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**The case for innovative
governance**

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Abstract

It is often assumed that governance reforms must take place along a predetermined geographic region, typically the country within which the governance reform is being considered. This essay argues for zone-based governance reforms. The targeted governance reforms can help countries overcome public choice challenges of reforming governance. The result is rapid improvements in governance which would not otherwise be possible under traditional methods of governance reforms.

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Introduction

Former British Prime Minister Gordon Brown famously quipped, “In establishing rule of law, the first five centuries are the hardest.”¹ His dictum applies to more than just rule of law. Governance, the process of creating and applying rules and norms, including rule of law, to a social organization, is at least as difficult to establish as the rule of law and also the most important determinant of human flourishing.

Efforts to improve governance typically take for granted the jurisdiction within which governance occurs. But this is a strong and potentially paralyzing assumption. Governance reforms should be considered not only for their own merit, but also for the territories they apply to. This new dimension widens the scope of potential improvements and has so far been an unfortunately minor part of the discussion.

There are a number of terms for zone-based governance reform, including special economic zones, charter cities,² free cities, seasteads, free zones, and more. For simplicity I refer here to these reform types as innovative governance.

The success of innovative governance projects depends on the conditions and constraints they face. Some, for example charter cities, require a high level of autonomy and independence from the host country, not to mention a large amount of land. Others, for example the Dubai International Financial Center, require relatively little amounts of land, and autonomy for only a specific section of law.

Innovative governance is both understudied and an area where greater experimentation with a variety of local models could lead to significant improvements in the preconditions for human flourishing. As illustrated by the example of Neom, a recently announced Saudi new city project, there is a great deal of practical interest in innovative governance.

Lessons from Shenzhen

China’s economic growth since 1980 has been the most important humanitarian success story of the postwar era. The World Bank estimates China has lifted 800 million people out of poverty.³ China’s growth has been driven by urbanization combined with decentralized economic reforms, something low-income countries around the world can learn from today.

China’s economic boom began in 1980, when China established four special economic zones, including one in Shenzhen. From 1983 to 1986, Guangdong and Fujian, the provinces where the special economic

¹ Adam Davidson, 2012, “How Honduras Can Pull Off Five Centuries of Legal Reforms in a Decade,” National Public Radio, May 14, <https://www.npr.org/sections/money/2012/05/14/152669302/how-honduras-can-pull-off-five-centuries-of-legal-reforms-in-a-decade>.

² Paul Romer, 2009, “Why the World Needs Charter Cities,” TED Global, https://www.ted.com/talks/paul_romer.

³ World Bank, 2017, “The World Bank in China,” March 28, <http://www.worldbank.org/en/country/china/overview>.

zones were located, attracted 56 percent of all foreign direct investment in China.⁴ As the success of the initial special economic zones became more apparent, China adopted the model in other provinces.

Chinese special economic zones were substantially different from what are commonly thought of as special economic zones. Shenzhen, for example, was not a mere export processing zone. Instead it was given “freedom to experiment with new policies and measures.” These measures included creating a new labor and wage system, a home-purchase scheme for workers, the first urban-land-rights development auction, and the first stock market in China.⁵

The economic growth in China that special economic zones sparked was accompanied by rapid urbanization. In 1980, fewer than one in five Chinese lived in cities, less than India, Indonesia, and Pakistan. China’s urbanization is currently 56 percent, the country having housing and work opportunities for added nearly 500 million urban residents in the last thirty-five years.⁶ China was able to urbanize so rapidly and with such great increases in living standards in large part because of the economic success it achieved via autonomy for cities.

Drawing from the Chinese experience, it is possible to further define the determinants of success for innovative governance in rapidly urbanizing areas. The typical special economic zone might offer lower taxes, a simplified business environment, or expedited customs for a single industry in a limited geographic area. Shenzhen, however, was not a typical special economic zone.

First, the Shenzhen had independent governance. The SEZ legislation created a sphere of autonomy for Shenzhen. However, it did not define the laws and legislation which would be implemented in Shenzhen. Instead, Shenzhen itself was able to respond to local, on the ground conditions, to determine what policies to implement.

Second, Shenzhen’s sphere of autonomy was substantial. It was not limited to just tax policy, an unfortunate failing of many modern special economic zones. Instead it could also improve labor law and create land reforms. Few, if any, low-income countries today are a single reform away from economic success. An innovative governance project must have substantial autonomy to be able to create the necessary environment to attract investment and entrepreneurs.

Third, governance improvements have a minimum viable size. The original Shenzhen special economic zone was fully 327.5 square kilometers, almost twice the size of Washington DC. If a zone is too small, it cannot create a sustainable economy, no matter how good the governance is. Innovative governance

⁴ Cletus C. Coughlin and Eran Segev, “Foreign Direct Investment in China: A Spatial Econometric Study,” *World Economy* 23, no. 1 (2000): 1–23.

⁵ Yue-man Yeung, Joanna Lee, and Gordon Kee, “China’s Special Economic Zones at 30,” *Eurasian Geography and Economics* 50, no. 2 (2009): 222–40.

⁶ Helen Roxburgh, 2017, “Endless Cities: Will China’s New Urbanisation Just Mean More Sprawl?” *Guardian*, May 5, <https://www.theguardian.com/cities/2017/may/05/megaregions-endless-china-urbanisation-sprawl-xiongan-jingjinji>.

projects must be scalable to ensure enough physical space to fully take advantage of the governance improvements.

Governance

Governance determines social outcomes. Consider this photo. In the bottom-right corner is South Korea. The top-left corner includes China. The middle is largely dark, with a single light: Pyongyang.



North and South Korea have the same people, the same history, the same culture, and the same language. Yet North Korea remains so underdeveloped it is able to light only its capital city.

The reason for South Korea's success is good governance. Governance is the process of creating and applying rules and norms to a social organization. When that social organization is the

state, good governance can mean the difference between feast and famine.

Good governance creates positive-sum interactions.⁷ A system with good governance can incentivize people to take actions that encourage human flourishing. The classic prisoner's dilemma is a useful tool for understanding the importance of governance. While cooperation leads to a better social outcome, defection leads to better individual outcomes.

Governance matters. Participants in a prisoner's dilemma do not defect because they are bad people but because the payouts encourage defection. A simple tweak, letting participants choose their partners, leads to cooperation.⁸ Good governance encourages cooperation.

There are three key aspects of good governance. First is the rule of law: a stable set of rules to allow people to effectively plan. Second is the open society: people must be able to start and join different organizations at low cost. Third is state capacity: the government must be an effective administrator and provider of public goods.

The rule of law is an essential part of good governance. Rule of law means everyone is subject to the same rules, the rules are known in advance, and the rules are not changed arbitrarily. Without a stable set of rules known before people are expected to follow them, it is impossible to effectively plan. Without the ability to undertake medium- and long-term plans, societies will necessarily remain

⁷ North, Douglass C. "Institutions." *Journal of economic perspectives* 5, no. 1 (1991): 97-112.

⁸ Gordon Tullock, "Adam Smith and the Prisoners' Dilemma," *Quarterly Journal of Economics* 100 (1985): 1073-81.

underdeveloped because it means they will only employ production processes with limited time horizons.⁹

The second important ingredient of good governance is openness. Because cultural and economic success are emergent, not planned, placing barriers on voluntary social organizations limits the forms of social organization and their potential to contribute to economic success and cultural innovation.¹⁰

Last, good governance requires state capacity. At a minimum, the governing body must control violence and provide some means to enforce contracts. If the governing body does not control violence, other mechanisms for controlling violence will emerge that are less legible, preventing potential economic activity from occurring. More generally, the governing body must be an effective administrator to collect taxes, enforce laws, and provide public goods.

States with rule of law, openness, and state capacity tend to develop rapidly. Unfortunately, however, improving governance is difficult. The low-hanging fruits of governance improvements have already been picked. Reforming government from the inside is typically politically infeasible in the short term. Successful reforms often require an independent body.

Take Singapore. It gained independence from the British in 1963 by joining Malaysia. However, it decided to keep the Privy Council, the highest court of appeals for certain Commonwealth countries. Singapore kept this Council after becoming an independent country in 1965. By using the Privy Council as the highest court of appeals, Singapore credibly signaled its commitment to rule of law to the world.

Dubai did something similar when creating the Dubai International Financial Centre. Realizing the Dubai legal system was not well known or trusted, particularly with regard to highly elastic financial markets, they decided to bring in a British judge. The Dubai International Financial Centre uses a curated version of common law with decisions being made by judges with experience in Commonwealth countries.

Hong Kong was a British colony when it experienced its most rapid growth. John Cowperthwaite, Hong Kong's financial secretary from 1961 to 1971, is generally credited with turning Hong Kong into a global financial center. As financial secretary, he had a high degree of autonomy in determining how to best govern Hong Kong. As a classical liberal, he adopted the policy of positive non-interventionism¹¹, restricting state interference in the economy and letting it grow.

The Crown Agents an international development nonprofit and independent governance authority which countries invite to help improve their governance. Part of the British government until 1997, it was created to help administer British colonies. It currently performs a similar role, helping low-income

⁹ Friedrich A. Hayek, *The Constitution of Liberty: The Definitive Edition*, 2013.

¹⁰ Douglass C. North, John Joseph Wallis, and Barry R. Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*, Cambridge University Press, 2009.

¹¹ Positive non-interventionism was the term for Hong Kong's economic policies.

countries create effective administration. For example, it helped modernize the customs system of Angola, increasing revenue sixteen-fold over an eleven-year period.

Theory of Innovative Governance

Governance reforms are typically applied along a single dimension. The political unit where the reforms take place is taken for granted. By creating a new dimension of governance reforms: the territory in which the reforms are applied, there is a new set of possibilities for governance improvements.

While innovative governance projects offer a mechanism to escape the limitations of traditional politics, they ultimately are the products of political actions. Their success requires the passage of legislation, and political support, and subsequently tolerance and non-interference.

The urgent need for rapid urbanization provides a context within which innovative governance legislation may be passed. The UN estimates there will be an additional 2.5 billion urban residents by 2050. Sixty-five million people are refugees seeking new homes. Old cities will grow and new cities will be built. Small villages will turn into metropolises. This is an opportunity for substantial innovation and experimentation in governance reforms.

Focusing on greenfield, or relatively undeveloped sites opens the door to deeper governance reforms than might otherwise be possible. The political equilibrium would be minimally affected, yet the potential would come for substantial long-term gains because successful reforms would rapidly attract residents and businesses. It is even possible to ex ante identify some key winners from reform—for example, property developers and owners. This can reverse the logic of collective action, which often is the reason why beneficial reforms fail to be enacted.

The success of an innovative governance project depends on its governing body. Maintaining independence, creating growth-oriented policies, building infrastructure, attracting capital, and becoming a desirable place to live are all the responsibility of the governing body. Consider three alternative governance models: high-income countries, nonprofit corporations, and for-profit corporations.

In Paul Romer's original formulation of a charter city, a high-income country is the guarantor, governing the city. The benefit of this approach is the governing body's strong independence. Creating a charter city requires a bilateral treaty, and any infringements on the governing body's independence would infringe on the treaty.

This approach has several disadvantages. First, many countries are unwilling to embrace it. Charter cities were often criticized for being colonial, and Romer's involvement in Madagascar may have been

partially responsible for large scale protests.¹² Second, charter cities may not have the flexibility and agility in public administration necessary for success. High-income countries, while well governed, are generally not known for quick, decisive action.

Alternatively, a nonprofit could govern the innovative governance project. The success of the innovative governance project would depend on the governance structure of the nonprofit, particularly who the initial appointees are and the mechanism for selecting replacements. If the appointees are internationally renowned and able to choose their successors, their independence will be preserved. If, instead, the appointees are political figures from the host country, or the host country has the right to appoint replacements, the innovative governance project will not truly be independent. The performance of the nonprofit in creating a good legal environment and attracting capital would similarly depend on its personnel.

Finally, a for-profit entity could govern the innovative governance project. The entity would have incentives for governing well and promoting economic success because such success would benefit its bottom line. It would also be proactive and responsive to conditions on the ground. On the other hand, for-profit entities are often viewed with suspicion, especially in less-developed countries where relationships with large foreign corporations have not typically been seen as benefiting local populations. Most countries may have concerns and objections about allowing for-profit entities to govern a zone.

Practice of Innovative Governance

Three types of innovative governance projects are currently under consideration: international efforts, new city projects, and entrepreneurial efforts. In international efforts, the international community is highly involved. New city projects are traditional real estate projects where the developers realize that governance improvements can increase the value of the property they are developing. Entrepreneurial efforts are small teams interested in creating radically new forms of governance.

The European community is still struggling under the influx of refugees and other migrants. Innovative governance projects led by the international community are a solution that appeals to both sides of the political spectrum by both helping refugees and creating an alternative to emigration.

A number of influential people have advocated economic zones for refugees and similar solutions. Financier George Soros called for special economic zones with preferred trade status.¹³ Viktor Orban,

¹² Sebastian Mallaby, 2010, "The Politically Incorrect Guide to Ending Poverty" *Atlantic*, <https://www.theatlantic.com/magazine/archive/2010/07/the-politically-incorrect-guide-to-ending-poverty/308134>.

¹³ George Soros, 2015. "Rebuilding the Asylum System," *Project Syndicate*, <https://www.project-syndicate.org/commentary/rebuilding-refugee-asylum-system-by-george-soros-2015-09>.

Prime Minister of Hungary has called for a refugee city in Libya.¹⁴ Gordon Brown called for ‘economic zones’ for refugees to be built in Lebanon, Jordan, and Turkey.¹⁵

The international community has even created a zone-based program in Jordan to help alleviate the refugee crisis. The Jordan Compact is an agreement between the international community and Jordan. The international community allocated \$2 billion in aid and concessional loans to Jordan in exchange for Jordan giving refugees work permits to be used in special economic zones. The Jordan Compact illustrates some of the advantages and disadvantages of governance by the international community.¹⁶

The Jordan Compact demonstrates that the international community is willing to think creatively. The community has coordinated with multiple foreign institutions have negotiated an agreement with the Jordanian government. Unfortunately, the Jordan Compact has so far been unsuccessful. Fewer work permits have been distributed than expected, in part because of a skills mismatch and in part because the special economic zones are geographically far from areas with migrants.

The Jordan Compact, for all its cleverness, is still a patchwork solution and illustrates the challenges facing efforts by the international community. First, innovation is hard. The Jordan Compact is rightfully celebrated for its innovative approach, but further steps are needed. Second, coordination is hard as innovative governance is complex. Executing them requires a leadership with clear vision. Third, private sector involvement is critical. The Jordan Compact has targeted the private sector, but did not involve it in discussions. Involving it earlier could have brought to light some of the pitfalls before the project went live.

Another type of innovative governance is led by new city projects. As mentioned previously, dozens of new city projects are operating worldwide.¹⁷ New city projects are real estate projects where private investors pour billions into infrastructure and housing, which makes governance comparatively cheap. They are a natural fit for innovative governance because improving governance would increase the land values of cities and they are big enough to internalize the benefits of good governance.

¹⁴ Harriet Agerholm, 2016, “EU Should Set Up ‘Giant Refugee City’ in Libya, Says Hungary Prime Minister,” *Independent*, <http://www.independent.co.uk/news/world/europe/europe-giant-refugee-city-libya-africa-hungary-prime-minister-viktor-orban-a7327931.html>.

¹⁵ Gordon Brown, 2016. “The Syrian refugee crisis calls for a new Marshall plan” *Guardian* <https://www.theguardian.com/commentisfree/2016/feb/04/gordon-brown-syrian-refugee-crisis-marshall-plan>

¹⁶ Government of Jordan, 2016, “The Jordan Compact: A New Holistic Approach between the Hashemite Kingdom of Jordan and the International Community to Deal with the Syrian Refugee Crisis,” <https://reliefweb.int/report/jordan/jordan-compact-new-holistic-approach-between-hashemite-kingdom-jordan-and>.

¹⁷ Adam Cutts, 2015, “New Cities and Concepts of Value: Planning, Building and Responding to New Urban Realities,” New Cities Foundation, <https://newcities.org/wp-content/uploads/2016/03/PDF-New-Cities-and-Concepts-of-Value-CityquestKAECForum2015.pdf>.

Rendeavour, for example, is the largest urban property developer in Africa. It has seven projects in five countries and is seriously thinking about governance to improve its projects. Two of its projects are in Kenya, where it plans to use the Kenyan law on special economic zones in its developments.

The most ambitious new city project is Neom. Built on Saudi, Jordanian, and Egyptian land, it will cost an estimated \$500 billion and seeks to transform the Middle East. Saudi Crown Prince Mohammed bin Salman said Neom would operate independently of any “existing governmental framework.”¹⁸ Promotional images of Neom show women in public spaces in Western attire. Whether or not Neom is successful, it illustrates a change in the conception of new city projects. Ten years ago, few new city projects were thinking about governance, and the ones that were did not think about it as ambitiously as Neom. The change will take years to be fully realized in new city projects. Most do not have the backing of a powerful head of state.

The final type of innovative governance project consists of entrepreneurial efforts. These are projects led by small, dynamic teams with ambitious visions. They tend to be the most willing to think creatively, but often lack the resources necessary for success. One past entrepreneurial project is Future Cities Development, a company launched by Patri Friedman, cofounder of the Seasteading Institute, to take advantage of Honduran legislation,¹⁹ which created a process to create charter cities.

Another entrepreneurial project is Blue Frontiers. Blue Frontiers is a for-profit spinoff of the Seasteading Institute. The Seasteading Institute signed a memorandum of understanding with the government of French Polynesia in 2017. Blue Frontiers is lobbying for legislation to create a special economic zone over water so it can build floating platforms in the protected waters of Tahiti.

I am currently in contact with seven entrepreneurial innovative governance projects. They are pursuing a variety of visions, from a libertarian conception of property rights, to reforming slums through design, to creating a regulatory environment encouraging technological innovation.

Conclusion

Public perceptions of innovative governance have changed greatly over the last decade. The evolution of the Seasteading Institute, founded in 2008, is a good example. Its original rationale was that no country would allow the type of autonomy necessary for innovative governance, and so it was necessary to go to international waters. While it made sense at the time of its launch, the Seasteading Institute has since modified its strategy. Instead of building in international waters, it recently signed a memorandum of understanding with the government of French Polynesia to create a seazone in territorial waters.

¹⁸ Alaa Shahine, Glen Carey, and Vivian Neriem, 2016, “Saudi Arabia Just Announced Plans to Build a Mega City That Will Cost \$500 Billion,” Reuters, <https://www.bloomberg.com/news/articles/2017-10-24/saudi-arabia-to-build-new-mega-city-on-country-s-north-coast>.

¹⁹ The RED legislation was declared unconstitutional. Honduras passed similar legislation (ZEDE) to address the constitutional concerns, and the supreme court declared the subsequent ZEDE legislation constitutional.

Other projects have been launched with much fanfare but have not yet found success. Honduras passed legislation to allow the creation of innovative governance projects. The legislation set up a body to approve projects, the Committee for the Adoption of Best Practices. While the legislation remains on the books, unfortunately, no projects have been approved.

Further research on innovative governance is needed. Projects around the world need to be catalogued. Technical understanding of the reasons for successes and failures of different projects must be developed. A scholarly community interested in the conversation must be built.