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# An Economic Integration Zone for the East African Community

## Exploiting Regional Potential and Addressing Commitment Challenges

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## Abstract

Integration in the East African Community offers significant opportunities not only to expand trade among member states, but more importantly to scale up regional production to take advantage of much larger global market opportunities. Special economic zones are a potentially valuable instrument to facilitate the integration of regional value chains in support of this scaling up. They also have the potential to deliver powerful demonstration effects on the benefits

of integration and to help entrench the integration process. This paper discusses the proposal for developing an “economic integration zone” in the East African Community. The benefits of such a zone could be substantial, as would be the practical challenges to implementation—in particular the political economy challenges. However, a number of institutional and commercial solutions exist to address these challenges.

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# AN ECONOMIC INTEGRATION ZONE FOR THE EAST AFRICAN COMMUNITY:

Exploiting regional potential and addressing commitment challenges

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## 1. EAC integration and the potential for scaling up regional production

The Treaty for the Establishment of the East African Community (EAC) was signed by the governments of Kenya, Tanzania and Uganda in Arusha, Tanzania in November of 1999<sup>3</sup>, and came into force in July, 2000, at which time the regional secretariat of the East African Community was formed. Burundi and Rwanda joined in 2007. The EAC aims at deep economic, social, and political integration, starting with a customs union and moving on to a common market, a monetary union, and ultimately a political federation among the five member states. It seeks to achieve these goals by laying down common rules governing, *inter alia*, trade in goods and services; cross-border investment; mobility of natural/legal persons; infrastructure development and maintenance; environmental and natural resource management; tourism; and regional industrial development, including industrial parks and SEZs.

Significant progress has been made in the implementation of regional integration. Most notably, the customs union was launched in 2004<sup>4</sup> and as of January 2010 all internal tariffs, surcharges, and excise taxes were removed for intra-regional trade, establishing a single market for goods and services. However, practical implementation of these and other ambitious integration arrangements faces numerous practical and, most importantly, political challenges. For example, such issues as permanent residency and the right of access to and use of land remain subject to national policies (thus in effect restricting mobility of labor and capital) rather than being a part of the common market protocol. Moreover, the community's plans for monetary union by 2012 are unlikely to be implemented given the current state of preparations.

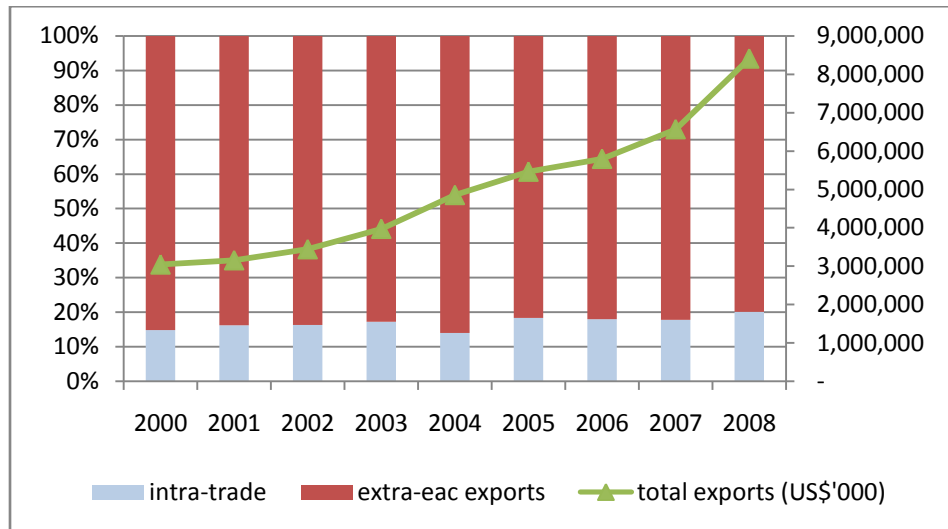
Thus the path to political federation remains a difficult one. On the other hand, economic integration through trade and investment is leading the way. Since the advent of the single customs territory, trade and investment in the region has grown strongly, both in terms of intra-regional flows and also with respect to global markets. As illustrated in Figure 1, exports from the region have grown rapidly; since 2005 total EAC exports have increased more than 15% per annum, with intra-regional trade growing 19% per year. Intra-regional trade rose from about 15% of total EAC exports in 2000 to more than 20% in 2008, reaching a value of nearly US\$2 billion.

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<sup>3</sup> This treaty effectively re-established the EAC, which was originally set up in 1967 but disbanded in 1977.

<sup>4</sup> Through the EAC Customs Management Act, which implemented the EAC Customs Union Protocol

**Figure 1: EAC exports and intra-regional trade**



Source: UN Comtrade via WITS

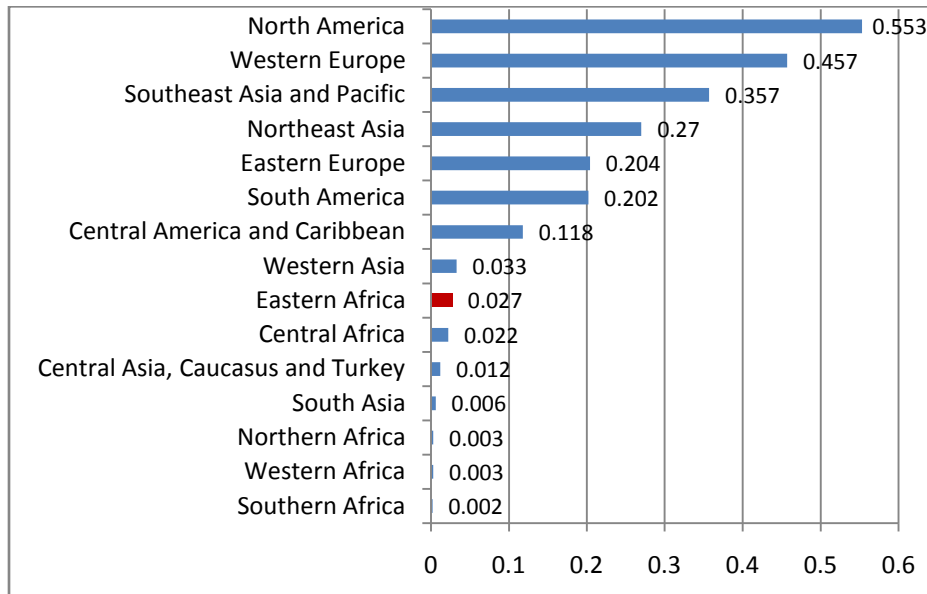
But as most East African countries are relatively small – and even in its larger economies, domestic market size is constrained by low income levels – regional trade has limits in its potential to drive growth. Complementarity of production also restricts the scope of intra-regional trade at the moment. Rather, exploiting the much larger global opportunities will be the key to sustained export and economic growth. Despite the significant growth of exports from the EAC in recent years, the region’s share of the world market for exports remains well below 0.1%, around half the global average on a per capita basis.

In fact, global market integration and regional integration are not alternative strategies, but rather complementary ones. Increasing the global exports of individual member states requires improving the competitiveness of its firms. One of the key mechanisms through which to improve competitiveness is through scaling up regional production – i.e. integrating regional value chains to allow firms to reap the advantages of greater specialization and scale. Successful integration of regional value chains will not only facilitate exports to global markets but, by definition, will result in greater inter-regional trade through increased task or component-based trade. Indeed, this process of regional integration of production is being supported through the EAC Industrialization Strategy<sup>5</sup>. At the moment, however, integration of production networks within the EAC is extremely limited. Figure 2 shows that while intra-industry trade (IIT) – a proxy for integration of manufacturing networks – within the EAC is higher than within other regions in Africa or in South Asia, it remains dramatically lower than through East Asia, Europe, and the Americas. In the case of ASEAN<sup>6</sup>, for example, the removal of formal and informal trade barriers resulted in the spreading of value chains across the regions, with most countries benefitting by specializing in the production of various components of complex goods that were shifted across the region in various stages of production.

<sup>5</sup> Articles 79 and 80 of the EAC Treaty

<sup>6</sup> Association of Southeast Asian Nations

**Figure 2: Intra-regional intra-industry trade (Grubel-Lloyd index, 2008)**



Source: Brulhart (2009)

According to research by World Bank (2010), if the scale economies of the East African Common Market are fully realized, the exports of goods and services would grow from US\$12 to US\$20 billion over the next decade, contributing to a doubling of formal employment and GNI per capita. While intra-regional trade has significant growth potential, clearly the majority of this export growth will need to come from global markets. As suggested above, regional integration is complementary with the aims of promoting competitiveness and growth in global markets.

However, while this combination of regional and global integration should contribute to faster growth EAC-wide, its effects will not be felt evenly across the region. As goods, capital, and labor markets open up in the EAC, economic activity is likely to concentrate increasingly in a few key areas where scale and access to global markets can be best exploited. Unlike in the ASEAN case, the unique geography of the EAC (3 of its 5 member states and 40% of its population is landlocked) is likely to restrict the spread effect of integration, resulting in higher concentration of economic activity. As discussed in the World Development Report 2009 (World Bank, 2008), such processes of agglomeration and therefore geographically unbalanced growth is inevitable and for the most part growth supporting. The challenge in the EAC context is to use the regional integration process to facilitate broad access of workers, firms, and finance to the fast growing agglomerations, while at the same time opening up more peripheral regions to investment and expertise to enable them to take advantage of opportunities that may be available for producing goods and services within regional value chains. But when the perception of winners and losers from agglomeration extends across national borders, the political implications can threaten the project. Indeed, such political economy issues are at the heart of this paper.

## 2. The role of Special Economic Zones

Accepting that agglomeration is both necessary and desired to achieve the benefits of regional scale, the question is how these processes can be best facilitated. The customs union and the wider processes of integration within the EAC should help overcome barriers to agglomeration caused by trade policies, border-related issues, investment, and the free movement of labor. But even assuming these processes are efficient, a number of barriers still remain. These include:

- Lack of reliable infrastructure, in particular transport, power, and telecommunications;
- Difficulty in accessing serviced industrial land and slow, cumbersome processes to secure it;
- Red tape and slow decision making relating to licenses, permits, and other aspects of starting and operating a business; and
- Information failures that prevent the private sector from coordinating investment activity.

One instrument used internationally to overcome such barriers to investment and agglomeration is special economic zones (SEZs). Special economic zones are spatially delimited areas within an economy that function with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) from those of the domestic economy. Operating through a variety of different forms such as “export processing zones”, “economic processing zones”, “free zones”, and “foreign trade zones”, SEZs aim to overcome barriers that hinder investment in the wider economy, including restrictive policies, poor governance, inadequate infrastructure, and problematic access to land. SEZs have been an important policy instrument for many governments seeking to attract foreign investment, promote export-oriented growth, and generate employment. Their popularity as a policy tool has grown enormously in the past 20 years – in 1986, ILO’s database reported 176 zones in 47 countries. By 2006 it reported 3,500 zones in 130 countries (Boyenge, 2007).

While there is a long history of failure around the world in using instruments like SEZs to promote investment in remote regions, the evidence suggests they can be highly effective when targeting regions that already have natural or economic geography advantages (World Bank, 2008). While SEZs are unlikely to be a trigger for agglomeration in lagging regions with low population densities, in places like China, where SEZs targeted coastal trade gateways, they have proven to be powerful catalysts for growth. Thus, while the World Bank’s *World Development Report 2009* (World Bank, 2008) suggests SEZs be approached cautiously, it supports the use of such hard and soft infrastructure to reinforce existing geographical advantages.

And so by leveraging agglomeration, SEZs have the potential to play a role in harnessing integration processes to support regional competitiveness. In an open regional integration context, SEZs may serve as regional public goods (see Box 1), as they may have significant spillover effects across the region – this gives them the potential to help entrench the integration process in the region.

**Box 1: Regional public goods**

A regional public good (RPG) is a service or resource whose benefits are shared by neighboring countries (the countries within the region). The benefits of pure regional public goods are “non-rival” (one country’s consumption does not subtract from the amount available to other countries) and “nonexcludable” (no country in the region can be excluded from benefiting, except at prohibitive cost). In reality, most RPGs are significantly, but not wholly, non-rival and non-excludable. Rather than being “pure,” they are “mixed,” meaning that they bestow a combination of national and transnational benefits<sup>7</sup>.

Three kinds of activities to pursue RPGs can be distinguished:

1. Non-country specific investments in knowledge, dialogue, basic research into technologies meant to be in the public domain (for example, vaccines) and negotiation of agreement on shared standards and policy regimes.
2. Inter-country mechanisms for managing adverse cross-border externalities or creating beneficial ones – e.g., coordinated public health measures to contain the spread of disease; investments in cross-border infrastructure to enhance the preconditions for growth through trade and integration among participating countries; creation of regional institutions to facilitate solutions in areas ranging from financial and banking stability to the sustainable management of shared environmental resources.
3. Country-specific action to take advantage (or enable absorption) of the benefits created by the two means above. This will create national public goods such as improved policy environments and institutional indicators. In turn, these can engender transnational externalities.

*Source: Adapted from Kanbur in Ferroni (2002)*

First, by concentrating core infrastructure around zones and addressing the constraints discussed above, zones reinforce processes of agglomeration and help industries to reach scale thresholds that will allow them to compete more effectively in regional and global markets. The benefits of creating competitive conditions for private sector development and an efficient trade gateway at the core will, however, spill well beyond the firms based in the zones to include firms through the regional supply chains that feed into them. Thus, SEZs benefits should extend well beyond the core. Second, SEZs may offer sector-specific public goods, such as warehousing and logistics platforms, shared processing facilities, design centers, etc., that facilitate competitiveness of wider industry clusters in the region<sup>8</sup>. Third, they have the potential to serve as pilots for broader economic reforms in the region. The most well-known case of this is in China, where SEZs were used explicitly as a “testing ground” for major economic reforms. The public good here stems primarily from the demonstration effect that such zones can have on the wider national environment (and eventually on economic efficiency)<sup>9</sup>. Finally, in the EAC context, the use of SEZs on a region-wide level has the potential to facilitate institutional convergence both by demonstration effects and through greater interaction among policymakers and technical officials across member states.

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<sup>7</sup> The usual definition of the characteristics of “publicness” of public goods involves individuals as the relevant units. However, in the discussion of international public goods, countries, not individuals, are taken as the relevant units

<sup>8</sup> Note these are not strictly public goods but rather “club goods”; they are excludable but generally non-rivalrous.

<sup>9</sup> This is, of course, more difficult in a regional context than in a national one, due to the differing legal and political contexts across states.



A commercially-focused SEZ designed at the regional level also has the potential to play an important part in addressing the political economy concerns resulting from the agglomeration processes. If implemented effectively and in the context of truly open labor, capital, and goods markets, such a zone could help ensure that some of the benefits of agglomeration are enjoyed by all countries in the region. Moreover, it could be designed to ensure that these benefits were distributed as evenly as possible across member states, through the distribution of revenue streams and other benefits arising from the zone. Thus a regional SEZ may offer a politically expedient and practical way of piloting federation, allowing each member state to test how processes of federation may play out within a tightly defined commercial "pilot", in advance of committing itself on an economy wide basis. This is the concept of an Economic Integration Zone (EIZ) for the EAC.

### 3. Introduction to the EIZ

The "East African Economic Integration Zone" (EIZ) is conceived as a special economic zone located near EAC's economic "core". This would most likely be based around a commonly-operated port on the coast and in close proximity to one of the areas in the region with high concentration of economic activity. The zone would be administered through a multi-level governance structure, with an autonomous local administration overseen by a regional supranational body. Investment, as well as taxes and revenues would be shared among the members. Its objective is to promote regional competitiveness directly (through the channels discussed above) as well as by providing demonstration effects not only on how to create a competitive investment climate, but more broadly on the potential benefits of key provisions of integration, including labor and capital mobility.

The EIZ could be designed broadly in line with the "wide area" SEZs usually associated with the Chinese model – i.e. occupying a surface area greater than 10,000 hectares (100 km<sup>2</sup>), with mixed-use developments (including industrial, commercial, and real estate), and normally with a resident population. As such it would effectively function as a new city or municipality. In this sense the EIZ bears similarity to two recent concepts proposed by academics – of "charter cities" (Romer, 2010) and "early reform zones" (Auty, 2010):

- **Charter cities** are born from the observation that bad rules and bad enforcement of rules is one of the most critical factors holding back growth in many developing countries. Inspired by the success of colonial trade hubs like Hong Kong SAR, China and, more recently, China's SEZs, they aim to use unoccupied land as a chance to establish a new city that operates outside the existing arrangements of the country, establishing their own tax regimes and legal structures. Under the concept, countries can act as host, source and guarantor. The host country provides the land, source countries provide the residents, and guarantor countries ensure that the charter is enforced. Honduras recently voted a constitutional amendment to allow for the creation of charter cities in the country (see Box 2).
- **Early Reform Zones** ERZs are geographical areas located within distorted economies, where

post-reform conditions (comprising: world class infrastructure; business-friendly services; and property rights and the rule of law) exist. The ERZ is executed as part of an economy-wide dual track strategy, whereby ERZs are used to kick-start a dynamic market economy, which forms Track 1 and rapidly expands employment, skills, taxes and exports. Track 1 also builds a pro-reform political coalition that can eventually take on opponents of reform and neutralize and/or co-opt them. Meanwhile, reform proceeds slowly in the rent distorted sector (Track 2) in order to avoid early confrontation with rent seekers, which a reforming government is likely to lose. Successful dual track economic reform in economies as diverse as Mauritius, Malaysia and China shows that SEZs can grow a dynamic market economy within fifteen years to a scale that dominates the total economy.

#### **Box 2: Charter cities in Honduras**

In 2011, the Honduran National Congress passed an amendment to the constitution that gives the government the power to create special development regions (known by their acronym in Spanish, REDs). The REDs would be a independent jurisdiction, with its own laws and administrative systems. Laws developed by the governing authority of the RED, however, must be ratified by the Honduran Congress with a simple majority.

The establishment of any region as an RED would require enabling legislation that must be supported by a two-thirds vote in Congress. Subsequent to this, Congress can change the enabling legislation and two-thirds majority and approval by referendum from the citizens living in the RED.

The President of Honduras has set aside 1,000 square kilometers in a yet-to-be defined location for the development of the charter city.

*Source: Adapted from <http://chartercities.org/blog/191/a-new-city-in-honduras>*

In the EAC context, it may not be necessary to develop an EIZ on the scale Romer proposes (population of around 10 million). However, it will almost certainly be necessary to have a city of some size not only for practical reasons such as housing of workers, but also for commercial and political reasons, such as ensuring a significant tax base to compel interest and commitment on the part of EAC members.

In line with the concept of SEZs, a critical characteristic of the EIZ would be its extra-territorial nature. Almost all SEZs operate under a different fiscal and legal framework than exists in the national economy in critical areas like the tax regime, rules on foreign currency, and sometimes labor law. Many also operate outside of the control of the municipal government authorities in the locality in which they are based. But the EIZ would differ from traditional SEZs in two critical ways. First and foremost is its regional nature. Because it is designed as a “regional space” and may indeed straddle two more existing countries, no single nation-state would be act as its natural sovereign. Second, and following from this, there is potential (and perhaps need) to operate the EIZ under a distinct legal, regulatory and fiscal regime that would differ further in scope than would normally be the case in an SEZ. In this sense, the

EIZ is unique – we are aware of no other such regional SEZ currently operating<sup>10</sup> – and potentially very much in line with the charter cities proposals.

The extra-territorial nature of charter cities does not simply allow the city to operate under a new set of rules. Of equal importance is the way in which those rules are interpreted and enforced – i.e. it is about governance. As Romer argues, if the whole point about the charter cities is to get around a system of rules that has failed, it will not be sufficient to simply establish a new set of rules outside the old borders and govern it by the same individuals and institutions. Therefore, what is critical to the charter city model is not just that it sits outside the traditional borders but also that it sits outside the traditional governance structures of the country in which it is physically located. In the charter city model, sovereignty of the city would come under some sort of third party “guarantor” – i.e. a country respected for good governance (e.g. Mauritius) or some other credible third party (e.g. an international organization) would have control over the zone at least for a defined time period, in order to guarantee that the necessary governance reforms were institutionalized.

So in this sense, in adopting the charter city approach to extra-territoriality, the concept of an EIZ for East Africa requires a significant departure from traditional modes of governance. But it is likely to be critical to the success of the EIZ. This is not because of problems with governance in Kenya, Tanzania or any of the EAC states per se, but rather for the political economy of dealing with a zone that is intended to serve the region rather than an individual country. Whether or not the EIZ would actually require external governance through, for example, a “guarantor” is unclear. Would collective participation by East African states, under a supranational body like the EAC, be enough to ensure its credibility?

#### 4. The challenge of “credible commitment”

While the EIZ is an appealing concept through which to test federation, its regional nature aggravates some of the already-difficult challenges faced in implementing an SEZ, as political economy considerations come to the fore. First is the challenge of convincing the host government(s) to give up control over the land on which the EIZ would be based, and to maintain this detachment over time. Establishing a territory as a separate jurisdiction requires careful consideration and often much political compromise within a country. But when one or more states are required to give up control of their sovereign territory to a collective or supranational authority, these political considerations become acute. As mentioned previously, we are aware of no precedent of a truly trans-national special economic zone, especially not one in which a country voluntarily gave up control over a portion of its land.<sup>11</sup> But

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<sup>10</sup> There are attempts at harmonizing SEZ regimes at the regional level, such as the ongoing efforts in the East African Community. There have also been attempts to coordinate SEZ development regionally, such as the BIMP-EAGA Growth Triangle in Southeast Asia. But none of these actually involve zones that are governed on a regional or cross-national basis.

<sup>11</sup> Although there are of course precedents like China’s leasing of Hong Kong SAR, China and many examples where long-term leases are given to other sovereign states to operate large military bases – for example the US in Okinawa, Japan; Stuttgart, Germany; and Guantanamo Bay, Cuba.

assuming the political will, the potential benefits to a host country should be sufficient to facilitate an arrangement on the land for an EIZ (*see a discussion in the next section*). Moreover, in the EAC context, this may be somewhat easier to overcome, as the member states have already agreed to gradually cede portions of their sovereignty to the Community.

Perhaps the bigger challenge, however, is in maintaining the commitment of the host government(s) and other partners over the long term. This is the challenge of managing the investment risk – or the issue of “credible commitment” (see Box 3). But how do governments – particularly those in developing countries – show a credible commitment to potential investors? Part of the answer lies in having a track record of policy stability. Unstable political regimes are inherently more risky, because the shorter time horizon raises the incentive for confiscate (nationalize) assets (North, 1994), or to undertake radical policy shifts. It is worth noting that in this respect what matters is the stability of the polity, not necessarily whether or not it is democratic. Indeed, a stable autocracy can in many cases offer commitment (at least in the medium term) that is more credible than what a democracy can offer. Growing democracy in the presence of still-weak institutions and the emergence of political competition can make enforcing the commitments of previous policies particularly tricky. This is the situation in many low income and African countries today. Within the EAC, Kenya’s experience in recent years may be seen as a good example of these difficulties.

The issue of credible commitment is particularly critical for developers and investors in zone infrastructure, with longer-term payoff horizons. However, it also impacts the perception of the individual firms that would invest in operations in the EIZ. While these investments would be smaller and more likely to have shorter-term payoffs, they would still factor any perceived additional risk in the fact that the project may be deemed to be on less stable ground than a traditional SEZ project backed by a single sovereign. Thus, the higher the risk perceived by potential investors, the less likely they will be willing to make commitments like paying for long-term leases upfront.

### Box 3: Credible commitment, investment risk, and the obsolescence bargain

The concept of credible commitment is essentially one of trust: how sure can two parties in an economic exchange be confident of the trustworthiness of the other in maintaining their side of the bargain? The basic problem and solution of credible commitment can be simply explained through game theory, as North (1994, p.2) notes: *“players can be bound when the gains from living up to an agreement exceed the gains from defecting”*. But in the absence of knowledge of one party’s trustworthiness, the other party faces a situation of increased risk, raising transactions costs (through the risk premium on the investment and the need to increase monitoring of the contract), restricting investment at the margin. Trustworthiness or “credibility” of commitment is relevant not only with respect to transactions between private parties, but also, and critically, with respect to government as one of the parties or stakeholders. The concept of credible commitment can be invoked across many aspects of government policy. Indeed, it has had renewed interest recently in the light of the global economic crisis and the implications of the credibility of government policies on the integrity of the financial system.

In the context of attracting foreign direct investment (FDI), the ability to make credible commitments to potential investors is an important source of competitive advantage. The challenge is how to convince investors<sup>12</sup> to make investments with long-term payoffs without concern that the investment climate under which they made the investments will change. This concern over the security of the investment climate can be as stark as one over whether or not the state will nationalize or otherwise expropriate the assets of the private investor. But in reality these wholesale appropriations are the exception. The significant risk is more prosaic – that the government will enact policies that change the risk/return nexus; cumulatively a series of such policies will ultimately make the financial case unfeasible. This is what Romer (2010b) refers to as the *“death by a thousand small cuts.”*

Investors making the type of large-scale, fixed cost investments in infrastructure and zone development that are critical to the success of the EIZ – i.e. zone developers and sub-developers – face greater commitment challenges due to what is known as the “obsolescence bargain” (Vernon, 1971). Essentially this argues that in industries requiring large, up-front investments with a stream of future revenues generated into the long term, power lies in the hands of the investor up until they commit the investment (which explains why investors in these sectors are often courted with significant incentives.) But once these investments are made, the balance of power shifts as investors are left exposed to high sunk costs, leaving the government with significant incentives to renege on their commitments. This may not mean wholesale nationalization or expropriation, but it often means smaller measures, such as levies and “windfall” taxes, to capture a share of the rents.

Investors will offset the perceived increased risk by attempting either to reduce their potential losses (by asking for large subsidies) or by aiming to recover their rents as quickly as possible. The first of these is problematic from an economic cost-benefit perspective. Indeed, it is the large infrastructure requirements in the first place that make public provision infeasible in most countries, and therefore the need for the private sector to absorb some of the risk. But there is enough project risk anyway to not have the additional cost of having to subsidize policy risk. The latter may not be viable in the SEZ situation as the main way for the developer to front-load returns is to charge high costs for land and facilities and high fees for services. This is unlikely to be feasible, particularly in a developing country context, as individual project investors are likely to be price sensitive on land and facility costs. Another option would be to require upfront payment for the full period of the land lease. In Malaysia, for example, the Penang Development Corporation required upfront payment on the full 60-year land lease period in their EPZs in order to generate cash flow to fund infrastructure investments<sup>13</sup>.

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<sup>12</sup> In the case of the EIZ, in addition to investors we must also consider the implications of credible commitment with respect to the workers and general population that would be attracted to move to or work in the EIZ. While these workers essentially “opt-in” (to use the language of charter cities), they clearly face risks and costs (both real and opportunity costs) in moving into the zone. Like any investor, they will also consider the viability of the regime and weigh the perceived risk/return payoff.

<sup>13</sup> Whether investors would be willing to consider such upfront payments in the context of investment in Sub-Saharan Africa is another questions

The risks to commitment that the EIZ would face are three-fold. First, is the risk of the host country or countries reneging on their EIZ commitments – i.e. reverting on their commitment to give up sovereignty over the zone (fully or potentially over certain aspects like revenue collection, security, etc.) or putting up barriers to the interaction between the zone and the national economy. One can imagine a number of reasons why this might happen. Some of the most likely triggers would be political, social and economic issues within the host country, including fiscal crisis, economic or political nationalism, and elections and subsequent policy instability. In the recent research by Wellhausen (2010), 57% of the 412 arbitration and expropriation events in a global FDI database between 1970 and 2009 took place in or preceding an election year. One need only look at some of the situations that have impacted EAC countries in recent years, including the post-election violence in Kenya in 2007-2008 and to a far lesser degree the constitutional referendum in Uganda in 2005. One can also imagine a scenario where natural resources were found in or near the EIZ location and the implications this might have on commitment of the host government to share revenues from the zone. Finally, the success of the zone itself might raise (or equally reduce) the incentive of the host government to renege on the agreement in an effort to capture more rents or reduce liabilities.

The second risk is that other EAC members renege on their own commitments to the EIZ. Most likely this would occur with regard to commitments to support some infrastructure expenditure, to commit necessary funds to operational budget or to deliver effectively on their responsibilities for managing certain aspects of zone governance. One of the most likely reasons for this would be if member states (particularly those that did not host the zone) felt they were not getting sufficient benefit from it. The main concern here is the distribution of gains – i.e. the fact that the EIZ will contribute to a concentration of investment and economic activity, at least in the short term, in the country or countries in which it is based, with the perception (if not necessarily reality) that it would actually detract from investment that otherwise might have been made in other member countries. Other member countries may feel they could enjoy greater benefits by, for example, setting up a competing economic zone (perhaps with a more generous set of fiscal incentives) outside the EIZ. This raises the importance of any agreements made with respect to competition between the EIZ and other existing or future SEZs in the region. In the absence of a clear agreement among EAC member states on the existence of other SEZs in the context of the EIZ and, perhaps more importantly, on the nature of the incentives that can be provided within zones, this presents a potentially serious risk to zone investors (developers). For example, in the early years following the agreement to establish the Singapore-Suzhou Industrial Park (SIP)<sup>14</sup>, the local government in Suzhou opened a competing industrial park in close proximity to SIP and with much lower land prices. This was one of several factors which dramatically impacted the economic returns of the project.

Finally, there is the risk of the wider breakdown of the EAC and the implications this would have for the EIZ. Should the zone be developed explicitly within the context of the EAC (e.g. with EAC institutions being involved in the board or in operational management, or with aspects of the EIZ Law being dependent on EAC Law or regulations), the EIZ might be undermined in the event of the dissolution of

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<sup>14</sup> A joint venture between the Chinese and Singaporean governments

the EAC. Even if the EIZ is not set up explicitly within an EAC institutional framework, the political fallout from the breakdown of the EAC would raise the risk of either the host country or one of the other members reneging on its commitments. The perception by investors of the likelihood of such breakdown must not be considered remote, given the history of the EAC,<sup>15</sup> and the overlapping nature of Africa's regional agreements. On the other hand, if even the dissolution of the EAC would not necessarily bring the EIZ down with it, if member countries find it to be a useful instrument. For example, the East African Development Bank survived the previous collapse of the EAC and has operated continuously for more than 40 years, because the leaders of the three member states found it to be in their interests to maintain it<sup>16</sup>.

On the other hand, regimes can be "bound together" through regional agreements like the EAC. If the EAC is delivering real benefits, reneging on EIZ commitments could have severe implications for members, either the risk of breakdown of the EAC or some sort of sanction within it. The experience of the EU, for example, shows that regional agreements can also be an effective disciplining force to lock a party (country) into economic or political reforms. Two main conditions are necessary in order for a regional trade and investment agreement or wider regional integration arrangement to serve as an effective commitment mechanism (see Box 4), in particular: (i) that the benefit of continued membership is greater than the immediate gains of exit / returning to alternative policies; and (ii) that the regional agreement has a credible punishment threat against a country that reneges. If the cost of exit from the agreement is low and/or implementing the rules and administering punishments is weak, the regional arrangement is unlikely to be effective in ensuring commitment. The ongoing Euro area crisis and its links with the inability of the EU to enforce agreements over fiscal discipline provide a telling example of the failure to deliver credible commitment.

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<sup>15</sup> The EAC was initially established in 1967 and dissolved in 1977, mainly over political disagreements between Idi Amin of Uganda and Presidents Kenyatta and Nyerere

<sup>16</sup> Specifically, they were concerned about the possibility of significant capital outflows should the bank be dismantled.

#### **Box 4: Assessment of the factors required for effective regional cooperation**

**First, the duration and depth of regional cooperation must be sufficient to make meaningful improvements possible.** Concluding a trade agreement is one thing, but persisting in the difficult effort of deepening integration is quite another. Deepening is likely to be needed in order to consolidate benefits over time, but it is also expected to call for contentious structural change. Meaningful regional cooperation requires long-term commitments and a willingness to go into adequate depth on the part of those involved. Depth has to do with the complementary national measures needed to enable countries to contribute to, and absorb, the benefits of transnational cooperation (see below). This is the hard part, more difficult than signing an international agreement and rhetorically committing to the course of action that it implies. Regional cooperation consists of national measures taken in accordance with some agreed international plan. The absence of, or lags in, complementary national measures can bring the best collective action framework to naught.

**Second, in the interest of sustainability, losers (or countries that gain less than others from cooperation in a given field) must be compensated to keep the coalition of actors and the pursuit of cooperative solutions alive.** Again, this can be very difficult because of the possibility of disagreement over the nature and extent of asymmetries and because of resource constraints.

**Third, contracting parties should bind themselves with treaties or agreements that are self enforcing,** where this is feasible, because of the absence of supranational authorities capable of exacting compliance. Barrett (2002) shows that the requirement of self-enforcement reduces the number of feasible cooperative solutions.

*Source: Adapted from Ferroni (2002)*

## **5. Addressing commitment challenges in the EIZ**

### **The distribution of benefits from the EIZ**

Before outlining possible solutions to commitment, we first summarize the benefits that are expected to flow from the EIZ, and to which groups these benefits are likely to accrue. It is only from understanding the relative winners and losers from a project like the EIZ that one can begin to consider the fiscal and institutional solutions by which to reach compromise.

In Section 2 we outlined some of the benefits that may be created by SEZs, particularly operating in a regional context. Table 1 summarizes these benefit streams and identifies how they are likely to be distributed, particularly across space in the region. Two things become clear from this brief assessment. First, the core will benefit more than the periphery (and to some degree at its expense) in terms of investment and trade flows, at least in the short term. This highlights the importance of the redistributive potential of the EIZ and the need to ensure that solutions are found to facilitate short-term employment gains for nationals from the landlocked states. Second, that within the core of the EAC, the state(s) in which the EIZ is based will benefit disproportionately. This is good news from the perspective of convincing the host(s) to give up land to the project.



**Table 1: Summary of likely benefit flows from the EIZ**

Benefits	Main beneficiaries
<b>Taxes and fees</b>	<ul style="list-style-type: none"> <li>All partners have the potential to benefit equally. Benefit flows depend on formulas agreed – i.e. open to negotiation (<i>see table 2</i>)</li> </ul>
<b>Land value</b>	<ul style="list-style-type: none"> <li>Host country(ies)</li> </ul>
<b>Employment</b>	<ul style="list-style-type: none"> <li>Host country(ies) inevitably stand to gain the most. Dependent on labor mobility and degree to which affirmative action on employment is taken.</li> <li>Peripheral regions to benefit from remittances</li> </ul>
<b>Spillovers: infrastructure and logistics</b>	<ul style="list-style-type: none"> <li>Host country(ies) / regions around the EIZ to benefit most, but will also create improved trade environment for businesses in the periphery, particularly if zone developed along a corridor model</li> </ul>
<b>Spillovers: supply links, technology, and knowledge</b>	<ul style="list-style-type: none"> <li>Regions in close proximity to EIZ will benefit most, although supply links may extend well into the periphery</li> <li>Technology and knowledge spillovers likely to remain in close proximity to the core (Crescenzi, Rodriguez-Pose, and Storper, 2007)</li> </ul>

Source: Authors

In the remainder of this section we outline a number of potential approaches to overcoming the commitment challenge in the EIZ context, bearing in mind the likely distribution of gains from the EIZ outlined in Table 1. They are organized in three broad categories. First, we address commercial and financial mechanisms that can establish an effective incentive system from the outset, enabling encapsulated trust. Second, we discuss the formal, institutional approaches to ensuring commitment – these are largely related to legal constraints and enforcement mechanisms through which to bind parties to commitments (*imperative* credibility). Finally, we discuss informal approaches to align mutual interests of stakeholders (which can facilitate both *imperative* and *motivational* credibility). These approaches are by no means mutually exclusive. Indeed, effectively addressing commitment risks likely relies on making use of all three mechanisms – according to North (1990, p.58): “*Creating an institutional environment that induces credible commitment entails the complex institutional framework of formal rules, informal constraints, and enforcement that together makes possible low-cost transacting*”.

### Aligning incentives

One of the first ways to align incentives in the zone is through its location. As noted earlier, the most appropriate location to serve international markets, from a natural agglomeration perspective, is probably on the coast, perhaps near a major metropolitan area like Mombasa. By locating the prospective zone on land encompassing an existing or new port, or along an existing growth corridor, it may be possible to benefit from the natural agglomeration forces while also helping to lock in the participation of key member states, thus helping to offset some of the political risks and sharing some of the benefits. As discussed above, the regions surrounding the EIZ would benefit directly through the spillovers of economic activity outside the zone. But the landlocked states, and specifically those regions far from the core – who currently face major barriers to participating in international trade as a result of inefficiencies and non-tariff barriers at the ports in Mombasa and Dar Es Salaam – would also benefit by getting access to a more efficient gateway through a port and trade facilitation process operated

collectively (or by the EAC) on behalf of all member states.

The next critical step to maintaining commitment of the participating governments is to get the financial incentives right over the long-term. As discussed previously, one of the key challenges is to convince the host government(s) to give up authority over a part of their territory. Part of the solution to this is commercial. The host government(s) may lease the (most likely unused) land to the EIZ for a period – probably a minimum of 30-40 years. If the EIZ is implemented successfully, the value of the EIZ land should rise substantially. This is a significant asset from which the host government(s) will benefit. Of course, this must be balanced against the need to keep land prices low enough to attract developers and investors. The increase in land value will not be restricted, however, to the footprint of the EIZ; rather, land surrounding the project should also increase substantially in value, creating an additional asset for the host(s)<sup>17</sup>.

At the same time it is critical that the realization of this land value not become an incentive for renegeing at some point in the project. There are likely to be a number of models for achieving this. The first, and most obvious, is setting a clear time limitation on the charter agreement, returning the land to the host government after a specified date. Even during the period prior to the land returning to the jurisdiction of the host(s), it might be possible to establish an agreement whereby the host government(s) is compensated for the increase in land value after a certain period of time (e.g. every ten or twenty years). Another option is through an incremental purchase agreement on the EIZ land. For example, say 10,000 hectares was set aside for the EIZ. The host government might lease 2,000 hectares to the EIZ project for the start-up phase, keeping the rest undeveloped. Should the EIZ be sufficiently successful to merit further development, land values would presumably rise considerably, allowing the host government to benefit from the sale or lease the next tranche. Note that these land-based financial mechanisms also offer a way in which the host government can negotiate with regional and local governments as well as local communities to garner their commitment to the project.

A more obvious issue is sharing of revenues that arise from the project. This is the main mechanism by which the EIZ can help to ensure a “win-win” situation for all EAC members. Managing revenue-sharing in the EIZ is likely to be tricky prospect, as the issue is not just one of how to share revenues among EAC members, but also about how much and what revenue streams can be retained by the EIZ itself (including its developers and operators) and how much should be reverted back to EAC member states.

The basic principle of the EIZ is that the tax revenues generated from the project would be shared across EAC countries – this is to ensure that they all have the fiscal incentive to concentrate SEZ investments in the EIZ. So revenue sharing needs to be sufficient to ensure their continued commitment while also somehow reflecting the potential unequal investment, risk, or commitment of member governments. In

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<sup>17</sup> For real estate developers, the growth of the value of the land surrounding major projects is often a major source of profit. Developers like Disney (i.e. Disneyland, EuroDisney, etc.) purchase large areas of land that extend well beyond their planned development footprint in order to capture as much as possible the land value spillovers that accrue from their developments.

assessing how revenue allocation might help support credible commitment it may be necessary to separate the different revenue streams that are likely to arise from the EIZ (see Table 2).

**Table 2: Revenue streams in typical SEZ arrangements**

<b>Revenue stream</b>	<b>Description</b>	<b>Typical recipient in SEZ regimes</b>
<b>Customs revenue</b>	Revenues received from charging duties on imports / exports	National government; note in case of existing regional agreements (EAC) there may already be a revenue sharing model
<b>Corporate tax</b>	Taxes of firm profits	National and sometimes state / provincial governments (often waived or reduced as fiscal incentive)
<b>Municipal taxes</b>	Taxes charged on profits, assets, etc. from local governments	Local government (often waived or reduced as fiscal incentive and to simplify tax administration for investors)
<b>VAT / sales taxes</b>	Taxes on production and sales	National government and sometimes state / provincial government (often zero-rated or reduced as fiscal incentive)
<b>Personal income taxes</b>	Taxes on incomes of individuals living in zone	National government
<b>Service fees</b>	Fees for provisions of licenses for operating or carrying out specific activities	SEZ developers; SEZ Authority; individual government agencies
<b>Land / facilities sales and lease</b>	Leases for land plots or rents for pre-built facilities in the zone	SEZ developers

*Source: Authors*

The selection of how these revenue streams might flow to different stakeholders and the formula by which they would be redistributed is a function of commercial and political negotiation, but also must take into account the practicalities of revenue generation and collection. Many alternatives are possible. In the Chinese SEZs, significant authority as well as financial responsibility was devolved to the zone level. They were given legislative power to develop municipal laws and regulations under the basic principles of national laws and regulations, which not only included policies such as labor market regulation (which was transformed in some of the zones), but also in terms of setting and administering local taxes, both in terms of structure and level. Thus, strong fiscal devolution was fundamental to China's SEZ development. SEZs were given responsibility for collecting all taxes and were required to return none or only a small portion to the national government during the initial stages of zone development. For example, the Shenzhen SEZ was not required to remit taxes to national or provincial government during its first decade. In the Aqaba SEZ in Jordan, locally derived revenues – including lease income, license fees, and customs receipts – are collected and retained by the local authorities governing the zone (Aqaba Special Economic Zone Authority); while sales tax, excise tax, income tax and land and building tax was shared equally between the local authority and the national government (with 75% of excise and income tax reverting to the national government after 7 years of operation, after which the sharing arrangement was to be 50/50).

In the Singapore-Suzhou Industrial Park (SIP), the revenue sharing model, however, failed to give the appropriate incentives to local government to ensure their commitment (see Box 5). In Aqaba, the incentives were generally well aligned, but the local authority found that revenue streams were insufficient to support growth and development in the long-term, and that they had limited flexibility to raise additional revenue streams<sup>18</sup>.

**Box 5: Challenges of partnership alignment in the Singapore-Suzhou industrial zone**

The Singaporean partners focused on using SIP as a platform to transfer developmental experience, and so they intended to build SIP infrastructure to international standards, which implied high development costs. By the end of 2000, infrastructure investment in the 9 sq km developed at SIP totaled RMB 7.8 billion (US\$1.14b), while in the other four state-level development zones in Suzhou 50 sq km was developed with an investment of only RMB 6.9 billion (US\$1.01b)<sup>19</sup> – i.e. infrastructure investment in SIP was 6 times more intensive (expensive) than in the other parts of the zone. As a result, the land needed to be sold or rented at a rate high enough to recover this development cost.

But for local government, which had only a minor share of the project, the incentives were quite different. They cared less about commercial returns more about the social and economic returns including job creation, GDP, and perhaps most importantly, tax revenue. In China, local government is responsible for the provision of most public goods and services, and its main source of revenue is the value-added tax paid by industrial firms. Thus, the incentive for local government is to attract as many industrial investors as possible, as quickly as possible. Land rents / prices that are too high to attract industrial investors results in less tax revenue and fewer jobs. Thus, there was a clear misalignment of incentives between the Singaporean majority stakeholders and the local government. This was exacerbated by the fact that the central government made a commitment in the initial project agreement to allow SIP to keep all tax revenues generated in the zone. Thus, local government had no incentive to invest in the critical connecting infrastructure to SIP.

Perhaps to the most significant difficulty in the partnership was the fierce competition that arose between SIP and neighboring industrial parks promoted by the Chinese partner. Before the launch of SIP in 1994, there were already four state-level economic development zones (EDZs) in Suzhou Administration – Suzhou New and Hi-Tech Development Zone (located west of the old Suzhou city)<sup>20</sup>, Kunshan Economic and Technological Development Zone (30km away from SIP), Zhangjiagang Bonded Area (90km from SIP), and Suzhou Taihu National Tourism and Vacation Zone – as well as numerous provincial-level EDZs. Most of these zones targeted industrial investors. As the other industrial parks were all government sponsored, land developers in those industrial parks were usually state owned enterprises. Their interests were naturally much more closely aligned with local governments. Attracting investors, rather than short or medium term commercial returns, were top on their agenda. Industrial land was therefore rented to industrial investors at subsidized rate, creating serious competition for SIP and making it almost impossible to maintain rents at the levels that could deliver a commercial return.

Moreover, free-riding could hardly be avoided. As SIP is an open area, roads built inside or connecting to SIP could also be used by users outside of SIP, including in adjacent industrial zones. At the time SIP attracted interested investors with the help of Singapore's promotion, other industrial parks and neighborhood villages and towns watched and learned from SIP, recruited staff who received on-job training in SIP, and even lobbied to attract investors away from SIP. The competition with Suzhou New and High-tech Development Zone drew the most attention and criticism from Singaporean partners.

*Source: Zhao and Farole (2011)*

<sup>18</sup> As a result the 75% local retention was extended.

<sup>19</sup> Data source: Suzhou Statistical Yearbook, various issues.

<sup>20</sup> This was the site that was initially offered to Singapore for development of SIP

In the case of SIP, the solution was to better align the incentives of the partners to ensure that all stakeholders are able to benefit in one way or another SIP's growth. VAT generated from SIP, which was allowed to be kept in SIP initially, was eventually shared between central government, Jiangsu provincial government, Suzhou municipal government and SIPAC (the local primary development and local government authority for the zone) – the central government now gets 75%, Jiangsu provincial government 12.5%, Suzhou municipal government 10%, while SIPAC now receives just 2.5%. The main tax revenue source for SIPAC is corporate and personal income tax, 60% of which is retained by SIPAC. SIPAC is also allowed to keep all revenues from land sales. Finally, the Suzhou New and High Tech Development Zone, a major competitor of SIP, took 5% of stake of the main developer in 2005. In Aqaba, the main development company was structured as a 50/50 joint venture between local and national government in order to ensure an effective tension was maintained between delivering revenues to the fiscus and reinvesting in the SEZ.

Sharing and redistribution of revenue streams from the EIZ would be administratively simplest should some fiscal union be formed that would allow for the pooling of revenues under the authority of the EAC, with subsequent redistribution through budgetary mechanisms. While this would not remove the need for a negotiation process, it would offer the potential to separate negotiations on redistribution of EAC revenues from the specific case of the EIZ (e.g. in the case, like in the EU, revenues from the EIZ would revert to the EAC common budget and would be pooled with other transfers from customs revenues, government contributions, etc.; the debate on redistribution of those revenues would then occur at a macro level). But in the absence of a fiscal union, it is necessary to consider both the administrative practicalities as well as the political economy concerns of revenue sharing in the EIZ.

The main revenue streams that may be shared among the EAC member states are the corporate taxes, the income taxes of residents, and VAT. While residents of the EIZ would maintain their national citizenship, a simple model for revenue sharing of income taxes would be to retribute taxes to the resident's home country. Of course, this is almost certain to deliver an imbalance of revenues to the host countries as, even assuming fully open labor markets, geographic proximity to the EIZ will. But it is likely to be seen by most states as the fairest approach. It could perhaps be combined with some model of affirmative action, short of quotas, to promote employment of workers from regions and member states outside the core.

The sharing of revenues from corporation tax is probably the simplest of the various tax-sharing arrangements to manage from an administrative perspective, and one that is likely to be most amenable to a negotiated solution (as well as having the greatest potential to be used in a redistributive way). Host governments may argue that the location of the EIZ in their country inherently reflects the comparative advantages and so *ceteris paribus* most of the investment would fall to them anyway. While the landlocked countries would undoubtedly argue that the EIZ is drawing investors that would otherwise have invested in their country. There are a number of models that can be used to develop an appropriate revenue-sharing formula taking these considerations into account. One option might be to retribute tax revenues to the home country of the investors, based on their nationality, with the share of

any non-EAC holding being shared equally among member states. Another is to base the formula in part on the markets which the companies serve (a kind of “customs union” revenue sharing approach).

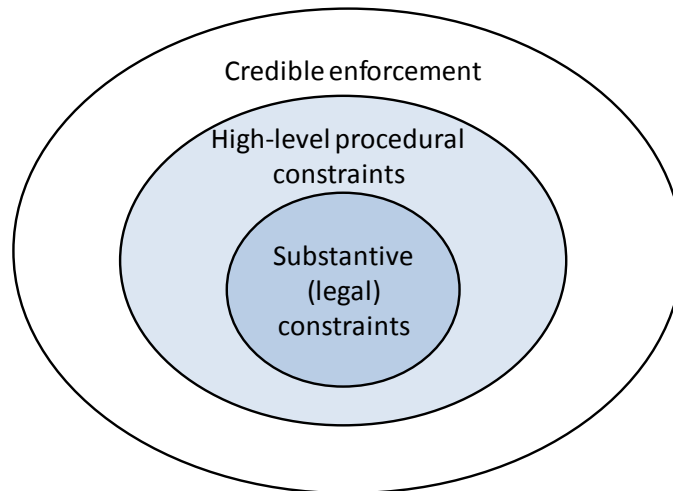
VAT revenue sharing would likely be the most complex from an administrative perspective, particularly with regard to revenues derived from trade between firms inside the EIZ and those outside it. However, from a revenue sharing perspective, it could be treated similarly to corporation tax.

### Formal, institutional mechanisms

Beyond the commercial arrangements, addressing the commitment challenge will require paying considerable attention to the institutions which govern the EIZ. Shepsle (1991) argues there are two ways in which commitment can be considered credible. The first is *motivational* credibility, whereby the parties continue to want to honor the commitment at the time of performance. This is essentially a model of encapsulated trust (Hardin, 2002) – i.e. parties will benefit equally by compliance and be harmed equally by non-compliance. Such commitment tends to be self-reinforcing. However, in an environment like the EIZ, with a large number of parties, high fixed costs and complex transactions, coordination through self-interest-based trust is less likely and risk premiums may rise to unacceptably high levels. This leads to the need Shepsle’s second type of credibility – *imperative credibility*, whereby players cannot act otherwise because performance is coerced or their discretion is disabled. This is where formal institutions come into play. Most of the literature on credible commitment focuses on the importance of institutions, in particular, meta-institutions like property rights and the rule of law, which help to establish the incentives that encourage (socially beneficial) commitment (North, 1990; Acemoglu and Robinson, 2006). Beyond this, institutions facilitate imperative credibility by ensuring the enforcement of rules rather than simply their existence. This enforcement characteristic is critical to aligning incentives, which is why laws must normally be backed up by a strong and impartial judicial system (including regulatory bodies, the police, and courts) to interpret and enforce rules (Levy and Spiller, 1996).

Levy and Spiller (2006) argue that three conditions are required for credible commitment in high sunk cost industries (see Figure 3). First is the existence of *substantive* restraints on renegeing. These should have some legal basis. Given that our focus is on restricting the risk of a sovereign state renegeing on its commitments to the EIZ, it is critical that the legal restraint be in the hands of an independent regulator. A second condition is the existence of high-level *procedural* constraints limiting change in the substantive constraints. An example of a procedural constraint would be a constitutional provision which places restrictions on the ability of the government of the day to change certain laws or to undo the autonomy of the regulator. Finally, commitment requires the existence of *credible enforcement* of both types of constraints.

**Figure 3: Conditions to ensure credible commitment in high sunk-cost industries**



*Source: derived from Levy and Spiller (2006)*

How can these conditions be addressed in practice in the context of the EIZ? A number of traditional legal approaches to managing risk in international investments may form part of the solution. First, bilateral and multilateral investment treaties may play a role in mitigating the risk that any one of the member countries of EIZ renege on their commitment to the EIZ (and thus to individual foreign investors in the zone). Investment treaties legalize a government's commitment to fair treatment toward foreign investors, requiring among other things national or most-favored-nation (MFN) treatment of in-country foreign investors and protection of contractual rights. Such investment treaties are normally enforced through the provision of independent dispute resolution mechanisms. In the context of BITs, the theoretical literature suggests that national governments will uphold their commitments out of concern to maintain their reputation, both with the bilateral partner and more widely (Goldsmith and Posner, 2005). However, there is certainly no guarantee that BITs alone will ensure commitment. Indeed, Wellhausen (2010) finds that since the 1990s there has been a huge growth in bilateral investment treaties but also a huge growth in the number of "expropriation incidents"<sup>21</sup> and investment arbitration, suggesting that even if BITs do contribute to greater investment in the short term, they may not offer a solution to the commitment problem.

A second element of the solution may reside in the use of political risk insurance. This can be provided through private markets or, for example, through the World Bank's Multilateral Investment Guarantee Agency (MIGA). MIGA guarantees can also to a degree be effective in securing a binding commitment from governments due to the reputational risk they would expose themselves to should they renege, and the implications this might have on their access to finance through the World Bank and other IFIs.

A third element may be the use of international dispute resolution mechanisms, normally involving binding arbitration, can play a role in helping to offset such project-related commitment risk. Such

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<sup>21</sup> "Expropriation incidents" defined as "forced divestment of equity ownership of a foreign direct investor" as per Kobrin in Wellhausen (2010)

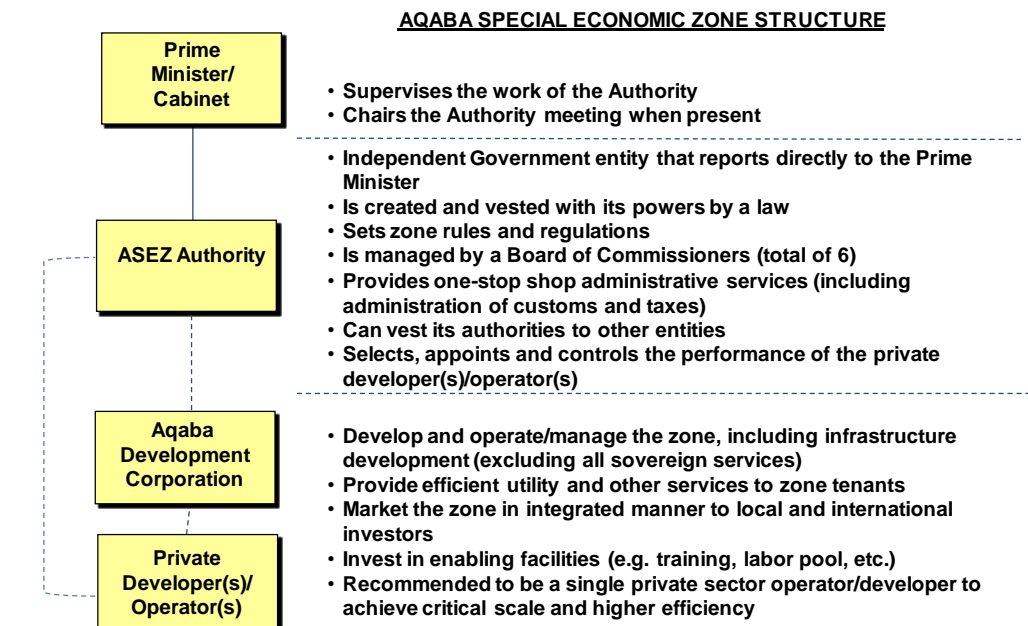
mechanisms are normally an important part of political risk insurance schemes. Again, international organizations play an important role here – for example the World Bank –hosted International Centre for the Settlement of Investment Disputes (ICSID).

But the most important institutional channel for managing commitment risk will be the structure of governance of the EIZ. In this context, international best practice suggests a multi-level structure that includes the following components:

1. A **master developer** of the EIZ (responsible for development and operations of the zone), which in turn may parcel out sections of the zone as well as infrastructure to subdevelopers;
2. An **EIZ regulatory authority**, which operates as an autonomous governmental agency overseen by a Board – the regulatory authority may also act as the **local government authority**; and
3. A **national or supranational government** that oversees the authority

Figure 4 illustrates the structure that governs the large-scale SEZ in Aqaba. Here the master developer – the Aqaba Development Corporation (ADC) – is a private shareholding company that was initially established and remains a 50/50 joint venture between the Government of Jordan and the regulatory authority (ASEZA). ADC is governed by a 6-member board of directors. In the case of the EIZ, the master developer could also be formed through some sort of joint venture development corporation established by member states. Alternatively the master developer could be a completely private company or consortium. Indeed, the original intention with the development of Aqaba was to attract a private developer and there remains a plan to eventually shift the ownership to private shareholders.

**Figure 4: Aqaba Special Economic Zone Structure**



Source: Fakhoury (2011)



In Aqaba, the regulatory authority (ASEZA) is responsible for establishing rules and regulations within the zone, providing all administrative services (including licensing, customs, and security), and appointing and monitoring the performance of the master developer and any sub-developers. This is a fairly standard approach for SEZs. Within Aqaba, ASEZA operates as the municipal authority, not only for overseeing the investors in the zone but also its residents. It is managed by a board of directors which are at the moment appointed by the Government of Jordan (note that elsewhere in the country municipal authorities are elected). Again, this is similar to the approach taken in most SEZs around the world, although best practice is to ensure balanced participation in the board by key stakeholders including, ideally, a majority from the private sector; wherever possible, board members should be elected or at least selected by the membership they represent, rather than being appointed by the board chairman or other governmental authority.

The EIZ would most likely establish a regulatory authority with similar responsibilities, but due to its regional nature, the board structure would need to be designed carefully in order to address the commitment challenge. In this respect three aspects of its composition are likely to be critical. First, of course the board must include representation from all EAC states involved in the project. Second, however, it may be necessary to give the governments of the countries in which the zone is hosted some additional power on the board, either through additional representation, their position on the board, or perhaps through having veto power over certain decisions. Third, the board should include other stakeholders that can play an important role in “checking” the power of the governments and ensuring that they maintain their commitment to the project. One important representative group here would be an association of all the investors in the project. Another might be a collection of private developers. A third important stakeholder group would include representatives of the private sector from the wider region which will be impacted by spillovers from the EIZ. Finally, including other respected external and neutral parties on the board that have some power to encourage commitment can be critical. This may include IFIs or a “third-party” national government, as proposed in the charter city model.

Experience from jointly-invested (i.e. government-to-government partnership) SEZ programs suggests that setting up a high-level steering council or committee, composed of senior political figures from member states, can be a powerful mechanism to encourage commitment. In the example of the China-Singapore partnership for the Suzhou Industrial Park, the steering committee was co-chaired by the Chinese Vice Premier and the Singapore Deputy Prime Minister, and includes ministerial chiefs of the two countries, senior officials of Jiangsu provincial and Suzhou municipal governments, and the head of Singapore’s Jurong Town Corporation (JTC).

As the EIZ regulatory authority would have jurisdiction and responsibility for delivering all aspects of governance in the zone (e.g. immigration, customs, policing, licensing, etc.) independently of the national institutions of the host country(ies), it offers a significant opportunity for the EAC to test different configurations of institutions, drawing on good practices from throughout the EAC and indeed beyond. Thus, the EIZ may become a model of what effective integration might look like in the EAC. Selecting the institutional models at the outset may not be optimal. First, there is unlikely to be

consensus as to which institutions are “best” in any specific domain. Second, even if there are “first-best” institutional approaches to individual aspects of governing the EIZ, taken together there is no guarantee that these institutional forms will work as effectively as some alternative configuration on the ground. Thus, one option may be to set up a bidding mechanism for the various governance and public service functions inside the zone, with the selection of the preferred bidders made either by the EIZ board or (perhaps better) by an independent selection panel consisting of technical experts.

Regional cooperation must be seen not only from its perspective as a commitment risk, but also as an important institutional mechanism that can in fact help render more binding the various commitments of EAC members. As previously discussed, regional agreements not only raise the prospective payoff from cooperation among members, but critically raise the costs of defection. In the context of regional cooperation agreements, Laursen (2003) outlines the set of institutional requirements needed to ensure commitment of members for different types of issues (see Table 3). In the case of EIZ, the commitment challenge is most likely one involving “co-ordination problems with distributional issues”. In general, the interest of all member states should be broadly aligned (investment attraction, job creation, etc.) but coordination across states may be problematic. Based on this context, Laursen’s model suggests the need for pooling and delegation of sovereignty as well as budgetary means to support redistribution, possibly in combination with sanctions against defection. How might this be achieved in practice?

**Table 3: Nature of issues and institutional requirements**

<b>Nature of issue</b>	Conflicting interests / pure conflict	Dilemmas of common interests; temptation to defect	Co-ordination problem with distributional issues	Simple co-ordination problem	Harmony of interests
<b>Institutional requirements</b>	Institutions to no avail’ convergence of interests required	Pooling and delegation of sovereignty; sanctions against defection	Pooling and delegation of sovereignty; budgetary means	Open method of coordination sufficient	Institution-alisation not necessary; “Parallel unilateral action” sufficient

*Source: Laursen (2003, p.18); shaded areas by authors identify those most relevant to the commitment issues related to the EIZ.*

The example of the EU is particularly instructive in identifying some of the institutional mechanisms that can play a role in gaining commitment from parties. “Pooling of sovereignty” (Moravcsik, 1998) involves member states actually ceding real power over certain issues to regional bodies and accepting binding majority decisions. It relies on the primacy of European law over national law and on the existence of “commitment institutions” (Laursen, 2003) like the European Commission and the European Court of Justice, which enforce this primacy. In the EAC, the precedence of national law and the lack of strong regional legal authority place significant limitations on the potential for EAC institutions to act as a strong, binding force. There may also be limited budgetary means to support redistribution to support regions that may have less to gain or could potentially lose from the EIZ (at least in comparison to the EU model). However, this could potentially be addressed through the distribution revenue streams (taxes

and fees) from the EIZ itself (*see discussion earlier in this section*). EAC institutions still have the potential to play an important role in resolving conflicts between member states over issues related to the EIZ. Specifically, mechanisms could be set up so that the EIZ board could raise issues for negotiation or arbitration through the EAC Secretariat and ultimately the East African Court of Justice.

### *Informal mechanisms*

Finally, informal mechanisms can also play a useful role in “checking” the governments which have power over the EIZ. Here, the role of firm-level collective action is important. Where there is an organized group of stakeholders that would be affected by any breakdown of commitment on the part of host governments, the government is more likely to be kept in check. Wellhausen (2010) shows that firm-level collective action against expropriation or nationalization is more likely to occur when the foreign investors have things in common, such as nationality, industry of operation, or mode of entry. In many SEZ programs (for example in countries like Honduras, Dominican Republic, and Colombia, where the programs are dominated by privately operated zones), associations of zone developers form to represent the interests of developers. In some programs they are even given a formal seat on the board of the zone regulator. In some cases, for example in the Dominican Republic, associations are also formed of individual investors inside each industrial zone.

When an existing association does not exist, an alternative is to assemble a “coalition” of interested parties who stand to gain from the success of the project and who have a strong incentive to ensure that the host governments, and all stakeholders, maintain their commitments. Such a coalition might include local governments (that have a stake in the project potential local and foreign investors, labor and possibly groups representing residents of the EIZ and of neighboring communities. It might also include IFIs and donors who are supporting the EIZ and who have a strong interest in ensuring that the critical parties maintain their commitment to the project and do not place it at risk of failure by renegeing. While such a coalition might have a formal governance role in the EIZ (e.g. on the board, as discussed above) it could also play the more informal and independent monitoring role discussed here.

## **6. Conclusions**

Integration in the EAC offers significant opportunities not only to expand trade among member states, but more importantly to scale up regional production to take advantage of much larger global market opportunities. Experience of other parts of the world, most notably of East Asia, suggests that regional integration is more likely to succeed and to have larger economic benefits if it helps the economies of all participating countries to leverage global demand. For the EAC, where three out of five member countries are land-locked, this is more difficult to accomplish.

In this paper we discussed the proposal for developing an “economic integration zone” in the EAC, a special economic zone jointly governed by the EAC member countries which would be located in proximity both to the coast and to the areas of high concentration of economic activity within the region. The benefits of such a zone could be substantial. It may help to facilitate the integration of

regional value chains in support of this scaling up. It would also have the potential to deliver powerful demonstration effects on the benefits of integration and to help entrench the integration process.

The practical challenges to implementation of this proposal are also substantial – in particular the political economy challenges. The largest of them is the issue of “credible commitment” – the challenge of managing the investment risk by maintaining the commitment of the host government(s) and other partners over the long term.

The paper offers a number of potential solutions to address these challenges. They include commercial and financial mechanisms that can establish an effective incentive system from the outset; formal, institutional approaches to ensuring commitment such as legal constraints and enforcement mechanisms; and informal approaches to align mutual interests of stakeholders. Effectively addressing commitment risks will likely require making use of all three mechanisms.

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