

# Charter Cities and Reform Zones

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**I. Reform**

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## Rules and Reform

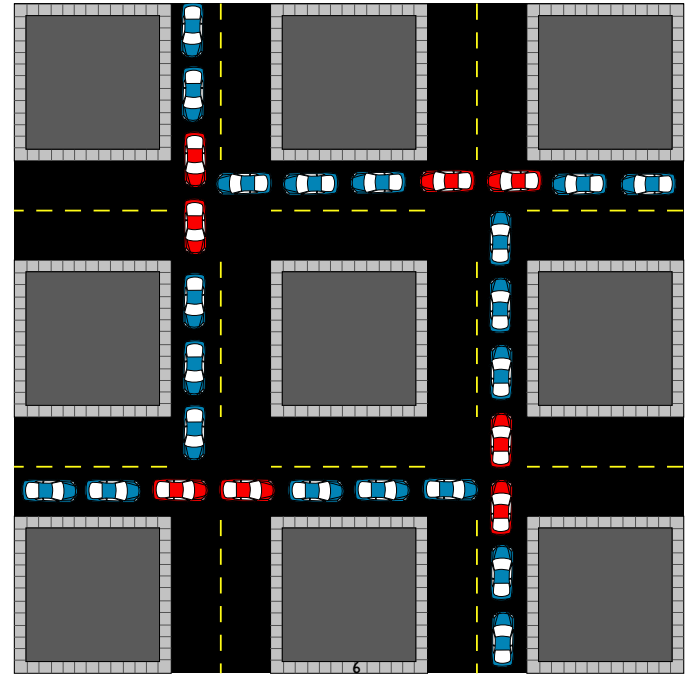
- Every society needs rules
- Sometimes an old rule no longer works and a new rule would be better
- A reform is a change in the rules that improves life for most people

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# A Small Reform

- With few cars, a good rule at an intersection was: “Stop when the traffic light is red”
- With lots of cars, this rule can lead to gridlock

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# A Small Reform

- With lots of traffic, a new rule works better: “Enter the intersection only if you can leave before the light turns red”
- Passing a new law is easy
- In reform, the hard part is enforcing the new rule

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# Usually, Reform is Not Deregulation

- Most reforms do not involve replacing a rule with no rule
- Instead, they replace an outdated rule with a new, better rule
- The government must be able to enforce the new rule

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# Winners and Losers

- Under a true reform, most people gain
  - They are “winners”
- But some people may still be hurt
  - They are “losers”

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# Traffic Example

- With the new rule, most people are winners because they get home sooner
- But there are still some losers
- They get a ticket and have to pay a fine when they get stuck in the intersection
- If losers can stop enforcement of the new rule, gridlock returns

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# A True Reform Creates Value

- If the total gain for all the winners is greater than the loss for the losers, the new rule creates value
- A true reform will create value in this sense

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# Opposition

- People caught breaking the rules always oppose enforcement
- Rule breakers always claim that the rules are not legitimate

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# Growth Strategy

- For a developing economy to grow, its leaders must create value by implementing true reforms
- To implement reform, they must find a way to overcome opposition so they can
  - adopt better rules
  - and enforce them

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# A Reform Zone Avoids Coercion

- People can decide if they want to live or work in a zone with new rules
- This lets some people try new rules without forcing them on others

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# A Reform Zone Builds Legitimacy

- The people who move to the zone give legitimacy to the new rules
- Legitimacy is the key to successful enforcement and to the rule of law

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# Types of Zone

- A. Reform versus Concession Zone
- B. Geographic versus Virtual Zone
- C. Big versus Small Zone
- D. With or Without Imports of Government Services

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## A. Reform Versus Concession Zone

- Some zones with new rules do not create value for the entire society
- They create a few winners and many losers
- These “concession” zones give special favors to these few winners

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## Example of a Concession Zone

- Suppose that the firms or people who work in a zone do not have to pay any taxes
- They are winners
- All the other taxpayers of the nation are the losers

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## Test for Reform

- About a policy proposed for a zone, ask:
  - Would it be good to have this policy last forever?
  - Would it be good if this policy spreads to the entire country?
- If either answer is no, this policy is a concession, not a reform

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## Applying the Test

- A temporary tax “holiday” is a concession, not a reform
- Free trade was a reform in Mauritius that started in a zone and did spread to the entire country
- Direct foreign investment was allowed first in a reform zone in Shenzhen then spread to all of China

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## B. Geographic versus Virtual Zone

- A Geographic Zone has boundaries we can mark on the ground
- A Virtual Zone offers a different set of rules that anyone anywhere can adopt

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## Virtual Zone in Mauritius

- Firms located anywhere could say they were in the “Free Trade Zone”
- If they said they were in the new zone, they had to follow different rules:
  - They had free access to imports
  - But all output had to be exported

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## C. Big versus Small

- A geographic zone can be as small as an industrial park - a few hectares
- Or big enough for a new city - e.g. 100 sq km for 1 million people
- See next image for examples of areas with 100 sq km

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## D. Imported Government Services

- The Chinese government imported services from the FAA (Federal Aviation Administration) of the United States
- Before the Beijing Olympics, it asked the FAA to rewrite its aviation safety rules

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## Other Imported Government Services

- Mauritius imported the services provided by the supreme court of Britain
- Solomon Islands has imported police and judicial services from Australia

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## A Charter City

A charter city is a

- large,
- geographic,
- reform zone

A charter city might, or might not, import some government services

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# Example

- Shenzhen was a successful charter city
- Geographic, large
  - 400 sq km for urban area
- Reform zone - allowed foreign investment and demonstrated the market model
- It did not rely on imported government services

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“In the beginning opinions were divided about the reform and the open policy ... It was my idea to discourage contention, so as to have more time for action. Once disputes begin, they complicate matters and waste a lot of time. As a result, nothing is accomplished.”

(Deng Xiaoping, 1992).

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First, two examples of reforms that might require a charter city

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## Driverless Vehicles

- We can now build vehicles that are controlled by computers
- It is difficult to combine these vehicles with other vehicles driven by humans
- Some state in the United States might create a new charter city in which only driverless vehicles are allowed

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## Switch to Clean Fuel

- Natural gas is getting cheaper
- Natural gas can generate electricity
- Compressed natural gas powers vehicles
- To have the cleanest air in the developing world, a country could start a new city that allows no gasoline, no diesel, and no coal

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Next, reforms that could use imported government services in a smaller geographic zone

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## Increasing the Supply of Urban Housing

- A zone could be established on the edge of a city to become a new neighborhood
- Firms from one country, perhaps France, could provide utilities such as water, power, and communications
- The government of another country, perhaps Britain, could be asked to regulate these firms

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# A Low-Crime Zone

- An agency from one country, perhaps Canada, could control the hiring and promotion of the local police officers
- The supreme court from another country, perhaps Britain, could select the local judges and act as the appeals court for the zone

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# Separation of Powers

- The Salvadoran legislature could pass laws for the entire country
- The Supreme Court of El Salvadoran court could adjudicate constitutional questions\*
- British judges could administer courts that apply Salvadoran law in the zone
- Canadian officials could administer police who have jurisdiction only in the zone

\* I added this bullet on the basis of feedback I received after I gave the talk

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# Coercion

- If the low-crime zone is established on land where no one lives, people would be free to decide if they want to live in the zone after it is established
- If the low crime zone with foreign government services were established in an existing neighborhood, some people would be forced to live under the new system

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# Voting Alone Does not Avoid Coercion

- If the majority of the residents or workers in an area vote to establish a low-crime zone that takes advantage of foreign government services, many residents who are opposed might be forced into a system they do not want

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# Every Zone Will Have Government

- To privatize government services like utilities, a zone must have other government services like utility regulation
- In a zone under the control of a company, the company will be the government
- In a zone under the control of an appointed board, the board is the government

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# Accountability

- The question is not whether to have government, but how to ensure that the government provides the services that citizens want and does so efficiently
- To ensure this, any provider of government services must somehow be held accountable

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# Accountability

For example, in a zone with foreign utility regulation low-crime zone, the agreement with a foreign country could require a periodic vote to reauthorize this arrangement by the residents of the zone

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## Conclusion

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## Efficient Government as a Competitive Edge

- Workers, residents, and investors are not attracted to places with weak government
- They go to the places with efficient government
- For example, in the US, they go to New York City and leave Detroit

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## The Trap

- A government can't reform until it can enforce new rules
- A government can't enforce new rules until it has reformed

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## The New Opening

- Countries that import goods and private services could also try importing some government services
- By improving the quality of government services, they can make the country a more attractive place to live and work

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# Use a Reform Zone to Experiment

- Because imports of government services will be controversial, a reform zone might be a good way to experiment
- It avoids coercion
- It builds legitimacy for the new rules

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# Gordon Brown

“In establishing the rule of law, the first five centuries are always the hardest.”

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# The Harmful Legacy of Colonialism

- Colonial powers used coercion to impose rules
- This can leave many people in a society with a belief that the rule of law is not legitimate

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# The Way Forward

Ironically, the best escape from the legacy of colonialism might be through reform zones that:

- allow voluntary imports of government services, and
- give citizens a choice within their country instead of a choice only if they leave

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