common law would prevail. Litigants had a right of appeal to the English Privy Council. They brought in retired judges from England, Australia, India, and other former British colonies that gave the courts credibility. Financial companies felt comfortable with this arrangement. Over the next 20 years, Dubai become one of the world's major financial centers.

While seemingly extraordinarily innovative, it actually followed the precedent of Singapore, which upon independence in 1966, designated the English Privy Council in London as its court of final appeal giving Singapore's courts immediate respectability. The Rulers in the United Arab Emirates were innovative in applying the concept to only a portion of their territory rather than the entire territory.

What the zones have done for Dubai is let the rulers protect the native Emiratis closed domestic markets, while becoming an international crossroad. The Emiratis make up less than 10 percent of the current population but still control over half of the domestic corporations.

Max Borders: I've heard you say in the past that there is no rulebook. Instead, I've heard you refer to the three Ps—"Predictable," "Productive," and "Profitable." What do you mean?

Bob Haywood: For most of my career, I have been working with countries or territories on the development of zones. I have taken the country's point of view. I firmly believe that the reason some countries are poor is not because of past colonial status, poor location, or that they have been exploited. Instead, for a variety of reasons, they have chosen not to be part of the global economy. Normally it's to protect the power of the local elite, and/or because the traditional culture is afraid of change. It's only when the countries decide that a traditional, stagnant, rural economy is not enough for them that they become interested in attracting foreign investors.

When called for advice, the first question I always asked is: "Why do you want a zone?"

The answer is generally that they're not getting the type of development or the pace of development that they would like. The next question is: "Why not?"

In each country, the types of development desired and the reasons they are falling short are different. Therefore, the zone needs to be designed to eliminate the specific reasons the country is not meeting its goals.

I consider it poor and inadequate planning if a country tries to borrow zone legislation from another country. I used to use the World Bank's "Doing Business" report as a guide to help determine what policies needed to be addressed, but the World Bank no longer produces that report as of September 2021, but the data is still accessible. For a less intensive look, the Heritage Institute/Wall Street Journal "Index of Economic Freedom" can be a useful guide. It ranks 12 policy areas covering the rule of law, government size, regulatory efficiency, and market openness. It provides a way for political leaders and businessmen to know the policies they need to address so their zones can become a more competitive investment environment. If a country is not prepared to commit to a zone program that encompasses enough policies to move the zone environment up to a "mostly free" or "upper moderately free" ranking, I will not recommend that they proceed with a zone program.

I gave the example above for Dubai where the problem was the inability of foreigners to establish a wholly-owned business. The "right to establish" is a fundamental business freedom, so the creation of the Freezone Corporation improved the economic freedom in Dubai's free zones over the domestic economy.

50 years ago, the problems in what became the Asian Tigers were relatively simple to solve. In places like Singapore, Hong Kong, South Korea, and Taiwan the legal system was fairly sound, utilities fairly reliable, labor markets were functional, personal security was fairly high, and the governments generally worked. In terms of the "Index of Economic Freedom," there were problems with "Trade Freedom", "Monetary Freedom" and "Tax Burden." These were fairly simple to solve in a zone by allowing duty-free entry of equipment and raw material, a guarantee of currency conversion, and a tax holiday. Because industrial land was sometimes scarce, and to control smuggling, these policies were put into effect in fenced industrial estates.

The problems in most of the developing and least developed countries today are much more pervasive. That is why modern zones are more complicated. For example, the index of economic freedom is a score from 0 to 100. On "Judicial Effectiveness" Honduras scores 29 (Repressed) and Costa Rica scores 76.6 (Mostly Free). That's why the ZEDE program in Honduras included a zone-based judicial system. That is not what I recommended in Costa Rica.

40 years ago, and even today many countries focus zones on manufacturing jobs. But

in the early 80s, I noticed that nearly 80 percent of developed countries' economies were in the service sector. I began to ask the question of clients: "Why does the country wish to eliminate 4 out of 5 potential investors?" The World Economic Processing Zone Association (WEPZA), which I was director of at the time, was originally founded by UNIDO as the World Export Processing Zones Association, and we changed the name to the World Economic Processing Zones Association to reflect the potential and now growing importance of the service sector in modern zones.

Taiwan is an excellent example of a country that kept its zone programs dynamic. I use the plural here intentionally because most countries have more than one zone program. Like in many countries, Taiwan's zones started as labor-intensive processing for export, but their incentive structures, regulation, infrastructure, and even their name changed to attract higher valued industries. The old Kaohsiung Export Processing Zone is now the Kaohsiung Port Technology Industrial Park. Taiwan maintained the zones as the leading edge of their development transferring the older, labor-intensive industries into the domestic economy so they could continue to use their zones to attract higher value-added companies. It's important to note that moving the old industries out should never be made by force but by additional legislation that makes an alternative location more attractive to a lower value-added industry. Now some of the zones are home to some of the most capital-intensive, high-technology, logistics centers in the world.

Honduras, unfortunately, is an example of a country that did not adapt its zone programs since we drafted its private sector zone rules in the mid-80s. They started with labor-intensive low-end garment manufacturing and 40 years later they were still predominantly in low-end garment manufacturing. The export processing zones program has been called the most successful economic development program in Honduran history, but the program has been largely stagnant for 30 years. The introduction of Zones of Economic Development and Employment (ZEDE) is an excellent attempt to upgrade their industry attraction programs to the 21st century. It is Hondurans exercising their full rights of sovereignty to create a world-class is Hondurans exercising their full rights of sovereignty to create a world-class investment environment within their country. It is a way of continuing the success of their earlier free zone program reflecting changes in international trade due to new WTO rules, twenty-first-century technologies, and the needs of more sophisticated investors. Unfortunately, the current government doesn't understand this and prefers to limit its sovereign powers. In anticipation of such a problem, I drafted a 10-year "stand still" because close clause, which allows investors to continue to operate by the rules under which they invested for 10 years should the underlying law change. It was a unique way to deal with often dramatic policy changes when a new leader is elected.

Now to the second part of your question. What investors look for are predictable, productive, and profitable locations, in that order. Predictable is first because the cost of not getting a product or subassembly to market can be enormous, not only in financial terms but in terms of the corporate reputation. A predictable environment includes consistent government action. Customs clearance for example doesn't take somewhere between one week and 20 weeks, there's not an ongoing violent conflict, and business regulations are not changed haphazardly. The lack of predictability is why countries like Haiti, Sudan, Somalia, Lebanon, and Papua New Guinea which have some of the lowest labor rates in the world, do not have much investment.

Some of these issues can be dealt with through proper zone legislation. For example, creating a special zone-based customs service to handle zone imports and exports may reduce or eliminate variable clearance times. In the Honduran legislation in 1986, I created a provision that goods imported and exported from a zone would be transported directly to the zone for customs clearance or to the port for export in a sealed container accompanied by a bill of lading and that "nobody could require any other documentation". This stopped the practice of police stopping trucks and soliciting bribes by requiring importers to produce spurious or unavailable documents. This provision would have been unnecessary in most countries and is a good example of why there is no "model" zone legislation that can be applied to any country.

A productive environment is one where there's an appropriate supply of labor, the country doesn't have a political tradition of national strikes, there is reasonable turnover, the infrastructure is reasonably reliable, and there are legal alternatives to any unreliable national utilities. There is appropriate and secure executive housing, and international transportation is readily available and convenient for both goods and people.

And lastly, one gets to profitability, which ironically is where most people focus but is irrelevant if the first two criteria are not met. This is when tax incentives, labor rates, shipping costs, etc. become a factor. It's also the point where good zone management becomes a major factor.

Max Borders: You have a reputation for being quiet and not taking any credit for all this. Why has it been important to keep your ego out of the way?

Bob Haywood: One of the Board members of our not-for-profit organization Community Matters Institute calls me a 'policy entrepreneur,' and as a policy entrepreneur it's about new solutions to create zones that capitalize on the unique characteristics of place.

In order to be successful, zones need local champions. All SEZs must operate within the country that creates them, and they need to be supported from within the country. If they're seen as entities of foreign origin, they're going to have considerably more opposition. I don't live in most of the countries I have worked in. I don't have investments there, and I have no long-term commitments. I can't follow closely the politics in 170+ countries. Therefore, I can't be the champion of every country's zone programs. The programs are more sustainable and beneficial for the host countries and investors if local businessmen and political leaders get credit for them.

Max Borders: Honduras's ZEDEs (special economic zones) are under threat. Yet zones like Prospera are already making tremendous strides. What does your crystal ball say about the future of ZEDEs?

Bob Haywood: I've already mentioned that it is unfortunate that the current government is attempting to dismantle one of the most progressive and viable zone programs in the Western Hemisphere. I spent a considerable amount of time helping to create a strong legal environment for the ZEDE program. Fortunately, in the ZEDE law I helped draft, I added a clause that gives investors a 10-year standstill. That is a clause that allows them to operate enjoying the rules under which they invested for 10 years if the government ever changed the laws to their detriment. There is also a clause that makes the government responsible for the damage it inflicts on investors through binding arbitration. Hopefully, in the next 10 years, there will be a change in government and the law can be revived. That of course is not a certainty.

I mentioned earlier the importance of predictability in a country attracting investment. The repeal of the ZEDE law has destroyed Honduras's reputation as a reasonably predictable country. It will be difficult for the country to recover from such a misstep. A good reputation can be easily lost and difficult to regain. The repeal of the ZEDE law will diminish all types of investments in Honduras, not just investments in the ZEDEs. This will be detrimental to all Hondurans.

Honduras lacks quality investments, not investment capital. The ZEDEs are an attempt to mobilize the existing investment capital through the creation of investment opportunities.

The problems with Prospera also emphasize the importance of SEZ developments having local champions and people with years of involvement in the local communities. I tried to emphasize that there were enough resources, including wealthy families, within Honduras to create ZEDEs, and that involving them in the creation would avoid some of the political liabilities. All zones must operate within the countries that create them. By the way, I disagree with the often-made assertion that zones are outside of a country's territory. They remain inside the country subject to different chapters of its custom codes, tax codes, and as in the case of ZEDEs their judicial system.

A country's sovereignty is exercising the full extent of its sovereign rights when it bifurcates its territory and creates different rules of governance and perhaps different administrative structures for different parts of the country. America's founding fathers did this when they created the District of Columbia, a special zone to house the administration of the federal government not subject to the jurisdiction of any state. It is by design governed only by the federal government, and should not have a state government, even if the state is the District, intervening. Indeed, the United States can be looked at as being composed of around 80 Zones. Each state, the District of Columbia, and the various territories such as the Marshall Islands, Puerto Rico, etc., and, as Michael Strong—a long time advocate of zones—has finally found out, even Indian reservations are zones with different judicial systems, police forces, economic regulations, welfare systems, and other aspects of governance.

Bifurcating sovereignty is actually not a new concept. It goes back hundreds of and even thousands of years. The fundamental question is the degree to which power is devolved to the subunit. In the typical Export Processing Zone, it can be fairly limited. In the Chinese SEZs, it was much broader. They were given the governmental powers of a province and then some extra powers. For example, almost from the beginning, the SEZs in China could grant entry visas, resident visas, and work permits to foreigners without needing to get approval from the Foreign Ministry. The system worked fine. Now traditional provinces are authorized to give travelers who land at certain airline hubs a 72-hour entry visa to visit the city.

Some traditional governments would protest that this is a loss of national sovereignty. That's nonsense. It is a decentralization of government. It is well within the traditional sovereign authority to determine how centralized or decentralized the government is going to be.

Max Borders: What advice would you give the next generation in attempting to set up Opportunity Zones amid difficult circumstances and predatory powers?

Bob Haywood: Keep trying!

I firmly believe that there is not a naturally habitable place on earth where a properly designed and managed zone cannot lift people from poverty to wealth. Consider Mauritius, one of the most isolated small island nations in the world. It has elevated itself from one of the poorest countries in Africa to one of the richest and is considered one of the developing world's most successful democracies. It began using zones for development in 1970 and by 1973 it had attracted 14,000 new jobs. It advertised that it was located an equal distance from Tokyo and London. It is, but it is also further away from either city, than these cities are from each other. In fact, it's about as far from Tokyo and London as any habitable place in the Eastern hemisphere! Originally, wholly dependent on sugar exports, it is now ranked as the 26 (out of 176) freest economy in the world, and has thriving manufacturing, tourism, and financial services sectors. If Mauritius can do it, any place can.

Be careful to have resources on your team who are well connected to the local economy and government and also somebody who is knowledgeable about what's going on at multilateral organizations. They are increasingly becoming impediments to trade and business.

As a current example, the OECD is trying to implement a 15 percent minimum corporate tax. If a multinational corporation based in OECD country doesn't pay the 15 percent in a developing country or in a zone it will be taxed by the home country of the multinational. I believe this tax starts in January 2024. However, there are ways to give investors the economic advantages of a tax holiday, benefit the host country for the zone or the zone itself, and still not have to pay the 15 percent to their home country governments.

Secondly, the WTO clearly forbids certain types of export incentives in its Agreement on Subsidies and Countervailing Measures, but there are also ways to minimize the impact of this. The agreement only applies to goods. It does not apply to services. Also, independent taxing authorities within a country can have different tax rates without it being considered a subsidy. Thus, it's not a subsidy if Texas has a lower tax rate than California, but a zone can also be an independent taxing authority if it is properly established.

Rules such as these have led many "experts" to project the end of SEZs. This is not the first time such projections have been made. The projections have been wrong before, and they will be wrong again.

Max Borders: What question would you have asked (that I didn't)–and would you answer it?

Bob Haywood: You are probably too polite to ask about personal failures, but I think there are a lot of lessons to be learned from failures. At our Institute, we are fond of reminding clients that success is often a result of failure. If you understand why an initiative failed, you can better design the next zone or economic intervention. I remember an early project that was specifically focused on job creation. We help develop an environment that attracted 20,000 jobs in five years in a community of originally 5,000 people. This led to squalid housing, inadequate schooling, high rates of crime, poor healthcare, traffic congestion, and almost all the other ills that can befall a boomtown. The community didn't have the resources, or the infrastructure, to handle such rapid growth. What had been a pleasant small town became a very stressful place to live for generations. I considered it my most successful failure as we achieved the project goals but completely failed the community. It was a good lesson.

After that project, I took a much more holistic view of the projects we worked on. True development involves more than just economics. If you're trying to develop export-focused jobs, then you need to consider that there are 3 to 5 other jobs in the community that are needed to support those export jobs. Grocers, doctors, teachers, policemen, homebuilders, other retailers, farmers, bakers, maintenance workers, linemen, taxi drivers, and all the other workers that make up society. In addition, all these people need recreational and sports facilities, entertainment, and public meeting areas. Too many of the early zones focused only on industrial buildings and industrial jobs. It has been a very beneficial and helpful trend that new SEZs have focused more on community development.

Zone Developers and investors focusing on community development may feel more intrusive to a country's political leadership. I now always try to read the country's national plans or vision statements before proposing a new SEZ project. Most countries spend a great deal of effort in drafting 5-, 10-, or 15-year goals. Aligning a new SEZ project with previously agreed-upon national goals and Country Plans can be an outstanding way to create more political stability. Developers must ensure that the zones continue to be seen in the Zones of Opportunity for investors and the host country.

Max Borders: Thank you, Bob. It was truly a pleasure.

Return to Part One: "The Invisible Hand Behind A Hundred City-States" You can also contact Bob Haywood via bhaywood - AT - communitymattersinstitute.org

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1 Comment

Chris Bateman Writes Stranger Worlds Jul 26

Bravo! Even as an economics-sceptic, I can see the immense merit in these spirited attempts to hack legislatures on a local scale. Obviously a perfect fit to Underthrow, but also a brilliant reminder that the strongest global visions are strengthened by avoiding the lazy assumptions of imperial economics.

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