A RAND NOTE

A Comparison of Hainan with the Other Special Economic Zones

Charles Robert Roll, Jr.

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Supported by the
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PREFACE

This is one of a series of four RAND Notes prepared for the National Research Center for Science and Technology for Development (NRCSTD) and the government of Hainan province, in accord with RAND's memorandum of agreement with NRCSTD and China's Ministry of Foreign Economic Relations and Trade. The other three Notes are Donald Putnam Henry, *Restructuring Hainan's Fiscal System,* N-3293-NRCSTD; Charles Wolf, Jr., *Restructuring Hainan's International Trade and Finance: Currency, Foreign Exchange and Trade*, N-3292-NRCSTD; and K. C. Yeh, *The Lessons of East Asian Development and Alternative Strategies for Hainan,* N-3294-NRCSTD. The RAND work is intended to assist NRCSTD and the Hainan government in planning the province's development along market-oriented lines.

SUMMARY

This Note discusses Hainan province and her sister Special Economic Zones (SEZs)—Shenzhen, Zhuhai, Shantou, and Xiamen—from the point of view of strategic development planning. China has been pursuing a mixed strategy for economic development: import substitution combined with export-led development. The SEZs are a main element of the export-oriented leg of the strategy. This Note examines some of the differences among the SEZs, including levels of economic development, comparative advantages, and the regulatory environments the central government has provided for the SEZs.

The comparison reveals that Hainan is at a less mature stage of development than are the other SEZs. Hainan has a higher share of its output in agriculture, and its participation in foreign trade is modest. Hainan has the lowest per-capita gross output of the SEZs. Nevertheless, Hainan's infrastructure development appears sound, including recent investments in electric power generation and water supply.

Hainan is the most southern part of China. Its location and climate give it a comparative advantage in tropical crops, aquaculture, and tourism. Despite some surface differences, the regulatory environment Hainan faces is similar to the environment the central government provides to the other SEZs. Probably the biggest difference is Hainan's status as a province. In addition, the market-oriented rules and regulations are slightly more generous with regard to land use (70-year instead of 50-year leases), and there seem to be more exemptions with regard to local taxes. However, most of the foreign trade and foreign exchange rules are similar to those of the other SEZs and are all designed to provide a market-like environment for economic development led by exports. Here and in the companion Notes, we provide considerable discussion of additional market-oriented policy initiatives, including currency convertibility, monetary and price reforms, and reform of foreign trade restrictions. Another important policy initiative should be the implementation of social-insurance programs (health, unemployment insurance, etc.) that are attached to the individual or the household, rather than the enterprise (the curent practice). This will facilitate labor mobility and allow factors of production to flow to their most productive uses.

The paper also considers whether there are sound arguments for maintaining different regulatory policies or systems in the different SEZs. The paper concludes that there do not appear to be strong analytic reasons to have different policies in different SEZs. Quite the contrary, efficiency and cost considerations argue just the opposite. Further, having a single set of policies and rules makes it less likely that unproductive flows of capital or labor will

take place to take advantage of different rules in different places over time. In addition, it is more efficient to present one set of rules to the international community rather than several. However, the suggestion that the SEZs all have similar economic or regulatory frameworks does not imply that the SEZs need to be centrally managed. Rather, the argument is that each SEZ should operate within the same policy guidelines, but should be free to take advantage of whatever its comparative advantages were. This logic would also extend to central government decisions regarding, say, infrastructure investment in the various SEZs. Where would such investments be most cost effective? In other words, the policies and procedures that all the SEZs follow should be consistent with a market orientation, and this means nothing more than allowing resources to flow to their most productive uses.

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I. INTRODUCTION

This paper compares Hainan Province with the other Special Economic Zones (SEZs) in China. These zones are all located on the southeastern coast of China. Moving along a map of the coast from north to south, the zones are Xiamen, Shantou, Shenzhen and Zhuhai. Hainan Province is a large island located off the southern coast of China in the South China Sea opposite Vietnam. It is the southernmost portion of the People's Republic. The purpose of the comparison is to analyze Hainan's development prospects in the context of these other SEZs so that Hainan's development can be facilitated.

I begin this paper with a general comparison of the five SEZs, noting similarities, differences, and comparative advantages from a development perspective alone. This discussion leads to a consideration of the regulatory environment SEZs face and of the differences between them. A natural extension of this question concerns the arguments for (or against) establishing different policies for the different SEZs. Essentially, this paper suggests that it is very difficult to find arguments that can support different policies, rules, procedures, or regulations for Hainan or any of the other SEZs. From a cost and efficiency point of view, the arguments are all in favor of a similar regulatory environment, so that resource allocation decisions can be undertaken on a sound basis. This suggestion is particularly important for China's external market, the international sector. This does not mean that different infrastructure investments or other projects cannot be undertaken differently in the different SEZs. Nor does it mean that Hainan, for example, could not operate its own central bank or manage its own customs union. It does mean, however, that the policy framework and guidelines should be similar for each of the SEZs.

II. HAINAN AND THE OTHER SEZs

This section compares Hainan province with the other SEZs to provide a background for discussions of development strategies for Hainan.

DESCRIPTION

Hainan's location and other basic geographic conditions are substantially different from the other SEZs. Many of the most significant differences relate to size and level of development. Hainan is a large island, of almost 34,000 km^2. The other SEZs are all very small in comparison, as shown in Table 1.

The next largest SEZ, Shantou, although large relative to the other SEZs, is not even one-third the size of Hainan. Hainan, on the other hand, has the smallest population density of the SEZs, while Shantou clearly has the largest.

Hainan is the southernmost part of China, located in the South China sea off the coast of Vietnam. Its climate is subtropical, verging on the tropical. This has some genuine implications for its comparative advantage in various agricultural products including, for example, rubber.[1] The other SEZs are all located along the southeastern coast of China, so all are in close proximity to the ocean and cheap water transport. Xiamen is the most northerly, located in Fukien Province. The other three are all located in Guangdong Province, with two situated very near Hong Kong. Indeed, Shenzhen abuts Hong Kong, with convenient road and rail transport available to both Hong Kong and the rest of the mainland. Zhuhai is a little to the south and has similarly convenient transportation access to Macao as

Table 1

Land Area and Population Density of SEZs

SEZ	Land Area (km^2)	Population, 1987 (Thousands)	Population Density (Persons/km^2)
Shenzhen	2021	556	275
Zhuhai	1266	442	349
Shantou	10346	9401	909
Xiamen	1516	1061	700
Hainan	33920	6151	181

SOURCE: NRCSTD Materials 1 and 2.

[1] Zhang Huimin, 1988, p. 4.

well as to the rest of the mainland. Shantou is located north of Hong Kong, about half the distance to Xiamen. Thus, Shenzhen enjoys a clear advantage with regard to economic development because its access to Hong Kong facilitates commerce between them. Zhuhai also has some potential locational advantage because of its proximity to Macao.[2]

Stages of Development

The SEZs all have different degrees of industrialization, and levels of economic development, which are also related to other differences between and among the SEZs. Convenient yardsticks to examine today's differences are the composition of output and the level of per-capita output. As can be seen from the data in Table 2, Hainan is by far the least industrialized of all the SEZs.

Hainan's industrial output share is very low (the complement is agriculture's share). Although one can argue about the problems of using the concept of gross output value instead of gross national product or gross domestic product, nevertheless, the order of magnitude displayed by these data suggests that Hainan has not reached anything like the level of industrialization found in the other SEZs.

The level of development in Hainan is lower than in the other SEZs, as indicated by the level of output on a per-capita basis shown in Table 3. Shenzhen's per capita output is almost 20 times that of Hainan. The data in Table 4 show how the gross value of industrial output is distributed between heavy and light industry. This table shows that the composition of industrial output value varies less among the regions than does the share of output attributed to industry. Thus, the low level of per-capita output in Hainan is largely explained by the share of output produced by the agricultural sector in Hainan.

Table 2

Share of Gross Value of Industrial Output in the Total Gross Value of Output, 1987 (Percent)

Shenzhen	97
Zhuhai	84
Shantou	76
Xiamen	92
Hainan	42

SOURCE: NRCSTD Material 1.

[2] Tim William, 1984, pp. 37–39.

Table 3

Per-Capita Gross Output Value, 1988

Shenzhen	1960
Zhuhai	760
Shantou	124
Xiamen	598
Hainan	100

SOURCE: NRCSTD Material 1.

Table 4

Share of Light Industry in Gross Industrial Output Value, 1988 (Percent)

Shenzhen	76
Zhuhai	81
Shantou	79
Xiamen	70
Hainan	62

SOURCE: NRCSTD Material 1, pp. 14–15.

Finally, relative volumes of foreign trade provide another indicator of level of development. For an economy that is intended to be export-led, Hainan's volume of total imports plus exports is very low compared to the volumes for other economic zones, as shown in Table 5. These data include trade with the mainland, but the same differences in magnitude obtain for exports entering foreign trade. For example, Shenzhen exported over $1.84 billion in 1988. Hainan, on the other hand, exported just under $115 million.[3]

Table 5

Volume of Imports and Exports, 1988 (in Millions of American Dollars)

Shenzhen	$6661
Zhuhai	2229
Shantou	1443
Xiamen	1365
Hainan	493

SOURCE: NRCSTD Material 1, pp. 102–103.

[3] NRCSTD Material 1, p. 104.

It is important to reemphasize a related point: all the other SEZs are parts of provinces, and very city-like in nature, while Hainan is a large, self-contained island with almost the land area of Taiwan. Hainan's comparative advantage relative to the other SEZs seems to lie in its relative state of underdevelopment, its location, and its natural endowments. This is not as contradictory as it seems, as the real issue in defining comparative advantage is that of determining advantage in the relative costs of factors of production. The relative disparities in level of development between Hainan and the other SEZs suggest that there is sufficient disguised unemployment, or employment in very low productivity endeavors, to provide Hainan with a significant comparative advantage in labor supply.

NATURAL COMPARATIVE ADVANTAGES

Hainan's natural endowment and location provide it with distinct advantages.[4] First, it is well known that Hainan has an abundance of tropical crops. These include rubber trees, coconut, coffee, and tea. Also, many tropical fruits, such as mangoes and bananas, are easily grown. In addition, unlike the bulk of China, Hainan has many forested areas.

Second, Hainan's location in the South China Sea and its attractive environmental conditions make it a natural place to harvest crops from the sea, including such cultivated crops as prawns, shrimp, or oysters. This access to the sea and proximity to world shipping routes would also seem to lead to favorable development prospects. The development of the harbor facilities at Yang Pu will enable Hainan to take advantage of its location.

Third, but certainly related to the first two, there is Hainan's potential for tourism. Hainan has many miles of attractive beaches available for development. Indeed, the international airport development planned for Sanya is intended to speed up this development alternative by making the area more accessible to international travellers.

Fourth, Hainan's mineral deposits, both on- and offshore, are expected to yield development opportunities and growth. The province has abundant reserves of iron ore and also has cobalt and zinc. Titanium reserves are also reported to be abundant. Other reserves, largely unexploited, are said to include oil shale, aluminum, uranium, and manganese. In addition, oil and natural gas appear to present rich opportunities for development, particularly offshore.

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[4] This discussion is based on observations and discussions in Hainan and Gillespie and Ruwart, 1989; Yang Xiaobing, 1988a and b; Cheng, 1989; Kirby, 1988; and Zhang Huiman, 1988.

Labor force considerations present both a strength and a weakness for Hainan's development. On the one hand, the surplus labor available among the disguised unemployment in agriculture will keep labor costs down for the foreseeable future. On the other hand, shortages of skilled and educated labor have been repeatedly reported by various observers, and the output of the schools of higher learning on Hainan cannot keep pace with demand. Hainan has been recruiting candidates from other parts of China, but finding talented recruits has been a major chore. According to one assessment of Hainan's educational system,

> Hainan has four schools of higher learning. However, they cannot meet the needs of the latest development, which explains why Hainan Province must recruit talent from other parts of China. Candidates for positions in Hainan numbered 20,000 by the end of last January [1988]; another 100,000 submitted written applications to work in the province. About 84 percent of them had college education. The Hainan Talent Exchange Centre is using computers to process information on the applicants.[5]

Seen this way, Hainan's low labor costs are a mixed blessing. Importing technology that requires a large component of skilled and/or educated labor could produce severe strains. If handled correctly, the flow from the rest of China could be quite positive. However, if mismatches occur or the flows exceed demands, problems will arise. In addition, rapid labor force growth raises the problem of increased housing and other infrastructure needs, including water, electricity, and transportation. Given this, Hainan's comparative advantage would appear to lie with industrial development that does not immediately stress its educational output and takes advantage of its low-cost labor pool.

POLITICAL AND REGULATORY ENVIRONMENT

The political and regulatory differences among the SEZs must be considered within their historical context. Most important, Hainan was not the first of the SEZs. The first four SEZs were established (really built in a more or less continuous fashion) from 1979 to 1982 because of policy determinations that China should open up to the outside world.[6] Although Hainan was not in this original group, Guangdong province, Hainan's "home province," began at the end of 1981 to allow the island to have many of the privileges that the SEZs enjoyed in relation to the outside world. Three of the original SEZs, plus Hainan as a quasi-

[5] Yang Xiaobing, 1988a, p. 19

[6] Ji Chongwei, 1984, p. 14. Also see Edmund Lee's manuscript (unpublished) for a discussion of the origins of the SEZs.

SEZ, were all administrative units of Guangdong province, with only Xiamen being a unit of Fukien province. Thus, fully 80 percent of the SEZ-like economic units were spawned by one province, and Hainan shares a sibling relationship with all but one. The significance of this is simply that this part of China has had a long history of commercial and industrial contacts outside China, and much of the overseas Chinese population comes from southeastern China. It is, therefore, very natural to see this part of China relied upon to develop the SEZs. In many respects such organizations reflected existing practices.

On April 13, 1988, Hainan changed status when the 7th National People's Congress declared Hainan a province and also officially named Hainan an SEZ. This obviously changed Hainan's relationship with the central government. Now, its channels of communication and authority go directly to Beijing and do not need to pass through the provincial lines of the Guangdong government. Nevertheless, its past administrative history would suggest that many of the responsible government personnel in Hainan would still have close ties and open lines of communication to Guangdong. In this regard, Hainan is probably more similar to the other SEZs than is Xiamen. Although beyond the scope of this paper to explore fully, it is important to note that China is not simply divided into the SEZs and the rest of China. For example, in 1984 fourteen coastal cities were authorized to open economic development zones that could provide certain incentives for foreign investment, although not on such a broad scale as the SEZs were permitted.[7]

A regulatory framework established by the central government provides the official context within which the SEZs are to operate and is intended to support the underlying purposes the SEZs are to serve. In addition to explicit regulations, the SEZs must also operate within the regulatory environment of China's overall administration and organization.

ORIGINS OF THE SEZs

There are explanations of why the SEZs were set up and are still sustained as a policy initiative in China. A recent article in *Economic Research* suggests that the SEZs are designed to carry out one part of a mixed development strategy of "import substitution and export-orientation."[8] According to the article, China should rely on interior localities to carry out a policy of import substitution, while SEZs should carry out an export-led economic development strategy. Indeed, the article summarizes the goals of the mixed strategy as follows:

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[7] Ji Chongwei, p. 15.

[8] Zhu Tiezhen, 1989, pp. 33–39.

> Firmly and irrevocably promoting the special zones to carry out economic reform and the opening up to the outside world and further enlivening these zones not only can promote the interior's economic development but also can have a major impact on the stability and prosperity of the economies of Hong Kong and Macao, on the absorption of investments from Hong Kong, Macao and Taiwan, on the implementation of the "one country two systems" policy, and on Taiwan's return to the fold of the motherland.[9]

This statement mixes both the political and the economic development goals. Our focus in this paper is only on the economic development side.

Interestingly, earlier policy statements regarding the SEZs are entirely consistent with a mixed development strategy, although some of these policy pronouncements may have a different emphasis on different elements of the development strategy. For example, a 1984 article about SEZs observed that

> The zones are not intended just as a way of providing employment, gaining foreign exchange and promoting local prosperity. A major purpose is dominated by production for export, but a supplementary factor is the manufacture of advanced products in demand for the domestic market.[10]

This not only notes the export-led orientation, but also calls attention to how the SEZs can assist in the import substitution goal more often assigned to the interior provinces and regions. In this vein too, a related comparison with other developing countries is generally raised with regard to export "processing zones." As one article has noted,

> While "processing zones" in other countries engage only in processing and manufacturing for export, China's zones such as Shenzhen and Xiamen are experiencing all-around growth in industry, agriculture, tourism, science and technology, and culture. The zones can become open doors for economic and technical cooperation . . . and bridges . . . [to] . . . the interior regions of China.[11]

This strategy is that China will provide the labor and land, and the foreign firms will provide the capital and technology. This will lead to labor training and growth in China's skilled labor force.

To carry out this export-led orientation for development, it is not surprising that the areas chosen to lead the way all had a "great many overseas connections and a tradition of

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[9] Zhu Tiezhen, op. cit.
[10] Ji Chongwei, p. 14.
[11] Ji Chongwei, pp. 14–15.

interaction with the outside world."[12] More important, these areas, particularly those close to Hong Kong, already had many of the vestiges of an export orientation. In addition to the general level of development of the SEZs, another measure of how well this export orientation has been put into practice is the degree to which foreign-owned enterprises operate in the SEZs. Table 6 below shows the level of output produced by "Three" Foreign Capital Enterprises. In the strictest of terms, "Three" refers to one of three types of organizational relationships: a joint venture in which Chinese and foreign capital are invested; a cooperative venture between Chinese and foreigners; and a wholly foreign-owned enterprise producing solely for export. Generally, however, this term is used to refer to firms that have some degree of foreign ownership or control. Sometimes it is used to denote enterprises that may qualify for a degree of tax-exempt status that is used as an incentive to attract foreign capital investment. As can be seen, Hainan's output level is extraordinarily low compared to the other SEZs. Although this level reflects Hainan's degree of maturity as an SEZ, the output is still very low when one considers that Hainan had some SEZ-like privileges in its relationships with the outside world as early as 1981.

The export-oriented development strategy for the SEZs required much more than simply choosing locations close to Hong Kong. It also required a set of rules and regulations that would serve as incentives for foreign firms to invest in the SEZs. This essentially meant changing to a more market-oriented regulatory structure and initiating other incentives (like tax incentives) to lure foreign capital. Major market-oriented and incentive areas have included land-use policy, facilitation of persons entering and leaving the zones, taxation, and foreign trade policy. In addition, major infrastructure projects, such as electricity generation, have been funded by the central government.

Table 6

"Three" Foreign Capital Enterprises Gross Output Value (Million Yuan)

	1988	1987
Shenzhen	6286	3366
Zhuhai	771	261
Shantou	755	443
Xiamen	1687	754
Hainan	46	15

SOURCE: NRCSTD Material 1, p. 17.

[12] Ji Chongwei, p. 14. Louise do Rosario, 1989, p. 28, offers a very interesting discussion of Guangdong from the same perspective.

LAND USE REGULATIONS

The principal land-use policy initiative has been to encourage construction capital investment by guaranteeing long-term leases (fifty years or more). In addition, various exemptions from land taxes have been provided if reclaimed land is used for development. Finally, if foreign capital is used, or advanced technology development is involved, exemption from land-use taxes may also be permitted.

TAXATION

Aside from the land-use tax, the principal tax-related incentive mechanism has been to exempt enterprise profits from local income taxes and to have tax holidays from the SEZ-wide profits tax.

> On December 13, 1981, the National People's Congress passed the "Foreign Enterprise Tax Law." According to this law, all foreign enterprises in China have to pay progressive income taxes. The rates of progressive taxes are set from 20% to 40%. Foreign enterprises also have to pay local taxes amounting to 10% of their total profits. SEZs, however, have their own regime. For enterprises in SEZs the government has set an income tax rate of 15% for both commercial and industrial earnings.[13]

SEZs have generally permitted an exemption of local income tax, and there have been cases of income tax holidays (of several years) from the general 15 percent profit tax for projects deemed worthy of special consideration.

FOREIGN ECONOMIC RELATIONS

Foreign trade policy has been a key area in which preferential policies have been promulgated to attract foreign investment, particularly with respect to currency convertibility, repatriation of profits, other general foreign exchange considerations, and tariff or quota restrictions.

In theory quotas or tariffs are not levied on materials or equipment imported for use solely in export production. Also, and again in theory, export taxes are not required. When Hainan was set up as a province, the initial condition was that

> no quotas will be set for export products from Hainan. Products manufactured using raw materials or semi-finished products from the mainland with more than 20 percent added value will be treated as products from Hainan.[14]

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[13] Lee, p. 12.

[14] Yang Xiaobing, p. 4.

In practice, all the SEZs have been subject to various kinds of export restrictions. The best example of this is the proposed shrimp factory in Hainan that was recently denied export quotas because its production would reduce the earnings of other Chinese shrimp producers. The Ministry of Foreign Economic Relations and Trade (MOFERT) retains the ability to grant export quotas and, in effect, allocate profits to less efficient producers in other parts of China. Interventions of this type make investments in the SEZs less attractive.

Foreign-exchange considerations are very important to the working of a market. Stability and convertibility provide confidence to investors and thus encourage long-run commitments of investment funds. China has provided several mechanisms to work toward these ends, although they are still much less than what would be desired from a market perspective. One important initiative that relates to currency convertibility can be found in the 40 or so foreign-exchange swap markets set up in the major cities in China. With the greatest maturity (and number) to be found in the SEZs, Hainan's Haikou foreign-exchange swap market being the largest and most developed. In most of these swap markets a firm can exchange People's Currency for Hong Kong or U.S. dollars. In Hainan, it is also asserted that even a private individual can exchange currency at the Haikou market, although it was also stated that there were some restrictions on this activity. The rates around the country during our visit were fairly similar (around 6 renminbi per U.S. dollar), although some restrictions are placed on trading in swap markets in other provinces. It is widely held that these rates reflect general supply and demand conditions, not central government intervention.

Retention of earned foreign exchange has been another area of preferential treatment for the SEZs. In most of China, foreign exchange has to be turned over to MOFERT. Therefore, profits earned in foreign exchange have lost their convertibility. Starting in January 1990, however, "the State Council gradually eliminated the preferential policies whereby the SEZ retained 100 percent of the foreign exchange, and implemented the 'inverse 2:8 ratio' for goods exported from a zone."[15] In other words, articles of less than 20 percent value added in the SEZ using raw materials and/or semi-finished products from the mainland would be subject to export quotas.[16] Apparently this rule was less rigorously applied in the past, although certainly heralded as an innovation to encourage production within the SEZ with links forged to the mainland. Now, production mixes can't meet the

[15] Ta Kung Pao, "SEZ Foreign Trade Enterprises in a Situation from Which They Cannot Advance or Retreat," November 13, 1989, as translated in Joint Publications Research Service (JPRS) CAR-90-012, February 15, 1990, p. 56.

[16] See Yang Xiaobing, 1988b, p. 4, for a description of this export control.

recently enforced standard, and various subterfuges are used to avoid the rule and thus keep foreign exchange earned in the transactions.

POLICY DIFFERENCES

The available data do not permit a complete examination of the policy differences between the SEZs and China, although this Note has already discussed some of them. The Appendix provides data that highlight differences in the policies and procedures applying to each of the SEZs to promote economic development. Notable among these differences are Hainan's slightly more liberal land-use policy (70-year instead of 50-year leases); the ability of both Hainan and Shenzhen to issue multiple entry visas to foreigners, although Hainan can provide a visa at the time of entry; and the varying availability of tax exemptions.

Since Hainan is a province, it should be easier to carry out the export-led development strategy. In practice, unfortunately, this has not always been the case. One example is the denial of permission to increase shrimp exports. Another example was the Hainan government's recent cancellation of a nongovernmental trade fair under heavy pressure from Beijing. Chinese sources said that the fair, due to start on February 28, was cancelled due to pressure from MOFERT, "which regarded it as improper for private organizers to run a nongovernmental trade fair that would consequently disturb the country's overall planning."[17] Thus, despite Hainan's ability to pursue an export-led orientation independently, MOFERT was nevertheless able to thwart an activity that should, at least, have increased interest in doing business in Hainan.

These problems do not seem to be restricted to Hainan. For example,

> the paring away of Guangdong's export privileges [began] in 1989. In the area of export regulation, about 160 export products are now subject throughout the nation to regulation through export permits, which is slightly more than in 1988, but Guangdong has lost the authority to export half of the products which it had been selling abroad.[18]

Guangdong has been a leader of orientation to the foreign community, with many special economic regions other than the four it gave birth to. As a consequence, it is not surprising that restrictions on Hainan are paralleled by restrictions on Guangdong. Other articles mention retrenchment in Zhuhai and Shenzhen.

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[17] Hong Kong Standard, "Hainan Trade Fair Cancellation Exposes Friction," March 9, 1990, p. 12 as translated in JPRS CHI-90-047, March 9, 1990, p. 24.

[18] Reported in "Wide Angle," September 16, 1989, and translated in JPRS CAR-90-006, January 25, 1990.

Other reported differences among the SEZs listed in the Appendix are various aspects of foreign trade policy. However, most of these claimed differences are minor with regard to economic regulation, and similar policies exist in the other SEZs. It is also noteworthy that other parts of China have various kinds of favorable rules and regulations regarding trade and development. Central banking, credit creation, interest-rate policy, and monetary controls are embedded in issues of foreign-exchange controls, foreign investment, and foreign trade policy, but no mention is made of differences between SEZs. In fact, the monetary relations of each SEZ are currently managed by the central bank. Credit creation is up to the center and the ministries. There appears to be no significant deviation from this among the SEZs.

Finally, as we have seen, the stability intended by these rules is, in fact, undermined whenever central government policies shift. Indeed, the fragile nature of the market-oriented rules is clear from the most recent entrenchment. It seems that on this basis as well there is very little difference among the SEZs. Thus, there are minor differences among the SEZs in an economic and regulatory environment that appears to exhibit a degree of instability because of central government intervention. However, the SEZs exhibit substantially more market-oriented features than do other localities on the mainland, in spite of the economic liberalization along the coast and in a few major municipalities.

III. COMPARATIVE POLICIES AND PERFORMANCE

In Sec. II, we examined what little comparative data we have on Hainan and the other SEZs. This examination was taken from the perspective of what differs among the SEZs, and how these differences might affect the goal of export-led economic development. This is the key to strategic development planning for Hainan. The theme we have taken, and which is discussed elsewhere in the companion papers to this paper, is focused on what policies to pursue to facilitate transition to a market-oriented economy whose leading sector is intended to be exports. In carrying out its own development plan, Shenzhen appears to have been very successful, perhaps aided by its proximity to Hong Kong by its initial level of development. However, the recent retrenchment is affecting Shenzhen as well. It demonstrates the embryonic and fragile market orientation of the SEZs in the face of central government policy changes.

In the limited examination we have been able to conduct, there do not appear to be large, observable differences among the SEZs with regard to market-oriented policies, although some differences do exist. Tax incentives, free trade, and relaxation of foreign-exchange restrictions all seem to promote growth. Singularly missing from the comparison, however, is evidence that the central government is willing to put market mechanisms in place that will endure, buttressed by a lasting legal structure and a regulatory framework. In addition, some market-oriented policies that seem important for establishing more competitive markets seem to be missing. This section will address that issue and will also address whether or not there are any compelling analytic reasons for SEZs to have different market-oriented policies or to be treated differently.

Easy (free) mobility of factors of production is a critical part of the implementation of market-oriented reforms, and the implementation of a social-security system that encourages such mobility is sorely needed within the SEZs. Most strikingly missing from our comparisons and the available data are significant rules and regulations about labor market operations and reform, particularly the implementation of a social-security system. The central government implemented fundamental changes to the social-security system during the early 1950s.[1] All social-security (or social-insurance) programs—health, unemployment, welfare, and retirement programs—were decentralized to the enterprise and local government level. This meant that the existence of the local enterprise (run by local

[1] See Deborah Davis, 1988, for a discussion of this history.

government or through the relevant ministry) was vital to the maintenance of health, welfare, and retirement benefits. Indeed, this made it virtually impossible for enterprises to go out of business. In addition, such arrangements make it difficult for labor to leave one employer for another without concern over loss of benefits. Because of this lack of central funding, the central government does not have the revenue to put in place a system of incentives that will encourage labor mobility and allow firms to go out of business. A first priority for economic reform is to create an actuarially sound social-insurance system funded by contributions from workers and employers that is vested in the worker and his family. Without this kind of reform, the vitally needed factor mobility required for market functioning will be severely hampered. The Hainan government is studying this issue. We would urge high priority be given to construction and implementation of a social-insurance system along lines consistent with a market orientation.

Lack of a social-insurance system appears to be the only serious void in the policy concerns we have seen evidenced. The remaining question was whether or not Hainan should have different policies or be treated differently than the other SEZs. Or, turning the question around, would significant benefits be attached to a fragmented set of SEZs? A definitive answer to this question, no matter how posed, is beyond the scope of this paper. Nevertheless, it seems useful to examine the question systematically, so as to suggest the costs and benefits under various alternative views of the world. It would also seem prudent to consider how the benefits and costs might be allocated to the three actors: Hainan, the SEZs and, of course, China itself.

What would a fragmented SEZ system look like? A polar case might have each SEZ governed by a different regulatory framework. These rules could change based on local initiatives approved by the central government. What are the presumed advantages of such a system? First, the central government would maintain a good deal of control in such a system. It could play one SEZ off against the other (much as export quotas are doled out today). The center can isolate economic experiments gone awry, or can start bolder experiments noting that damage can be limited to only one SEZ. Thus, from the center's point of view, a fragmented system could pose less risk.

From the standpoint of each SEZ, a fragmented system would provide the incentive to innovate, particularly because of the competition with the other SEZs. But it would also provide incentives to compete for preferential policies that favor only the SEZ proposing the policy, or a hoped-for coalition of other SEZs. However, this type of nonmarket competition would seem to be costly and artificial. Where policies act to change costs from factor costs, and sustain such differences, then resources are used improperly. For example, if Hainan

were to argue for and receive a tax exemption on imports immediately reexported to the mainland, the profits created by this regulation would quickly divert resources from productive endeavors to this artificially profitable endeavor. Therefore, rather than real innovation, fragmentation could lead to innovation in bureaucratic skills in the search for profits. On the other hand, if all SEZs have no freedom to evaluate alternative uses of resources or develop imaginative programs to acquaint foreigners of capital investment alternatives, then the real incentives for innovation sponsored by real competition are given up. On balance, a fragmented system is a symptom of a conservative central government.

Various scenarios of fragmentation or unification inevitably lead to different costs and benefits, but the appropriate model for comparison is one that allocates resources efficiently. In this model, prices reflect opportunity costs. Consequently, different, fragmented regulatory schemes that create nonmarket oriented prices do not use scarce resources efficiently. One SEZ may gain ephemerally, but China as a whole is less well off. In the broadest sense, this also means that some administrative mechanisms or organizations might be the same across all SEZs, so as to capture economies of scale or to pool risks. This does not mean that each SEZ cannot strive independently within its framework to excel, to innovate, to experiment, etc. Quite the contrary, that kind of competition should be fostered. The policy goal is simply to seek to achieve market-oriented resource allocations with the regulatory framework that governs the SEZs.

Implementation of a social-insurance system may, for example, be an instance where the SEZs should all be part of a common system. There appear to be no cost, efficiency, or management reasons for the SEZs not have to the same system. Also, the argument for a unified program may be substantial, particularly in the start-up phases, because of the opportunity for risk pooling. It is unlikely, for example, that a natural disaster would strike all the SEZs at once. Also, since the SEZs are at different stages of development, it is unlikely the business cycle would affect all SEZs similarly, although it is undeniable that a severe economic downturn in Hong Kong would have various serious effects on all the SEZs.

Currency reform, including full convertibility, central banking, and control of the money supply, is discussed at length in the companion notes. It is clear from our comparisons that all the SEZs have roughly the same market-oriented rules in place. Our recommendation for Hainan is to move to a freely convertible currency of some sort. It is also clear that there is no reason for the SEZs to have separate currencies. Central banking can easily control the rate of growth of the money supply and control credit across the SEZs. If each SEZ were to have its own independent central bank, it could lead to counterproductive situations where interest rate "price wars" were instituted to entice investment by

subsidizing the cost of capital rather than letting the natural comparative advantages lead to investment behavior. The costs of maintaining five different currencies with different rates of exchange would be excessive. This is not to argue that monetary policy should not be used as an appropriate hedge to business cycle conditions, but it should not substitute for the natural mobility of resources out of one industry and into another. The current banking system is run centrally out of Beijing. There is no reason a special unit cannot be set up to manage a single convertible currency for the five SEZs. Or, each SEZ could even have its own central bank, but each bank would have to operate within the same policy guidelines set down by the center. The argument for a common currency would still be valid.

Different rules for the various SEZs would almost inevitably lead to increases in the costs of administration and enforcement. Different rules always lead imaginative people to think of ways to take advantage of the system. From this point of view, and in keeping with the notion of a single convertible currency, the five SEZs could be conveniently included in a single customs union. This would enable goods in various stages of production to move freely among the SEZs. It would simplify the accounting system and make clear the burden that export controls place on the entire system. Current marketing arrangements would clearly provide those SEZs at lower stages of development with new opportunities and new markets. Of course, a similar result would obtain if each SEZ had its own customs union, so long as each customs union was open to all the others. Indeed, in this case there may be a good argument for separate customs unions simply from an enforcement point of view: It may be easier to control access to the five different SEZs locally. In particular, it could be argued that Hainan, because it is an island, requires different enforcement mechanisms.

There are several possible arguments for treating the SEZs all differently with regard to resource allocation rules. For example, it is often argued that special attention should be paid to the hardships associated with economic change. In general, if social-insurance programs are in place, dislocations attendant on moving to a market orientation will be minimized, and the transition can be smoother. Another argument relates to enforcement. It is sometimes argued that it is easier to maintain rules in smaller administrative units. No generalization is necessary here, since ease of enforcement would obviously depend on the circumstances. Lastly, an argument is made for various degrees of protection from competition to enable "infant industries" to grow. It is also hard to see how this is relevant to the SEZs. Their principal goal is not import substitution, but export-led economic development. The SEZs must be able to compete in the international market. Protection will just foster inefficiency.

IV. CONCLUSIONS

Hainan's level of development is different from, and at an earlier stage than, those of the other SEZs. Hainan has a larger share of its output in agriculture. Its per-capita output is lower, as is its involvement in foreign trade. Although not explicitly considered in the discussion, infrastructure building is on the right path, but the other SEZs seem to have that in hand as well. Hainan is much bigger than the other SEZs and, indeed, has become a province. In addition, Hainan would appear to have a comparative advantage in production of tropical crops and in tourism.

However, Hainan's principal comparative advantages derive from its stage of development. Significant amounts of land are available. Most important, the supply of relatively unskilled labor is very large relative to current demand and implies relatively low labor costs. Together, low-cost labor and low-cost land would yield very attractive cost incentives for foreign capital to invest in suitable productive endeavors in Hainan.

The general survey of the market-oriented rules and regulations set into practice in Hainan suggests that there is not much difference between Hainan and the other SEZs, although minor differences do exist. One could perhaps argue that more differentiation exists in terms largely related to approval of particular projects, such as airport construction in Sanya, or port construction. These are not policies related to the conduct of business, but simply central government approval of particular projects. The biggest differences may arise during implementation of the policies, particularly when intervention occurs within the normal conduct of business with the ministries and other organizations of the central government. Indeed, one of the most important strategic lessons to put into practice is allow the SEZs to implement the regulations without interference. This inspires business confidence. It puts into practice rules that everyone can rely on.

Several elements of policy implementation appear to be needed to ensure an export-led economic development strategy. As discussed in the companion Notes, issues of currency convertibility and relaxation of restrictions on foreign trade appear the most important to pursue. In addition, to ensure labor and other factor mobility (like capital), social-insurance programs need to be established that are attached to the individual laborer or household and do not rely on enterprise survival. This will enhance labor mobility and ensure that capital can move to the most productive sectors. This will also help to ease any dislocations caused by relying on a market-oriented development strategy.

In this context of policy comparisons, there does not appear to be a reason for treating one of the SEZs any different from the other SEZs from the standpoint of the regulatory framework. For example, if Shenzhen is granted permission to develop a social-security system or establish its own convertible currency, all SEZs should have the same authority, and that authority should be administered centrally. There appear to be no strong analytic arguments for not having the same regulations and market mechanisms in all the SEZs. This reduces the administrative burden and the opportunity to take advantage of local differences in the rules. It also has the advantage of presenting the same set of rules to the international community. This means that it is easier for the community that might invest in China to understand the regulatory environment in all the SEZs. In addition, one might argue that if all SEZs have the same set of rules, the central government may be less likely to change them. Still further, a central authority administering social programs or running the central bank is under the discipline that comes from dealing with a set of unified SEZs rather than dealing with each one at a time. It should therefore be more difficult to tilt policies in favor of one or the other.

In general, pursuing an export-led development strategy requires the kind of stable market-oriented situation that exists in Hong Kong. Implementing a policy of "one country–two systems" seems to argue strongly for treating the SEZs as one leg of the mixed development strategy of import substitution and export-led development. Proliferation of different regulatory environments that change over time is very counterproductive. Such conclusions do mean, however, that Hainan could not, for example, receive central government aid for projects intended to enhance Hainan's economic infrastructure, such as electric power generation plants. Such differential investments make eminent sense in a market context. The same would be true for the operation of separate customs unions by the five SEZs. This may make practical sense so long as the market-oriented rules are the same for all five SEZs. There is no doubt that Hainan will benefit from the implementation of the set of market-oriented reforms that have been discussed in this paper and its companions. China will benefit further if these reforms are widespread and real, rather than merely a changing set of economic regulations that encourages nonproductive economic activity and reduces foreign investors' confidence in their ability to make sound investments in Hainan or the other SEZs.

Appendix
COMPARATIVE SPECIAL ECONOMIC ZONE DATA

The data reported in Tables A.1 through A.5 were provided by officials of the NRCSTD in response to a variety of questions regarding differences among the SEZ, particularly with respect to rules and regulations concerning the conduct of economic activity. A "+" denotes the policy exists. The data were ably translated by K. C. Yeh.

Table A.1

Land-Use Policy in the SEZs

		Hainan	Shenzhen	Zhuhai	Shantou	Xiamen
A.	Transfer of right to use land with compensation, or use as collateral for loan.	+	+	+	+	+
B.	Maximum number of years of lease	70	50	50	50	50
C.	"Three Foreign Capital" enterprises exempt from land use tax and tax on occupation of arable land. (Tax Holiday)	+	5 yrs.	3 yrs.	–	–
D.	Domestic enterprises exempt from current urban land use tax if over 70 percent of output is exported.	+	–	5 yrs.	–	–
E.	Projects in energy, communications, water supply, culture and education are exempt from urban land use tax.	+	*	–	–	–
F.	Exempt from urban land use tax if new industrial development site is built on new (reclaimed) land.	+	–	–	–	–
G.	Exempt from land use fee if land is reclaimed from the sea.	–	10 yrs.	15 yrs.	–	–
H.	Projects involving advanced technology development are exempt from land use tax.	10 yrs.	+	+	–	–
I.	Open land markets exist.	+	–	–	–	–

*Only exempt for educational and cultural projects.

Table A.2

Organization and Power Structure in the SEZs

		Hainan	Shenzhen	Zhuhai	Shantou	Xiamen
A.	"Small Government, Big Society, in organizational structure.	+	–	–	–	–
B.	Hainan can adopt various good international practices in economic cooperation.	+	–	–	–	–
C.	Hainan has legislative power equivalent to provincial level power.	+	+	–	–	–
D.	The unit has the power to approve foreign capital used in exploring and developing resources.	+	–	–	–	–

Table A.3

Control of Entry and Exit in the SEZs

		Hainan	Shenzhen	Zhuhai	Shantou	Xiamen
A.	Persons entering can apply for an entry visa at the time of entry.	+	–	–	–	–
B.	The government unit can issue multiple entry visas for foreigners.	+	+	–	–	–

Table A.4

Aspects of Taxation in the SEZs

		Hainan	Shenzhen	Zhuhai	Shantou	Xiamen
A.	Construction is tax exempt.	+	–	–	–	–
B.	Tax on products imported for sale in the SEZ reduced by one-half.	+	–	–	–	–
C.	Income tax holiday for projects involving basic construction and agricultural development that will be in operation for 15 years or more. Income tax is exempt beginning from the first profitable year.	–	–	–	–	–
D.	Exempt from local income tax.	+	+	5 yrs.	–	+

Table A.5

Aspects of Foreign Trade Policy in the SEZs

		Hainan	Shenzhen	Zhuhai	Shantou	Xiamen
A.	Foreign enterprises with 25 percent or more owned by foreign investors have the right to engage in import or export.	+	–	–	–	–
B.	The province (or unit) can itself satisfy the export quota for local products.	+	–	–	–	–
C.	The province (or unit) accounts for its own profit and loss in foreign trade, retaining all foreign exchange earnings.	+	–	–	–	–
D.	The province (or unit) approves the imports of products for use in Hainan.	+	–	–	–	–
E.	Foreign exchange earned from foreign trade can be kept in current foreign exchange.	+	–	–	–	–
F.	Organizations and individuals can buy or exchange foreign currencies freely through the foreign exchange adjustment market.	+	–	–	–	–
G.	Foreign businesses that make their profits in foreign exchange can freely remit their profits out of the province (or unit) without having to pay income tax on the remittance.	+	–	–	–	–

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