KEY POINTS

- Special economic zones (SEZs) have become a powerful engine driving the reform process and economic growth **in the People's Republic of China (PRC)**.
- **In 1988, Hainan Province became the fifth and largest SEZ in the PRC.**
- **In 2018, Hainan became the 12th free trade zone and the first envisioned free trade port in the country.**
- For successful operation, the SEZ development program should be integrated in national investment plans. **With a robust legal and regulatory framework and preferential incentives, it must also be integrated** into longer-term urban planning.

Hainan Free Trade Port Development

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BACKGROUND

The island province of Hainan became the 12th free trade zone (FTZ) in the People's Republic of China (PRC) in 2018. It was also the first envisioned free trade port (FTP) in the country. As an FTZ, Hainan will primarily target the services industry. Domestic and international experiences identify key conditions to successfully operate special economic zones (SEZs), which include the integration of the SEZ development program in national investment plans, the development of a robust legal and regulatory framework, the establishment of appropriate incentives to improve business climate and private sector participation, and the integration of SEZs into longer-term urban planning. For Hainan to successfully develop, efforts have to be undertaken to ensure that (i) policies and institutional mechanisms are in place to strategically position Hainan as the first FTP of the PRC; (ii) an enabling environment is created to attract legitimate private investments; and (iii) the Hainan FTP investment plans are integrated into the overall urban development, spatial planning, and infrastructure development plans in the area.

SPECIAL ECONOMIC ZONES AND
HAINAN'S ECONOMIC DEVELOPMENT

In 1980, **the Government of the PRC** created the four special economic zones (SEZs) in Shantou, Shenzhen, Xiamen, and **Zhuhai**. **Hainan**, Shanghai Pudong New Area, and Tianjin Beihai New Area **were also designated as SEZs in the years that followed.**¹ SEZs also cover other modalities including economic and technological development zones, free trade zones, export processing zones, and high-tech industrial development zones. The government has been highlighting the role of SEZs as a testing ground for new institutions and policies that are market economy-oriented since the early stages of policy design. Specific preferential policies targeting the different modalities of SEZs have also been issued.

¹ In 1988, the newly created Hainan Province was designated as the fifth SEZ. It was followed by Shanghai Pudong New Area in 1992, to promote Shanghai's economic and social development, and then Tianjin Beihai New Area in 2000..

The later phase in the evolution of SEZs in the PRC involved the creation of several FTZs.² The first FTZ was announced in Shanghai in 2013 and was designed to attract foreign direct investment in the finance and service industries by streamlining customs procedures, rationalizing control of cross-border finance and people movement, and developing more efficient administrative institutions. From 2014 to 2015, the Government of the PRC selected an additional 10 local jurisdictions to test its FTZ development plans.

The development of SEZs has become a powerful engine driving the reform process and economic growth in the PRC. The role of SEZs in the PRC's rapid economic growth and in generating export revenues, technological and skill spillovers, employment creation, and economic linkages, has convinced policy makers from developing countries to replicate this model. Factors contributing to the success of the PRC's SEZ development include a sound business environment, quality infrastructure, institutional reform, adequate authority for local decision-making, and preferential policies for businesses and investors.

Hainan's economic growth is firmly linked to its SEZ development. Around the same time in 1988 that Hainan was upgraded to a province from a prefecture under the administration of Guangdong Province, Hainan was designated as the fifth and largest SEZ in the PRC. The PRC was then positioned at the lower end of the global production chain, and SEZs were seen as a means to attract foreign direct investment. In the first few years of Hainan's provincehood, large amounts of capital and professionals moved to Hainan. However, due to poor infrastructure and limited market size, Hainan remained inferior to Shenzhen in attracting investments in the manufacturing sector. Most of the inflow of funds was invested in the property market, generating a speculative bubble that burst in 1993 when the central government tightened monetary policies.

Afterward, Hainan fell into a painful recovery phase until the announcement of the "One Province Two Bases" development strategy in 1996, which saw the Hainan provincial government present its first well-designed midterm development plan. The plan aimed to convert Hainan into a newly developed industrial province in the coastal area by 2020, serving as a production base for high-value agricultural products and tourism. The production base for high-value agricultural products and tourism was referred to as "Two Bases" in the "One Province Two Bases" Strategy. This

strategy identified high-value agriculture and tourism as the two pillar sectors for Hainan based on its unique geographic location and economic comparative advantages. From then on, Hainan's economy jumped onto the high-speed growth track. By 2007, gross domestic product (GDP) per capita reached \$1,909, compared to \$249 in 1987. In 2017, the GDP per capita of Hainan reached \$7,179, falling into the World Bank's definition of upper- and medium-income countries' income range. However, compared to other coastal SEZs under the PRC's nationwide long-term continuous high-speed economic growth, Hainan's economic achievement was moderate. Hainan remained a less developed province in the coastal area.

In April 2018, at a conference celebrating the 30th anniversary of the creation of Hainan Province, the Government of the PRC announced Hainan as the 12th FTZ and the first envisioned free trade port (FTP) in the PRC by 2020.³ ("Hainan FTP" hereafter refers to the integrated Hainan FTZ and FTP program of the PRC). The Hainan FTP announcement verified the strong intention of the Government of the PRC to boost the Hainan economy and to test new institutions and initiatives through the development of the Hainan FTP. The policy is in line with the PRC's SEZ development policy, emphasizing SEZs as the testing ground for new institutions and initiatives that could be replicated on a national scale. It is also consistent with the government's present economic strategies and initiatives, including industry updating; economic restructuring; and the implementation of the "One Belt, One Road" initiative. With 2018 also marking the 40th anniversary of the implementation of the "Open to the Outside" policy of the PRC, the designation of Hainan FTP justified the PRC's commitment to push forward with market economy reforms to further integrate with the global economy.

CATALYZING ECONOMIC DEVELOPMENT AND IMPLICATIONS FOR HAINAN

An ADB study in the *Asian Economic Integration Report (AEIR) 2015*,⁴ identifies the following four preconditions and policies that are needed to successfully operate SEZs.

- **Special economic zone development programs integrated into the broader economic policy framework and national investment plans.** SEZ programs should be closely coordinated or linked with wider economic strategies as they evolve;

² Free trade zones, also known as commercial-free zones and free commercial zones, are small, fenced-in, duty-free areas. FTZs offer warehousing, storage, and distribution facilities for trade, transshipment, and re-export operations and are located mostly in entry ports. The core definition of an FTZ, as well as proposed guidelines and standards for them, are contained in the Revised Kyoto Convention of the World Customs Organization (WCO). (Source: World Bank. 2008. *Special Economic Zones Performance, Lessons Learned, and Implications for Zone Development*. Washington, DC.)

³ Free trade ports are generally a much broader concept than FTZs, and typically encompass larger areas. They accommodate all types of activities, including tourism and retail sales, and permit people to reside on-site. FTPs provide a much broader set of incentives and benefits. Nowadays, there are over 600 FTPs globally including Dubai; Hong Kong, China; and Singapore (Source: World Bank. 2008. *Special Economic Zones Performance, Lessons Learned, and Implications for Zone Development*. Washington, DC.)

⁴ ADB. 2015. *Asian Economic Integration Report 2015: How Can Special Economic Zones Catalyze Economic Development?*. Manila.

supporting domestic investments in SEZs; and promoting linkages, training, and updating along the value chain. SEZs should have a clear, coherent, and viable business and economic rationale anchored in local conditions. Diagnostic studies should identify a few sectors as growth pillars to be prioritized in SEZ development, promoting specialization and eventually cluster development that jives with an economy's dynamic comparative advantage. Economies should take advantage of existing industry clusters to develop SEZs rather than the other way around. SEZ development has proven to be more fruitful when strategically integrated into an economy's overall development framework. International development experience has showed that the success of SEZs needs clear, consistent, and credible political commitments at the highest levels of governments to achieve the development objective.

- **Robust legal and regulatory framework.** A sound macroeconomic policy regime also needs to be supported by a strong legal and regulatory framework that spells out the parameters for all stakeholders and mandates a high degree of transparency and accountability. A flexible labor market and ease of labor utilization are among the major attractions of SEZs, but labor protection and social issues should also be considered and placed on the host government's agenda, particularly in low- and middle-income economies where labor is a key resource. Also, as economies upgrade to more advanced stages, labor skills will be more important. To draw labor to SEZs, access to housing, social services, and other amenities can be a major inducement.
- **Appropriate incentives and benefits to improve the business climate and boost private sector participation.** SEZs offer a variety of tax and duty exemptions. Often, competition among zones tends to make these incentives more generous than needed. Hence, investment agencies should include “sunset clauses” during the incentive package design to increase the net gain accruing from SEZ creation. Fiscal incentives are usually beneficial at the initial stages of SEZ development. Ideally, the SEZ authority should enjoy a large degree of autonomy, with a one-stop service for project proposals, and outsource noncore functions. Involving the private sector financially and managerially, and creating incentives for private zone developers and operators can reinforce this autonomy, thereby relieving government's fiscal burden. According to a stocktaking exercise conducted by the World Bank in 2008, over 60% of the SEZs in developing and transition countries are developed and operated by the private sector.
- **SEZ development and spatial planning.** The concept of urban development and creation of smart cities will increasingly be an integral part of SEZs. Governments should perceive SEZs not only as a self-contained entity, but also as part of a longer-term urban development program.

As a “latecomer” to the new round of FTZ experiments, Hainan is facing its own challenges, consistent with the ADB study. As highlighted in the first point, the biggest challenge lies in ambiguous strategies positioning Hainan FTP with other similar programs. Despite the central government's clear support, the positioning of Hainan FTP at the operational level remains unclear. The Hainan provincial government and the central government line ministries need to clarify whether Hainan FTP is proposed to serve Hainan province's economic development only, or is a national priority program to test another round of new economic reform policies and initiatives.

The performance of the FTP experiment will contribute to Hainan's relative importance among other FTZs. If the Hainan experiment moves ahead of the other FTZs, the central government will pay more attention and allocate additional resources and policy testament assignments. Should Hainan fail to secure central government support and endorsement, as a latecomer, the Hainan FTP will have limited maneuvering space for preferential policy design and institutional innovation. However, those verified policies and arrangements from other FTZ experiments can be integrated into the Hainan FTP development plan.

In addition, administrative challenges faced by the Hainan provincial government during FTP development are huge. The Hainan government began participating in SEZ development in 1988. Hainan also initiated several institutional and policy reforms, most remarkable of which is the road toll collection and administration reform in 1994. In Hainan, there are several kinds of SEZs under operation, including the Yang Economy Development Zone, Haikou Free Trade Zone, and Yalong Bay National Tourism Holiday Resort. The government has gained some experience on SEZ regulation, development, and operation; however, FTPs are designed to develop a more competitive economy through limited government intervention in the distribution and allocation of global production factors. This raises a high-level criterion for the FTP host government's administration and governance capacity. The successfully developed and operational FTPs—like Singapore and Hong Kong, China—have administrative units with strong governance. For Hainan, capacity constraint is one institutional challenge in FTP development.

Despite these challenges, Hainan FTP can benefit from three geographical elements. First, Hainan is situated beside an important sea lane connecting the Malacca Strait and the more developed Northeast Asian economies. Second, being isolated from the mainland, Hainan has developed a unique value to perform financial regulatory sandbox test. Third, Hainan FTP development can be linked to the Belt and Road Initiative (BRI), especially the 21st Century Maritime Silk Road development.

The table below presents a strengths, weaknesses, opportunities, and threats analysis in light of the challenges discussed.

Strengths, Weaknesses, Opportunities, and Threats Analysis of the Hainan Free Trade Port

Strengths	Weaknesses
<ul style="list-style-type: none"> Strong promotion from central government Past SEZ administration experience Past sector strategy design experience Isolated island, ideal for financial regulatory sandbox test 	<ul style="list-style-type: none"> Unclear “positioning” among all FTZs Limited administrative capacity Diminished preferential policy impact Shortage of highly qualified professionals
Opportunities	Threats
<ul style="list-style-type: none"> May be promoted as a national FTZ or FTP priority May benefit from other earlier approved FTZs’ experience in new institutions and policy reform Ideal site for PRC–ASEAN RCI 	<ul style="list-style-type: none"> Other FTZs targeting at similar sectors Competition from existing FTPs, especially Hong Kong, China; and Singapore Approval of additional FTZ initiatives

ASEAN = Association of Southeast Asian Nations, FTP = free trade port, FTZ = free trade zone, PRC = People’s Republic of China, RCI = Regional cooperation and integration, SEZ = special economic zone.

Source: ADB staff analysis.

POLICY RECOMMENDATIONS

Overall Design

Policies and institutional mechanisms can be designed to strategically position Hainan as the first free trade port in the PRC. These policies could promote the entry of investors thereby generating employment opportunities. Highly trained workers and efficient services can be made available to commercial enterprises and help establish backward and forward linkages among industries in and around the FTP. Specifically, Hainan can consider the following:

- **Securing strong central government support.** Further support may be provided by the central government to Hainan Province by way of added legislative authority in economic affairs, similar to the case of Shenzhen in the 1990s.
- **Recalibrating the pillar sector development strategies.** Tourism, high-technology industry, and modern service industry have been identified as pillar sectors, each with a broad definition and coverage. During the preparation of the Hainan FTP development plan, detailed analysis can be conducted to recalibrate the pillar sector development strategies by identifying specializations for each sector.

- **Skills training of local workers.** Modern service industry relies heavily on high-quality professionals. Strengthening capacity building, vocational education, and training can help open the market to international players, and aid professionals in gaining international recognition.
- **Maximizing the potential of regional cooperation and integration and BRI.** Under the BRI structure, Hainan can be developed into an economic policy testing ground for Regional cooperation and integration, where specific targeted policies benefiting the Association of Southeast Asian Nations (ASEAN) countries can be introduced—a Sino–ASEAN partnership. This Regional cooperation and integration can include recognition of medical and nursery certificates issued by ASEAN countries in order to bring in qualified medical professionals for Hainan’s medical tourism development.
- **Conducting financial regulatory sandbox tests.** To make good use of its unique geographic isolation, the central government can conduct financial regulatory sandbox tests in Hainan, and ease capital control and no-visa entry tests.

Free Trade Port Operation and Administration

Hainan FTP needs to ensure that its operation will create an enabling environment that contributes to achieving the government’s vision for Hainan. It should adopt measures that can effectively attract legitimate and productive foreign and local (private sector) investments through the following:

- **Provincial institutional and administration reform.** Compared to potential competitors such as Singapore and Hong Kong, China, administration capacity is a major challenge to Hainan. With the upgrade in its status from SEZ to FTP, the Hainan government could learn from the Hong Kong, China; and Singapore models, and conduct institutional and administrative reform to ensure good governance. Officials assuming key positions should also be further trained. An option is to actively share administration experience with other FTP authorities and operators in Asia and the Pacific through existing regional and subregional platforms.
- **Private sector participation.** Throughout the entire FTP development process, the participation of the private sector—from FTP administrative framework design, to specific zone development and daily operations—should be promoted. International experience demonstrates that public–private partnership has been widely applied in SEZ development and operations. Private sector participation can help reduce the fiscal burden on government and improve the SEZs’ infrastructure service level.
- **Pragmatic approach.** To implement the largest FTZ design, practicality should be followed. With an over 35,000-square kilometer area, several small, theme-focused FTZs can be developed first based on the pillar sectors. From this pilot experience in small areas, FTZ promotion policy can be further calibrated.

- **Updating present economic development zones.** This can be considered during the early stage to generate enough direct employment benefits and sustain the development momentum. Even though the Hainan FTZ targets primarily the service industry, existing processing zones can be updated to accommodate new investments. The production industry has a long supply chain to generate more employment, benefiting more people. In the long run, with the enforcement of service sector promotion policies, more investments will flow to the service industry and dilute the portion of the manufacturing industry.
- **Environmental protection and public service improvement.** In addition to offering preferential policy packages, environmental protection and public service improvement should also be given importance. Hainan may have limited space to design preferential policy packages. The Hainan government's efforts should focus on long-term development strategies that attract investors and workers. The government should further invest on infrastructure, environment protection, urban development, and public services that make it conducive and easy for tourists, highly skilled workers, and service industry employees to come to Hainan.
- **Urban planning.** The planning and development of the FTP should be integrated with the concept of urban development and the creation of smart cities. These will increasingly be an integral component of high-technology and knowledge-based SEZs that combine research and development centers, e-governance, skilled labor, and other commercial and recreation centers. Given this changing trend, Hainan FTP should not only be perceived as a self-contained entity, but also as part of the long-term urban development process. A well-designed urban environment will help Hainan attract high-technology industry investors and international high-end tourists.
- **Labor protection and gender.** These issues should be built into the FTP development plan. The influx of skilled workers and professionals will lead to new challenges in labor protection, including international labor dispute arbitration and the like. The government should review the present legal framework and institutions to tackle these development challenges. In the tourism, medical, finance, and other service industries, women occupy a sizeable portion of job positions. Creation of gender equality in the workplace, elimination of discrimination on women in relation to family care responsibilities, and other gender issues should be considered during policy design.
- **Contain the impacts of development of tourism and finance sectors.** Large inflows of tourists and high-income professionals may worsen the traffic situation and raise the costs of living. Facing this situation, the government should play the role of income and welfare redistributor to ameliorate the residents' living standards through expanded public investments portfolio, vocational training to target groups, and even direct fiscal subsidy.

Urban Planning and Social Issues

Hainan needs to integrate FTP investment plans into the overall urban development, spatial planning, and infrastructure development in the area. This is to harness the potential of linking resources, people, and markets through urban development support and assistance with supply chain integration, logistics, and transport development.

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